

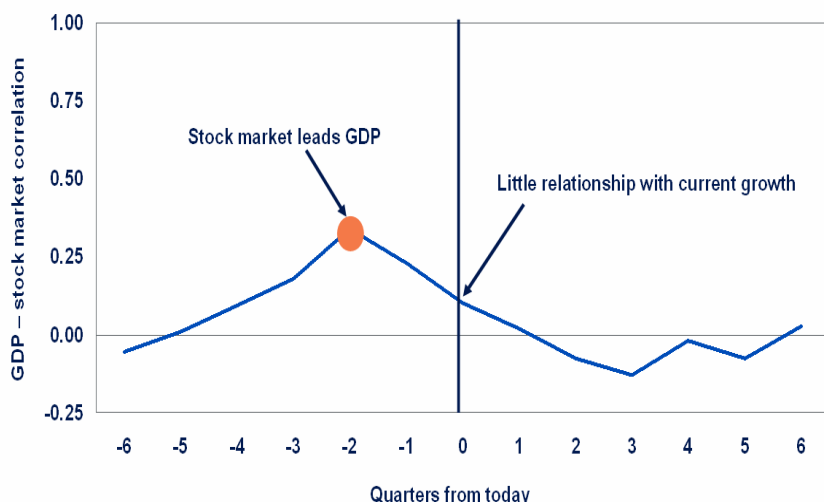
Schroders

Taking a long term earnings focus

by Martin Conlon, Head of Australian Equities, Schroder Investment Management Australia Limited

One of my bug bears in this industry is the continual attention that people give to economic data about whether the economy is improving or deteriorating etc on the assumption that it will give them some insight into what is happening in the market. Too many people focus on current economic market conditions when it's got no predictive market value for the stock market.

Chart 1: Correlation between nominal GDP Growth and S&P Returns (quarterly, 1947-2009)



Source: Schroders, Robert Shiller, US Bureau of Economic Analysis

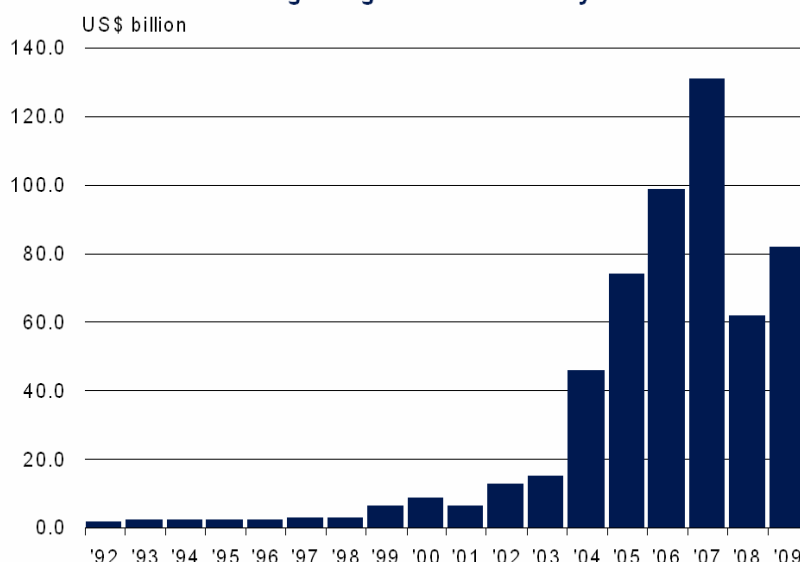
Chart 1 shows the correlation between S&P returns and GDP growth for the US market over the past 50 years. The picture will be broadly the same for other markets. What you see is that there is no correlation at all between nominal GDP growth and the returns in the stock market. Given that stock markets look forward and that markets will always lead GDP growth by a reasonable length of time then you should spend your time on longer term fundamentals.

With that in mind let's look at a few sectors and themes we are currently observing in the market.

Current market theme: Resources

Resources have and continue to attract considerable investor attention despite the Global Financial Crisis. Chart 2 shows the estimated global growth in commodity index investments. After a short decline in 2008 which was primarily driven by a drop in commodity prices there has been a significant re-acceleration of flows back into commodity index investments. We believe markets should be allowed to flow on a free market basis. However, what we are seeing is a lot of non-fundamental or investment flows that are speculating on the future and making a call on expectations of renewed inflation which are starting to become a self fulfilling prophecy and driving commodity prices.

Chart 2: Estimated global growth in commodity index investments

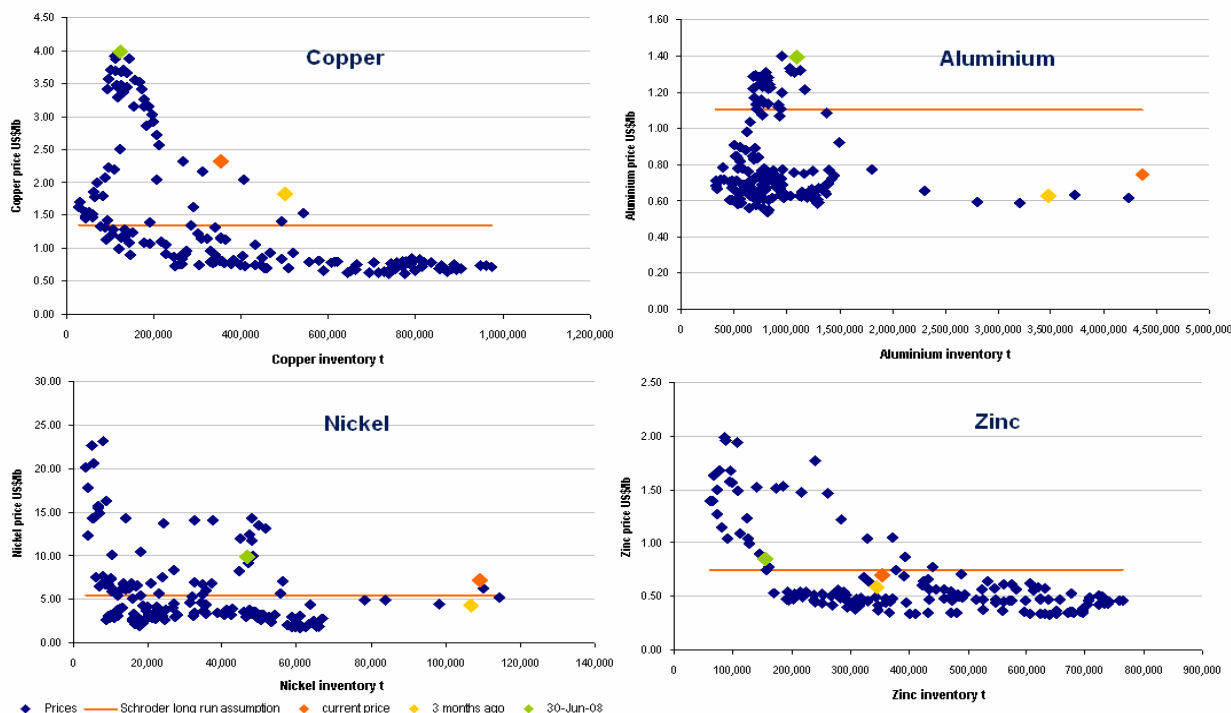


Source: GSJBW (FICC) estimates, June 2009

Taking a more fundamental view of resources Chart 3 shows pinch charts for copper, aluminium, nickel and zinc. They show prices for the relevant commodities according to inventory stock piles on a monthly basis over time. In mid-2008, prices rose very high for some commodities when inventories reached very low levels (indicated by the green diamonds showing prices as at 30 June 2008). Inventories have subsequently built up and prices have come back as you can see by the

orange diamonds which indicate the current price and inventory. What these charts are saying is that in most cases supply/demand dynamics work.

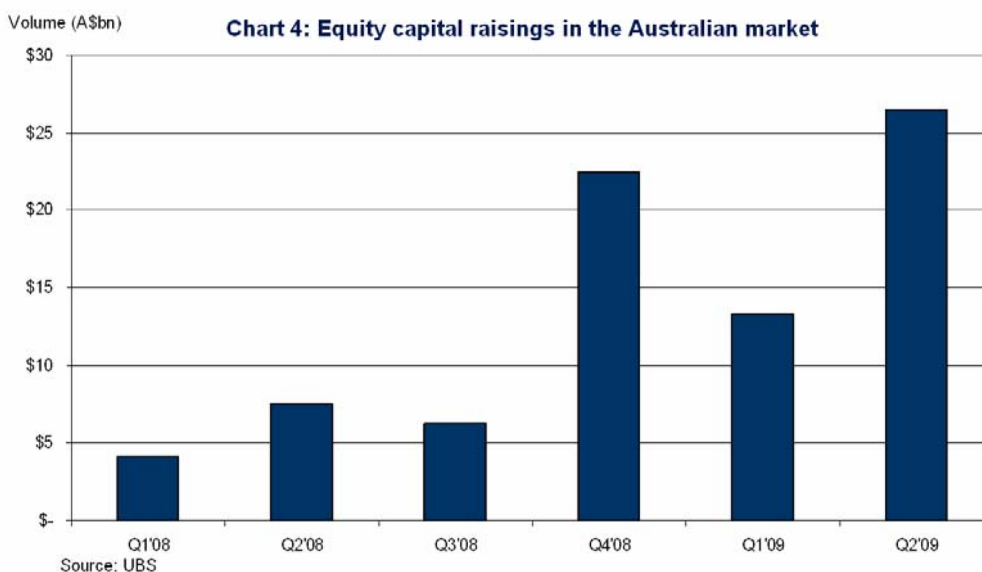
Chart 3: Pinch charts for Copper, Aluminium, Nickel and Zinc



Source: Citi, June 2009

The orange line indicates Schrodler's long run assumption for the prices. Interestingly, with the exception of aluminium the markets are starting to approach our long term average prices. We use this long run assumption price to value stocks on a longer term basis. I think actual earnings for resource companies are going to more closely represent their long terms earnings over the next year or so.

Current market theme: capital raisings



Another huge theme over the last 12-18 months has been capital raisings. What is important is how far through the capital raising cycle we are. The more equity a company has versus debt funding the lower the risk profile for equity investors. Combined with valuations which are materially lower than where they were 18 months ago you have a situation where you are buying less risky companies at materially lower prices. On a forward looking basis that should make equities

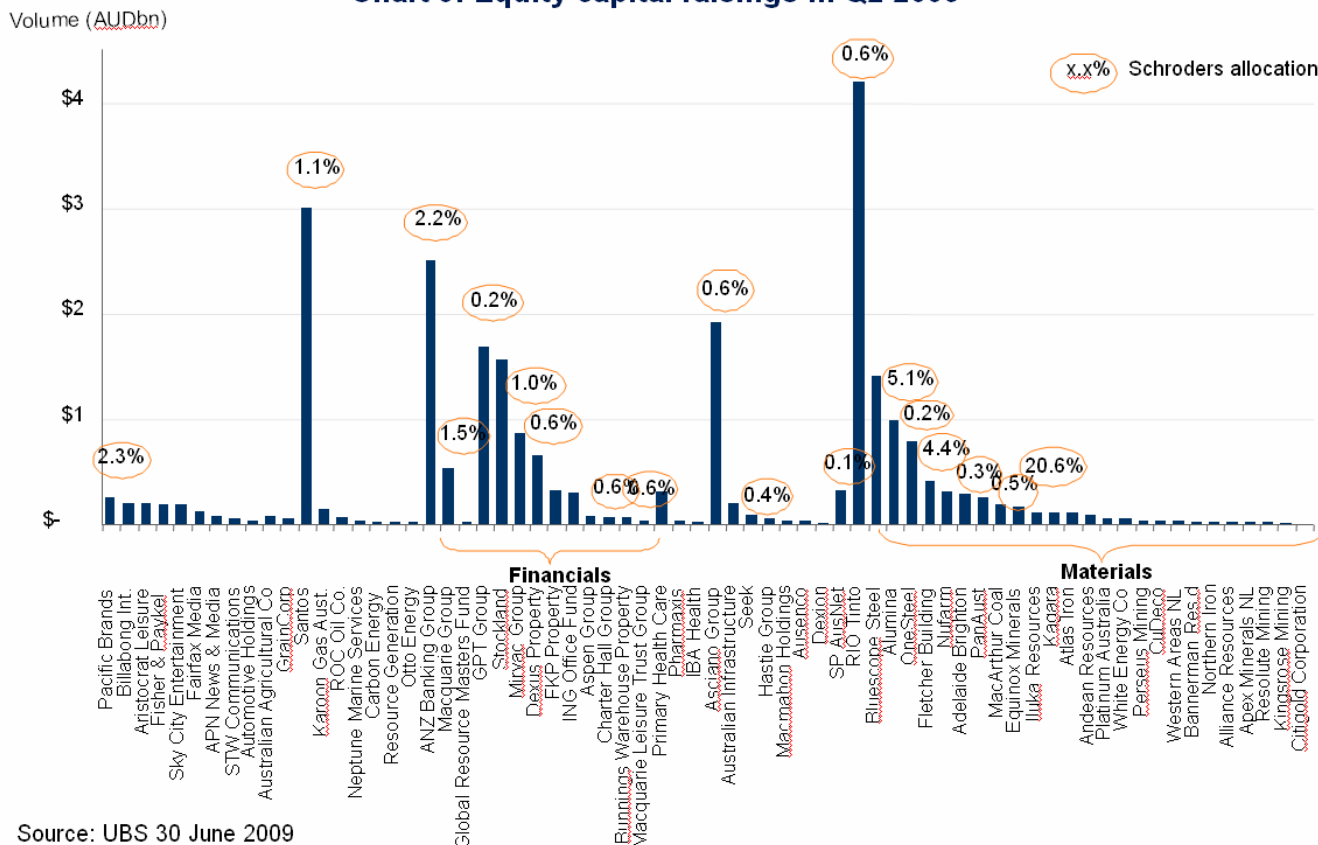
look more attractive.

Digging down into capital raisings during the second quarter Chart 5 shows a lot of companies have raised money in the market, particularly the materials sector. Interestingly it's not just the large companies who are raising capital. A number of small caps are also raising equity and refinancing which is a very meaningful positive for equities

because it means that the 'doom and disaster scenario' that everyone started predicting earlier in the year is highly unlikely to happen. Secondly, the fact that we are seeing so much capital raising in the materials sector indicates significant enthusiasm for equities again.

From Schrodgers' perspective, our participation in the capital raisings has been very selective. We think it's very dangerous to take a blanket approach and believe all these companies are going to do extremely well. You can see from the chart that there are a large number of issues that Schrodgers didn't participate in at all.

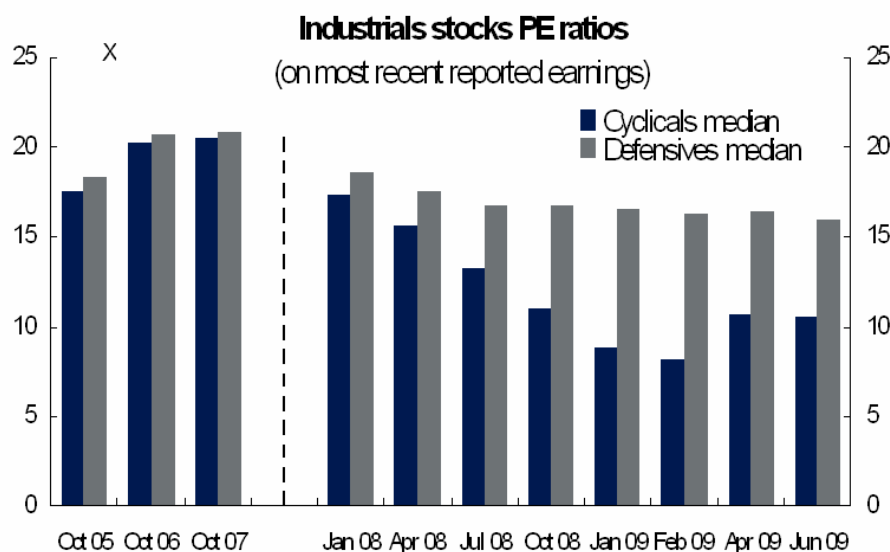
Chart 5: Equity capital raisings in Q2 2009



Source: UBS 30 June 2009

Current market theme: mispricing

Chart 6: Historic PE ratios for Australian industrial stocks



Source: IRESS, Company data, Deutsche Bank, June 2009

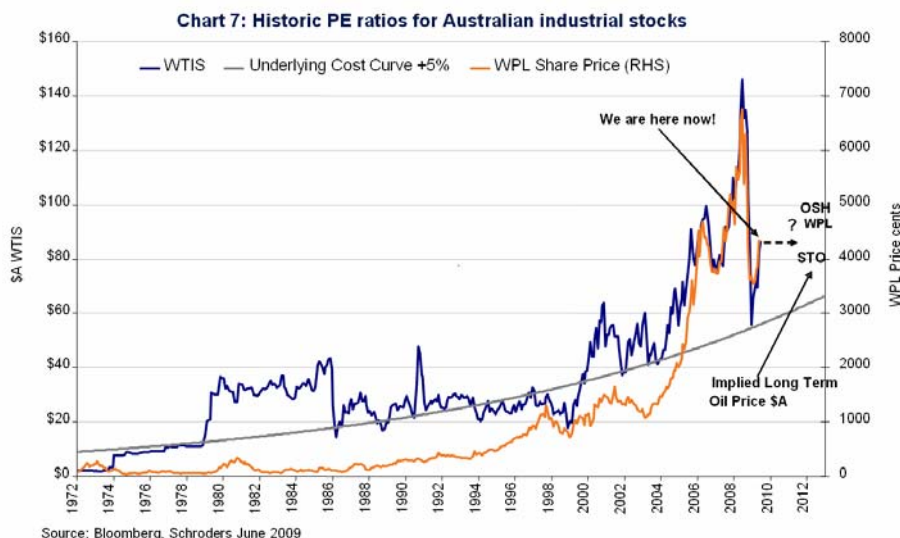
Chart 6 is interesting when analysing the last 6 months in the market. Looking at Jan/Feb 09 it's pretty obvious that PE ratios for cyclicals were going down very rapidly versus their defensive peers. That's a very good indicator of market panic. Thinking about GDP growth lagging markets this shows investors were panicking about the decline in earnings particularly for cyclical companies and they got down to paying about half what they were paying for their defensive counterparts.

We observed this panic to be at extreme levels around March this year and used it as an opportunity to buy into cyclicals while also taking on a little more

financial leverage (given that everyone was selling anything that was financially leveraged). Interestingly, over the past 3-6 months it's been the stocks that were sold down the most that have recovered the most. By June 2009, cyclicals' PE ratios had recovered from their lows while the defensives' PE ratios stayed level.

Prima facie, you might think that cyclicals still look like good value versus their defensive peers. However, we would advise caution on that as there were some cyclical companies that were materially over earning and their current earnings might not be reflective of what their longer term earnings might look like. It's a company's long term earnings power that should drive valuations.

Current market theme: Energy

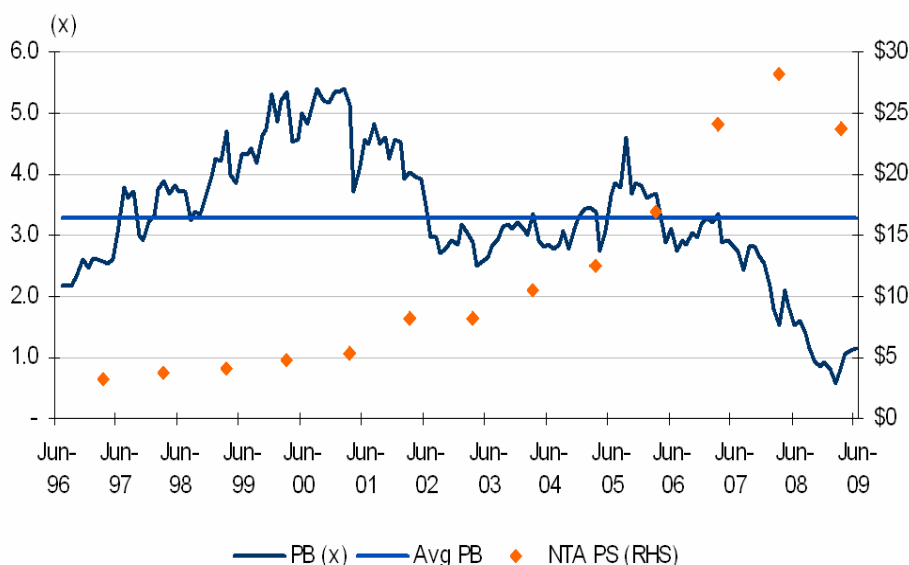


A lot of people have the belief that because oil is becoming harder to find, energy prices are only ever going to go up and therefore you have to be long energy. It's a nice simplistic sounding thesis but the problem is it's just that, simplistic. All of those beliefs have been around for decades. In chart 7 the grey line basically shows you what the oil price should do over time. It's cost plus an escalation of 5% pa which takes into account the costs of producing oil and the fact that it's becoming harder and harder to find and that companies need a premium to explore. The

blue line shows you the spot oil price and what it tells you versus the grey line is that oil prices are a little too high on that fundamental cost curve exercise. Secondly, the Woodside, Oil Search and Santos. Stock prices are telling you that perhaps the market's expectations of the oil price they are factoring in are a little bit too optimistic vs what fundamentals will tell you. What this says is that on a forward looking basis the market is a bit too optimistic about the long run sustainable oil price.

Stocks

Chart 8: Macquarie Bank 1996-2009

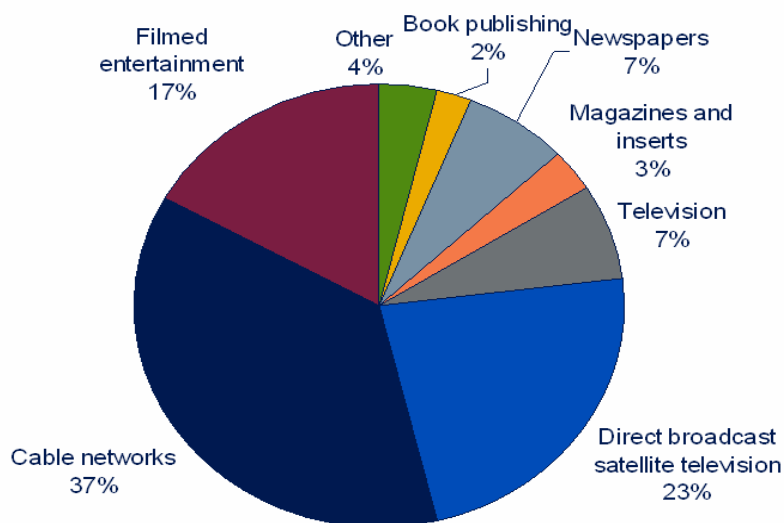


Macquarie Bank's wild share price gyrations over the past few years present an interesting parallel with market sentiment. Chart 8 shows Macquarie Bank's price to book ratio, a fairly simplistic measure of how much equity investors are paying for the book value of the company, over the past 10 to 15 years. Typically it's averaged a bit above 3 however over the same period the average net tangible assets (NTA) has grown pretty aggressively over time. Despite the wild sentiment, the NTA only fell from about \$28 to \$24 through the worst of the GFC which is not a huge shift in the scheme of things. The Price to Book ratio (PB) is indicative of investor sentiment and at the peak of optimism in June 2000

Macquarie was trading at 5 times book but earlier this year it got down to a level where it represented just 0.7 times

book value which is an extraordinarily cheap price for a company with a great track record in creating value. It's an interesting exercise in optimism and pessimism when everyone thought the world was going to end. From a portfolio perspective, we didn't own the stock at \$80 and we started buying earlier this year when it bottomed.

Chart 9: News Corp: revenue breakdown



Source: Schroders This is illustrative only and does not represent Schroders' recommendation on these stocks

News Corp is another interesting stock and one where investors have put a lot of emphasis on the impact that economic conditions are going to have on earnings. Chart 9 shows how small newspapers are in the scheme of News Corp's overall earnings. The newspaper segment is the only cyclical aspect to News Corp. However, investors like to focus on short term earnings but what this chart shows is that the vast majority of News Corp's earnings are in far more defensive businesses like satellite TV and cable network programming. We aren't too concerned about the short term impact of newspapers because they are a very small percentage of the value you are buying in the business. Again, our message is the same. Look at the long run earnings power of the business and value the business on that, not short term sentiment shifts.

As at June 2009

In summary

Equities must be a more attractive investment than 18 months ago. By virtue of a significant round of capital raisings, companies are now more lowly geared than they were, have far more attractive capital structures than they did and are more attractively priced. It's a case of vote with your head and not your heart.

The recent rally has shifted the market but there are still lots of pockets of opportunity if you do focus on sustainable fundamentals. We think investor sentiment swings will remain fairly savage because short term earnings concerns are still dominating investors attention and people continue to listen to short term measures such as consumer sentiment. We believe such short term measures are not important to stock valuations and will not be swayed by them.

Lastly, corporate earnings are likely to weaken for some time but, like GDP growth, this doesn't necessarily mean that stock prices will go down. Markets are forward looking and it's important to price stocks on what earnings will be on a sustainable basis, not next quarter.

Opinions, estimates and projections in this report constitute the current judgement of the author as of the date of this article. They do not necessarily reflect the opinions of Schroder Investment Management Australia Limited, ABN 22 000 443 274, AFS Licence 226473 ("**Schroders**") or any member of the Schroders Group and are subject to change without notice. In preparing this document, we have relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources or which was otherwise reviewed by us. Schroders does not give any warranty as to the accuracy, reliability or completeness of information which is contained in this article. Except insofar as liability under any statute cannot be excluded, Schroders and its directors, employees, consultants or any company in the Schroders Group do not accept any liability (whether arising in contract, in tort or negligence or otherwise) for any error or omission in this article or for any resulting loss or damage (whether direct, indirect, consequential or otherwise) suffered by the recipient of this article or any other person. This document does not contain, and should not be relied on as containing any investment, accounting, legal or tax advice. Past performance is not a reliable indicator of future performance. Unless otherwise stated the source for all graphs and tables contained in this document is Schroders. For security purposes telephone calls may be taped.