

# Schroders

## Australian equities – don't discount the unexpected

by Martin Conlon, Head of Australian Equities

---

The final quarter of the noughties decade saw the S&P/ASX200 gaining 3.4%, consolidating the strong gains for the year and leaving investors feeling decidedly more comfortable about the world than at the same date in 2008. Aggressive action by central bankers has created significant controversy and may create some unwanted side effects in the future, but if the key measure of success is restoration of confidence, it must go down as a winner.

With volatility waning and markets offering a little less excitement, the last quarter of 2009 saw Tiger Woods step up to the plate to provide some key surprises. That Tiger's incredible discipline would waver so significantly after the 18th hole that his wife would need to wrap a three iron around his neck in the driveway, should teach us never to discount the unexpected (or get on the wrong side of an angry Swedish model). Circumstances can change quickly. One minute you're driving a ball 300m dead straight, the next you can't reverse the family car out of the driveway without hitting a fire hydrant.

The past couple of years have provided harsh lessons as to how fragile confidence can be, and how important this confidence is to modern economies. Imbalances between rich and poor have been exacerbated substantially over the past decade. Corporate profits have been exceptionally strong, and the salaries of high earners have continued to expand at a far greater rate than those further down the pyramid. The less fortunate have relied significantly on borrowings to maintain and improve their standard of living.

### The past decade has been kind to Australia

Countries have followed a similar pattern, with the growth of many depending on the continued benevolence of a few. These growing imbalances make the contracts between borrowers and lenders and the maintenance of trust between the two, increasingly important. The continuing ebb and flow in sentiment is instructive on how fragile this trust remains and how closely many governments and central banks are sailing to the wind in losing this confidence altogether. Managing the equation of restoring growth and confidence, whilst convincing investors that neither inflation nor deflation will be tolerated, is no easy feat. Buoyant gold prices and surging commodity prices and stocks whilst treasury bonds remain at incredibly low yields are sure signs that not everyone expects the same outcome. It is for these reasons that we are sceptical of a rapid return to a low volatility, harmonious and predictable world for investors. Those who bet the house on a particular outcome and win, will undoubtedly continue to be lauded, however, we don't believe that makes it wise. A more uncertain environment should, in our view, warrant greater diversification, rather than greater concentration. The past decade has been kind to Australia, exceptionally kind to raw materials companies and kind again to major Australian banks. We don't believe investors should bet the house on exactly the same outcome in the next decade. Circumstances may change.

### A return of too much confidence?

The progressive return of confidence over the year was highlighted further in the 4th quarter with the return of merger and acquisition activity. The headline act was undoubtedly the battle for AXA Asia Pacific. As is normally the case when a business with that most alluring of characteristics, 'wealth management' becomes the subject of market attention, the major banks were quickly trotted out as prospective counter bidders for AXA after AMP launched its proposal. As we've done many times before, we sat around the table and tried to assess the probability that, despite what already seemed an exceedingly high price for the business, one of the speculated bidders would find a rationale to pay an even higher price. Our hopes that commonsense would prevail, proved misplaced again. The sweet whispers of "wealth management, wealth management" by tempting investment bankers proved too much for NAB management to resist. Neither the relative unimportance of wealth management in the overall value of the business, nor the litany of unsuccessful past acquisitions, were sufficient to dissuade NAB management that this was a once in a lifetime opportunity. Investors responded by slashing a good portion of the proposed purchase price for AXA Asia Pacific off the NAB market value, signalling their confidence in the shareholder value outcome. On the other side of the equation, the board of AXA Asia Pacific deserves commendation for actually focusing on the interests of their shareholders.

### Waiting for demand to recover

The tug-of-war between the global growth, inflation and commodity believers and those believing that spare capacity and the anaemic appetite for debt make deflation more likely, continued to play out in the final quarter. The continuing strong run in gold and commodities has left us in a situation where we can see little value in most resource stocks in the absence of commodity prices staying elevated for an extended period. Whilst prices have recovered sharply, the evidence of demand recovery is more difficult to uncover. Inventory levels in nearly all commodities are substantially higher than at the time prices were last at these levels, and investment, rather than consumer demand, seems to be a major factor. This



is unsurprising, given that the surfeit of money in the system needs to find a home, but it doesn't make the job of ascertaining a fair price for a pound of copper any easier. Signs of inflation in areas such as food and energy are easier to find (particularly in Australia, where the elevation of energy prices to levels closer to global parity will inflict significant pain on consumers), but are not yet at problematic levels.

### Going against the flow

Whilst in no way do we consider US treasury bonds to be a sensible investment at current rates, we do believe that the exodus of capital from the US trying to find a home in higher yielding assets is extremely mature. It is for this reason that we believe many businesses with significant proportions of their earnings offshore are often more attractive on valuation grounds than their domestic peers at present. Whilst the chartists all have the \$A heading through parity, we are struggling to find the Australian denominated investments which would have foreign investors eager to pour all their capital into Australia. However, with foreigners already pouring significant money into BHP Billiton and Rio Tinto at significant premiums to the price at which they can be purchased on the UK exchange, perhaps we are too hasty in expecting rational behaviour to suddenly take hold.

### Subdued enthusiasm in the outlook

The ability of the Australian economy to avoid the downward gravitational pull of imploding western economies has provided strong evidence that economies such as the US and Europe are now far less relevant to Australia's outlook. Commentators have universally rejoiced in Australia's greater linkage to China and the riches which this linkage is likely to bestow. Our intrepid prime minister is keen to break out his Mandarin phrases at the slightest provocation in an effort to further enhance Asian relations, whilst Treasury are roundly confident that the Chinese boom will continue for years to come. The prevailing sentiment on Australia's exposure to China could broadly be summed up in the title of the 80's hit from Timbuk3, 'The future's so bright I gotta wear shades'. Whilst we hope this optimism proves correct, as the benefits to Australia are obvious, our job is to focus on the facts and assess the probability that an investment will provide sensible returns. When so few question why Chinese growth is sustainable, our level of concern rises, as the risks to the value of investments which are premised on this assumption being true, are unlikely to be adequately considered. We have questioned the sustainability of growth in the Chinese economy in the past, as extreme reliance on fixed investment together with increasingly dubious quality of investment, would normally be reason for concern. For those interested in a very well thought out and researched view on these concerns (passed on to me by one of my learned colleagues) we would recommend the 'China's Investment Boom: the Great Leap into the Unknown' report found on [www.pivotcapital.com/research.html](http://www.pivotcapital.com/research.html).

Just as no-one really considered the risk of Tiger Woods being an off-course philanderer, very few are considering the risks to Chinese growth and the likely implications of a sharp slowdown. Raw materials stocks have been the strongest performing in the past decade in almost every major market on earth and one of the key reasons why Australia was able to deliver compound annual growth of nearly 9% p.a. whilst most other major markets struggled to, or didn't, manage forward progress. Although there are still a reasonable number of resource based investments which we believe can provide reasonable returns going forward, we do not believe the sector overall is likely to be the engine of investor returns again. Using the Tiger Woods risk calculator, we think we're on the back nine and it's best not to be leaving your mobile phone on the kitchen bench (he didn't make the 18th!).

Whilst not wanting to be too curmudgeonly, the sharp sentiment shifts we referred to earlier, together with artificial support from a healthy dose of fiscal and monetary stimulus, have left us with stock valuations which can't inspire wild enthusiasm. Few sectors are in obvious undervalued territory and the benefits of focusing on stocks in which investors panicked over financial leverage have passed. It's time to focus on companies which are less reliant on assistance from exogenous factors such as commodity prices or strengthening growth.

### Important Information

The views and opinions contained in this article are those of Martin Conlon, Head of Australian Equities and may not necessarily represent views expressed or reflected in other Schroders communications, strategies or funds. Investment in any of the detailed funds may be made on an application form in the Fund's Product Disclosure Statement which is available from Schroders' website [www.schroders.com.au](http://www.schroders.com.au). Opinions, estimates and projections in this document constitute the current judgement of the author as of the date of this document. They do not necessarily reflect the opinions of 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.