Schroders

Schroder Australian Equity Fund

Monthly Report - January 2019

Total return %	1 mth	3 mths	1 yr	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Schroder Australian Equity Fund (pre-fee)	3.95	-0.11	0.86	12.80	6.34	11.39
S&P / ASX 200 Accumulation Index	3.87	1.45	1.37	10.09	7.10	9.96
Relative performance (pre-fee)	**0.08**	**-1.56**	**-0.51**	**2.71**	**-0.76**	**1.43**

Please refer to www.schroders.com.au for post-tax returns

Inception Date: 03 Mar 1964, 54 years and 10 months.

Market cap	Portfolio[1]	Benchmark[2]
ASX 1 - 50	72.5%	78.2%
ASX 51 - 100	9.1%	12.9%
ASX 101 - 300	13.1%	8.8%
Non Index	3.0%	
Cash	2.4%	

Top ten holdings %	Portfolio[1]	Benchmark[2]
Commonwealth Bank of Australia	7.2%	7.9%
BHP Group Ltd	5.7%	6.6%
Rio Tinto Limited	5.2%	2.1%
ANZ Banking Group Ltd.	5.0%	4.6%
Westpac Banking Corporation	4.5%	5.4%
Woolworths Group Ltd	4.2%	2.5%
National Australia Bank Limited	3.6%	4.2%
Telstra Corporation Limited	3.2%	2.4%
Brambles Limited	2.6%	1.1%
ASX Limited	2.3%	0.8%
Total	**43.5%**	**37.6%**

Characteristics	Portfolio[1]	Benchmark[2]
No. of stocks	59	200
Portfolio turnover* (1 yr)	13.8%	
Sharpe Ratio (1 yr)	-0.06	-0.01
Volatility (5yr standard deviation)	11.4%	11.1%
Tracking error (3yr historic)	3.3%	

1 The 'Portfolio' is the Schroder Australian Equity Fund

2 Benchmark is the S&P / ASX 200 Accumulation Index

Unless otherwise stated all figures are as at 31 January 2019
Please note numbers may not total 100 due to rounding

*Turnover = ½(Purchases + Sales - ∑Cashinflows + ∑Cashoutflows) / ½(Market Value(T0)+ Market Value(T1) - ∑Cashflows)

Past performance is not a reliable indicator of future performance

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Commentary

The S&P / ASX 200 Accumulation Index rose by 3.9%, while the Schroder Australian Equity Fund (pre-fee) rose by 4.0% (pre-fee), outperforming by 0.1% (pre-fee) for the month.

The overall Australian equity market is now an expensive, low growth one. Ex resources, earnings growth went backwards in F18 and is forecast to be flat in F19. Earnings multiples of 20 for industrial stocks highlights that the absence of growth is not acquired cheaply. Last year, only Resources as a sector on the ASX advanced; the ASX200 ended the year declining, as did most equity markets. The Australian dollar underperformed most major currencies by 5% to 10%. Bonds rallied locally and globally, and that trend has accelerated this year, especially locally as the RBA now suggests the risk to the next move in rates is balanced as opposed to the prior bias to moving rates up.

Globally, that sees scope for MSCI World index defensives, which underperformed cyclicals by 2 standard deviations through the eighteen months to October last year, to continue their more recent outperformance. The local situation, however, is more nuanced, if only because defensives had continued to trounce cyclicals (broadly defined, not just Resources) in recent years. Indeed, looked at on a longer-term perspective (15 years), local cyclicals continue to be more than a standard deviation cheap relative to defensives. This is reflected in multiples; whilst the ASX is trading on an enterprise value (market cap plus net debt) to EBITDA multiple of close to ten times, in line with MSCI World, Health Care in Australia is trading at an immense (circa 50%) premium to the MSCI World Health Care multiple of 12 times. On our preferred valuation measure of EV to EBIT, the Health Care sector currently trades at a very high 40 times. Infrastructure stocks are trading at similar multiples.

Finding “cheap” defensives in Australia in recent years has been possible, but only opportunistically in response to episodic regulatory risk. AGL and Aurizon have some utility characteristics, but each has suffered from adverse regulatory and/or policy decisions through the past year. Defensives without such risk on the ASX have persistently traded at very high multiples. The past month has seen policy announcements which seemingly embed these high multiples; the end of January decision by the US Fed to “be patient” in increasing rates any further, coupled with the RBA a week later suggesting the next move in rates locally is evenly balanced (in contrast to their prior guidance that the next move would likely be up). The risk has now clearly tilted to global and more so with Australian interest rates being lower for longer, and in turn very high multiples for defensive equities to be sustained.

In contrast, the other side of the equation is growth. To a man with a hammer, everything looks like a nail; and to an investor in a market with no growth, as with the ASX, those stocks with the promise of growth (especially if this is coupled with momentum) continue to be aggressively bid. We noted last year the immense premium Australian tech stocks were trading at to global leaders, not just emerging peers; whilst volatile, the net outcome is that premiums have only increased in the past few months. Whilst some growth companies, such as IDP Education, are recording strong growth in revenues, profits and cashflows, and whilst trading at high multiples are driven by organic growth with conservative accounting, many others have cashflows that are not close to reported profits and have a large and growing proportion of assets represented by goodwill. This latter group we still believe will, on the whole, ultimately disappoint investors with less duration of excess returns than is currently being priced.

One argument we have heard as to why there are few genuine growth companies on the ASX is that the demands of investors inhibits the capacity for ASX listed entities to invest for growth. The management at Seek, which is a wonderful company, have made this argument publicly, often. We met with one of the founders of Seek’s major competitor in China, 51job Inc, recently, and asked their impression on whether being publicly listed had stymied their growth plans. 51job was founded in 1998 and listed in 2004. It has doubled revenues and operating cashflow in the past five years and funded growth from internal reserves and cashflows, leading its market valuation to increase more than 50%. Seek has similar operating metrics and also has been (largely) internally funded, yet has a flat market value. The founder at 51job was dumbfounded at why investors would have any bearing upon the growth plans or achievements for an entity which has little need for capital to grow. Nothing gives us more satisfaction than funding companies investing in organic capacity to allow them to grow valuably, especially when that investment is prudently managed (ie not overcapitalised without due regard to the resulting position on the cost curve for the asset).

Schroder Australian Equity Fund

Monthly Report
January 2019

Fund objective

To outperform the S&P/ASX 200 Accumulation Index after fees over the medium to long term by investing in a broad range of companies from Australia and New Zealand.

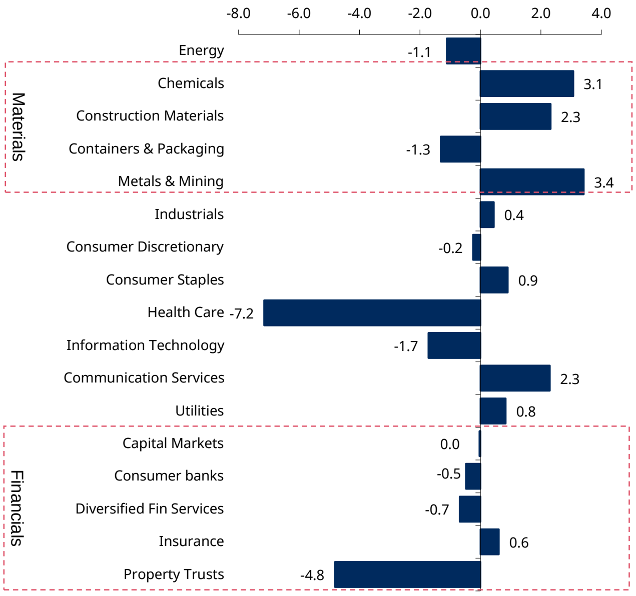
Investment style

Schroders is a bottom-up, fundamental, active manager of Australian equities, with an emphasis on stocks that are able to grow shareholder value in the long term.

Fund details

APIR code	SCH0002AU
Fund size (AUD)	$997,719,409
Redemption unit price	$10.3749
Fund inception date	March 1964
Buy / sell spread	0.25%/0.25%
Minimum investment	$500,000
Distribution frequency	Normally twice yearly - June and Dec
Management costs (p.a.)	0.62%

Sector exposure versus the benchmark %



Unless otherwise stated all figures are as at the end of January 2019

Benchmark is the S&P / ASX 200 Accumulation Index

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Commentary Continued

Indeed, Commissioner Hayne made that point, amidst others, in summarising the six ingredients for business culture; obey the law; do not mislead or deceive; be fair; provide services that are fit for purpose (be efficient); deliver services with reasonable care and skill (be effective); and, finally, when acting for another, act in the best interests of that other.

Whilst all of that seems a statement of the obvious, the Hayne Royal Commission proceedings and final report has to date claimed three CEOs and Chairs, from AMP, IOOF and now NAB, for failing the "obvious" standards. That's a real Summer Big Bash. Any residual suggestions from the consensus of two years ago that the Australian financial system was immune from the misconduct in other markets which had spawned penalties in excess of credit losses through the past cycle, has been discredited. A former CEO of a listed mortgage broker strongly argued to us in 2017 that there had been no misconduct in the mortgage business in Australia through the prior decade. It is for the best that he did not appear before the Commission, lest he be mugged by commercial reality. Any industry subjected to a Royal Commission into misconduct in that industry would see a litany of woe exposed; whether it be building and construction, education and childcare, aged care and health services, gaming, or law and order. The Royal Commission process in Australia has consistently uncovered common operating practices which tend to be lower, rather than higher, than community expectations. And so, perhaps unsurprisingly in those circumstances, it has transpired also with financial services.

There are two clear financial implications for investors post Hayne. Firstly, credit growth in Australia in the past decade, which has all been in mortgages, was driven by an unsustainable increase in lending as a multiple of income, to a level (7x) not seen elsewhere in the world (for example, the UK has a statutory cap of 5x). This was compounded by the growth in interest only loans (which as a proportion of flow for the system peaked at 50%, 18 months ago, and has now halved) and other lax lending standards. The Royal Commission and the resulting focus upon responsible lending, and criminal implications for neglect of legal responsibilities for lenders, will see ongoing tightening of lending volumes, albeit from an excessively loose starting point. This will probably see loan growth flatline or go negative (Bendigo Bank has just reported flat loan growth year on year and negative loan growth half on half). Flat or negative loan growth and rising bad debt expenses means bank executives must cut costs, which to date has not been done, to maintain levels of profitability even close to current levels. Secondly, valuations should be reduced by operating risk charges. This is far more than just added compliance costs – rather, just as the credit charges expected to arise in a recession should be deducted in deriving a fair value for banks, an operating risk charge should also be deducted, and this should be highly material given that the system-wide operating risk charges globally since the GFC (widely defined to include misconduct, mis selling and other penalties or taxes imposed upon the Financial system) has exceeded in value the credit losses experienced through and since the GFC. For the Australian banking system, we currently assume a recessionary bad debt charge of circa $60b for the system and about half that again for other regulatory imposts in our valuations for the sector. When we first put that operating risk charge into our valuations some years ago it was seen as both highly unusual and also aggressive; the risk is now, especially in the event of a change in government in several months, that it may prove conservative.

Even with those imposts, banks are one of few beacons of value in the Australian equity market. They have of course been beset with bad news whilst the Royal Commission ran its course and they offer no earnings growth, albeit as we highlighted earlier that is no different to the broader market. Their multiple, and relative multiple compared to history, is distinguishable from that of the broader market, producing the value case for the sector.

Portfolio Outlook

Risks can come from different sources. The most obvious to equity investors is operating leverage – earnings downgrades are normally met with a greater fall in the equity price than the fall in earnings growth expectations (just as, in the longer run, upgrades typically are accompanied by a re-rating). Financial leverage hurt equity owners far more than operating leverage through the GFC years, but ever since, easy monetary and credit conditions have rendered financial leverage impotent as a risk to equity holders. Predictably, the equity in more leveraged entities, both publicly and privately owned, have done better in such an environment. The resumption of the monetary policy put, announced in recent weeks, will likely see this endure, rather than be challenged, and has significant consequences for portfolio structure in an interest rate sensitive market such as Australia. We can only look to be as vigilant as we can in assessing financial and operating leverage, whilst not blinding ourselves to the inevitable episodic opportunities that present themselves.

Andrew Fleming

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