Schroders

Schroder Wholesale Australian Equity Fund

Monthly Report - February 2020

Total return %	1 mth	3 mths	1 yr	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Schroder Wholesale Australian Equity Fund (post-fee)	-8.26	-6.95	5.54	7.24	4.94	7.56
S&P / ASX 200 Accumulation Index	-7.69	-5.18	8.64	8.59	6.17	7.98
Relative performance (post-fee)	**-0.57**	**-1.77**	**-3.10**	**-1.35**	**-1.23**	**-0.42**

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

Inception Date: 01 Jul 2002, 17 years and 8 months.

Market cap	Portfolio[1]	Benchmark[2]
ASX 1 - 50	73.4%	78.0%
ASX 51 - 100	12.3%	13.0%
ASX 101 - 300	10.2%	9.0%
Non Index	1.0%	
Cash	2.6%	
Futures	0.5%	

Top 10 holdings %	Portfolio[1]	Benchmark[2]
Commonwealth Bank of Australia	5.4%	8.3%
BHP Group Ltd	4.9%	5.7%
Woolworths Group Ltd	4.9%	3.0%
ANZ Banking Group Ltd.	4.7%	4.2%
Rio Tinto Limited	4.0%	1.9%
Westpac Banking Corporation	3.8%	4.7%
National Australia Bank Limited	3.5%	4.2%
Telstra Corporation Limited	3.5%	2.4%
South32 Ltd.	2.8%	0.7%
Brambles Limited	2.6%	1.1%
Total	**40.1%**	**36.2%**

Characteristics	Portfolio[1]	Benchmark[2]
No. of stocks	58	200
Portfolio turnover* (1 yr)	12.7%	
Sharpe Ratio (1 yr)	0.45	0.63
Volatility (5yr standard deviation)	11.5%	11.2%
Tracking error (3yr historic)	2.4%	

1 The 'Portfolio' is the Schroder Wholesale Australian Equity Fund

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

Unless otherwise stated all figures are as at 29 February 2020

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

Commentary

The S&P / ASX 200 Accumulation Index fell by 7.7%, while the Schroder Wholesale Australian Equity Fund (post-fee) fell by 8.3% (post-fee), underperforming by 0.6% (post-fee) for the month.

Those of us remaining attached to the antediluvian idea that the price you pay for a business has consequences for future returns have had an uncomfortable decade. Even in the face of recent Coronavirus triggered market declines, investors have sought safety in healthcare stocks and defensives at multiples considered crazy for the vast majority of investment history rather than contemplate a resource or cyclical business with no debt trading close to book value. Little wonder many are discarding an investment approach which pays attention to valuation in favour of earnings and price momentum. Our attachment to valuation principles stems from the observation that a business must (eventually) return cash to shareholders to have value, whilst a low multiple on sustainable profits means the payback on an investment relies far less on the distant future. The reason we become less comfortable when valuations become ever more reliant on the distant future is its inherent uncertainty. Orwell and Huxley may have offered entertaining visions of the future, however, treating distant decades as relatively certain is fanciful. We have used the Rio Tinto versus CSL example previously, however, it remains a useful illustration for a couple of reasons. Firstly, the two companies are very similar in value, at around US$100bn each in enterprise value, though recent days are seeing the value of Rio Tinto shrink at a faster rate than CSL. Secondly, we view both as well positioned in their industries, relatively global in nature and long duration versus most listed peers. As it happens, the collective profits which CSL earned in the 8 financial years between 2012 and 2019 were less than the earnings of Rio Tinto in calendar 2019. Rio Tinto has paid nearly half its current market value back to shareholders as dividends in the past 8 years, while CSL has returned about 5% in dividends and nearly the same in share buybacks. At multiples of 40 times earnings and above, even with significant growth, investors will not recoup more than 10% of their investment value in the next few years, meaning more than 90% of their investment value is beyond this time frame. Ever higher share prices necessitate ever greater confidence in the future. Loss making businesses such as Afterpay obviously push this payback period out to a far greater extent, as more than 100% of valuation is based on hope for the future rather than fact of current profits. History says these odds are poor, but emotion rules. Being a 'value' investor, currently tantamount to being infected with Coronavirus, merely reflects a preference to skew away from businesses where returns rely on highly optimistic projections of the distant future and being happy to embrace a valuation philosophy where every short-term decline in profits does not necessarily mean perpetual despair nor every positive increment nirvana.

Much has also been made of the artificially low interest rate environment as a justification for far higher than normal multiples on stocks with long term growth. Whilst a zero discount rate imposed by unelected officials supporting a target for 'growth' which they can't define and can't measure might annoy those of us believing a free market might be a better solution, even free money shouldn't ensure actual profits are less valuable than forecasts. Instances of companies delivering double digit compound growth in cashflow overall long periods have been rare historically. As the developed world lumbers under excessive debt, ageing populations and increasing government intervention, it seems improbable these probabilities will improve. Given the large number of companies which have delivered exceptional returns to investors on the back of growing expectations for the future rather than through the delivery of actual profits and dividends to investors, it would appear there are many adherents to the mantra expressed in that 1980's classic from Timbuk 3, "The Future's So Bright I Gotta Wear Shades". Sometimes it's not different this time.

This optimism on the future is connected to a third arrow in the defence of high multiples; the narrative around the unprecedented impact of disruption from technology and the incipient transition in corporate profits which will justify these historically large multiple differentials. While we have some sympathy for pricing disruptive threats (another reason we prefer to skew towards more reasonably priced businesses), we can find little evidence to suggest profit transitions in the economy are currently, or likely to be, greater now than has been the case historically. Banks, resource and energy companies, supermarkets, hardware stores and most other large profit earners in the economy have to date lost little profit which has appeared in the bottom line of competitors fueled by disruptive technologies. Even in businesses such as free to air TV, perceived to be in structural decline, we would attribute far more of the profit decline to contracted content costs, primarily sports rights, which have decimated profits due to wildly optimistic revenue projections.

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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.

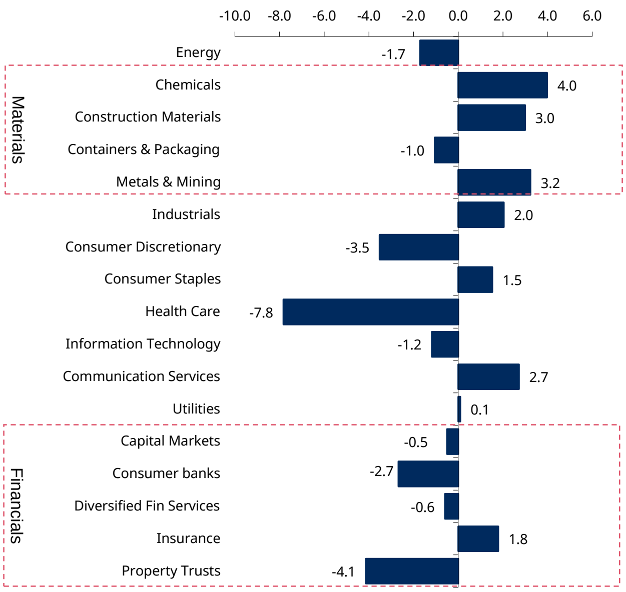
Investment style

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	SCH0101AU
Fund size (AUD)	$1,806,854,823
Redemption unit price	$1.3041
Fund inception date	July 2002
Buy / sell spread	0.25%/0.25%
Minimum investment	$20,000
Distribution frequency	Normally twice yearly - June and Dec
Management costs (p.a.)	0.92%

Sector exposure versus the benchmark %



Unless otherwise stated all figures are as at the end of February 2020

Benchmark is the S&P / ASX 200 Accumulation Index

Commentary Continued

Pay TV businesses, including Netflix, are struggling for exactly the same reasons. Technology is allowing content of all types to be distributed in different ways, streaming versus satellite and set top boxes, however, the simple dynamics of needing revenue to be greater than expenses to run a profitable enterprise are pervasive. If AFL, NRL and cricket rights were linked to the revenue they generated per hour of coverage rather than projections of overly optimistic sales forces, profit problems would abate sharply. Reality is more a tug-of-war on a relatively static profit pools. The adulation Australian investors have for ongoing price and volume gains for CSL and Resmed appears as a bloated healthcare bill funded by taxpayers in countries across the globe. The profit pain inflicted on Medibank Private and NIB by spiraling hospital and medical device costs is the other side of the ledger, not to mention every greater bills for customers.

Whilst we can offer little in terms of expertise when it comes to forecasting the spread and duration of Coronavirus, it is useful to think through the rationality of share price reactions. To date, market impact has been less than discerning. The vast majority of stocks fell through February, although usual suspects such as CSL, Resmed and Fisher & Paykel Healthcare were largely unaffected. Impact has been slightly more severe in those businesses where short term impact is obvious, although surprisingly, energy and resource related businesses have generally been even weaker, with Santos, Woodside Petroleum, Oil Search and Origin Energy all heavily impacted as oil and commodity prices were hit. Even gold stocks performed poorly despite strength in the underlying commodity. Evidence of systematic and quantitative strategies overwhelming traditional active market participants remains plentiful.

Tourism exposed businesses such as Flight Centre, Corporate Travel and Qantas will almost certainly see short term profit impacts, although history suggests these are rarely durable. However, when high levels of operating leverage are combined with financial leverage, equity holders can quickly find themselves at the mercy of banks. Businesses such as Flight Centre where large numbers of retail outlets deliver relatively small amounts of profit per outlet, can find themselves unusually vulnerable. The dynamics are identical to those for retailers experiencing negative same store sales growth. When rent and wages offer minimal scope for flex, profits unfortunately provide the flex to declining revenues. Similarly, the high fixed cost nature of airlines, leaves them amongst the toughest businesses to manage in the face of abrupt revenue shifts. Qantas, Virgin and Air New Zealand are all making rapid adjustments to capacity, however, even with highly capable management, significant short-term profit impact is inevitable. Given the sensible approach which airlines such as Qantas and Air New Zealand have to financial leverage, we believe it is highly likely impacts will be transitory and valuation impact relatively small. This is also the case for resource companies. Nearly all have very low levels of debt and in our estimation any demand impact is likely to be transitory.

Outlook

The 'free lunch' to which investors have become accustomed looks set to be tested. The globalisation which economists have long cheered as the engine of economic growth looks increasingly like a logistics operation supporting the Chinese economy. They produce, we consume. The highly unbalanced and centralised nature of global production remains seemingly at odds with a resilience and sustainability. While there is no doubt the Chinese economy will restore production faster than would be viable for almost any other country on earth, it should serve to highlight the vulnerability of a vastly over-leveraged western world producing few of its own goods and reliant on artificial asset price support. The panic accompanying a correction in the equity market which removes little more than a few months gains is a case in point. Calls for a new round of central bank intervention are inevitable; the likelihood of this remedy providing any sustainable solution remains roughly correlated to the level of interest rates. It does, in our view, potentially move us closer to an environment in which policymakers adopt policies more likely to fuel inflation in real economies rather than asset prices, even though lack of inflation remains a problem which only exists in the minds of economists rather than in the wallets of consumers.

We remain apologetic to investors who have tolerated portfolio performance below our targets for too long. The extended period over which valuation has been totally overwhelmed by narratives in driving investor behavior, has surprised us. Declining markets, such as those which prevailed in the period after the tech bubble and the global financial crisis are normally the period in which rationality returns to valuations. The most recent market declines have not yet seen this. While some technology valuations are under pressure, this seems more associated with specific instances in which financial results are struggling to keep pace with the persuasive narrative. Most still command multi-billion dollar valuations for minimal revenue and little or no profit; hardly the stuff of bear markets. Valuations in most defensives and healthcare remain highly elevated. Much of the remainder of the equity market remains at prices between reasonable and cheap, with the latter dominated by cyclical resource and industrial businesses.

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