Schroders

Schroder Equity Opportunities Fund - Wholesale

Quarterly Report - June 2020

Total return %	1 mth	3 mths	1 yr	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Schroder Equity Opportunities Fund - Wholesale (Post-fee)	1.92	14.35	-10.37	1.32	4.20	7.79
S&P / ASX 300 Accumulation Index	2.43	16.79	-7.61	5.24	6.00	7.71
Relative performance (Post-fee)	**-0.51**	**-2.44**	**-2.76**	**-3.92**	**-1.80**	**0.08**

Inception Date: 14 Dec 2007, 12 years and 6 months.

Market cap	Portfolio[1]	Benchmark[2]
ASX 1 - 50	61.0%	74.9%
ASX 51 - 100	15.5%	13.7%
ASX 101 - 300	13.1%	11.4%
Non Index	6.1%	
Cash	4.3%	

Top 10 holdings %	Portfolio[1]	Benchmark[2]
BHP Group Ltd	4.1%	6.3%
Aurizon Holdings Ltd.	3.9%	0.6%
Westpac Banking Corporation	3.5%	3.9%
Alumina Limited	3.4%	0.2%
Rio Tinto Limited	3.3%	2.2%
South32 Ltd.	3.3%	0.6%
Lendlease Group	3.2%	0.5%
Fletcher Building Limited	3.1%	0.1%
Boral Limited	2.9%	0.3%
Commonwealth Bank of Australia	2.9%	7.4%
Total	**33.6%**	**22.1%**

Characteristics	Portfolio[1]	Benchmark[2]
No. of stocks	54	301
Portfolio turnover* (1 yr)	28.0%	
Sharpe Ratio (1 yr)	-0.40	-0.31
Volatility (5yr standard deviation)	15.3%	15.1%
Tracking error (3yr historic)	4.2%	

1 The 'Portfolio' is the Schroder Equity Opportunities Fund - Wholesale portfolio

2 Benchmark is the S&P / ASX 300 Accumulation Index

Unless otherwise stated all figures are as at 30 June 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

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Commentary

The S&P / ASX 300 Accumulation Index rose by 16.8%, while the Schroder Equity Opportunities Fund - Wholesale portfolio rose by 14.4% (Post-fee), underperforming by 2.4% (Post-fee) for the quarter.

Hyman Minsky would be turning in his grave. His financial instability hypothesis appears a prescient assessment of the consequences wrought by easy money. Rising debt to GDP everywhere may only be a rough indicator of the magnitude of the problem; however, whatever the indicator, the message is consistent. The proportion of zombie companies (companies that are able to service, but not pay off, their debt) is ever rising, productivity is falling and economic growth is illusory. What undoubtedly began (many years ago) as hedge financing (Minsky's term for lending which funded investments able to repay both interest and principal) has degenerated to a level where significant proportions of lending are premised only on an expectation of rising asset values: Ponzi finance.

Even at manipulated and almost zero interest rates, most economies have growing debt, with destabilisation is being postponed by intervention in ever greater doses. Having cried wolf too often, no-one now takes seriously the prospect of central bank balance sheet reduction or an end to monetary repression. Cracks in the confidence tricks that have sustained belief in policymakers are widening. If talk of intervention to halt domestic real estate markets to avoid price declines, question marks on the legality of European bond purchases and similar issues around potential breaches of the Federal Reserve Act in US corporate debt buying programs don't scare you, we believe they should. The vast ramifications of COVID-19 and the necessary actions in response have significantly accelerated the pressures on stability and justified actions normally seen as wildly overstepping mandates. As the system becomes increasingly unstable, the scale of this overstepping will increase.

Equity investment cycles have mirrored Minsky's theory. The exploding disconnect between the financial system and the real economy has caused many to lose faith in any degree of mean reversion and valuation-based investment as a strategy. Popular wisdom promotes slavish adherence to purchasing 'quality' and 'growth', though perceptions of 'quality' seem to exhibit a high degree of subjectivity. Effectively, if one expects a sustained Ponzi finance environment, chasing high multiples for market darlings and loss-making businesses is advisable (after all 'growing' from a position of loss is easier than accelerating existing profits), whereas a belief in Minsky's hypothesis envisages mean reversion (at some point) and investment in real economy businesses which have not been inflated by easy money.

Adherence to our investment principles is, therefore, tougher than ever. Having always believed 'growth' to be an input in arriving at a business valuation rather than an attribute to be sought at any price, valuations of companies believed to have attractive growth prospects have exploded far beyond levels we believe to be realistic and retained these valuations even in the face of market declines. Imagination has won the day and intoxication with growth has prevailed. Ceding control of global investment to index construction rules which constantly reward share price winners and punish losers without regard to fundamentals has also helped.

A global economy offering few growth prospects is not preventing analysts proffering profit forecasts which would be unrealistic in a booming economy, let alone one in which policies are causing operating profits to be crushed. I have always liked Jeremy Grantham's illustration of the fanciful nature of perpetual growth: had the Egyptians started with just one cubic metre of possessions and grown them at the seemingly innocuous rate of 4.5% per year over their 3000 year civilisation, the storage of their accumulated possessions would have required a lazy 2.5 billion solar systems at its conclusion. Growth and sustainability are not comfortable bedfellows in the longer run.

Grantham's illustration highlights the obvious ridiculousness of seemingly innocuous assumptions in the long run. Acknowledging our piece of history is part of this long run, rather than a 'special' piece which is somehow not subject to these longer run laws is a tougher sell. We side with Hyman Minsky. Attempting to compound the money base at rates far beyond the level at which the real economy could co-operate was a dumb idea. The ridiculous wealth transfers currently being fostered will be painful to eventually adjust. How we choose to try and protect our investors' hard-earned wealth against these transfers is the question at hand.

Portfolio exposure to gold is one of our more contentious discussions in this regard. We have found no reliable way of determining the value of an ounce of gold. Sceptics will point to vast carbon emissions and toxic chemicals producing a yellow metal with few productive uses and high storage costs. Adherents will point to its long history as a store of value and its reliability as a hedge against government debauchment of fiat money. This tug of war does not provide an answer to the right price or a sensible portfolio weight.

The relatively small and finite nature of the gold market relative to the global money base means small shifts can drive large price moves. As central banks force investors to endure ever lower returns holding low risk investments, it is easy to make a case for the increasing appeal of gold. Nevertheless, there is a big difference between an elevated gold price for a few years and forever when it comes to valuing gold mining businesses. After all, wealth protection is about the ability to eventually exchange something for goods and services.

Quarterly contributors %	Position *	Attribution
CSL Limited	Underweight	1.73
Boral Limited	Overweight	0.59
James Hardie Industries	Overweight	0.51
St. Barbara Ltd.	Overweight	0.27
Regis Resources Limited	Overweight	0.24

Quarterly detractors %	Position *	Attribution
Incitec Pivot Limited	Overweight	-0.56
Nufarm Limited	Overweight	-0.53
Afterpay Limited	Underweight	-0.53
Fletcher Building Limited	Overweight	-0.35
United Malt Group Ltd.	Overweight	-0.34

* Portfolio weights versus benchmark are average weights over the quarter

Growth / income split for the financial year ended 30 June

	2018	2019	2020
Growth component (I)	12.39%	-3.08%	-12.60%
Distribution component (II)	2.88%	3.74%	2.23%
Return (post-fee)	**15.27%**	**0.66%**	**-10.37%**
Benchmark (iii)	13.24%	11.42%	-7.61%

i) Growth return is the price to price return excluding distributions.

ii) Distribution return includes both income and realised capital gains where applicable.

(iii) Benchmark is the S&P / ASX 300 Accumulation Index

Commentary continued

We have maintained a small weight in gold on the theory our significant exposure to a broad array of solid but tangible businesses should provide better and more sensible insulation to the fiat currency debauchment from which gold bugs seek to shelter. This has not been successful in the short run, as the gold price has benefited from reallocated cash while other commodities, excluding iron ore, have generally wallowed due to their greater reliance on the value in use over financial demand.

Countless stock price moves of recent months have left us scratching our heads. Many technology stocks are at all-time highs and at valuations we consider to be nothing short of laughable. Immutable laws of value creation have been forgotten. If one seeks a 5% return, turning $1 into $2 requires someone to invest that $1 at double your 5% return forever, not just for a year. High return on capital intangible companies may be the flavour of the month; however, they generally have one major drawback: they can only invest small amounts of capital. Earning a 50% return on capital is highly laudable and would allow $1 to be turned into $10 if maintained forever; doing it on large amounts of capital is tougher again.

$11bn in market value was created in Afterpay over the quarter without any cash profits today. Sustainability of this value will require huge amounts of investment at high rates of return or small amounts of investment at totally phenomenal rates of return. Buy now, pay later remains the mantra of both consumers and equity investors. Illustrating the difficulties, Qantas raised $1.9bn during the month, leaving the business capitalised at a little over $7bn (half Afterpay). Had the company not raised capital, the write-down of the fleet (largely A380 aircraft), would have seen the tangible asset backing of the business evaporate to nothing. Despite excellent management, which has seen Qantas investors receive reasonable dividends over time, the vagaries of the market have destroyed capital as well as creating it, and the Qantas accounts show the past decade or so eroded rather than augmented the net asset base. Shareholders need the future to be far more lucrative than the past.

Using repressed interest rates as a justification for these valuations ignores the inconsistency in failing to adjust revenues and profits for the exceptionally low growth environment which financial repression necessitates. Profit forecasts used to justify these valuations also have at their heart an expectation of scalability; revenues will continue to grow exponentially and costs will not. Online retailers such as Kogan or Temple and Webster have seen valuations explode on the back of COVID-19 induced online sales growth. Businesses such as Megaport command multi-billion dollar valuations with revenue well below $100m. All have these expectations at their heart.

Most mature businesses offer ample evidence this scalability is highly uncommon. Where it has been evident, such as in the case of US tech behemoths, Carsales or REA, it is generally a result of utilising the labour of third parties without bearing the costs (car dealers, real estate agents), and through price increases, gradually extinguishing the profits of these third parties and extracting more from end customers. These highly lucrative businesses interposed in the value chain are, however, still subject to the amount of value which the entire value chain can generate.

The totality of the economy and the costs of Ponzi finance as described by Minsky are being wrought and swept under the carpet. Qantas and similar airlines provide the essence of the value chain and the substantial capital investment on which capital-light businesses such as Flight Centre and Webjet rely. Whether you refer to the latter as enablers, facilitators or parasites depends on your perspective. Nevertheless, when the incentive to invest substantial capital at moderate rates of return is suppressed too aggressively and for too long, eventually the hosts succumb. We're pretty sure this will see the parasites (I mean enablers) run into difficulties.

Contributors

CSL (Underweight, -3.3%) We continue to believe CSL is well managed businesses with a strong global franchise. Like much of the healthcare industry we remain concerned that the exceptionally high returns earned due to regulatory barriers and artificial pricing are matched with very high multiples on these already high returns, effectively assuming things not only don't change but continue to improve relative to other industries. Recent events serve to highlight the fragility of an industry in which most countries like to have access to end products yet rely almost solely on the US for plasma collection. The recent acquisition of uniQure, a gene therapy candidate for haemophilia B is considered by some to be an opportunity for incremental profits, however, it can similarly be viewed as a defensive move in protecting high levels of profitability from the competition. The fact regulators see no problem in incumbents acquiring potential competitors rather than fostering a competitive environment should come as no surprise in the healthcare industry.

James Hardie (Overweight, +48.6%) James Hardie remains a standout business in the building materials industry, where for most mediocrity remains a stretch target. We remain optimistic on the ability of the dominantly US operations to continue improving earnings given the 1.2m – 1.3m housing starts do not seem elevated versus Australia (about 7 times the housing starts with 13 times the population), and Hardie products continue to take share from inferior products. A management team inclined towards proactive action on costs and constantly driving for improved efficiencies (evidenced by ongoing margin improvement in the face of COVID-19 challenges) adds a significant degree of comfort for shareholders.

Boral (Overweight, +84.9%) Wild share price volatility with a massive underperformance bias belies a core business with a strong core in essential building products and cyclical but highly durable earnings (an attribute we believe remains wildly undervalued relative to those with intoxicating prospects backed by minimal evidence of profitability or durability). The Headwaters acquisition in the US was another in the long line of ill-considered and wildly over-priced deals where private equity had applied lipstick to the pig and dressed it in questionable accounting, however, in our view the share price has revalued this business for incoming investors. We remain hopeful new management will opt for simplification and operational excellence in an effort to restore returns to reasonable levels.

Schroder Equity Opportunities Fund - Wholesale

Quarterly Report

June 2020

Fund objective

To outperform the S&P/ASX 300 Accumulation Index after fees over the long term by investing in a portfolio of predominantly Australian companies with no size or benchmark constraints.

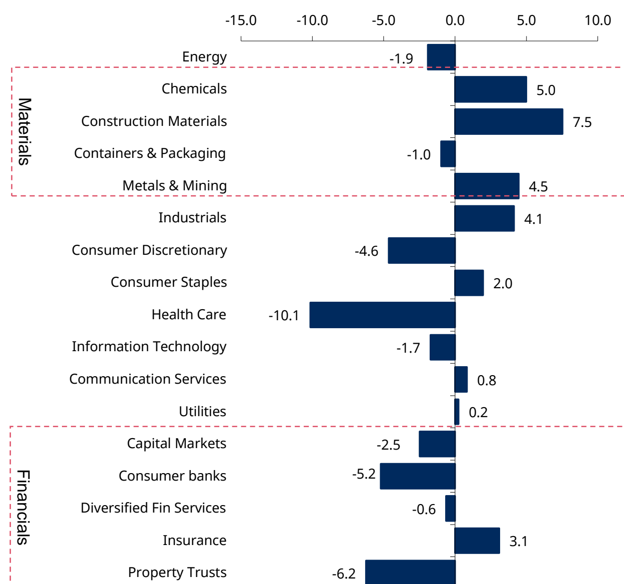
Investment style

Stocks are identified using bottom-up, fundamental analysis undertaken by Schroders' experienced and stable team of in house analysts. The stock selection methodology of the fund has no size constraint and benchmark weightings are not considered in portfolio construction. Securities are selected on the basis of business quality (comprising both business and industry scores) and valuation attraction.

Fund details

APIR code	SCH0035AU
Fund size (AUD)	$300,920,663
Redemption unit price	$0.9110
Fund inception date	December 2007
Buy / sell spread	0.30%/0.30%
Minimum investment	$20,000
Distribution frequency	Normally twice yearly - June and Dec
Management costs (p.a.)	0.92% pa plus performance fee of 15.4% pa of gross out performance above 2% pa

Sector exposure versus the benchmark %



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

Benchmark is the S&P / ASX 300 Accumulation Index

Commentary Continued

Detractors

Afterpay (Underweight, +224.4%) Valued at more than $15bn prior to any sign of making a cash profit, and having gained more than $11bn in value over the quarter (the whole of Suncorp and more than twice Boral), Afterpay is the poster child of the easy money environment. There is little doubt the business was a good idea as customers are embracing it wholeheartedly, whilst retailers, through the weight of customer demand and fear of losing business are following. Allowing consumers to bring forward the satisfaction of receiving goods before they pay for them and asking retailers to pay fees that were previously shouldered partly by retailers and partly by consumers is hardly revolutionary, however, the near zero cost of funding and the propensity to defer rather than acknowledge bad debts is is allowing such models to multiply and creating frenzy around any business involved in the payments system, except of course banks, which remain at its heart. In any normal environment, the cost of providing funding to customers desperate to bring forward purchases should require them to pay a higher price for the privilege; without it, the costs of funding and bad debt risks are effectively shouldered by other customers. We could write a long list of potential issues which would seem to threaten its business model and long run sustainability, however, the excitement of increasing subscriber numbers seems all that matters. Today, that is how the equity market casino rolls.

Incitec Pivot (Overweight, -7.2%) Looking back on the development of the Australian LNG industry is one of the more dismaying exercises in decades. The countless billions expended to deliver poor returns and much environmental carnage have also elevated East Coast gas prices to levels which have turned a resource advantage into a disadvantage. Converters of gas into essential products such as fertiliser and explosives have suffered accordingly, assisted by excessive capacity addition and ill-disciplined pricing of peers. Drought, floods and inept balance sheet management (buybacks at higher prices and capital raising at lower prices) add to a picture which sees Incitec Pivot friendless in an investment context. From our perspective, we expect the future should see some of these challenges to ease and profitability to improve significantly.

Fortescue Metals (Underweight, +38.5%) The exceptionally strong price performance of iron ore has surprised us. Supply challenges in Brazil have ameliorated potential oversupply, while the propensity of China to stimulate fixed asset investment and the production side of the economy due to its more significant short-term growth impact (in the same way Western economies always choose to stimulate consumption) have supported demand. Attention to the cost and operational excellence have come to be expected from a business which has consistently confounded sceptics (including us), however, the commodity price and its prospects remain the key determinant. Our valuation incorporates mid-cycle prices well below current levels and is substantially below the share price, however, the vast cash generation in periods of strong commodity prices remains an underappreciated attribute of commodity businesses and Fortescue (along with Rio Tinto and BHP Billiton) is a major beneficiary.

Macquarie Group (Underweight, +40.8%) Banking and financial businesses are necessarily more opaque than industrial and resource peers given lack of visibility on cashflow and far greater leverage. Macquarie is more opaque than most given the operation of numerous non-banking businesses within a bank structure. The ability to deliver relatively smooth and growing profit outcomes over a long period, a tribute to ongoing innovation and solid management, have afforded the business a significantly higher valuation than peers. While we appreciate the quality and high levels of profitability generated by the funds management business, we believe the extended period of strong asset price growth, particularly aiding those employing high levels of financial leverage such as Macquarie, is being unjustifiably extrapolated. The justifiable caution with which investors are approaching investment in other banks and financials is not translating to Macquarie.

Outlook

Policies aimed at maintaining the hegemony of the financial system over the real economy seem likely to continue. Looking for answers to share price moves in profits, cashflows and balance sheets may well remain fruitless. It seems more likely we will continue to run a global financial casino alongside a real economy which will increasingly be fuelled by debt-funded government ATM withdrawals. The difficulty posed by this environment is it distils investment strategies into two broad categories.

The first option is to discard any realistic attempts to value companies and chase the hot streaks in the casino. Some of you may remember the scene in 'The Big Short' where Selena Gomez describes synthetic CDOs with Richard Thaler in the casino: the accumulation of bets on 'the hot hand fallacy' where a run of success creates unwarranted confidence from an ever greater cohort of gamblers. Characterising this as 'investment' is disingenuous. The share price is creating the allure, not underlying value creation.

The second option is to rely on considered and realistic views of valuation, grounded in the low growth and high risk environment investors face. Fundamental value creation happens slowly and does not generally accord with 200% share price gains in a quarter. Ever more investors are being tempted into the former category as the 'hot hand fallacy' prevails, centred in a few sectors.

The Twitter videos of Davey day trader and the entry of armies of Robinhood traders into the US equity market may be amusing and are paralleled everywhere. However, as insiders realise extraordinary gains and raise ever more capital to plough into businesses with spurious longer term prospects it is difficult not to see the irony in Robinhood looking more like a low-cost trading mechanism facilitating large scale robbing of the poor to give to the rich. Attempting to invest sensibly in search of moderate but sustainable value creation has been an incredibly frustrating exercise for us and our investors over recent years. We can at least promise clients we will abide by social distancing rules and avoid entering the casino as it becomes ever more crowded.

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