Schroder Australian Equities

Quarterly Investment Option Update

30 June 2022

Aim and Strategy

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. With an established pedigree of investing in Australian equities for over 50 years, the Schroder Australian Equity option is an actively managed core Australian equity portfolio with a focus on investing in quality stocks predominantly in Australia characterised by strong returns on capital with a sustainable competitive advantage. The option draws on Schroders' deep research capabilities, with a long term focus on investing, it is suitable as a core portfolio holding over the medium term to long term.

Investment Option Performance

To view the latest investment performances for each product please visit amp.com.au/performance

Investment Option Overview

Investment Category	Australian Shares
Suggested Investment timeframe	5 years
Relative risk rating	7/Very High
Investment style	Core
Manager style	Single Manager

Asset Allocation	Benchmark (%)	Actual (%)
Equities	100	98.50
Cash	0	1.50

Sector Allocation	%
Communication Services	8.53
Consumer Discretionary	4.15
Consumer Staples	5.41
Energy	6.68
Financial-X-Property Trusts	21.15
Health Care	7.37
Industrials	9.90
Information Technology	0.73
Materials	26.74
Property Trusts	5.58
Utilities	2.46
CASH	1.30

Top Holdings	%
BHP Group Ltd	6.93
Telstra Corporation Limited	4.86
Commonwealth Bank of Australia	4.57
Rio Tinto Limited	4.04
Wesfarmers Limited	3.90
Australia and New Zealand Banking Group Limited	3.60
Alumina Limited	3.55
Brambles Limited	3.46
Ramsay Health Care Limited	3.06
Westpac Banking Corporation	3.00

Portfolio Summary

During the month, the fund decreased in value through both asset allocation and stock selection. At a sector level, the underweight exposure to the financials and information technology sectors and the overweight exposure to the materials sector were the major contributors to the overall Fund performance. The sector detractors for the month were an overweight allocations to industrials, utilities and communication services.

At a stock level, contributors included an overweight allocation to Telstra Corporation and Brambles and an underweight allocation to Commonwealth Bank of Australia. Offsetting some of the performance were the Funds underweight allocations to CSL and Transurban Group and the overweight allocation to South32.

Market Commentary

When Maverick clutches the dog tags and whispers the words “Talk to me Goose” in the original ‘Top Gun’, he’s attempting to block out the noise. Clear thought and intuitive action. He re-engages in the dog fight and good things happen. As the 2022 version passes $1bn at the box office, it would appear the intuition of Tom Cruise continues to serve him well. Investing, like many other pursuits, has seen intuition give way to a slavish adherence to ‘the data’. Investors, like economists, desperate to be perceived as ‘scientists’ rigorously testing against a hypothesis (rather than as participants in exceedingly complex systems influenced by incentives and behaviours) wear ‘data driven’ as a badge of honour. The cloud, artificial intelligence, loyalty programs, social media; collecting more data is seen as the path to more knowledge. While in no way dismissing the importance of basing decisions on sound data and research, Schroder feel the balance of importance between data collection and interpretation has perhaps been lost. A wise colleague puts it this way; “Schroder are often faced with decisions which depend on a range of connected elements and data sources. The path from A to B, then B to C and C to D, all seem like perfectly rational connections. However, when one stands back and looks at the path from A to D, the conclusions are less obvious and sometimes crazy. What is rational to one person could appear mindless stupidity to another.”

Choose your history wisely

Data interpretation is particularly relevant at present when it comes to equity markets. The same decade which saw the rapid wealth acceleration and declining business investment discussed above provides the data of greatest influence to investor behaviour. For many, it is their only decade of experience. The data on which investors rely in being ‘data driven’ emanates largely from financial statements and historic share prices. Correlations, earnings revisions and earnings growth rates are important to investors because analysis of past share price moves suggest they matter. If these observations on what’s worked (copying the behaviour of others (NB: this is not normally how it’s phrased on the investment philosophy page of investor websites!) are core to your investment approach, you need to decide which period of history to choose. Much of the love affair with (perceived) high growth, technology, and disruptive businesses reflects recent stock price performance. Cyclical businesses are low quality. Tech and high-quality structural growth are where it’s at. Constant reinforcement of these perceptions and ongoing justification that it was OK to pay ever higher prices for these characteristics resulted in the valuation gaps shown in the chart below. Using longer periods of history (choose any, just make sure they’re significantly longer), creates a different picture. Paying multiples this high has been a bad idea, regardless of the bond yield. Schroder’s intuition, and Schroder’s aversion to exceedingly high multiples, lies in an admission that the future is uncertain and lower multiples offer greater margin for error. Real life says earnings growth isn’t always associated with ‘growing’ industries and ‘pricing power’ and ‘quality’ sometimes disappear or pass to new sectors. Perceptions of MYOB used to be similar to those of Xero today, Netflix used to leave other streaming services for dead, and buy now pay later and infant formula looked a little more exciting a couple of years ago than they do now. Extreme confidence in the distant future becomes more unsettling when one honestly examines errors over far shorter timeframes

Sustainability and the energy decade

Vaclav Smil doesn’t tend towards the airy fairy. His most recent book, ‘How The World Really Works: A Scientist’s Guide to Our Past, Present and Future,’ should be compulsory reading for those interested in understanding decarbonisation challenges. Cutting energy use is both tough and economically damaging. It is vastly more important to our wellbeing and lifestyle than technology. As Smil highlights, the world existed perfectly comfortably prior to the advent of technology companies that dominate investors’ attention today. Apps, online gaming, social media and the cloud are not essential services and the world managed comfortably without them. There is no possibility these companies could exist without energy. The pandemic period was the first time the trajectory of coal usage approximated that necessary to reach 2040 targets. The global economy was decimated in the process and usage has reversed with re-opening. Intuition tells us the path to net zero will not be driven by further data collection, the number and complexity of emission measures and the length of sustainability reports. Capital should be supporting more engineers, fixed asset investment and technology (we're not talking apps, slides, cloud and the metaverse here). Measuring portfolio emissions, targeting ever more investment into intangibles/companies not requiring capital and holding more investor sustainability meetings is missing the point. It should not be surprising that technology areas which have seen vast over-investment in recent years have incinerated investor cash and are struggling to transition towards profitable business models. Nor should it surprise that essential sectors which myopic emission focused investors have shunned are suffering from under-investment and skyrocketing prices. The job of investors should be to direct capital to where it is needed and most productive.

Reactions are instructive. Skyrocketing prices are a vital signal in inducing supply to be expanded and demand to be quelled. Among recent political actions in the face of rising prices, a few come to mind. Rather than accept the demand impact of high fuel prices, governments around the world (including Australia) have leapt to fuel excise relief to artificially reduce prices. President Biden authorised the largest ever Strategic Petroleum Reserve release of 180m barrels (from the existing 580m barrel reserve) over the next six months rather than incentivising any additional production, and Queensland coal taxes (while admittedly fairly well designed), will strike further caution into capital which must support traditional energy sources until decarbonised substitutes are available. The next decade or two in energy will be some of the most crucial in history. They will require cool heads and rational conclusions from both investors and policymakers. Vaclav Smil will probably make you skeptical of the ability to transition in anything like the time frames which commitments currently envisage, however, he will also make you appreciate the importance of considered rather than emotional reactions to the challenges. Schroder continue to believe investors should be looking for ways to invest in and support energy, materials, and infrastructure through this period, not run away from them.

The inflation puzzle

The 'pricing power', which investors so dearly love, also has another name: inflation. The reason sectors such as healthcare continue to grow and squeeze others is the continued exercising of it. While not claiming any great insight into the durability of higher levels of inflation, history does have some interesting lessons. Arthur Burns, the Federal Reserve Chair from 1970-78 during a period of rampant inflation, reflected on some of the mistakes made during the period which offer interesting parallels today. The overarching problem he identified was the public expectation that government will ensure prosperity and growth, alongside a willingness to levy taxes which fell well short of the propensity to spend. Sound familiar? The pandemic and a rotten period for natural disasters on the east coast has led to government handouts to support ongoing consumption and reconstruction. An almost non-existent manufacturing sector, and the aforementioned chart on business investment, suggest no such associated investment in supporting supply addition. Stimulating demand while not stimulating supply provides the impetus for inflation. Crushing demand is unpleasant and unpopular, however without significant supply addition, it is the only way to address rising prices. As Arthur Burns put it: "My conclusion that it is illusory to expect central banks to put an end to the inflation that now afflicts the industrial democracies does not mean that central banks are incapable of stabilising actions; it simply means that their practical capacity for curbing an inflation that is continually driven by political forces is very limited." Investors extrapolating a future in which companies exercise 'pricing power' whilst expecting a level of interest rate and wage growth (which suggest there isn't any) might want to read a little more history.

Outlook

When the going gets tough, most will want cuts

Moving the interest rate dial on over-geared and thus hypersensitive economies is proving unsurprisingly challenging. Accustomed to the rising asset prices, apparent 'wealth' and buoyant consumption which interest rate declines have facilitated, the reverse was always going to be less appealing. Those without much of an eye for sustainability will quickly be calling for reinstatement of the policies of the past decade. Perhaps the 'growing wealth', consumption and diving business investment of the past decade can be resurrected just a little longer?

The shrinking labour pool of young workers relative to a growing pool of ageing asset owners creates obvious tension when the wellbeing of the former is consistently sacrificed to support the asset values and lifestyle demands of the latter, and the profit margins of corporates preferring to avoid the hard work of improving efficiency and ceaselessly campaigning for higher immigration as a supposed antidote to problems. Schroder struggle to comprehend how anyone believes it is reasonable for the lowest paid workers not to receive wage increases (which compensate for inflation which has already occurred) using the argument that the economy will be better off if they tighten their belts a little more to avoid instigating a wage price spiral. Intuition tells us that might be a slightly misguided and short-term interpretation of a deeper problem. We'd interpret falling house and asset prices together with rising wages as part of a necessary and logical correction on the path to a more sustainable economy. Imbalances built over many years cannot clear in a few months.

Choose a wider lens

Schroder are observing the same company financial history, share price and economic data as other investors. Schroder are choosing a wider lens in interpreting the data. The reversion of the past year or so has come as a shock to investors focused heavily on the period of history since the last financial crisis. Longer observations of history suggest this period might be the abnormal one, with extrapolations of near zero interest rates, abundant consumption and government spending, limited business investment and no inflation a touch unwise. The future is uncertain. This is exactly why Schroder prefer to buy businesses pursuing sustainable strategies at reasonable multiples. Investors should not be afraid of cyclical earnings, investing in staff and hard assets. This is how energy will be decarbonised and Australia's extremely attractive position in the energy transition maximised. Growing productive capacity is a far superior way to suppress inflation than crushing demand, and a better way of creating wealth than inducing another pandemic or mispricing bonds through central bank intervention. It all depends on how your intuition tells you to read the data. "Talk to me Goose".

Availability

Product name	APIR
SignatureSuper*	AMP0813AU
SignatureSuper Allocated Pension*	AMP1177AU
SignatureSuper Term Pension*	AMP1177AU
Flexible Lifetime Investment (Series 1)**	AMP0995AU
Flexible Lifetime Investment (Series 2)**	AMP1438AU

*Closed to new investors
**Closed to new and existing investors

Contact Details

Web: www.amp.com.au
Email: askamp@amp.com.au
Phone: 131 267

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