Schroder Australian Equities

Quarterly Investment Option Update

30 September 2021

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	90-100	98.52
Cash	0-10	1.48

Sector Allocation	%
Energy	3.52
Materials	25.24
Industrials	11.07
Consumer Discretionary	2.42
Consumer Staples	7.98
Health Care	6.40
Information Technology	2.27
Communication Services	8.25
Utilities	1.87
REITs	4.07
Financial-X-Property Trusts	25.45
CASH	1.48

Top Holdings	%
Telstra Corporation Limited	5.33%
Commonwealth Bank of Australia	5.28%
BHP Group Ltd	4.84%
Alumina Limited	4.03%
South32 Ltd.	3.92%
Brambles Limited	3.77%
Westpac Banking Corporation	3.73%
National Australia Bank Limited	3.34%
Woolworths Group Ltd	3.21%
Incitec Pivot Limited	2.87%

Portfolio Summary

The Schroder Wholesale Australian Equity Fund outperformed the S&P/ASX 200 Accumulation Index which rose by 1.7% in the quarter.

Investment Option Commentary

During this period, the Fund added value through stock selection. The overweight allocation to the Materials and underweight to Healthcare sectors were the largest contributors. Conversely, the overweight positions in the Industrials and Energy sectors were the main laggards.

At a stock level, the main contributors were the overweight positions in Alumina, South32, Incitec Pivot and Suncorp. The nil holdings in Fortescue Metals were also among the top contributors. Conversely, major detractors from performance included Underweight positions in Sydney Airport and Macquarie Group. Overweight positions in Brambles and Worley Limited also detracted from performance.

Groucho Marx, as always, nailed it: “Those are my principles, and if you don’t like them…well, I have others.” Central banks, politicians, and investors are all grappling with the same issue now. Many of the principles of the past thirty years – lower rates, fiscal prudence, globalisation, geopolitical stability, higher returns on capital maximising value and more recently decarbonisation – are all being challenged. Are they principles, or pragmatic approaches best ignored currently given the “transient” nature of post Covid financial markets? The confluence of all of these factors have recently conspired to not only challenge what had otherwise been a robust and largely uninterrupted orthodoxy, but aggressively so, and in so doing, equity markets have weakened, and relative performance has rotated, after what has been an exceptionally strong year.

The principle of lower rates has been challenged by the spectre of stagflation. Whilst interest rates have already risen in Norway and many emerging economies, the major Western world economies are sitting tight on a zero interest rate policy. The pressures are real; the last time US inflation forwards (10-year break evens) were at this level, US bond yields were close to double their current 1.5%. Nonetheless, raising rates, it is argued, will not increase inventories or the supply of labour, nor decrease energy prices. As Andrew Bailey, Governor of the Bank of England has said: “Monetary policy will not increase the supply of semiconductor chips, it will not increase the amount of wind, and nor will it produce more HGV drivers.” Locally, the biggest implication of low rates in Australia concerns even the RBA Governor; “Ever-rising housing prices relative to income, I don't think serves our collective good very well, it's something that as a citizen I would like to see addressed, but as a central bank we can't do anything about". Whether that is true or not, the path is clear; the RBA is continuing with a lower for longer interest rate policy.

One of the implications of this for the local equity market is that yield continues to be well bid, with any waning of demand by individual investors now being assumed at a corporate level, with the bid for Sydney Airport being followed by a bidding war for AusNet. Another implication is that banks, which have had a regulatory reprieve through the past several years after the tumult of the Royal Commission, have started to see asset growth and the potential for underlying earnings growth, as housing price increases has driven demand for mortgage finance to its highest level in many years. The ultimate irony is that the banks are now highlighting the weak regulatory environment and the consequent need for macro prudential intervention to the Government, choking the strong rally in bank equity prices, which have seen all four majors be the best performing stocks in the ASX top 20 through the past year. A final implication for the local equity market arising from the inflation spectre is an asymmetry; it is difficult to make a case for rates to go lower than the levels seen through the past twelve months, and to the extent that rates may increase at a faster pace than had been envisaged, the rotation to hard assets gains pace. This has seen the principle of harder assets having little pricing power being challenged, and market performance rotate towards material and energy stocks (as their selling prices have increased) and away from the more defensive and interest rate sensitive stocks which had hitherto led performance for many years. Lower rates were cited as the reason for the outperformance of many “growth” names, even at much higher nominal rates than we now see, and hence the principles attaching to those valuations driving portfolio positions (as opposed to just more recent share price momentum) can now be tested. Maybe, for all the rhetoric surrounding moats, in fact, Groucho called it right … if those stocks are no longer going up, well, I can try others.

At a company specific level, the principles that have been applied at James Hardie have served the group well for twenty years, as its revenues have doubled to US$3b and ebit grown from US$140m through $600m. The ambitious ebit target of US$1b, if achieved, would see Hardies placed as one of the highest earning building material companies in the world, with returns on capital more akin to a high performing IT group than a materials company. Whilst Hardies does have some IP protection, it would be fatuous to believe that is its competitive advantage. All of its advantages are innate – an innovative, evolving product range with high market shares and margins; strong relationships with the broadest range of trade and channel partners and home builders where market share continues to be gained, underwriting volume growth; lowest cost producer status, as scale advantages allow it an unrivalled plant network and production efficiencies; and a small presence in a large potential market in the EU where profits are currently circa 5% of that made in the US. And importantly for a growth company, Hardies has proven that its profits are backed by cashflow and that in the event of a downturn, whilst profits slip, market share grows such that at the same level of housing starts in the subsequent upturn the group is making significantly higher returns. All of this has been able to be achieved with a relatively high degree of management turnover; none of the existing senior management were in these roles a decade ago, and half of the senior management team have been with Hardies for five years or less. A refreshed strategy released during the month promised more of the same, but with even higher margins being promised in the US and Asia as operating conditions remain strong (as is the outlook). The issue of founder led corporations and their market performance relative to those run by "technocrats" is one which has received increasing attention, and Hardies, along with CSL, Aristocrat and others, suggests that ownership structure in itself is no impediment to strong, sustained performance if appropriate ambition and disciplines are in place.

Having said that, if all it took was an updated strategy presentation, then neither Brambles nor Lendlease would have continued their woeful performance of recent years. In each case, a poor base was not enough as management sought time to reset the business with a refreshed strategy. Perhaps a refresh of the management rather than the strategy may have been better received. Both groups are testament to the market ultimately valuing cashflows and not reported profits; they represent two of the most egregious proponents of a sustained mismatch between cashflows and reported profits on the ASX. Both stocks have been derated materially, with the market clearly believing the cashflow to be a truer representation of the sustainable economic earnings than reported profits. Investment examples like these two are complex; poster children for the "professional management do not invest wisely" argument, augmented by compensation structures which have been consistently misaligned with the investor experience, with questionable accounting, offset now however with lower multiples which more than fully discount global leadership positions in ostensibly attractive markets and the prospects for imminently improving returns (after the patience required through the next two years in each case).

Finally, it's not just Prime Minister Morrison who will have principles tested when it comes to the energy transition and the push for lower carbon emissions. A global shortage of coal and gas has seen prices react exactly as the textbook suggests should be the case for a commodity in short supply. Share prices have reacted accordingly after a tardy start to the year for the ASX energy names. Given the COP26 climate summit next month, a contemporaneous, material increase in coal production in China, seeing coal production and imports this year at highest ever levels, and more structural policy announcements such as accelerating approvals and providing tax incentives for the development of new coal mines in China makes a mockery of promises that China will hit peak carbon emissions before 2030 and achieve carbon neutrality by 2060. The UK also has domestic issues with energy security, and it is only because of the absence of manufacturing as an important part of the economy that the issue has not been more prominent domestically. This hasn't just impacted upon performance for the direct energy names on the ASX; Aluminium is effectively solid electricity, whilst ammonia nitrates and fertilisers are solid gases, seeing Alumina, South32 and IPL and Orica all benefit.

Outlook

As can be readily gleamed from performance differentials through the past several years, on balance, Schroder's portfolio remains positioned for a continued transition from longer dated (hoped for) cashflows to shorter dated ones; from (very) high multiples to lower multiples. These are Schroder's principles, albeit a blunt characterisation. In many sectors, for example, mean reversion has never been less likely; the energy transition, and increased levels of regulation legitimised by increased levels of government investment and de-globalisation means that historic levels of profitability will probably not recur in several sectors. Equally, the investor's dilemma is in discerning whether the expected levels of profitability in the highest rated stocks and sectors, will ever be reached. If the perception of the likelihood of this changes, the derating can be savage – of the much vaunted WAAAX stocks in Australia, for example, two fallen angels have underperformed by more than 75% through the past year. Whilst Schroder continue to seek balance in the portfolio – even after its rally through the past month, Alumina continues to trade on low multiples, for example, and Hardies on high multiples – in a market trading at record multiples, Schroder's strong overall portfolio bias towards more defensive earnings streams remains.

Availability

Product name	APIR
AMP Flexible Lifetime Super	AMP0465AU
AMP Flexible Super - Retirement account	AMP1375AU
AMP Flexible Super - Super account	AMP1504AU
CustomSuper	AMP0465AU
Flexible Lifetime - Allocated Pension	AMP0636AU
Flexible Lifetime - Term Pension	AMP0944AU
Flexible Lifetime Investment**	AMP0995AU
Flexible Lifetime Investment (Series 2)**	AMP1438AU
SignatureSuper	AMP0813AU
SignatureSuper Allocated Pension	AMP1177AU
SignatureSuper Select	AMP0813AU

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