Schroder Australian Equities

Quarterly Investment Option Update

31 March 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 (%)
Australian Shares	100	98.50
Cash	0	1.50

Sector Allocation	%
Communication Services	8.61
Consumer Discretionary	2.27
Consumer Staples	6.44
Energy	5.49
Financial-X-Property Trusts	24.59
Health Care	6.49
Industrials	10.04
Information Technology	0.68
Materials	27.50
Property Trusts	3.98
Utilities	2.42
CASH	1.50

Top Holdings	%
BHP Group Ltd	6.39
Commonwealth Bank of Australia	4.79
Telstra Corporation Limited	4.67
Rio Tinto Limited	4.19
Australia and New Zealand Banking Group Limited	4.05
Alumina Limited	3.70
South32 Ltd.	3.50
Westpac Banking Corporation	3.34
Brambles Limited	3.32
National Australia Bank Limited	2.86

Portfolio Summary

The Schroder Wholesale Australian Equity Fund outperformed the S&P / ASX 200 Accumulation Index during the quarter.

During this period, the Fund added value through both sector allocation and stock selection. The underweight allocations to REITS and Information Technology sectors were among the largest contributors to performance. Additionally, the overweight position in the Materials sector also added value. Conversely, the overweight positions in the Communication Services and Industrials sectors, along with the underweight position in Financials were the main laggards.

At a stock level, the main contributors were the overweight positions in South32, Rio Tinto & Incitec Pivot. The nil holdings in Goodman Group, along with the underweight position in CSL also added value. Conversely, major detractors from performance included the overweight positions in James Hardie Industries, Fletcher Building, Brambles and Ramsay Health care. The underweight positions in BHP Limited and the Woodside Petroleum also detracted from returns.

Investment Option Commentary

The great unwind has begun, and together with two successive supply shocks caused by a pandemic and then war, it has spawned the great chaos. After major central bank (US, EU, Japan and China) assets grew from US$5t to US$20t in the decade to 2019 following the GFC, covid hit and the liquidity afterburners were introduced, with a further US$10t introduced within the ensuing two years. The correlation between the size of this collective balance sheet and the MSCI world equity index is extremely high; and so it has remained as the unwind is presaged. The US Federal Reserve Chair, Jerome Powell, has described the size of the balance sheet as "… unnecessarily large …", in the face of inflation at 8%, equity multiples at their highest level in a century, and housing prices growing at 20% per annum. More recently, Powell's mooted successor, Lael Brainard, suggested that balance sheet reductions could begin next month, and at "… a rapid pace …". The great unwind has begun.

And with it, the greatest multiple dispersion seen in Australian listed company history has started to converge. The burst of liquidity seen through the past two years promoted the multiple afforded high PE firms on the ASX trade from 30 to 50 times earnings, before the recent 20% correction. Even now and after the correction of recent months, high multiple businesses on the ASX are still trading on multiples well above where they got to during the TMT bubble twenty years ago. The US experience has been more bifurcated; whilst the leaders, the so called FAANG stocks, are only 15% off their peaks, the Goldman Sachs non profitable Technology index in the US has seen prices decline by more than 50% through the past year. That the Australian experience with technology names mimics the GS Index more than the FAANG stock experience reflects the relatively poor cashflow generation of most of the listed Australian high multiple, mostly technology, stocks. Schroder still believe that this correction in Australia is nascent, with hitherto unseen multiples still as prevalent as poor business models among many of the fallen angels.

As excesses unwind, it is not unusual to see periodic rallies. Indeed, the Nasdaq corrected by 70% in the year following its March 2000 peak, and yet there were four rallies of 25%+ through that unwind and the following couple of years. Schroder saw a similar rebound in March, and yet to the extent that interest rates continue to increase and just as importantly, the Fed continues to reduce its balance sheet, the manager expect such rallies to continue to be ephemeral, for one simple reason. The quality of a business is ultimately reflected in its earnings. It is one thing for a business to not report a profit and produce free cashflow because it chooses not to; it is another altogether if it has every incentive to and yet cannot. This year, there is every incentive to produce free cashflow for the fallen angels of the ASX. For those that cannot or do not do so, and Schroder suspect there may be more of these than may currently be imagined, the consequences may be dire. A test of quality in recent years has been the revenue growth able to be generated when capital was costless; the real test of quality, the cashflow growth able to be generated when capital is priced fairly, may just be starting.

The banking sector is not cheap on any measure, with underlying profit multiples at 11 times and absolute p/e multiples at almost 15 times earnings, at their highest levels for many years. To be fair performance is divergent; the split between the higher rated CBA, Macquarie and NAB against ANZ and Westpac is as large as it has ever been. Ross McEwen has done a wonderful job at restoring NAB's fortunes in the three years since his appointment as CEO, however in itself it is telling that the turnaround in performance and multiple has occurred in that timeframe, with NAB being the lowest rated major bank when he joined. This position is currently assumed by ANZ, with their discount to the sector peers being as large for any major bank through recent decades. Operationally ANZ is in a world of pain currently, reflecting an overweight New Zealand position, and more importantly domestic market share losses arising due to inadequate systems and poor productivity; almost the identical set of issues which confronted NAB three years ago.

For NAB to have been rerated so aggressively in such a short time on the basis of simplifying processes (especially those related to mortgage processing) highlights that leadership matters, a lot, even in sectors that are superficially commoditised. To give this some context in value terms, should ANZ restore its operational performance to NAB's level and be rerated accordingly, there is a 40% relative performance prize on offer on a price to book basis (or circa $30b in market capitalisation). Schroder are not assuming this occurs, and nor do many given ANZ is trading at its largest discount to its peers in fifteen years. However, nor were many assuming it for NAB three years ago before the rerating which delivered $35b in relative alpha for NAB shareholders and so any improvements in ANZ's operational performance warrant close attention.

Schroder would make two final points on the banking sector, which is the fund's largest underweight; firstly, the Canadian government has in recent weeks introduced an additional corporate tax (1.5%) on large banks and insurance companies, and a one off tax surcharge of 15% for profit above C$1b. This mimics the UK tax surcharge for large banks. An equivalent move cannot be ruled out in Australia. Secondly, lending standards have been lax since the Royal Commission. The RBA's recently released Financial Stability Review highlighted that "… debt is high relative to income for many households and businesses. Household debt relative to income is high compared to other countries and to historical levels …". For context, the share of new lending attributed to those with a debt to income ratio greater than 6 has increased from 15% to almost 25% since the Royal Commission. And with that, one of the most senior RBA officials takes his leave. It is clear that the bad debt risk, even if not imminent, is highly asymmetric.

Amidst the turbulence of recent months, Schroder continue to see resources on Schroder's mid cycle estimates (which assume commodity prices more than halve from spot) at 14 times ebit, which is below every other sector in the market. Nonetheless, Schroder's portfolio has through the past quarter gone underweight resources for the first time in several years as higher commodity prices sees the relative gap between price and value cross the fair value rubicon. Thermal coal (450%), coking coal (330%), iron ore (170%), copper (100%), aluminium, nickel and alumina (all 30%+) are all trading well above the top of their respective cost curves. In turn, the excess cashflow generated by this extreme price reaction is materially accretive to valuations, especially for those projects with shorter lives. Obviously commodity markets have been major beneficiaries of the great disruption; not just hard commodities but also soft commodities, which has seen the portfolio's position in IPL enjoy remarkable appreciation after several frustrating years of low prices and disrupted production. Schroder continue to have an overweight position in several industrial sectors such as Chemicals, where more recent earnings strength has followed a decade of supressed returns and a consequent paucity of industry investment.

In many ways, the past several years in financial assets have been about nothing but imagination. No forecaster several years ago foresaw the explosion in central bank balance sheets that has been experienced. To be fair, no one could have seen the pandemic which has exaggerated that direction and quantum, let alone the war in Ukraine, however the manager's hope and expectation is that there is no further need to replicate either the social experiences nor the policy responses of the past two years. In that event, as Dr Powell stated, balance sheets are "far above" where they need be, and in recent weeks Ms Brainard has repeated the message for those that hadn't yet caught the drift. The strong correlation with asset prices on the way up will, Schroder expect, continue to hold as the balance sheet shrinks. Alas, it is more than possible that the deflationary forces prompted by asset price deflation will not directly impact upon energy price inflation and hence the manager suspects a stagflationary environment is possible. It doesn't much matter if that's not the case in terms of Schroder's portfolio positioning, however, because even a more sedentary unwind of the growth in central bank balance sheets will continue to see an unwind of the speculative excesses which has been spawned by the policy settings of recent years. The highest multiple stocks have started to unwind, however the manager believes a further large correction in their multiples is likely unless they quickly start to produce material free cashflow. As an investor, as always, the best form of defence in strained market environments is a higher, cash backed, nearer term, sustainable cashflow. That strategy has proven valuable through the unwinding of every period of market excess in the past, and Schroder fully expect it to continue to prove its worth as this cycle unwinds as well.

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

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