

Schroder Wholesale Australian Equity Fund

Performance overview

The S&P / ASX 200 Accumulation Index rose by 8.3%, while the Schroder Wholesale Australian Equity Fund (post-fee) rose by 6.4% (post-fee), underperforming by 1.9% (post-fee) for the quarter.

During this period, the overweight exposure to Industrials and an underweight allocation to Energy sectors added value. However, an overweight tilt to Materials along with underweight Real Estate sectors dragged the overall Fund returns into negative territory.

At a stock level, positive contributors included the overweight positions in ALS Limited, Boral and IRESS. The nil holdings in Woodside Petroleum, Sydney Airport and APA Group were also among the top contributors. Conversely, major detractors from performance included overweight positions in Incitec Pivot, Alumina and Lend Lease. The underweight position in the Commonwealth Bank and the nil holdings in Aristocrat were also major detractors from performance.

Market Summary

"In the short run, the market is a voting machine but in the long run, it is a weighing machine". The triumph of emotion over fundamentals to which Benjamin Graham's famous quote refers is being played out everywhere. The financial year end closed another strongly positive quarter and one of the strongest years ever. These returns were not generally propelled by exceptional revenue and earnings growth across either the domestic or global economy. Traditional benchmarks such as price-to-sales ratios lead to reasonably obvious conclusions. Unless margins earned on revenues in the future (across the entire economy) move markedly higher in the future (a scenario which wouldn't augur well for wage growth), near-term gains are eroding future returns for investors.

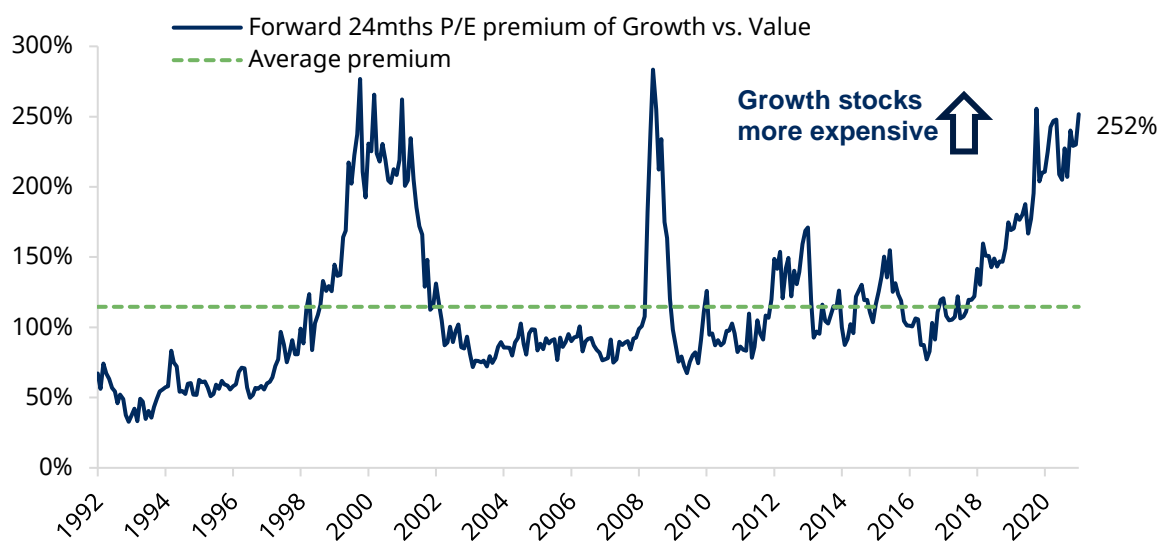


Source: Factset

The pandemic has proven a surprising panacea for wealth everywhere. As central banks have moved far beyond the necessary provision of liquidity to markets and taken a greatly more interventionist approach to the determination of asset prices, it is unsurprising many are questioning whether the role of the market as a weighing machine will ever return. If central banks can't ever afford declining asset prices given the implications for a fragile and highly leveraged financial system, wagering on rising asset prices rather than falling just has better odds (heads I win, tails you intervene). To borrow from Gordon Gekko, "greed is good". On the other side of the equation, central banks are necessarily foisting the cost of funding on those without Gordon Gekko's aggression.

Thinking through the process is always useful. Every time either an investor (or a central bank) chooses to purchase an investment, another investor is agreeing to turn the proceeds into cash. When markets are flooded with cash at unappealing yields, the price at which investors are happy to turn an investment in bonds, shares, real estate or bitcoins back into cash rises. The same is true in reverse on the way down. Much as bitcoin investors might rail against the debauchment of fiat money and exhort the next buyer to act quickly lest their cash becomes worthless, the seller is happily exchanging bitcoins for cash (probably whilst simultaneously producing a YouTube clip on how every dip should be seen as a buying opportunity). These are the terms in which they are denominating the price. Moving cash rates towards zero, merely makes cash a lower returning investment. When a central bank buys a bond and turns it into cash, they are merely forcing the previous investor to sit on cash or use the cash for an alternative investment. The textbook says this should see these investors seek organic investment opportunities, promoting investment and employment. Amazingly, here in real life, retirees sitting on conservative investments are not rapidly starting new businesses, nor are individuals borrowing money to do anything other than buy existing properties or businesses. The giant game of pass the parcel is making very little difference to anything other than the owners of every non-cash asset reporting successive market value gains. This 'market value' creation allows everyone to feel wealthier without much in the way of new businesses, new houses or improved profits. Economic growth remains low everywhere and the technology boom providing the rationale for skyrocketing valuations everywhere is unfortunately attached to productivity growth rates lower than most of the past century. This process has happened many times before over history and it's not 'different this time'. Nevertheless, wealth transfers are currently large, which means temptation is powerful.

The other obvious observation on market activity is the absolute dominance of 'growth' over 'value' investing. 'Growth' = good, 'Value' = bad. In simple terms, 'growth' simply means accepting a larger proportion of the expected return on an investment further into the future. 'Value' is about receiving a greater proportion sooner. In addition to valuations versus earnings and revenue, which haven't been seen previously, the gap between stocks perceived to have an incredibly appealing long-term future and those offering cash returns sooner has approached peak levels seen historically.



Source: Goldman Sachs

Illustrations of the stark nature of these differentials are plentiful. At the 'value' end of assets, coal is currently setting the unpopularity benchmark. BHP and Anglo recently disposed of their respective 1/3 stakes in the Cerrejón thermal coal mine in Colombia to Glencore for US\$294m each. Based on terms of the agreement and expected cashflows Glencore expect the payback on the investment to be less than 2 years. The mine is expected to operate until around 2034, so profits will hardly be exhausted in 2 years. Unpopularity and carbon emissions aside, the risks in any investment are mitigated significantly if the price is low enough. The pain of a deteriorating future is mitigated when you've already got your money back. But the reverse is also true. June and early July saw several proposed acquisitions/price reactions which in most market conditions would be seen as madness. In technology, Altium refused a takeover bid of around US\$3.9bn from US peer Autodesk. The company announced expected revenues of between US\$190-US\$195m and EBITDA margins a little below 40%. At 20 times revenue and 50 times EBITDA on already very high margins, it is fair to say the cash payback Autodesk is expecting will be a little longer than that for Glencore. Assuming, as management do, the future is extremely bright and market dominance awaits, allowing revenue to double and margins to be at least maintained, the price may reduce to only 25 times EBITDA once achieved. A handsome return of 4% will then be available should this profitability be maintained in perpetuity. Whether Altium is a 'quality' company (a term increasingly used by investors to justify paying exorbitant prices) is not the key issue. It is the inherent uncertainty of the distant future and the extremely limited protection which these prices offer against the chance it's not as rosy as projections. While the ineptitude of regulation in sectors such as technology may encourage investors to assume a future of abating competition and consistently rising prices, it potentially increases the probability of regulators reclaiming some of the gouging of customers in the future.

As the new financial year began the love affair with all things capital light and growing showed no sign of abating. IDP Education announced the acquisition of the Indian IELTS business (International English Language Testing System) of the British Council for \$240m.

This business had a little over \$100m revenue in 2019 and made an operating profit of around \$20m. Whilst it is not necessarily obvious why the vendor would seek to sell the business for less than full value, IDP - as an established and well managed operator - are a logical buyer with available synergies. On announcing the transaction, the IDP share price rose 20%, adding nearly \$1.4bn in additional value in response to a \$240m acquisition. Turning a dollar into six dollars would normally take a lot of years of hard work, investment and adept management. These days it merely takes enthusiastic investors. At more than \$8bn for a business which will have \$700m or so in revenue and earns margins in the 20% vicinity, these multiples make the 50 times attributed to Altium's earnings look pedestrian. We could run through the financial metrics of Xero, Afterpay, REA, Seek, Megaport, Pro Medicus, Resmed and a raft of others with similar results. All were exceptionally strong performers in June. The creed of Gordon Gekko rather than any change in fundamentals seemed the driver, although a raft of updated valuations with slightly lowered near term earnings but wildly more optimistic projections will almost certainly be proffered by those benefiting from the associated elevation in capital raising activity. Ever more market value is being attached to the expectation of growing cashflows into the distant future while businesses with far more of their value in a reasonable time frame remain as popular as an Astra-Zeneca vaccine jab.

On the more mundane, but long-dated cashflow front, Telstra announced the sale of a non-controlling 49% stake in its mobile tower operations to a consortium including the Future Fund for \$2.8bn or 28x EBITDA. As I write, Sydney Airport has announced a proposal from a consortium of infrastructure investors at \$8.25 a share or around 23 times EBITDA in the last non pandemic impacted year (2019). Enduring the pain of abysmal returns on low risk assets is clearly becoming too much for many. We quote EBITDA multiples more because they are more readily available. In every case, they offer an overly flattering and unrealistic view of true available cashflow and actual multiples are higher. The \$30bn price tag for the same airport for which Macquarie paid \$5.6bn in 2002 is a stark illustration of how well highly geared investments in relatively unchanged assets has worked in recent decades. Declining interest rates allowed Sydney Airport to fund virtually all capital expenditure through increased debt, whilst streaming all the cash to equity holders and no tax to the government. Duty-free seems to apply to the shareholder returns as well as the whisky!

Contributors

ALS (o/w, +36.3%) As a business with exceptionally strong market positioning in life sciences, commodities and industrial testing across the globe, we continue to see strong appeal in the scale economies and ongoing volume growth potential of well-managed testing businesses. Under CEO Raj Naran the business has worked hard to address pandemic challenges and produce highly creditable results.

Boral (o/w, +33.9%) Efforts by Seven Group to build a more significant ownership and control position in Boral have been frustrated by company efforts to demonstrate higher levels of unrealised value in the business. The sale of the US building product operations into both a strong US housing market and similarly buoyant asset price environment have gone some way to demonstrating this latent value, however, the road to turning this latent potential into earnings remains unrealised. As is the case for many large public companies, we believe

turning the blowtorch on performance impacted by years of accumulated inefficiency and bloat is entirely warranted.

Iress (o/w, +40.6%) As a reminder of what technology companies often look like when they grow up, Iress has suffered from being a technology business with solid margins and strong cash generation but limited revenue growth. As is the case for so many businesses, when organic growth gets tough, the tough start acquiring. After a lengthy period in which acquisitions have struggled to deliver the revenues and profits which the investment bank pitch books envisaged (you wouldn't read about it!) and valuation made little forward progress, rumours of takeover interest saw valuation rise markedly. While we continue to believe the foundations of the Iress business are extremely solid, we are hoping for a period in which simplification, focus and organic growth take the place of fully priced acquisitions.

Telstra (o/w, +10.6%) Although we are rarely supportive of financial engineering transactions which seek to accelerate the recognition of market value rather than focus on the delivery of profits and true economic value, we understand the motivation behind the transaction and the benefits of creating clearer lines of accountability in a business which is partially through the incredibly challenging process of turning bloated incumbent into an efficient and simplified telecommunications carrier. We believe the business has very strong long-term prospects given a market leading infrastructure position in an essential and strong growth industry. Some relief from a regulator whose time might be better spent on industries not characterised by already competitive prices, high levels of investment, no revenue growth and poor returns would also assist.

Detractors

Incitec Pivot (o/w, -17.9%) Shakespeare's 'A Comedy of Errors' would be an apt title for the Australian chemicals and explosives industry. Snatching defeat from the jaws of victory has become a habit. A competitive environment in which volume has taken precedence over profit in explosives for some years has coincided with plant outages at highly inopportune times. Production issues at the Waggaman ammonia plant are the latest in the list of issues which has seen shareholders endure extremely poor returns for an extended period. Whilst hope that the worst is over has proven unfounded to date, we continue to believe valuations place almost no probability on explosives serving a purpose other than blowing up shareholder returns.

Lend Lease (o/w, -11.3%) Hopes that growth would extend to profits rather than merely the size of the development book and executive salaries have proven unfounded to date. While Lend Lease has a highly appealing long-dated development pipeline, the propensity to turn any profits into further balance sheet investment or large scale engineering projects which deliver great infrastructure assets for the country but large losses for shareholders has driven abysmal share price outcomes. A future which transitions towards making cash from this large pipeline will hopefully offer shareholders a more rewarding experience.

CBA (u/w, +16.0%) An undoubtedly strong franchise and capable management team has seen the valuation of CBA vastly outpace the performance of peers over time. While we

acknowledge the superior execution of the business versus peers, we view the sector as a highly mature industry given its role as an intermediary in Australia's extremely aggressively geared housing market. Potential disruption in some market segments and a commodity product (mortgages) which supports the vast bulk of profit do not sit comfortably with the current valuation.

Outlook/positioning

Churchill purportedly said, "success is going from failure to failure without loss of enthusiasm". The past five or six years in which the price to sales ratio of the equity market has elevated (with a small pandemic induced hiccup) and investors have become increasingly besotted by companies able to paint a picture of ongoing growth into the distant future can only be described a period of moving from failure to failure for investors averse to exorbitant earnings and cashflow multiples. We are in this category, and attempting not to lose enthusiasm is tough. Whilst history would suggest a pandemic (like wars) would be the sort of event likely to drive reversion in multiples and shift wealth away from those with cavalier attitudes towards risk and financial leverage, the reverse has been true. Nothing in our knowledge of valuation suggests there is a sensible payoff in buying businesses at the sort of multiples described above. This has not stopped billions in market valuation being created as imagined cashflows in the distant future are incorporated into today's prices as though they are virtually certain.

Whilst the contrarian approach of Glencore in standing against the tide on out-of-favour assets at extremely low multiples may not be for everyone, it serves to highlight the extreme differences offered if one looks at the prices of businesses based on actual cashflow generation rather than reported market value. While wealth and investment performance become ever more disconnected from underlying business performance, it is increasingly easy to vote with the masses, cloaked in excuses of pursuing 'growth' and 'quality'. If Ben Graham was right and the market eventually needs to do some weighing, the scales are likely to shift vastly.

Martin Conlon

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