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April 2023

Schroder Equity Opportunities Fund – Wholesale Class

Performance overview

The S&P / ASX 300 Accumulation Index rose by 1.85%, while the Schroder Equity Opportunities Fund - Wholesale Class portfolio rose by 1.84% (Post-fee), underperforming by 0.01% (Post-fee) for the month.

At a sector level, the overweight exposures to industrials and communication services were the major contributors. The main detractors from performance were underweight allocations to health care and consumer discretionary.

At a stock level, contributors included underweight allocations to BHP Ltd and Fortescue Metals Group Ltd and an overweight allocation to Boral Ltd. Offsetting some of the performance were the Fund's overweight allocations to United Malt Group Ltd and Ramsay Healthcare Ltd and an underweight allocation to CSL Ltd.

Market Summary

No Rules Rules

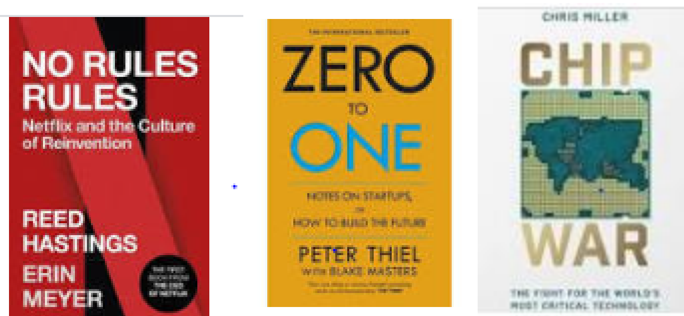
Rules attempt to create order where there is chaos. The line between too few and too many is grey. Most companies progressively become an ever larger spaghetti of policies and processes designed to create order. The downside of too many rules, policies and processes is observable everywhere. At the extreme you might find government or the tax legislation. You might also find committees far too large to make decisions, unworkable bureaucracies adding hugely to cost while preventing progress and accomplishing nothing, or a set of laws/rules designed to achieve a simple outcome (collecting money for governments to redistribute) which has become absolutely unfit for purpose. The solution seem obvious; simplify. Easier said than done.

Different businesses need different rules. One does not need to be a rocket scientist to understand a start-up technology company does not need the same control over processes as a complex chemical or steel plant. Giving employees free reign to innovate at a chemical plant may well end up in an environmental clean-up. Ascertaining where strict rules and processes are needed and where they are stifling innovation and impeding progress and profits is subjective. The lessons of successful businesses and leaders always seem a reasonable place to start. Peter Thiel's 'Zero to One' on creating PayPal and 'No Rules Rules', the story of the Netflix experience by Reed Hastings and Erin Meyer are a couple of my favourites. Thiel succinctly defines technology as a new and better way of doing things.

It is not limited to computers. Challenging incumbents, starting small (the eBay 'power sellers' were the silver bullet for PayPal) and thinking about business from first principles rather than formulas applies to any business. Hastings highlights the success Netflix achieved in emphasising people, context and judgement over process and control. Eschewing a 200-page employee handbook for a policy which says "do the right thing" isn't for everyone, however while Netflix thrived, Blockbuster (its primary competitor at launch) no longer exists. The Netflix culture and approach highlight the effort needed to avoid falling into the trap of rapidly adding rules and bureaucracy in response to every negative experience. Every company wants to grow and the tendency for companies to quickly fall into the trap of governments is powerful; endlessly adding rules, policies, employees and systems without directing equivalent effort to removing unnecessary rules and simplifying, is the path to becoming Blockbuster. Rules should be kept to a minimum and simplicity is a huge asset. We spend our days engaging with, observing and analysing a wide array of companies. From

our perspective, far too many are behaving more like Blockbuster than Netflix; pushing price rather than improving efficiency and adding complexity rather than simplifying, acquiring rather than growing organically.

'Chip War', Chris Miller's book on the story of the semiconductor industry, highlights what humans can achieve when traditional rules are thrown out the window. Whilst alarming in highlighting the dependence of the world on a small number of chip fabricators, the challenges which the industry has overcome in order to make Moore's Law come to life are astonishing. Harnessing extreme UV light was a particular favourite of mine. When it comes to taking "zero to one" in Peter Thiel parlance, bombarding tin with high powered lasers to produce the extreme UV light which allows lithography at sufficiently small scale to print billions of transistors on a chip; that's innovation! As Thiel proposes, this contrasts starkly with the biotechnology sector and the facetiously named Eroom's Law (Moore's Law backwards) where drug discovery is becoming slower and more expensive over time despite technology improvements. Examples of stifling improvement with undue rules and bureaucracy are everywhere.



The 'Rules' of Valuation

Economics and finance employees love to be perceived through a scientific lens. Formulas and equations add street cred. Unfortunately, companies are a complex blend of history, assets, employees, incentives and behaviours. Analysing and valuing companies is not just about observing whether a company has a nice chart of growing earnings for the past five years and a high ROE. If I read another article about the 'rules we use to identify high-quality companies', I'm going to puke. Earnings, cashflow and return on capital are the accounting identities which seek to measure the outcomes of companies in delivering value to their customers (revenue) and keeping a share of that value for shareholders (operating profit). They do not measure the 'how'. The vast differences in positioning of companies in their lifecycle, how they've developed (e.g. growing organically or via a myriad of acquisitions), whether assets or people are the drivers of profitability and the positioning on the spectrum between intensely competitive and monopoly are among the numerous reasons as to why valuing a business cannot be easily condensed into rules and formulas. Investors are buying the future. History, particularly just in numbers without context, will be a rough guide at best. In drawing the rough picture of how much money a company will earn in the future and how long it will last, we believe the answer is more likely to be found in first principles than in the capital asset pricing model.

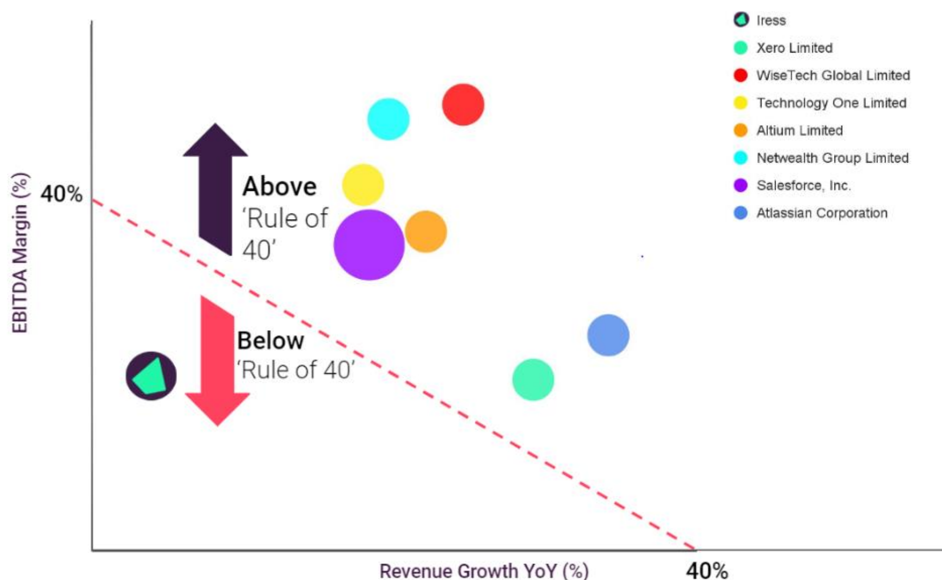
As understanding business from first principles gives way to finding patterns in proliferating data sources, it is unsurprising investors are seeking heuristics to aid decisions. The Iress Investor Day included an interesting example. The 'Rule of 40'[1] (I'd suggest more of a heuristic than a rule), indicates the propensity of investors to attribute greater value to businesses with an appealing combination of either high revenue growth or high margins. The ugly portion below this line sees business valuation revert towards metrics applied to traditional companies, and no-one wants to be there! While not criticising Iress at all for seeking to improve efficiency and performance in the business and rejuvenate growth in its traditional areas of

[1] The Rule of 40 states that, at scale, a SAAS company's revenue growth rate plus free cash flow rate should be equal to or greater than 40%.

strength, the areas of poor performance and simplification are the acquisitions and growth initiatives of years gone by. Avoiding the acquisitions, restructuring costs, write-downs and redundancies may prove a better route to growing durable value than advising equity investors how they might use the 'Rule of 40' to drive the share price higher.

Interestingly, April also saw Link Group announce they had sold their Fund Solutions business and reached a settlement with the Financial Conduct Authority in the UK. Again, the sum total of the Group's foray into the UK was the loss of a large amount of money. The hard work to simplify should be applauded. The lesson should be to avoid repeating the steps which led to it. The UK has not been a happy hunting ground for Australian companies. The pain and cost of simplification is often considerable. Years of watching companies and investors cheer on overpriced acquisitions only to watch disasters gradually unfold is torturous. To labour the hunting analogy, companies love to believe they are skilled and disciplined hunters. They are usually the ducks.

'Rule of 40'[1]: benchmark for leading software companies



1'Rule of 40' proxy being the sum of Revenue Growth + EBITDA Margin %
Source: Iress. For illustrative purposes only and not an investment recommendation.

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Investors reward SaaS companies that are at or above the Rule of 40 with consistently higher valuation multiples.

Median enterprise value/revenue multiples for B2B software-as-a-service (SaaS) companies, by Rule of 40 performance[1]

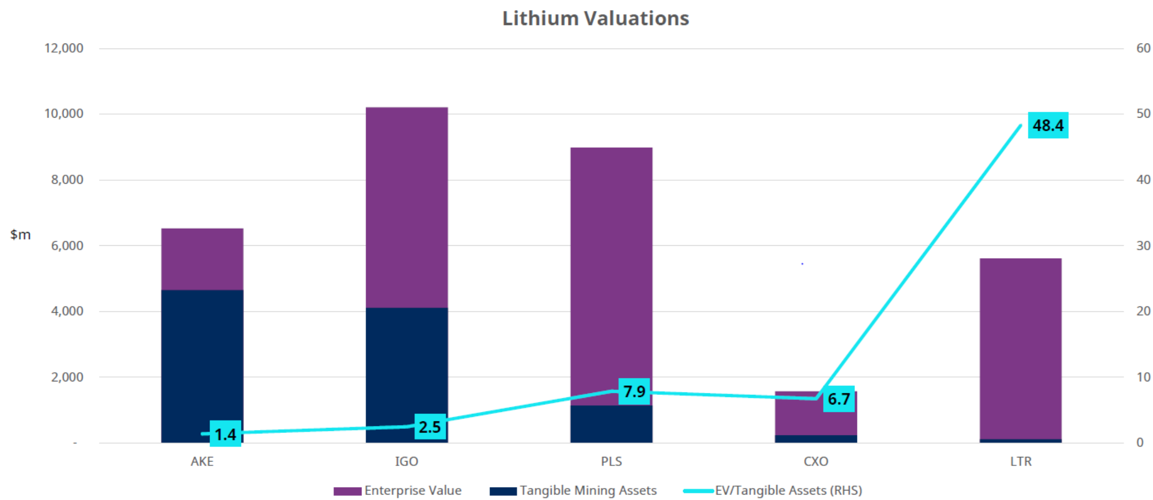
Note: data as of May 28, 2021; n = 100.
[1]Performance quartiles are based on companies' Rule of 40 scores (growth rate + free cash flow rate).

McKinsey
& Company

If it looks like a duck

Illustrating the difficulty of applying seemingly simple valuation rules and the need for understanding, the lithium sector is an interesting case in point. As a yardstick for asset intensive businesses in which asset quality and tangible invested capital drive value, ratios such as price to book and Tobin's Q (replacement value of assets) have historically provided some useful heuristics. In commodity businesses, tangible assets rather than competitive advantage through network economics or technology advantage are the primary driver of return. When one can't extract much value through pricing, given competitors are all selling largely identical products, advantage can only stem from cost (resource quality and operating efficiency) and capital efficiency.

Through this lens, one might question the wisdom of Albemarle offering $5.5bn+ for Liontown Resources. The most recent accounts showed tangible asset value of some $100m. While this will grow as the mine infrastructure is completed (to $800m or so after the cost escalation which has plagued most projects), Albemarle will be left with an investment of more than $6bn (the cost of acquiring the business and completing the mine). For Albemarle to earn a 10% return on its $6bn investment, the return on the $800m of tangible book needs to be 75% and it needs to stay at these levels for a long time. While a lengthy period of elevated lithium prices to facilitate these exceptional returns is possible, the purchase looks an extremely optimistic bet on both commodity prices and benign royalties and taxation from our perspective. Comparing valuations across the sector is problematic. Asset bases complicated by geographic diversity and historic takeover activity in the case of Allkem, a joint venture contributing much of the value in the case of IGO and an asset just beginning production in the case of Core Lithium, complicates a seemingly simple comparison. Pilbara Minerals has undoubtedly hit the ball out of the park, having earned vastly more than the entire construction cost of the asset in the last year, however, business value again bears no resemblance to asset value. Valuations in almost all cases have left both asset value and replacement cost in the dust. The list of great mining deals being done at large multiples of book value in the mining industry is short.



Source: Schroders, Annual and half-yearly reports from Allkem, Independence Group, Pilbara Minerals, Core Lithium, Liontown Resources. For illustrative purposes only and not an investment recommendation. Past performance is not a reliable indicator of future performance.

One good rule

Having spent the rest of this note explaining the dangers of a thick rule book and spurious rules, I'm going to have to admit there is one that's proved pretty reliable. When the Japanese bid for your company there is only one appropriate response; 'Yes'. Blackmores was the fortunate recipient of a $95-a-share bid from Kirin. Taking nothing away from the often successful history of Blackmores (e.g. cleverly creating price premium and brand value through simple initiatives such as glass bottles), the commoditisation of vitamins and exercising of power by retailers means one needs an extremely optimistic view of the future to suggest the price is not a full one. Artificially suppressed interest rates and a ravenous desire for offshore earnings has always created headaches in understanding the Japanese lens on valuation. This does not appear an exception.

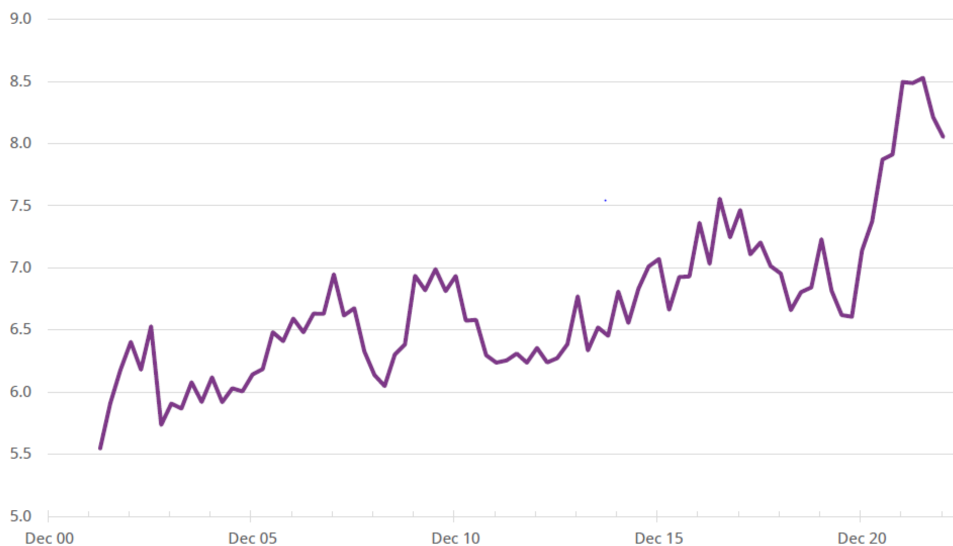
Why do you rob banks?

When asked why he robbed banks, Willie Sutton, the infamous US bank robber replied "because that's where the money is". One issue which continues to exercise our minds is that of attempting to determine which pools of profit the government will choose to raid in plugging the impending holes in taxation versus spending. While hoping for simplification and a quest for excellence in our equity investments, we cannot profess any such optimism when it comes to government. Monopoly power means squeezing others will almost always prevail over internal improvement. Highly lucrative (and arguably unjustified) profit pools such as those accruing to lithium companies at present, raises obvious questions on future vulnerability and remains a reason we are more cautious than some in extrapolating very high levels of profitability, particularly when returns are not stemming from competitive excellence. Pinpointing areas of vulnerability is tricky, but seems to us sensible. Assuming the status quo prevails indefinitely is easy but seems to us unwise.

Outlook

Bad behaviour

As Peter Thiel and Reed Hastings highlight, creating and sustaining excellence is tough. Adding bloat, bureaucracy and cost is easy. Though remaining extremely optimistic on Australia's positioning in the world and on the future of companies delivering great products and services efficiently, we similarly struggle to look past the failure to address some fundamental weaknesses. Housing remains the primary one. Mistaking financially-engineered illusory growth for progress is damaging and the chart below highlights the damage which has been wrought on the economy through bad lending behaviour. Accelerating migration creates the same illusion of progress and will obviously exacerbate the problem and risks extending inflationary pressures. As I write, the RBA has unexpectedly raised interest rates to combat these pressures. If governments fail to remove artificial pressures created by allowing non-resident purchases, negative gearing and capital gains tax discounts, the blunt and vastly more unfair tool of interest rates will need to do the work. There is little doubt investors should be prepared for stormier weather as behaviour and expectations connected to the housing market necessarily change and the path to more productive investment is embraced.



Source: ABS, Datastream

We retain a strong preference for enduring value built on either solid assets or businesses offering fair value propositions between customers and shareholders. While exceptionally high margins and returns can signify well run businesses with strong market positions, they can also signify artificially protected businesses or those who've pushed price too far. Rules will never be a substitute for thought.

Martin Conlon

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