

Data and facts are nothing without thought and insight

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As the world adapts to an environment where rates fall and valuations climb, it would be wise to look beyond the data for investors to form their own views on the potential for long-term returns. A business can only have value if it generates returns to investors – everything else is only noise.

It's hard not to feel a little like Guy Montag in Ray Bradbury's *Fahrenheit 451* at present. The world has a decidedly dystopian tinge as negative interest rates and subtle moves towards banning cash (which are probably necessary to sustain negative interest rates) sit alongside rampant speculation in growth and momentum segments of equity markets, increasing protectionism and a high gold price. Extremes remain the order of the day.

Despite things feeling decidedly wrong, most seem happy to remain mired in micro-level data while attempting to justify remaining invested in the businesses and assets that have delivered the warm glow of strong recent performance. Heretically, we feel like much of the 'data and facts' that are feeding behaviour in equity markets – and are increasingly the holy grail for every company in 'knowing more about their customers' – are a poor substitute for thought. As Captain Beatty says to Montag, "chock them so damned full of 'facts' they feel stuffed, but absolutely 'brilliant' with information. Then they'll feel they're thinking, they'll get a *sense* of motion without moving". Listed equity markets are moving a great deal and central banks have plenty of data; whether there is information in the movement or thought in the action, is more debatable.

Value is logical

Valuation is at least as much art as science; however, what hopefully shouldn't be debatable is that a business can only logically have value if it generates cash to give back to shareholders over time. All we are assessing in attempting to value a business is when and how much cash goes in, and when and how much cash comes back. As interest rates have fallen and investors have coalesced around this being a durable state of affairs, long duration assets have been understandably sought and very long duration bonds have delivered exceptional returns. In an equity market context, duration is a more nebulous concept. Whether we believe the path and quantum of Rio Tinto's earnings in 2030 is more or less predictable than that of CSL or Wisetech Global is not something we can prove, albeit we can do our best to both think through the issues and support with data and historic context.

What's observable is that multiples for some businesses – for example healthcare, infrastructure, real estate and technology – have risen sharply while others have not. Multiples of 30, 40 or 100, as are increasingly commonplace, requiring both high levels of growth and

long duration to provide reasonable returns to shareholders. This confidence in the distant future sits somewhat uncomfortably with a world increasingly challenged by extremes. It is also obvious that as multiples move higher (discount rates lower), capital gains wildly overshadow dividend yield as a source of return. Adjusting some long-dated assumptions in a valuation could be construed as a justifiable reaction to some new data or, as is more commonly our view, back solving a valuation to justify a share price. It does not take a rocket scientist to determine that a further \$1.6bn being added to the market value of Wisetech Global in August cannot be justified by revenue or earnings, which might be \$2m or \$3m better than anticipated (that's worth \$2m or \$3m). It stems from using a slightly higher base from which to extrapolate and manipulating growth rates into the distant future. Why the earnings data point gave rise to far greater confidence on the quantum and durability of the business into the distant future is a perplexing question. As biased observers increasingly questioning the who and the how of determining listed market valuations, we are not sure much of it arose from deep thought. It's a 'beat', as our US peers would say.

Searching for 'earnings surprises'

One simple rule by which we attempt to abide is to ask ourselves the question: If the business we are buying were delisted tomorrow, would we be happy to hold it for its future dividend stream? This does not mean pretending it isn't volatile and periodically revaluing it to a desired higher value; it means accepting that the cash returned as dividends is the only return on investment. If the answer is no, we are hoping for a greater fool.

The popularity of 'greater fool' investing is enhanced while capital gains continue to dwarf dividends as a source of short-term returns. 'Pro-forma EBITDA', management adjustments and capitalised costs have become the norm as companies seek to deliver the 'earnings surprise' which momentum and quantitative investors and the 'artificial intelligence' which often drives them, crave. We think we can claim with some confidence that the \$3.5bn or so in market value added in Nanosonics (+21.1%), Pro Medicus (+45.1%), Afterpay (+15.9%) and Wisetech (+15.6%) was not driven by undue focus on prevailing dividend yields (ranging between 0% and 0.3%).

Results season also reinforced one of our passionately held views: there are few more reliable paths to wholesale destruction of value than significant merger and acquisition activity. The successful ones are dominantly a result of using acquisitions to stymie competition, and the other 85% go wrong somewhere between the acquisition price, control premia for businesses that end up owned by groups of minority shareholders anyway, and spurious synergies. The tiny number of good ones (e.g. Aventis Behring by CSL) continue to justify searching the haystack for needles. SpeedCast (-58.9%), Worley Parsons (-23.0%), Corporate Travel (-24.8%), Boral (-15.0%), Mayne Pharma (-16.0%) and Clydesdale Bank (-17.7%) are at various phases along the path towards shareholders realising they found hay.

When mergers cause pain

While learnings from painful past experiences have allowed us to avoid much of the pain inflicted by the above, Clydesdale has caused much pain for us, and our clients. Despite a less-than-egregious purchase price, competition in the UK banking market has quickly revealed the mediocrity of the Virgin Money business, compounded by provisions for mis-selling in the core business. It is also highlighting the challenges for banking in a world of excessive debt, ultra-low/negative interest rate and increasing government intervention. Given the role of the

banking system is to collect short-term deposits and convert them into longer term loans, we are thinking hard about how and why depositors provide funds to borrowers through an intermediary (the bank) and receive no compensation for delaying consumption such that others can bring forward theirs. When there is also no time value of money, defining a bank's value proposition becomes tough. Publicising the merits of banning cash in allowing governments to crack down on the black market economy is fodder for those who don't think too hard about the real reasons. If negative interest rates are a forced tax on those with savings levied to correct past monetary policy errors, banks become tax collectors. Like tax, one should not expect depositors to pay the tax happily. As Kerry Packer highlighted, "as a government I can tell you you're not spending it that well that we should be donating extra".

In many cases, our post-result discussions with companies left us questioning how many companies are successfully identifying the wood for the trees. Buybacks, financial engineering and 'pro-forma' storytelling have in many cases supplanted the objective of running a business well and profitably delivering a product or service that meets customer needs. One of the largest mining companies in the country said they were devoting some time and resource to looking at their equity beta. A cursory look at the history of this business and the sources of value creation would suggest that insufficient attention to their equity beta was unlikely to be in the top 100 items requiring attention. Making reasonable returns in a sustainable manner is fine by us. We won't quibble over 0.5%. Encouragingly, there are also a number (e.g. Woolworths, Lend Lease, Suncorp) attempting to simplify their businesses and focus on doing the basics better. The path is not always smooth. Woolworths are dealing with significantly higher shrinkage (stuff getting flogged for those not up with retail terminology) as self-service checkouts prove more of a headache than imagined. Technology is not one-way traffic and the fact customers like it does not always make it a great business proposition.

In terms of forward-looking opportunities, short-term fluctuations in commodity prices saw businesses such as South 32 (-15.9%), Rio Tinto (-8.4%) and Iluka Resources (-25.7%), all with minimal debt, fall significantly, implying large and permanent diminution in value, as investors again reacted to the earnings momentum dog whistle. In our eyes, many saw no deterioration in longer term prospects, meaning future returns should be significantly enhanced. At the other end, ever higher multiples are accorded the likes of CSL (+4.9%), Sonic Healthcare (+5.0%) and Resmed (+8.7%) as investors (perhaps rightly) assume they will enjoy exorbitant and growing profitability as governments prove ineffective in controlling the escalating demand (which they help stimulate) and buoyant pricing (which often results when the bill is paid by taxpayers rather than the customer).

Outlook

Most economies remain in an uncomfortable feedback loop. To generate growth and productivity gain they need investment in industries that necessarily deliver relatively volatile and uncertain outcomes and operate in competitive markets. The airports, ports, roads and utilities that investors so crave are eventually hostage to investments made by others. Theorists continue to propose ever-lower interest rates to spur investment.

Unfortunately, theory is working in reverse and capital is cramming more aggressively into perceived safe havens such as real estate, bonds and gold rather than rewarding risk taking. Similar issues are pervading equity markets. As investors feed the rising volatility of real businesses in competitive industries into their databases, conformity requires ever more

investment into what has worked well in the past. More technology and health, more perceived safety. None of that listed equity beta for me, thanks. We might even suggest some regulation to ensure any underperforming superannuation funds lose all their money to the better performing funds. Oh wait!

Our curmudgeonly tendencies may make us prone to exaggeration, however, commonsense dictates that a sensibly constructed portfolio, like a sensibly constructed economy, should have exposure to a broad range of businesses which are held accountable for operating performance and focus on being good, rather than extracting some artificial gains from financial engineering or trying to swindle investors with ludicrously optimistic projections of the distant future. This objective is tough to keep paramount when conformity screams technology, disruption and safety.

Those of you who recall the ending to Bradbury's novel will recall Montag around the fire with the outcasts who worshipped knowledge and free thought as the repressive conformists self-destructed. Just sayin'!

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