

# PortfolioConstruction Conference 2008

## A fundamental view of risk in small cap portfolios

August 2008

### Representing Schroders:

David Wanis - Portfolio Manager

David Hallifax - Head of Retail

Schroder Investment Management Australia Limited — ABN 22 000 443 274  
Australian Financial Services Licence 226473  
Level 20 Angel Place, 123 Pitt Street, Sydney NSW 2000



**Schroders**

# Investor risk and return objective

## Traditional Small Companies Portfolio Management

- Primary objective for small company managers is to outperform their benchmark (the S&P / ASX Small Ordinaries Index)
- Risk taken in generating the outperformance is most often measured by tracking error, which is a relative measure of risk that relates the portfolio to the benchmark using a variance co-variance matrix
- Investors seek managers that can deliver returns in excess of the relative risk taken, shown by an information ratio of  $>1$
- Many managers design a proprietary process and dedicate resources to finding excess returns, suggesting a belief that the market for alpha is inefficient
- Few people design a proprietary process or dedicate resources to finding ways to reduce risk, instead using standardised models (Barra etc), suggesting a belief that the market for risk is efficient
- This presentation highlights an opportunity for investors to benefit from increased effort in the reduction of portfolio risk through a more active qualitative approach

<sup>1</sup> Source: Schroders

# Back to first principles

## What are we trying to achieve

	Lower Risk	Same Risk	Higher Risk
Higher Return	Value added on risk and return	Value added on return	No value added
Same Return	Value added on risk	No value added	Value destruction on risk
Lower Return	No value added	Value destruction on return	Value destruction on risk and return

# Diversification

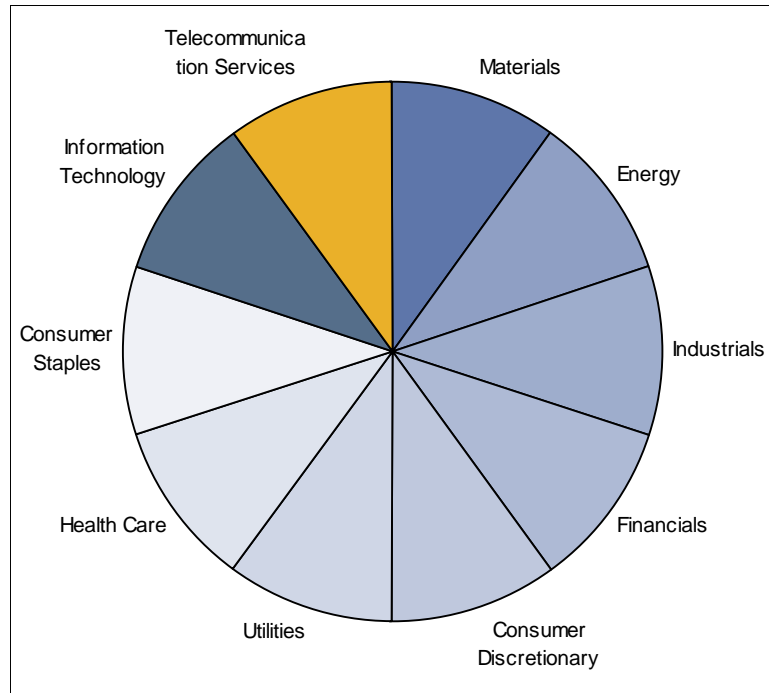
## What if the index is not adequately diversified?

- Diversification is intended to reduce or remove idiosyncratic (security) risk and leave only market risk
- The assumption is that the benchmark is the market and as such the diversification or absolute risk of the market is not a consideration
- Our analysis shows that the characteristics of benchmark diversification can change
- If our objective is to add value through risk relative to the benchmark then an awareness of the change in benchmark riskiness may be worthwhile

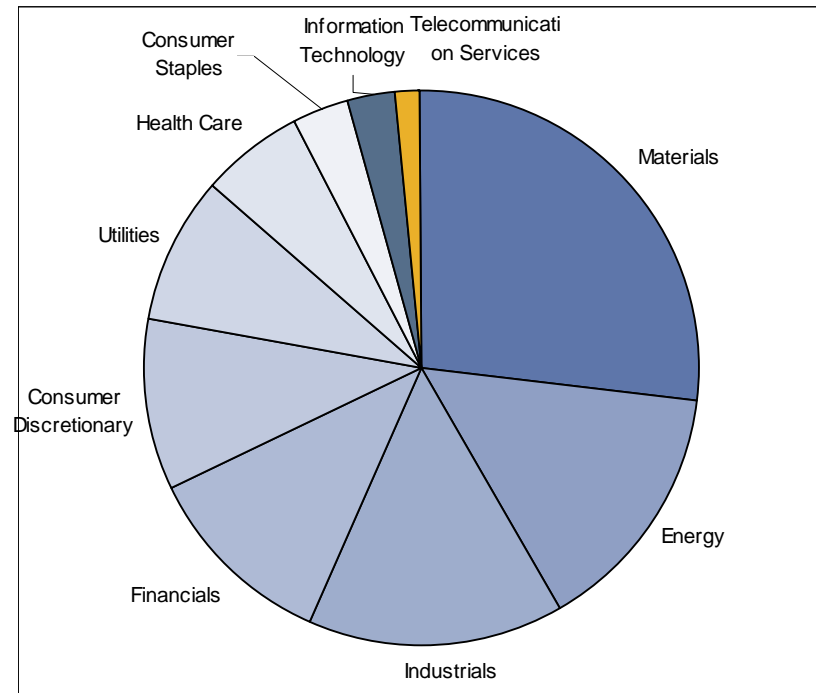
# Absolute diversity can be quantified

## Application of the Herfindahl-Hirschman Index

10 Sectors equally weighted: HHI score of 1,000



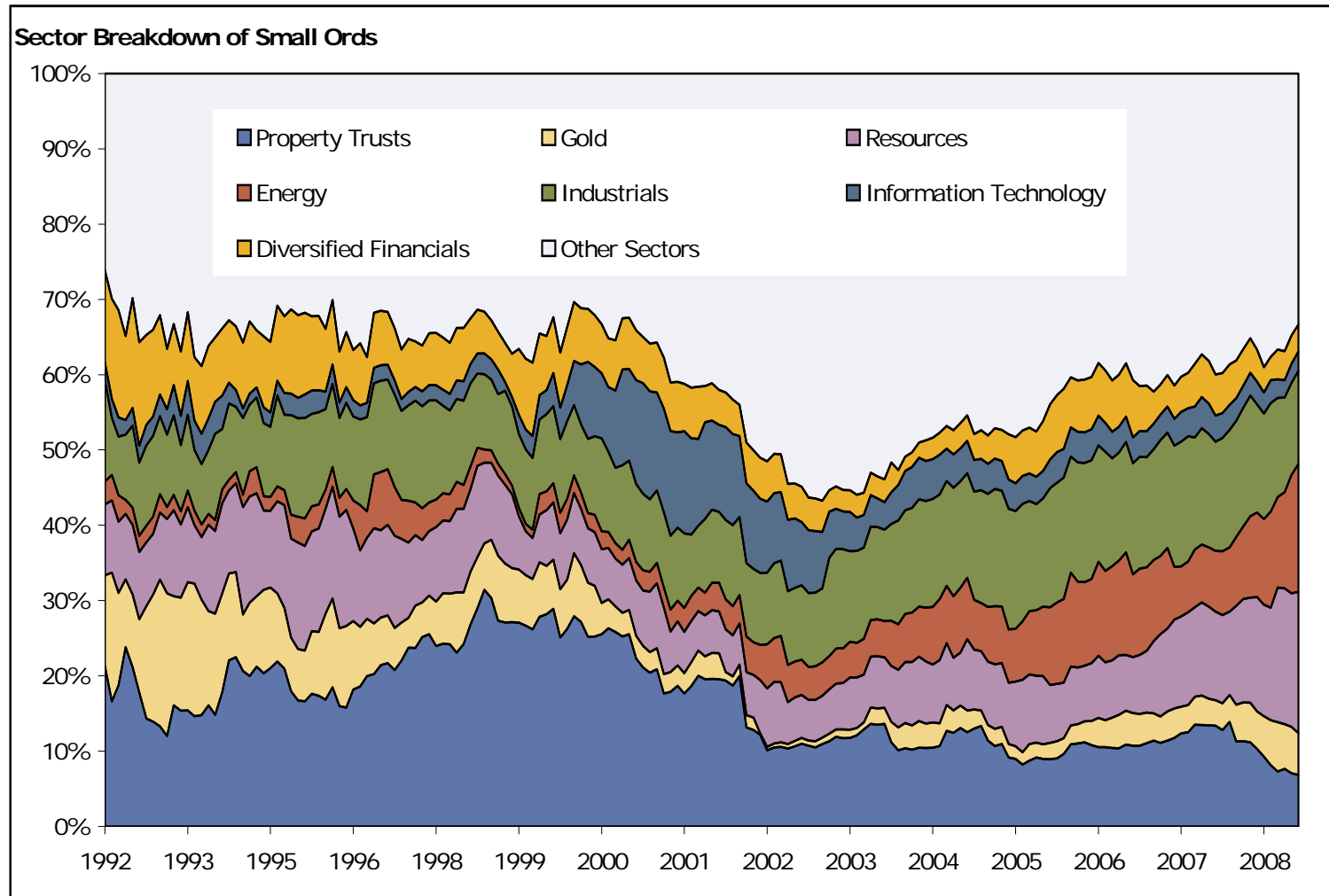
Small Ords Index weights: HHI score of 1,520



4 As at 30 June, 2008. Source: Goldman Sachs JB Were, Schroders

# Sector Weights of Small Ords Index

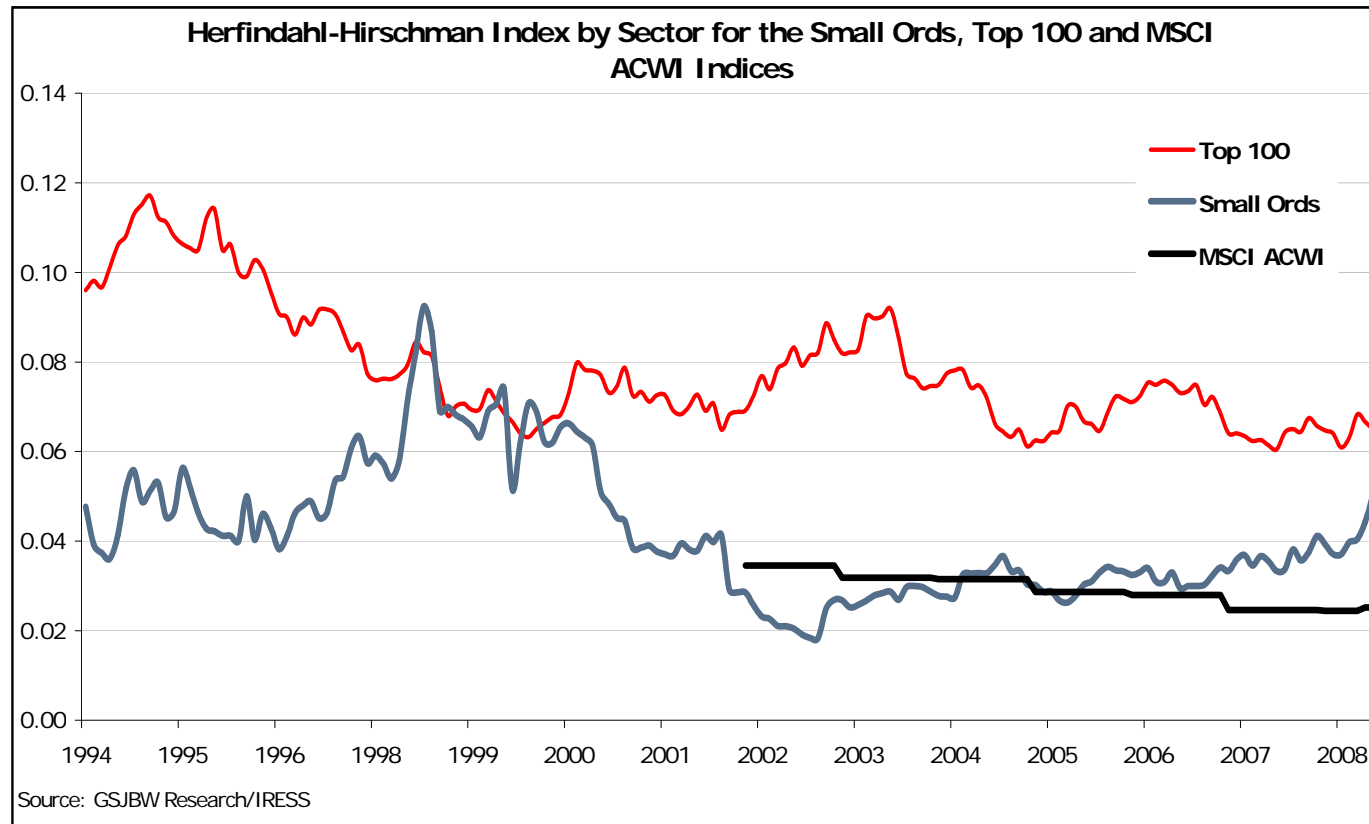
Jul 1992 to Jun 2008



5 Source: Goldman Sachs JB Were, Schroders

# Herfindahl-Hirschman Index as a measure of Concentration

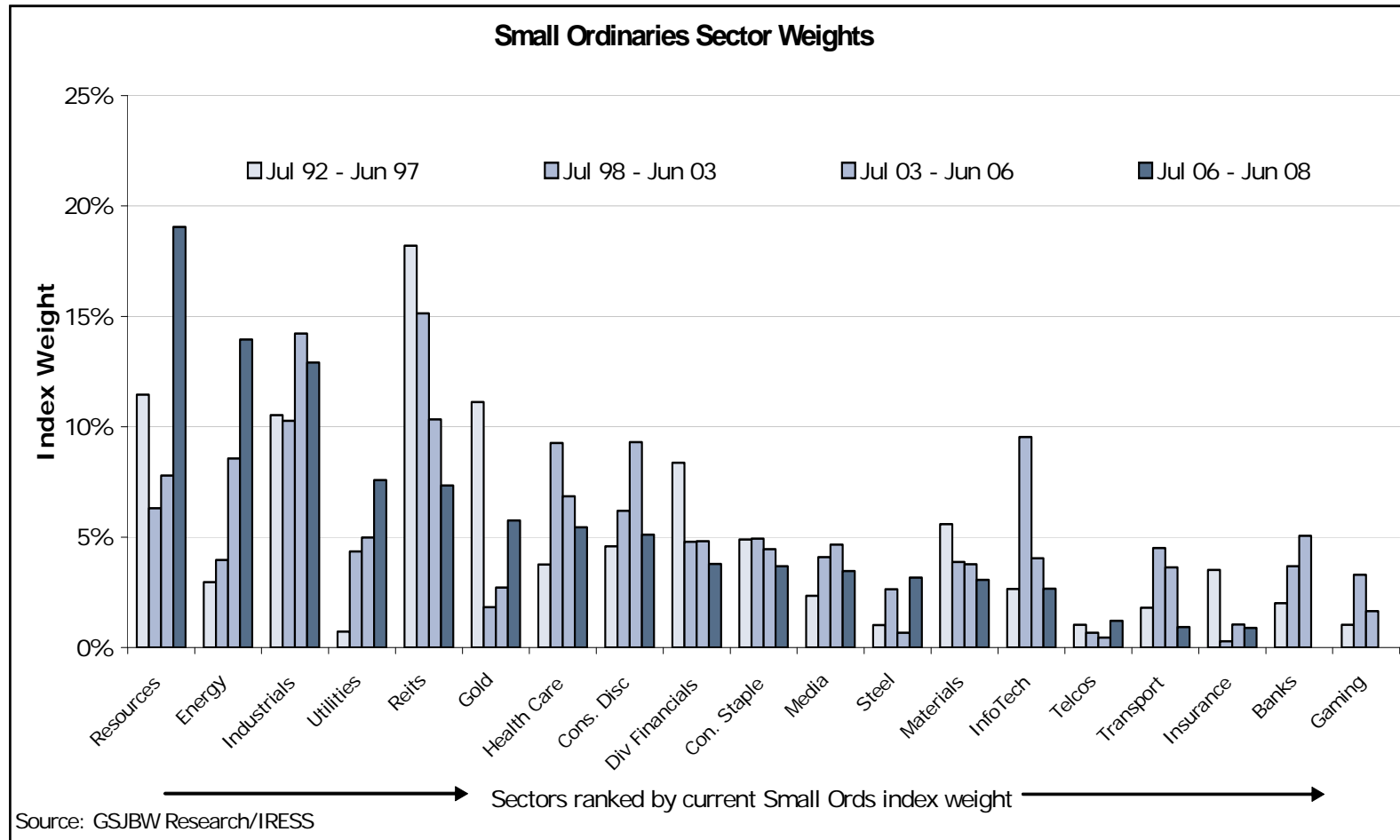
Index concentration is not static



A lower normalised HHI score reflects a less concentrated (more diversified) index

# Another view of Small Ords Sector Weights

Jul 1992 to Jun 2008

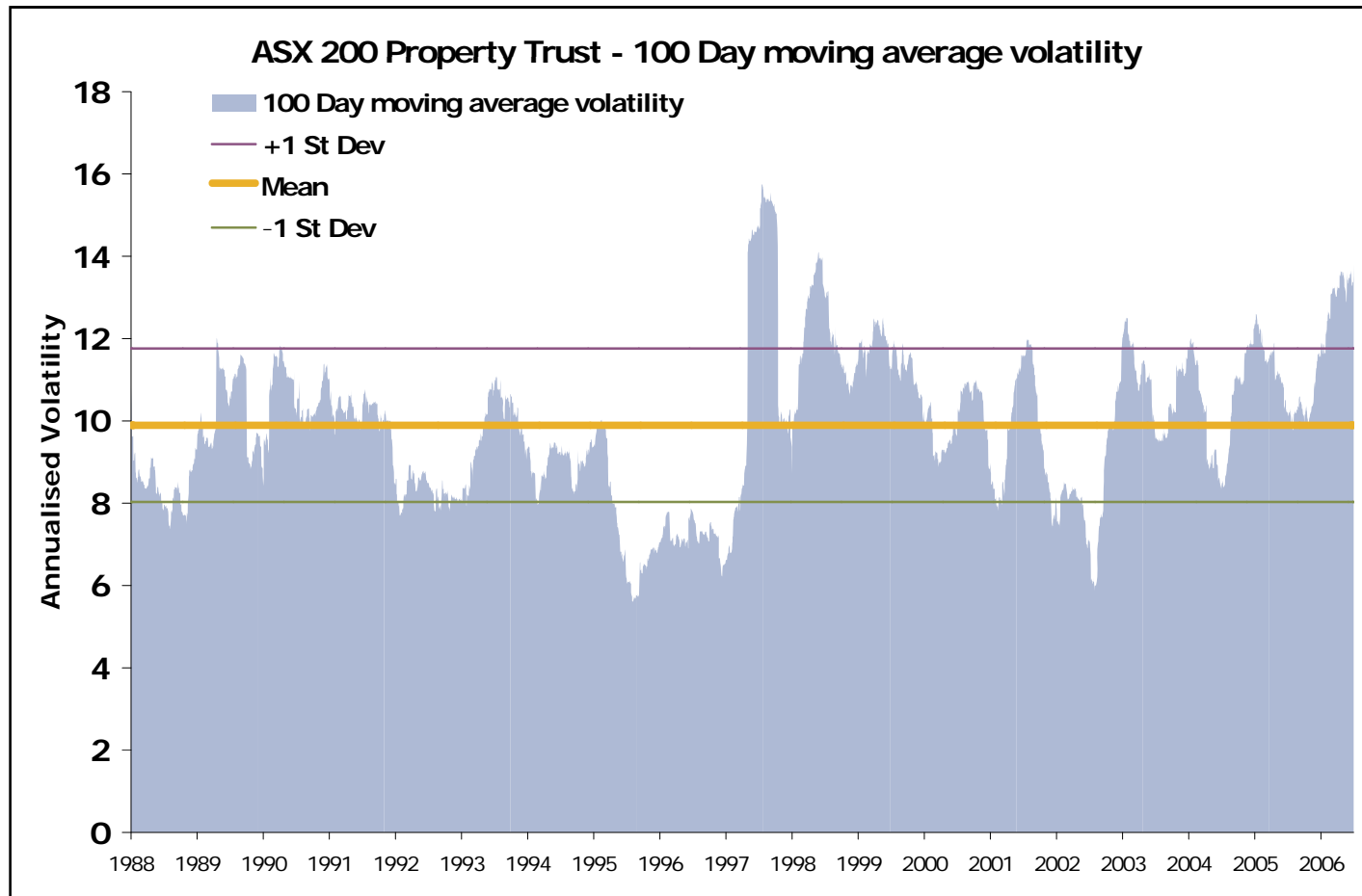


7 Source: Goldman Sachs JB Were, Schroders



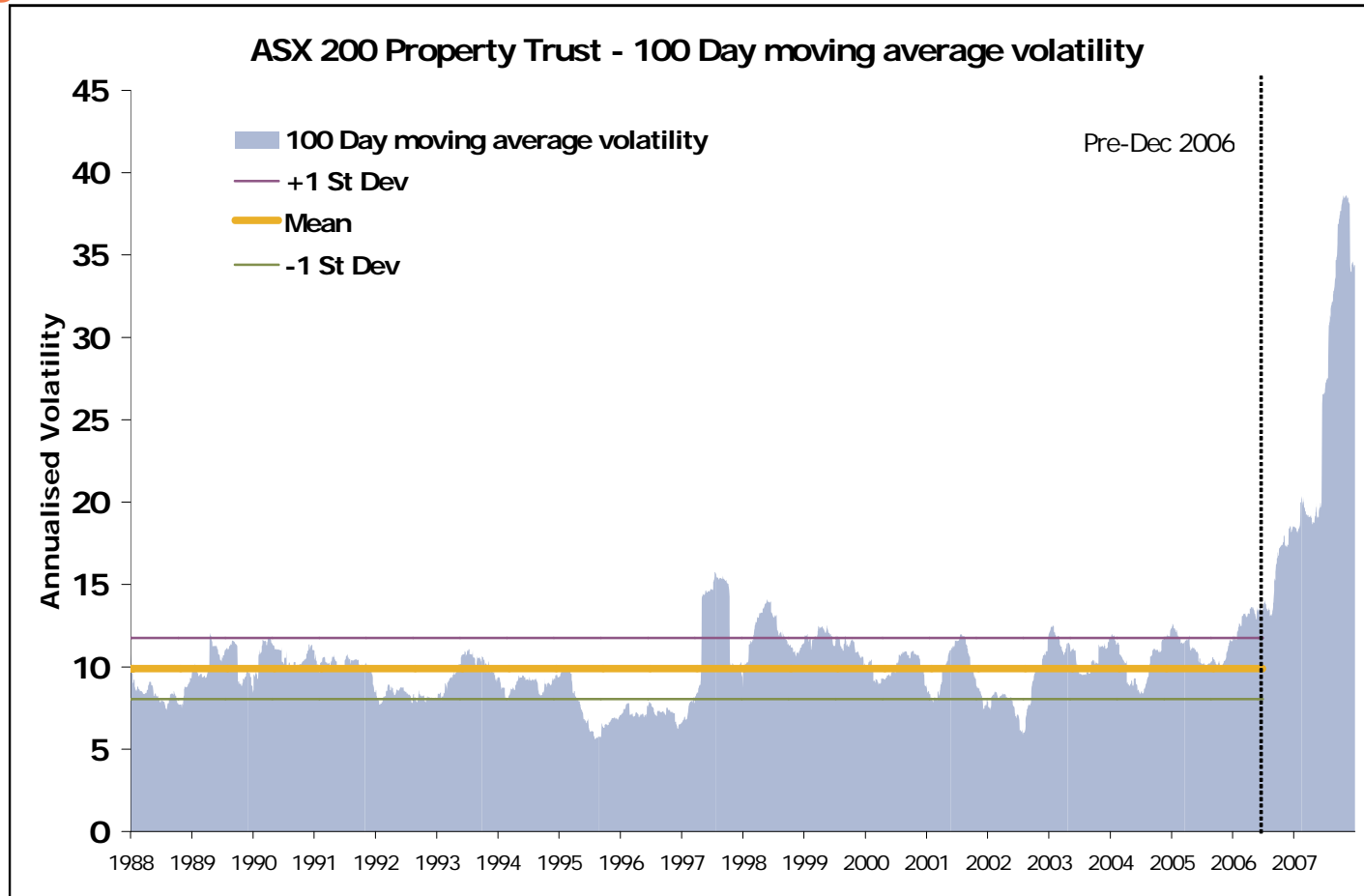
# Volatility of the ASX200 Property Trust Index

## July 1988 to December 2006



# Volatility of the ASX200 Property Trust Index

July 1988 to June 2008 – what a difference 18 months makes



# Matrix of Risk and Return Activities

## Qualitative and Quantitative approaches

Analysis	Return	Risk	Source of Data
<b>Quantitative</b>	Quantitative multi-factor models focusing on: -valuation (p/e, yield, pbv, p/sales etc) and -momentum (share price, EPS revision) factors	Commercial multi-factor risk models focusing on tracking error  Value at Risk (VaR)  Style exposures (value, growth, portfolio p/e etc)	Standardised  Publically available  Non-proprietary
<b>Qualitative</b>	Industry and business quality analysis  Sustainable earnings analysis  Long term value drivers relative to short term earnings drivers  Management assessment	?	Proprietary  Not publically available  User defined

# Qualitative Analysis for Returns

## Areas of focus in the application of fundamental analysis to alpha seeking

- Industry Analysis
- Analysis of firm competitive advantage
- Understanding drivers of company return on invested capital
- Differentiating between current and sustainable levels of profitability and returns
- Details behind key value drivers such as contractual terms, contingent liabilities, off-balance sheet liabilities, hedging policy, sensitivity to changes in primary business drivers, market values vs book values of assets and liabilities, re-statement of accounting earnings to reflect economic earnings
- Assessment of management ability and strategic direction of the firm
- Determining the appropriateness of a given capital structure

# Qualitative Analysis for Risk

## Areas of focus in the application of fundamental analysis to risk avoidance

- Corporate governance
- Transparency
- Quality of earnings
- Financial leverage
- Management capability
- Analyst confidence
- Structural shifts relative to historic experience
- Sources and magnitude of fundamental factor risk

# Compare the pair

The risk between these two stocks is significant

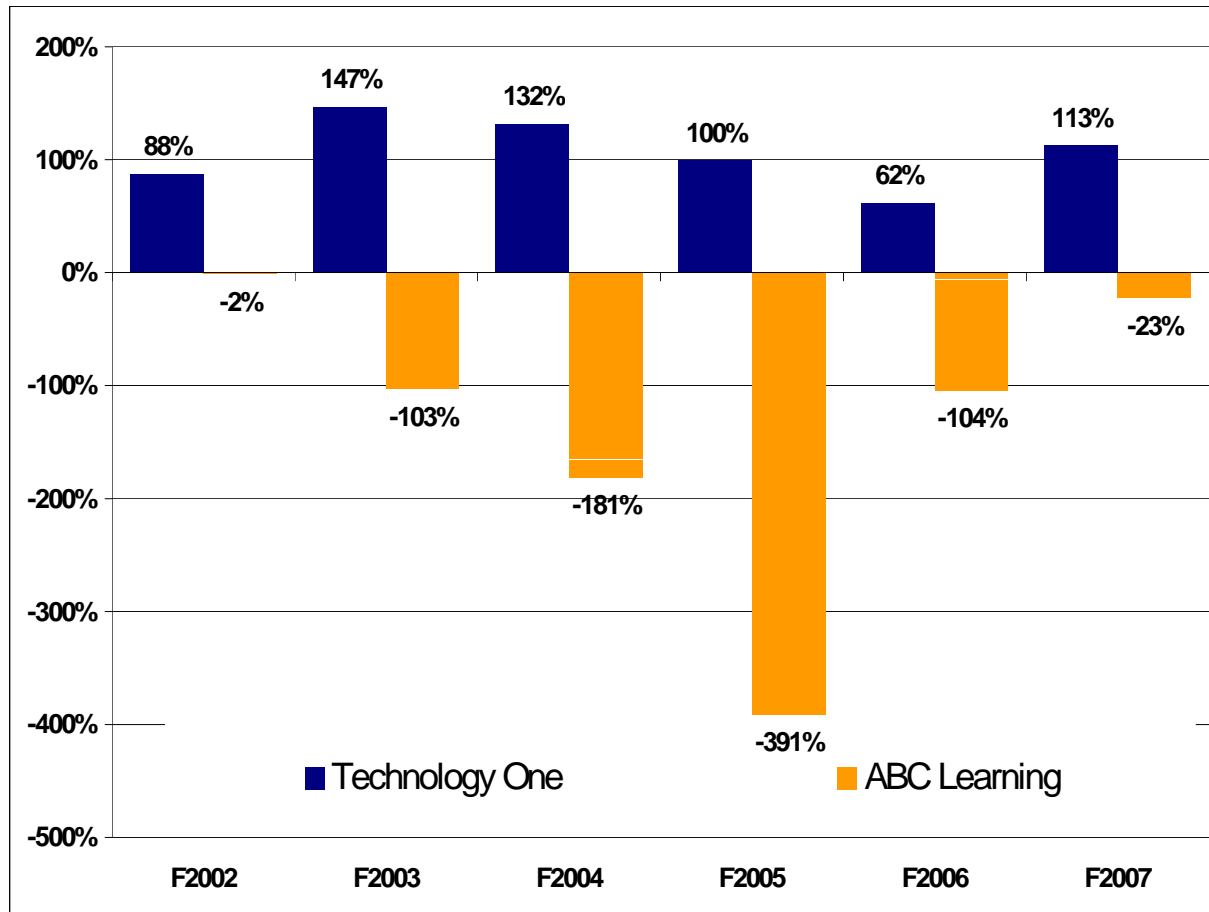
Factor	Stock A	Stock B
<b>Corporate Governance</b>	Many related party transactions  Mgt incentives not aligned with shareholders	No related party transactions  Mgt incentives aligned with shareholders
<b>Transparency</b>	Poor transparency into the business and / or poor accounting disclosure and reporting of activities	Clarity on how the business generates returns and adequate accounting disclosure of all activities
<b>Financial Leverage</b>	High financial leverage, either on balance sheet or through operating leases, off balance sheet vehicles, derivatives etc	Low to modest levels of financial leverage or net cash balance sheet
<b>Quality of Earnings</b>	Significant difference between accrual profits and reported cash flows which are difficult to reconcile or explain	Small difference between accrual profits and reported cash flows which can be readily identified and explained
<b>Management Capability</b>	Difficult to objectively identify how management have added value	Management that have added value by reference to clearly visible KPIs
<b>Analyst Confidence</b>	Analyst has low confidence in the investment merit	Analyst has high confidence in the investment merit
<b>Stock Examples</b>	ABC Learning, MFS Limited, Allco Finance Group	Blackmores, Technology One, IRESS Market Technology

13 Source: Schroders

This is illustrative only and does not represent Schroders recommendation on these stocks

# ABC Learning Centres (ABS.AX) vs Technology One (TNE.AX)

## Quality of Earnings – Conversion of reported NPAT to free cash flow



Note Free cash flow is defined as operating cash flow less capex and excludes investing cash flow identified as relating to acquisitions or "other". Including non-capex investing cash flow would have no difference to TNE but would materially adversely effect ABS

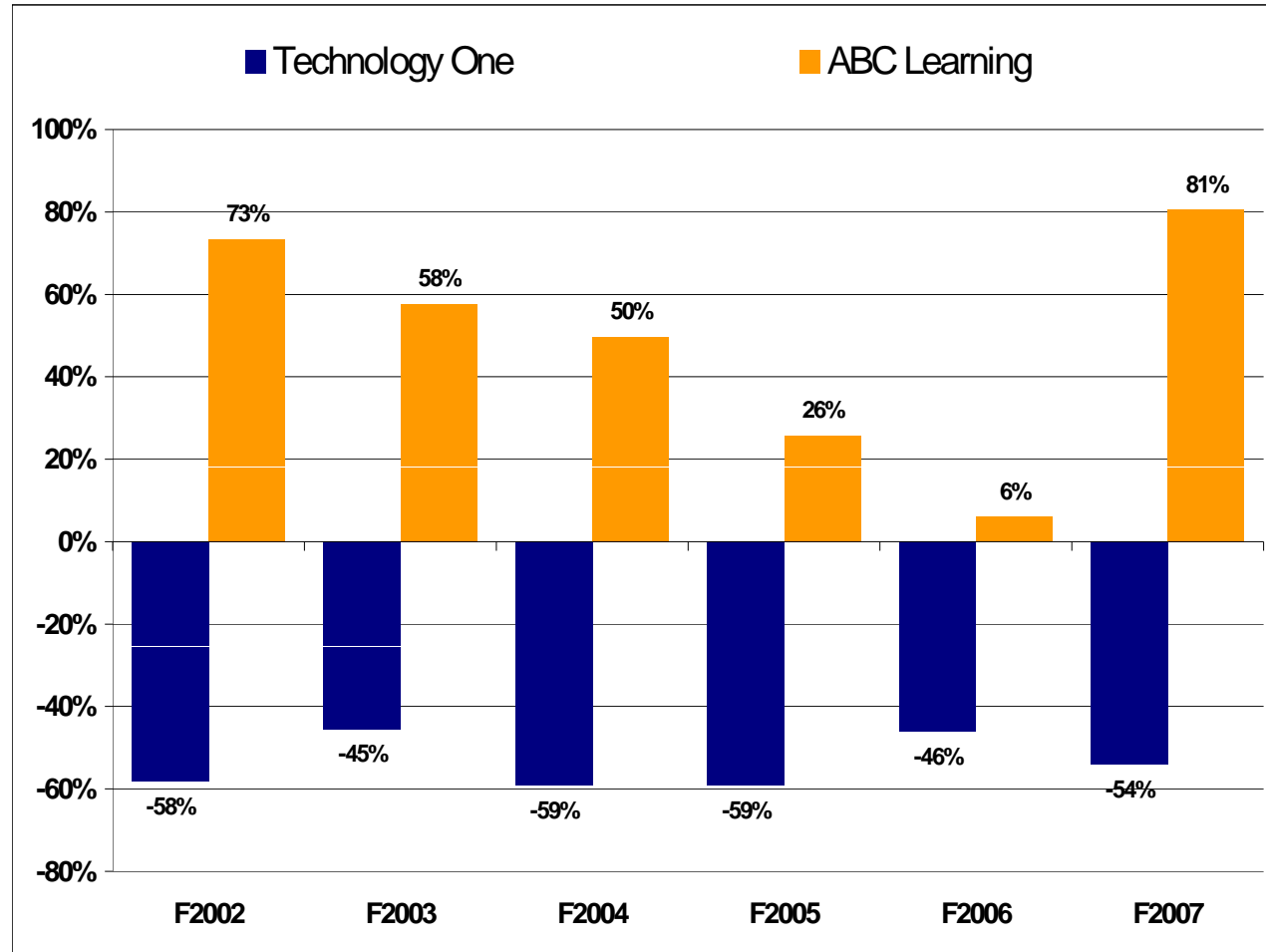
Source: ABS Learning, Technology One, Schroders

14 This is illustrative only and does not represent Schroders recommendation on these stocks



# ABC Learning Centres (ABS.AX) vs Technology One (TNE.AX)

## Financial Leverage – Net Debt (Cash) to Equity



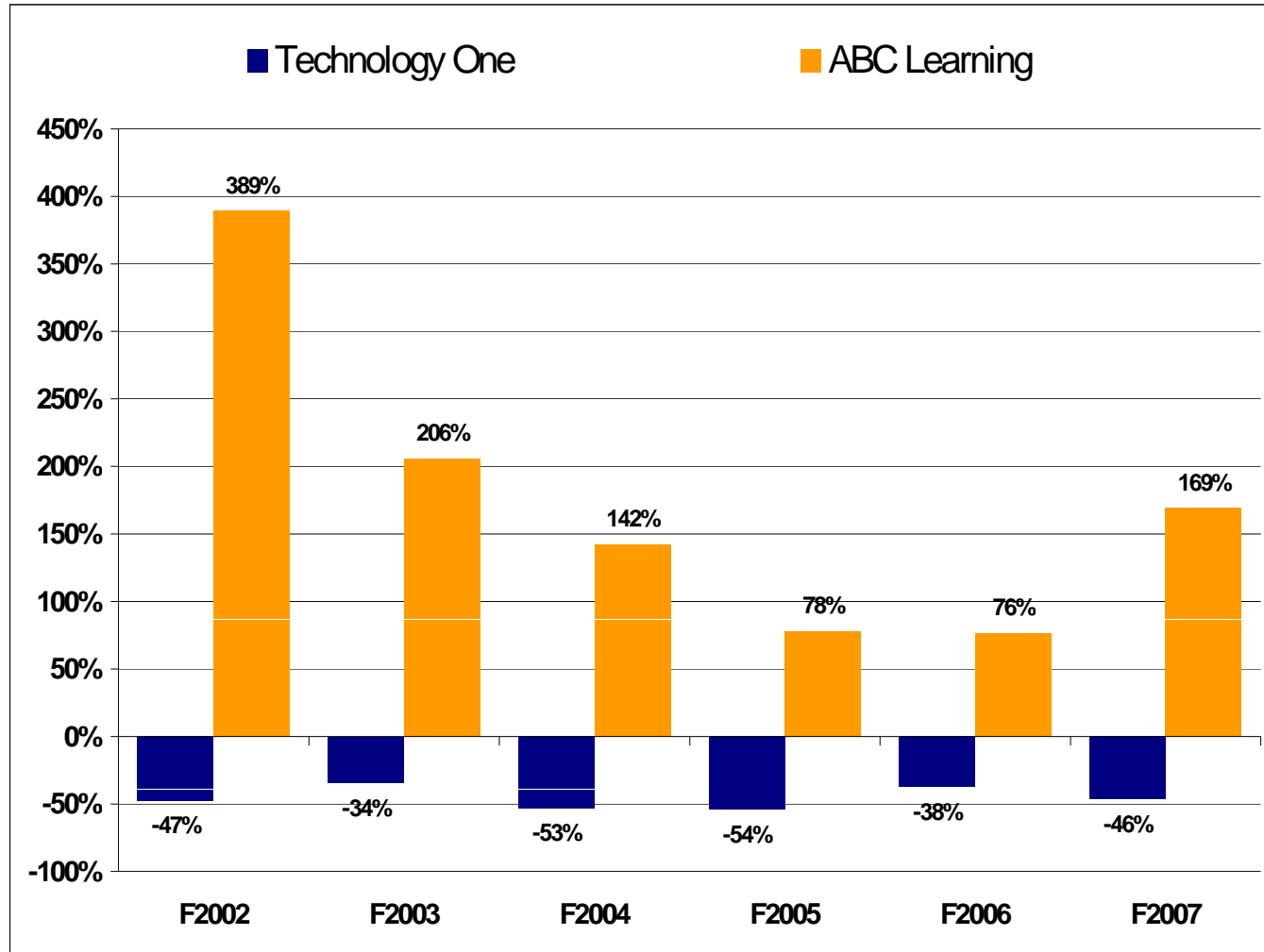
Source: ABS Learning, Technology One, Schroders

15 This is illustrative only and does not represent Schroders recommendation on these stocks



# ABC Learning Centres (ABS.AX) vs Technology One (TNE.AX)

## Financial Leverage – Net Debt (Cash) plus operating leases to Equity



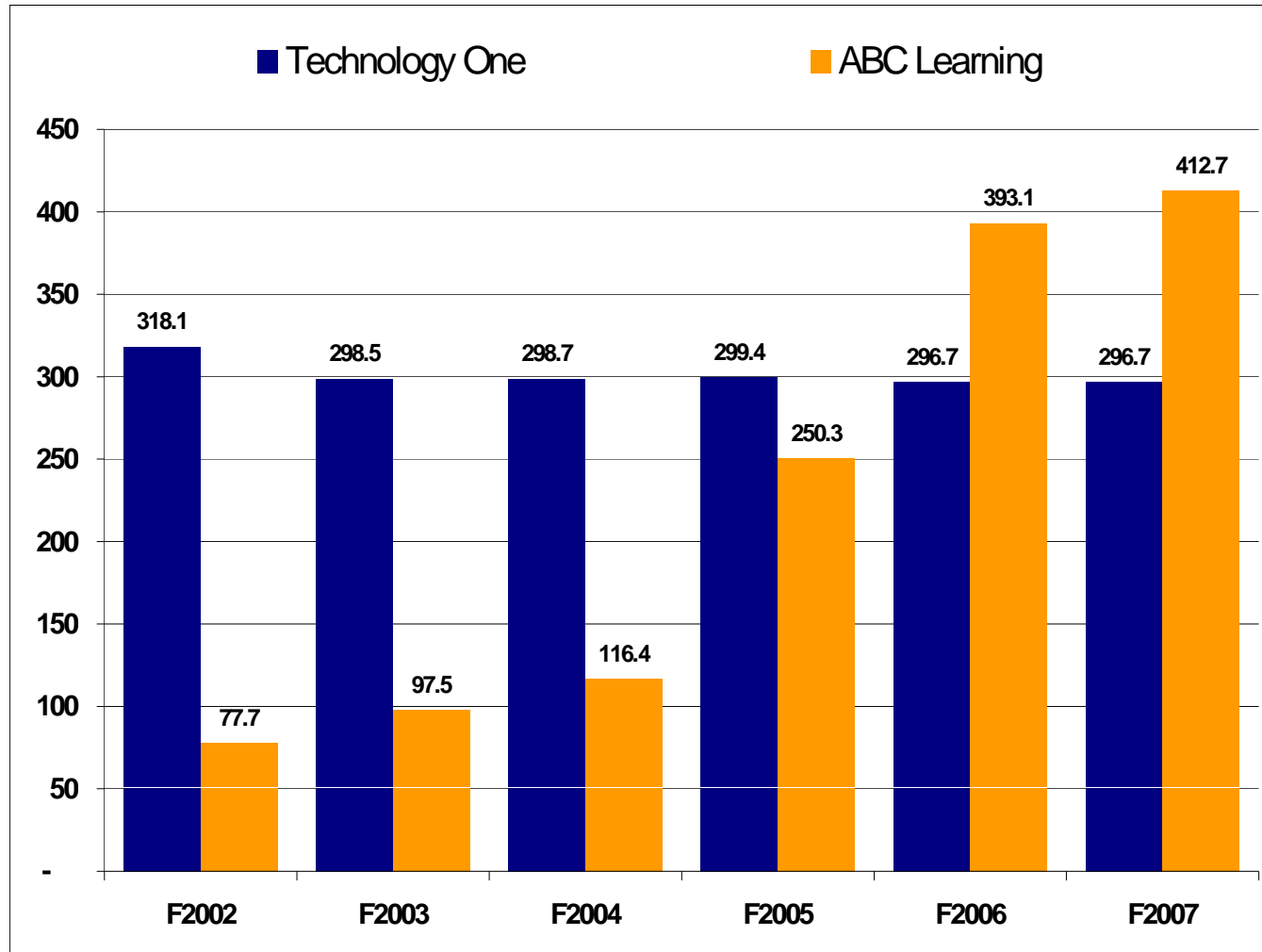
Source: ABS Learning, Technology One, Schroders

16 This is illustrative only and does not represent Schroders recommendation on these stocks



# ABC Learning Centres (ABS.AX) vs Technology One (TNE.AX)

## Shareholder Alignment – Shares on Issue



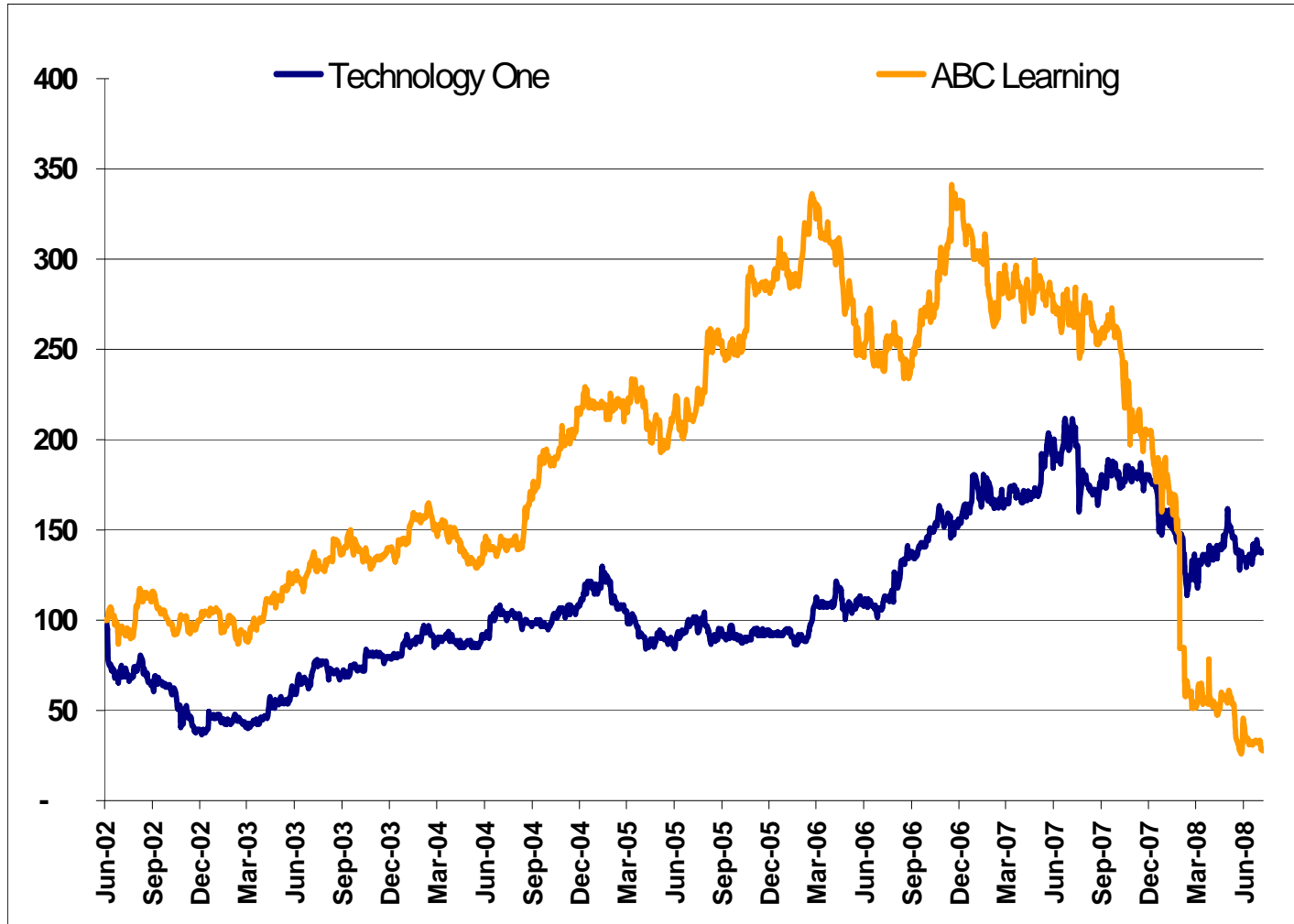
Source: ABS Learning, Technology One, Schroders

17 This is illustrative only and does not represent Schroders recommendation on these stocks



# ABC Learning Centres (ABS.AX) vs Technology One (TNE.AX)

## Relative Share Price Performance: June 2002 to July 2008



Source: ABS Learning, Technology One, Schroders

18 This is illustrative only and does not represent Schroders recommendation on these stocks



# Risk analysis and valuation

## Difficult to synthesize risk factors into a single discount rate

- Security valuation at its most simple is driven by two factors – the forecast of free cash flows generated by a business and the discount rate used to estimate the current value of this future cash flow stream
- There is a valid argument that qualitative risk analysis should be embedded within a valuation framework and reflect either lower (higher) terminal return on capital through our cash flow forecast or result in a higher (lower) discount rate
- The market appears to struggle to embed multiple probabilities into single discount rate estimates

# Risk analysis and portfolio construction

## Provides another dimension

- Increased granularity of stock factors and an ability to increase portfolio factor diversification.
- An alternative, proprietary measure of relative stock specific risk for each security within our universe. In a crude sense, this allows optimization of a portfolio using a fundamental measure of risk against a fundamental measure of return.
- An ability to compare proprietary qualitative risk measures against standard quantitative risk models to determine where significant differences occur and hence opportunity for a qualitative process to add value at both the stock, sector and market index level.

# Conclusion

## Qualitative risk analysis can add value to investor portfolios

- The diversification and riskiness of the benchmark is not fixed
- Investors can inadvertently create less diversified portfolios by adhering to benchmark weights
- History is not prologue when looking at sector risk
- Using a qualitative analytical framework for risk can augment existing quantitative approach
- The ultimate goal for investor portfolios is better risk adjusted returns

*“Not everything that counts can be measured. Not everything that can be measured counts”*     **Albert Einstein**

Questions?



Schroders

# Performance of the Schroder Australian Smaller Companies Fund

Since Inception to 31 July 2008

	St Dev of Daily Return %	Performance %
Schroder Australian Smaller Companies Fund (Post-fee)	0.84	-22.0
S&P / ASX Small Ordinaries Accumulation Index	1.55	-25.5
<b>Value Added (risk / alpha)</b>	<b>+0.71</b>	<b>+3.5</b>

\*Fund Inception 14 December 2007

Source: Schroders/IRESS

Past performance is not a reliable indicator of future performance



# Investment presentation

## Disclaimer statement

This presentation is intended solely for the information of the person to whom it was provided by Schroder Investment Management Australia Limited (ABN 22 000 443 274, AFSL 226473) (Schroders). Investment in Schroder Funds may be made on an application form in the Product Disclosure Statement (PDS) which is available from the Schroders website [www.schroders.com.au](http://www.schroders.com.au). The information contained in this Presentation is general information only and does not take into account your objectives, financial situation or needs. Before acting on the information contained in this Presentation you should obtain a copy of the PDS and consider the appropriateness of the information in regard to your objective, financial situation and needs before making any decision about whether to invest, or continue to hold.

Schroders does not give any warranty as to the accuracy, reliability or completeness of information which is contained in this presentation. Except insofar as liability under any statute cannot be excluded, Schroders and its directors, employees, consultants or any company in the Schroders Group do not accept any liability (whether arising in contract, in tort or negligence or otherwise) for any error or omission in this presentation or for any resulting loss or damage (whether direct, indirect, consequential or otherwise) suffered by the recipient of this presentation or any other person. Returns shown are before tax and fees and all income is reinvested.

You should note that past performance is not a reliable indicator of future performance. Opinions constitute our judgement at the time of issue and are subject to change. For security reasons telephone calls may be recorded.

Investment guidelines represented are internal only and are subject to change without notice.

**Let's start thinking about...**

**This session was:**

- 1. awful**
- 2. mediocre**
- 3. good**
- 4. excellent**

Gizmos brought to you by



**CONFERENCE**



**Time's Up!**

**Let's start thinking about...**

**This session was:**

- 1. awful**
- 2. mediocre**
- 3. good**
- 4. excellent**

Gizmos brought to you by



**CONFERENCE**