

Global Equity Investing Reassessed

Representing Schroders:

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PortfolioConstruction Conference 2006



Agenda

- The Fundamental Law of Active Management
- What's wrong with the Benchmark
- Options for a new Index
- Broadening the Universe
- Putting the Pieces Together

The Fundamental Law of Active Management

Information ratio depends on :

1. Skill (does the manager know what they are doing)
2. Breadth of the opportunity set (how many bets can they take)
3. Transfer coefficient (even if they do know what they are doing, is it implementable)

We spend a lot of time worrying about manager skill (rightly) but relatively little on what we can do to increase the breadth of the opportunity set and raise the transfer coefficient.

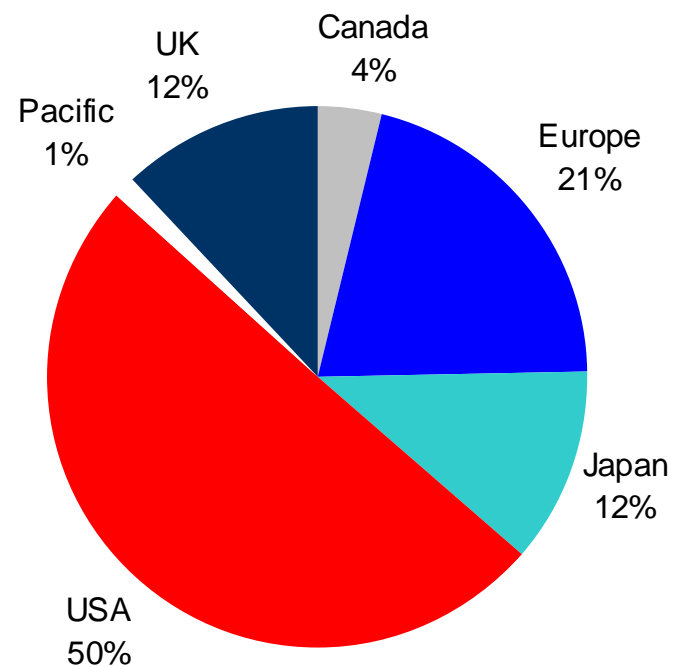
Let's start with the benchmark

MSCI World ex Australia (unhedged to AUD) index is the most common benchmark used for international equities.

1,833 biggest stocks in the world.

29% of the benchmark is in the top 50 stocks.

Exposure to big, liquid stocks in developed markets.



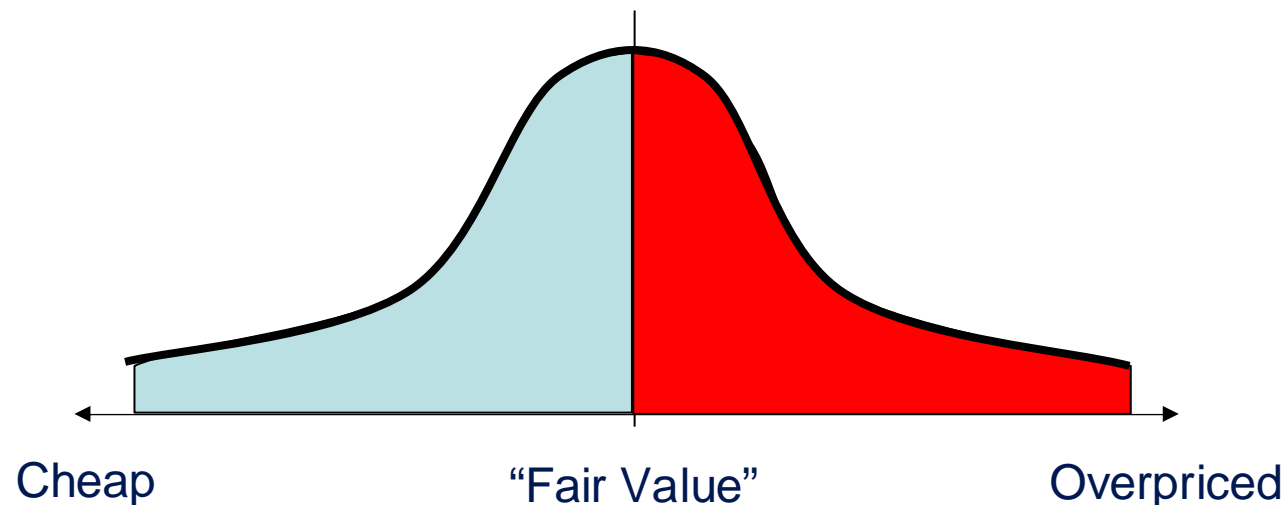
Source: MSCI at 14th August 2006

What's wrong with the benchmark?

Like most capitalisation weighted benchmarks, the stocks with the greatest weight within the MSCI World ex Australia index are the stocks most likely to underperform over time.

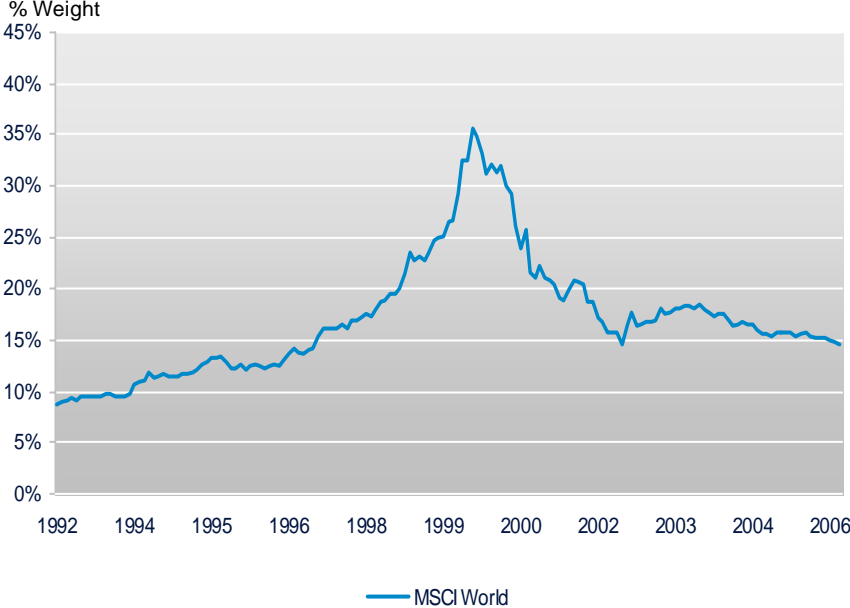
This applies to country weights as well as stock weights.

Distribution of stocks relative to “fair value”

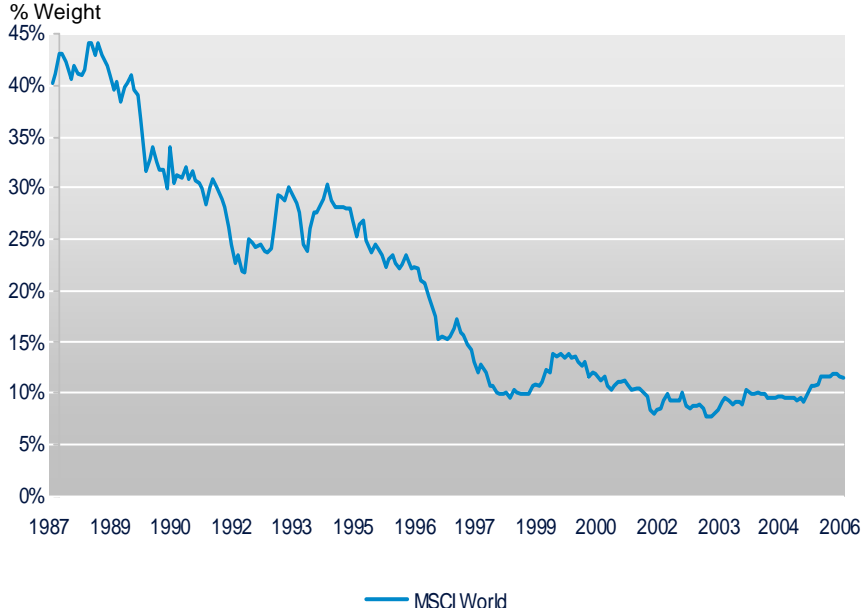


Avoiding sector and country bubbles...

Technology/Telecoms Bubble



Japanese Stock Market Bubble



Source: Schroders, MSCI
*Based upon simulation. Technology includes telecommunications.

Some Stats From the US

The universe of stocks in the US is currently more than 10,000 so the S&P 500 represents less than the top 5% by number.

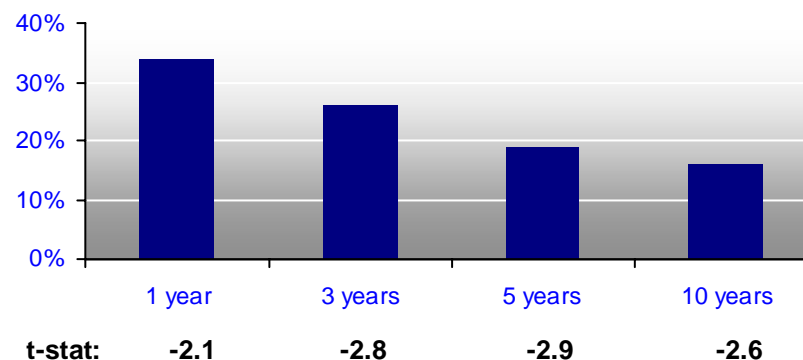
Since 1964, the largest stock in the market has beaten the average stock performance over the following 5 years only 19% of the time. This falls to 16% over a 10 year period.

The top 10% of stocks has only beaten the average stock 29% of the time over a 10 year period.

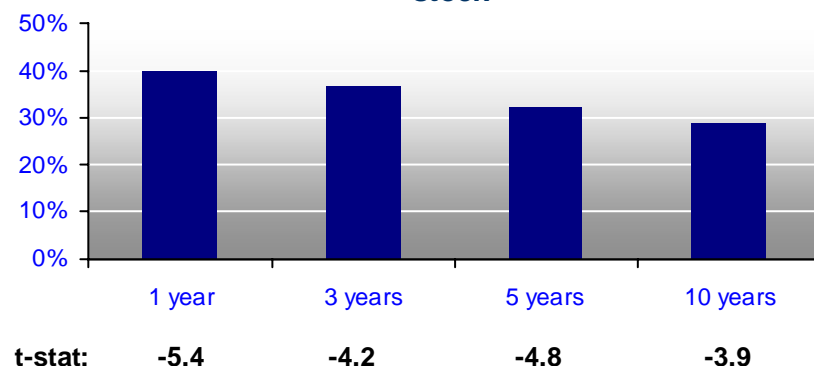
The magnitude of this underperformance is 3.6% per annum over the following decade. What is your outperformance target for US equities?

Source: Robert D. Arnott. FAJ March/ April 2005

Frequency largest stock beats average stock



Frequency top 10% of stocks beat average stock



The Average Stock versus the Benchmark

In the US since 1968, an equal weighted basket of 1,000 stocks has delivered 10.9% per annum.

Over the same time, a capitalisation weighted performance of the same stocks is 8.8%.

By “benchmark” weighting the stocks, we cost investors over 2.1% per annum.

Source: Compustat

What are the options for a new index?

Equally Weighted

Evidence suggests that equally weighting the top 1000 stocks in the US outperforms a capitalisation weighted index by over 1% per annum after costs over the long term.

However it is hard to invest large sums of money against an equally weighted index, for example each stock will have a weight of 10bp which isn't much in Exxon but is quite a bit in Longs Drug Stores Corp where a 10bp allocation equals a 12 times overweight)

Fundamental Indices –Arnott, Hsu and Moore

Evidence suggests that Fundamental Indices have outperformed capitalisation weighted indices by 1.5 - 2.5% per annum over the past 40 years with lower volatility.

The Benefits of Breadth

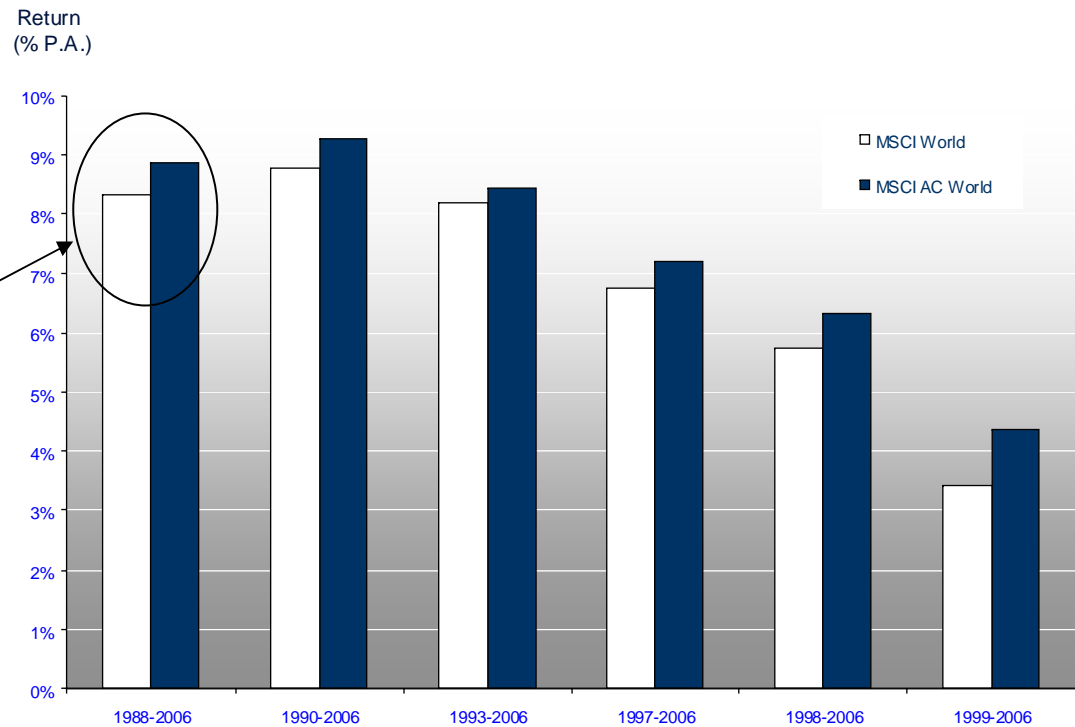
- Firstly, investors have a greater range of opportunities at their disposal;
- Secondly, it allows investors to tap into higher return themes;
- Thirdly, greater breadth leads to diversification benefits and lower volatility in returns;
- Fourthly, there are opportunity costs of having too narrow a focus. A wider universe also offers the option of avoiding certain sectors or countries.

Broadening the Universe : Inclusion of Emerging Markets

Simply by broadening (a flawed) index we can add materially to returns.

The AC index includes 7.5% emerging markets.

0.8% pa can be added over nearly 20 years

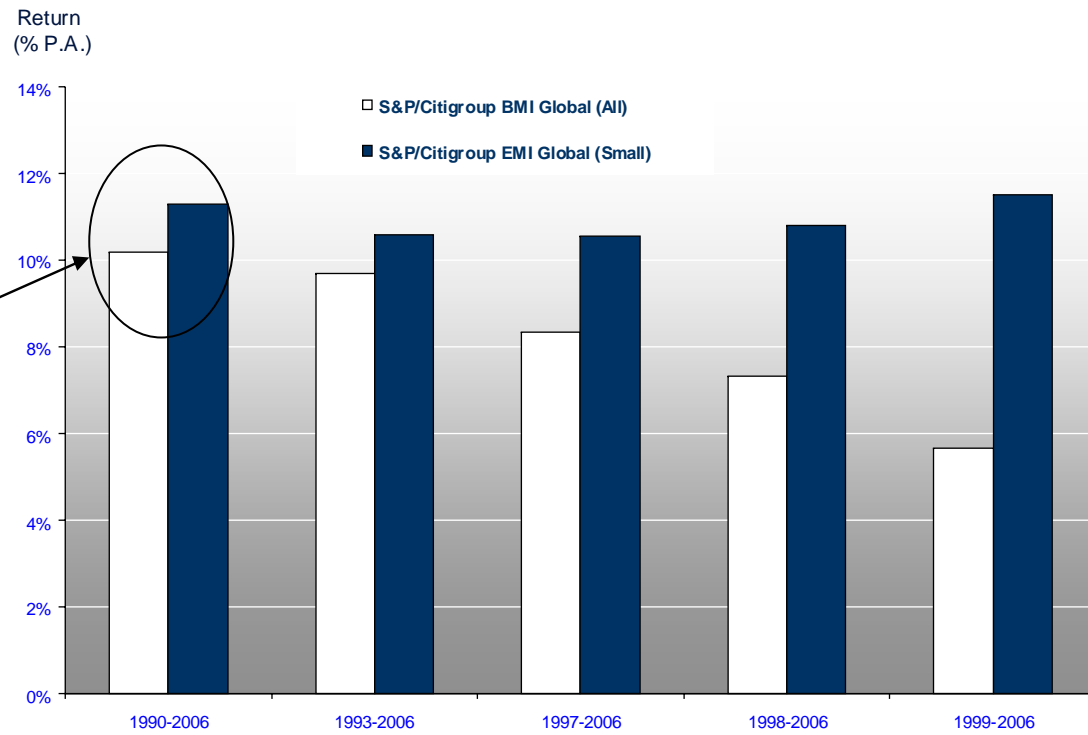


Source: Schroders

Broadening the Universe : Inclusion of Small Cap Stocks

Again, simply by broadening (a flawed) index we can add materially to returns.

1.0% pa can be added over 15 years



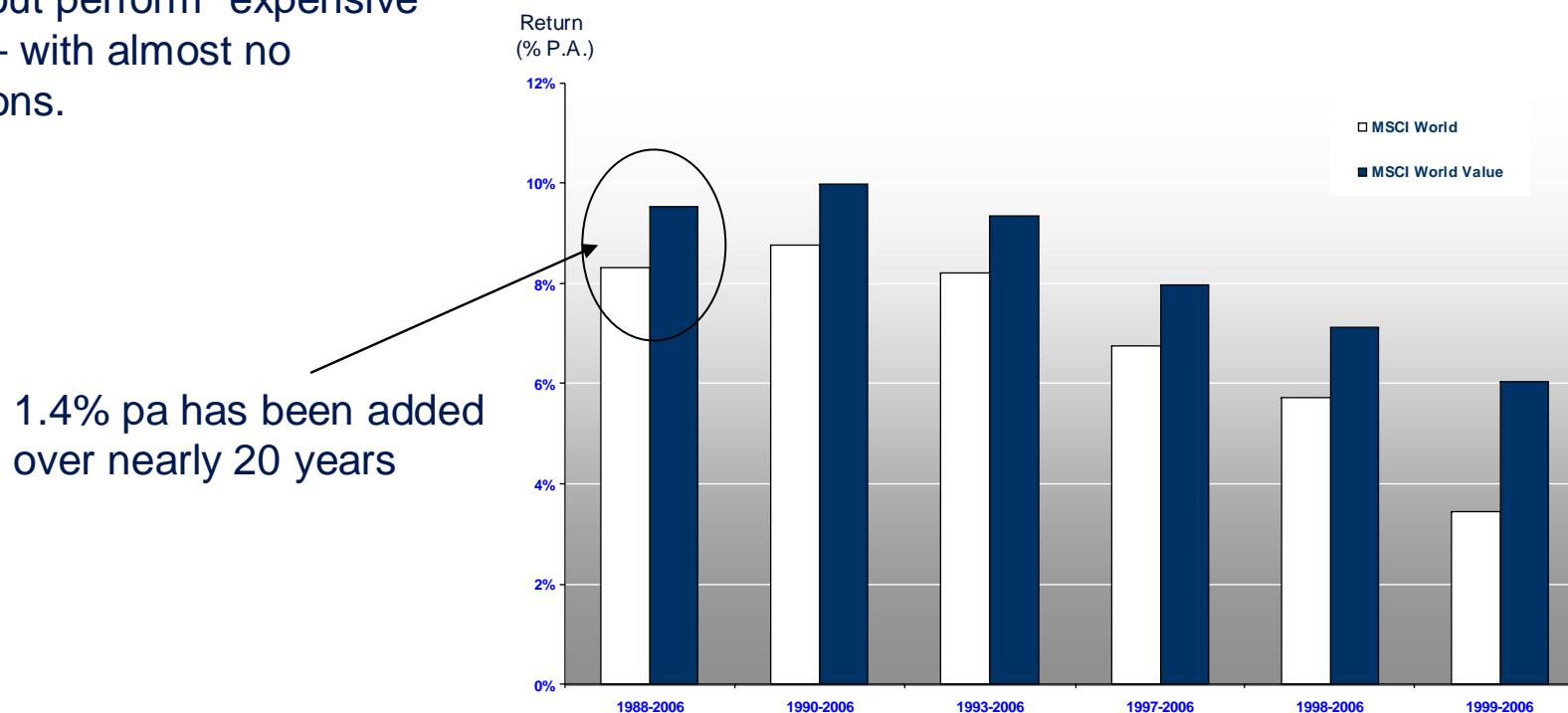
Source: Schroders

Where should we look for skill?

Picking managers is probably the hardest job in the investment arena but a couple of facts do stand out...

Start where the returns are easiest to find

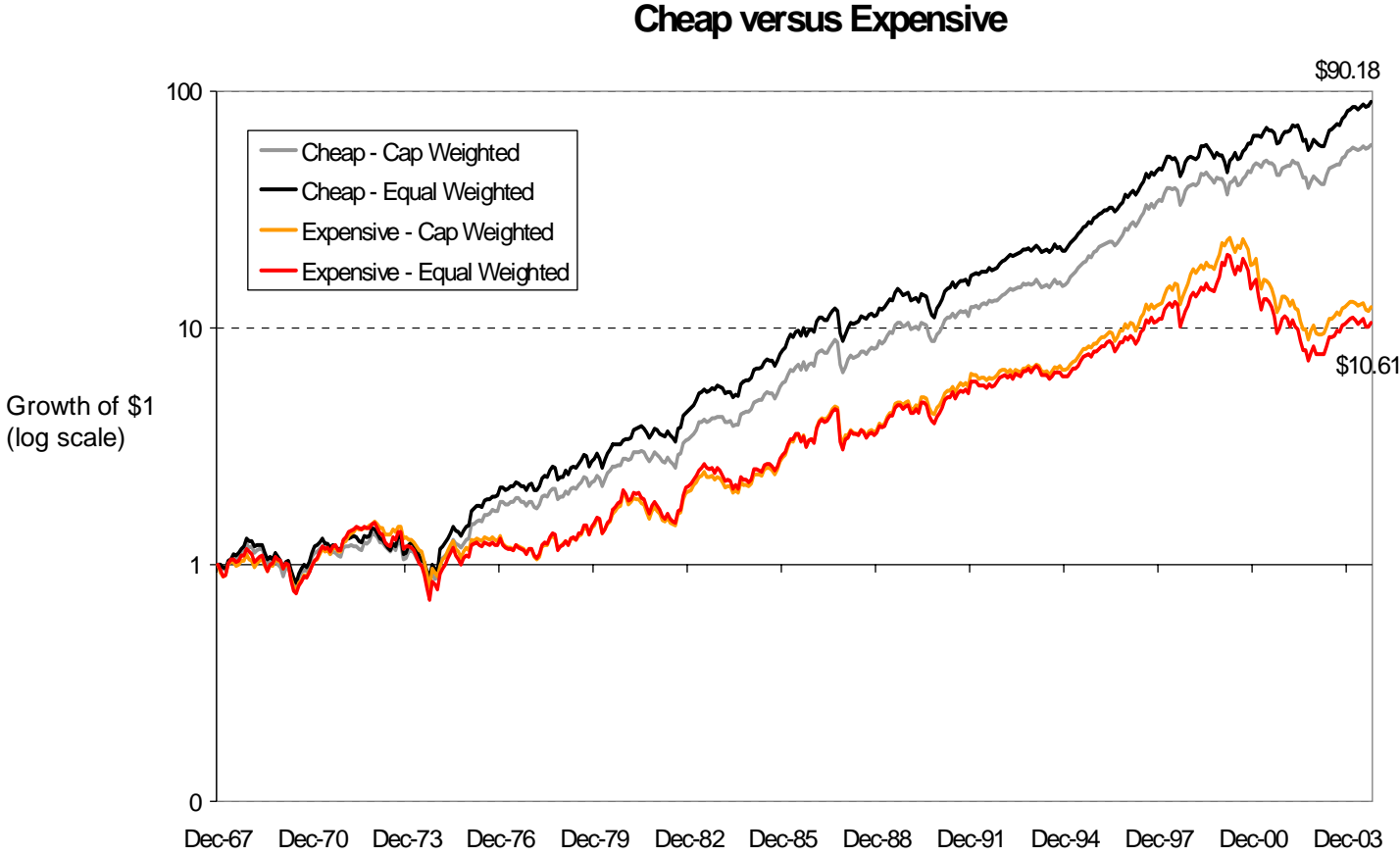
All evidence suggests that “cheap” stocks out perform “expensive” stocks – with almost no exceptions.



Source: Schroders

The value of Value

US Stock Market – The Evidence



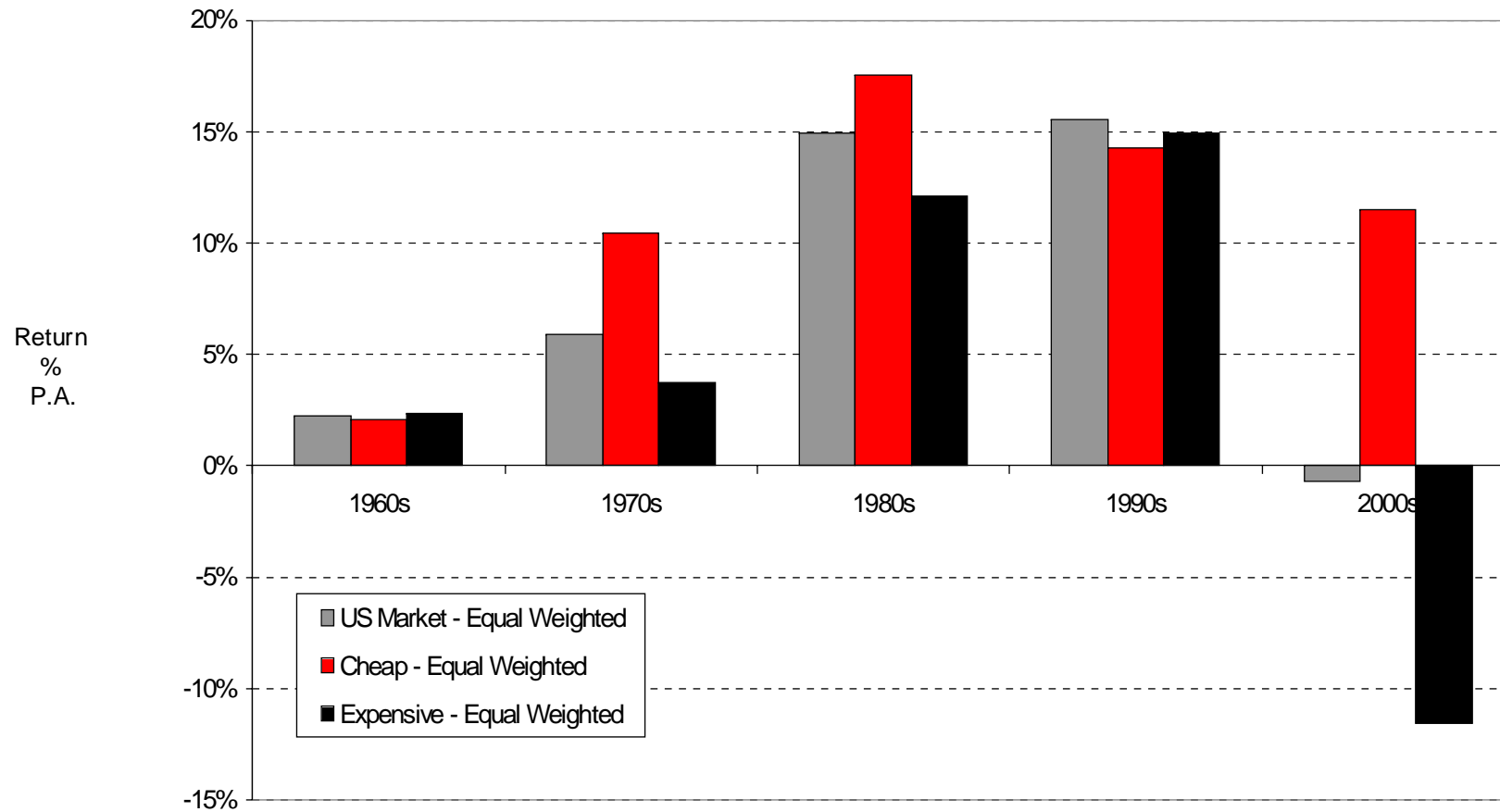
Source: Schroders



The value of Value

US Stock Market

US Cheap versus Expensive : Decade by Decade

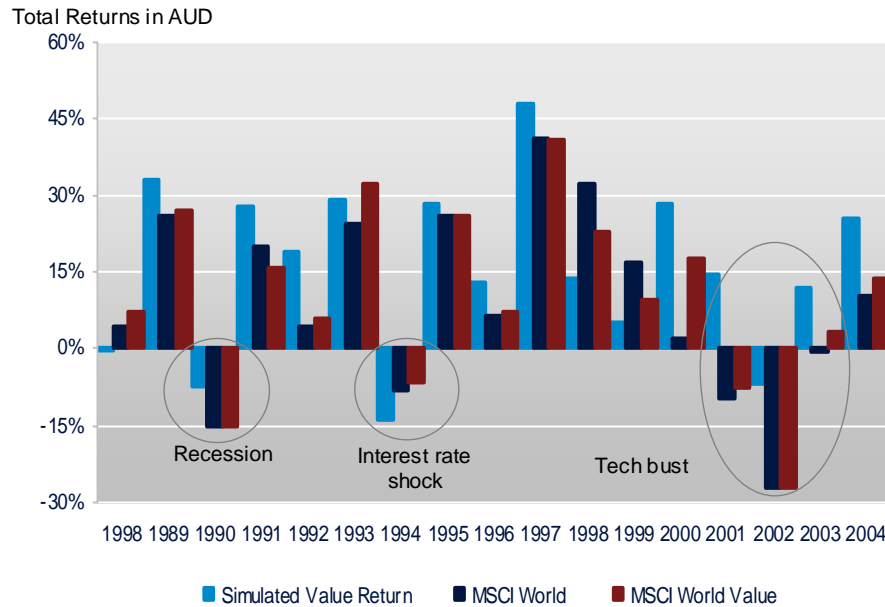


Source: Schroders

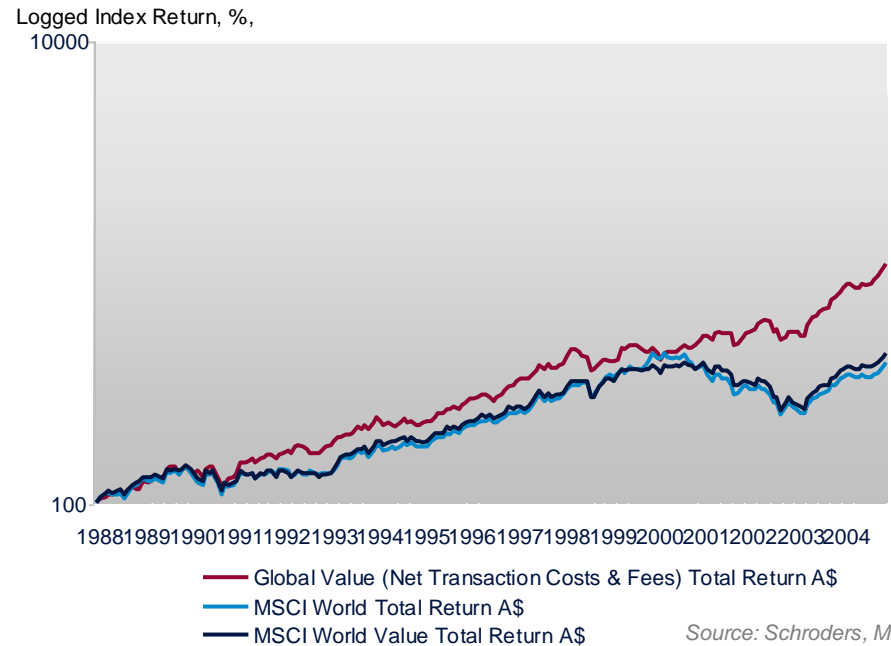
Strategy - Value outperforms over time

Simulated returns to Value

Value Simulation versus MSCI World and MSCI World Value



Value Simulation versus MSCI World and MSCI World Value



- Value has beaten MSCI World in 14 out of the last 17 years with lower volatility, beta and risk of loss over the longer term
- It is not Value that has done so well but rather it is **unconstrained global Value**

The simulated results shown above must be considered as no more than approximate representation of the portfolio's potential performance. They are the result of back-testing quantitative research results, which are based on a number of assumptions. There are a number of limitations on the retroactive reconstruction of any performance results based on simulations.

Putting The Pieces Together

Global Active Value

Value Investing: Highest returning investment strategy

Process Diversification: Low Correlation with other managers

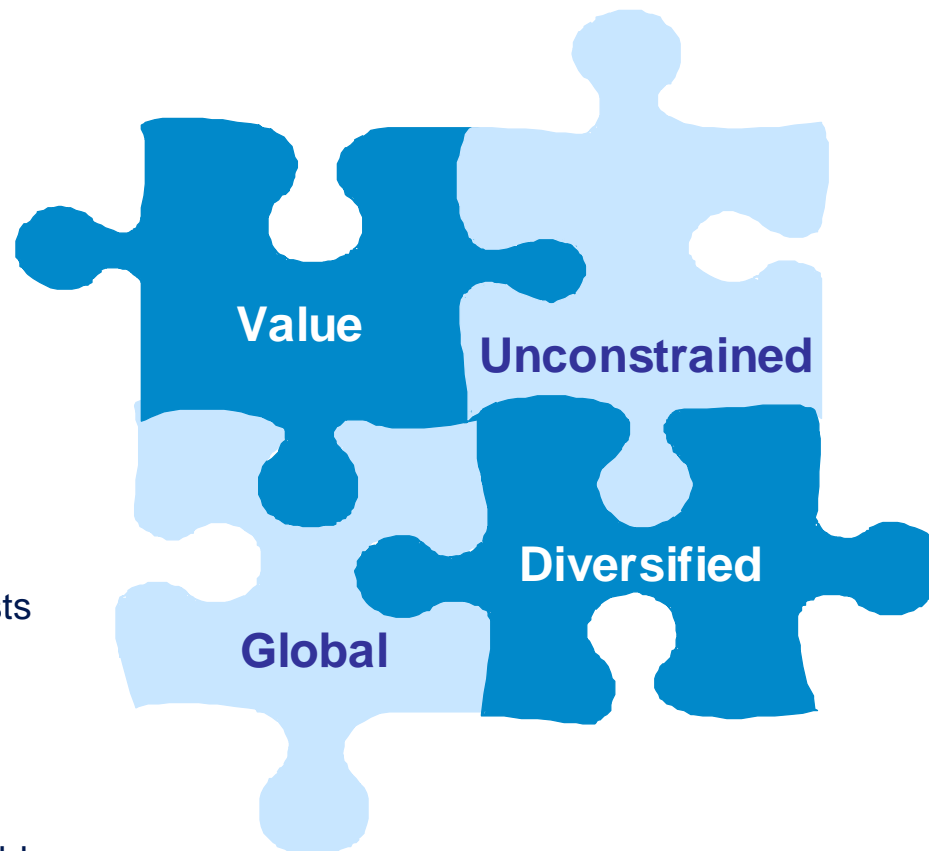
Capacity Unconstrained: Return not capped by liquidity issues

Unique Investment Process: Smarter way of modelling leads to consistency in performance

Strategic Diversification: Non-Benchmark boosts returns

Highly Risk Managed: No Nasty Surprises

Global Active Value offers a robust and repeatable process for capturing the returns to unconstrained global Value



Why Global Active Value?

- Targets high returns with minimal stock risk
- Innovative approach based upon proven investment criteria
- A strategic allocation to potentially higher long run returns

	Global Active Value	Stock Picking
Return Expectation	High	High
Tracking Error*	5 to 10% p.a.	High
Stocks	500+	< 50
Return Predictability	Higher	Lower
Beta	Lower	Higher

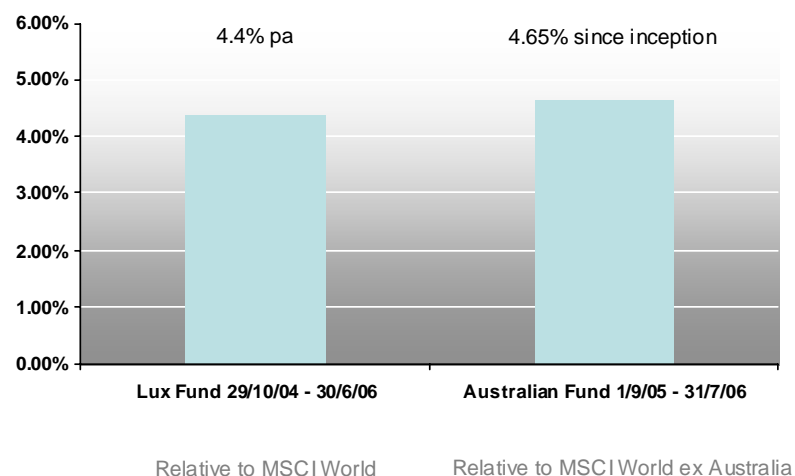
*Tracking error is not targeted, based upon simulations we expect a range of 5 to 10% p.a. relative to the MSCI world or comparable index

Global Active Value Performance

Relative Outperformance since inception

- Luxembourg based fund launched 29 October 2004
- Australian Fund launched September 2005 Hedged and Unhedged version (both ex Australia)
- UK Unit Trust launched in December 2005
- Assets grown to close to a billion dollars (A\$) in less than two years
- Annualised outperformance in excess of 6% since inception

Relative Outperformance versus benchmark



Source: Schroders
Total Returns in AUD (pre- fees)
relative out performance to MSCI World Index and does not take into account any taxes payable by the investor or the impact of exchange rate variations.

Fit within an investor portfolio

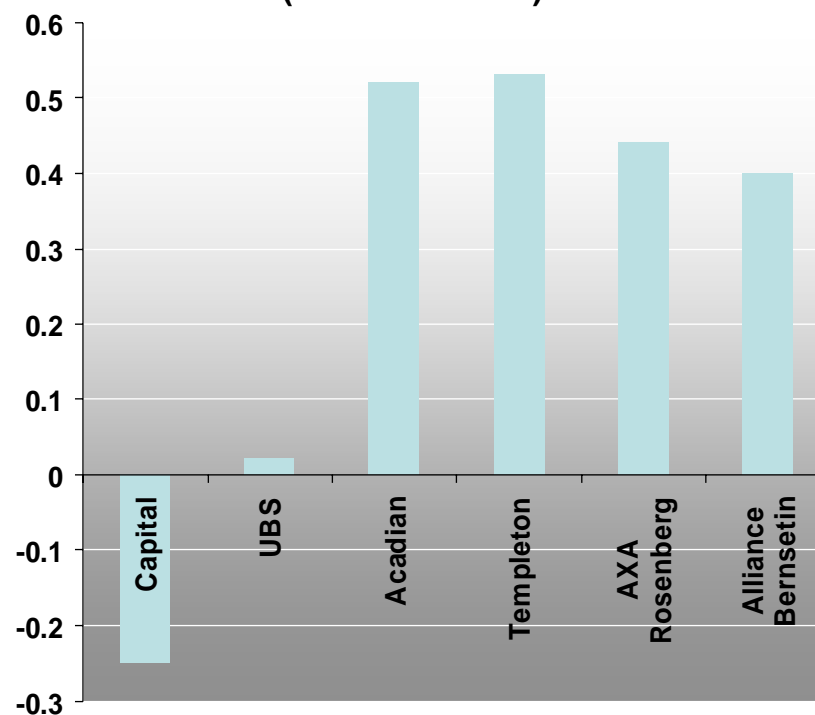
Global Active Value exhibits

- High tracking error and high alpha
- Low beta, volatility and correlations to other managers

Fit within an investor portfolio

- Replacement of an active core or passive global equity allocation
- Ideal blend for existing core, growth or value global equity managers and other benchmark constrained approaches

Correlation to frequently used global equity managers (Nov 04 - Jun 06)



Source: Zephyr, Schroders

Conclusion

- Let a fund manager use all of the possible tools to add value.
- Make sure the “skill” part of the process is based in defensible territory.
- Think about the index you will measure the manager against – it will go a long way to determine the type of portfolio held over the long term.



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Investment in the Schroder Global Active Value Fund (Hedged) Wholesale Class may be made on an application from in the PDS dated 1 September 2005, available from the Manager, Schroders.

Gizmo time

Which session are you in?

6. Tyndall

7. AMP Capital Investors

8. Schroders

9. Nicholas Applegate/Allianz
Global Investors

10. Challenger Financial Services

Gizmo time

Please rate the overall quality of this session...

1. awful
2. Poor
3. Mediocre
4. Good
5. Very good
6. Great!