SGH

SG HISCOCK & COMPANY

SGH20 Quarterly Commentary - June 2017

Quarter in Review

After three consecutive quarters of positive performance delivering 15.4%, the ASX300 pulled back -1.6% in the June quarter to post a total return of 13.8% for FY17 – the third best year post the GFC (bettered only by 2013 & 2014).

The global reflation trade and shifting sentiment amongst central banks continued to influence performance heavily.

In the quarter, scepticism continued to grow around President Trump's ability to implement his pro-growth economic reforms in a timely manner, as political controversies around his presidency became the focus. This, and comments the Fed "expects to begin implementing a balance sheet normalisation program this year", saw the 10-year US Treasury bond yield decline to 2.13% in mid June (down from 2.64% in mid Dec-16), and US dollar weaken. Against this, the US 3 month T-Bill rose to it highest level since October 2008 on the Fed raising rates a further 25bps to 1.25%, resulting in a flattening of the yield curve.

For now, the market seems to be questioning the Fed's ability to continue to raise rates and contract its balance sheet, given inflation remains below its 2% target and the strength of the underlying US economic data. Ironically, this is keeping real rates loose and continues to feed demand for equities and asset prices. That said, more hawkish commentary from the Canadian and European central banks late in quarter reignited the reflation trade, and saw a sharp sell off.

With the fade in the 'Trump trade' and, outside the gradual ongoing European recovery, China remains key to global reflation. There were further signs in the quarter China's growth trajectory may have peaked with the tightening in financial conditions to mitigate shadow banking and property sector risks being reflected in declining property sales in major cities and slowing credit growth. However, stronger export markets and supply-side reform are helping drive a recovery in private investment capex (+6.6% yoy in the first 5 months of 2017), while growth in infrastructure spending remains robust. Against this policy-led back drop the iron ore price fell to $56/t in mid June before recovering to $64/t by month end to finish the quarter down -20%.

Arguably, the most important political development globally year to date was the decisive election of Emmanuel Macron in the French presidential election in May, running on a pro European platform. If Angela Merkel is re-elected German Chancellor in September, then it potentially sets up the opportunity for a more cohesive relationship between France and Germany, expansion of the European State and possibly a new EU Treaty. This has the potential to be a positive development for Eurozone and global growth, and potentially heightens the risk around the UK's EU exit.

Domestically, the Federal Budget and imposition of a major bank levy, as well as backdrop of modest wage growth, combined with rising mortgage rates and retail electricity prices, saw weakness across domestic consumer-facing stocks and banks. Elevated business conditions and sentiment remain in stark contrast with falling consumer indicators. We stand on watch for a lift in 'animal spirits' and capex intentions, as well as any fiscal response.

Portfolio Performance & Activity

In the past 12 months, the US 10-year bond yield is up almost 100 basis points, and the global equity market cap increased US$10tn. Rising interest rates should in theory be negative for equity valuations, but equities offer better relative growth prospects in a structurally lower growth environment, and valuations have been pushed to record levels. The risk is we are at a point in the market where interest rates are taking over from growth as the key systematic risk for investors. This risk is compounded by the weight of passive money now in ETF's. Credit markets are the canary in the coal mine and we are watching them closely. It reinforces the need to maintain a rigorous focus on valuation and the margin of safety we pay for companies.

SGH20 returned 2.11% after fees for the June quarter, outperforming the -1.57% decline in the ASX300 Accumulation Index. Janus Henderson (which completed its merger at the end of May) and Saracen and CSL all contributed strongly to performance. During the quarter we added Rio Tinto on signs of strengthening in Chinese steel demand and Woodside Petroleum. Inghams Group, Metals X and Skycity Entertainment were exited in the quarter. We continue to hold a material underweight position to the Australian banks. The fund held 6% cash at the end of June.

	3 Month %	6 Month %	1 year %	3 years % p.a	5 years % p.a	10 years % p.a	Inception % p.a
SGH20 (after MER)	**2.11**	**6.79**	**10.12**	**10.38**	**9.76**	**4.72**	**10.43**
S&P/ASX 300 Accum Index	-1.57	3.07	13.82	6.64	11.63	3.44	7.85
Value added (MER)	3.68	3.72	-3.70	3.74	-1.87	1.28	2.58

June 2017 Quarter - Portfolio Performance & Characteristics

Top 3 Active Holdings
Janus Henderson Group
Saracen Minerals
Next DC

Portfolio Breakdown	
Materials	25.8%*
Financials	24.6%
Healthcare	10.9%

Top 3 Portfolio Attribution
Janus Henderson
CSL
Saracen Minerals

Bottom 3 Portfolio Attribution
ANZ
NAB
Woodside

inc. 4.9% in Gold

Figure 1: SGH20 Sector weights relative to ASX300

Our bottom-up stock analysis and structural views is evidenced in our deviation from the index

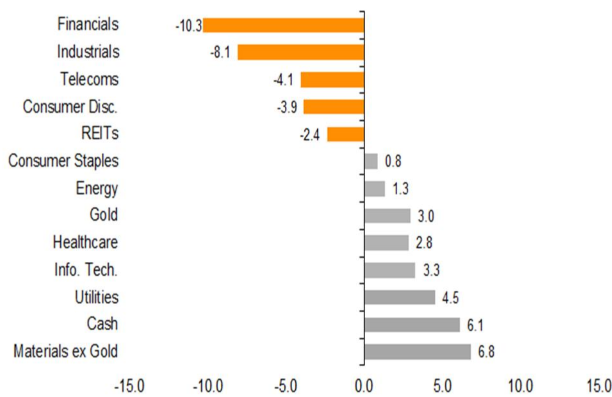


Figure 2: SGH20 Market cap weights relative to ASX300

Material underweight to the top ASX20, offset by a large overweight to mid caps stocks - ASX 50-100

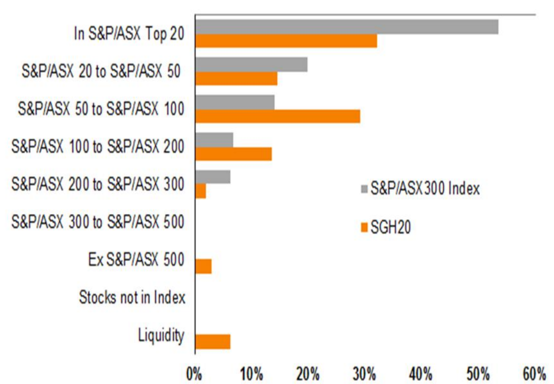


Figure 3: SGH20 Portfolio Characteristics

Superior Return on Equity (ROE) to the index with stronger growth (EPS and DPS) characteristics.

	Sales Growth		Yield		DPS Growth		ROE		EPS Growth		PER (x)	
	FY17/FY16	FY18/FY17	FY17	FY18	FY17/FY16	FY18/FY17	FY17	FY18	FY17/FY16	FY18/FY17	FY17	FY18
ASX300 Index	4.0%	1.3%	4.5%	4.6%	4.9%	6.3%	13.4%	13.7%	5.9%	8.7%	16.4	15.4
SGH20	8.0%	6.5%	3.0%	3.2%	12.3%	5.9%	17.2%	17.0%	10.3%	11.5%	17.7	16.2

Figure 4: $10,000 invested since inception in SGH20

SGH20 has a long track record of adding alpha

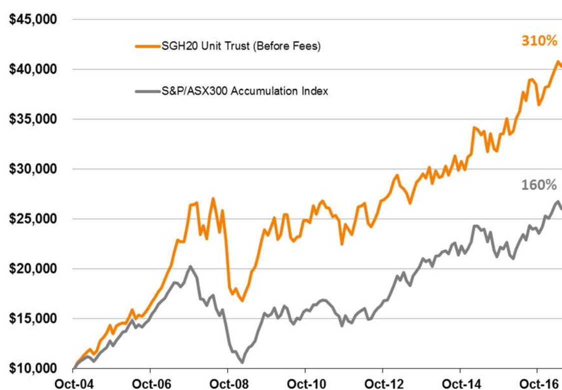
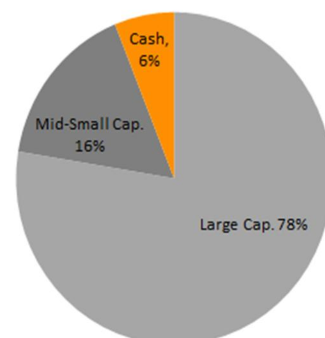


Figure 5: SGH20 currency exposure revenue split

Large exposure to companies with offshore earnings given their more attractive growth and earnings attributes



Large cap is companies with market capitalisations >$1.5b

Source: SG Hiscock, Bloomberg

Top of Mind

Our portfolio construction process is bottom-up stock driven, but overlayed with macro and sector insights and company life cycle considerations. Here we provide some thoughts and observations on the investment themes and issues that are currently top of mind.

Interest rate normalisation - slow and steady

Summary:

- Central banks are showing a desire to normalise rates
- Greatest risk is policy error of Fed being no longer data dependent and tightening into weakness
- Yield curve implies the market is betting against this
- We expect the normalisation of rates to be very gradual, but with potentially higher volatility as interest rates take over from growth as the key systematic risk.

"There is nothing so disastrous as a rational investment policy in an irrational world"

John Maynard Keynes

The Federal Reserve's decision to tighten rates twice in 2017 and comments that it "expects to begin implementing a balance sheet normalisation program this year", coupled with the recent more hawkish shift in sentiment from the European Central Bank, Bank of England and Canadian Central Bank , suggest a growing desire by central banks to normalise rates.

It seems the main factors driving this are a growing view that:

- monetary policy and central banks job in reflating the global economy post the GFC is done, and it is time to withdraw and rebuild interest rates to provide policy insurance and balance sheet capacity for future emergency programs as and when they will inevitably be required.
- excess liquidity is creating valuation anomalies, asset bubbles and growing social inequality.
- the US economy is now into its 9th year of expansion.
- the lower limit of rates has been reached and more proactive fiscal stimulus should increasingly be the next step in revitalising and supporting global growth.

In our view, the key to the success of a gradual normalisation in interest rates will not only be in the pace of the withdrawal of liquidity and tightening of rates, but also, and far more importantly, the extent to which the economic data and pick-up in private sector growth supports it.

The evidence to date at best seems mixed. There are few signs of acceleration in the underlying core US economy and GDP real growth beyond 1.5%-2.5%, and no meaningful pick up in wages and/or inflation pressures. The message is similar in most other developed economies. Whilst central banks have starved off severe deflation, demand remains tepid and there are little signs of acceleration in the velocity of money and inflation.

So why are central banks tightening into weakness? It seems the perils of not normalising rates and increasing unintended consequences of extreme monetary policy (outlined above) are driving the current more hawkish stance. We also think that, now the Fed has started raising rates, other central banks are concerned that they need to act in a co-ordinated way, as any major divergence in policy outlooks could easily result in significant and uncontrolled volatility in the bond and currency markets.

The greatest danger we see for markets over the next six to 12 months is increasing risk of policy error. The risk is the Fed continues to tighten into weakness and is no longer data dependent thereby exacerbating current deflationary pressures and, causing a market correction like we saw in Dec-15 and Feb-16.

The flattening of the yield curve in light of central banks' recent hawkish rhetoric for now suggests the market is betting against this, and:

- investors don't believe the Fed 'dot plot' to raise rates, and that the economy can support it; and
- if volatility picks up on the withdrawal of liquidity, the Fed will quickly lose the desire for further tightening.

The decline in expected substantive fiscal stimulus to support the reflation trade arguably adds weight to this view of a more cautious normalisation in interest rates. China appears to be prioritising stability and structural reforms over further stimulus, and mopping up the excesses of the previous stimulus, whilst the likelihood of US fiscal policy reform looks unlikely before 2018 (and potentially beyond).

Over the longer term, we continue to believe the merger of fiscal and monetary policies (i.e helicopter money) is highly likely, despite the political will and acceptance proving a slow process. The mid-term Congressional elections in November 2018 are increasingly shaping up as an important catalyst which could see tax reform come back into focus in early 2018, and renewed impetus to the reflation trade.

In the interim, and more particularly over the next 6 months, the risk is markets will be characterised by less reflation and potentially higher volatility as interest rates take over from growth as the key systematic risk in the market. We continue to believe any normalisation of rates will be very gradual but this does not preclude the potential for short term dislocations and higher levels of sector rotation as macro news flow buffets market expectations around reflation, interest rates/ bonds and valuations.

US Infrastructure: A need but what's the desire?

Summary:

- 20-years of underfunding has resulted in a US$1.1 trillion 'capex liability' in US surface transportation
- There are signs US State and local governments are taking more responsibility for infrastructure spending.
- Timing and quantum remains uncertain, but PPP's and capital recycling look like potentially part of the solution

Much has been made of the "fiscal stimulus" response from central banks as the end of QE appears on the horizon. The case for increased public spending seems as much a social one as an economic one post the GFC. Across the developed economies infrastructure spending has been declining. This is no more evident than in the US where public sector construction spending as a percentage of GDP has reached an all time low.

Figure 6: US Construction spend is at an all time low

US Construction spend as % of GDP

Source: Federal Reserve of St Louis

The American Society of Civil Engineers estimates that drastic underfunding over the last 20-years has built a US$1.1 trillion 'capex liability' in US surface transportation (roads and bridges). Further they estimate 56,000 bridges are 'structurally deficient' and 20% of roads are in 'poor' condition. At the heart of the under spend has been a combination of budget constraint and cumbersome development approvals. The Federal petrol tax, the primary source of funding for infrastructure investment, has not been raised for 24-years. However, the tide seems to be turning. 31 states have passed legislation to support increased infrastructure budgets over the past 3 years, and President Trump has emphasised a focus on reducing regulation.

With State and local governments taking an increasing responsibility for infrastructure asset development and maintenance, and given high levels of government debt, there is growing anticipation Private Public Partnerships (PPP's) will become a more popular means of funding and developing US infrastructure projects, like we have seen in the UK, Canada and Australia. Goldman Sachs estimates that PPP projects could drive incremental US infrastructure spending of $410bn over the next 10-years.

Whilst there appears strong private sector investor appetite to support PPP programs, a key political challenge in the US is the public resistance to toll roads and current prohibition on tolling federal highways. The Trump Administration has said it would like to reduce this restriction and excessive regulation around environmental permits, but it is not clear how much flexibility it would give states and local governments.

The political debate over potential policy changes to incentivise infrastructure is still at a surprisingly early stage, given the prominence it was given in the Presidential election campaign. The President's Budget included $200bn in federal funds for infrastructure and some details on the potential to incentivise $1tn in investment over 10 years, but there is a general lack of detail at this stage, and growing concern this could be pushed out with lack of progress on repealing healthcare and tax legislation unlikely before 2018. That said, there is some thought infrastructure spending could be a component of tax reform, which is seen as central to expanding the use of PPP's.

Predicting the quantum, and timing of any pick up in US infrastructure spending remains tricky. How to gain exposure through the Australian listed sector is also challenging. We believe Lendlease, as a global developer and contractor that has delivered several large global PPP projects, and Macquarie Bank, one of the largest global infrastructure investors, which the SGH20 Fund is currently invested in are potentially well placed to participate. We also see Transurban and Macquarie Atlas Roads, which already respectively have investments in toll roads in West Virginia and Washington DC, as potentially interested in investing further in US roads if they were to become available.

Where has wage growth gone?

Summary:

- There are signs the normalisation in Australia's wage growth is perhaps complete
- A broadening of jobs growth linked to infrastructure spending would be positive.
- More broadly we are concerned low wage growth is being driven by structural issues and will persist.

"Is the machine that turns out wealth giving us a permanent jobless class? Is prosperity going to double back on itself and bring us social distress?"

Bureau of Labour Statistics, Monthly Labour Review, 1927

Wage growth across developed economies continues consistently to disappoint despite tightening labour market conditions. Australia has been no exception.

Australia's labour market data remains mixed and difficult to read. After moving higher at the start of the year, the unemployment rate has declined sharply in the last few months to 5.5%, the lowest level since 2013. At the same time under employment and the labour cost adjustment in the wake of the resources boom has seen wage growth

decelerate to very low levels (wage price index 1.5% yoy, including bonuses).

There are some preliminary signs that the normalisation in Australian wage costs is largely complete. Further:

- the increase in the minimum wage by 3.3% from 1 July represents a material acceleration from the 2014-16 average of 2.6% yoy, However, this is before the offset of the reduction in penalty rates across the fast food, hospitality, retail and pharmacy sectors which will dilute the benefits; and
- a broadening of jobs growth linked to infrastructure and economy bright spots (education, tourism) could see a pick-up in employment and wages.

Figure 7: Wage growth and unemployment gap
US Construction spend as % of GDP

Source: RBA, JP Morgan

More broadly we remain concerned lower wage growth is being driven by structural issues, including:

- Demographics and the impact of an aging population weighing on the participation rate and placing pressure on productivity and pay scales.
- Technology and automation displacing jobs and driving price deflation. This is not a new phenomenon, but the pace of innovation is accelerating and giving the labour force and policy makers much less time to adapt, making the adjustment more painful.

Exacerbating this, the adjustment is taking place during a period of sustained low growth and economic weakness, and extreme monetary policy and low rates are seeing weak companies survive and leading to persistence of over capacity.

The possible implications of longer lives and fewer jobs are quite different, depending on whether you are a pessimist or an optimist. The gloomier conclusions point to rising income inequality and aggrieved middle class and growing political tensions (the reasons Trump was elected). Coupled with an ageing population, governments will be faced with higher unemployment benefits as well as pensions and healthcare benefits for retirees, and therefore need more revenue. (i.e. higher taxes). Alternatively, they will be forced to stimulate or introduce more protectionist policies that protect jobs. This may be a populist short term preventative measure, but long term risk inhibiting innovation and competitive advantage.

On a more optimistic front while wage growth may be lower, it may be that technology continues to be disinflationary, meaning that the cost of goods fall, and consumption patterns change as people embrace the sharing economy and invest less in cars and houses. Then there are the jobs of the future, ones that we haven't even thought of yet (eg the equivalent of internet publishers and bloggers that weren't around a decade ago) and associated training and education, and growing jobs to cater to retirees (travel, lifestyle services, aged care etc.).

From an investment perspective it is the opportunities based on things that we think aren't going to change, rather than trying to predict what is going to change, that are the most interesting opportunities. We know the population is aging and demand for health services will increase, providing strong demand and growth for companies (like CSL and ResMed) that are well positioned and managed, even if wage growth remains modest.

ESG watch - Rising risk and increasing importance of the social licence to operate

Summary:

- Companies focus on managing their social licence to operate is no longer optional, it has become imperative.
- Companies do not operate in a vacuum and the exact boundaries of the social license change with community and stakeholder expectations.
- Better companies are managing the 'expectation gap' between what they are doing and what stakeholders increasingly require (or desire).

"Banks don't just operate under a banking licence, they operate under a social licence and that is underwritten by public confidence and trust".

Malcolm Turnbull, Australian Prime Minister

The Federal Government's decision to impose a levy on the Australian major banks and Macquarie Bank, has brought into sharp focus the importance of companies managing their social licence to operate. The justification for the levy is highly questionably and smacks of poor policy, but more importantly we see the failure of the banks to manage their social licence to operate was a major contributing factor. We share the views from a recent meeting we had with David Murray, the former CEO of CBA, that in the period since the crisis, bank management and boards have left themselves politically vulnerable through focusing too much on their own self interest and not explaining publicly enough their role and importance in the economy.

Social licence to operate (SLO) can broadly be described as the ability of an organisation to carry on its business because of the confidence society has it will behave in an accountable

and socially and environmentally acceptable way. It does not just derive from a need for legal or regulatory compliance but takes into account the inputs from a wider group of stakeholders and a sense of transparency, accountability and responsibility in its conduct. This provides operational certainty, the ability to capitalise on future opportunities and lowers the operating risk for the business.

The idea of a social license to operate has it roots in the mining sector, where it was a means of engaging with local communities and gaining social acceptance. Now it has taken on much wider applicability which is embedded in the broader concept of corporate social responsibility and the role of business in society.

Companies focus on managing their SLO is no longer optional, it has become imperative given:

- The global financial crisis has shaken confidence in business, and been exacerbated by the unintended consequences of a decade of quantitative easing and easy money. Rising inequality and anti-establishment politics is leading to demands for change and greater accountability from business.
- Technology and social media have revolutionised public debates. Public sentiment can be influenced and organized in ways that were unknown even a decade ago.
- Consumers are more sophisticated and connected through social media and have greater expectations in how companies are addressing social and environmental issues
- Governments in a low growth fiscally constrained environment of marginal and populist politics are becoming increasingly interventionist.

The ideas underlying SLO are not new. Businesses have always been concerned with public reputation and goodwill. But in our view companies that are managing their SLO well have moved from measuring the explicit support or lessening opposition to their activities to understanding and managing the 'expectation gap' between what stakeholders increasingly require (or desire). We see companies that use the label 'social license' to claim reputational credit, rather than conceding the significance of the 'expectations gap' and looking to bridge the gap through engagement, or changing the way they offer their product or service, more at risk of reputational and brand damage.

Medibank CEO, Craig Drummond's recent call to arms around changing demographics and rising affordability of private health insurance, and the need to lower costs, engage government and change their product offering, shows signs of a company that is managing its SLO proactively through recognising the expectations gap and seeking to engage and address the issues in a transparent way.

Huon Aquaculture's actions to seek stronger regulation and enforcement of marine farming in the Macquarie Harbour, and ensure the sustainable future of salmon farming in Tasmania, in our view also shows a company engaged and managing its SLO with a eye to the longer term.

Our management quality review, which forms part of our quality assessment for each company, is where we look to consider explicitly how companies are managing and engaging on their SLO responsibilities.

Ultimately, companies do not operate in a vacuum and the exact boundaries of the social license change with community and stakeholder expectations. The key is how responsive and engaged management are in managing external stakeholder concerns.

Figure 8: How companies are managing their 'Social Licence to Operate' is considered as part of our management quality assessment

SGH20 Quality Assessment Framework

Source: SG Hiscock & Company

Company & Industry Insights

Research insight is critical to our investment decision making process. As part of this we undertake an extensive company visitation program and reading to develop our thinking and highest conviction idea. Here we provide some of our recent insights.

Edge computing the next IT paradigm shift

Summary:

- Edge computing is emerging as next IT paradigm shift ..
- ... as Internet of Things and Artificial Intelligence devices drive demand for decentralised computing.
- We see edge computing as complimentary to, not replacing cloud computing.
- Next DC remains structurally well positioned to benefit.

Staying abreast of innovation and technological advancements is vitally important for any investor these days. Not only do companies across basically all industries face challenges from new and disruptive technologies, but equally the opportunities for companies who develop and embrace new systems and processes are considerable.

As noted in our April 'Insights' note (US Travel Diary – April 2017), SGH20 was an attendee at The Montgomery Summit in March, an event that by its own account, "celebrates the innovation economy." The result of bringing together an array of investors, entrepreneurs and executives to discuss emerging trends in technology and the speed and scope with which technology is being utilised to transform and enhance businesses, is extraordinary.

Amongst our key observations from the summit was that there appeared to be an increasing acceptance for companies to partner with large cloud computing service providers to outsource key IT functions. On the back of considerable investment in their technology and in particular data security, there appears greater confidence key cloud players such as Amazon, Google, Microsoft and IBM can be trusted with vitally important company data.

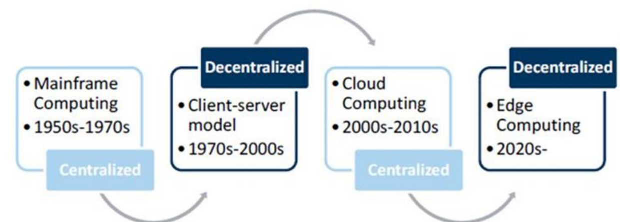
Simplistically, the preparedness of companies to retire proprietary servers and internal hardware in favour of outsourcing key IT functions to third parties suggests some clear winners and losers. In addition to the Amazon's and Google's of the world, data centre providers who house the ever increasing data being generated stand to benefit significantly. On the other hand traditional computer and hardware makers that have relied on the replacement/upgrade cycle of computers and accompanying software would appear to be increasingly challenged unless they can evolve.

At the time when companies and consumers finally seem to be embracing cloud computing, the IT paradigm seems to be shifting again. 'Edge' computing, which as the name suggests functions at the edge of the computing universe rather than relying on a centralised location such as a cloud network, is emerging as the next development in the IT evolution, driven by the twin forces of growth in Artificial Intelligence (AI) and the Internet of Things.

Broadly, edge computing refers to technology that exists within commonly used devices such as robots and other machines that allow the device to recognise, process and respond autonomously. As machines have become more and more automated and their responses increasingly driven by sophisticated algorithms and need to retain data, there is an increasing need for them to process vital information autonomously. The need for instantaneous responses that foregoes interaction with external data centres and separates IT and telecommunications infrastructure adds a new dimension to the digital age. SGH20 likens the concept to more and more widely used devices having their very own mini data centres that retain and interpret information for the devices to act increasingly independently.

At this point we see edge computing as more likely complimentary to the traditional cloud computing architecture rather than disruptive, and therefore likely to supplement not replace cloud computing.

Figure 9: Edge computing the next paradigm shift in IT evolution
Evolution of enterprise computing



Source: Goldman Sachs

As we approach the adoption of 5th generation mobile networks (5G), a development that will facilitate closer integration of technology and telecommunications than ever before, we maintain that favourable trends around mobile adoption and ever-increasing data consumption will persist in line with more and more automation of everyday devices.

At a portfolio level NextDC remains a company clearly well positioned to benefit from these supportive industry trends toward cloud adoption and centralised data storage. Amongst other SGH20 owned companies that have established themselves as innovators and leaders in the use of new cloud-based technologies in their respective industries, ResMed through its Airview technology and Huon Aquaculture through its real time land to sea data tracking have both sought to differentiate themselves from competitors.

Amazon's coming!

Summary:

- The worst kept secret is out Amazon is coming!
- The market has spoken, suggesting listed ASX retailers will be impacted materially
- We think this is providing opportunities: in the words of Buffet "be greedy when others fearful"

"There are many ways to center a business. You can be competitor focused, you can be product focused, you can be technology focused, you can be business model focused, and there are more. But in my view, obsessive customer focus is by far the most protective of Day 1 vitality. Is the business customer focused??"

"Decisions should probably be made with somewhere around 70% of the information. If you wait for 90%, in most cases, you're probably being slow. Plus, either way, you need to be good at quickly recognizing and correcting bad decisions. If you're good at course correcting, being wrong may be less costly than you think, whereas being slow is going to be expensive for sure".

"I very frequently get the question: 'What's going to change in the next 10 years?' And that is a very interesting question; it's a very common one. I almost never get the question: 'What's not going to change in the next 10 years?' And I submit to you that that second question is actually the more important of the two — because you can build a business strategy around the things that are stable in time. … In our retail business, we know that customers want low prices and I know that's going to be true 10 years from now. They want fast delivery; they want vast selection. It's impossible to imagine a future 10 years from now where a customer comes up and says, 'Jeff I love Amazon; I just wish the prices were a little higher,' or 'I love Amazon; I just wish you'd deliver a little more slowly'"

Jeff Bezos, CEO of Amazon, 2016 letter to Shareholders

While acknowledging we have touched on the topic of Amazon in recent reports and are at risk of labouring the subject, the June quarter was notable for some significant developments.

Having returned in March from the US convinced of Amazon's Australian retailing ambitions, but questioning the ambitious timelines being speculated by some in the market, Amazon broke their silence in April and confirmed they are planning to launch in Australia and extend their current operations beyond their Amazon Web Services product and Kindle device offer – sold from their Australian website.

Later in the quarter, they announced the proposed take over of listed US retailer Whole Foods Markets which operates 400+ retail stores across the US, Canada and the UK. In what has come to be expected as a typical facts only release with no accompanying commentary, Amazon left the public to speculate about its ultimate ambitions for the brand and its bricks and mortar retail ambitions.

For a company that is the poster-child for online retailing, the Whole Foods Markets announcement was intriguing. For some in the market, the move signalled a concession by Amazon that their attempts to be a serious player in the food and grocery market had failed and that physical stores are a vital part of becoming a profitable scale player. The alternate view is owning and operating physical stores merely represents the next step in Amazon's journey: where their leading supply chain position will underpin further disruption in the grocery segment and pain to traditional retailers.

The response of investors to these announcements during the quarter seemed to be one of "assume the worst until proven otherwise", and over reaction. While the credentials of Amazon for entering new markets and disrupting traditional retailers is well documented, we continue to believe that even after Amazon enters Australia there is an opportunity for adaptive and well prepared retailers to co-exist successfully.

For local retailers the news that Amazon plans to enter Australia should have come as no surprise whatsoever. Having been a credible online retailer in the US since the late 1990's and the clear market leader for many years now across numerous geographies, it was more a case of when, not if, Amazon would arrive down under. As we have previously highlighted, Australia continues to offer some very attractive features for an on-line retailer including a high level of internet penetration and comparatively high levels of retail spend per capita. Accordingly, for any company that finds itself ill prepared when Amazon does eventually enter, we have very little sympathy.

In our view JB Hi-fi is one company that has a very good chance to not only survive, but also continue to deliver profitable growth in an Amazon world. Possessing unrivalled scale in the Australian market, together with a strong brand and very capable management team, JBH undoubtedly enjoys a strong starting position from which to compete with Amazon. Our discussions with JBH leave us confident they are acutely aware of what challenges they will face and the investment required to make themselves ready for Amazon. There is no question that retailers must embrace the concept of 'omni-channel' retailing where the in-store and online propositions of retailers are increasingly integrated and expectations of customers ever changing.

Looking ahead, we consider JBH uniquely positioned now to make further investments that should hold the company in good stead for many years to come. As last year's 'The Good Guys' acquisition is further integrated into the overall JBH group, we expect the cost synergies delivered from this merger to be selectively reinvested in things like their online store and supply chain capabilities.

Summary of Our Macro Thinking

Australian Economy	Australia has managed to navigate the mining investment down swing remarkably well with the extended housing market cycle absorbing much of the fallout. The more recent spike in iron ore and coal prices has provided a positive surprise to national income and eliminates for now the threat of a sovereign credit rating downgrade. We remain concerned about the lack of income growth in Australia, high level of indebtedness and risk banks will be forced to implement out of cycle rate increases (as they have recently) even if the RBA keeps official rates on hold. Further rate cuts now seem unlikely given the tone of the new RBA Governor and US interest rate expectations.
Australian Equity Market	Potential US fiscal and economic policy reforms coupled with interest rates remaining well below "normalised" levels for a considerable period of time provide a positive back drop for equities in the medium term. In our view this favours US exposed companies and offshore earners. While we would normally expect small caps to outperform large caps in an environment of improving economic activity and steepening yield curves, the valuation premium that has been built into small/mid cap stocks in recent years represents a headwind. This reemphasises the need for a strong focus on valuation and margin of safety, and is arguably supportive for larger cap companies, but as ever, remains stock specific.
US Economy	The fundamentals of the US economy remain positive. The US labour market is already quite tight, and although uncertainty prevails around the detail of the Trump administration's economic policies, we expect a fiscal stimulus package comprised of tax reform, and increased spending on infrastructure is likely to stimulate growth. Other policies such as increased trade protectionism, tighter immigration and the Federal Reserve's response to higher inflation potentially provide some offset. The risk is equity markets have got ahead of themselves in the short term, and now there is a need for policy announcements to reinforce the bounce in confidence and markets.
US Bond Market	With the macro narrative having shifted from low inflation and coordinated central bank monetary policy to interest rate normalisation and reflation, we expect bond yields to rise through 2017. We expect US monetary policy to be tighter than Europe and Japan causing a widening short rate gap and stronger US dollar.
Australian Dollar	The recent rally in the AUD appears correlated to the recent strength in commodity prices, but more importantly the narrowing positive yield differential between Australian and US rates. We expect this to be a continuing feature through 2017 and, coupled with risk of ongoing capital controls by the Chinese Government, see a range bound AUD as our base case.
China	We expect the current official 6-7% growth rate will be maintained through ongoing fiscal and credit stimulus in the lead up to the leadership change and 19th CPC National Congress in Nov-2017. This sets the scene for domestic cyclical growth and policy for much of this year. Growing geopolitical risks particularly around the potential for trade wars (and North Korea) have the potential to be tail risks, and contribute to a strengthening in the US dollar and depreciation in the CNY increasing the risk around capital outflows.
Europe	We view the recent victory by President Marcon in the French elections on an explicitly pro Eurozone platform as an important political development. If Chancellor Merkel is re-elected in the German elections in September it potentially sets up the opportunity for a more cohesive and even expansion of the European State. Compared to twelve months ago the growth picture in Europe has improved, particularly in Ireland and Spain, and Germany, France and Italy which are expanding albeit modestly. Government debt burdens in much of Europe remain elevated placing limitations on fiscal stimulus policies.
Oil Price	We believe the moves by OPEC in agreeing to production cuts of 1.2 mmbpd, the first since 2001, and cooperation from non OPEC producers also to make cuts by 0.6 mmbpd, help shift the dynamics of the oil market into a potential balance within 12 months. Saudi Arabia and OPEC have indicated an intent to support the price in the near term which should put a (soft) floor under the price at circa USD50/bbl. Although we are somewhat constructive on the impact maturing production sources will have on market rebalancing, we remain cautious of overly optimistic projections of future deficits given the hedges and cost reductions experienced industry wide (with a focus on North American unconventional).
Commodities	Whilst expectations of fiscal spending under a US Trump presidency is arguably supportive for commodities, bulk commodity prices remain intrinsically linked to China and its start-stop fiscal stimulus and supply side reforms. We continue to look to the long-term demand and supply trends for opportunities. We are attracted to the demand side fundamentals of Electric Vehicle Commodities (Cobalt, Graphite and Lithium). In a very unsettled geopolitical and macro environment, we see gold offering protection.

SGH20 Overview

What makes us different?

- High conviction benchmark unaware portfolio holding 15 – 25 stocks
- Focus on capital preservation and absolute returns for shareholders
- Portfolio targets long term capital growth and tends to outperform in down markets
- Disciplined repeatable process to stock selection and portfolio construction
- Because the portfolio is significantly different from the benchmark, performance can differ materially from the benchmark

Our Investment Strategy & Process

SGH20 is a concentrated fund holding 15-25 stocks. Our strategy is to only allocate capital to high-quality ideas where we have conviction. Our focus is on identifying businesses with a competitive advantage that are well-positioned in attractive end markets to grow free cash flow, at an acceptable margin of safety to intrinsic value. This is done through a rigorous, repeatable and disciplined quality assessment of the company's earnings, business and management. As part of this we undertake an extensive company visitation program which is important in providing 'insight', testing our thinking and developing our highest conviction ideas. We seek to know as much about our companies as possible, with a view to mitigating permanent capital loss and delivering outperformance over the long term.

Our Philosophy

As a high conviction fund our portfolio has very different weights from the ASX300 Index. SGH20 is a true index unaware fund, where each individual position is selected to provide positive attribution, not simply because it is a large portion of the index. As such the tracking error of SGH20 is regarded as high.

The core premise of our philosophy is to pick stocks that can deliver sustainable value creation on a 3 to 5 year view, rather than simply because the stock is a significant part of an index. Our thinking is different from most managers, whereby if we don't have a high conviction view on a stock, we won't hold it in the portfolio. An index aware fund may have a low conviction view of a company, but still hold a stock at index weight (ie its holding are based on the index weight not a fundamental view of the company's future value creation). Index managers' may end up holding a basket of stocks that do not reflect any conviction. At SGH20, we do extensive due diligence on each company that we hold. Our focus is to invest in companies that deliver absolute returns for shareholders and out perform relative equity market benchmarks.

Contact Details

SGH Funds Distribution Team
1300 555 511
bdm@sghiscock.com.au
www.sghiscock.com.au

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