SG HISCOCK & COMPANY

SGH20 Quarterly Commentary - December 2017

Quarter in Review

"Never think that lack of variability is stability. Don't confuse lack of volatility with stability, ever."

Nassim Nicholas Taleb

Synchronised global growth, low inflation and low rates provided a 'goldilocks' environment for equities during the December quarter. Globally, the MSCI World index ex-Australia rallied 7.8% in USD (or 5.5% in AUD) in the quarter, taking the calendar year 2017 return to 22.5% in USD or 13.4% in AUD), whilst the ASX300 rose 7.8% to take the annual return to 11.9%; a good result considering at the end of September Australia significantly lagged nearly all global indices having returned just 3.9%.

Low volatility and the steady march higher in global indices was the defining characteristic of equity markets in 2017. The S&P500 saw a positive return in every month for the first time in history, and is now 395 trading days, and counting, without a correction of >5%; the longest streak since 1930. It is hard to think that volatility will not increase from here. What is interesting is it has remained so low given the controversies around the US Presidency, North Korea and Middle East. The fact is markets have been prepared to look through these issues, focusing on improving global economic fundamentals.

Much depends on inflation and bond rate expectations, which remain critical for equity markets. One could have equally argued this at the beginning of the last year. One year on, the concerns that the "late cycle" positioning of the US economy could lead to higher wage growth, inflation and bond yields and undermine elevated valuations are as, if not more, relevant. The passing of US tax reform in December has raised expectations among equity investors of a cyclical recovery in the US economy, but the question remains as to whether it will create the incentive for companies to invest in new capital and equipment. For the time being these hopes are not reflected in the bond or currency markets, which continue to be sceptical on both growth and inflation. This has been most evident in the flattening of the yield curve. In December the US 10-year ended the month where it started at 2.41%, whilst the US 2-year rose to 1.88% (a long way from 1.3% in August).

Inflationary pressures globally remain most visible in industrial commodities, a reflection of the strong demand and supply constraints in China. The PBOC Central Economic Work Conference in December reiterated China's goal of 'pursuing progress while maintaining stability'. For now it seems China will focus the 'quality' of growth over the 'quantity' of growth with a focus on reducing financial leverage, pollution and corruption.

The turnaround in performance of the Australian equity market since September has coincided with evidence the global recovery has become more synchronised, along with less pessimism around the Australian economy. Domestically, perceived downside risks from tighter financial conditions around APRA's macro-prudential measures, and out of cycle rate tightening by the banks have been alleviated by stronger employment numbers (360k jobs were added in the year to November and unemployment declined to 5.4%), strong trade data and signs of a pick-up in business investment. Overall, the domestic economy appears to be improving, with growth shifting from housing to investment and the downturn in the mining sector appears to have run its course. During the month the RBA remained on the side lines. There seems little urgency or inclination for the RBA to change rates with inflation and wage growth remaining muted.

Portfolio Performance & Activity

In the December quarter SGH20 returned 11.61% after fees, outperforming the ASX300 Accumulation Index by +3.87%. In the quarter Next DC, Sino Gas & Energy and James Hardie all contributed strongly to performance. The Fund benefited from the strengthening in the crude oil price (+17%) through positions in Woodside Petroleum, Sino Gas & Energy and Speedcast International which has leverage to the pick-up in energy exploration capex through its satellite services business. M&A also featured with Unbail-Rodamco bidding for Westfield, which we added to the portfolio in July.

During the quarter we made no changes to the portfolio outside reweighting existing positions. We increased our underweight position to the Australian banks, and took some profits in CSL, Next DC and Treasury Wine Estates. The portfolio continues to be overweight companies with offshore exposure (60% by revenue). This is less about our view on the currency, and more about our belief that these companies have better medium term growth prospects and are more diversified. This insulates them against the risk of ups and downs in a single market including the growing risk of rising Government intervention and regulation. The fund held 10.1% cash at the end of December.

	3 Month %	6 Month %	1 year %	3 years % p.a	5 years % p.a	7 years % p.a	10 years % p.a	Inception % p.a
SGH20 (after MER)	**11.61**	**13.79**	**21.52**	**13.25**	**9.86**	**7.32**	**4.57**	**11.10**
S&P/ASX 300 Accum Index	7.74	8.60	11.94	8.76	10.15	8.13	4.00	8.22
Value added	+3.87	+5.19	+9.58	+4.49	-0.29	-0.81	+0.57	+2.88

December 2017 Quarter - Portfolio Performance & Characteristics

Top 3 Active Holdings
Next DC
James Hardie
Orora

Portfolio Breakdown	
Materials	26.5*
Financials	23.7%
Healthcare	8.4%

Top 3 Portfolio Attribution
NextDC
Sino Gas & Energy
James Hardie

Bottom 3 Portfolio Attribution
Lend Lease
NAB
ANZ

**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

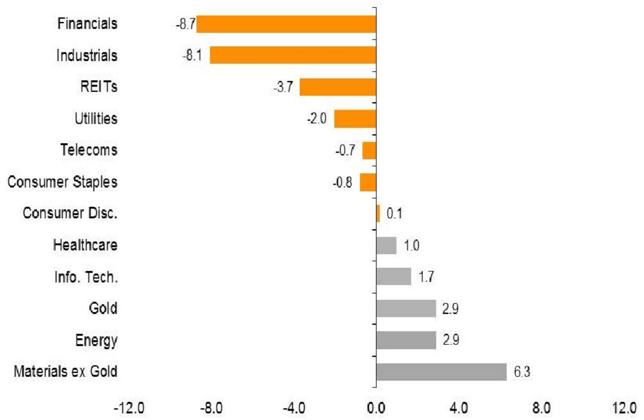


Figure 2: SGH20 Market cap weights relative to ASX300

Material underweight to the top ASX20, offset by a large overweight to mid-cap stocks

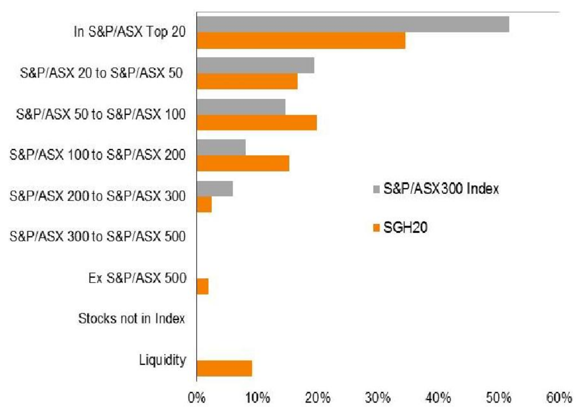


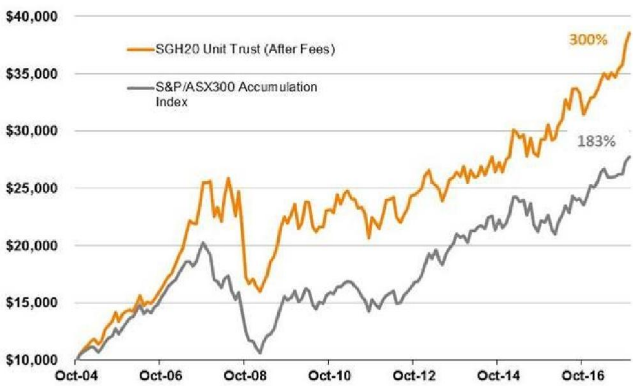
Figure 3: SGH20 Portfolio Characteristics

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)	
	FY18/FY17	FY19/FY18	FY18	FY19	FY18/FY17	FY19/FY18	FY18	FY19	FY18/FY17	FY19/FY18	FY18	FY19
ASX300 Index total	3.6%	4.1%	4.3%	4.5%	4.5%	6.5%	14.3%	13.6%	5.8%	6.3%	17.2	16.1
SGH20 Portfolio	9.0%	7.1%	3.1%	3.3%	9.6%	6.0%	15.6%	15.4%	15.6%	8.9%	22.0	20.1

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

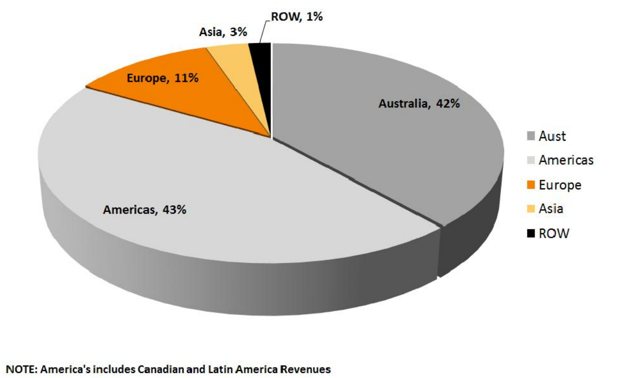
SGH20 has a long track record of adding alpha



Source: SG Hiscock, Bloomberg

Figure 5: SGH20 Portfolio exposure by revenue

Portfolio currency exposure



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.

2017 – 'The Goldilocks' year, will 2018 be the Bears year?

Summary:

- Our base case is global growth and low inflation should remain supportive for equities
- A rise in inflation expectations remains the biggest risk
- Continue to prefer companies that are growing and have secular tailwinds and/or reinvesting in growth options

"Bull markets are born on pessimism, grow on scepticism, peak on optimism and die on euphoria"

Sir John Templeton

At the beginning of 2017, we were expecting a pick-up in global growth on the back of the reflation policies proposed by the Trump administration, ongoing stimulus from China as they managed economic stability into the 19th Party Congress in October, and growing hope of a normalisation in broader growth expectations. However, what we did not anticipate was that conditions would be as supportive for equities as they turned out to be.

In our view, there have been two important drivers of the strong rebound:

i. Ongoing accommodative central bank policy and a weaker US dollar, which has been supportive of equities (and financial assets in general); and
ii. An unusual combination of synchronised global growth and low bond yields. Global bond yields barely moved over the course of 2017 and remained below consensus expectations.

So while economic growth has begun to normalise back to levels seen before the financial crisis, interest rates and monetary policy have not. The IMF is now forecasting global growth for 2018 of 3.9%. Meanwhile core inflation remains below pre-crisis levels in most advanced economies.

This has provided 'Goldilocks' conditions for equities. It has been further supported by low volatility which has boosted risk adjusted returns. In 2017 the S&P500 saw a positive return in every month for the first time in history and, the total return of 19% on 7% volatility put it on a risk-adjusted basis in the 95th percentile versus history.

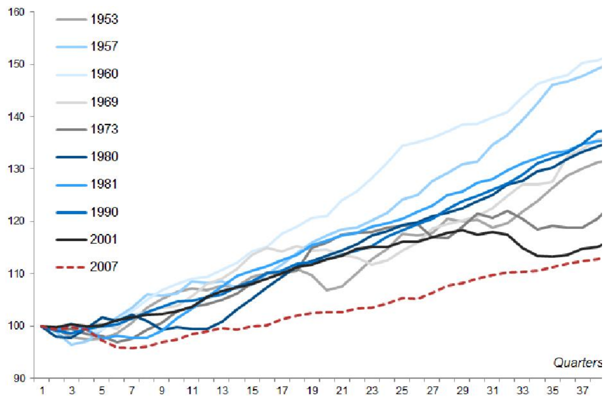
So what conditions can we expect for 2018?

From a more positive perspective, the strength of the pick-up in global growth is encouraging. If anything in the last six months the global recovery has become more synchronised with evidence of the broad-based recovery and investment cycle getting going in Europe. Fundamentally this should be supportive for growth, company earnings and markets.

On the more negative side, there is concern the current economic cycle has already been long by historical standards, and the bull market has mainly been driven by easy monetary policy. With valuations and Central Banks now commencing quantitative tightening the fear is we are due for a correction.

In thinking about the risk of a correction, we think there are two key points worth considering. First, whilst this economic recovery has been longer, it has also been slower. Goldman Sachs in its analysis of past cycles shows that historically the expansionary phase of the US economic cycle has on average been 60 months and expanded off its base by 120%. As Figure 6 highlights this cycle (highlighted by the red dotted line) has now been in the expansionary phase for greater than 100 months and up 114% from its lows. This is not uncommon following a financial crisis, and the length of this cycle can arguably be put down to the fact that the prior build-up of excesses around the GFC were greater meaning the pre-crisis imbalances have taken longer to unwind.

Figure 6: This is a historically weak economic recovery
US real GDP following recessions



Source: Goldman Sachs, Haver Analytics

Second, Goldman Sachs work shows historically economic cycles and bull markets do not generally die of old age, and major corrections generally require a trigger. Historically, this has been the unwinding of financial bubbles or, the end of the economic cycle which has nearly always been triggered by a tightening of monetary policy in response to inflation.

The strength of the current economic cycle, low unemployment and high valuations and asset prices are arguably all pointing to elevated risk of a correction, but importantly inflation remains low. Without higher inflation and interest rates, we continue to think it is unlikely we will have the conditions for a recession and bear market in the near term.

Our base case is global growth and low inflation should remain supportive for equities. We expect central banks will tighten slowly until they begin to get concerned, either about inflation, or about rising asset prices and associated financial stability risks.

A rise in inflation expectations that pushes up bond yields remains the biggest risk to equities (and arguably all asset classes) given where valuations are trading relative to history.

In terms of equity market returns the risk is 2017 was as good as it gets in this cycle, and we enter a phase of lower absolute market returns. The highest returns are typically when economic conditions are weak and recovering and valuations are low, not when confidence and visibility are high and valuations elevated. That said, real returns from equities should still be decent if inflation remains low, and should be attractive relative to bonds if global growth continues to hold together. This makes us cautiously optimistic there is still the opportunity to make good returns for investors over the next three to five years, if not in the next 12 months.

The challenge in the current environment is balancing the growth prospects of individual companies against low and rising bonds. We continue to focus on companies with the best fundamentals, but are conscious low bond yields have been very supportive for longer duration assets (i.e companies with long term cash flows) and companies with high growth and defensive characteristics. Given the outlook for better growth and risk of higher bond yields it would be logical for some of these trends to reverse.

We are therefore focused more than ever on the margin of safety we are paying for companies. This comes down to our confidence in the earnings and cash flow predictability and sustainability relative to our assessed valuation of the business. In our view, the most vulnerable stocks are those just paying a dividend or 'bond proxies'. They are very sensitive to rising bond yields, particularly if top line growth is slowing. We continue to prefer companies that are growing and have secular tailwinds and/or reinvesting their cash flows into higher growth options.

Why are markets so complacent and will volatility rise?

Summary:

- An increase in market volatility seems likely.
- Misguided to think low volatility has been driven by investor complacency
- Increasing volatility is not something we necessarily fear, it can provide an opportunity to upgrade the portfolio.

"In the assessment of a few participants, equity valuations were high when judged against standard valuation measures … a few participants expressed concern that subdued market volatility, coupled with low equity premium, could lead to a build-up of risks to financial stability"

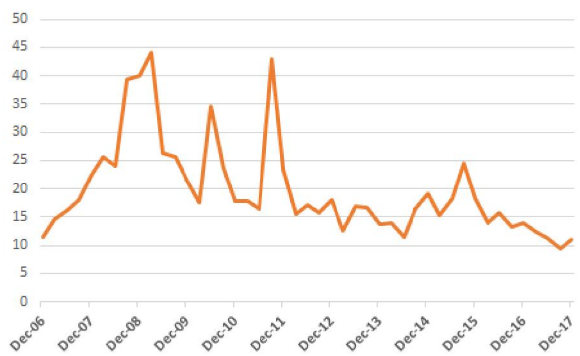
FOMC Minutes (13-14 June)

2017 will go down as one of, if not the least, volatile years in most asset classes. We see the most likely reasons for volatility being so low, as down to the combination of:

- better than expected synchronised global growth;
- low inflation which did not accelerate as much as expected in 2017; and
- Global central bank liquidity remaining incredibly accommodative. Despite the Fed tapering combined central bank liquidity still increased by US$1.8tn in 2017 to US$14.9tn.

This has created an environment of excess liquidity and where investors have been confident enough in growth and valuations to look through the macro risks and push volatility lower.

Figure 7: Market volatility is low, but don't get used to it
VIX Index hit record low in Sept-17



Source: Bloomberg, SG Hiscock

We expect volatility will increase with the changing of the guard on ultra-easy monetary policy through 2018 and given higher equity market valuations. By the time, we get to the second half of the year the Fed will be well into its gradual but slow run-down in its balance sheet, whilst the ECB has said it will further taper its balance sheet in January and the BoJ is purchasing less now it is targeting the yield curve and not a monthly amount. This coupled with prospects inflation will no longer consistently miss to the downside makes us think volatility is likely to increase, and some mean reversion is likely.

We think it is somewhat misguided to think low volatility has been driven by investor complacency. It is our view that despite strong returns most investors (and certainly most of the people we speak to) are cautious about future returns prospects and see the potential (or hope) of a correction as an opportunity to buy the market.

As active investors, increasing volatility is not something that we necessarily fear, rather it can provide an opportunity to capitalise on short term price dislocations and upgrade the portfolio.

As outlined above, we see the potential more for a correction (say 10% down) rather than a recession type scenario in the next 12 months. For a correction to turn into a bear market, we think inflation needs to rise, pushing up interest rates and increasing the risks for a recession. The fact is Bear markets are less common than people think, they happen but are not frequent events.

Do valuations look stretched?

Summary:

- The Australian market looks modestly expensive versus history, but there are pockets of extreme valuation.
- The 'fear of missing out' (FOMO) is increasingly observable (Bitcoin being the best example).
- We remain ever vigilant to the margin of safety we are paying for earnings and maintain a disciplined approach.

"People ask 'well what will trigger [a market correction]?' But it doesn't need a trigger, the dynamics of bubbles inherently makes them come to a sudden end eventually…"

Robert Schiller

Looking at the simple 1-year forward MSCI World PE Global equities look at bit extended relative to history trading on 16.9x. However, after adjusting for the US which is trading on 18.8x, and where c.24% of the S&P500 is technology stocks trading on an average PE of 24.9x, it doesn't look overly expensive in the current macroeconomic setting, in our view.

Figure 8: Global equities looking a bit extended, but not overly expensive ex -US

MSCI World PER 12 months forward

Source: Bloomberg, SG Hiscock

If inflation and rates remain low we believe the market PE could remain elevated for some time, on the basis that below average inflation means company earnings are worth more so a higher multiple is justified.

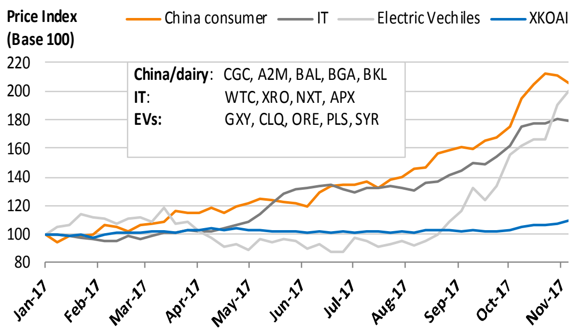
It is also the case that the market PE should look ahead to normalised earnings, and pay an above average PE for temporarily soft earnings. A pick-up in below trend economic and earnings growth of the last few years, as we are currently experiencing, justifies a higher PE.

Similar to Global equities the Australian market, which is trading on a 1-year forward PE of 15.7x, looks modestly expensive versus its long-term average of 14x. However, we see pockets of more extreme valuation. This has been most obvious in the small cap industrials which are now trading on 19.1x and driven by a small number of stocks exposed to Chinese consumption, electric vehicle battery materials and IT.

Our concern is how far the market is pushing valuations for perceived structural growth for businesses which in many cases have unproven or untested businesses models. This will see us pass on some things that may turn out to be winners, but experience suggests will also see us avoid some howlers.

Figure 9: *Pockets of extreme valuation in small cap powder milk, EV battery and technology stocks*

ASX Small Caps trading on 19.1x ,



Source: Bloomberg, SG Hiscock, UBS

The 'fear of missing out' (FOMO) is increasingly observable. The risk is this drives growing speculation and feeds asset bubbles. The rise of Bitcoin is the best example of the current madness of crowds, with many buyers speculating without any real knowledge of what they are getting themselves into, let alone how to value it and plans to get out! Bitcoin has all the hallmarks of an old-fashioned asset bubble, but predicting what will prick it, and asset bubbles more generally, is not obvious - sometimes a trigger is not required. The risk for markets more broadly is of contagion, particularly through the banking sector if significant leverage is involved.

We are conscious that with elevated multiples comes heightened valuation risk. We remain ever vigilant to the margin of safety we are paying. In a bull-market it is important to retain a disciplined approach, with an eye to managing long term shareholder value and preservation of capital.

Is the US as good as it gets now, and is inflation and bonds set to rise?

Summary:

- The US is entering late cycle. Evidence supports the economy continuing to recovery but reaching peak momentum in 2018.
- 2 to 3 rate increases would get policy to neutral.
- Whilst not our base case, the risk is inflation surprises to the upside causing rates to be raised in a more sustained way, which threatens growth and markets.

The US is close to operating above potential growth with the output gap close to zero. Since 1980 the US ISM index has only been higher than the current level (58.2) 9% of the time. On average, it has fallen to a level of around 56 after 6 months and 51 after 12 months (range 38-59). The "base line" therefore, is that this is "as good as it gets". However, closer inspection shows that the periods where the ISM remained elevated over the subsequent 12 months were periods when Fed policy was relatively easy (1987, 2003, and 2010).

Figure 10: US Economy continues to recover

Source: Bloomberg, US Census data

Our view is that the recovery should remain intact but that a peak in momentum will become evident by around mid-year. This brings us to the next question… will the Fed continue to maintain an "easy" policy position? It appears the US is at, or very near, capacity. If potential growth is around 2.75% , below the recent 3%-plus level, but above 2.25% level, it will still leave the US operating above potential, adding to cyclical wages/inflation pressures.

It remains to be seen as to whether the US Tax Reform Bill, which finally passed in December, will provide a further catalyst for capital spending and growth. The final Bill is nowhere as radical as the original border adjustment tax proposed by the Republicans in the House of Representatives, but the cut in the headline corporate tax rate (from 35% to 21%), increase in the deductibility of capital and repatriation of offshore earnings interest is estimated to lift US corporate earnings per share by around 10%. This is a fillip for the Trump administration and is potentially positive economically, but second and third round impacts in terms of whether corporates will reinvest and increase wages are harder to read. Simplistically the tax cuts should be stimulatory for the US economy.

Typically, the Fed sets policy "tight" (i.e. above the neutral rate which is currently estimated at 0% real or 2% nominal) when the economy reaches potential. In the last 3 tightening phases the Fed funds rate rose 50-100bps above neutral and if repeated, places the Fed funds rate as high as 3% (assuming the "neutral" estimate does not rise). Two to three rate rises in 2018 would get policy to neutral and a further three moves would be consistent with the "baseline" (and probably not until late 2019). Markets are not backing this "baseline" assumption, pricing in only 2% Fed Funds by 2020. It is clear that markets believe there are other more structural deflationary forces at work.

The risk as we move through 2018 is that inflation surprises to the upside versus expectations. As we exited 2017, the three-month annualised rate of the Fed's preferred inflation measure, the core personal consumption expenditure index, rose to 1.9%, quadruple the level earlier in the year. Higher wage inflation is certainly possible if growth remains strong. Couple this with higher commodity prices a scenario of rising inflationary pressures cannot be dismissed.

Our base case remains that Central Banks increase rates gradually. However, if central banks were to raise rates in a sustained and steady fashion in response to inflation, given the level of debt carried in all the major economies, it would certainly pose a threat to current rates of growth and equity markets.

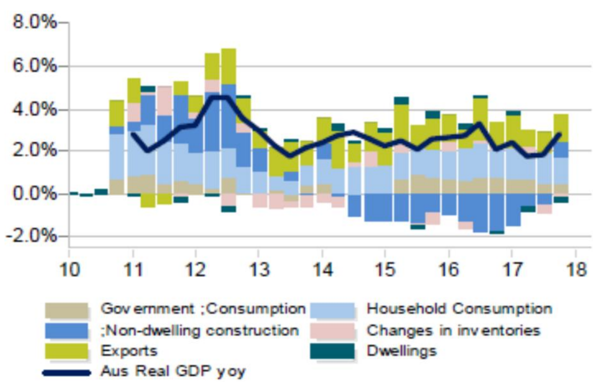
Will Australia's economic recovery follow the rest of the world?

Summary:

- There are continuing signs the domestic economy is improving, led by the pick-up in non-mining investment
- Inflation and wage growth remain subdued, but tighter labour markets could see upward pressure on wages
- Political uncertainty remains the key risk to confidence

Overall, the domestic economy appears to be improving with the mix of growth shifting from housing to investment, while the detraction from the mining sector appears to have run its course. However, with low inflation and wages growth, the banks imparting a lift in mortgage rates for some borrowers and households remaining cautious, there appears no urgency for an RBA rate hike. We suspect the more interesting policy moves in 2018 to be political and fiscal, (tax cuts, rolling into an early federal election) rather than monetary.

Figure 11: Australian GDP contribution



Source: ABS, Heuristics

Up until recently there was suggestion that the out-of-cycle mortgage rate hikes by APRA and the banks was inspiring tightening in financial conditions. Against the backdrop of elevated house prices, high levels of household debt and weak wages growth, there were serious perceived downside risks to the Australian economy. However, a series of strong employment releases (total compensation growth in 2017 exceeded 3%, while hours worked have expanded more than

4%), strong trade data and signs of a pick-up in business investment have underpinned a stabilisation in the economy and the earnings outlook.

The Government's Mid-Year Economic and Fiscal Outlook (MYEFO) showed an improvement in the budget bottom line, with the deficit for this year likely to improve by $5.8 billion compared with the original May estimate, largely the result of the bounce in commodity prices.

Regarding our outlook for economic activity, our base case is for GDP growth close to 3% (end 2018), with inflation around 2%. Employment growth should slow from the breakneck pace seen in 2017, leaving the unemployment rate trending only marginally lower over the coming year.

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.

Westfield: Bid by Unibail unlocks value - Is there more to come?

Summary:

- Unibail's bid for Westfield, and pick up in global M&A in retail REITs is a reality check to negative sentiment
- Unbail's bid is not a knock-out offer, but Westfield is now in play.
- For now we are sitting tight, given the underlying thesis why we invested in the company remains intact.

In July 2017, we added Westfield Group (WFD) to the portfolio. At the time the stock was trading at greater than a 20% discount to our assessed valuation of $10.36 - a reasonable margin of safety in our view when considering the quality of its portfolio and future earnings prospects versus the structural headwinds facing the retail sector from on-line and the general consumer outlook.

Amidst the fears of Amazon's arrival in Australia, slow wage growth and number of retail chain collapses, the market in our view was:

- Failing to properly reflect the value of Westfield's US$3.8bn development pipeline in future earnings; and
- Losing sight of the longer term strategic value of Westfield, and fact that its 'flagship' centres are the highest quality retail mall portfolio globally, located in some of the best city centres, and hard (if not impossible) to replicate.

The pick -up in M&A in the global retail REIT sector in the last quarter, with Brookfield Property Group's bid for US retail landlord GGP, UK-mall REIT Hammerson's bid for Intu and Unibail-Rodamco's (Unbail) bid for Westfield provided a reality check to the negative sentiment gripping the sector and reminder that retail REIT equity values are trading at a discount to direct property values.

Unbail's offer to acquire Westfield at an equivalent price of A$10.01 per share (based on US$2.67 cash per share and balance in Unibail scrip, and holding Westfield's property tech company, OneMarket) was an 18% premium to Westfield's last closing price prior to the bid.

Whilst not a knock-out offer and below our assessed fair value of Westfield of $10.36, it has put Westfield in play, with the Lowy family supporting the approach.

The sheer size and scale of the transaction at $32bn (Australia's largest ever takeover) limits the number of potential alternative suitors. However, given the strategic nature of the assets and synergies we expect a number of owners of US-based malls will be looking at the transaction. In our view, Simon Property Group is the most obvious potential alternate bidder, but it would likely require them to find a capital partner.

Since the deal was announced the implied price of Westfield has moderated due to movements in currency and Unbail's share price, and is currently around a 10% premium to the pre-bid price. At these levels, it arguably increases the prospects of another bidder, or the terms of the current deal needing to be sweetened.

For now, we are sitting tight, given our underlying thesis in why we invested in the company in the first place remains intact. We now await the Explanatory Memorandum and Independent Experts report, and opportunity to meet Unbail management in order to better understand their strategy, and whether we should stay invested in Unibail which will be listed via an Australian-listed CHESS depository interest in the ASX if the deal completes.

Artificial intelligence (AI) & Machine learning

Summary:

- Over the past decade, AI and machine learning has given us self-driving cars and speech recognition.
- It is a pervasive secular theme which we believe will ultimately impact all industries and daily activities.
- We are spending a lot of time understanding it better, and how to capitalise on it in our portfolio.

"Just as electricity transformed almost everything 100 years ago, today I actually have a hard time thinking of an industry that I don't think AI (artificial Intelligence) will transform in the next several years."

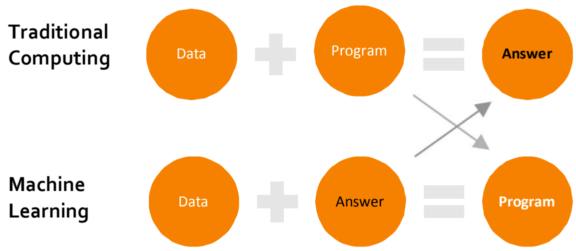
Andrew Ng, VP & Chief Scientist of Baidu

Technology drives efficiency, lowers costs, and changes the way we live. Technological change takes on many faces. Of current interest to SGH20 is the concept of automation; of processes, of tasks, and eventually, of thought.

Artificial intelligence is the encoding of human decisions and behaviour. A subset of this, machine learning takes this concept one step further, getting computers to learn and act without being explicitly programmed.

Figure 12 highlights the progression from traditional computing to machine learning, where the output of the process is a program (algorithm). These algorithms are the lessons that the machine learns through the process. 'Learning' is the term that describes machines reading observations in the dataset to identify patterns, and subsequently arrive at a result. Two key examples are replications of human senses: image recognition (sight) and natural language processing (sound). Your practical experience of this may be Siri or Face ID on your iPhone, or the new Google Home or Amazon Alexa. The fact is machine learning is already incorporated into many of your daily activities, and you probably use it dozens of times a day without knowing it.

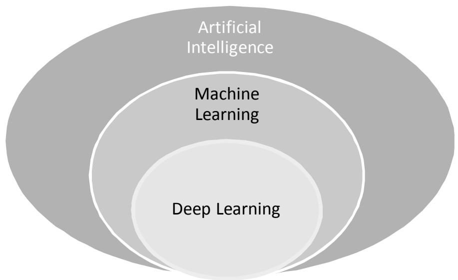
Figure 12: Traditional computing to machine learning



Source: SGH Hiscock, UBS

As the understanding of machine learning has increased, research and development is progressing from machine learning to "deep learning". Deep learning aims to replicate human decision making and a neural network; it is the foundation of artificial intelligence, and is explicitly reliant on high quality annotated datasets which enable computers to learn human behaviour.

Figure 13: Deep learning and Machine learning enable Artificial intelligence



Source: SGH Hiscock, UBS

Development of AI and machine learning applications is having real implications across the investment landscape. On the demand side, they are helping drive new consumption habits as we change the way we live and use technology in our day-to-day lives. On the supply side, they are generating efficiencies and cost out options for companies that we have rarely seen before, by automating processes and supply chains.

Machine learning heavily ties into our broader mega trend of "technology everywhere", and is an investment theme which we think has the potential to realign industry profit pools and create new segments of growth longer term.

In the Australian market finding direct or 'pure-play' ways to play the AI and machine learning is difficult given the small listed tech sector, but we do see a number of interesting emerging companies that we are watching closely and analysing to better understand their business models.

Looking at which industries and companies could benefit most from automation and the efficiencies it could bring is also challenging. The banks are an obvious beneficiary given their heavy transaction and people driven processes. They are already experimenting with robotic process automation that can perform error-free rules based administrative transactions. Last year, we visited Blue Prism a UK listed based robotics automation company that specialises in financial services and has been working with the National Australia Bank, to better understand what they are doing. It reinforced our view that there is a large and growing opportunity for AI and machine learning in financial services processing. However, how it integrates with legacy systems, timing and cost of how the benefits will flow remains difficult to predict and value.

Graphite - the other side of the battery story helping power EVs

Summary:

- We believe Electric Vehicles (EVs) will be a large and growing addressable market.
- The challenge is finding ways to play it in Australia. We see battery metal producers best positioned: Similar to Rockefeller fuelling the Model T boom, they provide the "new gasoline" for the EV industry.
- Out of the battery metal companies listed in Australia we see Syrah Resources as best positioned.

"We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten. Don't let yourself be lulled into inaction."
Bill Gates

We would encourage anyone with an interest in electric vehicles to read our latest SGH20 Insights publication. Andrew Gillies, in an excellent note, explains why we think the EV market is a large and growing addressable market and attractive investment theme.

As is often the case, the challenge is finding ways to play this theme in the Australian listed market. In our view the battery metal resource producers are best positioned. Similar to Rockefeller fuelling the Model T boom, we see them providing the "new gasoline" for the EV industry.

As a general rule, we think over the long-term that resource companies do not have pricing power. The world is well endowed with most resources and, if the incentive price is high enough, supply will respond. It is therefore vital in investing in resource stocks to identify companies that:

- Have a large, high quality resource
- Are low, and preferably at the bottom, of the cost curve
- Are well capitalised
- Led by experienced and focused management

Out of the battery metal companies listed in Australia we continue to see Syrah Resources as best positioned. As a supplier of high quality graphite, the Balama mine in Mozambique will be the largest natural graphite mine globally from 2018. It is a long life asset that will be at the bottom of cost curve in the first year of production, with optionality to expand. Sales agreements have been signed with traditional battery market customers, as well as off-take agreements with industrial customers for base load demand, giving it a secondary market many of the purer play battery metals players don't have. The opportunity to capture additional cash margin and move downstream and establish a core position in the battery supply chain through building a spherical graphite plant in the US, when coupled with the processing of graphite from Balama, provides additional optionality and potential growth. Strategically, this would make Syrah the first integrated battery anode material producer of significant scale outside China, a major competitive advantage in helping battery and auto manufacturers diversify and secure their supply chains.

Management changes over the last 12-18 months (including the appointment of Shaun Verner as CEO) have given us greater confidence in Syrah's operational capabilities and focus. Strategically, we also view the collaborative relationship for battery testing and product development with Cadenza Innovation, a leading innovator in downstream battery technology, as positive. Christina Lampe-Önnerud, Cadenza's CEO and Founder recently joined Syrah's board and is a globally regarded innovator and entrepreneur in battery technology.

Building a balanced high conviction portfolio

Summary:

- SGH20 Portfolio is concentrated (15-25 stocks)
- The portfolio is positioned around sector and company lifecycle considerations to build diversification and a balanced portfolio
- Risk is controlled through position sizes for liquidity and conviction

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.

The portfolio can hold up to 100% in large cap stocks (a large cap stock is defined as a company with a market cap in excess of ~$1,500m) and up to 25% in small/mid-caps. The reason for placing these limits is both liquidity and risk related.

Maximum active sector positions cannot exceed 25% of any ASX300 GICS Tier two sector classification.

In addition to this the portfolio is positioned around three main company lifecycle subsets to help provide diversification and build a balanced portfolio:

- **Mature franchises** - typically 40-60% of the portfolio. This includes:
  - ***Stalwarts*** - These are companies that are well positioned in attractive end markets with high barriers to entry which are hard to disrupt and replicate. They tend to exhibit strong pricing power, sustainable free cash flow and superior dividend growth.
  - ***Quality cyclicals*** - Companies with leverage to the cycle, experienced management and prudent capital allocation and, strong free cash flow generation and balance sheet
- **Structural growers** - typically 30-50% of the portfolio. These companies are innovative or have a unique product or service and strong value proposition and/or brand in large and growing end markets, and are often market leaders or taking market share.
- **Emerging companies** - typically less than 10% of the portfolio with the aim of adding optionality to the portfolio and increasing positions as conviction grows or exiting. These are emerging businesses or companies developing strategic assets in attractive end markets with a predictable path to free cash flow growth sustainability lead by focused and experienced management.

Figure 14: SGH20 Portfolio – Building a high conviction balanced portfolio

	Market Cap exposure		
	Large cap (>$1.5bn)	Mid-Small cap (<$1.5bn)	Cash
% Portfolio	>75%	<25%	0 - 20%

	Company Life-cycle positioning		
	Mature Franchises	Structural Growers	Emerging Companies
Est. % of Portfolio	40-60%	30-50%	<10%
Characteristics	**Stalwarts:**Well positioned in attractive end markets, high barriers to entry, hard to disrupt or replicate, strong pricing power, sustainable FCF and superior dividend growth **Quality Cyclicals:** Leverage to the cycle, experienced management and strong free cash flow generation and balance sheets	Innovative or unique product or service, strong value proposition, in large growing end market and/or taking market share	Emerging businesses or companies developing strategic assets in attractive end markets with a predictable path to free cash flow growth sustainability

Source: SG Hiscock

Summary of Our Macro Thinking

Australian Economy	Australia has managed to navigate the mining investment downswing remarkably well with the extended housing market cycle absorbing much of the fallout. The more recent rebound in iron ore 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 and high level of indebtedness, but with evidence the labour market is continuing to tighten on the back of the increase in non-mining investment we could be reaching an inflection point. Further rate cuts now seem unlikely given the tone of the RBA and US interest rate expectations.
Australian Equity Market	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 continues to 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 represents a headwind. This re-emphasises 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, but we expect the Trump administration's Tax Reform Bill and potential infrastructure plans to further stimulate growth. Other policies such as increased trade protectionism and the Federal Reserve's response to higher inflation potentially provide some offset.
US Bond Market	With the macro narrative having shifted from low inflation and co-ordinated central bank monetary policy to interest rate normalisation and reflation, we expect bond yields to rise through 2018. We expect US monetary policy to be tighter than Europe and Japan causing a widening short rate gap.
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 2018 and, coupled with risk of ongoing capital controls by the Chinese Government, see a range bound AUD as our base case.
China	China's economic growth beat market expectations in 2017 with real GDP growth at 6.9% in the first three quarters. With the passing of the 19th Party Congress in October and Xi Jinping's consolidating his power base there has been a discernible shift in policy to focus on 'quality growth' with a strong eye to managing corruption, pollution and financial stability. We expect headline growth to slow in 2018, but not dramatically. 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	Compared to twelve months ago the growth picture in Europe has improved. Government debt burdens in much of Europe remain elevated placing limitations on fiscal stimulus policies. However, with Euro growth having clearly strengthened over the last 6-12 months and running significantly above potential, and looking increasingly sustainable into 2018 it should give the ECB the room to follow the US lead and start winding down its asset purchase program.
Oil Price	We have become more constructive on oil around the improved demand and supply dynamics benefits from synchronised global growth coupled with the impact of maturing production sources. We believe Saudi Arabia and OPEC's indications to support the price in the near term should put a (soft) floor under the price at circa USD55-60/bbl. However, 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 shale).
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 despite the risks posed by quantitative tightening.

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 it's 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 outperform relative equity market benchmarks.