SGH20 Quarterly Commentary - September 2017

Quarter in Review

"The era of procrastination, of half measures, of soothing and baffling expedients, of delays, is coming to its close. In its place we are entering a period of consequences."

Winston Churchill

Global equity markets continued their rally during the quarter as forward looking economic survey indicators, ISM and PMI, rose to 5-6 year highs in Europe, and US inflation trended lower than expected. The favourable growth and inflation mix has allowed central banks to err on the side of caution when determining policy rates. Together with upwards revisions to earnings, this has contributed to rising risk appetites.

The Australian equity market continued its recent underperformance, flat in September and up just 0.8% for the quarter compared the MSCI Global Equity ex-Aust ($A unhedged) which rallied 2.5%. Much of the variance is being attributed to the composition of the index which is technology light and bank heavy.

Volatility remained eerily low; it has now been over 14 months since the US equity market underwent a correction of at least 5%, with monthly returns in 2017 all in positive territory. With a few months to go and a bright start to October already, could 2017 be the first year ever with positive returns in every month?

The market largely looked through the severe weather events in Asia and Gulf of Mexico region and escalation of tensions on the Korean peninsula. Despite the imposition of further UN sanctions, the North Korean regime has continued its missile testing program with the market discounting the risk of increasing rhetoric between the US and North Korean leaders leading to conflict.

Bond yields moved higher as the Fed inched closer to unwinding its US$4.4 trillion balance sheet and December tightening looking increasingly likely. The FOMC signalled reductions of around US$10bn per month initially, building up to US$50bn per month over time. The expectation is that the Fed balance sheet will shrink by around US$300 bn in the next 12 months, a decline as a percentage of GDP from 23% to 20%. The ECB is also making noises about its ultra easy monetary policy settings. The US 10-year bond yield ended the month at 2.33% after falling as low to as 2.04% in early September.

Commodities performed well across the quarter supported by strong global manufacturing PMI's and supply side shortages emerging in several commodities. Strength remains broad based in terms of sectors and geographies but there is the risk that bringing forward production in preparation for antipollution measures in China could also have been responsible for some of the strength. On the flip side, iron pulled back in September (-20%) after a strong July-Aug rally as a tightening in Chinese credit conditions and an anticipated slow-down in steelmaking ahead of the PNC in October undermined prices.

The Australian Dollar was up 1.9% to the end of September but fell from its highs post the FOMC meeting alongside the retracement in the price of iron ore in September. The RBA has noted that the next move in rates is likely to be up, although given the current low wages growth environment and high levels of debt, any move should be some time away.

Portfolio Performance & Activity

Calendar year-to-date the ASX300 has returned 3.9%, underperforming all major global indices. In large part this can be put down to the difference in relative growth expectations. Australian listed company earnings growth in the last 12 months has picked up on higher commodity prices, but outside this growth has been lacking and continues to lag global listed earnings trends. Consensus 1-year forward EPS growth for the ASX200 is +3.4% vs MSCI World +9.5%. In part this reflects the composition of the Australian market which has little technology exposure (and continues to lead global equity markets higher) and overweight the banking sector. In our view it also reflects the better global growth outlook, a theme the SGH20 portfolio is heavily weighted to with close to 60% (by revenue) of the portfolio with offshore exposure.

In the September quarter SGH20 returned 1.96% after fees, outperforming the ASX300 Accumulation Index by +1.16%. In the quarter Saracen, Syrah Resources, Orora and Lendlease all contributed strongly to performance. During the quarter we added Speedcast International and Westfield Corporation which in our view have good growth prospects and look oversold. BT Investment Management, Nufarm and AGL Energy were exited in the quarter. We continue to hold an underweight position to the Australian banks. The fund held 6.9% cash at the end of September.

	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)	**1.96**	**4.10**	**7.67**	**10.67**	**8.05**	**6.50**	**4.27**	**10.38**
S&P/ASX 300 Accum Index	0.80	-0.78	9.02	7.12	9.94	7.68	2.95	7.75
Value added (MER)	+1.16	+4.88	-1.35	+3.55	-1.89	-1.18	1.32	+2.63

September 2017 Quarter - Portfolio Performance & Characteristics

Top 3 Active Holdings
Janus Henderson Group
James Hardie
Treasury Wine Estates

Portfolio Breakdown	
Financials	28.0
Materials	24.4%*
Healthcare	9.5%

Top 3 Portfolio Attribution
Saracen Minerals
National Australia Bank
Syrah Resources

Bottom 3 Portfolio Attribution
James Hardie
Amcor
CSL

**inc. 4.0% 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

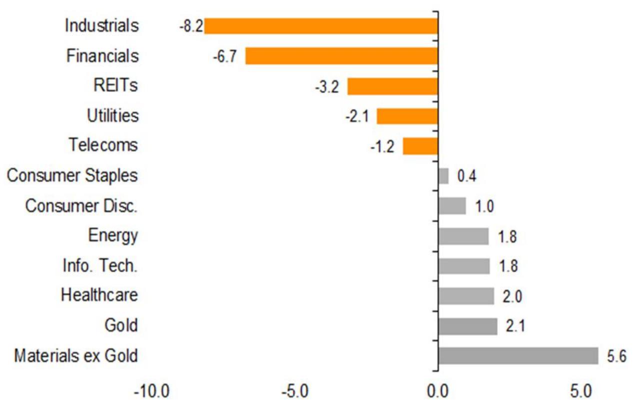


Figure 2: SGH20 Market cap weights relative to ASX300

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

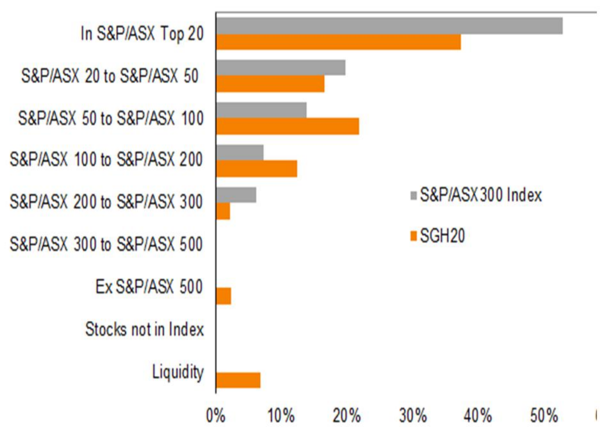


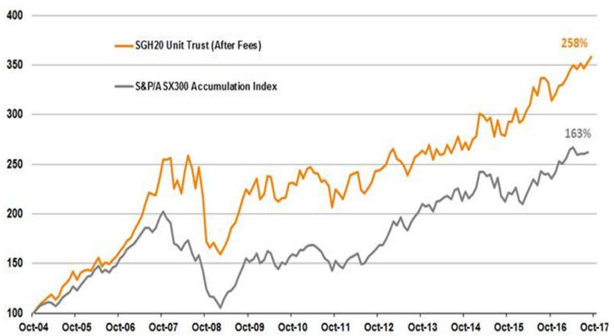
Figure 3: SGH20 Portfolio Characteristics

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)	
	FY17/16	FY18/17	FY17	FY18	FY17/FY16	FY18/FY17	FY17	FY18	FY17/FY16	FY18/FY17	FY17	FY18
ASX300 Index total	3.9%	3.2%	4.5%	4.7%	5.0%	5.8%	13.1%	13.1%	5.0%	7.4%	16.4	15.6
SGH20 Portfolio	8.4%	6.4%	3.3%	3.5%	9.9%	4.7%	15.5%	15.3%	17.2%	6.7%	18.4	16.2

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

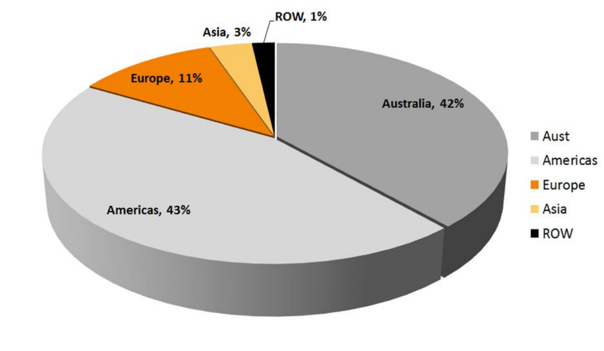
SGH20 has a long track record of adding alpha



Source: SG Hiscock, Bloomberg

Figure 5: SGH20 Portfolio exposure by revenue

Portfolio currency exposure



NOTE: America's includes Canadian and Latin America Revenues

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.

Navigating the yield curve - steepening anyone?

Summary:

- We are surprised the yield curve has not steepened more on Fed quantitative tightening and recent PMIs
- Copper Gold Ratio implies US 10-year closer to 2.6%
- Lack of inflation & geopolitics are anchoring bond yields
- New Fed Chair and reactivation of Trump tax plan are risks to yield curve potentially gapping up.

If we had a crystal ball on the US 10-year Treasury yield, our job over the last 12 months would have been a lot easier. Indeed, the direction of rates and shape of the yield curve continue to be the single biggest risk for markets.

It's easy to be accepting of the current size of central bank balance sheets as normal, as it has been that way for so long. However, in truth it is anything but normal. Since the financial crisis, in excess of US$10trillion has been added to the balance sheets of the largest four central banks in the world (equivalent to the annual output of China at $11.2trillion). The landscape is starting to change. Not only are interest rates starting to rise (e.g. USA and Canada) but Central banks are starting to exit QE.

To that end, the US Fed's comments that it will start to contract its balance sheet marks an important inflection point. Whilst the initial steps are small (US$10bn/ month increasing to c.US$300bn over the next 12 months) in the context of the Fed's balance sheet (US$4.5tn) it is an important transition in the attempt to normalise monetary policy nine years after the start of QE.

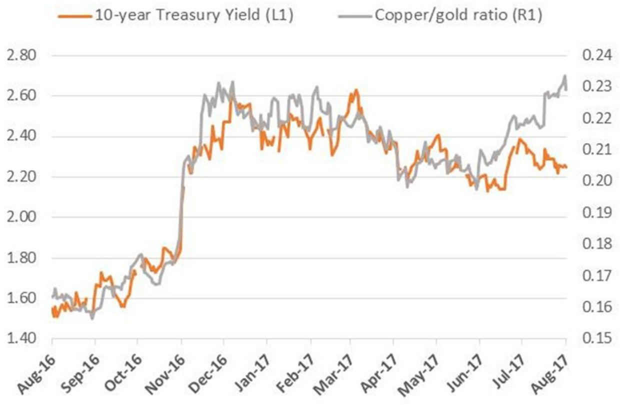
For now, markets appear to have taken the Fed comments in their stride with bonds being relatively well behaved. The US 10-year Treasury yield has moved higher, and closed the quarter at 2.33% after falling as a low as 2.04% in early September.

We have been somewhat surprised there has not been a greater sell-off in bond markets (and steepening in the yield curve) with the announcement of QE tightening given the synchronised pick-up in global growth across all major economies.

A chart frequently used by fixed income traders to try and forecast the direction of the 10-year bond yield is the copper-gold ratio (CGR). As Figure 6 shows this has proved a very good coincident indicator of interest rates in recent years with the R-square a very tight -0.88 to the US 10-year Treasury yield. With the pick-up in global industrial production indicators there has been a sharp rise in the copper price (a metal used in a wide variety of industrial applications) and spike in the CGR. Such an increase would normally suggest activity going on that might be inflationary, and see bond yields rise, but the reverse is the case.

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

Copper/Gold vs US 10-year Treasury yield



Source: Bloomberg

The main reason interest rate expectations remain low is the failure of inflation to rise to central bank targets of around 2%, especially in the US. US core CPI inflation fell to 0.6% in August (from 1.3% in Jan) and wage growth remains tepid. It adds weight to the argument inflation may have already peaked in this cycle, and ongoing excess capacity and longer term structural issues such as technological disruption, globalization, low rates of unionisation and demographics will keep inflation below trend.

The critical question is when and if inflation will pick up and, whether the Fed will maintain its current position that "additional gradual rate hikes are likely to be appropriate over the next few years" if economic data fails to support its inflation target, or reverse course?

Critical to this is who will be the next Fed Chair? If the Chairman is taken over by someone prioritising "normalisation" and inflated asset prices over "data dependency" then interest rate expectations could gap up. This would likely be negative for equity markets, a risk the market doesn't seem to be currently pricing.

Renewed evidence that the Trump administration is able to reactivate its fiscal and tax reform agenda could also see a steepening in the yield curve. The White House released its updated "tax framework" late in the quarter, but whether this will reignite the deflation trade we saw post Trump's election will depend on whether it represents juts tax cuts or more fulsome tax reform. The state of Washington politics and US public debt levels make us sceptical on landmark change, but we are mindful the Republicans have a common interest in getting a tax package agreed with the mid-term congressional elections looming in November 2018.

Our base case continues to be that normalisation of rates will be very gradual and long term rates rise over time, but the commencement of quantitative tightening and risk of policy error represents arguably the biggest systemic risk for markets. A gradual repricing of rates should not prove disruptive for equities, as it reflects an improving macro environment. However, a sharp rise in rates, precipitated by a more meaningful pick-up in inflation that highlights central banks are behind the curve, would likely be highly disruptive.

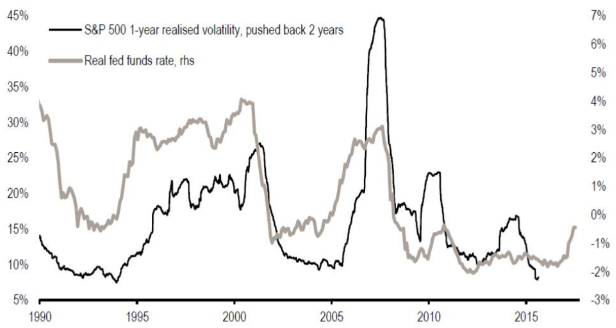
A quick look at volatility

Summary:

- Volatility has been eerily low
- Real Fed funds rates suggest some pick-up in equity market volatility

Volatility remains abnormally low which is implying a degree of complacency among investors. Is it a cause for concern? Two factors that help explain this are the low volatility in inflation and growth outcomes which in turn foster lower variance in corporate earnings and corporate defaults. While real economy outcomes are consistent with low volatility, a more fundamental factor – the degree of accommodation in recent monetary policy settings also underpins the current environment. The real Fed Funds rate has historically lead realised equity volatility by around 2 years and is now consistent with a modest pick-up in volatility going forward providing some food for thought.

Figure 7: Real Fed funds rate has lead equity volatility by ~2yrs
The real Fed funds rate and equity volatility



Source: Thomson Reuters, Credit Suisse

Synchronised global growth - supports increased offshore exposure

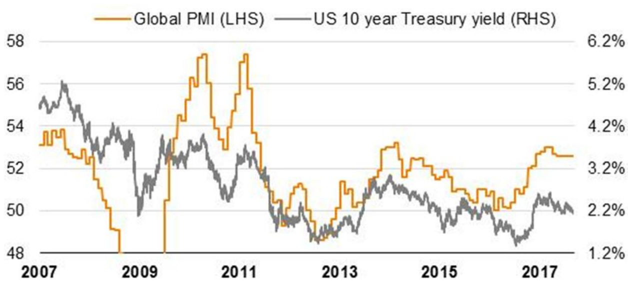
Summary:

- YoY global IP growth is strongest since 2011-12
- Risk is momentum slows, but expect to remain above average over 2017 and into 2018
- Supports increased exposure to offshore earners

Global industrial production (IP) growth, at 3.7%, is close to its highest level since 2011-12. For advanced economies, the lift has been impressive, from below zero a year ago to 3.4%, while Emerging Markets IP growth is 3.9%.

The IMF has also revised up its global GDP forecasts for 2017 to 3.6% (from 3.5%) and 2018 to 3.7% (from 3.5%), the first upward revision from the April forecasts since 2010.

Figure 8: Better global growth but bonds seem unconvinced
Global PMI vs 10-year US Treasury yield



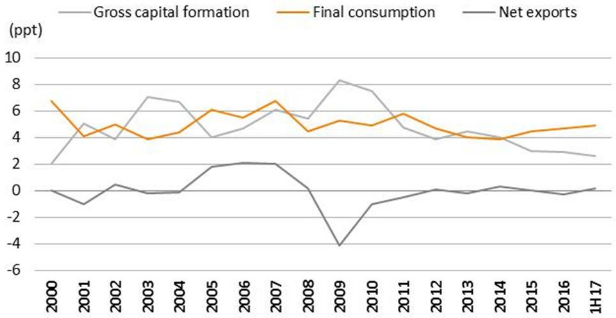
Source: Bloomberg, SG Hiscock

In the US, ISM (manufacturing and services) readings for the September quarter were consistent with GDP growth well above 3%. The recent hurricanes will likely detract from growth and provide some noise in near term date releases, but even real time proxies are forecasting growth around 2.8%. Labour markets continue to tighten; with the unemployment rate close to, or below the level at which inflation is expected to pick up (NAIRU) and underemployment is back close to pre-GFC levels.

The European economy continues to surprise to the upside with GDP growth of 2.1% over the year to June. The European and German manufacturing PMI are also at 6 year highs, and retail trade is relatively solid across Europe with volumes up around 2.4% and sales by nearly 3.3%. We continue to see the potential for a renewed move towards greater fiscal integration on the back of the French and German elections as the main potential positive surprise to growth outside emerging markets.

Chinese macro data of late has been somewhat mixed, but looks dramatically more stable than was the case at the start of 2016, when concerns abounded that the Government had lost control of the capital account and currency. Recent PMI readings have been reasonable and while the latest IP, retail sales and investment figures surprised to the downside, overall the data has been consistent with stable growth. There are near term cyclical risks due to the crackdown on polluting industries and continuing property tightening. But China reflation trade continues to have better fundamental support than in developed economies (most notably the US). Longer term we continue to view the "rebalancing" from investment to consumption as an important driver of the growth. In 1H17 final consumption contributed 4.4% to real GDP growth of 6.9%, and this was supported in 2Q17 by wage growth for unskilled workers growing at a faster rate than skilled workers – the first time this has happened for two consecutive quarters since the data series started in 2007.

Figure 9: China increasingly rebalancing towards consumption
Contribution to China real GDP growth



Source: CEIC Data, National Bureau of Statistics, CLSA,

Whilst the post crisis experience suggests caution and there is risk of a peak in growth momentum, with near term cyclical risks in China and evidence commodity prices are starting to roll over, the outlook has brightened considerably over recent months. This provides growing confidence growth is likely to remain above average over the remainder of 2017 and into 2018. It also supports our portfolio bias to companies with offshore earnings where we see stronger earnings growth through companies with strong franchises that are investing, and growing (e.g. CSL, James Hardie, and Treasury Wine Estates).

Figure 10: Australian earnings lagging global trends for 6-yrs now
EPS 1-yr forward for ASX200 vs MSCI World Index

Source: UBS, Factset, SG Hiscock

Australian domestic setting – mixed signals, but an infrastructure boom

Summary:

- Domestic economic indicators provide mixed signals
- Population growth and labour market are strong, but income growth and consumption trends remain soft
- Infrastructure spending is booming, providing timely support

In somewhat of a surprise, most economic indicators in Australia remain strong including the NAB business conditions, employment, housing, capital expenditure and consumer sentiment. Correspondingly, the RBA Policy Indicator continues to point towards a tightening bias. The only indicator that suggests a need for easing is the low levels of inflation, which reflects the relatively low growth in wages.

Retail sales have been in the spotlight. The fall in August of 0.6% was the largest fall since 2013. Sectors which had previously been strong (hospitality) were down but the poor performance was broad-based, up only 2.1% yoy. Offsetting modest income increases in official data, households are spending more on interest costs, debt reductions, utility costs and savings which is why there is a perception that conditions are tougher than being experienced.

Australia retains a high level of household debt at 190% -one of the "highest indebtedness levels around the world" – rising with the increase in house prices. This underlines why the RBA is expected to tread lightly when it does start raising rates.

The labour market data has been strong. Almost 270,000 jobs have been added this year (equivalent to the US adding 450-500,000 payrolls per month).

Figure 11: Labour market has been strong, but household income growth remains depressed

Source: ABS, SG Hiscock

Helping support this has been strong population growth which increased by 1.6% over the past year led by a strong rise in net overseas migration (231,900 people or 26.9%). The increase in net overseas migration during the quarter (87k) was the largest since Q1 2009. At a State level Victoria (2.4%) saw the fastest growth over the last 12 months versus the ACT (1.8%), NSW (1.6%) and QLD 1.6%).

With the housing boom considered by many to be in the late stages of a cycle, attention has turned to infrastructure investment in Australia to provide the next mini-boom. Over the next four years, the Federal Government (A$16bn) and the States (A$221bn) plan to spend around A$237bn on infrastructure. This will likely be exceeded as planning progresses on major projects that haven't yet received full funding. The NSW and VIC state governments are the arteries of the cycle. They're planning to spend A$73bn each by pumping property tax revenue from the booming Sydney and Melbourne property markets and their own recycled infrastructure sale proceeds into new projects. Roads (A$16.6bn) and rail (A$5.5bn) have near-record levels of work-in hand with more in the pipeline. Other areas of economic infrastructure such as water supply & sewerage and electricity are turning up, but coming later to the party. In social infrastructure, aged care has record levels of work in-hand (A$1.8bn), while the outlook for education and entertainment is improving from already-high levels.

The impact on GDP will not match that of the mining boom which added 7% to GDP between 2005 and 2013, however it should provide timely support to the economy as the housing cycle matures.

Over the cycle we expect our position in Lendlease to provide leverage to the pick-up in domestic infrastructure investment through its Australian engineering construction business (c.10-15% of earnings). We also see the business well positioned to participate in urban regeneration and affordable housing private public partnerships in the UK and US, where it has strong existing market position.

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.

Linking themes to stocks and investible ideas

Summary:

- Identifying stocks exposed to compelling thematic and secular trends is part of our idea generation process.
- Most themes emerge over time and can be identified with a reasonably high degree of visibility. The challenge is assessing which themes really matter and linking stocks to themes and ultimately investible ideas.

The role of 'Thematics' and identification of attractive industry dynamics that provide a positive structural tailwind in which to invest has long been a feature of the SGH20 process. It provides a useful tool for idea generation and filtering our investment universe for stocks exposed to compelling sector and secular trends. This helps shape the focus list of companies which we research in more detail to determine whether they have a sustainable competitive advantage that allows them to profit from exposure to the theme.

Over the years, we have tracked and mapped the investment themes in various ways. It is a dynamic process which we are constantly reviewing and assessing. Figure 12 shows our current theme map which groups our investment themes around high level mega trends which cut across traditional sector classifications and, seek to best provide some structure to our thinking.

Figure 12: SGH20 Investment Theme Map

Mega Trends	Technology Everywhere	Changing Consumption	Aging Population	Globalisation	Low Carbon Economy
Investment Themes	Artifical Inteligence/ Robots	Sharing Economy	Health & Wellness	Urbanisation	Shale Innovation
	Big Data	The Rise of Services	Biotechnology	Immigration	Battery revolution
	Social Media	Rising EM Incomes	Genomics	New breed of EM competitors	Electric Vehicles
	Mobile Payments	Feeding the World	Healthcare spending	Cybersecurity	Clean/ Renewable Technology
	3D Printing	Education	Retirement planning	Price deflation	
	Virtual Reality	Obesity	Aged care		
	Internet of things	Millenials			
	Blockchain				

Source: SG Hiscock

Our current mega trends are:

- *Technology everywhere*: capturing the accelerating pace and proliferation of technology innovation and disruption.
- *Changing consumption*: includes emerging market urbanisation and growth in consumers and changing development market consumption patterns.
- *Aging population*: including health and wellness and retirement planning.
- *Globalisation*: reflecting the global economy becoming increasing connected in trade, finance and knowledge.
- *Low carbon economy* and growth in environmental sustainable technologies

Tracking these trends and themes and their investment implications is important to understand in our view as they realign industry profit pools, recut winners and losers and create new segments of growth. Ultimately, they are borne out in the performance of individual stocks.

Most themes emerge over time and can be identified with a reasonably high degree of visibility. The challenge is assessing which themes really matter and:

- The speed of change - how quickly is the theme growing?
- The scale of change - how big the market opportunity is?
- The source of change - what is driving the theme?

The other key challenge is linking stocks to themes and ultimately investible ideas. In many cases, we struggle to find an obvious direct way to leverage a theme because of the lack of Australian listed companies exposed to the theme. However, it is often the case there are multiple different ways to play a theme through understanding the extended industry supply where Australian companies stand to benefit.

'Rising obesity', under our 'changing consumption' megatrend, is case in point. The incidence of obesity has risen by 11% on average in G7 counties since 1992 driven by growth in fast food and high fat and sugar diets. This has spurred growth in both the incidence of non-commutable disease like diabetes and demand for health and wellness products. We view obesity as one of the key drivers of the increasing incidence of obstructive sleep apena and sustainable source of demand for CPAP therapy, which underlies our investment thesis in Resmed.

More recently, ResMed's acquisition of Brightree has seen the company begin to leverage the 'big data' theme, part of the 'technology everywhere' megatrend. Brightree is a leader in business management and clinical software applications for the post-acute care industry including CPAP ad respiratory care. By recognising the increasingly important role remote data collection and cloud communications is playing in automating and enabling interaction between key players such as patients, physicians, healthcare funders and product distributors ResMed is growing its market reach and enhancing its competitive positioning. In this capacity, it is starting to leverage multiple themes.

The fact a company is leveraged to a thematic tailwind doesn't automatically translate into it being an investible idea. It must pass through our investment filters on liquidity, balance sheet and returns expectations, and stack up under our bottom-up fundamental research process in meeting our 'Quality', 'Insight' and 'Valuation' criteria.

Ultimately, we are looking to identify companies operating in attractive end markets with a competitive advantage and attractive business model that are well managed and attractive margin of safety to intrinsic value.

Speedcast - Leader in remote satellite services

Summary:

- We recently added a position in Speedcast
- Offers exposure to growing satellite communications sector at an attractive margin of safety to intrinsic value

In the last quarter, we added a position in Speedcast International having followed the progress of this company for some time, and evidence at its recent result that both the Harris integration is progressing to plan and operating cash flow is improving – two things we were looking to see.

Listed on the ASX since late 2014, Speedcast is a service provider primarily focused on the delivery of satellite-based communication services to a growing list of international customers primarily in the cruise ship, maritime and energy industry.

Both prior to its IPO and indeed since, Speedcast has been highly acquisitive, which has contributed to a period of fairly rapid expansion both geographically and, in terms of the industries it serves. This level of corporate activity in a relatively short space of time has added to the complexity faced when analysing the company. Indeed, without this it's quite possible we may have been an earlier investor given the underlying appealing features of the business.

A key attraction of Speedcast is it offers exposure to the increasing digital needs of businesses principally in remote locations that are away from traditional land based communications infrastructure. This is being driven by requirements for higher levels of access to the internet and mobile device usage, greater digital automation in its customers operating models and higher regulatory/safety requirements for industries that have mandated higher communications standards.

Despite this positive backdrop, the remote satellite services industry has faced a challenging environment over the last 3-4 years with maritime shipping and energy exploration and production customers showing weaker demand.

For Speedcast, first under private equity ownership and more recently as a listed company, this has provided the opportunity to consolidate what has been a quite fragmented industry. The result has been the development of a business that now enjoys the scale and expertise to compete with the largest players in the industry. This should allow it to tender for contracts with a wider group of customers (including Governments) and leverage its buying power when purchasing equipment and satellite bandwidth (~70 of operating costs) which it leases, at a time when there are signs the industry fundamentals are starting to turn.

The supply and demand dynamics for satellite bandwidth appears to be rebalancing after a period of oversupply on the back of a significant period of satellite launches in the late 2000's. There are also some signs global growth indicators are starting to pick-up – hopefully a precursor to improved expenditure in the shipping and energy industries.

We also see Speedcast as well positioned to capitalise on the increasing level of customer churn over the last few years which has seen the average duration of supply contracts fall to little more than 2-3 years. Speedcast appear well positioned to meet not only the demand needs of customers but importantly the service and support requirements, which should set them apart from peers and ultimately deliver both longer and more lucrative contracts with customers.

As part of our investment case, given the ongoing integration of recent acquisitions and more cyclical nature of some of Speedcast's customers, we have built in a significant margin of safety to our assessed valuation of the business. We purchased Speedcast on an FY1 PER of 11.5x and applying relatively conservative growth forecast for the business over the next 5 years, SGH20's current modelling of Speedcast's value suggests >25% upside to our target price.

Figure 12: Speedcast International company overview

	Energy	Maritime	Enterprise & Emerging Markets	Government
FY18 Revenue	38%	20%	14%	16%
Comments	- Cyclical industry, expected to come out of severe downturn in the near turn	- VSAT penetration driving growth in merchant shipping	- Diversified segment, fragmented industry and limited global players	- Government spending expected to rise globally in coming years
	- Consolidated services requirement with focus on reliability and support	- Strong volume growth fundamentals in cruiseships market still fragmented	- Cellular backhaul driving growth	- Access to US Govt. opportunities
	- Outsourcing likely to grow as customers need to be leaner	- Opportunities for new applications and innovation	- Mining spending expected to improve	- Significant opportunity in the IGO/ NGO space

Source: Company data, SG Hiscock

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 rebound 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 ongoing 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 RBA 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 tax reform and increased spending on infrastructure is likely to stimulate growth. Other policies such as increased trade protectionism 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 2017-18. 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 Oct-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 French and German elections as an important political development. 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. 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 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 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 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.