SG HISCOCK & COMPANY

SGH Australia Plus Quarterly Commentary - March 2018

Quarter in Review

"The most important lesson I've learned over time is that you have to contain your emotions. It's not easy to do on the way up, and it's not easy to do on the way down, but it is your enemy in terms of creating wealth over time."

Tim Armour, Capital Group

The March quarter saw a sharp rise in volatility, with the VIX Index recording its sharpest one day rise in history, and the S&P500 giving back literally all of its January gains (+5.7% and the strongest start to the year in 30 years) in the first few days of February. At the heart of investors' concern was the sudden and rapid rise in bond yields and inflation expectations as strong US data pointing to robust growth, was then coupled with the Trump administration's tax reform package. After a short period of stabilisation, February losses were further extended in late March on concerns around Tariff protectionism, stirring trade war developments, White House personnel changes, Facebook woes and weaker PMIs. The ASX300 finished the quarter down 3.8%, underperforming its global peers (in AUD terms), and back at October 2017 levels.

A growing question is whether the January top in the S&P500 marked the peak in US equity markets this cycle, or is the current sell off just another short correction. The fact the January top was characterised by multiple expansion on overwhelming bullish sentiment on the back of US tax cuts has the hallmarks of the final 'euphoria' phase of a bull market cycle, before the downturn. However, this needs to be considered against the fact global industrial production growth is running at just under 4%, and whilst momentum may have peaked, there is little evidence this is about to turn down sharply. The up and coming US quarterly reporting season will be important in confirming the trends for corporate earnings.

A key risk to the global growth outlook is whether the current tit-for-tat tariff moves between the US and China materialise into a fully blown trade war. President Trump as a candidate pledged if elected he would "use every lawful tool to combat unfair trade, protect American workers, and defend our national security". Despite the chaos in Washington, he would appear to be fulfilling his promise. Our working assumption is his objective is to reduce the US trade deficit with China and deliver a better deal through a negotiated outcome, rather start an all-out trade war. However, this is something we are watching closely, and we expect further volatility as the posturing and negotiations play out.

The other reason a potential top in markets may have been reached is US monetary tightening. In March the Fed raised the funds rate target range 25bps to 1.50-1.75% and released a somewhat more hawkish forecast for the path of policy rates over the 2018 to 2020 period. The closely-watched consensus expectations for 2018 continue to look for a total of three hikes, and in addition to this the Fed is on course to shrink its balance sheet by 9% (or US$420bn) over 2018.

Inflation also remains critical to the Fed's tightening, and interest rate expectations. The recent US tax reform and US February payroll print sparked an inflation scare and sell off in the US 10-year bonds, with the yield up 33bps calendar YTD and closing the quarter at 2.74%. For the moment bonds have not breached the critical 3% level many technical observers see as the threshold that would signal the end of the deflationary era that started in the early 1980's.

Portfolio Performance & Activity

In the March quarter SGH Australia Plus returned -0.63% after fees, outperforming the ASX300 Accumulation Index by +3.14%.

In the quarter CSL, ResMed and NextDC all contributed strongly. Woodside Petroleum was notably weaker in the quarter on the back of a large equity raising to support acquisitions and future project capex requirements. The dilutive nature of the raising highlights the ongoing need to balance investor expectations against prudent long term company planning. On a positive note, the Board remained committed to a high dividend payout ratio for the next few years, and we believe the company is investing at the right point of the cycle (as we discuss further inside).

During the quarter we initiated a position in Boral on the market pull back. We see the stock as well leveraged to the domestic infrastructure spending theme. We also exited a small position we inherited in China Literature, a spin-off from Tencent, and exited Bharti Infratel given growing headwinds we see for mobile tower tenancy on the back of further consolidation in the Indian Telecom sector.

The portfolio continues to be overweight companies with offshore exposure (c.65% by revenue). This is less about our view on the currency, and more about our belief that these companies have better prospects and are more diversified. The fund held 10.3% in Asian equities and had 9.7% cash at the end of March.

	3 Month %	6 Month %	1 year %	2 years % p.a	3 years % p.a	4 years % p.a	Inception % p.a
SGH Australia Plus (after MER)	**-0.63**	**9.06**	**17.83**	**18.37**	**14.43**	**18.30**	**18.55**
S&P/ASX 300 Accum Index	-3.78	3.67	2.86	11.21	3.92	6.33	7.21
Value added (after MER)	+3.14	+5.38	+14.97	+7.16	+10.52	+11.97	+11.35

March 2018 Quarter - Portfolio Performance & Characteristics

Top 3 Active Holdings	Portfolio Breakdown		Top 3 Portfolio Attribution	Bottom 3 Portfolio Attribution
NextDC	Materials	17.9%*	CSL	Janus Henderson
Saracen Minerals	Financials	16.8%*	ResMed	ANZ Banking Group
Orora	Consumer Staples	9.2%	NextDC	Woodside Petroleum

**inc. 4.0% in Gold*

Figure 1: SGH AusPlus Sector weights relative to ASX300

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

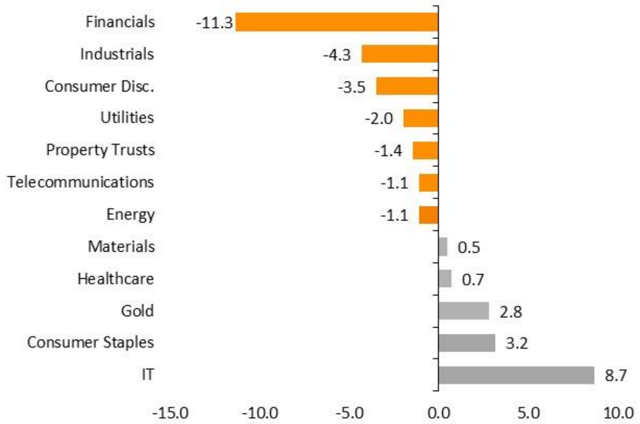


Figure 2: SGH AusPlus weights relative to ASX300

Material underweight to the top ASX20, offset an overweight to mid-caps stocks - ASX 50-100, and Asia 10.3%

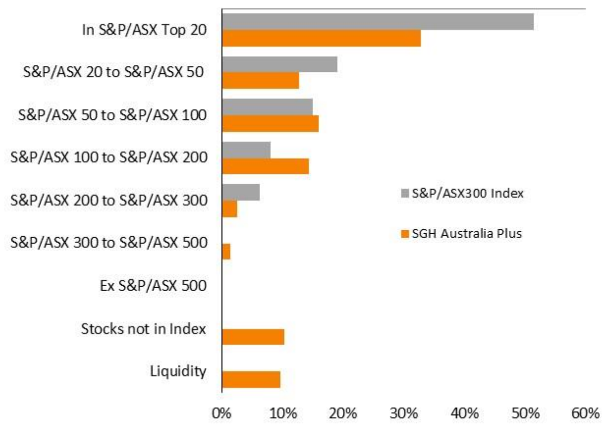


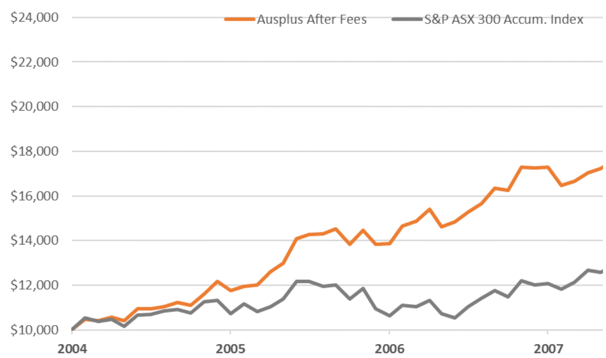
Figure 3: SGH AusPlus Portfolio Characteristics

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

	Sales Growth		EPS Growth		DPS Growth		Yield		PER (x)		ROE	
	FY18/FY17	FY19/FY18	FY18/FY17	FY19/FY18	FY18/FY17	FY19/FY18	FY18	FY19	FY18	FY19	FY18	FY19
SGH AustPlus Portfolio	11.0%	6.8%	15.8%	12.4%	14.9%	20.7%	3.0%	3.3%	21.6	16.4	16.4%	17.1%
ASX 300 Index	3.7%	3.4%	7.2%	5.6%	4.2%	4.3%	4.7%	4.8%	16.8	15.5	12.4%	12.9%

Figure 4: $10,000 invested since inception in SGH AusPlus

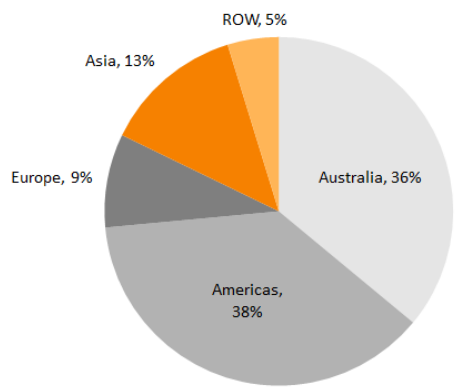
SGH AusPlus has established a track record of adding alpha



Source: SG Hiscock, Bloomberg

Figure 5: SGH AusPlus Portfolio exposure by revenue

Portfolio currency exposure



America's includes Canadian and Latin America revenues
Gold and commodity revenues in USD

Source: SG Hiscock, Bloomberg

Top of Mind

Our portfolio construction process is bottom-up stock driven, but overlaid 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.

Goodbye 'Goldilocks'

Summary:

- What concerns us most, is not the current trade issues, but that we are now in a period of solid but slowing growth with higher and rising inflationary pressures.
- Unless, growth takes a sharp turn down or financial conditions tighten appreciably we would be surprised to see the Fed shift its current strategy.
- If this is the case, it is likely the 'Goldilocks' phase and peak returns for equity markets this cycle has passed.

"Every time I get accustomed to low volatility … something erupts to remind us that the idea that anyone is in control of everything is hubris"

Lloyd Blankfien, CEO Goldman Sachs

The unusual combination of synchronised global growth surprise and low bond yields provided a highly favourable setting for equities in 2017: not too hot and not too cold, but just right - 'Goldilocks' conditions. This was supported by low volatility, boosting risk adjusted returns.

In our December Quarterly Commentary we commented that "it is hard to think volatility will not increase from here" and that "we see the potential for a correction (say 10% down) .." Little did we think it would happen days after going to print with the VIX Index recording its sharpest one day rise in its history, and the S&P500 giving back literally all of its January gains (+5.7% and the strongest start to the year in 30 years) in the first few days of February.

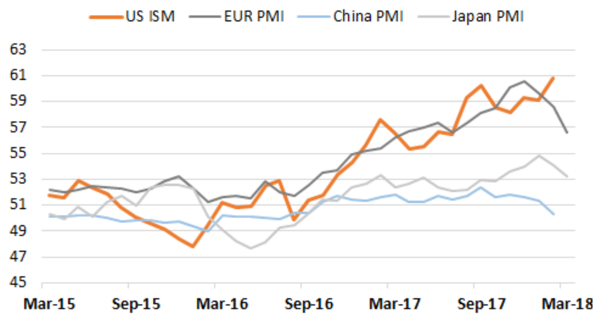
The February, and late March market drawdowns were due largely to rising volatility driven by technical factors relating to the rebalancing of exchange traded volatility products, and rising concerns around tariff trade wars and de-rating of the FAANGs, rather than a broad based slowdown in global growth prospects.

Our base remains that the broader upswing in the global industrial cycle remains in place, but the risk is momentum has peaked:

- Major economy PMI and ISM's have rolled over in the last few months (see Figure 6)
- Commodity prices, freight rates and commodity currencies appear to have peaked; and
- The global new order to inventory ratio has weakened

There is little evidence global growth is about to turn down sharply, but it would appear we are entering an interesting phase where global growth remains solid, but is slowing from its cyclical peak.

Figure 6: Global remains solid but slowing from cyclical peak
Global PMI and ISM for major economies



Source: Bloomberg

How equity markets respond to growth that is still good, but slowing, will inevitably depend on whether the slowdown is anticipated or comes as a surprise. It would seem the risk is markets assume some aberration in growth until the more recent weakness evident in the leading economic indicators stabilises. Our base case is global growth remains supportive for equities in 2018, but we are watching the data carefully.

A key risk to the global growth outlook is whether the current tit-for-tat tariff moves between the US and China materialises into a fully blown trade war.

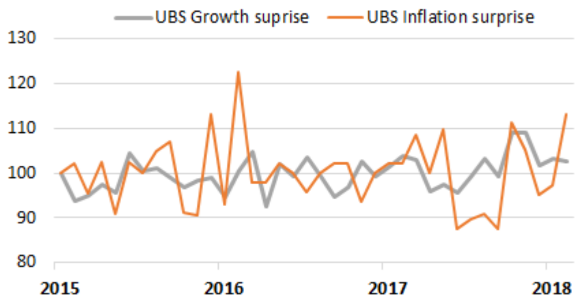
However, what concerns us more than the current trade issues is that we are now facing a period of solid but slowing economic growth with higher and rising inflationary pressures.

US Core inflation still remains below the Feds 2% inflation target, but inflation pressures look well entrenched with US wage growth hitting an 8-year high in January and the oil price up 25% yoy. The added danger is President Trump's policies to 'Make America Great Again' through deploying large tax cuts and a debt funded fiscal program into a growing economy close to full employment adds to the reflationary pressures.

Figure 7 shows that in February on the back of the US tax cuts and spike in the US payroll print US inflation upside surprise started to outpace growth surprise (as measured by UBS's surprise indices, which track actual economic outcomes to Bloomberg consensus estimates).

The question is will this trend be sustained? History suggests there are few periods where a modest downturn in growth is met with a sustained increase in inflation. Either inflation follows growth lower, or the growth cycle experiences a brief aberration but remains above trend and inflation pressures continue to build.

Figure 7: US Inflation upside surprise is now outpacing growth surprises
UBS US Growth vs Inflation surprise Index (moving annual % chg)



Source: Bloomberg, UBS, SG Hiscock

Ultimately it is these growth versus inflation expectations that will determine the Fed's path on interest rates. In March the Fed raised the funds rate target range 25bps to 1.50-1.75% and released a somewhat more hawkish forecast for the path of policy rates over the 2018 to 2020 period. Unless, growth takes a sharp turn down or financial conditions tighten appreciably we would be surprised to see the Fed shift its current strategy.

If this proves the case, it is likely the 'Goldilocks' phase and peak returns for equity markets this cycle has passed. That said, solid but slowing growth coupled with rising inflationary pressures and slow rising rates should still see decent real returns from equities.

China's 'War on Pollution' driving LNG demand

Summary:

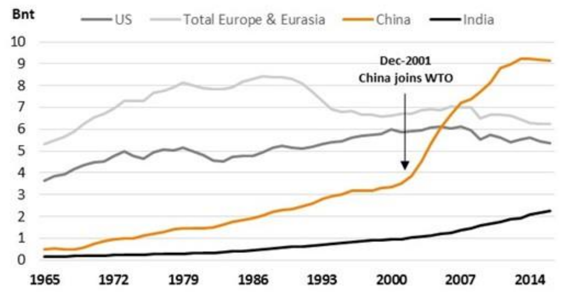
- China's crackdown on pollution has become an imperative to maintaining social stability.
- Coal to gas conversion is a key policy reform.
- China is short gas and will rely heavily on LNG imports.
- We hold Woodside Petroleum and Sino Gas & Energy which we believe are well leveraged to this theme.

"We will resolutely declare war against pollution as we declared war against poverty"

Li Keqiang, China's Premier

Following the 19th China CPC party congress meeting last October, where Xi Jinping consolidated his powerbase, there has been a discernible change in the Party's propaganda from the "China Dream" to "Beautiful China". This has seen more of an emphasis on the quality of growth and not just the quantity. It has also seen an increased 'war on pollution', with the Government announcing new green policies, clean energy reforms and recycled waste import bans.

Figure 8: China is the world's #1 carbon emitter
Carbon Dioxide emissions 1965-2016



Source: BP Statistical Review of World Energy, 2017

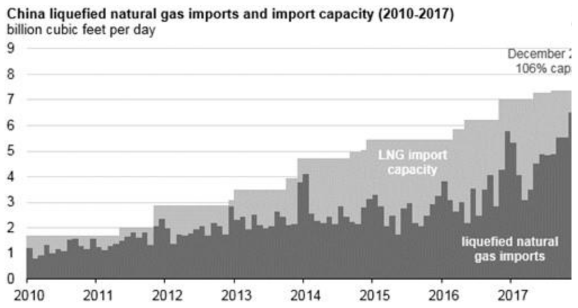
Living in Australia it is hard to fathom how extreme the Chinese air pollution is. Berkley Earth, the research group associated with Berkley University, estimates China's air pollution contributes to 1.6m deaths per annum, and the PM2.5 air pollution reading (which measures the fine particles which pose most risk and are the main cause of lung disease) in the winter months in northern industrial provinces of Shanxi and Hebei is equivalent to smoking 25 cigarettes a day! For the Government the crackdown on pollution has become an imperative to maintaining social stability.

A key plank to the Government's pollution reform agenda is to drive gas growth in China and invest in the conversion of coal to gas power generation. Under the current 5-year plan the Government is targeting to increase the nations gas energy mix from currently less than 5% to 10% by 2020, and 15% by 2025. This represents an effective trebling in China's gas demand over the next 15 years.

To deliver this growth China is investing heavily in infrastructure and gas pipelines to connect a greater percentage of the population in tier 2 and 3 cities. In 2010 190m urban residents had access to gas. In 2015 this had increased to 290m and is targeted to be 550m residents by 2025.

China has large indigenous gas reserves. It has the largest shale gas resources outside the US, and whilst this is expected to grow strongly, and potentially double over the next decade, it is only expected to meet around 50% of gas demand. The market is therefore expected to remain in significant deficit and dependant on gas imports. We expect this will see growth in pipeline gas from Central Asia and Russia, but we expect China will fill most of its gas shortfall through LNG imports. The Government has a target to increase LNG import terminal capacity from 45 million tonnes per annum (MTPA) presently to over 100MTPA in 2025, and in 2017 China's imports of LNG increased 46%. It is now the #2 LNG importer globally behind Japan, overtaking Korea last year.

Figure 9: China LNG imports in 2017 +46% yoy to 38mt, jumping to the #2 global importer begin Japan



Source: Bloomberg, SG Hiscock

We believe the structural changes to the China gas and LNG markets provide a positive back drop for LNG demand and supply and pricing. Whilst the US could play a major role in supplying this LNG, we see politics rather than just price being an important determinant and the Australian LNG producers standing to benefit, including Woodside Petroleum (WPL) which we currently hold. A large proportion of WPL's contract profile is coming up for expiry in 2018-19, and we see them being a beneficiary of rising spot LNG prices. Longer term we see the recent acquisition of Exxon's 50% interest in the Scarborough field and its c.13% stake in Wheatstone LNG helping provide long dated growth opportunities.

We are also exposed to the China gas thematic through an investment in SinoGas Energy, an Australian listed small cap company with an exposure to the Chinese indigenous gas market through its 49% interest in the Sino Gas and Energy (SGE) Joint Venture (JV), established to develop gas in China's Ordos basin. The JV owns interests in two gas production sharing contracts in Linxing (with CNOOC 30% and CBM energy 5.25%) and Sanjiaobei (where PetroChina is a 51% partner). The total JV resource is currently ~4.8 Trillion cubic feet (Tcf) of conventional/tight gas (not shale) and low cost at US$1.20/mmscf, less than ~20% of the equivalent LNG cost of supplying to the Chinese local market of ~US$7/mmscf. In our view this is a world scale resource, sitting at the bottom of the cost curve – ticking the key boxes we look for when investing in commodity based businesses.

Banking Royal Commission - What to expect?

Summary:

- The 2011 UK Independent Commission on Banking could provide precedent for the Commission's findings
- The finance sector is ripe for technological disruption, and the Commission may be a catalyst in accelerating change.
- We remain underweight banks given low growth and growing structural risks.

The Royal Commission into misconduct in Banking, Superannuation and Financial Services commenced in February with the initial focus being consumer lending to be followed by advice and platforms. As expected the headlines have not been good, and one could argue they have been worse than expected. This, coupled with the Commission's broad terms of reference, and media intent on focusing on the negatives, is creating a high degree of uncertainty as to what the eventual report findings and recommendations may be.

In thinking about this further, it is important to recognise this is not a conventional royal commission process where witnesses are cross examined and evidence sort on which findings and recommendations are made. Rather it would appear to be more of a politically driven process, with a tight (potentially unrealistically short) timeframe designed to produce a report for the Government before the Federal election next year. As a consequence the Commission has been structured through a series of case studies where topics are being examined based on selected examples from information that has been self-reported under a general demand by the Commissioner for information. There is no question many of the examples drawn on are disturbing and indefensible, but it begs the question whether the process is turning into somewhat of a show trial.

That said, much of what is being disclosed is not new news, and has been the subject of remediation and some regulatory action in recent years. The real question, in our view, is the degree to which the Commission sees these events being lapses in control and oversight procedures under poor management versus the need for further regulatory change given the already significant reforms in the last six years across the financials sector.

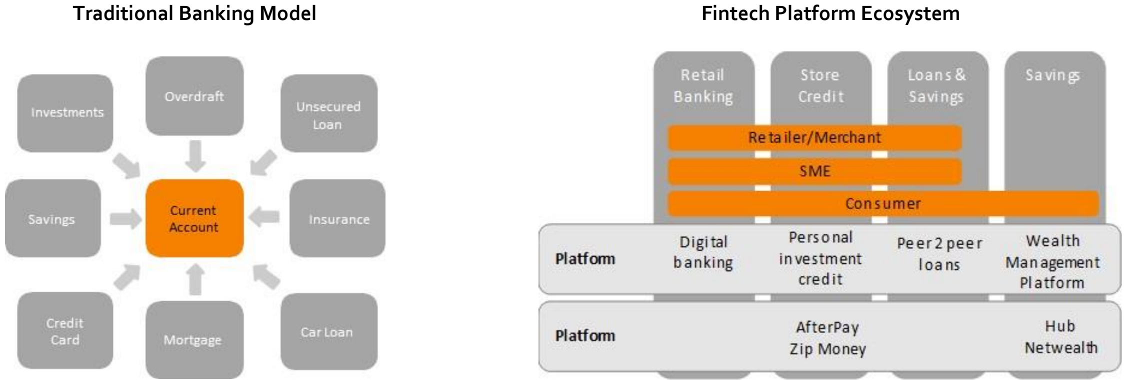
To this end, it is worth remembering the Commissioner's comments at the outset of the hearing when he highlighted the strength and stability of the Australian banking, superannuation and financial services sectors in a global context, and how they underpin the strength of the Australian economy with strong prudential regulation and oversight.

Looking further afield, we think it is worthwhile looking to the 2011 UK Independent Commission on Banking (ICB), in the wake of the GFC, and its findings in thinking about what conclusions the Royal Commission here may draw. Over the years we have watched industry structure changes and reforms play out in other countries, including the UK, only to seem them play out here subsequently, and at a faster pace.

Two key recommendations identified by the ICB were around (1) Financial stability and (2) Increased competition.

We see issues around financial stability as likely to be less of a focus for the Royal Commission given the well capitalised and historically well regulated nature of the Australian banking and financial system. However, we see increasing competition, and in particular reducing the barriers to new entrants and increasing customer choice, as potentially an area of focus.

Figure 10: Technology is disrupting the traditional banking model and moving more to a Fintech platform based ecosystem



Source: SG Hiscock

In the UK post the ICB recommendations, the regulations around granting banking licences were relaxed to make it easier for new entrants. Since 2014 14 new challenger and digital online banks have entered the market. More recently 'Open banking' legislation has been enacted to require the nine major UK banks to open up their customer data to approved third parties and allow them to execute transactions on customers behalf with their consent.

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Whilst the UK 'Open Banking' system has only been operating since January 2018 it is already radically changing the way data is managed, stored and used in the UK banking industry. Incumbent banks have a natural advantage in the knowledge they have of their clients. They know where we shop, how much we spend, when we do it and if we are spending our own money or using credit. Conversely, customers know very little about the real value of the deal they are getting. The fee structures are often complicated and unclear, and switching is cumbersome and inconvenient. By forcing incumbent banks to open up their data and share customer bank account and credit details with approved companies it makes it easier for customers to compare and switch providers. The broader implications of this is the potential to fundamentally disrupt how banks operate and make it easier for fintechs and credit card providers to compete.

Should Australia adopt a similar framework, it could shift the balance of power towards smaller fintech players. It would also remove the benefits banks see from bundling of services, as there would be no asymmetric information, with data open in a general pool. This would lead to greater disintermediation and a banking ecosystem comprising more players competing more vigorously for smaller pieces of the pie.

The timing around the introduction of an 'Open banking' style system in Australia is hard to predict, but it seems inevitable. The risk is the Royal Commission's final recommendations provide a catalyst for change and ushers it in, and with it greater competition. For the Australian major banks this would be a further potential headwind to credit growth in an environment of already low system growth.

From a bigger picture perspective, we are increasingly of the view the finance sector is ripe for technological disruption, and more importantly regulators are more open to change. The media sector in Australia is a case study in how technology can disrupt a sector, and strong incumbents slow to adapt shrink to a shadow of their former self. It is premature, to suggest a similar demise for the major banks given the higher regulation in the sector and their importance to the overall financial system and economy. We see them remaining a dominant force. However, like Telstra where changes to legislation ushered in competition and new entrants the risk is over time old annuity income steams fade and with it earnings and the ability to support dividends.

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.

Treasury Wine Estates: playing rising EM income

Summary:

- We believe companies with diversified geographic exposure and brand strength to protect margins are better positioned to weather the disruptive challenges of growth and reform in emerging markets.
- We continue to see Treasury Wines Estates as very well positioned to deliver strong growth in Asia.

"Just because you have a distributor in a market does not mean you are distributing in a market."

Nick Simms, CEO, Bubs

Identifying stocks exposed to compelling thematic and secular trends is part of our idea generation process. Put simply:

- we look for large end markets growing at above GDP; and
- companies well positioned in these markets that can sustainably win a large and growing share of revenues.

One theme we are currently playing through the portfolio is the emerging market consumer and how this ties in to the broader investment thematic of "feeding the world"; which we see as a compelling and sustainable investment trend.

At a high level, there are several things driving this:

- The shift of economic growth from developed to developing economies has led to significant numbers of people entering the consumer classes for the first time.
- Higher GDP in emerging markets is likely to have both income and substitution effects on consumption. Not only will wealthier individuals consume more goods, but we expect preferences will also shift in categories towards branded goods.
- Rising wealth drives increased food consumption and a shift towards more protein rich diets.

For companies to benefit from rising emerging market consumers geographic exposure is one thing, but it also requires a more nuanced view. One needs to understand:

- That tastes and social influences differ across markets - and growth is not uniform across geographies and categories.
- Market structure. Barriers to entry (typically through regulation and or distribution differ substantially by market and category. Brand strength and differentiation for local players is often limited, favouring more established developed market brand owners that have solid EM distribution and brand awareness.

In our view companies that have diversified geographic exposure and brand strength to protect margins are better positioned to weather the disruptive challenges of growth and reform in emerging markets.

Treasury Wine Estates (TWE), which has been a long standing portfolio position, we believe meets these criteria and we continue to see significant opportunity for the company to widen its quality trusted brand offering through its expanding Asian distribution platform. The demographic and consumption fundamentals in Asia, and particularly China, remain very attractive with wine demand growing strongly and imported wine winning share, and this should drive strong volume growth for Treasury for many years.

More specifically imports from Australia continue to gain share in China and Treasury's Penfolds brand is among the best sellers in almost every price range giving strong endorsement to the brand, and halo effect to the broader portfolio given the fragmented nature of China's wine market. Reducing their dependence on third-party distributors to sell their products into China, Hong Kong and Singapore has also resulted in a significant uplift in both volume and profitability over the last couple of years, and seen Asia become Treasury's largest profit contributor. The challenge for Treasury is to try to hold margins steady while continuing to expand distribution of its brands in China. Providing that it can maintain strong operating-cost discipline, we believe this can be achieved, and should be supported by the luxury nature of their products.

James Hardie: Quality sustainable growth intact

Summary:

- In the last few years James Hardie's growth potential has been brought into question, and with it increasing concerns around CEO succession.
- In our view the business is not broken, rather it has experienced some missteps which appear well on the path to be being fixed.

"In our early years, we didn't talk about culture much. We hadn't documented it all. We just built a business that we wanted to work in. And, that was great. But the real return on culture happened when we started getting more deliberate about it. By writing it down. By debating it. By taking it apart, polishing the pieces and putting it back together. Iterating. Again. And again."

Steve Jobs, CEO, Apple

James Hardie (JHX) is a current portfolio holding we have held for some time. Over a sustained period the company has shown an ability to innovate and grow and is increasingly seen as 'the name' in the US fibre cement category. The majority of JHX's fibre cement sales are in the USA (about 75%) with the main product being external siding. JHX's share of the US fibre cement market is more than 90%, with fibre cement holding 17% market share.

Building materials is generally perceived as a commodity industry, highly competitive and low returning. However, JHX has been able to develop a strong competitive position through investing heavily in research and development and developing a range of innovative products around a strong consumer driven distribution and marketing strategy.

In our view, JHX's real sustainable competitive advantage stems from its culture of innovation and focus and execution around its low-cost manufacturing and distribution.

In the last few years this has been brought into question as the company has struggled to realise its potential earnings growth. This has principally been due to capacity planning issues in its US fibre cement business and related manufacturing problems, which saw it unable to supply some customers and seed market share to competitors. A severe industrial accident at one of its plants around the same time, and departure of the Head of US business (who was seen as potential CEO successor) also raised questions around safety and management culture, at a time that several new competitors were entering the US siding market.

In thinking about the impact of these issues on the business the questions for us were, how is the company dealing with it, and is this an opportunity or more systemic issue impacting the sustainability of future earnings?

In September 2016, JHX flagged its intention to address safety in announcing a move from its historic target of "2 and 20" which focused on keeping injuries below a particular level to "zero harm". The company assessed its safety performance as being better than industry average, but saw the need to move to best practice. In our view safety is about changing behaviour and culture, not just the physical working environment. Pleasingly, through our ongoing discussions with management, we sense there is evidence of a cultural change going on, where employees are being empowered to take a proactive and predictive approach and rewarded on safety performance. Whilst this is an ongoing journey, we see it as a significant cultural change in the business which is likely to also have broader benefits around employee engagement, turnover and productivity.

The shift to a more engaged predictive work culture is also something JHX is seeking to implement as part of its broader 'LEAN' manufacturing process, where it is looking to move to a more predictive (rather than reactive) maintenance approach where employees are empowered to identify issues and track their resolution.

Cultural change within any organisation is difficult and in our experience stems from the top. Louis Grier, JHX's CEO for 14 years (and 27 year veteran with the company) has been a strong leader and been primarily responsible for driving the JHX's innovation and growth strategy. We characterise him as a 'business builder and owner' (as compared to a 'business fixer' or 'business manager') who is entrepreneurial and fiercely competitive – qualities that have been critical to JHX's success. However, under his tenure there has been a number of senior management departures over the last 5 years. This has arguably contributed to the more recent problems, but also raised questions about succession planning.

Importantly, the Board and company appears to recognise these issues and has been seeking to address them with a number of senior hires. In 2013 Matt Marsh was appointed CFO (previously CFO of GE's Healthcare IT business). More recently Zean Neilsen joined as Head of Sales (previously Bang & Olufsen and Tesla Motors), Jack Truong joined as Head of International Operations (previously CEO of Electrolux Group), and Kirk Williams joined as Head of Human Resources (previously Archer Daniels and Walmart). We view these appointments as an important step in broadening out the executive team.

Encouragingly, the most recent quarterly result also showed signs operational momentum is returning in the core North American business with supply issues being addressed, customers being won back and indications volume growth is sustainably returning. Critically, there are also signs manufacturing unit costs and efficiencies are returning to more normal levels, and with it margins.

In addition to growth returning in the core business JHX has recently completed the acquisition of Fermacell, a leading manufacturer of gypsum fibreboard (with 70% market share) in Europe. We see this providing a growth option, but more importantly a potential platform to expand fibre cement sales in Europe, something Hardie's has failed to do to date.

As a general comment, we are extremely cautious around acquisition driven strategies. History suggests more Australian companies have got it wrong than right. However, as CSL has proven (through its ZLB Behring acquisition), strategic acquisitions executed well can deliver material long term value. It is too early to make a call on Fermacell, but we are encouraged by the fact:

- Hardie's has followed Fermacell for many years and tried to acquire the business previously in 2008
- Existing management is being retained
- It looks like a high quality mature business that can immediately deliver 10% ROIC
- It provides optionality to grow fibre cement in Europe

With the fibre cement business returning to growth across all regions, and a number of growth options now available across the business (e.g Fermacell, greenfield expansions in the US, brownfields in Australia, fibreglass windows) and increased executive bench strength we see the Board is now in a stronger position to think about a change in CEO.

When Louis Grier does ultimately step down we expect it will be met with some trepidation by investors, given his influence and leadership in building the fibre cement business – it seems only natural. However we tend to think about JHX in a similar vein to CSL when Brian McNamee stepped down after a long and successful term. JHX has a strong culture of innovation and identifiable pathway of organic growth, and multiple growth options which we expect will continue to form the basis of the company's strategy going forward. In our view the business is not broken, rather it has experienced some missteps which appear well on the path to be being fixed, and we would be surprised if the strategy changes materially - in fact a new CEO could bring a new lease of life!

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, and is now being supported by the sharp increase in non-mining infrastructure investment. The rebound and sustained higher commodity 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 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 favour 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 Reforms 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 weakness in the AUD appears more correlated with the weakness in the USD on the back of trade concerns and growing US deficit, and widening yield differential between Australian and US rates. We expect this to be a continuing feature through 2018.
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 with the Government growth target maintained at "around 6.5%". 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. Whilst recent Euro growth data points suggest growth may have peaked and is starting to slow, there is little evidence to suggest growth is going to drop away sharply and it is still running significantly above potential. This should give the ECB the room to follow the US lead and start winding down its asset purchase program later in 2018.
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 continuing to offer protection despite the risks posed by quantitative tightening.

SGH Australia Plus Overview

What makes us different?

- High conviction benchmark unaware portfolio holding 25 – 40 stocks with a maximum of 10 Asian securities
- Australian equity large cap blend with ability to invest up to 25% of fund in mid-small caps and 20% of the fund in Asia
- 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

SGH Australia Plus is a concentrated fund holding 25-40 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.

In our view the Asian rising middle class provides an attractive long term investment theme. We feel that investors can appropriately diversify their portfolio and enhance returns by accessing the domestic demand thematic within Asia. Looking selectively at rising middle-class incomes in Asia, we have identified an appropriate universe of 40-50 consumer-facing stocks listed on Asian exchanges that we feel may be suitable for the portfolio at the right price.

Our Philosophy

As a high conviction fund our portfolio has very different weights from the ASX300 Index. SGH Australia Plus 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 SGH Australia Plus fund 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 SGH Australia Plus, 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.

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