SGH20 Quarterly Commentary - September 2018

Quarter in Review

"The market's position in the cycle won't tell you what's going to happen next, but it will tell you when the odds are in your favour and when they're against you."

Howard Marks

The September quarter provided further evidence that politics has replaced central banks as the main driver of financial markets. The problem with this is politics is inherently less predictable than central banks, potentially adding to uncertainty and volatility.

Front and centre in the political spotlight during the quarter was President Trump's attack on free trade. The US announced 10% tariffs on an additional $200bn of Chinese imports which will increase to 25% in January 2019, and China retaliated with 5-10% tariffs on a further US$60bn of US imports. Consensus views that trade tensions would be narrow tit-for-tat negotiations has given way to broader concerns of a more protracted and deeper trade rift. There is still the potential for a trade deal with China ahead of the November US elections (which we believe would be positive for emerging markets), but we continue to believe current trade ructions reflect a broader structural and potentially more permanent change in trade relations.

Trade tensions aside, the US economy continues to surge ahead and remain the beacon of global growth. The December tax cuts and Trump inspired attack on regulation has seen small business confidence hit an all-time high and after tax corporate profits up +15% in the first half of 2018, the US equity markets are currently outperforming and the Federal Reserve remains committed to tightening. The US 10 year yield ended the quarter at 3.06%, up from 2.86%, close to its highest level since 2011. . This sparked a modest pick-up in volatility and rotation away from growth and interest rate sensitive sectors. During the quarter, US markets largely ignored the ongoing discourse on trade tensions with China.

It was not all plain sailing over in Europe though, where Brexit negotiations continue to create political and economic uncertainty while the new populist Government of Europe's largest borrower, Italy, created investor concern ahead of its first budget. Meanwhile in Asia, Japan rejoiced in the re-election of Prime Minister Shinzo Abe and China growth continued to soften despite efforts to ease policy.

Domestically, we saw further political upheaval as Scott Morrison replaced Malcolm Turnbull as Prime Minister. This was compounded by the omnipresent threat of regulation as the Royal Commission into banking misconduct reached its interim findings, the ACCC review of the Energy sector was released and a Royal Commission into Aged Care was announced. Politics aside Australian corporate earnings growth remains only modest in comparison to the US, but importantly earnings revision remain positive.

The August reporting was notable for the strong price reactions to what in many cases where pretty muted earnings: the 15 best performing stocks were up an average of 17% on the back of average EPS upgrades of 1.5%. This was no relief rally, rather exhibiting the hallmarks of the late cycle optimism phase of the equity where valuations continue to expand on modest earnings before ultimately ushering in a market correction. We discuss the current mechanics of the current market cycle further inside. Needless to say we don't think the end of the cycle is imminent, but it is mature and valuations are elevated paving the way for a potential correction (which seems to be playing out as we go to write). Our view is global growth has peaked and we are past the best of equity markets this cycle. Growth remains positive but more moderate, and we expect US interest rates to continue to rise through 2019. If this transpires we expect equity returns will be lower than experienced over the last few year.

Portfolio Performance & Activity

In the September quarter SGH20 returned -0.93% after fees, underperforming the ASX300 Accumulation Index by 2.43%.

During the quarter Lonestar completed its takeover of Sino Gas & Energy which saw us exit the stock. We also took the opportunity take profits in a number of the more high growth names we own (including CSL, Treasury Wine Estates and ResMed) that have appreciated strongly and where the margin of safety was starting to become stretched. We initiated a position in Seven Group Holdings increasing our exposure to the domestic infrastructure theme and east coast gas prices and added to our gold exposure through Northern Star Resources via the placement to fund the Pogo mine it has acquired in Alaska. The fund held 12.1% 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)	-0.93	8.62	19.70	15.50	10.57	11.01	7.02	11.03
S&P/ASX 300 Accum Index	1.50	9.99	14.03	12.16	8.19	11.16	7.65	8.20
Value added (after MER)	-2.43	-1.37	5.67	3.34	2.38	-0.15	-0.63	2.83

September 2018 Quarter - Portfolio Performance & Characteristics

Top 3 Active Holdings	Portfolio Breakdown		Top 3 Portfolio Attribution	Bottom 3 Portfolio Attribution
Woodside Petroleum	Financials	25.5%	Woodside Petroleum	Speedcast International
James Hardie	Materials *	24.0%	ResMed	NextDC
Macquarie Bank	Healthcare	7.7%	CSL	Saracen Minerals

**inc. 5.4% 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

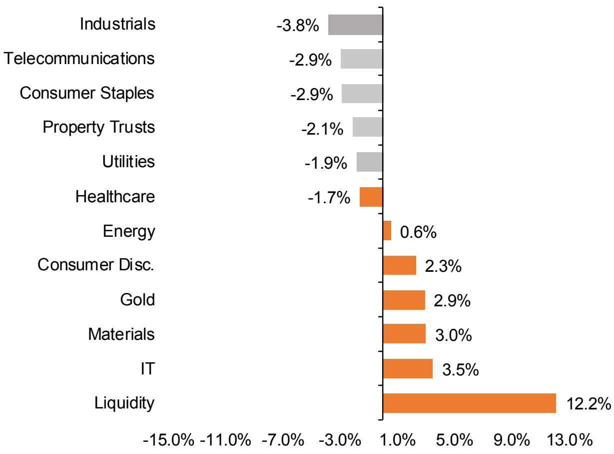


Figure 2: SGH20 Market cap weights relative to ASX300

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

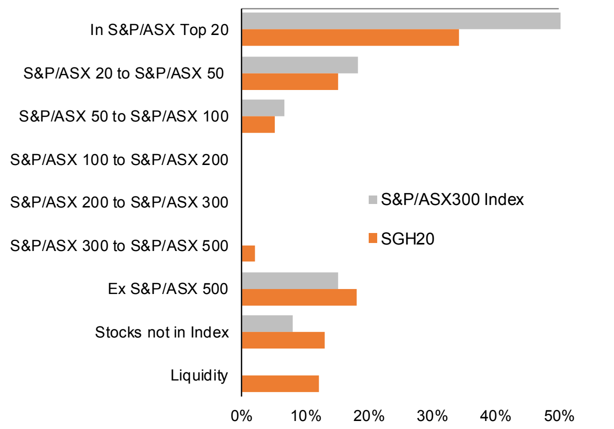


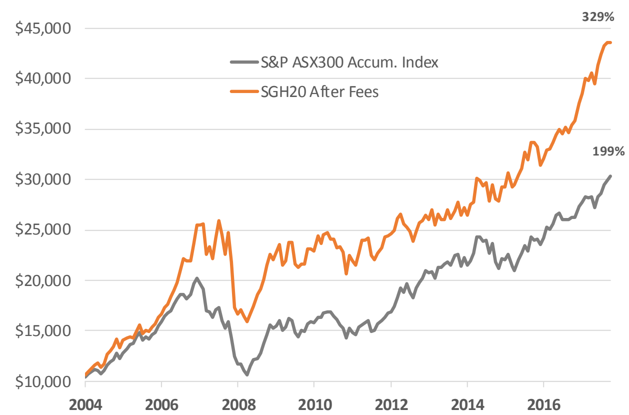
Figure 3: SGH20 Portfolio Characteristics

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

	Sales Growth		EPS Growth		DPS Growth		Yield		PER (x)		ROE	
	FY19/FY18	FY20/FY19	FY19/FY18	FY20/FY19	FY19/FY18	FY20/FY19	FY19	FY20	FY19	FY20	FY19	FY20
SGH20 Portfolio	9.5%	6.8%	11.2%	8.9%	10.3%	8.7%	3.2%	3.5%	20.7	17.8	13.5%	13.4%
ASX 300 Index	3.4%	4.6%	4.5%	5.8%	2.9%	3.5%	4.6%	4.8%	16.8	15.6	12.2%	12.9%

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

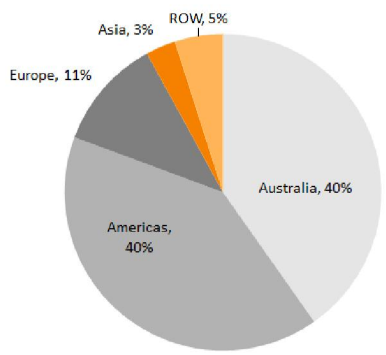
SGH20 has a long track record of adding alpha



Source: SG Hiscock, Bloomberg

Figure 5: SGH20 Portfolio exposure by revenue

Portfolio currency exposure



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.

The Cycle: Late cycle or end of cycle?

Summary:

- Global growth is slowing but has further to run
- We don't believe the end of the cycle is imminent, but it is mature and valuations are elevated
- Higher volatility and returns dispersion is likely
- Greater caution and margin of safety is required

"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets"

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

Sir John Templeton

"Where are we in the equity cycle?" is a question we are increasingly being asked, and clearly top of mind.

In our December 2017 quarterly, published in January, we addressed this to some degree in asking "Will 2018 be the Bear's year?" Our conclusion then was that " .. without higher inflation and interest rates, we continue to think it is unlikely we will have conditions for a recession and bear market in the near term", although noted that " .. high valuations and asset prices are arguably all pointing to elevated risk of a correction".

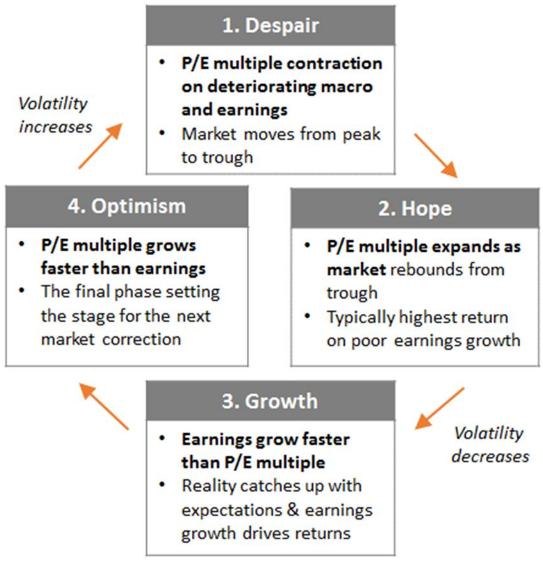
The February correction, came sooner than we anticipated. However, the subsequent resurgence driven by P/E expansion outpacing earnings, has the hallmarks of the final 'Optimism' phase of the equity market clock (see Figure 6). This is again raising concerns we are in late phase of the cycle, and the stage is set for the next correction. Whilst there is growing evidence this cycle is mature, the unique nature of it and how it has distorted 'typical' equity cyclical patterns and phases means one needs to be careful in comparing it to past cycles and assuming the next bear market is nigh.

By historical standards it has been a long and weak economic recovery, and equity market returns (and financial assets more broadly) have been much stronger than past recoveries. This has principally been due to aggressive policy settings, first through the coordinated and extreme monetary easing by central banks globally, and more recently US fiscal stimulus.

The effect of these policies has been that excess liquidity and low rates has driven a fall in the risk-free rate and increased demand for growth assets. This has contributed to rising valuations, which in many instances are higher than in the past.

Figure 6: Equity market cycle

Current conditions align with the late cycle 'Optimism' phase



Source: Goldman Sachs, SG Hiscock

Higher valuations by their nature ultimately imply either lower future returns or greater risk of a market correction. The concern currently is valuations are elevated at the time central banks (led by the Federal Reserve) are looking to exit easy policy settings and increase rates, making equities increasingly vulnerable to a de-rating.

Whilst interest rates and the discount rate used to determine the present value of future cash flows goes to the heart of equity valuations, growth expectations and margins are equally, if not more, important in determining equity returns.

In the context of this cycle, 2016 marked an important turning point as global equity markets moved higher on strong global synchronised growth. The improvement in growth occurred whilst inflation and wage growth remained well behaved leading to margins expanding, and meant for the first time this cycle a large share of the return in equities markets came from rising profitability as opposed to valuation expansion. Unsurprisingly, this drove equity markets higher, and was a key reason for such strong returns last year.

Growth expectations were further boosted for this year on the back of the US tax reform and fiscal package announced in late 2017. However, through much of 2018 the key global economic indicators of growth have been slowing and global trade tensions and geo-politics have escalated and started to weigh on growth expectations.

Although the pace of growth is slowing, we still believe the economic cycle has further to run, especially while the US continues to benefit from the recent fiscal stimulus and global monetary conditions remain broadly accommodative. However, if growth remains positive but more moderate, and US interest rates continue to rise through 2019 (as we expect) we believe equity returns will be lower than experienced over the last few years.

As we write, the pull back in markets we are seeing, seems to be reflecting escalating geo-political tensions, but more broadly the growing realisation we have more than likely passed peak policy and profitability this cycle. This is resulting in a reassessment of margins and valuations which are still high relative to history.

From a portfolio construction perspective the challenge is balancing the growth prospects of individual companies against low and rising bonds and valuation risks.

We continue to believe if growth remains positive but more moderate stronger growth companies will remain appealing. In particular we see companies with strong top-line sales growth and companies that are reinvesting for growth as more likely to prosper. The problem is many of these are expensive.

We are therefore focused more than ever on the margin of safety we are paying for growth companies. This comes down to our confidence in the earnings and cash flow predictability and sustainability relative to our assessed valuation of the business. Recently we have reduced our positions in a number of structural growers on high valuations (eg CSL and Treasury Wine Estates, NextDC, ResMed) and have been looking to reinvest in growth that is not as expensive. Seven Group Holdings and Northern Star are two companies we purchased in the quarter that fit this mould and show good growth at more reasonable prices.

In a positive but lower growth environment we also expect corporate simplification to become more of a trend. In the last 12 months the level of divestment and spin off activity and ASX listed companies looking to engage in 'self-help' and 'shrink to grow' has increased markedly. The major banks, BHP Billiton, Rio Tinto, AMP, Suncorp, IAG Insurance, Brambles, Healthscope, Wesfarmers, Woolworths and Caltex are some companies that have undertaken or announced divestment or restructuring plans. Whilst one needs to be careful of the motivation for demerger or divestment and look at each case on its merits, they have historically provided opportunities in allowing idiosyncratic stock drivers to become more important and often value to be unlocked for shareholders in the head stock and/or new list coy. Cydlesdale Bank (from National Australia Bank) and Orora (from Amcor) are two examples of demerged companies currently in the portfolio where we continue to see upside and growth in businesses that under new management are getting greater attention and focus.

Brexit - on the back foot preparing for no deal?

Summary:

- Significant uncertainty remains around Brexit
- We remain hopeful of some sense of pragmatism
- Our base case is the UK economy muddles through rather than enters a recession
- we see value in Clydesdale Bank and Lendlease

"There is nothing wrong with change, if it is in the right direction"

Winston Churchill

Tensions around Brexit negotiations are increasing ahead of the upcoming Brexit summit on 17th November and the EU Council meeting on 13th December. There is significant uncertainty around the eventual outcome which has seen markets become more risk adverse and pricing in an increasingly bearish view of a 'hard' Brexit.

The fear is a 'hard' Brexit and full exit from the customs union would be highly economically disruptive and compromise investment in major UK export sectors, not to mention the import dependent sectors across many European countries. Further the UK would lose the benefits of European immigration, and the financial sector under changes to passporting and aspects of the Eurozone's financial infrastructure would shrink.

So where are we exactly with less than six months to go before the imposed two year period of consultation expires?

- Prime Minister May has a tentative grip on things with a fragile coalition Government with the DUP (a Northern Ireland unionist party), growing division within her own conservative party and an opposition keen to undermine her every word.
- European Chancellor, Merkel, has said "the opportunity to conclude a good, sustainable agreement in a timely fashion remains" while adding Germany "also has begun preparing" for a no-deal Brexit. This hardly provides much comfort, but subsequent comments from Frau Merkel that the deal is 90% done perhaps provides some hope for more optimism.
- Separately, Prime Minister May has indicated to the UK Parliament that the "implementation period" for the UK leaving might need to extend beyond its December 2020 deadline, through to the end of 2021. This will be difficult to sell to hard-line Brexiteers, but the risk is some compromise may emerge in what is becoming a high stakes game.

From a negotiating position the key stumbling block between the UK and EU appears to be over what to do with the border between Ireland and Northern Ireland. Both the EU and UK agreed in December 2017 in the need for a "backstop" to protect the Irish border becoming a "hard border" where goods would need to be inspected if the UK was to leave the EU without securing an all-encompassing deal. Currently both the UK and Ireland are part of the EU single market and customs union meaning products do not need to be inspected for customs and standards. The EU is demanding that the "backstop" be in place before it will agree to a transitional period and substantive trade talks with the UK, and would prefer to solve the Irish border issue through an overarching economic and security deal. However, this is proving highly complex and messy to say the least.

So what does the Brexit process look like if an agreement can be reached? Simpler said than done, but Prime Minister May needs to strike a withdrawal agreement with her party and Europe that is then ratified by the UK parliament. The complexities of getting parliamentary approval are material, however at a high level the Government can tolerate up to 14 Conservative MP's voting against the motion. Against this there is the threat of 'no confidence votes', leadership challenges and scope for another election, all of which would delay the process and push the UK closer to a 'hard' exit. The answer would appear to lie in the leadership of Prime Minister May and her ability to find a solution that delivers the UK a limited withdrawal agreement with the 27 EU members by mid-November.

The reality is that the coming weeks are likely to deliver further political drama and noise for markets to digest and we are in the eye of the storm. We remain hopeful that some sense of pragmatism will prevail and negotiated outcome will see trade continue given the established supply chains and trade flows around areas of relative competitive advantage. Southern Europe is the food bowl for much of Northern Europe including the UK, and the UK remains heavily dependent on German manufactured goods. However, Brexit marks a journey into the unknown and markets don't like uncertainty and generally fear the worse: recession, house prices crashing and food hoarding (has even been speculated).

Our base case is the UK economy muddles through rather than enters a recession. The devaluation in the pound, accommodative BOE policy stance, potential for fiscal policy, and the fact London remains a vibrant global hub, remain insulating factors in our view.

At a portfolio level we continue to see longer term value in Clydesdale Bank, and see the tenants of our thesis around, a strong cost out story; more regional focus, potential for capital release and industry consolidation as still intact. About 10% of Lendlease's earnings are exposed to the UK and Europe. Over the medium and longer term it remains well positioned to participate in the regeneration and affordable housing projects in London, which if anything is now a higher priority for the Government in the wake of Brexit.

China - should we be worried about an extension to Trade Wars

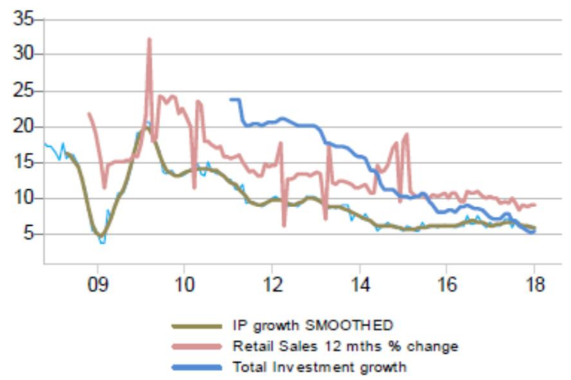
Summary:

- Nervousness has increased around US-China relations
- For now China remains a story of controlled slower growth from 6.8% to 6.5% in 2018
- The combination of quantitative tightening, Fed rate hikes and strong US dollar remains an ongoing obvious risk to China and emerging markets..

The release of Chinese data is getting more attention than usual; with a particular focus on whether or not recently announced fiscal stimulus is gaining traction and the impact of any of US-China trade tensions. Recent Fixed Asset Investment (FAI) growth showed a slowing to an annual rate of 5.4%, with infrastructure a key drag growing at 3.3% year on year, this was offset by Manufacturing FAI (+8.7%). Policy-led efforts to drive financial deleveraging, in particular in the shadow-banking sector, and constrain local government financing have driven the deceleration. In a bid to stabilise growth and offset trade-related pressures, the government has announced fiscal and monetary policies to boost domestic demand, specifically targeted at reviving infrastructure FAI.

To date, much of the data we have seen has been mixed, but there are some signs of stability. In September, retail sales rose by 0.8% taking the yearly growth figure to 9.2%, up from 9% while Industrial Production growth was slightly weaker at 5.8%, down from 6.1%. Total Investment growth came in line with expectations, rising by 5.4% and China's CPI picked up more than expected, rising to 2.5% from 2.3%. On the other hand, the PPI eased back to 3.6% in September from a year ago (previously 4.1%).

Figure 7: Chinese economic indicators



Source: National Bureau of Statistics in China

Exhibit 7 above shows investment spending, industrial production and retail sales all at 10-year lows. However, on the positive side, the so-called tertiary sector (largely services) is now accounting for 60% of growth (refer chart 4), up from 40% in 2010-11 with the reliance on the secondary industry having diminished.

Behind all of this, Chinese equities are down more than 20% this year, driven in part by ongoing trade tensions with the US. Previous similar sized declines have been associated with a decline in the China PMI new orders index to sub-50 levels. It would seem markets are already priced for such an outcome. This time the Chinese economy faces considerable challenges in responding to the current slowdown in the traditional fashion. Private sector debt to GDP is 160%, up from 100% in 2008 and increasing debt to fund capex has become less efficient according to the IMF as the level of capital expenditure required to deliver a unit of output has risen to 6 from an average of 3.

Finally, response to trade-wars has seen the yuan decline back to almost 6.9 to the USD, the equal lowest in the past 10 years and the PBOC has been injecting liquidity in order to offset weakness, Shibor rates are back to the 2015 lows.

Interestingly, trade activity has remained robust despite tensions with the US. September exports accelerated to 14.5 yoy, up from 9.8% in August and the overall trade balance increased suggesting a stabilisation. However, this could be a temporary lull. For now though, China remains a story of controlled slower growth from 6.8% to 6.5% in 2018 with many expecting a bounce in 4Q 2018 following recent stimulus. Nervousness has increased around US-China relations with commentators alert to events beyond just the trade discussion.

Portfolio & Company 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 company, industry and portfolio insights.

How do we identify 'quality' businesses?

Summary:
- SGH20 quality analysis assesses the company's DNA
- We try and assess how the business and management are likely to behave in certain situations and whether we think they have the right attributes and cultural fit to be included in the portfolio.

"Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of good business conditions. The purchasers view the good current conditions as equivalent to 'earnings power' and assume that prosperity is equivalent to safety"

Benjamin Graham, The Intelligent Investor

The SGH20 strategy looks to invest in 'quality sustainable growth at a margin of safety'.

Quality investing extends back to the work of Benjamin Graham in his 1949 book The Intelligent Investor. Whilst Graham is considered the father of value investing the book also indicates he was the founder of quality investing with the important claim that the greatest losses in share prices come not from buying quality at an excessively high price but, rather, from buying low quality at a price that seems like good value.

There is no one specific measure for assessing quality, but most methods look to identify companies that have high predictability of earnings and if possible earnings growth. Some investors take a more quantitative approach in looking for companies with high return on equity and low gearing and stable earnings, whilst others look at strong branding, good governance, and well-defined customer base. Others still look for staple products, large distribution, and input costs that are easily controlled and modelled.

So how do we assess quality?

As part of our investment analysis we undertake a quality assessment of each company. This compliments our quantitative analysis of the earnings and valuation by helping determine whether the company meets our minimum investment grade criteria, and the strength and relative attractiveness of its competitive advantage, earnings quality and management.

We do this through scoring each company based on three key criteria around:
- **Earnings quality:** this seeks to assess confidence in the underlying earnings predictability, transparency and cash conversion including use of accruals and revenue recognition.
- **Business quality:** assesses the growth in end markets in which the company operates and how well the company is positioned to capitalise on growth opportunity through assessing its source of competitive advantage with regard to industry positioning, pricing power and cost leadership.
- **Management quality**: assesses management experience and integrity including track record in allocating capital and strategic goals. It looks at the organisational checks and balances including board and remuneration structure and whether shareholders rights and controls are fit for purpose. Finally we consider risk and management and enjoyment around environmental, social and governance (ESG) issues.

Figure 8: *SGH20 Quality framework*

Source: SG Hiscock

Whilst there is some quantitative input, the quality assessment it is largely a qualitative review looking to better understand the DNA of the business and its management.

We characterise the process as similar to the type of due diligence you would do when you employ someone. When hiring a new person into a business you want to make sure they have the qualifications and skills to do the job. You interview them, review their academic record and previous work experience. You would generally also conduct reference checks and possibility get them to sit a psychometric test to understand their behaviour and disposition in different situations. All this is aimed at ensuring you understand as much about the person before you hire them, so as to avoid making a bad high and hopefully finding someone with the right motivations and cultural fit that you will be able to work with for a long time.

In investing we meet with management and analyse company's accounts to get an understanding of the business. We also conduct reference checks through meeting with competitors, customers, suppliers and make industry channel checks where possible. We then complete a quality assessment questionnaire (our psychometric test if you like) to try and assess how the business and management are likely to behave in certain situations and whether we think they have the right attributes and cultural fit to be included in the portfolio. Like in hiring the wrong person, putting the wrong stock in the portfolio, or buying something different from what we thought we were buying, is what we are trying to avoid as it tends to be costly and problem to fix.

By scoring each company on the three key quality criteria it also helps in building our conviction around out best ideas. In a concentrated portfolio of 15-15 stocks, the weight each stock holds in the portfolio is as important as the stocks in the portfolio. By scoring companies based on their quality we are able to rank them on the key criteria and then assess this against our earnings and valuation analysis in building a portfolio of our best ideas.

The other benefit of our quality process is that it helps manage investor behaviour biases. As investors we aim to be as objective as possible and change when the circumstances change, but we are all subject to biases and need to be conscious in managing them. Our quality assessment process looks to apply some objectivity, or at least reference points, to what can be a subjective assessment. By way of example, how do we assess whether management is trustworthy, motivated correctly and good steward of capital. Meeting them is a first step. But, we seek to reference this against our management quality score that looks to score their experience and integrity through assessing the coherence of their strategy, examining their track record and history of capital allocation and culture of the organisation. This is not intended to be a wholly comprehensive checklist, but is intended to provide a cross check and reference that enables us to join sufficient dots in making sure our quantitative and more intuitive instinctive views make sense, and avoid as much as possible behavioural biases incorrectly clouding our judgement.

Syrah Resources - a window into our process

Summary:

- Balama production ramp up issues have seen the Syrah share price underperform significantly
- We see the commissioning issues as largely temporary and not structural
- We continue to see strong end market growth for graphite in industrial applications and batteries and Syrah well positioned to service these markets.

"Investing requires qualities of temperament way more than it requires qualities of intellect"

Warren Buffett

Syrah's Resources is a stock we currently hold in the portfolio as part of our emerging company's exposure. These are smaller-mid market cap stocks that are developing strategic assets in new markets, innovative business models and/or disrupting incumbents. As a consequence they are smaller positions and are designed to provide optionality to the portfolio and are based around an 'up or out' view where we increase position size as conviction builds or exit.

It is fair to say Syrah's performance has been more volatile than we initially expected and to this point disappointing relative to expectations.

By way of background the company owns a large graphite mine in Mozambique which it has built and is now in the process of ramping up to supply the industrial steel refractory and battery anode material (BAM) markets. As part of its strategy it is also building a BAM processing plant in Louisiana in the US to supply spherical graphite for lithium-ion batteries for electric vehicles.

Whilst the development of the mine facility came in broadly on time and budget, the positive underlying progress in getting the plant built and establishing the logistics supply chain and initial offtake agreements with customers has been overshadowed by production ramp up issues through much of the course of this year. This has seen delay in cash flow, need to raise capital and the stock under perform significantly.

This has been disappointing, but from an investment perspective the question is has our investment thesis changed. In considering this we ask:

- is the thematic still something we want exposure to? and;
- is the exposure we have the best way to play the trend?

More specifically, in considering whether we continue to hold a stock there are three broad questions we consider:

- Can the risk/return profile be improved,
- Has there been an impairment to earnings power of the business,
- Is management still capable of building value?

Let's consider the first part of the question.

In our SGH20 Insights article on "Graphite – the other side of the battery story helping power EV's" published in January this year, we set out the general use case for graphite and why we see Syrah as best positioned to capitalise on the opportunity.

During the quarter we attended the Benchmark Minerals Intelligence (BMI) World Tour in Melbourne. BMI are a London-based battery metals & technology consultancy firm. They provide market research, dynamics and insights, as well as pricing data for battery metals and chemicals.

The conference reaffirmed the key tenants of our views around the demand for batteries, and added to our confidence around the potential in the medium to longer term for Lithium-ion batteries to serve as stationary storage; building blocks in an energy network solution, as well as electric vehicles.

Generally, energy systems are built to peak demand. This is inefficient in terms of greenhouse gas emissions and in cost. Efforts to assuage these peak power pressures and build a more efficient system are beginning to gain real traction. Batteries provide a solution for this, as evidenced South Australia's state government, collaborating with Tesla, has built the world's largest lithium-ion battery. It is powered by a nearby windfarm at Hornsdale in off-peak times, and energy is released back to the grid to meet peak demand. Although it is a specific example, it is synecdoche of a greater trend: lithium-ion batteries are, and will remain, the incumbent technology. BMI contend it will be the most commercially viable battery technology for the next 7-10 years.

Confirmation of this can further be found in the fact battery producers are allocating capital to battery 'megafactories'. In turn, with increased capacity, automakers are showing their hand. Auto manufacturers with household brand names like VW, Tesla, BMW, Daimler & GM have all made hard commitments to making EVs. Chinese manufacturers are also committing to EVs with 96% of the 711,000 EVs built and sold in China in the last year made by Chinese brands, and most of the new battery capacity coming online in China. This is increasingly dependent on natural graphite rather than synthetic graphite given the high cost and pollutive energy intensive drawbacks of synthetic graphite production.

Given we continue to see strong end market growth for graphite; we turn to the second part of our original question: is Syrah the best way to play this trend, and are we still confident there is value in the business and it can be realised?

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: 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
- Are well capitalised: Syrah has no debt and c$100m in cash which should be sufficient to fund to cash flow breakeven in 1H FY19.
- Led by experienced and focused management: 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

To reiterate, we see the ramp up and commissioning issues as largely temporary and not structural. It is not uncommon for start-up mines to experience teething problems. Fortescue's development and commissioning of its Port Hedland and rail facilities in 2008 and Oil Search's start-up in PNG LNG in 2014 are two examples where once initial teething issues were rectified and free cashflow realised there was a material re-rating in the company's share price.

Figure 9: Auto Manufacturers EV announcements

- Invest up to $24 billion to produce more than 3 million EVs pa by 2026
- Has sold 100,000 EV/PHEV in each of the last 3 years
- EVs to be15-20% of sales by 2025
- All sales to be EV/PHEV by 2019
- 50% of sales to be EV/PHEV by 2020
- 80% of core models to be EV/PHEV by 2023
- 20% of EU sales to be EV/PHEV by 2020
- 65% of all sales to be EV/PHEV by 2030
- 31 new models and 300,000 EV/PHEV sales by 2020
- Partnering with Nissan/Renault to launch 12 new EV/PHEV models by 2
- 10 EV/PHEV models by 2020
- 13 EV/PHEV models by 2022, including F-150 hybrid
- **Global Electric Vehicle Leaders** Over 500,000 full electric cars and trucks planned
- Leading Chinese EV car and bus producer

Source: Syrah Resources, SG Hiscock & Co

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 the Trump administration's Tax Reforms are further stimulating 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 strength in the USD 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, with the Government growth target maintained at "around 6.5%". Growing geopolitical risks particularly around trade wars escalating (and North Korea) continue to be potential tail risks, and contribute to a strengthening in the US dollar and depreciation in the CNY increasing the risk around capital outflows and equity market performance.
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.

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 holdings 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.

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