SG HISCOCK & COMPANY

SGH Australia Plus Quarterly Commentary - December 2018

Quarter in Review

"You get recessions, you get 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"

Sir John Templeton

2018 could not have started and ended more differently as markets shifted from synchronized global growth to synchronised global disappointment.

January saw the strongest start for global equity markets in the last 30-years, whilst December proved the worst month for the S&P500 since 1931, returning -9.2%, and the MSCI World Index (ex Aust) $A unhedged was down -4.3%. This saw the ASX300 return -8.4% for the December quarter, erasing prior year to date gains and finishing CY18 -3.04% - the first negative calendar year return since 2011.

From a macro perspective the three issues that have dominated the agenda this year: China growth, US-Sino trade war and US quantitative tightening remained front and centre.

The pull-back in equity markets has been rooted in growing concerns about slowing global growth expectations on the back of escalating trade and geo-political tensions. The year-end PMI surveys were notably weaker in China and the US. China's PMIs slipped through the important 50 level, and the US delivered the largest fall in a decade dropping to 54.1 vs 57.5 expected. European PMIs continued their downward trend over 2018, down 9 points for the year to 51.4. Underpinning this has been a significant change to policy on emissions standards, leading to weakness in autos.

The market correction also reflects the fact central banks are now withdrawing liquidity. Quantitative easing saw a massive injection of liquidity which helped drive valuations higher. The withdrawal of liquidity is resulting in a recalibration of valuations and with it sharp declines in share prices accompanied by a pronounced rise in volatility.

Adding to the falls in valuations and volatility has been growing investor concerns of an imminent recession with the inversion in the US 2 to 5 year bond yields. Whilst we believe global growth continues to slow in 2019, we are still of the view it should remain positive and a recession is unlikely. Key to this is the Fed adopting a more dovish policy stance. The FOMC decision during the month to lift rates, as expected, to 2.25% to 2.50%, and revise its median projection for 2019 from three to two further hikes is consistent with this. However, policy error and a combination of ongoing quantitative tightening and rate hikes remain the key risks to monitor.

The potential for economic fallout from rising US and China tariffs is also currently top of mind. Following the US-Sino G20 meeting if a deal or truce can be reached it will likely be taken positively by markets, whilst no deal and imposition of threatened tariff increases would likely accelerate 'risk off" and potentially fast forward the end of the current Fed tightening.

The deleveraging in the Chinese shadow banking sector appears to have been more responsible for the slowdown in the Chinese economy this year than trade wars. There is encouraging signs China could add stimulus and is looking to redirect credit to the private sector, however benefits appear only modest to date.

Amidst the market carnage, the US economy continues to show signs of robustness but the key will be how incoming growth, inflation and wage data evolves. The risk is US cyclical momentum has peaked and growth slows in 2019.

Portfolio Performance & positioning

The last quarter was a particularly challenging one, and it was painful to see a reasonably good start to the year reverse in the second half. In the quarter the portfolio returned -11.38% after fees, underperforming the ASX300 Accum. by -2.97%.

During the quarter we tilted the portfolio more defensively. We reduced our exposure to the higher growth stocks and 'structural compounders' on the view Fed rates will continue to rise and valuations were looking increasingly stretched, and increased our cash and gold positions. We also added to our 'quality cyclicals' and 'stalwarts' exposures through Seven Group and Link Administration, looking to trade some growth for companies on more compelling valuations leveraged to attractive thematic end markets. Continuing with this theme in November we added carsales.com (which we discuss further inside) and up-weighted Amcor into price weakness.

Whilst tactically it has been right to be more cautious, underperformance in the portfolio in the quarter was driven by the oil price weighing on energy exposed stocks, Brexit concerns impacting UK and European exposed names and company specific issues through James Hardie and Clydesdale reporting weaker than expected results and Lendlease announcing a disappointing trading update in relation to its Australian engineering business. We continue to see Hardies as well positioned with c.80% of its core US business exposed to the repair and renovation market, and attractive value proposition. The fund held 12.9% in cash and 8.4% in Asia at the end of December.

	3 Month %	6 Month %	1 year %	2 years % p.a	3 years % p.a	4 years % p.a	5 years % p.a	Inception % p.a
SGH Australia Plus (after MER)	**-11.38**	**-12.79**	**-6.99**	**8.59**	**9.30**	**12.35**	**13.71**	**14.30**
S&P/ASX 300 Accum Index	-8.41	-7.03	-3.06	4.17	6.65	5.68	5.60	6.28
Value added (MER)	**-2.97**	**-5.76**	**-3.63**	**+4.42**	**+2.65**	**+6.68**	**+8.11**	**+8.02**

December 2018 Quarter - Portfolio Performance & Characteristics

Top 3 Active Holdings
Saracen Minerals
NextDC
Orora

Portfolio Breakdown	
Materials	22.4%*
Financials	20.0%
IT	13.1%

Top 3 Portfolio Attribution
Saracen Minerals
WH Group
Northern Star Resources

Bottom 3 Portfolio Attribution
Clydesdale Bank
Lendlease
Seven Group Holdings

**inc. 6.5% 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

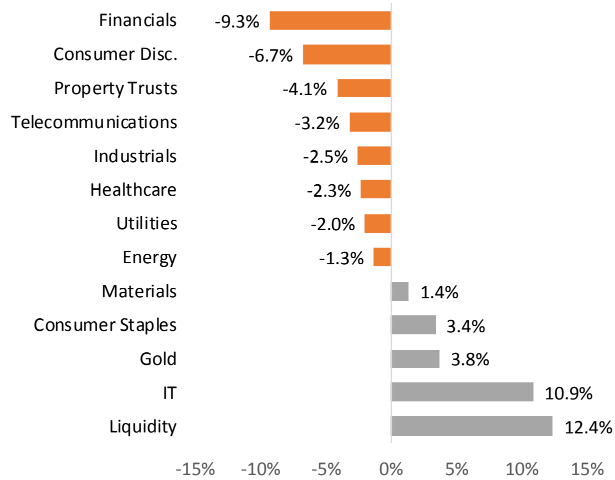


Figure 2: SGH AusPlus weights to S&P/ASX Index

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

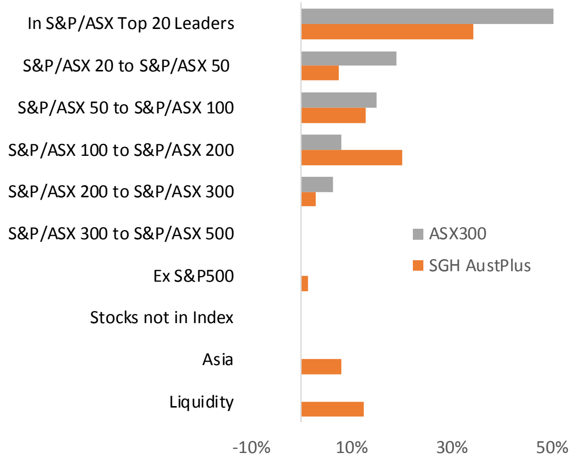


Figure 3: SGH AusPlus Portfolio Characteristics

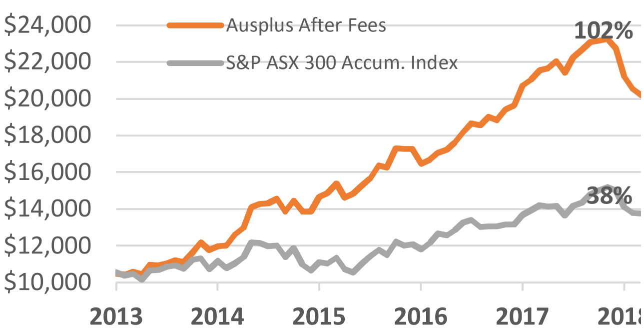
Superior Return on Equity (ROE) to the index with stronger growth (EPS and DPS) characteristics.

	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	12.5%	6.3%	7.5%	33.9%	11.4%	6.2%	3.1%	3.3%	13.4	12.1	14.3%	14.2%
ASX 300 Index	3.1%	3.2%	5.9%	9.0%	1.0%	1.6%	5.1%	5.1%	15.9	14.9	11.9%	12.4%

Note: PER excludes NextDC, if include NextDC FY18 24.3x and FY19 19.8x

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

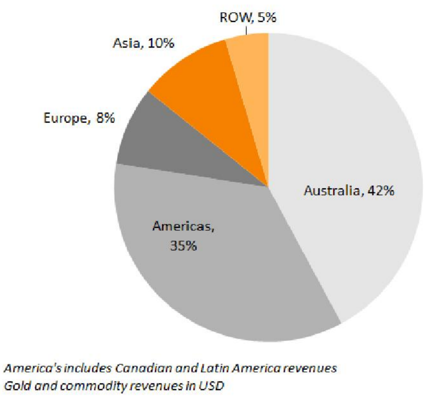
SGH AusPlus has established a track record of adding alpha



Source: SG Hiscock, Bloomberg

Figure 5: SGH AusPlus Portfolio exposure by revenue

Portfolio currency exposure



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 a late cycle slowdown

Summary:

- The recent pullback reflects growing realisation we have passed peak growth, policy and profitability this cycle, resulting in a reassessment of valuations
- In 2019 the combination of geo-political risks, quantitative tightening and worries about whether we are coming to the end of the cycle, will continue to consume markets and see ongoing volatility
- Until the Fed balance sheet contraction ends we think it is dangerous to assume asset prices have bottomed.
- Our base case is that global economies slowdown in 2019, but manage to avoid a recession. However, falling assets prices and rising credit spreads, and the fact we are late cycle warrants caution.
- Our challenge, as always, remains trying to look through the noise and focus on the fundamentals and try and buy companies at an attractive margin of safety for the longer term.
- During the quarter we looked to upgrade the portfolio by reducing our exposure to a number of higher growth stocks and selectively adding several stocks which have experienced sharp price declines.

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

Nassim Nicholas Taleb

"Stability leads to instability. The more stable things become and the longer things are stable, the more unstable they will be when the crisis hits."

Hyman Minsky

A radical shift in volatility - get used to it!

At the beginning of 2018, in our December 2017 Quarterly, we said that "*We expect volatility will increase with the changing of the guard on ultra-easy monetary policy through 2018 and given higher equity market valuations"*. It certainly did, but little did we expect the year to start and end so differently.

January saw the strongest start for global equity markets in the last 30-years with the US market surging 7% in the month, whilst December proved the worst month for the S&P500 since 1931, returning -9.2%.

The January 'melt-up' was particularly extreme considering that it followed such a powerful rally in risk assets in 2017, buoyed by strong growth and loose monetary policy. The passing of the US Trump tax cuts in late 2017 saw material upgrades to corporate earnings and financial conditions being looser than any time since the financial crisis started, adding fuel to market optimism.

The deterioration in markets in the second half of the year, and more particularly fourth quarter, reflected a radical shift in market sentiment and volatility. While in 2017 the US market didn't experience a single daily fluctuation greater than 3%, in 2018 there were 15 days, with 10 in the fourth quarter. Growing concerns about a slowdown in growth on escalating geo-political tensions, decline in liquidity with the changing of the guard on ultra-easy monetary policy, and stretched equity market valuations all began to bite, and optimism became consumed by pessimism and fear.

It is also important to recognise that recent market action and volatility has also been rooted in the unwinding of extreme positioning. The length and nature of this cycle has resulted in increased investor concentration in momentum strategies, particularly in growth stocks and sectors like technology. This has been amplified by the explosion in trend following algos and rise of electronically traded funds (ETFs) and quant strategies. The Wall Street Journal recently estimated 85% of all stock trading is now controlled by machines, models or passive investing strategies. The unwinding of these positions and 'forced' redemptions is exacerbating market moves and adding to volatility. The sheer growth in ETF funds and trading by algorithms rather than on fundamentals makes it incredibly difficult to know how the market will respond to unexpected changes in conditions.

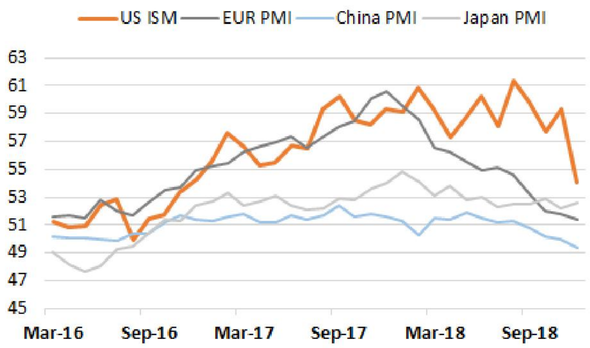
Looking forward into 2019 we believe higher volatility is here to stay. The combination of geo-political risks, quantitative tightening and worries about whether we are coming to the end of the cycle, whether or not these fears are realised, are likely to continue to consume markets and see sentiment swing and with it volatility.

What has changed?

In looking more closely at what changed, Fed Chair Powell's comments in October that monetary policy might be "a long way from neutral" was a defining moment for markets in 2018. Against the backdrop of a US$85 oil price and 3% wages growth it inflamed concerns about rising US inflation, and bond yields surged to 3.25%, causing the market to sell-off. What may have started as concerns about inflation, however, broadened into wider concerns about a slowdown in global growth expectations.

As Figure 6 shows the Purchasing Manufacturing Index (PMI) surveys across the major economies slowed throughout 2018, and in the US and China reached two-year lows at year end.

Figure 6: Major market manufacturing indices have been decelerating through 2018



Source: Bloomberg, SG Hiscock

China's economy progressively slowed through 2018 as the financial reform of its shadow banking sector and tighter credit conditions took hold. Whilst we view this as a positive development, it has weighed on the broader economy and seen lower domestic consumer spending and demand for housing. In 2018 Chinese passenger vehicle sales were down -5.8% yoy, the first decline in more than 20-years, and smartphones sales were down 8% yoy for the eleven months to November 2018.

Given China's importance to the global supply chain the impact has been felt well beyond its borders and been a major factor in the loss of economic momentum in Europe and Japan, as well as many of the emerging economies.

The escalating US-Sino trade war has exacerbated Chinese and global growth concerns. Whilst the direct economic impact of the tariffs has been relatively minor to date, it is causing damage to business confidence and investment spending. In the absence of a deal on trade between the US and China within the 90-day "time-out" the risk is this escalates, and with increased tariffs the economic impact becomes more serious.

The greater risk facing the global economy is that the last driver of growth, the US, is now poised to slow. Housing and auto sales fell over the course of 2018 in response to higher interest rates. Post the US mid-term elections the risk is the political environment becomes increasingly fractured and further drains confidence. The partial shutdown of the US government over funding debates may well be a prelude for what is to come.

Quantitative tightening biting

In many ways, the pull-back in equity markets and risk assets more generally has been understandable and should arguably have been expected. The shift from ultra-easy monetary policy to quantitative tightening and "double whammy" of Fed tightening, in terms of both rising interest rates and shrinking of the Fed balance sheet, has been relatively well telegraphed.

Wide dispersion in Financial vs Real asset returns since the GFC, but large reversal in 2018 as liquidity is withdrawn

Figure 7: Since January 2009 to January 2019 (in USD)

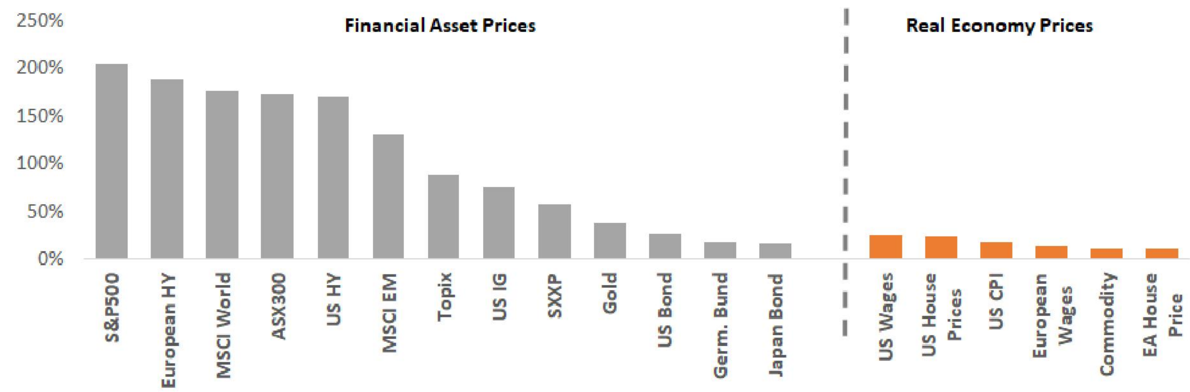
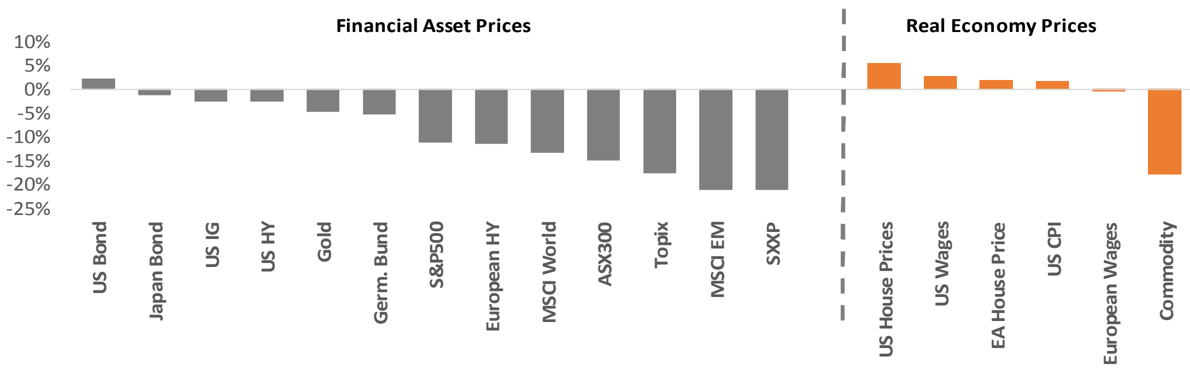


Figure 8: Since January 2018 to January 2019 (in USD)



Source: SG Hiscock, Bloomberg

As Figure 7 shows, since the start of QE in 2009 to today there has been massive dispersion in the performance of financial assets (lead by the S&P500) versus real economy assets (wages, consumer prices and house prices which most of the population depend on).

Since September 2017 the Fed has contracted its balance sheet by US$396bn (down 9%). Interestingly, Figure 8 shows, over 2018 as liquidity was withdrawn with few exceptions financial asset prices declined and unperformed real economy prices, which started to pick up.

Just as the injection of liquidity helped inflate financial asset prices and valuations, the reverse is true as liquidity is withdrawn.

If the Fed continues to shrink its balance sheet by US$50bn per month during the coming year as projected, it will decline by a further 14.7% by the end of 2019, providing a considerable potential further headwind for financial assets.

Whilst news on interest rate hikes tend to grab more of the headlines, as they more directly influence economic activity, we see the ongoing withdrawal of liquidity and shrinking of Fed balance sheet as likely more influential in driving assets prices. Until the balance sheet contraction ends we think it is dangerous to assume asset prices have bottomed. This is not to say, there won't be opportunities and periods of relief and rallies along the way, but as liquidity is withdrawn equities and financials assets remain vulnerable to further drawdowns, contributing to market volatility.

Credit spreads and recession risk

In the context of accelerating monetary tightening credit spreads need to be watched carefully for rising stress in the system. A significant flattening in the US yield curve has historically been seen as the canary in the coalmine and as a signal cyclical momentum has peaked and the risks of a slowdown are increasing.

At the end of 2018 the spread between the 10-year US Treasury bond yield and two-year Treasury note yield was 20bps, down from its most recent highs of 136bps in late 2016. The flattening, and growing risk of an inversion in the yield curve late last year raised concerns a recession is imminent.

This was arguably inflamed by the Fed Chairman's comments following the December FOMC meeting that the Fed balance sheet contraction was on "autopilot".

Subsequent clarification that the Fed "will be prepared to adjust policy quickly and flexibly" and be "patient" provided some relief around the prospects the Fed will be more data dependent.

Given the market correction and rising credit spreads, one can argue for an end of market tightening. In fact, at the end of 2018 the implied rate of the December 2019 Fed funds futures had fallen to 2.40%, implying no further tightening at all.

The key will now be how incoming growth and inflation and wages data evolves. The interest rate sensitive housing sector is slowing while core inflation has eased back to just below 2%. Meanwhile, the latest wages data showed annual growth of 3.1% in November. The challenge for the Fed will be to thread the needle between slowing global growth and less accommodative policy, with markets increasingly jittery as the cycle matures. This bears the risk of policy error.

Australia growth moderating and election looming

The Australian economy continues to face several challenges, most notably around a more pronounced slowdown in China and more severe downturn in house prices.

House prices in Sydney have already dropped 10% from their peak and judging by auction clearance rates and the tighter lending conditions now in place, the prospect for further house price declines is real, but not a cause for panic. APRA recently announced it was removing its cap on interest-only lending, stating the macro-prudential controls had "served its purpose", and unemployment and debt serviceability at current low rates remains supportive. Second order spill-over effects from lower house prices bear close watching, particularly around the potential for consumer confidence and consumption to be impacted by declining wealth.

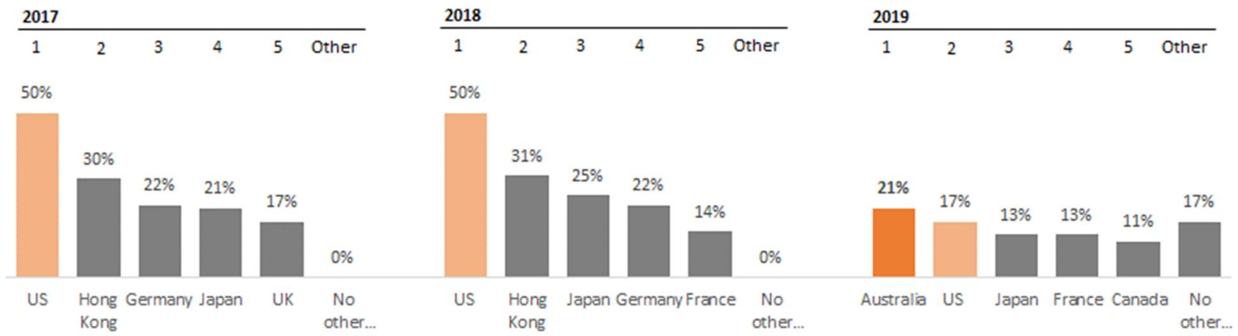
Political and policy uncertainty leading up to the next Federal election represents an additional risk. However, with Australia's public finances having improved markedly this year, a step up in fiscal stimulus is likely – something which we think is being under appreciated. The Labour Party's personal income tax package is c.70% larger than the current Government's policies for FY2020-21.

On the other hand the ALP's policy on removing negative gearing and capital gains tax concessions represent the biggest changes to financial planning in several decades and are likely to create uncertainty and be a further negative drag on housing.

While not our base case, the case for a cut to interest rates has strengthened with recent data releases. Australian GDP grew 0.3% in the September quarter, below market expectations of 0.6% and below the revised 0.6% growth recorded in the previous quarter. This took the yearly growth figure to 2.8%. Both Household and Government consumption have picked up in recent years, becoming the main drivers for GDP growth, whilst the largest pipeline of public infrastructure projects since the 1980's and normalising in the mining states has helped elevate the terms of trade.

There is no doubt that Australia's terms of trade remains vulnerable to rising trade tensions and in particular any slowdown in China. However, we expect Chinese authorities to remain accommodative through both monetary and fiscal measures. We were also interested to read in the recently released annual 2019 PWC CEOs survey, when China's CEO's were asked "Which three territories, excluding China, do you consider most important for your organisation's overall growth prospects over the next 12 months?" Figure 9 shows Australia was #1 after not even being in the top 10 last year. Will Australia be an unintended beneficiary of a trade war?

Figure 9: China's CEOs reliance for US growth drops from 50% to 17% and Australia moves to #1
2019 PWC CEO Survey of China's CEO - "Which three territories, excluding China, do you consider most important for your organisation's overall growth prospects over the next 12 months?"



Source: PWC CEO Survey 2019, Macquarie Macro Strategy

2019: Outlook & Positioning

From a big-picture perspective, we continue to see two key tectonic shifts shaping financial markets and broader economic conditions in 2019.

First, extreme monetary policy and shift from quantitative easing to tightening. Secondly, the technology and communications revolution which has fundamentally changed the way we use and share information and data and communicate.

These shifts are structural, and we think are important, as they will continue to shape and redefine the political and economic landscape and markets over the coming years.

As we have previously discussed, one of the most profound changes has been how extreme monetary policy has sharpened the sting of inequality. The full implications of this are far from clear, but we expect growing debate about where listed and private companies serve the public good and where they are over-reaching or don't belong. This comes with the growing risk of regulation, which has been only too evident through the call for Royal Commissions and populist policies.

Another seismic change has been the rise of China and change in world order. The global financial crisis has aided China's emergence as an economic superpower, and it is now entering the next phase of its industrial modernisation to upgrade its economy through its 'Made in China 2025' policy. We see it as akin to the US-Japanese relations in the 1970-80s when Japan emerged as an economic super power. In our view, the current trade tensions and tariff wars reflect a broader structural and more permanent change, to which investors will have to become acclimatised.

For the first three quarters of 2018, markets were largely prepared to look through these macro and political risks. In the last quarter of the year, however, this all changed as investors became all consumed with these issues.

Following the recent market correction equity valuations have pulled back, consistent with the typical de-rating in a bear market. There is no question slowing global growth and tightening financial conditions provide a more challenging environment, but when we compare fundamentals and what markets are now pricing in there is a strong chance that markets have overshot fundamentals.

Our base case is that global economies slowdown in 2019, but manage to avoid a recession. We recognise, however, that falling assets prices and rising credit spreads have created risk, which continues to rise the longer the Fed continues to raise rates and contract its balance sheet.

In a slowing growth environment which is late cycle, and after a long period when multiple expansion has been driving equity markets, we also recognise it is only right to be cautious.

It's always hard to know why markets seem to shrug off rising bad news and then swing to abject pessimism. Sometimes prices fall unrelated to fundamentals and valuations can remain stretched for a long time. At other times markets can look to be predictive of future events and appear to discount things ahead of time.

Our challenge, as always, remains trying to look through the noise and focus on the fundamentals and try and buy companies at an attractive margin of safety for the longer term.

Our approach is to remain disciplined to our process and look for companies that are still growing, are reinvesting in their businesses, and are leveraged to attractive thematic end markets, but which are at a more reasonable price. Current key themes we currently playing through the portfolio include:

- Domestic infrastructure boom (Seven Group Holdings and Lendlease)
- China pollution and rising LNG (Woodside Petroleum)
- Financial services disruption (Link Administration, Macquarie Bank)

Early in the quarter we also reduced our exposure to a number of of higher growth stocks including CSL, Treasury Wine Estates and ResMed on the view Fed rates will continue to rise and valuations were looking increasingly stretched. We used this to increase our gold exposure in Saracen Minerals and add to Amcor and our cash holdings.

During the quarter, we also took the opportunity to selectively add several stocks which have experienced sharp price declines in the broader sell off. We added to our 'quality cyclicals' and 'stalwarts' exposures through Seven Group Holdings and Link Administration, looking to trade some growth for companies on more compelling valuations leveraged to attractive end markets. We also bought into Carsales.com which is a market leader in online auto classified advertising in Australia with an emerging number of offshore growth options (which we discuss further below). It is rare to be able to buy a quality franchise like this at close to an industrial market multiple.

It's fair to say, buying in a bear market where day-to-day pricing is not reinforcing your fundamental analysis and views is never easy. It requires controlling your emotions and discipline. Stan Druckenmiller, the famous US hedge fund manager who founded Duquesne Capital, summarised it well in a recent interview with Bloomberg when he said, "I've never made a buy at a low that I didn't just feel terrible and scared to death making". We can certainly relate to feeling this uncomfortable disposition over the last quarter!

Looking out over the next twelve months, in a positive but lower growth environment we also expect corporate simplification to continue to be a trend. In the last 12 months the level of divestment and spin-off activity (as seen in BHP Billiton, Rio Tinto, AMP, Brambles, Wesfarmers and the major banks) looking to engage in 'self-help' and 'shrinking to grow' has increased markedly.

Whilst one needs to be careful of the motivation for demerger or divestment, and look at each case on its merits, company spin-offs have historically provided opportunities for company specific drivers to be unlocked and become more important drivers of shareholder value.

Clydesdale Banking Group, the UK challenger bank demerged from National Australia Bank is one stock in the portfolio that we are currently playing along these lines. Performance has been disappointing on the back of the escalation in Brexit news during the quarter, but we continue to see multiple catalysts for the stock to rerate over the next 12 to 18 months and valuation looks compelling.

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.

Carsales: A market leader on sale

Summary:

- They say 'price is what you play and value is what you get'.
- Carsales.com's recent 25-30% share price decline provided a rare opportunity to buy a quality franchise on sale at a 25% discount to our assessed valuation.

"The intelligent investor is a realist who sells to optimists and buys from pessimists".

Benjamin Graham

We are always thinking about how we upgrade the portfolio. As part of our process we have a recommended list of stocks which based on our fundamental analysis we would like to own subject to valuation. When markets pull back as they did in the last quarter we are looking for opportunities to add stocks we like at more attractive prices. In the quarter we took the opportunity to add Carsales.com (CAR) – a quality franchise that we saw as being on sale.

CAR is the leading domestic provider of online automotive classified advertisements on its carsales.com.au website and also operates a number of niche websites including boats, bikes, trucks, tyres, caravans etc. Over the past six years CAR has expanded internationally with acquisitions of automotive classified advertising websites in South Korea, Brazil, Chile, Argentina and Mexico.

CAR's share price fell 25-30% from its peak in August 2018 on several concerns. At its October 2018 AGM, the company's reported weakness in display advertising and its finance division. Subsequently, softness in ABS reported new car sales raised cyclical concerns activity levels had softened and this would result in lower advertising volumes.

We believe the share price reaction on these concerns was overplaying the cyclical exposure in the business and fundamentally mispricing the underlying value of the core franchise, its competitive position and entrenched market position.

Critical to understanding CAR's business model is understanding the network effect of its online business model and the virtuous cycle between customers (eyeballs) and online inventory (i.e. car listings). As the leading website in car sales advertising Carsales.com is the main website customers go to when looking to buy or sell a car. The fact it is the leader means anyone wanting to sell a car is more likely to advertise on the site, and given more cars are being advertised on the site more customers are attracted to the website, and so the cycle continues reinforcing the value proposition to both buyers and sellers.

Overtime as the business has matured and domestic online automotive classified advertising penetration has increased to greater than 90% of the market. This has afforded CAR an estimated 70% market share of the automotive classified ad market and an even higher share of the online market.

CAR's dominant market position gives it strong pricing power and in recent years as the market has matured CAR been able to increase prices to both dealers and private sellers by 5-15% per annum. Testament to the strength of its franchise in the private segment (approximately 15% of EBITDA) CAR charges customers between $68 to $95 per ad while its main rival Gumtree offers free ad listings.

In addition to leveraging its pricing power, in more recent years the business has started to tier its product offering by selling premium products (i.e. guaranteed top spot) at higher prices, improving the product yields and optimising its online car inventory to grow revenues.

The strength of the business model has given CAR the ability to grow earnings through the cycle and helps insulate it against the more cyclical part of its business in new car sales classified advertising and general website advertising.

In understanding the cyclicality in the business it's important to recognise around 80% of CAR's Group earnings are derived from its Australian domestic business, of which around 85% represents used car sales transactions and ~15% new car sales.

Used car sales transactions historically have proved to be far less cyclical than new cars where the purchase of a car is more determined by personal or family events than macroeconomic conditions. In more challenging times, when consumers tend to trade down and purchase either a lower value new car or used car, CAR is largely indifferent as it receives the same enquiry fee for used and new cars.

Since 2012, CAR has expanded into international markets including South Korea, Brazil, Chile, Argentina and Mexico, as it has looked to leverage its business in new geographies. We are always naturally cautious when companies venture offshore and look to take on the world. However, we see Encar (in South Korea) and Webmotors (in Brazil) as promising near term growth options.

Critical in our thinking is CAR has acquired businesses with either the dominant online website or one of the leaders where the dominant position is still contestable, and they can build the leading market position. Being the number one player is critical to being able to leverage the virtuous cycle and network effect in on-line: it is a winner takes all (or most) scenario.

In South Korea, where CAR recently acquired the remaining 50% of Encar, the opportunity is significant with the market approximately 50% larger than Australia and internet penetration and car ownership at similar levels. Encar is the clear #1 website and only 50% of the addressable car dealer market has been penetrated.

In Brazil, where CAR owns 30% of Webmotors, we also see good opportunity over the longer term given the car market is 5 times the size of Australia and the business is in the relatively early stages of rolling out new products and revenue streams. However, we also recognise this is higher risk with a number of country specific challenges, and are not assuming any meaningful contribution from this business in the near term.

Historically, weakness in CAR's share price around cyclical concerns has proven an attractive entry point. We think the recent broader market sell off amplified these concerns as growth stocks and the market sold off indiscriminately. This has provided an opportunity to buy a quality franchise with a dominant market position, strong pricing power, strong free cash flow and ability to reinvest in attractive growth options at an attractive price.

Figure 10: Carsales.com "virtuous cycle" reinforces its market Leadership positon and acts as a barrier for new competitors

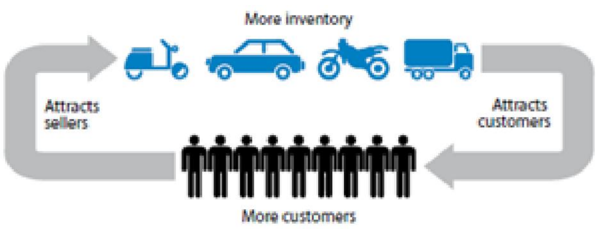
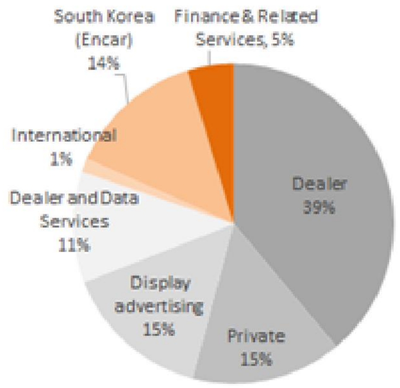


Figure 11: Caresales.com FY19 EBITDA Segment Splits



Source: carsales Prospectus, SG Hiscock

"Psychology of Money"

"Like sailors navigating the turbulent waters between Scylla and Charybdis, investors must regularly set a course between excessive caution and excessive risk-taking. Erring in the overly cautious direction leads to potentially meager returns, missed opportunities, and a failure to compound capital. On the other hand, the pressure of never- ending performance comparisons may drive normally cautious investors to embrace greater risk. Sitting on the sidelines is not typically seen as a viable option for many investors. They share the view of a former bank CEO who, a decade ago, quipped "as long as the music is playing, you've got to get up and dance."

But an excessively risky course may well lead to capital destruction. No one can embrace risk with impunity; it almost always catches up with you. The obvious path to safe navigation is to balance an energetic offense with a strong defense. But in investing, there are no offensive and defensive units. There is no effective way in investing for the offense to scramble off the field and have the defense replace them; you need to excel at both, and at the same time."

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Seth Klarman, CEO and Portfolio Manager, Baupost Group

Managing money isn't just about what you know; it's about how you behave and manage your emotions and behavioural biases and having a rigorous and disciplined approach to which you remain true. It is not easy to do particularly if you are being contrarian or underperforming for a period, but a critical part of successful investing.

During the recent break we came across an interesting article discussing the "Psychology of Money". It describes some of the behavioural biases and considerations that are important to manage in dealing with money. The following is a summary of some of the key points, which we thought worth sharing. It has plenty of home truths (!) and provides some salient and sensible thoughts to consider and reflect on in navigating these turbulent times, and more broadly investing and life more generally. The full article is well worth a read. There are a lot of parallels with it in the wit and wisdom in one of our favourite books 'Poor Charlie's Almanack' by Charlie Munger, which we also commend. Link:
www.collaborativefund.com/blog/the-psychology-of-money/

1. **Rich man in the car paradox**. People tend to accumulate material things to signal to others that they should be liked & admired … humility, graciousness, intelligence, and empathy tend to generate more respect than fast cars.
2. **Remember the first rule of compounding**: Never interrupt it unnecessarily. Buffett's success is in doing the same thing for decades i.e. he let compounding run wild.
3. **We are anchored to our own history bias**. Our own personal experiences make up a tiny fraction of what's happened in the world – but maybe 80% of how we think the world works … keep this in mind when debating people's investing views.
4. **You cannot believe in risk without believing in luck**, because they are two sides of the same coin. Realise that not all success is due to hard work, and not all poverty is due to laziness. Keep this in mind when judging people, including yourself.
5. **Historians are Prophets fallacy**. The idea that the past offers concrete directions about the future is tantalising. Experience leads to more overconfidence than prophetic ability. The further back in history you look, the more general your takeaways should be.
6. **The seduction of pessimism in a world where optimism is the most reasonable stance**. Optimism is a belief that the odds of a good outcome are in your favour over time, even when there will be setbacks along the way … also remember recession happen, but much less frequently than they are talked about.
7. **Shut up and wait**. Our greatest shortcoming is an inability to understand the exponential function….good investing isn't always about the highest returns – it's about generating pretty good returns that you can stick with for a long period of time … compounding run wild.
8. **Opportunity is almost always inversely correlated with popularity**. Very few people are true contrarians … most contrarianism is just irrational cynicism in disguise.
9. **Academia is valued but of less relevance in Finance**. What matters most in finance will never win a Nobel Prize; Humility and margin for error.
10. **We fiddle, far too much.** Long term financial plans are always susceptible to volatility – don't always act on volatility.
11. **Remember that the biggest gains occur infrequently**, either because they don't happen often or because they take time to compound. Leave enough room for error to stay the course. The purpose of the margin of safety is to render the forecast unnecessary (Ben Graham).
12. **Investing is about maximising returns not minimising boredom**. Boring is perfectly fine. Opportunity lives where others aren't, and others tend to stay away from what's boring …. Money is like a sporting event where you're both the fan and the player – it can be very entertaining and people tend to get overly excited
13. **No risk that could wipe you out is ever worth taking**. Why do people continue to play Russian roulette in the markets?! Leverage is the devil here. Money's value is in the options it gives you … Lehman Brothers had no chance of investing in cheap debt in 2009.
14. **Skills only matter if it's matched by the right behaviour.** Investment returns are dictated by a pyramid – stock selection gets the most focus - but it is at the top of the pyramid, the bigger drivers of returns are 1) investor behaviour 2) asset allocation and 3) fees & transaction costs

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. However, 2018 likely represented a high water mark in terms of economic momentum. We expect growth to decelerate in 2019 but remain above trend. The economy faces several challenges, most notably around a more pronounced slowdown in China and more severe downturn in house prices. Political and policy uncertainty leading up to the next Federal election represents an additional risk. The ALP's policy on removing negative gearing and capital gains tax concessions represents the biggest changes to financial planning in several decades and is likely to create uncertainty and be a negative drag on housing. Key tailwinds to growth include the largest pipeline of public infrastructure projects since the 1980's and normalising conditions in the mining states.
Australian Equity Market	Slowing global growth and tightening financial conditions provide a more challenging backdrop for equities. Bottom up consensus earnings for the ASX200 imply 8.1% in FY2019, slowing to 5.4% in FY2020. Slower economic growth may effect top line growth but we see greater risk around margin pressure on rising costs. Any change in government may provide a fiscal boost, but Labour policies could have negative impacts on investment returns (removal of negative gearing, limiting cash refunds on imputation credits, reduced capital gains tax discounts).
US Economy	US growth is likely to slow in 2019. Tighter financial conditions are likely to drag on investment and trade. The Fed is likely to pause their hiking as they become more 'patient' and data dependent. Our base case is for two hikes in 2019. Post the US mid-term elections the risk is the domestic political environment becomes increasingly fractured and further drains confidence. We also expect trade tensions with China to continue to weigh on growth. Both sides have strong incentives to avoid a sharp escalation in tariffs, but the fundamental issues around the change in world order, technology and China looking to upgrade its economy remain.
US Bond Market	With the macro narrative having shifted from low inflation and co-ordinated central bank monetary policy to interest rate normalisation and contraction of the Fed balance sheet, we expect bond yields to rise through 2019 and volatility to be higher. We expect US monetary policy to be tighter than Europe and Japan causing a widening short rate gap.
Australian Dollar	Australia remains relatively well insulated from global trade tensions, and if anything a ramp up in China infrastructure spending should be supportive for iron ore, coal demand, and in turn the AUD.
China	China growth is expected to slow in 2019. The economy looks set to remain under pressure from several headwinds including: US-Sino trade tensions, slowing credit cycle and softening housing market. High system wide leverage suggests little room for more debt funded growth stimulus, but we expect Chinese authorities to maintain policy support through more accommodative monetary policy and augmenting fiscal stimulus through investment in infrastructure as needed. The CNY will be sensitive to trade developments
Europe	Euro area growth slowed in 2018 and we expect it should again be weaker in 2019 as sluggish global trade growth drags on expects. Domestic demand should show some resilience. Having ended its asset purchase program we expect the ECB now look to move policy rates out of negative territory in the second half of the year, under a new ECB President.
Oil Price	The sharp correction in the oil price late in 2018 appeared an overshot based on fundamentals. 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). We remain positive on global LNG demand with China continuing to focus on pollution measures including coal to gas switching and investing in new storage capacity.
Commodities	Historically, commodities have provided a strong inflation hedge in the later stages of economic cycles. We expect this to be the case in 2019. 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 continue to see gold offering 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 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 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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