SG HISCOCK & COMPANY

SGH Australia Plus Quarterly Commentary - June 2018

Quarter in Review

"A great civilization is not conquered from without, until it has destroyed itself from within. The essential causes of Rome's decline lay in her people, her morals, her class struggle, her failing trade, her bureaucratic despotism, her stifling taxes, her consuming wars"

William J. Durant, The Story of Civilisation

The big theme for the June quarter was the underperformance in Emerging Markets, down 7.9% with the China and Hong Kong markets down 9.8% and 2.6% respectively. This saw inward flows into Australia from Asia with consumer staples (+6.2%), utilities (+5%) and Banks (+4.3%) the major beneficiaries. For the quarter to 30 June the ASX300 Accum. Index was up 8.4%, and 13.2% for the 12 months.

At the core of the Asian sell-off during the quarter was renewed focus on the Trump administration's agenda on trade and tariffs, directed primarily but not exclusively at China, and rising US dollar affecting US denominated emerging market debt. The sharp fall in the Chinese currency in the quarter triggered speculation China has embarked on a devaluation strategy in response to the Trump tariffs. The risk with such a sharp depreciation is it triggers renewed capital outflows.

Investor caution on China is also being impacted by the fact fixed asset investment has fallen to the slowest pace since 1995, as has retail sales. Both have been effected by the tightening in credit on the back of the Government's focus on deleveraging and change in policy to quality growth at a slower pace with less lending, rather than 'growth at all cost' of the last decade. The risk is the great industrialisation phase in China may be coming to an end. However, it is important to recognise China has emerged as a modern consumer economy, with a large middle class, and consumption now represents c.60% of the economy (versus 40% only a few years ago) whilst exports have fallen from around 35% of GDP to 17% today. Yes, China is more vulnerable to the US from the impact of trade wars given its reliance on exports, but it is far less exposed than a decade ago with a large growing consumer class.

The obvious explanation for the US dollar rally, is the ongoing cyclical strength of the American economy which has undoubtedly been stimulated by the US tax reform passed in December. What is interesting is that the bond market continues to discount the US recovery and is sending the message that, if the Fed really raises rates by the amount officially projected, then there is a growing risk that the yield curve inverts: a classic signal of impending recession. Whilst inflation is certainly stirring there is little evidence currently that inflation is surging to the point of the economy 'overheating' and a pending recession.

As we pass the middle point of year, global growth continues to remain robust and is on track to deliver an above trend result close to 4%. But we have passed a potential peak in activity and expect fears around trade wars, rising interest rates and slowing Chinese growth to remain front and centre for investors in the second half, and continue to drive heightened market volatility.

While US company growth is accelerating, Australian company growth remains only modest at single digits, but importantly earnings revisions have remained positive. Valuations for Australia are above average but consistent with a low interest rate environment, however the spread between 'value' and 'growth' is at historical highs implying the market is paying up for a select group of stocks offering above average growth opportunities. As such we have been taking profits in some of these names and exploring other opportunities where the margin of safety is more compelling.

Portfolio Performance & Activity

In the June quarter the Australia Plus Fund returned 7.7% after fees, underperforming the ASX300 Accumulation Index by 0.70%. The sell-off in emerging markets and particularly Asian markets was a headwind to portfolio performance, although early in the quarter we did take the opportunity to reduce our exposure to a number of Asia names given their strong appreciation. At quarter end we held 8.5% of the portfolio in Asian companies.

During the quarter we exited a position in Boral. We also added positions in Link Administration and Clydesdale Bank on pullbacks in share prices providing more attractive entry points.

The portfolio continues to be overweight companies with offshore exposure (c.65% by revenue). This is less about our view on the currency, and more about our belief that these companies have better prospects and are more diversified. The fund held 13.7% cash at the end of June.

	3 Month %	6 Month %	1 year %	2 years % p.a	3 years % p.a	4 years % p.a	Inception % p.a
SGH Australia Plus (after MER)	7.67	6.99	21.27	19.08	18.54	19.99	19.34
S&P/ASX 300 Accum Index	8.36	4.27	13.24	13.53	9.14	8.25	8.64
Value added (MER)	**-0.70**	**2.72**	**8.02**	**5.55**	**9.39**	**11.74**	**10.71**

June 2018 Quarter - Portfolio Performance & Characteristics

Top 3 Active Holdings	Portfolio Breakdown		Top 3 Portfolio Attribution	Bottom 3 Portfolio Attribution
Saracen Minerals	Materials	18.2%*	CSL	Beijing Capital Int. Airport
Next DC	Financials	16.9%*	Macquarie Bank	WH Group
Orora	Consumer Staples	8.8%	Saracen Minerals	JB Hi-Fi

**inc. 4.5% 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

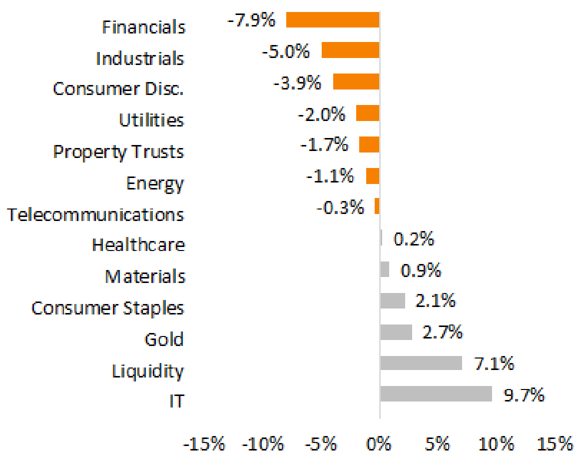


Figure 2: SGH AusPlus weights to S&P/ASX Index

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

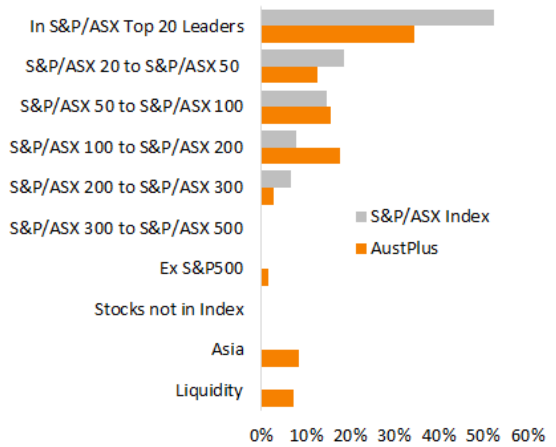


Figure 3: SGH AusPlus Portfolio Characteristics

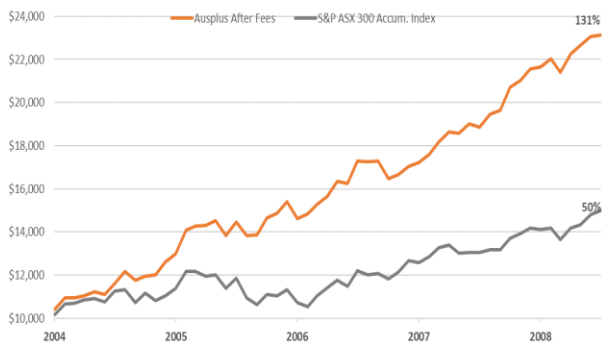
Superior Return on Equity (ROE) to the index with stronger growth (EPS and DPS) characteristics.

	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	12.2%	8.6%	16.3%	11.8%	13.5%	10.4%	3.0%	3.2%	16.7	14.9	15.4%	15.3%
ASX 300 Index	3.3%	1.1%	5.3%	11.3%	4.3%	3.8%	4.5%	4.7%	16.7	15.8	12.2%	12.8%

Note: PER excludes NextDC, if included FY18 including NextDC FY18 27.3x and FY19 23.6x

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

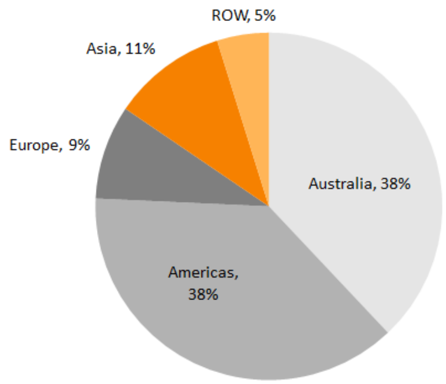
SGH AusPlus has established a track record of adding alpha



Source: SG Hiscock, Bloomberg

Figure 5: SGH AusPlus Portfolio exposure by revenue

Portfolio currency exposure



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

Source: SG Hiscock, Bloomberg

Top of Mind

Our portfolio construction process is bottom-up stock driven, but overlaid with macro and sector insights and company life cycle considerations. Here we provide some thoughts and observations on the investment themes and issues that are currently top of mind.

Recession risk rising or return to slower growth?

Summary:

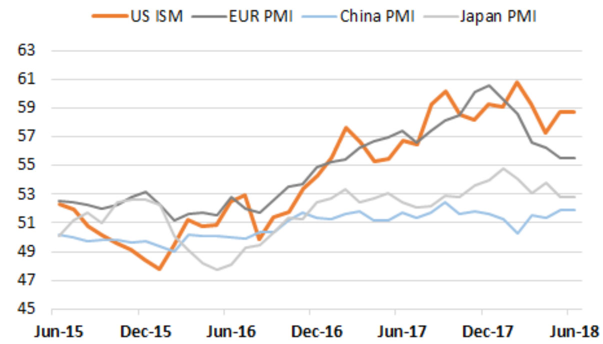
- Global growth remains robust with US accelerating
- Flattening in yield curve, raising recession concerns
- Next 12 months more likely a slowdown in US growth rather than recession.

The big themes influencing markets during the June Quarter continued to be:

- Rising US interest rates
- China's deleveraging and credit tightening; and
- growing fears of a trade war

We expect these issues will remain front and centre for much of the second half of the year. However, they need to be considered in light of the recent economic data which shows the momentum in global growth is still solid, although looks to have peaked and is less synchronised than last year.

Figure 6: Global growth has peaked but remains solid
Global PMI and ISM major economies to 30-Jun-18



Source: Bloomberg

The US remains the key driver, with growth having clearly accelerated as the benefits of the December inspired tax cuts start to gain traction. The Atlanta Fed now forecast GDP ~4.7% and unemployment has fallen to 3.8%, its lowest level since 1960. The obvious risk is the stimulus from the US tax reform is a sugar hit and adds to inflationary pressures.

In contrast to the US, European growth has slowed year to date after a strong pick-up in 2017. Industrial Production weakened in the quarter (exaggerated by bad weather) whilst retail sales continue to suggest consumption remains solid. Still the key risk in Europe appears more around politics than macroeconomics, with Brexit and the Italian elections flaring – up during the quarter and the ongoing question whether Germany will support the French call for greater fiscal integration to underwrite the EU. The concern is the cocktail of European politics and distortions created by the ECB's three years of quantitative easing and four years of negative interest rates make it the most likely source of global credit risk.

Chinese growth has been slowing for some time, as the Government seeks to achieve more balance and focuses on reigning in credit growth, particularly in the shadow banking sector. This has seen credit growth fall to around 8% (more in line with nominal GDP growth) and is beginning to weigh heavily on local government infrastructure spending. It has also spilt over to the Chinese stock market which is down 14% since January. The key question remains the potential spill-over effect of credit tightening on the real economy, and whether the Government can manage the delicate balancing act of deleveraging and not sinking the economy.

At the core of the China and broader Asian market sell-off in the quarter was renewed focus on the Trump administration's agenda on trade and tariffs, directed primarily but not exclusively at China, and rising US dollar affecting US denominated emerging market debt. The sharp fall in the Chinese currency in the quarter triggered speculation China has decided to embark on a devaluation strategy in response to the Trump tariffs. The risk with such a sharp depreciation is it triggers renewed capital outflows, and the more the US dollar rallies the more it will exacerbate these pressures.

The most obvious explanation for the US dollar rally, is the ongoing cyclical strength of the US economy and fact the Fed is by far the most hawkish on interest rates, having raised the US base rate a further 25bps in early June. What we continue to find intriguing is that the credit markets appear to be discounting the US recovery, with the US 10-year treasuries holding below the 3% mark and yield curve flattening. The two-year to 10-year US Treasury bond yield spread has declined by 46bp since mid-February to 32bp in late June, the lowest level since August 2007. The implication of this is if the Fed really continues to raises rates by the amount officially projected, then there is a growing risk that the yield curve inverts (with the 2-year trading above the 10-year): a classic signal of impending recession.

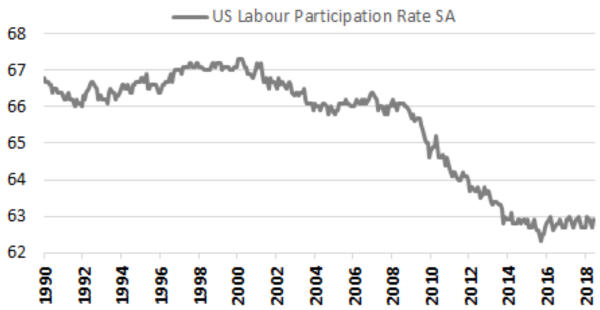
Figure 7: The most talked about in financial markets – critically not breached the 3% level yet!
US 10-year Treasury bond yield long-term (log scale)

Source: Bloomberg, UBS, SG Hiscock

Implicit in this is assumption is the Fed continues to tighten. In his latest testimony to Congress Chairman Powell reaffirmed that gradual interest rate hikes are the best option "for now" and he's pleased with the labour market and pickup in the pace of inflation. Looking at US data there is little evidence of "overheating'. US wage data is finally growing, but gradually, and US core inflation is at 2.3%, versus the Fed's 2% target.

A key reason for inflationary spirits not rising faster despite the ongoing economic recovery would seem to be that whilst the unemployment rate is at 18-year lows, the labour participation rate is still at 62.7% (little changed from when it bottomed in 2015) with 96m Americans not in the labour force (implying still plenty of capacity).

Figure 8: 96m Americans not in the labour force
US Labour force participation rate still close to 2015 lows



Source: US Bureau of Labour Statistics

This all seems to suggest "for now" the Fed is prepared to continue on its tightening path and deal with an inverted yield curve if and when it happens, or current growth momentum starts to slow more appreciably.

The risk, is the acceleration in growth this year on the back of the recent tax reforms marks the peak in growth, and 2019 sees a slowdown back closer to the core trend rate of 2.2% witnessed since the recovery, or even slower rate of growth given the base effect form this year's pick-up.

If this is the case and inflation remains well behaved the current Fed 'dot plot' in terms of proposed interest rate increases is likely to be too optimistic, and the cash rate is more likely to peak between the 2.5% and 2.75% currently implied by the market. This scenario would imply a return to slower trend growth, rather than a recession. It would also likely see a weakening in the US dollar.

A slowdown in US growth could act as catalyst for the Trump Administration to revitalise its infrastructure plans. The current proposed plan is to spend US$1.5tn on infrastructure projects in the next 10 years, but only US$200bn coming from the Federal Government. It is assumed the balance will be funded by the private sector through Private Public Partnerships (PPPs), and cash repatriated by US corporates under the recent tax reform changes. This could further provide impetus to the cycle.

Trade wars - Escalating or more permeant state of affairs?

Summary:

- Risk of trade tensions escalating has increased
- Modelling the economic impact is next to impossible
- At a company level focus is on supply chain changes
- We see current trade tensions reflecting a broader structural and more permanent change in trade as China enters the next phase of its industrialisation

"You cannot negotiate with people who say what's mine is mine and what's yours is negotiable"

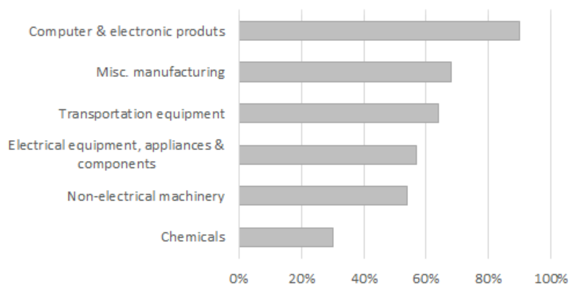
John F. Kennedy

Aside from the Fed tightening and China deleveraging, the main risk to the global growth outlook appears the Trump administrations agenda on trade. The key question is whether President Trump is engaged in a negotiation with China to try and secure a deal ahead of the November mid-term Congressional elections, or a longer term strategy to attack China and it's so called "Made in China 2025 Policy" and "Make America Great Again", which has the potential to escalate into a broader trade war.

The answer to the question remains unclear at this point. However, the recent tariff announcements by the US against China, Canada, and Europe, and potential retaliatory measures, certainly raises the stakes and risk of trade tensions escalating. Various economists have tried to estimate what the impact of trade tariffs imposed to date may be, suggesting it could take 0.3-0.5% off global GDP. This doesn't seem big enough to derail global growth. However, the reality is trying to economically model the impact is next to impossible given the complexities and unknown second round implications, of which there will be many.

Not least is the potential impact on inflation from tariffs. It will also be interesting to see the degree US corporates lobby and push back. To date it has been limited, but as the full impact sets in will the protest increase particularly from the likes of Apple and US IT sector where around 90% of tariffs announced to date are levied?

Figure 9: US tariffs will hurt non-Chinese multinationals just as much as China ..
US imports from China from non-Chinese multinationals



Source: Oxford Economics, PIIE, Macquarie

Determining sector and stock implications is complicated. For commodities it is overall hard to see how it can be anything other than a negative drag. However, this will also depend on any change in Chinese domestic policy to offset the impact. At the Chinese PBOC meeting in April the authorities signalled this was an option. The decision in April and June to cut the Reserve Requirement Ratio (RRR) by 100bp and 25 bp respectively for most Chinese banks could be seen as first step. Taking a less hard-line and gradual approach to deleveraging, reforming the shadow banking sector and restimulating infrastructure are other possible measures that could help limit the damage on the domestic economy, and provide a fillip for commodities.

More broadly it is important to understand company supply chains, how they could be recalibrated, and if costs are going to rise can companies pass them on in higher prices. This emphasises the need to be invested in companies with pricing power, or least have the ability to pass through costs. Our portfolio has limited direct exposure to the tariff announcements to date. Outside commodities and Rio Tinto, Treasury Wines US wine exports into China appears most directly exposed, but still is relatively small in the scheme of things. The broader risk is from any slowdown in the US economy given our overweight international and US exposures.

A bigger picture consideration is whether the growing trade tensions between the US and China are idiosyncratic of President Trump and his agenda and style, or reflect a broader structural and more permanent change in trade relations and new world order, akin to the change in US-Sino relations in the 1970-80's when Japan emerged as a leading global exporter and economic super-power.

The risk is we are in a new regime as China enters the next phase of its industrial modernisation and looks to replace foreign technologies with home grown initiatives under its "Made in China 2025" policy. Under this program China has identified ten prioritised industries that it wants to become globally competitive in by 2025. These include aerospace, information and communication technology, robotics, ocean engineering equipment, agricultural machinery, railway equipment, power equipment, new materials, new energy vehicles and medical devices.

China may be prepared to negotiate on tariffs and even some intellectual property issues, but it is hard to think they will be prepared to negotiate on upgrading their economy. If this is the case, trade tactics may change with US Presidents, but the fundamental trade issues are unlikely to.

The moral limits of markets, 'War on inequality' and increasing risk of regulation

Summary:

- Extreme monetary policy and shift to a 'market society' has sharpened the sting on inequality
- We are entering a new super-cycle: "War on Inequality"
- We expect greater scrutiny around where the private sector is overearning or doesn't belong, resulting in heightened regulatory risk
- This threatens the premium valuations of businesses that enjoy privileged positions and earn excess returns

"In progressive societies the concentration [of wealth] may reach a point where the strength of number in the many poor rivals the strength of ability in the few rich; then the unstable equilibrium generates a critical situation, which history has diversely met by legislation redistributing wealth or by revolution distributing poverty."

William J. Durant

".. the question of markets is really a question about how we want to live together. Do we want a society where everything is up for sale? Or are there certain moral and civic goods that markets do not honour and money cannot buy?"

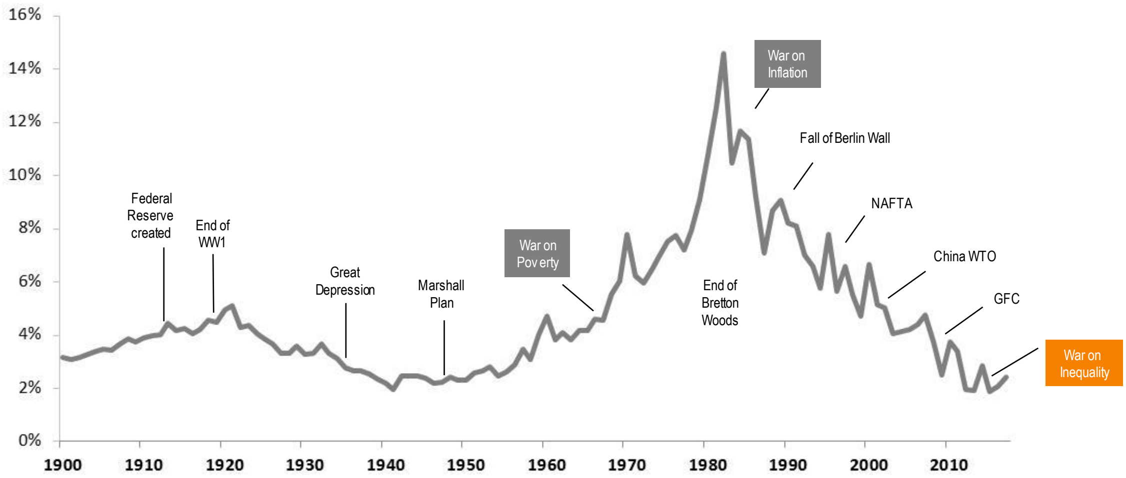
Michael J. Sandel

As investors we are conscious of not jumping to conclusions and trying to predict change. However, we observe growing evidence, through the changing nature of politics and public debate more broadly, that a new longer-run environment is emerging as we transition from a 30-year economic deflationary cycle driven by low rates to a new order and greater focus on rising inequality and role of markets. Drawing on Michael Hartnett at Bank of America Merrill Lynch's strategy super cycle work we have coined this new regime the "War on Inequality".

Highly instructive and influential to our views has been reading Michael Sandel's book *'What Money Can't Buy: The Moral Limits of Markets'*. Michael teaches political philosophy at Harvard University and in his latest book seeks to address the big ethical question of 'what is the role of money and markets in our society?' – not an insignificant undertaking!

Central to his argument is that over the last three decades under a period of extreme monetary policy and deflation, financialisation and market thinking has extended to reach into almost all aspects of life and we have drifted without realising it, and with relatively little public debate, from a 'market economy' (a valuable and effective tool to organising productive activity) to a 'market society' where everything is up for sale. This has resulted in a price being put on almost everything and move away from the post-World War II welfare state which provided a safety net and attempt to ease inequality, back to public goods being privatised and left to markets. He points to the fact in the US and UK where more people today are employed as private security guards than public police officers, and the Iraq War where there were more

Figure 10: "War on Inequality" born out of three decades of extreme monetary policy, low rates and excessive financialisation
US 10-year Treasury yield



Source: SG Hiscock, BoMAL

private military contractors on the ground than US military troops. Australia has not been immune with the privatisation of roads, utilities, airports and growth in for-profit operators in health and education.

Sandel argues that the result of this shift to a 'market society' is it has sharpened the sting on inequality, as the more things money can buy, the more affluence, or lack of it, matters.

One of the main points of Sandel's book is there has been blind faith that a 'market society' will deliver the best public outcomes with little debate around justice, the common good and what it means to be a citizen. The result has seen a hollowing out of public discourse which has become largely technocratic and a reluctance to debate the big questions.

We find Sandel's observations insightful in helping explain the current state of politics and growing debate around inequality. We think this is important to understand, not just in a broader social context, but also from an investment perspective. Change at the ballot box and in Government policy can impact on the regulatory and operating environment for companies, the cash flows they are able to earn, and ultimately the returns and value investors derive.

In Australia, a combination of concentrated industry structures and high returns (by global standards) coupled with marginal politics and growing concerns around affordability is seeing heightened regulatory risk across many industries. Banks, health insurers, utilities, toll roads and airports are all currently in the frame facing inquiries and increased scrutiny around the price of their services and their social licence to operate. Having privatised many of these assets and provided long term incentives and industry structures that have almost guaranteed earnings growth for investors, the sting of affordability is biting. As a result governments and regulators are intervening in the interests of consumers as they are increasingly being squeezed by higher prices and asset values outpacing income and savings rates.

The "War on Inequality" is still in its infancy and the full implications are far from clear. However, a number of the principle trends appear evident. We expect growing debate around where markets and listed companies serve the public good, and where they are overearning or don't belong. We expect this will continue to see pressure on Governments to reduce the impact of excessive prices to deliver better value for consumers and taxpayers and maintain political relevance (perhaps the ultimate motivation for any politician!). We see this resulting in an environment of heightened regulatory risk, where companies will increasingly be scrutinised around their social licence to operate, the moral limits of what they should be able charge consumers for and returns they earn.

The risk is this threatens the premium valuations of businesses that enjoy privileged positions and earn excess returns. The major Australian banks have been the most high profile example of this in recent years, but we see other sectors and businesses which are often considered essential services or public utilities like infrastructure assets where competition is limited (like toll roads, utility retailers and distributors, healthcare providers) as vulnerable.

We try to capture this risk in assessing the sustainability of a company's competitive advantage in our research process through our business quality assessment. The other way we look to limit downside risk is through the margin of safety (valuation) we pay.

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.

Portfolio diversification

Summary:

- Sufficient but not excessive diversification is the key to constructing a concentrated portfolio
- Owning 15-25 companies allows us to be amply diversified and gives flexibility to back our conviction
- We apply three company lifecycle groups in helping construct and diversify the portfolio

"The academics have done a terrible disservice to intelligent investors by glorifying the idea of diversification. Because I just think the whole concept is literally almost insane. It emphasises feeling good about not having your investment results depart very much from average investment results"

Charlie Munger

We have discussed the topic of portfolio construction in recent quarterlies, but the question of how we think about and manage risk and portfolio diversification in a highly concentrated portfolio like Australia Plus is something we constantly get asked about, and we thought it worth providing some further colour.

As high conviction investors, our modus operandi is capital should only be allocated to high quality ideas where you have conviction, and only a few quality ideas are required to build a good portfolio.

Academic portfolio theory has instilled in many investors the idea that concentration increases risk, and by extensive diversification into more holdings you are able to reduce risk and improve returns. Numerous studies and statistical analysis shows that company-specific risk is adequately diversified after 12-14 names in different industries, and the incremental benefit of each additional holding is negligible.

By owning 15-25 companies we believe it allows us to be amply diversified, but also have the flexibility to back our conviction and overweight a particular company, or own more than one business within an industry, were the fundamentals are particularly attractive.

More practically, by limiting the number of holdings we own it allows us to know the companies and management teams we are investing in extremely well and build conviction and back our views.

In owning a larger number of stocks in a portfolio and not knowing your companies intimately, there is a risk that you invest too little into companies you know well, and too much into companies you don't know well or little about. We see buying a company without sufficient knowledge, is potentially more risky than inadequate diversification.

We therefore believe sufficient but not excessive diversification is the key to constructing a concentrated portfolio. Whilst we invest in companies based on their underlying fundamentals with a margin of safety in case of error, bad luck or thesis not playing out as expected, we are also conscious in ensuring the different ideas are not correlated. If each investment turned out to be a similar bet the risk is the portfolio could be overly skewed to changes or corrections in a particular theme or market development.

We look to construct a portfolio that is both highly concentrated and our best ideas, whilst providing sufficient diversity in terms of company specific risks by focusing on liquidity, sector and company lifecycle positioning and valuation considerations.

Figure 11 shows the three main company lifecycle groups, and characteristics we think about in helping construct and diversify the portfolio:

- ***Structural compounders***: provide superior growth and their earnings power is often underestimated by the market, providing the potential for excess returns. This is due to them having a competitive advantage through a unique product or service, or brand which gives them a dominant position and/or ability to take market share in large attractive end markets. Understanding these companies' earnings persistence and predictability is critical given the higher multiple they tend to trade on. CSL and James Hardie are examples of companies currently held of this nature.
- ***Mature growers***: provide ballast and uncorrelated returns to the portfolio through investing in:
  - ***Stalwarts*** - exhibit free cash flow and superior dividend growth, by providing steady margin accretive growth and out growing peers, often by only a few percent. These companies are generally well positioned in attractive end markets with high barriers to entry which are hard to disrupt and replicate, and often exhibit strong pricing power. Orora and Unibail-Rodmaco-Westfield fit this mould.
  - ***Quality cyclicals*** - are where we are looking for a step change in growth through leverage to a cyclical upswing with multi year earnings momentum. Important to investing in these companies is aligning ourselves with experienced management and companies with a strong balance sheet which sit low on the cost curve and have operating leverage to the cycle. Current holdings include Lendlease and Rio Tinto.
- ***Emerging companies:*** add optionality to the portfolio. These companies are entrepreneurial or emerging businesses that are growing and benefiting from developing strategic assets in new markets, innovative business models or disrupting incumbents. A predictable path to free cash flow growth and being aligned with passionate, focused and experienced management is critical. These investments are typically smaller and based around an 'up or out' view where

we increase position sizing as our conviction builds or exit. NextDC is an example of a company in the portfolio where as our conviction has grown we have increased our position size, whilst Syrah Resources is a more recent addition which is bringing on a new graphite mine and processing facility leveraged to the electric vehicle battery theme.

Figure 11: Australia Plus Portfolio diversification focuses on sector and company lifecycle positioning and valuation

	Company Life-cycle positioning			
	Structural Compounders	Mature Growers		Emerging Companies
		Stalwarts	Quality Cyclicals	
Characteristics				
Earnings growth	**Consistent sector beating growth** *Large dominant position in large under penetrated market*	**Maintaining an edge** *Well positioned in often competitive end markets, high barriers to entry, hard to disrupt, strong pricing power, superior dividend growth*	**Looking for step change in growth** *Leverage to the cycle run by experienced management and strong free cash flow generation and balance sheet*	**Entrepreneurial or emerging growth** *Strong growth benefiting from developing strategic assets in new markets or disrupting incumbents*
Earnings predictability	**Earnings power & persistence tends to be underestimated**	**Steady margin accretive growth & outgrowing peers (often by a few percent)**	**Clear multi year earnings momentum**	**Clear multi year revenue momentum**
What price to pay?				
Margin of safety …	**Tend to trade at higher valuations**	**Often trade at valuation premium given earnings visibility**	**Looking for step change in PER multiple and earnings**	**Predictable path to free cash flow growth sustainability**
… risks we think about	*- New competitive threats - Structural slowdown - Regulation*	*- Execution missteps - Erosion of underlying competitive strength*	*- Operating leverage to the cycle - Cyclical slowdown*	*- Execution - ability to deliver - Robustness of business model - Cash burn and funding*

Source: SG Hiscock

Orora - Mature grower marching on

Summary:

- Orora's Investor Day gave us increased confidence in the opportunities to refresh the Australasian assets and enhance earnings over the next few years
- It also reinforced a strong culture of accountability and management discipline that we expect to drive further value creation

"We define 'innovation' as the implementation of ideas that create value for our customers, and our company"
Nigel Garrard, Orora CEO

Orora is a position we added to the portfolio early last year. It is a good example of a 'Mature grower - stalwart' being:

- Well positioned in mature but rationale end markets;
- Hard to disrupt;
- Highly cash generative with financial flexibility and superior dividend growth; and
- Managed by a focused, disciplined and experienced management team.

Since being divested from Amcor in December 2013, Orora has undertaken a strategy of consolidating and upgrading its Australian domestic packaging operations (glass, metal and paper) and growing its North American operations through investment and bolt-on acquisitions around adjacent businesses and moving downstream into the Point of Sale (POS) marketing sector through its Orora Visual business.

During the quarter we attended Orora's first Innovation Expo and Investor Day. This provided an update on each of the key businesses and strategic initiatives as well as exposure to each of the business heads, line management and a tour of some of the manufacturing facilities.

Overall, it confirmed the Orora Visual business is 6-9 months behind on its integration plans, but more importantly it highlighted there is plenty of opportunities to refresh its Australasian assets and enhance earnings over the next 12 months. Key to this will be investing in new assets and restructuring initiatives aimed at delivering productivity and efficiency gains, and production innovation driving new sales and organic growth opportunities with customers.

A good example of the growth optionality that the Group's legacy business enjoys is in the glass bottle business where Orora has 63% share in glass wine bottles and 38% share in wine closures. Growth in bottled wine exports in Australia has grown 8.8% p.a. over the past three years led by Chinese demand (which has increased 63% over the last 3 years). At the

Investor day Orora announced it is going to invest $35m in the glass business on a new warehouse which it expects to be completed in 2019 and generate a return of 15% within 2 years.

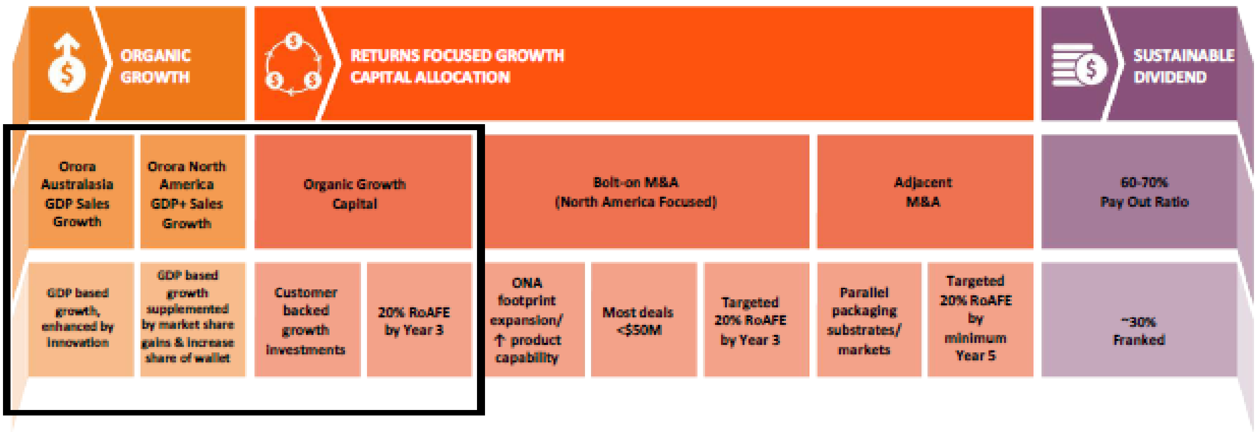
Another example of a growth opportunity outlined was in the Fibre Packaging business where Orora is investing in the latest digital printing and laser cutting technology. With the growth in on-line sales Orora is seeing an increase in demand by customers looking to redesign their primary packaging for better transport durability and more individualisation and short-run promotions. Following printing trends in Europe, Orora has ordered two ultra-high speed digital Nozomi printers. These will be exclusive in Australasia, and the 5th and 6th such printers in the world, and will print magazine quality imagery directly on corrugated board. This will enable individual or short run promotions at affordable prices, replacing the expensive and slow die making process, and opening up a whole raft of potential new customer opportunities.

Initiatives like this and insight into Orora's focus on customer orientation, innovation, performance and efficiency suggest the organic growth outlook and fundamental strengths of the Australia and New Zealand business remain healthy, and that the long-term strategy of the Group is not overly dependent on M&A.

At a broader level, the investor day gave us greater confidence in the opportunities and potential for Orora to deploy its balance sheet and financial flexibility to influence future earnings growth. We estimate if management is able to deploy the $250m borrowing headroom it currently has towards value accretive acquisitions, and fast-track beneficial internal restructuring initiatives, it would add a further $50m to EBIT. This represents an incremental 15% step-up on FY18 EBIT, assuming the capital deployed generates the targeted 20% return on funds employed within a 3-year period which the company is targeting.

Perhaps most importantly, we came away from the investor day with the impression from listening and talking to management that there is a high degree of rigour and consistency with what management is saying and doing. This is evident in the Orora's record on delivering to date, and gives us confidence there is a culture of accountability and management discipline that should deliver further value creation.

Figure 11: Orora blueprint for creating shareholder value



Source: Orora Investor Day Presentation, May 2018

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, but not dramatically with the Government growth target maintained at "around 6.5%". Growing geopolitical risks particularly around the potential for trade war escalating (and North Korea) have the potential to be tail risks, and contribute to a strengthening in the US dollar and depreciation in the CNY increasing the risk around capital outflows.
Europe	Compared to twelve months ago the growth picture in Europe has improved. Government debt burdens in much of Europe remain elevated placing limitations on fiscal stimulus policies. Whilst recent Euro growth data points suggest growth may have peaked and is starting to slow, there is little evidence to suggest growth is going to drop away sharply and it is still running significantly above potential. This should give the ECB the room to follow the US lead and start winding down its asset purchase program later in 2018.
Oil Price	We have become more constructive on oil around the improved demand and supply dynamics benefits from synchronised global growth coupled with the impact of maturing production sources. We believe Saudi Arabia and OPEC's indications to support the price in the near term should put a (soft) floor under the price at circa USD55-60/bbl. However, we remain cautious of overly optimistic projections of future deficits given the hedges and cost reductions experienced industry wide (with a focus on North American unconventional shale).
Commodities	Whilst expectations of fiscal spending under a US Trump presidency is arguably supportive for commodities, bulk commodity prices remain intrinsically linked to China and its start-stop fiscal stimulus and supply side reforms. We continue to look to the long-term demand and supply trends for opportunities. We are attracted to the demand side fundamentals of electric vehicle commodities (Cobalt, Graphite and Lithium). In a very unsettled geopolitical and macro environment, we see gold continuing to offer protection despite the risks posed by quantitative tightening.

SGH Australia Plus Overview

What makes us different?

- High conviction benchmark unaware portfolio holding 25 – 40 stocks with a maximum of 10 Asian securities
- Australian equity large cap blend with ability to invest up to 25% of fund in mid-small caps and 20% of the fund in Asia
- Focus on capital preservation and absolute returns for shareholders
- Portfolio targets long term capital growth and tends to outperform in down markets
- Disciplined repeatable process to stock selection and portfolio construction
- Because the portfolio is significantly different from the benchmark, performance can differ materially from the benchmark

Our Investment Strategy & Process

SGH Australia Plus is a concentrated fund holding 25-40 stocks. Our strategy is to only allocate capital to high-quality ideas where we have conviction. Our focus is on identifying businesses with a competitive advantage that are well-positioned in attractive end markets to grow free cash flow, at an acceptable margin of safety to intrinsic value. This is done through a rigorous, repeatable and disciplined quality assessment of the company's earnings, business and management. As part of this we undertake an extensive company visitation program which is important in providing 'insight', testing our thinking and developing our highest conviction ideas. We seek to know as much about our companies as possible, with a view to mitigating permanent capital loss and delivering outperformance over the long term.

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

Our Philosophy

As a high conviction fund our portfolio has very different weights from the ASX300 Index. SGH Australia Plus is a true index unaware fund, where each individual position is selected to provide positive attribution, not simply because it is a large portion of the index. As such the tracking error of SGH Australia Plus fund is regarded as high.

The core premise of our philosophy is to pick stocks that can deliver sustainable value creation on a 3 to 5 year view, rather than simply because the stock is a significant part of an index. Our thinking is different from most managers, whereby if we don't have a high conviction view on a stock, we won't hold it in the portfolio. An index aware fund may have a low conviction view of a company, but still hold a stock at index weight (i.e. its holding is 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.

To find out more about the SGH Funds, contact our distribution team:

Call 1300 555 511 or email bdm@sghiscock.com.au

Eliza Weaving	National Distribution Manager (VIC/SA)	03 9612 4660 / 0422 007 051
Mani Papakonstantinos	Distribution Manager (VIC/WA)	03 9612 4661 / 0439 207 869
Paul Sleiman	Distribution Manager (NSW/QLD)	02 9220 5109 / 0422 511 231