SG HISCOCK & COMPANY

SGH High Conviction Fund
Quarterly Commentary - December 2021

The SGH High Conviction Fund is a concentrated portfolio that invests in 15-30 high quality Australian listed companies. The Fund aims to deliver long term capital growth and growing income stream whilst reducing the risk of permanent capital loss.

Quarter in Review

- The quarter was defined by the emergence of the Omicron wave of the virus and hawkish pivot by the Fed now it no longer sees inflation as 'transitory'.
- There is no set playbook for returns when the Fed raises rates but looking back at periods when this has been the case the common thread is valuations typically fall and returns are driven by earnings and dividends.
- The quandary is navigating the prospects of reopening and better earnings as supply shocks ease and peaking in inflation, against more hawkish central bank policy if supply chain issues and inflation persist.
- The added risk is the Fed could start quantitative tightening and shrinking its balance sheet soon after the first-rate hike. The last time this occurred in late 2018 the S&P500 fell around 20%. It is hard to think the Fed would not pause, if not reverse course, if this happened and rate hikes will remain data dependent.
- We continue to favour selective reopening trades and higher cyclical exposure which not only stand to benefit as demand recovers from the pandemic but also as rates tighten. We also think it's important to maintain a diversified portfolio and retain a healthy position to quality growth companies with a margin of safety.
- In positioning for the prospects of reopening, tapering and more persistent inflationary pressures we added Computershare and increased our commodities and energy exposures. We also initiated a position in EBOS.
- The Fund returned 2.72% in the December quarter outperforming the S&P/ASX300 Accum. Index by 0.51%. The top portfolio contributors were National Australia Bank, Macquarie Bank and Cooper Energy whilst Marley Spoon, Carbon Revolution and CSL were the largest detractors. Cash at the end of quarter was 3.9%.

Outlook

"We will use our tools both to support the economy and a strong labour market and to prevent higher inflation from becoming entrenched."

Jerome Powell, Chairman, US Federal Reserve, 15 Dec-21

A new tightening cycle: How much and fast?

Throughout 2021 the course of the pandemic and policy positioning have remained the central influences on markets. During the last quarter this remained the case, however, there were two discernible shifts.

Firstly, with broader vaccination take-up there has been easing in social distancing restrictions and greater focus by Government's on stabilisation and living with the virus over lockdowns and stimulus. This coincided with emergence of the Omicron variant resulting in a surge in case numbers and new pressures on supply changes and disruption to economies reopening.

Secondly, the growing risk of inflation becoming more entrenched saw a hawkish pivot by central banks and discussion around whether interest rates will rise sooner, and faster and central bank balance sheets shrink earlier and more quickly than expected.

For equity markets the implications of these moves are important. Higher interest rates, and importantly real yields pose challenges for market positioning.

The first order impact is valuation and rotation. Long duration and growth stocks (i.e those with earnings and profitability projected more into the future and which have seen the greatest valuation expansion as real yields and implied discount rates have fallen) are susceptible to being derated as rates rise, whilst cyclical stocks stand to benefit.

Performance to 31 December 2021

	3 Month %	6 Month %	1 year %	**2 years % p.a.**	3 years % p.a	5 years % p.a	7 years % p.a	10 years % p.a	Inception % p.a
SGH HCF (after MER)	2.72	6.07	14.39	9.93	12.89	10.61	10.24	9.78	10.38
S&P/ASX 300 Accum. Index	2.21	4.03	17.54	9.35	13.96	9.94	9.15	10.79	8.50
Value added (after MER)	0.51	2.04	-3.15	0.58	-1.07	0.67	1.09	-1.01	1.88

The rotation has already been evident with unprofitable US technology stocks down over 30% in the last month. The reversal has been similar to prior rate reactions but much faster this time.

In part this reflects the degree of the shift in expectations. Last January, the market assumed the first Fed interest rate hike would be around April 2024 (40 months away). Last August, this had moved in 12 months to around April 2023. Pricing now implies the first Fed rate will be in March 2022 (2.5 months away!).

There is no set playbook for returns when the Fed raises rates but looking back at periods when this has been the case the common thread is valuations typically fall and returns are driven by earnings and dividends.

The second order debate from higher rates is what will be the implications for growth and rising cost of doing business and costs of capital.

Strong EPS momentum was a major tailwind for equities in 2020 and 2021 on the back of synchronised fiscal stimulus, quantitative easing and resurgent demand as economies reopened from lockdowns. Earnings revisions turned negative in the September quarter as the Delta variant saw renewed lockdowns and exacerbated and broadened supply chain disruptions and inflationary risks.

The most recent Omicron wave further clouds the growth outlook. Whilst less virulent it is far more infectious and seen a spike in case numbers. This has tempered consumer behaviour and amplified labour shortages and disruptions as workers testing positive or close contacts have been forced to isolate. It has also exacerbated supply chains issues and inflationary pressures.

Woolworths and Bega Foods Christmas eve trading updates provided a good window into the cost pressures and disruption currently being faced. Many essential service providers and businesses that were largely unaffected, and in fact prospered under earlier lockdowns, are now facing staffing and labour shortages, experiencing higher costs of testing, logistics and indirect costs of lost sales. No doubt we will hear more of this leading into and through the February reporting season.

It points to potential for some further earnings weakness near term and downgrades to GDP in the March quarter. However, household balance sheets and demand more broadly remain healthy. In Australia, a peaking in the current wave over the next month coupled with high vaccination and savings rates and tight labour markets should see to economic growth bouncing back in Q2. Consensus is still forecasting 4%+ GDP growth in Australia in 2022.

There has been talk about the potential for a mid-cycle slowdown driven by a shift in spending from goods to services as the economy reopens and stimulus benefits fade. A sharper than expected rise in interest rates could potentially exacerbate this if it started to erode consumer and business confidence and see falls in leading manufacturing (PMI and ISM) data. This is a risk as the cycle matures.

The quandary for markets is navigating the prospects of reopening and better earnings as supply shocks ease and peaking in inflation, against more hawkish central bank policy, particularly if pandemic dislocations and supply chain issues persist. Even if there is good potential for earnings to continue to grow the risk is valuation multiples start to converge resulting in lower returns.

The added risk is the Fed has signalled it could start quantitative tightening (QT) and shrinking its balance sheet soon after the first-rate hike. The last time we had hikes plus QT in late 2018 the S&P500 fell around 20%. It is hard to think the Fed would not pause if not reverse course if this happened.

Whilst the Fed has signalled inflation has moved beyond transitory and the need to act, we expect rate hikes will remain data dependent and central banks don't want to end the cycle.

Drawing on all this, we continue to favour selective reopening trades and higher cyclical exposure which not only stand to benefit as demand recovers from the pandemic but also as rates tighten.

We also think it's important to maintain a diversified portfolio and retain a healthy position to quality growth companies, but actively manage exposure to long and higher PE stocks. We have been taking some profits in this area and are keeping a watchful eye for opportunities to buy quality businesses at more attractive prices.

Beyond Transitory: Assessing the inflation pulse

The US November CPI which came in at 6.8% yoy, up from 5.4% in September, was a catalyst for the Fed to stop focusing on 'transitory' and shift to focus on inflation not becoming 'entrenched'.

The timing and shift in market sentiment for higher inflation comes at an interesting juncture where there is growing potential for the inflation narrative to potentially take a breather. This is due in part to the high base effect already in effect, but also because of the near-term peaking of Covid related supply chain problems and bottlenecks, which have been exacerbated by the back-to-back effects of Delta and Omicron waves.

This has the potential to delay or reduce the number of rate hikes consensus expectations is now implying. It also adds weight to the need to maintain a diversified portfolio. Any fading of inflationary concerns will be positive for growth stocks, whilst reopening will benefit cyclicals such as travel and energy stocks. Both scenarios are plausible, and potentially probable, in the coming quarter.

Beyond this we see increasing evidence why inflation could prove more persistent and structurally higher, including:

- The dramatic expansion in G7 money supply on back of synchronised fiscal expansion post Covid.
- Continued strong demand given the strength of household balance sheets and stimulus and welfare payments.

- Tightness in labour markets and Increasing demands for wage increases.
- Rising energy and commodity prices as demand recovers and with the transition to a lower carbon economy and investment in green tech.
- Higher food prices as inputs for grains and meats, fertiliser and ammonia increase.
- Willingness of companies to pass on higher costs in prices.

As we highlighted in our March quarterly, we also remain conscious looking back over the last 100 years rising inflation rate episodes are mostly due to unexpected inflation shocks. The Covid crisis has been a major shock to the system, and the effective lockdown of all economies has arguably resulted in the biggest global supply shock in history and been met with a radical pivot and unprecedented move to fiscal policy. As Figure 1 shows the US CPI yoy increase is currently the highest since 1982 and now meets the definition of an inflation regime with inflation growth year-on-year having risen above 5%. The question is how persistent this will be?

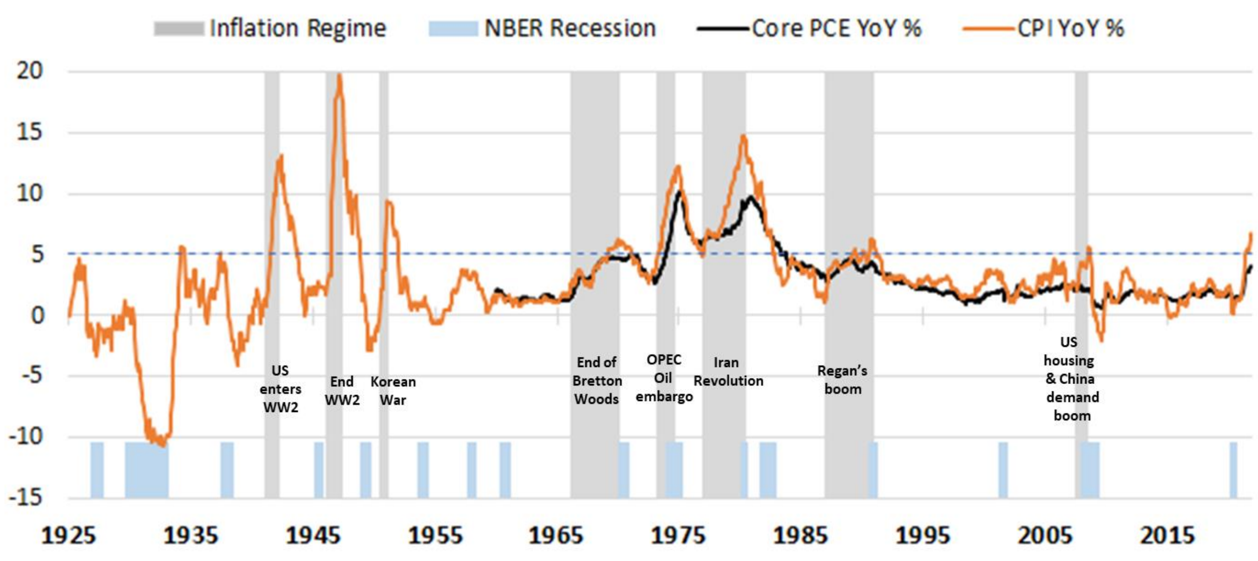
Considering the risk of higher inflation and looking to maintain a diversified portfolio across our company lifecycle groupings, we are very focused on ensuring:

- Companies in the portfolio have pricing power and able to pass on costs. Our recent decision to sell Reliance Worldwide was in part predicated on concerns of the ability to continue to do this in the face of rising commodity price inputs.
- We continue to add quality cycles leveraged to economic recovery and higher rates where its supported by fundamentals. In the last quarter we added **Computershare (CPU)**. We also used the pullback in the **Woodside Petroleum (WPL)** share price on the back of the BHP Petroleum merger proposal and retreat in the oil price as an opportunity to add to the position.
- Avoiding/ reducing longer duration assets without an adequate margin of safety or clear catalyst for a re-rating.
- Capitalising on companies experiencing positive tailwinds from Covid and which we believe will emerge stronger. This includes **James Hardie (JHX)** and **Uniti Group (UWL)** which continue to benefit from strong demand tailwinds from Covid, but also companies Like **Aristocrat Leisure (ALL)** and **Corporate Travel (CTD)** which have experienced Covid headwinds, but been able to emerge stronger through taking market share and actively participating in industry consolidation.

Portfolio performance & positioning

During the quarter we initiated positions in Computershare and EBOS.

Figure 1: In the last 100-years rising inflation rate episodes have been mostly due to unexpected inflation shocks
US YoY CPI and Core PCP overlaid with inflation regimes and recessions



Source: Bloomberg, NBER, 'The Best Strategies for Inflationary Times', April 2021 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3813202
Notes:
1. *Core PCE data history starts in 1960*
2. *Inflation regimes are time periods when the year-on-year realised inflation rates rise materially above 2% (i.e reaching 5% or more). This level is often targeted by central banks, and even when not explicit, is often considered a psychologically important threshold. The regime end is the point at which CPI year-on-year reaches its peak without having fallen below 50% of its maximum annual rate in rolling 24-month observation windows. Episodes shorter than 6 months are excluded and considered too short to constitute a regime change.*
3. *NBER recession periods are periods where the US economy was in recession as defined by the National Bureau of Economic Research*

Computershare (CPU) (+9.8%) is a quality financial cyclical with a direct earnings benefit from higher rates which we have followed for a long time and previously owned. Its core business is providing back office and call centre functions in over 20 countries across a variety of financial services including registry services, mortgage services and employee share plans. The Group is well diversified and by its nature this provides a portfolio effect to earnings, insulating some of the downside risk from its more cyclical businesses, but also can cap upside. As a result, earnings growth has been relatively flat over the last decade. The low and flat yield environment has contributed to this with little upside to the investment income/ margin income Computershare earns on holding cash balances for its clients.

At its peak margin income can contribute almost 60% to Group earnings (EBIT). Currently it is less than 30%. While the increase in yields could be a slow grind back up, Computershare's earnings are one of the highest correlated to rising rates on the ASX. A 25 basis point uplift in the exposed balance running yield can add over 10% to Group NPAT. Further if Computershare is successful in converting some of the money market funds from its recent acquisition of Wells Fargo's Corporate Trust business into exposed balances it could add a further 8-10% to Group NPAT.

Computershare is also somewhat of a Covid recovery story. In 2021 earnings were affected by the pandemic with loan moratoriums and stimulus packages affecting mortgage service volumes and corporate conditions, and the headwind of historically low rates. There is evidence of a gradual improvement in operating conditions. Synergies from the large complimentary Wells Fargo Corporate Trust acquisition and upside from higher interest rates should also be beneficial driving multi year earnings growth.

EBOS (EBO) (+13%) is a company we have been following closely for several years. The announcement in the quarter to acquire LifeHealthcare and subsequent placement provided the opportunity in a quality company with a diversified range of businesses in the health and animal care sectors.

The Group's roots stem back to being a pharmacy and medical supplies wholesaler and third-party logistics provider in New Zealand. In 2013 it acquired Symbion a leading pharmaceutical wholesaler in the hospital and pharmacy market in Australia, and then in 2014 acquired Blackhawk. Along the way it has made a variety of bolt-on acquisitions in extending its footprint as a marketer, wholesaler and distributor of healthcare, medical and pharmaceutical products, as well as been active in consolidating the Australian pharmacy sector under the Terry White Chemmart brand.

The Healthcare segment now includes community pharmacy, institutional healthcare, contract logistics and consumer products. The Animal Care segment includes pet supplies (Animates), vet distribution services (Lyppard) and pet food and treats (BlackHawk, VitaPet).

A hallmark of the business over the years has been good execution as illustrated by consistent earnings per share growth (5-year NPAT CAGR ~11%), cash generation, improving returns, and good integration of acquisitions despite competition and regulatory pressures. We have few reasons to believe this momentum should change or the opportunities to expand in its chosen verticals will dry-up.

The acquisition of LifeHealthcare is the latest new opportunity to expand EBOS's medical device distribution business in new therapeutic areas and into the South East Asian market. On a pro-forma pre synergies basis the deal is expected to be low double-digit EPS accretive in CY22. This should augment the current earnings tailwinds in the underlying healthcare and animal care businesses from Covid allowing the business to grow NPAT mid-teens over the next 3-5 years.

As discussed, we continue to favour the energy stocks as a beneficiary of reopening and tapering. Following the sector outperforming strongly in September performance in the December quarter was more mixed with most names in the sector finishing down (WPL -8.7%, STO -11.9%, BPT -15.7%). The Brent oil price tumbled 18% in November on calls for additional supply and increased demand risk from Omicron, before bouncing back 13% in December. We think the moves to curtail recent price strength only highlight the limited ability for production to respond to current tightness, and the level of under investment in upstream appraisal and development in recent years. All of which points towards higher long-term prices in the years ahead and supports our overweight thesis.

Woodside Petroleum (WPL) (-8.7%) remains the best placed domestic beneficiary of higher global prices, in our view. Woodside's exposure to spot cargoes of LNG is around 10% but its valuation starting point is cheaper owing to the complex merger of equals with BHP Petroleum announced in August, which is expected to be finalised in early 2022. The deal if approved, will position Woodside with twice the levels of production and a balance sheet with low levels of gearing and sufficient flexibility to fund various growth projects, including Scarborough in Western Australia.

The price of iron ore also experienced a highly volatile quarter plunging 22% to US$83 per tonne in November before rallying back to US$116 per tonne at the end of December. The bounce was in response to Chinese authorities taking several measures to support the embattled real estate sector including encouraging banks to fund acquisitions by healthy property firms. Combined with the lowering of the benchmark lending rates the moves are a positive sign that demand for steel is starting to recover. This coupled with the cyclical rotation on the back of the pivot in Fed policy saw **BHP (+10.3%)** perform strongly in the quarter.

In a grand finale to a record year of M&A **CSL (-1%)** in December announced a ~A$17.2bn tender offer for Vifor Pharma and A$6.3bn share placement to fund the deal (the largest secondary market raising in Australian corporate history). The acquisition complements elements of CSL's existing product portfolio and expands the business into renal disease and iron deficiency anaemia. This market is currently growing at double digit growth and CSL is expecting it to double in the next 5-years from US$13bn to US25bn, providing a strong growth opportunity. Strategically, the deal also facilitates access to patient populations to support CSL's clinical trial programs in transplant medicine, diabetic kidney disease, ischaemia-reperfusion.

December 2021 Quarter - Portfolio Performance & Characteristics

Top 3 Active Holdings	Portfolio Breakdown		Top 3 Portfolio Attribution	Bottom 3 Portfolio Attribution
Chorus	Industrials	17.7%	National Australia Bank	Marley Spoon
Uniti Group	Financials	17.6%	Macquarie Bank	Carbon Revolution
Woodside Petroleum	Materials*	13.5%	Cooper Energy	CSL

**incl. 3.4% in Gold*

Figure 2: Sector weights relative to ASX300

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

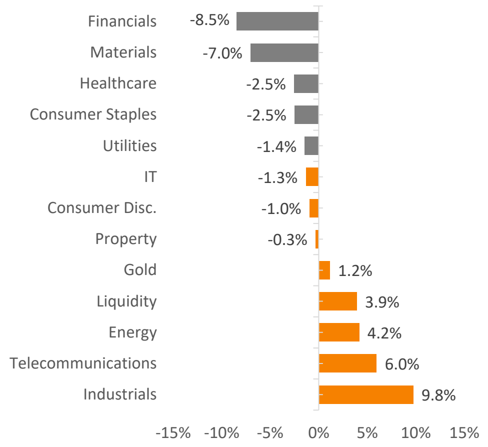


Figure 3: Market cap weights relative to ASX300

Underweight ASX20 and overweight to mid-cap stocks

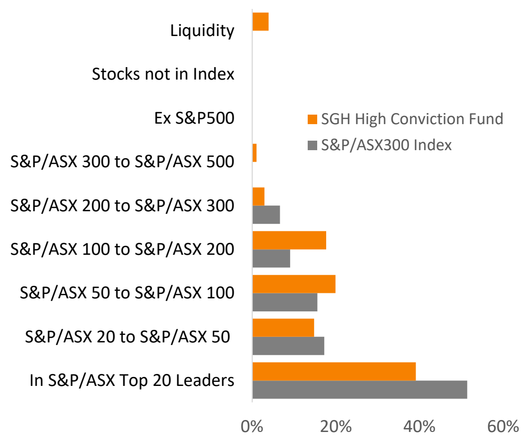


Figure 4: Portfolio Characteristics

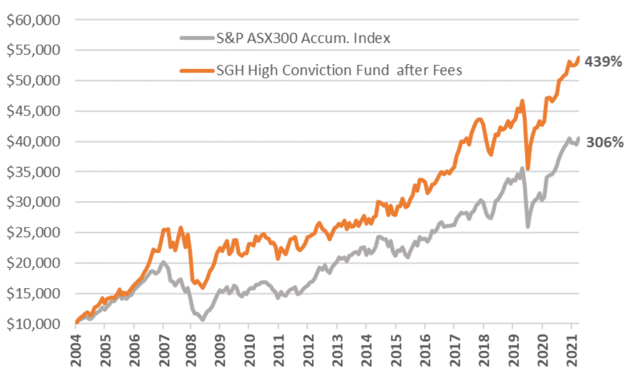
Superior Return on Equity (ROE) to the index with stronger growth (EPS) and trading on a similar valuation multiple

	Sales Growth		EPS Growth		Yield		PER (x)		ROE	
	FY22/FY21	FY23/FY22	FY22/FY21	FY23/FY22	FY22	FY23	FY22	FY23	FY22	FY23
SGH High Conviction	16.4%	9.3%	17.7%	13.2%	2.7%	3.0%	22.1	20.2	15.3%	13.9%
ASX 300 Index	5.7%	1.3%	11.1%	7.1%	3.6%	3.7%	18.9	17.2	13.0%	12.8%

Source: Bloomberg, SG Hiscock

Figure 5: $10,000 invested since inception

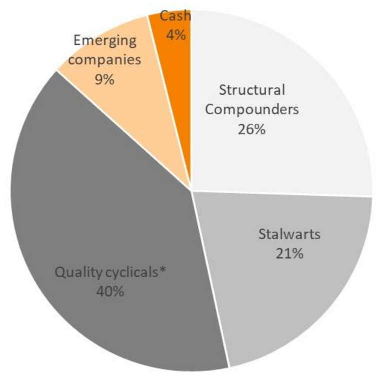
SGH HCF has a long track record of adding alpha



Source: SG Hiscock, Bloomberg

Figure 6: Portfolio lifecycle diversification

Portfolio lifecycle exposure by NAV



SGH High Conviction Fund - Overview

What makes us different?

- High conviction benchmark unaware portfolio holding 15 – 30 stocks
- Focus on quality businesses that are sustainably growing free cash flow and improving returns
- Focus on capital preservation and absolute returns for shareholders
- Disciplined repeatable process to stock selection and portfolio construction

Investment Philosophy

The core premise of our philosophy is to invest in companies that deliver absolute returns for investors, with a strong focus on capital preservation. In our view this is best achieved by investing in quality businesses that can deliver sustainable value creation over the medium term, rather than simply investing in companies because they are a significant part of an index. We allocate capital only to high quality ideas where we have conviction, believing only a few quality ideas are required to build a good portfolio. We to do this through investing in quality companies which are sustainably growing free cash flow and returns and are mispriced. We believe price is what you pay, and value is what you get, and valuation discipline is fundamental to investing and creating longer term shareholder value.

Investment Strategy & Process

The SGH High Conviction Fund is a concentrated portfolio holding 15-30 stocks. Our focus is on identifying businesses with 'quality sustainable growth' that are mispriced. We do this through a disciplined and repeatable process that seeks to identify companies which are:

- Sustainably growing free cash flow and returns
- Well-positioned in attractive end markets with a source of competitive advantage
- Appropriately structured and have a sound balance
- Lead by engaged, focused and innovative management

Where we are satisfied companies meet these criteria, they are eligible for portfolio consideration subject to valuation. A range of valuation methodologies are used depending on the nature of the business.

As part of our process we undertake an extensive company visitation program which is important in providing 'insight' in developing and testing our thinking, understanding and investment thesis. We seek to know as much about our companies as possible, with a view to mitigating permanent capital loss.

The portfolio construction process is determined by our confidence and conviction in the underlying quality of the business and margin of safety to valuation. It is also influenced by top-down economic considerations and industry and company life cycle risk characteristics.