SG HISCOCK & COMPANY

SGH High Conviction Fund

Quarterly Commentary - March 2022

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 Russian invasion of Ukraine dominated the headlines last quarter, but the rising inflation risk and Central bank tightening remains the key risk for equity markets.
- The Fed's more hawkish stance has also raised concerns Central Banks will be tightening into a slowing cycle and raised the spectre of stagflation (higher inflation and rates and slowing economic growth) and mid cycle slowdown, or worse recession.
- Global growth estimates have been coming down over recent months with the Russia-Ukraine crisis and Chinese Covid lockdowns. The risk Europe goes into recession seems increasingly probable. We see US and particularly Australia as overall better placed to absorb higher rates.
- 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.
- The portfolio came through the February reporting season in good shape. In fact, it was one of the cleanest reporting seasons we can remember for a while in terms of results delivering relative to expectations. As a consequence, we made few changes to the portfolio. In positioning for reopening, and higher rates during the quarter we added Netwealth and to exiting positions in Computershare and Corporate Travel.
- The Fund returned 3.22% in the March quarter outperforming S&P/ASX300 Accum. Index by 1.14%. The top portfolio contributors were Woodside Petroleum, BHP and National Australia Bank whilst James Hardie, Aristocrat and CSL were the largest detractors. Cash at the end of quarter was 4.9%.

Outlook

"Inflation is a monetary phenomenon. It is made by or stopped by central banks"

Milton Friedman

"We need to be open about what we can and cannot do as a central bank. For example, our monetary policy cannot fill pipelines with gas, clear backlogs at ports or train more lorry drivers."

Christine Lagarde

Australia: 'the lucky country'

Global equity markets began 2022 with a significant sell-off as investors responded to the increasingly hawkish pivot by the US Fed. With US inflation pushing 7%, the highest level since 1982, and the economy approaching the NAIRU (theoretical measure of full employment), the market began to price in further rate hikes through 2022.

The invasion of Ukraine by Russian forces late in February only added to concerns around rising inflation and saw most global equity markets post a negative return for the quarter. Despite this the ASX300 Accumulation Index finished up 2.1%, outperforming the MSCI Global Index (-8.4%) and global indices.

The dominance and representation of resources and banks in the Australian listed equity market, and outperformance of these sectors in the last quarter, in good part explains the outperformance of the Australian market.

More broadly though, we see the Russia-Ukraine war as a significant historical moment with longer term geopolitical and economic implications that are likely to favour Australia.

Performance to 31 March 2022

	3 Month %	6 Month %	1 year %	**2 years %**	3 years % p.a	5 years % p.a	7 years % p.a	10 years % p.a	Inception % p.a
SGH HCF (after fees)	**3.22**	**6.03**	**16.84**	**25.46**	**10.99**	**10.32**	**9.45**	**8.89**	**10.42**
S&P/ASX 300 Accum. Index	2.08	4.34	15.21	26.24	10.85	9.38	7.95	10.10	8.50
Value added	1.14	1.69	1.63	-0.78	0.14	0.94	1.50	-1.21	1.92

First and foremost, the dislocation in commodity markets and rise in prices is a tailwind for Australia and other resource rich countries. Ukraine represents the largest area of arable land in Europe and is a key supplier of barley and wheat as well as being Europe's largest producer of ammonia (a key fertiliser input), whilst Russia is a major source of energy. Together they produce 15-20% of global output of main grains and Russia supplies 35% of Europe's gas demand.

As a resource rich nation and exporter of both hard and soft commodities, in a relative sense Australia's economic growth stands to benefit versus most other developed countries, and particularly those heavily reliant on commodity and energy imports. The effects of higher commodity prices is also likely to exacerbate the impact of inflation in those high commodity consuming countries adding the risk of monetary tightening and consequent risk of growth slowing. The probability of Europe now entering recession has increased materially, and history shows that the US consumer and growth tend to slow during periods of strong commodity price and oil price inflation.

Apart from the obvious GDP uplift Australia stands to benefit from, its geographic remoteness and political stability make it an attractive partner to do business with, and also place in which to invest. For the first time in several years there seems a growing interest by international investors to invest in Australian equities, but also more broadly in infrastructure and property assets given the tailwinds favouring the economy and potential strengthening in the Australian dollar (AUD).

We would not normally expect the AUD to rise in periods where the US cycle is slowing, but high commodity prices and capital inflows stand to see the AUD strengthen. A simple model using commodity prices and Australian bond yield differentials suggests the AUD should currently be trading at AUDUSD 96 cents. It is worth remembering, in July 2011 during the last commodities boom the AUDUSD rose to $1,10!

A more complex world

The current confluence of events makes the world a complicated place in which to invest. Whilst it may come across as bold to say it, the current environment is arguably more complex than anything we have faced in the last 30 years, including the crises in 1987, 2008 and 2020. The problem is, it is not just about the price of money and managing to a 'nominal' world in which deflation has been the predominant force. Now we need to think about the 'real' world of inflation and rising commodity prices.

This presents a very different problem for investors, but also Central banks and policymakers than faced over recent decades. Monetary policy and money printing under quantitative easing (QE) has been effective in slowing/stimulating demand by controlling nominal credit, but commodities are real resources (food, energy, metals) and inequality and supply cannot be addressed by QE. Simply, you can print more money, but not more oil or wheat. As Christine Lagarde, the President of the European Central Bank, recently put it, "monetary policy cannot fill pipelines with gas, clear blocked ports or train more lorry drivers".

The reality is that the inflation genie was already out of the bottle long before the invasion of Ukraine was launched on 24 February. The Russia-Ukraine conflict adds to the post Covid inflation impulse and supply chain problems.

A key consideration in whether inflation will prove structurally higher and more persistent going forward depends on how central banks engage in real monetary tightening. In March the US Federal Reserve announced it will increase the Fed funds rate by 0.25% after confirming it has achieved its objectives of maximum employment and inflation.

When rates move, they rarely are one-off. We think the Fed can continue to raise once per meeting, likely by 50b basis points, until they get back to neutral. Credit markets are suggesting as much by now discounting a further 200 basis points of Fed tightening over the balance of the year to 2.25-2.5% by end of 2022. This has seen the US yield curve flatten dramatically and pushed up real yields putting more pressure on valuations. This was most evident in the derating in growth and technology stocks, but also felt in interest rate sensitive sectors like housing and REITs (as we have seen in performance of James Hardie and Aristocrat Leisure).

Inflation and monetary tightening are not just an American affair, and increasingly an issue being faced by most advanced economies including Australia. In March, the market priced in earlier commencement of the RBA rate hikes following Governor Lowe's pivot and to saying, "it is plausible that the cash rate will be increased later this year". Until recently the official line from Lowe had been that there could be no rate increase until at least late 2023. This saw Australian 10-year bond yields spike to 2.97% (up from 2.15% before ending the month at 2.9%.

The spectre of ongoing monetary tightening clearly raises the risk Central Banks will be tightening into a slowing cycle and raised the concerns of stagflation (higher inflation and rates and slowing economic growth) and a mid-cycle slowdown, or worse recession.

In raising rates and managing inflation ultimately Central Banks are trying to tighten financial conditions. If higher short-term rates undermine economic growth too much, the prevailing consensus view seems to be Central Banks will pause, or even reverse course. It is these expectations that have been preventing the tightening of financial conditions.

Acknowledgement by Central Banks that they are now behind the curve and need to move off emergency settings and tighten financial conditions means they are now likely to keep raising rates until there is a clear sign the economy cannot handle it or there is a financial shock.

Pushback to this view (exacerbated by mainstream media) tends to centre around concerns tightening rates too aggressively will impact the housing market and household consumption. Whilst we recognise these risks it is also important to recognise the geopolitical and economic backdrop is different this time. The starting position in terms of record low real rates and employment and household savings is better than during previous hiking cycles

More immediately, the issue facing investors is how to position for rising rates and central banks that increasingly look to be "behind the curve" and need to tighten in the face of higher inflation and risk of it becoming more entrenched. In our view 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 continue to be focused on:

- Ensuring companies in the portfolio have pricing power and able to pass on costs.
- Adding quality cycles leveraged to economic recovery and higher rates where it's supported by fundamentals.
- Avoiding/ reducing longer duration assets without an adequate margin of safety or clear catalyst for a re-rating.

Portfolio performance & positioning

In the current environment there is a need to be active and selective in terms portfolio construction. In building the portfolio around our lifecycle groupings we currently maintain a higher exposure to quality cyclical companies where we see a better margin of safety and opportunities.

We have continued to add to quality cyclicals leveraged to the economic recovery and higher rates. During the quarter we added further to our position in **Computershare (CPU).** With rates rising there is good operating leverage through higher margin on the cash float CPU holds across several of its businesses. 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. We also see CPU as somewhat of a Covid recovery story. As loan moratoriums come off and interest rates rise this should provide a tailwind for its mortgage services and Business services divisions.

During the quarter we also added **Netwealth Limited (NWL)** to the portfolio. NWL is a specialty platform provider with strong growth in Funds Under Advice driven by a superior technology stack that is resulting in market share gains from the incumbent bank owned platforms (former and current) including ANZ, IOOF, MLC and BT Panorama. As interest rates rise we also see NWL benefiting from an increase in its cash administration fee, with a 20 basis point increase in rates equal to approximately 8% uplift in earnings.

During the quarter we took the opportunity to add to **Corporate Travel (CTD)**. With border and Covid isolation restrictions starting to relax there is growing evidence travel is starting to recover. We see CTD as well positioned to benefit from the reopening both here in Australia, but also in the US and UK. In stark contrast to many of its domestic listed travel peers CTD has not had to undertake a deeply discounted recapitalisation through Covid. By contrast it has used the industry dislocation as an opportunity to build out its business with the acquisition of Travel and transport, a leading corporate travel agent in the US and UK, and more recently acquire Helloworld's Australian corporate travel business.

The spike in commodity and energy prices on the back of the Russia-Ukraine invasion during the quarter saw the portfolio's overweight exposure to Energy stocks (particularly **Woodside Petroleum (WPL)**) benefit materially. Brent crude hit a high above USD130/bbl in early March before closing the quarter up 37% at USD107/bbl. European gas prices also surged closing up 58% for quarter and are now up 228% over the last year.

Even before the Ukraine crisis, we were seeing sharp increases in European energy prices on the back of changing weather patterns, growing dependence on renewables and under investment in base load capacity. The war and threat of sanctions and dislocation in Russian European dependence on Russian energy only exasperates the situation: Russia accounts for around 12% of global oil exports and 19% of global gas supplies, with Europe sourcing more than 40% of its gas supply from Russia.

Short term we expect energy prices to be volatile, but over the medium to longer term the Russian-Ukraine situation is likely to see a strategic rethink around European energy security. We see this as positive for large low-cost producers with well-endowed resources and growth options like WPL. A core tenant of our initial thesis for investing in WPL was the need for LNG gas in providing baseload electricity supply in the transition to a lower carbon world. This still stands, and we noted with interest that Larry Fink, the CEO of Blackrock, in his annual letter to CEO's in January made this point well in justifying his firm's investment in traditional oil and gas E&P players and how it aligns with the firm's ESG commitment. However, the current geopolitical events and likely realignment of critical supply chains and need for strategic partners is a further tailwind to the investment case and plays well for WPL and the broader Australian LNG sector.

In February the **BHP** vote for the collapse of the DLC structure was passed by shareholders resulting in the company delisting in the UK and being upweighted in the ASX200 Index from 6.6% to 10.9%. We have upweighted our position based on the strong underlying fundamentals for commodities and seeing BHP as having a well-diversified portfolio with leverage to soft commodities production through potash, future-facing commodities (used in batteries and electrification) through its nickel business as well as iron ore and metallurgical coal.

In March **Uniti Group (UWL)** was the beneficiary of a takeover bid from two independent parties: the Morrison - Brookfield Infrastructure Group consortium, and secondly, a rival bid from Macquarie Infrastructure and Real Assets (MIRA). The competing bids highlight the reason we were attracted to UWL initially - long duration social infrastructure type assets with stable and recurring revenue streams.

Chorus (CNU) is another highly attractive stalwart holding leveraged to the fibre theme which we view as a covid beneficiary and with social infrastructure and annuity type qualities. The company in our view has been trading at a deep discount to intrinsic value on regularly uncertainty. In

December 2021 the NZ regulator finalised the regulatory setting and in February the company provided first time dividend guidance. On our analysis CNU is trading on an expected dividend yield of between 7-10%. By way of comparison Transurban and Sydney Airports have historically traded on dividend yields of around 4-5%, and Telstra is currently trading on 4.6%. This is providing an opportunity to invest in a high-quality defensive business, with a near monopoly position in New Zealand fibre telecommunications at an attractive margin of safety.

During the quarter a number of the portfolio's more growth orientated 'Structural Compounder' holdings dragged on performance, including **James Hardie (JHX), Aristocrat Leisure (ALL)** and **CSL (CSL).** We don't believe the fundamentals in these businesses has changed, rather they have experienced a valuation derating as real yield have risen. In the case of CSL and ALL we see both companies as well positioned to benefit as economies reopen from Covid. There market leading positions, strong competitive advantage, global nature of their businesses and strong free cashflow generation continue to see them as extremely well positioned in the medium and longer term, and even more compelling at current prices.

More generally, the February reporting season provided the opportunity to gain a broad insight into the underlying economy and operating environment. The portfolio came through reporting season in good shape with no real result disappointments. In fact, it was one of the cleanest reporting seasons we can remember for a while in terms of results delivering relative to expectations.

March 2022 Quarter - Portfolio Performance & Characteristics

Top 3 Active Holdings
Uniti Group
Chorus Group
Woodside Petroleum

**incl. 3.6% in Gold*

Portfolio Breakdown	
Financials	18.7%
Industrials	15.6%
Telecommunications	11.0%

Top 3 Portfolio Attribution
Woodside Petroleum
BHP
National Australia Bank

Bottom 3 Portfolio Attribution
James Hardie
Aristocrat
CSL

Figure 1: Sector weights relative to ASX300

Our bottom-up stock analysis and structural views is evidenced in our deviation from the inde4

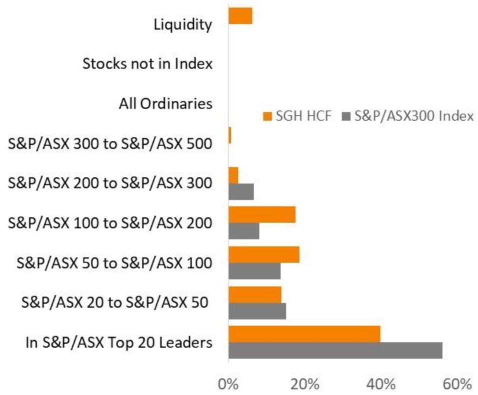


Figure 2 Market cap weights relative to ASX300

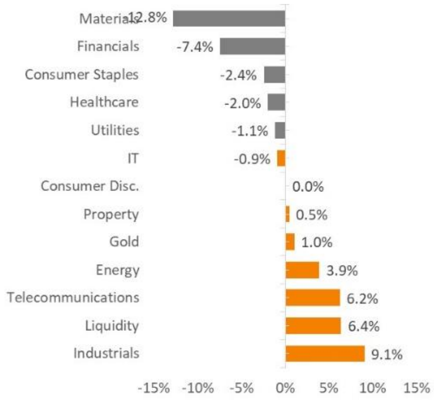


Figure 3: Portfolio Characteristics

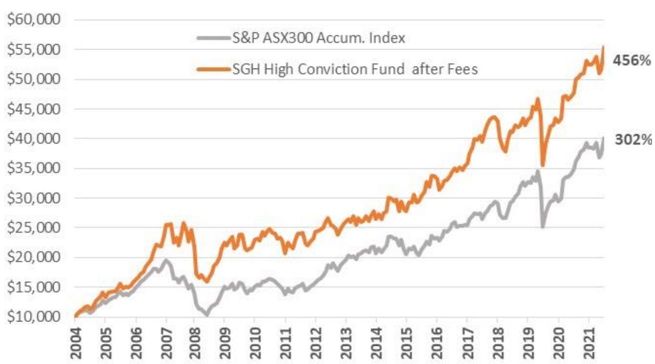
Superior Return on Equity (ROE) to the index with stronger sales growth EPS characteristics

	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	15.9%	8.7%	17.0%	10.1%	3.1%	3.1%	18.7	17.9	14.5%	13.9%
ASX 300 Index	5.5%	1.1%	12.9%	6.3%	4.1%	4.1%	18.8	17.6	15.9%	14.8%

Source: Bloomberg

Figure 4: $10,000 invested since inception

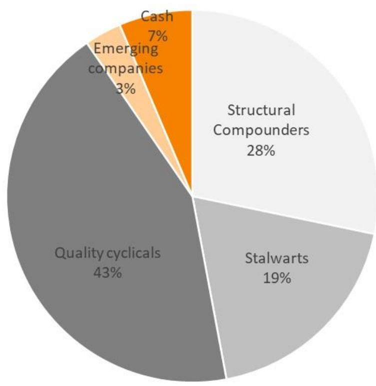
Long track record of adding alpha



Source: SG Hiscock, Bloomberg

Figure 5: Portfolio lifecycle exposure

Portfolio diversification by lifecycle, sector and size



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

SGH High Conviction 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.