SG HISCOCK & COMPANY

SGH High Conviction Fund

Quarterly Commentary - June 2023

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 portfolio returned 1.02% (net) during the quarter outperforming the benchmark by +0.03% but struggled to keep pace over the 12 months to 30 June returning 9.91%.
- By historical standards the market rally over the last 12 month has been 'narrow' with 75% of the ASX Index performance driven by the Materials, Financials, and IT sectors.
- Looking ahead into the second half of 2023 we expect financial conditions will continue to tighten due to higher interest rates and living costs. This is likely to result in an uneven economy and ongoing earnings and returns dispersion, necessitating being selective and active in managing the portfolio and focusing on quality businesses and their fundamentals, rather than trying to predict macroeconomic outcomes.
- The US construction boom, energy transition, Australia's surging migration and persistence in inflation are providing strong tailwinds and investment opportunities for a number of companies in the portfolio despite the broader economic uncertainty, which we discuss further in this report.
- In the June quarter NextDC, James Hardie and AUB Group contributed strongly, while BHP, IDP Education and Treasury Wine Estates were the major detractors.
- During the quarter we added AUB Group to the portfolio and added to existing positions in Genesis Minerals, QBE Insurance and Worley.

Performance to 30 June 2022

	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 High Conviction Fund (net)	1.02	3.66	9.91	2.69	8.52	4.59	7.85	8.54	9.47
S&P/ASX 300 Accum. Index	0.99	4.36	14.40	3.27	11.07	7.12	8.91	8.55	7.93
Value added	0.03	-0.70	-4.49	-0.58	-2.55	-2.53	-1.06	-0.01	1.54

Outlook

"I was having dinner with Warren Buffett. And he says to me, for a piece of information to be desirable, it has to satisfy two criteria. It has to be important, and it has to be knowable. The macro is very important. Seems to be the thing that moves the market most, but it's not knowable"

Howard Marks

"A model is useful only if the person using it understands that it does not represent 'the world as it really is', but is a tool for exploring ways in which a decision might or might not go wrong"

Radical Uncertainty, John Kay and Mervyn King

A narrow market rally & AI euphoria

For the quarter the SGH High Conviction Fund was broadly flat with the ASX300 Accumulation Index returning 0.99% (+0.03% outperformance) but struggled to keep pace over the 12 months to 30 June returning 9.91% versus the Index 14.4%. Cash at the end of June was 1.6%.

It is fair to say, equity markets have been incredibly resilient in the face of monetary tightening, with individual stock positioning key in driving portfolio returns given the high level of sector returns dispersion.

By historical standards the market rally has been 'narrow'. This has been most evident in the US, with the Nasdaq and S&P500 up 32% and 16% respectively in the last 6 and 12 months, and five mega cap technology stocks (Apple, Microsoft, Nvidia, Amazon and Meta) in the S&P500 accounting for 62% of Index performance. This is down from 88% since the beginning of June, but still very skewed.

Performance to 30 June 2022

The announcement in recent days Nasdaq and Standard & Poors will undertake a 'special rebalance' of their Indices to reduce the weight of the large technology stocks further highlights the concentrated nature of recent performance. The US Securities and Exchange rule on fund diversification, aims to limit a handful of names distorting the overall health of the market and is rarely implemented, only being used twice before in 1998 (during the dotcom boom when the Nasdaq sored over 400%) and in 2011 (when Apple accounted for greater than 20% of the Nasdaq).

A major catalyst driving performance in the technology sector in the last quarter has been the euphoria around Artificial Intelligence (AI) and take up of ChatGPT, the generative AI app launched by OpenAI in November 2022. Take-up has been nothing short of phenomenal, hitting over 100 million users in just over 7 months. AI euphoria hit fever pitch during the quarter on Nvidia's trading update on 24 May when it highlighted incredible demand for its Graphics Processing Unit (GPU) chips which are being used to upgrade and retool data centre infrastructure for accelerated computing driven by AI.

In Australia, the ASX IT sector has also been a beneficiary of the sharp improvement in sentiment being the best performing sector in the last quarter and 12 months, finishing up +18% and +28% respectively. However, it has had far less impact on the overall Index than in US given the relatively small weight of technology (2.5%) and lack of options by which to gain exposure to the AI thematic.

A lot of the narrative around AI has been focused on the productivity enhancing growth and deflationary benefits it will deliver more broadly across the economy. This might sound convenient at a time when productivity growth is languishing and inflation a concern. However, the unprecedented consumer take-up of ChatGPT and potential for generative AI to be highly disruptive suggests it needs to be considered seriously.

Applying 'pick and shovel' principles to AI, domestically data centres are one of the more obvious beneficiaries and way to capitalise on the AI thematic. Given high performance AI computing generally takes place in data centres, they offer an exposure to the increase in demand for AI, and the relative scarcity of high-quality DC space is supportive for data centre economics and operators like portfolio holding **NextDC (NXT)**, which performed strongly in the quarter returning 21%.

China reopening fading

The performance of the ASX over the last year has been less 'narrow' than the US market, but still relatively concentrated with the Materials, Financials and IT sectors delivering 75% of the Index performance.

Resources was the key contributor to the ASX over the last 12 months returning +23% (versus the ASX Industrial +11.8%) and contributing 35% to total Index returns. The portfolio benefited from its position in **BHP** but has been overall underweight resources which dragged on performance in the last quarter and over the year.

Resources, and particularly iron ore prices, have proved very resilient in the face of ongoing weakness in Chinese growth and property markets.

The Covid reopening and easing of financial restrictions on Chinese property developers helped support steel demand and the iron price in the first half of 2023 as construction on partially completed and presold properties restarted. However, recent channel checks suggest there is little evidence of a lift in sales or new starts to refill the pipeline, and steel production profitability continues to be challenging.

Evidence also suggests the initial post Covid reopening recovery in consumer demand and the service sector is starting to fade, and there are no real signs of manufacturing volumes recovering post the pandemic. In fact, manufacturing in nominal terms (with core CPI at around 1%) is contracting and below 2015 levels. The Chinese Government has eased official interest rates this year, but this has failed to stimulate private sector investment and household spending given a lack of confidence.

More than anything else it appears to be the hope of a soft landing in the US and China stimulus that continues to support iron ore prices and resources more broadly. There is no question China has relied on fiscal stimulus to sustain economic growth in recent years. However, we see limitations to the implementation and effectiveness of fiscal support given the changing economic agenda around deleveraging in the property sector and State-Owned Enterprises, and growing concerns of deflation and a liquidity trap where further stimulus fails to feed growth. This brings with it the risk any stimulus is more measured and targeted to provide space for the consumer to recover and protect the downside, but it also caps upside risk for a China linked resources recovery.

Outside BHP, our preference has been to play resources and commodities through the high-quality diversified producers and more industrial exposures leveraged to volume over price, via the likes of **Seven Group Holdings (SVW)** through its Caterpillar franchise which sells and repairs mining equipment for the major miners as well as infrastructure and construction sectors, and **Qube (QUB)** which provides logistics and export container services to the commodities sector, including all the major lithium producers.

US manufacturing construction boom

In stark contrast to China, the US is currently experiencing a boom in manufacturing construction investment. It is easy to get caught up in the month-to-month data and miss the bigger trend, but as Figure 1 shows there is a massive new wave of investment taking place in US heavy construction.

Figure 1: US Manufacturing construction spending

Monthly seasonally adjusted rate: Jan-05 to Apr-23

Source: US Census Bureau

Post covid, supply chain disruptions and the US-China tariff wars US manufacturers have been starting to invest in onshoring and re-establishing capacity previously outsourced to China. This has been invigorated by the Biden Government's legislation and stimulus under the Inflation Reduction Act, Bipartisan Infrastructure Law and CHIPs and Science Act. As of April, spending on factories is tracking at a US$189 billion annualised run rate, triple the average in the 2010's (US$63m). Further 192k jobs have been added in the construction sector over the last year despite weakness in the housing sector as interest rates have risen.

Arguably, this helps explain some of the underlying strength of the US economy. Moreover, the types of projects taking place tend to involve large capital outlays and create high-wage jobs.

Understanding how this manufacturing boom plays out – how lasting and big it will be – will be important from an economic perspective and which companies stand to prosper.

One company we believe is well positioned to capitalise on the opportunity is **Worley (WOR)**, a leading player in engineering and project management services.

Worley has a strong legacy in providing consulting and engineering services to the energy, resources, chemicals, and infrastructure sectors. It has deep expertise and long-standing relationships working with customers in the traditional hydrocarbon energy sector, and has more recently sought to leverage its skills and relationships in helping solve the challenges in transitioning to more sustainable lower-carbon technologies. In doing this Worley has made an early strategic shift to invest $100 million in scaling up and building out its sustainability consultancy capability and capacity, with the aim of 75 per cent (currently 32 per cent) of its sales being from sustainability projects by 2026.

The US Inflation Reduction Act (IRA) has been instrumental in seeing a shift in attitude and behaviour by many of Worley's customers to commit to lower carbon technology projects. Further, the European New Green Deal, UK Energy Security Plan and Canadian renewable tax credit initiative show further commitment that governments are becoming more serious in funding the energy transition.

The growth in sustainable work for Worley is coming off a low base and it is still early days. But at its recent investor day in May, it highlighted there is growing momentum in the key operating indicators around growth in headcount, backlog and sales pipeline.

Sustainability work is also outpacing work in traditional markets, and now represents 40 per cent of the backlog, and supports the target of having 75 per cent of its sales coming from sustainability work by 2026.

The combination of better market growth and the ability to take share and fixed cost leverage should drive medium term earnings per share compound annual growth of around ten per cent.

In a lower growth environment, and where increased spending on transitioning to lower emissions energy technologies seems an undeniable trend in an uncertain world, we believe Worley looks an attractive proposition, with plenty more upside.

Navigating an uneven economy

Looking ahead into the second half of 2023 we have an expectation financial conditions will continue to tighten due to higher interest rates and living costs.

Recent company trading updates from some of the more consumer discretionary listed companies such as Baby Bunting, Kathmandu, Adairs and Domino's Pizza highlight that the waiting game for proof of the impact of higher rates and costs of living pressures appears to be over, and the impact of the slowdown is starting to be felt in categories like entertainment, eating out and discretionary retail.

This has flamed growing concerns around an economic recession, with many press reports suggesting it is now pretty much an inevitability.

We expect in some parts of the economy, particularly in the lower income thresholds and those households experiencing higher rents and mortgages, it will feel like a recession. By contrast, high income earners and/or those households unincumbered with a mortgage and able to draw on savings or investments will be less impacted. This points to an uneven economy and dispersion in how the pain will be felt.

There are not enough headwinds to conclude on a recession or not in Australia, in our view. Much depends on the labour market. While the extreme tightness has eased in recent months conditions remain consistent with solid employment growth. The risk is if the RBA needs to raise rates further to bring down inflation it will lead to weaker growth and ultimately higher unemployment through 2024 and onwards.

We expect our view around an even economy will continue to see a high level of earnings dispersion. It remains unclear whether this will be disproportionately driven by a top-line sales slowdown, or more by a contraction in profit margins. In both cases what is trend, or 'mid-cycle', has been distorted by Covid and changing consumer behaviour patterns and business models.

There is a risk of overestimating recent revenue growth trends for many companies. Inflation has seen an increase in most company's top line as they've increased prices. As inflation falls, it will become harder to push through prices, and tighter financial conditions will also put pressure on volumes. There are also signs wage restraint is starting to break down with a 5.75% increase in the minimum wage from 1 July and unions pushing for higher wage increases given the persistence of inflation pressures. This risks seeing a slowdown in sales and margins unless costs are being pulled or there's productivity gains.

In conversation with the management of several portfolio holdings over recent months this is something that is very much a focus. **James Hardie (JHX), Treasury Wine Estates (TWE), Seek (SEK) and Netwealth (NWL)** have all highlighted they are being proactive in managing their costs to the changing environment.

Our view around an uneven economy and uncertain economic outlook reinforces the need to be selective and active in managing the portfolio. It is also important we remain focused on the underlying earnings drivers and identifying companies with observable tailwinds and a competitive advantage, rather than trying to be too prescriptive about trying to forecast the unknown.

Energy transition

We see the tailwinds behind the energy transition thematic and shift to renewables as attractive. If the latest estimate by the Global Energy Transitions Commission in its Financing the Transition report - that around US$3.5 trillion a year of capital will be needed on average between now and 2050 to build a net-zero global economy – proves correct, it will provide a strong runway of growth.

Importantly, as highlighted through what's happening in US construction spending, there is also growing evidence government policies and regulations are providing the right incentives to invest. This is supportive of maintaining an exposure to future facing metals like copper (through BHP), as well as service providers (like Worley, discussed above) and asset owners of these assets (like **Cleanaway (CWY)** and **Infratil (IFT))**. We also continue to believe gas is important in the transition to a lower carbon economy and continue to hold positions in **Woodside Energy (WDS)** and **Cooper Energy (COE)**.

COE has been a poor performer and one of the key detractors in portfolio performance over the last 12 months. Whilst the investment thesis around the shortfall in East Coast gas and ever-tightening domestic gas market is playing out as expected, operational issues have continued to plague the company around unplanned maintenance at its Athena Gas plant in the Otway Basin, and lower than expected production at the Orbost Gas Plant (OGP) due to technical difficulties in treating and processing the Sole, Gippsland gas.

It has been incredibly frustrating both for the company and investors that after nearly three years the root cause of the OGP production issues have not been rectified. This has caused significant reflection and internal questioning around our conviction and position.

With a new CEO, the company now having taken ownership and control of the Orbost plant from APA Group, and modifications to the plant processes we continue to believe a higher and more stable production profile can be achieved as the Sole/OGP is derisked over the next 6-12 months. We also continue to believe there is significant value latency in the assets with the stock trading at a 30% discount to book value of $0.21cps, close to a 20% discount to our producing asset value of $0.17cps and c.70% discount to our unrisked value of the growth assets.

Inflation persistence and higher rates

Over coming months, the reported monthly and annualised inflation numbers in most developed economies are likely to come down significantly as they cycle softer comparisons and energy price declines. However, we still see confusion in the market about the state of financial conditions and sufficiency of rate hikes to beat inflation. This favours stocks with positive rates leverage and has seen us tilt to favour insurers over banks at this point of cycle.

During the quarter we added on weakness to **QBE Insurance (QBE)** which we continue to see benefitting from the hardening of the premium rate cycle, improving underwriting conditions and higher returns on investment assets.

We also added **AUB Group (AUB)** to the portfolio. AUB is a leading Australian and New Zealand insurance broker group which has expanded into the UK through the acquisition of Tysers, a Lloyd's of London broker. AUB is currently benefiting from ongoing increases in premium pricing in commercial lines, both domestically and offshore. We expect a hardening insurance premium rate cycle to persist driven by increased frequency and severity of catastrophe events as well as insurers needing to recover their cost of capital after several periods of insurance losses. Our investment thesis is also predicated on various inorganic initiatives that are being progressed within the business (including the acquisition of Tysers) that drive operating margin expansion over the coming years.

Reopening and surging immigration

With borders open and kinks in the visa system ironed out, migration is surging in Australia with Treasury forecasting 350k migrants in financial year 2023, and the number of temporary visa holders increasing by ~600k in the year to February 2023, with the return of 320k students and 210k workers.

The rebound in immigration is most likely immediately positive for supermarkets and discount department stores, as new migrants drive increased demand, but adds to inflation and housing supply pressures. To the extent increased migration reduces labour shortages it should also be positive for the mining and healthcare sectors and benefit recruiters and job advertisers, including portfolio holding **Seek (SEK)**.

We also see our holding in **IDP Education (IEL)**, through its international student placement and English language testing business, as a beneficiary of borders reopening and a strong recovery in international student volumes into Australia, and other key markets such as Canada and the UK. However, during the quarter, IDP performed poorly (down -21%) on the back of a decision by the Canadian Government to approve additional International English Language Test (IELTS) providers for certain Canadian visa applications. IDP had previously been the sole administrator of the IELTS test which was the only recognised test for certain streamlined Canadian visa applications. As a result of this change, we expect IDP to cede some market share (c.25%) to competing test providers in Canada. Whilst a negative, the share price reaction implies significant market share loss not only in the Canadian IELTS business but also globally. It also seems to be discounting the fact IELTs industry tailwinds remain positive and offer room for growth for multiple players, and IEL's student placement business is unaffected.

Longer term, stronger population growth in Australia should be positive for the housing construction sector, although new dwelling supply is likely to remain constrained in the near term due to higher interest rates, slowdown in completions, sagging approvals and elevated building costs. Once cash rates stabilise and industry stresses in the sector start to abate, we expect a recovery. Timing this is the issue. We are conscious of the predictive nature of markets and have a checklist of things we are wanting to see in becoming more constructive.

June 2023 Quarter - Portfolio Performance & Characteristics

Top 3 Active Holdings	Portfolio Breakdown		Top 3 Portfolio Attribution	Bottom 3 Portfolio Attribution
Chorus Group	Financials	18.7%	NextDC	BHP
Northern Star	Materials*	18.3%	James Hardie	IDP Education
Qube	Industrials	13.4%	AUB Group	Treasury Wine Estates

Figure 1: Sector weights relative to ASX300

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

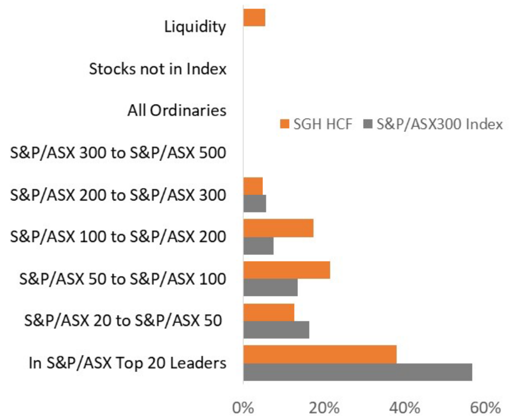


Figure 2 Market cap weights relative to ASX300

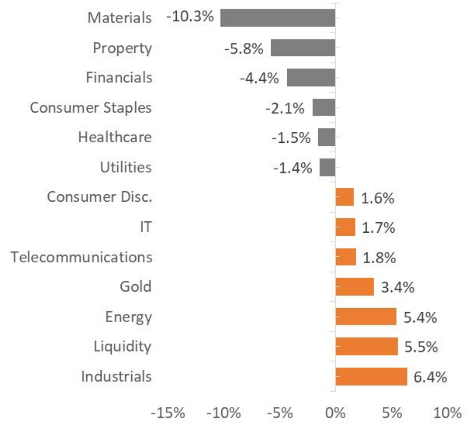


Figure 3: Portfolio Characteristics

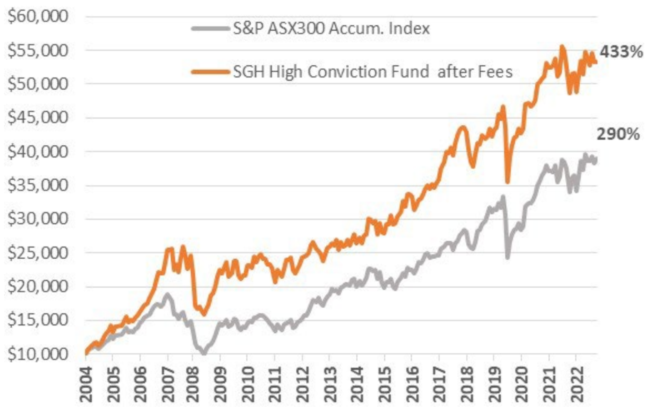
Superior Return on Equity (ROE) to the index with stronger sales growth EPS characteristics

	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	11.8%	6.7%	6.2%	9.0%	2.9%	3.1%	18.9	18.4	13.7%	15.1%
ASX 300 Index	5.6%	1.1%	-0.8%	-1.1%	4.3%	4.1%	17.4	17.2	13.6%	13.6%

Source: Bloomberg

Figure 4: $10,000 invested since inception

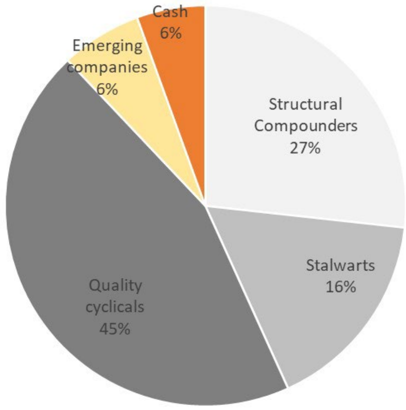
Long track record of adding alpha



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.