CHESTER ASSET MANAGEMENT
• 2017 •

Chester High Conviction Fund
Quarterly Thoughts
October 2024

In partnership with COPIA

The Chester High Conviction Fund Philosophy

Our Key Principles

High Active Share	For active managers to outperform over the long term, the fund has to be truly different than the benchmark. This strategy has had an active share above 80% since inception. Don't follow the crowd.
Mid Cap Bias	Broadly speaking, we find more interesting opportunities outside the large cap universe. Exposure to mid and small caps is essential for long term outperformance.
Cash Flow Growth	We seek to invest alongside companies that either generate predictable cash flows in high quality industries, or determine an appropriate margin of safety where valuation support is paramount, which is in more cyclical sectors of the economy.
Back Owners Of Capital	Allocating capital to management teams that think like owners alleviates the principal-agent problem. "Show me the incentive and I'll show you the outcome" Charlie Munger.
Concentration In Few Ideas	We keep a tight watchlist of stocks that are deemed suitable for investment. Focusing the research effort into fewer ideas provides more opportunity to gain higher conviction views. Too much diversification becomes counter productive.
Focus On Insights	Do we have a different view than the prevailing wisdom of the market? High conviction often comes from a granular understanding of where the market expectations are wrong.
A Contrarian View?	Backing ourselves in unloved, underappreciated or undiscovered stories has been the most consistent source of alpha generation of this strategy.
Keep It Simple	Ultimately, we allocate capital to sectors and companies we understand. The investment thesis needs to be easily articulated for a high conviction idea.
Invest With Humility	All fund managers make mistakes, it's part of the profession. Our tightly knit culture accepts these, tries to learn from them, and keeps making decisions. It is a profession where humility is absolutely essential.
Stay Curious	Fresh ideas or unique insights is critical to ensure the portfolio stays invested with conviction. To consistently generate outperformance we seek to test the investment thesis behind each decision. This requires discipline and a repeatable process in company visitation schedules.

At 30 September 2024	1 mth %	3 mths %	6 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a	Incep. % p.a. *
Chester High Conviction Fund (after fees)	3.2	6.0	5.2	17.7	8.9	13.3	12.5
S&P/ASX 300 Accumulation Index	3.1	7.8	6.5	21.7	8.1	8.3	8.9
Outperformance (after all fees)	**+0.1**	**-1.8**	**-1.3**	**-4.0**	**+0.8**	**+5.0**	**+3.6**

* 27 Apr 2017

> *"By three methods we may learn wisdom: First, by reflection, which is noblest; Second, by imitation, which is easiest; and third by experience, which is the bitterest."* — Confucius

In May 1989, on a windy Friday afternoon, the Xavier College school football team turned up to Caulfield Grammar expecting a tough match. Xavier had not lost an APS school football match for 5 years, while Caulfield Grammar had a side full of future AFL players. There was a very good chance that this fixture would determine the champion football school of 1989. The entire Caulfield Grammar school was in attendance, expecting a win. The conditions were tricky, with a strong southerly wind favoring the city end goals. At 3 quarter time Xavier held a 3 goal advantage, with Caulfield kicking with the strong wind in the last quarter. Caulfield had all the play in the first 15 minutes of the last quarter, but couldn't kick accurately. They kicked 8 points in a row, which left the hapless Xavier full back having to kick the ball back in play 8 times, with varying degrees of encouragement from the 800 odd Caulfield students behind the goals. Each time, the plan was to simply kick it as far away from the goals as possible. The howling gale made this task challenging as the wind and the Caulfield pressure trapped the ball inside their forward line. Eventually the full back tried a short pass to the back pocket, it missed the target, an opponent picked it up, ran into an open goal and sent the crowd into a frenzy. One goal quickly became two, the floodgates opened and Caulfield slammed on six goals in the last 10 minutes, as they ran away with a 4 goal win. The lessons from this? Momentum is a powerful force, and sometimes, you just find yourself kicking into a massive headwind. The fullback still has nightmares.

Have the winds changed? Given the US Federal Reserve has now started a rate cutting cycle and China has embarked on a long awaited stimulus program, will we finally see a rotation from the leadership of the past 12 months being technology (+55%), REITs (+38%) and financials (+30%), into materials (+6% including gold) and energy (-22%), the two most hated sectors? We only have to witness the frenetic buying of all things China (and commodities) in the last week of September to realise how one sided this trade has been for the past 12 months. We were told on more than one occasion throughout reporting season that valuation doesn't matter any more. It's only the narrative (investment thematic) that counts. We would politely beg to differ. It hasn't mattered for the past 12 months given the backdrop of disinflation and economic softness leading to the prospect of rate cuts.

We would err on the side of caution on the speed of rate cuts, given credit spreads are very benign and asset prices are at record highs. This is hardly the backdrop for aggressive monetary policy response, while the market has priced in another 6 interest rate cuts by December 2025. The only logical answer in our view for rapid interest rate cuts, is that the US Public Debt is actually a far bigger problem than the Fed is wanting to admit. To us, the US deficit remains the most pressing issue in finance through this decade. Interest rates above 4% are very problematic for the US budget deficit. We are in the camp that believes if interest rates are cut this quickly, it would most likely end up being inflationary given where asset prices are currently trading while liquidity is abundant. The last bout of inflation in 2022 didn't end so well for stocks trading on 100x forward earnings.

China

Many pundits are posing the question, is this enough? We all know China has been faced with a backlog of housing inventory, with domestic developers either bankrupt or close to it, and an ageing population, which has seen China in an ongoing deflationary spiral throughout 2024. The recently announced monetary policy initiatives of an interest rate cut, an RRR cut (reserve requirement ratio for banks, a lower RRR makes it easier to expand credit growth), housing policy relaxation (cutting down payments on second homes to 15% from 25%) and providing liquidity support for the stock market (up to CNY500bn) was very well received, but in itself, we don't believe this is enough to see a meaningful change to animal spirits in domestic consumption. It has given more weight to the notion that for the first time in 10 years, President Xi is focused on turning the economy around. Post the GFC the fiscal policy response was to spend 13% of GDP on nation building projects. There is still a structural challenge with an enormous bad debt burden within the property sector, so more is needed. We would believe the China story on a cyclical basis, if China was to lay out a range of fiscal policy measures over the coming weeks to support these monetary policy responses. We have heard speculation that a fiscal response could be in the order of CNY5Tn over 2 years (or CNY10Tn in total), which would equate to 8% of GDP over 2 years (or 4% per year). This would be the Mario Draghi "whatever it takes" response, which would very likely see an ongoing meaningful rotation into the commodity sectors. So as we write, we are optimistic that China has finally reached a point where the economy is taking precedence, without seeing the actual evidence that new fiscal policies are in place, but it feels like the intention is there. We expect more details of the fiscal policy to be released shortly.

The US Election

Last quarter we wrote that it was almost inevitable Trump would win the US Presidential election. Three months later the bookies have Trump as a slight favorite, in a race too close to call. We do spend (too much) time thinking about the permutations of what each election outcome would mean for markets, as we see Harris as being a challenging outcome for markets (mostly around increased taxes), but would also depend on who controlled both houses. We also see very different geopolitical approaches under Harris or Trump and attitudes to immigration. Without overstating the importance of this election, we do think it will have a strong influence on the direction of asset prices over the coming 12 months.

So what does this mean for positioning?

We try to insulate the fund as much as possible from macro variables by allocating most of the capital (60-70%) to predictable cash generating companies where there is evidence of sustainable cash flow growth. We are happy to allocate capital to cyclical stocks, but with lower weightings given the cycle of cash flows, while a consistent allocation to gold equities tends to assist the fund in times of inherent volatility. **Our philosophy with the Chester High Conviction Fund remains to protect and then grow (what we hope to be) generational wealth. Protecting capital means a rigorous focus on asymmetric investing. What is the downside vs what is the upside of an initial investment? This focus on fundamental investment drivers we believe will benefit our fund over the next 2-3 years as we believe the style bias will be in the favour of value oriented investing, which hasn't been the case over the last 12 months.**

Portfolio changes this quarter

The portfolio was more active during the September quarter, both with new additions and weight changes. In the gold space we exited the long held OceanaGold **(OGC CN)** which collapsed its dual listing on the ASX 2 years ago. At the time we felt it was extremely undervalued, so continued to hold the Canadian listed entity. We exited OGC during the quarter, 100% higher than if we had have been forced to sell it on the closure of trading on the ASX. We re-entered a position in Evolution **(EVN)**, which is a stock we haven't owned since they purchased Red Lake in Canada in 2019. We were cautious then on Red Lake, and still are. The difference being expectations are significantly lower now for what the EVN group can do production wise, including Red Lake. It operates two world class assets in Cowal and Ernst Henry, while 30% of the revenue is actually copper, giving EVN strong exposure to our two preferred commodities. We also purchased Orora **(ORA)** during the quarter. The Saverglass acquisition by ORA in 2023 was poorly timed, which left ORA with a downgrade cycle and a weakened balance sheet. ORA has significantly changed its operating landscape in the past 8 weeks. After rejecting a Private Equity bid for the company, they announced a sale of their North American packaging solutions business (OPS), for AUD1.775bn, which leaves ORA effectively debt free, with a very strong presence in glass and canning in Australia, and a world class bottling business in Saverglass. Once again having capital flexibility, this should set up ORA to deliver predicable total returns (eps plus dividend) of greater than 10% p.a. The other addition to the portfolio was Worley **(WOR)**, which we believe is well placed to demonstrate a strong uptick in earnings once the significant CP2 project is awarded in the US. This is a US20bn LNG import terminal that is waiting for approval, which is unlikely before the US election. The way we view WOR is the risk/reward trade off in the low AUD14/share range is very favorable, should this project receive the necessary approvals. The fund exited NIB Holdings **(NHF)** during the quarter, becoming concerned with the structural challenges of the health industry profitability. The fund exited GQG Partners **(GQG)**, which shot through our valuation as it ran above AUD3/share in July.

How is the portfolio positioned?

We remain in the camp that the global monetary debasement issue (printing more fiat currencies because of unrelenting fiscal deficits) will shape the portfolio construction framework over the next decade. Because of this issue, our investment thesis has been focused on structurally higher inflation during this decade, as opposed to the past 2 decades of deflationary forces. We separate near term disinflationary pressures from goods deflation from this structural thesis around monetary debasement. Our focus remains on four key areas of investing, which are listed below and have been consistently applied for the past 5 years. Appropriate diversification is absolutely fundamental in this current environment, given the heightened geopolitical risk and the political uncertainty ahead.

Gold. We continue to hold a high conviction view that gold equities will perform strongly over the next 2-3 years, given sentiment remains poor, the underlying commodity price has broken out and cash flows will start improving. Gold equities are still trading significantly below the 2011 peak (as per the GDX gold ETF) and as such, we believe as economies slow, and interest rate cuts start being factored in, gold miners will have a very strong period ahead of them. Gold equities currently comprise just over 9% of the portfolio, with a strong earnings cycle about to start.

Real assets. Assets that are very hard to replicate or disrupt indicates a strong starting point. All remain essential services in a modern economy. We would place **AZJ, QUB, EGH, ALX**, **ASK** and **MIN** in this category. We think REITs are interesting when interest rates start falling, while suspect the recent rally in REITs may have jumped the gun on interest rate expectations. Artificial Intelligence will find it hard to disrupt real assets.

Valuation margin of safety. An asymmetric risk profile. We would place **ASB, LLC**, **NUF** and **WOR** in this category. A material discount to book value has provided a strong starting point in many cases with catalysts emerging over the next 12-18 months to see the valuation gap close. We are mindful that several of these positions simply haven't worked as yet, with the catalysts for any re-rating being pushed to the right.

Pricing power, or at a minimum pricing pass through. With cost inflation evident, how likely is a company to be able to at a minimum hold margins, that is, pass through higher costs to their customers without impacting customer engagement? We would place **CSL, RMD, TLC** and **NWS** (through its holding in REA, Dow Jones and Move) in this category. We think margin resilience becomes an important driver of equity returns in the post free money era.

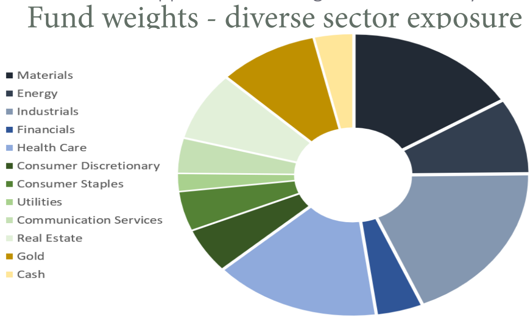
The Portfolio

The CHCF posted a 6.0% rise in the quarter, relative to the 7.8% rise in the ASX300 Accumulation Index. Ridley **(RIC)** had a strong quarter, after delivering strong FY24 results, but also gave a confident outlook for continued growth from organic sources and small bolt on acquisitions. RIC remains a highly cash generative business. Austal **(ASB)** we will talk about inside, simply because they received a significant grant from the US Navy in September to build out a facility in Mobile (next to existing assets) which will then enable them to deliver modules for the AUKUS submarine contracts. We are of the view that the market doesn't grasp (or care) how material this award was. Light & Wonder **(LNW)** suffered a sell off during September after a Nevada court issued an injunction against LNW for IP theft in the product Dragon Train. Whilst this isn't a good look (the designer of Dragon Train used the same algorithms she used when she designed the highly successful Dragon Link for Aristocrat), LNW maintained their FY25 guidance and stated this game was around 4% of earnings. There is a range of steps LNW are taking to mitigate this issue. Our view is the sell off is overdone and the outlook for LNW remains compelling. NIB Holdings **(NHF)** had a disappointing FY24 result on claims expenses for policy holders, while our decision to exit the stock was not just based on this profit outcome, the tenuous relationship between hospital operators, patients and health funds appears set to weigh on the industry as a whole.

Top 3 holdings	Portfolio breakdown	
CSL	Industrials	18.8%
Austal	Materials ex Gold	16.2%
Develop Global	Health Care	15.5%

Top 3 portfolio attribution	Bottom 3 portfolio attribution
Ridley Corp	Light & Wonder
Austal	NIB Holdings
Resmed	Nufarm

Fund weights - diverse sector exposure



WHAT ARE WE THINKING ABOUT?

THEME	IMPACT	EQUITY CONSIDERATIONS
US ELECTION	In our view there remains a large divergence as to how asset markets may price in either outcome. As it stands today with less than 4 weeks to go, it appears too close to call. Unfortunately, the lack of focus on any sustainable economic policy is a feature of the public discourse.	We have spent a lot of time thinking through policy changes should either outcome occur. While the gold price appears to be factoring in an ongoing debasement of the USD, there are wide differences in the outlook for various sectors. We remain of the view that Trump would be negative for the Big Tech sector.
US ECONOMIC DATA	At the risk of sounding like a conspiracy theorist, the ongoing revisions of past US economic releases leaves us concerned as to how believable the headline numbers actually are at the time of release. US Payroll revisions (revising past "jobs" created down by 1.1m) being the case in point.	The quant buying or selling of the reaction to headline economic "beats" or "misses" often drives asset price direction is at risk of appearing manipulated. The US government has added 800K jobs to the US economy in the past 6 months, to give the appearance of economic strength into an election. Deficit spending is already above prior recessions.
FREE SPEECH	Historically governments, universities (through academic papers), religious organisations, large corporates or media outlets have controlled the prevailing public narrative. Social media has transformed the way individuals consume content, with a platform available to anyone with a loud voice. The debate has become should this be regulated? Who is trustworthy enough to do the regulation?	Elon Musk on the X platform argues strongly for free speech, which also includes misinformation and disinformation as collateral damage. The result being an amazing amount of distrust and cynicism for any content we consume. AI does not solve this, but adds to the confusion of mistrust. The fracture of public trust is one of the largest trends emerging for our generation. Not a solution, just an observation.
ACCOUNTING TREATMENT	We raised this in February, and highlight it here again, because in a bull market, the market only rewards eps momentum and top line growth. Thus CEO's are incentivised to become more creative with "one-off" adjustments, "proforma" accounting and changing divisional reporting lines or proportional adjustments to leases, capitalised interest or R&D spend to prop up eps numbers at the expense of the quality of the results. We are getting told more often that valuations don't matter.	These tricks have been around for eternity, but the amount of pressure on executives to deliver, enter certain indexes or just be bought on eps momentum as a popular investment strategy (popular because it works), leaves us more cynical on the quality of information we receive from companies every year. Our solution? More and more it is to invest alongside executives of strong alignment and integrity. Ultimately free cash flow determines the valuation which remains as true now as it always has.
ARTIFICIAL INTELLIGENCE	This thematic remains a key influence in markets, where we continue to keep assessing and re-framing our thinking. Our concern currently lies with the extreme exuberance of data centre capital investments, which is the current bottleneck for the future exponential data growth required by AI, according to many forecasts we currently observe. The cycle for new data centres to plan, construct, fit out and grow capacity takes 4-5 years. Our query has always been, what if actual demand isn't as strong as current optimistic forecasts? There is a "build it and they will come" mentality to this investment.	We have watched the lithium market with fascination over the past 5 years. The observation being rarely do optimistic forecasts ever get exceeded, the most likely outcome is project delays, funding issues, capex overruns that make all real world activities harder than an excel spreadsheet. We have watched with great interest the recent funding round of OpenAI (owner of ChatGPT), who as the first mover in open-sourced AI data, is struggling to get investors to stump up the next round of funding for future losses. Most of the key executives of OpenAI have left in the past 3 months. We sense trouble ahead for the AI bubble.
CHINA	The Chinese PBOC declared war on deflation with a raft of monetary policy responses in an attempt at reviving animal spirits in domestic consumers. The recovery in China has to be consumption led, but we still wait for confirmation of fiscal stimulus to support the 30% rise in the Hong Kong Stock Exchange (HSI) over the past 2 weeks.	Obviously some sizeable stimulus from China was all the market needed to start a significant sector rotation out of ASX banks (as a hiding spot) into beaten up ASX miners and Chinese equities. We have only made incremental moves over the past 2 weeks as we prefer to see confirmation of the underlying demand for material portfolio changes.
MIDDLE EAST	The escalation of the middle east conflict has only caught the attention of equity markets over the past week, while Israel effectively has conflict on three borders, Hezbollah on the Northern border (Lebanon), Hamas and Houthi's to the South, and now Iran on the Eastern Flank.	An observation can be made that if the IDF can identify and plant detonators in mobile phones, walkie talkies and pagers of their enemies, then the undetected Hamas invasion of Israel on Oct 7th, 2023 appears more confusing 12 months on. Nevertheless, unfortunately peace appears a long way off.

Chester High Conviction Fund top 10 holdings

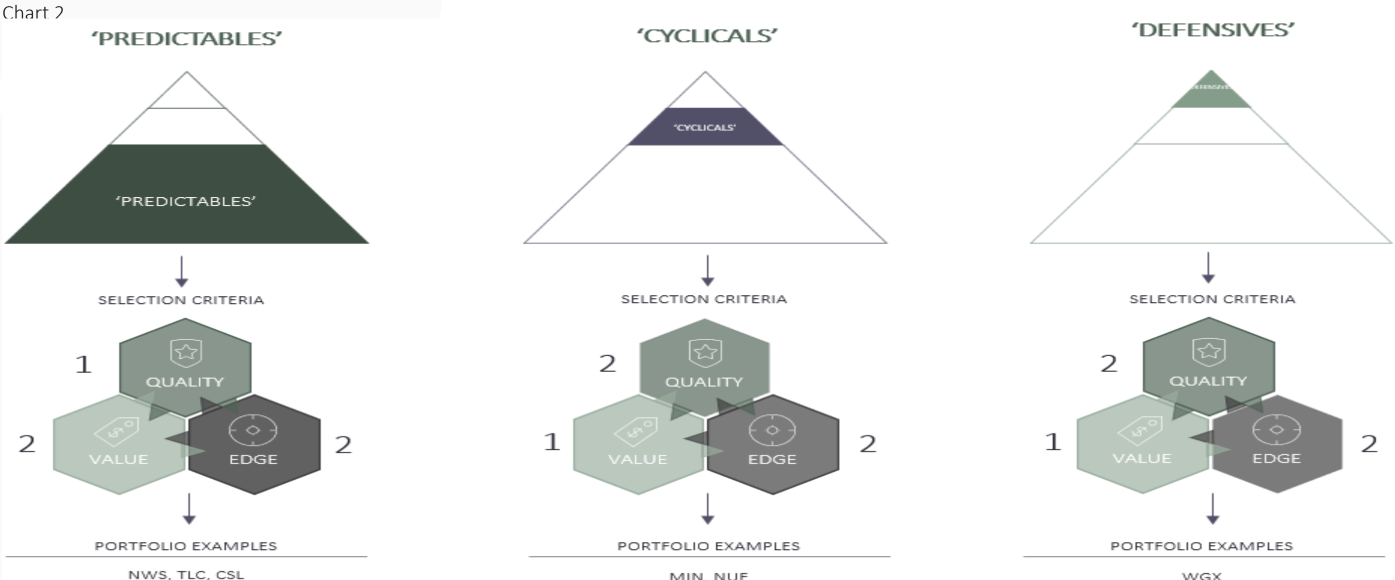
	Cash flow style	FY1 Sales GR	FY2 Sales GR	FY1 Div Yield	FY2 Div Yield	FY1 ROE	FY2 ROE	FY1 BOOK VALUE	FY25 EV/EBITDA	FY1 EPS GR	FY2 EPS GR	FY1 PER	FY2 PER
Abacus Storage King	Predictable	nm	10.7%	4.6%	4.6%	4.1%	4.2%	0.9	20.2	6.5%	4.5%	21.2	20.5
Austal	Predictable	3.9%	11.7%	0.3%	1.2%	4.6%	5.8%	1.0	7.4	45.5%	30.5%	21.7	16.5
Aurizon	Predictable	13.6%	4.9%	5.2%	6.6%	10.7%	11.7%	1.4	6.8	0.4%	7.7%	14.3	13.2
CSL	Predictable	7.3%	7.3%	1.5%	1.7%	17.5%	18.2%	4.9	20.0	10.0%	16.6%	29.3	25.1
Develop Global	Cyclical	54.9%	98.1%	0.0%	0.0%	-1.0%	5.0%	2.3	20.2	nm	nm	nm	12.8
Evolution Mining	Defensive	18.8%	-2.1%	2.1%	2.3%	15.0%	13.9%	2.0	6.3	56.2%	2.0%	14.1	13.8
Mineral Resources	Cyclical	-6.4%	25.3%	0.3%	2.7%	nm	12.1%	2.8	14.2	nm	nm	nm	17.2
Resmed	Predictable	7.9%	7.2%	1.0%	1.0%	24.5%	23.8%	6.0	19.3	18.5%	10.2%	25.7	23.4
Telix	Predictable	52.3%	23.3%	0.0%	0.0%	27.4%	30.2%	13.8	41.2	348.9%	73.3%	101.1	58.5
Westgold Resources	Defensive	111.8%	13.8%	1.3%	1.7%	30.5%	23.5%	2.5	3.2	73.8%	5.2%	7.1	7.0

Source: Chester Asset Management, Bloomberg consensus data

We have listed here our top ten holdings at the 1st of October, 2024. Our fund is actively managed and has no position that is simply there to lower the tracking error against the index. It is truly benchmark unaware investing. We broadly hold positions between 1% and 6% depending on our conviction level on the stock and the size of the company. Our conviction level is dictated by the broad art of combining; 1/ the appropriate valuation of the stock, with; 2/ our assessment of the quality of the assets and management team, overlayed by; 3/ our expectations vs the market (or insight/edge) of the earnings projection. I.e. Do we think the market is mispricing earnings? For our thesis to hold, we require at least 2 of these 3 factors to be validated for the investment case.

To explain that in more detail we have used a slide from our presentation material (chart 2 below). The majority of the stocks currently held in the top ten holdings are classified as "predictables" (industrials, REITs or healthcare, etc) while Develop Global (DVP) and Mineral Resources (COI) are classified as "cyclicals". Our gold holdings are classified as "defensives", and currently our two largest positions are Westgold (WGX) and Evolution (EVN). When we are allocating capital to those sectors that are more predictable in nature, our primary focus is the quality of the industry position they hold and relative cash flow certainty. We determine this by asking ourselves 7 questions around pricing power, barriers to entry, threat of disruption, etc. We also ask a range of questions around the management incentive structure and track record. Once we decide that a company is well positioned, we then seek at least one other "thesis" to hold true. For predictable companies, we need to be convinced around the quality first, and then valuation or edge. For cyclical or defensive (gold) companies, we need to have a high degree of confidence in the valuation support first (as by definition, we cannot be sure of how predictable the cash flows are). We then seek a degree of conviction around the management team and whether we have a unique insight ("edge") to those particular assets. Thus for the cyclical or gold stocks, it is primarily a valuation driven decision first.

Chart 2



Source: Chester Asset Management

CHCF portfolio construction framework

We have always broken down our portfolio construction into three categories as outlined in chart 3. We think of most sectors in the predictables bucket: healthcare, consumer staples, defence, infrastructure, etc. as, in general, able to offer relatively predictable cash flow profiles from the industry structure they operate in. We are the first to admit this is a relatively primitive exercise given that many stocks have very different cash flow characteristics that may be categorised in several ways. For example, gaming or more specifically casinos have historically been relatively predictable cash flow generators, but COVID derailed many of these formerly "predictable" sectors. We focus heavily on the industry structure and competitive advantages of each company when assessing the investment thesis for "predictable" stocks.

We use the word "relatively" predictable, as sectors that are genuinely cyclical in nature (energy, commodities, retail, etc) there is always less certainty over the longevity of a cash flow cycle and sustainability of margins, hence given the uncertainty, we tend to desire much greater valuation support in cyclical sectors.

The "defensive" sleeve is comprised of positions that are historically uncorrelated to the ASX300. We classify gold equities with this lens, as a historical study of large equity market drawdowns highlights how well gold holds up in extremely volatile markets. Cash is often a residual position that we simply state as the option to buy something cheaper in the future.

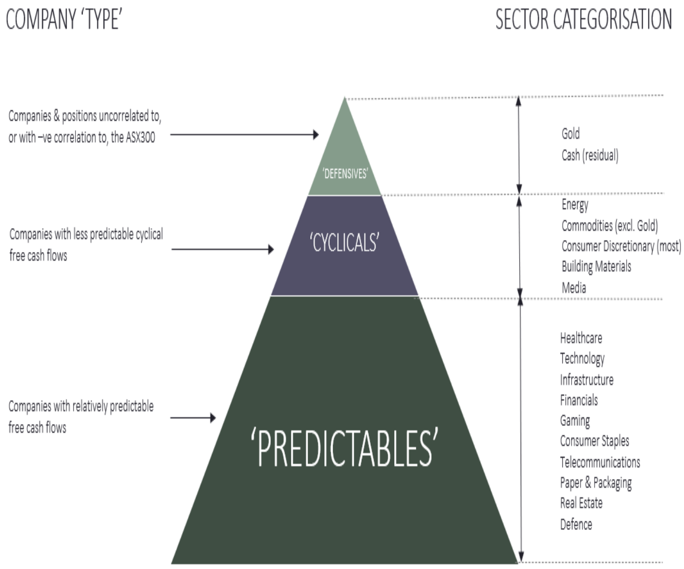
Chart 4 illustrates how these "buckets" have looked over the past 9 years. On average, the allocation to predictables has been 60-70%, while cyclicals have averaged around 18% (10-25%) and defensives have ranged from 10-25% (averaging around 15% of the fund). We have tended to hold an increased cyclical position over the past 6 months, which is predominantly in energy, uranium and select idiosyncratic ideas. The history of the strategy has been successful in delivering alpha, outside FY19, in which the fund was (in hindsight) too cyclical leading into the end of 2018, and then far too defensive during the first part of 2019. We are aware that cyclicals by their nature are higher beta, which means they often appear as the best, or worst performers. Hence the exposure to this part of the market is managed accordingly.

Chart 5 highlights the portfolio characteristics of the CHCF vs the ASX300. We historically find these metrics relatively fluid given the portfolio changes that reflect new weights and new decisions. While these characteristics provide a snapshot of the fund at a point in time, in aggregate, we don't find them particularly insightful.

What this data highlights is that the fund has a value bias, which is assisted by stocks such as Westgold (WGX), which is trading on 7.1x PER and has 73.8% eps growth in FY25. These types of idiosyncratic decisions can influence the overall shape of the portfolio. But at an aggregate level, the fund has a lower yield than the ASX300, which is primarily a result of no exposure to BHP, RIO or the major banks, which is where the bulk of the ASX300 yield is generated. The fund also shows far superior eps growth relative to the ASX300, with far better valuation support. Bearing in mind, this strategy is designed to be different from the ASX300. The ambition of our strategy is to provide a very different product than the ASX300, as without thinking differently, we would never have achieved the track record over the past 10 years, with lower volatility than the market. It is truly index unaware investing.

How do we allocate capital?

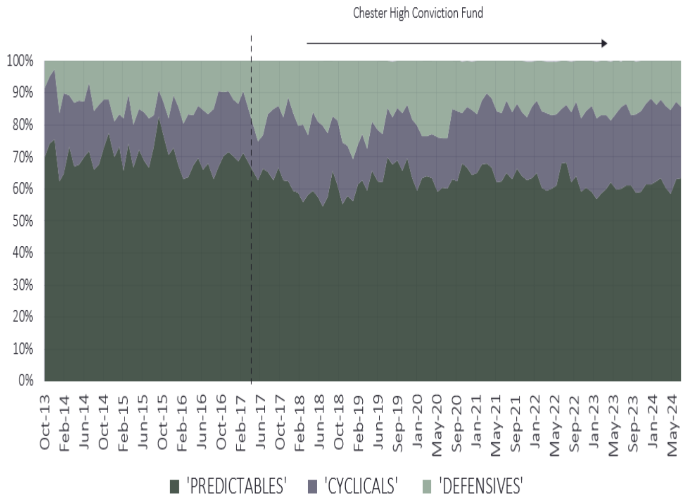
Chart 3



Source: Chester Asset Management

Which has been done consistently over time

Chart 4



Source: Chester Asset Management

Chester High Conviction Fund portfolio characteristics

Chart 5

	CHCF	ASX300 Index
PER FY1	17.6	18.9
PER FY2	14.7	18.3
FY1 EPS growth	26.9%	-3.6%
FY2 EPS growth	18.9%	3.7%
ROE	12.2	12.6
Beta	0.86	1.00
FY25 Yield	2.1	3.4
FY1 DPS growth	10.6%	2.2%

note Chester data excludes non revenue generating companies

Source: Chester Asset Management, Bloomberg, Macquarie research

Stock selection - Austal Limited (ASB) - There’s been a significant change to the thesis

Description

Austal (ASB ASX) The world’s largest provider of aluminium ships has developed a long-term successful partnership with the US Navy in providing Littoral Combat Ships (LCS) and Expeditionary Fast Transport Vessels (EPFs) over the past decade from its base in Mobile, Alabama. It also builds commercial vessels (fast ferries and vehicle passenger ferries) as well as Navy vessels out of its locations in Perth, Vietnam and the Philippines. Much of the recent concern with ASB has been the run-off of maturing LCS and EPF programs and consequences of a historic Department of Justice investigation. In the past 3 years however ASB has announced 2 material contracts in the US being the OPC (Offshore Patrol Cutters) for the US Coast Guard and the award for the T-AGOS program (Tactical Auxiliary General Ocean Surveillance vessels) taking the current order book to >AUD11bn. A Heads of Agreement with the Commonwealth of Australia has also established ASB as the exclusive national shipbuilder with AUD8bn+ of work likely to follow, as well as a September 2024 agreement to expand their Mobile facilities to be submarine ready. ASB forms part of the critical industrial base that is an essential cog in both the US and Australian Navy ambitions to renew their naval fleets over the next decade(s).

Quality

ASB developed a strong reputation for delivering LCS and EPF vessels with increasing efficiency over contract lives. The recent upgrade of Mobile to allow for steel fabrication is testament to the US Government’s desires to maintain key strategic shipbuilding capacity and enhances ASB’s total addressable market. Combined with the Australian Navy awards and submarine subcontractor work, ASB is entrenched as a reliable supplier of shipbuilding services to national governments. On top of this, ASB has developed a global network of support services to maintain navy fleets. This allows for sustainment revenue, forming a strong part of the predictable nature of ASB’s earnings over the next decade with a record order book as well. The recent Submarine Industrial Base (SIB) contract from General Dynamics of US450m is transformative for ASB in terms of asset backing, and a sustainable revenue stream.

Valuation

AUD4.50/share DCF derived valuation (WACC 10%, 3% TGR), although we note the peer comparisons below. Both on a price to book ratio (peers trade on 2.0x P/B), a percentage of the order book or on an EBIT multiple, ASB looks compellingly cheap on all metrics.

Insight

ASB continues to trade well below historical and peer multiples (refer below), despite the record high order book (AUD20bn vs historical peak of AUD5bn in FY19). Whilst Hanwha has formally walked away from a bid, we believe the positive developments over the past 3 months have completely overshadowed this. The DOJ investigation overhang has been finalised with a US24m fine (for misleading investors in 2015) and then ASB was awarded a hugely significant General Dynamics US450m contract (16th of September 2024) to expand their production base in support of the US Navy Submarine Industrial Base (SIB). Effectively this is a grant that enables ASB to expand their current asset base in Mobile. It will take 2 years to complete this capex program, which will then allow ASB to be a key manufacturer for the US Submarine program, including the delivery of one Columbia-class and two Virginia-class submarines annually, starting in 2026. The ongoing revenue stream from this contract is likely to be around AUD300m p.a. for 20+ years. The key to this AUD670m grant is that once spent, it ends up as part of the ASB asset base, so in reality it has increased the ASB NTA by AUD1.85/share. This is separate to the upcoming formalisation of the Australian Strategic Shipbuilder Agreement (SSA), which potentially adds up to AUD20bn over 20 years.

ASB is undervalued on a book value and order book basis

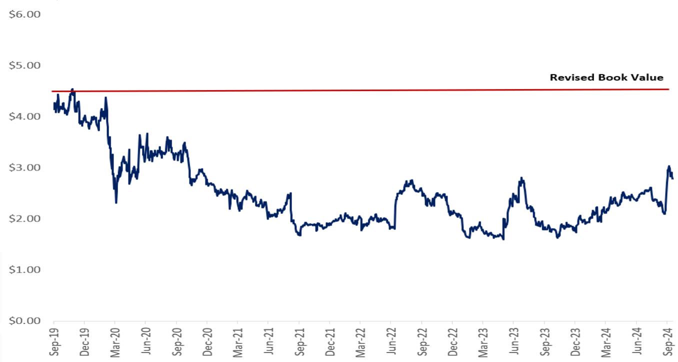
Chart 6

Book Multiple	Amount	Comment
Item	**AUD/share**	**Notes**
Current Book Value	2.66	As at 30 June 2024
US Navy SIB contract	1.85	16 September announcement
Pro-forma Book Value	**4.51**	**Sum**
Hanwha Multiple	2.15	Bloomberg
Implied AUD/share	**9.70**	**Implied Book Value x Hanwha multiple**
Contract Multiple	Amount	Comment
Item	**AUD/share**	**Notes**
Current Order Book	12,700	As at 30 June 2024
SSA & Subs Likely	7,300	SSA up to AUD20bn, Subs AUD5bn
Pro-forma Order Book	**20,000**	**SSAs likely to be agreed FY25**
Assumed Order Book multiple	20%	*Hanwha ~43%, HI 28%, Lockheed 100%*
Implied EV	4,000	EV x Implied Order book multiple
Market Cap (EV ex debt)	3,760	Assumed ~AUD250m of net debt
Implied AUD/share	**10.37**	**Implied market cap / share count**

Source: Chester Asset Management

ASB share price materially undervalues the asset backing

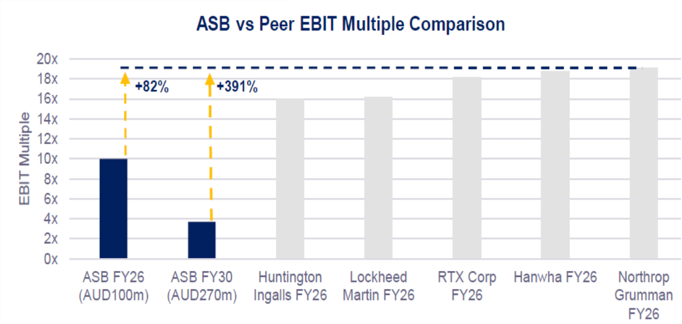
Chart 7



Source: Chester Asset Management

ASB remains an orphan stock in Australia with no direct peer

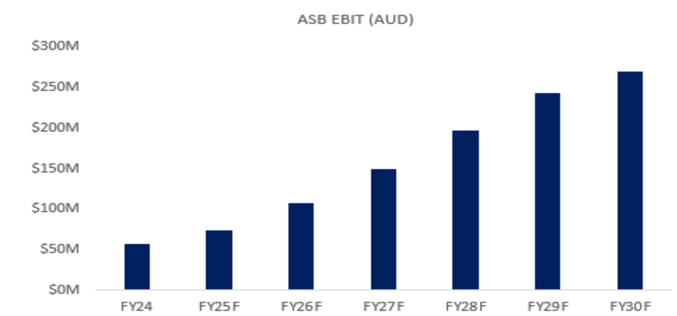
Chart 8



Source: Chester Asset Management

ASB EBIT growth will only accelerate from FY26

Chart 9



Source: Chester Asset Management

Stock selection - Develop Global (DVP)

Description

Develop Global (DVP ASX) is a mining services company controlled by former Northern Star CEO, Bill Beament. DVP operates under a hybrid model as an underground mining contractor and operator of three mining assets: The Woodlawn Zinc-Copper Mine in NSW; the Sulphur Springs Zinc-Copper project in WA; and post the completion of the Essential Metals acquisition in November 2023 has added the Pioneer Dome Lithium project, located 130km south of Kalgoorlie in WA. DVP has three external underground mining contracts, the first of which is the AUD100m p.a. production and development contract for Bellevue Gold, while in CY24, DVP has also signed an 18 month contract with Mt Marion (MIN) for an underground development, and an initial 18 month contract at the Westgold (WGX) flagship gold asset, Beta Hunt in WA. The Woodlawn project is a restart operation, with FID signed recently, production is expected to commence in mid 2025. Woodlawn has robust project economics with PFS commodity price assumptions well below current spot prices. It is a polymetallic ore body, so will produce payable loads of zinc, copper, lead, gold and silver. It was purchased out of administration in 2021 for AUD100m, while the replacement cost of the plant and mining inventory is in excess of AUD500m.

Quality

DVP, as an underground miner, forms a critical component of developing new mining districts and is very much a people driven business. A high performance culture is essential in winning tenders profitably. Essentially the business is driven by Bill Beament (CEO and largest shareholder). Bill is well known to the market for taking Northern Star from a AUD100m mkt cap gold explorer, to an AUD5bn mkt cap at the time it merged with Saracen (SAR). So in many ways, an investment in DVP is backing Bill Beament to allocate capital towards the right projects, at the right time in the cycle. We believe DVP has a range of assets, that if executed well, will deliver a material step up in free cash flow over the next 3-5 years. It has strong leverage to a rising copper price, which is one of the key attractions.

Valuation

AUD3.98/share on a risk adjusted basis. This is risking both Sulphur Springs and Pioneer Dome projects heavily as there is an uncertain pathway to project development currently. On an unrisked basis DVP, is worth AUD5.57 using our current commodity price assumptions.

Insight

DVP has significant portfolio optionality with its range of projects, although the market will not reward DVP until there is evidence of a commercial ramp up at Woodlawn (their first project to come on stream in mid 2025, after FID was announced in September). Our positioning in DVP is early as we believe Bill Beament has both the historical track record as an owner/operator and the incentives in place to ensure the Woodlawn ramp up is a success. Once DVP confirms strong cash flow growth out of Woodlawn, it may be in a position to sell-down a small percentage of the project to an offtake partner (historically, Japanese and Korean entities are happy to invest minority stakes in projects for guaranteed offtake). A project level sell-down would then enable DVP to recycle this capital into either Pioneer Dome or Sulphur Springs, depending on the macro landscape at the time. Whilst not a base case, it is something DVP is exploring, which would enable an acceleration of their portfolio development. The Chester approach (which differs from most generalists) is to value the assets in the ground and invest on that basis, while most investors will wait for confirmation of the production ramp up, which will drive the earnings uplift. We forecast DVP to be generating just under AUD200m EBITDA in FY27, based on the Woodlawn ramp up. If the successful execution of Woodlawn occurs, DVP will be materially higher in 12 months time.

DVP has a suite of assets that are materially undervalued

Chart 10

Asset	Unrisked NAV (AUDm)	Risking	Risked NAV (AUDm)	Per Share (AUDps)
Producing & Near Production Assets				
Woodlawn	479	95%	455	1.58
Sulphur Springs	296	40%	118	0.41
Underground Services Divisi	341	90%	307	1.07
Pioneer Dome	208	65%	135	0.47
Key Assets	**1,324**		**1,015**	**3.54**
Development and Exploration Assets				
Whim Creek	27	40%	11	0.04
Exploration	165	20%	33	0.12
Other	**192**		**44**	**0.15**
Corporate/ Other				
Cash / (Net Debt)	26	100%	26	0.09
Ongoing Exploration	-	50%	-	-
Corporate G&A	(45)	100%	(45)	(0.16)
Investments / Other Assets	100	100%	100	0.35
Corporate	**82**		**82**	**0.28**
Total	**1,597**	**5.57**	**1,141**	**3.98**

Source: Chester Asset Management

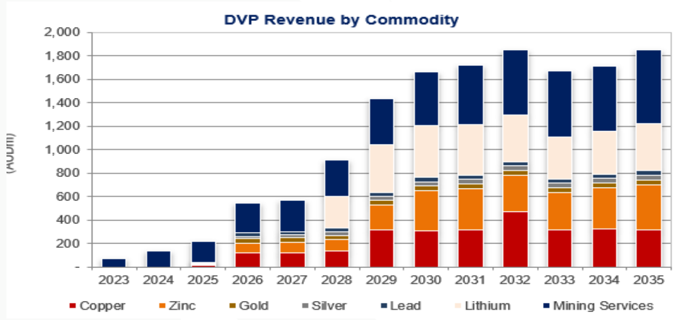
DVP share price has been in line with weak commodity sentiment

Chart 11

Source: Chester Asset Management

DVP has significant diversification from a commodity perspective

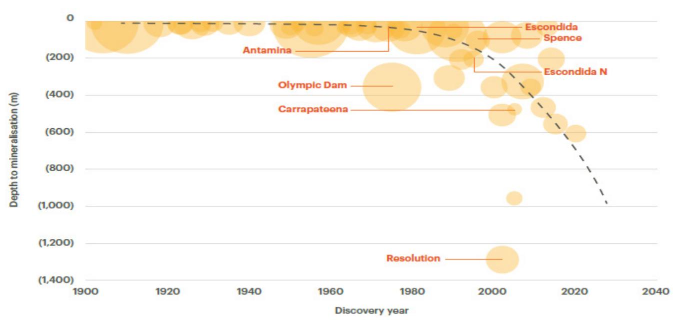
Chart 12



Source: Chester Asset Management estimates. Assumes all 3 projects ramp up

Copper discoveries are harder to find and far deeper

Chart 13



Source: MinEx consulting, BHP analysis

Stock selection - Worley Limited (WOR)

Description

Worley (WOR ASX) is a leading engineering, procurement and construction (EPC) provider, delivering project and asset services globally. The WOR business is broken down into 3 segments, Energy (48% of sales), Chemicals (30% of sales) and Resources (22% of sales). Across the business, services range from project management for oil & gas majors such as Saudi Aramco, to full EPC services for carbon capture facilities. The business has undergone meaningful change in recent years, shifting from a pure oil and gas contractor to a business with a global earnings base and broad end market diversification. Importantly, WOR has focused on winning a high degree of 'energy transition' work, for which the pipeline is significant (a fourfold increase in decarbonisation and green energy projects are projected to come to market in the medium-term). This, in combination with the continued recovery in traditional oil and gas capex and low competitive intensity, puts WOR in a position to grow earnings at a double digit CAGR over the next 3 years.

Quality

The majority of projects WOR works on are large and complex leaving only 2 other major competitors to complete a significant pipeline of globally available contracts. CEO, Chris Ashton was recently quoted, "From a competitive intensity perspective, is the lowest it's been in my career, in 35 years in the industry." This lack of competition means WOR can selectively work on high quality and low risk contracts, with 84% of WOR's work contract being reimbursable. Additionally, the favourable supply/demand dynamic means WOR can continue to lift contract pricing above inflation – positive for growing margins. Perhaps most importantly, a focus on energy transition has diversified WOR's earnings base from being reliant on highly cyclical oil and gas capex, to one that is leveraged to more steady sustainability work.

Valuation

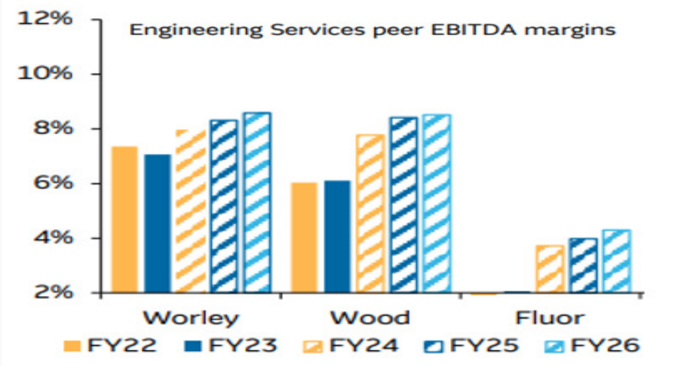
Our assessed value for WOR is currently AUD18.60 using a 10% WACC and a 3% TGR. On Chester projected earnings WOR trades on ~12x FY26 EPSA.

Insight

We believe the market is assuming little chance of Venture Global's CP2 contract ramp up (given perceived uncertainty surrounding final project approvals) and therefore see an asymmetric opportunity in WOR. Should full CP2 ramp up occur, we believe market expectations of FY26 earnings are likely to increase 10%+, given the chunky nature of contracts at high single digit EBITA margins. In our opinion, CP2 is likely to move full steam ahead, noting WOR is already on-site and part way through engineering/procurement work. We also believe the market is underestimating WOR's progression in shifting to a higher degree of sustainability work and as such are still valuing WOR like an oil proxy. Given the business is no longer a pure oil & gas contractor, and as the proportion of sustainability work increases (management are targeting 75% by the end of FY26), we believe the market will change its view of WOR. We also see the prospect of a pick up in projects being announced/approved once the US election is out of the way. Companies can then plan with more certainty, hence the order backlog should recommence post this lull over the past 6-12 months.

WOR delivers strong margins on higher value added work

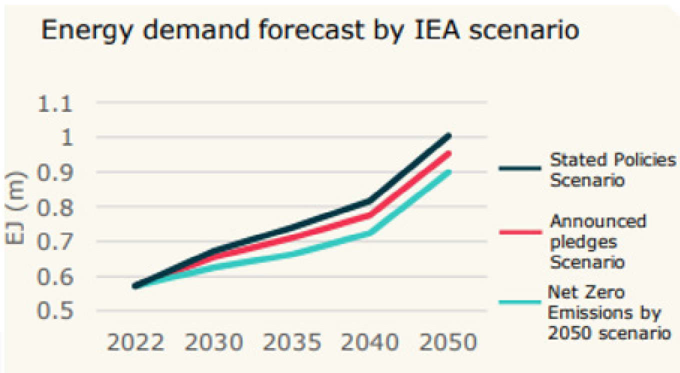
Chart 14



Source: Macquarie Research

WOR is a strong beneficiary of this tailwind over the next 2 decades

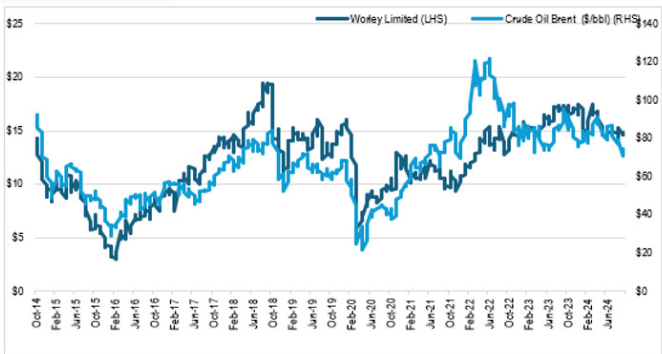
Chart 15



Source: IEA World Energy Outlook

WOR still trades in line with the oil price as a legacy relationship

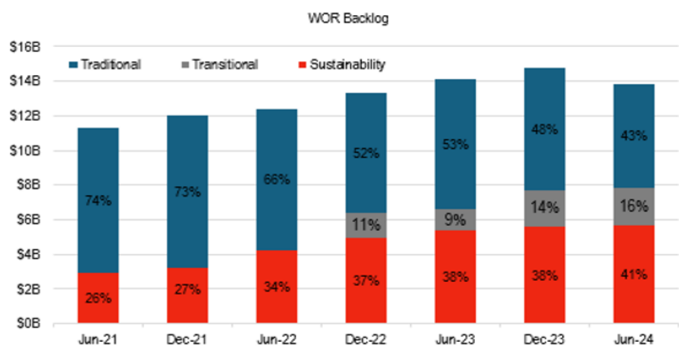
Chart 16



Source: Chester Asset Management

Sustainability work has grown to 41% of the backlog

Chart 17



Source: Worley, Chester Asset Management

How do we define Quality?

Chart 18

	Business Quality	WTC	REA	SEK	XRO	GYG	PME	DHG	CAR
1	Does the business have the ability to pass on higher prices without impacting customer engagement?	High	High	Medium	High	Low	Medium	Medium	High
2	Are these assets/distribution channel easy to replicate?	Low	Medium	Medium	Low	High	Medium	Medium	Medium
3	The risk of being disrupted over the next 5 years? Are there new technologies emerging?	Low	Low	Medium	Low	Medium	Low	Medium	Low
4	How concentrated is the industry?	Low	Medium	Medium	Medium	High	Medium	Medium	Low
5	Does the Company have the ability to grow top line at greater than 5% (GDP plus) organically?	High	High	Medium	High	High	High	Medium	High
6	Does the company have control over the input costs?	High	High	Medium	Medium	Low	High	Medium	Medium
7	What is the risk of government intervention?	Low	Low	Low	Low	Low	Low	Low	Low
8	Total Business Quality	1st	2nd	6th	3rd	8th	5th	7th	4th

Source: Chester Asset Management

The above framework is how we assess each company we have on our watchlist. We actually rank each question out of 10 but have simplified the framework shown here. We assess the Business Quality, Financial Quality and Management Quality using a range of questions as illustrated above (for Business Quality). This then provides us with a ranking system for each stock in a particular sector or thematic that we then overlay with an appropriate valuation to determine the appropriate stocks for the portfolio.

So these are the seven (relatively generic) questions we ask ourselves when looking at each company. This is clearly an exercise in subjective analysis as each answer is considered with the industry structure as we currently view it. When looking at these tech or online names, they obviously operate in different industries so comparing like for like is a subjective exercise.

Part of this exercise is to ask ourselves what is the source of the competitive advantage? (Essentially questions 1 through 5 above). Simplistically, a company can generate a competitive advantage for two reasons. Firstly generating a price premium - whether by having an innovative product (product is patent protected), brand strength, perception of quality (luxury goods mostly) or customer lock in, whereby customers are unwilling to switch to competing products (Microsoft or Apple are the best exponents of this, but generally SaaS companies). Secondly, a competitive advantage comes from a cost or capital allocation efficiency- whether by having a unique resource or asset (Toll road or geopolitically sensitive resources), innovative business method (Costco) or economies of scale (Amazon)

When looking at the answers above, we demonstrate a preference for Wisetech (WTC), Realestate.com.au (REA) and Xero (XRO) relative to the other tech companies, largely as a result of both the dominant industry position and the large runway over the 5-10 year view for pricing power. This will be a powerful driver of future cash flow growth with an incredibly strong franchise (we don't think it will impact customer engagement. We only included Guzman & Gomez (GYG) out of curiosity. Outside an ability to grow store count and have expanded offerings per store, we see fast food retailing as highly competitive with no obvious source of competitive advantage, post the removal of all escrowed and highly motivated shareholders over the next 3-5 years. All these companies can grow organically above 5% to a greater or lesser degree while the control of input costs for technology companies is largely controlling development spend and labor costs, which are largely driven by internal drivers. We focus on this as a way of understanding the ability to grow (and protect) margins.

The question about whether these assets are easy to replicate is often the most challenging. Our current challenge for any capital light software business is trying to understand how generative AI may change the current competitive dynamics of an industry. Does it make it easier or harder for new entrants to emerge? We don't actually have an answer yet. For what its worth, below we have illustrated the companies (large caps) that we view as having the best quality businesses in Australia. This doesn't mean we will hold them all, we still overlay a valuation framework to much of our thinking.

CSL ResMed xero ARISTOCRAT Transurban realestate.com.au wisetech global CAR Group The Lottery Corporation MACQUARIE

WHAT IS THE IMPLIED REVENUE GROWTH TO ARRIVE AT THE WISETECH (WTC) SHARE PRICE?

Chart 19

Recreated financials	FY24	FY25	FY26	FY27	FY28	FY29	FY30	FY31	FY32	FY33	FY34	FY35
Revenue	1,042	1,329	1,666	2,090	2,621	3,287	4,122	5,170	6,484	8,132	10,199	12,792
Growth		27.5%	25.4%	25.4%	25.4%	25.4%	25.4%	25.4%	25.4%	25.4%	25.4%	25.4%
EBITDA	496	685	903	1,153	1,468	1,858	2,351	2,974	3,763	4,760	6,020	7,615
Margin	47.6%	51.6%	54.2%	55.2%	56.0%	56.5%	57.0%	57.5%	58.0%	58.5%	59.0%	59.5%
D&A	-115	-129	-142	-158	-177	-260	-374	-529	-738	-1,020	-1,398	-1,901
D&A as % revenue	11.0%	9.7%	8.5%	7.6%	6.8%	7.9%	9.1%	10.2%	11.4%	12.5%	13.7%	14.9%
EBIT	381	556	761	995	1,291	1,598	1,977	2,445	3,024	3,739	4,623	5,713
Tax Rate	28.5%	28.5%	28.5%	28.5%	28.5%	28.5%	28.5%	28.5%	28.5%	28.5%	28.5%	28.5%
Tax	-104	-157	-221	-294	-389	-455	-563	-697	-862	-1,066	-1,317	-1,628
NPAT	263	393	558	742	985	1,143	1,414	1,748	2,162	2,674	3,305	4,085
Gross operating cash flow	472	656	876	1,119	1,425	1,802	2,280	2,885	3,650	4,617	5,840	7,386
FCF Conversion	95.2%	95.7%	97.0%	97.1%	97.0%	97.0%	97.0%	97.0%	97.0%	97.0%	97.0%	97.0%
Working Capital	-24	-29	-28	-34	-44	-56	-71	-89	-113	-143	-181	-228
Net Investing CF	-243	-362	-420	-488	-573	-686	-819	-975	-1,158	-1,371	-1,618	-1,901
% Revenue	23.3%	27.2%	25.2%	23.4%	21.9%	20.9%	19.9%	18.9%	17.9%	16.9%	15.9%	14.9%

DCF & Valuation	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
DCF											
EBITDA	685	903	1,153	1,468	1,858	2,351	2,974	3,763	4,760	6,020	7,615
Tax	-157	-221	-294	-389	-455	-563	-697	-862	-1,066	-1,317	-1,628
WC	-29	-28	-34	-44	-56	-71	-89	-113	-143	-181	-228
Investing CF	-362	-420	-488	-573	-686	-819	-975	-1,158	-1,371	-1,618	-1,901
FCF	136	234	337	462	661	898	1,213	1,630	2,180	2,904	3,857
Discount factor	0.926	0.857	0.794	0.735	0.681	0.630	0.583	0.540	0.500	0.463	0.429
PV FCF	126	201	268	340	450	566	708	880	1,090	1,345	1,654

WACC		8.0%
TGR		3.5%
PV Cash Flow		7,629
Residual FCF	3,992	
Residual PV Factor	0.429	
Continuing value	88,702	
Residual Value		38,043
Operating Value		45,672
Net Cash		40
Investments		0
Equity Value		45,712
Diluted Share Count (millions)		333.2
Value Per Share		137.19
Todays price		137.19
Revenue CAGR FY25-35		25.6%

Broker	WACC	TGR	Multiple	Comment
JPM	7.80%	3.50%		
Macquarie	9.70%	4.24%		
Jefferies	7.70%	5.00%		
RBC		3.30%		No WACC in note
UBS			FY27 Sales multiple of 23x	50/50 DCF/x, No WACC in note
GS			FY26 EBITDA multiple of 39x	

Source: Chester Asset Management

This is purely an exercise in backsolving the current share prices. While internally, we tend to run 5yr DCF's (extrapolating assumptions out by 10 years tends to extrapolate errors), for the purpose of this exercise, we have used 10yr DCF's. On this page we are looking at what you are paying for when you are buying WTC at AUD137/share (end of September closing price).

On these assumptions (which include the EBITDA margin expanding from 47.6% to 59.5%), WTC needs to grow its revenue from AUD1.042bn in FY24 to AUD12.79bn in FY35 to justify the current share price. 26% revenue CAGR, for 10 years. Can that make sense? Global container movements tend to rise 4-5% per annum, which is a proxy for the freight forwarding industry. Cargo Wise (WTC's software program) has approximately 50% global market share now (and yes, they are offering new adjacencies and will grow inorganically as well). But implicit in a 26% revenue CAGR is very strong yield enhancement (read pricing power).

Our fundamental (long term) question is this. How sustainable is this business model? The key issue being, how confident are we that this business will be in the same (or stronger) position in the next 5 years. On the previous page we set out a range of questions that we use to seek out the best quality businesses in Australia. We are of the view that WTC (along with REA) are two of the highest quality companies in Australia. So to put this in perspective, looking at the bottom table (bottom row) which is highlighting how much of the business valuation is captured post the explicit forecast period. For all these companies, there is still a significant component of their valuation (for WTC 83% of the market cap is captured by the terminal value, meaning post 2035) that is determined by making an assumption on what the business looks like in 10 years time. Our own challenge (an inherent Chester bias) is having to make the leap of faith that a capital light software company will continue to dominate an industry into perpetuity. Microsoft, Amazon and Apple are probably the global leaders that have this ability. Microsoft trades on 31x FY25 PER, WTC trades on 110x FY25 PER. Hence our challenge. We just don't see the margin of safety in capital light businesses where generative AI will make rapid progress from a coding perspective. Who's to say there is not a significant competitor to WTC in the next 5 years? It is certainly not priced for it.

Chart 20

8% WACC & 3.5% TGR	WTC	REA	SEK	XRO	GYG	PME	DHG	CAR
10 Year Revenue CAGR	25.6%	12.0%	6.1%	16.2%	20.4%	29.2%	5.1%	10.2%
Current Margin	47.6%	55.0%	43.3%	29.0%	13.2%	74.7%	35.0%	52.9%
10 Year Margin	59.5%	64.0%	53.0%	43.5%	20.0%	81.3%	40.0%	58.5%
WACC	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
TGR	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
TV as a % of Total value	83.3%	72.3%	67.5%	78.4%	84.7%	81.8%	66.7%	70.1%

Source: Chester Asset Management

AI ADOPTION

We continue to spend much time considering this thematic, as without a doubt, it will be transformative. Our query has always been, is it transformative, yet? Chart 21 highlights that outside 3-4 key industries, the average use of AI across all US businesses, is still less than 5%. Many businesses are just wondering how the cost benefit of implementing AI software will actually deliver benefits to the firm. There are sectors of the economy, that have already transformed the way they work, but it is the rate of change that we are trying to understand.

Visitors to the ChatGPT website have fallen from the peak of 1.7-1.8bn hits per month, to now, 121m (August 2024). There has absolutely been a level of curiosity that has stemmed from AI software, we are searching for evidence of broad based adoption as opposed to simply experimentation. Open AI (the owner of ChatGPT) recently completed a funding round of USD6.6bn, for an enterprise value of circa USD150bn. Whilst a private company, it is still incurring losses and has lost 3 members of its senior executive team in the past 3 months. Chart 23 below highlights just how many start ups are chasing the same dream.

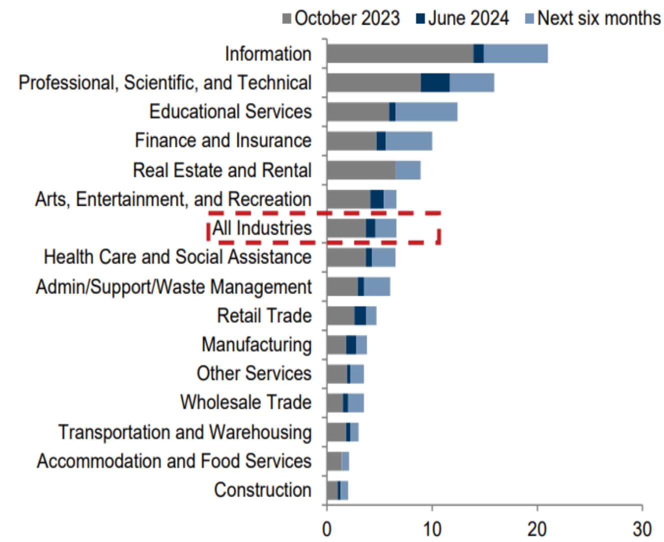
Jim Covello (head of global equity research at Goldman Sachs) we believe asks the most pertinent question on the huge infrastructure build out now occurring (over US1.0tn on data centres, applications and utilities alone). What problem does AI solve for? Replacing low paying jobs with expensive technology (which admittedly should get cheaper with scale) is not a business model many businesses will chase. Which points us back towards chart 21 above, only 5% of US firms are currently using AI. There is the philosophical question as to whether the evolution of AI is ultimately good for humanity (if it does end up replacing millions of jobs). The question becomes one of trust. Can we trust the providers of AI software to act with integrity and benevolence (to access personal data and use it in the right way). These are some significant ethical questions we are facing with the progress of the AI evolution. We do know, you can't stop progress.

So again, this is a thematic we are thinking deeply about, not just because of the commercial ramifications, but the broader humanitarian issues alongside it. For us, our approach has been to watch with interest. We believe much of the capital that is currently being thrown at data centres and software will end up generating very poor returns as the demand curve is far slower to react to the new capacity than the current hype. Much like the hype around EV demand which may still be valid, but far slower than expectations. We still believe the safest way to gain exposure to the narrative is through utilities, whereby robust demand is met with value.

The cycle of sentiment

Chart 21

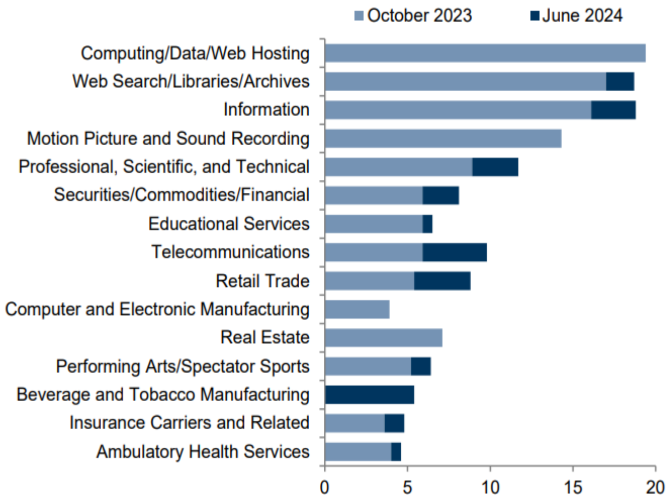
Share of US firms using AI by sector, %



Source: Goldman Sachs

Share of US firms using AI - top 15 subsectors %

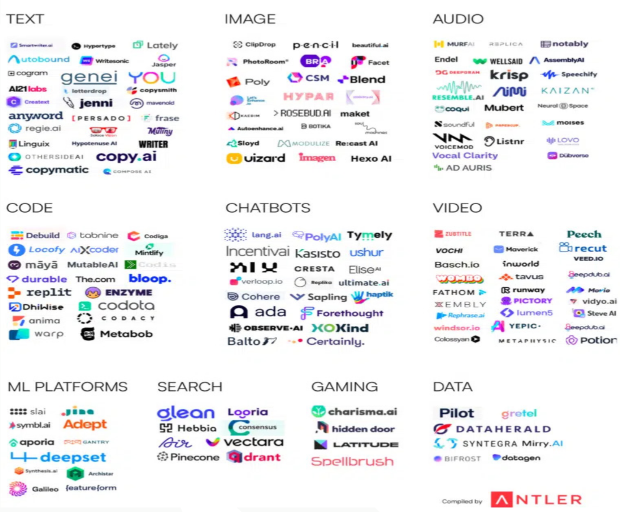
Chart 22



Source: Goldman Sachs

The Generative AI Landscape - over 250 start ups

Chart 23

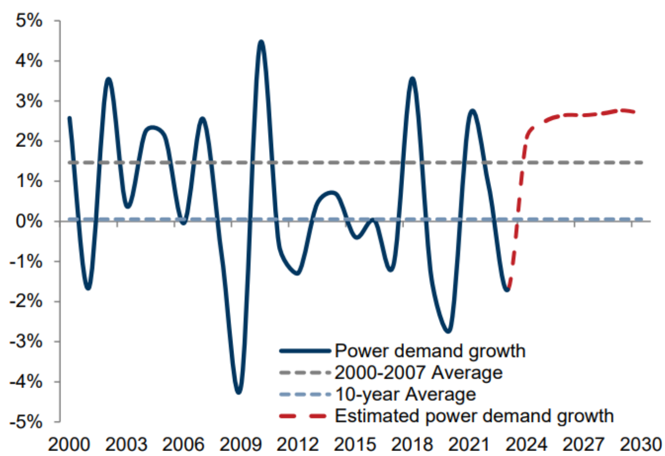


Source: Antler

US Electricity demand to grow 2.4% p.a out to 2030

Chart 24

US power demand growth, %



Source: Goldman Sachs

Current thoughts on gold equities

Regular readers will understand the role gold plays in our portfolio, so we don't need to cover that again. We were however surprised to see chart 25 whereby on a global basis, less than 2% of investment advisers actually allocate more than 5% of total assets to gold. That is, 98% of advisers currently think gold should be less than 5% of total assets. That puts us firmly in the 2%.

Over 100 years, the S&P500 has had bear market drawdowns (in excess of 20% falls) 16 times, for an average decline of 34%. During these 16 time periods, the gold price has actually rallied, on average, 9%. Hence our thinking that gold provides a ballast in volatile times.

We have been curious observers this year where despite the obvious gold price strength, the gold equities, in a broad sense, have failed to show the leverage that the underlying companies will deliver in such a strong upward price move. For the spot gold price to move 28% CYTD (in USD terms) the ASX gold mining index has only risen 16% (there is obvious idiosyncratic stories to a wide dispersion of gold miners performances). We can't help but think there are better times ahead for the gold miners for the reasons we outline here, using Westgold (WGX) as our example.

Firstly, broking houses tend to revise commodity prices quarterly, and when they do, a forecast is provided by a commodity group which is then used across the group on a global basis. Hence chart 26 highlights that the average sell-side gold price assumption is still meaningfully below the spot gold price (US2503/oz at the time of the exercise), so simply using a slightly less conservative gold price assumption, Chester (using US2350/oz) was using a gold price assumption that was 25% higher than the sell-side.

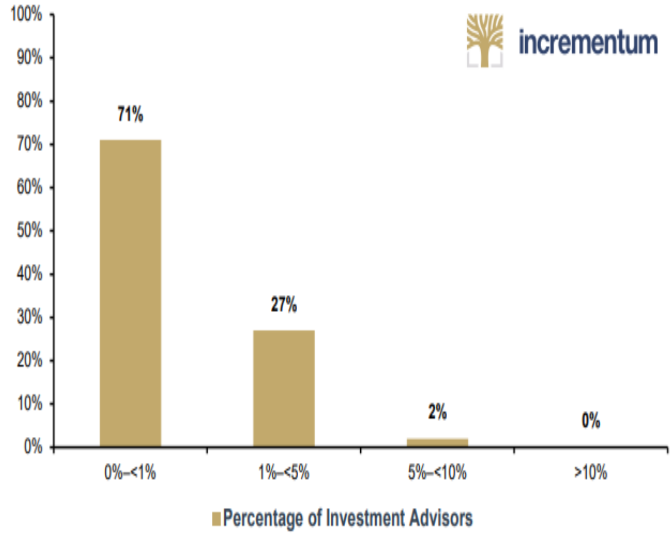
Chart 28 below highlights the leverage that the WGX valuation moves by with a change in the commodity (either the AUD or the gold price). Chart 28 illustrates that with a 15% move (black area) in the gold price, the WGX valuation moves by 40%, which is effectively 2.5x the move in the gold price. This is the reason we have been so surprised at the lack of real leverage in the price movement of gold equities, yet. Yet being the important point.

Chart 27 below highlights that using the assumptions in chart 26, the Chester forecast free cash flow (FCF) is both growing significantly from FY25 to FY26 (which is a WGX stock specific issue, as production grows), but is also materially higher than the broker consensus numbers, simply as a result of using a higher gold price assumption (that still look conservative).

Hence we believe as brokers start revising their gold price forecasts, the actual cash flow growth (and eps momentum) will start driving far more interest in the sector. WGX is trading on 7x FY25 PER with upgrades to come.

Only 2% of investment advisers hold more than 5% in gold

Chart 25



Source: BofA Global Research, Crescat Capital, In Gold We Trust report

Gold assumptions lagging the spot price

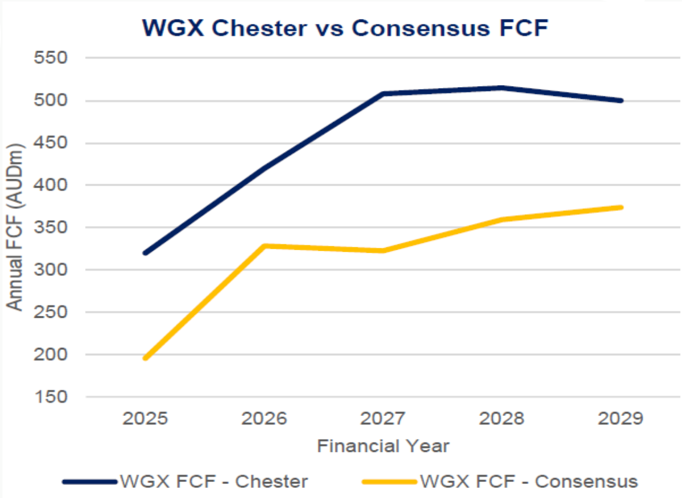
Chart 26

Key Brokers	Gold Px Real (USD/oz)	AUDUSD	Gold Px Real (AUD/oz)	Spot Upside (%)
Spot	**2,503**	**0.66**	**3,792**	**-**
Argonaut	1,850	0.65	2,846	33.2%
Barrenjoey	2,100	0.75	2,800	35.4%
Cannacord	2,350	0.70	3,357	13.0%
Jarden	1,800	0.70	2,571	47.5%
Macquarie	1,850	0.70	2,643	43.5%
ORDS	1,800	0.72	2,500	51.7%
UBS	1,950	0.75	2,600	45.9%
Average	**1,957**	**0.71**	**2,757**	**38.6%**
Chester	**2,350**	**0.70**	**3,357**	**13.0%**
Difference	**393**	**0.70**	**601**	**25.6%**
At 2.5x Leverage				**64.1%**

Source: Chester Asset Management, September 2024

Westgold (WGX) has material upgrades to come

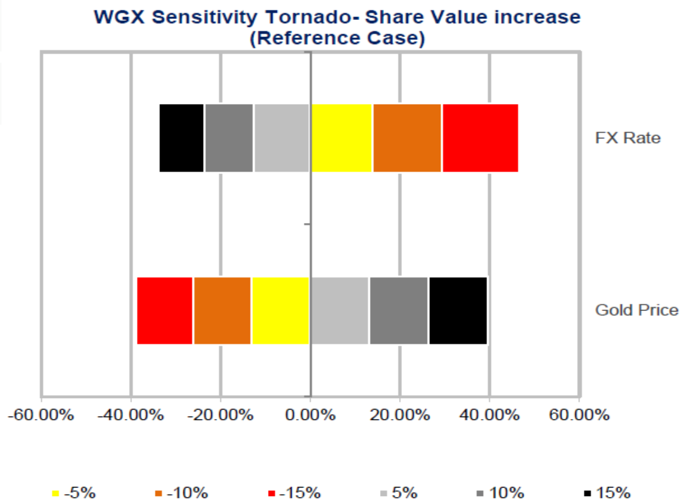
Chart 27



Source: Chester Asset Management

Gold equities have strong leverage to spot gold

Chart 28



Source: Chester Asset Management

US Politics - sector thoughts into a US election

Chart 29

Sector	More favorable policies under	Why?
Healthcare	Toss-up	Pharma may fare similarly while Harris favors Hospitals (extension of subsidies) and Trump favors Managed Care (less regulatory pressure in MA)
Energy	Toss-up	The policy proposals from both sides have more nuanced pluses and minuses than at first glance
Financials	Trump	Lower corporate tax rates and potential deregulation
Utilities	Harris	Clean Energy policy remains a priority and Federal tax credits may be extended, though Trump administration not necessarily negative for Utilities
Consumer & Retail	Harris	Consumer stimulus will benefit lower-to-middle-income households buying power; while Trump tariff risk is negative for retail & consumer prices
Autos	Toss-up	OEMs likely still investing in EVs even if EV and MPG mandates were suspended, delayed, or terminated. Removal of consumer subsidies might dampen demand
Capital Goods	Harris	Harris' proposals on climate, clean energy, and residential construction could benefit industrials. Megaprojects most significant revenue opportunities
Metals & Mining	Trump	Increased tariffs benefiting domestic producers
Paper/Packaging	Trump	Global sector, potential positive FX tailwinds if Trump policy weakens the USD
Technology	Harris	Expect Trump administration to be more aggressive on Big Tech and China
Housing	Harris	Down payment assistance and funding for affordable housing construction, rent control measures
Gaming/Leisure	Trump	Extended personal tax cuts, potential lower corporate tax rate and making tips tax-free
Communications	Toss-up	No material impact
Transportation	Trump	Potential benefits from infrastructure stimulus, lower corporate taxes
Chemicals	Toss-up	Status Quo (Harris) balanced by incremental risks to global trade/US exports via potential retaliatory tariffs against US product (Trump)
Media	Trump	Increased M&A activity, lower corporate taxes
REITs	Harris	Increase in the corporate tax rate would make the REIT tax shield more valuable

Source: JP Morgan

We must confess to being captivated by US politics, a B grade script writer couldn't have envisioned all that has gone on in US politics over the past 3 months. A former president has two assassinations attempts on his life, the sitting president has clear signs of age related health issues and decides (or is decided for him) that he won't contest the next election, while the Democratic party choose (no election) to endorse the current vice president, who is in line to be the first black female president. With that the Democrats have raised over USD540m since Harris was confirmed, outspending the Republicans by 3 to 1 in swing states.

The election appears too close to call, although we note at the time of writing, Trump has taken a small lead, which (according to our sources at X), is because of the way the Democrats have handled the Hurricane Helene humanitarian issues in North Carolina.

Given how divided the country is, the level of misinformation regarding both sides is extraordinary, although we do find it concerning that there are so many states (starting with California), that do not require any form of identification to vote (you do to drive, purchase alcohol, purchase firearms, gamble and buy a car, but not to vote). The concern being the almost 8m illegal immigrants let into the country since the end of 2022, if they are able to vote, it is most likely to be for the party that gives them the most benefits.

The key to any legislative change will be if there is either party that is able to gain control of both the house and senate, so while we can speculate on economic policy as per above, any seismic shift will depend on the size of the election victory.

Our initial view of a Trump victory leans towards being more inflationary, given the likelihood for increased tariffs on goods manufactured offshore, and increased deficit spending via lower corporate taxes. It is possible Trump would embark on a lower USD policy, promoting domestic goods, which would augur well for gold, commodities and economically sensitive stocks. He would be far less friendly to the Tech sector, but far less hawkish when dealing with foreign policy.

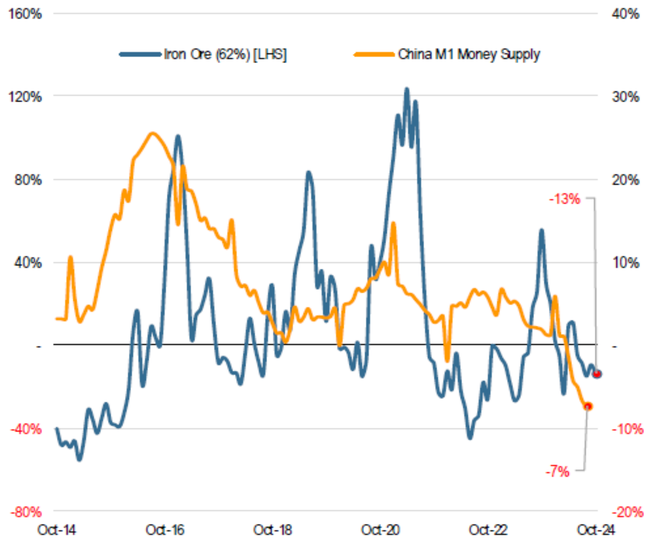
Harris would be seen to continue the current administrations economic agenda, with an emphasis on residential construction and affordable homes, while looking to raise taxes at a corporate level and maintaining the commitment to the energy transition agenda. Markets would appear less likely to favour a Democratic win, given the prospect of higher taxes. Although it must be said that while illegal immigration is not helpful, immigration itself does lend itself to higher economic activity. There are many swings and roundabouts, but the next month will determine how we think about the US economic outlook for the next 4 years. Sector rotation, inflation expectations, interest rates, currencies and commodities will all be impacted by the outcome.

China

A compilation of charts on China will only tell the same story. Property prices are falling from unsustainable levels, there is still an excess of housing inventory to work through and state and local government have significant debt burdens given the over reliance on land sales to finance regional budgets. Which gets us back to the focus over the coming weeks. How big does a stimulus package have to be to engender both consumer confidence, and enable the banking sector to accelerate credit growth. Without these key planks (credit growth or money supply) and consumer confidence, any tick up in the Chinese economy will be just that, a tick. A fiscal package in our view needs to be in excess of 5% of GDP (approx CNY6Tn) to jump start the economy. The Chinese consumer needs the defibrillator paddles to kick in. The messaging from the PBOC in September was strong, now the Ministry of Finance (MoF) needs to back up the fiscal support in the coming weeks. Clearly there has been money sitting on the sidelines waiting for something to happen in China, but as we have seen, it can leave as quickly as it arrived. We must confess to being confused in early October after NDRC press conference that saw the metals complex get sold off aggressively. The NDRC doesn't set fiscal policy so was never going to unveil any large program, but the market sold off aggressively anyway. It is one of the key catalysts (or otherwise) of the 4th quarter.

Money supply is still declining

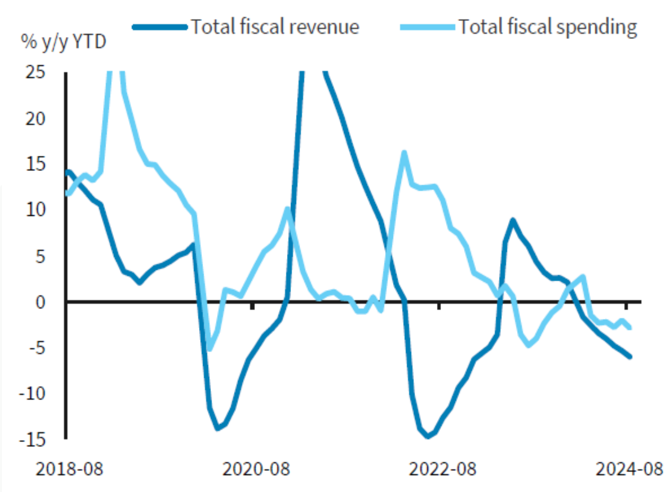
Chart 30



Source: JP Morgan

The key question - how big will the stimulus be?

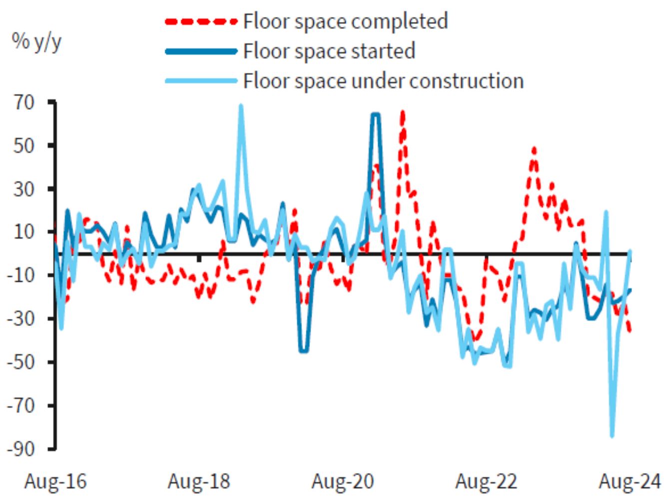
Chart 31



Source: Barclays

Chinese floor space completed is down 30% yoy

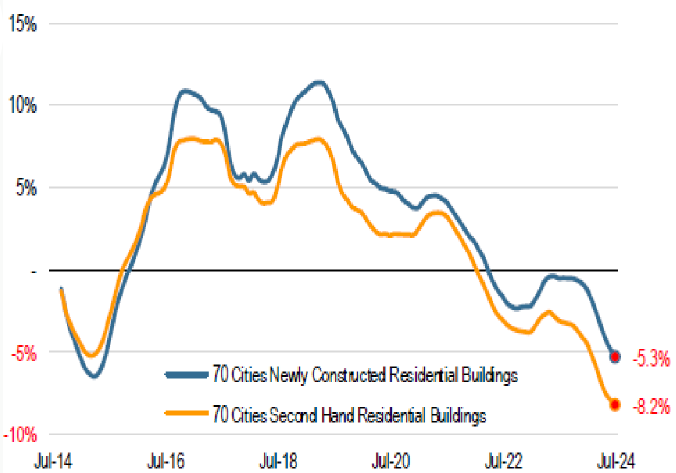
Chart 32



Source: Barclays

Chinese house prices are going backwards

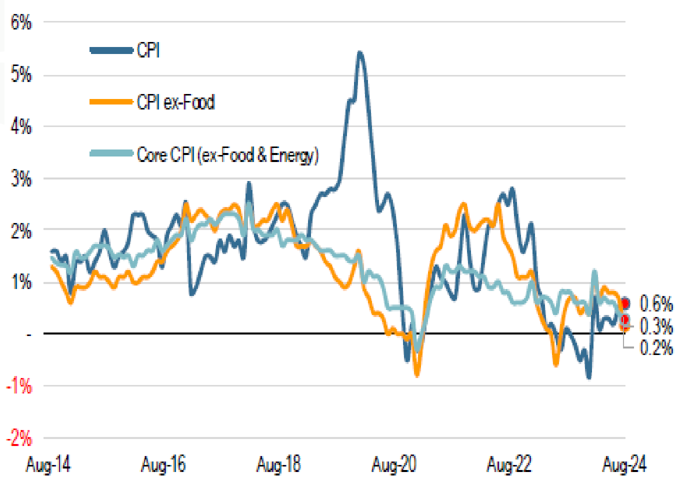
Chart 33



Source: JP Morgan

China is dangerously close to a deflationary spiral

Chart 34



Source: JP Morgan

Australia

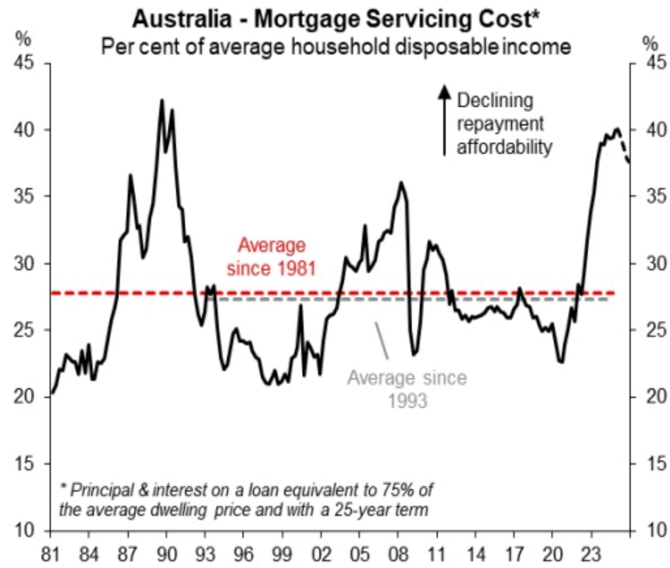
There seems little pressure on interest rates, which as we sit here today, suggests Australia is stuck in the “no landing” camp. This may remain the case going forward, which doesn’t augur well for any interest rate cuts in 2024. We would need to see unemployment rise considerably (above 4%) and wage growth fall below 3% (in our humble opinion) to warrant a change in monetary policy, albeit Australia will be influenced by the US rate cycle as well.

We are less confident in the ability for Australia to raise the cash rate again, based on anecdotal feedback about the stress in the retail sector, albeit tax cuts on July 1st may soften this stress over the coming quarters. Our real concern though, lies with the mortgage belt, already highly indebted, and as per chart 35, with the average Australian with a mortgage having to spend around 40% of their disposable income on servicing that mortgage. The only previous time this occurred was our last severe recession. Again, we don’t see the imminent risk to this as everyone still has jobs, but we think the banks are very poorly priced for an uncertain outcome given how highly geared their customers are.

Chart 38 below is a strong indication that housing will be well supported in the near term, simply because of the excess demand for housing relative to the supply of available stock. Simply, demand exceeds supply.

Households with mortgages still doing it tough

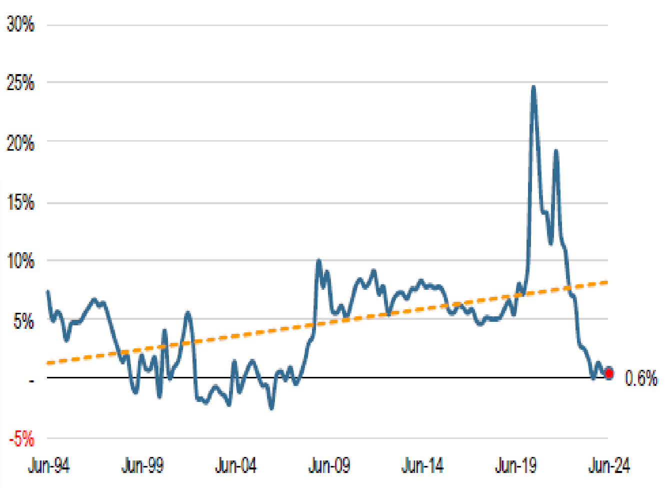
Chart 35



Source: Macquarie Research

Australian savings rate is just about depleted

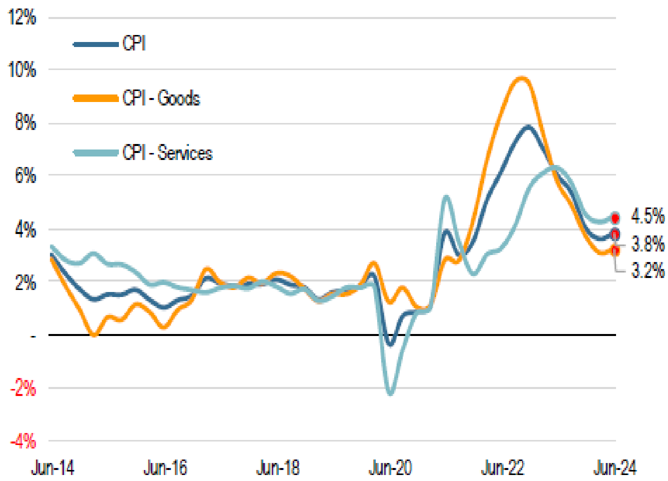
Chart 36



Source: JP Morgan

Inflation still looking too high in Australia

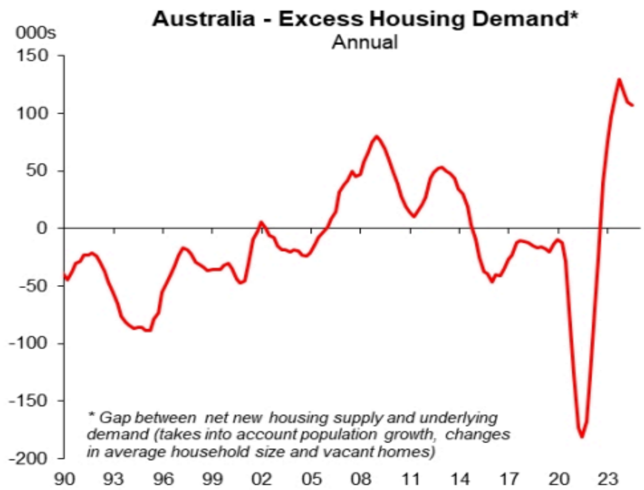
Chart 37



Source: JP Morgan

Hard to be too bearish with level of demand

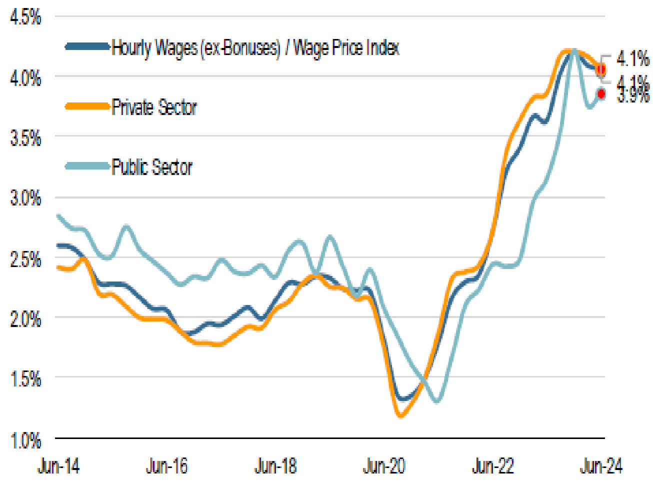
Chart 38



Source: Macquarie research

Wages and rents are the main pain points for inflation

Chart 39



Source: JP Morgan

Charts that make you go hmmm...

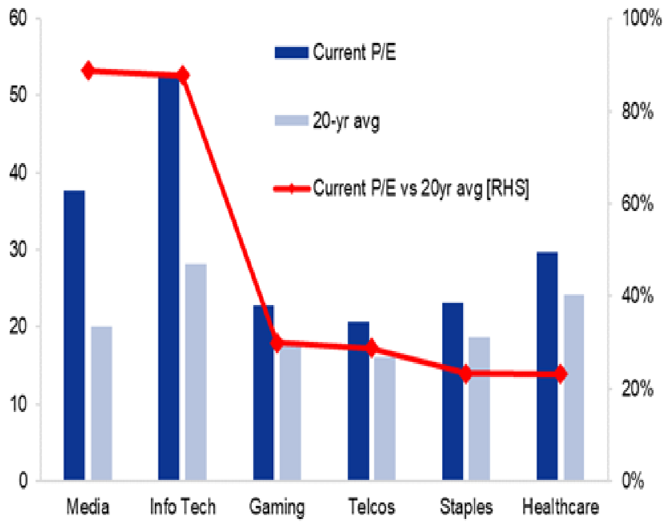
We often simply post some charts in the quarterly as we tend to think that sometimes, a picture is worth 1000 words. We have been surprised at the strength in long duration equities over the past 12 months, given the back up in bond yields. We are still very much in the camp that value as a style should outperform growth over the coming decade, based on the simple premise that interest rates, while cyclical, will be structurally higher than the previous 20 year deflationary period. There is a generation of investors that believe quality and momentum are the only ways to manage money. We are being asked to pay a significant premium for the privilege of gaining exposure to the tech space currently.

Chart 42 highlights that tech and other long duration assets (online classifieds or consumer discretionary names and REITs) have been very strong performers over the past 12 months. Given how resilient economic data has been (including inflation) we think these sectors are priced poorly for an outcome that suggests rates should be on hold. The premium the market is paying for these sectors, seems asymmetric to us.

Historically speaking, we should expect market returns to be lower over the next decade given the starting point of elevated PE multiples (real earnings based on the average for the past 10 years). Caution is warranted.

Tech and online names trading at 90% premiums to history

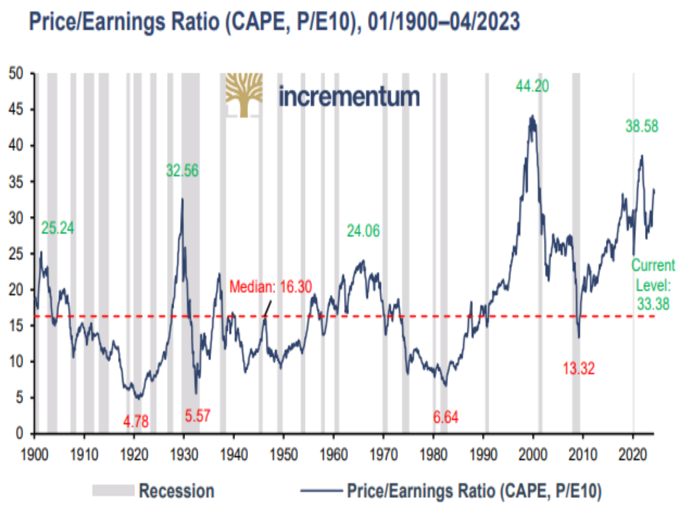
Chart 40



Source: Goldman Sachs

US market is stretched using traditional tools

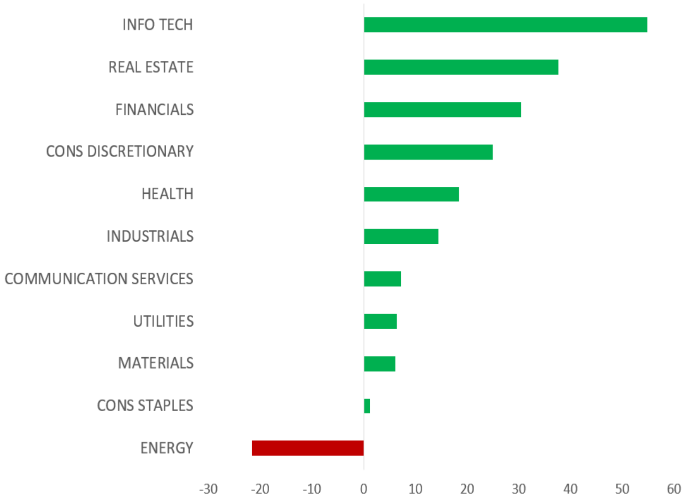
Chart 41



Source: In Gold We Trust report

ASX300 returns over the past 12 months - pricing in rate cuts

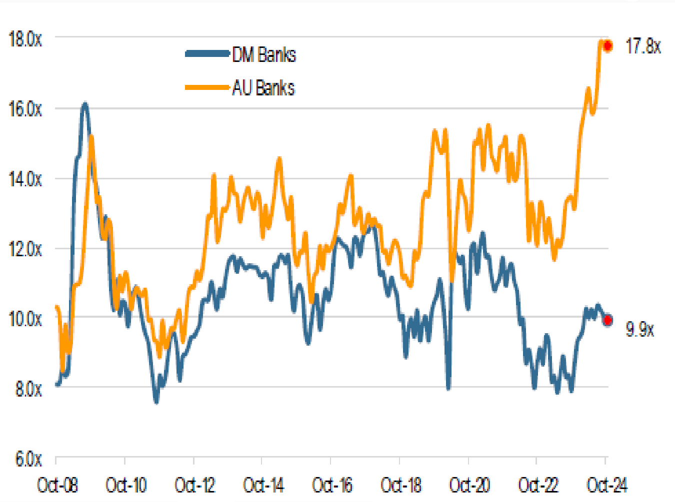
Chart 42



Source: Chester Asset Management, Bloomberg

Australian banks are at an 80% premium to global peers

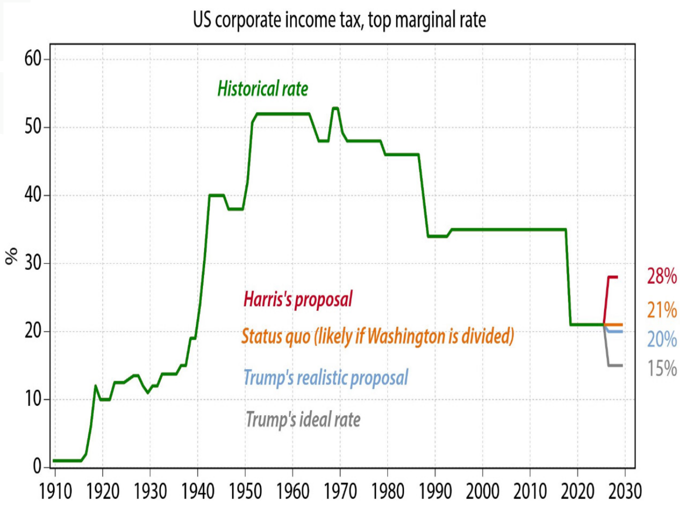
Chart 43



Source: JP Morgan

Wide dispersion of outcomes in the US election

Chart 44



Source: Gavekal Research

Executive summary

Equities

We are entering a volatile period for equities (in our view) given run up to the US election, the prospect of ongoing conflict in the Middle East, and the "will they, won't they" debate around a Chinese stimulus package. All these events have the ability to change the current goldilocks environment the global equity market has enjoyed in 2024 to date. The rate cutting cycle has started in the US, with the backdrop of record high asset prices and very benign credit spreads. It does appear to be a soft landing based on what we know today. The outperformance of growth as a style with the backdrop of the powerful thematic of AI behind it, in our view, has seen valuations stretch well ahead of fundamentals. Not that this notion alone has ever stopped a bull market. It does appear that Jay Powell has taken a more dovish view of the world in the past 12 weeks, which may be the reason for the recent strength in gold, and copper, signaling structurally higher inflation ahead or ongoing deficit spending. We are surprised how many rate cuts the market is currently pricing over the next 12 months (6), based on what we know today. The obvious wildcard in this decision matrix is geopolitical tension, which given the current tension in the Middle East, will create uncertainty for both policy makers and government planning. Wars tend to be inflationary given commodity pressure, supply chain logistics and security planning. Perhaps the only deflationary aspect to a Trump presidency would be a far more passive stance on Russia/Ukraine and less US support for NATO. Every other policy under a Trump presidency would appear to be inflationary, starting with higher tariffs on Chinese imports. China remains a swing factor, as to exactly how stimulatory their monetary policies will be this year to reignite the economic growth engine. We approach China with caution given the banking system leverage, high property prices and an ageing demographic, while still being heavily reliant on export markets (their manufacturing base) to generate GDP growth. Aggressive stimulus will be needed given the current deflationary forces are showing no signs of abating.

Our view remains that real assets (property, infrastructure, agriculture, commodities, gold etc) will outperform capital light or long duration assets over the coming period, where we still see a wide valuation dispersion that needs to unwind. We believe inflation moderates over the next 12 months, but remains somewhat embedded due to localisation of supply chains, decarbonisation, capital investment and a reversal of cheap labour arbitrage from emerging markets over the past 20 years. We are also mindful of the relentless deficit spending in the US, which is accelerating, and needs to be funded, somehow. Our thesis leads itself to see continued pressure on the USD, combined with strong energy transition tailwinds and an underfunded energy sector, which we believe, sets this decade up for an outperformance of commodities relative to financial assets, which again ties into the notion of real assets providing strong returns.

We believe Australia is well placed to benefit from this trend over the coming decade, with an enviable lifestyle and strong (if not somewhat flawed) democracy. As a primary producer of agriculture and commodities, we are well set up to continue to prosper as a nation, which should all else being equal, attract global capital and labour via both skilled and unskilled migration. Whilst this may appear contradictory (relative to our positive stance on Australia), we remain cautious on China. Hence our commodity exposures are energy, base metals and agriculture over iron ore. At a sector level, we see merit in the idea that select industrials look attractive from a valuation perspective, energy and healthcare should see earnings resilience in this environment while gold equities look fascinating from a sentiment perspective. Bull markets historically follow bear markets and in that context, small caps tend to perform better as risk appetite increases. From a strategic perspective, as more dovish interest rate policies come into view (Australia appears at least 6 months behind the US), we may start to see some rotation from growth into value as a style, given many value driven stocks provide cyclical exposure to domestic economies. For the same reason, it would be a reason why small caps finally start outperforming large caps with higher domestic exposure. The Australian banks are priced as though there will never be another bad debt cycle. We remain very cautious towards the banking sector should we see unemployment pick up. We are also of the view that PE re-ratings are a thing of the past, hence earnings will be the only driver of stock prices going forward, meaning we believe a far more fundamental investment process will provide superior returns over the next 2-3 years.

By and large, our stock selection framework continues to focus on:
Real assets - **AZJ, MIN, QUB, AGL, STO**
Valuation margin of safety - **SUN, LLC, ASB, WOR**
Pricing power - **CSL, RMD, NWS, TLC**
Gold - **WGX, EVN, GMD, SPR**

As we have demonstrated over the past 10 years with this strategy, the returns we generate do deviate significantly from the benchmark, where we are proud of the track record of the strategy, delivered with lower volatility than the ASX300.

Government spending and bond yields

Interest rates are under enormous strain with the amount of debt issuance by central banks, and we still wonder how ongoing US deficit spending is financed outside the Fed Reserve embarking on QE. With this backdrop, the only way the debt burden to society gets repaid, is through asset reflation, or in some cases, debt forgiveness. Central banks (led by Japan) have had no other playbook since the GFC, and will continue to issue new bonds to finance the deficit spending of governments and the debt burden, which becomes debt monetisation. Since Alan Greenspan, Fed governors have always issued a "put" on the stock market with new easing policies, which in the next sharp downturn, eventually becomes yield curve control, and ultimately direct equity purchases, if needed. Jay Powell may well have "blinked" recently with his relatively dovish language, despite the fact that inflation remains well above trend.

Chester High Conviction Fund

Quarterly Thoughts

October 2024

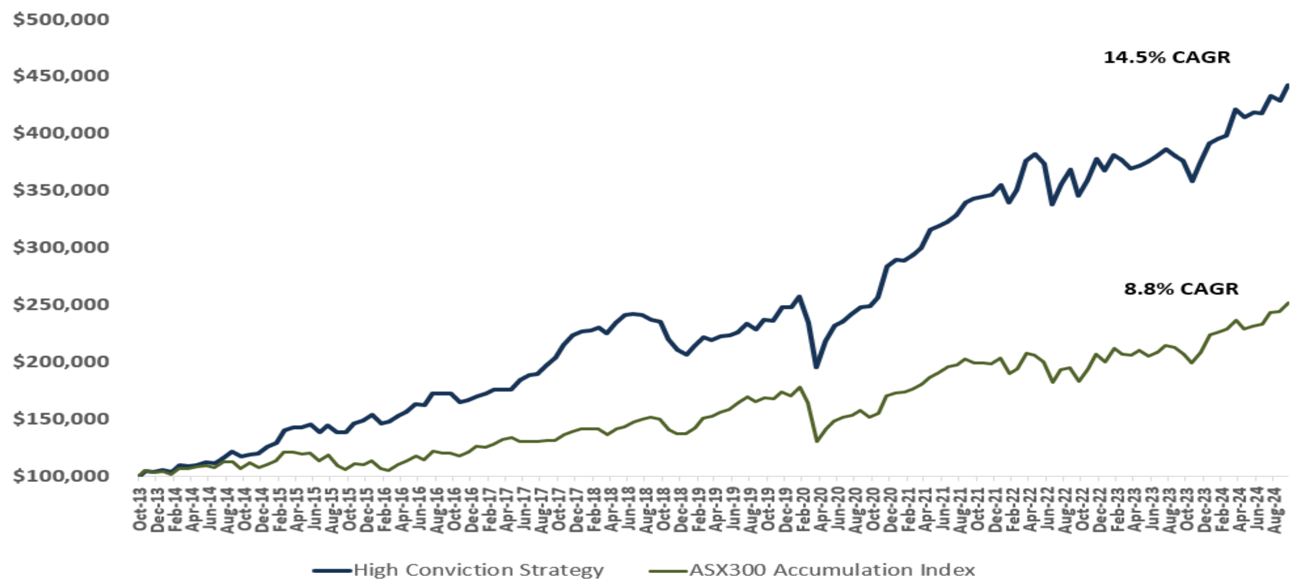
APIR OPS7755AU
ARSN OPS7755AU

Accumulated Performance by Financial Year - Same Strategy

	FY14 (%)#	FY15 (%)	FY16	FY17 (%)*	FY18 (%)	FY19 (%)	FY20 (%)	FY21 (%)	FY22 (%)	FY23 (%)	FY24 (%)	FY25 (%)	Since Incep (%)
Same Strategy (after MER)	+11.2	+24.5	+17.4	+11.2	+28.3	-6.4	+3.9	+37.2	+4.8	+12.5	+9.7	+6.0	+14.5
S&P/ASX 300 Accum Index	+7.8	+5.6	+0.9	+9.1	+13.2	+11.4	-7.7	+28.5	-6.8	+14.4	+11.9	+7.8	+8.8
Value added (after MER)	+3.5	+18.9	+16.4	+2.1	+15.1	-17.8	+11.6	+8.7	+11.6	-1.9	-2.2	-1.8	+5.7

Per Annum. The inception date of SGH Australia Plus was the 8th of October, 2013, where Rob Tucker was the sole Portfolio Manager, until his departure on February 28th, 2017.
* The inception date of the Chester High Conviction Fund was April 26th, 2017, hence FY17 reflects 8 months of SGH Australia Plus and 2 months of the CHCF.
We note this is a statement of fact of the performance achieved by the fund during the time which Rob Tucker was the sole Portfolio Manager making active decisions on the SGH Australia Plus portfolio. We note performance is the record of the firm not the individual however past performance has been constructed from publicly available unit price data. Past performance is not necessarily indicative of future performance and should not be relied upon in making investment decisions.

High Conviction Strategy - accumulated performance



Note this graph is representative only of the combination of the same Portfolio Manager running the same strategy, and would only represent actual returns for unit holders that invested money at inception of SGH Australia Plus, withdrew those funds at the end of February 2017 and then invested all those initial funds again at inception of the Chester High Conviction Fund in April 2017. Note, this depicts returns after fees.

Contact Copia

1800 442 129 clientservices@copiapartners.com.au copiapartners.com.au

John Clothier	General Manager, Distribution	+61 408 488 549	jclothier@copiapartners.com.au
Mani Papakonstantinos	VIC/WA, Distribution Manager	+61 439 207 869	epapakonstantinos@copiapartners.com.au
Chris Barnett	NSW/SA, Distribution Manager	+61 413 763 927	cbarnett@copiapartners.com.au
Sam Harris	NSW/QLD, Distribution Manager	+61 429 982 159	sharris@copiapartners.com.au
Justin Cilmi	VIC/TAS, Distribution Manager	+61 428 153 431	jcilmi@copiapartners.com.au
Tony Harte	QLD, Distribution Manager		tharte@copiapartners.com.au

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