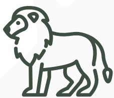
Chester High Conviction Fund Quarterly Thoughts July 2024

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.

Chester High Conviction Fund

Quarterly Thoughts

July 2024

APIR OPS7755AU
ARSN OPS7755AU

At 30 June 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)	-0.3	-0.8	6.8	9.7	9.0	13.0	12.1
S&P/ASX 300 Accumulation Index	0.9	-1.2	4.2	11.9	6.1	7.2	8.1
Outperformance (after all fees)	**-1.2**	**+0.4**	**+2.6**	**-2.2**	**+2.9**	**+5.8**	**+4.0**

* 27 Apr 2017

> *"We give government the right to print money because we trust elected officials not to abuse that right, not to debase that currency by inflating. Foreigners hold our dollars because they trust our pledge that these dollars are equivalent to gold. And trust is everything."* — Paul Volcker

The ocean changes its mood often. In January 2001, we were attending our cousin's bucks day, which involved a deep sea fishing expedition out past Rottnest Island in Western Australia. 24 excited friends and family ventured down to Fremantle Port for a 6.30am departure time. Admittedly conditions were blustery. We were expected back for dinner. The first 15 minutes or so were plain sailing out from the port towards Rottnest Island, however, things deteriorated quickly. The trash talk and false bravado turned into silence and a steely determination to focus on the horizon. The 4 metre swells made this task almost impossible. The first sea hardy passenger to surrender was Denis Tucker who proclaimed to anyone within earshot that "nobody was having any fun". He was right. By 7.45am his sons also surrendered their sea legs and one of them ended up in the fetal position on the starboard side wishing his life would end. Fortunately the captain realised the passengers that day weren't expecting to join the Navy as a career path, took sympathy on us, and turned the boat around to let the troublesome passengers off at Rottnest. It was 9am. The worst bucks day ever. In better news the cafe latte on Rottnest Island was perfect, and the fast ferry back to Perth took 25 minutes.

The stock market also changes its mood often. The first half of 2024 has been remarkable for the lack of volatility. In fact the measure of volatility (the VIX Index) has been eerily calm. This in spite of a dysfunctional US political system, ongoing geopolitical tension on 3 fronts and interest rates showing signs of finally slowing down Western economies. Yet the growthiest market (the US) saw a continued, unrelenting upward trajectory, as the Magnificent 7 led growth stocks to outperform value stocks by 18% in 1H 2024. The AI narrative is well known, but the capital being thrown at the space in the attempt to secure "first-mover" advantages is both fascinating and concerning. We discuss our thoughts on this more inside. This might be stating the obvious, but it feels far more likely that we see rising volatility over the second half of this calender year. Hopefully not 4 metre swells. They make everyone nauseous.

The most recent CPI print in the US has all but confirmed the near term trajectory is falling (while still 3.0% yoy, the most recent month on month data has turned negative) which allows Fed Chair Jerome Powell to cut rates in 2024, potentially as early as September. Clearly a rate cutting cycle alleviates pressure on households, the Fed's own interest expense and recognises the weakening consumer. In our view, if interest rate cuts occur, the fight against inflation is far from over, but may extend the equity bull market. We have always invested with the mantra of finding mispriced opportunities whereby the risk reward is skewed in our favor. Asymmetric investing. We see far less opportunity to invest in long duration (technology sector) assets given the pricing disconnect we see relative to other opportunities. We would also add Australian banks to this framework, particularly CBA. On all metrics, impairment charges are extremely benign and the fundamental reasons for owning banks at these prices looks increasingly illogical to us. A trend is a trend, until it's not. Australia may be 6 months behind the US from an interest rate cycle, while we view the recent tax cuts (from July 1st) as influential as to how the consumer backdrop appears into the 2H 2024. Simplistically, the longer Australia remains on hold, the higher the support for the AUD on interest rate differentials alone.

As long term holders of gold equities, it is increasingly difficult to paint a bearish picture for the fundamental back drop for gold equities. The gold price, in our view, is signaling that as rate cuts appear imminent, the world still hasn't even pretended to start solving the ongoing OECD deficit spending. To us, the US deficit remains the most pressing issue in finance through this decade. The disconnect between the strength in the gold price year-to-date and many of the gold equities, in our view, provides a compelling opportunity for both alpha generation and a non-correlated sector exposure should volatility actually start increasing.

Political volatility

An assassination attempt? It is fascinating yet disturbing watching US politics. We did postulate on this in our previous quarterly, but the recent public appearances of Joe Biden only confirms the likelihood of Donald Trump being re-elected as US President in November. This assassination attempt probably gives Trump a stronger base. The Democrats (in our humble opinion) would be far better served trying something left field as a Biden/Trump race looks to have only one winner. A gamble involving a younger alternative, which would most likely be Gavin Newsom. But what would a Trump presidency look like? Arguably he would be far less aggressive geopolitically, as he appears concerned with the level of US support of NATO funding while openly is more pro-Putin than any Western leader. He also has a dislike of many of the tech entrepreneurs (particularly Mark Zuckerberg). This is something worth monitoring. We understand his leadership would be very focused on raising tariffs once more, as manufacturing jobs in the US (particularly the auto industry) would be a focus of his presidency. Mexico and China would be the trade losers under this framework. Trump has never had any problem with deficit spending, thus this current trajectory is unlikely to change with a change in administration. None of this is deflationary. Undoubtedly there would be a focus on the largesse of the US public service sector, with a working paper suggesting the top 5000 bureaucrats could be made redundant under a Trump administration. For all the rhetoric of geopolitical tensions, ongoing conflicts in Ukraine and the Middle East, the US is actually budgeted to spend a record low 2.7% of GDP on defense in 2024 (above 10% during war time spending historically). This optically suggests the US is not prepared, or preparing for an escalation of global tension. This appears unlikely to change under Trump's leadership, which means it really does suggest we are entering an era of a multi polar world (two major superpowers) as opposed to the US being the world's policeman it has been for the past 70 years. There are many ramifications of this, including the appropriate reserve currency.

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 wasn't the case in FY24.**

Portfolio changes this quarter

The portfolio was again relatively quiet from a portfolio construction perspective. Telstra **(TLS)** was added to the fund in the second half of the quarter as the market became too pessimistic over the prospect of future mobile price increases. It appeared logical to us that raising prices at the same time as removing 2800 employees is not a wonderful optic for a company with high public scrutiny. The fact that Vodafone and Optus raised mobile plans shortly after this announcement suggested to us the predictable nature of the TLS cash flows would ensure the dividend profile remained in tact, after derating by 20% over a 12 month period. The recent announcement from TLS to increase mobile prices has validated that thesis. The TLS purchase was effectively a switch from our position in Aussie Broadband **(ABB)**. While ABB has been a very successful holding for our fund over many years, we have chosen to remain on the sidelines while the integration of Symbio takes place, and ABB deals with losing the Origin Energy white label contract. We would also look for evidence of increasing momentum in the enterprise business (winning corporate customers) before considering the position again. The fund also took a position in fund manager GQG Partners **(GQG)** early in the quarter. The funds management business model is obviously well understood, while the enviable track record of key man Rajiv Jain combined with operating momentum (FUM growth) on a single digit FY25 PER and high single digit dividend yield appeared to provide a favourable risk reward outcome. The other position we exited in the second quarter was **QBE**, which had been in the portfolio since early 2021. We felt a combination of a peaking premium cycle with the prospect for the peak in US interest rates and what appears to be ongoing heightened catastrophe claims, suggested to us that the next leg higher for QBE would be far harder, with the risk reward far more evenly balanced.

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 the near term disinflationary pressures from goods deflation from this structural thesis around monetary debasement. We note the recent strength in the gold price, oil and copper as a sign that hard assets may remain a valuable store of wealth in an inflationary environment. The challenges with energy transition and security, demographic shifts into labour scarcity and supply chain security suggests structurally higher cost pressure than markets have been used to, which all else equal, suggests structurally lower valuations (and higher bond yields). We are highly focused on pockets of the economy or individual stocks with either strong valuation support and asset backing, or earnings resilience, and hopefully both. 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 **NUF**, **ASB, SUN** and **LLC** 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, TLC**, **LNW** and **NWS** (through its holding in REA and Move) in this category. We think margin resilience becomes an important driver of equity returns in the post free money era.

The Portfolio

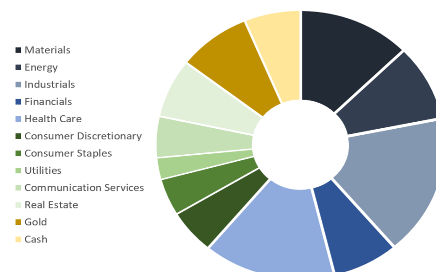
The CHCF posted a 0.8% fall in the quarter, relative to the 1.2% fall in the ASX300 Accumulation Index. Telix **(TLX)** had a very strong first half, largely on the strength of gaining market share with its imaging product Illucix, while also demonstrating efficacy with its longer term therapy products for prostate and kidney treatment. Austal **(ASB)** continues to attract media attention given the public interest in the defence sector and ongoing takeover speculation. The order book underpins a strong 5-10 year outlook for ASB which, in our view, remains undervalued. Mineral Resources **(MIN)** suffered a dramatic fall throughout June, as sentiment in the lithium market hit extreme pessimism. We hold MIN for its diversified earnings stream which we feel in the mid AUD50s range to be compelling on a 3 year view. Beach Energy **(BPT)** continues to disappoint, with a strategic review of the assets in June from new CEO Brett Woods, which led to both operational and resource downgrades. We continue to hold (patiently) given the optics of a strong production ramp up from Waitsia in the coming months and its position with uncontracted gas on the East Coast trading on just 3.3x EV/EBITDA in FY25 on revised numbers.

Top 3 holdings
CSL
Austal
Aurizon

Portfolio breakdown	
Industrials	17.0%
Health Care	14.9%
Materials ex Gold	12.7%

Top 3 portfolio attribution	Bottom 3 portfolio attribution
Telix	Mineral Resources
Austal	Beach Energy
Spartan Resources	Nufarm

Fund weights - diverse sector exposure



THE KEY THEMES DRIVING PORTFOLIO CONSIDERATIONS

THEME	IMPACT	EQUITY CONSIDERATIONS
TRUMP VS ANYONE BUT BIDEN	The likelihood of the democrats getting rid of Biden has to be increasing, given his recent press outings. They can't win with him. So what would happen with another candidate so close to November? The most likely prospect seems to be Gavin Newsom, a divisive governor from California.	We have spent a lot of time thinking through policy changes should Trump win. There would be sweeping immigration changes, increased tariffs, incentives for the manufacturing sector (auto's particularly), repeal the IRA policies and on-going deficit spending. None of these would be deflationary. Trump vs anyone but Biden would create more interest.
INFLATION	Gold, copper and oil are trading technically very strongly which appears to be an indication that renewed interest is appearing in hard (physical) assets. This coincides with the current disinflationary pulse at the heart of the prospect of interest rate cuts in 2024.	Our long-term view throughout this decade has been for inflation to remain stickier and a basket of hard assets to be highly desirable as a store of wealth. This trend remains well represented in our portfolio, with a value bias remaining. Note this thesis is structural and not cyclical.
MEGATRENDS	We have always started looking at an investible universe through the lens of a megatrend framework. This is how we narrow down the universe of appropriate stocks to do fundamental research on. Once a year we "zoom out" from micro managing the portfolio to observe the prevailing winds of capital flows around us.	This quarterly explores some of these trends in detail, whereby the most influential in our view (AI is a close second) is the fragmentation of the world between the Eastern Bloc and the Western Bloc, which is largely concerned with the US twin deficits (budget deficit of 6% of GDP and a trade deficit of 4% of GDP). Remarkably unsustainable.
US PUBLIC DEBT	US public debt at USD34.9tn with 5% cash rates and has grown by USD2.5Tn in the past 12 months. The US interest bill is exploding higher. One of the most powerful incentives for the lowering of US interest rates is the public debt burden. Running a US2.5Tn deficit has to be financed by someone, which is unlikely to be foreigners.	The only solution to us has to be financial repression, meaning inflation is structurally higher than the 10yr bond yield for significant periods. Real assets and gold become highly desirable as stores of wealth under this scenario. We remain firmly of this view, which ties into our portfolio construction framework as per above.
ARTIFICIAL INTELLIGENCE	Like most investors, we have spent the past 18 months exploring and trying to understand the ramifications of this explosion of large language models (LLMs) in generating content, whether written form or visual content. Who are the winners and who are the losers.	As we sit here today, the winners have been crowned to be Nvidia as the semiconductor provider of choice, members of the Mag7 with access to capital and customers and hyperscalers. We explore this further inside as we are fascinated by the capital investment in the space, and the associated expectation of future revenue growth that comes from it.
DEMOGRAPHIC TRENDS	Megatrends are observable over decades rather than cyclical shifts, and there is no longer, more easily identifiable trend than demographics, which in essence, is plotting the demise of the fertility rate across most countries (outside Africa). This has ramifications for the dependency ratio (retirees relative to the working population) and labour scarcity. The western world solution to this has been immigration, while Europe is now grappling with this as a societal issue.	As an Australian investor, observing the declining birth rate in China has obvious ramifications for the demand for our natural resources, but the aging Chinese population also has ramifications for global consumerism, healthcare and trade flows. Our own immigration patterns have had significant ramifications for household formation and construction shortages, the rental and cost of living crisis in Australia amongst other societal impacts. We explore some of these issues on page 10.
ENERGY TRANSITION	This thematic is also a multi-decade trend, whereby the western world is fixated on reducing carbon emissions through a mixture of policy initiatives and new technologies.	We touch on one material trend inside around sustainable aviation fuels (SAF), attempting to solve one of the largest carbon emission problems globally.
DEFENCE SPENDING	The rise of the Eastern bloc and the Western bloc does pose a significant challenge for both globalisation (trade flows) and for geopolitical stability. We are obviously all too aware of the social divide in the Middle East and the Russia/Ukraine war, which is becoming a defacto East vs West conflict. We only hope diplomacy prevails.	It appears inevitable that defence spending increases over the next decade. The trajectory of conflict appears to be escalating not de-escalating. With this comes a nation's responsibility to protect its citizens as best it can. It doesn't necessarily augur well for budget deficit spending, but is a megatrend that appears to us as inevitable.

Chester High Conviction Fund top 10 holdings

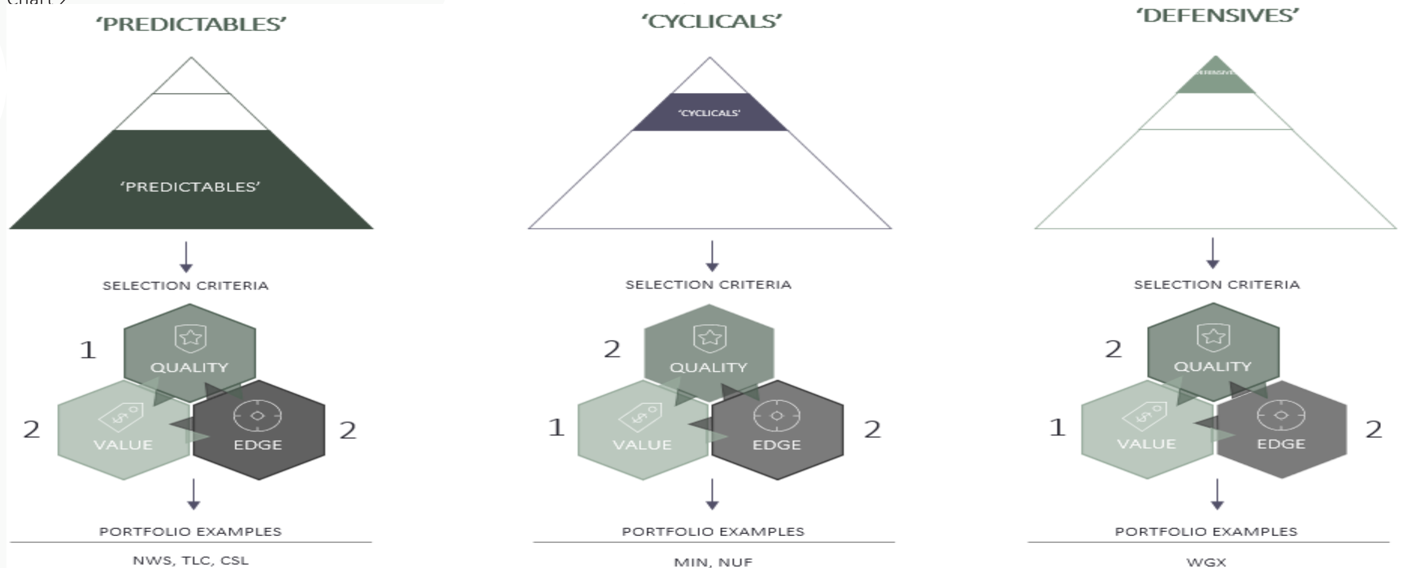
	Cash flow style	FY1 Sales GR	FY2 Sales GR	FY1 Div Yield	FY2 Div Yield	FY1 DPS GR	FY2 DPS GR	FY1 ROE	FY2 ROE	FY1 BOOK VALUE	FY1 EV/EBITDA	FY1 EPS GR	FY2 EPS GR	FY1 PER	FY2 PER
Abacus Storage King	Predictable	nm	9.6%	5.2%	5.2%	nm	1.7%	3.9%	4.0%	0.7	18.2	7.5%	2.1%	19.4	19.0
Atlas Arteria	Predictable	-8.2%	-0.2%	7.8%	7.8%	0.0%	0.0%	9.2%	9.8%	1.2	12.1	16.1%	6.7%	13.2	12.4
Aurizon	Predictable	13.6%	4.9%	5.2%	6.6%	20.5%	26.1%	10.7%	11.7%	1.5	6.7	17.5%	13.7%	14.5	12.7
Austal	Predictable	15.2%	17.4%	0.3%	1.4%	-75.0%	250.0%	3.4%	5.2%	0.9	6.7	nm	54.4%	28.3	18.4
Comet Ridge	Cyclical	nm	nm	nm	nm	nm	nm	nm	nm	nm	nm	nm	nm	nm	nm
CSL	Predictable	10.7%	7.9%	1.3%	1.5%	13.9%	15.4%	17.3%	17.8%	5.1	20.9	20.0%	14.5%	32.1	28.1
Develop Global	Cyclical	112.6%	43.1%	0.0%	0.0%	nm	nm	nm	nm	2.0	12.5	nm	nm	nm	35.3
Suncorp	Predictable	15.6%	16.8%	4.4%	5.1%	2.7%	16.4%	10.4%	10.3%	1.6	nm	14.3%	-2.1%	15.7	16.0
Telix	Predictable	47.3%	29.3%	0.0%	0.0%	nm	nm	29.2%	37.5%	18.9	35.5	331.0%	108.8%	102.7	49.2
Telstra	Predictable	1.6%	1.3%	4.7%	4.9%	5.9%	3.3%	12.8%	13.4%	2.8	7.3	7.3%	6.3%	21.7	20.4

Source: Chester Asset Management, Bloomberg consensus data

We have listed here our top ten holdings at the 1st of July, 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 Comet Ridge (COI) are classified as "cyclicals". Our gold holdings are classified as "defensives", but they currently sit outside our top ten holdings. 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.

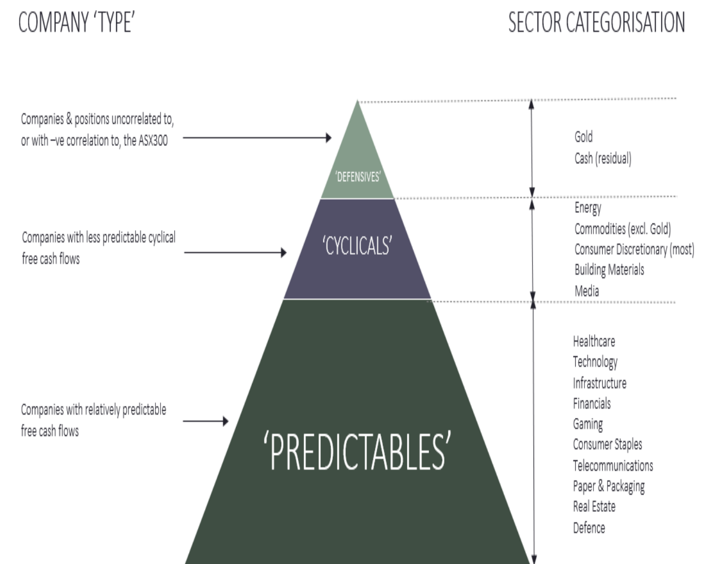
Chart 4 illustrates how these "buckets" have looked over the past 9 years. On average, the allocation to predictables has been 60-70%, while cyclicals have averaged around 18% (10-25%) and defensives have ranged from 10-25% (averaging around 15% of the fund). We have tended to hold an increased cyclical 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 8.4x PER and has 378% eps growth in FY24. 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 better valuation support and a better ROE to the market. 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.

How do we allocate capital?

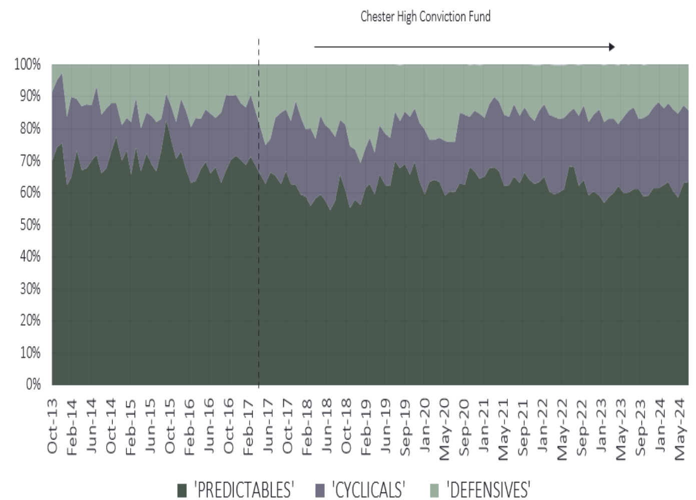
Chart 3



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 FY24	17.9	17.7
PER FY25	15.8	16.2
FY1 EPS growth	30.3%	-5.7%
FY2 EPS growth	25.0%	9.0%
ROE	13.9	12.9
Beta	0.9	1.00
FY24 Yield	2.1	3.9
FY1 DPS growth	7.6%	2.5%

note Chester data excludes non revenue generating companies

Source: Chester Asset Management, Bloomberg, Macquarie research

Stock selection - CSL Limited (CSL)

Description

CSL is one of the best known Australian businesses given its global success over 33 years after an IPO in 1991 as the Commonwealth Serum Laboratory (CSL). Given a stock split in 2007, the IPO price was AUD0.767 as a AUD312m mkt cap. Today the market cap is AUD148bn and generates 95% of its revenue offshore. The CSL business is broken down into 3 segments, CSL Behring (65% of sales), CSL Seqirus (23% of sales) and CSL Vifor (12% of sales). Behring is a global leader in plasma derived therapies, with the core product being IVIG (intravenous immunoglobulin), Seqirus is one of 3 major influenza vaccine manufacturers, while Vifor manufacturers and distributes products for iron deficiency and nephrology (kidney disease). The Vifor acquisition in December 2021 has been disappointing given challenging top line growth and several products coming off patent which exposes the business unit to generic competition. The organic growth rate in IVIG and the plasma therapies business has been 7-9% for 20 years, with projections for this to continue, despite several gene based therapies that may offer alternate products to IVIG based therapies. CSL has been derated over the past 3 years given margin erosion in the core IVIG business (largely around collection costs of safely extracting plasma) and the management discount now in place given the capital allocation towards an inferior business (Vifor). We think there is a very compelling story for CSL to regain its premium status over the next 3-5 years, hence it remains our largest holding.

Quality

The quality of the CSL Behring IVIG franchise is undeniable, with an approximate 30% global market share (slightly above Grifols and Takeda) but at a superior margin given the combination of the location of collection centres (access to raw material) and last litre economics (meaning they sell more of an entire litre of plasma extracted given the various products they manufacture from that plasma). All 3 major players consistently speak to the inability to meet underlying demand with supply bottlenecks (actually collecting and processing enough plasma). The organic growth rate seen in CSL Behring suggests it is in an enviable position as a market leader in a supply constrained industry, as demand is growing at 7-9% consistently. Sequris is also a high quality business given the structural tailwinds of ongoing vaccination rates (albeit well off its COVID induced peak). CSL is in a strong position to improve margins as cell based quadravalents (4 types of flu) are rolled out across Europe and production capacity is optimised.

Valuation

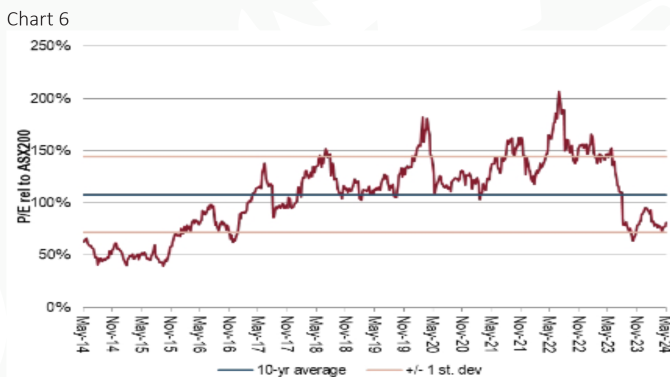
Our assessed value for CSL is currently AUD355 per share using a 8.5% WACC and 4% terminal growth rate. However, if we assume a more aggressive return to pre COVID margins (above 58%), then we see material upside to this valuation.

Insight

We believe CSL has rebased expectations enough around the margin recovery story in the CSL Behring business unit. The market only assumes margins recover back to 58.5%, while the prospect of the new Rika device (increasing both speed of plasma extraction and the yield upon fractionation), lower donor fees, normalisation of supply chains and manufacturing retooling suggests margins may well and truly exceed pre COVID levels. We also believe the market is underestimating the long term growth rates achievable in the Seqirus business, and the margin optimisation story given capacity utilisation and ongoing R&D well above peers for vaccine delivery. Given the derating witnessed over the past 3 years (much of it around Vifor which accounts for 8% of EBIT), and the relative confidence in the earnings trajectory going forward, CSL appears to have a far stronger 3-4 years ahead of it.

CSL has suffered a significant derating over the past 3 years

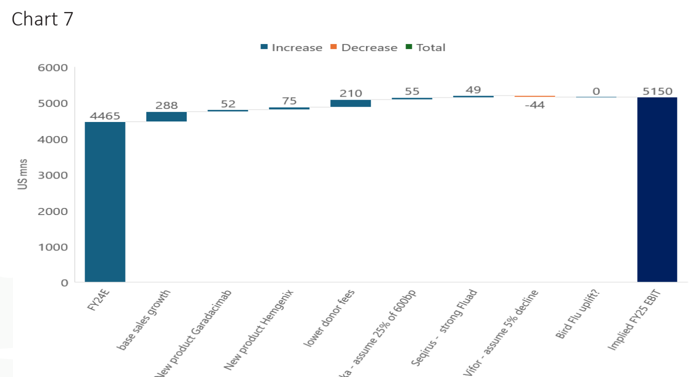
Chart 6



Source: EAP research

CSL EBIT forecast to grow 15% in FY25 with a margin recovery story

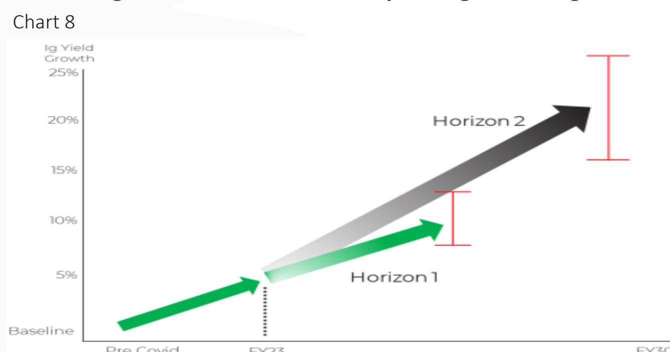
Chart 7



Source: Jefferies research, Chester Asset Management

CSL Behring Yield maximisation the key to long term margins

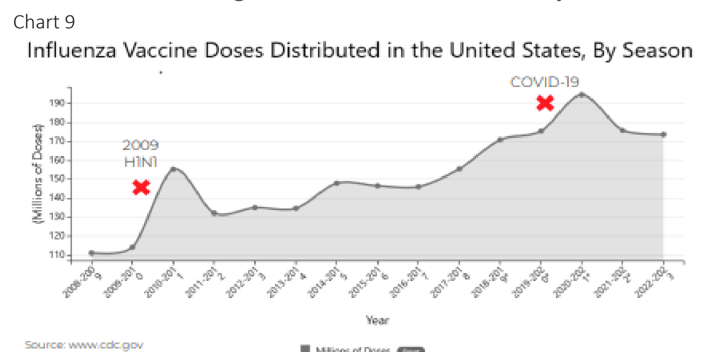
Chart 8



Source: CSL Capital Markets Day, October 2023

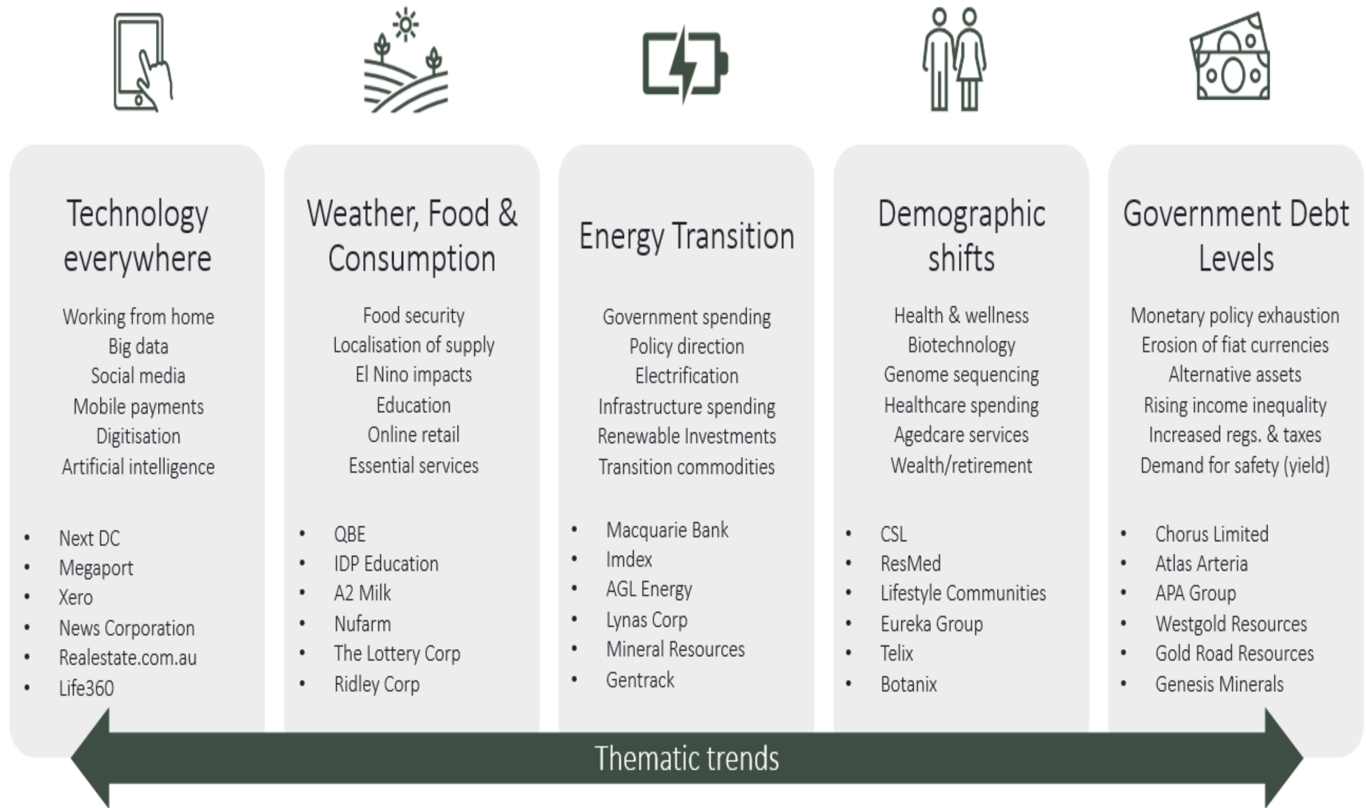
Vaccines sales have grown at 4.5% CAGR over 13 years

Chart 9



Source: CSL Capital Markets Day, October 2023

The Megatrend Framework



Source: Chester Asset Management

We have used this template for more than 10 years (with a few tweaks), simply as a way of formulating a framework for how we start filtering down the investible universe into stocks that we ultimately focus on - our watchlist. There are many varied forces at play globally and assessing them all takes a considered approach, where we have aggregated these broad topics into one of five "megatrends".

Of course there is a large amount of overlap between different megatrends, particularly when assessing the population growth of the world and the demographic shifts (formerly aging population) thematic, and then assessing technological changes and how that affects consumption habits.

The one megatrend we have changed over the past 7 years is the trend towards the energy transition (or de-carbonisation). We do believe the capital being allocated towards a carbon neutral society is going to change the investment thesis for many sectors and having exposure to this trend is going to be a powerful driver of returns over the next 3-5 years. The sheer will of policymakers and the capital being allocated towards this cannot be ignored. Nor can the magnitude of actually extracting the raw materials out of the ground to fulfill the demand side of this trend.

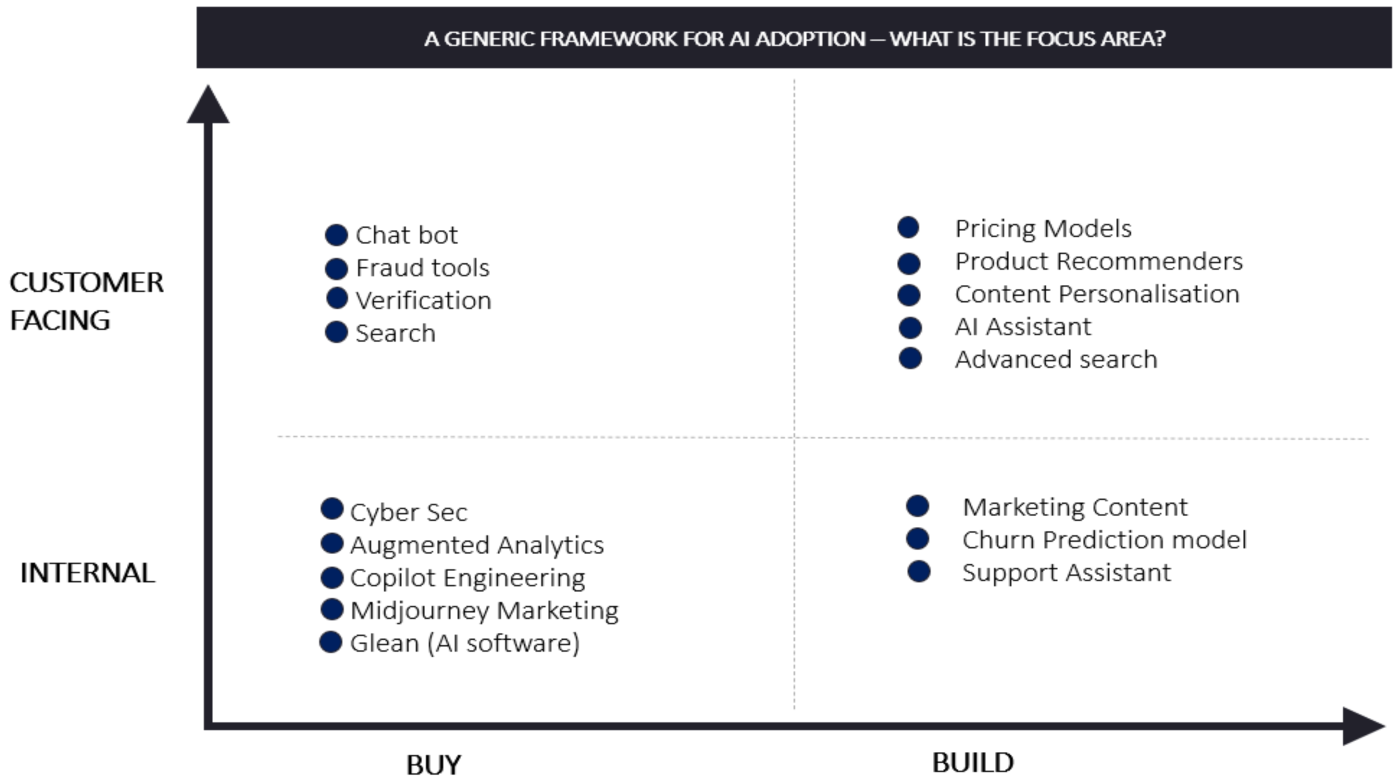
What we are ultimately trying to do is identify a subset of stocks that have "tailwinds" behind them. We define tailwinds as stronger than GDP growth rates over the foreseeable future. This is not always easy when every asset class is faced with the amount of government and central bank intervention as has been the case over the past 12 years. It has certainly changed the way markets operate, all of which is out of our control. What we can control however, are the individual investments we allocate capital to in our portfolio, albeit being mindful of how much we are being asked to pay for that investment.

Whilst far from perfect, this is one of the frameworks we use to develop our watchlist. Our watchlist is a subset of the ASX300 that we then spend more time understanding in greater depth. Our watchlist ends up being around 50-60 stocks, not already in our portfolio (25-40 stocks).

Then, to how we narrow the focus on sectors, let's use an example. i.e. government debt levels appears to be a structural trend that will play out over a number of years, particularly as no western central bank (or Chinese for that matter) appears to have any motivation to run budget surpluses. The build up of deficit spending and debt levels is truly the most overriding influence of our generation, as is how to tackle it. Ultimately we see only fiat currency debasement (ongoing printing of currencies) to finance this deficit spending, which forces more debt on to central bank balance sheets. While in the short term interest rates remain on a hawkish setting, it appears unavoidable that over the longer run, interest rates have to be structurally lower to reduce the interest burden to society. The search for reliable yield and alternative assets (gold) has been a strong ballast in our portfolio for almost 10 years. From a reliable yield perspective, CNU, APA, AZJ or ALX sit on the watchlist or in the portfolio, while in the gold space, OGC, GMD, GOR, NST, EVN, NEM, WGX and SPR are either in the watchlist, or the portfolio. Once the sector has been narrowed, we then filter through the individual stocks and focus heavily on the idiosyncratic (stock specific) risk of each company. This means assessing the operational risk (earnings sensitivity and volatility, working capital concerns etc), the financial risk (balance sheet risk and debt profile) and the corporate governance risk (board structure, remuneration policy, OH&S issues or reputational risk). This is how we evaluate each company. Combining this assessment with our internal valuation then helps us identify which (if any) of the stocks we would like to own. In this scenario, it is very much a competition for capital between stocks that offer a compelling risk reward outcome, combined with any particular insights we may have that gives rise to the highest conviction ideas.

AI ADOPTION - CONSIDERING OPPORTUNITIES FOR EACH COMPANY

Chart 11



Source: Chester Asset Management, SN consulting

We are absolutely of the view that using AI software will (already is) change the way certain industries work, and the nature of workflow for many workers. Creative design agencies have already been significantly disrupted, as will many business processing activities. We are spending a lot of time trying to understand individual organisational capability to both transform their businesses and display the requisite internal capability to drive outcomes, which for the average investor, means productivity gains leading to top line growth or margin expansion.

Chart 11 above highlights a conceptual framework for how to think about this for any organisation. If AI is transformational, does the organisation decide to buy existing software (hence is a commodity that everyone else has access to, so is there a competitive advantage?), or do they try to develop software internally (and potentially burn a lot of capital in developing this software that may be superseded quickly by the rapidly evolving technology from the largest players).

The other question really becomes is it for internal use (improving the productivity of internal systems, business processing- i.e. insurance claims, or mortgage applications etc), or external use (growing customer engagement through targeted advertising or retention initiatives).

The other important distinction with this framework is whether the software uses predictive AI (making decisions with statistical modeling or previous customer behaviour), or is it generative AI, which creates content (such as the growing list of companies with the ability to generate virtual images). Generative AI is evolving exceptionally quickly, which is the real reason for the enormous investment in data centres given the data intensive nature of large language models.

Strategically, every company needs to work out where they want to play. It may be at a simplistic level with customer support (chat bots handling initial customer queries, or real time assistance including online tutorials). Most companies will focus on automating routine data entry, which is where much of the labour productivity gains will come from. In reality most customer facing companies already operate at this level and have done for some time. The more sophisticated companies will start using predictive analytics, using generative AI to forecast financial trends or likely marketing success rates. Customer satisfaction will increase with further process automation (populate forms for easier application processes- something the financial industry is in desperate need of!). Retention strategies including automated approvals, reminders and follow-ups are the next version of generative AI. The most advanced companies will utilise AI for deep analysis and creating custom workflows or solutions for individual business or customer needs. The extremely integrated AI practices will continue to optimise business practices as a positive feedback loop.

So what does all this mean? From our perspective, most corporates are focused on how to upskill their workforce and build the organisational capabilities with AI specialists. Given how quickly this space is evolving, we are having an internal debate about how large organisations with embedded business practices and cultures can ultimately compete with smaller, more nimble entrepreneurial cultures that can pivot quickly. Large addressable markets are the obvious holy grail for software companies and we are witnessing the enormous investment into data centres and chips (Nvidia) from those companies desperate to be the first movers and own the space.

On the following page, we explore where we believe the market sentiment is for the AI narrative. Needless to say, the overwhelming enthusiasm for new technologies has been consistent with other new transformations (the internet boom). Not to say it isn't real, but the momentum looks overdone to us.

AI ADOPTION

We are not anti AI. We have spent a significant amount of time considering the ramifications of this thematic. To our detriment. As per chart 12, the technology trigger occurred in November 2022 when Open AI released ChatGPT for the first time. The first half of 2023 was really the best time to be invested, which we admit we were too slow to react to. But markets are psychological animals. We believe we are at the peak of inflated expectations, but really that is just an instinct on sentiment more than anything. We just have not seen one article yet suggesting the hype is overblown or there has been such an enormous investment in hyperscalers (Microsoft, Amazon, Google) that potentially there may be a misallocation of capital.

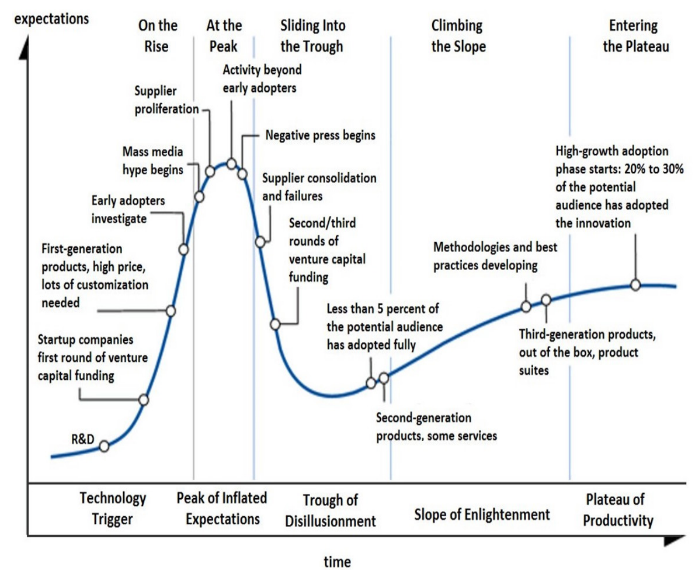
We did suggest that when Jensen Huang (Nvidia CEO) was signing the chest of female fans after a presentation, the signs of exuberance are there. We would be far happier to allocate capital to the space once we see "the trough of disillusionment" This sentiment cycle of new technologies is not dissimilar to the mining "Lassonde curve", whereby enormous excitement is generated by a new discovery (in any commodity) which reaches fever pitch with new drilling results and proof that the resource is real. Mining companies then typically spend 4-5 years studying the resource and reaching FID (final investment decision), before then raising capital to build the plant, commission it, only to reach the prospect of generating cash flows after between 5-15 years (depending on the commodity and geographic location). The key is knowing when to sell after the initial hype.

Chart 13 highlights that the real winners thus far have been Nvidia and to a far lesser extent, the infrastructure providers (which includes the hyperscalers). There is no doubting the eps momentum behind this investment theme. The rest of the market (those companies that generate software sales, or will benefit from enhanced productivity- which is where we have been spending much of our energy) are yet to show any meaningful returns from this AI narrative. Arguably the electricity generators (AGL and ORG) have been a better second derivative on the AI thematic than many companies that will over the long-term, enhance the economic moat of their business model through customer engagement activities.

This thesis can't be proven, but we are wondering (given such an enormous prize for first mover advantages), whether the sheer acceleration of Nvidia revenues (and Microsoft and Google) is not a cyclical allocation of capital (a large investment phase), that then, at some point normalises as perhaps under a Trump regime, AI has more scrutiny on it and there is a period of indigestion for the thematic. We are watching with interest.

The cycle of sentiment

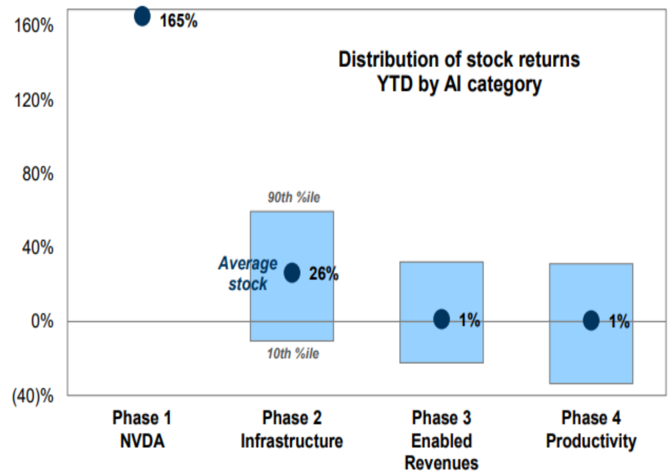
Chart 12



Source: X

Performance of subsectors in the "AI" trade

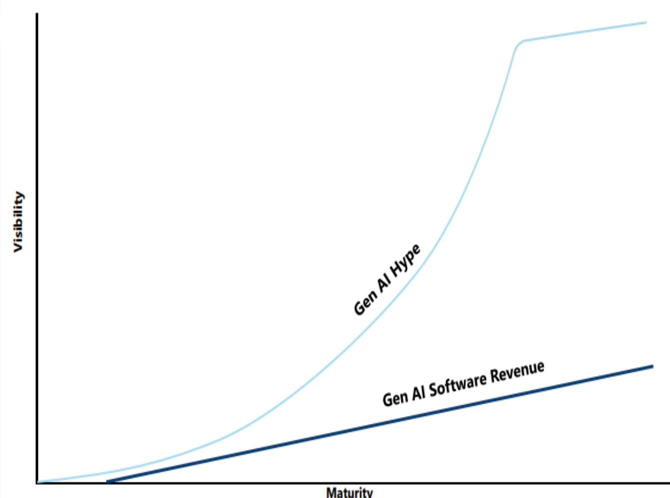
Chart 13



Source: Goldman Sachs

Are we at peak hype yet?

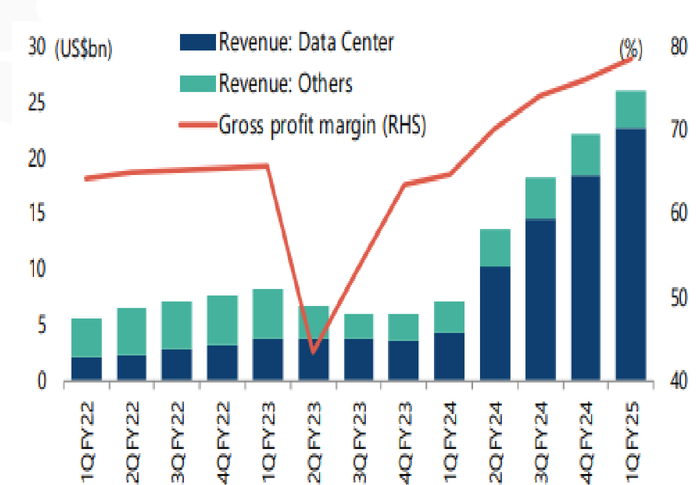
Chart 14



Source: Jefferies research

Nvidia sales and gross margins - structural or cyclical?

Chart 15



Source: Jefferies research

Sustainable Aviation Fuel (SAF)

One theme that's been occupying our thoughts lately, is the role that Sustainable Aviation Fuel (SAF) will play in an energy transition future, given aviation's outsized impact on carbon emissions.

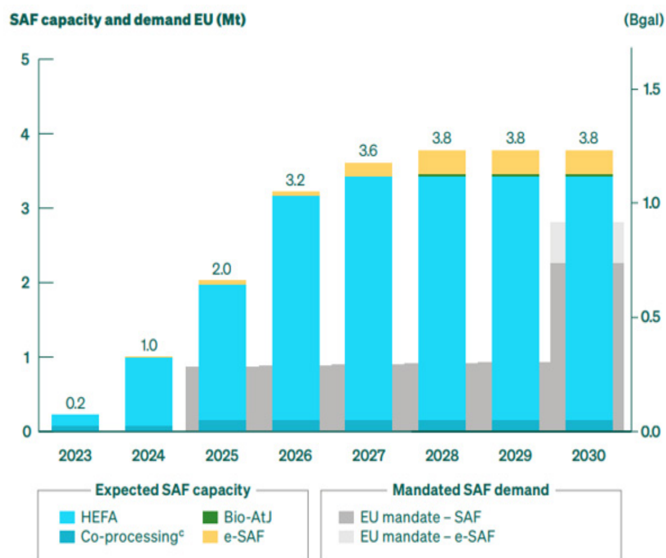
Governments globally are introducing means to reduce emissions to net zero by 2050, as called for by the Paris Agreement. While this issue will likely take longer than expected to play out, it's become clear that SAF usage will rise exponentially over the coming decades.

The benefits of SAF stem from its production from sustainable feedstocks such as waste products (i.e., used cooking oil) and purpose-grown biomass crops, such as Nufarm's (NUF) Carinata crop. While the effectiveness of SAF is comparable to that of hydrocarbon-based aviation fuels, the former produces up to 80% less carbon emissions over its life-cycle – hence recognition that SAF is a key tool to reduce aviation's contribution to CO2 emissions. This recognition has led governments to develop mandates supporting the production and use of SAF. Chart 16 illustrates the EU's 'ReFuelEU' legislation for EU producers to supply a 2% blend of SAF to EU airports, increasing to 6% in 2030. Similarly, the UK has set policy to achieve at least 10% SAF in the UK aviation fuel mix by 2030 and the US has set policy to reach 5% by 2030, with the other nations following suit.

Longer term, the tailwinds behind SAF usage are quite astounding. Chart 17 shows projected global SAF supply and demand from 2030 to 2050. Mandated usage of SAF is set to continue with an estimated 23% of the UK aviation fuel mix coming from SAF by 2040, with the US ultimately reaching 63% SAF use by 2050. Perhaps what's even more astounding, is the projected supply deficit seen in Chart 17 and it appears that SAF usage towards 2050 is capacity constrained. What we then question, is how will the aviation supply chain meet demand? The solution is twofold. Firstly, a significant increase in capex is needed. Between 500 to 800 SAF facilities are required to meet the 250 Mt SAF production target and assuming USD 2 billion per facility, this is a cumulative investment of more than 1 trillion USD – not insignificant, but still well below projected oil and gas capex to 2050. Secondly, a material step-up in reliable feedstock is needed. Chart 19 shows the potential global feedstock availability for all end use sectors to 2050, or essentially a picture of where supply is projected to emanate. While it's clear more than one feedstock stream is necessary, a supply response will likely be driven by growth in biomass. We highlight the potential growth of Carinata (seen in chart 18), NUF's IP protected seed product and a key SAF feedstock. Given exposure to SAF thematic, there is a tailwind behind NUF's seeds business.

Mandated use of SAFs ratchets up from 2030

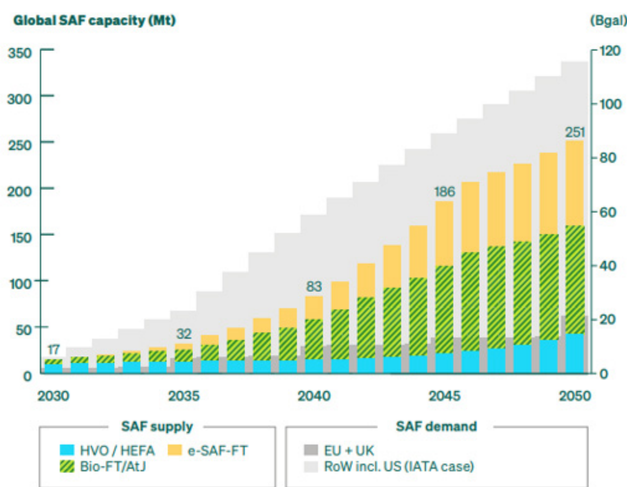
Chart 16



Source: SkyNRG

Demand materially higher than supply from 2030

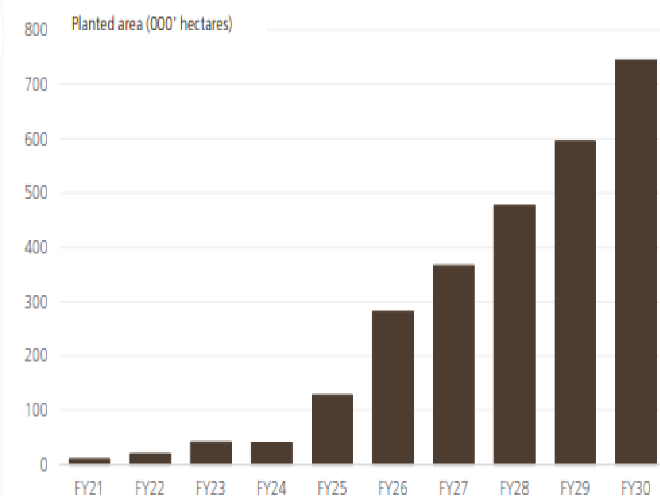
Chart 17



Source: Sprott webcast Uranium and Copper, March 2024

Carinata's value proposition driving 50% CAGR planted area

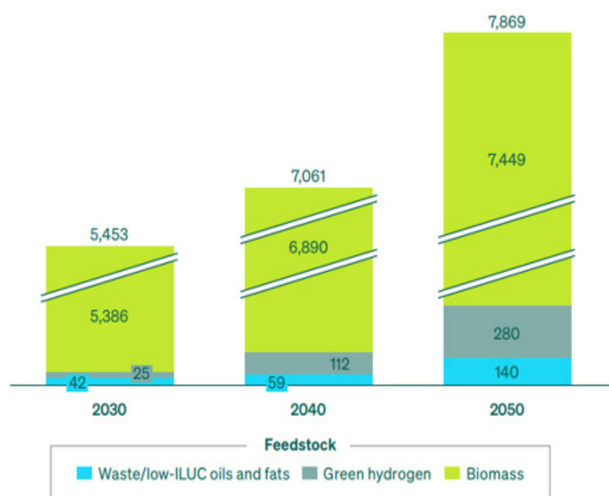
Chart 18



Source: UBS research

The SAF response will be driven by growth in biomass

Chart 19



Source: SkyNRG

Debt Monetisation

We continue to highlight this issue, as we think it is the most challenging aspect to investing over the next decade. Note this was published in our April quarterly, but it remains as relevant as ever.

We thought we would revisit this given the logic provided by Jared Dillian in a recent thread on X, which articulated the thesis for deficit spending and ultimately gold in a far more succinct manner than we ever could. The italics are from his post.

Gold has been called lots of things, like an inflation hedge. It is an imperfect inflation hedge, at best.

It has been called a store of value, a disaster hedge--it has been called all sorts of things. What it really is, is protection against debt monetization

Debt monetization is when the government runs out-of-control deficits, interest rates skyrocket, and the central bank is asked to cap interest rates in response. Rates are capped by the CB being willing to buy all available bonds at a given price.

With printed money, of course. The money supply explodes, inflation skyrockets, and investors flock to hard assets, like gold, but also pretty much all commodities.

A government bond is a claim. It is a claim on some asset, and that asset is the productive abilities of all the citizens in the country. When the supply of claims exceeds the supply of assets, the result is inflation. This is the main reason gold is rallying right now--interest expense is spiraling out of control, and if interest rates tick up 1 or 2% higher, we will be in fiscal checkmate. The only path forward will be debt monetization So anything that increases the probability that we will monetize makes gold go up, and anything that decreases the probability that we will monetize makes gold go down.

You're probably noticed that rates and gold are now positively correlated. Why? Because when interest rates go higher, it actually increases the probability of monetization. In a normal environment, high rates are bad for gold because gold yields nothing in comparison. Now, high rates are actually good for gold. Gold responds to a number of different economic variables, but the one that it has the highest correlation to is budget deficits. When deficits are large (like 2009-2011), gold goes up. When deficits are small (like 2011-2016), gold goes down.

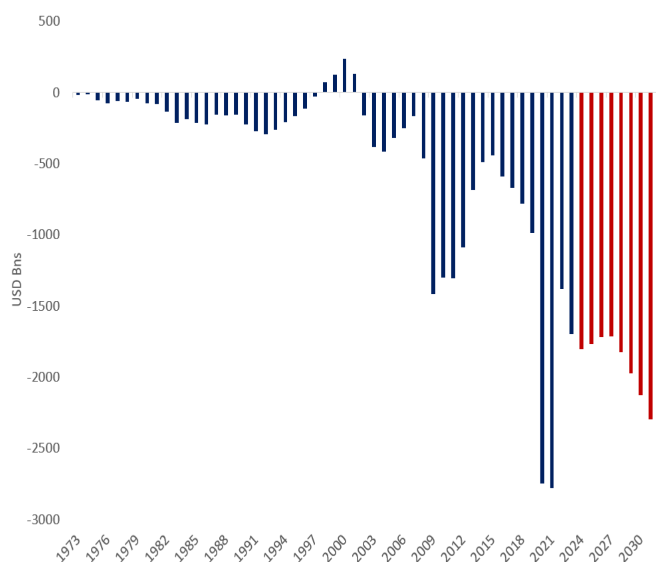
The one thing we know about the 2024 election is that no matter who gets elected, the deficit is likely to get even larger. Outside of some big disinflationary impulse, we are likely to get much higher rates. There is historical precedent for that, too. The Fed pegged the yield curve during WWII, and after it lifted the peg, inflation went to high double digits. Gold was not freely floating at the time. I have always thought debt monetization was possible since we started QE in 2008. And it's worth talking about QE. How is QE different from monetization?

With QE, you set aside a finite amount of money to buy bonds. With monetization, you set aside an infinite amount. We've been inching closer to this for the last 16 years. Things always take longer than you think in finance, but I wouldn't be surprised if we're doing full-blown monetization in 2024-2028. That is the endgame.

In this scenario, the Fed Reserve will most likely be the buyer of last resort, or be forced to enact YCC (yield curve control) like the Japanese. Both of which will be bullish for equities, but more so gold and hard assets. We believe this thesis has been the most influential factor in the gold, copper and oil price action over the past 4 weeks.

US deficit spending expected to accelerate

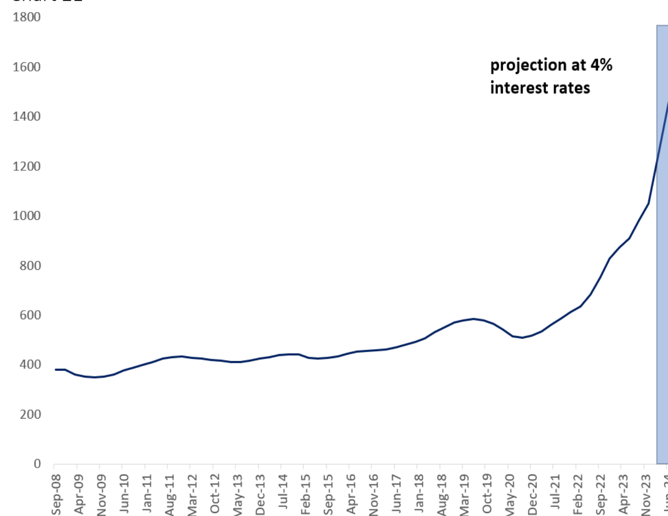
Chart 20



Source: Chester Asset Management, CBO

Meaning the US interest expense is exploding

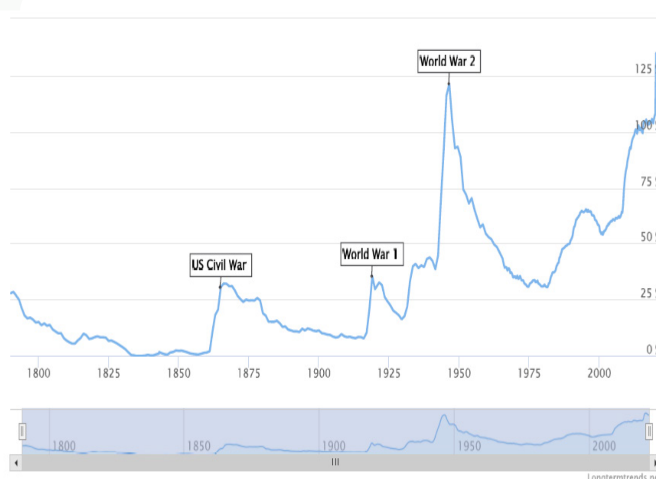
Chart 21



Source: Bloomberg, Chester Asset Management

US Debt to GDP over 200 years - at record highs

Chart 22



Source: longtermtrends.net

Demographic shifts

This is essentially an extract of a piece Anthony Kavanagh wrote recently and published on Livewire https://www.livewiremarkets.com/wires/a-different-kind-of-trend

Ultimately we are believers in the notion that population growth provides a strong framework for economic growth (infrastructure spend, housing formation, employment opportunities), which ties into the core tenet of human existence. Hope. Optimism about your own economic prospects. This may be a more philosophical way of thinking than we have room for here. In 2024 we are experiencing globally the frustrations of western societies being crowded out by mass migration.

With fertility rates declining rapidly over the past 50 years across the globe, immigration trends have sought to boost economic data in certain regions, while others (China and Japan) have far more rigid migration laws. This creates significant working age dependency challenges over the coming years (the ratio of those in the workforce, i.e. tax payers relative to those retired, i.e. non tax payers). Most governments enact policies to enhance workforce participation (part-time, casual or flexible work arrangements) given how relevant it is for the tax base.

The Livewire piece goes to a significant level of detail around the sector ramifications of Australian listed equities which have exposure to these demographic trends, whether it be China, India or Australia itself. An ageing population obviously ties into the health care sector and increasing demand for medical needs, whether it be surgery, medical devices, pharmaceuticals or diagnostic imaging. Retirement living ties into this framework as well.

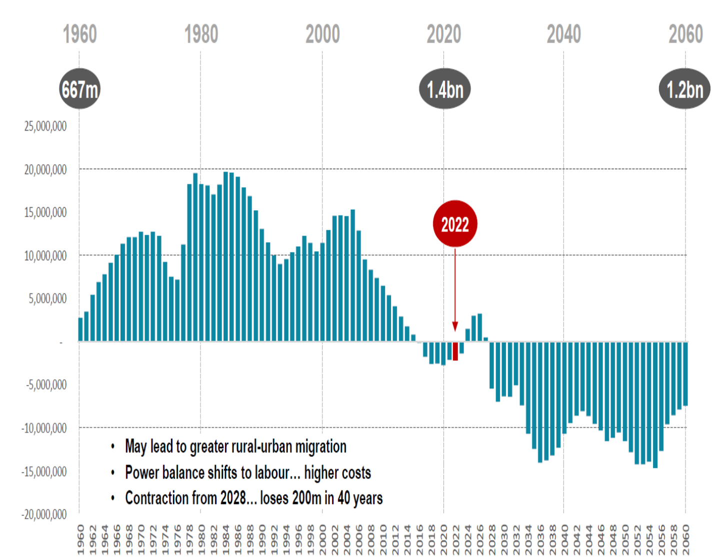
Our primary concern with the ageing population in China is the declining demand for property and hence steel and iron ore, Notably though as the economy transitions from manufacturing based to service oriented it might put further pressure on steel demand and demand for some other raw materials might stabilise or decline. We continue to note though the Government's emphasis on decarbonisation and the strong adoption rates of electric vehicles in China leaves us positively predisposed to copper, aluminium, rare earths and lithium (but are conscious of supply dynamics).

India's growing population and expanding economy should continue to drive up energy demand. Demand will be met through a mix of traditional fossil fuels and increasing investments in renewable energy sources.

Coal demand in particular stands as an ongoing beneficiary of Indian demographics.

China's population on an irreversible trajectory

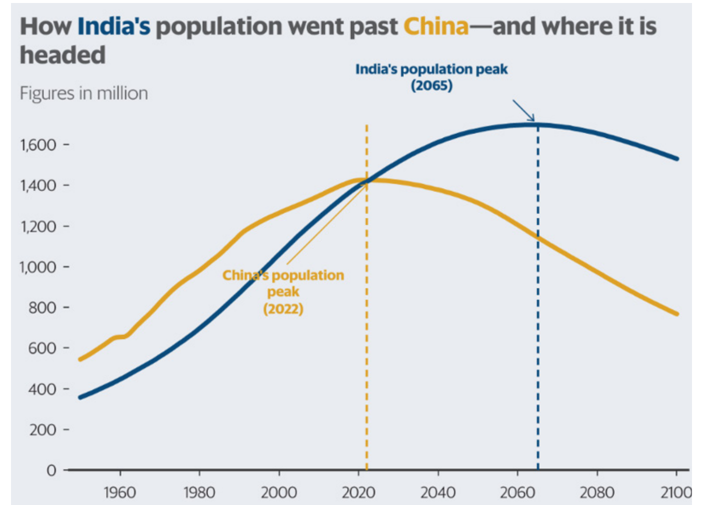
Chart 23



Source: Bernard Salt, UN World Population Prospects 2022

India has far stronger demographic tailwinds

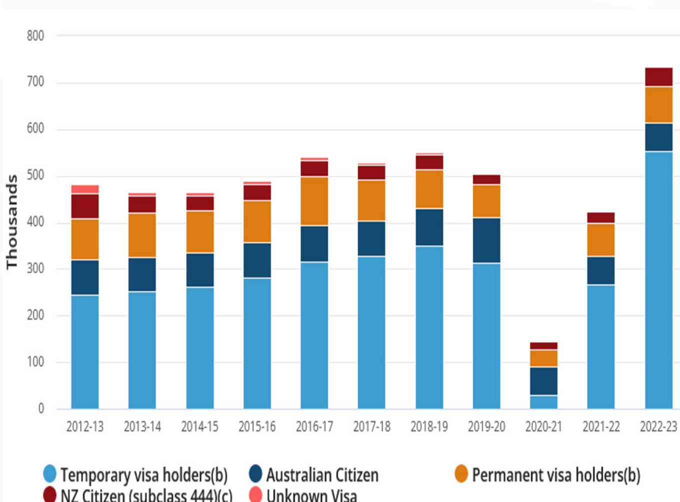
Chart 24



Source: mint, State of World Population Report 2023

International immigration has offset our decline in birth rates

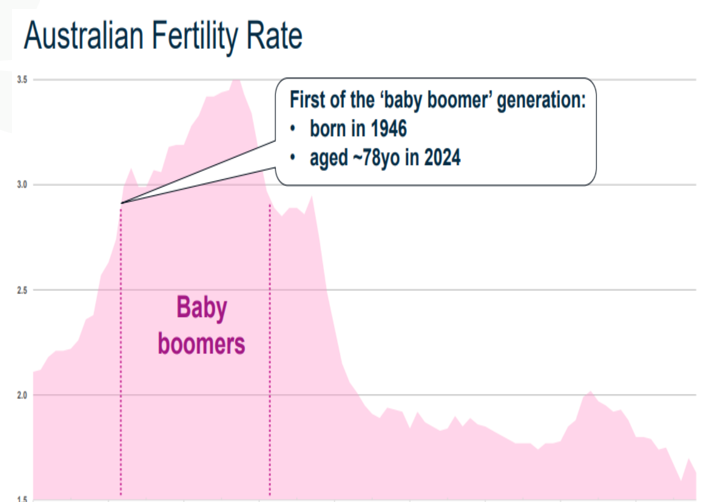
Chart 25



Source: ABS

Like other OECD countries, our birth rate has declined for 50 years

Chart 26



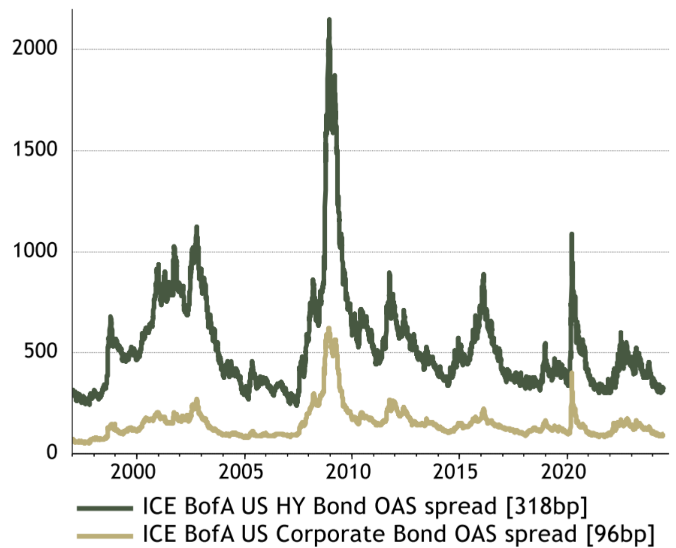
Source: Propel Funerals presentation, May 2024

USA

One of the reasons we became concerned around inflation in 2021 was the real time rental increases, shown as the BLS Cleveland Fed New Tenant Repeat Rent in chart 28 below, which lead the statistical measure of house price inflation (called Owners Equivalent Rent) included in the CPI basket as shown. This measure is roughly 24% of the CPI basket, which is why it's so widely watched. Chart 28 below illustrates why the CPI measure is likely to continue lower over the coming months. We are already seeing goods deflation (chart 29). This, in our view, gives the Fed ample room to cut rates, noting the forward curve still has 7 rate cuts forecast. This cycle now extends out to 2028. We won't enter that debate, but suffice to say, the below chart is reason for the positive sentiment towards the rate cutting cycle in the US. We note the lack of any stress in the credit markets currently (chart 27). Chart 31 is instructive. Many people (including ourselves) have been surprised at the resilience of the US economy in spite of the rapid interest rate increases since 2021. The explanation being that most home owners took advantage of historically low rates in 2020 and locked in fixed rates then. Logic suggests then that unless interest rates go back below the 2020 lows, home owners will have little incentive to refinance their mortgages, hence a rate cut cycle may not have the stimulatory effect that prior cycles have had.

Credit spreads showing no signs of distress

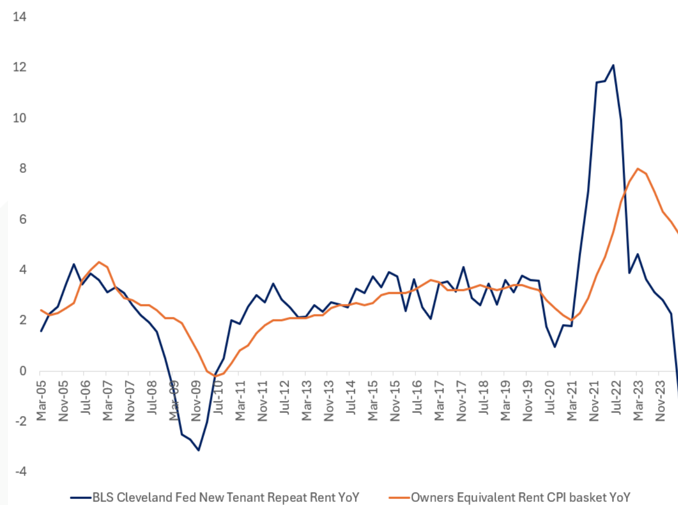
Chart 27



Source: ASR research

Owners Equivalent Rent (OER) lagging real time rent

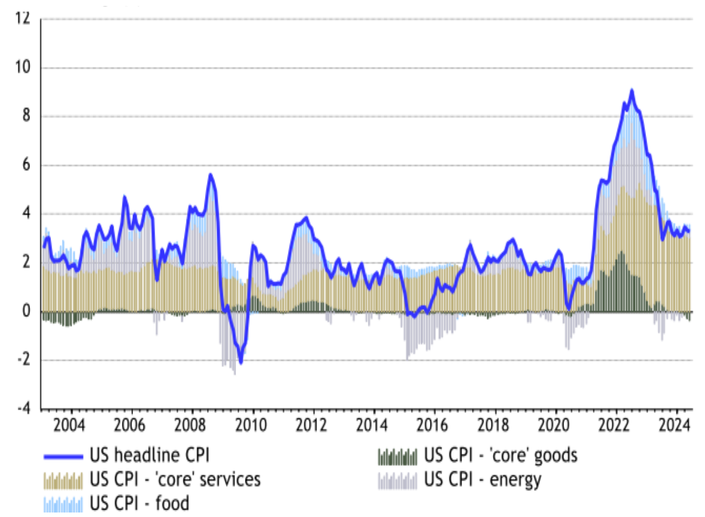
Chart 28



Source: ASR research

Service inflation far more worrying than goods deflation

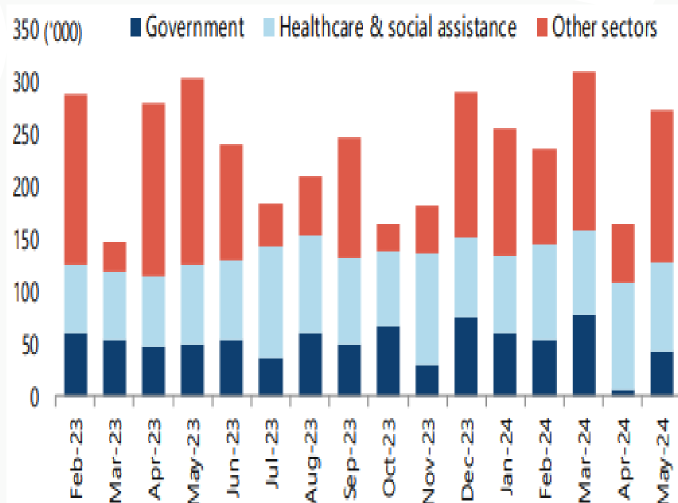
Chart 29



Source: ASR research

60% of jobs in past year have been government or healthcare

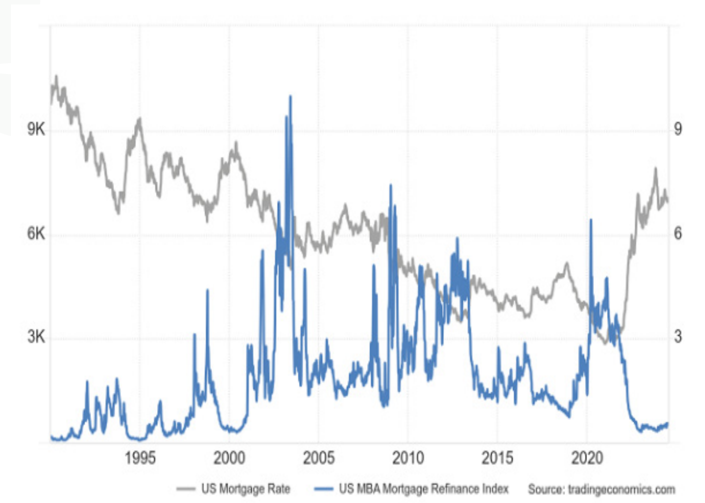
Chart 30



Source: Jefferies research

Interest rates have to fall materially to inspire refinancing activity

Chart 31



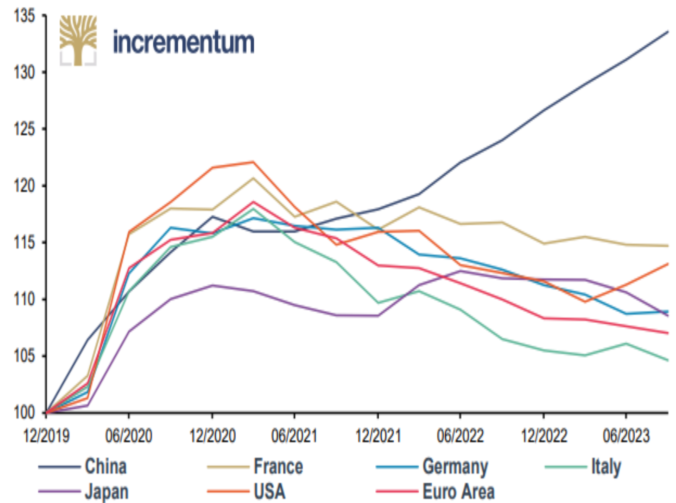
Source: Lyn Alden

China

In the global race for the biggest deficit spending, China retains its yellow jersey. Given anaemic domestic consumption and overcapacity, there seems little evidence yet to suggest China can break its reliance on the manufacturing sector for any economic growth. There has been a significant amount of focus in 2024 on China as an exporter. Chart 35 illustrates how reliant the rest of the world is on China for the energy transition investment. This is something the US is very focused on changing, starting with semi conductors. Under a Trump administration, this only gets worse. Of course given how poorly the domestic market has been performing led by the property market (chart 34), China has had no option but to provide goods for the rest of the world. The biggest domestic problem in China (unlike Australia or the US) is the household savings rate is 45% of income (in Australia it is 3%). So for China to re-accelerate the economy, it has to be led by domestic consumption, which is an argument we have been using for 5 years, and it hasn't changed yet. The biggest threat from China over the next few months is if they devalue the RMB, to ensure their manufacturing sector remains a world leader from a cost perspective (the Japanese Yen has depreciated by 15% against the USD). Wonder why China has been the most aggressive buyer of gold in the past 2 years? Is it as a store of wealth against a currency debasement?

China is the most prolific user of debt

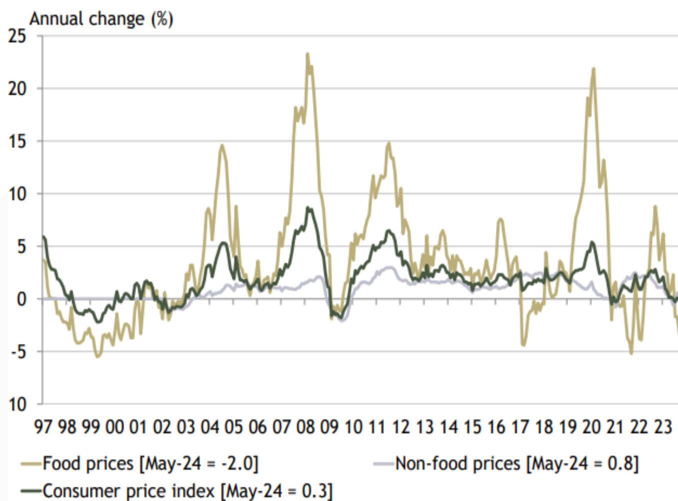
Chart 32



Source: Incrementum

China experiencing deflation on weak demand

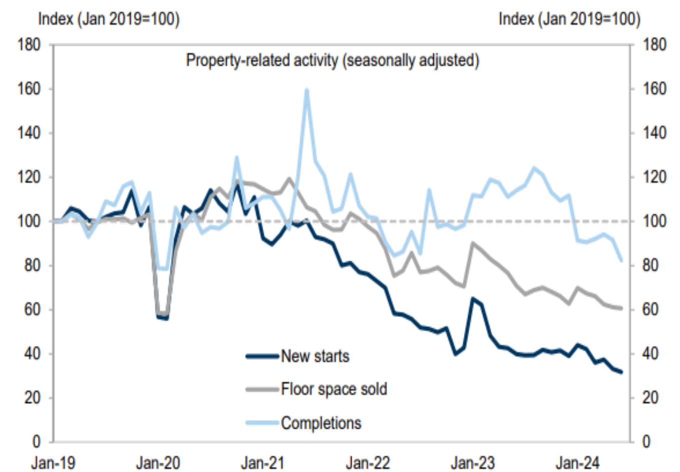
Chart 33



Source: ASR research

Chinese residential property is a massive issue

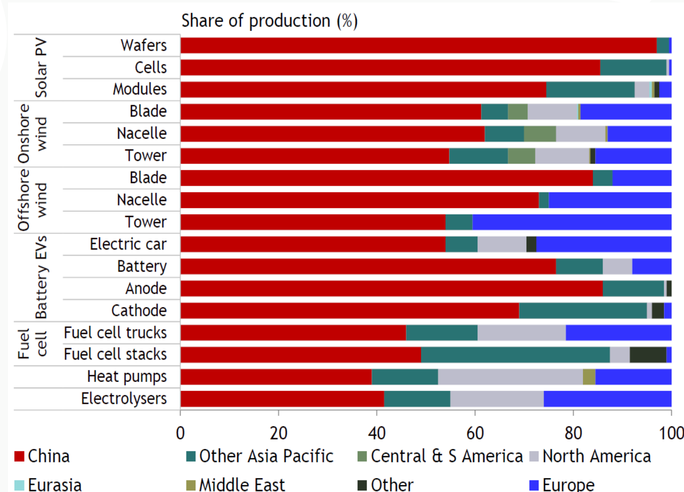
Chart 34



Source: Goldman Sachs

China remains the world's manufacturer in many cases

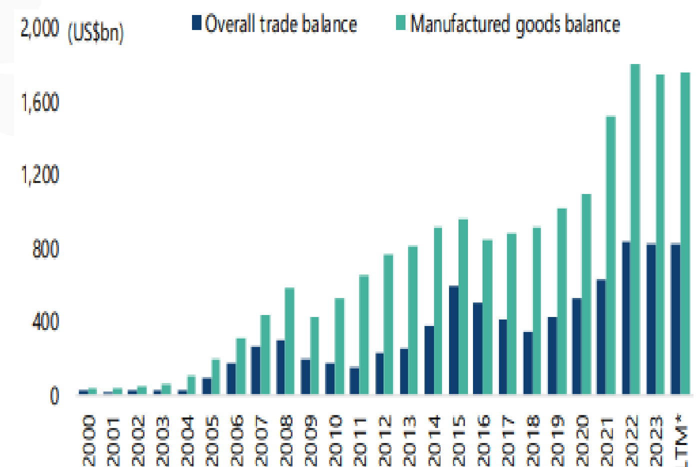
Chart 35



Source: ASR research

China still produces far more than they consume

Chart 36



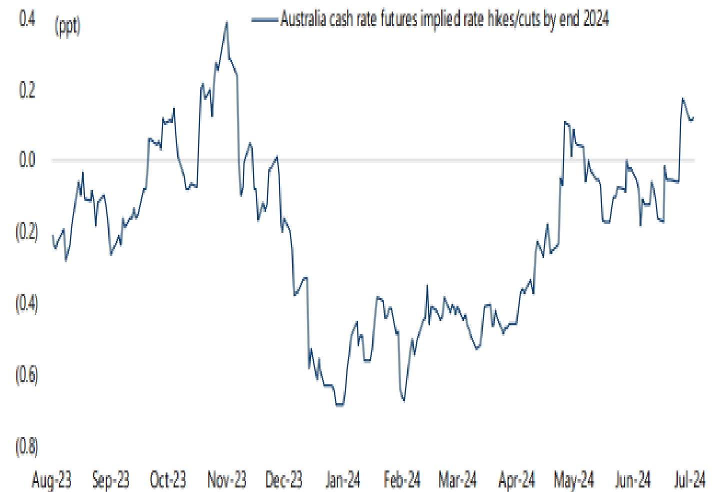
Source: Jefferies research

Australia

We have been surprised at the level of resilience in the economy given how quickly interest rates rose through 2022. For the foreseeable future, while households remain fully employed, house prices are at record highs and the equity market is at record highs, both ensuring the wealth effect on discretionary expenditure remains strong. 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. In fact, current expectations are for one further rate hike in Australia in 2024. We would need to see unemployment rise considerably (above 4%) and wage growth fall below 3% (in our humble opinion) to ensure 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 40 below, another rate hike would see 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. CBA is not priced for that. At all.

Futures are pricing in one rate hike currently

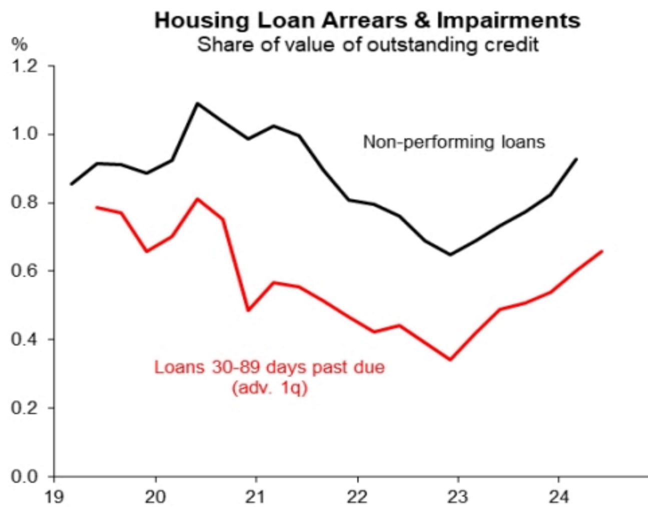
Chart 37



Source: JP Morgan

Unemployment stuck near generational lows

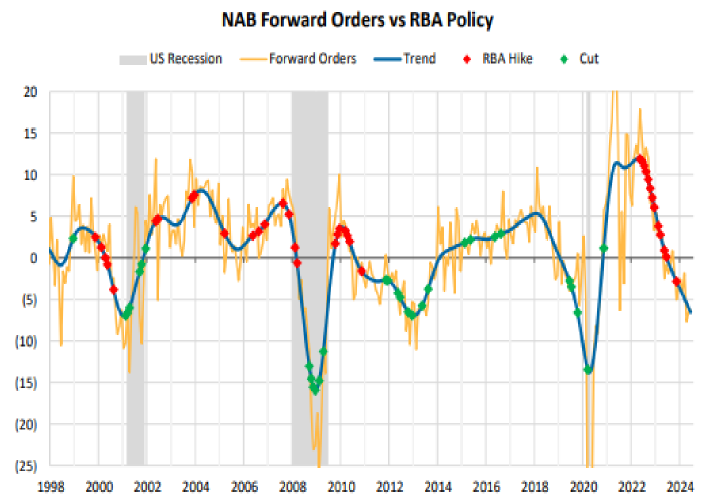
Chart 38



Source: Macquarie research

While new orders (businesses) are looking recessionary

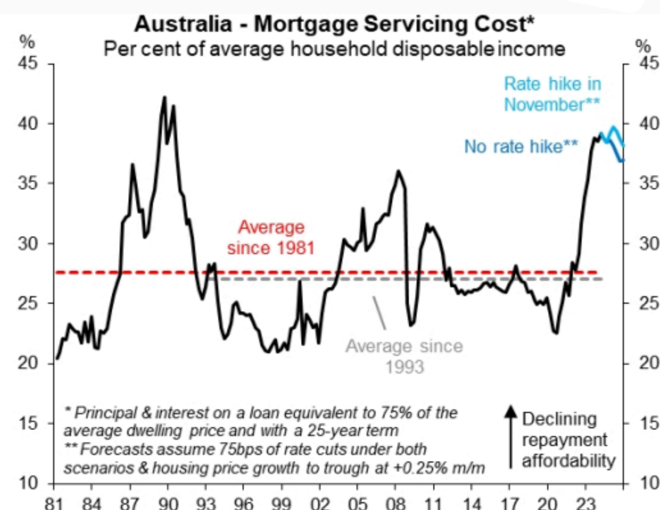
Chart 39



Source: Macquarie research

Another rate hike - 40% mortgage servicing cost?

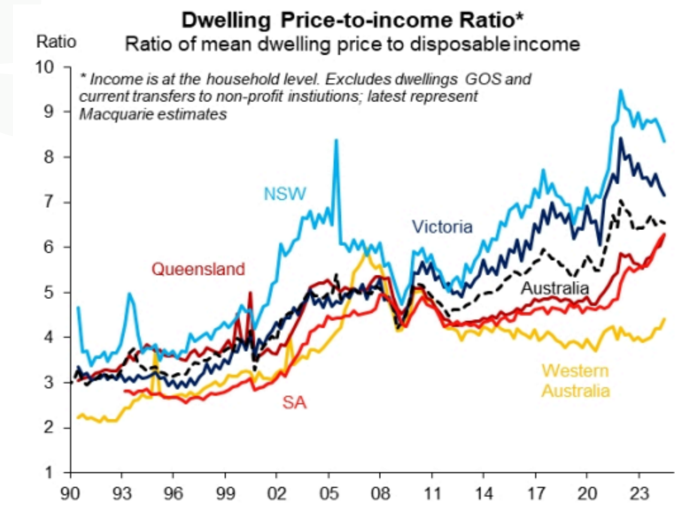
Chart 40



Source: Macquarie research

Move to Western Australia for appropriate house prices

Chart 41



Source: Macquarie research

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 were surprised at the strength in long duration equities in FY24, 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. Chart 42 suggests to us there will be a significant period of mean reversion to this 15 year trend, eventually.

Chart 44 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.

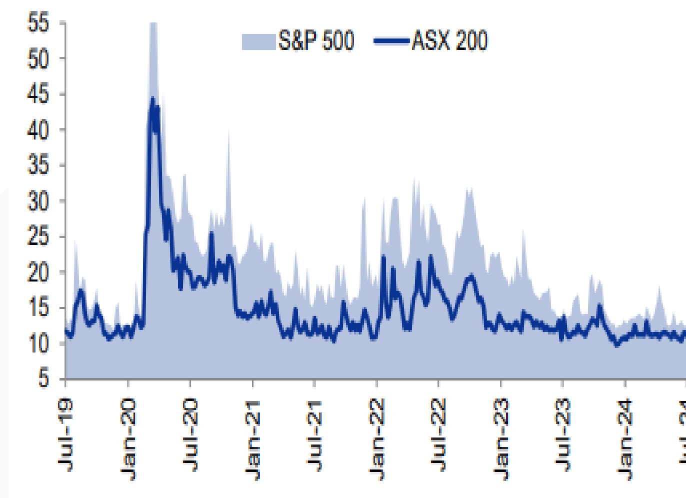
Nasdaq has seen heroic outperformance for 15 years

Chart 42

Source: Chester Asset Management

Implied volatility - eerily quiet

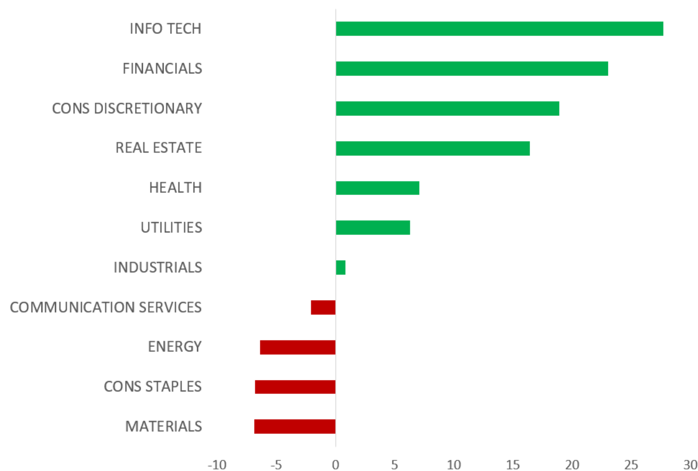
Chart 43



Source: Goldman Sachs

ASX300 returns over the past 12 months

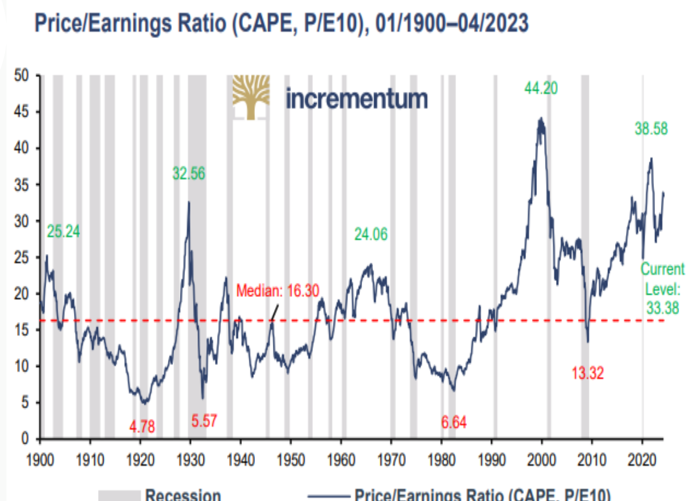
Chart 44



Source: Chester Asset Management, Bloomberg

Equities look expensive relative to history on a real eps basis

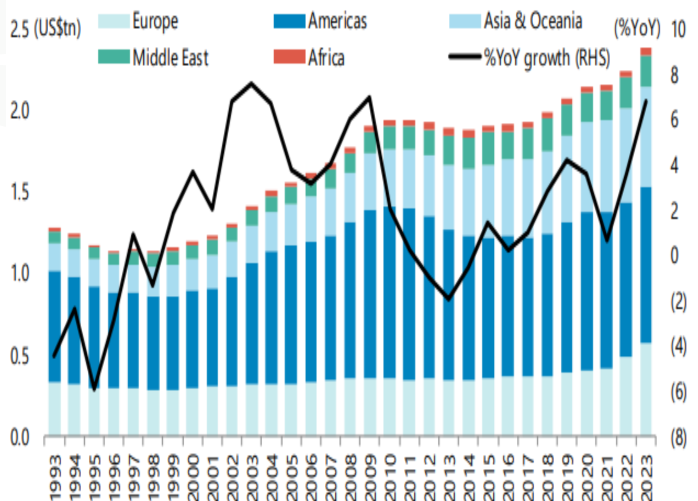
Chart 45



Source: Incrementum

Global military expenditure, appears to be accelerating

Chart 46



Source: Jefferies research

Executive summary

Equities

Markets are always forward looking. Hence while we have been on the cautious side of the fence over the past 12 months, the global equity market has enjoyed Goldilocks conditions, while keeping the rate cut cycle firmly on the horizon. Given US CPI has softened over the past 4 weeks, the first rate cut is now within touching distance, which has seen further risk seeking behaviour. 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 6 weeks, which may be the reason for the recent strength in gold, copper and oil, signaling structurally higher inflation ahead or ongoing deficit spending. 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 may well be needed if the current deflationary forces in China continue. We look to any currency devaluation as a sign of economic stress in China.

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 suggesting 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, NUF**
Pricing power - **CSL, RMD, NWS, TLC**
Gold - **WGX, OGC, 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

July 2024

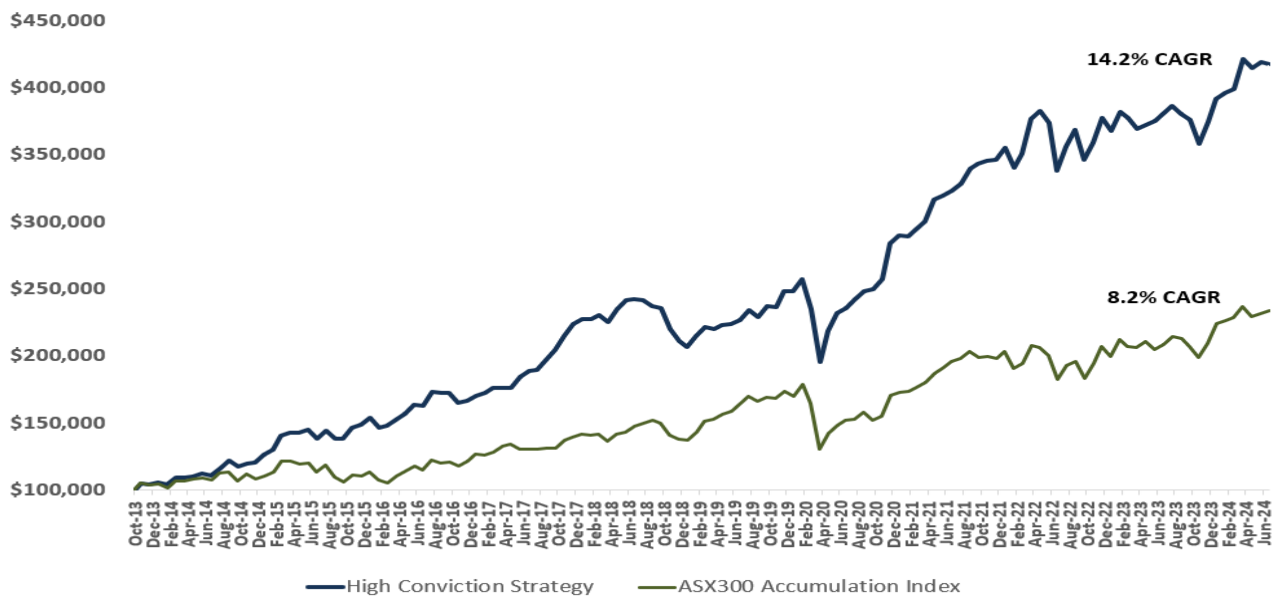
APIR OPS7755AU
ARSN OPS7755AU

Accumulated Performance by Financial Year - Same Strategy

	FY14 (%)#	FY15 (%)	FY16 (%)	FY17 (%)*	FY18 (%)	FY19 (%)	FY20 (%)	FY21 (%)	FY22 (%)	FY23 (%)	FY24 (%)	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	+14.2
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	+8.2
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	+6.0

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.

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