Chester High Conviction Fund

Fund Update

August 2024

APIR OPS7755AU
ARSN OPS7755AU

At 31 August 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)	-1.0	2.4	7.7	12.7	8.1	13.4	12.2
S&P/ASX 300 Accumulation Index	0.4	5.6	6.7	14.6	6.4	8.1	8.5
Outperformance (after all fees)	-1.4	-3.2	1.0	-1.9	+1.7	+5.3	+3.7

* 27 Apr 2017

"Markets can remain irrational longer than you can remain solvent"

John Manyard Keynes

Month in review

Having just sat through over 50 presentations or discussions with senior management teams in the past 4 weeks, it feels odd to comment on the underlying macro environment. The prevailing winds are strong, given the relentless outperformance of the bank sector. But for a small 3 day blip in early August when the carry trade in Japan was the focus, record highs continue every day in our largest sector. We back solve this for two reasons. Firstly, the Australian economy has been more resilient (lower unemployment) than previously forecast, meaning impairment charges are benign and secondly, as net interest margins have started stabilising, the bank earnings momentum is slightly better than feared (with eps upgrades of 2-3%). Combined with the extreme pessimism around China and any prospect of an economic recovery, this has seen a crowding effect of regional flows out of China and into Australian banks. CBA is currently trading on almost the same FY26 multiple as CSL (24x vs 26x FY26 PER), for a 2-3% eps growth rate vs a 12-13% eps growth rate, that we see as sustainable. Global banks trade at between 7x (HSBC) to 13x (JP Morgan), so CBA on 24x appears increasingly illogical to us. With impairment charges at or near historic lows. Go figure.

The extreme pessimism towards China has also hit sentiment towards the commodity sector (combined with a US slowdown), with energy and iron ore names all sold off aggressively. Lithium (spodumene) has now fallen 92% from the peak of USD8000/t to trade at USD740/t. Over the past 12 months to the end of August the ASX Banks index has risen 41%, while the Energy sector has fallen 20% and the Materials sector has fallen 8%.

Given we tend to think with a contrarian framework, the extreme sentiment positioning here has us wondering what the catalyst is for a style rotation to occur. It has been suggested to us that China will not embark on any stimulus package until they know who is in the White House for the next 4 years. The logic makes sense, given the polar opposite policy direction from the respective candidates, in a US Presidential race that looks too close to call. Commodities are prone to violent moves in either direction. It appears to us that the entire world is sitting on one side of the boat. It won't take much for renewed interest in the sector.

The August reporting season continued recent trends of extreme results day volatility, whereby the most obvious trend was for the strong PE rerating afforded to the results of highest perceived quality companies. We offer our other reporting season insights inside.

Portfolio review

During the month the fund returned -1.0% relative to the 0.4% rise in the ASX300. Outperformers for the month were led by AGL Energy with a result above market expectations, and confidence of momentum continuing into 2025, given ongoing concern around the reliability of electricity supply. Westgold Resources (WGX) remains our preferred gold exposure, after merging with Karora, the combined entity has a strong pipeline of growth projects, with the Beta Hunt asset appearing more exciting with extension drilling ongoing. Resmed (RMD) also had a strong August after a result that demonstrated gross margin expansion and CEO Mick Farrell convincing the market that actually, GLP-1s are good for OSA (Obstructive Sleep Apnea) awareness and therefore, RMD as the current standard of care for OSA, with a market leadership position that is only getting stronger.

Mineral Resources (MIN) is now a wildly polarising stock given the short interest has accelerated on the perceived balance sheet issue and weak lithium prices. We were fully supportive of the MIN strategy to spend AUD3.3bn in capex to bring the Onslow Iron Ore project on line. A low cost, 30 year mine life, that at US100/t iron ore pricing, will generate MIN over AUD1.0bn in EBITDA from the combined mining service operation and their 57% ownership of the iron ore tonnes. With a stable iron ore price (sentiment is obviously poor), MIN will be able to deleverage over the next 3 years before the first loan USD700m loan matures, which actually can be refinanced by MIN, any time over the next 3 years. MIN also has other levers to pull in lowering the gearing level, including selling the WA gas assets, or even reducing their stake in the Onslow JV from 57%, while retaining the mining service rights. Our valuation, excluding any value for lithium assets, is still over AUD70/share.

Austal (ASB) also underperformed in August. We realise this is a unique position, but with an AUD20bn order book and trading well below its own book value and global peers, we believe patience will be well rewarded, eventually.

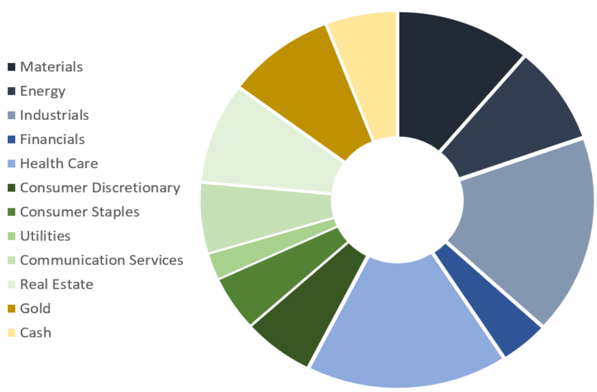
Top 3 holdings
CSL
Telstra
Develop Global

Portfolio breakdown	
Industrials	17.3%
Heath Care	16.8%
Materials ex gold	11.1%

Top 3 portfolio attribution
AGL Energy
Westgold Resources
Resmed

Bottom 3 portfolio attribution
Mineral Resources
Austal
Beach Energy

Fund weights - diverse sector exposure



BROAD REPORTING SEASON THOUGHTS

OBSERVATION	IMPACT
BANK SECTOR STRENGTH	It is the dominant prevailing market theme. Bank eps upgrades with low impairment charges has led to very strong PE reratings on the back of poor alternatives, both resources in Australia and Chinese stocks on a regional basis. Momentum is a powerful force.
PE EXPANSION FOR HIGH QUALITY NAMES	The valuation uplift not just from earnings, but from investors willing to accept higher valuations for the privilege of owing names such as WTC, PME, SEK, REA, CAR, CBA, WES, JBH has been an all pervasive theme during August. This PE expansion comes with the backdrop of a disinflationary environment. We ponder whether conditions will remain the same post the US election, whereby both candidates appear to have inflationary policies.
R&D SPEND EXPENSED OR CAPITALISED?	Wisetech (WTC) is undoubtedly a high quality stock, but had eps upgrades of 4% on the back of increasing their capitalised R&D spend by AUD61.7m, or a 46% increase in development costs that ended up on the balance sheet, not on the profit and loss statement (revenue grew 30% in FY24). For this accounting treatment, investors wiped on AUD10bn of value to WTC, such that it now trades on an FY25 PER of 103x. Yes, we understand earnings momentum. CSL on the other hand or Telix (TLX) expenses 100% of R&D spend on future products. Technology spend is more likely to be opex, while pharmaceutical development requires risk taking for phase II and III trials. One is conservative, the other one isn't.
INVESTMENT IN TECHNOLOGY	Every corporate is joining the race to be an AI leader. There is increasing evidence of real world practical applications. Productivity gains are highly sought after in Insurance, Financial Services, Retail, Telcos, Health Care and Industrials. The holy grail of cost out is still very early in its infancy. Are these productivity gains competed away? Arguably though the initial AI exuberance is fading (slowly).
CAPEX - GOOD OR BAD?	It depends on which sector you are allocating capital too. If it is data centres, then NXT can't spend enough and is rewarded with a price to book ratio of over 4x for the exposure. If it is an old world industrial- MIN, AZJ, KLS, WOW or EDV then it is less rewarded. For old world industrials, free cash flow generation is all that counts.
HOUSING MARKET UNDERBUILD	Construction activity remains subdued, with REH, GWA and RWC pointing to a weak period ahead, while Bunnings (WES) highlighted a softer start to DIY consumption. MGR also pointed to slower activity levels in FY25. The under supply of housing remains a key reason why rental pressures will persist in Australia, making inflation stickier than the US.
THE HEALTH CARE SYSTEM	The health care system is structurally challenged with health insurers remaining profitable (albeit claims have accelerated/normalised in the past 12 months) at the expense of hospitals which are suffering negative jaws from lower utilisation and higher costs. It becomes a delicate balance for the industry/government in terms of affordability and commercial viability.
THE DOMESTIC CYCLE	The domestic cycle appears bifurcated – certain categories have momentum JBH, SUL, BRG, TPW all reporting better than expect results. Travel names are struggling with airline price deflation. Trade (timber and hardware/Bunnings) is softer. Maybe JBH, SUL (Rebel) are thematic ways to play a staple (electronic devices) and active lifestyle (positive trends) although we make the observation that JBH NPAT in FY24 was AUD438m which is 20% below the COVID induced FY22 NPAT of AUD544m, even though the share price is up 100% since August 2022. Go figure.
OTHER OBSERVATIONS	The excellent CBA demographic chart in the FY24 presentation highlights the dispersion between baby boomers (wealthy retirees with no mortgages) and mortgage holders or millennial's. The gap between the asset rich and the borrowing class is only getting wider, which doesn't suggest the bank sector should be trading where it is.
CHINESE CARS ON SALE	Given the global tariffs being imposed on Chinese EV's (with Canada recently imposing a 100% tariff, similar to the US tariff), maybe we should expect to see Australia as dumping ground for cheap Chinese cars. We have no industry to protect and it would be a tailwind for QUB and potentially AZJ.

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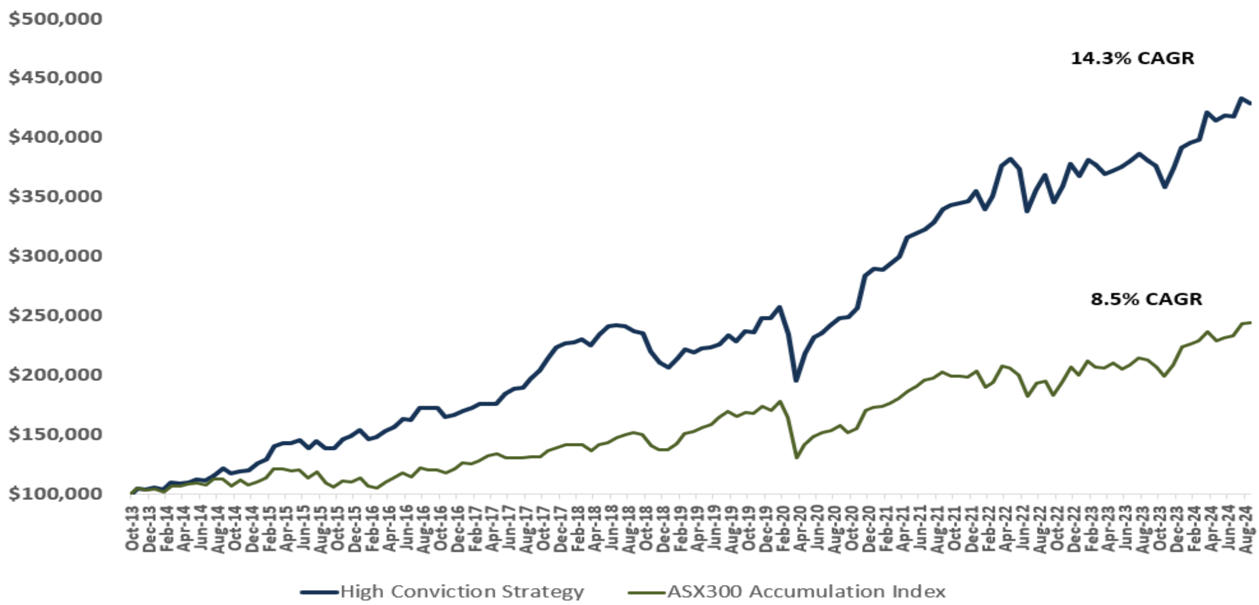
Accumulated Performance by Financial Year - Same Strategy

	FY14 (%)#	FY15 (%)	FY16 (%)	FY17 (%)*	FY18 (%)	FY19 (%)	FY20 (%)	FY21 (%)	FY22 (%)	FY23 (%)	FY24 (%)	FY25 (%)	Inc (%)
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	+2.8	+14.3
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	+4.6	+8.5
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	+5.8

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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