# Chester High Conviction Fund

## Fund Update

February 2024

APIR OPS7755AU
ARSN OPS7755AU

| At 29 February 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) | 0.7 | 6.4 | 4.7 | 5.6 | 10.6 | 12.5 | 12.0 |
| S&P/ASX 300 Accumulation Index | 1.0 | 9.4 | 7.4 | 10.5 | 9.1 | 8.6 | 8.2 |
| Outperformance (after all fees) | -0.3 | -3.0 | -2.7 | -4.9 | +1.5 | +3.9 | +3.8 |

* 27 Apr 2017

> *"Be fearful when others are greedy and greedy when others are fearful"*
>
> Warren Buffett

## Month in review

There appears to be a high level of greed in the market at the present time. Of course, this can continue for longer than everyone expects. Markets often do what surprises most people most of the time. What started out as an AI rush (and still is), is broadening into a buy everything rally. As long term holders of gold (equities), we note the recent breakout to all time highs in USD terms as an indicator that all is not as well under the surface as it looks. Often golds price action forebodes of changing risk appetite. We watch with interest.

We remain of the view that with equity markets at record highs, housing markets at record highs and unemployment still extremely low, any changing monetary policy stance appears premature to us. We are obviously aware that equity markets to tend to be forward looking and are still pricing in 4 interest rate cuts in the next 12 months (in the US).

We are surprised with the extent of the Australian bank outperformance over recent months, with CBA now trading on 21x FY25 PER and a 3.8% dividend yield, well below the return of the cash rate. A record high share price with extremely benign impairment charges. We wouldn't want to be standing in the way when this cycle changes. We do consider the notion that Australia is a beneficiary of regional equity flows given the apathy towards the Chinese stock market, which might help explain the CBA premium.

The recent reporting season saw a stronger set of results for domestic cyclicals than feared, which led to a relief rally in both the banks (better credit quality) and retailers (better margins). Of course the technology sector was the clear stand out during February, rising 20% on the back of the bid for Altium (ALU) and investors willingly accepting paying a premium for the thematic privilege of gaining exposure to the AI narrative. We also note the pick up in M&A activity over recent weeks, which historically aligns with late cycle behaviour. Expensive equity enables companies to buy rather than build. We could cite at least 12 companies in our portfolio that would look attractive to buyers on valuation grounds. Other reporting season themes are discussed inside.

## Portfolio review

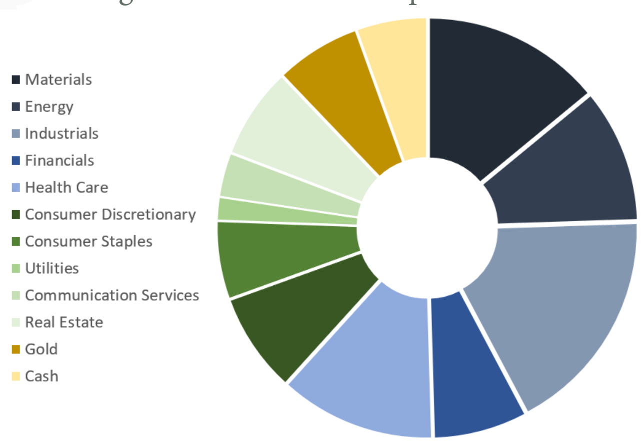
During the month the fund returned 0.7% relative to the 1.0% rise in the ASX300. Outperformers for the month were led by Light and Wonder (LNW) with a result above market expectations, with confidence of momentum continuing into 2024, given the early success of the Dragon Train launch in Australia, which is being rolled out to the US market in the first half of 2024. Momentum is a powerful driver of corporate culture, and LNW is winning at the moment. Imdex (IMD) also provided a result which exceeded pessimistic market expectations. IMD's exposure to global exploration spend is well understood. What is less understood is their ability to continue to win share with innovative drilling solutions and integrated technology. Maas Group (MGH) also has a strong February. MGH addressed concerns around its balance sheet and cash conversion with a solid result and property monetisation strategy commencing with divestment of their storage portfolio. Corporate activity of other building material companies (BLD, ABC, CSR, etc.) is also creating a scarcity factor and highlighting the strategic nature of MGH's asset portfolio, namely quarries.
Underperformers for the month were led by OceanaGold (OGC) a long term holding we have continued to hold after delisting on the ASX 18 months ago. OGC remains undervalued in our view, given the 1.0m oz resource they have discovered in NZ at 15.9g/t, making it one of the highest quality discoveries globally in the past 5 years. Unfortunately this asset is 4 years away from production, while the rest of the portfolio will produce over 530koz in FY24, all for a US1.4bn market cap and 3x EV/EBITDA. Westgold (WGX) also underperformed during February as golds sold off. Price action in early March has been noticeably different. Ridley (RIC), also underperformed after a strong 2023. It seemingly spooked the market on the outlook for tallow prices. One market commentator has been running with the thesis since March 2023 that RIC's growth was driven by a favourable tailwind from tallow/protein prices. Despite this tailwind becoming a headwind RIC still delivered a solid result, with immaterial downgrades, however there has been ongoing profit taking. We have taken the opportunity to increase our holding and believe that RICs performance over the past 3 years is more related to strong execution than favourable commodity prices, not withstanding the fact that we expect tallow prices to recover this year.

| Top 3 holdings |
|---|
| CSL |
| Light & Wonder |
| Austal |

| Portfolio breakdown | |
|---|---|
| Industrials | 17.8% |
| Materials | 14.0% |
| Health Care | 12.1% |

| Top 3 portfolio attribution | Bottom 3 portfolio attribution |
|---|---|
| Light & Wonder | OceanaGold |
| Imdex | Westgold |
| Maas Group | Ridley Corp |

## Fund weights - diverse sector exposure



## BROAD REPORTING SEASON THOUGHTS

| OBSERVATION | IMPACT |
|---|---|
| **DOMESTIC CYCLE STRENGTH** | Bank eps upgrades with low impairment charges and domestic retailers showing far better gross margin (nominal revenue higher, with cost discipline and unwinding of supply chain pressures). Boon for CBA, WBC, JBH, WES, albeit that retail sales have continued to moderate in CY24. So, what becomes of the interest rate cycle with the incredibly resilient consumer? |
| **INVESTMENT IN TECHNOLOGY** | Every corporate is joining the race to be an AI leader. Productivity gains are highly sought after in Insurance, Financial Services, Retail, Telcos and Industrials. The holy grail of cost out is still very early in its infancy. Are these productivity gains competed away? |
| **R&D SPEND EXPENSED OR CAPITALISED?** | Wisetech (WTC) capitalised 54% of its R&D spend on product development, 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 |
| **GOVERNMENT FOCUS ON COST OF LIVING PRESSURES** | A populist government aiming for the perception of relieving cost of living pressures for consumers. The highly public ACCC focus on grocery margins will be followed by other sectors under scrutiny. Toll roads (TCL) already has a government inquiry into pricing (75% margins), while insurance, fuel retailing and electricity are other consumer facing sectors that are easy targets. For now, mobile phone charges (TLS mobile margins at 47%) and Bunnings (Australian staple?) remain safe |
| **M&A AND THE SCARCITY PREMIUM** | With CSR, Adbri (ABC) and Boral (BLD) receiving bids, the secondary market options for building materials companies has shrunk to James Hardie (JHX) Reliance Worldwide (RWC), Reece (REH) and Maas Group (MGH). The Altium (ALU) bid also highlights the lack of suitable technology exposure in Australia, with Wisetech (WTC), Next DC (NXT) and Xero (XRO) commanding significant premiums on cash flow multiples for the thematic privilege of gaining exposure. We think M&A will accelerate over the next 6 months as a late cycle play to buy rather than build now interest rates have stabilised |
| **IMMIGRATION AND THE PROPERTY MARKET** | Expectations of rate cuts and house shortages have seen an uptick in residential property volumes, while construction activity remains subdued. The dispersion in valuation changes across the property sector remains challenging for office landlords (ongoing cap rate expansion and divestments) while shopping centres have stabilised. Any mention of data centre development has been richly rewarded |
| **PRICING POWER** | We have spent significant time considering whether firms have genuine pricing power (realestate.com.au), or cyclical pricing power given shortages over the past 2 years of goods they supply (car dealerships, insurers, building materials). How sustainable are pricing pass throughs? There is a large dispersion in many cases as to the perceived "quality" of the top line resilience |
| **LABOUR FORCE CHALLENGES EASING** | Labour challenges appear to be easing with plenty of anecdotes across different sectors (Industrials citing VISA changes, miners citing nickel mining woes, healthcare naming training as a key driver) but are we setting ourselves up for future failure? Anecdotally we have heard 50% of RIO's staff in the Pilbara have <2 years' experience which is quite an alarming stat (All companies, miners, healthcare services, industrials, etc) |
| **DAILY VOLATILITY** | 15% of ASX200 companies moved more than 10% in February indicating extreme stock specific volatility. In 2007 the intra day move of a company reporting averaged 1.5%. In 2024 the intra day of a company reporting averaged 4.5%. We put this down to the rise of passive funds and quant funds chasing headline earnings beats or misses. During the month the extreme moves often feel like a casino, whereby often moves can be contrary to prevailing wisdom. The good news is that over time, these price dislocations can often give rise to opportunity to pick up stocks cheaper, or lighten stocks that have melted up. |

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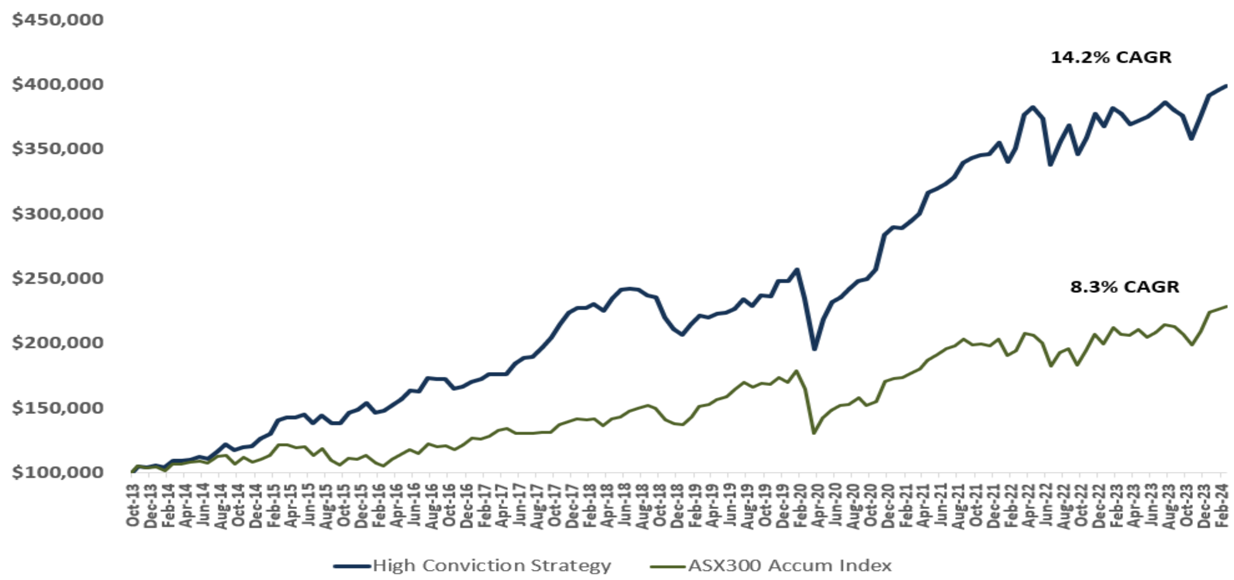
## Accumulated Performance by Financial Year - Same Strategy

| | FY14 (%)# | FY15 (%) | FY16 (%) | FY17 (%)* | FY18 (%) | FY19 (%) | FY20 (%) | FY21 (%) | FY22 (%) | FY23 (%) | FY24 (%) | 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 | +4.8 | +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 | +9.7 | +8.3 |
| Value added (after MER) | +3.5 | +18.9 | +16.4 | +2.1 | +15.1 | -17.8 | +11.6 | +8.7 | +11.6 | -1.9 | -4.8 | +5.9 |

# 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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