Total returns

At 31 March 2022	3 mths %	6 mths %	1 yr %	2 yr % p.a	3 yr % p.a	Incep. % p.a. (27 Apr 2017)
Chester High Conviction Fund (after fees)	6.0	9.7	25.5	38.8	19.6	15.6
S&P/ASX 300 Accumulation Index	2.1	4.3	15.2	26.2	10.9	9.4
Outperformance (after all fees)	**+3.9**	**+5.4**	**+10.3**	**+12.6**	**+8.7**	**+6.3**

* The inception date of the Chester High Conviction Fund was April 26th, 2017. The NAV at March 31st, 2022 was 1.6480

"There is no greater danger than underestimating your opponent"

Lao Tzu

Quarter in review

Our eight year old daughter attended her first AFL football match recently. She is allowed to barrack for any AFL team she wishes, as long as it's Geelong. She is very passionate, as is her father. The tantrums being thrown as Collingwood kicked 9 goals in a row to lead by 5 goals at 3 quarter time were a concern, particularly as they weren't being thrown by the eight year old. The exhilaration of watching Geelong kick the last 8 goals of the game was both exciting and curious at the same time. A full range of emotions in a 40 minute window, proving life can change very quickly. We often wonder why so much emotion is tied to a game of football? The sense of tribalism and belonging to a community is the most cited logic. It provides an outlet for friends and families to bond over a common goal or purpose. When the most pressing issue of the weekend in most Australians lives becomes the success or failure of their respective football team, Australia really is the lucky country.

Globally, the first quarter of 2022 was overshadowed by the Russian invasion of Ukraine. Perhaps the Russians underestimated the sense of tribalism of the Ukrainian people in defending their homeland. The world has significantly changed in the past 8 weeks, as this conflict has bought into sharp focus the delicate balance between economic trading partners and autocratic leaders with ulterior motives. The over-reliance of Europe (Germany in particular) on Russian energy highlights the risks surrounding a lack of self sufficiency in primary production (both food security and commodity security). The lack of short term alternatives puts much of the European population at significant risk of fuel and heating shortages come winter. Australia as a significant exporter of both food and energy is blessed with an abundance of primary production. The lucky country. This enviable position cannot be underestimated over the next decade.

This shift in thinking amongst global policy makers around self sufficiency (or localisation) has been talked about for the past 2-3 years, but has significantly accelerated over the past 6 weeks. Shifting semi conductor manufacturing out of Taiwan, localising defence spending, reducing reliance on crop protection ingredients sourced from China, to ensuring rare earths are sourced from western nations, this thematic has only just started. It will play out over the next 3-5 years as many of the decisions taken this year, will really only come into play by the middle of the decade. Our most significant takeaway from the tragic events in the Ukraine, outside the humanitarian crisis is that globalisation is very much a thing of the past. Companies and consumers will willingly be paying higher prices for the security of supply rather than the lowest cost of supply, which of course only plays into the notion that the 2020's will incur higher inflation than the preceding decades.

Geopolitics aside, the current narrative around inflation is well and truly the biggest dilemma for policymakers. Cost inflation is rampant and a level of demand destruction is needed to reign in inflation expectations, so much so that market expectations for US interest rates have risen from 3-4 hikes in 2022, to 8-9 hikes this year. Adding balance sheet contraction (QT) to the mix suggests that financial conditions are tightening very quickly. Credit spreads need to be watched closely for broader financial market stress, but this is not apparent yet. While the bond market has reacted to the change in interest rate expectations, we are not so sure the equity market has. It appears to us the RBA has decided to let the upcoming Federal election play out over the next 6 weeks before changing monetary policy course, whereby interest rates will be going up. The key variable obviously becomes "for how long?". With the prospect of financial conditions getting tighter in 2022, the focus will be very much led by stock specific earnings drivers, hence the most in demand stocks will be those that have earnings, dividends or cash flow tailwinds, valuation support or very strong pricing power. Outside commodity producing tailwinds, earnings strength looks far tougher from here, while Australia looks to be a wonderful place to allocate capital from a global perspective.

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? We remain heavily focused on owning a portfolio of stocks that remain compelling on a bottom up cash flow basis, and by no means do we want to be overpaying for those cash flows. There remains significant risk around long duration valuations (the higher the bond yield goes, the lower the value attached to those cash flows). We think the backdrop is favourable for finding unloved and underappreciated assets, where the risk/reward trade off is far more compelling. This focus on fundamental investment drivers we believe holds our philosophy in good stead over the next 2-3 years as the significant dispersion in valuations unwinds. We believe we still have a significant number of stocks in the fund that fall into the category of unloved, underappreciated or undiscovered. Equally as important is our portfolio construction framework, which has remained consistent for over 8 years and has ensured a diverse exposure to non-correlated sectors.

Portfolio changes over the past 3 months

The quarter was relatively active from a portfolio stand point. We took a significant position in Woodside **(WPL)** in early January, given its relative exposure to both spot LNG cargoes and the pending merger with BHP Petroleum which alleviates the near term funding issues for some of the WPL growth projects. The near term oil price strength has been fortuitous. Other additions to the fund over the quarter were Red 5 **(RED)** in January on the discount to our NAV and the early completion of the King of the Hills (KOTH) gold plant. Stockland **(SGP),** as buying high quality land bank at a material discount to NAV and >6% dividend yields offers asymmetric risk in our view. We also added the global fund manager GQG Partners **(GQG)** to the portfolio in March after it retraced 45% from the IPO price in November 2021. On our estimates, this purchase was on a dividend yield in excess of 10%. Much of the selling the fund did in the first quarter was idiosyncratic (stock specific drivers), but broadly speaking it fell into the discretionary thematic of the rising cost burden on consumers. The cost of living increases (food, energy, mortgage rates) will see significantly reduced ability for consumers to spend on things they want. This saw us reducing positions in (or exiting) Sky City **(SKC)**, Aristocrat **(ALL)**, Endeavour Group **(EDV)**, James Hardie **(JHX)** and Premier Investments **(PMV)** during the quarter. We see more reason to be very focused on the valuation margin of safety with the initial investment, with a strong emphasis on the assets on the balance sheet (asset backing) as well as favourable catalysts that hopefully provide reason for the intrinsic value of the company to be realised over the next 18 months.

So what now?

Financial conditions will get tighter with interest rates rising, which ties into our framework of desiring strong cash generation and asset backing. Broadly, we maintain our focus on four key areas of investing, while appropriately diversifying the fund from an industry standpoint. These four key areas are listed below. Very simplistically, we want our investments to be able to grow earnings through this challenging period of rising inflation. For this to occur, we need to see either extremely strong pricing power, or cyclically led tailwinds, leading to margin expansion and higher cash generation. We do believe dividend yields will become far more important in a more challenging earnings cycle, which does augur well for the Australian market in a global context.

Real assets. Inflation will drive real asset valuations significantly higher. Simplistically assets that are very hard to replicate or disrupt indicates a strong starting point. We would place **QUB, TCL, ORG** and **MQG** in this category, while all commodity producers fall into this framework as well.

Valuation margin of safety - an asymmetric risk profile. We would place **ASB** and **SM1** in this category, while recent purchases **SGP** and **GQG** also fit this framework.

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? This remains the biggest risk to any portfolio holding currently, as while cost pass-through has been apparent in many cases over the past 12 months, as liquidity conditions dry up, only the very strong business models, or those with commodity linked tailwinds (energy/electricity) will see margins continue to improve. We would place **CSL, TAH** and **NWS** (through it's holding in **REA** and Move) in this category

Gold. Historically, more often than not, gold performs the best as a defensive asset class in times of inherent volatility, while on a cash flow basis, we believe there is strong value in gold equities. While gold equities had a strong first quarter, we do note that the previous peak in the USD gold price (in 2011), the global gold mining index was 50% higher than it currently is. We see any significant volatility in 2022 as providing a favorable backdrop for gold, and hence our portfolio weight remains consistent, albeit spread across several different holdings.

The Portfolio

The CHCF posted a 6.0% gain in the March quarter, relative to the 2.1% increase in the ASX300 Accumulation Index. While the portfolio remains very benchmark unaware, it is currently significantly underweight mining stocks relative to the benchmark, with no **BHP, RIO** or **FMG** currently in the portfolio. We have always invested in mining stocks on a stock specific basis, and have a level of caution around the economic activity within China. We touch on this more inside. We remain optimistic with the valuation support within the portfolio, as well as a pre IPO position that will come to the market in 2H 22 where we expect a significant valuation uplift. As discussed above **(WPL)** was purchased early in the new year and subsequently rose 50%. Nufarm **(NUF)** was purchased in the 2H 21 and offered a compelling discount to book value. Cyclical tailwinds in the crop protection business continue to support near term cash generation while the Nuseed business now has material upside should the aspirational targets outlined at the February investor day be achieved. The thesis for Origin (ORG) was outlined here, and remains valid, with stronger tailwinds behind the end markets. https://www.livewiremarkets.com/wires/not-a-sequel-but-an-origin-story

The health care sector underperformed during the first quarter. **CSL** remains, in our view, well placed to benefit from elective surgeries reopening through the increased use of specialty products, while the price increases through the IVIG business suggests the gross margin pressure should be alleviated by the end of the FY22 year. Ramsay **(RHC)** has had an extremely tough 2 years battling COVID with fixed costs and nursing shortages as significant headwinds. We would hope that the worst is behind the hospital system, with pent up demand for elective surgeries suggesting a volume led recovery into FY23.

Top 3 Holdings	Portfolio Breakdown		Top 3 Portfolio Attribution	Bottom 3 Portfolio Attribution
CSL Ltd	Industrials	16.4%	Woodside Petroleum	CSL Ltd
Nufarm Ltd	Materials	13.4%	Nufarm Ltd	United Malt Group
Tabcorp Holdings	Consumer Staples	8.6%	Origin Energy	Ramsay Health Care Ltd

Accumulated Performance by Financial Year - Same Strategy

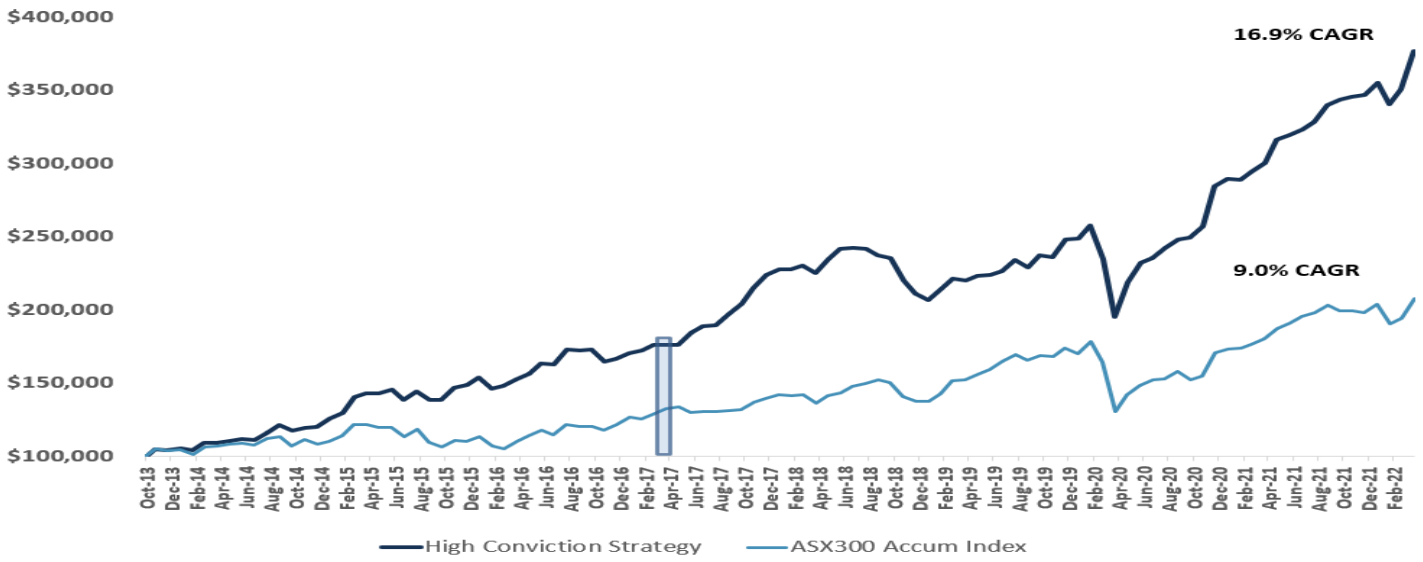
	FY14 (%)#	FY15 (%)	FY16 (%)	FY17 (%)*	FY18 (%)	FY19 (%)	FY20 (%)	FY21 (%)	FY22 (%)	Since Inception (%) p.a.
Same Strategy (after MER)	+11.2	+24.5	+17.4	+11.2	+28.3	-6.4	+3.9	+37.2	+16.6	+16.9
S&P/ASX 300 Accum Index	+7.8	+5.6	+0.9	+9.1	+13.2	+11.4	-7.7	+28.5	+6.2	+9.0
Value added (after MER)	**+3.5**	**+18.9**	**+16.4**	**+2.1**	**+15.1**	**-17.8**	**+11.6**	**+8.7**	**+10.4**	**+7.9**

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.

The Chester High Conviction Fund philosophy - building a strong track record with these key principles

High Active Share	For active managers to outperform long term, the fund has to be truly different from the benchmark. This strategy has had an active share of over 80% since inception
Mid Cap Bias	Broadly speaking, we find more interesting growth opportunities outside the large cap universe. For funds to perform well over an extended period, exposure to mid caps and small caps is essential
Back Owners of Capital	Allocating capital to management teams that think like owners is more likely to ensure longer term success. Alignment of interests is crucial. Managers must take a long term view
Concentration in Few Ideas	While a portfolio can be appropriately diversified with approx 20 stocks, our mid cap bias has seen the strategy average around 33-35 stocks since inception
Own Our Decisions	As a team, Chester has worked together for over 10 years, we each know our role and the strengths and weaknesses of each employee. We are proud of the culture we have built
Keep It Simple	Ultimately, we allocate capital to sectors and companies that we understand
Focus on Insights	Do we have a different view than the prevailing wisdom of the market? Backing ourselves in unloved or undiscovered stories has been the most consistent alpha generation of this strategy
Cash Flow Growth	We seek to invest alongside companies that either generate predictable cash flows in high quality industry positions, or determine an appropriate margin of safety where valuation support is paramount

These are the themes that have us contemplating the portfolio structure into 2022

GEOPOLITICS	The unknown known. We know a war has started, we don't know how it will play out. The duration, sanctions, implications, response from NATO, response from China? Optically the easiest trend to observe is the energy shortage into Europe, which suggests oil and gas prices stay higher than they would otherwise. Putin may be simply trying to reclaim what he thinks is ideologically Russian territory, or it may be a broader, longer term plan over food security. Commodity producers with significant tailwinds? **WPL, STO, BHP, RIO, MIN, S32, IPL, NUF**
THE OUTCOME BEING HIGHER INFLATION THAN PREVIOUSLY FORECAST	The implications of the above suggest both food and energy prices remain structurally higher than previously thought, which will flow through to cost of living increases, on top of the prospect of higher monthly mortgage rates. The extension of this being consumers have far less discretionary income going forward as more monthly income is put towards things they need (food, shelter and energy) as opposed to things they want. S**uggests caution on the consumer discretionary sector**
HOW DO CENTRAL BANKS RESPOND?	Whilst still focusing on the macro landscape, the Fed now has to balance the risks of tightening into a slowing economy with rising inflationary pressures continuing. The recent language has been remarkably hawkish, interesting given most of the inflationary pressure is due to forces beyond their control (energy). Does an accelerated interest rate cycle significantly diminish demand to lower inflation? **CPU, QBE, Banks are the traditional interest rate cycle beneficiaries**
ACCESS TO CREDIT AND COUNTERPARTY RISK	Credit spreads must now be watched closely for the prevailing credit environment sentiment. Contagion of counterparty risk in dealing with economic sanctions has just started in the European financial system. Given the very early days of these sanctions, it is very difficult to assess where the problem might arise, but the risks are clearly growing. The downside to the massive liquidity injections post the COVID-19 central bank response was the free capital available to everyone, and with that came almost unprecedented speculation. The promotion of "narrative stocks" meant a great story would see some share prices and market capitalisations pushed to exorbitant levels. That game is over.
PRICE PASS THROUGH	Many companies were able to hold margins during 1H 22 as there appears to be a wide acknowledgment that cost escalation is real, hence very little push back was received for raising prices, with one (Orora) raising prices 8 times over the past 12 months. We don't think genuine pricing power has been tested yet as there are still many cyclical tailwinds playing out. Energy companies are the clear beneficiary of the cycle, while traditional CPI pass through mechanisms see toll roads, certain property exposures and healthcare companies well insulated. Rent, insurance and labor costs are the major cost pressures facing many businesses, with access to the right talent a common issue. **ORA, CSL, SEK, TCL**
"JUST IN CASE" INVENTORY VS CASH REALISATION	A very popular expression during reporting season. Retailers and manufacturers holding higher levels of inventory than they otherwise would have due to the unreliability of supply chains. Broadly speaking, a feature of reporting season was the disparity between reported EBITDA and operating cash flow (OCF), the difference being a build up of working capital "just in case". Does this mean that inventories will be unwound as supply chain bottlenecks decrease? We will be watching very carefully in August for OCF to increase. Inventory destocking into a slowing growth environment doesn't lend itself to higher prices. **BXB, ANN, GUD, SUL, IMD**
PEAK CYCLE EPS?	It became apparent through reporting season that many management teams were bemused at share price reactions to the published results. With many upgrades in earnings actually being sold. This continues the trend of a changing landscape as in a low interest rate environment, eps upgrades normally herald in PE expansion (the share price rises more than the earnings would suggest). In this new environment, eps upgrades saw PE compression as the share were sold off. Our stocks weren't immune to this. The question simply remains are we comfortable with the underlying business? **NWS, MQG, IMD, NEC, SEK**
STAYING CONNECTED	A hangover from the COVID lockdowns, but the trend towards localisation we think only gets stronger as supporting local communities remains a key thematic for business leaders keen to re-engage customers. Localisation of supply chains where possible is also front of mind to ensure security of supply. Companionship is also an interesting trend with pet ownership rising from 61% of households, to 69% over the past 2 years. **RIC, LIC, EGH, INA, MTS, SGP, LLC, EBO, MVF, BBN, NUF**

Note, these thoughts were written post the February reporting season, but remain relevant in the context of sticky cost inflation and supply chain constraints, which remain ongoing

Stock selection - Nufarm (NUF)

Description

Nufarm (NUF) is an Australian based chemical company that produces a large range of primarily off-patent crop protection products and has developed a diversified portfolio of seed technologies. Crop protection products include herbicides, phenoxies, fungicides and insecticides which are sold through the Asia Pacific (namely Australia), North America and Europe across over 3,300 registered products. NUF are exposed to 4 key global agribusiness trends, being: global nutrition, land productivity, sustainable agricultural practices and the rise of sustainable crops. We recently published an in depth piece on NUF in this livewire article. https://www.livewiremarkets.com/wires/have-you-got-enough-food-in-your-bunker

Quality

In the past NUF has struggled with: a stretched balance sheet, tough weather conditions (Australian drought 2017-2019), glyphosate concerns, and a challenging European environment exacerbating the underperformance of acquisitions. However, the sale of Latin America to Sumitomo (Sep 19), strong Australia conditions (2021, 2022) and a potential environment where food security is prioritised over organic farming have potentially turned those headwinds into tailwinds. I.e. in March French president Emmanual Macron announced the desire to adapt the EU's 'Farm to Fork' (organic farming) policy in an effort to maximise yield. Synthetics can deliver up to 40% greater yield. The move to more localised manufacturing is also providing benefits to NUF including Government support.

Beyond crop protection the NuSeeds business offers proprietary technology with the 2 key products being Carinata and Omega-3, in addition to core seeds (Sorghum, Sunflower and Canola). These technologies offer sustainable cropping solutions for a global challenge.

Carinata is a biofuel feedstock grown between main crop rotations to help with the decarbonisation of the planet, effectively a sustainable alternative to diesel and aviation fuel which in itself is a 57bn gallon market. Importantly it is a non GMO plant protein source. Recent technology validation has been received with a 10-year commercial offtake and market agreement with BP. Nuseed's Omega-3 Canola solution has been developed as the world's first land based source of DHA essential ingredients, currently derived from fish oil. Hence this Omega 3 solution has the potential to relieve the pressure on our oceans and reduce the number of fish required to supply the world's demands for Omega 3, believed to be in material deficit. The Omega-3 canola is processed into 2 oil ingredients: Aquaterra for aquafeed and Nutriterra for human nutrition. NUF estimates the market supports AUD850m EBITDA future market potential. A number of commercialisation steps have so far been achieved for Omega-3 including AUD30m of sales orders.

The 'aspirations' of the Nuseeds business were recently defined at the investor day, to grow revenues to AUD600-700m by 2026 and AUD1.5bn by 203 at 25-30% margins

Valuation

We most recently re-entered the position in October 2021 when trading at ~AUD4.50/share and the stock was trading at ~80% of book value and compares to our current DCF derived valuation of the business at ~AUD6.40/share (WACC10%). Based on our projection of earnings, refer below, we see NUF trading on ~12x FY22 EPSA (NUF had AUD125m in amortisation in FY21 largely related to acquisitions). There are two points to note, a) It includes a heavily risked valuation for Nuseed, we suspect will derisk over time and b) We have discounted the business at the same cost of capital however we believe ultimately the Nuseed business deserves a higher multiple given the proprietary nature of technology and the stronger growth than the core NUF crop protection business.

These points are addressed in our alternative valuation scenario tabled below, based on Management's aspirational targets (not guidance statements). They rely on execution, weather and the general range of other uncertainties that come with any projection. However, based on these aspirations, if NUF were to achieve these, under our assumptions there is material upside to current share price and our view on risked valuation.

Insight

Potentially a function of a good season and strong soft commodity prices, in February 2022 NUF announced Q1FY22 (December Quarter) revenue had grown 36%. Associated with this statement was vague guidance that NUF expects revenue and earnings growth in FY22 with the market now projecting 6% and 9% revenue and EBITDA growth. We have analysed historic earnings and industry participants as well as held discussions with Management and believe the market is underappreciating the strength of current year (and future earnings) I.e., our projections are ~11% above consensus on revenue and ~7% above consensus on EBITDA but note that there are a wide range of possible outcomes in the current environment.

Chart 2 **Nuseed aspirational valuation scenario**

Nuseed - Aspirational Scenario	Measure	2021	2026	2030	Notes
Revenue	AUDm	240.6	650.0	1500.0	Aspiration is to grow to AUD600-700m by 2026 and 1.5bn by 2030
Margin	%	19.1%	22.5%	27.5%	Aspiration is for EBITDA margins of 20-25% by 2026 and 25-30% by 2030
EBITDA	AUDm	46.0	146.3	412.5	Midpoint of Revenue target x midpoint of EBITDA margin target for 2026 and 2030
Multiple on Seeds Asumed	x	10	10	10	Picked an arbitrary multiple to reflect growth and technology of the segment
Capitalised Value	AUDm	460	1,463	4,125	EBITDA at assumed 10x Seeds multiple
Years	#	0	4	8	Year from 2022
Discount Factor	:	1.00	1.46	2.14	At assumed 10% discount rate
Discounted Valuation	AUDm	460	1,000	1,920	Capitalised value discounted to current day

NUF Valuation scenario	Measure	2021	2026	2030	Notes
Current NUF Shares	m	380.0	380.0	380.0	Per IRESS
Current Share Price	AUD/share	5.65	5.65	5.65	Per IRESS
Market Cap	AUDm	2,147	2,147	2,147	Shares x share price
Net Debt - 30/9/2021	AUDm	173	173	173	Chester has considered Net Debt excluding lease liabilities
Payables Financing and Hybrid	AUDm	544	544	544	Hybrid step up secutiries AUD247m + payables financing of AUD297m
EV inc. Payables Financing + Hybrid	AUDm	2,864	2,864	2,864	Market Cap + Net Debt + Payables Financing + Hybrids
Seeds Valuation	AUDm	460	1,000	1,920	Assuming NUF targets are met, at 10x EBITDA multiple, refer above
EV - Seeds	AUDm	2,404	1,864	944	Residual EV of crop protection business if targets are hit
Core 2021 EBITDA - Seeds	AUDm	315	385	385	Management targeting AUD3.8bn in 2026, assumed at FY21 margins (ambition is for higher)
2021 EV/EBITDA	x	7.63	4.84	2.45	EV - Implied Nuseed valuation
Multiple on CP assumed	x		6.50	6.50	Based on FY21 EBITDA multiple is 7.3, assumed 6.5x to reflect FY22 EBITDA ~10% >21
Valuation at base multiple above	%		7.34	9.76	Scenario under assumptions above (i.e. retaining base multiple)
Upside	%		29.8%	72.7%	

Source: Chester Asset Management

Chester High Conviction Fund Portfolio top ten holdings as of March 31st, 2022

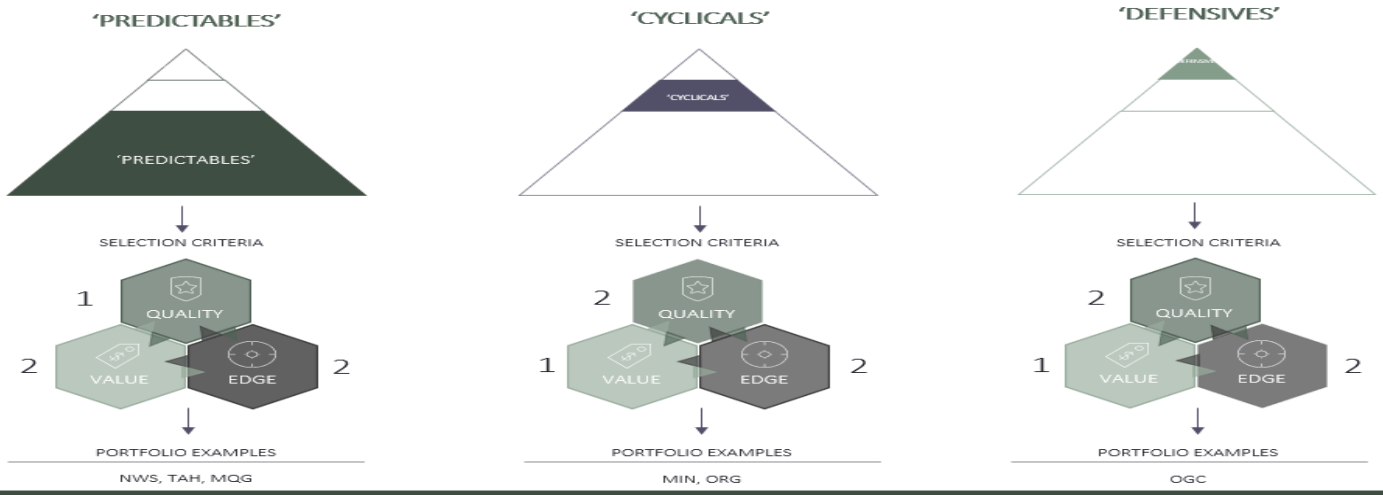
Chart 3

	Cash flow style	FY22 Sales GR	FY23 Sales GR	FY22 Div Yield	FY23 Div Yield	FY22 DPS GR	FY23 DPS GR	FY 22 ROE	FY 23 ROE	FY22 BOOK VALUE	FY23 EV/EBITDA	FY22 EPS GR	FY23 EPS GR	FY22 PER	FY23 PER
Austal Ltd	Predictable	-8.9%	-3.0%	4.3	4.2	1.2%	-2.4%	8.75	6.40	0.9	4.6	-11.4%	-16.4%	9.7	11.7
CSL Ltd	Predictable	5.9%	22.4%	1.0	1.2	2.0%	18.5%	19.20	18.70	6.6	21.6	-2.7%	18.8%	40.6	34.2
Downer Ltd	Predictable	-1.6%	1.4%	4.6	5.4	29.1%	17.4%	7.99	1.20	1.3	6.4	-3.2%	25.8%	16.6	13.2
Mineral Resources	Cyclical	-16.4%	46.4%	1.4	4.0	-74.3%	179.9%	10.40	28.60	3.4	6.2	-73.0%	214.7%	32.5	10.3
NAB Ltd	Predictable	6.0%	6.7%	4.4	4.8	14.9%	9.3%	10.96	11.70	1.7	nm	7.1%	9.4%	15.7	14.4
News Corp	Predictable	12.9%	2.4%	0.8	0.9	-2.1%	5.8%	6.40	6.70	1.6	7.8	75.3%	10.9%	23.9	21.5
Nufarm Ltd	Cyclical	11.9%	0.1%	1.3	1.5	nm	19.5%	4.60	5.21	1.1	7.1	82.4%	16.5%	25.8	22.1
Origin Energy	Cyclical	1.8%	1.5%	4.4	4.8	39.6%	9.2%	5.50	8.00	1.1	6.8	101.3%	51.3%	21.4	14.1
Ridley Corp	Predictable	7.2%	0.2%	4.0	4.3	nm	9.0%	11.50	12.40	1.7	6.3	55.7%	12.8%	15.1	13.4
Tabcorp	Predictable	4.8%	4.2%	2.5	3.1	-1.4%	21.6%	5.87	6.85	1.8	12.1	-2.2%	18.8%	30.8	25.9

Source: Chester Asset Management, Bloomberg consensus data, stocks shown in alphabetical order

We have listed here our top ten holdings at the end of March, 2022. Naturally we find that our stock weights can change over the course of a quarter or year. 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 expectation vs the market (or insight/edge) of the earnings direction. 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 5 below). The majority of the stocks currently held in the top ten holdings are classified as "Predictables" (Consumer Staples, Communication Services or Healthcare) while Origin Energy, Mineral Resources and Nufarm are classified as "Cyclicals". Our gold holdings currently sit just outside the top 10 stocks, which we classify as "Defensive". We view the non-correlated returns of the gold sector (which has historically been the case) as a way for the portfolio to lower the volatility of returns.
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 4



Portfolio Construction

We have always broken down our portfolio construction into three categories as outlined on chart 5. 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 has 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 better 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.

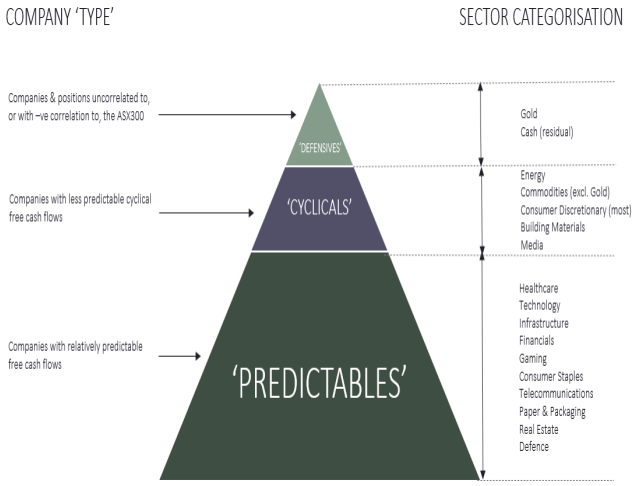
Chart 6 illustrates how these "buckets" have looked over the past 8 years. On average, the allocation to predictables has been 60-70%, while cyclicals have averaged around 15% (10-25%) and defensives have ranged from 10-25%. We have tended to hold an increased defensive position over the past 2 years, while in the last 6 months have added incrementally to our cyclical position, increasing our energy position while the other exposures remain very stock specific. We note the cyclical exposure is around 24% currently, which is very much at the upper end of our targeted range. 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.

Chart 7 has been pulled directly from the Morningstar database of large cap Australian Equity strategies, whereby it highlights the strong track record relative to its peer group (ranked 5/301 funds over 1 year, and 2/280 over 3 years). While this is pleasing, the portfolio construction as described above, we think creates a differentiated product to our peer group. Largely because we use the defensive sleeve, our drawdown has been lower than the index and the peer group, which also shows in the beta of the strategy (0.9 vs peers at 0.97). This effectively means the fund demonstrates less volatility than the peer group, which is also shown by the standard deviation (16.7 vs 17.8).

What these tables also highlights is the lower level of correlation (R-squared) to the index, which shows this strategy is only 90.2% correlated to the index, relative to the peer group correlation of 93.1%. The portfolio is designed this way deliberately, which we think becomes even more important over the next 12 months with increasingly volatile markets, thus ensuring some focus on capital protection (although it is a long only product) is paramount to the way we invest.
Hence the fund, to this point (past performance is no guarantee of future performance), has been able to demonstrate higher alpha (returns) than many of its peers, for significantly lower beta (or volatility) and correlation. Thus, it has achieved its objective, while being a very different offering than most other Australian equity funds.

How do we allocate capital?

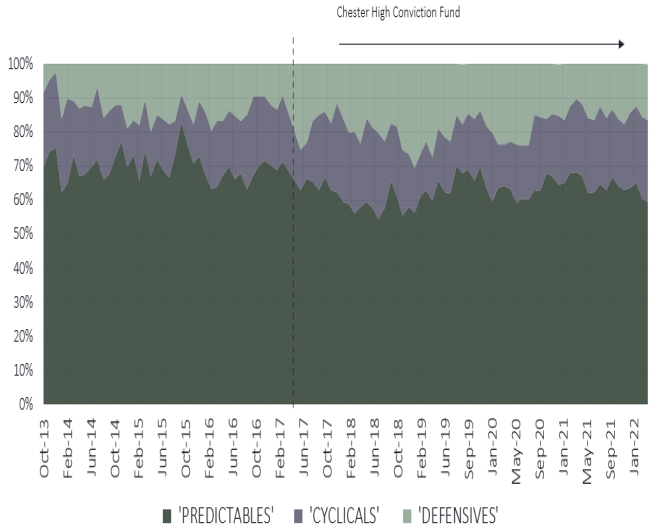
Chart 5



Source: Chester Asset Management

Which has been done consistently over time

Chart 6



Source: Chester Asset Management

Chester High Conviction Fund portfolio characteristics

Chart 7

Trailing Total Returns as at 31 Mar 2022

	Total Return	+/- Cat	+/- Index	Cat Rank
1 Month	7.42	1.51	0.53	31 / 313
3 Month	6.03	4.95	3.79	22 / 313
1 Year	25.50	10.93	10.53	5 / 301
3 Year	19.56	9.03	8.97	2 / 280
5 Year	--	--	--	--

Risk Analysis as at 31 Mar 2022

3-Year Risk Measures	Fund	Category	Index
Standard Deviation	16.69	17.78	17.64
Sharpe Ratio	1.14	0.63	0.64
R-Squared	90.18	93.07	--
Beta	0.9	0.97	--
Alpha	8.82	-0.04	--

Source: Morningstar database, March 2022

Who has pricing power?

Chart 8

	Business Quality - Xero	Score (/10)	Notes
1	Does the business have the ability to pass on higher prices without impacting customer engagement?	9	XRO has a highly engaged captive customer base where switching costs are relatively high. High degree of pricing power given the stickiness of the customer base
2	Are these assets/distribution channel easy to replicate?	9	Once rolled out with an engaged audience, the barriers to entry become the incumbency of the product, where historical data becomes more ingrained and switching costs elevated
3	The risk of being disrupted over the next 5 years? Is there emerging technology that will change industry dynamics?	8	There is always some risk of a new technology platform being rolled out to threaten incumbents. The best protection against this is continual investment in the product suite to ensure customer engagement
4	How concentrated is the industry - number of players?	7	For the majority of markets, XRO operates with 2-3 competitors, in what is a relatively competitive industry. New entrants are likely to be attracted to the market size and customer (SME) inertia
5	Does the company have the ability to grow top line at greater than 5% (GDP plus) organically	10	There appears very little chance (outside COVID disruption) that XRO doesn't continue to grow organically well inexcess of 5% through ongoing subscriber growth and pricing power in outer years
6	Does the company have any control over input costs?	8	Highly scalable cost base dependent on marketing spend and product development. Like most Saas products, these are effectively variable, but an essential cost of doing business to continue to win market share.
7	What is the risk of government intervention?	9	There appears to be very little risk to government intervention for accounting software, while further compliance or training may be the risk of integrating software into new practices

Source: Chester Asset Management

Cost inflation is by far the biggest concern for every corporation in 2022. From energy, wages, building materials, insurance and electricity, most categories of the expenses are seeing large increases. So how do companies preserve margins in this environment? Simplistically it is one of 2 ways, either: be fortunate enough to have strong commodity price tailwinds (energy, resources, electricity, agribuiness); or have strong pricing power (high quality industrials).

These are the seven (relatively generic) questions we ask ourselves when looking at each company. This is clearly an exercise in subjective analysis as each answer is considered with the industry structure as we currently view it. The above framework is how we assess each company we have on our watchlist. We assess the business quality, financial quality and management quality using a range of questions as illustrated above (this is assessing business quality). This then provides us with a ranking system for each stock in a particular sector or thematic that we then overlay with an assessed valuation to determine the appropriate stocks for the portfolio.

When looking at the answers above, we demonstrate a preference for Xero relative to the other tech companies, largely as a result of both comfort with the technology (we use and recommend it) and the large runway over the next 5-10 years for Xero to consistently raise prices. This will be a powerful driver of future cash flow growth with an incredibly strong franchise (we don't think it will impact customer engagement). In our view, it is the strongest technology platform listed in Australia, others may disagree, but that's what makes markets!

We do seek out companies that offer predictable cash generation using this framework. We focus on this as a way of understanding the ability to grow (and protect) margins. The question about whether these assets are easy to replicate is often the most challenging. For what it's worth below we have illustrated the companies (large caps) that we view as having the best quality businesses in Australia. This doesn't mean we will hold them all, we still overlay a valuation framework to much of our thinking. There are others, but we couldn't fit them all on the page!

Source: Chester Asset Management

How we assess the G in ESG

Chart 9

ESG Review

	Sustainalytics	Glass Door Review ($)			Insider Information (G)				Rem Report Review (G)						
Company	ESG Risk/50	Employee Engagement (/5)	Recommend to Friend (%)	Approve of CEO (%)	Founder Led	O/ship	Sells 24 months	Buys 24 months	Fixed % CEO	STI % CEO	LTI % CEO	STI	LTI	STI Score/10	LTI Score/10
Ansell	18.0	4.3	80.0%	N/A	No	0.7%	0.22%	0.004%	18.5%	19.5%	62.0%	90% financial (Sales growth - 1.5x GDP 25%, EBIT 50%, Cash conversion 10%, profit attributable 5%, 20% non financial - individual	1/3 EPSg 4-10% 3yr CAGR, 1/3 Organic sales growth 2-5% CAGR, 1/3 ROCE 14%-15.5% in year 3	7	7
Aroa Biosurgery	N/A	4.4	78.0%	N/A	Yes	24.4%	0.07%	0.000%	25.0%	10.0%	65.0%	Based on achievement of annual performance targets	Share plan and option plan, no other details provided	2	2
Australian Clinical Labs	N/A	3.0	30.0%	N/A	No	4.6%	0.00%	0.000%	33.3%	33.3%	33.3%	Budgeted EBITDA performance	Index TSR + 5% CAGR, Index TSR + 10% CAGR	3	5
Capitol Health	N/A	N/A	N/A	N/A	No	6.3%	0.00%	0.000%	40.0%	30.0%	30.0%	Financial metrics, Strategic Objectives, Individual Performance and effort	Vesting and granting subject to set KPI service and performance	3	5
Cochlear	27.4	3.4	63.0%	91.0%	?	0.4%	0.05%	0.003%	34.0%	33.0%	33.0%	Minimum NPAT gateway, 60% sales revenue, 40% strategic	50% Relative TSR (50% to >75%), 50% EPS Growth 7.5% to >12.5%	6	6
CSL	25.2	3.3	57.0%	80.0%	No	0.1%	0.06%	0.000%	15.0%	26.0%	59.0%	Business Measures 60% (NPAT 35% and CFO 25% at cc), Individual performance 40%	4 year vesting 50% ROIC (20% to >21.4%) and EPSg (5% to 8.3%)	6	7
Ebos Group	17.7	3.9	89.0%	N/A	No	0.4%	0.02%	0.024%	31.0%	31.0%	38.0%	Cash Payment - based on Group Profit before tax, EBITDA targets	Performance Rights - continuous 3yr employment - growth in EPS	4	5
Fisher & Paykel	27.5	4.2	86.0%	98.0%	No	0.4%	0.1%	0.002%	45.0%	30.0%	25.0%	Constant Currency Operating Profit 45%, Constant Currency Revenue 25%, CCC pre Tax OCF 10%, Non Financial Measures 20%	Perf Shares: Relative TSR >10% over DJSMDQT partially vesting over 5 years, Options: Share Price > compounded amount	7	6
Integral Diagnostics	N/A	3.2	48.0%	N/A	No	4.7%	0.08%	0.003%	44.5%	11.0%	44.5%	50% 1yr NPAT growth target. 50% strategic priorities	EPS CAGR 20% at 5% to 100% at 12% p.a. over 4 years	5	5
Mayne Pharma	N/A	3.1	69.0%	44.0%	No	10.2%	0.0%	0.490%	33.3%	0.0%	66.7%	KMP and Senior executives do not have any entitlement to short term incentives	Absolute TSR 8-15% subject to vesting over a 5 year period	N/A	4
Monash IVF	N/A	2.4	15.0%	N/A	No	1.4%	0.0%	0.082%	34.0%	33.0%	33.0%	70% financial based on EPS performance, 30% non financial measures - engagement, market share growth, doctor attraction, etc	70% EPS growth 3 years (10% p.a.), 30% Relative TSR	8	6
Nanosonics	18.4	3.0	49.0%	N/A	No	16.1%	0.0%	0.020%	42.6%	31.9%	25.6%	Company Objectives (PBT 40%, Installed Base 20%, product expansion 20%, Customer & culture 20%) x Individual measures	3 year average PBT gate then absolute CAGR TSR 8%-13%	7	6
Healius	22.3	2.7	49.0%	N/A	No	0.2%	0.0%	0.026%	33.0%	17.0%	50.0%	Measured against scorecard (50% Financial: EBIT, margin OCF. 25% Operational: SP targets and relationships. 25% Strategic)	50% Relative TSR, 50% EPS Growth (4-10%)	7	6
Healthia	N/A	N/A	N/A	N/A	Yes	25.9%	0.1%	0.079%	40.0%	30.0%	30.0%	Specific Short term targets KPIs: profit contribution, customer satisfaction, leadership and product management	Service Condition, 50% EPS Growth >10% p.a., TSR 150% over 3 years	5	6
Polynovo	32.2	4.0	49.0%	N/A	No	9.2%	0.0%	0.000%	10.2%	2.0%	87.8%	Based on exceeding group revenue by at least 10%	Based on market cap >AUD2bn for 3 consecutive months	3	2
Ramsay Healthcare	24.4	3.7	69.0%	84.0%	No	2.1%	0.0%	0.001%	27.0%	27.0%	46.0%	50% Financial (Core NPAT Rev + EBIT), 10% Strategic, 10% People, 15% NPS, 15% Quality	50% Relative TSR, 50% EPS Growth subject to ROIC	7	7
Resmed	26.6	4.0	82.0%	93.0%	No	1.6%	0.0%	0.000%	10.1%	15.4%	74.1%	50% adjusted net sales, 50% adjusted operating profit	50% absolute TSR%, 50% time vested over 3 years	5	5
Silk Laser	N/A	3.8	62.0%	N/A	Yes	14.2%	2.6%	0.000%	62.5%	18.8%	18.8%	Specific annual targets and key performance indicators (EBITDA). Not specified	Granting LTIs in FY2022 - no comment as to what basis	3	2
Sonic Healthcare	18.2	3.3	45.0%	64.0%	Yes	0.7%	0.12%	0.003%	31.0%	29.0%	40.0%	80% based on EBITDA growth, 20% based on strategic objectives	45% Relative TSR, 33% Aggregate EPS, 22% Average ROIC	5	7

Source: Chester Asset Management

We include this table as a way of highlighting some of the detail that we undertake when selecting stocks. We have always focused on the "G" in Governance as we subscribe to the notion of Charlie Mungers famous quote. "Show me the incentive, and I'll show you the outcome". So this example, undertaken when we do a sector review (such as healthcare above), includes a detailed review of the STIs and LTIs of the management team, how much of the salary is fixed vs variable, and what level of buying and selling insiders have been doing. It's a very comprehensive look at remuneration structures, and then compared to the nearest peer group on an absolute and relative basis.

This table also highlights our analysis of Glass Door reviews we have been completing to assist in our assessment of an culture from a social and governance perspective.

Glass Door is an American website where current and former employees anonymously review companies, submit and view salaries as well as search and apply for jobs. We commenced inclusion of a Glass Door review for research library stocks during COVID, partially to circumvent the lack of middle management access we were achieving during lockdowns which we might otherwise have gained from company site visits.

Even as lockdowns have subsided and site visits resumed however we continue to view Glass Door as a useful tool for independent insights into a companies employees (and culture).

In more detail the website provides for each company:

- Independent reviews with a ranking out of 5
- A ranking as to whether employees would recommend the company to a friend
- A % of employees that approve of the CEO
- Unfiltered reviews (that can be anonymised) from current and past employees summarising pros and cons of an organisation and its culture

Below is an example of a review we noted during our research update on James Hardie (JHX) – notably one opinion among many (a fair few of which were positive) but interesting in its own right. The obvious response being there are always ex-employees that become disenfranchised, but then the CEO did get sacked 6 months later. Effectively it's simply another data point for us to assess the culture of a business.

Toxic culture, avoid like the plague! Don't believe the propaganda they spin!!

21 June 2021 - Sales

✕ Recommend ✕ CEO Approval — Business Outlook

Pros

If you fit the mould & drink the JH kool aid, there's a chance you'll be promoted...however the promotion will involve additional work for no financial or professional reward.

Cons

- A very toxic culture from the top down.
- Generally, people will step over other people to succeed. Team meetings involve nonstop shameless self promotion.
- Outdated systems and processes across the board.
- No awareness of what customer service is & operate like dictators to the market and channel.
- Operate with underhanded tactics that have you questioning your morals & the business you work for.
- Business is run with an iron fist type rule.
- Salary is lower than other manufacturers.
- Lots of hype and promotion of the company brand yet no substance behind any of it.
- No diversity within the sales team. Probably a good thing however as women (or anyone else for that matter) aren't subjected to the terrible work environment & boys club mentality.

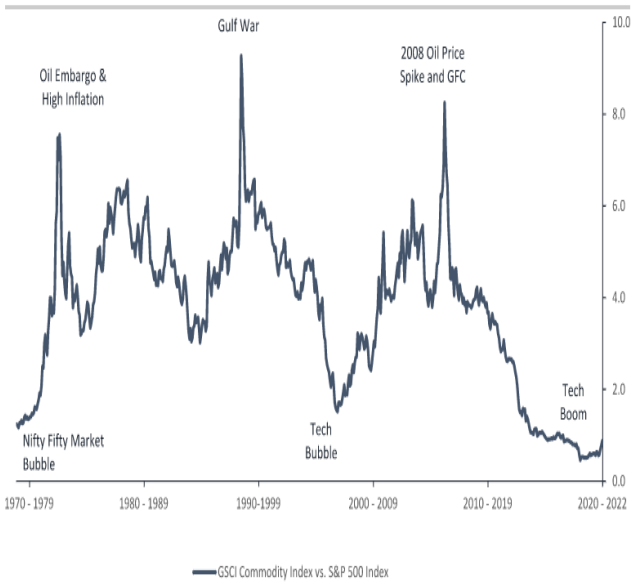
Source: Chester Asset Management

Commodities

We think chart 10 is quite instructive as to how to think about the investment landscape over the next 3-5 years. We have had an unprecedented period of financial assets (the S&P500) outperforming commodities since the GFC, thanks largely to ever lower interest rates. It does appear that given the inflationary pressures occurring globally, the pressure on interest rates is higher, and with that, the unwind of the relationship shown on chart 10. We see having the ability to invest in commodities as almost mandatory over the coming 5 year period. Chart 11 highlights that in periods of high inflation, oil, commodities and gold (including miners) have a very strong track record of outperforming through these periods. We don't see any reason why this period should be any different. While gold as an asset class performed quite poorly through 2021, we see the inflationary parallels with the 1970s (chart 10) as a road map as to what could transpire in the 2020s. The supply shock of the Russian invasion of Ukraine has only placed further pressure on the commodity producers while the security of supply becomes paramount. Until this point Europe has been heavily wedded to Russian energy, at the expense of trading with Canada and the US. Subsequently the capex spend in both Canada and the US on replacing energy reserves has significantly declined. Until this investment mindset changes, there appears to be significant upward pressure on energy prices globally, now that Europe is committed to diversifying away from Russian influence.

The ratio of commodity price vs the S&P500

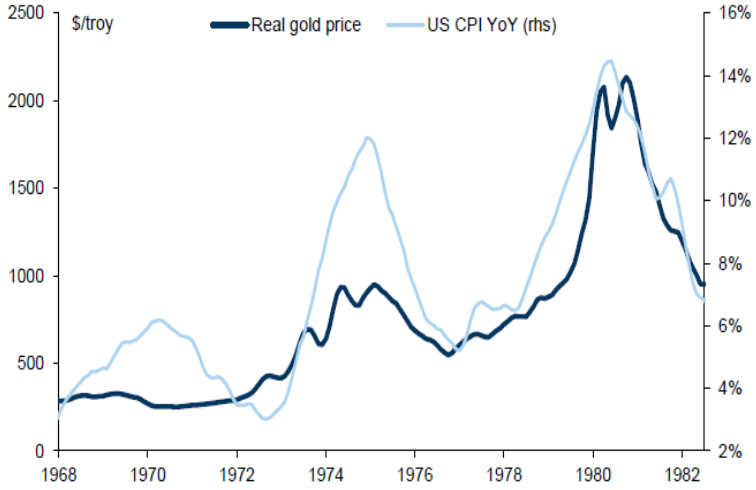
Chart 10



Source: Jefferies

Gold saw significant price appreciation in the 1970's

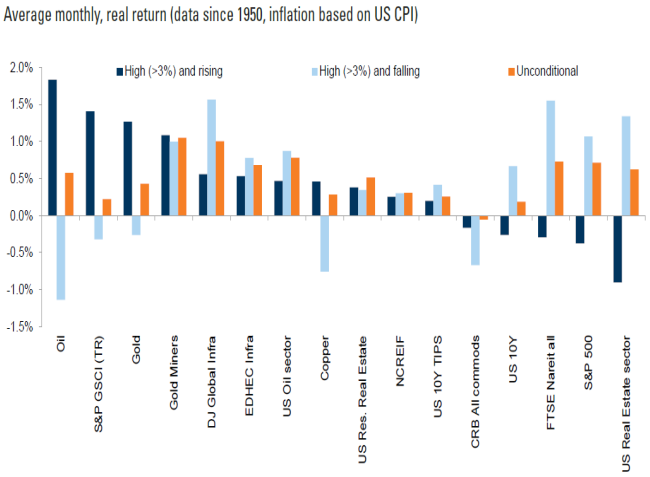
Chart 14



Source: Goldman Sachs

Real assets outperform in periods of high inflation

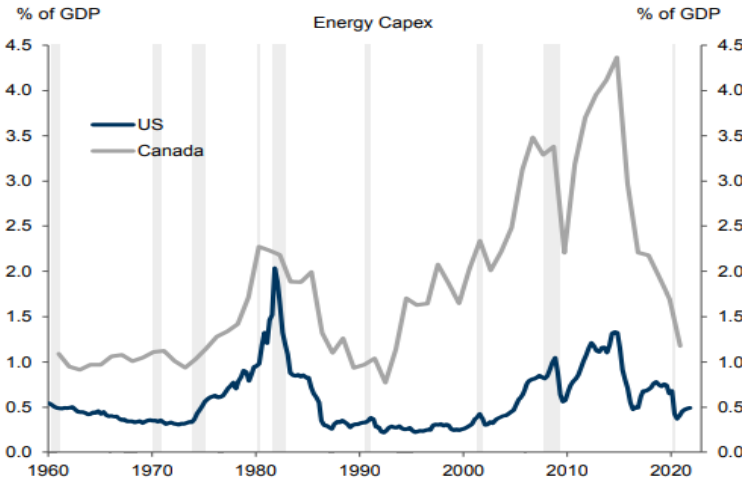
Chart 11



Source: Goldman Sachs

There has been a dramatic decline in energy capex spend

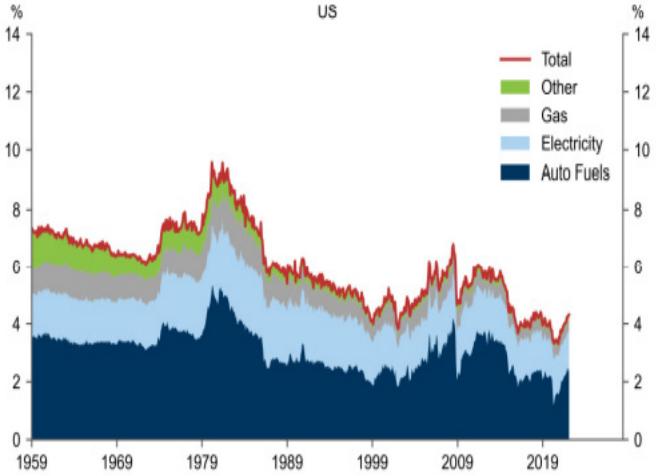
Chart 13



Source: Goldman Sachs

Energy consumption as a % of total consumption

Chart 12



Source: Goldman Sachs

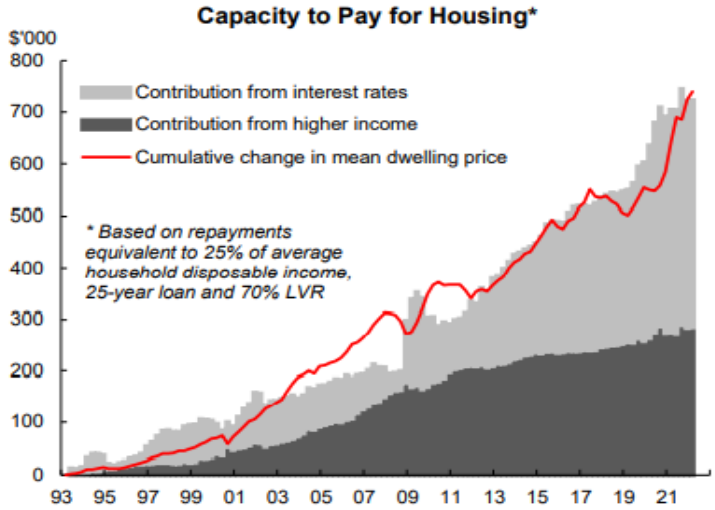
Australian domestic trends

The era of rising interest rates will be an interesting one to navigate. While Australia is very much driven by household wealth, which has boomed over the past 2 years thanks to lower interest rates, this party appears to be ending. There is now much caution around the entry into the Australian housing market. Chart 19 highlights just how much of the recent property price gains have been driven by lower rates. While the well worn narrative that banks do well in times of rising interest rates (due to the spread between what the deposit rate is and what the variable mortgage rate is), we are still very mindful of the fact that impairment charges are at or near historic lows. It will be interesting to see what a 100-150bp rise does to impaired loans. Having said that, while we have full employment, this should not be an issue for the next 12-18 months or so. We also have the prospect of an uplift in immigration back to the country for the first time in 2 years, which should theoretically create more demand for housing stock.

What is more apparent, is how well Australia fares relative to the rest of the world during commodity cycles. Naturally this is due to our higher exposure to resource companies in our index. But this natural hedge against a softening housing market can see an uplift in mining investment and the associated flow on effects, including our federal deficit. With a labour shortage as bad as its ever been and Australia still one of the leading democracies in the world, the investment case (food, commodities and energy) and migration case back into Australia is as compelling as ever.

House prices has been led by lower interest rates

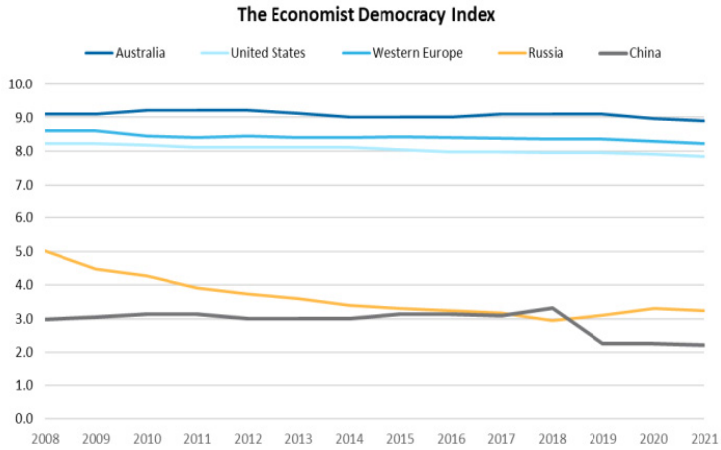
Chart 19



Source: Macquarie research

Australia still a leading democracy

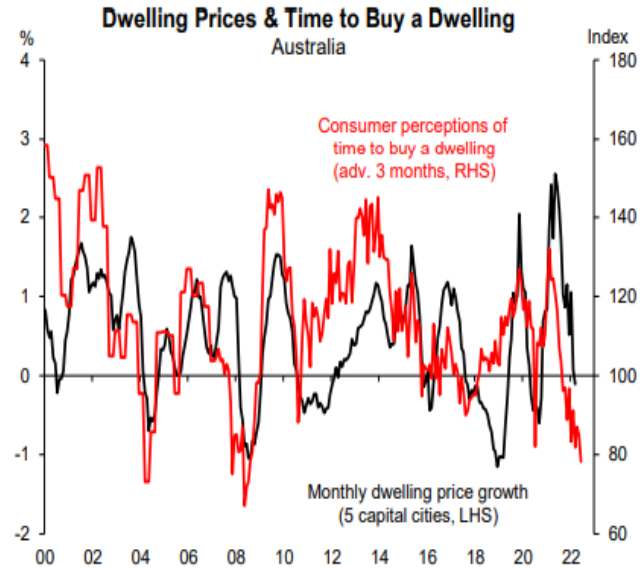
Chart 18



Source: Macquarie research

Not a great time to buy a house

Chart 15



Source: Macquarie research

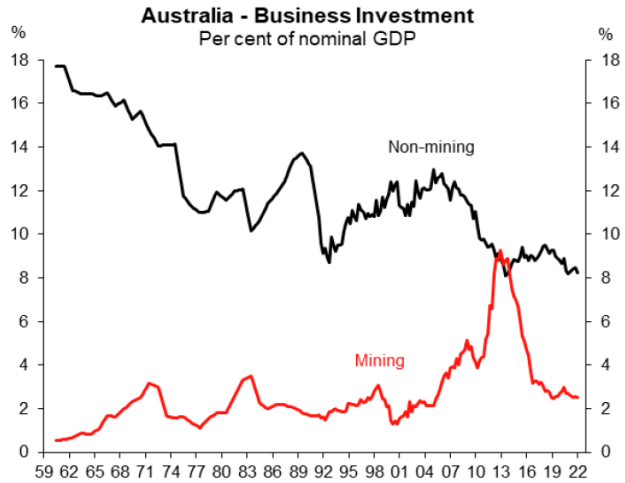
Australia outperforms the US in commodity cycles

Chart 16

Source: Macquarie research

The case for mining investment to lift is strong

Chart 17



Source: Macquarie research

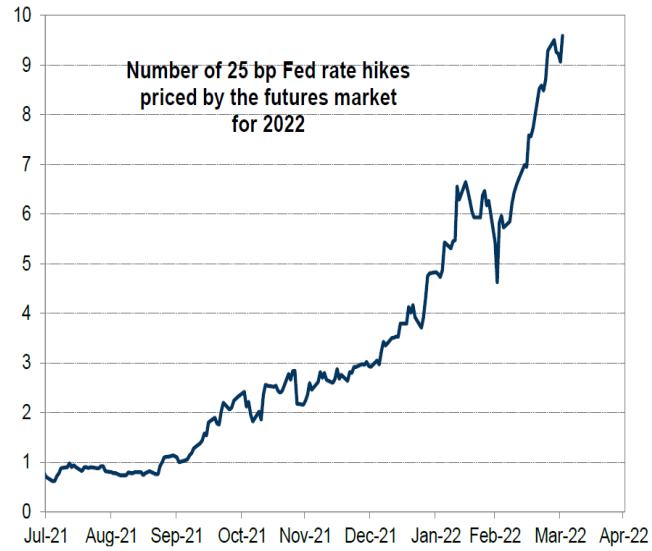
US big picture trends

Chart 20 illustrates just how quickly monetary policy expectations have changed in the space of the past 5 weeks. The Fed works on a dual mandate of managing inflation (not working) and full employment (hot). Hence the switch in focus over the past 8 weeks. The Fed has also warned that quantitative tightening will start in May, by unwinding USD1.15Tn (circa US95bn per month) a year from the Fed Balance Sheet (chart 21). So in the space of 5 months we have gone from the easiest monetary conditions of all time, to expectations of the most aggressive tightening in 40 years (combination of 9 interest rate rises and QT). We are not sure that equity markets have priced this correctly (while the bond market has reacted with the worst 4 months for US government bonds in recorded history (the bond yield rising from 1.5% at year end to 2.65% at the time of writing). Former Fed President, Bill Dudley suggests that for the Fed to be effective, it'll have to inflict more losses on stock and bond holders than it has so far. To get inflation under control, a level of demand destruction is going to have to be manufactured.

Equity markets thus far have been far more focused on the inverted yield curve (the US 10yr bond is lower than the US 2yr bond) implying that if rates rise too quickly in the short term, they'll have no option but to embark on an easing cycle eventually. Hence, equity markets are calling Powell's bluff. We suspect he's been looking at chart 23 below and working on the assumption that much of the wealth accumulation over the past 2 years can be unwound to reign in inflation going forward. Our summary? Volatility will get worse this year.

The most aggressive rate rises in 40 years?

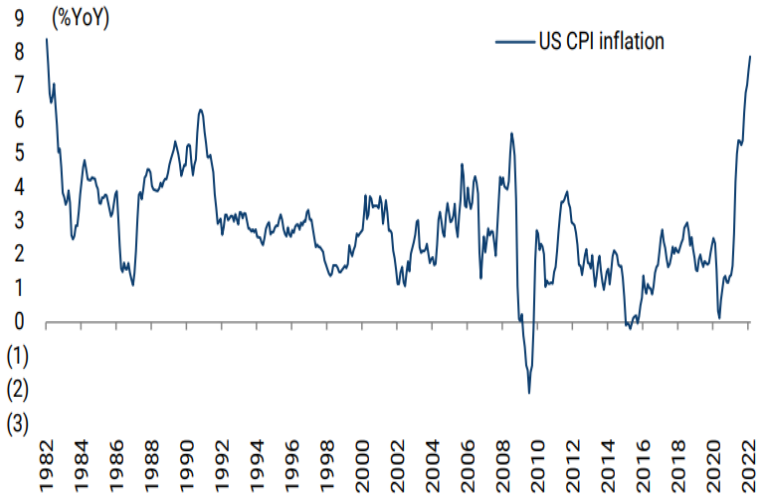
Chart 20



Source: Goldman Sachs

Inflationary pressures still rising, before oil spiked...

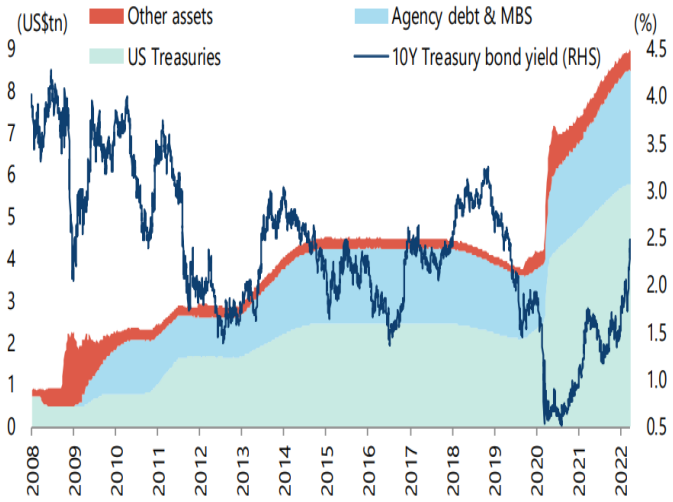
Chart 24



Source: Jefferies

US Balance sheet is going to start unwinding

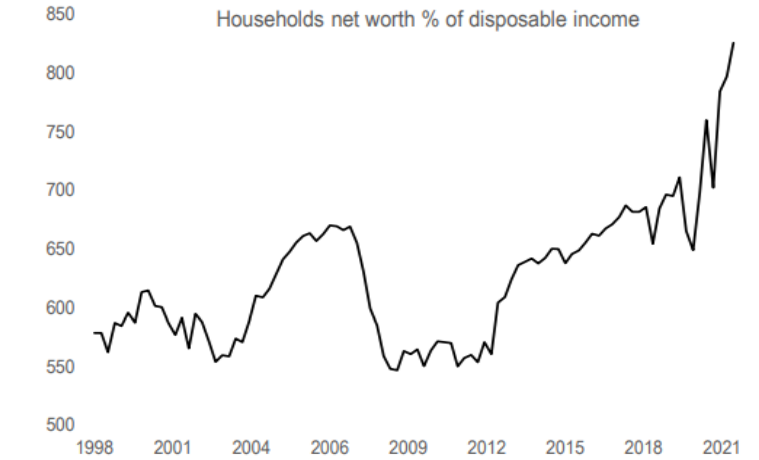
Chart 21



Source: Jefferies

Great for asset owners, but creates further inequality

Chart 23



Source: Credit Suisse

US High Yield spreads - no near term risk yet?

Chart 22

Source: Chester Asset Management, Bloomberg

China thoughts

Having watched China carefully manage the economic data it releases for almost 20 years, we must confess to being more confused than we normally are around the apparent lack of CPI inflation relative to the rest of the world. Given China is broadly facing the same input cost pressure (energy, iron ore etc) we can only interpret the CPI data to mean that domestically the demand side of the equation is anaemic.

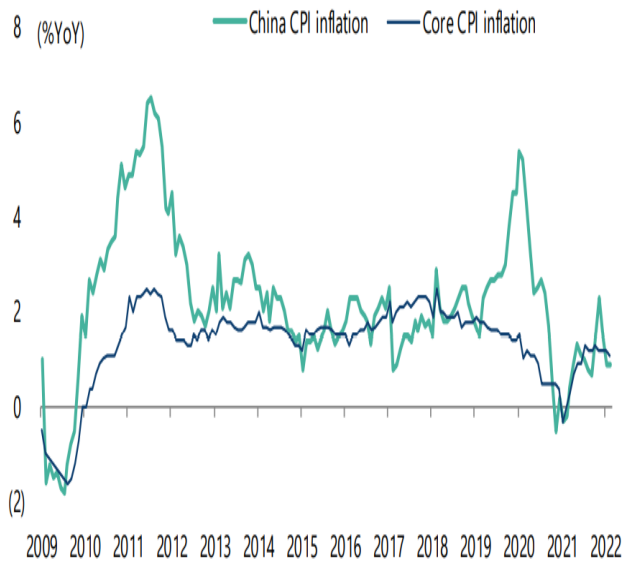
Surveying a broad range of China data doesn't leave us with any more comfort that the economy is recovering. In fact, with the recent lockdowns and the determination to run a COVID zero policy, consumer sentiment is only deteriorating. Chart 27 highlights the near term declines in the PMI data, which only captures part of the recent citywide lockdowns. This is reflected in the official language coming out of the State Council who acknowledged the broad downward pressure on the economy.

We interpret this to suggest that China will embark on another round of dovish monetary policy and easing lending requirements, at the exact time the rest of the world will be raising rates. The extension of this is downward pressure on the RMB from a demand perspective and also the prospect of a competitive devaluation to ensure that Chinese export markets remain open. This would be relatively precarious for the price of metals should this eventuate.

So we start the quarter with a very cautious tone regarding China, more so because it has become clear that President Xi is far more concerned with social issues than capital markets, meaning the path forward is less clear.

China isn't seeing the same CPI pressure...??

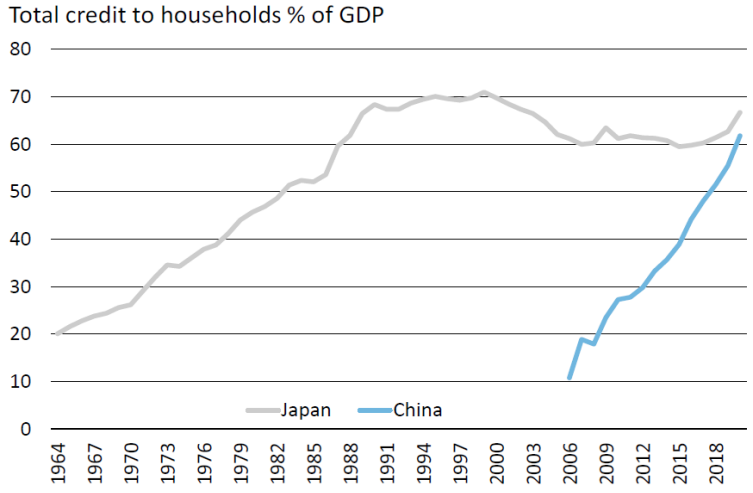
Chart 25



Source: Jefferies

Similarities betwen China housing and Japan circa 1990?

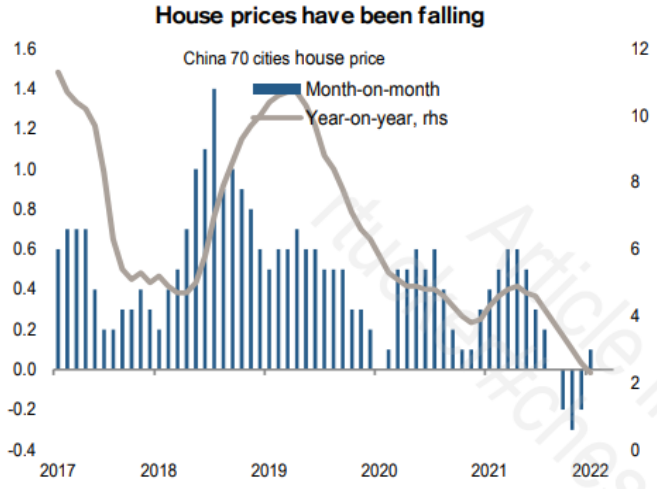
Chart 29



Source: UBS

Household wealth isn't coming from house prices

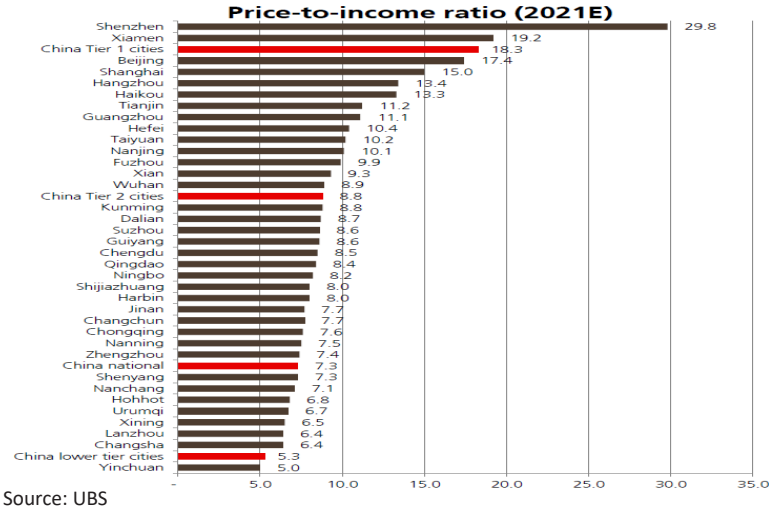
Chart 26



Source: Credit Suisse

Chinese property some of the most expensive in the world

Chart 28



Source: UBS

PMI data starting to weaken on lockdowns

Chart 27

Source: Chester Asset Management, Bloomberg

More macro musings...

These charts frame our thinking in terms of where the risk/reward lies in portfolio construction. We have left chart 30 in the pack because we do think it's relevant in terms of change in leadership. Clearly growth has been the major style beneficiary over the past 12 years as interest rates and bond yields kept falling. We do think that the dispersion of valuations (chart 34 below) highlights just how expensive high PE firms have become relative to the ASX200. Some of this premium has unwound, we think as interest rates rise, there is more to go as the PE dispersion normalises. We don't think of ourselves as "growth" or "value" investors per se, but we are focused on the risk and reward dynamic with each individual stock decision. Hence these charts demonstrate to us, that we shouldn't be taking undue risk this year with high PE stocks, as there is very little margin of safety, as we are witnessing, the style rotation as the market starts pricing in higher interest rates. This really ties into the notion of asymmetric investing.

We also see the strength in the AUD (chart 33) as a significant headwind for the offshore earners (well loved names that have benefited from a falling AUD since 2013), one of the various reasons we have a bias towards domestic companies in 2022. We also can't ignore chart 32. While we have always had an allocation to gold for diversification reasons, the global gold miners we think are significantly undervalued using today's spot price. We think the risk reward to our gold mining companies here is as strong as it's ever been.

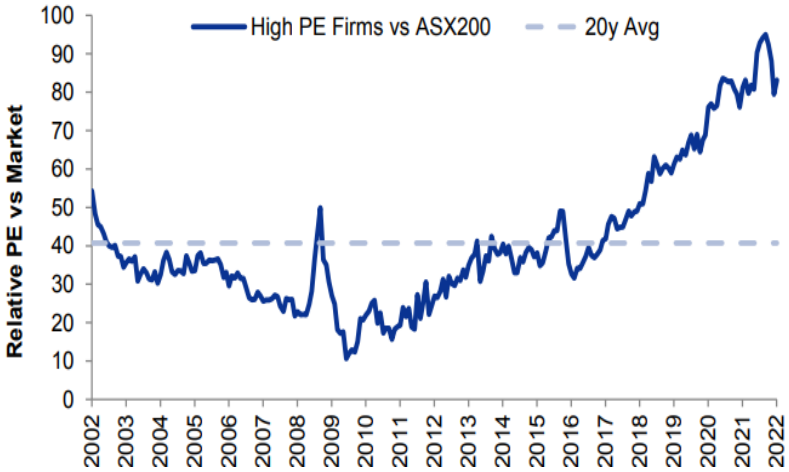
World value stocks vs world growth stocks

Chart 30

Source: Chester Asset Management, Bloomberg

The unwind in the growth stocks premium has started

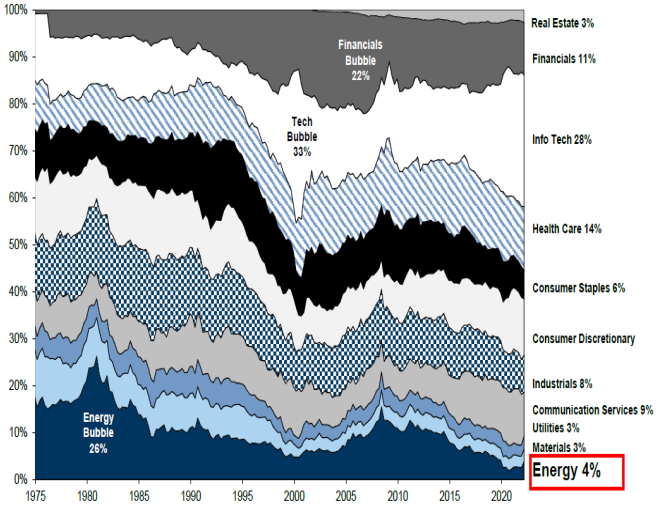
Chart 34



Source: Goldman Sachs

While energy and materials are just 6% of the S&P500

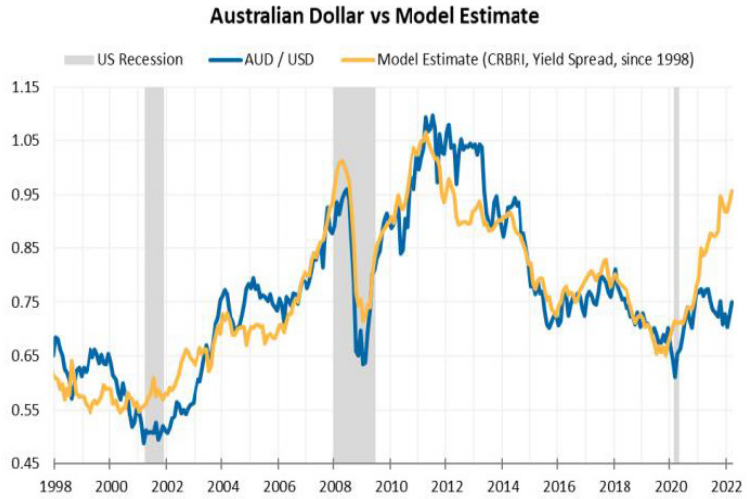
Chart 31



Source: Goldman Sachs

Significant upward pressure on the AUD

Chart 33



Source: Macquarie Research

Global gold stocks still 100% below prior peak

Chart 32

Source: Chester Asset Management, Bloomberg

Behaviorial Biases

We've always been fascinated with the psychology of investing, and as humans, we all exhibit biases, mostly these are unconscious traits that lead individuals towards an outcome. It's helpful to understand the different behavorial traits when investing, the idea being it can help identify how to improve our decision making.

Loss aversion. People often feel the pain of loss more than the joy of gains. Researchers Ori and Rom Brafman, in their 2008 book, "Sway: The Irresistible Pull of Irrational Behavior,". Loss aversion takes hold when people recall investment portfolio declines more vividly than gains, sometimes even when the gains are greater. "It upsets people if they lose money when the market goes down. People remember losses forever, but they don't remember the years they made 30 percent – just years they lost 20 percent,"

Confirmation bias. People are often drawn to information or ideas that validate existing beliefs and opinions. For example, many TV viewers prefer a news channel that represents their own political views, avoiding those featuring commentators of different opinions. People do the same when it comes to financial topics. An investor may have a belief about market conditions and gravitate toward information sources that confirm that belief. "Oftentimes, it happens when we attach an emphasis to the outcomes we desire, such as investing too much in the stock of the company you work for, which also reduces your diversification. The best way to overcome this bias is to consider information from multiple sources,"

Mental accounting. First identified by behavioral economist Richard Thaler of the University of Chicago, mental accounting occurs when a person views various sources of money as being different from others.

Mental accounting can manifest itself in a few ways. Money earned at a job may be viewed differently than money from an inheritance. This can affect the way the money is spent or invested.

In a 1999 paper on the topic of mental accounting, Thaler cited an example of a trip he took to Switzerland to give a talk. Afterward, he and his wife took a vacation in the area. "At that time the Swiss franc was at an all-time high relative to the U.S. dollar, so the usual high prices in Switzerland were astronomical. My wife and I comforted ourselves that I had received a fee for the talk that would easily cover the outrageous prices for hotels and meals. Had I received the same fee a week earlier for a talk in New York though, the vacation would have been much less enjoyable," he wrote.

Mental accounting shows up in investor portfolios, too. "People get emotionally tied to certain stocks," Wire says. She recalls a particular elderly woman who wouldn't part with a large holding of stock in a local bank started by a family member. Wire says it's a fairly common problem.

"Especially if it's something they inherited or was a gift, or it's a company they used to work for, people can become emotionally involved with owning certain stocks. When people have employee stock purchase plans to buy company stock, they feel like they're more loyal employees if they own it, even if it's a bad investment and they're not diversified," Wire says.

Illusion of control bias. After a prominent plane or train crash, it's not hard to find online commentators proclaiming a preference for travel by car, saying they feel more in control when driving. Many are resolute in this preference despite decades of research showing that air and rail are statistically much safer.

A similar thought process applies to some people's investing decisions. "The illusion of control begins with the word 'should,' as in, 'I should be able to pick the right stocks,' or 'someone should have the ability to time the market to achieve superior results consistently,'" says Michael Kay, president and advisor at Financial Life Focus in Livingston, New Jersey.

Recency bias. When gas prices fall, sales of large sport-utility vehicles and trucks tend to rise. It's not difficult to see the connection: Consumers believe what's happened recently will continue to happen. The phenomenon also exists with investing. It's no secret that retail investors tend to chase investment performance, often piling into an asset class just as it is peaking and about to reverse lower. Because the investment has been climbing higher recently, investors believe that will remain the case.

Unfortunately, research has shown that it's essentially impossible to predict which asset class, sector or geographic region will be the top performer in any given year. But past performance can be a strong driver, as few people want to feel left behind.

Wire says interest in gold, which took a sharp turn lower in late 2012, was an example of investors' recency bias before the yellow metal plummeted. "For three years, everybody wanted to buy gold. I just kept saying, 'Really?'" she recalls.

Hindsight bias. "I knew that would happen." Who hasn't said or heard that, probably many times?

While the know-it-all who reminds people of his or her forecasting prowess can be annoying, hindsight bias can have detrimental effects on one's finances.

"Humans tend to overestimate the accuracy of their predictions. This can be costly as we get a false sense of security when making investment decisions, which can lead to excessive risk-taking behavior and place people's portfolios at risk," Porter says.

Herd mentality. Rugged individualists aside, people are social animals. Marketers know this, and have become adept at creating social proof that since other buyers like their products, so should you. It's another type of thought process that takes hold when a person doesn't want to be left out of a trend or a movement.

Our Executive Summary

Equities

The risk to equity markets is that financial conditions (interest rates, quantitative tightening) have the potential to be considerably tighter in 2022 as central banks embark on fighting inflation, after calling it transitory for 12 months. Tighter financial conditions will most likely lead to higher volatility through 2022 than we have seen over the past 18 months.

We do think the conflict in Ukraine has changed the mindset of policy makers around the security of supply, which will override the cost of supply (whether it be energy, commodities, semi conductors, consumer goods). This shift in mindset will take 3-5 years to unfold given the long lead times to deploy onshore capability, but will ensure a cost of doing business that will be structurally higher than it has been for the past 20 years.

We believe Australia is extremely well placed to benefit from this trend over the coming decade, with an enviable lifestyle and strong (if 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 see a rebound in immigration of both skilled and unskilled labor.

By and large we prefer to be contrarian with our investments which has been remarkably difficult over the past 5 years. Our most successful ideas have either been somewhat unloved, underappreciated or undiscovered stories. We actually view the current environment to be more favourable for a more contrarian style bias to be rewarded over the course of 2022, as the bond market tries to reprice higher inflation expectations, leading to further sector rotations. This suggests a period ahead of value outperforming growth.

The inflation debate is only now "structural" in nature, while the real debate is how hawkish the monetary policy response is. Asset prices haven't had to deal with this issue since 1981. Simplistically, while US 10year yields are at 2.6% and inflation is at 8% and rising, the notion that real yields will remain negative for the foreseeable future is relatively apparent to us. Under this setting, our view remains that real assets (property, agriculture, commodities, gold) will outperform capital light or long duration assets over the coming years, predominantly based on the view that inflation will be more persistent than current expectations, and that this is actually a desired policy response for governments burdened with insurmountable debt.

Our strategy is very focused on individual companies with appropriate diversification, given the wide range of outcomes possible over the next 12-18 months. Many of our positions are where we believe there is a strong margin of safety and the risk reward profile is favourable to generating positive returns over the next 12 months, regardless of the move in the ASX300.

By and large, our stock selection framework focuses on:
Real assets - AZJ, MIN, QUB, ORG, WPL, S32
Valuation margin of safety - NWS, LLC, DOW, ASB, RIC, SM1
Pricing power - TAH, EGH, CSL, TCL
Gold - OGC, AMI
As we have demonstrated over the past 8 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.

Gold

Gold effectively has a dual purpose. As a store of safety in uncertain times, which we saw through 2020, and as a store of value when inflation occurs, as real interest rates turn negative. As discussed, we are less confident that real yields ever turn significantly positive again. We do see the prospect of a stronger USD as the biggest hindrance to gold's price action this year, notwithstanding the gold equities (globally) remain out of favour and very cheap. We are turning more favourably disposed to gold equities, simply given the cash generation provided at USD1900/oz. We are excited by the opportunites for alpha generation from this portfolio allocation.

Gold has proven highly successful in outperforming when equity markets fall through the course of history and hence remains a valuable allocation to the portfolio construction.
We spend much of our time analysing gold equities which are selected primarily on valuation grounds first, and then an assessment of the quality of the resources and cost of extraction. Clearly management competency and a track record of delivery is also an important variable.

Government spending and bond yields

The enormous increase in deficit spending across the globe to ensure the unemployed workforce can pay bills has left (and will leave) most central banks with an insurmountable debt burden. There is no longer any pretense of any political party anywhere to try to repay these debt burdens the future generations are faced with. Interest rates simply cannot rise materially with the amount of debt issuance by central banks, and it appears we are more likely to see negative real interest rates in the US, than positive real interest rates in the foreseeable future. Obviously the prospect of interest rate rises in 2022 will challenge this thesis, but inevitably there is an absolute structural ceiling on how high interest rates can go before bankrupting the US Government. Very simplistically if US interest rates were 3%, on USD30tn of debt, the US interest bill on that debt would be USD900bn, against 2022 revenues of USD4.2tn (and a deficit of USD1.9tn)
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. Since Alan Greenspan, Fed governors have always issued a "put" on the stock market with new easing policies, which in the next downturn, eventually becomes yield curve control, and ultimately direct equity purchases, if needed. Is this possible in 2022? Absolutely.

CONTACT COPIA

1800 442 129 | client services@copiapartners.com.au | copiapartners.com.au

John Clothier	General Manager, Distribution	0408 488 549 | jclothier@copiapartners.com.au
Mani Papakonstantinos	Distribution Manager	0439 207 869 | epapakonstantinos@copiapartners.com.au
Greg Black	Distribution Manager	0438 297 616 | gblack@copiapartners.com.au
Jude Fernandez	Distribution Manager	0414 604 772 | jfernandez@copiapartners.com.au
Sam Harris	Distribution Manager	0429 982 159 | sharris@copiapartners.com.au