Chester High Conviction Fund
Quarterly Thoughts
July 2022

In partnership with COPIA

The Chester High Conviction Fund Philosophy

Our Key Principles

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

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At 30 June 2022	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)	-9.5	-10.1	-4.7	4.8	14.3	12.4	12.5
S&P/ASX 300 Accumulation Index	-9.0	-12.2	-10.4	-6.8	3.4	6.9	6.2
Outperformance (after all fees)	**-0.5**	**+2.1**	**+5.7**	**+11.6**	**+10.9**	**+5.5**	**+6.3**

* 27 Apr 2017

"It was only necessary to buy "good" stocks, regardless of price, and then let nature take her upward course. The results of such a doctrine could not fail to be tragic"— Benjamin Graham & David L Dodd, Security Analysis, 1934

The chief operating officer of our house recently decided that it would be a worthwhile father-daughter bonding session to enter a puzzling competition with our keenest puzzler. Remnants of the COVID era. Little did the COO know (or let on) that we had been entered into the VJPA (The Victorian Jigsaw Puzzlers Association) annual competition. 120 pairs, all ages. The sense of humour started failing as we were informed that this was a 3 hour competition, not one hour as promised by the COO. The VJPA rankings were determined by first the speed of completion, and failing that, how many pieces of the (500 piece) puzzle were completed at the end of the allotted time. All information we were learning in real time. The first inkling we were in trouble was when the winners were announced 45 minutes into the competition, before we had completed the bottom row (less than 50 pieces). As more and more participants finished the puzzle, it became clear that this father daughter combination were out of their depth. Unfortunately our team recorded a DNF, we resigned our VJPA membership effective immediately and our puzzling career was over. It wasn't fun while it lasted.

We view all the pieces of the macro environment as a jigsaw puzzle. The intersection of inflation, interest rates, currencies, commodity prices, government deficits and most importantly monetary and fiscal policy in light of these forces. Without question, the desire of central banks in the first half of 2022 has been to (belatedly) focus on fighting inflation. Jay Powell (Fed Chair) even admitted that risking recession was necessary in bringing inflation under control. Price stability is key. The USD is driving much of the macro forces currently given the relative weakness in Europe. So we are in the middle of a co-ordinated western world economic slowdown, to effectively crush the demand side of the inflationary debate. Realistically though, it has been the supply side (supply chain constraints, energy and food supply) that has been the major driver of the inflationary pressure. This is a difficult puzzle, but maybe the commodity complex rolling over solves a piece of it?

Equity markets try to discount 6-12 months into the future, which considering the first half of 2022 suggests a period of economic weakness ahead. Historically, business cycles tend to last 18 months or so. We are of the view though that in this information driven age, as real time data is disseminated so quickly, these business cycles are becoming far shorter, perhaps 9-12 months. This shows up in confidence indicators, capex intentions, forward orders and hiring intentions. Perhaps most relevant in terms of leading indicators, is purely M2 (or money supply), which at the end of 2020, had risen 25% or so year over year, and is now decelerating sharply. Combined with broad commodity price weakness, the economic landscape is changing rapidly.

The Fed (and to a lesser extent, the RBA) tend to focus on a dual mandate, inflation and unemployment. Both remain very strong, which suggests that the hawkish interest rate environment continues for the foreseeable future. Only when we see signs of inflation peaking and unemployment rising will we see a change in language from central banks. The problem with both inflation and unemployment is that they are both lagging indicators. Leading indicators (confidence, freight rates, new orders, inventory levels, hiring etc) are suggesting a far weaker outlook than the lagging indicators. To that end, commodity prices themselves (led by copper) are also signaling economic weakness ahead. Thus the bond market is taking instructions from the real time economic indicators, while the equity market is still grappling with the inevitable earnings revisions downwards over the coming months. There are simply too many companies that face rising cost pressures, without the ability to pass on these costs anymore as demand is weakening. These earnings revisions will create somewhat of a minefield through the July/August reporting season, and hence the key attribute we are looking for currently is earnings resilience. There will be some wonderful buying opportunities ahead.

So what could go right?

We believe the market is heavily focused on earnings resilience (as are we) in light of significant cost pressure being felt by every business. We are also very mindful of higher discount rates being reflected in falling share prices. In this context, significant economic weakness will be seen as good news for equities, as the prospect of the interest rate tightening cycle would appear to be peaking. In fact, the forward interest rate curve is starting to price in interest rate cuts in 2023, such is the changing economic landscape. We have long been of the view that central banks (particularly the US Fed), can not afford materially higher interest rates, given the amount of public debt held by central banks themselves. We go through this maths again inside. There has been the notion of the Fed put for the past 20 years, whereby the Fed runs to a 3rd mandate, which is equity market strength. This appears to be off the table for the time being, but should the S&P500 fall another 15% (thus down 35% from its peak), the notion of the Fed put may well be back on the table, with the most likely approach being yield curve control (YCC).

Forgotten in much of the current financial commentary is the ongoing Russian occupation of Ukraine and how disruptive this has been to energy markets and food supply. Whilst along way from a base case, the prospect of a peace deal being brokered and oil falling significantly in short order should not be ruled out. As we approach a European autumn, the humanitarian crisis of heating and food will become critical for much of Western Europe (Germany), hence we would ascribe a probability to a peace deal being brokered in the next 3-4 months as higher than zero. Markets would rally significantly.

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. 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 this quarter

The quarter was again relatively active from a portfolio stand point. With volatility as elevated as it has been, we find being prudent with portfolio weights important in managing equity market risk. Given the deterioration in economic forward indicators and equity market activity, we decided to exit Macquarie Group **(MQG)**. This has effectively been held in the portfolio since inception, but recorded a 65% uplift to FY22 earnings which we view as unsustainable, combined with a peak cycle PE multiple, we felt the risk to both eps and PE compression highlighted a poor risk/reward framework in this environment. We also exited Woodside **(WDS)** as we viewed the share price >AUD34.00 as trading above our valuation support. With cyclical stocks such as **WDS**, we do focus heavily on our valuation framework. For the same reason we also exited South 32 **(S32)** during the quarter, effectively acknowledging strong near term cash flows, but a deteriorating outlook. The fund took new positions in Telstra **(TLS)** whereby the cash flows appear to be resilient through the mobile network which is as close to a consumer staple as we can find, while there is still value to be unlocked with the InfraCo assets. Brambles **(BXB),** was also added, a company we have been watching and modeling since 2001. We find that the changes to their large contracts over the past 3 years with cost pass through (freight and fuel) suggests margins should be more resilient than they have been in the past. The 50% reduction in lumber prices in CY22 should result in the capex bill for new wooden pallets being far lower in FY23 than it has been over the past 18 months suggesting, perhaps, the holy grail of strong FCF is not just an illusion. The fund also took a small position in Pointsbet **(PBH)** during the quarter. While PBH is still loss making, the Australian business is profitable, as is the US iGaming business, suggesting that, after falling 85% over the past 15 months, at a AUD600m mkt cap with circa AUD400m (end of June) in cash and 2 profitable business units, the strategic value of PBH is being underplayed in any future wagering consolidation.

So what now?

Financial conditions will continue to tighten with interest rates rising, which ties into our framework of desiring strong cash generation and asset backing. In this environment, asset backing does provide a level of downside protection, as earnings will incur volatility. 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 believe sustainable dividend yields will become far more important in a more challenging earnings cycle. We do think the 2H of 2022 will provide more opportunites than the first 6 months.

Real assets. Inflation theoretically drives real asset valuations higher, or hold at a minimum. Assets that are very hard to replicate or disrupt indicates a strong starting point. We would place **QUB, TCL, ORG** and **BXB** in this category, while commodity producers and REITS 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 entry points in **SGP** and **GQG** also tied into this framework. We note the recent US Coast Guard contract awarded to **ASB** and subsequent share price reaction illustrates the notion of how we think about asymmetric investing. Clearly, the market had not allowed for any prospect of future US contract wins. A 20% discount to book value does help.

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, TLC** and **NWS** (through it's holding in REA and Move) in this category. We think margin resilience becomes the most important driver of equity returns in the post free money era.

Gold. Historically, more often than not, gold performs the best as a defensive asset class in times of inherent volatility. Gold equities globally had an extremely weak 2Q, with major indices down 30-40%. Our holdings weren't immune. We rationalise this with two reasons. USD strength which saw the USD gold price soften over the quarter, while far more impactful has been the rise in mining costs through higher fuel (diesel) and contract mining rates. This has impacted profitability materially, although we would note, we still see extreme value in many of the gold equities right now, and still see strong merit in the non correlated exposure that gold historically delivers.

The Portfolio

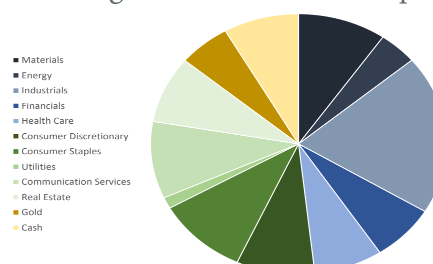
The CHCF posted a 10.1% fall in the June quarter, relative to the 12.2% fall in the ASX300 Accumulation Index. The positive attribution being led by Ridley **(RIC),** which we consider to be a very well run animal feed producer, that has cost pass through mechanisms in place, while still having multiple internal drivers to grow earnings over the next 3 year period. Transurban **(TCL)** responded to bond yields falling over the past 3 weeks, while again, CPI linked revenue mechanisms are highly sought after in this environment. Our gold holdings (which comprise less than 6% of the fund currently) had a challenging quarter, led by Aurelia **(AMI)**, which is seeing the cost pressure discussed above, but is ignoring a significant uplift from a world class asset (Federation) in FY24 in our view. Both News Corp **(NWS)** and Imdex **(IMD)** saw strong share price declines on the expectation of future weakness in earnings, diverging significantly from the actual earnings trajectory.

Top 3 holdings
CSL Ltd
Brambles Ltd
QBE Insurance Group

Portfolio breakdown	
Industrials	19.8%
Consumer Staples	10.0%
Materials	9.7%

Top 3 portfolio attribution	Bottom 3 portfolio attribution
Ridley Corp	Aurelia Metals Ltd
Transurban Group	News Corp Ltd
Ramsay Healthcare	Imdex Ltd

Fund weights - diverse sector exposure



What we are thinking about...

GEOPOLITICS	Europe. Remains the wild card into FY23. Europe has an enormous energy crisis unfolding, to the extent that officials in Germany are warning of the collapse of the aluminium, glass and chemical industries. Germany has just recorded its first trade deficit since 1991. Trying to be glass half full, perhaps this increases the possibility of a Russia/Ukraine cease fire and compromise of sorts. Whilst this appears a low probability outcome currently, it would remove the largest impediment to tackling the inflation problem, namely energy prices. Equity markets would rally significantly should this eventuate in our view. In the meantime, we are watching European bank credit default swaps carefully.
INFLATION PEAKING?	We tend to separate the inflation mindset into two categories, the core component and the food and energy component (which is actually the most important aspect of inflation for consumers). It is the core basket of goods that has many components that appear to be rolling over (household durable goods, used cars, apparel, housing prices as a lead indicator of shelter costs). Whilst we're not brave enough to pick the top in an individual CPI print, the rate of change appears to be heading lower over the next few months. The recent pullback across the commodity complex suggests an acceleration of this disinflationary trend is occurring. Still high and problematic, but peaking.
DON'T FIGHT THE FED (YET)	We have loosely used the framework of the on/off switch with monetary policy since the GFC. For the most part, the US Fed has been dovish and accommodative, providing a tailwind for asset prices. The switch is currently off, in the attempt to tackle inflation. In our view, witnessing the demand destruction taking place, the switch may only be off for another 3-6 months before changing monetary policy course again. Whilst frustrating, understanding how monetary policy is changing is essential in navigating markets. We would prefer to spend all our energy on individual companies and bottom up stock selection, but this is unavoidable.
BASIC MATHS	One of the most obvious megatrends that we are faced with over the next decade is deficit spending. Whether it be the US, the Euro zone, or Australia, the notion of running balanced budgets appears to be a 20th century ideal. Hence, we look at the simple maths behind the US government deficit spending inside, whereby the financing of a USD1.5-1.8Tn deficit appears problematic, unless propped up by the Federal Reserve. Of all the US 10yr bonds issued since 2014, US Banks or the Federal Reserve themselves have purchased 96% of the securities. This remains the central thesis behind holding an allocation to gold (equities) in the portfolio, as the ongoing erosion of fiat currency paper seems all but guaranteed. The clear risk to this thinking is the current USD strength, given the relatively poor alternatives, particularly in Europe.
UNLISTED VALUATIONS	We will watch with interest over the next 6 months as many super funds and venture capital funds with unlisted assets have to start re-pricing the holding of certain investments down. Of course, in the secondary market (the ASX) assets get marked to market every day, but unlisted assets have really only been revised up over the past 8-10 years. There will, we suspect, be some naval gazing around some of the unlisted assets being held at 2021 valuations. It highlights to us that the IPO market will be extremely challenging (closed) for the rest of 2022.
AUSTRALIAN BANKS	We review our thesis on the banking sector inside given its influence over the ASX300 Index (25% weight). While the upside case is driven by rising net interest margins as interest rates rise, we err on the side of being cautious around the rise in impairment charges, whereby the banking industry is far more leveraged to a credit impairment cycle (through earnings and dividends) than rising NIMs. On a risk reward basis we tend to tread carefully with Australian banks, being acutely aware of how leveraged Australians are to property prices. The risk/reward trade off for us is far from compelling.
VALUE EMERGING YET?	One of our projects when we first started in finance was to provide a study of drawdown periods of bubbles deflating. This was post the Nasdaq crash in 2001/2002. This study over history suggests that many bubbles end with wealth destruction from peak to trough of between 80-90%. We have a screen internally that highlights when stocks fall 85% from their peak. It certainly makes us pay attention. There are many stocks that fit into this category across the ASX300 universe, many that actually will never come back with unprofitable business models and limited cash on the balance sheet. There are several that we believe have strategic merit that we are doing more work on. There are plenty of unloved companies at the moment.
REPORTING SEASON	For us the key focus in reporting season will be cash flow (it always is), but also the ability for companies to demonstrate margin protection. Obviously companies with industry tailwinds (energy or agriculture) should see strong top line growth, thus will be insulated somewhat from the cost inflation that will impact every corporate. Other companies that can genuinely demonstrate rising margins through a strong cost out program or strong pricing power will be well rewarded. The other focus of ours will be on inventory management. February reporting season saw a build up of working capital as supply chain challenges saw many companies switch to "just in case" inventory management. But what has happened to demand for these goods since? This will be a very interesting reporting season.

Stock selection - Qube Holdings (QUB)

Description

Qube (QUB) is regarded as Australia's leading provider of integrated logistics solutions across both imports and exports.
QUB has traditionally been split into 3 segments

- An operating Division (Logistics & Ports and Bulk)
- Property Division (predominantly Moorebank but now divested)
- Patrick 50% stake (with Brookfield). Australia's leading container terminal operator, undertaking ~3m TEU lifts per annum across 4 ports: Port Botany (NSW), East Swanson Dock (VIC), Fisherman Island (QLD), Fremantle (WA)

Quality

The QUB business benefits from customer diversity and the essential nature of their logistics services in which they are largely integrated within customer supply chains. Patrick's runs as an effective duopoly (DP World being the other major player) with incredibly strategic, difficult to replicate assets exhibiting strong pricing power. We have always regarded QUB as a high quality business but with the sale of Moorebank, completed December 2021, we believe there is an opportunity to refocus on a number of fronts.

- Operational Focus: Moorebank had become a drag on management time and capital. From a reporting standpoint QUB are now splitting operations into 2 distinct segments: Logistics & infrastructure and Ports & Bulks (and disbanding the property segment). Management (and the market) are able to devote greater time to operations. The 1H results and outlook showed strong performance in the period, assisted by acquisitions, agricultural conditions and new customer contracts
- Balance Sheet strength. With the sale of Moorebank, we have seen net debt decrease from AUD1,388m (29%) at 30/6/21 to AUD387m (10%) at 31/12/21. I.e., from ~4x ND/EBITDA to ~1x
- Shareholder returns. At the 1H result QUB announced a capital management plan which culminated in a AUD400m discounted, off-market buyback. QUB also announced a target dividend payout ratio of 50-60% of EPSA
- Acquisitions. QUB has never shied away from making acquisitions but can now do so more comfortably with their balance sheet strength. They have already made 2 acquisitions in the first half: Newcastle Agri Terminal (NAT) and AST Logistics (AST) with a further bolt on in January. These incremental bolt-ons will add to the growth story and maintain a leadership position in the Australian logistics industry.

Valuation

Although our preferred methodology for infrastructure businesses remains a DCF it is impossible to ignore the complexities and differing structures of businesses within QUB from an operating logistics business, historically Moorebank (an infrastructure/property development opportunity) and Patricks (ports and stevedoring business) hence we find the most appropriate way to value QUB is a sum of the parts (with a DCF cross check). Our SOTP Valuation is AUD3.75/share. At current prices, based on Chester projections of earnings QUB trades on ~22x FY23 earnings (EPSA) which we think understates the strategic nature of their business. In our view, QUB represents a strong 2-3 year opportunity below AUD3.00.

Insight

QUB is seemingly friendless which, apart from being Paul Digney's first year as CEO, we think reflects: a labour intensive business, heavily impacted by COVID; in an environment of global supply chain challenges (including higher energy costs). Despite these pressures we believe the strength of current conditions for areas like agriculture and bulk commodities offset some of these obvious headwinds.
QUB is an extremely diversified business so there are many puts and takes in any year but specifically on Agriculture (Ag) revenue, QUB doesn't give exact detail but implied from their 1HFY22 presentation, QUB generated ~AUD297m in Ag revenue in 1H FY22 compared to ~AUD144m in the pcp, with the newly acquired Newcastle Agri Terminal (NAT) contributing ~AUD7m. Ex NAT we can thus estimate that Ag contributed ~AUD146m in extra revenue for 1H FY22, against a relatively fixed cost base. Multiple (upgrade) announcements since February by GNC suggests Ag conditions have strengthened over the 2H FY22 for QUB. We are also of the view that the 50% shareholding in Patricks undervalues the asset in the QUB corporate structure, due to lack of visibility as to the underlying cash flow within the JV, which is also 50% owned by Brookfield in a PE fund entity. There may be the opportunity for QUB to employ their pre-emptive right and buy out the 50% stake in Patricks held by the Brookfield entity as/when it happens to be winding up that specific fund.

Chart 2

Logistics and Infrastructure revenue split

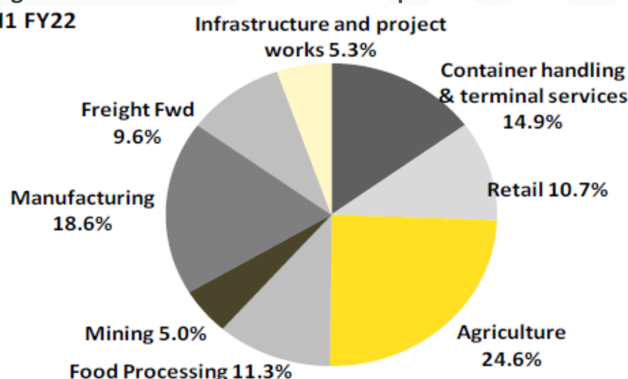
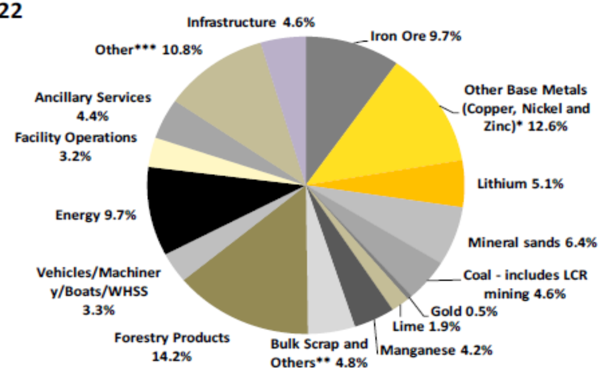


Chart 3

Ports and Bulk revenue by industry - strong diversification



Source: Qube 1H FY22 results presentation

Chester High Conviction Fund top 10 holdings

	Cash flow style	FY1 Sales GR	FY2 Sales GR	FY1 Div Yield	FY2 Div Yield	FY1 DPS GR	FY2 DPS GR	FY 22 ROE	FY 23 ROE	FY22 BOOK VALUE	FY23 EV/EBITDA	FY22 EPS GR	FY23 EPS GR	FY1PER	FY2 PER
Austal Ltd	Predictable	-9.1%	3.4%	3.4	3.4	1.2%	0.0%	8.90	7.90	0.9	5.5	-10.5%	-12.3%	12.1	13.9
Brambles	Predictable	9.2%	4.7%	3.0	3.2	10.0%	7.4%	22.10	22.20	3.7	7.0	7.5%	4.8%	19.2	18.3
CSL Ltd	Predictable	5.8%	18.9%	1.1	1.3	0.2%	16.7%	19.70	19.10	5.8	20.1	-4.6%	17.2%	39.1	33.4
News Corp	Predictable	12.6%	3.4%	1.3	1.3	6.2%	2.4%	6.10	6.40	1.0	6.2	66.5%	13.6%	18.2	16.0
Nufarm Ltd	Cyclical	19.1%	-3.8%	2.0	2.1	nm	4.8%	6.20	6.32	1.0	6.3	130.1%	-3.5%	16.6	17.1
QBE Insurance	Predictable	22.8%	6.0%	4.0	6.0	17.3%	51.7%	10.50	14.90	1.2	nm	2.2%	47.5%	13.5	9.1
Ridley Corp	Predictable	7.0%	1.2%	3.9	4.4	nm	15.2%	11.50	12.30	1.6	6.5	52.9%	13.1%	16.2	14.3
Synlait Milk	Predictable	29.8%	0.8%	0.0	0.5	nm	nm	4.50	7.00	0.8	6.8	nm	54.6%	17.9	11.6
Telstra Corp	Predictable	-4.3%	1.5%	4.1	4.1	0.0%	0.6%	11.20	13.10	3.2	7.8	3.7%	19.3%	27.2	23.2
The Lottery Corp	Predictable	6.3%	3.5%	2.5	5.2	nm	75.0%	5.87	6.85	4.5	18.2	17.0%	6.9%	30.8	25.9

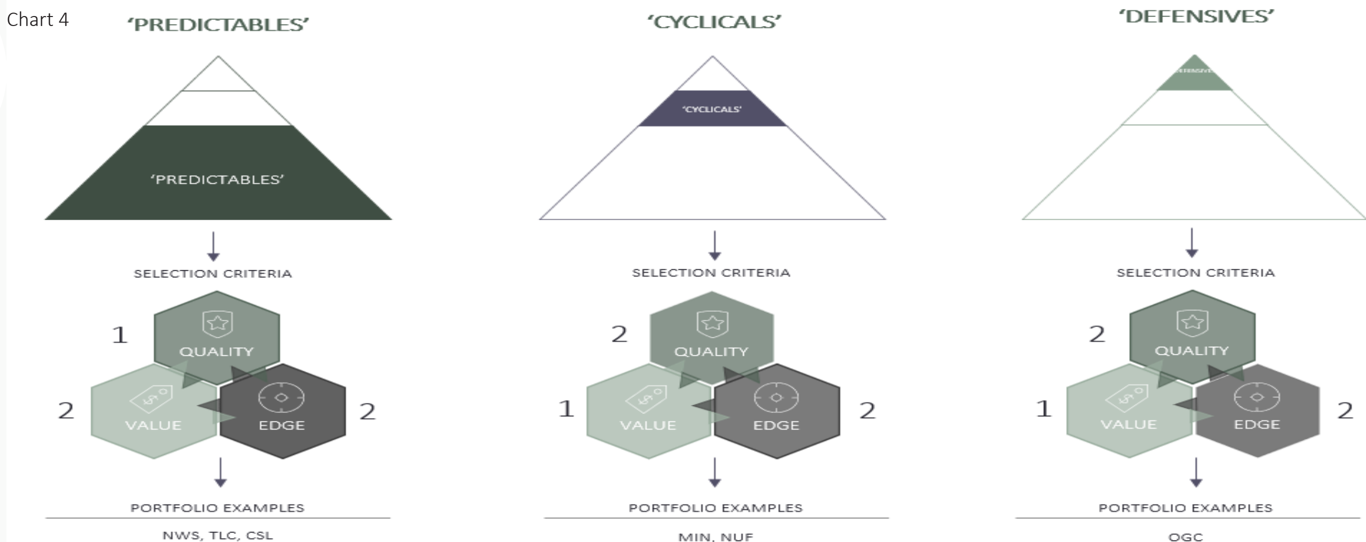
Source: Chester Asset Management

We have listed here our top ten holdings at the 1st of July, 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 expectations vs the market (or insight/edge) of the earnings projection. I.e. Do we think the market is mispricing earnings? For our thesis to hold, we require at least 2 of these 3 factors to be validated for the investment case.

To explain that in more detail we have used a slide from our presentation material (chart 4 below). The majority of the stocks currently held in the top ten holdings are classified as “Predictables” (Consumer Staples, Communication Services or Healthcare) while Nufarm is classified as a “Cyclical”. Our largest gold holding currently sits 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



Source: Chester Asset Management

CHCF portfolio construction framework

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.

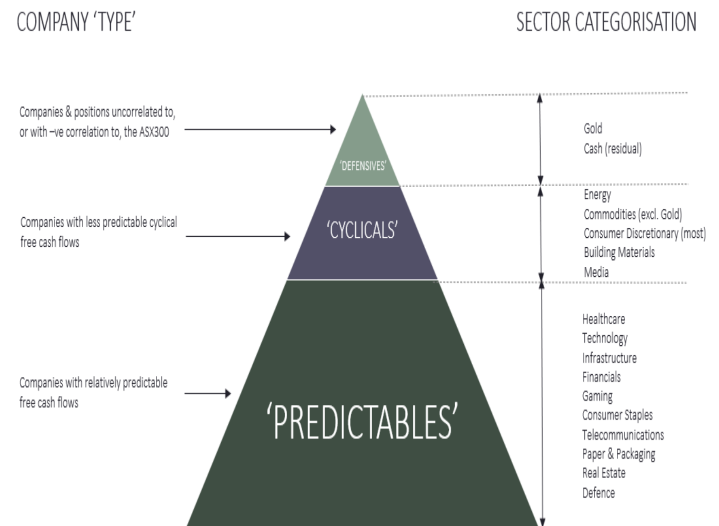
Chart 6 illustrates how these "buckets" have looked over the past 8 years. On average, the allocation to predictables has been 60-70%, while cyclicals have averaged around 15% (10-25%) and defensives have ranged from 10-25%. We have tended to hold an increased defensive position over the past 2 years, while in the last 3 months have added incrementally to our predictable positions, reducing our energy position while the other exposures remain very stock specific. We note the cyclical exposure is around 16% currently, which has been reduced from 24% in the past 6 weeks. 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 2/307 over 3 years and 2/274 funds over 5 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. This effectively means the fund demonstrates less volatility than the peer group, which is also shown by the standard deviation. What these tables also highlights is the lower level of correlation (R-squared) to the index, which shows this strategy is only 92.4% correlated to the index. 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 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?

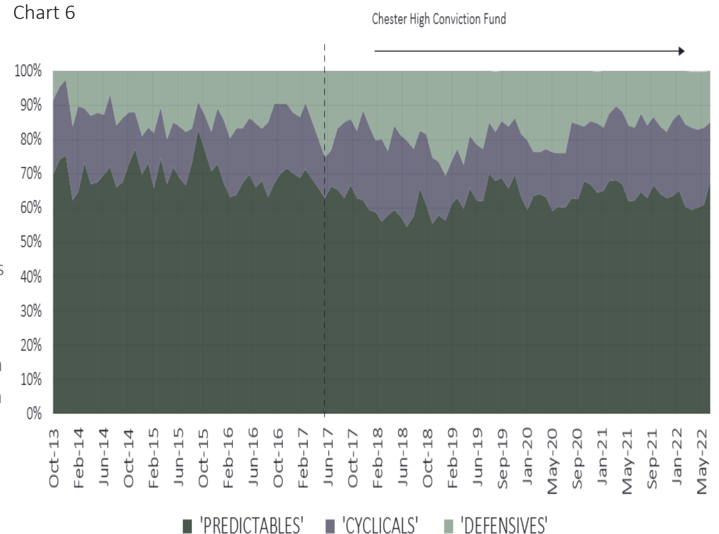
Chart 5



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 30 Jun 2022

	Total Return	+/- Cat	+/- Index	Cat Rank
1 Month	-9.52	-1.00	-0.75	289 / 342
3 Month	-10.13	1.77	1.77	84 / 340
1 Year	4.79	11.24	11.25	6 / 331
3 Year	14.33	10.72	10.99	2 / 307
5 Year	12.34	6.16	5.52	2 / 274

Risk Analysis as at 30 Jun 2022

3-Year Risk Measures	Fund	Category	Index
Standard Deviation	17.99	18.61	18.49
Sharpe Ratio	0.82	0.26	0.25
R-Squared	92.4	93.56	--
Beta	0.94	0.97	--
Alpha	10.34	0.14	--

Source: Morningstar database

US Economy

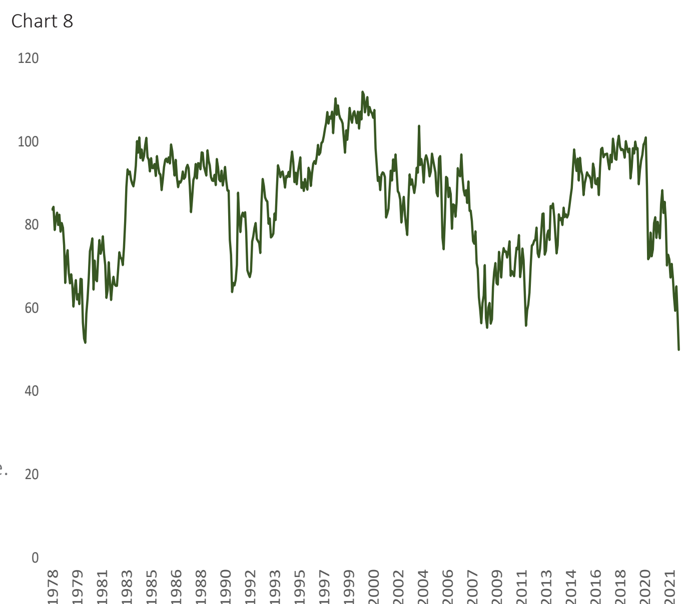
We can be accused of chart crimes here, as we have found a series of data points that help illustrate how quickly the US economy has rolled over in terms of momentum. This is what we refer to when we reference a business cycle being shortened due to the very public real time data dissemination. Historically a business cycle was around 18 months, we believe (with no quantitative analysis), that these cycles are now only 9-12 months. Charts 8 and 9 are self explanatory, while chart 10 showing durable goods purchases suggests that a downturn could really lead to a consumer strike, given the amount of stockpiling that occurred through COVID stimulus. This is really where the inventory overhang resides. We would be very surprised if this didn't revert to the long term trend line over time, which also shows up in the ISM data showing new orders deteriorating rapidly, while business inventories remain at all time highs. One of the many reasons why combined with rising wage, fuel, insurance and freight costs, for many corporates, current margins are unsustainable.

The largest influence over commodity prices in 2022 has been the strength of the USD (chart 8 below). We attribute this strength to the significant heating and food crises going on in Europe, at a time where there appears to be no consensus amongst the member states as to the correct course of monetary policy. Hence, the USD is attracting global capital as the interest rate differential (+150bp) and relative stability of the economy gains traction. The USD is trading at 20 year highs relative to the trade weighted basket of other currencies. Whether this is the cause or effect of global economic weakness (USD is a flight to safety), but also places pressure on emerging market economies that borrow USD denominated debt (which is going up), placing pressure on many of the US's trading partners. We are of the view that the recent strength in the USD has meaningfully contributed to the sell off in the commodity complex (again, cause and effect) exacerbating the global slowdown. Conversely this outcome will ultimately lead to the US rate expectations changing (as they are already), in terms of interest rate cuts in 2023.

Hence this is a roundabout argument whereby we think the end of 2022 will see the ECB still hiking rates, while the FED will be closer to an easing cycle, suggesting interest rate differentials should narrow again by the end of this year. This thinking also ties into the notion that ultimately, the Fed will have to be a significant contributor to the ongoing US deficit.

US consumer confidence at all time lows

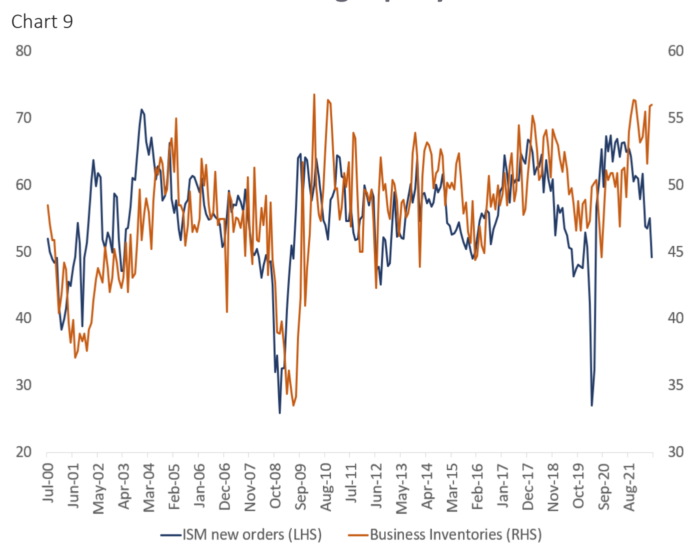
Chart 8



Source: Chester Asset Management, Bloomberg

US ISM new orders falling rapidly

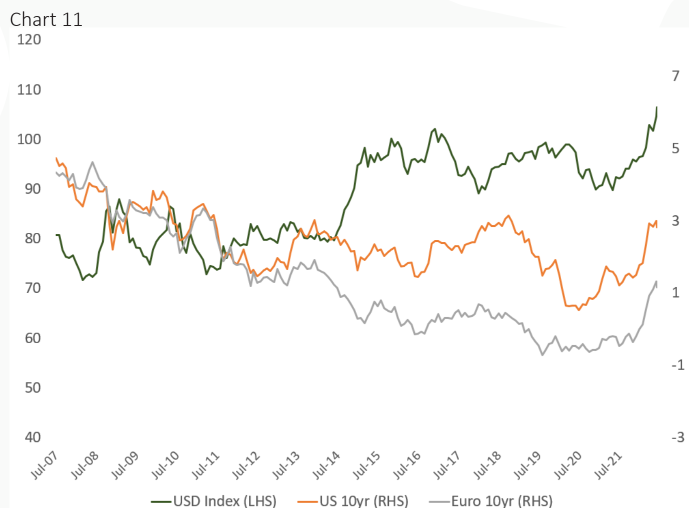
Chart 9



Source: Chester Asset Management, Bloomberg

US Dollar causing much of the damage

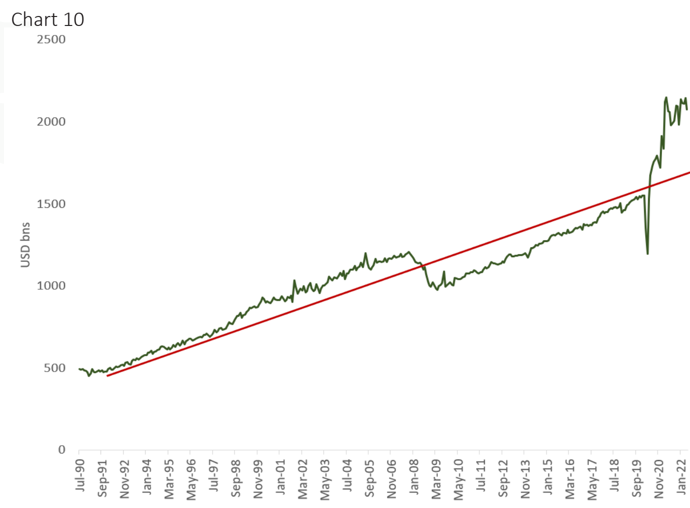
Chart 11



Source: Chester Asset Management, Bloomberg

US durable goods still well above the long term trend

Chart 10



Source: Chester Asset Management, Bloomberg

US Deficit Spending

We refer back to this thesis because it remains central to our portfolio construction framework. Yes, the USD is strong presently as the “cleanest dirty shirt” in terms of alternative currencies. Europe currently looks like an unmitigated disaster in terms of policy setting and aligning interests again of the Euro member states.

Having said that, we do ponder how the US continues to finance this deficit spending over the next 10 years. Whichever way you cut this, somewhere between USD1.5tn and USD2.0tn will need to be financed every year (Australian GDP is USD1.6tn currently). We note these revenue projections never include a recession and hence the deficit historically, has always ended up far larger than the CBO projections forecast. The CBO (Congressional Budget Office) release yearly budget estimates as to the trajectory of revenues and expenses over the next decade.

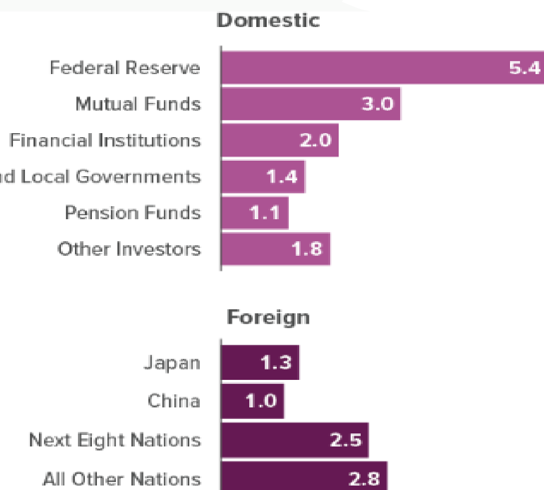
Chart 12 highlights Mauldin Economics’ strong visual representation of what these projections mean in reality. The difference between the black line (tax revenue) and the coloured area above the black line indicates deficit spending. What has always intrigued us is the level of mandatory spending- Social Security, Medicare, Medicaid, Veterans Affairs etc) comprises 80% of tax revenue, and growing. Chart 13 highlights that the US population reliant on social services or medicare is only going to accelerate. The interest bill (calculated here using a 2.5% cash rate), would actually be higher using forward curve estimates.

So to us, the simple maths is this, tax revenue of USD5.0tn, which has to pay for USD4.0tn or so of mandatory outlays, defence spending (also mandatory) of USD800bn and growing and an interest bill of at least USD500bn (this is using different securities with different coupons. At spot interest rates, the interest bill would be well over USD1.0tn. Before spending anything on nation building projects (schools, hospitals etc), which is also forecast to be USD1.0tn or so.

The obvious question to us then becomes, who is going to finance this over the next 10 years. Over the last 8 years since 2014, US Banks and the Federal Reserve have financed 96% of all bonds issued. We suspect without repairing the relationship with China (who are letting their USD assets mature), then it is likely that the US Fed has to remain as the buyer of last resort of US debt. Hence US dollar strength, but for how long?

Current holders of US Federal debt

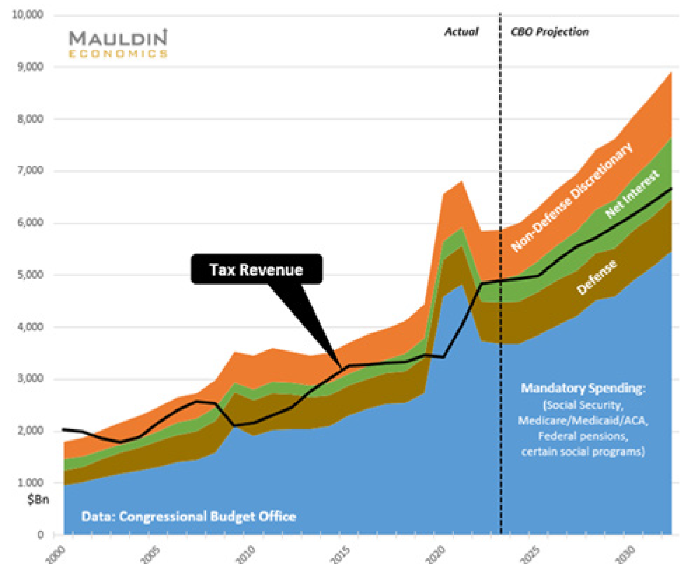
Chart 15



Source: Congressional Budget Office

US Federal spending vs tax revenue 2020 - 2032

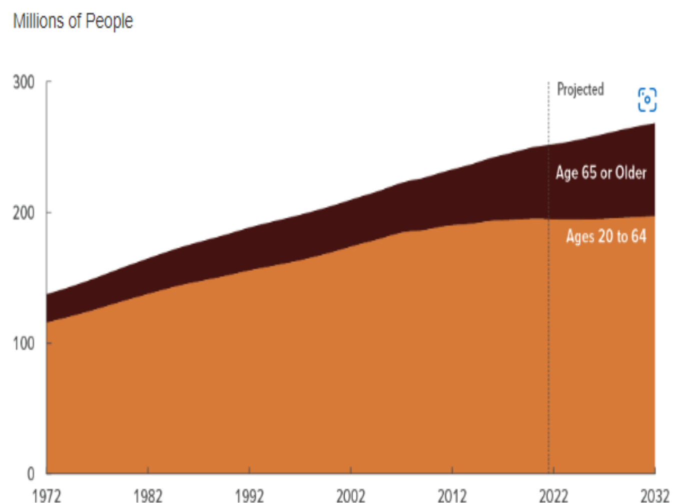
Chart 12



Source: Mauldin economics

US population over 65 is growing

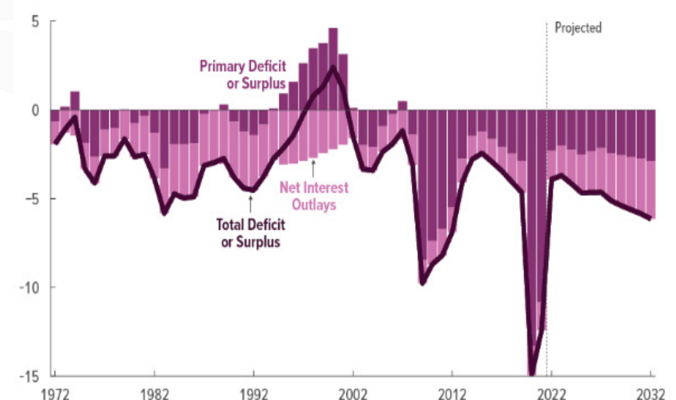
Chart 13



Source: Congressional Budget Office

US Budget deficit projections with no recession

Chart 14



Source: Congressional Budget Office

Gold

We often ask ourselves why continue with the gold sleeve? Gold technically looks very friendless currently. Sometimes it creates headaches given like other commodities, gold equities are subject to the same volatility of macro forces driving the end product (gold price) and subject to the vagaries of mining, which is currently as challenging as it has ever been given labour shortages and rising diesel costs. For all the volatility, we still find gold equities to be non correlated most of the time (this wasn't true in the 2Q 2022), and historically very useful as a portfolio diversification tool. On average it comprises around 6% of the portfolio.

The bull case for the gold thesis lies in chart 18. This is often used by gold bugs when presenting the case against fiat currencies. Given the deficit spending outlined on the previous page, the fiscally conservative argument suggests that all fiat money should be backed by gold reserves. Gold having been used as the World's store of value for 5000 years. Looking at the table below, using the US monetary base in 2022, it is currently sitting at just over USD6tn, while the US gold reserves are publicly quoted at 260 Moz. At today's price, that suggests that the gold coverage of the US fiat currency position is only 8%. This is clearly due to the dramatic increase in money supply of USD over the pandemic period, with the US monetary base more than doubling over the past 11 years. The simple maths of this becomes (if fiscal conservatives had their way in seeing each country's monetary base backed by gold reserves) gold would need to be trading at USD23,477/oz to see the US gold reserves (260 Moz) completely back the amount of USD in circulation. A 12x increase from todays price. Let us be clear, we do not subscribe to this notion, nor do we see any real prospect of this eventuating (simply put, the USD has too many structural reasons to run the deficit spending forever, that tying the USD back to a gold standard would simply be too difficult). But it does highlight to us, the frailties of fiat currencies. Money, in its simplest form is just a store of confidence for people to transact with. So what happens if/when people lose confidence in the USD?

Enough preamble. We look at chart 16 above and recognise how poorly gold equities have performed vs gold over the past 10 years, with the Gold bugs index still down more than 50% from its previous peak in 2011. This to our mind, is more of an opportunity than a threat over the next 3-5 years, particularly with many gold miners trading less than 6x EV/EBITDA (our very crude proxy for cash flow).

We do find that gold equities can be useful sources of alpha, but we are very detailed in the way we assess the merits of each gold company. In no particular order, management quality and track record, AISC (All In Sustaining Costs), production growth, resource and reserve life, grade, geographic location, exploration permits (greenfield or brownfield) and plant capability are all input factors as to the end product. Cashflow. While we haven't presented our database above in chart 17, we have presented a snapshot of several metrics. Our largest gold position is OceanaGold (OGC) which held up very well in FY22. It currently trades on 3.3x EV/EBITDA for 14% production growth from FY22-FY24, which is all organic growth. Capricorn (CMM) we simply find too expensive for the asset base they currently have. Aurelia (AMI) has been disappointing (cost pressures) for the cash generation it produces (net cash position), with its best asset not yet quite finished its FID process. We remain encouraged by the ore body that should start producing in FY24 (but not yet in these forecasts).

USD Gold price vs Global gold mining index

Chart 16

Source: Chester Asset Management, Bloomberg

Select Australian gold producers

Chart 17

	Market Cap (AUD mn)	TSR past 12 months	EV/EBITDA	FY22 Production	FY23 Production	FY24 Production	3 year CAGR
Newcrest	17505	-21%	8.80	1960	2400	2500	12.9%
Northern Star	8004	-29%	5.17	1550	1750	1850	9.2%
Evolution	4418	-46%	5.16	640	720	800	11.8%
Regis	1129	-39%	3.18	440	470	550	11.8%
Gold Road	1188	-14%	6.31	163	178	180	5.1%
St Barbara	663	-53%	3.31	270	300	340	12.2%
Westgold	554	-36%	2.26	270	320	330	10.6%
Red 5	566	21%	6.93	50	250	260	128.0%
OceanaGold	1279	6%	3.34	460	500	600	14.2%
Aurelia	334	-37%	1.74	104	115	120	7.4%
Capricorn Mining	1179	63%	8.81	120	125	125	2.1%
De Grey	1149	-35%	-98.22	0	0	0	
Bellevue Gold	639	-33%	-35.72	0	0	170	

Source: Chester Asset Management, Macquarie research

US Monetary base - the lowest gold coverage ratio ever

Chart 18

Year	US Money Stock (Base Money in USD bn.)	US Gold Reserves (Moz)	Gold Price (oz)	Value of Gold Reserves (in USD bn.)	Gold Coverage Ratio	Gold Price to Fully Back Monetary Base (in USD)
1971	84	290	41	11.9	14%	290
1980	156	263	835	220	141%	593
2008	1,136	260	830	216	19%	4,369
2011	2,638	260	1,623	442	16%	10,146
2022	6,104	260	1,921	499	8%	23,477

Source: In Gold We Trust report

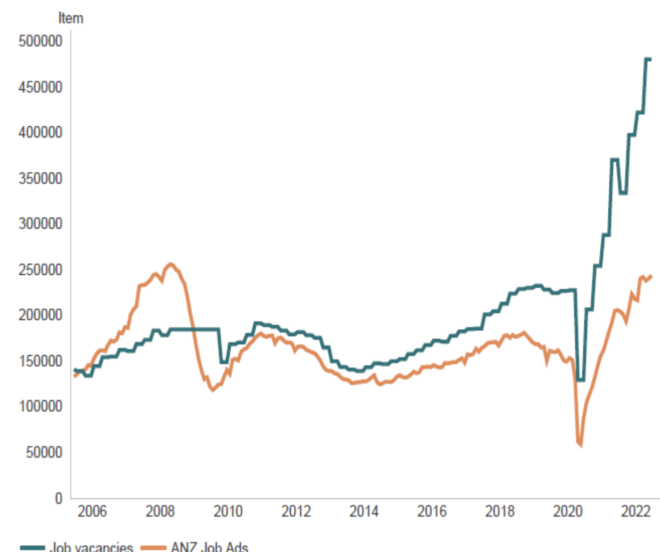
Australian Economy

It's never easy distilling all the variables of an economy into 400 words and 4 charts, but this is our summary. The labour market remains extremely tight for the time being. One of the main causes of chronic shortages in higher risk sectors (COVID inspired problems with hospitality and travel) has been the dearth of immigration through this period, seen in chart 22 below. Basically Australia requires our net migration to be at least 250k people to fill some of these service economy roles, then hopefully Qantas can stop canceling flights whenever they want. So labour market tightness is driving up wages, which is unremarkable in itself. It is placing significant stress on many corporates, with staff churn a significant factor in lowering the productivity of the economy. Broadly speaking the market has de-rated many of the stocks that have a significant portion of their cost base as salaries. Looking 12 months forward, we see the prospect of this pressure unwinding. That is, there will be far less job vacancies, there will be a wider pool of available labour and much of what we have seen over the past 12-18 months will unwind (subject to immigration).

Consensus appears to be forecasting a 15% decline in Australian house prices, since the RBA became serious about inflation. Chart 20 from Macquarie research is visually useful, suggesting that, given the average mortgage servicing costs are going up, the ability to finance those mortgages goes down, to the extent that should interest rates rise 200bp, the ability to finance those mortgages falls 18% (broadly in line with the notion of the housing price correction. Should interest rates rise 300bp, housing prices would fall 24% all else being equal, and the Australian banking sector would find themselves with a wall of impairment charges. If you thought that interest rates would rise 300bp, you would sell every Australian bank. We think this scenario is unlikely, simply because, Australians are too leveraged to house prices, and we also believe that inflation is peaking (or close to it). The other consideration given to the economy, is chart 21 below. On average the household mortgage servicing cost has been just over 25% of the average household disposable income. The RBA would be acutely aware of how sensitive consumer spending is to this metric. Our suspicion is that this thinking forms much of how hard the RBA needs to "tap the brakes". Until they do though, we remain very watchful as to how much discretionary spending ability Australians have. The next 6 months look very tough.

Labour market remains tight

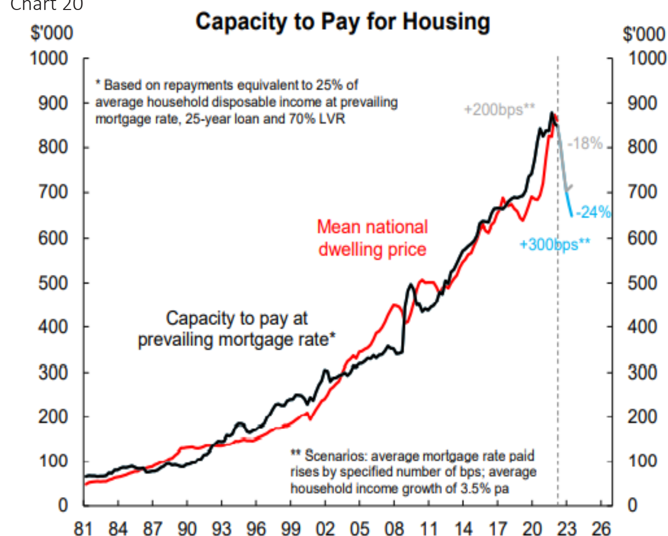
Chart 19



Source: Barrenjoey

Consensus view is that housing falls 15% or more

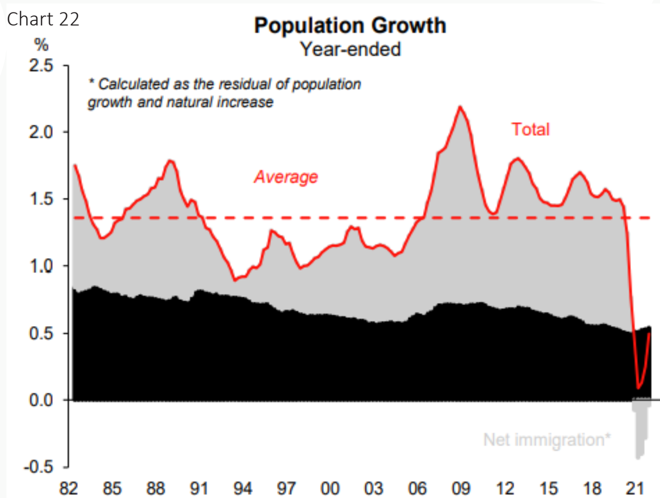
Chart 20



Source: Macquarie research

Australia needs immigrants to solve the labour shortage

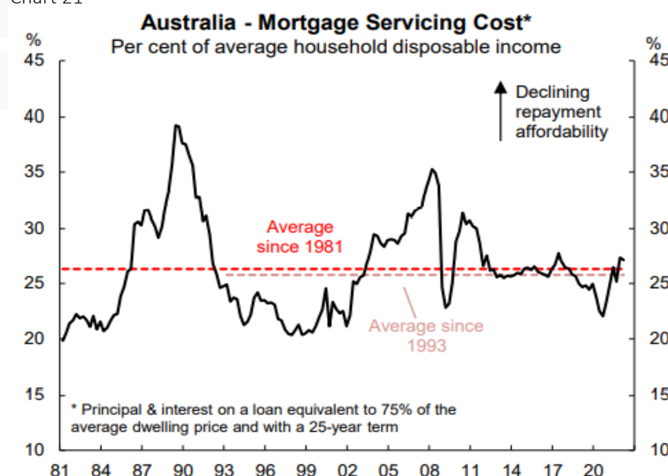
Chart 22



Source: Macquarie research

The key metric in watching consumers spending ability

Chart 21



Source: Macquarie research

Australian Banks

Chart 23

Item	ANZ 2022	ANZ 2023	ANZ 2024	CBA 2022	CBA 2023	CBA 2024	NAB 2022	NAB 2023	NAB 2024	WBC 2022	WBC 2023	WBC 2024
Share Price	22.59	22.59	22.59	92.55	92.55	92.55	27.77	27.77	27.77	19.94	19.94	19.94
Shares (m) - YE underlying	2,801	2,806	2,818	1,724	1,685	1,679	3,219	3,158	3,170	3,570	3,513	3,542
P/B	1.01	0.98	0.95	1.97	1.84	1.83	1.47	1.42	1.36	1.01	0.97	0.94
ROE	9.71%	9.75%	10.14%	12.37%	12.67%	13.07%	11.40%	12.40%	12.70%	7.57%	9.57%	10.37%
P/E	10.18	10.18	9.43	17.09	16.30	15.21	13.07	11.83	11.13	13.63	10.46	9.35
ROA	0.60%	0.59%	0.63%	0.80%	0.80%	0.80%	0.70%	0.71%	0.75%	0.54%	0.71%	0.72%
Yield	6.37%	6.55%	6.99%	4.17%	4.43%	4.68%	5.38%	5.91%	6.16%	6.19%	6.62%	7.56%
Grossed Up Yield	9.11%	9.36%	9.99%	5.96%	6.33%	6.69%	7.68%	8.44%	8.80%	8.84%	9.46%	10.79%
Loan growth	5.3%	3.9%	3.7%	7.1%	4.3%	4.3%	9.4%	5.4%	4.7%	3.1%	3.3%	3.5%
Net Interest Margin	1.53%	1.56%	1.58%	1.83%	1.85%	1.93%	1.59%	1.64%	1.71%	1.79%	1.80%	1.83%
Housing as a % of Total Loans	57%			71%			56%			71%		
Offshore Earnings as % of earnings	26.3%			13.7%			18.1%			14.2%		
Cost to Income Ratio	51.7%	47.6%	44.7%	45.7%	43.9%	41.6%	44.5%	42.3%	40.8%	55.1%	47.5%	42.7%
Pre Provision Operating Profit (PPOP)	8,635	9,901	10,906	13,226	14,293	15,965	10,055	11,459	12,626	8,849	10,744	12,421
Growth	2.8%	14.7%	10.1%	1.1%	8.1%	11.7%	11.9%	14.0%	10.2%	2.8%	21.4%	15.6%
Impairment Charges	-4	1,083	1,348	65	794	1,537	242	853	1,324	440	1,033	
Non Performing Loans	2,126	2,220	2,307	7,359	7,410	7,454	6,353	6,735	7,071	8,120	9,412	9,601
Annualised Provision Charges to GLA - Specific	0.12%	0.18%	0.20%	0.05%	0.08%	0.10%	0.08%	0.13%	0.13%	0.02%	0.09%	0.09%
Annualised Provision Charges to GLA - Collective	-0.08%	0.03%	0.03%	-0.03%	0.01%	0.07%	-0.03%	0.01%	0.05%	0.04%	0.05%	0.10%
Cash Net Profit (AUDm)	6,134	6,234	6,422	9,323	9,562	10,220	6,996	7,586	8,083	5,374	6,870	7,697
Cash EPS (AUD/share) - diluted	2.22	2.22	2.40	5.42	5.68	6.09	2.12	2.35	2.49	1.46	1.91	2.13
EPS growth	2.0%	0.0%	8.0%	12.3%	4.8%	7.2%	8.2%	10.6%	6.2%	2.8%	30.3%	11.9%
Dividends	1.44	1.48	1.58	3.86	4.10	4.33	1.49	1.64	1.71	1.23	1.32	1.51
Dividend Growth	1.4%	2.8%	6.8%	10.4%	6.2%	5.6%	17.6%	9.8%	4.3%	4.5%	7.0%	
Core Equity Tier 1 Capital	11.5%	11.6%	11.7%	11.4%	11.6%	11.6%	11.8%	11.5%	11.6%	11.4%	11.6%	11.7%

Source: Chester Asset Management

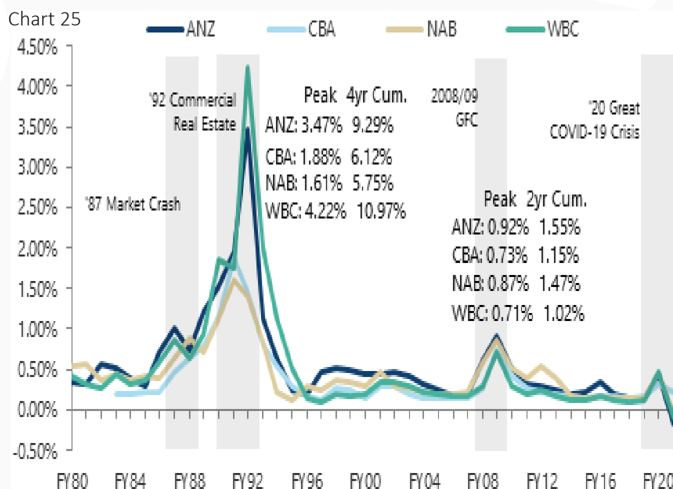
We have shown the key metrics that we assess when looking at the bank sector above. Given banks remain a material part of the ASX300 Index, it is essential to have a view. As a benchmark unaware strategy, it is highly unlikely that we would ever take an overweight position in the bank sector (which by definition, would mean allocating over 25% of the fund to banks).

We have long held a cautious stance on the Australian banks for three relatively simple reasons. Net interest margins continue to be under pressure over the medium term given significant competition in the mortgage channel. Obviously the current rate tightening cycle alleviates this challenge in the next 12-18 months, but it is outweighed (in our view) by the significant risk of an impairment cycle. We haven't had a significant bad debt cycle since 2008 (chart 25 below). The stimulus packages announced in 2020 all but saved both the Australian economy and the banking system, but as interest rates start to normalise, the amount of over-leveraged borrowers will float to the surface. The third reason is we see a slow erosion of profit centres of the banking system from "fintechs" or non-bank lenders. Credit cards, personal lending, auto finance, etc. are all being dis-intermediated by new entrants and new technology. Whilst loan growth assumptions appear to track around GDP growth, we see downside risk to this assumption in a slowing cycle.

Banks are no longer cheap in the traditional sense (chart 24), but have historically been seen as income generators. Our concern over the medium term remains the prospect for increased bad debt (impairment) charges, particularly with a cash rate above 2% and fixed rate mortgages getting repriced. If bad debts normalise, dividends will be under significant pressure. We see banks as highly leveraged to the Australian housing market, and hence if the current trajectory for interest rates is right, then we remain very cautious. Simplistically, this in our view, is a poor risk/reward scenario.

Long term impairment charges - risks looming

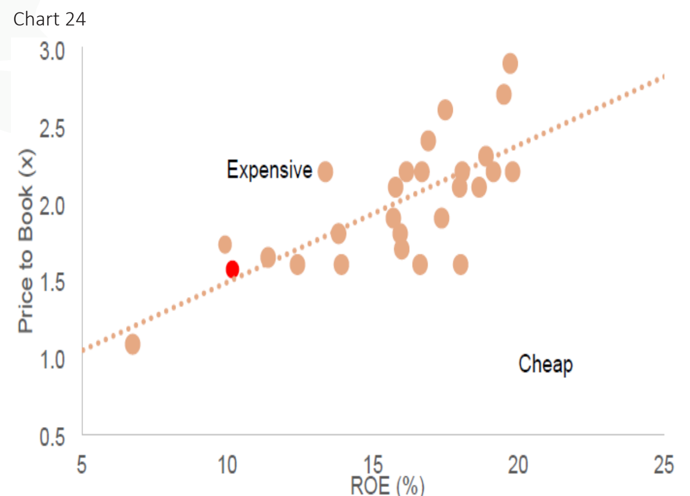
Chart 25



Source: Jefferies

Bank ROE vs P/B over time - look fair value

Chart 24



Source: Barrenjoey

Tech sector - where are the opportunities?

Chart 26

	Chester Valuation Details					Enterprise Value (Current)			Year 1 Estimates				Multiple Comparison		Multiple Comparison		Returns Comparison		Chester Scoring			
Company	Model Link	Shares on issue (Millions)	Market Price	Reference Valuation	Price Difference	Mkt Cap (AUDm)	Net Debt (AUD)	EV (AUD)	Sales (AUD)	EBITDA (AUD)	EBITDA%	Est Yr.1 EV/Sales	Est Yr.1 EV/EBITDA	Est Yr.2 EV/EBITDA	Est PE Yr.1	Est PE Yr.2	Est ROE Yr.1	Est ROE Yr.2	Financial Quality	Business Quality	Mgmt Quality	Insight score
Computershare (USD)	CPU	604.7	24.17			14,616	2,056	16,672	4,358	1388	31.8%	3.83	12.0	10.6	20.1	17.3	21.9%	24.4%	6	4	7	7
ASX Ltd	ASX	193.6	83.59			16,183	-1,550	14,633	1,031	745	72.3%	14.19	19.6	19.0	31.1	29.3	13.4%	13.8%	8	8	5	6
Link Group	LNK	513.0	4.03			2,067	935	3,002	1,198	265	22.1%	2.51	11.3	10.6	17.9	16.4	7.9%	8.6%	6	6	5	5
Pexa	PXA	177.3	14.59			2,587	215	2,802	275	120	43.6%	10.19	23.4	21.6	35.6	31.0	5.7%	6.0%	7	8	7	5
Iress	IRE	193.7	11.32			2,192	265	2,457	670	168	25.1%	3.67	14.6	13.4	24.6	21.2	18.9%	22.0%	6	7	6	5
Hansen	HSN	200.7	5.26			1,056	17	1,073	316	105	33.2%	3.39	10.2	9.8	20.1	19.2	17.9%	17.1%	8	7	7	5
Technology One	TNE	323.4	10.99			3,554	-154	3,400	399	164	41.1%	8.52	20.7	17.7	37.4	32.6	37.9%	37.0%	9	7	6	5
NextDC	NXT	456.7	11.13			5,083	645	5,728	361	200	55.4%	15.87	28.6	24.3	530.0	210.0	0.5%	1.3%	5	8	7	6
Megaport	MP1	157.8	6.41			1,011	-71	940	142	8	5.6%	6.62	117.6	27.7	na	na	-13.0%	2.6%	7	8	6	4
Carsales	CAR	330.5	18.97			6,269	543	6,812	732	409	55.9%	9.31	16.7	14.7	24.6	22.4	14.6%	13.1%	7	7	7	6
Domain Group	DHG	634.8	3.25			2,063	178	2,241	409	152	37.2%	5.48	15.6	12.8	28.0	22.6	6.6%	8.6%	7	7	7	5
REA Group	REA	132.1	117.30			15,497	155	15,652	1304	789	60.5%	12.00	20.5	18.0	34.3	29.5	31.8%	33.6%	8	8	7	5
Seek	SEK	356.0	21.34			7,597	1,049	8,646	1136	545	48.0%	7.61	15.9	14.8	28.6	26.5	16.3%	18.4%	7	8	6	6
Xero (NZD)	XRO	149.6	84.26			12,604	25	12,629	1244	272	21.9%	10.15	46.4	37.1	156.0	92.6	7.8%	12.8%	8	9	7	6
Wisetech	WTC	326.3	40.75			13,299	-425	12,874	766	371	48.4%	16.81	34.7	27.7	56.6	45.3	16.3%	17.9%	9	8	7	5
Promedicus	PME	104.3	45.65			4,762	-68	4,694	123	89	72.4%	38.16	52.7	40.8	81.5	62.1	47.8%	49.0%	9	9	8	5
Altium	ALU	131.5	28.76			3,781	-265	3,516	343	116	33.8%	10.25	30.3	27.0	46.4	36.9	19.4%	21.6%	8	8	7	5
Life360 (USD)	360	185.7	4.02			746	-45	701	506	-19	-3.8%	1.39	-36.9	-140.3	na	na	-6.6%	-0.7%	7	7	7	5

Source: Chester Asset Management

The prospect of seeing a peak in inflation expectations leaves us pondering the wealth destruction seen in many names in the Tech sector over the past 12 months. It is a sector where we have little exposure currently, but that may change over the next 6 months. The prospect of owning highly scalable businesses with high incremental margins and often, relatively low ongoing capital requirements ticks a lot of boxes. Combining these features with often highly relatable products and brands and the case for including some Tech in one’s portfolio is strong, but for us it always need to have some valuation underpinning the investment thesis. The differentiation of business models helps explain the huge valuation differences that exist across the market, as well the share price dispersion seen across the sector over the past 12 months. We have always been very reluctant to use “EV/Sales” as a relevant metric, and we are now in a market environment that has little tolerance for loss making companies. Acknowledging the challenges of accurately forecasting the growth of technology companies over long periods (typically 10 years) and the sensitivity of valuations to changing inputs (growth rates and margins in 2024 as an example) this work consistently highlights just how much value the share prices of technology companies are attributing to the terminal years. That is, the performance of the business beyond a typical 10 year forecast period. It’s with this in mind that Chester attempts to gain greater conviction in the sustainability of technology businesses via our ‘Quality’ assessments. Evident in the range of Quality scores ascribed to its Tech universe above, Chester see considerable variability in the quality of local tech companies. At the heart of these assessments is the question; how likely are these traditionally disruptive companies themselves likely to be disrupted by new technologies and competitors in the future?

Pricing power remains very influential in how we frame our assessment, as does switching costs, that is, how costly would it be for customers to stop using the product/service. NextDC (NXT), a carrier-neutral data centre operator is one example of a company that exhibits these characteristics and one that Chester has been a long-term investor in, albeit not at current prices. Equally, there is considerable value in being the recognised ‘first mover’ in an industry that has been disrupted, a characteristic shared by all of Seek (SEK), Carsales.com (CAR) and REA Group (REA). Through a combination of innovation and product enhancement, acquisition and brand development these businesses remain category leaders and by extension price-setters in their markets. The challenge for Chester remains identifying the winners of changing consumer patterns and identifying what we consider to be companies that have genuinely strong economic moats.

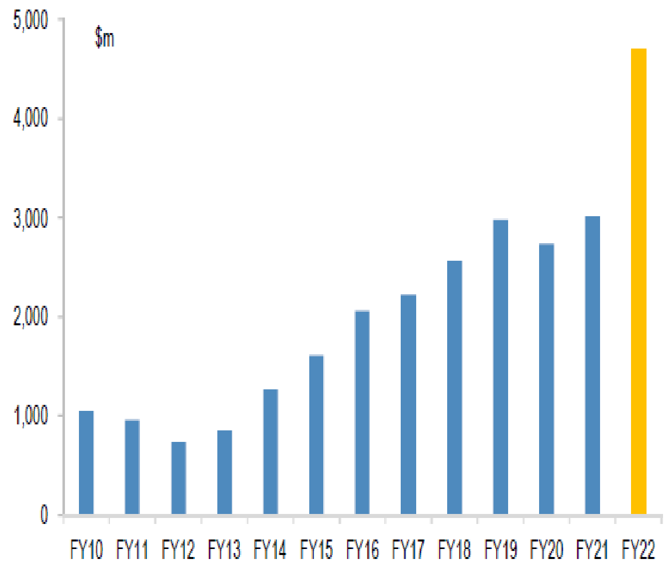
There are some very strong businesses here, but we always try to overlay the valuation discipline with it. We are watching several of these names very closely for where we consider an appropriate entry point might be. We suspect we may get an opportunity over the next 6 months. If we were truly just assessing business models in this space, we consider Promedicus, Xero and Realestate.com.au to have the strongest “moats”. Computershare is a strong interest rate beneficiary, but our concern is the long term sustainability of the registry business, which we see as under significant risk of being disrupted over the next 3-5 years.

Charts that make you go hmmm...

We often simply post some charts in the quarterly as we tend to think that sometimes, a picture is worth 1000 words. The bottom 2 charts show the iterative effective between inflation and commodities. It does appear to be peaking, which is very much assisted by the change in the commodity complex over the past 4 months. While chart 30 is taking the drawdown from the peak, many of these commodities are actually trading well below their 2021 average, which suggests they are starting to contribute to deflationary forces. Sounds strange. The most obvious trend line that has to come down is US earnings per share (eps), some of which can be directly attributed to the expansion of the Fed balance sheet (chart 29). We have touched elsewhere on the maths around the Fed balance sheet, hence remain sceptical that this outcome can ever be achieved. Much of the higher eps trend is actually lower interest and tax, much of which will unwind organically over the next 3 years.

Macquarie Group NPAT over time - peaking?

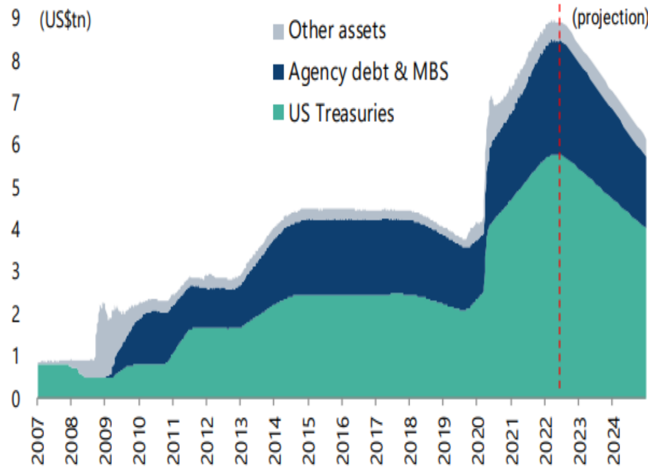
Chart 27



Source: JP Morgan

Federal Reserve balance sheet reduction?

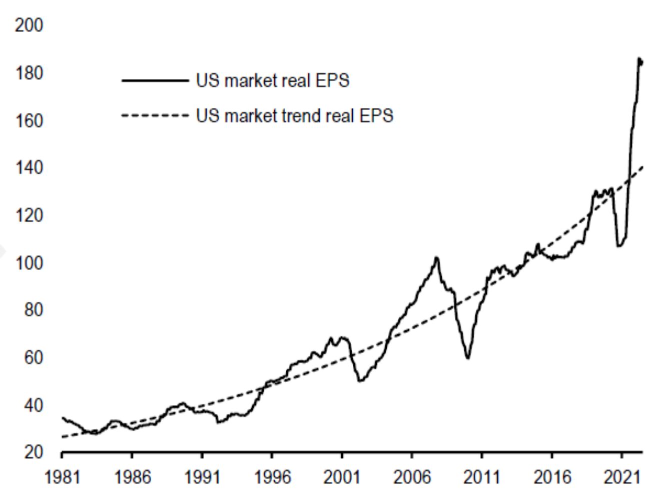
Chart 29



Source: Jefferies research

US S&P500 EPS still well above trend

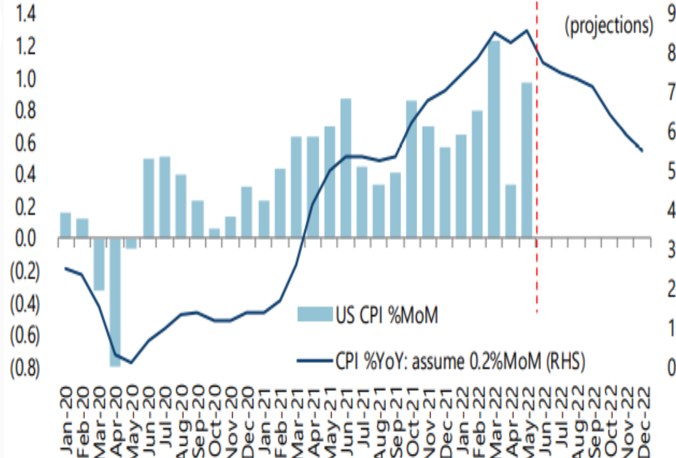
Chart 28



Source: Credit Suisse

Inflation peaking right now?

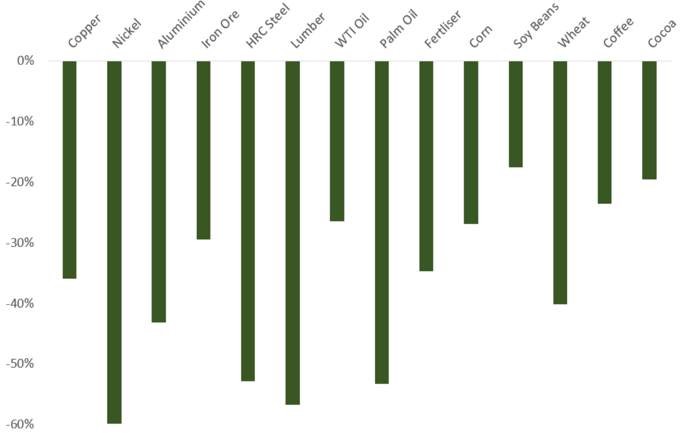
Chart 31



Source: Jefferies research

Input costs rolling over - fall from peak this year

Chart 30



Source: Chester Asset Management, Bloomberg

Executive summary

Equities

Tighter financial conditions has led to higher volatility through 2022 than we have seen over the past 2 years. Don't fight the Fed. The economic slowdown underway is an interesting one, given the Fed has to be seen to fight inflationary forces, whereby many of those forces are arguably out of their control (food and energy shortages). We are of the view that inflation is close to peaking given the fall in the commodity complex over the past 4 months (led by copper, palm oil and lumber prices) and the inevitable demand destruction we should see across durable goods spending. Forward orders and consumer confidence suggest a broad based slowdown is upon us, albeit the labour market remains extremely tight, which we do see as a lagging indicator. We say interesting, because we are of the view that many of the forces that will lead to the eps revisions (downgrades) across the market over the next 3-6 months, will actually be abating by the end of CY22. Therefore our current thinking assumes a choppy 3-4 months period ahead as earnings are reporting and outlook statements explain how challenging the world is currently. We see reason to look over the horizon on a 12-18 month view at some of the cost pressures abating, and the potential for a pick up in CY23 as a demand recovery, but that will still rely on central banks becoming less hawkish, with more certainty over the interest rate trajectory.
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. Hence we are of the view that while inflation will decelerate from its current levels (9.1% yoy in the US), we believe it will remain more persistent throughout this decade for structural reasons (predominantly localisation of manufacturing and the capital intensity of decarbonisation). 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 labour.

The real debate is how hawkish the monetary policy response is in fighting inflation. Asset prices haven't had to deal with this issue since 1981. 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 continues to focus on:
Real assets- AZJ, MIN, QUB, ORG, BXB
Valuation margin of safety- QBE, NWS, LLC, DOW, ASB, SM1
Pricing power- TCL, EGH, CSL, TLC
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. We do see the ongoing 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, which is function of being contrarian. A deeply unloved sector currently, but we would think that any sector relief will come with the USD showing signs of peaking.
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.

Government spending and bond yields

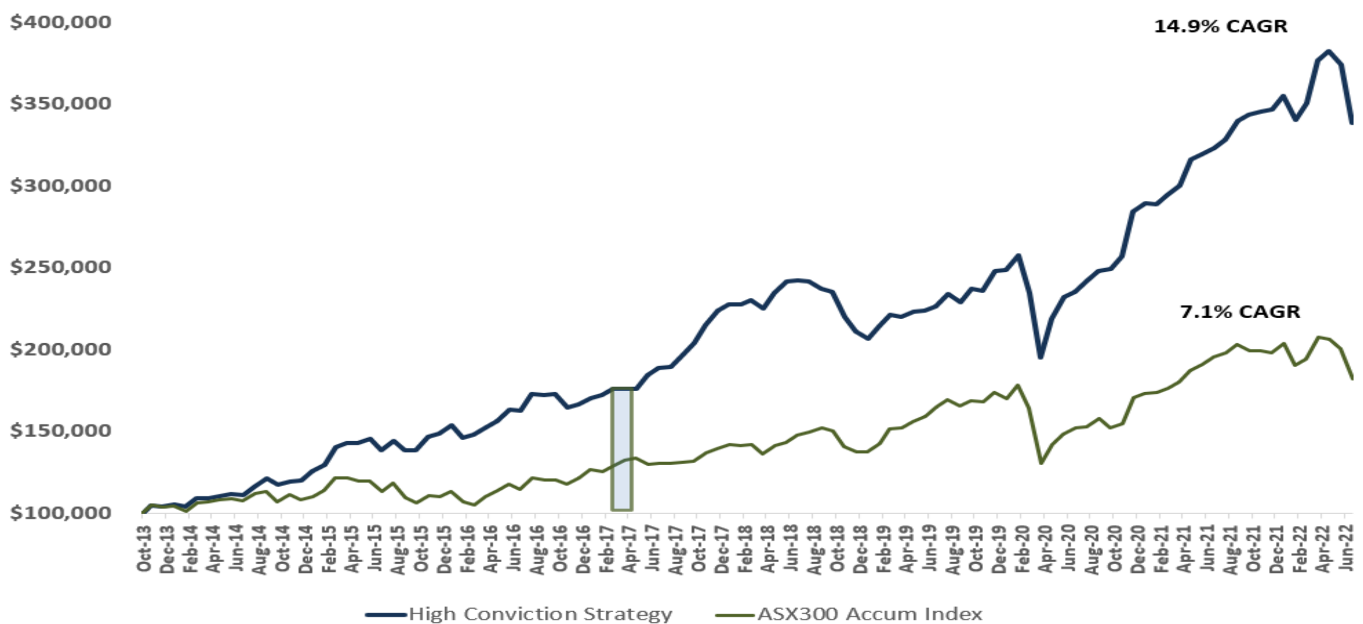
The enormous increase in deficit spending through the pandemic response will leave most central banks with an insurmountable debt burden. There is no longer any pretense of any political party anywhere to try to repay these debt burdens the future generations are faced with. Interest rates simply cannot 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 the US government is technically insolvent. 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 sharp downturn, eventually becomes yield curve control, and ultimately direct equity purchases, if needed. Is this possible in 2022? Absolutely.

Accumulated Performance by Financial Year - Same Strategy

	FY14 (%)#	FY15 (%)	FY16 (%)	FY17 (%)*	FY18 (%)	FY19 (%)	FY20 (%)	FY21 (%)	FY22 (%)	Since Incep (%)
Same Strategy (after MER)	+11.2	+24.5	+17.4	+11.2	+28.3	-6.4	+3.9	+37.2	+4.8	+14.9
S&P/ASX 300 Accum Index	+7.8	+5.6	+0.9	+9.1	+13.2	+11.4	-7.7	+28.5	-6.8	+7.1
Value added (after MER)	+3.5	+18.9	+16.4	+2.1	+15.1	-17.8	+11.6	+8.7	+11.6	+7.8

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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