



Total returns

At 30 June 2021	3 mths %	6 mths %	1 yr %	2 yr %	3 yr % p.a	4 yrs % p.a.	Incep. % p.a. (27 Apr 2017)
Chester High Conviction Fund (after fees)	7.6	11.5	37.2	19.4	10.1	14.4	14.4
S&P/ASX 300 Accumulation Index	8.5	13.0	28.5	9.0	9.8	10.6	9.5
Outperformance (after all fees)	-0.9	-1.5	+8.7	+10.4	+0.3	+3.8	+4.9

* The inception date of the Chester High Conviction Fund was April 26th, 2017. The NAV at June 30th, 2021 was 1.6623

"I see tremendous imbalance in the world. A very uneven playing field, which has gotten tilted very badly. I consider it unstable. At the same time, I don't exactly see what is going to reverse it."

George Soros

Quarter in review

Remember Cluedo? Professor Plum in the kitchen with the candlestick? It has been a staple in the family through lockdown periods. Of the four kids, two play it regularly, the 8 year old and the 7 year old. It's been fascinating to watch the differences in the strategy of the two. The 8 year old is methodical and deliberate in determining the facts to rule out as many suspects as possible. The 7 year old? She just picks up on what everyone else is doing (and the questions they are asking) and will often reach a conclusion before anyone else. She has won the last 10 games in a row. She may well be cheating, but she also has an innate understanding that it's not actually what she thinks that counts, it's picking up the signals from everyone else that helps her reach the conclusion first.

She'll probably make a very good fund manager one day. She has grasped a really important concept of the way markets work. Cluedo has three variables, the person, the room and the weapon used to commit the crime. Solve all three and you win the game. Markets have three main macro variables as well. Interest rates, currencies, and commodity prices. Understand what is driving those variables before anyone else and you'll probably become a very successful investor. If we're being more cynical, maybe the markets have just one key variable - inflation (or deflation?), which is largely interlinked with the three variables listed above.

What has surprised us over the past 6 weeks has been the strength in the bond market, with the US 10 year yield falling from 1.6% to 1.4% (at the time of writing). Nominal bond yields have two components, (GDP) growth expectations and inflation expectations. The price action of the US 10 year bond suggests to us that the market has lowered its expectations for one of these components. This implicitly suggests future (GDP) growth expectations have fallen. We can't see how inflation expectations are falling yet. Commodity prices (oil in particular) remain elevated, housing prices (in the US) are rising, which suggests that almost 25% of the CPI basket (a measure called owners' equivalent rent or OER) is also rising and wages are accelerating. Wages in our mind become the structural piece of higher costs and it remains our view that in the US (and Australia) the overriding metric being used to guide policy response is the unemployment rate. When unemployment falls to an "acceptable" range, only then will monetary policy become less accommodative. Hence wage growth is being mandated by policy makers.

The intellectual challenge here becomes the inflation delta (or the rate of change). In 2021 thus far, inflation has risen from 1.36% in December to 5.4% in June, hence inflation has accelerated. The wide ranging consensus expectations are for inflation to now moderate (fall) from 5.4% to below 4% over the next 3 months, all due to the base effect of the severe lockdowns in the 2nd quarter 2020. The real black swan event would be if CPI kept on RISING from here as this would disrupt the current goldilocks scenario, where growth as a style has had a very strong 3-4 weeks, as bond yields have fallen, signaling the economic recovery period has now peaked. We are not as willing to make that assessment. The earnings growth in the market can largely be attributed to the cyclical sectors, with financials and materials seeing the best eps momentum.

The conundrum for equity investors with all this lingo is the key question of how to price future cash flows appropriately. We continue to err on the side of being reluctant to price in current bond yields (at 1.4%) into perpetuity. The valuation dispersion between high growth (predominantly tech and healthcare) and industrial value stocks remains at record highs, hence we see the risk reward trade off as being relatively unpalatable in the event that there was a black swan event with the CPI print, or heaven forbid, monetary policy becomes tighter. While we are at pains to reiterate the bottom up nature of our stock picking process, the unfortunate reality is that equity valuations are highly sensitive to the risk free rate (the US 10yr bond), which is becoming more politicised and less "free" every year. Equities are so highly leveraged now to this risk "free" rate that merely talking about a change in monetary policy can result in significant sector rotation.

Our philosophy with the Chester High Conviction Fund is to protect and then grow (what we hope to be) generational wealth. Under this framework, the least risky way to protect capital over the next 12 months is to not over pay for future cash flows. 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 this year, given the risks 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 under appreciated assets, where the risk/reward trade off is far more compelling. This is how the fund initially invested in stocks such as MIN, ABB, NWS, LYC and GOR over the past 3-4 years. We believe we still have a significant number of stocks in the fund that fall into the category of unloved with valuation support.



Our portfolio construction has remained relatively consistent over the past 6 months

We see no reason to alter our view that structurally, the only way for governments to exit the unprecedented emergency spending of 2020/2021 is to inflate the debt away. The US budget deficit increasingly looks irreparable, with the Biden administration heavily focused on the stimulus packages to paper over the cracks and is beholden to further stimulus in Q4 2021 to ensure current economic momentum is continued into 2022.

We view the governments debt accumulation through 2020 as akin to war time spending and note at the end of both those efforts governments let real yields (nominal bond minus the inflation rate) fall to between -12 to -13%. This saw the debt to GDP burden reduce relatively quickly over the next 5-10 years. We are at the same juncture now, which would be the equivalent of a powerful inflationary boom period ahead, which would be a very strong period for real assets (things we can touch - property, farmland, agricultural products and commodities including gold).

So what are we focusing on?

Our thinking hasn't changed materially over the past 3 months, hence simplistically, we still categorise our thoughts into four key areas.

Real assets - as outlined above. Inflation will drive real asset valuations significantly higher. We would highlight the current bid for Sydney Airport as the perfect example of investors with different time horizons paying significantly more for real assets than the equity markets currently do. This ties into our thinking and while not owning Sydney Airport (admittedly a very strategic asset) has left us more confident in the way we value the real assets in the portfolio. We also believe there is a wall of cash in private equity hands that is ready to be deployed.

Valuation margin of safety - not over paying for concept stocks or long duration assets.

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)?

Gold. We must confess to being slightly confused by the price action in gold relative to the deeply negative real yield (US 10 yr bond less inflation) we are currently faced with. Historically this has coincided with a period of gold price strength, but ultimately (and we have been using gold as a non-correlated equity exposure for over 17 years) gold does beat to its own rhythm. This idiosyncratic price action does make it non-correlated, which combined with valuation support sees us allocate a consistently small portion of the portfolio to gold equities. Historically, more often than not, gold performs the best as a defensive asset class in times of inherent volatility.

We see Tabcorp (**TAH**) as well positioned to benefit from the demerger of the Lotteries business and the Wagering business. There has been significant corporate interest in the underperforming wagering business, while the Sydney Airport transaction only illustrates how undervalued the Lotteries business currently is in the combined group. Mineral Resources (**MIN**) has been a strong contributor for the portfolio, but remains a very well balanced exposure to both iron ore production growth and strong optionality around a rising lithium price over the next 3 years.

We would classify Sky City (**SKC**), United Malt Group (**UMG**) and Lend Lease (**LLC**) all as companies that have real assets with valuation support, but also significant leverage to the world re-opening. There have been several bumps along the way with these stocks, but we remain compelled by their valuation support combined with an eventual recovery to pre-pandemic activity. Gold, as previously mentioned, remains a core holding, with OceanaGold (**OGC**) our preferred name on valuation grounds, while Aurelia Metals (**AMI**) falls into the same camp, but has a polymetallic asset base (includes copper, lead and zinc) to diversify its revenue streams and is undeniably cheap.

The Portfolio

The CHCF posted a 7.6% gain in the March quarter, relative to the 8.5% increase in the ASX300 Accumulation Index. The strategy had a pleasing 12 month period, with contributions across a wide range of stocks in different sectors. While past performance is not a reliable indicator of future returns, we remain of the view that we have a significant portion of our fund that hasn't meaningfully participated in the market recovery. We believe there are several key holdings that are well positioned for strong periods over FY22. Mineral Resources (**MIN**) had a strong quarter, while our current thinking on MIN is articulated in this note <https://www.livewiremarkets.com/wires/life-after-40-time-to-go-overseas>. ALS Limited (**ALQ**) had another strong quarter, on the back of an exploration upgrade cycle, leading to higher margin assumptions and earnings upgrades.

Carbon Revolution (**CBR**) was a disappointing investment. The patented technology to deliver carbon fibre wheels to high end cars looks to be very promising. CBR is in a cash burn situation and investing to scale up the manufacturing facility to lower the costs of production, while still working on contracts to underwrite future cash flows. The lack of progress with new contracts saw us exit the position in the second quarter. Lend Lease (**LLC**) has been a significant laggard in the real estate sector as the pandemic has pushed out permitting times and development schedules in Australia, the UK and the US. A new CEO (Tony Lombardo) has taken some significant provisions against previous projects in a relatively standard new CEO procedure to clean the Profit and Loss Statement for accelerating growth from FY22 onwards. Given the pipeline of opportunities and the poor share price performance, we would not be surprised to see LLC come under the microscope of private equity.

Top 3 Holdings	Portfolio Breakdown		Top 3 Portfolio Attribution	Bottom 3 Portfolio Attribution
Tabcorp Holdings	Materials	15.5%	Mineral Resources	Carbon Revolution
Mineral Resources	Consumer Staples	15.4%	ALS Limited	Lend Lease
Downer Ltd	Industrials	15.1%	OceanaGold	Austal Ltd



Accumulated Performance by Financial Year - Same Strategy

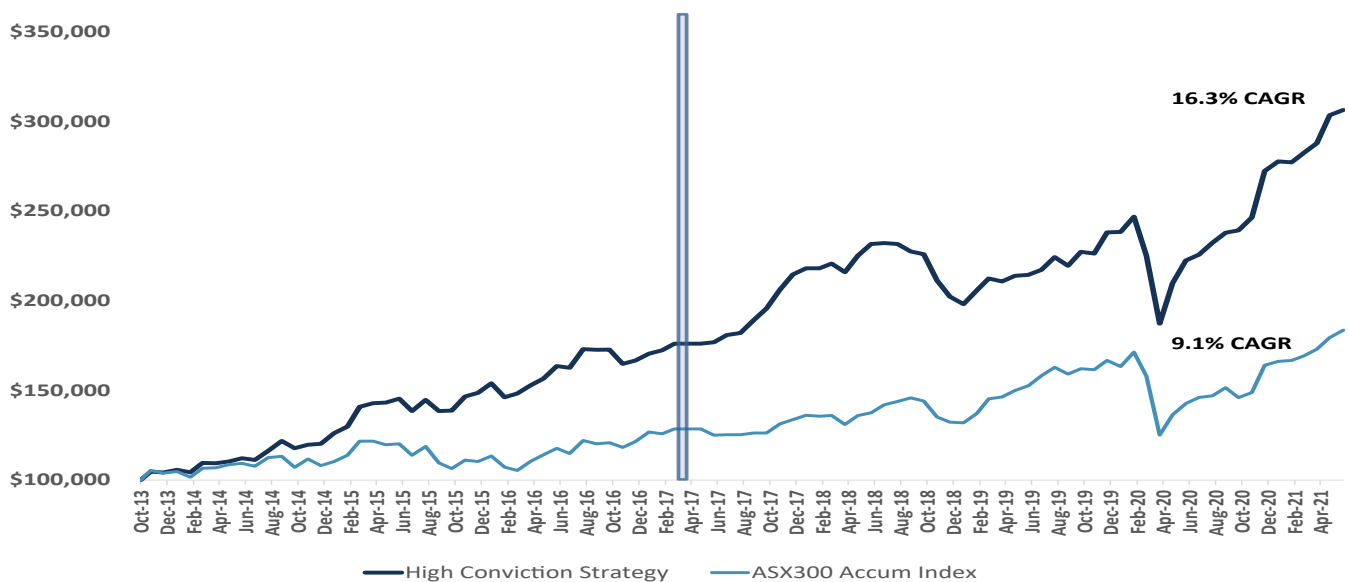
	FY14 (%)#	FY15 (%)	FY16 (%)	FY17 (%)*	FY18 (%)	FY19 (%)	FY20 (%)	FY21 (%)	Since Inception (%) p.a.
Same Strategy (after MER)	+11.2	+24.5	+17.4	+11.2	+28.3	-6.4	+3.9	+37.2	+16.3
S&P/ASX 300 Accumulation Index	+7.8	+5.6	+0.9	+9.1	+13.2	+11.4	-7.7	+28.5	+9.1
Value added (after MER)	+3.5	+18.9	+16.4	+2.1	+15.1	-17.8	+11.6	+8.7	+7.2

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.

Same 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 almost 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 in the second half of 2021

HOW TRANSITORY IS INFLATION?	<p>The most debated topic of the first 6 months of 2021. Many pundits suggest the current inflationary pulse will recede over the coming months, having peaked from a year on year perspective in May/June. We formed a view that many of the forces driving up inflation were in fact more structural in nature, which includes de-carbonisation (the cost of energy will rise), localisation of supply chains (security of supply is more important than the cost of supply) and wage growth. So the market is wrestling with the rate of change which is receding versus the structurally higher cost of doing business in the coming years. We err on the side of higher inflation as we believe it is actually desired by policy makers.</p>
GROWTH VS VALUE	<p>Much of the above topic is very macro driven. Unfortunately the reality of the investing landscape is driven by these inflationary considerations, which are driving the direction of the US 10 yr bond yield. Although it can be argued that the price discovery of this asset class is limited due to the relentless intervention of the Federal Reserve. Nevertheless, the direction of the US 10 yr bond yield (will also influence the direction of the Australian 10 yr bond yield) influences the direction of sector allocation. The lower the bond yield, the higher valuations afforded to growth stocks, the higher the bond yield, the more value based assets and cyclical companies are supported. We would prefer the outcome of portfolio construction to be more stock specific than this simplistic framework. Given we err on the side of higher inflation, we also err on the side of being measured from a valuation perspective.</p>
DE-CARBONISATION	<p>With many 2020 trends receding as the northern hemisphere starts re-opening in 2H 2021, the one trend that will only accelerate is the focus on a carbon neutral world. It is the one certainty of the next decade in terms of where capital is being allocated, so it has altered the way we think about the mega trends that shape the investible universe.</p>
ECONOMIC RATE OF CHANGE	<p>This ties into the thesis around lower bond yields over the past 6 weeks, as there is a strong consensus view that the cycle of stimulus induced spending from 2020 has peaked and the rate of change in liquidity declines from this point. Most of this ties into how and when the Federal Reserve actually starts tapering the US\$120bn per month of asset purchases.</p> <p>The missing ingredient of the economic recovery has actually been stronger credit growth, which we haven't seen yet in the US, but the economy is now almost fully open, and we do know that lending standards are becoming easier again. This credit pulse will ultimately dictate the direction of the economy, while the Biden administration remains focused on another stimulus package slated for the 4th quarter. Hence we think it is too early to suggest the economic cycle has peaked.</p>
SURPLUS LIQUIDITY	<p>In a world of excess money supply and currency debasement, with cheap rates, private equity is highly incentivised to put money to work. We think this heralds the start of a strong M&A cycle. Balance sheets in the listed space are also strong relative to history and looking to either grow or embark on capital management initiatives. The recent bid for Sydney Airport only accentuates the gap between the way the equity market is valuing some real assets, and the view of private equity investors and super funds. We are of the view that a wave of M&A activity is normally needed before a bull market has finally reached its zenith.</p>
PROPERTY PRICES	<p>Everyone's favorite pastime in Australia. Cheap interest rates have created a boom for the housing sector (by design) as it is the easiest way to shore up the Australian economy, given more than 15% of Australian jobs are directly linked to real estate or indirectly through finance, admin and support services. The language from the RBA will be watched closely as to how the air is taken out of the white hot property sector, without causing any loss of confidence. The price strength is certainly supportive for confidence and consumer spending.</p>
SALE AND LEASE BACKS	<p>We take a look at one of the themes we believe will be topical in FY22. Given the strength in property prices, how many listed corporations will take advantage of this tailwind to restructure their capital allocation. Casino's and hospitals are obvious candidates to release capital in this manner.</p>
CRYPTO CURRENCIES	<p>While outside our circle of competence, we watch with fascination the narrative around the "network" effect of crypto currencies. In this context, we generally accept the "network" effect to mean "ponzi" as any crypto currency requires new investors to push up prices. Until they demonstrate far lower volatility and an actual function in society, we err on the side of being very cynical as to the eventual outcome.</p>



Stock selection - Tabcorp (TAH)

Description The recent announcement that the Tabcorp (TAH) board intends to pursue a de-merger of the group's lotteries and keno business from the wagering, media and gaming services operations of the organisation comes little more than 3.5 years since the establishment of the combined group via the merger of the former Tabcorp and Tatts Group entities. The board's decision follows a period in which the company had fielded several proposals from external parties about potentially acquiring the group's wagering and media business in various forms, including in conjunction with the gaming services business. While the board have so far resisted endorsing any of the offers it has received to sell parts of the current business, instead favouring the greater perceived certainty of a demerger, the ~12 months demerger timeline leaves open the possibility that a sale of the business as a whole, or parts thereof, could materialise.

Quality For Chester, irrespective of the ultimate corporate structure under which they operate, TAH's portfolio of businesses share several attractive qualities. True of the group's lotteries and wagering segments in particular, these businesses are highly cash generative driven by a negative working capital model that sees tickets sold in advance of potential customer payouts, along with no requirement to invest in physical inventory. Combined with an expansive network of third-party retail distributors that supports relatively modest ongoing capital investment requirements compared to the group's profits, TAH enjoys a very healthy free cash flow profile.

The fact that TAH's businesses operate across highly regulated industries and for the most part enjoy long-dated exclusive licences are also appealing. Such conditions have undoubtedly contributed to healthy alignment of interests over time between the various state authorities and TAH as the primary operator in these jurisdictions and seen the various wagering, lotteries and EGM industries maintain healthy growth over recent decades. While the COVID-19 pandemic and associated social disruption has had a mixed impact on the various TAH businesses in the last 12 months, arguably positive for lotteries and keno, and negative for wagering and gaming services, it remains likely that as Australia emerges from the pandemic TAH's businesses will capably adapt to any permanent shifts in consumer behaviour. In the case of lotteries and keno, strong customer adoption and increased digital play during the pandemic will likely continue to support higher margins in the segment (each incremental 1% of tickets sold digitally equals ~\$4m additional EBITDA) while for the wagering and media business continued enhancement of the digital capabilities of the group, together with the ongoing return of patrons to licensed wagering venues should be favourable. The prospect for favourable regulatory change to TAH's wagering licences post COVID is also a potential positive in coming years, in terms of the changing landscape of digital wagering experience, which diminishes the value associated to the in venue license.

Valuation On a pure cash flow basis Chester's assessed value for the combined TAH business is AUD5.85/share. This valuation is DCF derived (WACC = 8.5%, TGR = 3%) and is based on a forecast that Lotteries and Keno can sustain EBITDA growth of ~5% CAGR for the next 5 years while the combined EBITDA of the wagering and gaming services can stabilise in the AUD450-\$500m range in the next couple of years as the cost bases of these businesses are adjusted to reflect industry change. Valuing the businesses separately on a Sum of the Parts basis using 20x EBITDA for lotteries and 8x EBITDA for wagering, allowing for the dis-synergies of the demerger sees our group valuation closer to AUD6/share.

Insight The strongest endorsement of the value that exists in the TAH business is unquestionably provided by recent events in the public markets themselves. Together with the unsolicited offers received by TAB for their wagering, media and gaming services businesses which support the potential identified by interested parties for improved performance in these businesses, the spate of proposed transactions for businesses with either physical infrastructure assets (ie; Telstra mobile tower network & Sydney Airport) or business models that support the prospect of predictable recurring cash flows (ie; Pexa Group IPO) is very positive for TAH as it embarks on its demerger. Without over complicating it, the Lotteries business is one of the best businesses we can find in Australia with 3.5-4.0% compound annual revenue growth since the mid 1990's. Combined with the migration to online lottery sales, enhancing margins sees us form a view that lotteries can actually trade on 20x EBITDA hence our conviction level remains high in unlocking value in TAH over the next 12 months.

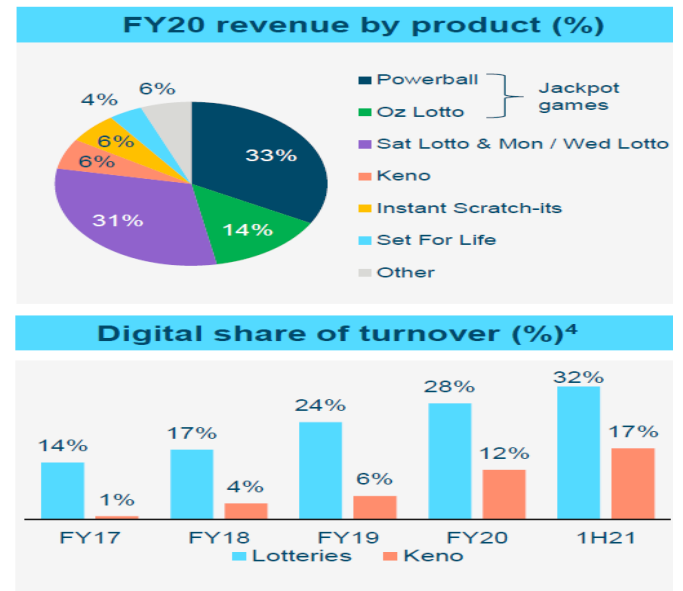
Chart 2 The TAH Group as separate entities

	Tabcorp (current) ¹	Lotteries & KenoCo ²	Wagering & GamingCo ²
FY20 Revenue (\$m)	5,224	2,917	2,305
FY20 EBITDA (\$m)	995	542	454
FY20 transactions		560M tickets sold ³	1.1B wagering bets taken
Digital share of business turnover ⁴		32.1% for Lotteries; 17.1% for Keno	59.0% for Wagering
Number of customers ^{4,5}		~8.7M active lotteries customers	~1.9M active wagering customers
Number of venues ⁴		~3,800 lottery outlets; ~3,400 Keno outlets	~4,300 wagering venues
Number of employees ⁴	4,350	950	3,400

FY20 revenue by segment	Lotteries & Keno	Wagering & Gaming
Lotteries & Keno	94%	6%
Wagering & Gaming	4%	52%
Other	4%	40%

Source: Tabcorp

Chart 3 Digital uplift driving margins higher



Source: Tabcorp



Chester High Conviction Fund Portfolio top ten holdings

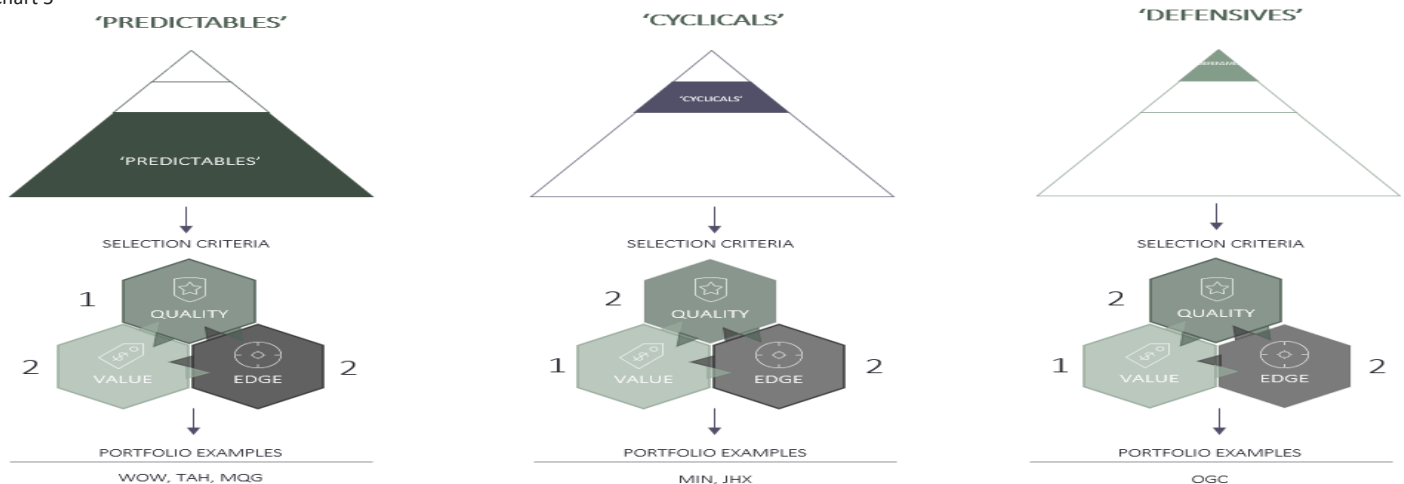
Chart 4

	FY1 Sales Growth	FY2 Sales Growth	FY21 Yield	FY22 Yield	FY1 DPS Growth	FY2 DPS Growth	FY 1 ROE	FY 2 ROE	FY1 EPS GROWTH	FY2 EPS GROWTH	FY21 PER	FY22 PER
Austral Limited	-25.6%	-3.0%	3.9	4.2	8.0%	6.2%	10.10	8.70	-5.3%	-9.1%	9.3	10.3
Bluescope Steel	10.9%	10.6%	0.7	1.2	38.0%	62.7%	15.30	18.30	205.0%	39.3%	10.2	7.3
Downer Limited	-9.0%	0.2%	3.6	4.7	40.0%	27.6%	7.60	8.90	28.9%	18.6%	15.8	13.4
Mineral Resources	72.2%	14.3%	5.1	5.1	271.0%	3.5%	43.40	33.50	220.0%	2.3%	9.3	9.2
Macquarie Group	3.1%	4.4%	3.6	3.9	15.5%	10.3%	13.40	14.10	0.8%	10.1%	18.6	16.9
News Corp	1.8%	4.6%	0.8	0.9	6.0%	4.6%	4.10	4.80	215.0%	33.4%	44.3	33.4
Qube Logistics	6.3%	6.4%	1.8	2.0	3.9%	9.4%	4.10	4.60	9.1%	13.6%	40.6	35.6
Tabcorp Holdings	9.1%	2.4%	2.9	3.3	27.0%	13.5%	6.00	6.40	35.6%	12.3%	26.7	18.4
Westpac	2.0%	-1.7%	4.5	4.8	nm	6.2%	9.70	9.40	120.0%	1.6%	14.6	14.4
United Malt Group	-2.0%	9.8%	1.7	3.2	NA	45.0%	4.80	6.80	-2.0%	46.7%	26.9	18.7

Source: Chester Asset Management

We have listed here our top ten holdings at the end of June, 2021. Naturally we find that our stock weights can change over the course of a quarter or year. We broadly hold positions between 1% and 6% depending on our conviction level on the stock and the market capitalisation. 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, overlaid 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). Most of the stocks currently held in the top ten holdings are classified as “Predictables” (Consumer Staples, Communication Services or Financials) while Mineral Resources, Bluescope and Qube Logistics are classified as “Cyclicals”. We have defined DOW as a predictable business driven by the change in strategy that leaves the core business as more predictable than DOW has been historically. The focus of the fund has been very much on essential services with relative cash flow certainty in this unique economic climate, while we have been selectively adding more cyclical names over the past quarter. 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 5





Portfolio Construction

We have always broken down our portfolio construction into three categories as outlined on chart 6. 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.

Chart 7 illustrates how these “sleeves” have looked over the past 7 years. On average, the allocation to predictable companies has been 60-70%, while cyclicals have averaged around 15% (10-25%) and defensives ranging from 10-25%. We have tended to hold an increased defensive position over the past 2 years, while in the last quarter have added incrementally to our cyclical position with the backdrop of an economic recovery that appears underwritten by central banks. 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.

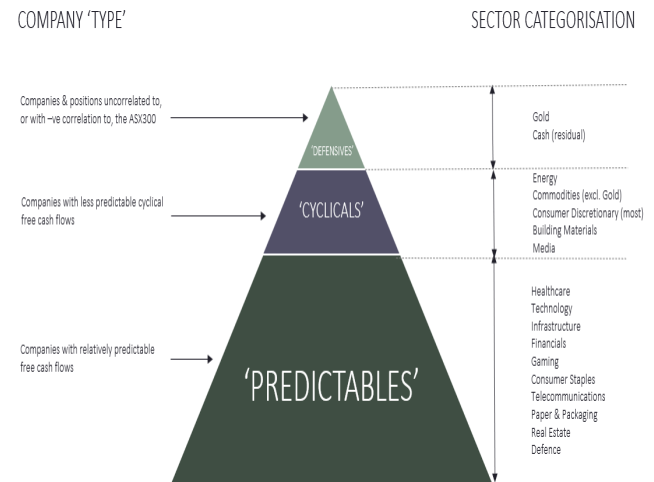
Chart 8 highlights the portfolio characteristics of the fund as of the end of FY21. We don’t tend to display these characteristics often as they are a snapshot of a static point in time. Nevertheless it highlights that the fund (in an overall context) delivers far superior eps growth for a lower overall PE, hopefully suggesting that the fund demonstrates growth at a reasonable price. It does have a lower yield than the ASX300 as the fund has historically had only minimal exposure to banks and property (which drive the ASX300 yield). The ROE of the fund is dragged down by several larger holdings such as Tabcorp with a higher level of intangibles on the balance sheet that drag down the ROE (intangibles inflate the equity component of a balance sheet). News Corp is similar.

But what it also highlights is the lower level of volatility (standard deviation) to the index, and a lower overall beta than the index. The maximum drawdown of the fund has also been lower than the index. The fund 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, and past performance is no guarantee of future performance), has been able to demonstrate higher returns than many of its peers over the 7 years of the strategy, 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?

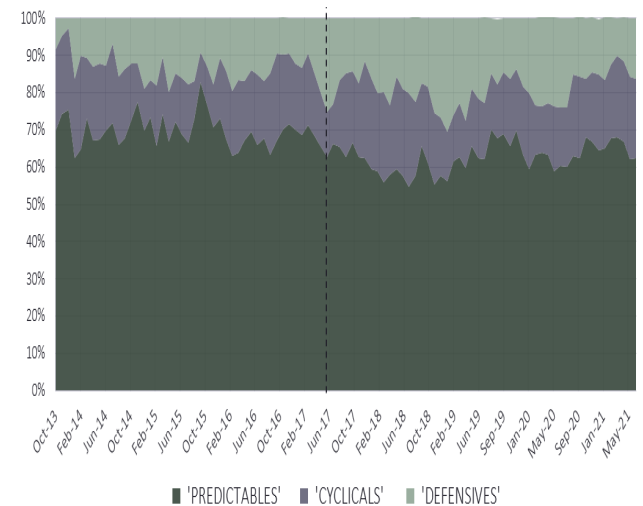
Chart 6



Source: Chester Asset Management

Which has been done consistently over time

Chart 7



Source: Chester Asset Management

Chester High Conviction Fund portfolio characteristics

Chart 8

	CHCF	ASX300 Index
FY1 PER	17.5	17.7
FY2 PER	14.9	17.8
FY1 Yield	2.3	3.7
FY1 DPS growth	40%	12.5%
FY1 EPS growth	26.3%	11.7%
FY2 EPS growth	25.6%	-0.6%
FY1 ROE	11.3%	13.1%
Tracking Error	5.5%	na
Beta	0.91	1.00
Standard Deviation	17.2%	17.6
Sharp Ratio inception	0.87	0.48
Max drawdown	-24.25	-26.98

Source: Bloomberg consensus data, Morningstar

Revisiting our Mega Trend framework

Chart 9



Source: Chester Asset Management

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

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

The one megatrend we have changed over the past 7 years is the trend towards de-carbonisation (and away from globalisation). We do believe the capital being allocated towards a carbon neutral society is going to change the investment thesis for many sectors and having exposure to this trend is going to be a powerful driver of share prices over the next 3-5 years. The sheer will of policy makers and the capital being allocated towards this can not be ignored.

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

Whilst far from perfect, this is one of the frameworks we use to develop our watchlist. Our watchlist is a subset of the ASX300 that we then spend more time understanding in greater depth. Our watchlist ends up being around 55-60 stocks, not already in our portfolio (25-40 stocks).

Then, to how we narrow the focus on sectors, let's use an example. i.e. feeding the world appears to be a structural trend that will play out over a number of years, particularly as Asian incomes rise, and the demand for dairy products and proteins (almonds, salmon and beef) only increases. The obvious sector to focus on is agriculture, which extends from wine, dairy products, beef, cereal producers to fertilisers and crop protection. Using ASX codes to illustrate the universe here; TWE, SHV, HUO, TGR, ELD, A2M, BGA, SM1 and NUF all provide exposure to this theme. We have provided an update on the agriculture sector on the following page as a way of illustrating the detail that we look into when assessing individual stock names.

Once the sector has been narrowed, we then filter through the individual stocks and focus heavily on the idiosyncratic risk (stock specific risks) of each company. This means assessing the operational risk (industry structure, earnings sensitivity and volatility, working capital concerns), the financial risk (balance sheet risk and debt profile) and the corporate governance risk (board structure, remuneration policy, OH&S issues or reputational risk). This is how we evaluate each company. Combining this assessment with our internal valuation then suggests which (if any) of the stocks we would like to own. In this scenario, it is very much a competition for capital between stocks that offer a compelling risk reward outcome, combined with any particular insights we may have that gives rise to the highest conviction ideas.



Feeding the world - using our framework to discover bottom up ideas

Chart 10

Company	Model Link	Market Price	Modelled WACC	TGR Assumed	NPV (1x)	Price Diff.	Mkt Cap (AUDm)	Net Debt (AUD)	22 ND/ EBITDA	EV (AUD)	EST 22 ROE	EST 22 Div Yld	2021 PE	2022 PE	2023 PE	2022 PEG	Est 2021 EV/EBITDA	Est 2022 EV/EBITDA	Est 2023 EV/EBITDA	Financial Quality	Business Quality	Mgmt Quality	Insight Score
A2 Milk	A2M	7.15	10.0%	3.0%			5,315	-790	-3.7	4,845	14.6%	0.0%	53.9	26.2	18.1	0.3	31.7	15.9	11.1	9	7	5	5
AACo	AAC	1.37	11.0%	3.0%			826	345	5.3	1,171	0.9%	0.0%	-140.0	84.5	35.7	N/A	48.0	24.7	17.7	2	5	5	5
Aust Vintage	AVG	0.81	10.5%	3.0%			227	68	1.6	295	7.5%	6.8%	11.9	9.5	8.7	0.4	6.9	6.2	5.8	6	6	6	6
Bega Cheese	BGA	5.35	9.5%	3.0%			1,619	400	1.5	2,019	7.6%	2.4%	35.7	16.6	14.5	0.1	15.2	8.3	7.6	5	8	8	6
Blackmores	BKL	72.86	10.0%	3.0%			1,413	-56	-0.1	1,358	14.1%	2.3%	38.5	26.6	19.0	0.6	18.1	13.9	10.8	9	8	5	5
Bubs Australia	BUB	0.50	10.5%	3.0%			306	-26	N/A	281	-4.5%	0.0%	-26.2	-52.1	-360.2	N/A	-16.1	-26.3	-60.0	8	7	6	5
BWX	BWV	5.08	10.0%	3.0%			713	-10	0.4	703	7.2%	1.3%	43.0	26.4	20.5	0.4	21.4	15.0	11.7	9	7	6	6
Clover Corp	CLV	1.81	10.0%	3.0%			301	5	-0.3	306	13.7%	0.0%	56.7	33.9	25.4	0.5	34.6	21.9	16.8	6	8	5	5
Costa Group	CGC	3.22	10.0%	3.0%			1,291	462	0.5	1,753	13.8%	4.2%	18.3	14.4	12.3	0.5	7.9	7.0	6.4	6	7	6	5
Elders	ELD	10.97	10.0%	3.0%			1,716	264	0.9	1,980	14.5%	4.1%	11.8	12.3	11.9	N/A	10.0	10.1	9.8	6	7	8	6
Freedom Foods	FNP	0.39	11.0%	3.0%			95	341	6.3	435	10.7%	0.0%	-7.1	33.1	8.9	N/A	13.4	8.2	7.0	3	6	5	5
GrainCorp	GNC	5.12	10.0%	3.0%			1,172	240	0.8	1,412	5.2%	3.3%	11.4	19.7	18.2	N/A	5.1	6.7	6.5	7	7	7	6
Huon Aqua	HUD	2.71	11.0%	3.0%			298	120	2.8	418	6.4%	0.0%	-17.3	17.8	7.8	N/A	30.2	6.8	4.5	2	5	5	5
Ingham's	ING	3.80	10.0%	3.0%			1,412	350	1.4	1,762	55.9%	5.3%	14.2	12.4	11.1	0.8	8.4	7.5	6.9	6	6	5	5
Nufarm	NUE	4.46	10.0%	2.5%			1,694	883	1.8	2,577	5.9%	3.2%	20.5	14.0	11.1	0.3	6.9	6.1	5.6	5	6	5	6
Ridley Corporation	RIC	1.07	10.5%	3.0%			342	100	0.9	442	9.3%	0.0%	14.5	11.7	11.0	0.5	6.4	5.7	5.5	6	6	5	5
Select Harvest	SHV	6.49	10.0%	3.0%			780	80	1.0	860	5.3%	2.2%	135.1	27.3	15.2	0.1	25.3	12.9	8.7	5	7	7	6
Synlait Milk	SMI	3.58	10.0%	3.0%			783	450	2.2	1,280	5.6%	0.0%	N/A	18.0	10.5	N/A	20.6	9.1	7.1	3	7	5	5
Tassal Group	TGR	3.40	11.0%	3.0%			722	310	1.5	1,032	10.0%	6.6%	12.1	8.3	7.1	0.2	6.5	5.1	4.6	4	6	6	7
Top Shelf	TSI	1.65	11.0%	3.0%			70	2	-1.0	72	-40.9%	0.0%	-5.7	-6.2	-9.3	0.8	-8.0	-6.9	-13.2	5	7	6	5
Treasury Wine	TWE	11.90	9.0%	3.0%			8,553	786	0.5	9,338	8.2%	1.9%	27.7	25.7	22.2	3.3	15.0	14.1	12.7	6	8	6	5
United Malt	UMG	4.44	9.5%	3.0%			1,328	250	1.5	1,578	6.1%	3.0%	34.0	17.2	15.3	0.2	12.3	9.1	7.6	6	8	6	6

Source: Chester Asset Management

We include this pack as a way of highlighting some of the detail that we undertake when selecting stocks. We have always started our search to narrow down our universe of stocks with a megatrend framework seeking strong thematic tailwinds. With this in mind, we have illustrated here some of the work that we put into reviewing each sector, with this review looking at the agriculture sector or consumption stocks, which tie into the megatrend of "feeding the world".

We generally undertake such detailed sector reviews once every 12 months, in sectors where we can find value. With the case of these consumption related stocks, we look to see where value lies from a contrarian perspective. We gravitate towards stocks that either offer a significant discount to valuation, or have strong earnings surprises ahead of them. So while we look at each stock in detail once per year, from this work we will narrow down the focus list to around 7-8 stocks in each sector that form our watchlist of approximately 50-60 stocks, outside those already in the portfolio. In aggregate, we find the consumption related stocks to offer far greater margin of safety than many other sectors that we look at presently. There are three aspects to how we assess a stock for investment, the first one being a discount to valuation (which we have blacked out for IP purposes). Note we also highlight what WACC we use for each stock as this will vary by sector and by size. For example, Treasury Wine Estates uses a WACC of 9% as effectively an FMCG (Fast Moving Consumer Goods) company that is more predictable than the Salmon producers (Tassal and Huon) where we use an 11% WACC to account for greater volatility in their earnings.

Once we assess a reasonable basis for a valuation we then use a qualitative ranking system that assesses the industry structure from a business quality perspective, assess management using our own ranking system largely based on how they are compensated and their track record and then the balance sheet or financial assessment.

The last component of the framework assigns a rating to whether we think the earnings outlook is stronger or worse than consensus expectations, based on our own due diligence. Given many of these stocks have a commodity cycle influence, often the earnings expectations are driven by the expectations of these underlying commodity drivers (almond price, milk price, beef price, salmon price etc). Where some level of commodity influence occurs, we do focus heavily on the valuation, as we do require a margin of safety with our initial purchase. Simplistically, we often follow the rule of 3. That is, can we see 3x the upside relative to the downside (always asking the question, what can go wrong?). Hence if a stock has 30% upside but on our metrics, theoretically only a 10% downside, we see that as a compelling investment from a risk reward perspective.

We currently hold several stocks from this research effort in the portfolio, with United Malt Group being one of our more recent investments. Our thesis (below AUD4.00/share) was that it had significant support at AUD3.50/share (around book value), whereby we still see significant value in the earnings recovery over the next 12-18 months, assuming the world returns to a version of "normal" in terms of entertainment (clubs, pubs and sporting venues). On our current estimates as the demand for beer recovers, we can see a valid reason why UMG trades towards our assessed fair value of AUD5.70 and hence the 3:1 risk reward trade off is evidenced for UMG at the AUD4.00 range. There's very few stocks in the top 50 that offer that asymmetric risk profile over the next 12 months.



Sale and Leasebacks?

Chart 11

Deal	Date	Buyer	Amount (AUDm)	EBITDA (AUDm)	Multiple (x)	Simple Cap Rate	Note
Milestone Logistics	Apr-21	ESR	3,800	150	25	4.0%	AS reported, 3.8bn and ~150m rental income
TLS Mobile Towers	Jun-21	Consortium (Future Fund, etc)	5,900	210	28	3.6%	49% interest
Halcyon	Jul-21	Stockland?	500-650	N/A	N/A	4-5%	As reported in AFR, deal still to complete
Sydney Airport	Jul-21	Consortium (IFM, etc)	30,000	1,300	22.8	4.4%	Bid mate, no certainty as yet
Moorebank	Jul-21	LOGOS	1,680	N/A	N/A	N/A	Deal to complex to impute a cap rate
					Average	24.3	4.1%

Source: Chester Asset Management, Bloomberg

Accounting Trickery or efficient WACC arbitrage mechanism? The Sale and Leaseback question is one board rooms have been vigorously debating since the “Sonneborn (McDonalds) model” was developed in the 1950s. Recent M&A deals (tabled above) and outperformance of Charter Hall (CHC) and Home Consortium (HMC), highlights the market is rewarding OpCo PropCo deals, capital is available and cap rate compression continues. I.e., “the worm” has been inching further across to the WACC arbitrage side of the argument.

Clearly these types of capitalisation rates are supportive of traditional infrastructure and industrial property assets but on the whole these are priced as such. However, we think opportunity exists to unlock latent value in some less obvious sectors.

Gaming

The US Casinos were early proponents of OpCo, PropCo models none more so than Caesars who lease their land from Vici. But to say that the model hasn't been employed in ANZ would be ignoring the deal SkyCity (SKC) completed with Macquarie for its Auckland Car Park in August 2019. Crown (CWN) also proposed in 2016 to spin off their hotels into a specialised trust but that never progressed beyond a proposal.

Focus however has once again shifted to CWN given takeover bids from both Blackstone and Star (SGR), with both deals including sale and leasebacks (to justify valuations). Hence the market has clearly considered what value can be unlocked within property for CWN and SGR but for us SKC has largely been ignored in the discussion. We believe SKC's property is now worth circa NZD2bn and on our numbers we see potential for NZD750-1.bn to be unlocked for the casino under a sale and leaseback model.

Hospitals

Similar to the CWN proposal of 2016, sale and leasebacks were a hot topic for the hospital space in 2018 given the “strategic review” Healthscope was undertaking (prior to its eventual takeover by Brookfield). The review identified a number of opportunities to realise value from its property assets with a core focus on 20-30 freehold properties that had a book value of AUD1.0bn.

Healthscope proposed to transfer these properties into a REIT in exchange for rental payments of approximately AUD80-90m in the first year. At the time Ramsay (RHC) was mentioned as similarly placed to entertain a sale and leaseback. For us the potential for RHC to undertake this has been somewhat forgotten and outside of the macro we find it interesting RHC has made a GBP1,041m bid for the entirety of Spire Health, particularly as it was noted by Spire in March 2019 that their property portfolio was valued at GBP1,100m. we would guess that portfolio is worth >GBP1,200m now. Assuming the Spire deal goes through we have completed analysis suggesting RHC could be sitting on >AUD8bn of property. We see an uplift of >AUD4bn in value compared to where the company is trading, which could be partially unlocked via a sale and leaseback

Energy

Viva Energy, BP and now Ampol (you're still Caltex to me) have all completed sale and leasebacks of service stations in recent years. The most recent of these saw ALD divest a 49% interest in 203 core freehold convenience retail sites to a consortium including Charter Hall and GIC. AUD77m in rental payments with a weighted average capitalisation rate of 5.5% (18x multiple) valued the property at AUD1,400m. At the time ALD was trading at ~9x EV/EBITDA. In oil and gas, we have also seen deals recently for QGC Common facilities; Sale by Shell of 26.25% interest for USD2.5bn (March21 completion) and Senex, sale of Roma North Gas facility to Jemena (September19 completion). There are a number of companies for which similar opportunity exists particularly given energy multiples remain extremely depressed. STO has announced midstream assets with ~USD400m in earnings so stands as a likely contender for a sale and leaseback. WPL also has infrastructure opportunities particularly at Pluto given they own 90% of the downstream. ORG via its 37.5% APLNG interest also has multiple opportunities in their infrastructure including pipelines and gas processing facilities.

Aged Care

There's a graveyard of fund managers who've tried to suggest there's opportunity in the aged care operators (Estia, Japara and Regis) but with Japara now attracting multiple bids question turns to what property value exists within their portfolios and whether it can be liberated. As highlighted by the JHC bid the opportunity becomes particularly more compelling for not-for-profits as they have the ability to avoid quite onerous payroll taxes.

Agribusiness

Previous examples of companies that have benefited from sale and leasebacks include CGC (Vitalharvest/ MIRA leases), GNC (Australian Bulk Liquids Terminal business sale), SHV (Rural Funds leases) and Ingham's (TPG property deals). We see potential for the first of these three names to continue to complete deals. Furthermore, we see a number of other companies in the space that are asset heavy and have potential to unlock property value such as BGA (particularly Port Melbourne and LDD property portfolios) and SM1 (Dunsandel and Pokeno sites).



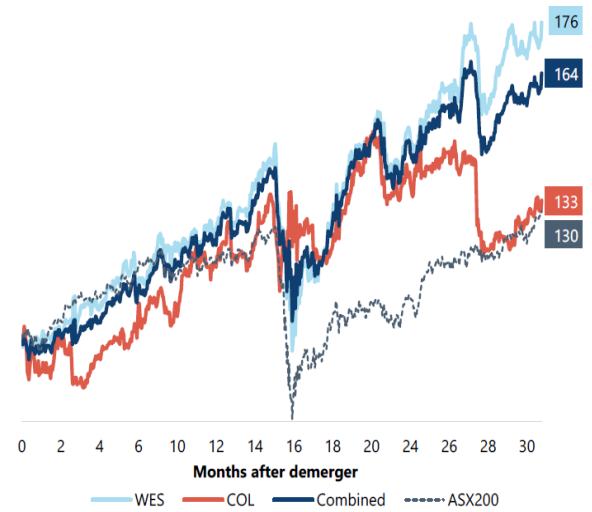
De-mergers

As a general rule, we tend to view de-mergers far more favourably than mergers because we find it easier to believe that de-mergers actually add value. UBS data looked at 28 de-mergers over the past 20 years in Australia and found that after a 1 year and 3 year period, both spin off and parent company were materially higher. After 3 years the average spin off rose 42% while the average parent company rose 20%. This is supported by the Goldman Sachs research below. This is topical at the moment as we have just witnessed Endeavour Group (EDV) de-merge from Woolworths (WOW) and Tabcorp (TAH) has just announced the pending lotteries de-merger from the wagering business, as discussed on page 5. Clearly it has been a disappointing 3 years for TAH wagering, with the promised integration and synergy realisation from UBet never coming to fruition. Often synergies are a little bit like the pot of gold at the end of the rainbow.

The attraction for de-mergers are relatively straight forward, stronger management incentives (senior team members actually feel a tangible outcome for their efforts as opposed to being a small cog in a big wheel), more appropriate capital allocation for the separate entities (as opposed to being prioritised from a corporate perspective), and greater focus. There is also the prospect of a spin off being acquired by another entity looking for scale. This is perhaps relevant for EDV, the TAH wagering business and the recently de-merged UMG (where we are still waiting patiently for alpha!).

Wesfarmers and Coles de-merger performance

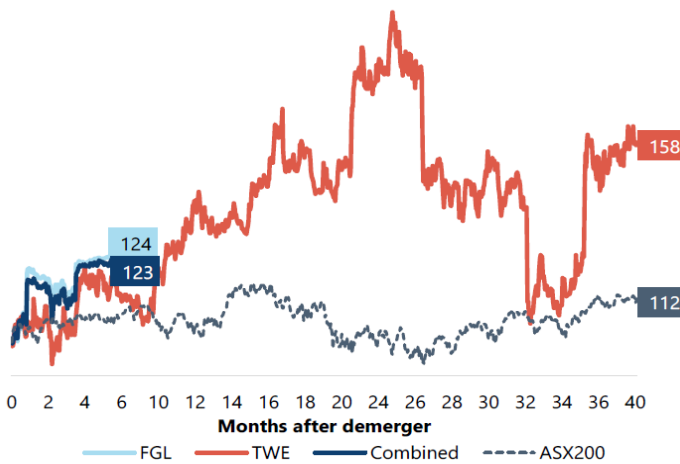
Chart 12



Source: Jefferies

Treasury Wine had better focus - Fosters was taken over

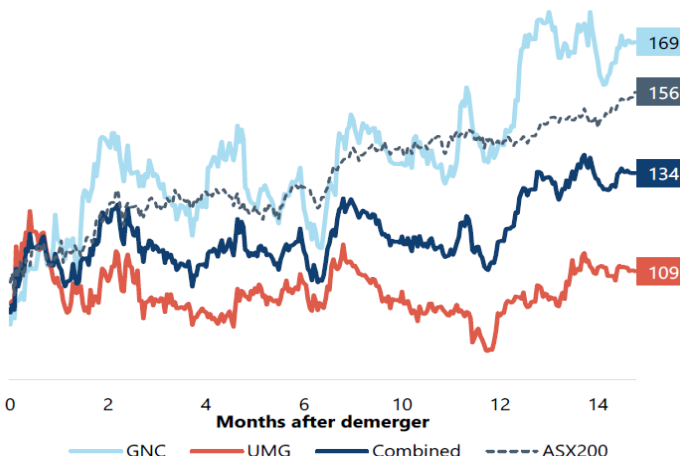
Chart 16



Source: Jefferies

United Malt (UMG) a laggard - but COVID related

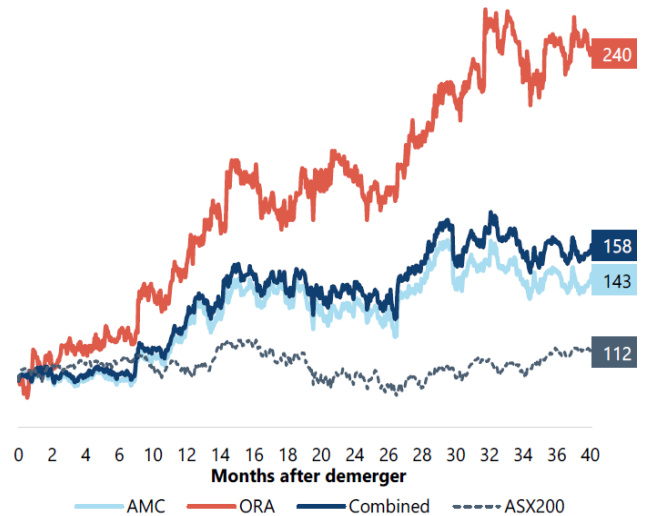
Chart 15



Source: Jefferies

Ancor and Orora created value

Chart 13

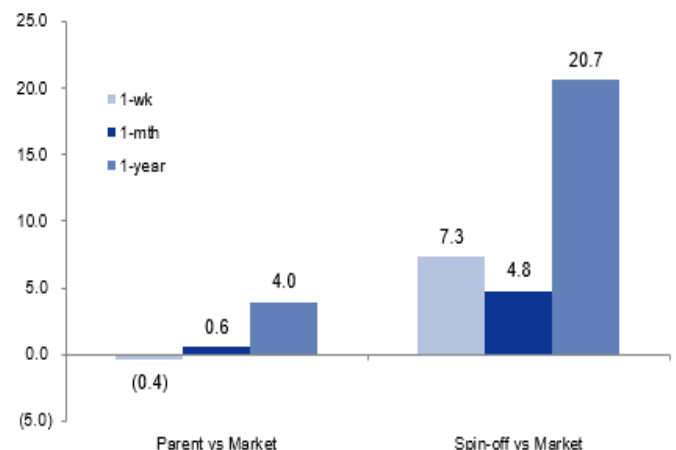


Source: Jefferies

Spin Offs tend to perform better over time

Chart 14

Performance of Parents vs Spin-offs post de-mergers



Source: Goldman Sachs



There is only one solution to the debt burden

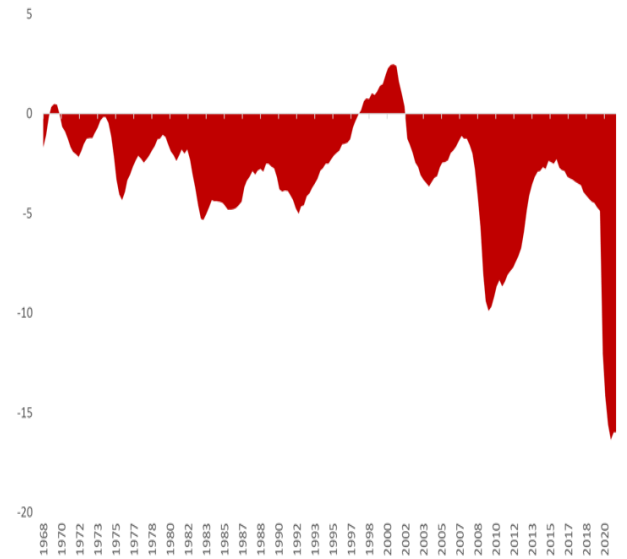
We have left this page in the quarterly to reinforce just what a dilemma the US is faced with in terms of deficit spending. The prospect of running deficits well north of 10% of GDP looks to be inevitable for the foreseeable future, all fine, because the US can use the US Dollar as the reserve currency to create more of them. But ultimately the only solution to this debt burden is higher inflation.

We look to the previous examples of WWI and WWII when the US debt to GDP ratio fell sharply post the deficit spending of the war years. The way this happened was for structurally higher inflation, which saw real yields turn sharply negative as inflation rose up to 14-15% for a period, while the long term bond yields remained below 5%. This is chart 20 below. Hence real yields spent times through this period at -12 to -13%. This is the way to manufacture higher GDP prints that enables this Debt to GDP metric to fall over time. It has worked before.

The risk this time is shown on chart 19. Who will continue to finance the US deficit? We monitor the bond auctions for how well covered they are (how many bids there are to cover the amount of the auction). Currently the Fed is purchasing roughly 25-35% of most auctions, but the risk lies in the need to incentivise foreign investors with higher yields to account for the higher sovereign risk. This is a key metric to observe this year.

US Budget deficit appears to be infinite

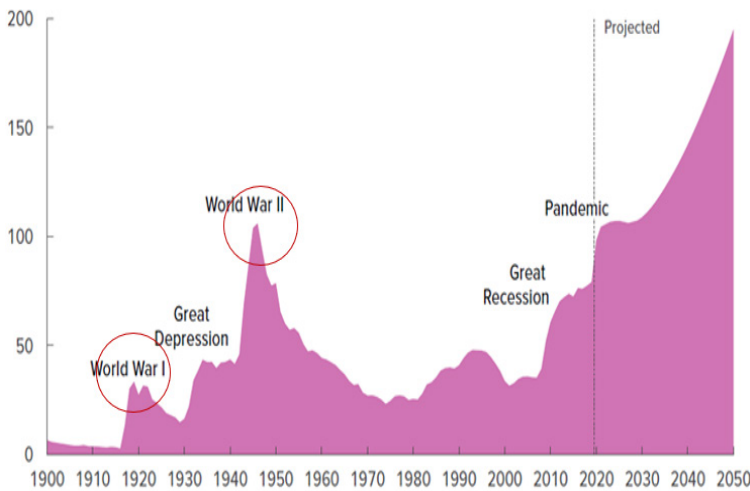
Chart 17



Source: Chester Asset Management

US Federal Debt as a % of GDP - how to deflate it

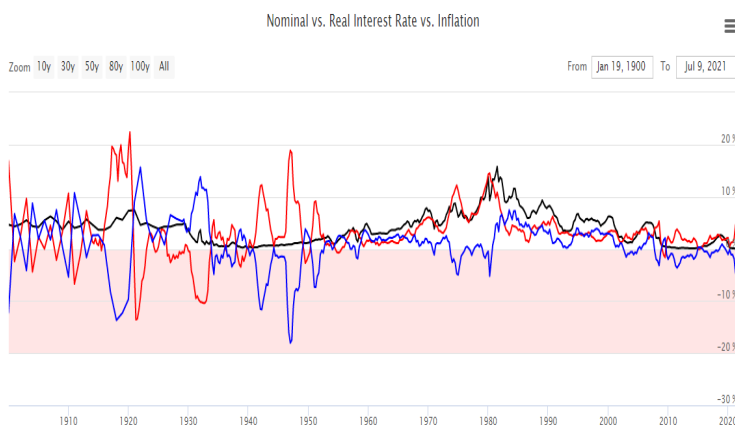
Chart 21
Percentage of Gross Domestic Product



Source: Congressional Budget Office, Chester Asset Management

The blue line indicates real yields - going lower??

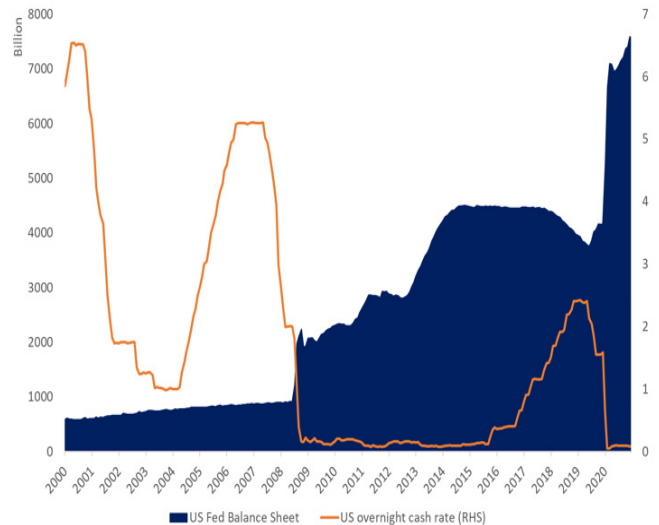
Chart 20



Source: longtermtrends.net

US deficit spending financed by the Fed

Chart 18



Source: Chester Asset Management

Who will finance the deficit?

Chart 19

US bid to cover ratio



Source: Deutsche Bank



Inflation and where could we be wrong?

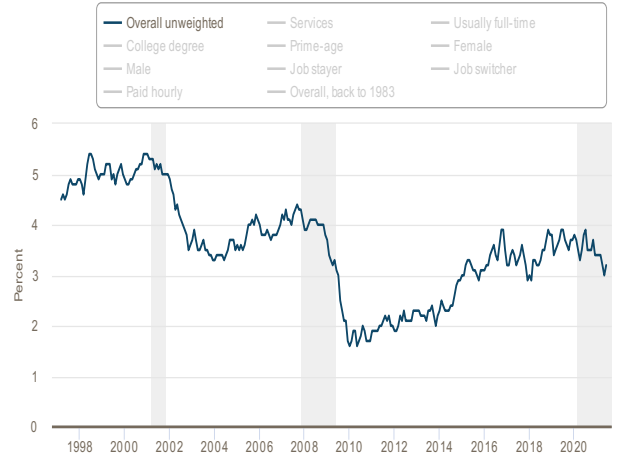
There is a wide range of charts being bandied around from both deflationists and inflationists trying to convince the other camp of the logic of their argument. We have always said that wage inflation is a core tenet of structurally higher inflation, as we do think it is desired by policy makers. Anecdotally there is much evidence of strong wage growth in certain sectors, while many firms have realised that productivity gains can be made with fewer workers through lockdowns. Hence, the jury is still out on the sustainability of wage growth over the next 12-18 months. We do think there is significant data to suggest that many components of inflation are unlikely to be resolved any time soon. Chart 26 highlight that US auto inventories have never been lower, which speaks to ongoing supply chain constraints and a backlog unable to be replenished yet. We also note that (due to flight availability), US gasoline demand was at a record high on July the 4th weekend. Autos are 25% of global oil demand which helps the narrative that oil isn't dead yet (and is currently at 7 year highs). The other key metric to watch is OER (owners' equivalent rent) which is 24% of the CPI basket and is a theoretical measurement of the cost of housing (both house price increases and renting). Clearly chart 25 illustrates that OER has lagged house price growth significantly, but appears to us to be headed higher - and is 24% of the CPI index. Where could this thesis be wrong? In short, the dramatic increase in durable goods spending in 2020 (everybody bought stuff online in lockdown). As that unwinds, and if wages don't pick up, then we would accept the notion that CPI may be more transitory than we currently anticipate.

Wage growth is key to structural inflation

Chart 22

Wage Growth Tracker

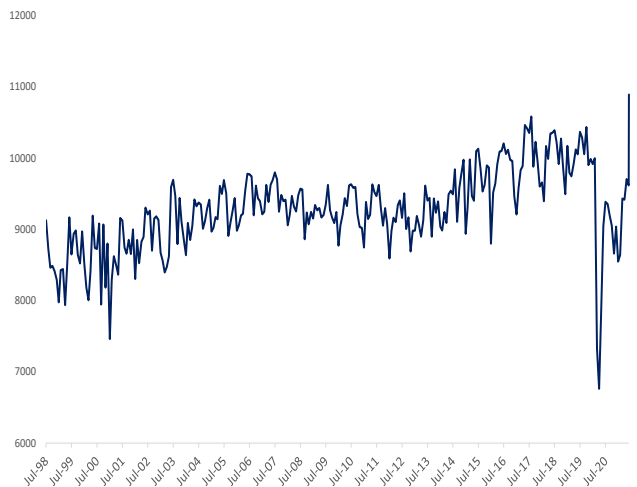
three-month moving average of median wage growth, hourly data



Source: Atlanta Fed

US Gasoline demand at record high

Chart 23

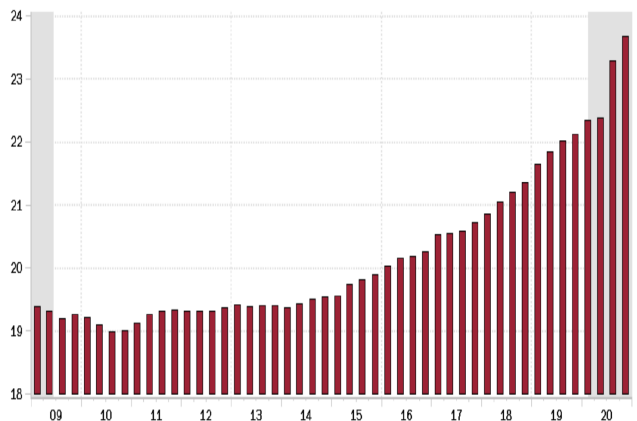


Source: Chester Asset Management

US Durable goods spending - unsustainable?

Chart 24

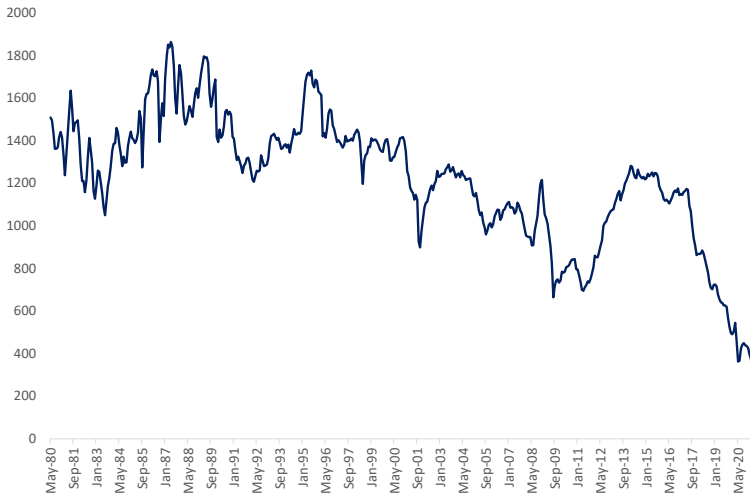
United States: Consumer Durable Goods Assets per Capita (\$ thousands)



Source: Haver analytics

US Auto inventories historical low = restock coming

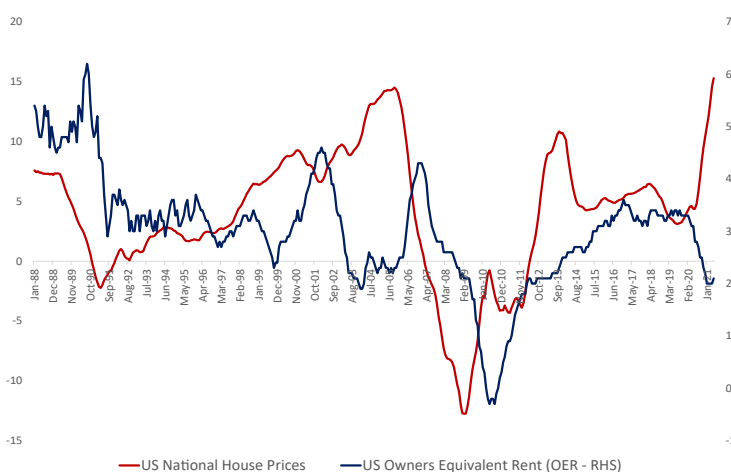
Chart 26



Source: Chester Asset Management

Rental growth (in the CPI basket) catches up to house prices?

Chart 25



Source: Chester Asset Management, Bloomberg



The valuation dilemma

These charts frame our thinking in terms of where the risk/reward lies in portfolio construction. 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 (charts 28 and 31 below) highlight just how expensive high PE firms have become relative to the ASX200, while low PE firms (value stocks) are trading at near record lows. We don't think of ourselves as "growth" or "value" investors per se, but we are focussed 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, particularly if bond yields do start pricing in higher interest rates or there is an inflation scare over the next few months. The recent pick up in growth as a style has been entirely due to the notion that the second half of 2021 will see a slowdown in economic data (thus bond yields falling). Clearly there is an element of the year on year base effect in play with the second order impact (the rate of change) falling, but we do think there is still pent up demand for manufacturing - taking note of the extremely low level of auto inventory currently, which points to an ongoing restocking of goods over the next 12 months. This is combined with an extremely tight labor market in many industries, which does suggest wage inflation will be more than a temporary phenomena.

World value stocks vs world growth stocks

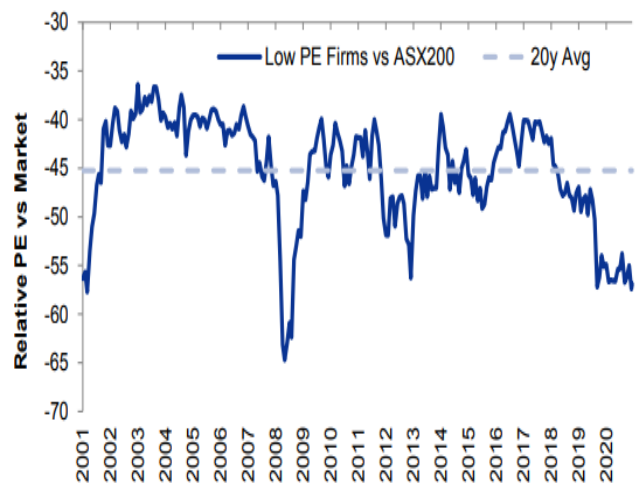
Chart 27



Source: Chester Asset Management, Bloomberg

has never been higher

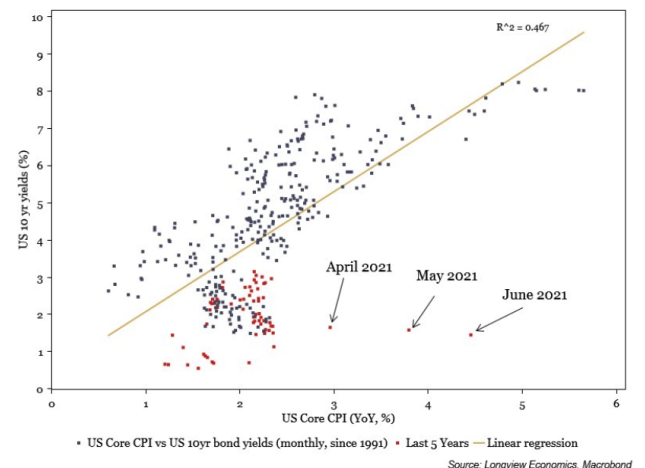
Chart 28



Source: Goldman Sachs

But what do we make of this US 10yr vs CPI?

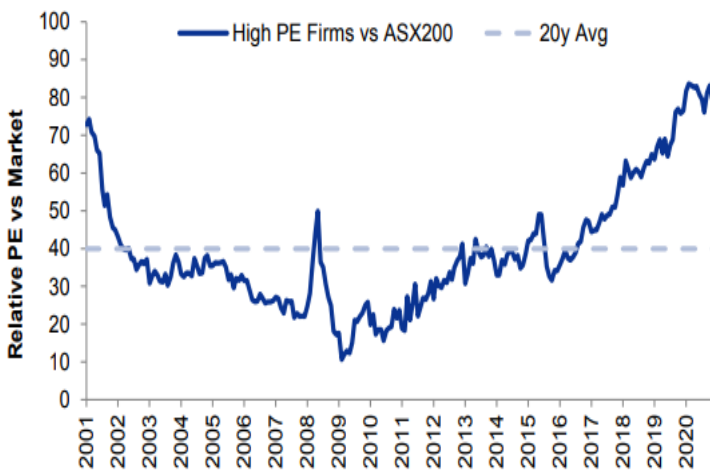
Chart 29



Source: Longview Economics

The dispersion between high PE firms and low PE firms...

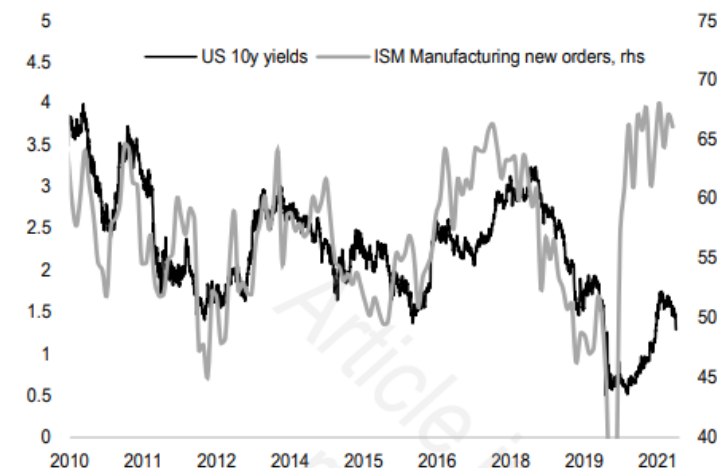
Chart 31



Source: Goldman Sachs

US 10yr bond is suggesting economic pulse weakens

Chart 30



Source: Credit Suisse



Bob Farrell's 10 Market Rules to remember

Bob Farrell was the chief stock market analyst and senior investment advisor at Merrill Lynch, where he worked for 45 years. Farrell is well known for his work as a technical analyst, recognizing the importance of data and patterns.

Some would say Farrell was immortalized by his rules of investing that remain widely quoted today. They still remain incredibly valid.

1. Markets tend to return to the mean over time
2. Excesses in one direction will lead to an opposite excess in the other direction
3. There are no new eras — excesses are never permanent
4. Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways
5. The public buys the most at the top and the least at the bottom
6. Fear and greed are stronger than long-term resolve
7. Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names
8. Bear markets have three stages — sharp down, reflexive rebound and a drawn-out fundamental downtrend
9. When all the experts and forecasts agree — something else is going to happen
10. Bull markets are more fun than bear markets



Our Executive Summary

- Equities** Is a bout of inflation cyclical or structural? It appears to be the financial debate of 2021. We are in the structural camp, but this is dependent on wage inflation. The US bond market appears as though it is already pricing in a softening in economic data and cost pressures through the second half of 2021, albeit in the face of a wide range of data points that suggests inflation is more embedded than that. Hence macro signals are providing no real assistance in stock picking.
- We have a view 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.
- We do believe central banks will err on the side of over heating economies as the focus of both fiscal and monetary policy appears to be firmly on job creation. We are of the view that financial conditions will remain favourable until the US (and Australia) achieve full employment and in fact wage inflation. The social issues around inequality we think remain one of the most inflammatory social issues of this generation. Structural inflation will not occur until there is full employment and stronger credit growth. Both of which look to be endorsed by fiscal and monetary policy, but broadly need to start supporting economic momentum now as fiscal stimulus starts waning.
- 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 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 2021.
- By and large, our stock selection framework focuses on:
Real assets - MIN, QUB, SKC, SHV
Valuation margin of safety - DOW, LLC, UMG
Pricing power - TAH, EGH, JHX
Gold - OGC, AMI
- All else being equal, equities remain attractively valued relative to bonds, albeit we do see risks around the pace of the vaccine roll-out and the potential for an inflation scare (inflation surprising to the upside). This conundrum has caused several pockets of significant speculation in various asset classes, which we think will give rise to higher volatility through 2021.
- Having said that, we are genuinely excited by many of the stocks in the portfolio today, where we can justify materially higher prices over the next 12 months. As we have demonstrated over the past 7 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. It 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 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. 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.
- Currencies** Our track record of predicting currency movements is very poor, but we offer the following thoughts. Given the level of deficit spending in the US relative to Europe, and the relative success in getting the economies reopened safely, it appears the US dollar may be entering a period of underperformance (relative to the EUR), which is helpful for emerging economies that are faced with high USD loans. It also augurs well for commodities that are priced in USD. This has played out somewhat, but we see reason why these trends persist through much of 2021.
- Risks** The outlook remains more optimistic in 2021, with the prospect of a globally synchronised recovery post vaccine roll out in the second half of the year. Still, the complete reliance of asset markets on stimulus packages and government spending combined with historically low interest rates means heightened risks of policy error. Combined with pockets of speculative frenzy, there is always reason to remain vigilant on the portfolio. If 2020 has taught us anything, an ability to be nimble and change our assessment of the likely outcomes is critical to not only protecting capital, but identifying opportunities when they arise.



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
Iain Mason	Director, Institutional Business	0412 137 424 imason@copiapartners.com.au
Mani Papakonstantinos	Distribution Manager	0439 207 869 epapakonstantinos@copiapartners.com.au
Matthew Roberts	Distribution Manager	0438 297 616 mroberts@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

Past performance is not a reliable indicator of future performance. The total return performance figures quoted are historical, calculated using end-of-month mid prices and do not allow for the effects of income tax or inflation. Total returns assume the reinvestment of all distributions. The performance is quoted net of all fees and expenses. The indices do not incur these costs. This information is provided for general comparative purposes. Positive returns, which the Chester High Conviction Fund (the Fund) is designed to provide, are different regarding risk and investment profile to index returns. A performance fee of 15.0% is payable quarterly on any excess performance (after deducting the management fee) above the benchmark, S&P/ASX Small Ordinaries Accumulation Index. A performance fee is only payable where the unit price is higher than when the last performance fee was paid. This document is for general information purposes only and does not take into account the specific investment objectives, financial situation or particular needs of any specific reader. As such, before acting on any information contained in this article, readers should consider the appropriateness of the information to their needs. This may involve seeking advice from a qualified financial adviser. Copia Investment Partners Ltd (AFSL 229316, ABN 22 092 872 056) (Copia) is the issuer of the Chester High Conviction Fund (ARSN 620 091 858). A current PDS is available from Copia located at Level 25, 360 Collins Street, Melbourne Vic 3000, by visiting chesteram.com.au or by calling 1800 442 129 (free call). A person should consider the PDS before deciding whether to acquire or continue to hold an interest in the Fund. Any opinions or recommendation contained in this document are subject to change without notice and Copia is under no obligation to update or keep any information contained in this document current.

