



Total returns

At 30 September 2021	3 mths %	6 mths %	1 yr %	2 yr % p.a	3 yr % p.a	4 yrs % p.a.	Incep. % p.a. (27 Apr 2017)
Chester High Conviction Fund (after fees)	6.3	14.3	37.6	20.4	13.4	13.9	15.1
S&P/ASX 300 Accumulation Index	1.8	10.4	30.9	8.6	9.9	10.9	9.4
Outperformance (after all fees)	+4.5	+3.9	+6.7	+11.8	+3.5	+3.0	+5.7

* The inception date of the Chester High Conviction Fund was April 26th, 2017. The NAV at September 30th, 2021 was 1.5028 after a 24.8c distribution was paid in July

"Often, there is no correlation between the success of a company's operations and the success of its stock over a few months or even a few years. In the long term, there is a 100 percent correlation between the success of the company and the success of its stock. This disparity is the key to making money; it pays to be patient, and to own successful companies."

Peter Lynch

Quarter in review

We remember September 11 vividly, as does everyone old enough to look back fondly on the turn of the Millennium. It was such a prosperous time. We watched the second plane fly into the South Tower at 9.03am NYT, brushing our teeth preparing for bed on the other side of the world. We had only really been involved in finance for 18 months or so and we spent the night awake contemplating what this would mean for society as a whole, and capitalism more broadly. The 20 year anniversary of this event recently had us reflecting on the way US policy makers responded to this threat to the American way of life, and every threat to that way of life since.

The moral hazard of not doing enough to protect capitalism and citizens has been prominent since that fateful day 20 years ago, to the point where we have arrived at a tipping point of sorts. The most recent COVID inspired emergency response has seen 20 years of US central bank debt accumulation double in 12 months. We have arrived at a juncture of financial repression, for governments themselves can not afford materially higher interest rates, but are effectively forced to run budget deficits, for the greater good. Hence the control of the supply of money is changing from central banks to governments as they grapple with the moral hazard of looking after their citizens' way of life. The consequence of this appears to be that short term interest rates will not reflect inflation expectations and any sign of significant asset price volatility will see the effective capping of long term interest rates. This line of thinking outlines the playbook for a decoupling of inflation and interest rates for the first time since the 1940s. This is actually a necessary policy setting to have any chance of governments solving the current debt crisis. The pathway to this outcome may not be smooth, but essentially this is the most probable scenario, given so many others (materially higher interest rates, austerity or even sovereign debt default) are far more unpalatable.

We realise we spend some time in these pages outlining macro thoughts, while ultimately the portfolio we run is constructed on a bottom up basis. The unfortunate reality is that interest rate and inflation expectations are driving much of the relative performance and stock price outcomes currently, hence the micro (stock picking) has to be somewhat intertwined with the macro. The current Fed Reserve "Dot Plot" illustrates 12 different views from the Fed Reserve committee members of where US interest rates will be in 2024 with a range from 0.5% to 2.5%. This suggests to us that if the 12 smartest economic minds in the US can't forecast with any certainty interest rates in 2 years' time then we are absolutely wasting our time trying to do the same exercise. We aim to diversify the portfolio across a range of industry sectors (in a very benchmark unaware framework), while focusing on the idiosyncratic nature of stock picking outlined so eloquently by Peter Lynch above.

So where to now? It is easy to paint a more cautious approach as we end 2021. US monetary policy is wading through the potential for a change in Fed Chairman, a tightening of liquidity (removing ongoing Balance Sheet purchases every month) while grappling with passing renewed spending bills (the US\$3.5tn infrastructure bill) which pave the way for stronger economic activity into 2022. Without this bill and the persistence of underlying inflation (supply chains, labour shortages, energy prices and housing prices) suggests a period of less easy financial conditions, and most likely, more volatility. While on the subject of Peter Lynch, we also like this quote from him. *"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."* Having said that, we remain excited by many of the companies we hold in the portfolio today, as we (eternal optimists) see compelling reasons why their share prices are not currently reflecting the underlying latent value held in the asset base of that company. Hence we have a portfolio of companies that can, and often will trade in a non correlated manner to the broader market.

Our philosophy with the Chester High Conviction Fund is to strive 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, which means a rigorous focus on asymmetric investing. What is the downside vs what is the upside of an initial investment? We remain heavily focused on owning a portfolio of stocks that remain compelling on a bottom up cash flow basis, and by no means do we want to be overpaying for those cash flows. There remains significant risk around long duration valuations (the higher the bond yield goes, the lower the value attached to those cash flows). We think the backdrop is favourable for finding unloved and 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 DOW 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.



We have made several changes to the portfolio over the past 3 months

From a bottom up basis, over the quarter we took profits in several stocks that have performed very well for the fund, in ALS Limited (ALQ), BHP, Select Harvest (SHV), Ioneer (INR) and Bluescope Steel (BSL), while lightening Mineral Resources (MIN), Downer (DOW), Woolworths (WOW) and Aussie Broadband (ABB). We added to our positions in Origin Energy (ORG), Ridley Corporation (RIC), Oceana Gold (OGC) and Synlait Milk (SM1), while taking new positions in Transurban (TCL) and several smaller stakes that we will build on over the 4th quarter.

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. This debate around future spending and the impending requirement to raise the debt ceiling will lead the macro related uncertainty.

So what are we focusing on?

Our thinking has been very consistent over the course of 2021, with a desire to focus on four key areas of investing, while appropriately diversifying the fund from an industry stand point. These four key areas are listed below. There is still a wide range of outcomes possible from a macro perspective over the next 12 months, so we look to have an appropriate blend of stocks with significant valuation support, while also holding several stocks with strong pricing power and dominant industry positions.

Real assets. Inflation will drive real asset valuations significantly higher. We would highlight the multiples being paid for Sydney Airport, Ausnet, Spark Infrastructure and the Telstra Mobile Towers as providing us strong confidence in the way we value several of our holdings in the portfolio. We are still of the view that there is much cash waiting to be deployed into assets generating an acceptable return (i.e above cash).

Valuation margin of safety - Not overpaying for concept stocks or long duration assets. Upward pressure on bond yields exacerbates this risk.

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 have been intellectually wrong with the gold position this year, as historically negative real yields (US 10 yr bond less inflation) 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 follow its own rhythm. Historically, more often than not, gold performs the best as a defensive asset class in times of inherent volatility, while on a cash flow basis, there is extreme value emerging in gold equities, as the most unloved sector across global equities right now. We revisit this investment thesis inside. The most obvious near term headwinds are rising real rates (less negative) and USD strength.

We see Tabcorp (**TAH**) as well positioned to benefit from the demerger of the Lotteries and Wagering businesses. 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. News Corp (**NWS**) also has a portfolio of assets that are without doubt, mispriced in the NWS conglomerate structure. This allows us an investment in a highly cash generative business, with high quality assets in property and media, with undeniable valuation support. We believe Origin Energy (**ORG**) is experiencing trough earnings in FY22, and there are several catalysts ahead of it to see the stock trade closer to book value. Origin's 20% stake in Octopus, a fast growing energy retail platform in the UK, together with an FY23 earnings recovery and significant free cash generation from its 37.5% stake in APLNG make it a compelling investment at these levels.

The Portfolio

The CHCF posted a 6.3% gain in the September quarter, relative to the 1.8% increase in the ASX300 Accumulation Index. The strategy has had a pleasing 12 month period, with contributions across a wide range of stocks in different sectors. We believe there are several key holdings that are well positioned for strong periods over FY22. Aussie Broadband (**ABB**) has been the strongest performer for the fund over the past 12 months. The simple premise of the ABB investment thesis was (and remains) a founder led business with exceptional customer service leading to strong market share gains. A recent capital raise to potentially double their business looks to be transformative. We have just initiated a position in another pre IPO investment that has us as excited as we were about ABB 12 months ago. We will touch on this more in the lead up to the IPO in the next 12 months. Ioneer (INR) has been a small position as it has a very strategic lithium deposit (Rhyolite Ridge) in Nevada, as US investors are bidding up locally based assets for the EV wave that is coming. We exited the position over the past month as in our view, a very full valuation is now being reflected in the share price after selling down the project into a JV structure to fund the development of Rhyolite Ridge.

BHP was softer through the quarter as the iron ore price saw a significant correction after Chinese steel production appears to be slowing on concerns over property development funding. We had significantly reduced our MIN and BHP exposure by early August. United Malt Group (**UMG**) was weaker after another mildly unsurprising downgrade related to re-opening issues for event and hospitality industries. While this has been treated by the market as structural, we believe these issues are far more cyclical in nature.

Top 3 Holdings	Portfolio Breakdown		Top 3 Portfolio Attribution	Bottom 3 Portfolio Attribution
Tabcorp Holdings	Industrials	15.8%	Aussie Broadband	BHP Ltd
News Corp	Consumer Disc	14.3%	Ioneer Ltd	United Malt Group
Origin Energy	Consumer Staples	14.0%	Downer Limited	Aurelia Metals



Accumulated Performance by Financial Year - Same Strategy

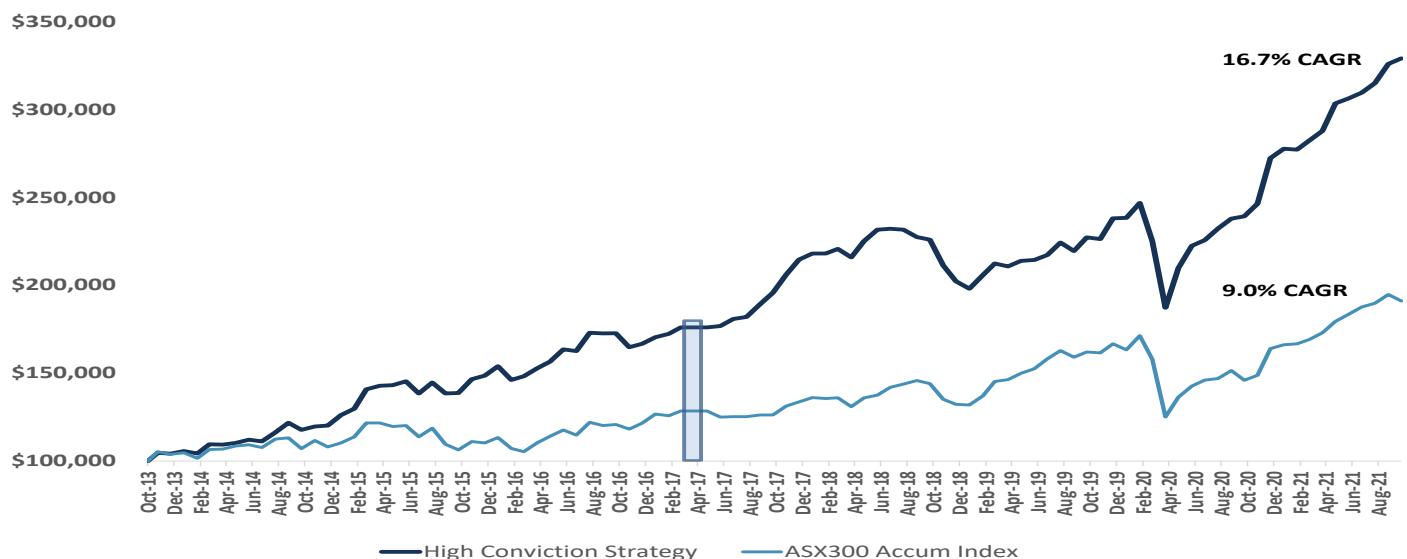
	FY14 (%)#	FY15 (%)	FY16 (%)	FY17 (%)*	FY18 (%)	FY19 (%)	FY20 (%)	FY21 (%)	FY22 (%)	Since Inception (%) p.a.
Same Strategy (after MER)	+11.2	+24.5	+17.4	+11.2	+28.3	-6.4	+3.9	+37.2	+6.3	+16.7
S&P/ASX 300 Accum Index	+7.8	+5.6	+0.9	+9.1	+13.2	+11.4	-7.7	+28.5	+1.8	+9.0
Value added (after MER)	+3.5	+18.9	+16.4	+2.1	+15.1	-17.8	+11.6	+8.7	+4.5	+7.7

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 into 2022

<p>HOW TRANSITORY IS INFLATION?</p>	<p>The most debated topic of 2021. The current backdrop of chronic supply chain bottlenecks, persistently higher energy costs, used car prices, owners equivalent rent (OER) as a measure of house price inflation and pockets of significant labour shortages suggests to us that the “transitory” narrative is becoming longer and longer. Many pundits believe the current inflationary pulse will recede over the coming months, having peaked from a year on year perspective in June/July. 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 have erred on the side of higher inflation all year, now with growth turning lower. Stagflation?</p>
<p>GROWTH VS VALUE</p>	<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 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, while still having a growth bias to our portfolio construction framework.</p>
<p>ASYMMETRIC RISK</p>	<p>What is more stock specific, and at the core of how we think about allocating capital, is determining an appropriate margin of safety in an investment thesis. Margin of safety is a fund manager’s way of saying, “what is the downside to this investment thesis vs what is the upside?”. Or more simply, the risk vs the reward of an investment. With the stock market at record highs, how do we gain confidence that our capital allocation is appropriate to drive returns over the next 2-3 years, with many sectors seeing pockets of exuberance? Asymmetric risk is a fancy way of saying we are looking for more upside than downside in the investment case. We feel our top 3 holdings are perfect examples of this thesis.</p>
<p>CHINA</p>	<p>This fund has historically had the ability to invest a portion (up to 10%) of the fund outside Australia, but we removed any exposure to Asia (China) in 2020 as we found that not only were we not generating any alpha from these non index positions, it was distracting us from our core competency of picking Australian stocks. Do we have any great insight into the China Evergrande debt crisis? Not really. But we would say that while the CCP has been vigilant on other sectors in terms of stamping out excess profits (education) or unproductive pursuits (gaming), we tend to think that housing is viewed differently and there appears to be a repayment plan that will be explicitly or implicitly backed by Beijing, for the greater good.</p>
<p>SURPLUS LIQUIDITY</p>	<p>The bids for infrastructure like assets in 2021 (including SYD, SKI, AST) 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 and to us highlights how under valued some of the assets in our portfolio are.</p>
<p>RE-OPENING TRADES</p>	<p>We’re dusting this off from last year, given the repeat challenges of mobilising the economy in Australia in 2021. We do believe there is significant pent up demand for experiences and “living” from sitting at home and buying “stuff” for the past 18 months. We think the best ways to play this are via UMG, TCL, EDV and SKC. QAN, FLT, WEB are the more obvious travel trades but we find them broadly speaking to be fully priced for the uncertainty of international travel recovery.</p>
<p>ESG</p>	<p>Environmental, Social and Governance risks have been the fastest growing topic of conversation in investing over the past 2 years. Chester has been observing these trends (like all investors) and understands the importance of articulating a view and stance on our framework. We recently released our ESG Policy which is available on our website.</p>
<p>GOLD</p>	<p>Over the past 12 months the ASX300 Accum Index has risen 30.9%, while the ASX Gold Index has fallen 28.3%, for spectacular underperformance of 59.2%. That’s uncorrelated and deeply unloved. The anemic level of interest at the Gold industry flagship Denver Gold conference in September was in complete contrast to the euphoric Bitcoin conference held in Miami in March. Sentiment plays a strong part in these alternate asset classes and as such plays in to what type of investor you are at your core. A momentum investor, or a contrarian? While we can never be sure (the gold price can absolutely fall if the USD gets materially stronger), we see a degree of asymmetric risk in allocating capital to gold equities here.</p>



Stock selection - Origin Energy (ORG)

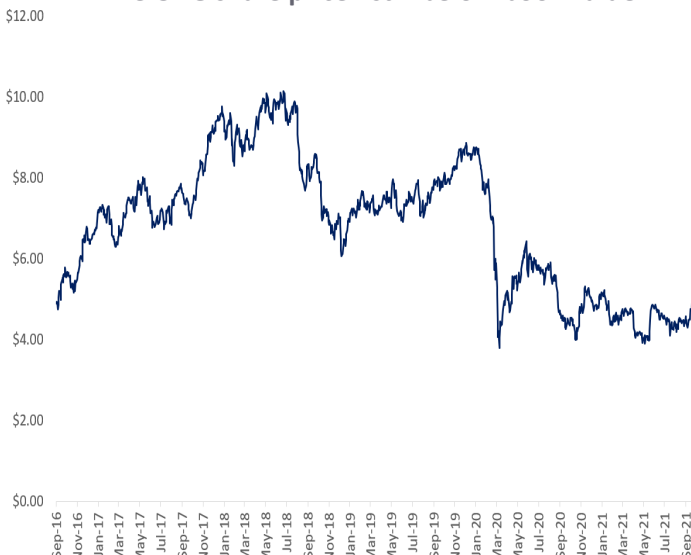
Description Origin Energy (ORG) is an integrated electricity generator sourced from both fossil fuels and renewable energy, while also operating a downstream retail business for both gas and electricity. It serves 4.2m customers across Australia. This combined business operates under the Energy markets division of ORG and is expected to generate approximately AUD500m of EBITDA in FY22. ORG also holds a 37.5% stake in APLNG, a LNG exporter whose largest customer is Sinopec (who is also a shareholder of APLNG along with Conoco Phillips). Most of the LNG is exported under contract, while around 15% is sold into the spot market. This JV is expected to contribute around AUD1.5bn in EBITDA to ORG in FY22. ORG also holds 20% of Octopus Energy, a UK based energy retailer that has developed a market leading user interface for consumers to understand electricity prices and consumption. This technology is named Kraken and has allowed Octopus to capture a 9.5% market share of UK electricity customers over the past 3 years. It is now licensed globally and ORG will roll it out in Australia. ORG invested approx AUD400m in 2020, which post a recent transaction sees the ORG 20% stake valued at AUD1.1bn.

Quality Clearly electricity is one of the most essential services there is, and a stable market (while transforming to cleaner fuel sources) is one of the key bedrocks of the economy. ORG is at the bottom of the cost curve with their integrated offering and ability to extract costs out of servicing their customers with Kraken. Sentiment has been so poor due to the weakness in the wholesale electricity price, which has largely been for two reasons. COVID related shutdowns of C&I (commercial and industrial) electricity usage in 2020 which caused significant oversupply - while electricity prices are contracted 12-18 months out the 2020 price weakness is now impacting FY22 energy markets EBITDA. The second reason clearly has been the push for cleaner energy and the phasing out of coal fired electricity. Coal generation is less than 15% of ORG's EBITDA and is being phased out over the next 10 years, and most likely sooner. The consequences of this push for renewable energy and with AGL exiting Liddell in the next 18 months sees around 920MW of baseload electricity reduction in summer 2022/23, which actually tightens up the wholesale electricity market from a supply perspective. Hence we are of the view that FY22 (using the 2020 demand trough) will be the bottom of electricity pricing and we expect ORG energy markets to recover from around AUD500m in FY22, to more than AUD1.0bn in FY24 (FY20 was AUD1.46bn). With global LNG prices spiking in 2021 on shortages, APLNG is very well placed to sell their spot contracts into a buoyant market, providing a positive tailwind over the next 6-12 months. Having mentioned Octopus above, the other material component of the ORG investment thesis is the Beetaloo Basin, where they control 77.5% of a Northern Territory gas province that looks highly prospective. How ORG drills out and develops this province is still unclear, but it is an extremely gas rich holding, that is arguably not valued at all.

Valuation ORG is a good example of how we assess an asymmetric profile. Normalising Energy Markets for FY24 EBITDA, running an NPV through the APLNG project and adding AUD0.60 for the Octopus holding, we believe ORG is worth roughly AUD6.00/share. Clearly there is a wide range of outcomes dependent on the oil price assumption used for APLNG and the electricity price used for Energy Markets. Underpinning our entry point into ORG was a book value of circa AUD5.50/share, thus in the low AUD4.00 range, we saw little downside and potentially 50% upside. ORG is currently trading on 4.6x FY23 EV/EBITDA or 10x FY23 PER (using WTI at USD70.00/bbl).

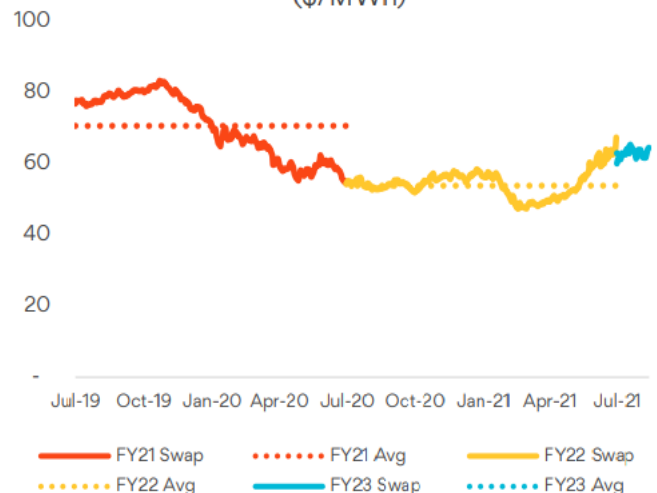
Insight ORG has several levers to improve share price performance over the coming 12-18 months. Clearly an improvement in electricity pricing remains the most important variable, and to that end, we have seen a strong improvement in 2021 (AUD60/MWh) from the depths of 2020 (AUD45/MWh). A AUD10/MWh increase equates to an approximate AUD200m EBITDA uplift to the Energy Markets division. The roll out of the Kraken technology over the next 12 months is expected to save ORG around AUD150m p.a. in back office and processing costs, largely stemming from the integration of electricity and gas bills. The largest swing factor we believe will come from the strengthening of the ORG balance sheet, not that it is over leveraged currently (ND/ND + E = 33%), but the dividend payment can be significantly higher over the next 2 years as debt is paid down and electricity prices stabilise. ORG has intimated that they can reduce the debt burden by monetising the APLNG investment. This could be done in 3 ways: Sell down some of their 37.5% stake in the JV, re-gear the APLNG balance sheet and pay higher distributions to the JV partners, or potentially, sell some of the infrastructure assets (pipelines, terminals) that sit within the JV, which would crystallise far higher prices than currently realised given the demand for such assets in the private/unlisted space right now. With latent value in the ORG share price, and a recovery in their end markets, we see ORG offering strong value here.

Chart 2 The ORG share price - still below book value



Source: Chester Asset Management, Bloomberg

Chart 3 Electricity prices are bound to recover
NSW electricity forward price (\$/MWh)



Source: Origin Energy



Chester High Conviction Fund Portfolio top ten holdings

Chart 4

	FY22	FY23	FY22	FY23	FY22	FY23	FY 22 ROE	FY 23 ROE	FY22	FY22	FY23	FY22 PER	FY23 PER
	Sales GR	Sales GR	Div Yield	Div Yield	DPS GR	DPS GR			BOOK VALUE	EPS GR	EPS GR		
Austral Ltd	-4.5%	3.1%	4.5	4.5	3.7%	0.0%	8.60	8.30	0.84	-13.6%	-4.2%	9.8	10.2
Eureka Group	10.5%	7.9%	2.0	2.2	8.3%	7.8%	7.20	8.10	1.50	7.2%	12.9%	20.6	18.3
Lend Lease Group	-12.2%	12.7%	2.2	3.1	-18.0%	45.0%	4.80	8.00	1.23	-23.0%	55.7%	24.3	15.6
Macquarie Group	10.5%	1.5%	3.1	3.4	16.0%	7.6%	14.50	14.50	2.76	11.4%	2.0%	19.3	18.9
News Corp Ltd	8.5%	3.3%	0.8	0.9	3.1%	4.5%	4.60	5.80	1.66	35.4%	18.4%	32.6	27.5
OceanaGold	43.8%	39.0%	0.4	0.5	nm	28.6%	5.20	11.00	0.70	nm	113.2%	13.0	6.0
Origin Energy	-3.9%	2.5%	4.4	5.3	4.0%	19.0%	3.90	5.30	0.88	51.3%	48.5%	21.1	14.2
Ridley Corp	3.4%	3.6%	4.4	5.2	nm	16.7%	10.60	11.50	1.40	42.9%	18.0%	13.5	11.4
Tabcorp Holdings	1.5%	5.7%	2.9	3.5	2.1%	18.8%	5.80	6.80	1.60	1.5%	19.3%	27.1	22.7
United Malt Group	10.6%	3.2%	3.1	3.6	77.5%	22.0%	6.20	7.40	1.16	52.5%	25.4%	19.2	15.1

Source: Chester Asset Management, Bloomberg consensus data

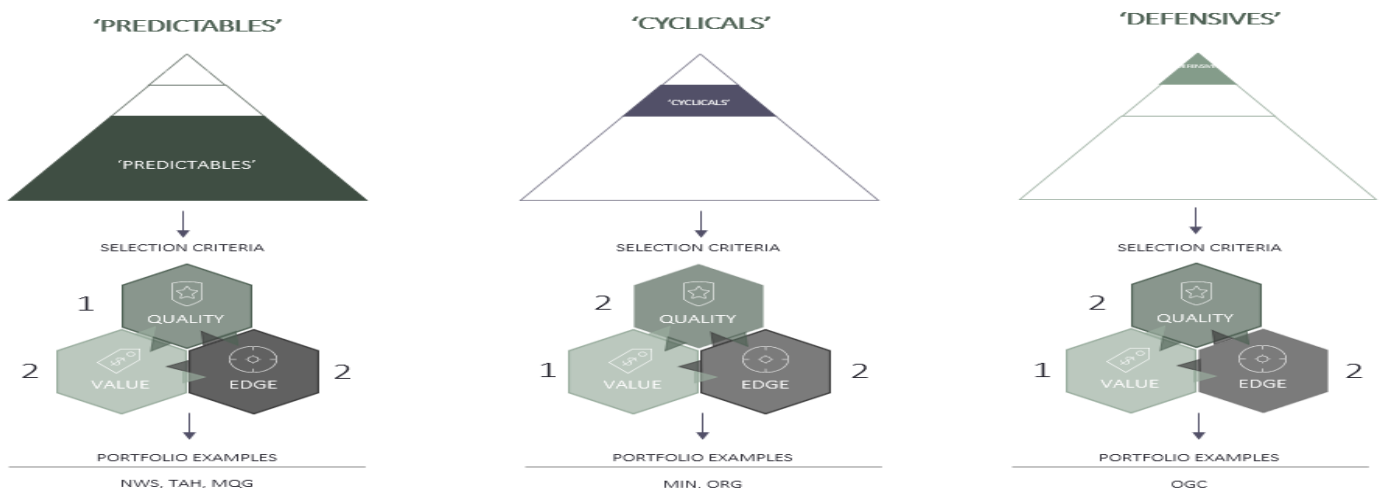
We have listed here our top ten holdings at the end of September, 2021. Naturally we find that our stock weights can change over the course of a quarter or year. Our fund is actively managed and has no position that is simply there to lower the tracking error against the index. It is truly benchmark unaware investing. We broadly hold positions between 1% and 6% depending on our conviction level on the stock.

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 Origin Energy is classified as "Cyclicals". OceanaGold is what we classify as a "Defensive", where 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 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.

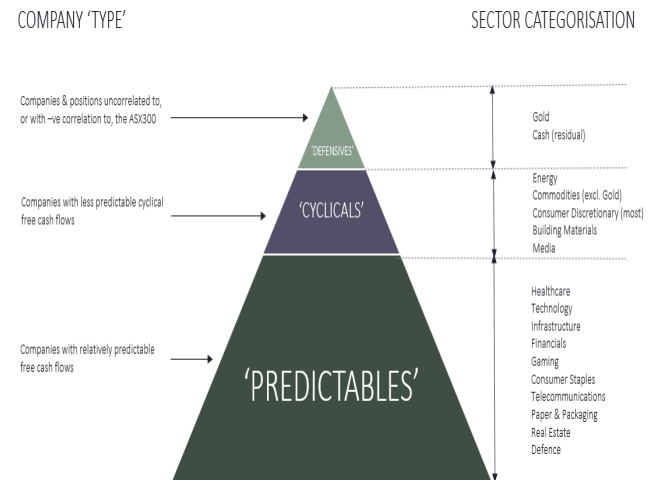
Chart 8 has been pulled directly from the Morningstar database of large cap Australian Equity strategies, whereby it highlights the strong track record relative to its peer group (ranked 29/308 funds over 1 year, and 12/283 over 3 years). While this is pleasing, the portfolio construction as described above, we think creates a differentiated product to our peer group. Largely because we use the defensive sleeve, our drawdown has been lower than the index and the peer group, which also shows in the beta of the strategy (0.92 vs peers at 0.99). This effectively means the fund demonstrates less volatility than the peer group, which is also shown by the standard deviation (17.19 vs 18.0).

But what it also highlights is the lower level of correlation (R-squared) to the index, which shows this strategy is only 87.8% correlated to the index, relative to the peer group correlation of 93.5%. The portfolio is designed this way deliberately, which we think becomes even more important over the next 12 months with increasingly volatile markets, thus ensuring some focus on capital protection (although it is a long only product) is paramount to the way we invest.

Hence the fund, to this point (past performance is no guarantee of future performance), has been able to demonstrate higher alpha (returns) than many of its peers, for significantly lower beta (or volatility) and correlation. Thus, it has achieved its objective, while being a very different offering than most other Australian equity funds.

How do we allocate capital?

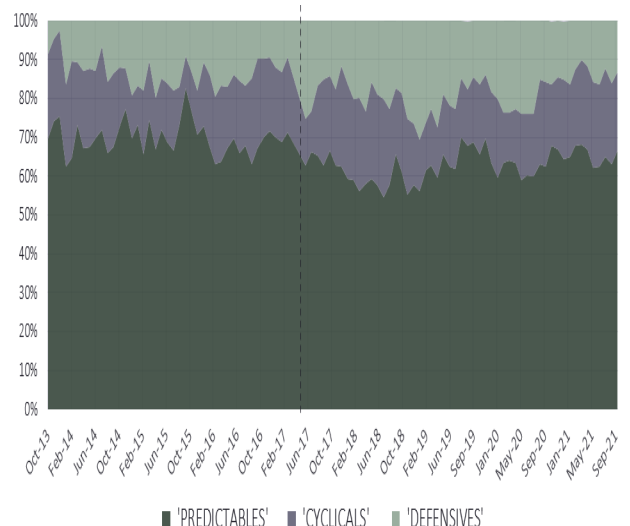
Chart 6



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

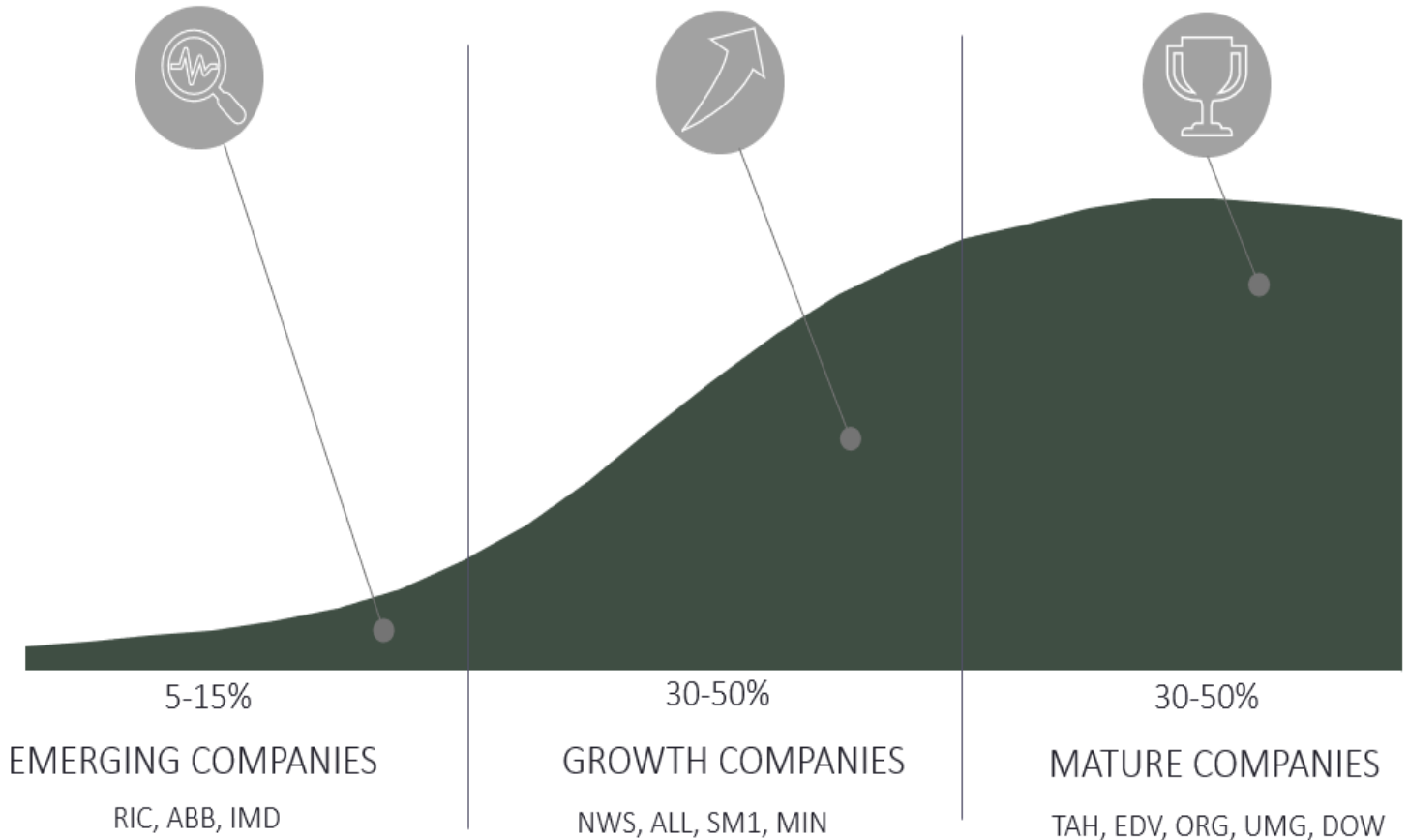
Trailing Total Returns	as at 30 Sep 2021			
	Total Return	+/- Cat	+/- Index	Cat Rank
1 Month	0.96	2.40	2.81	11 / 323
3 Month	6.29	3.59	4.58	16 / 320
1 Year	37.68	6.69	7.12	29 / 308
3 Year	13.26	4.33	3.61	12 / 283
5 Year	--	--	--	--

Risk Analysis		as at 30 Sep 2021		
3-Year Risk Measures	Fund	Category	Index	
Standard Deviation	17.19	18	17.61	
Sharpe Ratio	0.77	0.53	0.58	
R-Squared	87.81	93.52	--	
Beta	0.92	0.99	--	
Alpha	3.98	-0.69	--	

Source: Morningstar database

Revisiting the lifecycle approach to portfolio construction

Chart 9



Source: Chester Asset Management

We have discussed this previously, but it's often useful to reinforce the way the portfolio is constructed. We think of portfolio construction in two dimensions. The first being the type of company we are investing in. As discussed on the previous page, this is broken down into three categories, predictable cash flow generators, cyclical companies and non-correlated companies (gold equities).

While we recognise the relative simplicity of the exercise it helps us maintain what we determine to be a balanced portfolio between growth stocks and those that benefit from economic cycles. Gold does act in a non correlated way which helps smooth the overall volatility of the fund.

The other way we consider our portfolio construction is via a lifecycle approach. We have always allocated a small portion of the fund to emerging companies, where we see a pathway to unlock what we determine to be a significant discount to our assessed valuation on either assets in the ground, or the size of an addressable market. We acknowledge these emerging companies come with heightened volatility and hence for us the trade off is being consistent with the small allocation to this part of the market. Currently the fund has invested roughly 17% of its assets in market caps less than AUD1.0bn and another 28% or so in market caps less than AUD5.0bn. This leaves roughly 46% or so in companies with market caps above AUD5.0bn (and 8% in cash). Given this range of investment opportunities, the fund exhibits a mid cap bias. As such the fund is genuinely benchmark unaware with no regard for the index weights of stocks. Of course market caps can be misleading, as ABB was a sub AUD200m company on investment (now >AUD1.0bn). IMD is also now >AUD1.0bn when the initial investment was as a sub AUD500m mkt cap.

We have had a strong degree of success with this framework over the past 7 years, where clearly Aussie Broadband (ABB) has been the standout from it's IPO at AUD1.00 last October, to trade around AUD5.00 as at the end of September. Piedmont Lithium (PLL) and Ioneer (INR) in the lithium space have also contributed to the fund's returns over the past 12 months, but given the inherent volatility in these cyclical stocks, a smaller portfolio weight is prudent. We have recently taken on another pre IPO investment that leaves us as excited as ABB did 12 months ago. We will discuss this in more detail as it nears the IPO process in June - October 2022.

The rest of the lifecycle approach is allocating capital with an appropriate trade off between identifying clear growth industries (or monopolies) or stock specific drivers, with a valuation overlay. We certainly view the current opportunity set as more favourable to those companies with genuine valuation support and identifiable catalysts to close that valuation gap. One such company that we have held for a period of time is Synlait Milk (SM1). SM1 is a NZ based dairy processor across Nutritionals (Infant Formula), Ingredients (whole milk and skim milk powder), Liquids and Consumer (Cheese, Yoghurts). SM1 has had a litany of issues over the past 2 years, largely involving their major customer (A2 Milk) which has been losing market share in the Chinese Infant Formula market. These issues should be well understood. What is less understood, is the self help program SM1 is currently undertaking, along with the pending ramp up of a new multinational customer in the nutritionals space, that will significantly reduce the influence of A2 in terms of customer concentration. While we do expect a stabilisation of infant formula volumes in the SM1 facilities (little growth), with the liquids business, new customer and stabilisation of A2 inventory, we forecast SM1 to grow revenues from NZ1.36bn in FY21 to NZ2.0bn in FY24 once the new customer is fully operational. It is currently trading at book value and 8x FY24 PER. Unloved and under appreciated? Tick and tick.



Gold - where to now?

Chart 10

Australian Gold producers	Market Cap AUD (m)	Production					CAGR FY20-FY24	EV/Resource	Reserve Life Years	FY22 AISC USD/oz	FY22 EV/EBITDA Multiple	TSR past 12M
		FY20	FY21	FY22	FY23	FY24						
Newcrest (NCM)	19,484	2,174	2,093	1,900	2,050	2,200	0.3%	178	26	958	6.7	-21.4%
Northern Star (NST)	10,787	1,425	1,596	1,600	1,750	1,850	6.7%	209	13	1,143	6.4	-40.8%
Evolution (EVN)	6,763	747	681	698	803	885	4.3%	255	15	883	7.9	-37.7%
Regis Resources (RRL)	1,627	352	373	488	550	650	16.6%	162	10	969	3.3	-55.6%
OceanaGold (OGC)	1,689	308	350	480	550	650	20.5%	130	13	1,050	2.8	14.1%
St Barbara (SBM)	1,041	382	328	325	330	420	2.4%	78	19	1,303	4.2	-51.5%
Westgold (WGX)	778	235	245	270	280	285	4.9%	108	8	1,184	3.5	-30.1%
Gold Road (GOR)	1,192	129	130	165	175	180	8.7%	282	10	950	6.1	-10.0%

Source: Chester Asset Management, Bloomberg consensus data

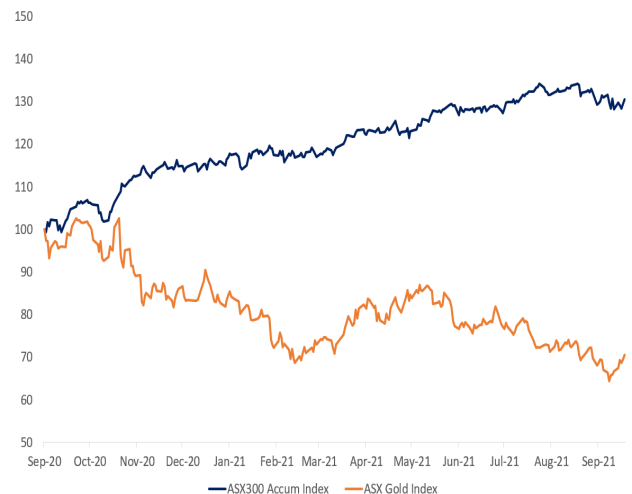
We have been surprised/underwhelmed with how gold as an asset class has traded in 2021 thus far. We would put this down to two themes, firstly is the crypto currency asset class. While we remain sceptical, clearly there is a cohort of investors happy to invest in an asset class that may still be regulated out of existence. The risk reward to us (yes sceptics) is far from compelling, but most likely, crypto currencies will be here to stay in some form or another. This (while still only 10% of the market cap of the gold market) clearly attracts some capital of the “alternate asset class” allocation, hence it appears that his has been one reason for golds poor 2021 return.

The other reason, possibly more valid, is the notion that gold performs well when real interest rates are negative. Chart 12 below highlights gold’s inverse relationship with real yields over the past 50 years. Gold clearly performs well with negative real yields, until 2021. We think the most observable explanation for this is the narrative around inflation being transitory, suggesting the current negative real yield environment is not sustainable, and in fact the rate of change (yields turning less negative) is unfavourable. As nominal US yields rise, so to does the USD, acting as another headwind for gold in the near term. As we are of the view that inflation will be more persistent than current expectations, and the US deficit remains in diabolical trouble, on a 2-3 year view, we are still very much in the camp of gold performing well with rising debt burdens and persistently negative real yields globally.

The other major factor when investing in gold as an asset class, is the non correlated nature of it. Historically gold does provide insurance in times of inherent volatility, which drives the underlying motivation for maintaining gold as a valuable place in the portfolio construction. Chart 11 shows you just how uncorrelated gold equities have been to the ASX300 over the past 12 months. Which brings us to selecting the most appropriate gold stocks to hold in our equity portfolio. We have listed here what we consider to be the key metrics when selecting gold equities. In no particular order, the cash costs of extraction (AISC), reserve life, production growth and cash flow multiple. We then weight all this up and compare these variables to our assessment of a company’s Net Asset Value (NAV - not included above), assessing the future cash flows of each asset within the respective portfolio of each company. From the table above, and while OceanaGold (OGC) hasn’t actually generated much alpha for the fund yet, we remain optimistic that should gold regain a positive tailwind (as opposed to how poor sentiment is currently), then OGC is very well placed to benefit. Having secured the renewed FTAA (mining license) in the Philippines for another 25 years, OGC has organic growth ahead of it for the next 3 years, well ahead of any of its listed peers in Australia. It currently trades on 2.8x FY22 EV/EBITDA (using USD1750/oz). All of these metrics are actually before we get further information on what we consider to be the jewel in the OGC stable, updated drilling from the WKP prospect in the Waihi district in New Zealand. We think this asset (which is forecast to start producing in 2026), is still very under explored, and has significant upside.

Gold has underperformed the ASX300 by 60%

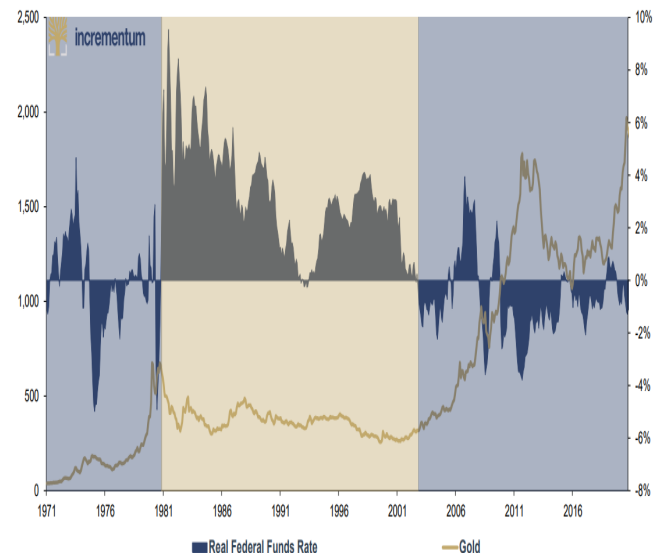
Chart 11



Source: Chester Asset Management

Do US real interest rates ever turn positive?

Chart 12



Source: Incrementum, In Gold we Trust report, Oct 2021



Chesters ESG framework

Chart 13

Material Topics	Company	Suppliers	Clients	Societal Impact	Comments
Environment					
Emissions and pollutions Management and proactive response to climate change Recycling and waste management Supporting sustainable economic development Preservation of heritage and wilderness areas					
Social Factors					
Community Engagement Occupational health and safety track record Inclusive workforce and business practices Indigenous peoples, land rights and opportunity Labour standards, compensation and working conditions Employee engagement Child labour Human rights abuse or issues					
Governance Factors					
Ownership and alignment Board experience and composition Ethical and responsible decision making Timely and balanced disclosure of material matters Conflicts of interests and related party transactions Management tenure and remuneration reports Values and culture					

Source: Chester Asset Management

Every investor will realise the prominence that ESG is having on the investment landscape. Chester has recently formalised our own ESG framework with a policy document obtained via our website. We frame our thinking into the categories as indicated above. Obviously the responses will vary by industry segment (that is investing in mining is very different to technology, healthcare or retail which will all have different variables that we focus on). Most often for us, this is a peer review comparing companies in the same industry.

Chester aims to enhance our capital allocation framework with a specific understanding of sustainable investing. Sustainable investment includes:

- ESG integration into our investment philosophy and decision making
- Responsible business conduct

Chester aims to be aware and monitor key ESG issues for its investments, but does not construct its portfolios purely on ESG grounds, however ESG considerations may lead to removal of a company from its investment universe. For the avoidance of doubt, we are pragmatic investors and will invest in beverages, gaming or defence companies should we see the investment merit in doing so and the stewards of capital in those companies are responsible corporate citizens. We look at AZJ on the next page as a way of thinking about the issues involved with investing in a business that may be screened out by funds with a pure ethical investment universe.

We provide our opinion through participating in voting and proactive company engagement (Management and Board of Directors where appropriate). Importantly Chester does engage with a level of feedback through voting and direct communication to senior executives, however, we are not activists. Chester considers that often the most appropriate course of action when disagreeing with a management team's culture or strategic direction is simply to exit the investment and allocate capital elsewhere.

ESG factors are assessed in the 'risk assessment' stage of Chester's investment process. The assessment of the ESG factors is both qualitative in the assessment of ESG risk, and quantitative in our attempts at monitoring the relevant ESG areas. Although the primary assessment of a company's ESG credentials is conducted during the initial assessment phase of a potential investment, data including external publications, management discussions and industry communication is conducted on an ongoing basis to identify and respond to changes or additions to ESG risks in real time. Media scrutiny can also be a catalyst for change (i.e Rio Tinto or Crown Resorts). These changes can tend to lead to far more sustainable business practices going forward, as opposed to the poor governance that led to the media scrutiny in the first place.

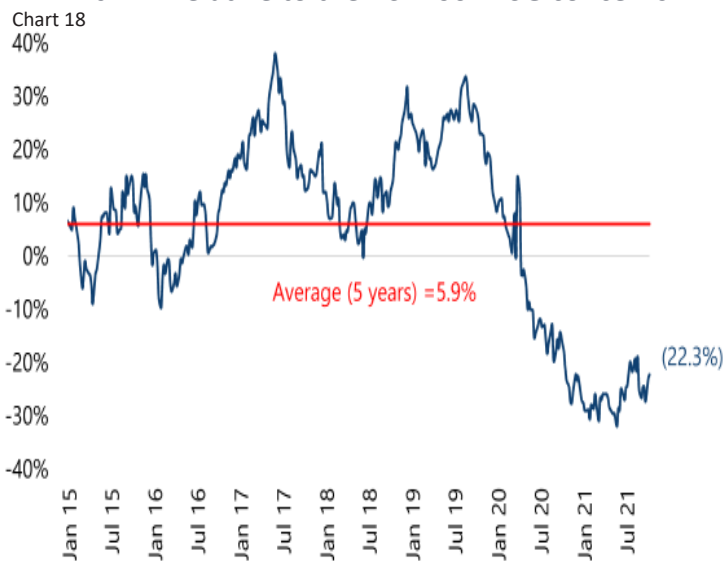
Chester has a firm view of governance, as in our opinion, good governance will lead to a strong corporate culture, which ultimately leads to sustainable business practices. Strong corporate culture will focus on improving the business with which they operate – whether that be improving OH&S, modern day slavery or supply chain concerns, achieving carbon neutrality or gender diversity. These issues start and are addressed by firms with a strong corporate culture. We actually rank Aurizon (AZJ) highly on all of these attributes, allowing for the industry in which they operate.



The investment case for Aurizon (AZJ)

Chart 14 is mischievous, as there is some nuances around the regulated asset base (RAB) of the AZJ network business and the operators, the WACC is reset every 5 years and it is exposed to coal movements, which on a 20 year time frame, are in decline. But the multiples paid for Sydney Airport (23.3x FY19 EBITDA) or the Telstra Mobile phone towers (28x FY22 EBITDA) by industry funds suggests there is significant appetite for long duration predictable cash generating assets. At spot price (AUD3.85), this only values the Network on around 8x (all else equal). We think this is a strong case of very little downside, but material upside should the true value of the network be reflected. We are paid a 7.3% dividend yield to wait. Using a 20x EBITDA multiple for the network sees AZJ worth AUD 9.36. It is well understood that coal is considered uninvestible by many and Aurizon transports coal. But we think the current share price doesn't distinguish between the need for thermal coal (used in power generation) and coking coal (used for steel making). If we were being truly global in our ambition for lowering carbon emissions as much as possible, then we would require that every exported tonne of coal needs to come from Australia, as we have the lowest cost to serve, and therefore produce the lowest emissions of all coal exporting nations. We do believe the world will be a far better place once electricity is generated from sources other than fossil fuels, but the reality is that much of SE Asia's development is being fueled by coal fired generation. Realistically this means that demand for Australian exported thermal coal will persist for at least the next 15-20 years. The sustainability report just released by AZJ does make for very balanced reading, and to us, only strengthens the investment case.

AZJ PER relative to the ASX200 - ESG concerns



Source: Jefferies

What if the network was valued like Sydney Airport?

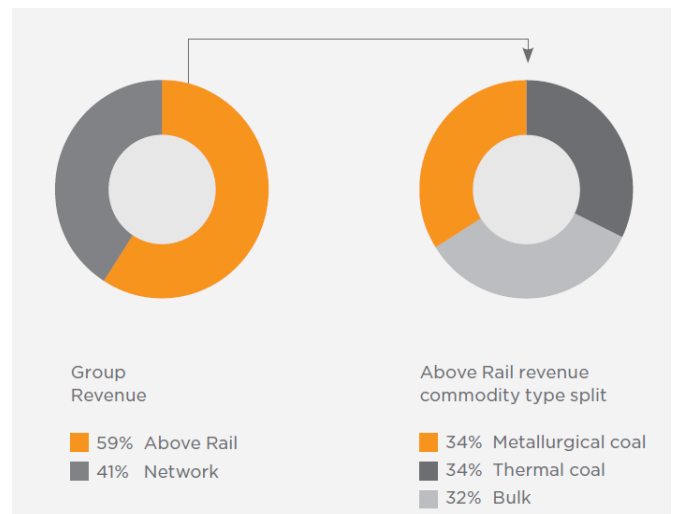
Chart 14

AZJ	2022F EBITDA	EBITDA Multiple	
Network	830	20	16600
Coal	530	6	3180
Freight (Bulk)	145	10	1450
Corp costs	-40	10	-400
Chester forecast	1465		20830
Net Debt			3600
EV			17230
No of shares			1840
Share price			\$ 9.36

Source: Chester Asset Management

Only 20% of AZJ's revenue comes from thermal coal

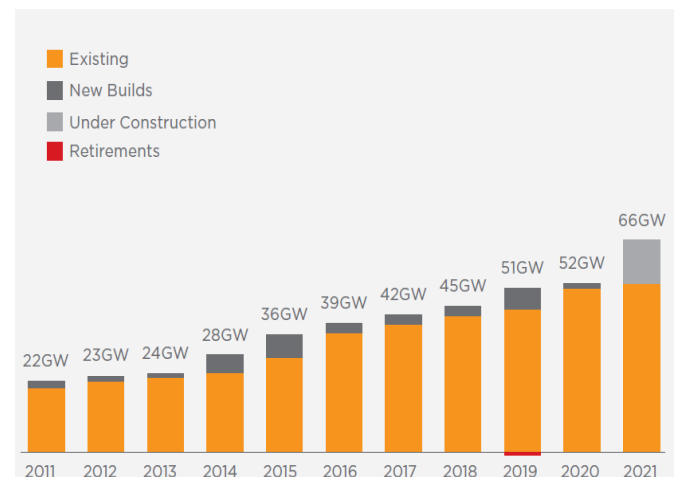
Chart 15



Source: AZJ sustainability report 2021

SE Asian (ex Indo) Coal fired electricity capacity

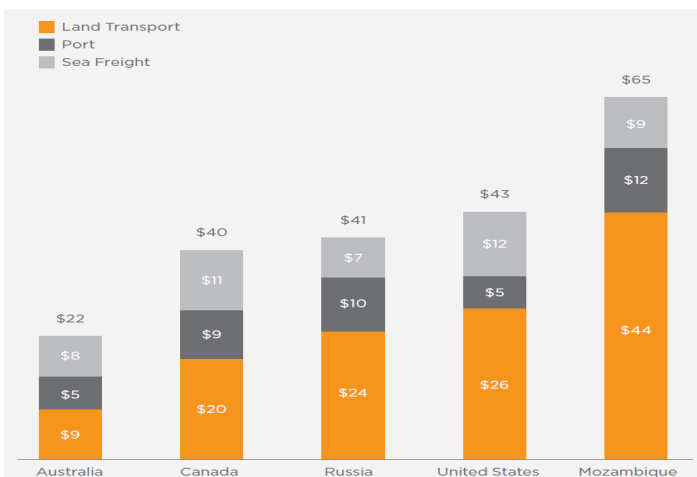
Chart 16



Source: AZJ sustainability report 2021

Cost to transport coal from Aust is 50% below others

Chart 17



Source: AZJ sustainability report 2021

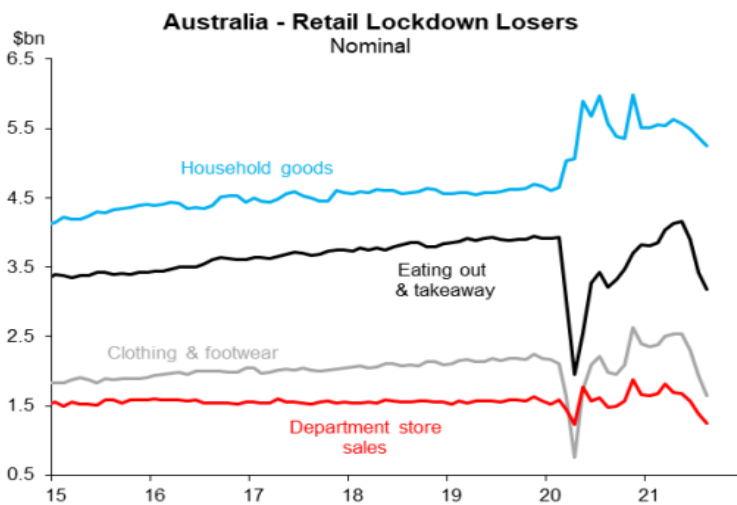


Australia reopening?

This is relatively consensus thinking, but that doesn't make it wrong. With almost 50% of the Australian population locked up for the past 4 months, it clearly impacts spending, and after 2020 lockdowns, much of the durable goods spending (new TVs, computers, home offices) had already occurred, so there was definitely been a marked slowdown in spending (chart 23 below). The flipside of this is as Sydney and Melbourne come out of what we desperately hope is our last lockdown, there is a wall of cash still waiting to be spent on "living". Simply doing things we haven't been able to do properly for 18 months. Travel, concerts, sporting events, etc. We have a hunch (based on a sample size of every person we speak to) that there will almost be euphoric trading in Melbourne and Sydney in the lead up to Christmas. House prices are up 30% yoy, interest rates are still extremely accommodative and household savings are as high as they've been since the late 1980s. The job market is extremely tight given the lack of international students/travelers providing the bulk of hospitality and service sector jobs meaning significant wage pressure in certain sectors. So the backdrop for confidence remains high as we head into 2022, while we admit, much of this is based on policy settings, the confidence of consumers in their expectations for 2022 is strong (chart 21 below). Endeavour Group (owns Dan Murphy's, BWS and pubs and clubs), is looking to hire an extra 4000 workers in anticipation of the "opening up" trade. It might be hard to comprehend outside Melbourne (and Sydney) but the pent up demand to resume "living" is a very positive backdrop for retail spending as we head into 2022.

Pent up demand for spending will see a strong consumer

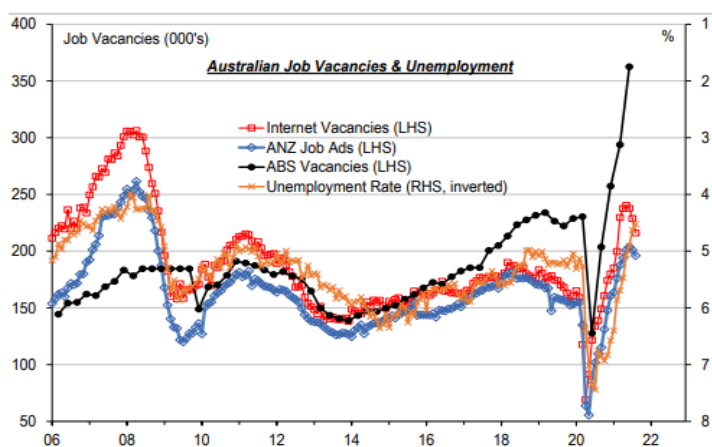
Chart 23



Source: Macquarie research

Australian job market is very tight with no internationals

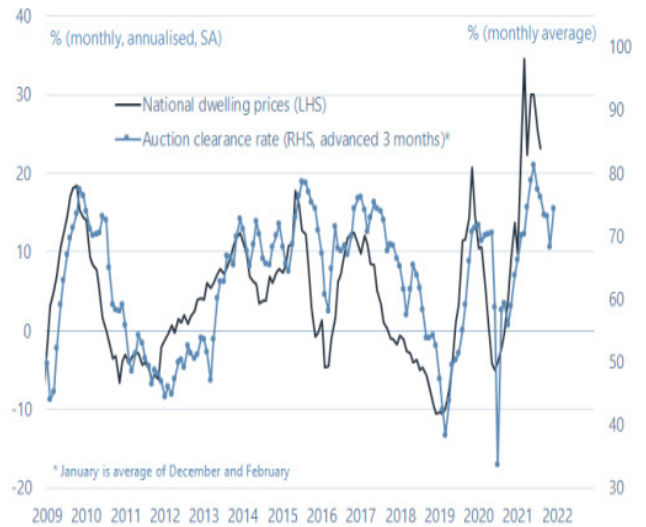
Chart 22



Source: UBS research

Australian house prices showing extreme strength

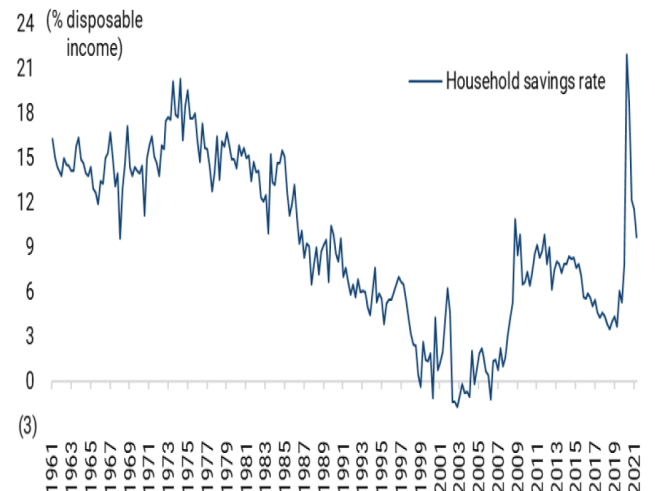
Chart 19



Source: Jarden research

Household balance sheet is still very healthy

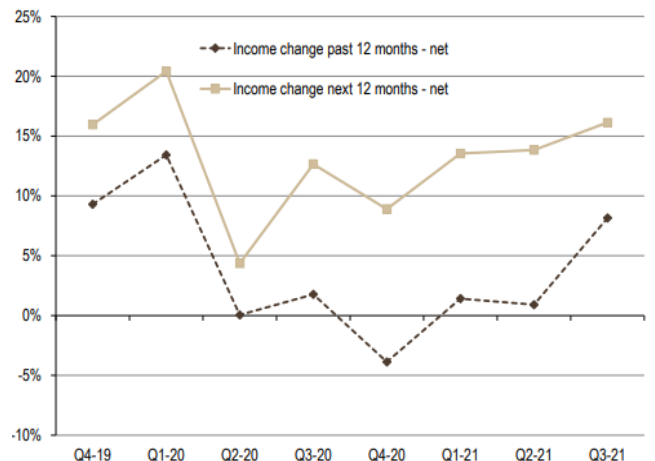
Chart 20



Source: Jefferies

Households feeling positive about income growth

Chart 21



Source: UBS research



China

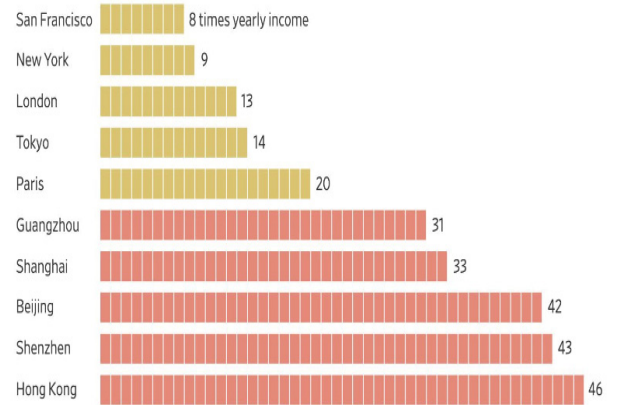
When we first arrived in Hong Kong in 2005, we were taught the first rule of investing in China. Just follow government policy. If they want an outcome, they will get it. We won't spend too long on the nuances of the government directives over the past 12 months, they have been well documented, but it does appear that the communist party is very focused on inequality and making sure the benefits of capitalism are distributed more evenly, serving several billionaires very public humiliations. Whether it be education, healthcare, gaming, social media or financial services, the CCP has had profitability at the expense of the greater good of society firmly in its sights.

Which brings us to China Evergrande and the moral hazard of capitalism and in particular domestic property. Is China Evergrande allowed to fail? Does the CCP send a message to shareholders and investors? Or are they more focused on the greater good of the 1.7m units that have been paid for and not completed, or the millions of retail investors that may lose their life savings in Evergrande Bonds? This brings us to the second order effect of what happens in the Chinese property market will have a direct bearing of what happens to Australian commodity producers in terms of demand for steel production. Chinese property represents 20% of GDP and over 60% of household assets, which means we have to watch it very closely for broader weakness. There is clearly structural imbalances (chart 24 above), but again the most important participant in any eventual Evergrande scenario is Xi Jinping. It may just be that Chinese property, in aggregate, is too big to fail, while the risks are clearly growing.

China house price to income ratio's are extreme

Chart 24

Ratio of home prices-to-income, by city



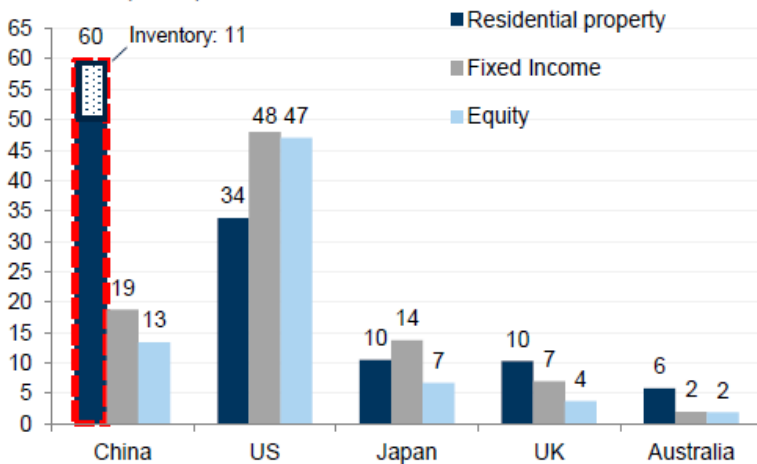
Note: Ratio of median apartment price to median family disposable income, as of mid-2021

Source: JP Morgan Asset Management

Chinese property is the biggest asset class in the world

Chart 28

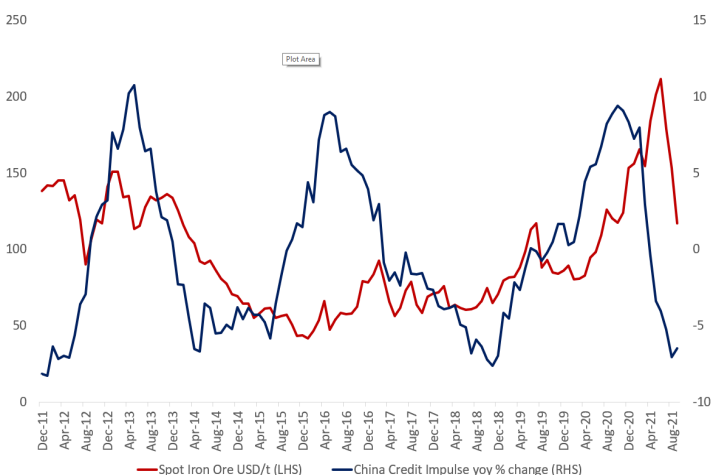
Total value (US\$tn)



Source: Goldman Sachs research

Credit growth leads demand for commodities

Chart 27

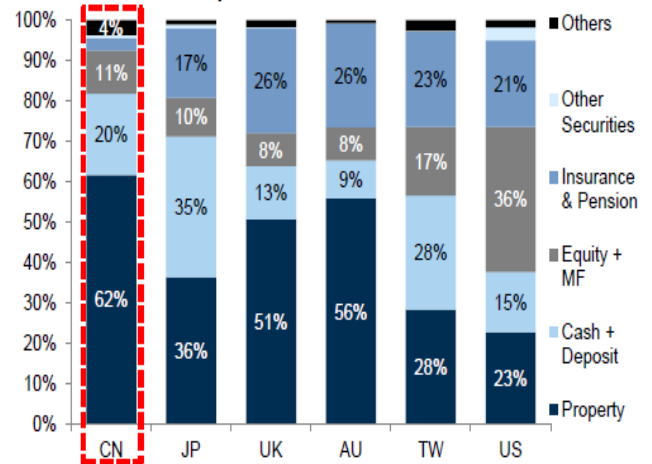


Source: Chester Asset Management, Bloomberg

Chinese household wealth in property

Chart 25

Composition of household total assets

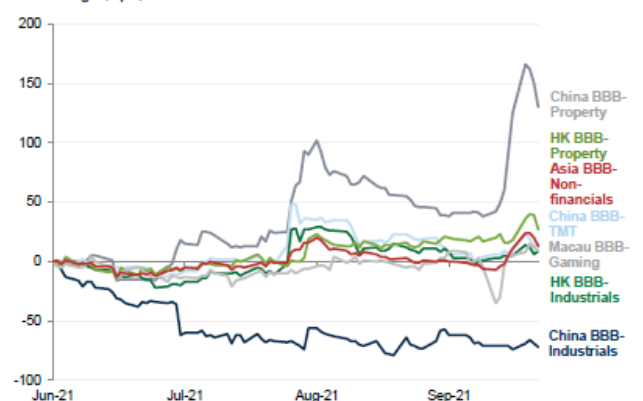


Source: Goldman Sachs research

Broader contagion in credit not apparent yet

Chart 26

OAS change (bps)



Source: ICE-BAML

Source: Goldman Sachs

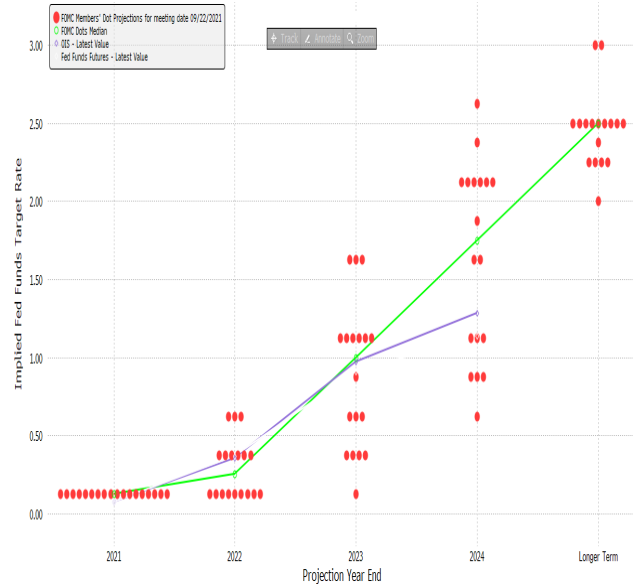


US Inflationary check - appears risks are to the upside?

Chart 29 highlights to us the folly of trying to predict interest rates. The 12 Fed committee members expectations for 2024 are vastly different (signaled by each Fed member using a red dot to plot their individual forecast), which does suggest, there is a wide range of outcomes possible as the world tries to move on from COVID induced emergency policy settings. Certainly the past 18 months have seen some of the easiest (ever) financial conditions globally and removing these policy setting appears necessary as inflation looks to be stickier than most pundits (including the Fed) had been expecting at the start of the year. Which ties into why we think the next 12-18 months looks vastly different from the past 18 months. Some of the fiscal and monetary tailwinds are being wound back at a time when the real economy is starting to see genuine cost escalation across housing, energy, cars (used cars prices remain stubbornly high) and freight. Wages are absolutely an issue in certain pockets of the economy. Blue collar (truck drivers) and hospitality jobs are desperately hard to fill, creating genuine shortages in certain areas. We touch on elsewhere the energy markets (coal and oil) which are seeing significant y-o-y gains. In commodities normally the cure for high prices is high prices, as they attract further capital to invest and production (supply) rapidly catches up. Given how quickly the world is accelerating towards a carbon neutral position (which we support), the risk remains that we could be headed for higher energy costs in the next 2-3 years as the transition of fuel sources plays out, and very few global oil majors are willing to invest significant capital in replacing depleting oil reserves, driving supply down.

No consensus on FY24 interest rate outcomes

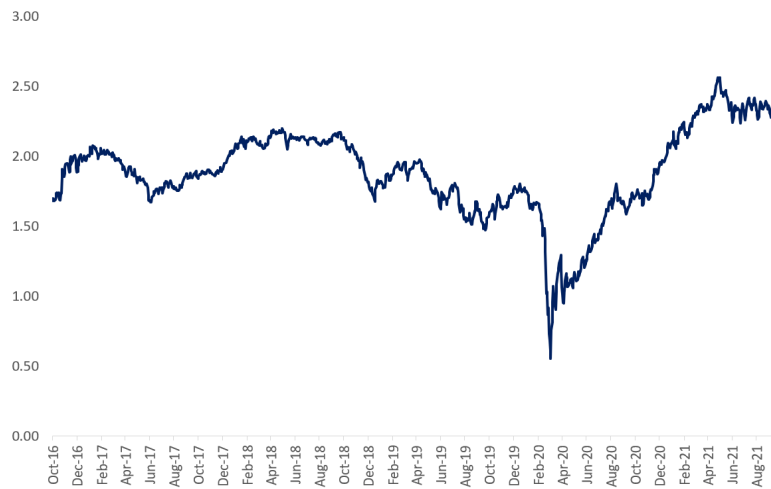
Chart 29



Source: Federal Reserve, Bloomberg

US 10yr Inflation expectations will drive sector rotation

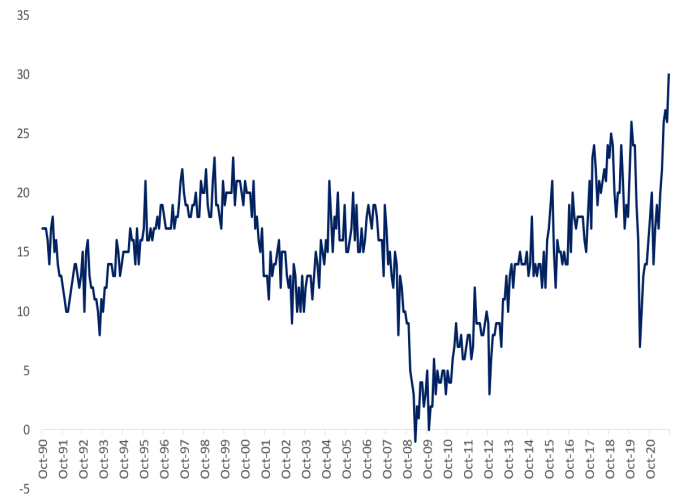
Chart 33



Source: Chester Asset Management

US SME compensation expectations for the next year

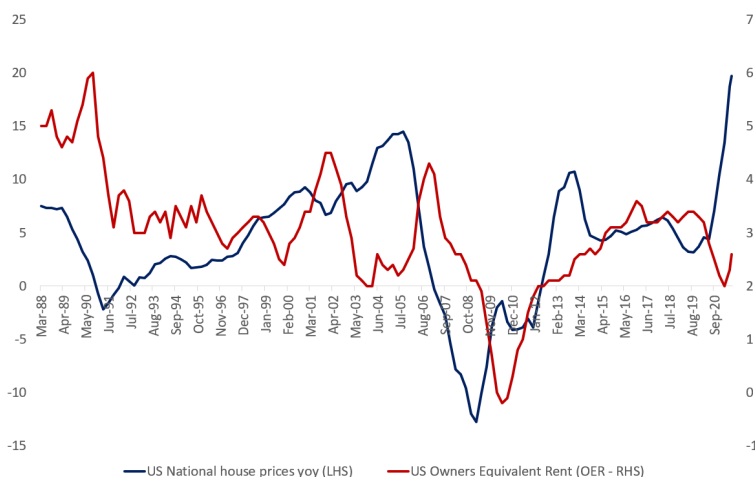
Chart 30



Source: Chester Asset Management

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

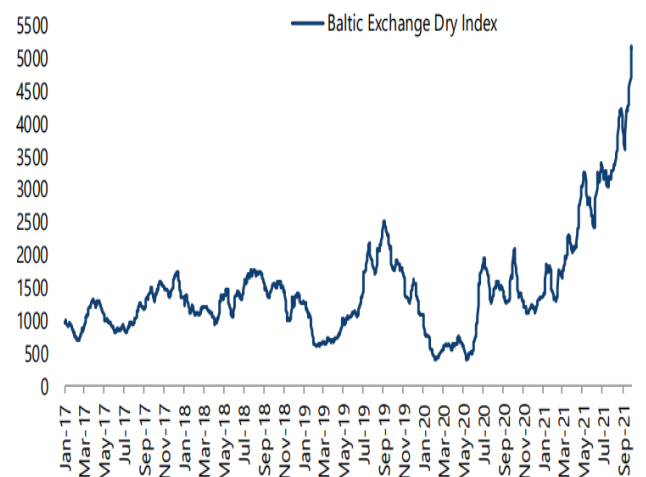
Chart 32



Source: Chester Asset Management, Bloomberg

Shipping costs aren't deflating

Chart 31



Source: Jefferies



More macro musings...

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 (chart 38 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 focused on the risk and reward dynamic with each individual stock decision. Hence these charts demonstrate to us, that we shouldn't be taking undue risk this year with high PE stocks, as there is very little margin of safety, particularly if bond yields do start pricing in higher interest rates or there is an inflation scare over the next few months. This really ties into the notion of asymmetric investing.

Chart 35 is remarkably simple, but it does highlight just how much of the move in equity markets has been assisted by the ever growing Fed balance sheet. Which poses the obvious question, does this continue? We ultimately think it has to (we could write a thesis on how structurally flawed the US budget is becoming) so the Fed ultimately has no choice but to support the budget deficits of the US Government (the Fed has been buying between 40-70% of all US bond issuance this year) which is pretty much direct monetisation of the US deficit. It does tie into the notion that interest rates can't rise materially (ever), but there is the short to medium term (12-36 months) issue of inflation to deal with.

World value stocks vs world growth stocks

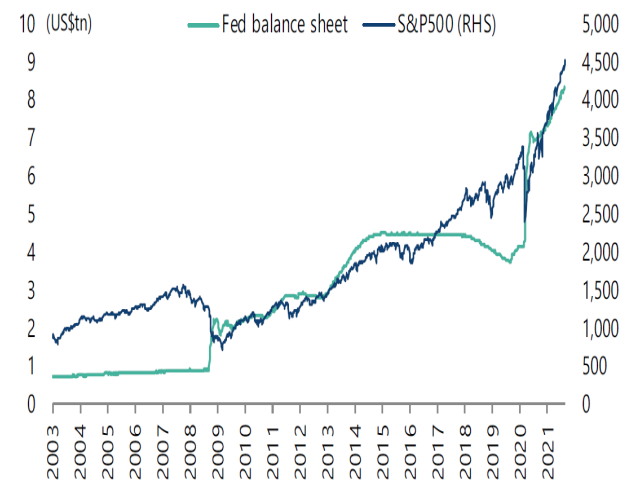
Chart 34



Source: Chester Asset Management, Bloomberg

S&P500 is 0.90 correlated to the Fed BS since 2008

Chart 35



Source: Jefferies

Are there enough oil rigs in the US?

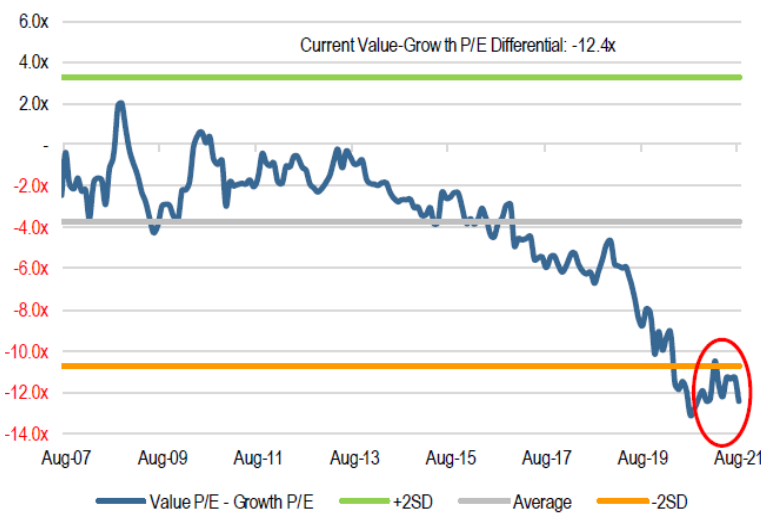
Chart 36



Source: Chester Asset Management, Bloomberg

The dispersion bw value and growth has never been wider

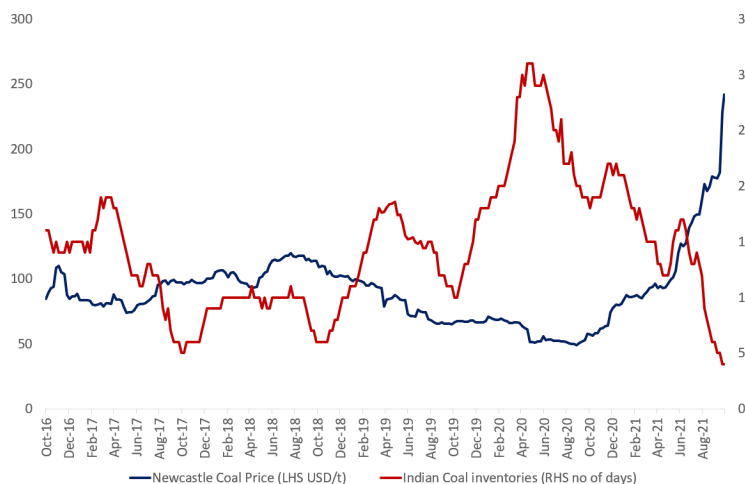
Chart 38



Source: JP Morgan

Indian Coal volumes are at critical levels

Chart 37



Source: Chester Asset Management, Bloomberg



Investing lessons from Peter Lynch

Peter Lynch is one of the most successful and well-known investors of all time. Lynch is the legendary former manager of the Magellan Fund at the major investment brokerage Fidelity. He took over the fund in 1977 at age 33 and ran it for 13 years. His success allowed him to retire in 1990 at age 46. His investment style has been described as adaptive to the prevailing economic environment at the time, but Lynch always stressed that you should be able to understand what you own. The fund earned an annualized return of 29.2% during his time running it, more than twice what the S&P 500 earned during that time. This is a truly remarkable track record.

“A decline in stocks is not a surprising event, it’s a recurring event—as normal as frigid air in Minnesota. If you live in a cold climate, you expect freezing temperatures, so when your outdoor thermometer drops below zero, you don’t think of this as the beginning of the next Ice Age. You put on your parka, throw salt on the walk, and remind yourself that by summertime it will be warm outside. A successful stockpicker has the same relationship with a drop in the market as a Minnesotan has with freezing weather. You know it’s coming, and you’re ready to ride it out, and when your favorite stocks go down with the rest, you jump at the chance to buy more.”

“By now you might be wondering what’s the point of investing in a stodgy old company such as IBM, GM, or U.S. Steel? There are several reasons you might do this. First, big companies are less risky, in that they generally are in no danger of going out of business. Second, they are likely to pay a dividend. Third, they have valuable assets that might be sold off at a profit.” (We would suggest TAH, NWS and ORG as suitable replacements)

“The list of qualities (an investor should have) include patience, self-reliance, common sense, a tolerance for pain, open-mindedness, detachment, persistence, humility, flexibility, a willingness to do independent research, an equal willingness to admit mistakes, and the ability to ignore general panic.”

“The trick is not to learn to trust your gut feelings, but rather to discipline yourself to ignore them. Stand by your stocks as long as the fundamental story of the company hasn’t changed.”

“Whenever you invest in any company, you’re looking for its market cap to rise. This can’t happen unless buyers are paying higher prices for the shares, making your investment more valuable.”

“It takes remarkable patience to hold on to a stock in a company that excites you, but which everybody else seems to ignore. You begin to think everybody else is right and you are wrong. But where the fundamentals are promising, patience is often rewarded...”

“Invest in simple companies that appear dull, mundane, out of favor, and haven’t caught the fancy of Wall Street.”

“Know what you own, and know why you own it.”

“Once I’ve established the size of the company relative to others in a particular industry, next I place it into one of six general categories: slow growers, stalwarts, fast growers, cyclical, asset plays, and turnarounds.”

“My diaries are full of such missed opportunities, but the stock market is merciful—it always gives the nincompoop a second chance.”

“Nobody can predict interest rates, the future direction of the economy or the stock market. Dismiss all such forecasts and concentrate on what’s actually happening to the companies in which you’ve invested”



Our Executive Summary

Equities All else being equal, equities remain attractively valued relative to bonds, albeit we do see risks around the potential for an inflation scare (inflation surprising to the upside). Most likely volatility will rise as the easy financial conditions that have been in place since March 2020 are wound back (very slowly).

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 2022, as the bond market tries to reprice higher inflation expectations, leading to further sector rotations. This suggests a period ahead of value outperforming growth.

The inflation debate around “transitory” or “structural” is widely discussed as it is really something asset prices haven’t had to deal with since 1981. We are in the structural camp, but this is dependent on wage inflation. As discussed through the quarterly, there are many other components of the inflation basket supportive of continued CPI prints higher than expectations. 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, and that this is actually a desired policy response for governments burdened with insurmountable debt.

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

By and large, our stock selection framework focuses on:

Real assets - AZJ, MIN, QUB, MQG, ORG

Valuation margin of safety - NWS, LLC, UMG, RIC

Pricing power - TAH, EGH, JHX

Gold - OGC, GOR

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. To be honest, this hasn’t turned out the way we had envisaged in 2021, largely we suspect for two reasons. Firstly, the onset of crypto currencies as a competing alternate asset (not around in the 1970’s) and secondly, the consensus thinking that because inflation is “transitory” the current negative real yields will inevitably turn positive again. Assisted by rising nominal yields and a strengthening USD, which act as headwinds for gold. We are less confident that real yields ever turn significantly positive again.

Gold has proven highly successful in outperforming when equity markets fall through the course of history and hence remains a valuable allocation to the portfolio construction.

We spend much of our time analysing gold equities which are selected primarily on valuation grounds first, and then an assessment of the quality of the resources and cost of extraction. Clearly management competency and a track record of delivery is also an important variable.

Government spending and bond yields The enormous increase in deficit spending across the globe to ensure the unemployed workforce can pay bills has left (and will leave) most central banks with an insurmountable debt burden. There is no longer any pretense of any political party anywhere to try to repay these debt burdens the future generations are faced with. Interest rates simply cannot rise 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.

Risks The outlook takes on a more cautious tone in the aggregate sense, given the easy financial conditions of the past 18 months are starting to be incrementally tightened. We do think for US leadership in global equities to continue, then a strong endorsement of the Biden administration’s infrastructure bill needs to be seen. If this doesn’t eventuate, the prospect for slower growth in the US combined with higher inflation really does signal a period of stagflation ahead. 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.



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