Chester High Conviction Fund
Quarterly Thoughts
October 2023

In partnership with COPIA

The Chester High Conviction Fund Philosophy

Our Key Principles

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

At 30 September 2023	1 mth %	3 mths %	6 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a	Incep. % p.a. *
Chester High Conviction Fund (after fees)	-1.2	-1.2	1.8	8.7	14.7	9.8	11.8
S&P/ASX 300 Accumulation Index	-2.9	-0.8	0.1	12.9	10.8	6.6	7.0
Outperformance (after all fees)	**+1.7**	**-0.4**	**+1.6**	**-4.3**	**+3.9**	**+3.2**	**+4.7**

* 27 Apr 2017

> *"Hard times create strong men. Strong men create good times. Good times create weak men. And weak men create hard times."* — G. Michael Hopf

In March 2006, we attended the Credit Suisse Asian Investment conference in Hong Kong. We were living there at the time, which coincided with the annual Hong Kong 7's Rugby tournament. It was traditionally the biggest week of the year in Hong Kong and in 2006, as China was industrialising rapidly, there was no better city to be. The peak in irrational exuberance was still a good 12-18 months away, but the mood was very bullish. The IPO market was hot, there was money to be made. We had a very positive disposition on the commodity markets at the time given we (felt at least) had a front row seat to the accelerating demand of Chinese steel production. Every quarter, Shanghai was changing, and you had to be on the ground to feel it. We felt we had an edge being so close to the coal face.

At this particular conference we listened to a talk that had a profound impact on the way we think about investing. The speaker stood up and asked the audience to think of a number between 1 and 100. This task was easy enough. He then asked us to assume what the average number chosen by all the people in the room (roughly 200 or so investors) would be. Relatively straight forward. Finally he asked us to write down a number, that we thought would be 2/3rds of the number the average audience member wrote down. He repeated this 3 times so it sunk in. Write down a number that is 2/3rds of what the rest of the room would write down. This task was infinitely more complex given the assumption that every investor is then second guessing what everyone else is writing down.

Now this is the essence of how a market functions. Often it's not first order thinking (pick a number), or even second order thinking (what consensus thinks). Actually investing involves the complexities of a room (or market) full of incredibly well educated people, using third order (or fourth order) thinking, and trying to get ahead of the pack by extending that thinking even further. Using the example above. The actual answer most investors gave was around 14. That is, if the average number between 1 and 100 is 50 (consensus), then most investors assumed that 2/3rds of 50 is 33, but that is what everyone else wrote down, so the next derivative is 22 (2/3rds of 33). However extending that thinking again, arrives at the number 14 (2/3rds of 22). We found this fascinating as a (relatively) young portfolio manager thinking about expectations and market psychology. This talk was given by widely regarded financial author Michael Mauboussin, who later wrote the book Expectations Investing, amongst many other widely acclaimed books.

Successful investing often requires a different train of thought to consensus thinking, and often outliers tend to be the most successful investors, by extending their thinking the furthest. This shouldn't be confused with complexity of a business model, as many of the most successful investors keep the company fundamentals relatively simple. In 2023, this third and fourth order thinking can be observed in the AI space, the GLP-1 space (weight loss drugs), the energy markets, the lithium market and at a macro level, the USD, inflation expectations and the inverted yield curve (recession watch). Much of our process tends to try to understand what consensus thinks, and where (if at all) we have a different view than the crowd. It's not difficult to find sectors where the crowd has pushed expectations too high (or too low), and what that ultimately means for allocating capital at a point in time. The obvious missing link here is having a high conviction view on what an assessed valuation should be versus what is being priced in.

Macro themes

The overriding narrative at a macro level over the past quarter has been the strength in the USD, in conjunction with higher bond yields. Led by higher inflation expectations leading to higher interest rate expectations, combined with higher deficit spending by the US Government. This deficit spending requires higher bond issuance, coming at a time where foreigners are reducing exposure to US Treasuries (China and Japan), hence part of the recent explosion in US 10 yr bond yields (4.1% at the end of August, to 4.84% at the time of writing) has been investors believing a higher interest rate is needed to attract sponsorship of the US bond market. Simplistically, supply (issuing bonds) is outweighing the demand (desire for those bonds at a particular yield). Sentiment, expectations and pure momentum are playing a significant role here. The conundrum for investors has been the inconsistency between monetary policy and fiscal policy. The hawkish monetary policy response from the Fed (defeat inflation) is at odds with fiscal policy, where spending is off the charts. US public debt was capped at USD31.4Tn until the debt ceiling was removed in early June. 4 months later the US public debt is USD33.5Tn (USD2.1Tn in 4 months). In context, for the entire year in 2008 at the peak of the GFC, US public debt rose USD1.5Tn. It doesn't matter until it matters, but unquestionably, the move in the bond market is going to cause far more volatility in the markets over the coming months given where real interest rates are. Geopolitical turmoil in the Middle East suggests there are other macro variables that will complicate the demand and supply issue of US Treasuries, and potentially impacts the shape of the US interest rate curve (slows down hawkish commentary?).

We have been surprised at the resilience of both the US economy, and the Australian economy in 2023. At the start of the year, it appeared that interest rates would be more likely to be heading down as we enter 2024. We put this resilience down to several factors. Largely deficit spending in the US (as above) has underpinned many employment programs in the US, where labour force data remains very resilient. Consumer spending continues to be a surprise, as the savings rate continues to deplete. Neither the fiscal spending, or the declining savings rate we see as sustainable. Combined with the lagged impact of the fastest tightening cycle in history, we remain cautious as to economic conditions looking into 2024. The labour market we see as the key variable to watch for "peak rates". We are often reminded of the notion that the stock market is not the economy, hence the confusion between rising interest rates, deteriorating economic conditions and the performance of the stock market. Which is ultimately why we revert back to investing in businesses. We try to insulate the fund as much as possible from macro variables by allocating most of the capital (60-70%) to predictable cash generating companies where there is evidence of sustainable cash flow growth. We are happy to allocate capital to cyclical stocks, but with lower weightings given the cycle of cash flows, while a consistent allocation to gold tends to assist the fund in times of inherent volatility. We believe this framework will hold the fund in good stead over the coming 2-3 year period. **Our philosophy with the Chester High Conviction Fund remains to protect and then grow (what we hope to be) generational wealth. Protecting capital means a rigorous focus on asymmetric investing. What is the downside vs what is the upside of an initial investment? We remain heavily focused on owning a portfolio of stocks that remain compelling on a bottom-up cash flow basis. This focus on fundamental investment drivers we believe will benefit our fund over the next 2-3 years as we believe the style bias will be firmly in the favour of value investing.**

Chester High Conviction Fund

Quarterly Thoughts

September 2023

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ARSN OPS7755AU

Portfolio changes this quarter

The portfolio made several changes over the quarter, largely on a stock specific basis, without changing the overall shape of the portfolio materially. We took new positions in Resmed **(RMD),** far too early as it transpired, taking a small position into the FY23 result, and ignoring all sensible trading advice, trying to catch it all the way down. We discuss the thesis inside, but effectively we think the emergence of the GLP-1 drug thematic is too early to conclusively prove that sufferers of OSA (Obstructive Sleep Apnea) will not continue to use CPAP machines as the standard of care into the future. Medicine tends to move slower than equity markets, while RMD is clearly the whipping boy for the weight loss drug narrative. Light and Wonder **(LNW)** was also added at the expense of Aristocrat **(ALL).** Both companies look to be dominating the ship share (market share) in land based slot machines, while LNW is also growing its social gaming business at a rate exceeding **ALL**. We note Jamie Odell (LNW Chairman, ex ALL CEO) has employed 65 ex ALL employees at **LNW** over the past 12-18 months, including several of the game developers. LNW looks to be priced far more attractively for superior growth rates over the next 2 years in our view. The other significant position we initiated during the quarter was NexGen Energy **(NXG)**, which is a dual listed (Canada/Australia) Uranium development company. NXG is sitting on a 256Mlbs Uranium deposit in Saskatchewan, Canada, with first production slated for 2028. It has ambitions to be a 30Mlb p.a. producer at an ASIC of around US10/lb, making it one of the lowest cash cost producing assets globally in a Tier 1 mining jurisdiction. This makes it (in our view), a far more attractive asset than many of the Australian listed peer group. The portfolio sold out of Origin Energy **(ORG)** during the quarter, notwithstanding the current press suggesting some funds believe Brookfield should be paying more for ORG. We heard none of these comments when ORG was trading at AUD5.80 before the bid was lodged in November last year. Effectively if ORG is worth more due to the uplift in the Energy Markets division, then our position in **AGL** would also benefit from the uplift. We also exited **ABB** very late in the quarter. We value ABB in the mid AUD3.50 range, and above AUD4.00, we feel there is too much optimism around future growth assumptions. We do note the recent bid for Symbio (SYM), which hot on the heels of the Over The Wire transaction in 2022, feels to us like ABB have bitten off a lot.

How is the portfolio positioned?

This year has been dominated by interest rate expectations, whereby it appears to us the only metric that will change the current hawkish bent is employment data. Interest rates will only start falling should unemployment spike enough to relieve the embedded wage pressure we are currently experiencing. Our investment thesis has been focused on structurally higher inflation during this decade, as opposed to the past 2 decades of deflationary forces. The challenges with energy transition and security, labor scarcity and supply chain security suggests structurally higher cost pressure than markets have been used to, which all else being equal, suggests structurally lower valuations (and higher bond yields). We are highly focused on pockets of the economy or individual stocks with either strong valuation support and asset backing, or earnings resilience, and hopefully both. Our focus remains on four key areas of investing, while appropriately diversifying the fund from an industry standpoint. These four key areas are listed below. We also note the significant divergence between large cap performance and small cap performance over the past 5 years (the ASX20 has outperformed the ASX Small Ordinaries by 38% since 2018). We are increasingly confident that small/mid caps will be strong outperformers overs over the coming 3-5 years.

Real assets. Assets that are very hard to replicate or disrupt indicates a strong starting point. All remain essential services in a modern economy. We would place **AGL, AZJ, QUB** and **BXB** in this category, while commodity producers and REITs fall into this framework as well. We think REITs will look very compelling as interest rates start falling. **Valuation margin of safety**. An asymmetric risk profile. We would place **NUF**, **ASB, QBE, SUN** and **SM1** in this category. A material discount to book value has provided a strong starting point in many cases with catalysts emerging over the next 12-18 months to see the valuation gap close. We are mindful that several of these positions simply haven't worked as yet, with the catalysts for any rerating being pushed to the right. While frustrating (and wrong) the fundamental thesis for each remains in tact. **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? We would place **CSL, TLC**, **LNW** and **NWS** (through it's holding in REA and Move) in this category. We think margin resilience becomes an important driver of equity returns in the post free money era. **Gold**. We continue to hold a high conviction view that gold equities will perform strongly over the next 2-3 years, given sentiment is still tied to real US interest rates, which we believe are peaking, and cash flows improving. Gold equities are still trading 60-80% below the 2011 peak and as such, we believe as economies slow, and interest rate cuts start being factored in, gold miners will have a very strong period ahead of them.

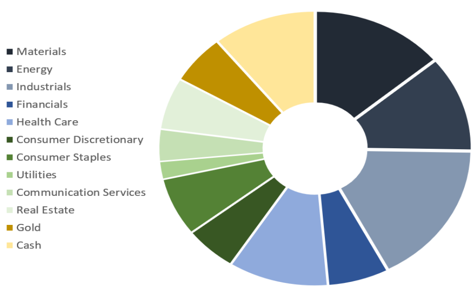
The Portfolio

The CHCF posted a 1.2% fall in the quarter, relative to the 0.8% fall in the ASX300 Accumulation Index. Aussie Broadband **(ABB)** had a strong quarter on the back of stronger cash flow growth in FY23 and a confident outlook in FY24 for enterprise customer wins. We note the recent bid for Symbio (SYM) which we must confess surprised us after only owning Over The Wire for 16 months. Our jury is out. Beach Energy **(BPT)** had a strong quarter on the back of a strong oil price, while NexGen Energy (discussed inside) we think is the best exposure to uranium globally. The uranium narrative is a very strong one. Our bottom three performers all fall into the category of idiosyncratic risk. We discuss all three underperformers inside, while disappointing, we remain firmly of the view that the asymmetric risk/reward of each is compelling on a 2-3 year view. Resmed **(RMD)** is probably the most topical stock in Australia given the powerful weight loss drug narrative, while Austal **(ASB)** and Abacus Storage King **(ASK)**, for different reasons offer compelling growth outlooks while trading at a heavy discount to book value.

Top 3 holdings	Portfolio breakdown	
CSL Ltd	Industrials	17.1%
Mineral Resources	Materials	13.9%
Austal Ltd	Energy	11.4%

Top 3 portfolio attribution	Bottom 3 portfolio attribution
Aussie Broadband	Resmed Inc
Beach Energy	Austal Ltd
NexGen Energy	Abacus Storage King

Fund weights - diverse sector exposure



THE KEY MACRO THEMES DRIVING 2023 SENTIMENT AND PORTFOLIO CONSIDERATIONS

OBSERVATION	IMPACT	EQUITY CONSIDERATIONS
PEAK INTEREST RATES YET?	We need to see slack in the labour market for a change in central bank rhetoric and to visualise the end of the tightening cycle. How long is the pause?	Cautious banks and discretionary spending. We still have to navigate the resetting of mortgage rates and the inevitable end of reducing household savings rates
ENERGY GAME THEORY	The Eastern Bloc keeps cutting supply as they watch the US dilemma of running down the SPR (Strategic Petroleum Reserve), which worked for a while, now the US is short 400mbbls of oil	Challenges the peak inflation narrative with oil price starting to add to inflationary pressures again. Less to do with fundamental supply and demand than geopolitics. Energy stocks remain very cheap on a cash flow basis
A COMMODITY BULL MARKET?	Seems paradoxical given decelerating activity across the Western world, but given the systemic deficits of western governments, fiat currency debasement seems inevitable against a basket of real assets. The current strength in the USD tests this underlying thesis	The ratio of the S&P500 vs GSCI (global commodity index) has rarely looked more compelling. It also ties in to the Energy transition thematic. Exposure to various commodities over the next 3-5 years appears essential, while we mitigate too much volatility with a maximum portfolio limit
USD STRENGTH	Tied into the higher yield argument as the ongoing bond supply (issuance) is requiring higher yields to incentivise buyers. This interest rate differential is attracting buyers of USD (in simple terms)	Translation impact of AUD companies earning USD revenue provides a tailwind for offshore earnings, while creating a significant challenge for emerging market companies that borrow in USD (the loan amount gets bigger against the home currency). Often a source of cross asset volatility
CENTRAL BANK DEFICITS ONLY GOING HIGHER	The US deficit will top USD2tn in CY23 and is accelerating. US public debt at USD34tn with 5% cash rates. The US interest bill is exploding higher. We ponder how this spending is financed with foreigners stepping away from owning US Treasuries. Eventually, the Fed has to be the buyer of last resort, but it could be volatile in the meantime	The only solution to us has to be financial repression, meaning inflation is structurally higher than the 10yr bond yield for significant periods. Real assets and gold become highly desirable as stores of wealth under this scenario. We remain firmly of this view, while recognising as the USD rises and bonds remain under pressure, the thesis will take longer to play out than we had expected
WEIGHT LOSS DRUGS	Has been the most topical investment thesis since Lilly announced the success of their Mounjaro trial that saw the average patient lose 22% of their body weight. There are obvious winners and losers from this wave of GLP-1 (Glucagon like peptides). The market is grappling with the size of the addressable market, the reimbursement rates (if any) and the potential side effects	Realistically, if the take up is significant, this craze could impact various industries from paper and packaging companies, to FMCG companies, restaurants, fitness centres and even home delivery companies, outside the obvious impact on health care companies, other pharmaceutical drugs and medical device companies, Resmed in particular
CHINESE STRUCTURAL IMBALANCES = JAPAN CIRCA 1989?	We have long been concerned with the overbuild of the Chinese economy in the face of demographic headwinds and provincial government debt issues. Outside ongoing aggressive stimulus, the Chinese economy remains too reliant on the industrial manufacturing base and needs to convince private consumption to pick up	We think China (16% of the world's population) producing 50% of the world's steel is very close to the end of the cycle, hence peak steel production is inevitable. While the iron ore majors are disciplined and rational, we remain cautious on iron ore over the next 3-5 years, while admit we have been surprised at the resilience in iron ore in 2023
WEATHER PATTERNS EL NINO VS LA NINA	Appears to be a structural cycle change occurring in the northern hemisphere, with expectations for an Australian summer to be significantly drier than the previous 3 years	Significant implications for both the agricultural and insurance sectors. Ag has had very strong growing conditions for the past 3 years in most cases, while insurance companies have been burdened with higher catastrophe claims and increasing reinsurance costs. Requires monitoring
SMALL CAPS VS LARGE CAPS	Rarely do we see such significant dispersion between asset classes (calling small caps a separate asset to large cap equities). 38% underperformance over the past 5 years, while 26% since the start of 2022, or rolling 30% underperformance over the past 3 years. Compelling evidence for future outperformance	Absolutely we see this as an opportunity rather than a threat, we are seeing significant value emerge in many small cap names, that literally have no buyers. We believe the catalyst for future outperformance of small caps will come as we see a rate cutting cycle emerge

Chester High Conviction Fund top 10 holdings

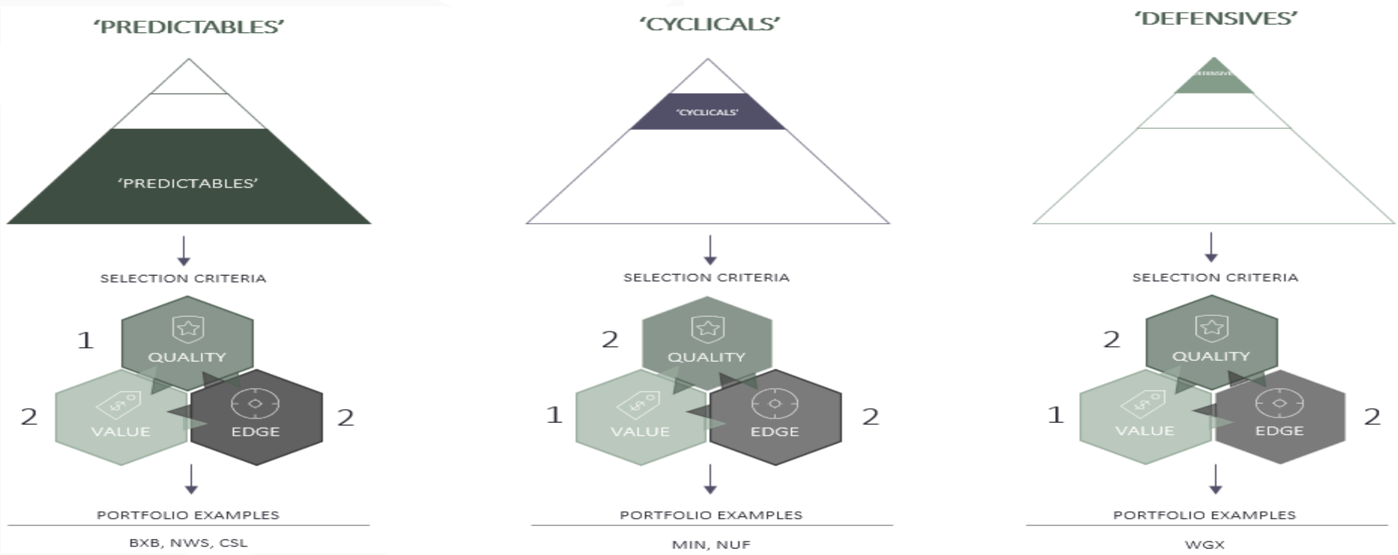
	Cash flow style	FY1 Sales GR	FY2 Sales GR	FY1 Div Yield	FY2 Div Yield	FY1 DPS GR	FY2 DPS GR	FY1 ROE	FY2 ROE	FY1 BOOK VALUE	FY1 EV/EBITDA	FY1 EPS GR	FY2 EPS GR	FY1 PER	FY2 PER
Austal	Predictable	15.9%	14.2%	3.3%	3.8%	-15.7%	16.9%	3.6%	5.4%	0.7	5.9	nm	58.1%	19.3	12.2
Aurizon	Predictable	12.0%	5.3%	5.4%	6.3%	18.6%	17.3%	18.6%	17.3%	1.4	7.0	17.0%	13.3%	13.9	12.3
Brambles	Predictable	8.1%	6.4%	3.2%	3.5%	12.0%	11.0%	12.0%	11.1%	4.0	7.1	11.1%	10.4%	17.2	15.6
Computershare	Predictable	1.7%	1.1%	3.8%	3.9%	1.1%	3.4%	33.9%	36.4%	5.0	8.7	9.2%	1.5%	13.9	13.7
CSL Limited	Predictable	11.1%	8.9%	1.7%	1.9%	13.9%	13.5%	17.3%	18.2%	4.3	18.0	18.2%	16.6%	26.1	22.4
Light and Wonder	Predictable	14.1%	6.2%	0.0%	0.0%	nm	nm	9.2%	24.7%	5.5	9.2	nm	232.5%	69.4	20.9
Mineral Resources	Cyclical	10.8%	16.8%	2.2%	3.5%	-17.9%	57.5%	18.8%	25.4%	3.2	7.8	-0.1%	64.7%	16.9	10.3
QBE Limited	Predictable	21.7%	5.1%	4.8%	6.2%	85.4%	27.6%	15.3%	18.0%	1.5	7.2	113.1%	23.5%	10.5	8.5
Resmed	Predictable	9.8%	7.3%	1.3%	1.5%	10.2%	9.2%	22.3%	21.9%	4.4	15.4	8.8%	12.9%	20.7	18.3
Suncorp	Predictable	18.4%	5.4%	5.4%	6.1%	0.8%	13.5%	10.3%	10.5%	1.3	nm	13.0%	2.4%	12.7	12.4

Source: Chester Asset Management, Bloomberg consensus data

We have listed here our top ten holdings at the 1st of October, 2023. Our fund is actively managed and has no position that is simply there to lower the tracking error against the index. It is truly benchmark unaware investing. We broadly hold positions between 1% and 6% depending on our conviction level on the stock and the size of the company. Our conviction level is dictated by the broad art of combining 1/ the appropriate valuation of the stock, with 2/ our assessment of the quality of the assets and management team, overlayed by 3/ our expectations vs the market (or insight/edge) of the earnings projection. I.e. Do we think the market is mispricing earnings? For our thesis to hold, we require at least 2 of these 3 factors to be validated for the investment case.

To explain that in more detail we have used a slide from our presentation material (chart 2 below). The majority of the stocks currently held in the top ten holdings are classified as “predictables” (consumer staples, industrials, financials or healthcare etc) while Mineral Resources (MIN) is classified as “cyclicals”. Our gold holdings are classified as “defensives”, but they currently sit outside our top ten holdings. 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 2



Source: Chester Asset Management

CHCF portfolio construction framework

We have always broken down our portfolio construction into three categories as outlined in chart 3. 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 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 greater valuation support in cyclical sectors.

The "defensive" sleeve is comprised of positions that are historically uncorrelated to the ASX300. We classify gold equities with this lens, as a historical study of large equity market drawdowns highlights how well gold holds up in extremely volatile markets. Cash is often a residual position that we simply state as the option to buy something cheaper in the future.

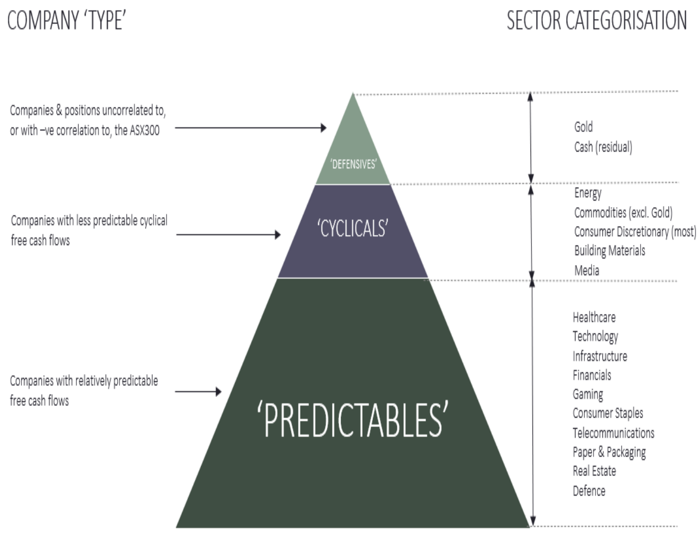
Chart 4 illustrates how these "buckets" have looked over the past 9 years. On average, the allocation to predictables has been 60-70%, while cyclicals have averaged around 18% (10-25%) and defensives have ranged from 10-25%. We have tended to hold an increased cyclical position over the past 6 months, which is predominantly in energy, uranium and the critical minerals space. 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. We are aware that cyclicals by their nature are higher beta, which means they often appear as the best, or worst performers. Hence the exposure to this part of the market is managed accordingly.

Chart 5 highlights the portfolio characteristics of the CHCF vs the ASX300. We historically find these metrics relatively fluid given the portfolio changes that reflect new weights and new decisions. For example, if we sold our CSL position the FY2 PER of the fund would fall below 10x, hence while these characteristics provide a snapshot of the fund at a point in time, in aggregate, we don't find then particularly insightful.

What this data highlights is that the fund has a value bias, which is assisted by stocks such as Westgold (WGX), which is trading on 8.0x PER and has 436% eps growth in FY24. These types of idiosyncratic decisions can influence the overall shape of the portfolio. But at an aggregate level, the fund has a lower yield than the ASX300, which is primarily a result of no exposure to BHP, RIO or the major banks, which is where the bulk of the ASX300 yield is generated. The fund also shows far superior eps growth relative to the ASX300, with better valuation support and higher ROE than the market. Bearing in mind, this strategy is designed to be different from the ASX300. We try to look different than the overall benchmark, as without thinking differently, we would never have achieved the track record over the past 9 years, with lower volatility than the market.

How do we allocate capital?

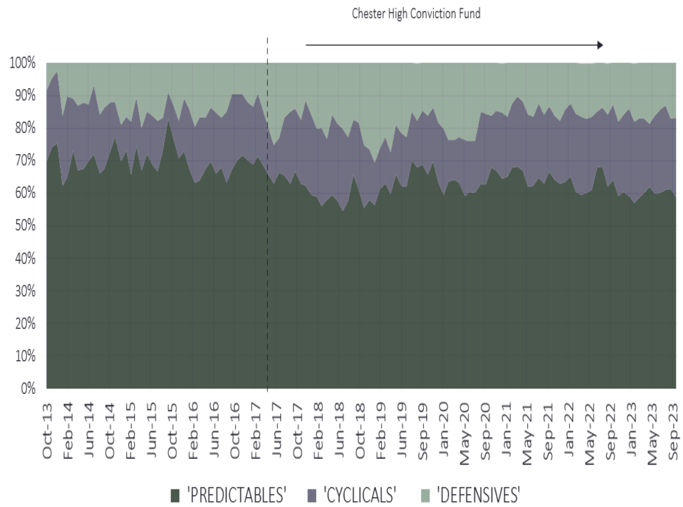
Chart 3



Source: Chester Asset Management

Which has been done consistently over time

Chart 4



Source: Chester Asset Management

Chester High Conviction Fund portfolio characteristics

Chart 5

	CHCF	ASX300 Index
PER FY24	15.8	15.5
PER FY25	11.1	14.2
FY1 EPS growth	23.9%	-4.0%
FY2 EPS growth	27.1%	9.4%
ROE	13.9	13
Beta	0.91	1.00
FY24 Yield	2.2	4.1
FY1 DPS growth	13.3%	-5.3%

note Chester data excludes non revenue generating companies

Source: Chester Asset Management, Bloomberg, Macquarie research

Stock selection - Abacus Storage King (ASK)

Description	Abacus Storage King (ASK ASX) is one of only 2 pure-play storage Real Estate Investment Trusts (REITs) listed on the ASX that was spun out of Abacus Group (ABG) in a de-stapling in June 2023. ASK owns 135 sites with 112 of those sites full trading stores and 23 future stores. 89% of sites are located in metropolitan areas with in particular 41 operating sites in Sydney, 23 in Melbourne and 24 in Brisbane and the Gold Coast. We suspect as the market gets comfort with the business we could see a possible re-rate to at least a multiple comparable to National Storage Reit (NSR) or possibly corporate activity with storage assets potentially doubling as data centre sites which are increasingly scarce.
Quality	We are attracted to storage as an asset class on a number of fronts: Diversification –ASK in particular has 90k units let by 49k customers across its 112 sites highlighting the limited exposure and hence risk from any one customers Growth –Given the diversified portfolio ASK has the ability to increase rents periodically. The business also has a strong development pipeline with an estimated completion value of AUD434m Geography –89% of ASK's portfolio being located in Metropolitan regions The industry is highly fragmented with NSR holding 17% market share, ASK holding 14% market share and Kennards with 11% share. The opportunity for bolt on storage facilities is high over the coming 2-3 year period to supplement organic growth We also believe that as the industry matures, with the efficiency of scale, operating margins can grow from the mid 60's towards the US model of mid 70's margins. This we believe is achievable for both ASK and NSR over the coming 5 year period.
Valuation	AUD1.45/share DCF derived valuation with SOTP cross-check Comparable Peer NSR trades at ~90% of NTA. On the same multiple of NTA ASK would trade at AUD1.35/share. The cap rate across the industry is possibly too high, but we see ASK trading at a 32% discount to NTA, which we believe is excessive for the growth opportunities ahead of it. Trading at AUD1.06 it offers a 5.9% yield with revenue growth consistently in the mid single digits over the past 5 years. While gearing is slightly high at 26%, we note that ASK actually owns AUD200m of NSR stock (7% of the register). This could easily be recycled into lowering gearing or further industry consolidation.
Insight	ASK has only split from Abacus Property Group just over a 2 months ago and to date the trading has been sporadic and unfavourable to ASK particularly vs listed comp NSR. NSR has the benefit of track record with the market and to date has traded like the market believes it deserves the premium position of the two companies. ASK was also removed from the ASX200 Index removing a source of liquidity. We believe: A) The difference in cap rates is a reflection of asset quality differences between the two, evident in REVPAM, Occupancy and historical growth rates and B) Storage assets in general are high quality REIT exposures. We believe the opportunity for a re-rate exists with ASK, but will be a function of the market gaining confidence with the outlook as a separately listed entity. The free float is also small relative to NSR, given 2 large shareholders, while understanding the management service agreement with Abacus Group is an area that investors need to be comfortable with, and potentially addressed over time.

Chart 6

ASK operates in a secular growth industry

ASK vs NSR - Key Matrics	Measure	ASK	NSR	Notes
NTA	AUD	1.56	2.48	Per results presentations 30 June 2023
Share Price	AUD	1.06	2.19	Per IRESS
Discount to NTA	%	-32%	-12%	Suggests 20% upside to ASK to trade comparable to NSR
FY24 P/E	%	16.5	19.4	Suggests 18% upside to ASK to trade at NSR P/E
FY24 Dividend Yield	%	5.7%	4.9%	Suggests 15% upside to ASK to trade at NSR yield
Weighted Average Cap Rate	%	5.57%	5.91%	Per results presentations 30 June 2023
Total Assets	AUDm	3,100	4,480	Per results presentations 30 June 2023
Gearing	%	26%	20%	Per results presentations 30 June 2023
Cost of Drawn Debt	%	3.6%	4.9%	Per results presentations 30 June 2023
Hedged	%	69.0%	37.0%	Per results presentations 30 June 2023
Sites	#	135	234	Per results presentations 30 June 2023
Operating	#	112	189	Per results presentations 30 June 2023
Development	#	23	45	Per results presentations 30 June 2023
NLA	000 m2	583	1,264	Per results presentations 30 June 2023
Occupancy	%	91%	85%	Potential NSR upside but could indicate quality difference
Customers	#	49,000	90,000	Per results presentations 30 June 2023
RevPAM FY23	AUD/sqm	319	270	ASK RevPAM suggests higher quality
RevPAM Growth FY23	%	9.0%	3.6%	Per results presentations 30 June 2023
REvPAM Growth FY18 to 1H23	%	5.8%	4.9%	Per ASK (another indication of asset quality difference)
Metro Sites	%	89%	72%	Per results presentations 30 June 2023
Brand Awareness Australia	%	63%	31%	Per ASK results Presentation 30/6/2023 (maybe biased!)

Source: Chester Asset Management

Stock selection - Austal Limted (ASB)

Description

We have been writing about Austal (ASB ASX) for the past 2 years believing it to be materially underappreciated and unloved. Given the portfolio weight, we thought it worth reviewing our thesis here. The market is clearly telling us we are wrong. ASB is the largest provider of aluminium ships in the world and has developed a long term successful partnership with the US Navy in providing Littoral Combat Ships (LCS) and Expeditionary Fast Transport Vessels (EPFs) over the past decade from its base in Mobile, Alabama. It also builds commercial vessels (fast ferries and vehicle passenger ferries) as well as Navy vessels out of its locations in Perth, Vietnam and the Philippines. Much of the historic concern with ASB had been the lack of contract success with the US Navy, which was needed to replace the LCS and EPF programs as per above. In the past 12 months ASB has announced 2 material contracts being the OPC (Offshore Patrol Cutters) for the US Coast Guard and in May 2023 the award for the T-AGOS program (Tactical Auxiliary General Ocean Surveillance vessels). This takes the current order book to in excess of AUD11bn with the potential for other awards to come. ASB forms part of the critical industrial base that is an essential cog in the US Navy's ambitions to renew their naval fleet over the next decade.

Quality

ASB has developed a reputation for delivering LCS vessels to the US Navy with increasing efficiency over the life of the contract, with labour hours per vessel decreasing more than 35% over the past 6 years, which has driven both a strong margin improvement, and a strong working relationship with the US Navy. The recent upgrade of Mobile to include steel hulls is testament of the desires of the US Government to maintain key strategic shipbuilding capacity operating and enhances ASB's total addressable market. Combined with the Australian Navy recently awarding ASB a AUD350m contract in Perth (Cape Class Patrol Boats), ASB is well entrenched as a reliable supplier of shipbuilding services to national governments. On top of this, ASB has developed a global network of support services to maintain the current fleet of LCSs and EPFs that they have already built. To this end, the US Navy has recently awarded ASB support contracts on both the East Coast and West Coast of the US which provides ASB predictable long term maintenance revenues.

Valuation

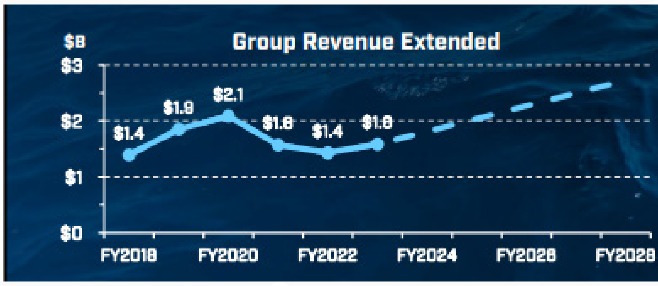
Our assessed value for ASB is currently AUD4.20 per share. Book value is AUD2.62/share, so is trading at 0.65x P/B. ASB as per below, now has strong visibility into the revenue trajectory of their recent contract wins, with strong visibility out to 2034.

Insight

There has been recent speculation around private equity interest in ASB, which drove the share price higher in the second quarter. The retracement would suggest that is no longer the case, while in our mind, the outlook for the business has never been brighter. In our view ASB has a predictable maintenance business (that is growing) to underwrite steady cash generation, while the record order book should see the US shipyard full for the next 10 years. In the absence of a corporate transaction, we are happy holders of ASB due to the defence spending thematic, predictable earnings trajectory with a strong upgrade cycle and compelling valuation discount. We also believe it is one of the most unloved stocks on the ASX. We see FY25 EBIT at AUD100m, while consensus forecasts are still visible at AUD77m. Thus we see consensus earnings upgrades needed for FY25 by at least 20%, and more in outer years. ASB management are highly confident that the recent T-AGOS program has been priced with favorable margins, given the highly fixed cost base of the shipyard at Mobile. We believe given the fixed cost leverage involved in man hours on the shipyard, with 2 large contracts and several smaller ones, absolutely there should be leverage to the rising revenue, while the market remains unconvinced. All else being equal, an AUD at 0.63c vs 0.72c would see 15% eps upgrades.

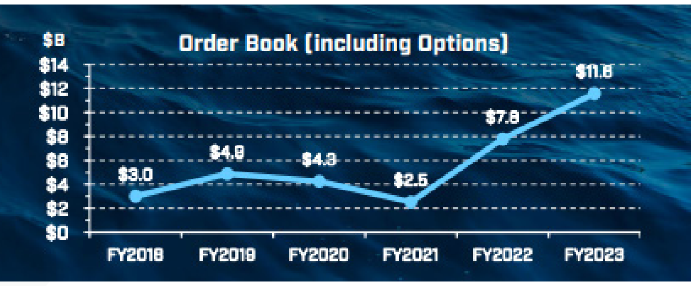
ASB has a revenue and margin recovery ahead of it

Chart 7



ASB has a far more diversified revenue base going forward

Chart 8



ASB has material earnings upside should margins return to historic levels, which we believe they should

Chart 9

Consolidated Results	FY18 A	FY19 A	FY20 A	FY21 A	FY22 A	FY23 A	FY24 E	FY25 E	FY26 E	FY27 E	FY28 E
Revenue By Segment (AUDm)											
USA	1,162.6	1,472.7	1,603.8	1,176.6	1,055.9	1,225.0	1,388.6	1,695.8	1,870.3	2,054.3	2,254.3
Australasia	256.5	393.2	496.8	405.8	384.0	366.4	344.6	389.2	430.1	438.7	447.5
Corporate / Eliminations	(27.1)	(13.8)	(14.6)	(10.2)	(10.9)	(6.4)	(6.6)	(6.7)	(6.9)	(7.1)	(7.2)
Total	**1,392.0**	**1,852.1**	**2,086.0**	**1,572.2**	**1,429.0**	**1,585.0**	**1,726.7**	**2,078.3**	**2,293.5**	**2,486.0**	**2,694.6**
EBIT by Segment (AUDm)											
USA	83.0	106.4	123.0	131.7	133.7	5.2	66.1	95.5	120.6	164.3	180.3
Australasia	(8.3)	11.7	30.9	17.3	14.6	15.8	21.1	28.0	33.0	33.6	34.3
Corporate / Eliminations	(9.7)	(25.3)	(23.5)	(34.4)	(27.6)	(25.8)	(25.6)	(26.3)	(26.9)	(27.6)	(28.3)
Total	**65.0**	**92.8**	**130.4**	**114.6**	**120.7**	**(4.8)**	**61.6**	**97.1**	**126.6**	**170.4**	**186.4**
EBIT Margin by Segment (%)											
USA	7.1%	7.2%	7.7%	11.2%	12.7%	0.4%	4.8%	5.6%	6.4%	8.0%	8.0%
Australasia	-3.2%	3.0%	6.2%	4.3%	3.8%	4.3%	6.1%	7.2%	7.7%	7.7%	7.7%
Corporate / Eliminations	35.8%	183.3%	161.0%	337.3%	253.2%	403.1%	390.6%	390.6%	390.6%	390.6%	390.6%
Total	**4.7%**	**5.0%**	**6.3%**	**7.3%**	**8.4%**	**-0.3%**	**3.6%**	**4.7%**	**5.5%**	**6.9%**	**6.9%**
Chester / Management vs Consensus											
Chester EBIT	65.0	92.8	130.4	114.6	120.7	(4.8)	61.6	97.1	126.6	170.4	186.4
Consensus	65.0	92.8	130.4	114.6	120.7	(4.8)	56.8	77.5	113.0	122.5	132.8
Difference							**4.8**	**19.6**	**13.6**	**47.9**	**53.6**
%							**61.6**	**97.1**	**126.6**	**170.4**	**186.4**
EV/EBIT Multiple	**10.3**	**5.9**	**8.1**	**5.2**	**6.8**	**(125.5)**	**9.9**	**6.2**	**4.4**	**2.9**	**2.3**

Source: Chester Asset Management, Austal FY23 results presentation

Stock selection - NexGen Energy (NXG)

Description

NexGen Energy (NXG) is a dual listed (TSX/ASX) exploration and development company with a portfolio of large-scale uranium assets in the southwestern region of the Athabasca Basin. It owns the Rook I property, which is a world-class development stage project, and is host to some of the most exciting uranium discoveries in recent times including the Arrow deposit. NexGen holds ~200,000 ha of land in the Athabasca Basin of Saskatchewan, ranked the 3rd best jurisdiction for mining investment attractiveness in 2022, and home to the largest high-grade uranium deposits in the world. The FS-stage Arrow deposit is being permitted and developed along the Patterson Lake Corridor (PLC). A key catalyst for the NXG story is a mining permit which we expect in the very near term. Arrow is a large tonnage, high-grade basement hosted deposit with ~337Mlbs in resources and ~240Mlbs in reserves, and a high-grade core of ~162M lbs at 17% U3O8. Mineralization remains open in several directions. Average annual production is forecast to be 21.7Mlbs U3O8 over 10.7 years, including an average of ~29Mlbs over years 1-5. First production is slated for 2028 pending the appropriate permits.

Quality

If you happen to believe that Nuclear Power is a key ingredient for reaching any carbon reduction goals (as we do), then the Uranium story is well known. NXG hosts a significant uranium resource in a Tier 1 mining jurisdiction, which in our mind, significantly de-risks the project relative to African assets, of which there are many listed in Australia. Given the significant demand from the growth in Nuclear reactors globally, there is mounting evidence that Uranium will be in a structural deficit for a significant period of time over the next 10-15 years. While NXG will bring to market one of the worlds lowest cost Uranium mines, it will still see significant shortages in new deposits meeting the demand growth. We note that 30% of France's Uranium supply is sourced from Russia and 20% from Niger, hence the sovereign profile of mined supply is becoming increasingly pertinent. There has been a massive underinvestment in uranium for the past 10 years.

Valuation

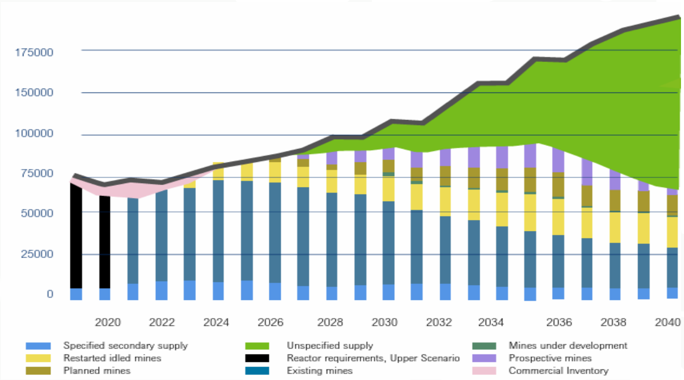
Our unrisked valuation of NXG is CAD11.68 (AUD13.43) per share. This is using a LT price assumption of US65/lb. There is a range of scenarios that could play out for NXG in terms of realised price, but using a LT price of US60/lb would see an average EBITDA of CAD2.0bn for the first 5 years of production. Most Uranium producers trade on between 6-8x EV/EBITDA, which would see NXG have an EV range of CAD12-16bn. The current market cap is CAD3.6bn indicting as the project de-risks there is significant upside, albeit with a capital funding commitment to come of approximately CAD1.3bn

Insight

One of the strengths of NXG has been their engagement with the local communities, with 4 indigenous groups having already signed off on the environmental permit. We see little resistance and much support for this project in the region, which places it ahead of many Australian projects. It was discovered in 2014, so it will be a 14 year timeline to first production, which is also why the supply side appears to be a material challenge in the next 10 years given the lack of accelerated projects. There is a significant amount of preparation going into the area on the expectation that permitting will proceed. NXG will have bargaining power with utilities in terms of long term offtake agreements. CEO Leigh Curyer is confident that there is no rush to sign offtake partners yet, given the upward pressure on price. While most modeling is done between USD60-65/lb, it is believed that Cameco (the current largest producer in Canada) is only profitable at USD55/lb, hence the expectation that Uranium is headed higher give the structural dficit emerging.

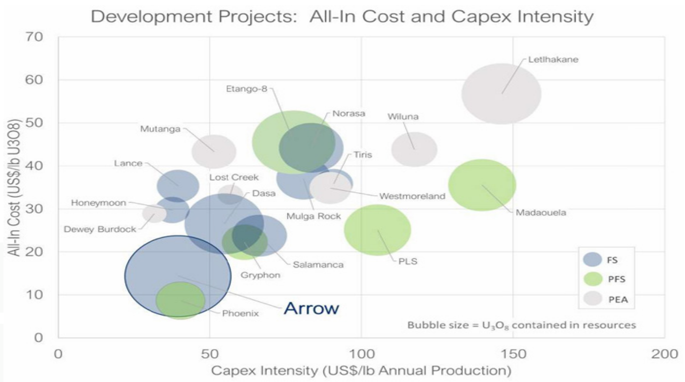
Uranium market has a material shortage looming

Chart 10



NXG project Arrow is the largest and lowest cost mine in the world

Chart 11



The Arrow project economics are very compelling

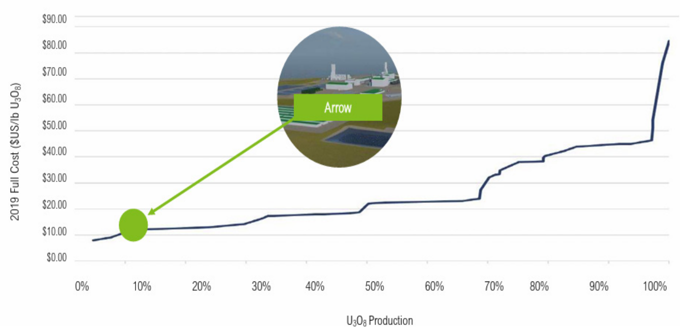
Chart 12

Uranium Price ($ USD/lb U_3O_8)	After-Tax NPV_8	After-Tax IRR
$100/lb U_3O_8	CAD $8.13 Billion	81.6%
$90/lb U_3O_8	CAD $7.20 Billion	76.8%
$80/lb U_3O_8	**CAD $6.27 Billion**	**71.5%**
$70/lb U_3O_8	**CAD $5.33 Billion**	**65.8%**
$60/lb U_3O_8	CAD $4.40 Billion	59.5%
$50/lb U_3O_8 (Base Case)	CAD $3.47 Billion	52.4%

Source: NexGen corporate presentation

As it is one of the lowest cost operations in the world

Chart 13



Stock selection - Light and Wonder (LNW)

Description

Light & Wonder (LNW) is a participant in the gaming market, developing products for the slot machine, social casino and igaming markets. It is a competitor to Aristocrat (ALL) who with approx 27% ship share, is the market leader in slot machines, while IGT (20%) and LNW (23%) are the other major players. In recent times, IGT has been ceding share to both ALL and LNW. LNW was previously known as SciGames, which was saddled with too much debt and a poor ownership structure. Former ALL CEO Jamie Odell took over as the Chairman of LNW in June 2020, divested the lotteries business and sports betting division to reduce debt and focus on the 3 key product lines (slots, social casino and igaming). Over the past 3 years, LNW has employed over 65 ex ALL employees as they try to emulate the success that ALL has had bringing new product to market. At the core of this industry is product development (new games) to continue to enhance the player experience. We believe LNW is well placed to grow in excess of its peer group for the foreseeable future, while it continues to deleverage. It recently listed in Australia given the local understanding of ALL as a listed peer.

Quality

The industry continues to grow above GDP with the increasing product suite, most recently igaming (real money casino's online). Land based gaming is circa 75% of LNW profit, which continues to take share from IGT. A recent industry survey suggests that casino's will be looking to buy 25% of their machines off LNW over the next 12 months. Of the land based gaming, 70% of the revenue is recurring through gaming operations and leasing of machines. The game developers that have come to LNW from ALL are launching new product with strong success. Frankenstein, Dragon Train and Squid Game (a licensing deal with Netflix) are all creating strong ship share momentum. Social gaming is currently 18% of profit, with in excess of 20% revenue growth. LNW believe a successful social gaming business assists in rolling out new product to land based gaming by testing new content online to see take up rates before converting to hardware. This leads to better ROI on games.

Valuation

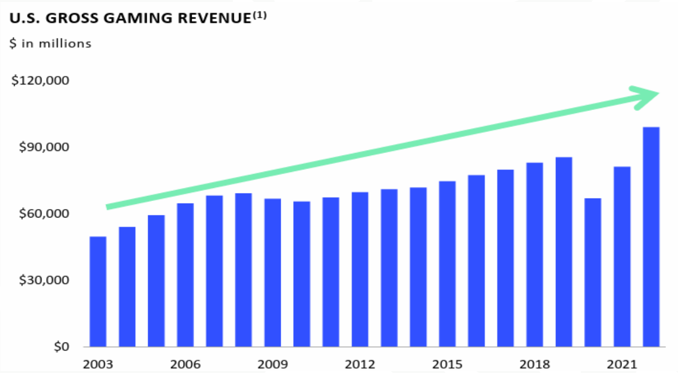
Our DCF derived valuation of LNW is AUD151/share (9% WACC 3% TGR). This valuation would see LNW trade on 8.2x EV/EBITDA in FY25, relative to ALL trading on 10.6x. LNW has ambitions to generate USD1.4bn in EBITDA while consensus is still forecasting USD1.28bn. We believe the current momentum in the business can see the EBITDA target being achieved, while if LNW traded at closer to an ALL multiple (given stronger growth rates and significant deleveraging), then on 10x EV/EBITDA, LNW could trade at AUD200/share. Whilst this is still execution heavy, we believe the building blocks are in place for a re-rating over the next 2 years.

Insight

This industry is based on game development, and to that end, we believe LNW is well placed to grow above system with highly motivated developers (many of whom have crossed from ALL over the past 3 years). Given the current ship share momentum and the positive feedback from the Eilers survey on 2024 expectations, we view the risk reward of earnings surprise to the upside. LNW are receiving strong feedback on new games including Dragon Train, while Squid Game promises to create a significant amount of interest. The sheer number of ex ALL employees that have continued their career at LNW speaks strongly to the culture and the talent across all divisions, which we believe sets the company up very well for the next phase of growth with new products and new markets (igaming opportunities).

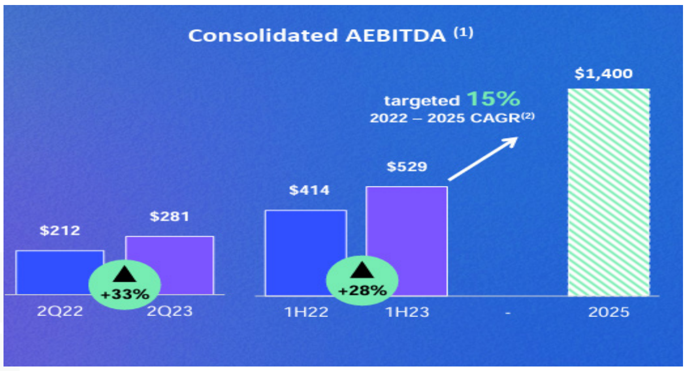
US gaming industry growing at 6% CAGR for 20 years

Chart 14



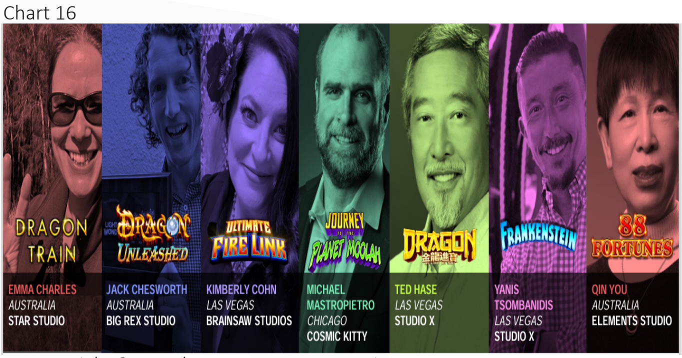
LNW showing strong momentum towards an aspirational target

Chart 15



LNW have a big focus on talent driving game development

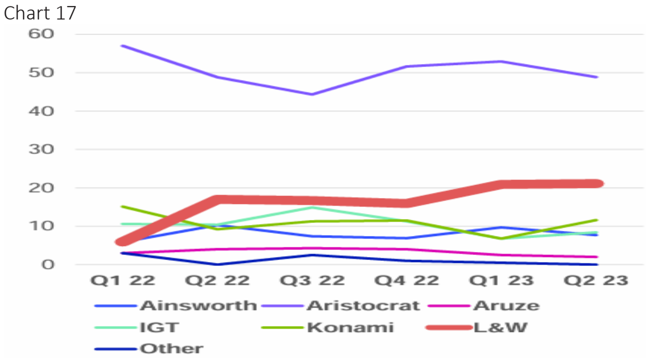
Chart 16



Source: Light & Wonder corporate presenation, August 2023

LNW ship share increasing with more to come

Chart 17



Stock selection - Resmed (RMD)

Description

Resmed (RMD) has been an Australian success story, as a medical device company that is a market leader (circa 60% share globally) in sleep devices and masks. These devices are sold internationally for patients with Obstructive Sleep Apnea (OSA). OSA is a medical issue whereby a patient stops breathing during sleep (as the tongue blocks the airways). The majority of patients suffering from OSA have either cranial-facial features that lead to this outcome, are male, ageing and most often obese. RMD has enjoyed 14.7% revenue CAGR for 21 years as sales have risen from USD200m in FY02 to USD4.2bn in FY23. The total addressable market of OSA sufferers according to RMD is close to 1.0bn worldwide, while only circa 30m patients are using CPAP devices. This is all well known and until recently RMD traded as a high quality growth stock with a strong runway. Anyone following stock markets over the past 3 months will have seen the significant impact the rise of GLP-1 drugs have had on the RMD valuation. A GLP-1 drug stands for Glucogen-like peptide-1. A GLP-1 hormone is excreted from the pancreas after food consumption that assists in lowering the blood sugar level and lowers food intake. A GLP-1 drug mimics these traits and causes the same impacts as food consumption (without the food consumption). Hence an injection of a GLP-1 lowers the blood sugar level and tricks the brain into feeling full. Recent studies have found that over a year using GLP-1s, patients can lose up to 22% of their bodyweight, should they continue to stay the course. The narrative around the success of weight loss drugs across many industries (supermarket basket sizes, hospital occupancy, restaurant spending habits, medical device sales) has been a very powerful one.

Quality

RMD as a market leader in OSA treatment is well understood, while there are expectations that competitor Philips will re-enter the device market after suffering a significant product recall 2 years ago. Thus while RMD expect to retain market share gains after 2 years, the pricing dynamics are likely to be more competitive going forward (while it is unknown when Philips will re-enter the market). The debate for RMD and the industry then is the long term growth rate assumed, as the implication of the weight loss industry success infers that as obesity is treated more widely in society, there will be less patients with OSA, or using CPAP machines (and masks) for treatment. Of course all this is unknowable at this point in time, while many more trials in weight loss drugs and their impacts on different diseases are being studied.

Valuation

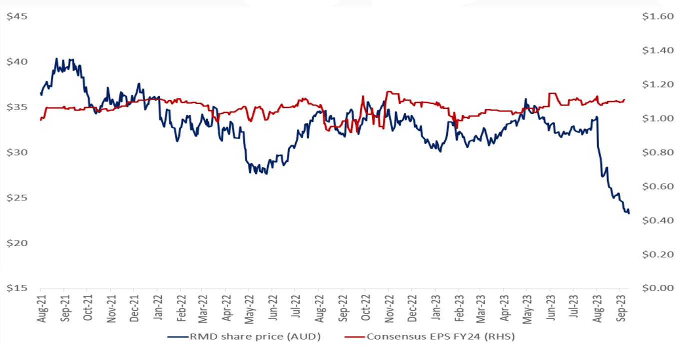
Our valuation for RMD using our base case of 5% long term growth rate is circa AUD30. Note we do assume the impact of GLP-1 drugs will impact the long term growth rate which we had previously assumed at 8%. At AUD22/share the base case assumes RMD has zero future growth, which we believe prices in a far too pessimistic scenario. At AUD22/share, RMD is trading on 19x FY24 PER, a 33% discount to its long term average.

Insight

Our simplistic insight, at this point in time, is that medicine is by nature a conservative practice, and the current standard of care (for OSA that is CPAP devices) is considered the most optimal standard of care. It will take significant and material trial success to change this (while there is a study due for release in April 24 around the impact of weight loss and OSA, which may change this current thinking). Our other concern at this stage is the side effects of these new drugs (which are relatively new) in terms of overall compliance (if not in a trial study, compliance is around 32% of starting on these drugs and still taking them 12 months later. There has also been studies suggesting much of the weight loss success has come from muscle loss (not fat), while the current cost of weight loss drugs is around USD1000/pm, which without reimbursement, makes it significantly more expensive than CPAP treatment. We see this as more of an opportunity than a threat currently, while we may just be at "peak hype" for GLP-1s.

RMD share price in CY23 is not about near term earnings

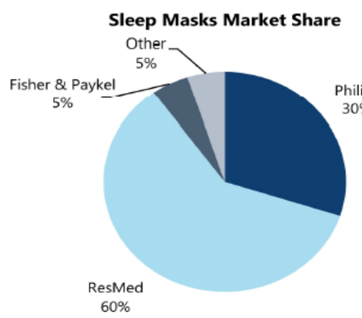
Chart 18



Source: Chester Asset Management, Bloomberg

RMD has signicant share in the sleep industry

Chart 19



Source: Jefferies

GLP-1 drugs have been around for several years

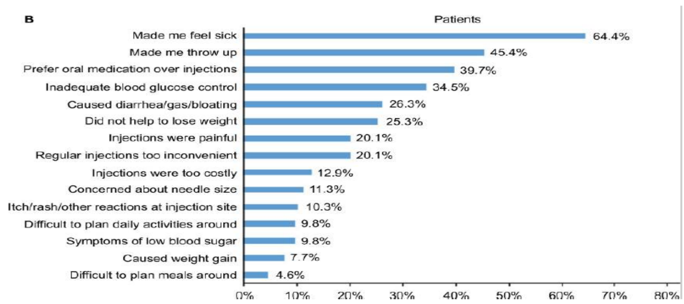
Chart 20

Brand name	Generic name	Manufacturer	Approval date	Approved for
Byetta	Exenatide	Astra Zeneca	Apr-05	Type 2 Diabetes
Bydurean Bcise	Exenatide	Astra Zeneca	Jan-12	Type 2 Diabetes
Trulicity	Dulaglutide	Eli Lilly	Sep-14	Type 2 Diabetes
Mounjaro	Tirzepatide	Eli Lilly	May-22	Type 2 Diabetes
Victoza	Liraglutide	Novo Nordisk	Jan-10	Type 2 Diabetes
Ozempic	Semaglutide	Novo Nordisk	Dec-17	Type 2 Diabetes
Rybelsus	Semaglutide	Novo Nordisk	Sep-19	Type 2 Diabetes
Wegovy	Semaglutide	Novo Nordisk	Jun-21	Weight loss
Saxenda	Liraglutide	Novo Nordisk	Dec-14	Weight loss

Source: Jarden

Compliance to GLP-1s are still low given side effects

Chart 21



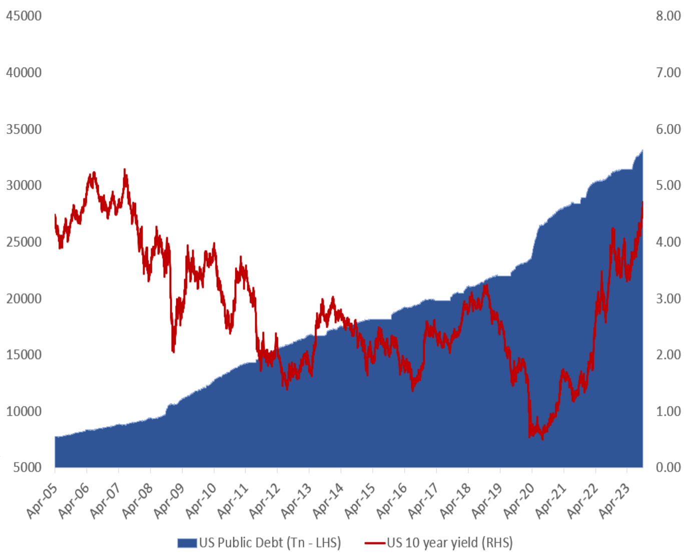
Source: Jarden, Sikirica 2017

What is going on with the US bond market?

We first heard the thesis of what is coined the “great reset” in a book written by Scottish economist Russell Napier in 2006. This thesis involves a deluge of bond issuance stemming from relentless budget deficits whereby bond buyers go on strike. In this scenario bond yields continue to rise until an appropriate margin of safety is priced into a sovereign bond auction. That is, very little interest at 4%, but if offering US 10 year coupons at 6%, then the demand side is willing to step up. The simple function of demand and supply. So is this where we are today? The US 10 year has risen from 4.1% in August to 4.8% today. This is at a time of large scale US Treasury issuance to roll over the existing treasuries reaching maturity, while also funding the increasing deficit spending. Chart 25 highlights the acceleration of US public debt, which has risen from USD31.4Tn in June, to USD33.5Tn today. An unfathomable number even in the depths of the GFC. So it begs the question, who funds this spending? Given the reserve currency status, the USD has been in a privileged position of having an underlying bid for the currency, but will this be the same in 3 years time? Given foreigners (China, Japan and Russia) have stepped away aggressively over the past 6-7 years, US households have stepped up a little, but it remains to be seen who the buyer of last resort will be. Most likely the Fed itself, in the face of the next crisis.

US Public Debt has risen USD2.1Tn in 4 months

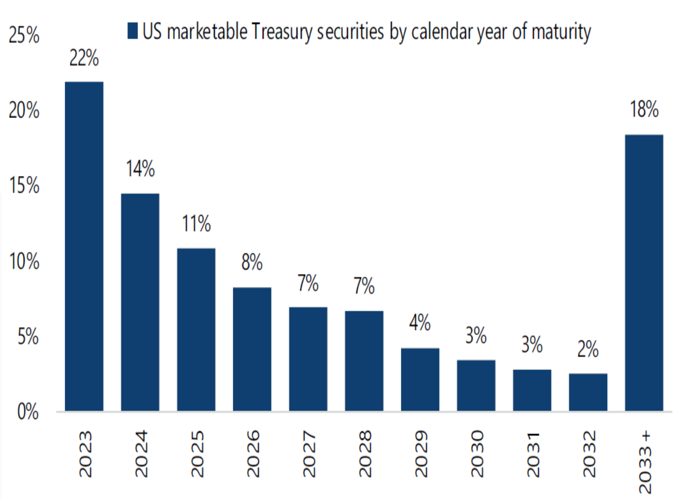
Chart 22



Source: Chester Asset Management, Bloomberg

With USD12Tn of Tresuries maturing in the next 3 years

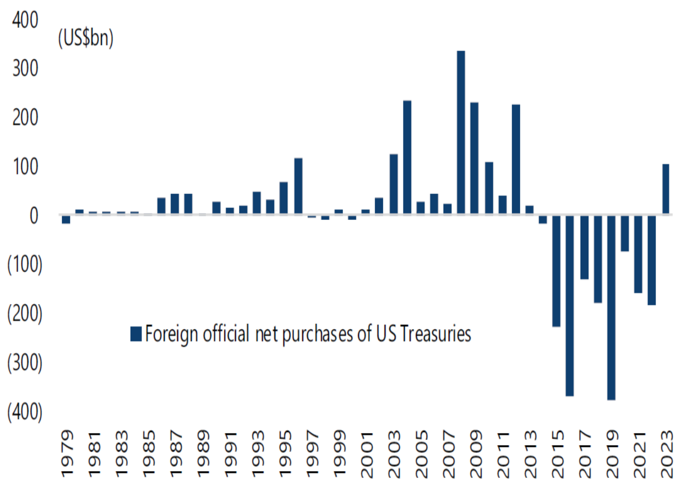
Chart 26



Source: Jefferies

Foreigners (China and Japan) have been sellers

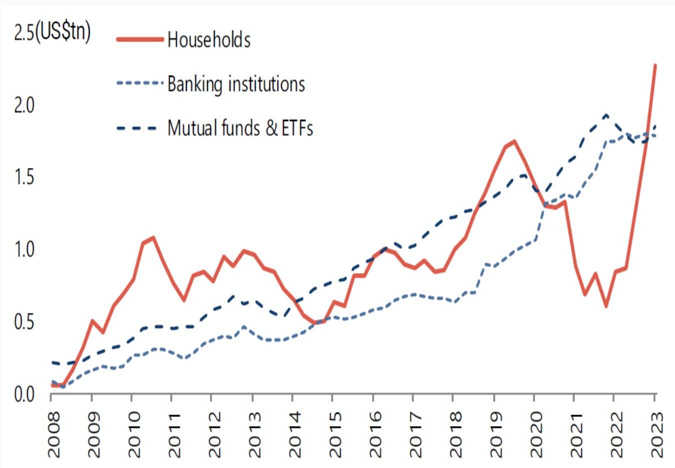
Chart 23



Source: Jefferies

US households have been the largest buyer

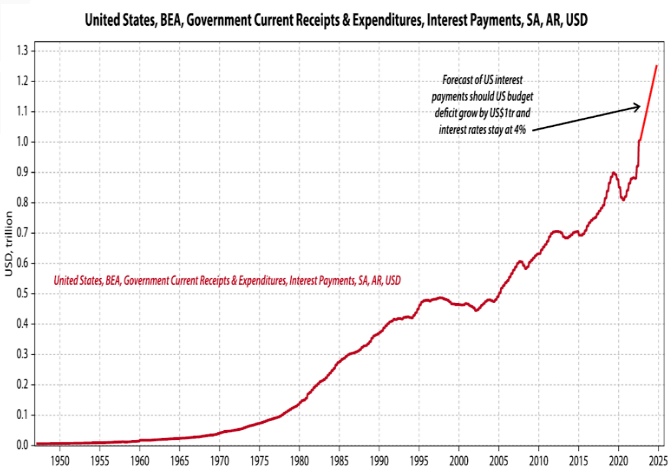
Chart 25



Source: Jefferies

US interest payments about to pass defence spending

Chart 24



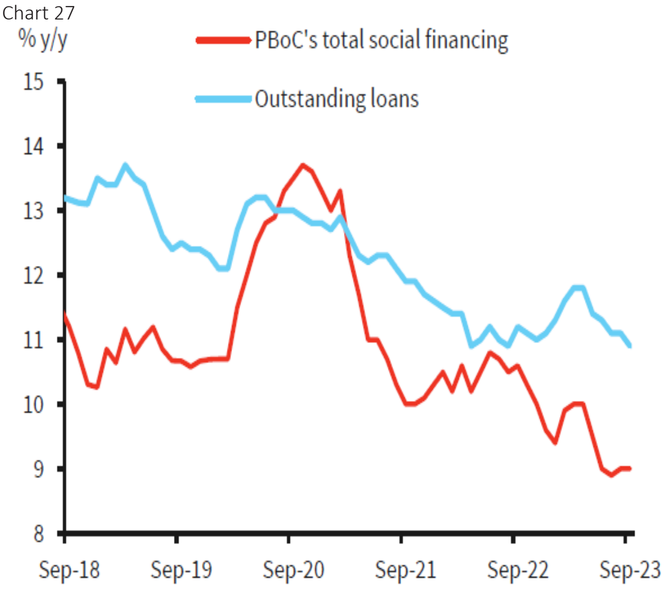
Source: Gavekal, Macrobond

China

Sometimes we question whether we have a unique insight into China, the reality is we don't. Much of what we write about is consensus thinking and already known. We often look for angles about what could go right in China and what are we missing? We have been intellectually wrong this year with the strength in the iron ore price, which has remained steadfastly above USD100/t, which from chart 31, suggests the Australian miners (BHP, RIO, FMG) are generating strong cash flows currently in an otherwise challenging market. So why do we continue to hold our view. Simplistically it is demographics and the sheer weight of the bad loans sitting in the hands of Chinese listed property developers. The confidence in property speculation has been shot, while household savings in China remain extremely high given the lack of a social security safety net. Hence in absence of China remaining the manufacturer of cheap goods to the world (chart 30), we think the domestic model is under significant stress. Much of the central planning this year has been to invest in infrastructure and manufacturing capability as the property market malaise is seeing no real signs of a pick up. But the risk is that the added investment in manufacturing capability is coming at a time when the western world is working out how to remove China from the supply chain. In the next 2-3 years we expect Chinese steel production and therefore iron ore demand to be far weaker.

Lending will be the catalyst for any reacceleration

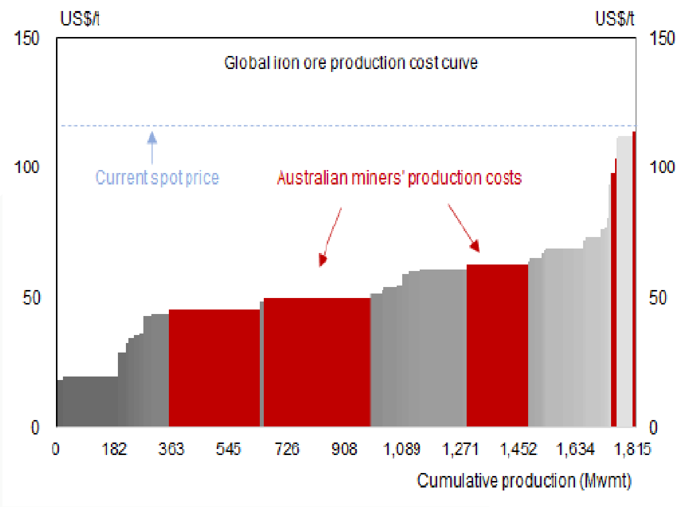
Chart 27



Source: Jefferies

Australian Iron Ore miners remain well insulated

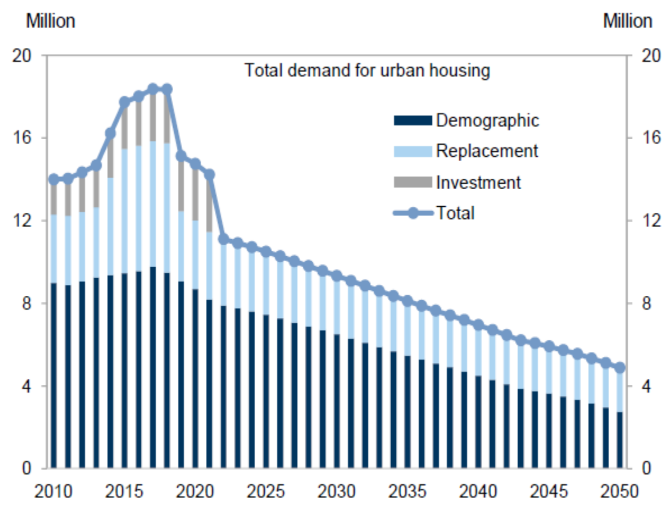
Chart 31



Source: Goldman Sachs

Housing/demographics paint a poor outlook

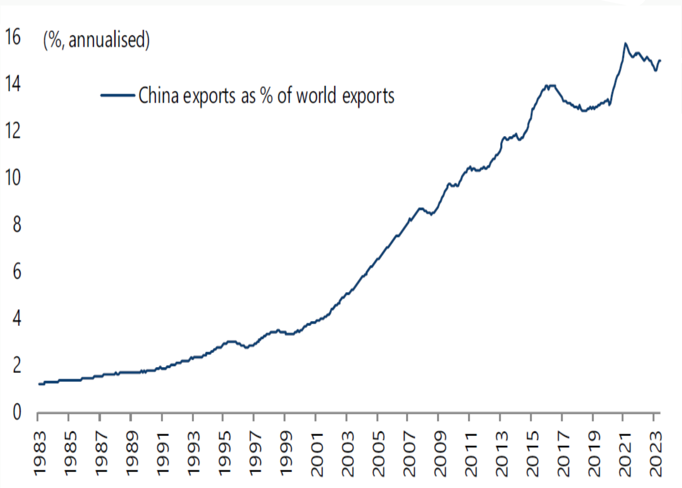
Chart 28



Source: Goldman Sachs

China needs the world to continue to buy Chinese goods

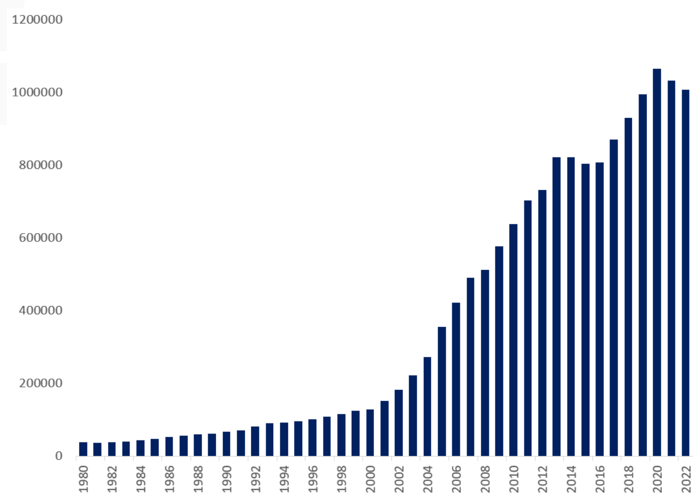
Chart 30



Source: Stephen Roach, IMF working paper, April 2023

Steel production looks to have peaked in China

Chart 29



Source: Chester Asset Management, Bloomberg

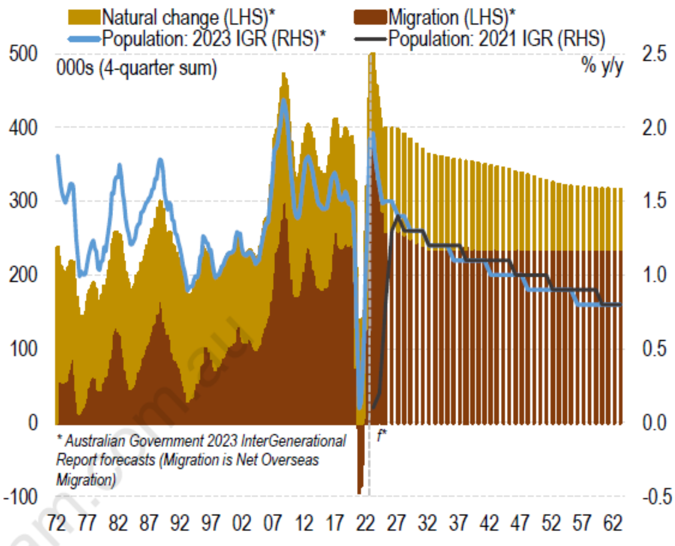
Australia

We see reason to be optimistic about Australia over the next 10 years. Demographics play a large part in this given we still have strong tailwinds of immigration that sees our population growth projected at 2% or above for the next few years (chart 32). This sees Australia as a relatively young country, with an average age in the low 40s by the middle of the century, well and truly at the low end of OECD countries. We do believe capital flows to the easiest tailwinds, and on a global scale, Australia still sets up incredibly well on a long term view. Rule of law and a (relatively) harmonious democracy sees Australia continue to be the lucky country. The challenge for us as a nation is to prosper from this, outside primary production and housing construction, both of which have driven the economy for the past 30 years.

We do think in the short term though (next 12-18 months), Australia remains behind the curve in terms of its fight against inflation. Wage pressure (chart 36) sees Australia having more risk of a wage price spiral than the US, which immigration is trying to assist with in terms of labour shortages, while this is only exacerbating the rental vacancy rate and upward pressure on housing/rental costs, which feed into CPI data. So longer term we remain very optimistic about Australia, offset in the shorter term concerns that interest rates remain with a hawkish slant.

Australian population growing by 400k again in FY24

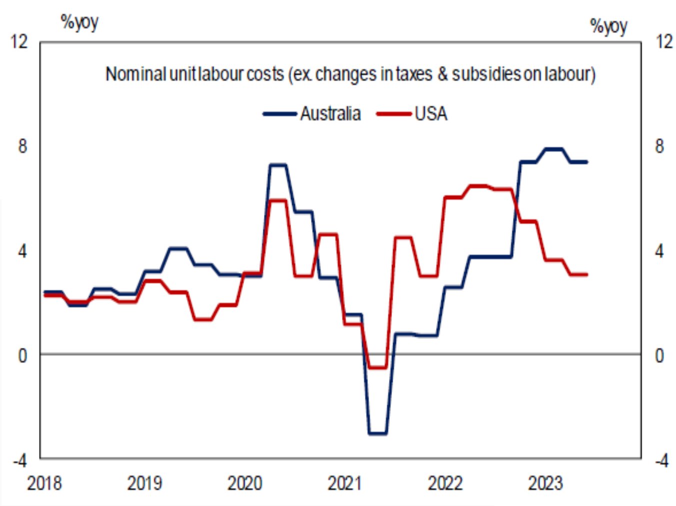
Chart 32



Source: UBS

Sticky wages and rents in Australia mean rates go up?

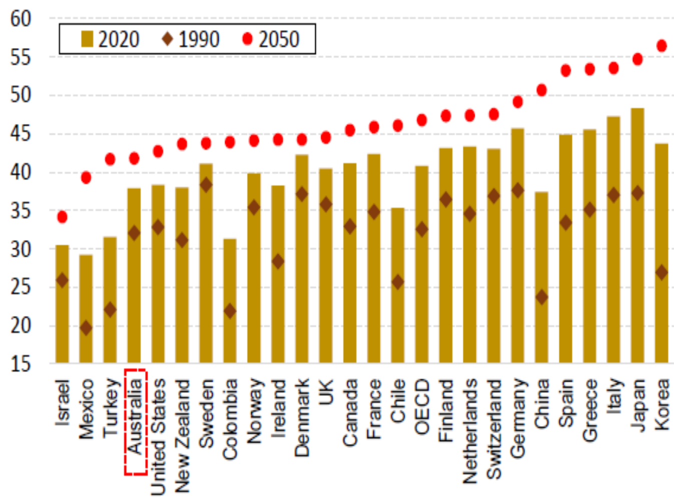
Chart 36



Source: Goldman Sachs

This results in a younger population than OECD peers

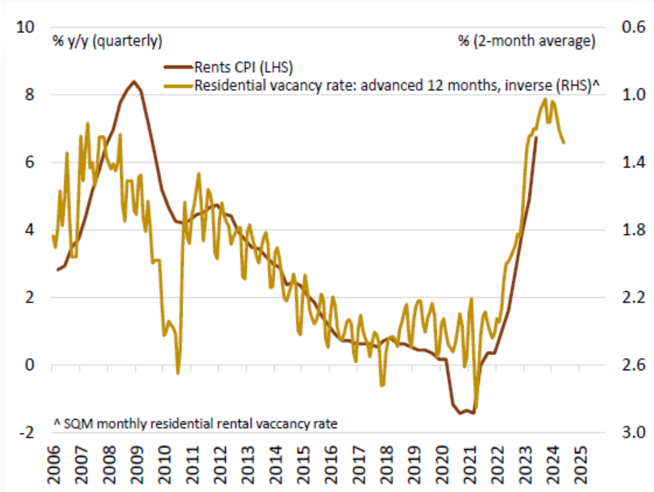
Chart 33



Source: UBS Big Australia report

Rental vacancy tightness impacting CPI significantly

Chart 35



Source: UBS Big Australia report

Capital will flow where growth goes

Chart 34

2020's (f'cast)		2030's (f'cast)		2040's (f'cast)	
Philippines	1.8%	Australia	1.2%	Australia	1.0%
Australia	1.3%	Philippines	1.1%	Philippines	0.9%
Malaysia	1.2%	Malaysia	0.7%	Canada	0.5%
India	0.8%	India	0.6%	Malaysia	0.4%
Canada	0.8%	Canada	0.6%	India	0.4%
Indonesia	0.8%	Indonesia	0.5%	Indonesia	0.3%
New Zealand	0.7%	New Zealand	0.5%	New Zealand	0.3%
France	0.5%	US	0.4%	US	0.2%
US	0.4%	UK	0.2%	UK	0.1%
UK	0.3%	France	0.0%	France	-0.1%
China	-0.1%	Taiwan	-0.1%	Taiwan	-0.2%
Germany	-0.1%	Germany	-0.2%	Germany	-0.3%
Korea	-0.2%	China	-0.3%	China	-0.5%
Taiwan	-0.2%	Korea	-0.4%	Japan	-0.6%
Japan	-0.6%	Japan	-0.7%	Korea	-0.8%

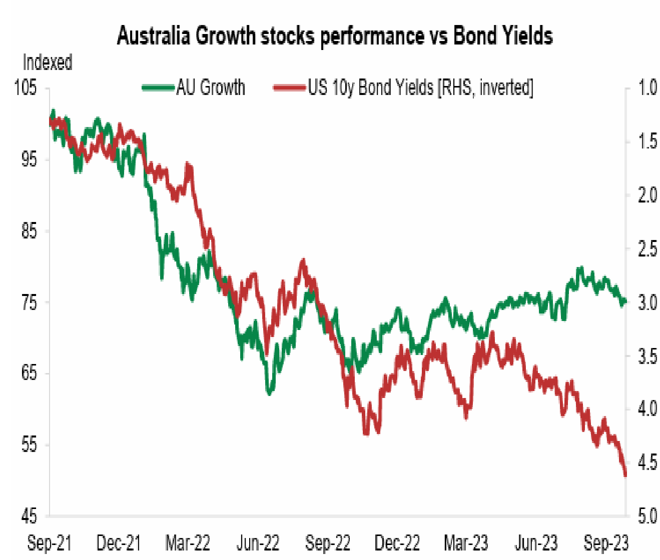
Source: UBS Big Australia report

Charts that make you go hmmm...

We often simply post some charts in the quarterly as we tend to think that sometimes, a picture is worth 1000 words. We find the simplest ideas are often the correct course of action, whereby simply, we have been surprised at the strength in long duration equities this year, given the back up in bond yields. Chart 37 highlights how this relationship has broken down this year, and if we were wagering an outcome, the growth stock premium is most likely to unwind. This is reinforced by the charts 39 and 40, illustrating the premium high quality names are trading at, while low PE stocks are still materially underappreciated. Given our bias towards seeing valuation support, we see a significant number of opportunities in this space currently, while also being incredibly mindful of how much small caps have underperformed large caps over the past 3 years (chart 38). We think this sets up as a relatively compelling opportunity for small caps with strong valuation support to meaningfully outperform over the next 3 years. Although we would say that, as that is how our fund is positioned. The catalyst we believe, will be at the first signs of interest rates being cut, whereby small caps will start outperforming the large liquid "safe havens".

Growth stocks have disconnected from bonds

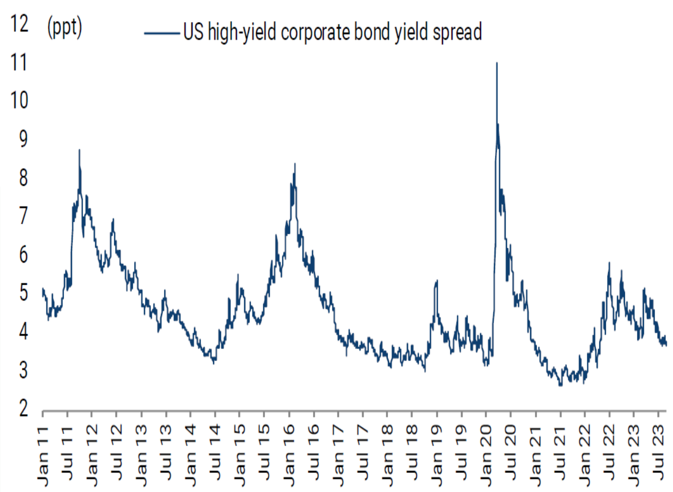
Chart 37



Source: Goldman Sachs

High yield spread is currently benign

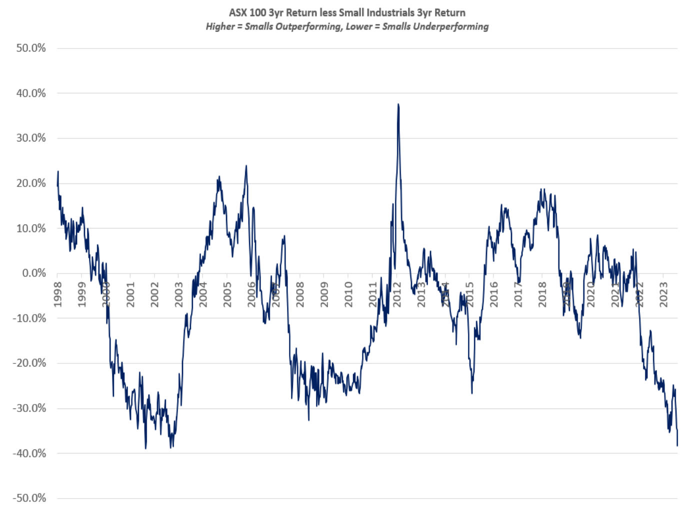
Chart 41



Source: Jefferies research

ASX small caps look very compelling on a 3 year view

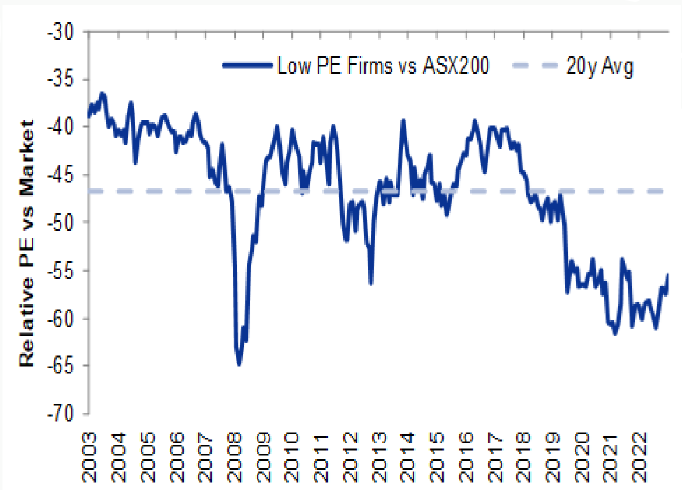
Chart 38



Source: Marlon Pickett

ASX low PE firms trading at a 56% discount to the market

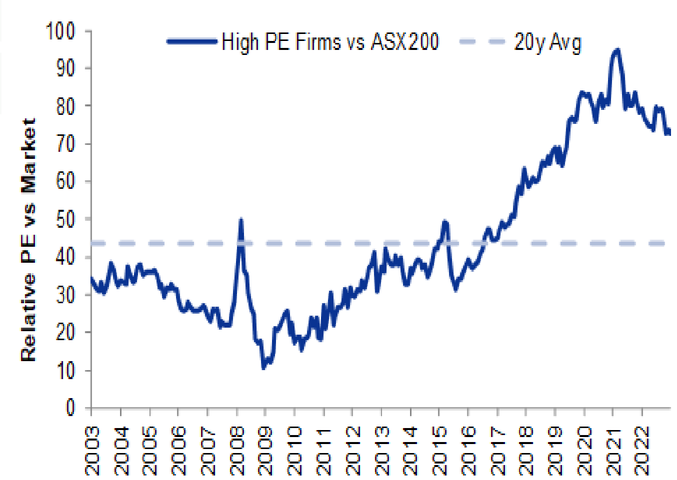
Chart 40



Source: Goldman Sachs

High PE firms trading at a 73% premium to the market

Chart 39



Source: Goldman Sachs

Executive summary

Equities

We have been surprised at the resilience of consumers and house prices in 2023 in the face of rising interests rates and the cost of living pressures. The easiest explanation for this is the decline in the savings rate, both in Australia and the US, while Australia has used immigration as a form of fiscal policy to keep demand for housing very strong. The US has used fiscal policy extremely loosely, as public debt has risen USD2.0Tn in 4 months (annualising at 22% of GDP), which is at odds with monetary policy trying to tighten financial conditions. While CPI data has come off highs, it remains above the 2% target range, which may keep the hawkish rhetoric from policy makers longer than we previously thought. In our view, it will take an acceleration of unemployment numbers to both ease wage pressures and signal a change in policy is near. The obvious wildcard in this decision matrix is geopolitical tension, which given the current tension in the middle east, will create uncertainty for both policy makers and government planning. Wars tend to be inflationary given commodity pressure and security planning. China remains a swing factor, as to exactly how stimulatory their monetary policies will be this year to reignite the economic growth engine. We approach China with caution given the banking system leverage, high property prices and an ageing demographic, while still being heavily reliant on export markets (their manufacturing base) to generate GDP growth, aggressive stimulus may well be needed if the current deflationary forces in China continue.

Our view remains that real assets (property, agriculture, commodities, gold) will outperform capital light or long duration assets over the coming period, where we still see a wide valuation dispersion that needs to unwind. We believe inflation decelerates over the next 12 months, but remains somewhat embedded due to localisation of supply chains, decarbonisation, capital investment and a reversal of cheap labour arbitrage from emerging markets over the past 20 years. We are also mindful of the relentless deficit spending in the US, which is accelerating, and needs to be funded, somehow. Our thesis leads itself to see continued pressure on the USD, combined with strong energy transition tailwinds and an underfunded energy sector, which we believe, sets this decade up for an outperformance of commodities relative to financial assets, which again ties into the notion of real assets providing strong returns.

From a strategic perspective, we see far more reason to be allocating capital to essential services than discretionary sectors over the next 12 months, as eps pressure on discretionary spending we think will intensify. We are also of the view that PE re-ratings are a thing of the past, hence earnings will be the only driver of stock prices going forward, meaning a far more fundamental investment process will provide superior returns over the next 2-3 years. We believe Australia is well placed to benefit from this trend over the coming decade, with an enviable lifestyle and strong (if somewhat flawed) democracy. As a primary producer of agriculture and commodities, we are well set up to continue to prosper as a nation, which should all else being equal, attract global capital and labour via both skilled and unskilled migration. Whilst this may appear contradictory (relative to our positive stance on Australia), we remain cautious on China in spite of the likely stimulus packages prior to year end. Hence our commodity exposures are energy, battery materials and agriculture over iron ore. At a sector level, we see merit in the idea that insurance is looking attractive from a valuation perspective, energy and healthcare should see earnings resilience in this environment while gold equities look fascinating from a sentiment perspective. Bull markets historically follow bear markets and in that context, small caps tend to perform better as risk appetite increases. Perhaps this is too early, but we do try to prepare for outcomes, rather than predict outcomes (as this is heavily reliant on monetary policy settings).

By and large, our stock selection framework continues to focus on:
Real assets- **AZJ, MIN, QUB, AGL, BXB, STO**
Valuation margin of safety- **QBE, SUN, LLC, ASB, SM1**
Pricing power- **CSL, RMD, LNW, TLC**
Gold- **WGX, SPR, GMD**
As we have demonstrated over the past 10 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.

Government spending and bond yields

The enormous increase in deficit spending through the pandemic response has left 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 are under enormous strain with the amount of debt issuance by central banks, and it appears we are in the throws of finding out where the clearing price is for the US 10 year bond. Maybe we have reached peak bearishness, but this itself hasn't been reflected in the price of long duration equities. Obviously the current environment challenges this thesis, but inevitably there is an absolute structural ceiling on how high interest rates can go before the US government is technically insolvent. With this backdrop, the only way the debt burden to society gets repaid, is through asset reflation, or in some cases, debt forgiveness. Central banks (led by Japan) have had no other playbook since the GFC, and will continue to issue new bonds to finance the deficit spending of governments and the debt burden. Since Alan Greenspan, Fed governors have always issued a "put" on the stock market with new easing policies, which in the next sharp downturn, eventually becomes yield curve control, and ultimately direct equity purchases, if needed. Jay Powell has given no indication of this event currently, hence it is far too early (with no signs of credit stress apparent....yet) to prepare for the Fed to support asset prices, in fact it appears the Fed is intent on seeing further demand destruction (removing wage pressure from the inflation indicators) before a "pivot" eventuates.

Chester High Conviction Fund

Quarterly Thoughts

October 2023

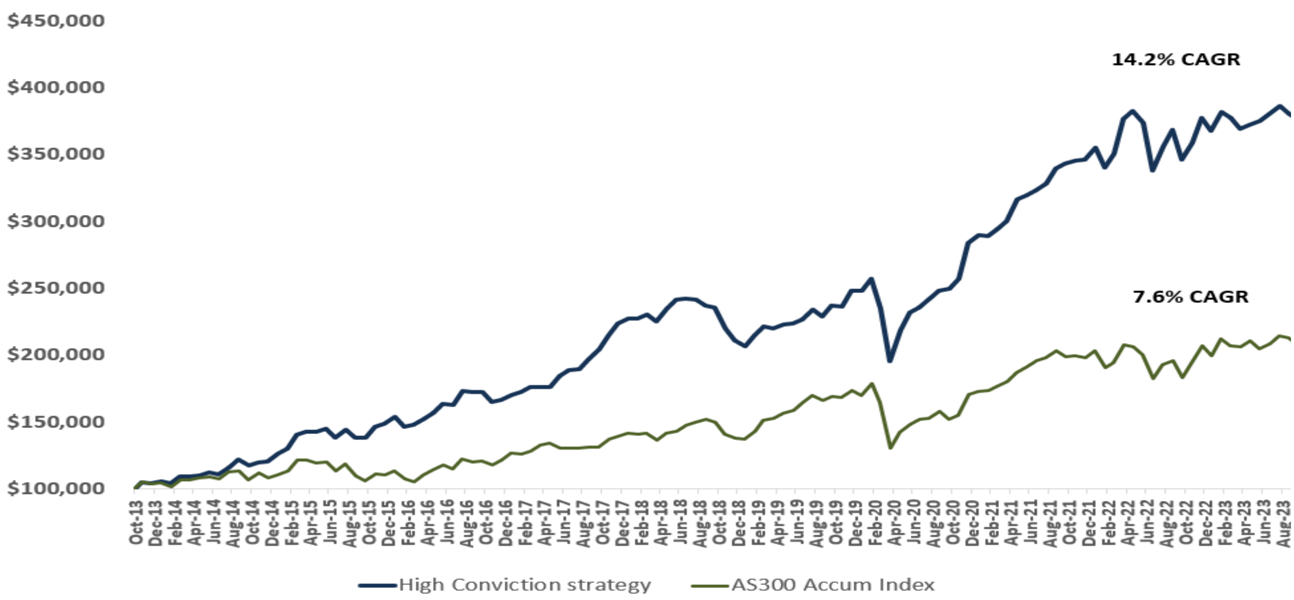
APIR OPS7755AU
ARSN OPS7755AU

Accumulated Performance by Financial Year - Same Strategy

	FY14 (%)#	FY15 (%)	FY16 (%)	FY17 (%)*	FY18 (%)	FY19 (%)	FY20 (%)	FY21 (%)	FY22 (%)	FY23 (%)	FY24 (%)	Since Incep (%)
Same Strategy (after MER)	+11.2	+24.5	+17.4	+11.2	+28.3	-6.4	+3.9	+37.2	+4.8	+12.5	-1.2	+14.2
S&P/ASX 300 Accum Index	+7.8	+5.6	+0.9	+9.1	+13.2	+11.4	-7.7	+28.5	-6.8	+14.4	-0.8	+7.6
Value added (after MER)	+3.5	+18.9	+16.4	+2.1	+15.1	-17.8	+11.6	+8.7	+11.6	-1.9	-0.4	+6.6

Per Annum. The inception date of SGH Australia Plus was the 8th of October, 2013, where Rob Tucker was the sole Portfolio Manager, until his departure on February 28th, 2017.
* The inception date of the Chester High Conviction Fund was April 26th, 2017, hence FY17 reflects 8 months of SGH Australia Plus and 2 months of the CHCF.
We note this is a statement of fact of the performance achieved by the fund during the time which Rob Tucker was the sole Portfolio Manager making active decisions on the SGH Australia Plus portfolio. We note performance is the record of the firm not the individual however past performance has been constructed from publicly available unit price data. Past performance is not necessarily indicative of future performance and should not be relied upon in making investment decisions.

High Conviction Strategy - accumulated performance



Note this graph is representative only of the combination of the same Portfolio Manager running the same strategy, and would only represent actual returns for unit holders that invested money at inception of SGH Australia Plus, withdrew those funds at the end of February 2017 and then invested all those initial funds again at inception of the Chester High Conviction Fund in April 2017. Note, this depicts returns after fees.

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