

# SGH High Conviction Fund

30 September 2023

Performance <sup>1</sup>	Total Net Return	Distribution Return	Growth Return	S&P/ASX300 Accum. Index
1 month (%)	-2.67	0.00	-2.67	-2.89
3 month (%)	1.25	0.00	1.25	-0.84
6 month (%)	2.28	3.80	-1.52	0.14
1 year (%)	10.73	5.17	5.56	12.92
3 years (% p.a.)	8.39	9.30	-0.91	10.78
5 years (% p.a.)	5.04	8.87	-3.83	6.62
7 years (% p.a.)	7.40	9.53	-2.13	7.99
10 years (% p.a.)	7.77	10.56	-2.79	7.40
Inception (% p.a.)	9.41	7.43	1.98	7.78

<sup>1</sup> Distribution Return is the return due to distributions paid by the Fund, Growth Return is the return due to changes in initial capital value of the Fund, Total Net Return is the Fund return after the deduction of ongoing fees and expenses and assumes the reinvestment of all distributions.

Past performance is not a reliable indicator of future performance.

- For the month the portfolio returned -2.67% outperforming the benchmark by +0.22%.
- The selloff in the broader market was primarily driven a sharp rise in nominal and real global and domestic bond yields, with the US 10-year Treasury bond yield rising from 4.1% to 4.6%, its highest level since October 2007.<sup>1</sup>
- The macroeconomic outlook remains uncertain with data continuing to give mixed signals about the growth outlook and whether things are overheating (inflationary) or underheating (deflationary). In navigating this environment, we believe it is important to dial down the macro noise, maintain a longer-term perspective and remain focused on the underlying earnings drivers and identifying quality companies with observable tailwinds and a competitive advantage, rather than being too perspective about trying to forecast the unknown.
- During the month Seven Group Holdings, QBE Insurance Group and Treasury wine Estates contributed strongly, while CSL, Northern Star and James Hardie were the major detractors.

<sup>1</sup> [Euro zone bond rout continues as Treasury yields surge to 2007 levels | Reuters](#)

## Key Facts

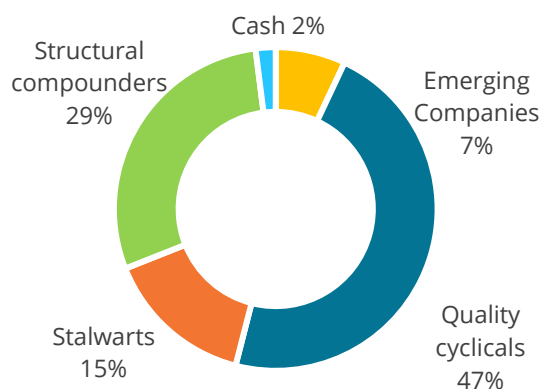
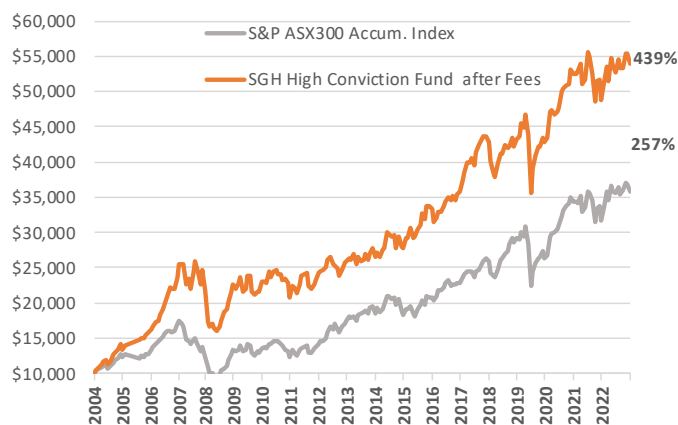
Investment manager	SG Hiscock & Company Ltd.
Launch date	28 Oct 2004
Benchmark	S&P/ASX300 Accumulation Index
Management fees <sup>2</sup>	0.90%
Performance fee <sup>3</sup>	15.00%
Fund size	\$18.1M
Dividends payable	Biannual
Buy/sell spread	+0.25/ -0.25%
Minimum initial investment	\$20,000
Base currency	AUD
APIR	ETL0042AU
mFund code	SHF01
Domicile	Australia
	<b>Unit price</b>
Application	\$1.4517
Net Asset Value	\$1.4481
Withdrawal	\$1.4445
	<b>Distribution cpu</b>
30-Jun-22	19.8711
31-Dec-22	1.4301
30-Jun-23	5.5247

**Investment objective** The Fund invests in a concentrated portfolio of Australian stocks that aims to offer long term returns in excess of the S&P/ASX 300 Accumulation Index (after fees).

**Investments held** A portfolio of 15 to 30 stocks that are listed on the Australian Securities Exchange.

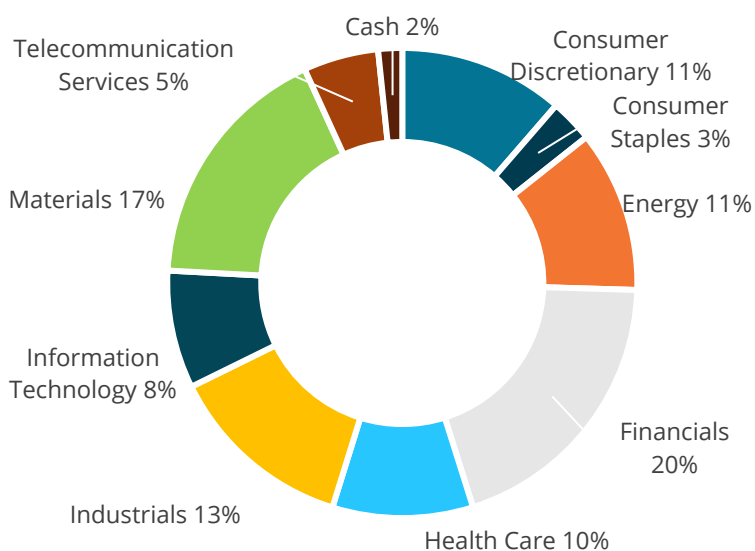
<sup>2</sup>Includes estimated GST payable, after taking into account Reduced Input Tax Credits ("RITC").

<sup>3</sup>Effective 1 Dec 2018, a performance fee of 15% (net GST and an estimate of RITC) of any investment return above the fund's benchmark may also be payable as an expense of the fund, subject to a highwater mark.



## Asset Allocation

Sector	Fund (%)
Consumer Discretionary	11.36
Consumer Staples	2.97
Energy	11.14
Financials	19.66
Health Care	9.67
Industrials	12.92
Information Technology	8.12
Materials	17.33
Telecommunication Services	5.17
Cash equivalent	1.65
	<b>100.00%</b>



## Commentary & Outlook

In September the ASX300 Accumulation Index was down 2.89% for the second successive month but finished ahead of the US market (S&P 500) which lost 4.8%.

The selloff was primarily driven a sharp rise in nominal and real global and domestic bond yields. During the month US 10-year Treasury bond yields rose from 4.1% to 4.6%, their highest level since October 2007.<sup>2</sup> Australian bonds yields rallied in sympathy almost 50 basis points to 4.5%, their highest level since 2011.<sup>3</sup>

Along with the repricing of Treasury yields, concerns interest rates will have to stay higher for longer due to sticky inflation expectations has resulted in a lift in the so called “term premium” and seen real yields, the 10-year Treasury inflation protected Securities (TIPS), increase from negative levels in 2022 to 1.59% in June and 2.27% at the end of September.<sup>4</sup>

<sup>2</sup> [Euro zone bond rout continues as Treasury yields surge to 2007 levels | Reuters](#)

<sup>3</sup> [Australian 10-year bond yields hit decade-high as traders import hawkish US Federal Reserve worries](#)

<sup>4</sup> [United States 10 Year TIPS Yield](#)

Compositionally, Energy was the only sector to post positive returns for the month. Sector losses were broad based with Real Estate (-8.5%), Technology (-7.9%) and Healthcare (-6.2%), the worst performing sectors owing to their greater sensitivity to rising real yields.

Over much of this year fears about recession have gradually faded, at least in the US, and rising confidence that inflation has peaked has supported a reasonable rally. Markets have been pricing a soft landing, peak in interest rates and re-emergence of technology deflationary forces on the back of the AI phenomena.

More recently a narrative of a resurgence in oil prices, stickier inflation, and stronger economic data, predominately in the US, has raised the risk that interest rates will need to stay higher for longer, and may even have to move higher.

This coupled with renewed debate about the US debt ceiling, subdued demand for US Treasuries by foreign buyers (particularly China and Japan) which historically has helped finance the growing US deficit have collectively contributed to the rise in bond yields.

In the absence of better growth in corporate profitability the risk is rising real yields will create growing headwinds for equities and may see markets weaken further.

Intuitively tightening financial conditions should result in weaker growth and disinflation. We continue to believe this is the most likely scenario, but the uneven nature of how higher rates are impacting households and consumers, distortions from Covid and fiscal policy initiatives make the timing and path difficult to predict.

The fact is the macroeconomic outlook remains uncertain with data continuing to give mixed signals about the growth outlook and whether things are overheating (inflationary) or underheating (deflationary).

In navigating this environment, we believe it is important to dial down the macro noise, maintain a longer-term perspective and remain focused on the underlying earnings drivers and identifying quality companies with observable tailwinds and a competitive advantage, rather than being too perspective about trying to forecast the unknown.

## Portfolio positioning & performance

For the month the portfolio returned -2.67% outperforming the benchmark by +0.22%, resulting in the portfolio returning 1.24% for the quarter ending 30 September, +2.09% ahead of the benchmark.

**Seven Group Holding (+11.2%)** continued to perform strongly following a solid full year 2023 result in August which showed ongoing signs of operating momentum in its core Coates and Westrac businesses, and investment in Boral. We expect solid earnings growth over the next few years to continue to be underpinned by the ongoing turnaround in the Boral business and sustained demand for mining parts/ service at Westrac given aging fleet and rebuild activity.

Seven Group has also signalled plans to take a more active approach in managing its 28.5% investment in Beach Energy. Ryan Stokes recently announced he will re-join the board and this coincided with Brett Wood being appointed CEO starting in the new year. Brett is an experienced oil and gas executive from Santos who we know, and who has a strong engineering and geo-science background and track record in project delivery. This should help in providing greater focus and supervision to the Watsia project, which has been a repeated source of disappointment over the last few years with reserve downgrades, sub-contractor issues and start-up delays in bringing the gas

processing plant on-line. We increasingly see a path to latent value being unlocked over the next 12 months as the Watsia project is derisked.

**QBE Insurance Group (ASX: QBE +6.9%)** also performed well during the month being a perceived beneficiary of rising bond yields and potential for interest rates to be higher for longer. Over 50% of QBE's investment book is in corporate bonds which have been less impacted than longer dated Treasuries, and in an environment of sustained higher rates this is positive for insurers. When combined with the benefits from the hardening of the premium rate cycle and improving underwriting conditions this continues to be supportive for higher returns and the insurance sector.

**Treasury Wine Estates (ASX: TWE +3.4%)** also outperformed during the month on continued speculation that the Chinese tariffs on Australian wine could be relaxed following the recent decision to remove duties on Australian barley. We currently don't assume any tariff removal by China in our forecasts, but should it happen and TWE is able to regain half of the 300k cases it lost over the next 3 years, we estimate it would add around 12-15% to group earnings.

During the month Treasury also announced that CFO Matt Young would be replaced by Stuart Boxer. Mr Baxter is an experienced executive with strong listed financial and strategy experience who prior to joining TWE we have known through his roles as Executive General manager of Strategy at DuluxGroup and as CFO at South Cross Broadcasting.

**CSL (ASX: CSL -7.8%)** was the biggest detractor to performance during the month and has underperformed the market over the last quarter. The healthcare sector more generally has underperformed on rising rates as longer duration valuations have come under pressure. However, the slower than expected recovery in CSL's Behring plasma business post pandemic, concerns around FcRn disruption to immunoglobulin (IVIg) treatment for neurological disorders and questions around its acquisition of Vifor has also arguably been weighing on the share price. After a period of relative stability there has also been a degree of change in CSL senior management team. In March Paul McKenzie succeeded Paul Perreault as CEO and in June Andy Shmeltz joined CSL and became Executive Vice President of CSL Behring with Bill Campbell Executive Vice President, Chief Commercial Officer to retire in December. This has arguably added to the uncertainty around the recovery in plasma margins, competitive risks, and acquisition integration and whether the company can return to the margins and returns the business historically earned.

Having followed CSL closely since IPO we have seen the company go through several changes and cycles. The acquisitions of ZLB Bioplasma, Aventis Behring and Novartis flu business have all resulted in step changes in CSL's business, but at the time were treated with a degree of scepticism and uncertainty. Similarly in the early 2000's there was concern around oversupply of plasma and competition and price discounting which weighed on performance and the share price.

We are conscious that CSL operates in an extremely dynamic and competitive environment, and given the price paid for Vifor and step out into a new therapeutic area it is unlikely we are going to know for some time whether the deal will deliver. This adds complexity and uncertainty, however, we believe the current share price is providing an opportunity to own a quality business at an attractive margin of safety.

The recent result provided encouraging signs that the Behring business is starting to recover and plasma collections and margins are improving. The recovery has been slower than expected but importantly IG demand remains strong providing increased confidence plasma gross margins have the potential to trend back to pre-pandemic levels over the next 3-4 years.

We also believe at current prices little is being ascribed to the optionality in the R&D portfolio, which has grown significantly in terms of growth in therapeutic opportunities and candidates outside CSL's current core immunology and vaccine areas, including gene therapy, organ transplant, respiratory and cardiovascular and metabolic.

CSL currently has a number of candidates in advanced stage trails with imminent data reads outs and potential to become commercial products including Garadacimab (a differentiated treatment for hereditary angioedema (HAE)) which is pending regulatory approval), Clazakizumab (which is in Phase 3 trials for the potential treatment of active anti-body mediated rejection (AMR), a leading cause of kidney transplant rejection) and CSL112 (aimed at preventing acute coronary syndrome (ACS) and major adverse cardiovascular event (MACE) which is in Phase 3 with expected data read out in early CY2024).

R&D success is never guaranteed, but we estimate the post-tax investment rate of return (IRR) on CSL's R&D investment in new products and market developments over the last 20 years has been greater than 20%. Assuming CSL can show similar success it implies significant latent value and optionality which is not being reflected in the share price.

**Northern Star Resources (ASX: NST, -11.7%)** underperformed with the entire gold sector under pressure owing to the sharp rise in real bond yields. Macro aside, we continue to like the name owing to its low-cost operations coupled with strong production growth over the medium to long term which is entirely self-funded.

Another key detractor was building materials manufacturer **James Hardie Industries (ASX: JHX, -10.9%)**. In addition to the general selloff particularly for growth style names, the stock this month effectively gave back all the gains it made off the back of its stellar August results. This was following the release of the US Homebuilder sentiment index which hit a 5-month low as higher mortgage rates risked pushing prospective buyers out of the market. We continue to believe that the quality of JHX's products will continue to enable market share gains over time, whilst recognising that most of its business stems from Repair and Remodel (R&R) rather than new builds, which should continue to see lower volatility as resiliency for this business has been well demonstrated in the past.

## SGH High Conviction Fund - Overview

### What makes us different?

- High conviction benchmark unaware portfolio holding 15 – 30 stocks
- Focus on quality businesses that are sustainably growing free cash flow and improving returns
- Focus on capital preservation and absolute returns for shareholders
- Disciplined repeatable process to stock selection and portfolio construction

### Investment Philosophy

The core premise of our philosophy is to invest in companies that deliver absolute returns for investors, with a strong focus on capital preservation. In our view this is best achieved by investing in quality businesses that can deliver sustainable value creation over the medium term, rather than simply investing in companies because they are a significant part of an index.

We allocate capital only to high quality ideas where we have conviction, believing only a few quality ideas are required to build a good portfolio. We do this through investing in quality companies which are sustainably growing free cash flow and returns and are mispriced. We believe price is what you pay, and value is what you get, and valuation discipline is fundamental to investing and creating longer term shareholder value.

### Investment Strategy & Process

SGH High Conviction is a concentrated portfolio holding 15-30 stocks. Our focus is on identifying businesses with 'quality sustainable growth' that are mispriced. We do this through a disciplined and repeatable process that seeks to identify companies which are:

- Sustainably growing free cash flow and returns
- Well-positioned in attractive end markets with a source of competitive advantage
- Appropriately structured and have a sound balance
- Lead by engaged, focused and innovative management Where we are satisfied companies meet these criteria, they are eligible for portfolio consideration subject to valuation. A range of valuation methodologies are used depending on the nature of the business.

As part of our process, we undertake an extensive company visitation program which is important in providing 'insight' in developing and testing our thinking, understanding and investment thesis. We seek to know as much about our companies as possible, with a view to mitigating permanent capital loss.

The portfolio construction process is determined by our confidence and conviction in the underlying quality of the business and margin of safety to valuation. It is also influenced by top-down economic considerations and industry and company life cycle risk characteristics.

## Distribution team



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The Fund's Target Market Determination is available on the [SGH website here](#). A Target Market Determination is a document which is required to be made available from 5 October 2021. It describes who this financial product is likely to be appropriate for (i.e. the target market), and any conditions around how the product can be distributed to investors. It also describes the events or circumstances where the Target Market Determination for this financial product may need to be reviewed.

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