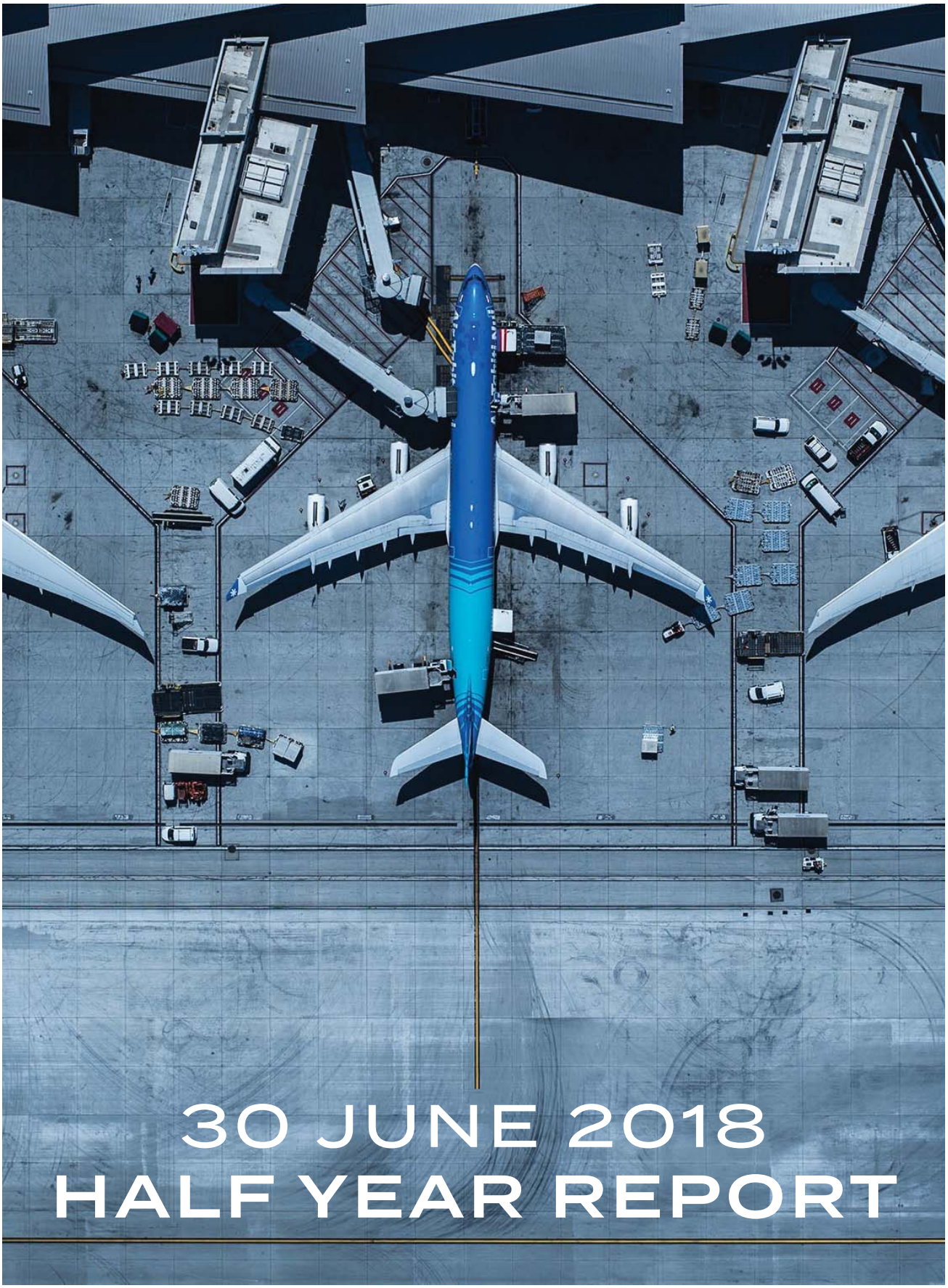


30 JUNE 2018
HALF YEAR REPORT

CAPTURING
OPPORTUNITY

SGF

WWW.SGF.COM.AU

STRATEGIC GLOBAL FUND

ARSN 613 886 392 | APIR OMF0027AU

SGF

MR. JOHN SAMPSON
PORTFOLIO MANAGER

Structure: Global Equity Fund, unhedged

Minimum investment: $20,000

Unit valuation: Monthly, Sydney Business Day

Period: 1 January 2018 to 30 June 2018

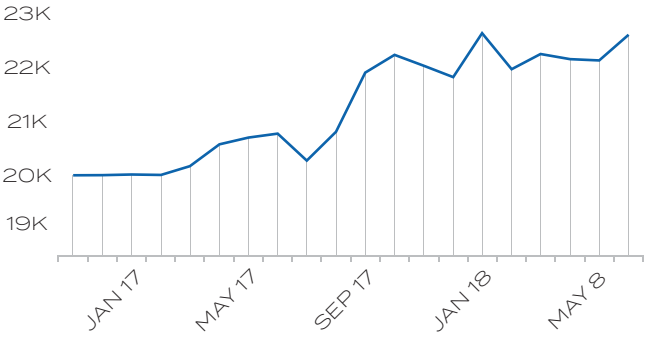
Base currency: AUD

Performance measure: Time Weighted

Return Performance for the period[1]: 4%

[1] The performace figure is net of all fees and expenses

CUMULATIVE PERFORMANCE



Value of $20,000 invested since inception

The value of your investment can rise or fall. Past performance is not necessarily indicative of future performance. Assumes distributions are reinvested.

FUND FEATURES

Specialised Global Equity Fund, $AUD unhedged

- Invests globally in strong businesses with sustainable competitive advantages
- Relatively concentrated portfolio
- Benchmark unaware
- Maintains long-term investment horizon

DISPOSITION OF ASSETS TOP 5 HOLDINGS

COMPANY	INDUSTRY
Altice USA Inc	Communication Services
BBX Capital Inc	Consumer Discretionary
Genworth Financial Inc	Financials
Altice Europe NV	Communication Services
American Axle & MFG	Holdings Industrial

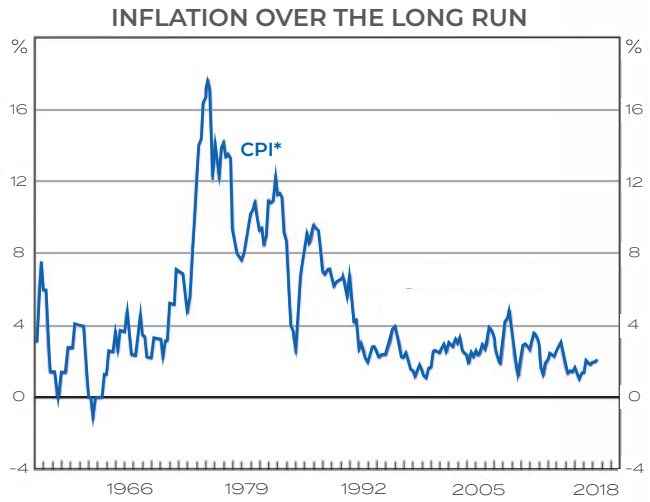
ALLOCATION BY REGION

REGION	30/06/2018
Australia	16.48%
North America	60.04%
South America	1.92%
Europe (incl UK)	14.94%
Asia (incl Japan)	6.61%

MACRO OVERVIEW

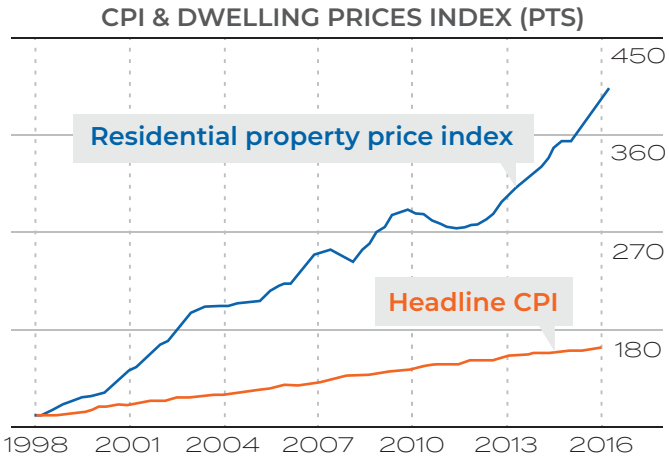
Stuck between a rock and a hard place: the difficult environment facing investors today

Investors, or "savers", are in a particularly tricky spot in the current environment. Why is this? The primary difficulty savers face stems from the likely level of inflation in the future versus the return that can be reliably achieved on their investment savings. Inflation is the increase in your cost of living increasing year on year. As time marches on, a dollar today will purchase less goods or services in the future as compared to today. This inflation is typically estimated by changes in the consumer price index (**CPI**) which measures price changes in a sample basket of consumer goods and services purchased by households whose prices are collected periodically. CPI is also a key basic benchmark used by the Reserve Bank of Australia to set official interest rates. Inflation is largely considered to be contained in many countries around the world. The following is a graph from the Reserve Bank supporting that notion:



Source: Reserve Bank of Australia

The problem with CPI it that it does a pretty poor job of measuring increases in the cost of living that each of us would consider are relatively important to how we wish to live in the future. To us, the CPI measure always feels too low. It doesn't suit Governments to have inflation that is too high or too low. If the rate is too high, then it means interest rates must move higher which in turn places greater pressure on the serviceability of government debt making it more expensive. So, CPI becomes a figure that is prone to manipulation by varying what is included in the index. Should bananas rise in price, the index will drop them for apples. Should the price of beef increase, it will be assumed that consumers will switch to a cheaper meat, even if the reality on the ground is different. Problematically, land costs aren't included in the official inflation numbers[1]. If inflation statistics are adjusted to include house price increases, the picture looks very different indeed:



Source: Commonwealth Bank of Australia

It is a fair assumption that real inflation will continue at a far higher rate than the current inflation target set by the Governor of the Reserve Bank of Australia of between 2% and 3% per annum. At the lower end of this scale, this means that in 15 years time, what costs $100 today will cost $135 from inflation of 2% per annum. For savers to maintain their current purchasing power, they will need to grow their wealth by at least 2% per annum just to **maintain** their current position. This didn't use to be as tricky an issue as it is today.

1 The reason given by the Reserve Bank for not including changes in housing costs is that the purchase of an existing home is a transfer within the household sector, implying zero net expenditure by the household sector. Try asking anyone aspiring to purchase a house if an increase in housing costs will be relevant to their view of what constitutes an increased cost of living.

Where can savers turn today to earn an adequate return on their savings in the current environment?

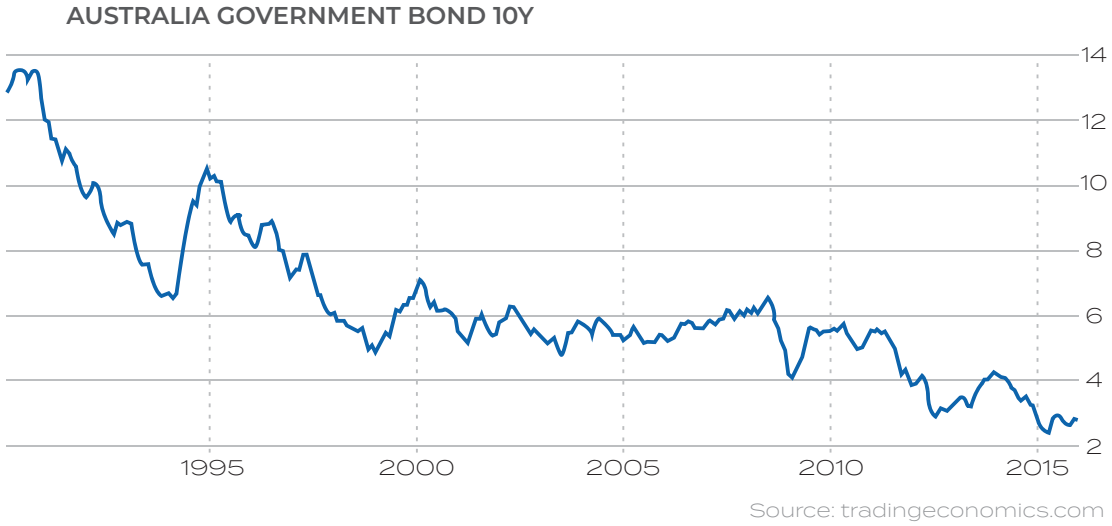
MONEY IN THE BANK

As we have written previously[2], interest rates are as low as they have been in human history. As a result, putting money in the bank won't work. Interest rates are trending upwards but they are moving from a very, very low base.

BONDS

How about purchasing bonds (debt issued by companies or governments)? The interest rate on Government bonds is not enough to justify the investment and in many countries Government bonds have a **negative** yield. That is to say, you pay the borrower for the privilege of lending it your money!

That leaves corporate bonds. The problem here is that many bonds essentially will guarantee a loss as interest rates increase. Interest rates move inversely to the bond price. As interest rates go up in the wider market, existing bond prices will go down (all else being equal). The other pertinent problem is that companies, being the issuers of bonds, are very indebted on the whole. This is fine when interest rates are very low. This will become a lot riskier when interest rates inevitably begin to rise. You may find a bond that is currently yielding 3.5% but the problem is that there is no point earning such interest if you are going to lose many times that on your capital. Accordingly, we view bonds as an area to avoid. Savers therefore must go elsewhere to obtain a satisfactory return.



PROPERTY

Property has been a popular long-term investment option for many investors with memories of the strong returns of around 7% per annum over the past 15 years.[3] Today however, high property prices have low yields that are pressured by the holding costs of rates, taxes and maintenance repairs. Such holdings costs can absorb half of the rental yield. Long-term property values ultimately depend on affordability which, in turn depend on wages and interest rate levels. The upward trend of interest rates will ultimately have a large impact on property prices. Although property has been a decent option previously that is looking less likely to be the case going forward. The Hayne Banking Commission and consequent restrictions on bank lending and tighter credit availability are likely to put ongoing pressure on this sector. As the fundamentals for the sector begin to look wobbly, we believe it is a less secure option.

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[2] "The dangers of investing via the rear view mirror": www.sgf.com.au/news/2017/2/5/the-dangers-of-investing-via-the-rear-view-mirror

[3] Australian Bureau of Statistics, 2018, Residential Property Price Indexes: Eight Capital Cities, Mar 2018, 'Table 01. Residential Property Price Index, Index Numbers and Percentage Changes , cat. no. 6416.0, viewed 07 August 2018, www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/6416.0Mar%202018?OpenDocument

ETFs

Are the popular passive investing products the answer for investors?

iSHARES ETFs	
INCEPTION DATE 03/12/1996	ANNUALISED RETURN SINCE INCEPTION (%)
MSCI Australia	7.87
MSCI Austria	5.60
MSCI Belgium	5.82
MSCI Canada	8.03
MSCI France	6.65
MSCI Germany	6.19
MSCI Hong Kong	5.99
MSCI Italy	4.14
MSCI Japan	0.96
MSCI Malaysia	2.01
MSCI Mexico	6.73
MSCI Netherlands	5.97
MSCI Singapore	3.02
MSCI Spain	9.25
MSCI Sweeden	9.25
MSCI Switzerland	7.58
MSCI United Kingdom	5.45

Source: Blackrock Investment Management

Exchange-traded funds (**ETFs**) are low cost investment products that track an index, a commodity, bonds, or a basket of assets. The reason for the low cost is that there is limited brainpower employed in choosing the assets that go into them. ETFs contain a pre-selected collection of assets. There is no price discovery or research involved as the holdings are pre-selected assets. Due to the low cost nature of these products, many investors have flooded into them.

The most long standing ETFs have been around for over 20 years and the results are relatively poor. Of the ETFs with 20 year return histories or more, the average return was 5.7% per annum[4]. Keep in mind that result was achieved in an investing environment that was very supportive to a passive strategy. But, what was good in the past will likely not be good for the future. The future will hold less or no fiscal stimulus from Central Banks.

But perhaps a subset of the ETFs could be selected by investors to achieve great results? What about emerging markets over the past decade to ride the rise of China's amazing economic growth? Think again, the iShares MSCI Emerging Mkts ETF has returned 4.72% per annum over that period[5].

What about high flying categories such as technology? If an investor had the foresight 18 years ago to have selected a Global Tech ETF, they would have done a lot better than many other ETFs over the period. However, we say that with the benefit of hindsight. At the time it was not necessarily obvious that incredibly disruptive technology companies would emerge. In late 2000, Apple Computer traded for $14.44 despite having $12.66 in net cash per share, valuing the operating business at $600m. Accordingly, few saw its coming rise to become a trillion dollar company. Despite the rise of such tech giants the EFT in this sector achieved solid, but unspectacular, returns of 7.8% per annum over the past 18 years[6]. This under performed the average return of the market. The problem is that the returns in technology were not across the whole technology sector but concentrated in the FANGs; Facebook, Amazon, Netflix and Google (now called Alphabet, Inc.) and their Chinese equivalents. You had to be a stock-picker to enjoy the better returns offered by the technology sector over the past decade.

That brings us to the next problem with ETFs: everyday more money goes to passive investing strategies. More of that money flow is directed at the **same asset classes** and the **same sufficiently liquid stocks.** This money flow is substantial, amounting to $1.3 billion per day![7] This is a huge amount of money going to a very select group of stocks. ETFs continue to buy vast amounts of the same shares even though valuations are on the high side and the best days of these companies are likely well behind them. Ultimately, **price is critical to investing** and ETFs by their nature are price indifferent. And that is the problem.

The ETF flow creates a divergence between companies that are included in ETFs and those that are not. For a time, this huge flow of money to the stocks included in ETFs is a self-fulfilling prophecy as more and more dollars pour into the same large companies causing their prices to rise regardless of the business fundamentals. The danger is that this process can also operate in reverse should investors all look for the exit at the same time. We also know from history that it is wise to avoid the most hyped-up stocks as it is inevitable that high multiples will eventually lead to disappointment for investors (does anyone remember the dotcom bubble?). Excessive valuations can only depress future returns.

Markets have been very supportive for the last ten years to a price indifferent approach. Ultimately, markets will not always move up in unison and there is likely to be less fiscal stimulus in the future. For investors in passive strategies to do terribly over the next 15 years a major drop like in 2008 is not necessary. All is needed is for valuations to revert to more historic levels. That alone would cause major ETF investor misery.

4 BlackRock Investment Management: Ishares ETFs; www.blackrock.com/investing/products/product-list-fund#!type=ishares&tab=overview&view=list

5 BlackRock Investment Management: iShares MSCI Emerging Markets ETF; www.blackrock.com/au/individual/products/273417/ishares-msci-emerging-markets-etf#/

6 BlackRock Investment Management: iShares Global Tech ETF; www.blackrock.com/investing/products/239750/ishares-global-tech-etf#/

7 Pisani, B. Like a Lion: Like a lion: Roaring ETFs on pace for $500 billion this year; www.cnbc.com/2017/05/01/etfs-taking-over-1-billion-a-day-this-year-on-pace-for-500-billion.html

SGF APPROACH

Against the above investment backdrop, with the hottest (and most overpriced) stocks in the market becoming hotter (and more overpriced), less loved parts of the market hold our attention. For investors to have done well with momentum stocks in recent years, it was necessary for them to ignore the fundamentals of certain businesses and the high price multiples they were paying. We prefer to avoid such crowded investments and do our own work to find shares whose prices do not reflect their ultimate worth, that are not exposed to indiscriminate buying, and whose businesses operate independently from the general business cycle.

Our investment process is from the bottom-up, with a focus on investing in businesses rather than chasing momentum or following fashions. Our search for the very best investment opportunities has led us to invest in markets, industries and companies that are out of favour, misunderstood or going through a transition. We take great care to understand the companies in which we invest, placing an emphasis on quality, growth and free cash flow generation. Once we have found such investments, we wait patiently for the underlying value to emerge over time.

In the balance of this report we set out some of the Fund's holding's and why we believe them to be compelling.

MARKET CONDITIONS

The market conditions over the half year were particularly challenging for most markets. The calm of last year's markets feels a world away. Geopolitical turbulence from Trump-uttered escalations, such as the brewing trade wars with China, together with a backdrop of rising interest rates have turned investor sentiment negative. Other worries that have risen to the top of investors' minds include the likelihood of further interest rate rises which, if done too aggressively, risks the chance of causing a wider recession. Although we stay abreast of political events and wider economic measures, our performance ultimately depends on our company level research. The wider economic picture feels more fragile that it has in recent years but this may yet prove to be a positive for the Fund. We welcome volatility as it increases the chances that good companies become available at attractive prices. Such conditions should create a pathway for our future returns.

PORTFOLIO COMMENTARY

SGF invests in world-class businesses with durable competitive advantages. These are companies that have a competitive moat, are well-managed and have a demonstrated track record of creating shareholder value. We are very excited about the current investments in the portfolio as we look out over our projected holding timeframe.

For the most part, there was steady progress in the business fundamentals of our portfolio holdings over the half year. Although we had few losing positions by number we did suffer from a couple of disappointing 'round trips' where previously strong gainers reverted back to our entry price (see further detail below). There was a notable lack of large gainers outside of **Genworth Financial** and **Altice**. This is perhaps not a large surprise as most of our holdings are at the early innings stage of our projected holding time frame.

The major disappointment of the half year was the 'round trip' from our holdings in two Argentinian banks. We had enjoyed very strong returns from both positions, with unrealised gains of around 90%, representing a large unrealised gain for the Fund overall. However, we overstayed our welcome by failing to adequately anticipate the impact a resurgent US dollar would have on certain emerging market currencies. In the space of one week, the Argentine administration raised interest rates to 40%(!) and involved the International Monetary Fund, all of which caused its currency to drop by 30%. We acted swiftly by closing the positions as soon as it became clear that these changes will cause great difficulty in the economy in the near term. The Fund currently has no exposure to the country. We will continue to monitor the situation as we had been very impressed by much of the progress being made by the new government administration but would require the macroeconomic picture to strengthen considerably to reconsider a position. Together, although we made a modest profit on the positions overall, these "round trips" cost the Fund from enjoying a vastly more profitable year. Although disappointing, such bumps in the road are inevitable part of the process that will occur from time to time.

We are particularly encouraged by the business progress of many of our portfolio holdings, much of which is yet to be reflected in their share prices. Many of these positions are at the early innings stage as we wait for the underlying value to emerge.

One standout performer was the Fund's holding in **Fu Shou Yuan International Group Ltd** (**FSY**), which has increased by over 50% since the Fund's purchase. We keep a close eye out for companies that do something disagreeable or depressing because their ugly duckling nature tends to be reflected in the share price, so good bargains often turn up. FSY fits this mould as a funeral home operator based in China. The unpalatable nature of the industry goes a long way to preventing much in the way of competition. We have witnessed the amazing long term performance of such businesses in the Western markets and believe FSY's growth trajectory should be similar.

PORTFOLIO

Some interesting companies in which the Fund holds a position include:

MagnaChip Semiconductor Corporation

MagnaChip Semiconductor Corporation (**MagnacChip**) is the second largest supplier (in a duopoly) of active matrix OLED (**OLED**) display driver integrated circuits in the world and the largest independent supplier. OLED screens are replacing LED-LCD screens as OLED are thinner, lighter, more vibrant, less power consuming (better battery life) and can be made flexible and into curved screens. Its OLED products will drive strong future growth as the adoption of OLED displays becomes more prevalent in smartphones, televisions, tablets, virtual reality headsets, and more. Under-appreciation for the shift in the business and lack of sell-side coverage make the company an OLED diamond-in-the-rough. MagnaChip recently reported year on year growth of over 80% in its OLED division, providing strong support to our belief in the ability of this business to continue to grow over the next five years. Our price target is three times the current quote.

Crown Holdings

Crown Holdings is a global metal packaging company. It is the world's leading manufacturer of food and aerosol cans and the third largest producer of beverage cans. It recently purchased Signode, a leading global provider of transit packaging for $3.9 billion. Investors have put the company in the penalty box as a result of this acquisition which we believe has created an excellent entry point into this long term "compounder". The company generates strong, consistent free cash flow and high returns on capital as the low-cost producer in its industry.

EQT Corporation

EQT Corporation (**EQT**) is an exploration and production company that produces natural gas liquids in the Appalachian Basin in the US. EQT has completed a major transformation in recent years and has narrowed its focus to its best assets. Its competitive advantage stems from being one of the lowest-cost producers in the US with one of the strongest balance sheets. The company is moving towards separating its midstream business from its production business. This transaction will close a meaningful portion of the valuation gap between EQT and its peers.

Genworth®

GENWORTH FINANCIAL

One interesting company SGF owns is **Genworth Financial, Inc.** (**Genworth**) in the US, which is a very compelling investment opportunity. Genworth is a leading Fortune 500 insurance holding company committed to helping families achieve the dream of homeownership and address the financial challenges of aging through its leading positions in mortgage insurance and long term care insurance. Headquartered in Virginia, Genworth traces its roots back to 1871 and became a public company in 2004.

Genworth used to be a huge company but it is now much smaller. It is currently subject to a takeover offer from a Chinese group. The Fund established an initial position at an average price of $3.08. The takeover offer is a cash offer of $5.40, so the upside should the deal close is close to 76%. There are two ways to win with this situation. With the Trump administration voicing a very anti-China position, the price of Genworth reflects the fact that the market does not think this takeover will close. In addition, the takeover has been hanging around for about a year. When the takeover bid was initially made it was only a 5-10% premium to where the stock was trading. The stock at one point was down by half since then. At the same time, comparable businesses in the US have risen about 40% over that time period.

The market is expecting that the Trump administration will block this deal because it is a Chinese bidder and the US administration has blocked a number of Chinese deals since President Trump came to office. We reviewed all of these transactions one by one and the common theme to the transactions that were blocked was some form of national security issue or potentially serious consumer privacy issue. What's interesting with Genworth is that they have amended their proposal to the regulators proposing that a third party looks after all of the consumers' private data. We believe that there is a good chance that the transaction will close, and the Fund will generate a gain of 80%.

What's really interesting though, what happens if the takeover fails?

Our general view is that it is a bad idea to bet on takeovers. You need very specialised knowledge, such as having US merger and acquisition lawyers on staff. However, what's really interesting here is that after the takeover bid was announced, long term holders of the stock sold. The company will soon not be listed so why would long term holders own it?

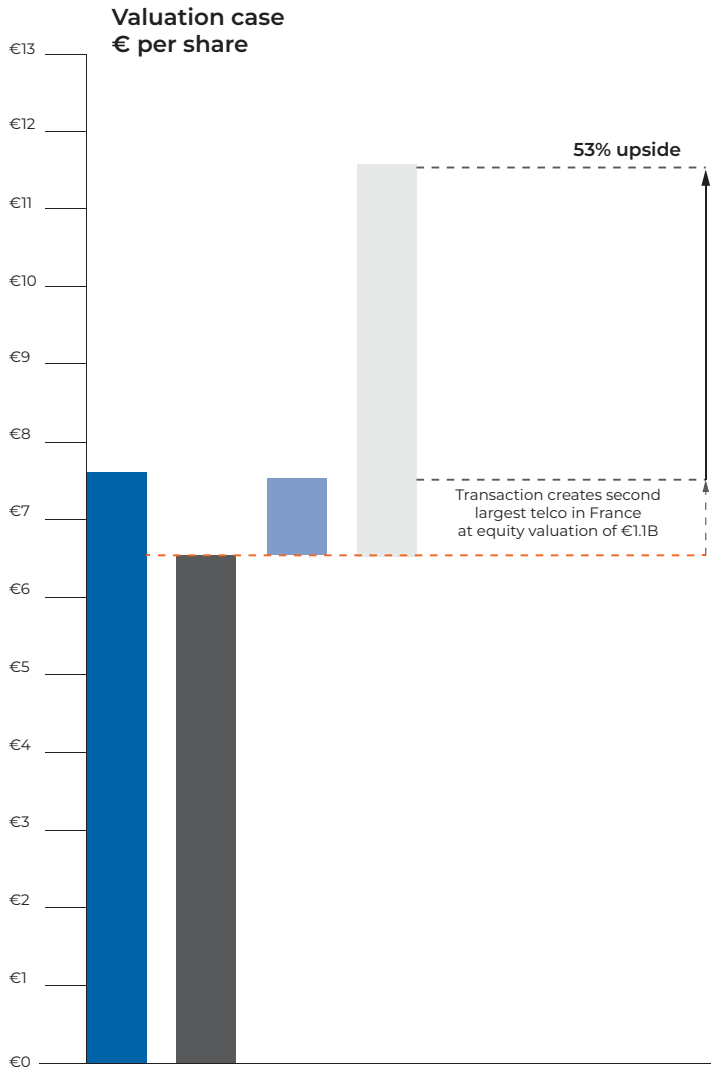
As a result, at the time of purchase, the stock price was trading at about 3.5x times earnings. A P/E of 3.5x for a good business is an incredibly rare situation. On a sum of the parts basis we reach a long-term target of about $8 to $11 per share, so should the deal not proceed, we believe that there is huge upside. Our ideal situation would be the takeover bid actually failing, given that the shares are worth around about $8 to $11. Should the takeover go through we make 76%. It is a classic heads-we win, tails-we also win. We believe it is an amazing situation so accordingly, Genworth Financial is one of the larger holdings for the Fund.

altice

ALTICE N.V.

During the half year, the Fund established a large position in **Altice N.V.** (**Altice Europe**), a substantial French telecom and media business. Altice Europe is the majority owner of a separately listed US subsidiary called **Altice USA** (**ATUS**). At the time of purchase, Altice Europe was in the process of distributing its shares in ATUS to Altice Europe shareholders. Following the completion of this transaction, as owners of Altice Europe, we were due to receive the bulk of our purchase price back in the form of ATUS shares. As a result, we were creating the leftover Altice Europe business at a purchase price of around €1 billion. We considered this a bargain purchase price for major telecom and media assets in France and Portugal. Amongst its assets are the French rights to the UEFA Champions League football competition and cell phone towers worth around €3 billion. Pre-tax free cash flow amounts to over €1 billion. The opposite graph illustrates our view on the possible upside at the time we purchased our stake.

Our investment played out largely as expected and our purchase price of Altice Europe equated to €1.02 and it currently trades at around €2.80 for a fantastic result.



Altice NV share price
€ 7.59

Value of ATUS stacks being distributed
€6.57

Net cost of "stub" - Altice NV's European business
€1.02

Base case value of European business
€15

BUSINESS UPDATE

SGF mFund Lists on the ASX

We were pleased to announce that SGF has recently listed on the ASX mFund platform. An mFund product is an unlisted managed fund admitted for settlement under the ASX Operating Rules and available to investors through the mFund Settlement Service. You can easily buy and sell units in SGF via a participating broker and the transactions are settled using CHESS, the ASX's world-class electronic settlement system. Your holdings in these funds are held electronically and can be linked to the same Holder Identification Number (HIN) used to hold other investments transacted through the ASX. This means you can track your investments in SGF using the same systems you use for shares and other securities.

STRATEGIC GLOBAL FUND

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NSW 1225 Australia

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Website www.sgf.com.au