ESCALA PARTNERS

DECEMBER QUARTER FUND REVIEW

Big tech, interest rates and discontent in China.

2023 was all about big tech, interest rates and growing discontent among investors in China.

It was also a year of surprises. 2023 defied all expectations — recessions that didn't arrive, rate cuts that didn't materialize, banks that didn't implode, bond markets that didn't bounce (except in short-lived, vicious spurts), inflation that wasn't transitory, inflation that wasn't persistent, and rising equities that pained most managers who were cautiously positioned throughout the year.

1. The year of the Magnificent 7

The Magnificent 7 account for 29% of the S&P500 market cap — that is a record. At the height of the dot-com bubble in the year 2000, the 7 largest companies comprised 22% of the US market. The question is: will the Magnificent 7 continue to be magnificent in 2024? As Newton's first law of physics states — an object will not change its motion unless a force acts on it. Momentum is a powerful factor in the US equity market — that is why you should always sell your losers early and let your winners run. Apple hit a record market cap of $3 trillion in 2021. By mid-2022 Apple had lost a third of its value. The force that stopped Apple was higher interest rates. The Magnificent 7 have already adjusted to higher interest rates. They haven't yet adjusted to slower growth. There is a risk we could get some growth disappointments. The outlook for the Magnificent 7 will very much depend on earnings this year.

Chart 1: Magnificent 7 vs the rest (Index Jan-22 = 100)

US Lg Cap ex Mag 7 Total Return Index Magnificent 7 Total Return Index
Source: Bloomberg

2. The year of the rate hike

Mortgage rates in the US hit a peak of 8% in October. In Australia they got to almost 9%. This has been the most aggressive interest rate cycle in four decades. Revolving US consumer debt is at record highs at a time when delinquencies on that debt are rising and average hourly earnings are flat lining. Spending on interest payments, excluding mortgages, currently stands at 4.5%, approaching levels near the historical peak. If the trend continues, it is reasonable to expect a slowdown in consumer spending. That would give the Federal Reserve confidence that rate hikes are working as intended.

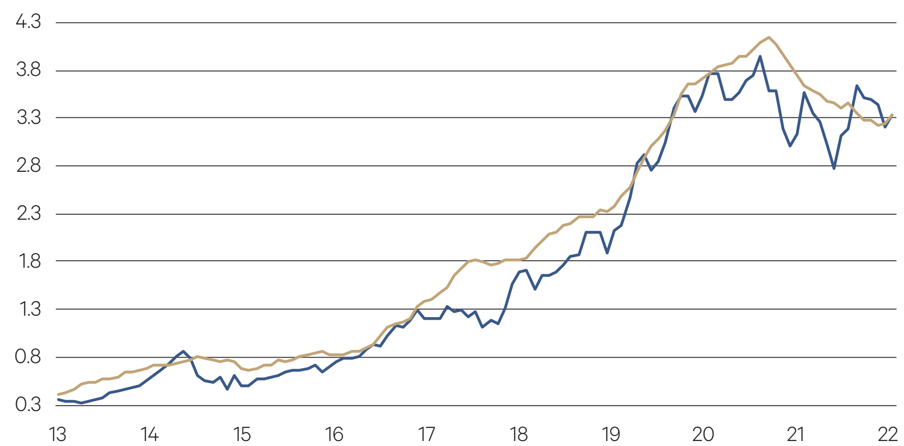
Chart 2: US 30-year fixed mortgage rate (%)

Source: Bloomberg

3. The year of investor discontent in China

Foreign presence in China's capital markets has increased markedly since Xi became president in 2013. The government carved out channels to let capital flow in, including stock and bond trading links via Hong Kong, and pushed for the inclusion of yuan-denominated assets in major global benchmarks. The goal was to encourage inflows, fund private enterprise and energise the economy — all while retaining significant control over capital flowing out. But Xi's government has shown little regard for global investors recently. In 2021 he unleashed a series of crackdowns on the country's most profitable companies. In 2022 he imposed a strict Covid-Zero policy. The result is growing distrust and confusion over the Communist Party's goals, as well as punishing losses for shareholders. Allocations to China among emerging-market equity and bond funds have fallen to the lowest in three years. The world's second-largest economy possesses a $21 trillion bond market and an equity market valued at $16.4 trillion onshore and in Hong Kong.

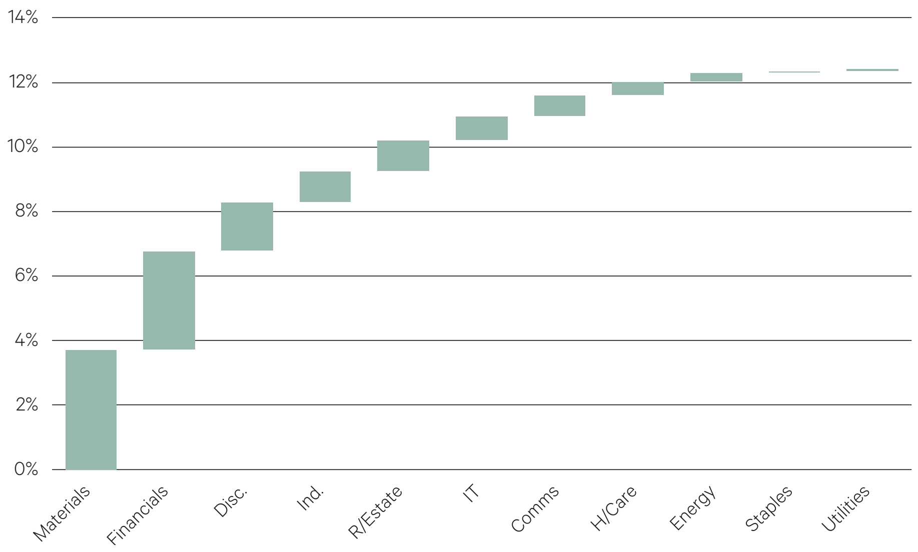
Chart 3: Foreign interest in Chinese financial assets (tn, yuan)



China domestic financial assets held by overseas entities – Bonds
China domestic financial assets held by overseas entities – Equities
Source: Bloomberg

Australian Equities Quarterly Review

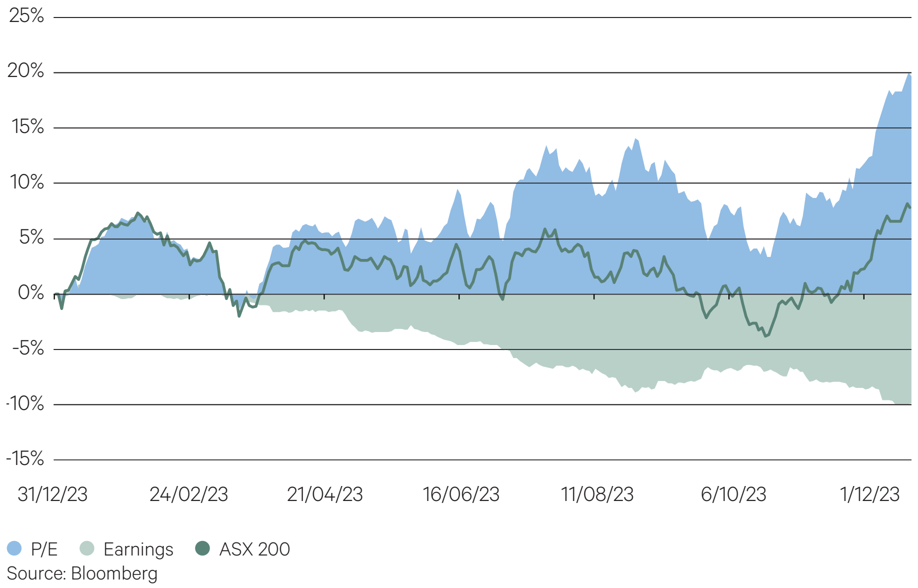
Chart 4: ASX 200 sector attribution: All sectors contributing to returns in 2023



Source: Bloomberg

While Australian equity returns were dominated by cyclical sectors in 2022 as interest rates rose sharply, performance was much more evenly spread across the market in 2023 with all sectors generating a positive total return. The large materials and financials sectors still provided just over half of the index's overall attribution, while it was the discretionary sector which defied expectations as consumer spending held up relatively well despite the sharp tightening of monetary policy.

Chart 5: P/E expansion drives the market higher in 2023



Source: Bloomberg

What drove Australian equity returns in 2023? Forward earnings estimates actually declined by 10% for the 12 month period, leaving an expansion in valuations to lead the market higher. While long bond yields ended the year at a similar level to where they started, the P/E ratio on the market expanded by 20%, lifting the market higher. This was particularly the case in the December quarter.

Australian Equities Performance Table	3 m	1 yr p.a.	3 yr p.a.	5 yr p.a.	10 yr p.a.
Chester High Conviction Fund	4.02%	6.42%	10.47%	13.64%	
Pendal Focus Australian Share Fund	7.50%	13.57%	8.52%	11.27%	9.09%
WaveStone Australian Share	8.09%	13.19%	10.21%	10.77%	9.26%
Alphinity Sustainable Share	8.76%	11.38%	7.35%	11.25%	8.80%
Selector Australian Equities	9.90%	22.39%	4.98%	10.54%	
Selector High Conviction Equity A	9.66%	20.35%	4.04%	9.65%	11.28%
Pendal Australian Share SMA	7.04%	11.97%	8.23%	10.45%	
S&P/ASX 200 Accumulation Index	***8.40%***	***12.42%***	***9.24%***	***10.28%***	***7.93%***
Ophir Opportunities Fund	7.39%	18.47%	10.24%	18.08%	17.23%
Fairview Equity Partners Emerging Co	7.35%	12.84%	4.31%	12.37%	8.71%
QVG Opportunities Fund	2.21%	9.99%	3.95%	10.86%	
Pendal Microcap Opportunities Fund	5.63%	6.21%	5.09%	13.56%	13.84%
Spheria Australian Smaller Companies	13.94%	15.91%	6.66%	10.40%	10.20%
DNR Emerging Companies Fund	8.65%	7.98%	10.75%	16.93%	
S&P/ASX Small Ordinaries Accumulation Index	***8.52%***	***7.82%***	***0.95%***	***6.40%***	***6.01%***

Key points

- The Australian market closed out the calendar year on a particularly strong note, with a rally in the final two months of the year lifting the benchmark index to a positive double-digit return for the 12 months.
- Renewed geopolitical risk in the Middle East was overshadowed by a sharp decline in long bond yields as the key driver of market performance. The Australian 10 year yield fell in sync with overseas markets from almost 5% to below 4% as investors anticipated the peak in the monetary policy tightening cycle, particularly in the US. This was despite Australia lagging most other countries in bringing inflation back to target.
- The gains across the market were fairly broad-based, though interest rate-sensitive sectors were among the strongest performers, particularly real estate and health care.
- Mining stocks also performed well, buoyed by strength in key commodities including iron ore, copper and gold.
- Among large cap managers, the market's drivers favoured more growth-orientated managers, with Selector our best performing and rounding out a strong calendar year after lagging the market in 2022.
- The beta of small caps was illustrated by falling to a greater degree than large caps in October, before rallying more across November and December.
- Spheria was a standout performer among out small cap managers, with the fund's return lifted by takeover activity among key holdings in December and contributing to the fund's 8% outperformance of the small ordinaries accumulation benchmark in 2023.
- After posting solid returns in the September quarter, QVG was a laggard in the final three months of the year after some of the fund's prior winners failed to keep up with the rally into the year end.

International Equities Quarterly Review

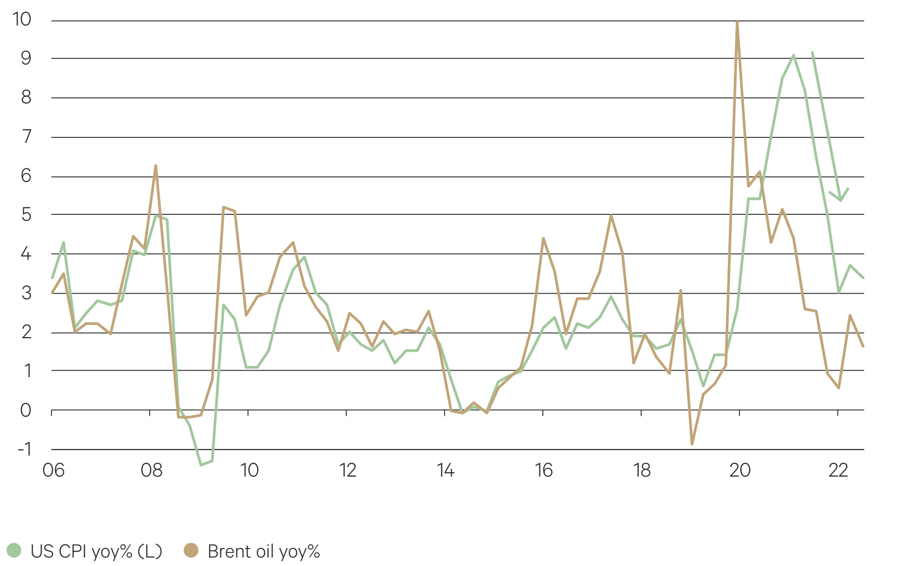
These are heady times for gold. The precious metal closed out 2023 with a weekly gain at the end of a monthly rise. That in turn capped a quarterly increase that sealed the first annual climb since 2020. The principal drivers of gold's ascent are well-known, with the Federal Reserve expected to loosen the monetary-policy shackles that defined 2023. That speaks to a weaker US dollar and lower Treasury yields. Cyclicals don't appear to have received the rate cut memo, however. Rate cuts imply slower growth. Why else would the Federal Reserve be cutting rates if not for slower growth, as implied by weaker oil and base metal prices? The historically close relationship between cyclicals/defensives and copper/gold has broken down in the past six months or so.

Chart 6: Somebody missed the rate cut memo

Source: Bloomberg

Oversupply and flagging demand growth have been the main drivers pushing down oil prices over the past few months. Lower oil prices are driving gasoline prices in the US lower. The historically tight correlation between gasoline costs and inflation expectations is in place. Consumers see prices rising 3.1% over the coming year, the lowest level since March 2021; the decline from the prior month was the largest since October 2001. Meanwhile, gasoline has slid ~18% since peaking in September.

Chart 7: Oil prices easing inflation pressure



Source: Bloomberg

International Equities Performance Table	3 m	1 yr p.a.	3 yr p.a.	5 yr p.a.	10 yr p.a.
WCM Quality Global Growth	7.61%	25.41%	5.04%	15.49%	14.51%
Royal London Concentrated Global Equity Share Fund	4.34%	33.48%	20.05%	18.48%	13.20%
Ironbark Royal London Diversified Global Equity Share Fund	4.73%	26.16%			
Barrow Hanley Global Share Fund	2.43%	13.53%	12.34%	13.24%	
Loftus Peak Global Disruption	15.33%	61.19%	10.11%	20.45%	15.33%
Munro Climate Change Leaders	5.47%	15.06%			
Impax Sustainable Leaders Fund A	7.58%	14.46%	7.00%	12.13%	
Pengana WHEB Sustainable Impact	4.68%	9.47%	1.22%	8.03%	3.66%
Stewart Investors Worldwide Sus-Class A	8.93%	13.13%	3.71%	8.04%	
ClearBridge RARE Infrastructure Income - Unhedged	7.24%	2.76%			
ClearBridge RARE Infrastructure Income - Hedged	10.23%	0.74%	4.25%		
ClearBridge RARE Infrastructure Value - Unhedged	6.28%	5.99%	8.96%	9.35%	8.46%
ClearBridge RARE Infrastructure Value Fund - Hedged	9.49%	4.16%	5.69%	8.04%	6.98%
Artisan Global Discovery	3.92%	20.77%	1.99%		
MSCI AC World ex Aus ($A)	***4.95%***	***21.60%***	***10.17%***	***12.46%***	***10.96%***
CC Redwheel Emerging Markets Fund	-2.51%	3.51%	-5.52%		
Fidelity Asia	0.28%	5.57%	1.05%	8.84%	11.20%
GQG Partners Emerging Markets Equity Fund	7.23%	30.30%	4.34%		
MSCI Asia-Pac Ex Japan ($A)	***4.23%***	***6.44%***	***-4.43%***	***4.72%***	***4.89%***
Quay Global Real Estate Fund (Unhedged)	13.26%	17.58%	8.46%	7.38%	
Quay Global Real Estate Fund (AUD Hedged)	16.93%	13.73%			
FTSE EPRA Nareit Developed Index ($A)	***9.33%***	***10.17%***	***6.43%***	***4.44%***	***7.39%***

Key points

- The MSCI World Index rose by 11.1% in the quarter. The S&P 500 index finished the quarter up by 11.2% while the Nasdaq rose 13.6%. This takes the annual gains to 24.2% and 43.4% respectively. Our tech disruption fund was a key beneficiary of this rising by 15.3% over the quarter and is now up 61.2% for the year.
- European shares again underperformed the US with the Eurostox index up by 8.3%. Energy was by far the worst-performing sector and the only one that decreased in value. Information technology led the gains, up 16.9% in the quarter and 56.4% over the year.
- Emerging market (EM) equities were up a more subdued 7.4%. Weighing on the index was a 6.2% decline in Chinese equities. China's growth recovery remains weak and policy measures remain small and targeted. Our Asian equities fund Fidelity and our broad EM equities fund, CC Redwheel, underperformed. Our GQG Emerging Market Fund performed in line with the market.
- The Australian dollar rose 5.9% against the US dollar and was up to a lesser extent against the euro and British pound. Global funds that were currency hedged therefore benefited.
- The fall in bond yields over the quarter was particularly beneficial for our more growth-oriented funds such as Stewart Investors.

Fixed Income Quarterly Review

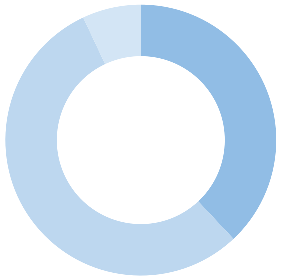
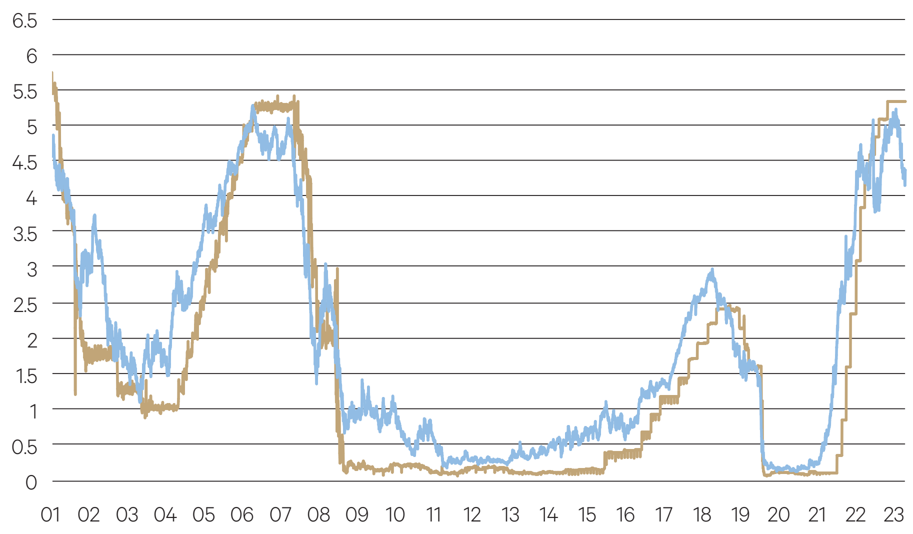


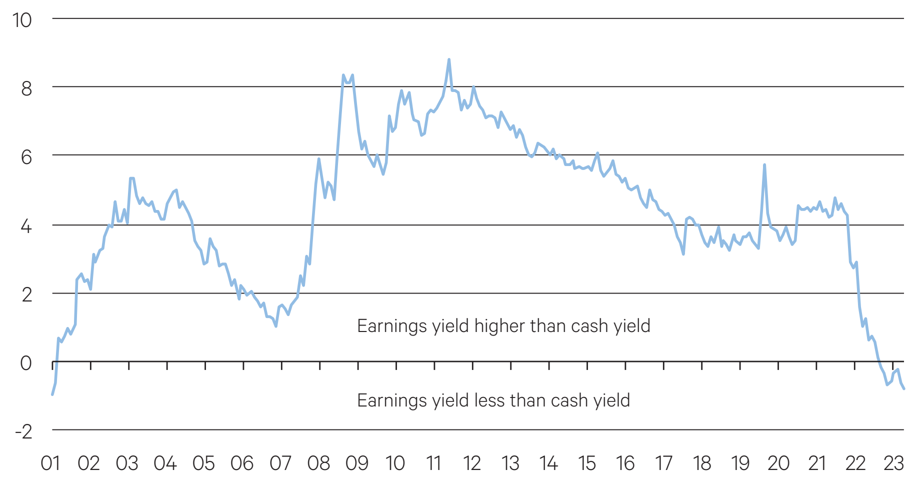
Chart 8: Yields fall, financial conditions ease (%)



US 2-yr bond yield (%) Fed Funds Rate (%)
Source: Bloomberg

Two-year Treasury yields slumped almost 45 basis points last month, making it their best December in more than two decades. Yields are down more than 80-basis points over the past two months. This represents a significant loosening of financial conditions since the release of the December dot plot and has had the effect of a de facto rate cut or two. Bond investors have been bullish on Treasuries since November, when Federal Reserve Chair Jerome Powell hinted the US central bank was done hiking rates. The bond bullish lean carried into December as inflation declined and as investors moved into positioning for year end. The trouble with Treasuries after their huge rally of the past two months is that they have priced in all the good news.

Chart 9: Yield on cash exceeds equities (%)



Source: Bloomberg

No wonder money market funds are seeing record inflows. The yield from cash now exceeds that on equities. The last time that happened was at the height of the tech boom in 2001. No wonder there is a record US$6 trillion sitting in US money market funds. In fact, 2023 saw the largest annual money-market inflow ever - a whopping US$1.2 trillion. That is the seventh year in a row of annual money market inflows. Interest rate cuts will help to make equities relatively more attractive.

Fixed Income Performance Table	3 m	1 yr p.a.	3 yr p.a.	5 yr p.a.	10 yr p.a.
Perpetual Credit Income	2.79%	9.12%	3.76%	3.83%	3.89%
Perpetual Ethical SRI Credit	2.65%	8.20%	3.64%	3.43%	
Bentham Global Income Fund	6.59%	8.09%	3.94%	4.15%	4.41%
Alexander Credit Income Fund	1.88%	7.26%	5.06%	4.37%	
Realm Short Term Income Ordinary	1.31%	5.86%	2.98%	2.90%	
Realm High Income - Wholesale	2.90%	9.78%	4.20%	4.81%	4.47%
iShares Core Composite Bond ETF	3.76%	4.96%	-2.81%	0.51%	2.48%
Bloomberg AusBond Bank Bill Index	***1.06%***	***3.89%***	***1.71%***	***1.40%***	***1.77%***
Bloomberg AusBond Composite Index	***3.79%***	***5.06%***	***-2.69%***	***0.64%***	***2.64%***
PIMCO Global Credit W	6.11%	5.87%	-3.11%	0.68%	2.67%
PIMCO Global Bond Fund – Wholesale Class	5.80%	6.30%	-2.85%	0.96%	3.18%
PIMCO ESG Global Bond Fund - Wholesale	5.86%	5.48%	-3.31%	0.68%	
Barclays Global Aggregate $A (Hdg)	***5.43%***	***5.31%***	***-3.11%***	***0.49%***	***2.63%***

Key points

- Government bond yields fell in the quarter, in particular in December and November, and yield curves flattened as short-term rates fell less than longer term yields. This reflected markets pricing in the probability of a soft-landing in the US economy. Credit spreads narrowed, consistent with this narrative.

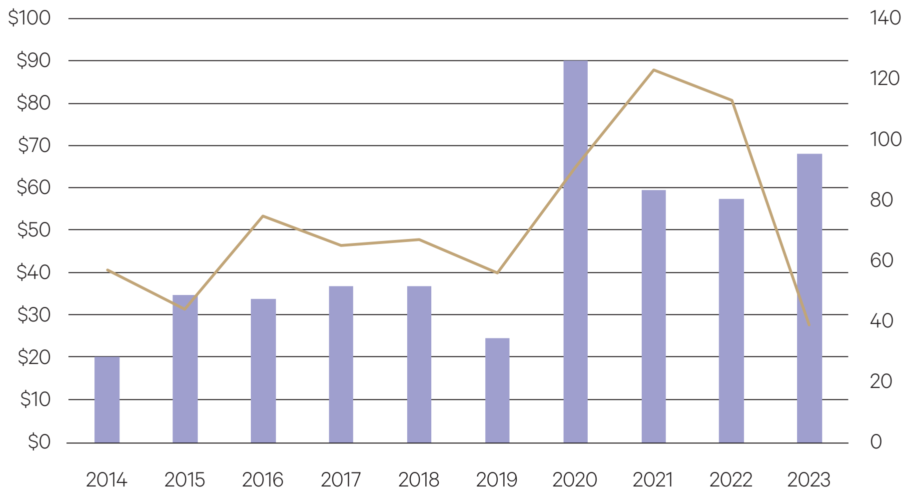
- 10-year government bond yields fell by 53 basis points in Australia and by 69 basis points in the US. The Reserve Bank of Australia raised interest rates once over the three months while the US Federal Reserve left rates unchanged at 5.5%. Germany's 10-year bond yield fell by 82 basis points while Italian 10-year yields fell 109 basis points.

- The fall in yields helped investment grade credit where duration risk is higher. High yield credit benefited from the contraction in spreads. This was beneficial for our credit funds, particularly the Bentham Global Income Fund.

- Our liquidity funds, Realm and Alexander, performed in line with expectations for the quarter.

Alternatives Quarterly Review

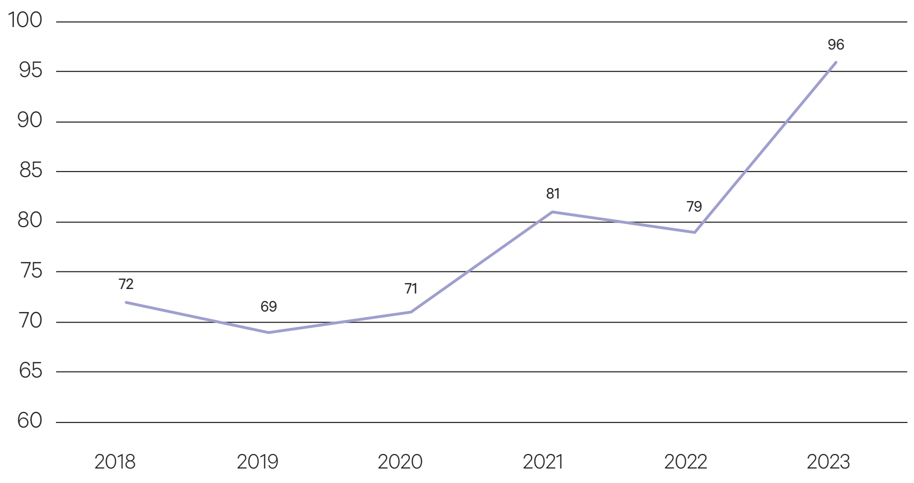
Secondaries fundraising activity



Capital Raised ($B) Fund Count
Source: Pitchbook

Secondaries fundraising, in the first nine months of 2023, has surpassed annual fundraising totals for every calendar year except 2020, hitting $68.1 billion. Given the large fundraises that have occurred through 2023, the level of secondaries dry powder is at its highest-ever level. The increased momentum in secondaries fundraising was driven by two factors. Firstly, many of the large funds that closed in 2020 have come back to market this year. Second, the gap is narrowing between buyer and seller expectations in the LP-led market. As public markets have largely recovered in 2023, valuations of LP-led portfolios in most asset classes outside of venture capital have also rebounded enough that sellers are willing to transact while still providing enough of a discount to entice buyers.

Global Private Equity backed public to private deals



Source: S&P Global

Private equity backed deals to de-list small and medium sized companies on global stock markets hit a record in 2023 as the dislocation in public markets increased the opportunity set for PE funds with large cash balances. The valuation of small and medium sized companies globally traded at some of the widest discounts to large cap stocks in recent times throughout 2023 and this created buying opportunities for PE sponsors to execute take-private transactions. Private markets, with their longer-term time horizons and more patient source of capital, have also become more attractive for many CEO's looking to execute transformational projects with their businesses.

Alternatives Performance Table	3 m	1 yr p.a.	3 yr p.a.	5 yr p.a.	10 yr p.a.
Hedge Funds					
Munro Global Growth Fund	9.31%	16.04%	1.42%	10.49%	
Tiger Global Hedge Fund *	8.75%	19.37%			
L1 Capital Long Short Fund	2.96%	6.90%	15.39%	19.94%	
Infrastructure					
Morrison Growth Infrastructure Fund †	1.69%	6.35%			
Morrison & Co Infrastructure Partnership †	9.83%	18.03%			
Macquarie Private Infrastructure Fund †	0.65%	4.35%			
Private Debt					
Merricks Capital Agriculture Credit Fund	2.67%	10.94%			
Aquasia Enhanced Credit Fund	2.45%	9.39%	5.78%	5.37%	5.99%
Merricks Capital Partners	2.21%	8.93%	8.92%	9.47%	
Realm Strategic Income Enduring	2.51%	10.11%	7.18%		
Partners Group Global Income Fund **	2.29%	15.23%			
Private Equity					
Spire Oaktree Opps XI (AUD) Frst Cls	-4.41%	5.04%	8.56%		
Alium Alpha Ordinary	-1.54%	1.87%	3.14%	8.51%	
Partners Group Global Value Fund **	-0.19%	8.77%	10.43%	11.44%	11.73%
Hamilton Lane Global Private Asst (AUD) **	0.85%	8.58%	13.99%		
Hamilton Lane Global Private Asst (Unhedged) **	-0.07%	10.86%			
Property					
Barwon Healthcare Property Fund	-0.33%	-10.41%	4.43%	6.19%	
Charter Hall Direct Office Fund	-8.90%	-17.21%	0.49%	4.46%	
Charter Hall Wholesale Property Series 2 **	-7.89%	-10.30%			
Venture Capital					
StepStone Secondaries Fund V ††	-3.13%	-6.75%			

*Performance as at 31 October 2023. **Performance as at 31 November 2023.
†Performance as at 31 September 2023. ††Performance as at 31 June 2023.

Key points

Hedge Funds

– Equity long short manager Munro Global Growth finished the quarter +9.3%. The Fund's long positions contributed positively to performance, whilst hedging and currency detracted from performance. Within the long book, artificial intelligence (AI) was a dominant theme, with holdings in software, ServiceNow, Microsoft, and Adobe all recently releasing Generative AI products that saw their share prices appreciate. Elsewhere, semiconductor enablers also contributed to performance, with Nvidia and Applied Materials the standouts.

– Equity long short manager L1 Capital Long Short finished the quarter +2.9% against the backdrop of a volatile market environment. During the quarter, stock contributors were broad-based, while weaker oil prices created a headwind for some of the portfolio's energy exposures.

– Tiger Global benefited from core positions across ecommerce and fintech. The manager continues to maintain a conservative level of exposure.

Alternatives Quarterly Review – Key points cont.

Private Equity

- Private equity (PE) markets continued to deal with below average levels of deal activity in Q4 2023 as both M&A and IPO markets remain slow, capping off what was the lowest levels of deal activity since 2016 for PE. Add-ons and consolidation of small fragmented markets was one of the bright spots for PE markets throughout the year as smaller deals were executed here.
- For the three-month period ending November 2023, our PE fund managers had muted returns as Partners Group Global Value Fund fell 0.2% whilst Hamilton Lane Global Private Assets Fund added 0.9%. To the end of November the funds had one-year returns of 8.8% and 8.5% respectively. Partners Group had positive attribution from positive earnings growth for healthcare device manufactures and climate infrastructure companies, which was offset by multiple compression across the portfolio during this period. Hamilton Lane had positive attribution from industrial and software companies reporting growing EBITDA during the quarter.

Private Debt

- Merricks Partners added 2.2% over the December quarter. Underlying loan income performed strongly across the quarter, with floating rate loans continuing to pass through rising interest rates in Australia and New Zealand. The portfolio currently comprises senior secured loans diversified across fourteen sub-sectors and is additionally diversified by geographic spread and borrowers. Credit default Swap (CDS) protection continues to provide the Fund with a cost-effective macro credit hedge.

Infrastructure

- The Macquarie Private Infrastructure Fund returned 1.4% over the September quarter. The strongest contributors for the quarter were Australian focused funds and Asia-Pacific focused funds, while these were partially offset by the volatility experienced in global listed infrastructure markets. At an unlisted asset level, the Fund's aggregate Australian airports exposure and Chinese data centre asset, Bohao, were notable contributors to their respective underlying funds.

Property

- Direct property funds continued to weaken on softening capitalisation rates, broader negative sentiment in many sub-sectors of property leading to lower transaction volumes and rising yields putting pressure on financing costs for property managers. The MSCI/Mercer Wholesale Property Index finished the year to December 2023 down 7.5%. Direct office property has been worst affected by widening capitalisation rates and higher interest rates affecting total returns for investors. For the fourth quarter, Charter Hall Direct Office Fund fell 9.7% whilst the Wholesale Property Series No.2 finished down 8.3%.

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