JM Financial Group

Issue 10: February 2016

Investment Newsletter

Market Performance (As at 29th Feb 2016)	February 2016 (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P - All Ords Accum. Index	-1.47%	-6.78	-12.23

Month in Review - *A review of events that influenced the share market in February.*

February was another tough month for equity markets with the Half Year Reporting Season highlighting the impacts the China slowdown, the oil price fall and the increasing global debt burden are having on the business environment and the wider consumer.

Although the All Ordinaries Index fell over 2% across the month the composition of the fall was intriguing with the Top 200 Resources Index rising 6% and the Top 200 Industrials Index falling over 3.5%. The strong bounce in resources was particularly surprising given the continued write-downs of assets and bearish commentary from the large miners including BHP, Rio Tinto and South 32.

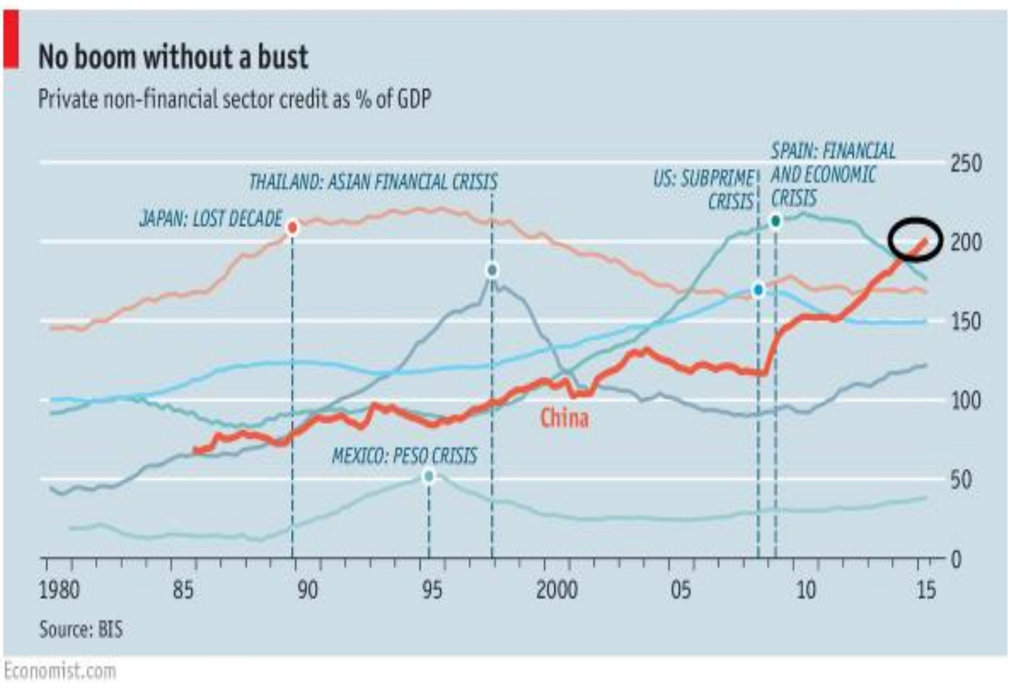
Given the substantial underperformance of the resources sector over the last 18 months this may be an indication that most of the bad news is now factored into current valuations. As we have discussed previously we remain heavily underweight resources and despite the bounce in resource stocks we are not convinced that we are moving into a prolonged period of resource stock outperformance.

In global news the Bank of Japan moved to negative rates early in the month in yet another attempt to stimulate their economy whilst the ongoing "Brexit" saga dominated European headlines as a British exit from the EU gained further momentum. In the US, Google or "Alphabet" as it is now known surpassed Apple to become the world's largest publically traded company.

On the stock front, BHP and RIO abandoned their previous dividend policies, opting to pay out their dividends as a portion of profits rather than paying them out of cash reserves or debt as was the case under their previous progressive dividend policy.

As widely flagged The National Australia Bank finally divested their UK based Clydesdale Bank through a distribution to shareholders – Clydesdale Bank (CYB) is now trading on the ASX in its own right. And lastly, two client holdings, Veda (VED) and M2 Group (MTU) were taken over in the month with M2 now trading as Vocus Communications (VOC) and Veda shareholders receiving cash consideration for their holding.

Chart of the Month – An imminent banking crisis?



We stumbled across this sobering chart from the Economist during the month that highlighted how bad China's private debt levels are.

At 200% of GDP this is only slightly lower than Japan before its "lost decades" of economic growth and above the US debt levels before the subprime crisis.

Although the chart to the left is interesting it's very hard to compare China's current situation with previous crises. For example the Asian crisis of 97-98 was fuelled by a foreign lending bubble.

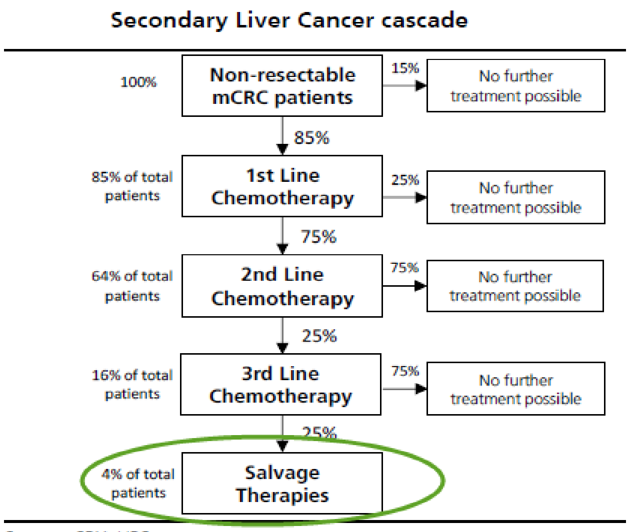
Nearly all of China's debt is contained within its own financial system and thus makes it relatively immune to a flight of capital out of the system.

Due Diligence – *A closer look at a company of interest.*

Sirtex - SRX

As many readers will appreciate, Sirtex has been a successful long term investment and a wonderful Australian success story rising from $4 per share in 2012 to $32 per share today. Although the rise has been meteoric, it hasn't been linear with the stock falling over 50% in July last year before returning to its pre-fall levels.

For those that aren't familiar with the story, Sirtex is the developer of SIR (Selective Internal Radiation) Spheres for the treatment of late stage liver cancer. The SIR spheres treatment has gained increasing acceptance over the last few years with dose sales volumes growing >20% p.a. Whilst the treatment has been successful in late stage cancer as a salvage therapy the company continues to trial its treatment in a range of scenarios to determine its viability as an earlier stage treatment - possibly in combination with chemotherapy for the treatment of metastatic colorectal cancer (mCRC).



Source: SRX, UBSe

Although the current share price is supported by continued growth in the salvage market, the blue sky for Sirtex shareholders is the potential for the treatment to be used earlier in the treatment timeline. If the treatment is successful in earlier stages of intervention this market could be up to six times larger than the current salvage market – and more importantly could extend the lives of patients suffering from the third most common cause of cancer mortality.

Despite the potential, the path ahead could be paved with disappointment as there are no guarantees that Sirtex's trials will be successful or more effective than the current gold standard of treatment. We remain comfortable that share price is supported by the growth within the salvage market and hope that the company can continue to make inroads into the successful treatment of such a terrible disease.

Reporting Season Wrap – *The Industrial sell off*

As alluded to earlier in the newsletter, reporting season was disappointing in many respects with a range of companies sold off substantially after missing their forecast earnings. The lion's share of the disappointments were industrial stocks with resource stocks significantly outperforming their peers across the month.

In fact, 16 of the top 20 performing stocks in the ASX200 were mining or mining service stocks with gold miners accounting for 1/3 of the top performers after the gold price rallied 9%. We continued our busy company meeting schedule over the month, meeting with over 20 companies as we sought to understand whether the sell-off was fundamentally driven or an overreaction to a small earnings miss.

We have touched on some of the more notable performers across reporting season below:

St Barbara (SBM) – SBM was once again a great performer rising 26% for the month after yet again upgrading its production guidance. As readers will know, SBM has been a strong performer over the last year as it continues to increase its gold production and lower its operating costs and debt levels.

IPH Ltd (IPH) – one of top performers across CY15, IPH was heavily sold off across the month after reporting earnings at the bottom end of their forecast range. Despite the fact that earnings were up 75% on last year the stock was sold off 22% in the days following. We feel this was a severe overreaction for one of the highest quality businesses on the ASX.

iSentia (ISD) and Blackmores (BKL) – two fellow market darlings suffered similar fates to IPH with Isentia falling 23% and Blackmores falling 17% despite recording earnings growth of 22% and 160% respectively. Given clients don't hold either name we weren't exposed to these moves but the magnitude of the sell-off is potentially presenting an opportunity. We continue to do work on both businesses.

Bank of Queensland (BOQ) and Bendigo Bank (BEN) – the regional banks were heavily sold off in Feb, falling 20% each after increased funding costs and bad debts impacted profitability. We have actively avoided the regional banks for these reasons.

McGrath (MEA) – new IPO, McGrath Ltd. was sold off 17% despite recording 1H16 revenues and earnings above its prospectus forecasts and reaffirming its full year 2016 forecasts. McGrath is an interesting situation where the noise surrounding the peaking of the house market and potential changes to negative gearing are causing anxiety for shareholders that is not currently being reflected in the company's revenues and earnings. After repeated meetings with management we believe McGrath will continue to consolidate the market and grow revenues and earnings beyond market expectations. On a positive note, at the time of writing, directors were buying shares on market – a very healthy sign.

Although the broad based sell off in Industrial stocks was unexpected and severe we believe that it is an opportunity to buy high quality businesses at a significant discount to fair value. The movement in resource stocks is surprising and we continue to monitor the space to determine whether it is a short term bounce or the start of sustained long term rise in the sector. Given the lack of growth in end user demand and the significant headwinds still being witnessed in China we feel it is the former but it's dangerous to dismiss such strong price movements without careful consideration.