JM Financial Group

Issue 11: March 2016

Investment Newsletter

Market Performance (As at 31st March 2016)	March 2016 (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P - All Ords Accum. Index	4.74	-2.35	-8.05

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

March was a better month for equity markets with the All Ords finishing up 4.74%. Despite the strong move the market is still down 2.3% for the quarter as investors struggle to gain confidence around the ongoing Chinese slowdown and the stop-start US economy.

Late in the month, Federal Reserve Chair, Janet Yellen, expressed caution in respect to further raising US interest rates pointing to weak growth abroad, low oil prices and uncertainty over China. Markets are now forecasting only two more interest rate rises this year.

The bounce in resources continued with oil prices rising another 13%, up 50% from February lows. Despite the bounce in prices, oil consumption remains weak and inventories remain stubbornly high. With OPEC set to meet in April to discuss production freezes it is likely oil prices will remain volatile in the short term.

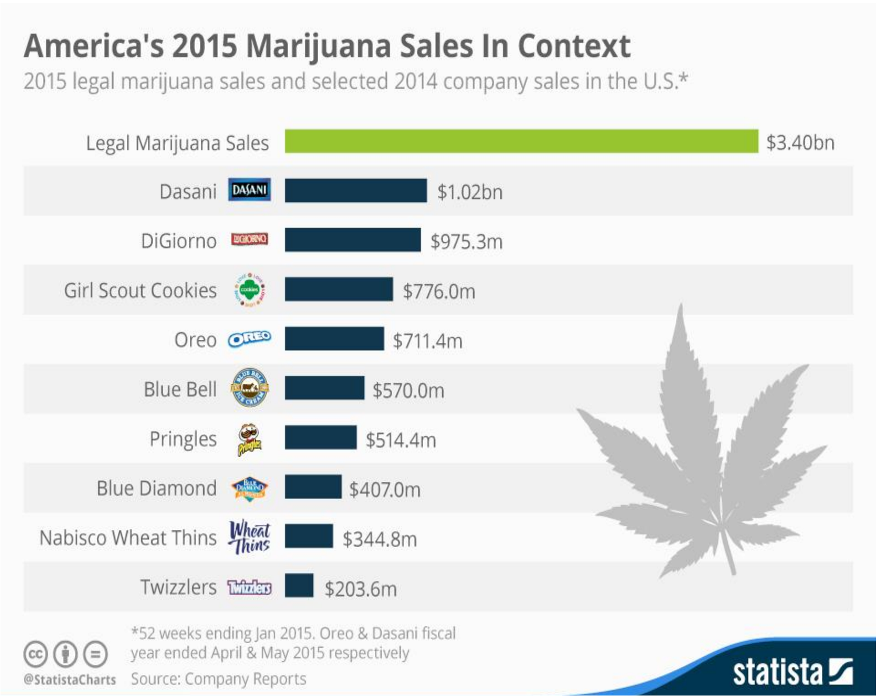
With US rates remaining flat and resource prices rising, the Australian Dollar hit its highest level in ten months, sitting at over 77c at the time of writing – good news for travellers and importers, bad news for US dollar earners and exporters.

In stock specific news the recovery in bank share prices was halted during the month after ANZ came out flagging higher bad debt provisions due to ongoing weakness in resource related lending. This should've come as no surprise but once again served as a reminder that although commodity prices have risen from their lows the operating environment remains very tough for a large majority of producers. With ANZ now yielding over 7% the market appears to be factoring in further bad debts and a potential cut to dividends.

After an arduous 'will they or won't they' saga, Qube finally lodged a formal bid for Asciano in concert with rival bidder Brookfield, announcing an $800m equity raising in the process. If the ACCC clears the deal QUB will have market cap of nearly $4bn, a remarkable effort for a company that was worth only $750m five years ago.

On the retail front, Premier Investments (PMV) rose strongly after 1HF16 earnings came in above analyst expectations.

Chart of the Month – Up in Smoke



Former President Bill Clinton may not have inhaled but it's clear many are, with *legal* marijuana sales in the United States reaching an amazing $3.4bn in 2015.

As the chart on the left shows the sales of marijuana in America are relatively phenomenal given it's only legally available for sale in five States.

In fact marijuana sales dwarf the sales of household names such as Oreos and Pringles, although the latter two may be significant beneficiaries of increased sales of the former. *Complementary goods* is the official economic term.

With the Australian Government amending the Narcotic Drugs Act in February the interest in Australia's three listed cannabis stocks has increased dramatically.

Whilst we like to take advantage of regulatory change, at this stage the listed companies remain a little too speculative.

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

Medical Developments (MVP)

The company 'Medical Developments' may not be familiar to most but at some stage most readers will have come across MVP's key asset, Penthrox or more commonly, the "Green Whistle". The green whistle can be seen quite regularly in the AFL, NRL and numerous other sporting codes given its wide use in treating serious sporting injuries.

The green whistle contains the active ingredient, methoxyflurane, an analgesic that is used to treat acute trauma pain as well as assisting in pain relief for brief but painful procedures such as wound changing, patient transportation and dental procedures.

Johnathan Thurston getting pain relief from the 'green whistle'

Unlike alternatives such as morphine and fentanyl, Penthrox is a not an opioid based narcotic – opioid based narcotics can close the airways which makes them potentially hazardous in many trauma procedures. The easy application of Penthrox through inhalation makes the drug highly portable and avoids the obvious needle risks that come with injectable pain relief.

Although the green whistle has been a mainstay for ambulances and doctors in Australia for thirty years the product was largely abandoned in the USA in the 1970's due to a lack of adequate clinical data and fears that the drug could become toxic at higher concentrations.

Medical Developments along with the CSIRO has done a significant amount of work in recent years reformulating the product and manufacturing process in order to produce the drug in larger quantities and at a lower cost. Alongside this process the company back filled its clinical profile including a 300 person Phase 3 trial in UK hospitals which overwhelmingly proved its value as a safe and highly effective pain relief treatment.

This hard work has been handsomely rewarded with the company signing distribution deals with Mundipharma and Galen Pharmaceuticals to distribute the drug throughout the UK, and thirty nine additional countries in Europe. Whilst this been impressive the company is hoping to get approval in the US in the next few years which could dramatically increase revenues and profitability.

Thematic Discussion – dividends or growth?

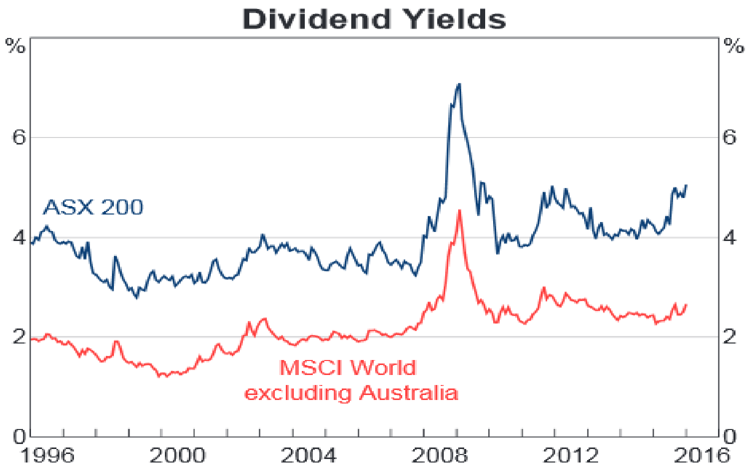
One of the ongoing themes within Australian equity markets is the continued discussion about the "efficient allocation of capital". At the risk of putting readers (and the author) to sleep, it's probably more interesting to refer to this concept as 'how are companies spending their cash?'

Former PM and Treasurer, Paul Keating is possibly most remembered for introducing dividend imputation (as well as his rapid fire insults and throwing an arm around the Queen), which allows some company tax to be imputed to shareholders through a tax credit.

The unintended consequence of this dividend imputation has been the addiction and reliance shareholders have developed to their fully franked dividends which can sometimes be up to 8% p.a – incredibly attractive in a 2% interest rate environment.

Herein lies the problem for Boards at companies in Australia, do they preserve their cash in order to reinvest in their businesses at a time of high technological change or do they distribute the cash to income hungry shareholders, who in many instances require the income to fulfil the minimum pension draw down?

The average dividend pay-out ratio is now 78% for the ASX200 vs the global average of about 40%. To put this another way less than a quarter of company profits are being re-invested in the company for future growth.



Sources: Bloomberg; MSCI; Thomson Reuters

The challenge for investors is to find a healthy mix of companies that are rewarding shareholders with a solid yield but also reinvesting for future profits.

Examples of this are the decisions from both BHP and RIO last month to realign their dividend payouts in order to preserve more capital for future projects and protect their balance sheets. It's no surprise that BHP and RIO rose 10% and 6% in March following the announcements.

Some examples of non-bank stocks that provide a healthy dividend whilst still retaining cash for investment purposes include Amcor – 4% yield and 70% payout ratio, Macquarie – 5.8% yield and 64% payout ratio and IPH 3.6% yield and 73% payout ratio.