JM Financial Group

Issue 6: October 2015

Investment Newsletter

Market Performance (As at 31st Oct 2015)	October 2015 (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P ASX All Ords Accum. Index	4.59	1.80	1.33

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

October was a strong month for equity markets with small resource and energy stocks rebounding strongly after months of underperformance.

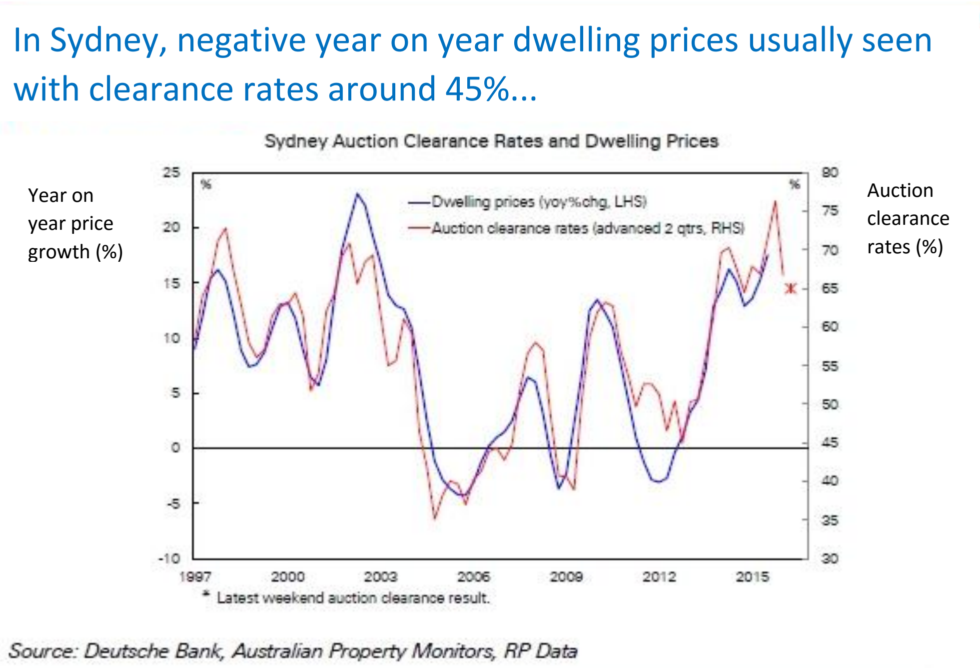
Monetary policy was again the major macroeconomic driver of our market with the world's largest economies continuing their easing bias. The US Federal Reserve again opted to hold off on raising interest rates with analysts now expecting a rate rise in December or early in 2016. The European Central bank signalled it will look to increase its economic stimulus when it meets again in December and the People's Bank of China cut rates further in an attempt to stimulate demand.

Domestically the banks were again a hot topic of discussion with Westpac announcing a capital raising and a subsequent out-of-cycle 20 basis point interest rate rise in order to compensate shareholders for the higher costs of equity now required by the recent APRA regulations. Unsurprisingly the other banks followed suit, leading many market commentators to call an end to the housing boom. Although this call has been made many times before (*and been incorrect each time*) there has been a fall in clearance rates in both Sydney and Melbourne since the interest rate moves. (This can be seen in more detail in the chart below).

On the policy front the Trans-Pacific Partnership was finalised early in the month and was applauded as a way of diversifying our economy away from mining and resources. It's still very much in its infancy but the lowering of export tariffs should be a boon for Australia's agricultural and manufacturing sectors.

At a stock level, ANZ, National Australia Bank and Woolworths all posted disappointing profit numbers and the major M&A news was an opportunistic bid for Santos from a private equity consortium for $7bn. At the smaller end, Qube made a raid on Asciano buying 19.9% of the company and potentially blocking the takeover by Brookfield. Qube has stated its desire to purchase some of Asciano's old Pacific National rail assets that were formerly run by Qube Chairman, Chris Corrigan.

Chart of the Month – *Relationship between Sydney auction clearance rates and dwelling price growth*



The chart to the left highlights the high correlation between Sydney auction clearance rates (red line) and % increases in dwelling prices (blue line).

Given the recent slowdown in clearance rates in both Sydney and Melbourne it would appear inevitable that the rate of price growth (left hand axis) in the housing market will slow.

The good news for home owners though is that historically price growth has only been negative when clearance rates have fallen to 45% or lower (right hand axis).

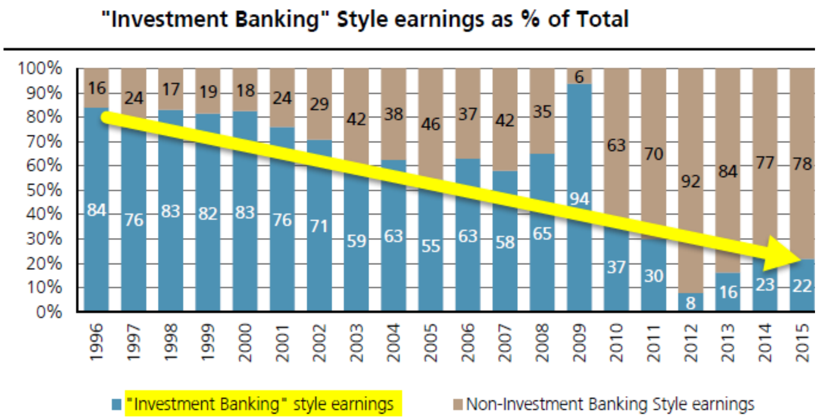
Due Diligence – *A closer look at a company of interest.*

Macquarie Group (MQG) – More than an investment bank

In 1996, Macquarie listed as a modest Australian investment bank with the majority of its earnings coming from the traditional businesses of Corporate Finance and Equities. Over the proceeding 20 years Macquarie has continually diversified its operations and geographical footprint with earnings now being generated from a wide array of annuity style businesses such as asset and wealth management, mortgage lending and asset finance. In fact, it is estimated that only 22% of earnings are now generated from the classic investment banking style businesses, down from 84% of earnings back in 1996.

This diversity is set to increase with the announcement early in the month that Macquarie was purchasing the Esanda dealer finance portfolio from ANZ for $8.23bn. The Esanda finance portfolio is predominantly composed of loans and leases of motor vehicles and is being funded by Macquarie through debt and $400m of new capital.

We (and the wider market) have viewed the transaction and capital raising positively with many reports suggesting that ANZ was somewhat of a forced seller given the need to increase its capital buffer inline with the recent regulatory changes.



Source: UBS

Post the equity raising, Macquarie is now trading at a discount to the market on an undemanding price to earnings ratio of 14x with a healthy 4.6% dividend yield and forecast earnings growth of 30% for this financial year. Not only is the "new" Macquarie growing strongly but its increased annuity style earnings have added an element of defensiveness that was absent in its early days when it was subject to the whims of the boom and bust cycles inherent in investment banking and stockbroking.

Hitting the road – *Feedback from our October company meetings*

At JMFG we believe one of the keys to selecting good companies and good investments is to actively get out and meet with company management. In the industry it's referred to as "tyre kicking" and it forms one of the essential aspects of our due diligence process.

We look to catch up with the CEOs and CFOs of companies we have invested in multiple times per year as well as meeting with potential new investments, competitors, suppliers and customers and unlisted industry participants. By increasing the number of companies we see, we not only increase our chances of finding the next CSL or Wesfarmers but are able to build a large library of feedback on how the underlying economy is faring across a variety of sectors.

Throughout the month of October the JMFG team met with 21 companies face to face, attended a Microcap Conference, a Biotech Conference, an Emerging Tech conference and travelled interstate for two days for back to back meetings. We have provided feedback from some of our meetings below:

Tabcorp (TAH) – the entertainment dollar remains strong with pokies, keno and wagering revenues growing between low to high single digit percentages this year. The land grab in wagering continues with Sportsbet, Crownbet, William Hill, Ubet and bet365 continuing to offer generous free bet deals in order to sign up new customers. One analyst calculated that on Saturday early in the Spring Carnival it was possible for a punter to access up to $3,000 worth of free bonus bets across all of the different wagering companies.

APN Outdoor (APO) and Ooh Media (OML), the two market leaders in outdoor advertising, continue to see good growth in their businesses as the amount of advertising and marketing spend dedicated to the outdoor sector grows at the expense of free to air television. This growth is further supported by static billboards being converted to digital and allowing much greater flexibility for advertisers.

The APO digital billboard above Young and Jacksons. (Historically JMFG has done many more hours of due diligence inside the building than outside it.)

Recently listed specialty retailers, Adairs (ADH) and Lovisa (LOV), continue to see strong growth in their respective sectors of homewares and fast fashion jewellery. Adairs has benefitted from the low interest rate environment and household wealth effect, with like for like sales up an incredible 20% in FY15. Lovisa has pitched itself perfectly at the 15-35 year old female market through its range of relatively inexpensive and high margin ($20 ave. price point) fast fashion jewellery which can augment an outfit cheaply. Both companies believe they can continue to grow profits in a slower housing, or higher interest rate environment.

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