JM Financial Group

Issue 10: February 2016

Small Companies Strategy – Investment Newsletter

Performance (As at 29th February 2016)	Month to Date (%)	Quarter to Date (%)	Cal. Year to Date (%)	Fin. Year to Date (%)	Rolling 1yr (%)	Inception (%)
JMFG Small Co. Strategy	**-5.30**	**-6.72**	**-6.72**	**14.44**	**13.07**	**35.69**
Small Ords Accum. Index	0.95	-4.21	-4.21	2.48	-3.56	2.93
Outperformance	**-6.25**	**-2.51**	**-2.51**	**11.96**	**16.63**	**32.76**

Although the JMFG Small Companies Strategy is generally representative of client portfolios, Individual performance may differ from the results above. These differences can arise due to various issues, some of which may relate to initial timing of investments and cash inflows and outflows. Performance is non-annualised, excludes fees and the effects of franking credits and tax. Strategy Inception date July 1st 2013.

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 Small Ordinaries Index was up 0.75% across the month the composition within that move was intriguing with the Small Ords Resources Index rising 19% and the Small Industrials Index falling 3%. 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.

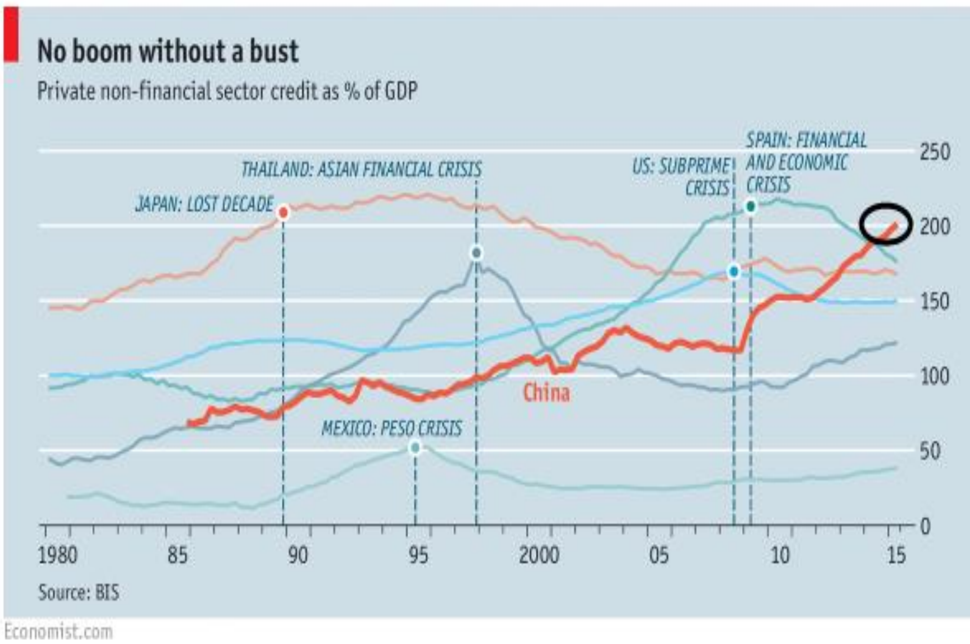
Given the substantial underperformance of the resources sector over the last 18 months this may be an indication that most of the bad news is now factored into current valuations. As we have discussed previously we remain heavily underweight resources and unfortunately this impacted returns for the month. Despite this short term 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.

Two Strategy 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.

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Best & Worst Performers for February 2016

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
St Barbara – SBM	Temple & Webster – TPW	Kingsgate Consol. – KCN	Arrium – ARI
Mainstream BPO – MAI	Amaysim – AYS	Sino Energy – SEH	OzForex – OFX
Maxitrans – MXI	Datetix – DTX	Resolute Gold – RSG	Sundance Energy – SEA

What We Think – *A summation of the top hits and misses for the month of February.*

St Barbara – (up 28% for the month)

SBM was once again a great performer rising 28% for the month after yet again upgrading its production guidance. As readers will know, SBM has been incredibly consistent over the last year as it continues to increase its gold production, lower its operating costs and substantially pay down its debt levels.

Kingsgate Consolidated – (up 108% for the month). **Not held.**

Kingsgate, like many other gold miners, bounced strongly during the month, up a remarkable 108%. Despite this incredible move the stock still remains 35% lower than where it was trading in November.

Temple & Webster – (down 70% for the month)

One of the keys to managing a Small Companies Strategy is avoiding stepping on landmines. Temple & Webster was unfortunately, a landmine. TPW was sold off savagely after committing the cardinal sin of revising down its IPO forecasts after only three months as a listed company. Despite numerous meetings with management over the last few months the revision of revenue forecasts from $76m to potentially $70m took us (and others) by surprise. Whilst extremely disappointing the sell-off appears potentially overdone with the business now trading at a 30% discount to the value of the cash on its balance sheet, implying a negative valuation ($-8m) for the value of its three market leading online businesses. Whilst it appears oversold we are reviewing the position within the Strategy.

Arrium – (down 76% for the month). **Not held.**

Iron ore miner and steel producer, Arrium nearly succumbed to the prolonged impact of weak iron ore prices during the month with the company exploring various ways in which to recapitalise its balance sheet.

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, 18 of the top 20 performing stocks in the ASX Small Ords were mining or mining service stocks with gold miners accounting for half of the top 20 performers. 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 taken a look below at a few companies we believe have been unfairly dealt with in February which represent attractive value at these 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 the Strategy doesn't own either 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.

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 in the process. McGrath is an interesting situation where the noise surrounding the peaking of the housing 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 real estate 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.