JM Financial Group

Issue 14: June 2016

Investment Newsletter

Market Performance (As at 30th June 2016)	June 2016 (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P - All Ords Accum. Index	-2.28	1.55	2.01

Month in Review *– A review of events that influenced the share market in June.*

The month of June was dominated by the holding in the UK of a referendum on whether or not to leave the European Union. In a surprise result the leave campaign (or Brexit) won the day, resulting in momentous movements in financial markets and the resignation of Prime Minister David Cameron. The ASX200 fell 3.4% on the day, the worst one-day fall in nine months, while the British Pound fell 10% against the $US, gold jumped 5.7% and Government Bonds around the world fell to record low yields. Japan and Germany are among a growing number of countries where investors actually pay the Government to borrow their money!

As is customary with global shocks, the markets soon righted themselves with the ASX200 recovering to finish down 2.5% for the month and 4% for the Financial Year. Oil had a flat month but finished 26% higher for the quarter, the biggest quarterly rise in 7 years, as US supply eased. Gold rose 9% for the month and 27% for the year on Brexit concerns, low interest rates and economic and political uncertainty. Commodities in general staged a comeback rising 13% this year versus a 25% decline for 2015.

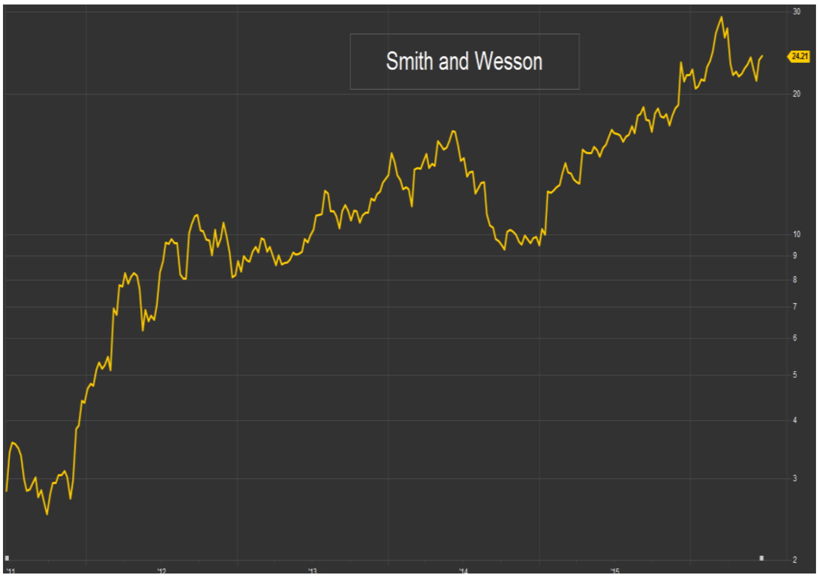
The long-term effects of the UK leaving the EU remain to be seen, but the vote result, plus the rise of Conservative hard liners around the world, reflects the growing unease that populations have around their security and prosperity. It is likely that Governments will continue to stimulate their economies with monetary measures. Further interest rate easing, particularly in Europe, is on the cards and it is increasingly likely that the US will delay increasing interest rates until at least 2017.

On the corporate front, Cadbury maker Mondelez made a takeover offer for fellow chocolate giant Hershey, producing what would become the world's largest confectioner. The bid deadline for Woolworths' Home Timber and Hardware and its Masters Home Improvement chain has been pushed out to July 18th, and Mayne Pharma (formerly Fauldings) further expanded its international business by buying a suite of generic drugs from international giants Teva and Allergan.

As we go to print, the Federal election result is hanging on a knife edge with neither party getting a clear mandate on the night.

Chart of the Month – *Smith and Wesson and the US gun culture*

Only one week after the terrible events in Orlando, the US's second largest gun manufacturer, Smith and Wesson reported a 22% annual increase in sales and forecast "robust sales growth" for the year ahead. The sobering chart below shows the Smith and Wesson share price rising a staggering 800% in 5 years. The 'success' of companies like Smith and Wesson further highlights the endemic issues around gun prevalence in the United States which see more than 30,000 gun deaths per annum.



2016 Financial Year Score Card – *What we got right and what we got wrong*

Although 2016 was largely a successful year for JM Financial Group clients, performance was very much driven by stock picking with the economy doing little to assist market returns. With the market flat to slightly down over the year it often felt like the hamster on the wheel: *doing a lot of work for not much return*. In many instances the market was a tale of two halves. The industrial darlings of the first half of the year were shunned when resources bounced after Christmas making it a tough year for investment managers. We take a look at our winners and losers below.

Gold was the stand out sector over the year with the price rising over 10% as its "safe haven" status was re-affirmed. Amazingly five of the top fifteen performers were gold mining companies. Fortunately, some client portfolios contained a gold stock or two. Widely held stocks Transurban Group and Sydney Airport also performed strongly, rising 29% and 24% respectively.

The new JMFG standing desks, ideal for flat markets.

One of the key sectors that we unfortunately missed in the first half of 2016 was the infant formula and nutritionals sector which rose strongly on the back of increasing demand from Chinese buyers. Despite still being one of the top performers for the year our decision to avoid Blackmores and Bellamys at the height of the hysteria was a prudent one with both stocks down over 30% and 20% respectively over the last six months.

Our move to reduce oil exposures to near 0% for clients back in December 2014 was a masterstroke with oil falling to below $30/bbl. in February this year. Since that time we have seen prices rise strongly to around $48/bbl., with Santos and Origin both bouncing 25% and hurting relative client performance.

Our investments in the health sector produced mixed returns with Cochlear, CSL and Ramsay all performing well, but our decision to keep Sirtex impacted client returns. After posting disappointing dose volumes and announcing changes to key regional management some of the heat has come out of the share price. With no immediate positive catalysts we have been reducing client exposure to Sirtex.

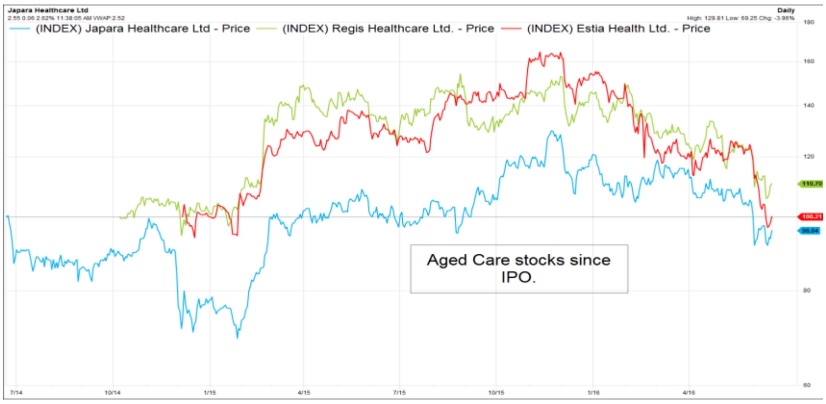
With interest rates falling and concerns in the banking sector increasing, investors went searching for stocks with perceived "safe" dividend yields. The hunt for safe yield benefitted clients with Transurban and Sydney Airport performing strongly, and property stocks, Vicinity Centres and Scentre Group reaching new all-time highs.

Sector Discussion – *Aged care: Positive demographics outweighed by high risk funding*

The aged care sector is one in which we feel quite conflicted. On one hand the thematic is strong; Australia has an aging population and incidences of dementia related diseases such as Alzheimer's are growing at an alarming rate. There is no doubt that demand for aged care facilities is outpacing supply and increasingly the government will look to the private sector to support this demand.

On the other hand, we tend to avoid companies and businesses that rely on a significant amount of government funding. These businesses have an added element of risk and tend to come under scrutiny with every budget and general election, as politically based decisions can impact revenues and profitability overnight.

Our other concern is that we love investing in businesses with high margins that can generate high returns. When businesses that rely on government funding produce high returns the sector inevitably attracts increased scrutiny. This is especially true in aged care where the customer demographic is in many cases distressed, frail and/or mentally impaired.



The other aspect of the aged-care model that concerns us is the resident funding where the gap in funding provided by the government is incurred by the resident.

In many cases a resident will enter an aged care facility and pay a residential accommodation bond (RAD). The operator then holds this cash for the duration of the stay and is able to use the cash for acquisitions, development and/or to repay debt. The operator must then repay the bond (less deductions) when the resident departs. These RADs are mostly funded through the sale of the resident's home and allow the operator to use the resident's cash as a cheap, non-interest bearing source of funding.

Putting the morality of that model aside and given the bonds need to be eventually repaid, the operator must continually keep replacing the bonds to preserve its funding levels for future growth. This also increases the operator's exposure to future house price moves.

The sector has been strong since the three listed businesses (Japara Healthcare, Regis Healthcare and Estia Health) came to the market but has been sold off over fears that recently announced changes to government aged care funding will impact profitability. We appreciate the positive tailwinds from an aging demographic but prefer to invest in it through other means.