JM Financial Group

Issue 17: September 2016

Investment Newsletter

Market Performance (As at 30th September 2016)	September 2016 (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P - All Ords Accum. Index	0.40%	6.93%	14.01%

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

Equity markets were mixed in September with the All Ordinaries rising 0.4% and the Small Ordinaries rising 1.5%. With August's reporting season passing, the market's focus has turned from company financial results to global macro-economic issues.

As widely expected the US Federal Reserve elected to keep rates on hold for another month leaving the door open for a potential raising in December following the US presidential election. With the US now firmly in an interest rate increasing cycle the questions for investors are now, "how quickly will rates rise?" and "can the improvement in the underlying economy offset the increase in borrowing costs?"

With bond yields currently so low the potential for increasing interest rates has already began to impact bond prices and *bond-like* equities such as high yielding real estate investment trusts and infrastructure stocks such as Transurban and Sydney Airport (we discuss this phenomenon later in the newsletter).

On the oil front, OPEC finally agreed to output cuts after months of deliberation, with Saudi Arabia softening its stance against fellow producer Iran amid continuing weakness in the oil price. On the back of the news, oil prices rose strongly settling around $50/barrel at the time of writing. Whether this price rise can be sustained remains to be seen with the new output range of 32.5-33 million barrels per day (bpd) set not far below current production levels of 33 million bpd.

And finally, late in the month, German banking powerhouse, Deutsche Bank, came under a spotlight as investors questioned whether its stretched balance sheet could survive a potential $16 billion settlement with the US Justice Department over an investigation into the selling of mortgage-backed securities. A collapse of Germany's largest bank would have wide ranging ramifications for global markets, with its share price falling to its lowest level in twenty years.

***Chart of the Month** – "Trumped Up, Trickle Down".*

Although Republican candidate Donald Trump may have believed he won the first presidential debate, financial markets indicated otherwise pushing the Mexican Peso up to monthly highs during the live telecast.

The Mexican Peso has become the bellwether for investor anxiety due to Trump's pointed comments on Mexican trade and immigration. With the Mexican Peso breathing easier a number of market indices bounced intraday as millions watched the first of three debates.

Despite not achieving the knockout blow the Democratic Party was hoping for, a number of gaffes and odd digressions from Donald Trump led to most political pundits awarding the points in Hillary Clinton's favour.

The December election is looming as a pivotal time for markets with a potential Trump victory being viewed as negative for equities. However, not all sectors would be worse off under a Trump presidency with cyber security highlighted as a key issue.

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

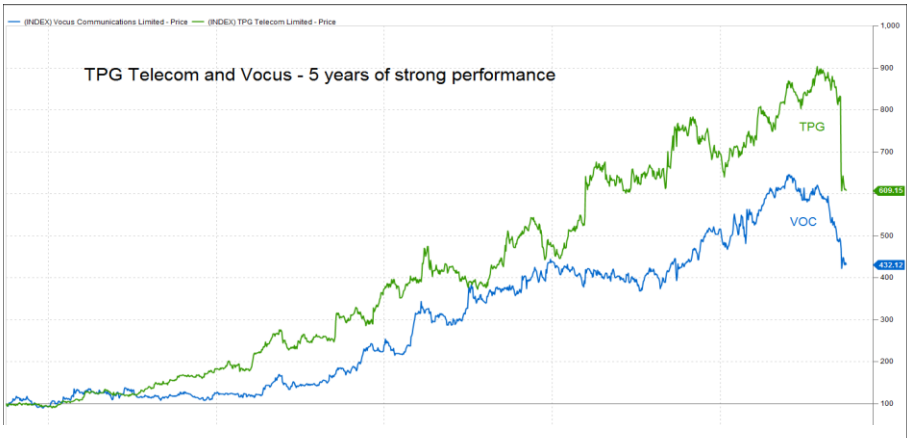
September was a poor month for the Telco sector with former market darlings TPG Telecom (TPM) and Vocus (VOC) being sold off heavily. Although we haven't had any client exposure to TPG, some clients are investors in Vocus.

The sector sell-off began when the former CEO and founder of Vocus, James Spenceley announced the selling of 75% of his personal shareholding to seed his new funds management venture. As highlighted in some of our pervious newsletters we enjoy investing alongside founders and although it's not a smoking gun, it's always a red flag for us when a founder sells down such a large portion of their holding.

Things went from bad to worse for the sector three weeks later when TPG announced its financial results, lowering its 2017 profit forecasts in the process.

After many years of strong growth TPG flagged that as customers migrate from ADSL broadband to NBN broadband its access costs increase dramatically, negatively impacting its operating margins.

Although the cost increase has been flagged for many years, TPG was sold down 20% on the news, dragging Vocus and a number of competitors with it.



"directors sell shares for many reasons, but they buy for just one – they think the price will rise."

It's important to note that although Vocus and TPG compete with similar broadband offerings, Vocus has always operated with much smaller margins given it was a reseller of Telstra's network capacity. Due to these marked differences in business models we don't think Vocus will be affected in the same way and may even benefit in an NBN environment.

Whilst the founder sell-down is still a troubling issue we took heart from the fact that Vocus Director, Tony Grist, took advantage of the price fall to purchase an additional $1.57m of Vocus shares.

Given the strong falls we have taken the opportunity to review client positions in Vocus and feel that the Director buying supports our view that the market has sold down Vocus too harshly given its limited exposure to the NBN access issues that are impacting TPG.

Thematic Discussion – The yield trade

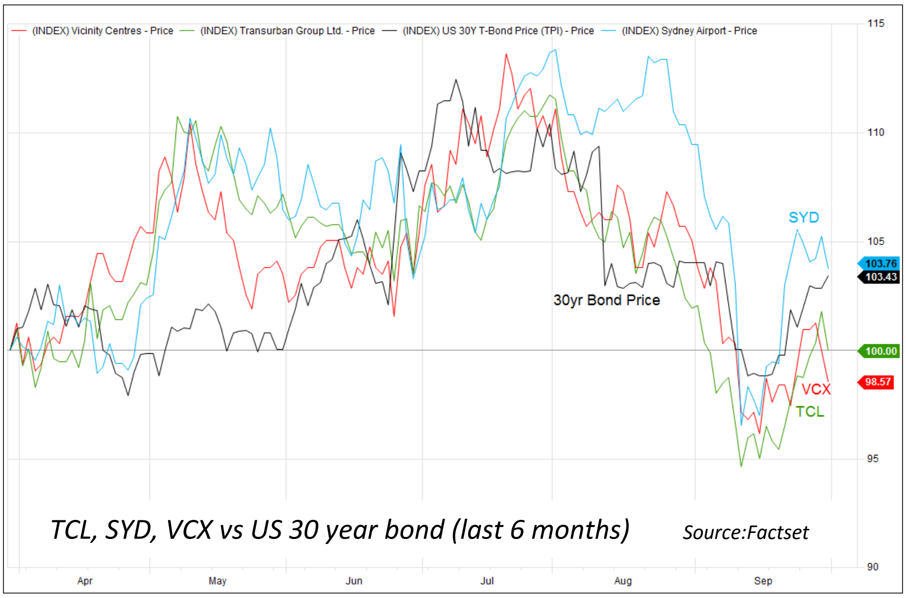
As we discussed briefly at the start of the newsletter, as the world begins to consider the possibility of a rising interest rate environment we have witnessed a corresponding sell off in bond prices and prices of "bond like" equities such as Transurban (TCL), Sydney Airport (SYD) and Real Estate Investment Trusts such as Vicinty Centres (VCX) and Scentre Group (SCG).

Economic theory tells us that as interest rates begin to rise new bond issues will come to market carrying a higher notional interest rate, reducing the relative attractiveness of current lower yielding bonds or high dividend paying stocks.

Simplistically if interest rates go up the argument is that investors who require a defensive income stream now have another alternative source for that income besides equity dividends or distributions.

This may be true for bonds which have no operational leverage but ignores the operational growth that is inherent in both Transurban and Sydney Airport, both of which own long life assets with limited competition.

Interest rates may be increasing but we believe they will move up slowly over many years, yet traffic numbers for TCL and SYD should continue to grow strongly month on month creating further scope for higher distributions.



TCL, SYD, VCX vs US 30 year bond (last 6 months) *Source:Factset*

Transurban, Sydney Airport and to a lesser extent Scentre Group and Vicinty have been very successful investments for clients and despite the recent sell off they continue to look attractive both from a yield and asset base perspective.