JM Financial Group

Issue 18: October 2016

Small Companies Strategy – Investment Newsletter

Performance (As at 31st October 2016)	Month to Date (%)	Quarter to Date (%)	Cal. Year to Date (%)	Fin. Year to Date (%)	Rolling 1yr (%)	Inception (%)
JMFG Small Co. Strategy	**-1.93**	**-1.93**	**14.83**	**9.05**	**22.78**	**67.05**
Small Ords Accum. Index	-4.72	-4.72	10.55	3.38	14.90	18.79
Outperformance	**2.79**	**2.79**	**4.28**	**5.67**	**7.88**	**48.26**

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 calculated on TWRR basis; non- annualised, excludes fees and the effects of franking credits and tax. Strategy Inception for Performance Data is July 1st 2014.

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

October justified its reputation as one of the worst months for equity markets with the ASX Small Ords falling 4.7%. Since 1927 the S&P 500 Index in the USA has risen on average only 0.5% during the month of October, making it one of the worst trading months of the year.

Stock markets around the globe traded down due to continuing political uncertainty in the United States and a weaker than expected third quarter reporting season. This was compounded by well-known tech heavyweights, Ebay and Amazon, falling heavily after posting weaker than expected earnings results.

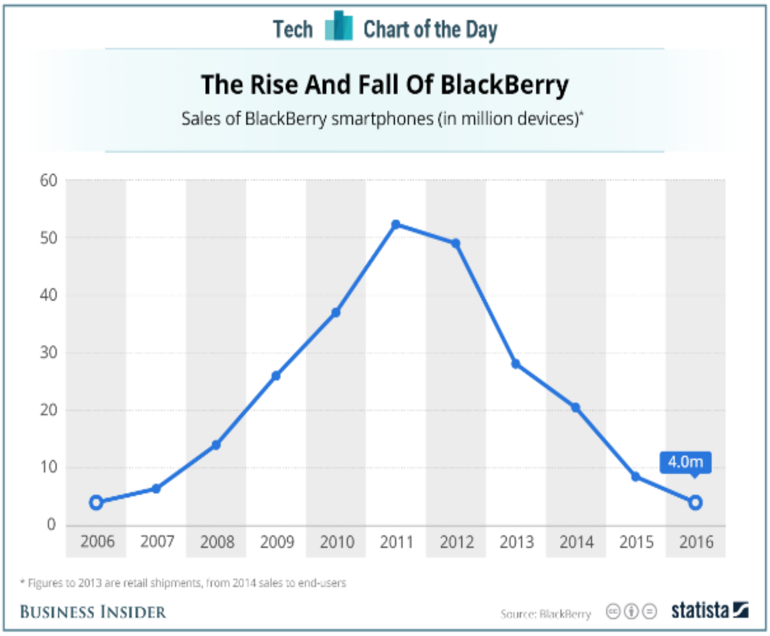
Domestically the Small Ordinaries Index underperformed the Top 100 Index for the first time in a number of months with several high growth stocks retracting from their recent highs. Over the last calendar year we have seen the Small Ordinaries outperform the Top 100 Index by over 11%. An incredible performance as investors shied away from banks, supermarket operators and large insurers.

In stock specific news the long awaited merger between gaming rivals Tabcorp and Tatts Group was finally announced with the combined business set to become an $11 billion dollar gaming giant with dominant positions in wagering and lotteries.

It wasn't all good news for the gaming sector however with Crown Resorts falling heavily after a number of its employees were detained on suspicion of advertising its casino business in mainland China. We discuss the risks of investing in the gaming and other highly regulated industries later in the newsletter.

Other notable falls were private hospital operator, Healthscope, after announcing a slowdown in elective admissions and Ardent Leisure following the terrible tragedy at its Dreamworld theme park on the Gold Coast.

Chart of the Month – The rise and fall of Blackberry



One of the biggest risks to a company's long term success is…*its continued success*. Whilst this may seem a contradictory statement, history is littered with companies that have become complacent in their success and stopped innovating.

Kodak is possibly the most famous example, having at its peak over 90% market share of the camera and film market only to then file for bankruptcy in 2012 after failing to adapt to the digital photography world.

The most recent example of complacency is Blackberry which debuted its final in-house designed phone during the month announcing it will now focus on producing mobile software.

At its peak in 2011, Blackberry sold over 50 million phones and captured 20% of the mobile phone market. Such is the speed of innovation that now, only 5 years later, the company is no longer producing its own phones.

The Blackberry example is a pertinent reminder of how quickly things can change and is something we are continually watching for with all of our invested companies. If you aren't willing to change, the world will simply pass you by.

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Best & Worst Performers for October 2016

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
Datetix - DTX	Mayne Pharma - MYX	Karoon Gas - KAR	The Reject Shop - TRS
Australian Agricultural - AAC	St Barbara - SBM	UGL Ltd - UGL	Magnis Resources - MNS
GTN Ltd - GTN	Aconex - ACX	Infigen Energy - IFN	Ardent Leisure - AAD

Hits & Misses – *A summation of the top hits and misses for the month of October.*

Australian Agricultural – up 16% for the month

Beef producer, Australian Agricultural Company, rose strongly as the beef price continued to set record highs. Given the volatile nature of this business we opted to lock in some profits and exited our position during the month.

Karoon Gas – up 73% for the month **(Not held)**

Karoon had a terrific month after being awarded the right to negotiate an agreement on the acquisition of two large offshore Brazilian oil fields. Whilst there are a number of risks involved in the transaction the market responded overwhelmingly in favour of the transaction.

Mayne Pharma – down 18% for the month

After being one of the year's star performers Mayne retracted from its recent highs as the Australian Dollar strength led to some analysts revising down their forecast earnings due to the large amount of US Dollar revenues the company earns. We don't believe there is any change to the fundamental value within the business.

The Reject Shop– down 29% for the month **(Not held)**

The Reject Shop fell heavily after flagging the turnaround in the business was taking longer than expected amid a patchy consumer spending environment. Despite record low interest rates we remain comfortable in holding only a limited exposure to retail spending.

'On the road' – feedback from a month of company meetings

October was a busy month for the JMFG investment team attending a number of conferences including the Australian Micro Cap Conference and the' Tech Know' Technology Conference before heading to Sydney to see a number of companies of interest.

Throughout the course of our travels we caught up with IVF market leader Virtus Health, disruptive financial companies Hub24 and Clearview Wealth, software providers Class and Nearmap, online retailers Temple & Webster and Redbubble, vacuum retailer Godfreys, traffic data provider GTN and telecommunications provider Vocus. Pleasingly a number of these companies have been added to the strategy or have been earmarked for addition when the valuation becomes more attractive.

The benefit of meeting with companies in a face to face, one on one environment cannot be underestimated as time spent with a CEO or Managing Director understanding their vision of the future is incredibly valuable when constructing an investment thesis.

In the case of Vocus, CEO Geoff Horth has been in a challenging situation of late having survived a proposed spill by two now ex-members of his Board and dealing with the resultant fall in share price that comes with boardroom uncertainty. Having sat face to face with Geoff we feel relatively confident that we have an understanding of the issues confronting the business as opposed to reacting blindly to rumours in the press.

We feel this is one of our strengths as investment managers; understanding the multitude of issues and complexities within a company that aren't apparent in a balance sheet or profit and loss statement. Investing is as much art as it is science and one of the more intangible aspects of investing is understanding the personality of management – are they calm, and clear thinkers? Do they present well and show strong leadership? Are they positive communicators? These are all questions we ask ourselves during these meetings and the answers go a long way to impacting our investment decision.

With over 2,000 listed Australian companies there is a large universe of potential investments out there and unfortunately the only way to keep finding gems to is to turnover as many rocks as possible.