JM Financial Group

Issue 20: December 2016

Small Companies Strategy – Investment Newsletter

Performance *(As at 31st December 2016)*	Month to Date (%)	Quarter to Date (%)	Cal. Year to Date (%)	Fin. Year to Date (%)	Rolling 1yr (%)	Inception (%)
JMFG Small Co. Strategy	**-4.97**	**-6.92**	**+8.98**	**+3.49**	**+8.98**	**+58.53**
Small Ords Accum. Index	+3.61	-2.45	+13.18	+5.84	+13.18	+21.62
Outperformance	**-8.58**	**-4.47**	**-4.20**	**-2.35**	**-4.20**	**+36.91**

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 December.*

December was another strong month for equities with the market reaching a 16-month high in the lead up to Christmas. The Trump related exuberance combined with the much talked about "Santa Rally" pushed the All Ordinaries 4.71% higher.

Unfortunately, the combination of a series of capital raisings in a number of stocks in the portfolio and a market rotation out of *"high growth"* stocks into *"value"* stocks saw the Strategy record a poor performance in December. We discuss the capital raisings later in the newsletter but remain of the belief that this underperformance is temporary in nature.

Equity market strength wasn't confined to Australian markets with the Dow Jones setting another all-time high, coming within a whisker of the much vaunted 20,000 point level. This was a particularly impressive move considering the US Federal Reserve raised rates by 25 basis points during the month and alluded to three more possible rises in 2017.

How quickly markets can change – only a matter of months ago the Dow Jones would've fallen 300 points on even the mere mention of interest rates increasing. The psychology of the market is a fascinating topic and worthy of a newsletter in itself.

Although our share market rose strongly, the September quarter GDP figures were surprisingly quite weak, indicating a shrinking economy. Economists are collectively holding their breath in the hope that the December quarter numbers will indicate strong growth and the dreaded 'R' word (Recession) will be avoided.

Historically a quiet month in terms of company news, December threw the market a curveball with a number of high profile surprises including the announced merger of APN Outdoor and Ooh Media, Santos' $1.5bn capital raising, Mayne Pharma being named in a US price-fixing lawsuit, and the trading suspension of former market darling Bellamy's after a shock downgrade and question marks around its future supply agreements.

Chart of the Month – Prices and interest rate rises

The Producer Price Index or PPI, measures movements in input prices, and is regarded as an indicator for future consumer price rises and ultimately interest rate movements. According to Factset data, US CPI has moved largely in sync with US PPI, as indicated in the chart.

The PPI in both China and the U.S. has moved into positive territory in recent months with US CPI rising from largely static levels in 14/15 to over 1.5% recently.

While this may lead to increased global inflation, the signs are by no means alarming and we feel both US and global inflation will continue to remain moderate whilst wage inflation in the US and Europe is contained.

With this backdrop we feel rate rises in Australia (and the U.S.), whilst more likely to be up than down in 2017, will be limited in size until we see more sustained wage inflation.

Best & Worst Performers for December 2016

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
Temple & Webster - TPW	Catapult - CAT	Cover-More Group - CVO	Bellamy's - BAL
Appen - APX	Datetix - DTX	WPP AUNZ - WPP	Perseus Mining - PRU
Clearview Wealth - CVW	GTN Limited - GTN	Programmed - PRG	Dacian Gold - DCN

Hits & Misses – *A summation of the top hits and misses for the month of December…*

Temple & Webster – up 21% for the month

TPW bounced strongly during the month after announcing the integration of its Milan Direct furniture business. This also coincided with the initiation of broker research on the stock which appears to have generated some buying interest at what we feel are depressed prices.

Cover-More – up 46% **(Not held)**

After raising equity at $1.20/share only a few months ago, domestic travel insurer, Cover-More, entered into a deal to be acquired by Zurich Insurance at $1.95/share.

Catapult – down 24% for the month

Catapult fell heavily during the month despite a positive trading update and four directors purchasing additional shares on market. We continue to investigate the reason for the abnormally large sell-off.

Bellamy's – down 45% for the month (**Not held)**

The once market darling fell heavily in December after announcing weaker than expected sales through its Chinese sales channels. In more alarming news the stock then went into trading halt a week later to clarify further "supply related" issues. As at the time of writing Bellamy's is yet to return to trading but when a stock goes into suspension for a matter of weeks it's rarely good news coming…

Due Diligence – *a closer look at a stock of interest*

Datetix (DTX) and navigating capital raisings

As mentioned previously the Small Companies Strategy was negatively impacted in December due to a number of companies in the portfolio raising capital. Whilst the act of small companies raising capital is not uncommon given their growth demands, having four (DTX, GTN, M7T, QMS) do so in the same month within a concentrated portfolio strategy is unusual and has had an impact on monthly performance, given raisings are typically conducted at a discount to market prices.

This can lead to an arbitrage-style scenario where investors can subscribe for new shares at the discounted price and sell their current shares at the (higher) market price, thus forcing the prevailing market price down to nearer the capital raising price.

Whilst this can be frustrating in the short term, generally the capital has been raised to fund further growth in the business and over time, should the company successfully execute its plans, the share price *should* rise back above its previous levels.

One of these companies was dating and matchmaking company, Datetix (DTX), which raised $1.7m to fund further growth following the acquisition of the Lovestruck matchmaking business earlier in the year. As part of our ongoing due diligence we caught up with management in Hong Kong during the month and were pleased to find the Lovestruck business had a strong reputation within that market.

As can be seen in the picture to the right, the Lovestruck brand is advertised in many prominent locations throughout Hong Kong. This strong brand awareness appears to be working with the number of Lovestruck and Datetix active users growing 133% over the prior quarter.

Whilst it's disappointing that the Datetix share price has retracted we feel confident that if the business continue to keep growing revenues at this rate, the share price should return to its previous highs.

The Lovestruck branded tram in Hong Kong