JM Financial Group

Issue 25: May 2017

Investment Newsletter

Market Performance (As at 31st May 2017)	Month To Date (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P - All Ords Accum. Index	-2.58	2.60	10.23

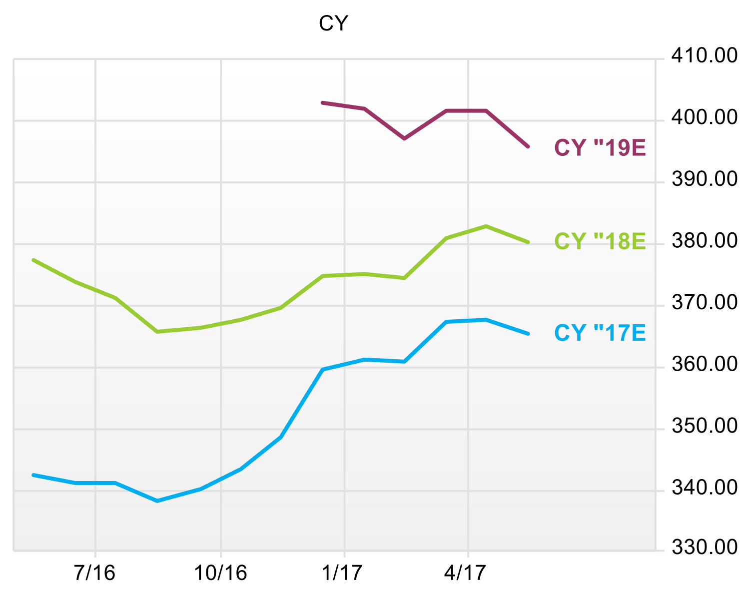
Month in Review *– A review of events that influenced the share market in May*

The ASX 500 Accumulation Index fell 2.6% in May. Sizeable declines in the major banks CBA (-8.9%), NAB (-11.4%), ANZ (-14.5%) and WBC (-13%) caused by benign quarterly trading results and announcement in the Budget of a new tax on the major banks that would ultimately see their earnings reduce by 2-3% on an after-tax basis were the main causes. The Financials sector fell 7.7% (dividend adjusted) for the month. Weakness was experienced across several sectors including Consumer Staples (-0.5%), Health (-2.1%), IT (-0.7%), and REITs (-1.1%). Exceptions included Telecommunications +3.4% (Telstra rebounded following dramatic declines in previous months), Industrials +4.7% (Sydney Airport +8%, Qantas +18%, Aurizon +7% amongst the best performers), Energy (+2.0%) and Utilities (+0.8%). The Financials sector virtually accounted for the entire fall in the market for the month with the net effect across other sectors about neutral.

There were however many downgrades of smaller companies during May, dominated by discretionary expenditure businesses, including RCG Corporation, Oroton, SurfStitch, Super Retail Group, Myer Holdings, Automotive Holdings Group, A.P. Eagers, Autosports Group and Pacific Smiles. Other downgrades included Mayne Pharma, Pact Group, Vocus Communications, Adacel, Vita Group (while a discretionary business, its downgrade related to less favourable trading terms with Telstra), Capral Ltd, Southern Cross Broadcasting, Qantm Intellectual Property and Select Harvests. The only stocks we found that experienced upgrades in the month were Appen Group (EBITDA guidance for CY17 increased from mid-to-high teen percentages to 40-50% higher) and while not technically an upgrade HUB24 confirmed 15% growth in Funds Under Administration (FUA) over the past three months, which was taken well in relation to guidance for strong FY17 FUA growth.

Iron ore took another large fall in May – having dropped from US$87/t to US$70/t in April, it fell further to around US$60/t. The estimated Market PE multiple for the next 12 months for the ASX All Ordinaries has moderated to 15.5x, having peaked above 17x in August 2016. Excluding Financials, BHP and RIO, the ASX All Ordinaries would be trading north of 16.5x in our estimation.

Chart of the Month – ASX Earnings Per Share Estimates



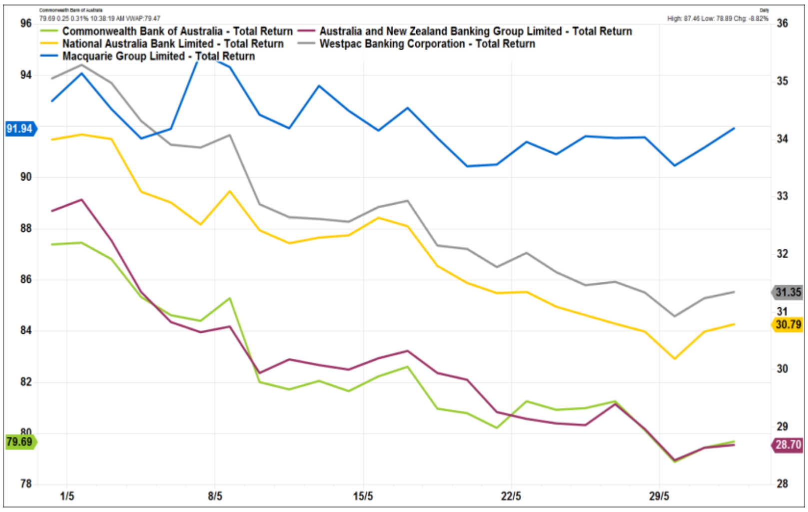
Source: Factset

This month we look at EPS growth estimates for CY17, CY18 and CY19 and in particular how they have changed over the past 6 months.

Having been in a distinct uptrend since the middle of CY16 there has been a marked change in the last month, with a clear rollover in estimates. While growth is still forecast from one year to the next, the base level of earnings for CY17 is under pressure. Commodity price improvements were a large part of the upgrades through CY16 but they have not been a factor in recent downgrades. This is despite a significant fall in the iron ore price since March. Analysts upgraded resource earnings in CY16 on higher spot prices. However, upgrades to longer-dated forecasts were more muted. Recent declines in the spot prices for iron ore have not taken the ore price below long-term forecasts.

While several factors have caused downgrades (new bank tax, company specific issues) a component has been consumer related and this in our view presents the major risk to the market and economic growth from here. We still have confidence in a level of underlying growth but further downgrades could compromise confidence.

Due Diligence – *The Major Banks*



The major banks have dominated the Australian financial news over the past month courtesy of the Federal Budget handed down Tuesday 9th May when a new tax on the big four banks plus Australia's fifth biggest lender, Macquarie, was announced.

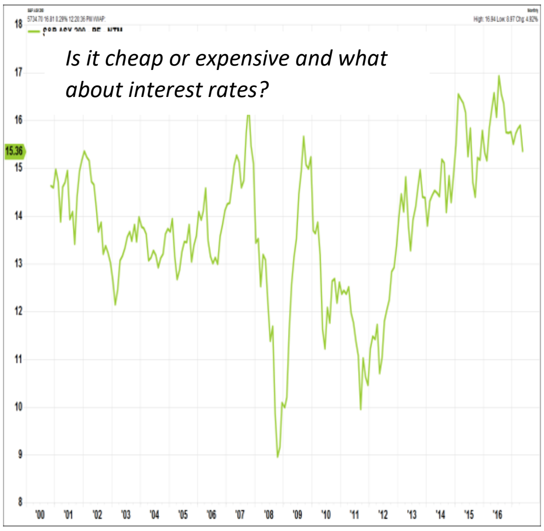
The new tax – which is actually a levy and expected to be tax deductible – is applied to bank liabilities at the rate of 0.06% annually, and calculated at 0.015% quarterly. The levy applies to banks' riskier borrowings, being corporate bonds, commercial paper, certificates of deposit, and all Tier 2 capital which includes revaluation reserves, hybrid capital instruments, and subordinated term debt. It does not apply to deposits of less than $250,000 or Tier 1 capital such as shareholders' equity or retained earnings. By only taxing higher risk liabilities, the tax should slow higher risk funding.

The tax is expected to raise $1.5-$1.6b annually. It will ultimately be paid by customers or shareholders. If the banks attempt to recover this additional cost, they would need to raise interest rates by an estimated 0.2%. In doing so, they would provide the smaller banks that are not subject to the levy a definite advantage. We suspect only around half of the levy would be recoverable without damaging the major banks' competitive positions. If the banks (i.e. shareholders) absorb the full cost of the levy, earnings may be 2-3% lower (less for Macquarie), all else being equal. Interestingly, the major banks affected, ex Macquarie (-1%), have fallen between 9-13% over the month after adding back dividends. However, before May 9 the banks, on somewhat disappointing trading results, had already fallen between 4-9%. The additional declines since then have been 4-6%, more than accounting for the tax's likely earnings impact.

Is the Market Expensive?

Always a difficult question to answer and a question that throws up more questions: Where are interest rates going? Is the Chinese economy about to slow? Will geo-political tensions create uncertainty that will slow global growth? It would be arrogant of us to think that we can answer these questions with any degree of accuracy. It would therefore be negligent of us to structure portfolios based on predictions of major turning points in economies or markets. Our approach is to structure portfolios based on the environment we are in and to skew them toward value in the market with a focus on companies that operate in structurally sound industries.

In terms of thinking about investment merits of a company we firstly try to determine if it sits within an industry with good structure and then try to determine if it has a competitive advantage. If we can then find value in a company for a given/likely level of expected growth and it has good management then it becomes a candidate for investment. One way to think about potential companies is to apply the WISHMAN approach; WISHMAN being an acronym for a range of attractive industry or company attributes that should lead to longer term growth prospects.
WEALTH: Ageing western population with growing wealth provides long-term, above average growth attributes not seen in many sectors. *INTERNET*: The internet of things, disruptive technologies that have potential to grow new businesses or add a growth arm to nimble incumbent operators. *SCALE*: Large operators that can use scale to generate a sustainable competitive advantage. *HEALTHCARE*: Ageing populations with growing wealth provides funding for, and inherently growing demand for, various healthcare services and provisions. *MONOPOLY*: A range of privatised infrastructure and utility assets and demand for privately funded future assets should provide ample growth opportunities, some with guaranteed returns to investors. *ASIA*: Growing wealth in Asia provides an enormous range of opportunities for Australian companies, both in terms of exploiting opportunities within Asia and exploiting growing Asian tourism into Australia given its proximity and time-zone convenience. *NATURAL ADVANTAGE*: Resource companies operating at the lower end of the cost curve as a result of a natural geological advantage can provide very attractive equity returns at certain points in the economic/commodity cycle.



Every stock in a portfolio must have a sound reason for inclusion. If it is not a structural reason it must still have some other significant characteristic. It could be an industry consolidation theme, cyclical leverage from a low point in the cycle or an efficiency opportunity that can be, at least partly, enjoyed by shareholders. However, these latter opportunities have a shorter duration and, as such, timing is more critical. In our view, these stocks should generally be a smaller component of portfolio construction.