JM Financial Group

Issue 26: June 2017

Small Companies Strategy – Investment Newsletter

Performance (As at 30th June 2017)	Month to Date (%)	Quarter to Date (%)	Cal. Year to Date (%)	Fin. Year to Date (%)	Rolling 1yr (%)	Inception (%)
JMFG Small Co. Strategy	**2.57**	**0.62**	**2.50**	**6.20**	**6.20**	**62.68**
Small Ords Accum. Index	1.99	-0.35	1.11	7.01	7.01	22.97
Outperformance	**+0.58**	**+0.97**	**+1.39**	**-0.81**	**-0.81**	**+39.71**

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, includes fees (post 1 Jan 17) 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 June*

The Small Ords Accumulation Index rose 1.99% for the month, marginally ahead of the All Ordinaries Accumulation Index which rose 0.3%, with the market down 1.6% on the final day of the month after a weak lead from foreign markets. The Small Ords has outperformed the broader market for two consecutive months with far fewer trading downgrades in June compared with May. There were also some encouraging recoveries in many smaller stocks which had previously experienced significant declines earlier in the year.

The yield trade stumbled in June with REIT, Utilities and Telco sectors amongst the worst performers, declining 7.8%, 3.8% and 3.1% respectively. After adjusting for many REIT stocks that went ex-dividend in June, as did APA Group in the Utilities, the sector was still down. The Energy sector was also hit hard, falling 6.7%, with West Texas Intermediate Oil falling over 7% and Brent down 4% in June.

The Small Companies Strategy outperformed its benchmark by +0.58% in June, rising 2.57% compared with the Small Ordinaries Accumulation Index at +1.99%. It has outperformed its benchmark by 1.39% calendar year to date and finished 6.2% ahead but behind its benchmark by 0.81% for FY17. It is well ahead since inception. Through June, the Fund benefited from a number of substantial recoveries in stocks that had previously been weak. These included Catapult +45%, Temple & Webster +13%, Love Group +14% (formerly Datetix), Hub 24 +7%, and Appen +9%. Apart from Temple & Webster, with a trading update in line with expectations, there was no new news across these stocks. Appen continued to perform well, probably off its very strong guidance upgrade in May. The Fund's worst performers included Netcomm Wireless -4%, Base Resources -11% and Opthea -6%. Netcomm eased after a strong rally in May, despite announcing a device supply arrangement with Telefonica for a range of 3G/4G devices. During the month, we added Super Retail Group (SUL) and Melbourne IT (MLB) to the portfolio and redeemed Stokes convertible notes for cash. We reduced holdings in Emerchants, Temple & Webster and GUD on share price strength, and added to GTN and SRG on weakness – and saw pleasing recoveries later in the month.

Chart/Table of the Month – Global Economic Factors

Region Economic Summary

	Real GDP %	CPI %	Unemploy-ment rate %	Current Account % of GDP	Govt Debt % of GDP
China	6.9	1.2	4.0	0.7	16.6
European Union	2.1	1.6	7.8	--	83.4
Euro Zone	1.9	1.4	9.3	2.4	88.3
France	1.1	0.7	9.3	-1.6	97.9
Germany	1.7	1.5	3.9	6.0	67.7
India	6.1	1.1	5.0	-0.6	41.8
Italy	1.2	1.2	11.1	2.6	131.7
Japan	1.3	0.4	3.1	4.1	205.5
United Kingdom	2.0	2.9	4.6	-3.4	90.6
United States	2.1	1.9	4.3	-2.5	104.4

Source: FactSet Economics Standardized Database

Australia is entering an unusual phase where global growth is accelerating but not having its typical impact on Australia's rate of growth. Since we last looked at a table of economic growth factors in January there have been some interesting, albeit modest, improvements particularly in Europe. Real GDP growth in China has improved marginally from 6.8% to 6.9% but growth in the European Union has increased from 1.9% to 2.1%. In addition, stronger growth in the U.S. which has risen from 1.9% to 2.1%, and Japan from 1.0% to 1.3%, more than offset weaker growth from India, which has moderated from 7.3% to 6.1%.

The improved growth has understandably been reflected in lower unemployment levels. While there have been mixed changes in inflation rates, it is encouraging to see the CPI rise from 1.2% to 1.6% in the European Union – although a significant reversal in China (2.3% to 1.2%) is a concern and could become a risk to asset inflation, an important requirement for consumer confidence.

Government debt as a % of GDP was stable in Europe but rose from ~13.8% to 16.6% in China.

Best & Worst Performers for June 2017

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
CAT – Catapult Group Intl	BSE – Base Resources	CSV – CSG	GXY – Galaxy Resources
TPW – Temple & Webster	SKS – Stokes	RCG – RCG Corporation	MGC – Mg Unit Trust
LVE – Love Group Global	GFY – Godfreys Group	SRX – Sirtex Medical	AYS – Amaysim Australia

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

CAT – Catapult Group International Limited – up 43.8% for the month

A significant rebound on no new news other than it had previously experienced a large fall. The company continues to lead the market in the elite wearables devices and video analytics business.

CSV – **CSG Limited** – up 60.2% for the month **(Not held)**

An unusual increase given there was no new news although the stock had fallen from around $1.50 at end FY16 to sub $0.50 prior to its strong rally in June 17.

BSE – Base Resources Limited – down 10.9% for the month

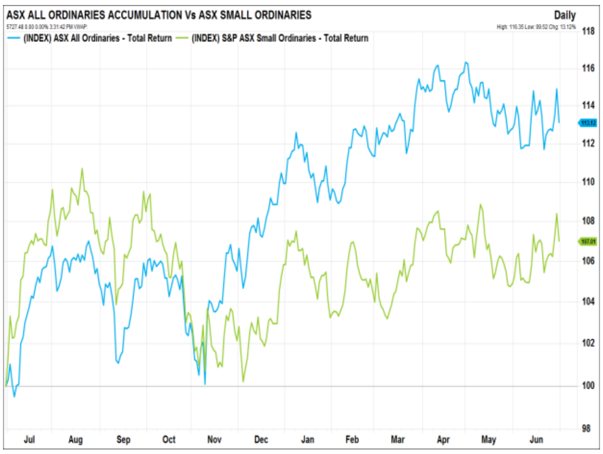
Base experienced a decline following a solid rally over many months. The outlook for mineral sands product continues to be strong and solid cashflow should see this business perform into the future.

GXY – Galaxy Resources Limited – down 29.6% for the month (**Not held)**

Two company updates during the month on its suspended Siana Gold project in the Philippines and confirmation of royalty payments from its interests in the Mt Cattlin lithium mine in Western Australia were not enough to slow the share price decline which started in January.

Small Ordinaries Stocks – *a year in review*

After the end of another financial year, we thought it worthwhile taking a look across the Index over the last 12 months to see where outperformance and underperformance came from and whether there were any strong themes over the year. To put things in perspective, the Small Ordinaries Accumulation Index underperformed the All Ordinaries Accumulation Index by around 7% for the year, having outperformed by 12% in the prior fiscal year. In most years the Small Ordinaries Index does underperform the broader market and yet there is greater capacity to generate excess returns through targeted investment at the smaller end of the market. This can be achieved by avoiding companies with challenged business models, small resource businesses that are dependent upon exploration success to sustain economic value, and companies that have attracted unjustified hubris that are simply coming back to the field. Looking through the list of companies in the Small Ordinaries Index we find many of these companies at the bottom of the performance table.



For example, amongst the bottom quartile performers (50 stocks) for the year we find 15 resource businesses, 10 discretionary retail/old media businesses, many with challenged business operations, and 7 companies that had previously suffered unjustified hubris including 3 aged care operators. Interestingly Aveo, which has been in the news recently and suffered large falls, is not one of these 3 aged care operators.

In contrast, amongst the top quartile stocks we only find 3 resource companies and 2 discretionary retail/old media businesses. The challenge will be to weed out those that have experienced unjustified hubris over the past twelve months that will be at the bottom of the table after fiscal year 18. The top quartile of performers included a mixture of mining service operators, Software-as-a-Service providers, agricultural businesses, service and distribution businesses, and a smattering of specialist manufacturing operations. We have doubts around mining service businesses repeating their FY17 performance but a number of the Software-as-a-Service operators have good product and real scale potential but this is already factored into the share price in many cases. As for the rest, our focus will be on identifying the quality operators.