JM Financial Group

Issue 30: October 2017

Investment Newsletter

Market Performance (As at 31st October 2017)	Month To Date (%)	Calendar YTD (%)	1 Year Rolling (%)	3 Years Rolling (%)
S&P - All Ords Accum. Index	+4.06%	+8.17%	+15.45%	+23.66%

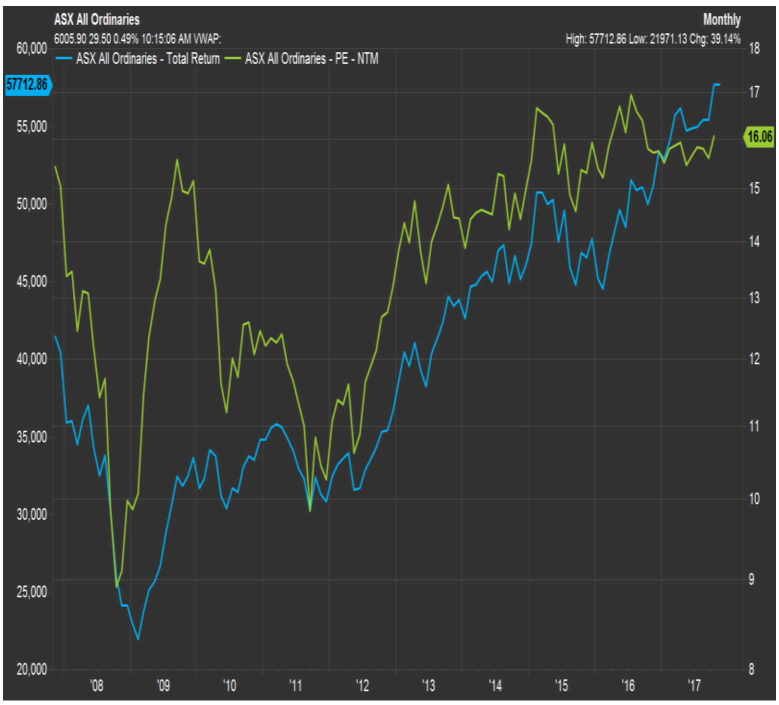
***Month in Review** – A review of events that influenced the share market in October*

The All Ordinaries Accumulation Index increased 4.06% for the month and has risen 15.45% over the twelve month period to end October 2017. The market was strong across the board in October, with the strongest sectors including I.T. +8.6%, Energy +6.5% and Consumer Discretionary +6.0%. Lagging sectors included REITs and Telecommunications at +2.2% and +2.4% respectively. Other high-yield sectors were mixed with Financials (ex-REITS) +3.2% and Utilities +5.0%. The Materials sector rose 4.4%, with Iron Ore across the different exchanges holding broadly steady around the US$60/t level. Oil was firmer, with Brent Crude and West Texas Intermediate both rising 5-6% over the month. The large Materials companies recovered in October, with BHP rising 3% and Rio 4%. Fortescue Metals Group fell a further 10%, following the dividend-adjusted fall of 9% in September.

Last month, we highlighted areas of the Australian equity market that look challenged, and mentioned a number of sectors which could find growth difficult for a range of different reasons, including a changing competitive environment, regulation and rising interest rates. Four of the six sectors we identified have since underperformed the market. The exceptions being Consumer Discretionary and Utilities.

From a low point in February 2016, the All Ordinaries Accumulation Index has risen by 30% and the forward 12-month rolling Price to Earnings Ratio (PER) has increased from 15.2x to 16.1x, based on consensus *Factset* data. To put this in perspective, over the past ten years, the All Ordinaries Accumulation Index has briefly peaked at a touch over 16.5x on just two occasions before retreating back to sub 15.5x. There has been a steady climb in the forward 12-month PER, from around 14x in CY13 to over 15.5x for much of the past 18 months. Interestingly, this has occurred while the Materials component of the market (~15% of total market) has retreated from a forward 12-month PER of 23x to 15x. This implies that the non-Materials components of the market have moved up substantially. With a reasonable global growth outlook and strong commodity prices, the higher PER multiples may continue for some time yet.

Chart of the Month – All Ordinaries Index & 12-month forward PER



Based on historic data, the All Ordinaries Index is starting to move into stretched territory again, with the index trading at 16.1x the 12-month forward rolling Price to Earnings Ratio (PER) based on *Factset* consensus data. On two occasions over the past decade (February 2015 and May-July 2016) the Index has traded above 16x the 12 month forward PER. On each occasion, it subsequently retreated to 15.5x or less.

The reversion back to 15.5x PER however can be caused by several factors. These include:

1) A decline in the value of the Index.
2) A growing earnings base as the rolling 12-month period progresses forward.
3) An adjustment in earnings expectations.

For example, from July 16 to May 17 the All Ordinaries Accumulation Index rose 6% but the forward 12-month PER declined 6%. In this instance, it would appear there was either a strong growth progression in rolling from one year to the next, or earnings expectations increased. Certainly there was some increase in earnings expectations due to a substantial improvement in the price of iron ore achieved over the period, relative to expectations.

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

Costa Group (CGC)

Costa Group listed on the Australian market in July 2015. The IPO price was set at $2.25/share. The stock traded lower in subsequent months but this was during a period where the All Ordinaries fell 12%. Since then, the stock has been on an upward trajectory – currently trading above $6.00/share.

Since listing, the business has grown from $736m of revenue and earnings per share of 6.2c in FY15, to $909m of revenue and earnings per share of 18.4c in FY17.

The company, through specialisation in growing and partnering with suppliers, distributes a range of fruit and vegetables. Its focused plant produce strategy includes berries, mushrooms, tomatoes, citrus, bananas, avocados and grapes.

A$m	FY2016	FY2017	Variance
Revenue	821.7	909.1	87.3
Share of assoc. and joint ventures	14.4	16.2	1.8
Operating expenses	(747.0)	(810.1)	(62.9)
EBITDA before SGARA	**89.1**	**115.2**	**26.1**
Fair value mvmt in bio. assets	4.3	5.9	1.5
EBITDA	**93.4**	**121.1**	**27.7**
Depreciation & amortisation	(22.5)	(27.8)	(5.3)
Profit/(loss) on sale of assets	(1.0)	0.3	1.3
EBIT	**69.9**	**93.6**	**23.7**
NPAT (before material items)	**47.3**	**64.8**	**17.5**
Material/pro forma items, post tax	(22.0)	(7.1)	14.9
Non-controlling interest	-	0.1	0.1
NPAT attributable to shareholders	**25.3**	**57.7**	**32.4**
NPAT-S (before material items)	44.2	60.7	16.5

Costa has achieved growth through a combination of acquisitions and further development of its existing farms. In addition, it has pursued an international growth strategy in China and Morocco. Investment in technology – particularly high-speed vision technology has eliminated the need for manual sorting, improved grading and increased packing throughput – resulting in a 50% efficiency increase. Future growth should continue through expansion of its Australian berry and mushroom operations, vertical integration into avocado farming and increasing volumes of international produce following a period of investment.

Timing Your Equity Investment

Timing investment in the equity markets is always difficult to gauge. Picking turning points is essentially an attempt to make calls against the consensus view. Why should anyone believe they have the capacity to make such calls with any degree of consistency or certainty? Many doomsayers have been calling the demise of the Australian housing market for much of the past two decades – yet, the Melbourne and Sydney established housing markets have increased 700-900% over that timeframe. Of course, there is nothing wrong with "taking a view" of things, but the key to prudent investment is managing risk. Selling all property assets, including one's residential property, on a view the market is overvalued, is clearly not prudent. There can be no guarantee the view taken is correct. The same goes for equity markets.

Since May 1992, the All Ordinaries Accumulation Index has increased by 864%. On a compound basis that equates to a very healthy annualised return of 9.3% per annum. Note that from our starting position, the low point in the market occurred 5 months later with the index down a further 15%. As a worst-case scenario, an investment at the top of the market in October 2007 through to October 2017 would have yielded a total return of 36.5% or a comparably disappointing annualised return of a little over 3%.

However, a process of steady investment into the market can deliver acceptable returns even when the starting point is relatively poor.

For example, if steady investment was made into the market from the peak in October 2007 through to the trough in February 2009, the annualised return on those combined funds would be in the order of 6.3%. While still not spectacular, one could argue these returns are acceptable on the basis of the original "unfortunate" timing.

If equal investment continued to be made for the three years to October 2010, the annualised returns would lift to around 7.4%. If they were made constantly for the ten year period from October 2007 through to October 2017, the annualised return would be in the vicinity of 7.80%. This would arguably be an acceptable return given the "unfortunate" starting point.

In all of these examples we assume Index returns. Shifting between higher and lower volatility/risk stocks, as markets become more or less expensive, can help to improve long-term returns – along with prudent selection of better-performing industries and companies within them. These are essentially the skills of an adept portfolio manager.

It's not necessarily all about timing.