# JM Financial Group

Issue 33: January 2018

## Small Companies Strategy – Investment Newsletter

| Performance *(As at 31st January 2018)* | Month (%) | Rolling 3mths (%) | Rolling 1yr (%) | Rolling 3yrs (%) | Inception (%) |
|---|---|---|---|---|---|
| **JMFG Small Companies Strategy** | **+2.52** | **+11.87** | **+25.01** | **+79.69** | **+97.50** |
| Small Ords Accumulation Index | -0.54 | +6.65 | +22.35 | +47.47 | +44.42 |
| **Outperformance** | **+3.06** | **+5.22** | **+2.66** | **+32.22** | **+53.08** |

*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 a TWRR basis; non-annualised, and includes fees (post 1 Jan 17) but excludes 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 January*

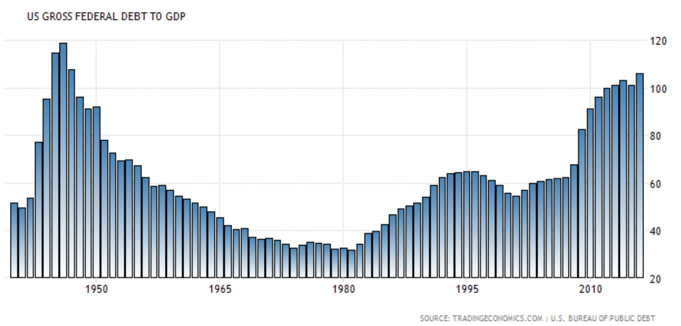
The JMFG Small Companies Strategy increased 3.06% in January, well ahead of the Small Ords Accumulation Index, which fell 0.54% (ASX Small Resources -0.93% and ASX Small Industrials -0.43%). Rising global interest rates again became a focus of equity markets, with concerns that synchronised growth would lead to inflation/wage growth, and hence rising global interest rates. As a result, income-related sectors were the worst-affected in January. Utilities fell 4.5%, Property Trusts fell 3.3%, and the Industrial sector (major components being Transurban and Sydney Airports) fell 2.1%. The Health sector had a good month, rising 3.2%. The I.T. sector rose 2.0% and most other sectors finished within +/– 1% of the prior month end.

After rising over 20% in CY17 and nearly 14% over the December quarter, the ASX Small Ordinaries was due for a breather. Major upward movers within the Small Ordinaries included Sirtex, +66%, where a takeover proposal was announced, Bellamy's, +42%, driven by a guidance upgrade, Thorn Group, +13%, and Vita Group +24%. A number of the ASX Small Resource companies experienced sizeable declines, including Pilbara Minerals, -15%, Galaxy Resources, -13%, Syrah Resources, -12%, Beadell Resources, -17%, and Mineral Resources, -11%. Amongst the small industrial companies, Impedimed fell 22% and Retail Food Group fell 21%.

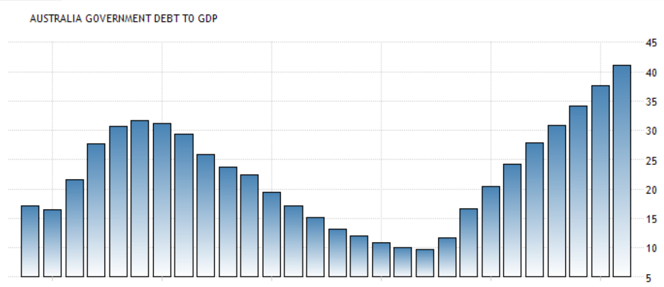
During the month, we neither introduced new stocks into the portfolio nor eliminated any stocks. We did trade several positions, with reductions on share price strength to Global Geoscience, Temple & Webster, Hub 24 and Base Resources. We added to positions in BIG Un Ltd (although we subsequently removed this position entirely in the early part of February at what proved to be attractive prices). The portfolio cash balance at month end was close to 14% (and this extended further in the first few days of February following the sell-down of Big Un Ltd). The portfolio is cashed up to take advantage of opportunities, which as we write, are presenting themselves with high levels of volatility becoming evident across global markets.

***Charts of the Month – Gross Debt to GDP***

US national debt stands at over US$20.6tr, which compares to US$19.8tr for annual US Gross Domestic Product. US Federal tax revenue is around US$3.35tr annually with Federal spending at US$4.04tr, hence its annual national debt is growing at about US$685b per year. *(Source: US Debt Clock.org)*




US Gross Federal Debt stands at 104% of GDP, a traditionally high level but other developed nations are at higher or similar levels. For example Japan is well over 200%, Singapore is around 110%, Spain and France are both around 100% and the U.K. is around 90%.




Australia's Government Debt to GDP is low by comparison at 40%, but has increased from sub 10% to over 40% over the last decade. The magnitude of the increase is broadly similar to the US, where its Debt/GDP ratio has increased from sub 70% to over 100% in the same timeframe. Whilst growing Debt to GDP ultimately needs to reverse, the cost to service debt is very low by historic standards but rising interest rates will be a concern.

## Best & Worst Performers for January 2018

| JMFG Small Companies Strategy | | ASX Small Ordinaries Index | |
|---|---|---|---|
| **Best** | **Worst** | **Best** | **Worst** |
| Mach7 Technologies – M7T | Yowie Group - YOW | Sirtex Medical - SRX | Impedimed - IPD |
| Echo Resources - EAR | LiveHire - LVH | Bellamy's Australia - BAL | Retail Food Group - RFG |
| SelfWealth - SWF | Opthea - OPT | Vita Group - VTG | Beadell Resources - BDR |

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

**Mach7 Technologies Limited** – up 30% for the month

An investor presentation mid-month provided encouragement to the market with new sales and partnerships announced, along with an expectation of positive EBITDA being achieved for FY18.

**Sirtex Medical Limited** – up 66% for the month **(Not held)**

Sirtex announced it had entered into a binding Scheme Implementation Deed with Varian Medical Systems to acquire 100% of the shares in Sirtex at A$28.00/share. The Sirtex Board unanimously recommended the proposal to shareholders.

**Yowie Group Limited** – down 31% for the month

A revenue and earnings guidance downgrade early in January, along with Board and Management upheaval, has seen the share price decline rapidly with a significant loss in confidence around the company's strategic direction.

**Impedimed Limited** – down 21% for the month (**Not held)**

The market reacted poorly to its quarterly cash-flow release, with net cash consumed from operations of $5.6m taking the six-month operating cash consumption to $11.7m.

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

**Afterpay Touch Group (APT) – A New Way To Buy Things**

We introduced Afterpay Touch into the portfolio several months back at prices substantially lower. The company develops and provides payment solutions, offering a "buy now, receive now, pay later service" where goods are purchased at associated retailers (see below) with payment made over 8 weeks, in 4 equal instalments. The product is particularly attractive to millennials, a demographic that has shown reluctance to enter into traditional credit arrangements via credit card or personal loan arrangements. The Afterpay system deducts instalments from a debit card, thereby matching a customer's fortnightly income payments with purchase liabilities.

Afterpay funds the initial purchase and makes an immediate payment to the retailer, less a 4% fee. This fee covers operating costs, funding costs, bad debts and profit to Afterpay. Any non-payment by customers is a cost to Afterpay.

Customers are not required to go through any credit checks, but Afterpay uses a set of demographic data to determine a customer's eligibility to become an Afterpay member. This ultimately could be the Achilles heel – if Afterpay does not take due care, or have adequate systems in place, it risks a high level of bad debts, which could ultimately damage earnings potential. This risk is potentially low and reduces as the customer base grows and refines, and as Afterpay improves its knowledge position on customer purchasing habits and repayment reliability – noting, however, that late payment can incur additional charges.

Afterpay has established itself in the Australian market, with relationships across major retail groups in Australia and New Zealand, telcos, convenience stores, and insurers. It has also established a pilot partnership with Jetstar and is examining entry into the US market. All in all, the growth prospects look strong, but it may be a business easily replicated by new competitors or existing operators within the financial services sector. Afterpay does, however, have first mover advantage, and its opportunities still seem significant.