JM Financial Group

Issue 37: May 2018

Small Companies Strategy – Investment Newsletter

Performance *(As at 31st May 2018)*	Month (%)	Rolling 3mths (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception (%)
JMFG Small Companies Strategy	**+3.36**	**+1.46**	**+25.45**	**+60.40**	**+99.04**
Small Ords Accumulation Index	+3.70	+4.11	+25.40	+38.82	+50.41
Outperformance	**-0.34**	**-2.65**	**+0.05**	**+21.58**	**+48.63**

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 May*

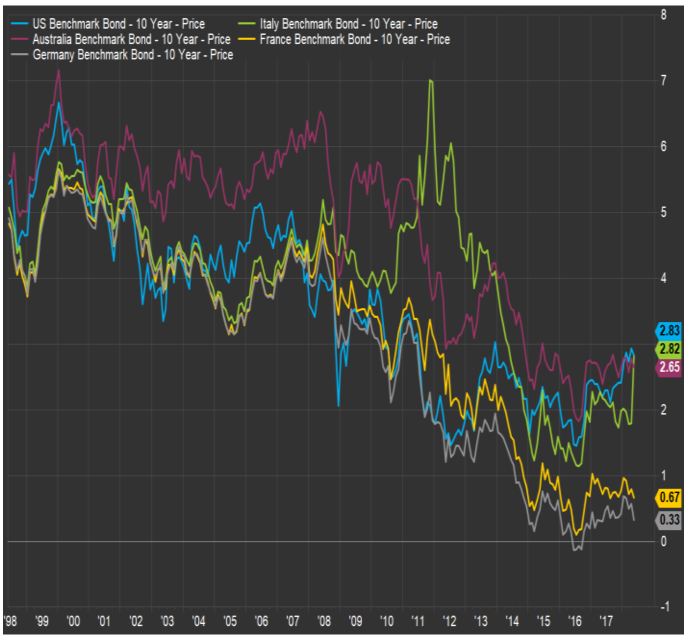
The JMFG Small Companies Strategy appreciated 3.36% in May, slightly behind the ASX Small Ordinaries Accumulation Index which increased 3.70%. The ASX Small Ords Accum substantially outperformed the ASX All Ordinaries Accumulation Index, which increased 1.40% through the month. Last month, the performance of the ASX Small Ords was dominated by resources. In May, returns were more evenly spread, with the ASX Small Industrials rising 3.84% and the ASX Small Resources rising 3.26%. Most sectors of the market registered positive returns during May with the strongest being Healthcare +5.6% and Consumer Discretionary +4.9%. However, on the weak side, Telecommunications declined over 10% and Financials fell 1.8%, the latter continuing to be dogged by the findings of the Royal Commission, and the former continuing to suffer from increasing competition due to structural change.

The portfolio's best performers in May included Wisetech Global and Hub24, rising 46% and 24% respectively. Its weakest performers were Mach7 Technologies and Medical Developments, falling 21% and 15% respectively. Unlike many May months, the market rallied; globally, May is often a weak month and, for the Australian market, May is typically a confession/downgrade period, as companies near their financial year end. There was an absence of downgrades this year; unlike last year when we counted in excess of 20 sizeable earnings downgrades across the ASX Small Ords, which contributed to a market fall in excess of 2%. The two-month rally in the market now sees the Small Ords nearing its 10-year highs based on its 12-month forward PER, which is now at 17.5X and has touched 18X on three occasions over the past 5 years, prior to moderating shortly thereafter. The ASX All Ords now sits at 15.7X.

After two quiet trading months, activity in the JMFG Small Companies Strategy stepped up somewhat, with portfolio reductions across several stocks on price strength and top-ups around attractive capital raisings, including SRG Ltd and Sensen Networks. We also sold out of several companies either on valuation grounds or to take advantage of perceived better opportunities. Cash at month-end was 9.1%.

Chart of the Month – Ten-Year Interest Rates

Longer-term interest rates have been on the rise since the middle of 2016, but rises in the major European economies have been modest. Long-term Interest rates in France and Germany (10 year Bonds) have risen from around 0% to 0.3-0.7%. The European economy has seen improved economic growth over the past 18 months. Its two largest economies, France and Germany, have seen real economic growth improve from around 1.5% early 2017 to 2.5% by late 2017. That rate of growth has started to moderate slightly and with concerns around Italy's finances, reduced confidence levels may see a delay in capital investment plans. Italian long rates have increased from near 1% in 2016 to almost 3% currently and 100 basis points of that increase has occurred since late April 18.



Long rates in the U.S. have lifted from around 1.5% in mid-2016 to a little under 3% currently, but economic growth in the U.S. has continued to improve from sub 2% early in 2017 to around 2.8% currently. Australia has a similar long-term interest rate and real economic growth rate to the U.S., with both sitting around the 2.7-2.8% level.

Best & Worst Performers for May 2018

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
Wisetech Global – WTC	Mach7 Technologies – M7T	Seven West Media – SWM	Ainsworth Game Tech. – AGI
Hub24 - HUB	Medical Developments – MVP	Wisetech Global – WTC	Amaysim Australia – AYS
Polynovo – PNV	Integrated Research – IRI	Sino Gas & Energy – SEH	Metcash – MTS

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

Wisetech Global (WTC) – up 46.4% for the month

Further acquisitions, a $100m placement of stock to a single global institutional investor at $13.30, and an investor day through the month all combined to see the share price rally back toward share price highs seen earlier in the year.

Seven West Media (SWM) – up 47.8% for the month (Not Held)

SWM experienced a significant rally off a low base with a strong trading update showing metropolitan free to air revenue growing at 3.1% in the March quarter, ongoing ratings momentum and confirmation of prior EBIT guidance of $220-240m.

Mach7 Technologies (M7T) – down 21.4% for the month

Lack of meaningful news flow has continued to see Mach7 Technologies drift lower and is likely to do so until sizeable new contract wins are announced.

Ainsworth Game Technology (AGI) – down 39.3% for the month (Not held)

One of the few companies to downgrade expectations through May saw its share price come under serious pressure. Management downgraded second-half Profit Before Tax expectations from around $42m to $20m.

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

Lovisa (LOV) – Spreading The Love

Established in 2010, Lovisa has grown rapidly to become Australia's leading fast fashion jewellery retailer with a target audience of young women in the 15-45 age group range. It has grown into a network of over 300 stores with around 50% located in Australia and 50% in international markets including New Zealand, Singapore, Malaysia, South Africa, Spain, France, the USA and United Kingdom as well as franchised stores in the Middle East and Vietnam.

Its success has been built on fast fashion with a model that identifies trends early, maintaining relevance to its target customers. It operates a vertically integrated model where it develops, designs, sources, and merchandises all of its branded product. Lovisa was founded by Brett Blundy, a highly successful Australian retail operator, through his BB Retail Capital group, and Managing Director, Shane Fallscheer who has 30 years of experience across Australia, the USA and United Kingdom with Sanity, Diva and Rip Curl.

With a significant store base already in Australia, the upside potential exists in its international operations and, in particular, in Europe and the USA, where it currently has 28 stores (25 UK, 2 Spain, 1 France) and 1 store respectively.

Fast, affordable fashion came to Australia through a number of the European chains entering the market over the past decade. The most notable being Zara which adopted an eight-week cycle, thereby changing the bulk of its inventory around 6 times a year. The concept of fast affordable fashion should translate into European markets with early results very positive in the U.K.

Translation into the rest of Europe and the USA could see significant upside to both the earnings and share price of Lovisa. The company should continue to achieve strong double-digit revenue and earnings growth as it continues its store rollout, but it does need to achieve double-digit growth rates given its consensus PER of 34X in FY18 and 29.5X in FY19. Should major foreign markets prove successful there is every likelihood earnings growth will be stronger than that forecast in FY19 with the prospect of strong earnings growth continuing for several years.