

Small Companies Strategy – Investment Newsletter

Performance (As at 30 th September 2018)	Month (%)	Rolling 3mths (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception (%)
JMFG Small Companies Strategy	-0.57%	+2.66%	+24.04%	+62.81%	+104.96%
Small Ords Accumulation Index	-0.35%	+1.10%	+20.32%	+60.03%	+53.68%
Outperformance	-0.22%	+1.56%	+3.72%	+2.78%	+51.28%

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 September

The ASX Small Ordinaries Accumulation Index declined 0.35% in September following its solid 2.49% rise in August. The JMFG Small Companies Strategy marginally underperformed, falling 0.57%, but that comes off a 6.96% increase in August. The strongest sectors of the market in September included Energy +4.3%, Materials +4.2% (dominated by large caps BHP and Rio Tinto) and Telecommunications +2.7%. Weakest sectors included Healthcare -8.0%, Consumer Discretionary -4.2%, and Utilities -3.3%. The ASX Small Industrials declined 0.4% during September, while the ASX Small Resources fell 0.1%, with falls in small golds offsetting rises in energy and small materials.

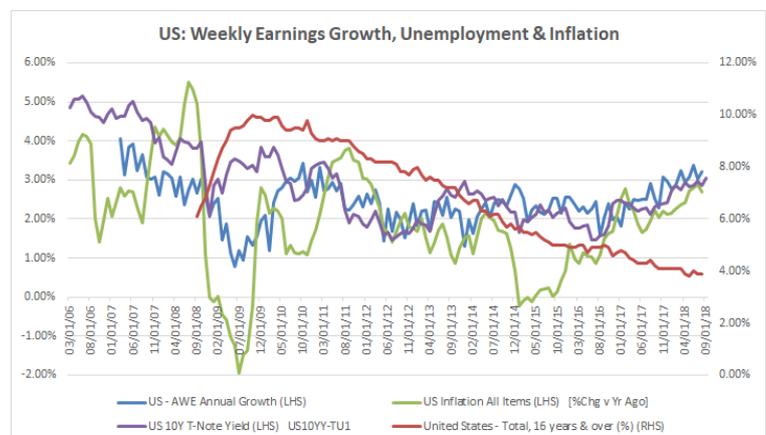
The portfolio's strongest performer during September was Vault Intelligence, +52%, a stock that was added to the portfolio through the month on a capital raising opportunity. Enevis (previously Stokes), +27%, after much disappointment over recent years, made what looks to be an accretive acquisition and simultaneous capital raising, allowing considerable debt reduction. Sundance Energy, +16%, was the beneficiary of strong energy prices, and rallied around 5% over the month. Alongside Vault, the only other new stock introduced into the portfolio through September was Pinnacle Investment Management. We removed three stocks from the portfolio during the month: Afterpay, on share price exuberance; Scottish Pacific, following announcement of a private equity proposal coupled with a solid rise in the share price; and Megaport, on concerns around its ongoing cash burn. We reduced holdings in Appen and Sundance Energy on share price strength, and continued to build our holding in Netwealth, and added to St Barbara Mines on price weakness.

While the ASX Small Ords Accum. Index moderated only slightly in September, its 12-month forward PER eased from 19.0x to 18.5x, or around 2.5%, indicating a small net upgrade to total earnings post reporting season. The Index continues to trade at relatively high valuations but is supported by high single-digit earnings growth expectations, based on Factset consensus data. With interest rates rising in the US to above 3%, perhaps the greatest risk to the Australian market is any valuation impact that ongoing rate increases might have in the US and other major economies, and the contagion effect on global equity markets.

Chart of the Month – Interest Rates & Valuation

Economic growth in the U.S. has accelerated through 2018, with current estimates for Real GDP growth at 2.9%, up from 2.2% in 2017. Improved economic growth in the U.S. has seen unemployment levels fall to under 4% (Total for 16 years and over). Unsurprisingly, average weekly earnings annual growth has pushed above 3%, having averaged 2% or less for most of the five year period from 2012 to 2017. Inflation has moved from a sub 2% range to 2.7-2.8% over recent months and yields on longer-term treasury notes has pushed up to around 3%. All of these factors have led to a strong US\$.

While economic strength drives earnings growth, there is a danger point where that economic strength drives rates to a level where the valuation impact of higher interest rates more than offsets the positive impact of earnings growth. Growth for now is at healthy levels and interest rates are by no means stretched. Market multiples however are on the high side – the S&P 500 trading at close to 17x its forward 12-month PER. The US markets are generally priced for ongoing consistent growth and moderate interest rates. This may continue to be the case for some time, but rising tariff regimes present a left-field risk which is difficult to quantify. Any significant tariff intervention is likely to have direct consequences upon economic growth, inflation, overall risk and ultimately interest rates. How these all combine and affect market valuation is impossible to quantify, but unlikely to be positive.



Best & Worst Performers for September 2018

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	Worst	Best	Worst
Vault Intelligence – VLT	Lynas Corporation – LYC	Clinuvel Pharma – CUV	Lynas Corporation – LYC
Enevis – ENE	RMA Global – RMY	Mesoblast – MSB	Estia Health – EHE
Sundance Energy – SEA	Mainstream Global – MAI	Aurelia Metals – AMI	Japara Healthcare – JHC

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

Vault Intelligence (VLT) – up 51.6% for the month

Vault, an EH&S software and hardware business, assists companies in managing their workforce, and ensuring all aspects of safety and compliance are up to date. Vault raised capital during September and announced a major distribution partner, based in Singapore.

Clinuvel Pharmaceuticals (CUV) – up 49.3% for the month (Not Held)

The market reacted positively to a company presentation, a US FDA update and an announcement that it had reached agreement with two European centres on clinical trial protocols to conduct Phase IIa proof of concept studies to evaluate product safety and effectiveness.

Lynas Corporation (LYC) – down -27.2% for the month

A review into Lynas' operations in Malaysia, as announced by the new Malaysian government, has placed a dampener on the stock, with media speculation the chair of the proposed committee may be a long time anti-Lynas campaigner.

Estia Health (EHE) – down -22.3% for the month (Not held)

The Prime Minister Scott Morrison's call for a Royal Commission into Australia's aged care sector saw a marked retreat across all listed aged care stocks. Estia was amongst the worst performers. Following some quite startling revelations from the Banking, Superannuation & Financial Services Royal Commission, the view in the market is that any outcome of a Royal Commission will be detrimental to earnings.

Due Diligence – A closer look at a stock of interest

Vault Intelligence (VLT)

Vault Intelligence develops technologies that help corporations manage risk and maintain compliance requirements through integrated online SaaS based tools and wearable location devices. Vault helps to create an efficient line of communication between staff on the ground and management. The aim is to prevent incidents and increase visibility around risk and safety management. Vault's compliance software helps avoid financial liabilities and protect businesses through a comprehensive compliance management system.

Vault is also currently in the process of launching Vault Solo, an integration of technology across desktop, laptop, smartphone and smartwatch interfaces, allowing notifications to be sent and received in real-time, with simple to use check-ins and customisable escalation and notification options.

The Solo Web Portal is a live dashboard for use on desktop or laptop, while the Solo App is designed for a mobile workforce offering workforce management tools including GPS mapping, all on a smartphone. The Vault Solo Watch is essentially an extension of the Solo App but more manageable in certain work situations when carrying and using a mobile phone is not practical.

Vault is at the smaller end of the scale in terms of listed "small companies", with a market capitalisation less than \$50m. It had a revenue base of only \$2.5m in FY18, with a forecast around \$7m in FY19 – but it has significant ongoing growth potential, particularly on the back of the recent initiatives.

Perhaps Vault's most pleasing aspect is its existing client base, which is a validation of their technology. Clients include Visy, Rheem, Mercedes-Benz, Cleanaway, McCain, Perilya, GUD and Vocus, to name a few. To date, it has over 400 enterprise customers, covering over 1 million workers across 30+ industry sectors. With only 22,000 app downloads so far, the upside from Vault Solo and the entire integrated offering is still significant, as is the yield potential as Vault becomes more established across industry segments.

