JM Financial Group

Small Companies Strategy – Investment Newsletter

Performance (As at 31st May 2019)	Month (%)	Rolling 3mths (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception (%)
JMFG Small Companies Strategy	-2.44	+4.97	+1.37	+32.22	+101.78
Small Ords Accumulation Index	-1.25	+2.69	+2.06	+32.53	+53.52
Outperformance	-1.19	+2.28	-0.69	-0.31	+48.26

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) and taxes. Strategy Inception for Performance Data is July 1st 2014.

Month in Review – *A review of events that influenced the share market and portfolio in May*

After rising 17% in the four months to end April, the ASX Small Ordinaries Accumulation Index moderated in April, declining 1.25% in May. The JMFG strategy underperformed by 1.19% in May, but is ahead of its benchmark over the quarter by 2.28%. May is typically the start of confession season and our portfolio was hit with guidance downgrades to Costa Group and Citadel. This year seemed to be particularly poor, with downgrades coming through at a slightly faster rate than in recent years. Other notable downgrades in the market included Reliance Worldwide, Mayne Pharma, Adelaide Brighton and Flight Centre (late April). The ASX Small Industrials fell 1.32% while the ASX Small Resources fell 0.95%. Strongest sectors during the month included Telecommunications +7.3%, Healthcare +3.3% and Materials +3.2%. Weakest sectors included Consumer Staples -4.2%, I.T. -4.0% and Energy -3.8%.

Our best stocks for the month were once again small technology companies with Mach7 +40% and Polynovo +16%, and gold company Saracen +15%. Weakest stocks included Citadel -37%, Costa Group -30% and Sensen -26%, the latter being a relatively minor holding. Valuations continue to trade at historically high levels with the ASX Small Ords 12-month forward PER, as per *Factset* consensus data, trading at 18.0x, down slightly from 18.4x at the end of April. The high valuations mean that any level of disappointment relative to expectations results in offenders being treated harshly with share price declines of 30-40% quite common.

We cut four stocks from the portfolio and added four new stocks. Superloop was cut following an unexpected potential takeover announcement, which post sale was subsequently abandoned. Adairs was sold following price strength, while Costa was immediately sold upon downgrade, with the stock continuing to fall post sale. Praemium was switched into Bravura, on the basis we see the latter as having better growth prospects. We also added Imdex, Webjet and Codan to the portfolio, increased the holding in Citadel following price weakness, and reduced our position in Ioneer. Despite the high level of trading through the month, we retained our cash holdings at relatively high levels through the month, ending the month with cash at 10.8%, slightly down from prior month-end at 11.8%.

Chart/Table of the Month – *Global Economic Conditions*

Region Economic Summary

	Real GDP % vs year ago	CPI % vs year ago	Unemployment Rate Percent	Current Account % of GDP	Govt Debt % of GDP
China	6.4	2.6	3.7	1.8	14.7
European Union	1.5	1.9	6.4	-	79.3
Euro Zone	1.2	1.7	7.6	2.5	84.4
France	1.2	1.3	8.7	-0.6	97.4
Germany	0.7	1.6	3.2	8.0	60.4
India	5.8	8.3	5.0	-2.5	43.6
Italy	-0.1	0.9	10.2	3.6	126.7
Japan	0.8	0.9	2.4	2.8	199.2
United Kingdom	1.8	2.1	3.8	-4.4	83.5
United States	3.2	2.0	3.6	-2.6	104.8

Source: FactSet Economics Standardized Database

We last updated the Global Economic Conditions table in November 2018. Since then, there have been minor reductions in growth rates across Europe. Real GDP growth across Europe has moderated from 1.9% to 1.5%, with France declining from 1.4% to 1.2% and Germany from 1.2% to 0.7%. However, the US and UK have had slightly stronger growth, with the US at 3.2% from 3.0% prior and the UK at 1.8% from 1.5% prior. Inflation levels have generally moderated, by around 0.5% across most regions while unemployment levels are broadly unchanged.

The measures mentioned above are historical and tell us nothing of future growth. Interest rates do however offer some insight into expectations and they have fallen quite dramatically since November. The US 30-Year Treasury Bond yield has fallen from a high of 3.4% to its current rate of 2.6%, with the 10-year falling a similar amount to 2.1%. UK 10-year treasuries have fallen from 1.7% to 0.9%, German 10-year treasuries from 0.5% to negative 0.2% and French 10-year treasuries from 0.8% to 0.2%.

Low interest rates provide valuation support for equities via lower discount rates for high growth, high PER stocks whilst making high yielding lower growth stocks an attractive alternative to low yielding bank term deposits and bonds.

JM Financial Group
AFSL 238397 ABN 68 007 364 132

Level 8, 140 Bourke St, Melbourne, VIC, 3000
Ph: +61 3 9627 9900

Web: www.jmfg.com.au
Email: enquiries@jmfg.com.au

Best & Worst Performers for May 2019

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
Mach7 Technologies – M7T	The Citadel Group – CGL	Lynas Corp – LYC	Costa Group Holdings – CGC
Polynovo – PNV	Sensen Networks – SNS	Kidman Resources – KDR	Liquefied Natural Gas – LNG
Saracen Minerals – SAR	St Barbara – SBM	Clinuvel Pharmaceuticals – CUV	Class – CL1

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

Mach7 Technologies (M7T) – up 40% for the month

Mach7 appointed a new Vice President of Sales and Marketing in the US. While this news in itself is not significant, recent contract wins and upgrades are placing the company on the verge of cashflow breakeven, which is an important achievement given the high fixed cost nature of the business and hence will scale given the very high gross margin achieved on each new product deployment into the field.

Lynas Corporation (LYC) – up 54% for the month (Not held)

Under takeover offer, and with China proposing restrictions on rare earth exports, interest levels in this company have surged given China's dominance in the production of rare earths and Lynas providing the world a significant non-Chinese alternative source.

The Citadel Group (CGL) – down 37.1% for the month

Citadel revealed a guidance downgrade for FY19 following what the company says were delays in product upgrades to Government departments ahead of the Federal election.

Liquefied Natural Gas (LNG) – down 29.9% for the month (Not held)

The company cited difficulties in executing contracts for the Magnolia LNG blaming trade and geopolitical disputes between the US and China, which in turn has caused some softness in spot LNG pricing.

Due Diligence – A closer look at a stock of interest

Codan (CDA)

Codan has three core operating divisions being Communications, Metal Detection, and Defence. It also has a Tracking division where product has been developed, and is now in the testing/early deployment phase at two underground mining locations, with new commercial orders expected over the coming twelve months through their distribution relationship with Caterpillar. Codan, based in Adelaide, is a global operator with the bulk, around 85%, of its sales outside of Australia.

Metal Detection provides the bulk of revenue (65%) and earnings (75%) with further growth expected through the development of detecting technologies, and extending product features into entry level ranges, with the anticipation of significant uplift in consumer sales. Codan is the leading provider of detection products across all categories, from entry level through to professional, servicing the recreational gold and treasure hunters, as well as professional operators and detection units used in Defence.

Communications/Defence includes tactical and land mobile radio solutions used in military, humanitarian, domestic security, public safety (fire, ambulance, enforcement), and remote land management. Tactical communications solutions are purpose-built for maximum reliability and ruggedness, and extend from military through to public safety, while in the Land Mobile Radio division, Codan has developed a product niche for lower density, cost-conscious US state and local governments.

The Tracking division offers significant upside but has been slow in coming to market. It essentially tracks mobile equipment and personnel to provide a safer environment as well as enabling intelligent mine scheduling to maximise efficiency and assist toward the implementation of fully autonomous machines.