JM Financial Group

Issue 46: February 2019

Investment Newsletter

Performance (As at 28th February 2019)	Month (%)	Rolling 3mths (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception (%)
JMFG Australian Equities Strategy	**+4.69**	**+4.87**	**-0.44**	**+30.97**	**+48.84**
All Ords Accumulation Index	+6.05	+9.79	+6.56	+43.31	+42.22
Outperformance	**-1.36**	**-4.92**	**-7.00**	**-12.34**	**+6.62**

Although the JMFG Australian Equities 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 in February*

JMFG's Australian Equities Strategy increased 4.69% through February, underperforming the ASX All Ordinaries Accumulation Index which rose 6.05% for the month. February's half-year company reporting season brought another mixed bag of shocks and pleasant surprises – on balance, results and forecasts exceeded expectations and led to the robust rise. Over the 3-month period, the Australian market has rallied by 9.79%. The Consumer Staples sector was the only sector that didn't finish February with gains. Best performing sectors were Financials +9.1%, Energy +7.9%, Information Technology +7.6%, with Materials, Industrials and Consumer Discretionary sectors each rallying in the mid-6% range. The weakest sectors were Consumer Staples -1.5%, Healthcare +1.0%, and Property +1.7%.

We added a number of new stocks to the portfolio, including some returners – Telstra and GUD Holdings as defensive long-term businesses that have stabilised following recent falls, Appen following a strong result and outlook, and Medical Developments. We removed Cochlear and Mayne Pharma following disappointments in earnings and outlook, and increased our positions in St Barbara, The Citadel Group, Ioneer, and Bapcor on price weakness, and increased Polynovo following its strong 1H result. We also reduced our exposure to CSL; its sales growth fell a little short of expectations, making valuation look stretched. The portfolio cash holding at month-end was 8.2%.

The stronger performers for the portfolio during the month included:

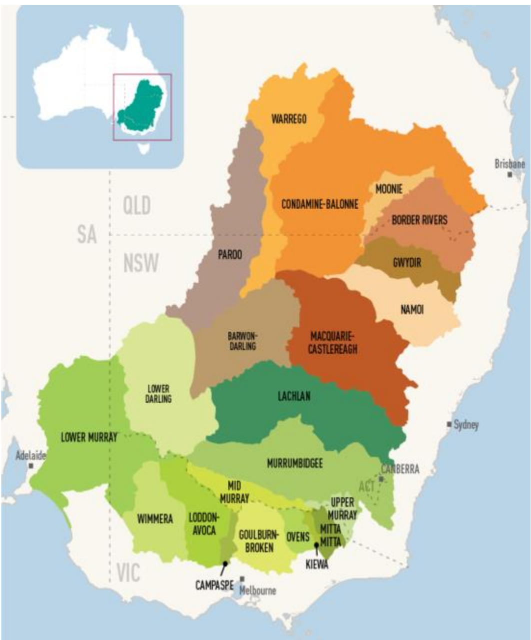
- Echo Resources +24%, Cleanaway Waste Management +20%, and New Century Resources +18%

The weaker performers for the portfolio during the month included:

- The Citadel Group -20%, SRG Global -19%, and Mayne Pharma -13%

The ASX All Ords' rally extending through February has pushed its 12-month forward PER from near 15.0x to around 15.7x, which is starting to get on the expensive side versus its long-term average.

Chart/Table of the Month – Australia's Food Bowl



The Murray-Darling Basin is Australia's major food bowl. Like any food bowl it is highly dependent on rainfall and water storage levels. When rainfall is low, water storages provide a buffer that helps to smooth annual production levels. According to ABARE Australia's farm production for 2018/19 is likely to be 4% lower at $58b, largely due to poor winter crops in eastern Australia. Higher prices and near record crops in Western Australia provided a significant buffer. Production in eastern Australia has been severely impacted by drought and more lately by the Queensland floods.

Without good rain across NSW and Victoria this coming autumn/winter production may not rebound given Murray-Darling Basin water storage levels are currently around one third full. This compares with storages in excess of 50% full 12 months ago and two thirds full 24 months ago. Winter crops (wheat) typically rely on rainfall but many summer crops (rice cotton) rely on irrigation.

To put this in perspective, Murray Irrigation covers irrigation areas along the northern side of the Murray from Mulwala to Moulamein. In FY16/17 100% of general security annual water entitlements were allocated. In FY17/18 around 50% of annual entitlements were allocated and in FY18/19 there were no allocations. General Security water is used for annual crops and allocation history is volatile. General Security water is only allocated after High Security water allocations can be met. High Security water is typically used for orchards, where minimum levels of water are required for plant survival.

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

Appen (APX)

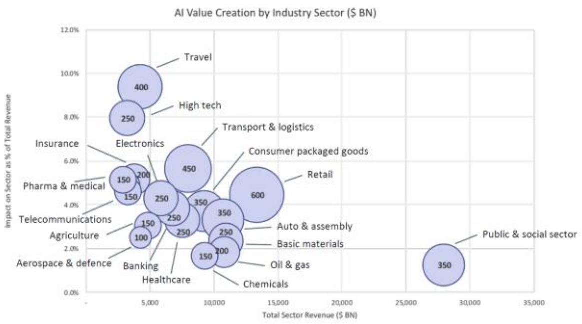
We've followed Appen closely since 2016, when the stock was trading around the $3.00 level, growing well and hitting its milestones convincingly. The stock now trades around the $24 level, and the business has grown substantially. In 2016, Appen generated revenue of A$111m, EBIT of A$22m and earnings per share of 10.5c. With a combination of significant organic growth and the 2018 acquisition of Leapforce, Appen achieved FY2018 revenue growth of 119% to A$364m, underlying EBITDA growth by 153% to A$71m, with a forecast EBITDA for the year ahead of $85-90m. The company is now held in the JMFG Australian Equities Strategy based on the proven track record of delivering and exceeding expectations.

Appen is a leader in high-quality, human annotated datasets for machine learning and artificial intelligence. Essentially, it is the process of labelling information in various forms (text, voice, video etc) for computers to use the annotated data to recognise similar patterns when presented in new datasets. Patterns in the annotated data can then be used to determine an intended search, without having to type out the full search request. For example, if one types into Google 'when are taxes' a series of likely search phrases may appear including 'when are taxes due in Australia'. In other words, it fast-tracks search requests. Alternatively, when a search request is made, context-relevant advertising, based on the annotated data, may also appear – for example, local tax agents or tax reference books.

The work that Appen does has relevance to anyone that uses the internet, which of course is a very significant proportion of the world population. Appen has been developing its annotated databases for more than 20 years. It uses a crowdsourcing model with access to over 1 million flexible workers worldwide, in more than 180 languages and dialects, and across more than 130 countries. Appen's database of information is unparalleled, and is the main reason that the largest global technology firms use Appen to assist in the ever-expanding world of artificial intelligence. Around 75% of Appen's revenues are derived from five or six of the largest global tech firms, including Facebook, Microsoft, Apple, Google and Amazon.

Further adding intelligence to defining and recognising patterns in information should continue to enhance the user experience for internet users, advertisers and so on, and provide Appen with many years of opportunity.

Vast Market Opportunities in Artificial Intelligence



- AI will disrupt every sector
- Total potential value creation of $3.5 TN to $5.8 TN[3]

AUTOMOTIVE SALES AUSTRALIA

Australian new vehicle sales for 2018 numbered 1.153 million – a fall of 3%. Given declining wealth over the year, driven by falling house prices, and not helped by a flat equity market, a reduction in car sales is not surprising.

It is interesting, however, to look at the component growth: the chart to the right shows major growth categories (blue bars) as small and medium SUVs, pick-ups/crew cabins 4x4, heavy commercial and upper large SUVs. Largest declining categories were small and medium vehicles in particular, with the darker shaded red/apricot bars. A small decline in large SUVs is represented by a lighter shaded pale apricot, with this decline most likely picked up in medium/small SUVs.

While a shift to electric vehicles will be slow, at least in the foreseeable future, it is interesting that there is a shift to four wheel or all-wheel drive SUVs, which are typically heavier than sedan vehicles, all of which are in decline (small, medium and large). The point here is that lighter, smaller vehicles are better suited to a shift toward electric powered motors, given the range of an electric powered smaller lighter vehicle is far greater than larger heavier vehicles.

Vehicle range is still a major limiting factor, in terms of broad-scale sale of electric vehicles. It is difficult to imagine a family purchasing an electric SUV that, when fully loaded, has a range under 250km.