JM Financial Group

Issue 51: July 2019

Investment Newsletter

Performance *(As at 31st July 2019)*	Month (%)	Rolling 3mths (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception (%)
JMFG Australian Equities Strategy	**+4.04**	**+11.02**	**+12.33**	**+25.64**	**+71.51**
All Ords Accumulation Index	+2.96	+8.27	+12.94	+38.38	+59.00
Outperformance	**+1.08**	**+2.75**	**-0.61**	**-12.74**	**+13.91**

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 July*

The Australian Market furthered its 2019 rally finishing seven months of consecutive rises at 6812.6; one day earlier it had reached 6875.5 and exceeded the previous record high of 6851.5 set in November 2007. The JMFG Australian Equities Strategy gained 4.04% and outperformed its benchmark by just over 1%; the ASX 200 Accumulation Index rose by 3.0% for the month. Market sector performance for the month was led by Consumer Staples 9.8%, followed by Healthcare 5.9% and Information Technology 5.0%. All sectors performed positively in July, with the weakest sectors being Materials up just 1.0%, Energy and Financials both up 1.7%, and Utilities growing by 1.9%.

There were no stocks added to the portfolio during July, however we topped up Nearmap and Netwealth both on price weakness, and increased the holding of Cleanaway, given its strengthening position in the Australian waste industry space in light of increasing demand for treatment of materials previously sent offshore for treatment. We reduced Transurban, given its recent strong rally putting the stock into riskier over-valuation territory, and trimmed St Barbara on gold price strength to lock in profits amid volatility. Citadel Group's share price struggled to deliver the expected recovery post-downgrade and we removed the stock from the portfolio in the absence of anticipated evidence of underlying conditions improving for the company. The portfolio cash holding at month-end was 13.3%.

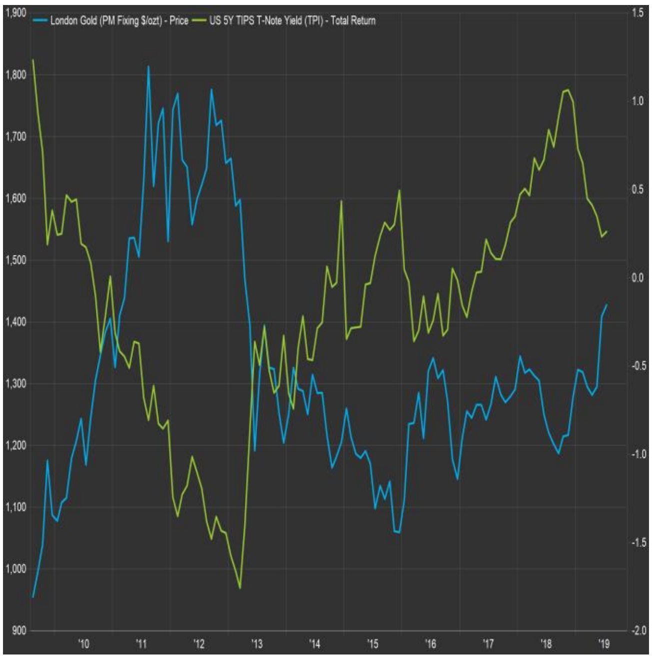
The strongest performers for the portfolio during the month included:

- Ioneer +37%, Mach7 Technologies +37%, and St Barbara +26%

The weaker performers for the portfolio during the month included:

- Elixinol Global -11%, Nearmap -11%, and Rio Tinto -4.7%

Chart/Table of the Month – Gold Price & Yield Relationship



The A$ gold price has continued to reach new all-time highs throughout calendar year 2019. This has been a function of the high US$ gold price and the depressed A$, relative to the US$. Many factors are arguably behind the recent rise in the US$ gold price, including trade wars, rising tensions in the Middle-East and the impact of Brexit. The manifestation of all of these factors could potentially have an impact on global growth and the anticipated impact on global growth is reflected in real interest rates.

The chart opposite compares the US$ gold price, in blue, against US Treasury Inflation-Protected Securities (TIPS), in green. TIPS are a good measure of real interest rates as the principal value is adjusted for inflation and they are low-risk, being backed by the US government, and interest is typically paid every six months.

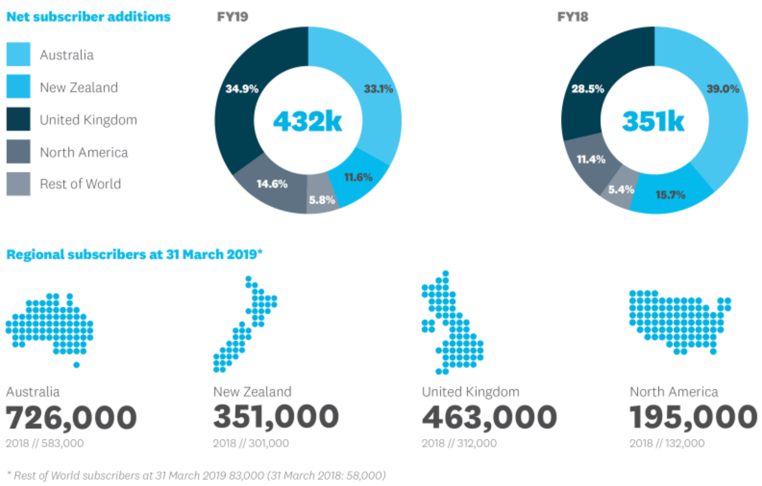
Gold appears to be priced inversely to real interest rates. Gold is an asset that provides capital return potential but no yield. As yields on interest rates diminish, the opportunity cost of holding gold also diminishes. Declining real yields are typically synonymous with weak economic growth and valuation fears around economically linked assets in a weak economy drive investors into non-economically linked safe-haven assets like gold.

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

Xero (XRO)

Xero is a cloud-based online accounting software platform for small businesses, accountants and advisors, and has grown consistently since its 2006 inception. It provides its users with seamless links between bank transactions, general ledger, invoicing, receivables and payables, fixed assets, payroll, GST, financial reporting, and expense claims. Xero efficiently brings together all of the information for in-house accounting or accounting practices to produce accounts and cash flow reports, minimising the requirement for manual data entry.

Xero's Software-as-a-Service (SaaS) model provides a low-cost path to market. Its competitive pricing model has made Xero the market leader in terms of growth, with over 1.8 million subscribers and growing. Pricing starts at $25/month per account for the starter package, which allows for a limited number of bank transactions, invoices, bills and quotes, and payroll for 1 person. The standard package at $50/month provides unlimited bills and transactions, and payroll for 1 person. The premium package at $60/month includes unlimited transactions, payroll for up to 5 people, plus automated superannuation and handling of multiple currencies. Higher-tiered packages are available for businesses with larger payroll requirements.



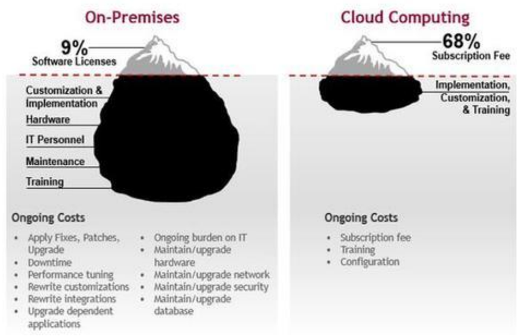
Xero is a highly leveraged business that has only relatively recently surpassed operational breakeven; but given its high fixed cost base, Xero has the capacity to substantially grow its operating cash flow. Xero, in its 2019 result, reported $553m in revenue and $121m EBITDA. To demonstrate the leverage, this is a major improvement on the $295m in revenue and $17m EBITDA loss reported two years earlier for 2017.

Average lifetime value per subscriber was estimated at $2400 in March 2019, with many years of subscriber base growth potential – particularly given the significant opportunity in the UK and North America markets, where the subscriber base is still only around 463,000 and 195,000 respectively. The Xero business is also gaining traction in South East Asia and South Africa and has the opportunity to continue to grow its Australian/New Zealand customer base from its current over one million client accounts.

A Brief History of Cloud Computing and Software-As-A-Service

The modern term "cloud computing" represents an idea that has been around since the earliest model of commercial computing – where, in the 1960s, time-shared access to centralised processing power and data storage was provided as a payable service to organisations who could not justify the cost of ownership of on-premises mainframes. Over the decades, as technology improved, the costs/benefits landscape evolved to enable affordable on-premises computing facilities and came back again to favouring computing services providers; typically a blend of both is used depending on the application. The "*cloud*" part of the term comes from how network diagrams are usually drawn with a cloud-shaped communications graphic concisely denoting "*we don't have to know the details of how we access it; it's some other/outside computer facility run by someone else*."

As commercial computing and its vernacular has transformed through the decades, we have also seen a significant transformation of the financial accounting metrics used to assess such businesses – terms such as "monthly recurring revenue (MRR)", "average revenue per user (ARPU)", and "lifetime value (LTV) per subscription". The term Software-as-a-Service (SaaS) itself has many flavours, all basically denote a subscription-based access to an application, a platform, processing time, or data storage where the access is treated much like established service-business models with a recurring fee, such as utilities.



Software Platform Models Costs Comparison

Image Source: epms.guru

SaaS is becoming an increasingly attractive alternative for the subscriber in cash-flow terms, as it typically means minimal up-front cost, especially when converting from an on-premises platform, and avoidance or recovery of significant investment in on-premises infrastructure and personnel, and simpler ongoing maintenance and training considerations.

SaaS providers have to capitalise the facilities up front to provide the service and hope to recover the investment over many years of subscriptions before seeing profits. Converting from providing on-premises software solutions to cloud-hosted SaaS platforms has been hard for smaller providers trying to wear the cost of migration, but newcomers starting out as a SaaS-based alternative to expensive on-premises incumbents have generally done well.