JM Financial Group

Issue 62: June 2020

Australian Equities – Investment Newsletter

Performance *(As at 30th June 2020)*	Month (%)	Quarter (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception Gross (%)	Inception Annualised (%pa)
JMFG Australian Equities Strategy	**+3.47**	**+23.19**	**-0.15**	**+18.52**	**+56.10**	**+7.71**
All Ords Accumulation Index	+2.37	+17.75	-7.21	+17.19	+43.30	+6.18
Outperformance	**+1.10**	**+5.44**	**+7.06**	**+1.33**	**+12.80**	**+1.53**

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 – and is after management fees, taxes (excl imp. credit benefits) and any paid or accrued performance fees. Strategy Inception for Performance Data is July 1st, 2014.

***Month in Review** – A review of the share market and overview of the portfolio for June*

Pandemic related volatility continues to plague equities markets across the world, although Australia is faring comparatively well which is reflected in strength returning to consumer and financial sectors. The ASX All Ords Accumulation Index rallied 2.3% through June and the JMFG Australian Equities Strategy surpassed its benchmark finishing up 3.5%. Importantly, the financial year picture shows the JMFG Australian Equities Strategy outperformed at a healthy margin over this timeframe, achieving 7.1% outperformance against the All Ords, which has nevertheless recovered much of the losses seen earlier in 2020, finishing 7.2% lower for the 12-months period. Whilst pleasing to reflect on a strong set of numbers, our work is never done, even more so in the unprecedented circumstances we find ourselves in, and so with focus, discipline and humility it's heads down again for FY21.

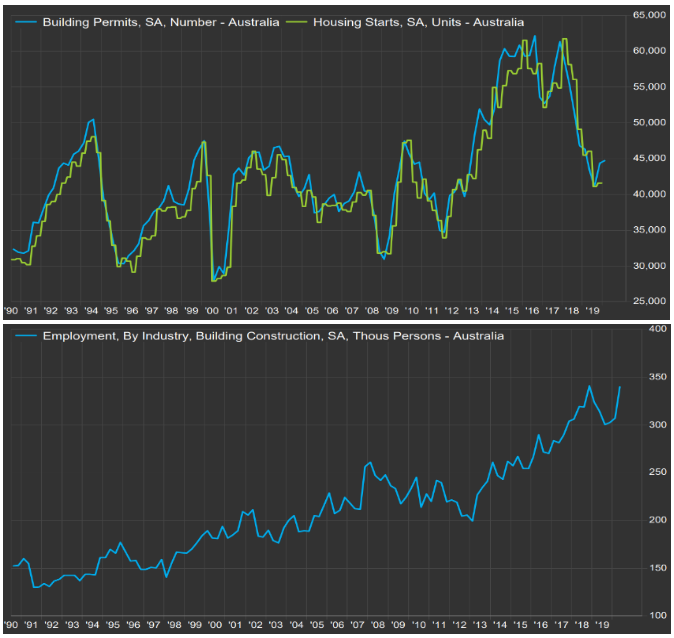
The IT sector was again the strongest performer in the broader market, rising 6.0% for the month and a cumulative 48% over the quarter. Other strong sectors included Consumer Discretionary +5.4%, Consumer Staples +5.1% and Financials +4.4%. The weakest sectors included Energy -2.0%, Property Trusts -1.4% and Industrials -1.3%.

During the month, we made some adjustments to the portfolio composition. New to the strategy are Centuria Industrial REIT as a defensive play, Sezzle, a growing player in the buy-now/pay-later technology driven online payments space, and Universal Biosensors, which is gaining traction after a management change and expectation for some of its existing technologies and future opportunity by effectively deploying its large cash holdings. With the Financial sector risk moderating locally, we increased our financial exposure by adding to ANZ Bank and making it a more meaningful portfolio weighting. We trimmed our holding in Newcrest Mining, locking in profit on recent price strength, and moderated positions in Xero on uncertainty around its future growth potential in a weaker economic environment. We also reduced positions in Opthea, BHP Billiton and Rio Tinto.

The strongest performers for the portfolio during the month were: Mach7 +43.6%, Coles Group +11.8%, and Wesfarmers +11.1%

The weaker performers for the portfolio during the month were: Opthea -20.5%, Altium -12.7%, and SmartGroup Corp +9.5%

Chart of the Month – Building Approvals, Starts and Employment



Building permit approvals are a leading economic indicator examined by analysts. Available every month, it provides insight into future building activity. As shown by the chart to the left, the building permit curve marginally leads the housing starts curve. Building construction is strongly procyclical, shifting significantly with changes in demand. Representing ~8% of Australian GDP, the construction sector is followed due to the size of the industry and the effects that substantial shifts in demand can have on GDP.

In recent years, building permits and construction activities have declined on the back of an overall housing price stabilisation, reaching 7-year lows in 2019. Due to the time it takes for permits to be reviewed and approved, it will be some time before the effects of the pandemic and the Federal Government HomeBuilder grant become apparent.

Employment is generally much stickier and makes for a lagging indicator as employers prefer to maintain employees during short periods of low demand. Therefore, the construction industry employment provides a clearer indication of the industry trend over the last 30 years.

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

Altium (ALU)

Altium Ltd is one of Australia's recent dynamic global growth stories in the technology space. The company is engaged in the development and sales of software solutions for the design of electronic circuitry products. Since 1985, the company has developed and sold software and hardware electronic design tools that aid electronic designers to manage projects from the initial design stage, with a unique interactive task routing engine, through to production including supporting documentation for manufacturing and assembly. The bottom line is that the platform requires a lower learning curve, meaning that users can rapidly become proficient in circuitry design.

The company has enjoyed a very rapid growth path over the past 7 years with revenues rising from US$62m from FY13 to US$171m in FY19 and EBITDA increased from US$5.9m to US$62.7m, demonstrating the operating leverage the company is now enjoying after many years of development expenditure. For the latest six month reported period to end 31 December 2019, Altium revenues increased 19% to $92.8m and EBITDA increased 30% to $36.8m. The company has a $500m revenue target by FY25, which does look ambitious but as a market leader, its management believes there will be a tipping point where ultimately their technology becomes the global standard.

The current Covid-19 environment may, at least in the short term, challenge management ambitions. The company made an initial COVID-19 impact statement in February stating they believed the impact would see revenue and EBITDA guidance at the lower end of its FY20 range of US$205-US$215m revenue and 39-41% margin. In April, the company withdrew guidance but maintained an aspirational target of US$200m for FY20. In May, it suggested that, without a strong finish to the year indicated, the US$200m target would be difficult, and in June, the company suggested analyst forecasts of US$200m were unlikely to be achieved and that demand had been slipping. While the company, in our view, is sound and has a very good long-term growth path, its high pricing at over 70x FY20 PER is full – and, given the impact of Covid-19, it may need to consolidate for a period.

Australia's Shifting Stock Exchange Profile

Every quarter, the S&P ratings agency re-aligns its published Index adjustments, with the biggest changes usually occurring in June. This year saw several technology and health sector stocks climb their way into new Index tiers.

We are observing a trend in Australia, where the traditional incumbent banks are diminishing in their dominance of the equities market, while mining and refining holds a consistent representation – we may regard the developing strength in biotech and information technology sectors as the outcome of investment and focus on STEM (Science, Technology, Engineering & Mathematics) education and federal stimulus to support R&D functions. Health care in the past year has noticeably surged, but this trend originated well before the current pandemic related spike in interest. I.T., while growing 605% in the 10-year period, is still in the early days of gaining substantial traction, even though it includes considerably large companies AfterPay, Xero, WiseTech and Computershare as its biggest constituents.

It is worth noting that several relatively new companies climbing the Index ranks are also new players in the buy-now-pay-later payments platform technologies, where the providers are classified as IT businesses, yet they are playing in a niche that would otherwise have been provided by banks.

Examining how the composition of the S&P/ASX 200 has changed over the last 10 years we can see that Information Technology has grown from just over 0.5% of the index to now 3.8% of the Index in 2020. Similarly, Health Care has grown from 3.5% to 12.3% of the Index.

On the other hand, Financials have decreased their overall prominence in the Index from 29.3% to 25.5%, having peaked at 37.7% in 2015, reflecting the maturing banking sector paradigm. The Materials sector has also fallen from 28.2% to 19.3%.