

## Australian Equities Strategy – Investment Newsletter

Performance (As at 30 <sup>th</sup> September 2020)	Month (%)	Rolling 3 Months (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception Gross (%)	Inception Annualised (%pa)
<b>JMFG Australian Equities Strategy</b>	<b>-3.07</b>	<b>+2.81</b>	<b>-1.72</b>	<b>+24.82</b>	<b>+60.65</b>	<b>+7.88</b>
All Ords Accumulation Index	-3.43	+1.10	-8.76	+17.27	+44.88	+6.11
<b>Outperformance</b>	<b>+0.36</b>	<b>+1.71</b>	<b>+7.04</b>	<b>+7.55</b>	<b>+15.77</b>	<b>+1.77</b>

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 1<sup>st</sup>, 2014.

### Month in Review – A review of the share market and overview of the portfolio for September

The JMFG Australian Equities Strategy fell 3.07% in September, beating its benchmark by 0.36%; the All Ordinaries Accumulation Index fell 3.43%. The Strategy outperformed its benchmark by 1.71% for the rolling 3 months and by 7.04% for the rolling 12-month period. The annualised return since inception, over six years ago, is 7.88% p.a., compared to its benchmark return of 6.11% p.a., after all fees and taxes and excluding any imputation credit benefits, outperforming this benchmark by 1.77% annualised.

The market was weak across all sectors in September, with the exception of Healthcare, rising +0.9%. The other better-performing sectors for the month included Industrials -0.3%, Property Trusts -1.5%, Telecommunications -2.2%, and Consumer Discretionary -2.6%. The weakest sectors included Energy -11.1%, I.T. -6.8% (consistent with US tech falls), Consumer Staples -6.7%, and Financials -6.1%. The ASX Small Ordinaries Index, -2.8% in September, continued to perform better than the larger ASX 200 Index, -3.7%, the former having less exposure to the weaker sectors, in particular Financials, and greater exposure to Property Trusts and Consumer Discretionary.

During the month, we made several portfolio changes. We continued to trim our position in Universal Biosensors on price strength. We also exited National Australia Bank and St Barbara mines over the month. The month saw the return of Medical Developments to the portfolio and we topped up positions in Sezzle, Opthea and LiveHire. The cash position increased to be a touch over 8% of the portfolio at month-end.

The strongest performers for the portfolio during the month included:

- Opthea +9%, Netwealth Group +8%, and Pro Medicus +4%

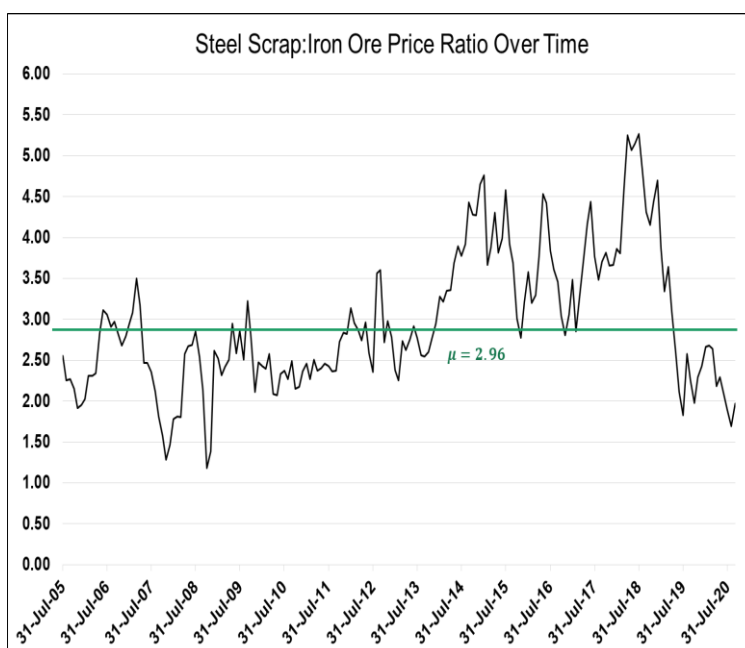
The weakest performers for the portfolio during the month included:

- Sezzle -33%, LiveHire -14%, TPG Telecom -11% and Universal Biosensors -11%

### Chart of the Month – Steel Production Input Prices

Steel scrap and iron ore are interchangeable inputs in the production of steel. While the production methods differ in their use of these inputs, there is a tendency for steel producers to alter production methods in favor of cheaper inputs. Because of this, the price ratio of inputs should tend to revert towards the mean, as steel producers alter their production method.

The chart opposite shows the ratio of Heavy Metal Steel Scrap (HMS1) to the price of 62% Iron Ore. The 15-year average ratio calculated was 2.96x, compared to the ratio on 30 September 2020 of 1.97x. We can see that the ratio hit low levels in both 2007 and 2008. In '07, iron ore had a significant price run-up towards US\$200/t, greatly outpacing the scrap steel price at the time, before the scrap price followed in early '08 where HMS1 was a touch over US\$500/t. This was before both iron ore and scrap steel prices fell significantly at the end of '08 and scrap became relatively cheap. The next 10 years, however, saw the relative price of scrap rise significantly more before falling off in 2018 and continuing its decline through 2019 and 2020. Scrap steel prices once again look relatively cheap.

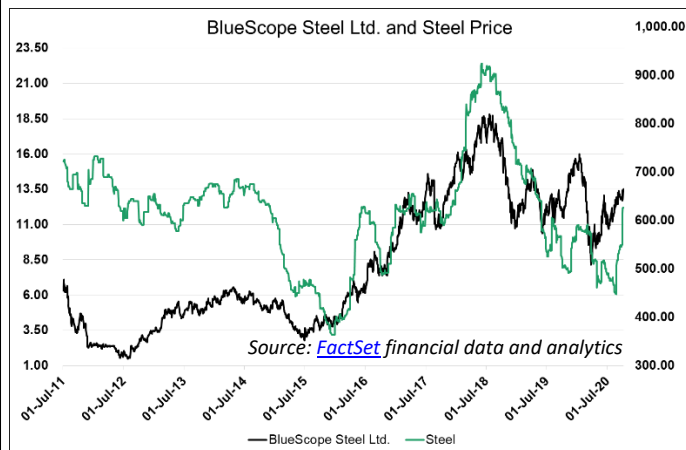


Source: [FactSet](#) financial data and analytics

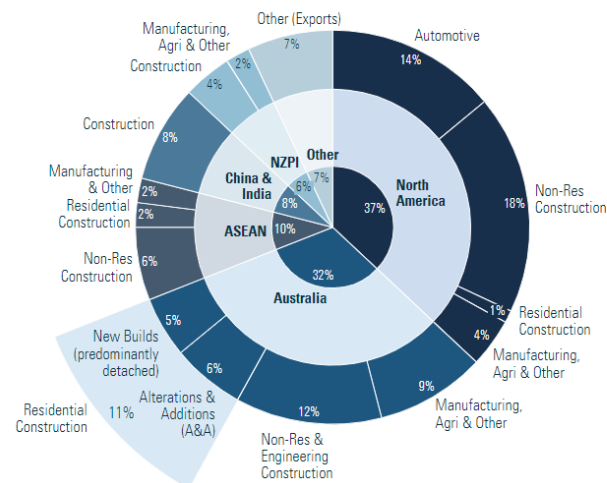
## Due Diligence – A closer look at a stock of interest

### BlueScope Steel Limited

BlueScope Steel, which we featured early last year, is an Australian steel producer selling domestically and internationally. While BlueScope has regionally and industrially diverse clients, it operates on thin margins, and profits are largely dependent on the demand for steel – demand which is primarily driven by large capital investments. This makes it highly procyclical as such investment spending is more volatile than goods and services spending through economic cycles. Consequently, with continued weakness in the steel price, BlueScope saw earnings substantially decline in 2020. This was further exacerbated by strong iron ore prices, with Chinese steelmakers maintaining high iron ore demand.



### BlueScope indicative despatch volume split by region and end-use segment



BlueScope recently reported that its volumes had significantly recovered from the lows of March, with much of the adverse impact at the time relating to project delay rather than complete cancellations. In particular, Australian residential developments have recovered to pre-lockdown levels and infrastructure demand continues to be strong. This Australian market accounts for around 45% of BlueScope annual revenues.

Whilst BlueScope is highly dependent on the steel price and state of the Australian economy, the company also holds cash of A\$1.4Bn, providing it with a liquidity buffer to weather short-term volatility as it awaits upside potential on any steel price recovery.

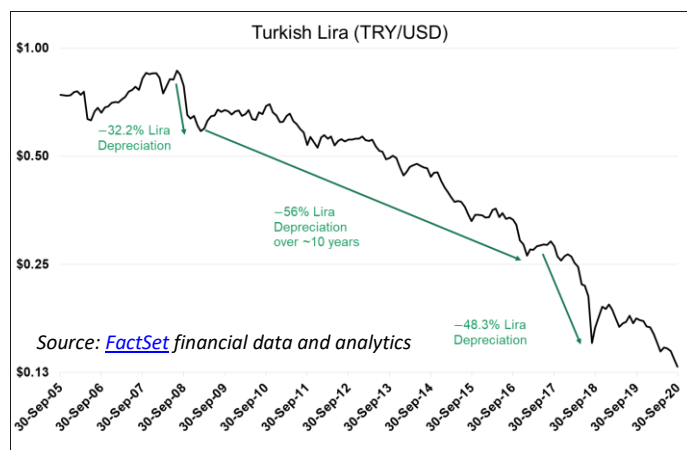
### Steel Production Inputs: Iron Ore and Steel Scrap

Steel production typically either takes place using the Basic Oxygen Furnace (BOF) Method or the Electric Arc Furnace (EAF) Method, each requiring different inputs to the process. The primary difference in inputs is the amount of scrap steel that is used in the production process, with iron ore comprising 50% of the input cost for BOF production, while scrap steel accounts for 75% of the input cost for EAF production. In this sense, iron ore and scrap steel are substitutes in the steel making process.

The preferences of steel producers typically depend on the availability of the required resource in their location. BOF producers require a steady supply of iron ore, coal, and limestone, and produce more CO<sub>2</sub> than EAF producers, who only require steel scrap and a steady supply of electricity. As such, carbon tariffs will also alter producer preferences – as has happened in China with their emissions trading scheme.



Heavy Melting Steel #1 (HMS1) is a commonly used designation of steel scrap defined by the Institute of Scrap Recycling Industries



As such, production methods differ substantially around the globe. China, the world's largest steel producer, is also the largest importer of iron ore and primarily uses BOFs for steel production. However, the majority of steel scrap imports go to Turkey, which is the largest user of scrap-fed EAF technology. As the production methods are fragmented in this way, the relative demand for iron ore and steel scrap can be heavily influenced in the short term by the currencies, economies, and political affairs of China and Turkey.

During the GFC, high inflation caused the Turkish Lira to depreciate rapidly. This corresponded to a rapid drop in the price of scrap steel relative to iron ore. Similarly, following the 2018 Turkish Debt Crisis, 2019 saw the scrap steel price fall while iron ore sharply rose.