JM Financial Group

Issue 66: October 2020

Australian Equities Strategy – Investment Newsletter

Performance *(As at 31th October 2020)*	Month (%)	Rolling 3 Months (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception Gross (%)	Inception Annualised (%pa)
JMFG Australian Equities Strategy	**-0.41**	**+1.37**	**-3.25**	**+16.16**	**+59.99**	**+7.70**
All Ords Accumulation Index	+2.08	+2.24	-6.51	+15.04	+47.90	+6.38
Outperformance	**-2.49**	**-0.87**	**+3.26**	**+1.12**	**+12.09**	**+1.32**

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 October*

The JMFG Australian Equities Strategy fell by 0.41% in October, underperforming its benchmark by 2.49%; the All Ordinaries Accumulation Index rose by 2.08%. The Strategy underperformed its benchmark by 0.87% for the rolling 3 months but outperformed by 3.26% for the rolling 12-month period. The annualised return since inception, over six years ago, is 7.70% p.a., compared to its benchmark return of 6.38% p.a., after all fees and taxes and excluding any imputation credit benefits.

The market was mixed in October, with the better-performing sectors for the month including I.T. +9.0%, Financials +6.3%, Consumer Staples +4.8%, and Consumer Discretionary +1.5%. The weakest sectors included Industrials -3.9%, Utilities -1.5%, and Materials -1.2%. The ASX Small Ordinaries Index, +0.5% in October, after several months performing better than the broader market, underperformed the larger ASX 200 Index, which increased by +1.9%.

There were no large portfolio changes during the month, with some trading activity to adjust positions where there were notable price changes. We topped up our position in Megaport on price weakness following its quarterly business update, which continued to show strong growth in its customer base. We also added to positions in Telstra and Medical Developments on price weakness, and Opthea before its listing on the NASDAQ. We also lightened ANZ after a strong price rally during the month.

The strongest performers for the portfolio during the month included:

- Pro Medicus +20%, PolyNovo +17.7%, Universal Biosensors +16%, and Netwealth Group +14%

The weakest performers for the portfolio during the month included:

- Opthea -24%, Megaport -16%, Mach7 Technologies -15%, and Newcrest Mining -6%

Chart of the Month – Market Pricing & Interest Rates

Source: FactSet financial data and analytics

The chart opposite demonstrates that pricing of the Australian market has become expensive in the context of historical levels. Both the ASX 200 and ASX Small Company Indices are trading in the order of 17.5-18.5 times their 12-month forward consensus earnings estimates, as shown on the left-hand scale in the chart. This compares with their historical averages, over the past 15-20 years, in the range of 14-15x.

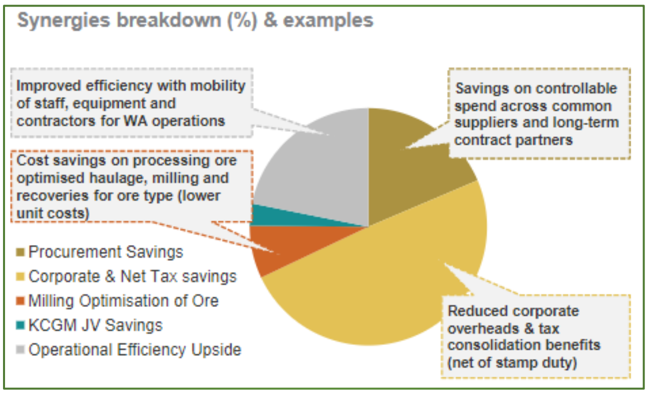
One could conclude from this that it is time to take a far more defensive stance, given the backdrop of rapidly rising government debt levels and likely economic slowdown once government handouts are eased back. We are inclined to back this view to an extent, but other factors also need to be considered. With interest rates in Australia now so close to zero, as demonstrated in the chart by the Australian 2-Year Bond (right-hand scale), the multiples paid for equities today could be considered cheap in the context of funding costs. Consider 2007, for example, when forward price-to-earnings multiples hit 16x and the two-year bond rate traded in a 6-7% range.

While we are starting to lean toward a more defensive strategy, we know from experience that getting it wrong is overly punishing, so any strategic portfolio move is made with small steps initially and will require further supporting evidence to continue on this path. We also know from experience, that the ability to continually reassess and readjust is critical to effective and agile portfolio management.

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

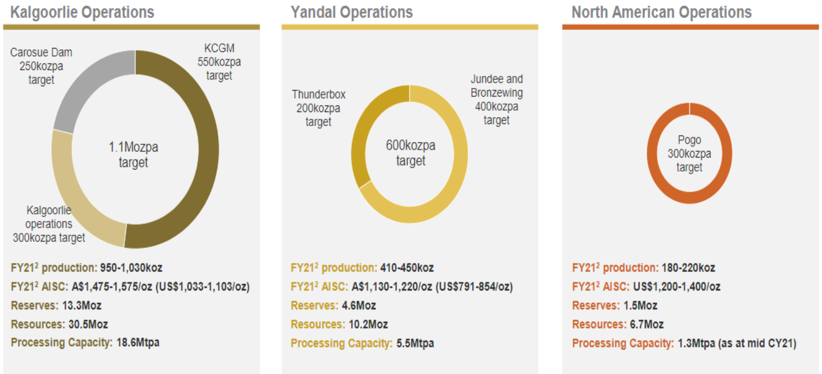
Northern Star Resources & Saracen Mineral Holdings

On October 5th, Northern Star and Saracen announced an agreement to a merger of equals; a deal that would combine the two 50:50 owners of the Kalgoorlie Consolidated Gold Mines (KCGM) Joint Venture to form the second biggest Australian gold producer. The merger offers the consolidated entity greater expansionary opportunities, with better optionality allocating capital across Kalgoorlie to target higher grade orebodies. The combination is targeting production of 1,540-1,700koz in FY21, with 550koz coming from the KCGM joint venture. This is projected to grow to 2,000koz by FY27, with mine life extending to 2035. The merger is also projected to offer cost savings worth A$1.5-2B over the next ten years, offering EPS accretion to existing shareholders.



Source: Investor Presentation – Diggers & Dealers Conference

Merged Co with Three Tier-1 Production Centers



Source: Presentation – SAR and NST agree to Merger of Equals

Northern Star also brings to the table expertise in underground mining operations, while Saracen has historically operated open-pit operations. Combined, the group has stronger credentials to better manage the consolidated mines.

The market reacted favourably to this merger of equals with the share prices of both Northern Star and Saracen rising ~10% on the morning of the announcement. In a positive position for exploration and production growth, we see the proposed merger as offering continued upside for shareholders and we continue to hold Saracen in the portfolio.

The Golden Mile & Super Pit – A Brief History

The gold range of South Kalgoorlie became known as the "Golden Mile" over 125 years ago due to the span of alluvial gold found in the area. Through to the 1980s, land use in the area was fragmented with leases to several companies to operate across the Golden Mile. Then, in the 1980s, the idea for the "Super Pit" began to take shape.

Australian Businessman Alan Bond mapped out a plan to buy out all the leases to the Golden Mile to form the largest open-cut gold mine in Australia – through his company Bond International Gold. While initially successful in obtaining finance and control of Golden Mile leases, Bond faced insolvency in 1989 and was forced to sell off his ownership in the Golden Mile. As a result, Kalgoorlie Consolidated Gold Mines was formed as a 50:50 joint venture between American company, Homestake Gold, and Australian Company, Normandy Mining. At inception, the mine was only expected to have a life of 14 years. The consolidated mine went on to pour 1Moz within its first 3 years.

The Homestake-Normandy ownership continued for 12 years, over which 7Moz of gold was produced. In 2001, Homestake Gold was acquired by Canadian gold producer Barrick Gold, which went on to become the world's largest gold producer shortly thereafter. The following year, Normandy Mining merged with Newmont Corporation, which has since continued to grow and, in 2019, took over as the world's largest gold producer.

In the past year, the Super Pit has come to sit with its current owners, with Saracen having acquired Barrick Gold's share last November, and Northern Star acquiring Newmont Corporation. The agreed merger of equals between Saracen and Northern Star will see the Super Pit wholly owned for the first time in its history.

The mine has exceeded expectations since inception, with the mine now forecast to produce until 2035, 32 years longer than initially expected. With room for more exploration and the strong capital backing of its consolidated ownership, the site is likely to continue as a rich source of gold production in Australia.

The Kalgoorlie Consolidated Gold Mines (KCGM) Super Pit