JM Financial Group

Issue 66: October 2020

Small Companies Strategy – Investment Newsletter

Performance *(As at 31st October 2020)*	Month (%)	Rolling 3 Months (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception Gross (%)	Inception Annualised (%pa)
JMFG Small Companies Strategy	**+0.07**	**+8.64**	**+14.97**	**+60.80**	**+178.57**	**+17.56**
Small Ords Accumulation Index	+0.46	+4.69	-2.40	+14.55	+55.13	+7.18
Outperformance	**-0.39**	**+3.95**	**+17.37**	**+46.25**	**+123.44**	**+10.38**

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 events that influenced the share market and portfolio in October*

The JMFG Small Companies Strategy marginally appreciated in October, rising 0.07%, and after seven straight months of outperformance against its benchmark, it underperformed by 0.39%, with the benchmark ASX Small Companies Index rising 0.46%. The Strategy has experienced an unprecedented run of outperformance. Not only had it outperformed for seven straight months up to September 2020, it has achieved outperformance in 15 of the last 22 months, but, more importantly, the best outperforming months have been much larger, in absolute terms, than the underperforming months. The Strategy outperformed its benchmark for the rolling quarter by 3.95% and by 17.37% for the rolling 12-month period, after all fees and taxes, both paid and accrued, and has achieved an excess return over the benchmark in excess of 10% since its inception over six years ago.

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%.

In general, we took a more defensive stance in the portfolio through the month, reducing holdings or trading out of several high-growth, high-PER names. We sold out of Temple & Webster and the balance of Clover Corporation, and reduced holdings in Netwealth and Pro Medicus. Apart from Clover, each of these companies was sold at a significant profit. We introduced two new stocks into the portfolio during the month, Metcash, a lower-growth, low-PER business, and a new medical health business, Aroa Biosurgery, with a small starting position. Our best performing stocks for the month included Tesserent +66%, Pro Medicus +20%, PolyNovo +18%, and Universal Biosensors +16%. Our worst performers were Opthea -24%, Uniti Group -17%, Megaport -16%, and Mach7 Technologies -15%. Our cash position at month-end was 14.5%, down from 16.5% at the end of September.

Chart of the Month – Market Pricing & Interest Rates

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.

Best & Worst Performers for October 2020

JMFG Small Companies Strategy		ASX Small Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
Tesserent – TNT	Opthea – OPT	Ioneer – INR	Mesoblast – MSB
Pro Medicus – PME	Uniti Group – UWL	Nickel Mines – NIC	Opthea – OPT
Polynovo – PNV	Megaport – MP1	Pilbara Minerals – PLS	Mayne Pharma – MYX

Hits & Misses – *A summation of the top hits and misses for the month of October*

Tesserent (TNT) – up 66% for the month. Tesserent provided an integration synergies update following several acquisitions over the past several months. The company confirmed several wins from co-selling strategies as well as $4m in enterprise contract wins in September, with recurring revenue in excess of $30m and over $100m in gross annualised run rate revenues.

Ioneer (INR) – up 46% for the month (Not held). The Ioneer share price moved well ahead of its quarterly activities update released on the last trading day of the month. The stock gained attention recently following commentary in the US around a requirement for increased locally sourced critical metals for the battery industry, lithium included.

Opthea (OPT) – down 24% for the month. A listing and capital raising in the US saw the stock come under pressure, with demand for the new listed shares a little underwhelming.

Mesoblast (MSB) – down 40% for the month (Not held). Mesoblast fell significantly following an FDA request for the company to undertake a further randomised controlled study to provide further evidence of the effectiveness of remestemcel-L in the treatment of SR-aGVHD, an acute reaction that occurs in approximately 50% of patients who receive an allogeneic bone marrow transplant.

Metcash (MTS)

Metcash distributes and markets a range of consumer goods largely through independent retailers in food, liquor and hardware segments. Food distribution is the largest division, comprising around 60% of total revenue and 55% of operational earnings. Liquor accounts for about 25% of revenue and 20% of earnings and the higher margin hardware business about 15% of revenue and 25% of earnings. While Metcash may not be a household name, the retail groups it supplies most definitely are – with some of the larger branded, independent retailers including IGA, Foodland, Cellarbrations, the Bottle-O, Home Timber and Hardware, and Mitre 10.

Metcash essentially services independent, family-owned retailers by providing merchandising, operational and marketing support across three core business areas. It allows these independent businesses to create a point of difference from the corporate-owned retailers by allowing them to locally source product, particularly fresh product, but also locally produced processed foods where it makes sense to do so. This, in turn, enhances their mantra of support for local communities, extending beyond providing financial support and engagement with local sporting and community groups.

At the height of the Coronavirus outbreak, Metcash strengthened its balance sheet with a $300m capital raising, placing the company in a strong net cash position. Over the past 12 months, Metcash has been hit with the loss of two major supply contracts, 7-Eleven on the East Coast of Australia and Drakes Supermarkets in South Australia. Wins and losses occur from time to time and Metcash will only enter contracts on the basis that they provide a reasonable return on investment. In the case of 7-Eleven on the East Coast, the majority of its $800m in annual sales is from lower margin tobacco sales. The additional financial flexibility provided by the raised capital has helped to support the company through Covid-19 restrictions, with increased working capital at year-end to ensure supply to its retailers. In addition, it will help fund investment in its future growth program and support the purchase of further bolt-on acquisitions. Three recent bolt-on acquisitions for $45m included Liquor Centre in New Zealand, Kollaras & Co, a private-label liquor brand portfolio, and a large independent hardware retailer. Metcash also recently completed the acquisition of a 70% stake in Total Tools for $57m.

We do not expect Metcash to produce stellar returns for the JMFG Small Companies Strategy; it is a more defensive investment that is designed to provide balance in the Strategy in what is becoming an increasingly expensive market. MTS currently trades at a comparatively modest price-to-earnings ratio of 14x, based on consensus data, and has a fully franked yield in excess of 4%. With the RBA cash rate being cut from 0.25% to 0.10%, we expect Metcash's attractive yield will provide a firm base level of support, while the combination of bolt-on acquisitions and moderate underlying organic growth should provide the potential for capital appreciation from current multiples.