JM Financial Group

Issue 67: November 2020

Australian Equities Strategy – Investment Newsletter

Performance *(As at 30st November 2020)*	Month (%)	Rolling 3 Months (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception Gross (%)	Inception Annualised (%pa)
JMFG Australian Equities Strategy	**+9.13**	**+5.35**	**+5.87**	**+24.92**	**+74.61**	**+9.07**
All Ords Accumulation Index	+10.16	+8.60	-0.08	+24.36	+62.93	+7.90
Outperformance	**-1.03**	**-3.25**	**+5.95**	**+0.56**	**+11.68**	**+1.17**

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 November*

The JMFG Australian Equities Strategy rose by 9.13% in November, underperforming its benchmark by 1.03%; the All Ordinaries Accumulation Index rose by 10.16%. The Strategy underperformed its benchmark by 3.25% for the rolling 3 months but outperformed by 5.95% for the rolling 12-month period. The annualised return since inception, over six years ago, is 9.07% p.a., compared to its benchmark return of 7.90% p.a., after deducting fees and taxes and excluding any imputation credit benefits.

The announcement of a vaccine during November saw the companies worst affected by COVID-19 perform the best over the month. The market was broadly strong in November, with the best-performing sectors being Energy +28.5%, Financials +16.1%, Telecommunications +13.6%, and Property +13.3%. The weakest sectors included Consumer Staples -0.7%%, Utilities 1.5%, and Health Care +2.7%.

Over the month, two new companies were added to the Australian Equities Strategy: Fortescue Metals Group and Macquarie Group. We also topped up positions in Saracen Mineral Holdings, Megaport, and Medical Developments on price weakness. Earlier in the month, we bought more Woodside Petroleum before selling down towards the end of the month on rapid price gains. We exited a small position in Newcrest which we had been progressively scaling back over the last few months. Pro Medicus and Netwealth Group were also scaled back, both having had strong performances over the year.

The strongest performers for the portfolio during the month included:

- Universal Biosensors +44%, Mach7 Technologies +36%, Woodside Petroleum +28%, and Medical Developments +24%

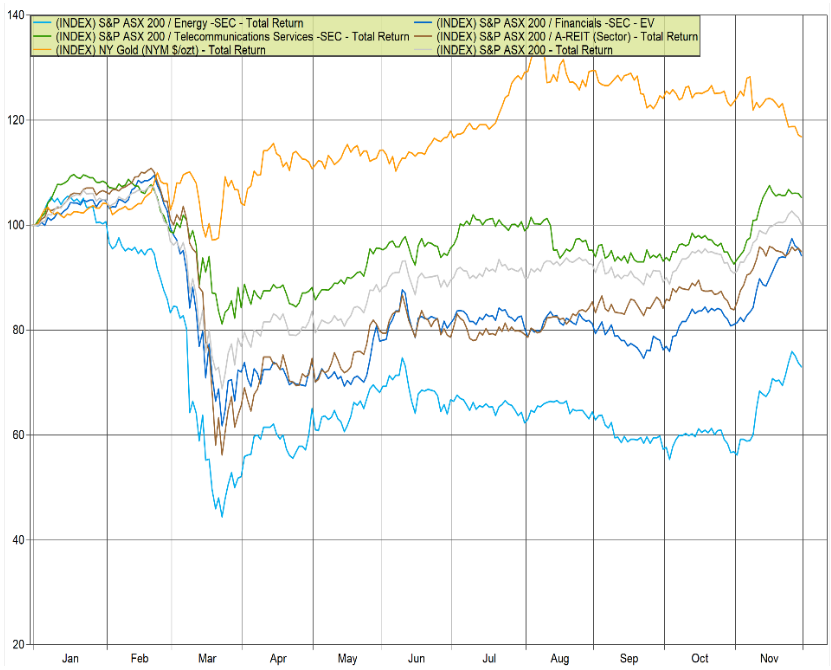
The weakest performers for the portfolio during the month included:

- Saracen Mineral Holdings -16%, Pro Medicus -9%, Sezzle -8%, and Ansell -7%

Chart of the Month – Vaccine Related Recoveries

The chart opposite shows the performance over the year of the four best performing sectors in November against the ASX Small Ordinaries Accumulation Index and Gold. The chart highlights that after the knee-jerk recovery from the initial market impact of the pandemic from late March through to end May, those four best performing sectors in November all lagged the market significantly from June through October, while the ASX Small Ordinaries Index continued to rise.

While not shown, the components of the Materials sector tell a similar story, the weakest components – base metals stocks – all rallied strongly in November as base metals prices recovered on increased optimism following several vaccine announcements. At the same time, gold stocks declined as the US$ gold price retreated. The US$ gold price, having rallied 30% from March through to early August, has been on a steady decline since then, but that decline accelerated in November as the vaccine announcements were made.



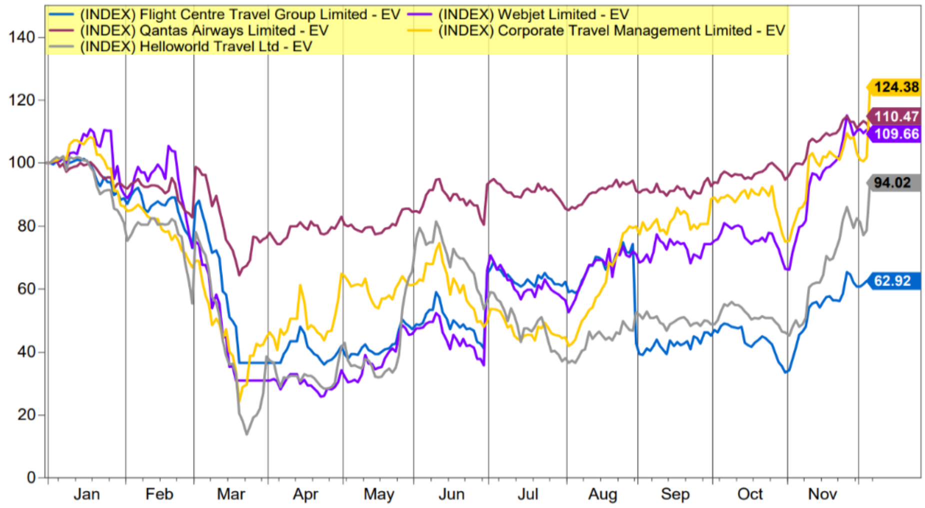
Source: FactSet financial data and analytics

Due Diligence – *Travel Companies*

Enterprise Value of Travel Companies

Share prices of travel stocks fell rapidly in March this year and most of them still sit significantly down calendar year-to-date: Flight Centre Travel -57%, Webjet -39%, Helloworld Travel -37%, and Qantas Airways -24%. Corporate Travel Management is an outlier which has marginally risen over the year. At first glance, these falls may look like bargain prices compared to January, especially if domestic travel bounces back in 2021 and international travel recovers over the following years. However, this metric in isolation ignores the effects of capital raises and debt issuance by companies – such actions can erode shareholder value through dilution.

By looking at Enterprise Value rather than just the share price, we gain a clearer picture of how the total value of a business has changed over time, after accounting for changes in capital structure. Enterprise Value is the value of all company shares outstanding plus the value of debt outstanding, less the cash held by the company.



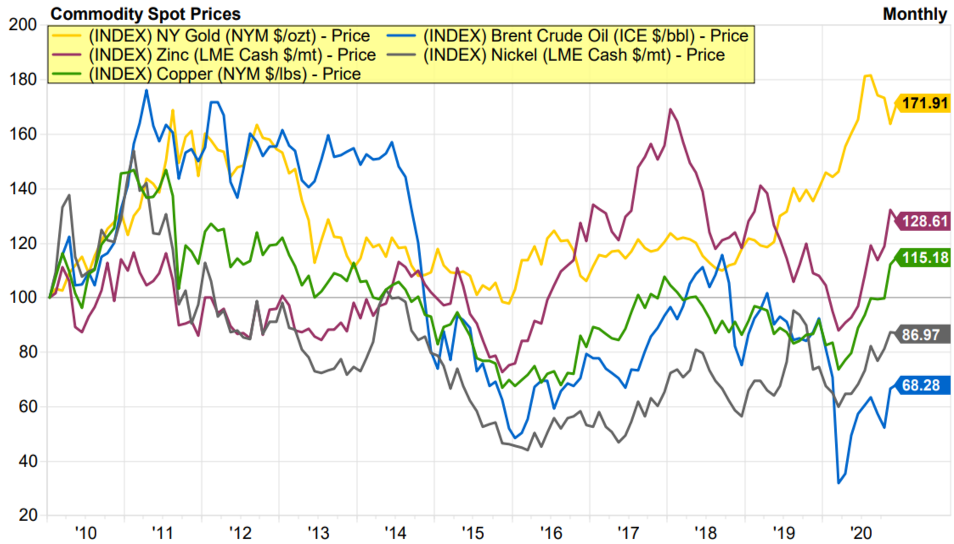
Source: FactSet financial data and analytics

Looking at the Enterprise Value of these travel companies, we see that many of them have risen in share price in the year to-date, despite issuing substantial amounts of shares to raise capital. This makes it much more difficult to justify investment in these companies purely on the basis that they appear to be bargains. With the strong recovery in the sector over the last few months, rapid recovery in travel is already priced in. While a vaccine significantly improves the near-term prospects of the industry, we still see significant uncertainty in the recovery potential of the industry. With these risks, and the value of businesses mostly recovered already, we remain cautious and underweight in the sector.

Recovery of Commodity Prices

In February, we wrote about how US$ industrial commodity prices had been in decline for the last 2 years while gold, by contrast, had been running. Not long after writing, these commodity prices bottomed and have been recovering for the last 6 months. After a steep decline over the previous few years, Zinc has recovered +40% over the last 6 months and is now up again from the start of 2010. Copper and Nickel also bottomed around the same time and have recovered by similar amounts. With the fall in demand, oil had the steepest decline into March before staging the largest recovery, more than doubling off its low earlier in the year. It is worth noting that this recovery is, in part, attributable to a significant weakening of the US Dollar against most other major currencies, after showing strength in March. While the commodity price swings are less pronounced in other currencies for the last 6 months, the rises are still significant.

Although the industrial commodities have a clear, high degree of correlation and move in similar directions over the short run, gold does not have an obvious relationship with these other commodities. Gold has been running since late 2018 steadily and continued to rise throughout this year, while other commodities returns have been volatile. Only after reaching an all-time high price in August did the gold price begin to fall; nevertheless, it remains the best performer from the beginning of 2010, up 72% in that time.



Source: FactSet financial data and analytics

As prices rise, more miners will be able to produce above their breakeven level, leading to increased supply of the commodity into the market and tapering of the price. Alternatively, as prices fall, low-grade and thin-margin producers may be forced to close as the economic viability of the mine is threatened, ultimately decreasing supply to the market. While this volatility inevitably causes the returns of commodity producers to fluctuate, low-cost producers are less leveraged to the volatility of the underlying commodity price. As such, we prefer lower-cost producers when seeking commodity exposure in our portfolios.