JM Financial Group

Issue 78: October 2021

Australian Equities Strategy – Investment Newsletter

Performance *(As at 31st October 2021)*	Month (%)	Rolling 3 Months (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception Gross (%)	Inception Annualised (%pa)
JMFG Australian Equities Strategy	**+1.34**	**+2.78**	**+16.90**	**+41.02**	**+88.72**	**+9.05**
All Ords Accumulation Index	+0.15	+1.13	+28.24	+46.42	+90.75	+9.21
Outperformance	**+1.19**	**+1.65**	**-11.34**	**-5.40**	**-2.03**	**-0.16**

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 after management fees (post 1 Jan 2017), performance fees (paid or accrued), GST, and excludes the effect of franking credits. 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*

For the month of October, the JMFG Australian Equities strategy outperformed the All Ordinaries Accumulation Index by 1.19%, finishing the month up 1.34%. The improvement in relative performance is continuing, bringing the 12-month return to 16.9%, after fees and taxes. Whilst the strategy has underperformed the benchmark in recent times, we continue to see encouraging signs of improved performance from many of our individual holdings, as covered in previous newsletters. We are anticipating further positive months of relative performance through to the end of the year.

The best-performing sector for October was Information Technology which rose by 2.0%. Other strong-performing sectors in September were Healthcare +1.0%, Financials +0.8%, and Real Estate Trusts +0.4%. Industrials was the worst-performing sector falling 3.2% on the back of a subdued global construction outlook. Other weak sectors included Energy -2.7%, Staples -2.3%, and Telecommunications -1.1%.

Trading was minimal during October as the market continues to stabilise around the post-pandemic recovery thematic. We increased the portfolio exposure to IT services by increasing our position in voice recording services company Dubber, and reduced exposure in the underperforming Healthcare sector by exiting ResMed. The cash position was maintained following trading activities during the month.

The strongest performers for the portfolio during the month included:

- Lotus Resources +34%, Liontown Resources +32%, Appen +20%, and Jervois Global +16%

The weakest performers for the portfolio during the month included:

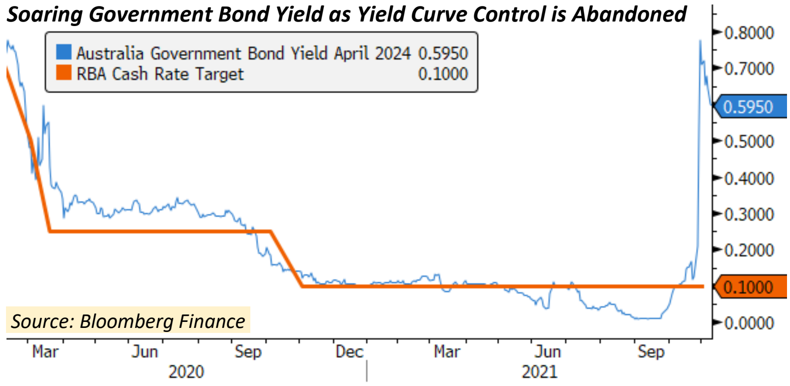
- Dubber Corporation -15%, Mineral Resources -14%, Mach7 Technologies -10%, and Transurban Group -5%

Chart of the Month – Australian Government Bonds Due April 2024

Since the beginning of the pandemic the Reserve Bank of Australia has been following a yield curve control program in which the RBA has been targeting a 3-year yield of around the RBA Cash Rate. In support of this target the RBA stands ready to buy government securities to drive this yield toward this target and has been buying government securities at a rate of $4Bn a week. This strategy of yield curve control contrasts with typical cash rate targets which simply targets the overnight cash rate. The 3-year yield target aims to give the market confidence that monetary policy will remain supportive in the longer term to encourage lending activities while ensuring adequate liquidity.

However, Australia's April 2024 government bonds yields soared over 7 times the Reserve Bank's yield curve control target in the last week of October. In fact, bond markets around the world have become more volatile in response to strong inflationary data coming through for the September quarter. For example, the RBA's quarterly core inflation measure rose to 2.1 per cent on an annualised basis and similarly New Zealand's CPI increased by 2.2 per cent.

Soaring Government Bond Yield as Yield Curve Control is Abandoned



The following week, RBA's Governor Phillip Lowe confirmed that the yield curve control program had been abandoned, as the RBA would have ended up owning all April 2024 bonds on issue if it continued purchases in this market. He also stated that a late 2023 lift in the cash rate is now plausible, accelerating the previous schedule of "not before 2024." However, the market continues to doubt the credibility of the RBA's forecasts and has priced in rate hikes for 2022. Both the US Fed and Bank of England have made dovish announcements since then, with the BOE, surprisingly, keeping rates on hold for November.

JMFG Australian Equities Strategy		ASX All Ordinaries Index	
Best	**Worst**	**Best**	**Worst**
Lotus Resources (LOT)	Dubber Corporation (DUB)	Class (CL1)	Warrego Energy (WGO)
Liontown Resources (LTR)	Mineral Resources (MIN)	Bubs Australia (BUB)	Strike Energy (STX)
Appen (APX)	Mach7 Technologies (M7T)	Liontown Resources (LTR)	Marley Spoon (MMM)

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

Lotus Resources (LOT) – up 34% for the month. Lotus acquired the Livingstonia Uranium Project to add significantly to its Malawi asset base. The company is seeing benefits from the burgeoning interest globally for uranium supply.

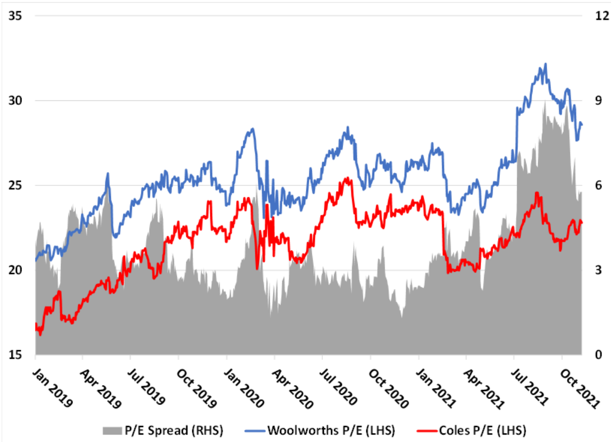
Class (CL1) – up 70% for the month (Not held). After declining since 2017, Class had been recovering for the best part of the past two years. In October, Class received a strong scheme proposal for acquisition by HUB24 who will consolidate its assets and client base into HUB's platform. HUB24's offer values Class at $3.11 per share, and will be paid mostly in HUB shares with some cash and a dividend factored in.

Dubber Corporation (DUB) – down 15% for the month. The voice recording services provider grew steadily through 2021 with news flow relating to ongoing growth in its service offerings and customer adoption. Given the good news flow recently, the share price slide suggests selling was due to profit-taking after the recent sustained rally.

Warrego Energy (WGO) – down 37% for the month (Not held). The company announced its recent Perth basin discovery merits further exploration. However, NSAI independent reserve estimate fell on the short side of expectations and the stock was dropped by speculators.

Due Diligence – *A closer look at a sector of interest – Consumer Staples*

Woolworths (ASX:WOW) and Coles (ASX:COL)

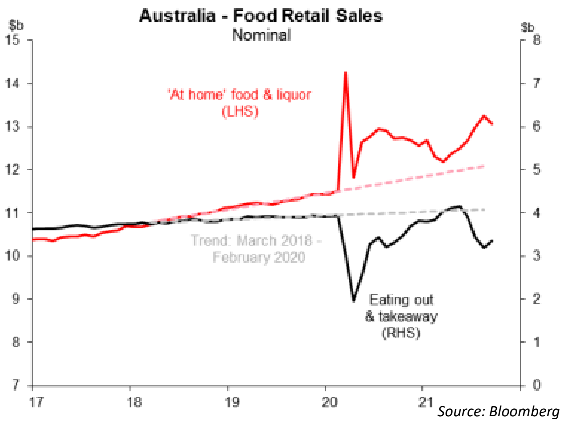


Source: Bloomberg

Woolworths and Coles operate largely as a supermarket duopoly in Australia, with store networks of 1,050 and 800 respectively. Both are listed in the ASX 20 with market capitalisations of $48bn and $24bn respectively. Alternative offerings in the food space include the independents (IGA and local grocers) and the internationals (Aldi and Costco). Others, such as Kaufland, have tried to enter and failed. Woolworths is the better operator having generally enjoyed higher margins than Coles – its competitive advantage can be attributed to a superior store network (larger, less reliant on shopping centres), management team, supply chain, drinks offering (recently demerged as Endeavour Group), online facilities, and a focus on the whole ecosystem of food (with acquisitions like Marley Spoon and PFD).

Historically, the superior Woolworths offering commanded a valuation premium of around 4x Price/Earnings (P/E) points to Coles, as shown in the adjacent chart. This relationship held true through the last 3 years as the P/E of both companies steadily rose from high teens to mid-20s, while investors adjusted P/E's higher in the low interest rate environment. This relationship, however, appears to have broken down in recent months, following the demerger of Endeavour at the end of June. Surprisingly, with the removal of one of the contributors to the P/E premium, Woolworths P/E increased. Perhaps the market is playing catchup to the lower earnings of the demerged Woolworths, perhaps it's rewarding the company's fortress-like balance sheet, given the $2bn buyback recently announced. While Woolworths is the preferred leader of the supermarkets, it appears to now be expensive relative to Coles.

Supermarkets have enjoyed a 2-year run of above trend sales growth, driven by COVID stay-at-home orders necessitating eating at home in lieu of eating out. The lockdown sales bumps are clear to see in the adjacent chart, but so too are the return to sales trend on reopening. With vaccination rates now heading towards 90% double-dosed and major cities reopening, lockdowns ought to be a thing of the past. At the very least, state leaders will find it difficult to impose the large-scale lockdowns that have become a feature of the last 2 years. It is expected that sales growth for the large supermarkets will return to trend, presenting a headwind as high growth periods are cycled. Additional headwinds were highlighted at the recent first-quarter sales calls as COVID costs remained elevated in addition to other cost pressures throughout the supply chain. Signs of inflation are emerging and, while this will aid top-line revenue growth, supermarkets are expected to soften the blow to the consumer by absorbing some of these costs through lower margins.



Source: Bloomberg

With these headwinds, the preferred portfolio position is underweight Consumer Staples, with any exposure to the sector gained via Coles ahead of Woolworths on valuation grounds.