JM Financial Group

Issue 70: February 2021

Australian Equities Strategy – Investment Newsletter

Performance *(As at 28th February 2021)*	Month (%)	Rolling 3 Months (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception Gross (%)	Inception Annualised (%pa)
JMFG Australian Equities Strategy	**-2.51**	**-0.51**	**+4.02**	**+21.26**	**+73.73**	**+8.65**
All Ords Accumulation Index	+1.43	+3.52	+5.12	+25.93	+68.66	+8.17
Outperformance	**-3.94**	**-4.03**	**-1.10**	**-4.67**	**+5.07**	**+0.48**

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 February*

The JMFG Australian Equities Strategy underperformed its benchmark, the ASX All Ordinaries Index, for the month of February by 3.94%, and for the rolling quarter by 4.03%, as the rotation from growth stocks into cheaper so-called value stocks continued. This move has been driven, in part, by higher US Treasury yields and inflationary expectations which are resulting from increased global economic activity forecasts. One area benefiting from increased economic activity is commodity prices, most of which reached new highs in recent weeks.

At JMFG, we tend to favour long duration industrial growth companies, as we believe these provide the best prospects for superior long-term performance. From time to time, when the market does rotate back to lower growth companies, it is normal to expect periods of underperformance, sometimes for months on end. From experience, we have found the best strategy is not to chase the latest market rotation but remain focused on finding companies that have a sustainable competitive advantage. It is, however, a time to increase focus on the price that one should pay for such companies, as rising rates put a spotlight on growth levels required to justify high multiples.

There were stark contrasts in sector performances in February with value-based sectors, Materials and Financials, leading returns at +7.34% and +5.20% respectively. The Energy sector also improved 2.44% on higher energy prices. At the other end of the spectrum, the high-growth, high-PER I.T. sector fell 8.92% and Health Care fell 2.94%. The small Utilities sector fell 8.02%, a function of locked in regulated returns against a backdrop of rising treasury yields providing an improving relative alternative. Consumer Staples and Discretionary fell 4.64% and 2.92% respectively, easing off relatively high multiples, having both been major beneficiaries of the lockdown environment.

The strongest performers for the portfolio during the month included:

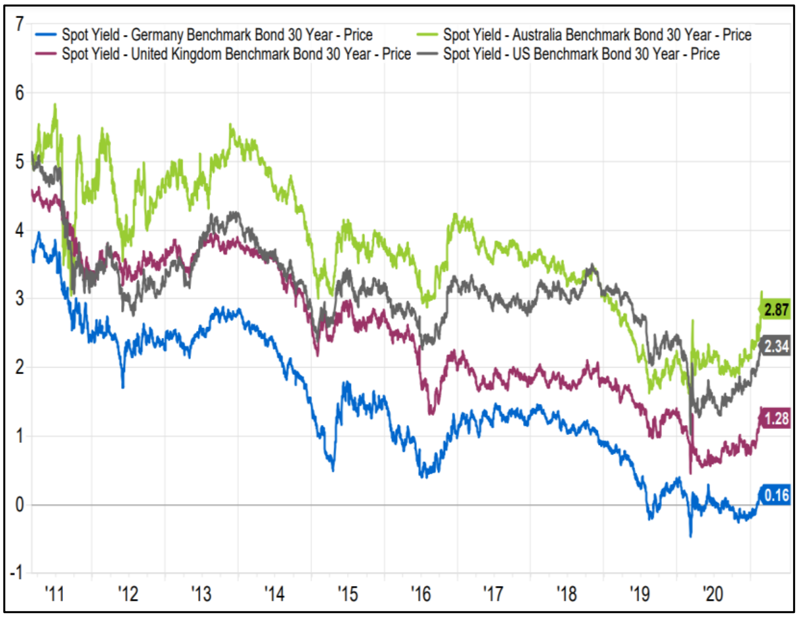
- LiveHire +23%, Sezzle +20%, Uniti Group +17%, and Rio Tinto +15%

The weakest performers for the portfolio during the month included:

- Nuix -34%, Appen -25%, Northern Star -21%, and Temple & Webster -19%

Chart of the Month – The Cost of Risk

Rotation in market returns from growth to value-based companies is, in large part, a function of the rise in treasury yields, which is itself driven by improving economic activity and demand for capital. The chart to the right demonstrates the yield expansion across the US, UK, Germany, and Australia. Higher yields increase the cost of capital, which has two major impacts on the market.



Source: Factset financial data and analytics.

It lowers the long-term discounted value of earnings streams, thereby reducing valuations of companies without a commensurate increase in earnings growth. This impact is more pronounced for companies with earnings skewed to the outer years of forecasts – i.e. the high-PER, high-growth companies that have underperformed over the last couple of months.

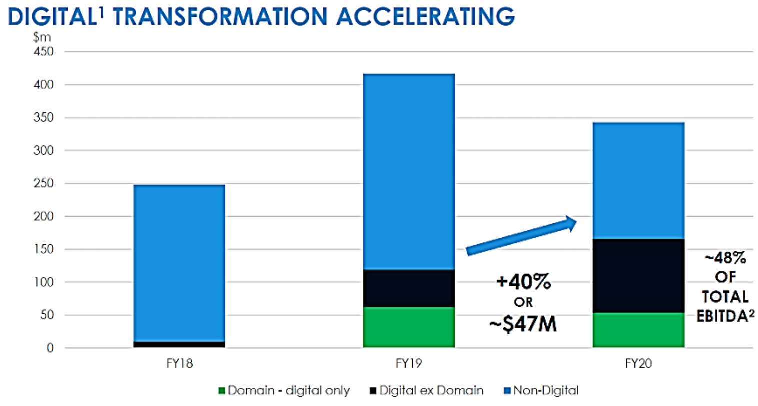
Higher interest rates provide a more attractive alternative to other asset classes including equities. In other words, higher interest rates provide a more attractive relative return and therefore attract capital away from equities and other asset classes into fixed interest products.

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

Nine Entertainment Holdings (NEC)

Following its merger with Fairfax Media in 2018, Nine Entertainment has continued successfully expanding its digital media assets with a substantial proportion of the companies EBITDA now coming from its digital media assets.

Obtained via the merger with Fairfax, Stan continues to grow within Nine Entertainment. The online streaming service saw EBITDA in the first half 2021 up 161% compared to the prior corresponding period, with significant leverage coming from the growing number of active subscribers. In November 2020, the company also announced that it was launching Stan Sport, a streaming platform for live and on-demand sports coverage. Nine hopes to drive long term Stan Sport subscribers by investing in exclusive sports rights to distribute through its platform. Having only launched in February, we don't yet have any numbers on the take-up of Stan Sport by existing Stan customers.



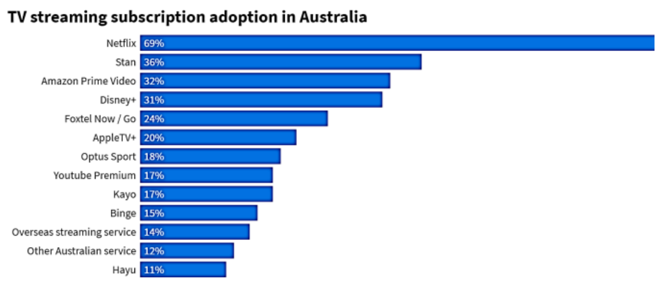
Source: Nine Entertainment Co. Holdings Limited – FY20 Results Presentation

Having invested heavily early in shoring up its digital asset offering, Nine Entertainment has been able to offset the decline of its traditional media assets. While advertising is a particularly volatile market segment, the company now has a diverse product offering with a more stable subscription base to sustain it through cyclical fluctuations. The company has also managed to substantially reduce its net debt position over the most recent half to a more manageable level going forward.

The Rise and Rise of Subscription Video-On-Demand in Australia

The past few decades have precipitated a huge but seemingly incremental series of paradigm shifts in how we access video entertainment at home. We've moved away from ad-funded, free-to-air limited scheduling to restrictively programmed, term-contract pay-TV giving the appearance of diverse offerings, and away from renting or buying cumbersome tapes to CDs to DVD to BluRay discs. In 2021, while free services are still utilised, and some of us are attached to our physical media library nostalgia, more than 88% of Australian homes are subscribed to at least one internet-based subscription video-on-demand (SVoD) streaming service; the change has been enabled by parallel leaps in internet connectivity, home and mobile device capabilities to handle the progressive increases in video detail and the accompanying data transfer and encryption and compression computing demands.

Netflix began as a DVD distributor in the US in 1997 and disrupted the video rental scene entirely – before Blockbuster and VideoEzy could go from denial to anger, Netflix was already leading the charge to moving the world to online streaming of its burgeoning library of view-when-you-want licensed content uninterrupted by ads at a comparably inexpensive recurring subscription rate. By the time Netflix launched in Australia, only 10% of Aussie homes had unlimited data allowance on broadband services – now, it's over 50% of homes on unlimited data plans. In just a few years, we've seen all major free-to-air television broadcasters rising to viewer demand and building internet VoD services that provide ad-funded catchup programming – for the most part, this has displaced the utility of broadcast recording devices. And we've seen a surge in other SVoD providers riding the wake Netflix created, fulfilling either separate niche demand or taking segments of the Netflix library as licence owners and streaming it themselves, or making deals for original content to further differentiate its offerings. While we are not yet seeing on our shores the full diversity on offer in the USA, we already can choose from Netflix, Stan, Amazon Prime Video, Disney Plus, Binge, Youtube Premium, Foxtel Now, Apple TV Plus, Optus Sport, Kayo Sports and CuriosityStream. Disney recently added Star to double its library by bringing its more adult-targeted brands to the platform. Stan's addition of Stan Sport sets it apart for offering on-demand and live sports viewing on the service. Netflix now has around 205 million users globally; its nearest rival Amazon Prime was catching up with 150 million users in Jan-20, with a rate of growth that would have it now closing in sharply.



Source: Finder 2021

Australia has its local biases, regulation, and exclusivity deals to cover which may limit some providers' library replication here, but it enables some locally differentiated content providers, such as Stan, to find a stable financial footing. The adoption survey by Finder shows that consumers of SVoD content are often happy to afford more than one subscription to access a more diverse library of content. We note that, with the current universal business model where customers are free to switch subscriptions from month to month to focus on different provider's libraries, providers are motivated to compete for subscriber money through quality, affordability, ease of use, and especially through unique original content as a focus for ongoing growth of subscriber numbers.