JM Financial Group

Issue 81: January 2022

Small Companies Strategy – Investment Newsletter

Performance *(As at 31st January 2022)*	Month (%)	Rolling 3 Months (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception Gross (%)	Inception Annualised (%pa)
JMFG Small Companies Strategy	**-8.3**	**-5.9**	**-0.6**	**+63.6**	**+194.6**	**+15.3**
Small Ords Accumulation Index	-9.0	-8.0	+6.7	+33.6	+87.0	+8.6
Outperformance	**+0.7**	**+2.1**	**-7.3**	**+30.0**	**+107.6**	**+6.7**

Although the JMFG Small Companies 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 January*

For the month of January, the JMFG Small Companies strategy fell 5.4% as the market had its softest start to the year since 2010. The strategy outperformed the Small Ordinaries Accumulation Index by 0.7% for the month, continuing the recent trend which has seen outperformance in each of the last four months. The market volatility anticipated in the last newsletter arrived in January, along with the latest virus variant, however confidence in the strength of the economy remains. The portfolio is positioned to take advantage of some of the longer-term investment themes favoured by the market lately, although further volatility is expected as reporting season gets into full swing.

The best-performing sectors for the broader Australian market in January were Energy, which rose by a substantial 7.9%, Utilities, which rose by 3%, and Materials which rose modestly by 0.8%. Overall, the rest of the market sectors fell away significantly through the month. The weakest sectors for January were also the weakest in December – Information Technology -18%, Health Care -12%, Consumer Staples -10%. Remaining sector falls were in the range from 6.5% to 9.5%.

During January, a few adjustments were made to the portfolio. Earlier in the month, profits were taken on a couple of positions that had been performing well. As the market fell quickly later in the month, we took the opportunity to add to some positions in which we were confident.

The strongest performers for the portfolio during the month included:

- Strandline Resources +16%, Jervois Global +8%, IGO +2%, and Aurelia Metals +2%

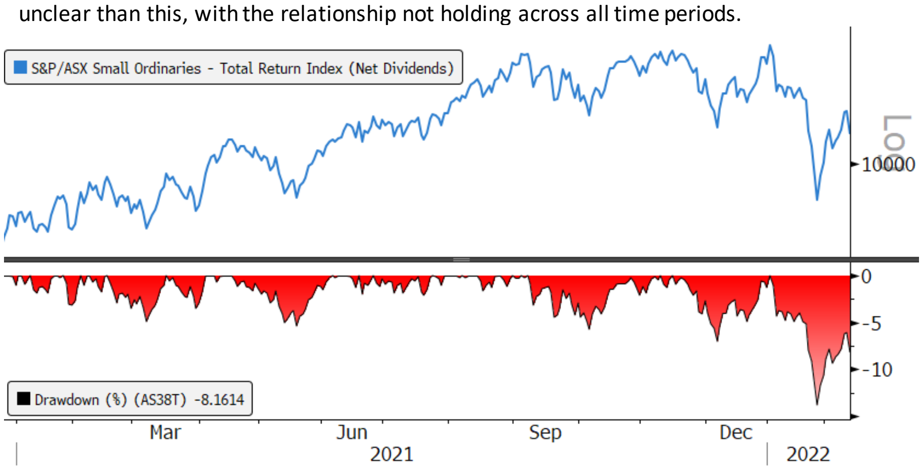
The weakest performers for the portfolio during the month included:

- Dubber Corporation -35%, Megaport -28%, Adairs -23%, and Chalice Mining -20%

Chart of the Month – *January Drawdown*

Following a strong rally to all-time highs in December, the Australian market experienced its biggest fall since the March 2020 crash. The move appears to be driven by a number of factors including a pull-forward in interest rate hike expectations, rising inflation, growing geopolitical concerns with the Ukraine-Russia stand-off, the continued economic impacts of the global pandemic, and high equity valuations. The chart below shows this most recent fall and how it compares in size and speed with others over the last year.

The fall has had the biggest impact on growth companies with a low level of earnings relative to their current valuation. The suggested reason for this is that rising interest rates make these companies comparatively less attractive to value companies with a high level of current earnings relative to their valuations. However, the historic relationship between growth company valuations and interest rates is more unclear than this, with the relationship not holding across all time periods.



Source: Bloomberg Finance

Most interesting is that the recent pullback comes at a time of accelerating economic growth and broadly improving business conditions, albeit with some setbacks. In his February address, RBA Governor Philip Lowe highlighted that ***"the Omicron outbreak has affected the economy, but it has not derailed the economic recovery. The Australian economy remains resilient, and spending is expected to pick up as case numbers trend lower".***

An increasing number of attractive opportunities are appearing given the recent pullback and the strong economic backdrop. In early February, we have seen strong rallies in some names as investors are buying the dip.

JMFG Small Companies Strategy - January		ASX Small Ordinaries Index - January	
Best	**Worst**	**Best**	**Worst**
Strandline Resources (STA)	Dubber (DUB)	Brainchip (BRN)	Redbubble (RBL)
Jervois Mining (JRV)	Megaport (MP1)	Champion Iron (CIA)	Dubber Corporation (DUB)
IGO (IGO)	Adairs (ADH)	Beach Energy (BPT)	Nuix (NXL)

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

Strandline Resources (STA) – up 16% for the month. The company reported progress on its Coburn mineral sands project in WA was 50% completed and on track for first production later this year, being both ahead of schedule and working to spot prices now at least 25% higher than DFS assumptions. The agreement struck with the Government of Tanzania is also positive for Strandline's mineral sands portfolio.

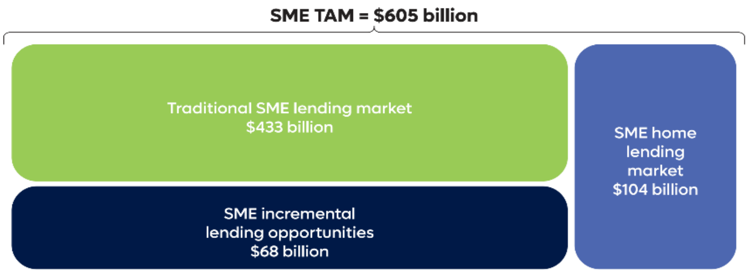
Brainchip Holdings (BRN) – up 110% for the month (Not held). Brainchip recently lodged a spate of announcements indicating its long-awaited, and potentially revolutionary, Akida Spiking Neural Network AI processing support chip was commercially available on mini-PCIe boards and in boxed kit units and was available to deliver expected high-volume orders for partners and customers to develop Next-Generation Edge-Based AI solutions.

Dubber Corporation (DUB) – down 35% for the month. Dubber reported solid growth in ARR to $52M with subscriber count now over 510,000, and significant service provider network agreements. However, a combination of overall tech sector sell-down through January and Dubber's quarterly cashflow numbers saw Dubber's share price continue to decline last month.

Redbubble (RBL) – down 46% for the month (Not held). Redbubble continues to unwind its pandemic-supported growth path, as revealed in its mid-January business update where the company lowered FY22 guidance to below FY21, despite growing marketplace revenue and gross profit, increased underlying costs eroded EBITDA margins to negative single digits.

Due Diligence – *A closer look at a Company of Interest* – **Judo Limited (ASX: JDO)**

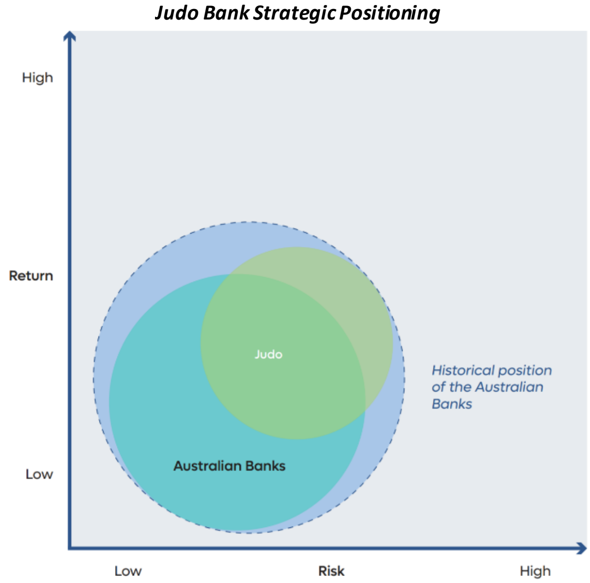
Judo Bank was founded in 2016 with a focus on targeting the small and medium-sized enterprise (SME) lending market, particularly those SMEs under-catered by the larger banks. In its five years of operation, Judo has shown that there is strong credit demand within this target market as the company has experienced rapid growth in its loan book. Now Judo must continue to capture this growth to scale the business and recognise the operating leverage of the model.



Source: Judo Bank Prospectus

Judo is particularly targeting companies with a turnover between $1 million and $50 million. DBM Consultants estimates that this lending market, as a whole, is worth $119 billion and that a significant portion of this is considered to be too risky for the other established banks. While these loans are broadly more risky than those taken out by the larger companies targeted by traditional banks, Judo believes that the cost of this risk is approximately a 0.5% provision of the lending book per annum and that there are sufficient margins to justify this excess risk. This estimate is quite conservative when compared to the historical business lending market and, to date, Judo has not incurred any realised losses on its lending book.

Judo Bank Strategic Positioning



Source: Judo Bank Prospectus

Judo's strategy has been very successful, to date, at driving organic growth and confirming the opportunity in the SME lending market. At the end of the financial year, the company had a loan book balance of $3.5 billion, up 97% on the prior year balance, and guidance indicates this is growing to $6.0 billion by the end of FY22. At the end of December, the loan book balance stands at $4.85 billion, putting Judo on track to beat its guidance for FY22. While Judo currently only generates a skinny profit relative to its valuation, there is substantial leverage in the operating model as the business grows its scale. Based on its prospectus, Judo views its minimum efficient scale is a loan book of between A$15 billion and A$20 billion, which looks achievable given the current demand for SME lending and growth Judo is currently experiencing.

Once at scale, Judo believes it can generate net interest margins above 3% and a return on equity in the low-to-mid teens. Currently its average cost of funding is 1.3%, which has been continuously improving over recent years as Judo obtains better wholesale funding terms. Judo still offers among the highest term deposit rates in the market, offering up to 1.12% for a 1-year deposit. While these deposit rates are expected to remain relatively high for some time due to the sensitivity of this market, Judo expects relatively cheaper wholesale funding sources to be available in the future as its credit rating improves.