JM Financial Group

Issue 86: June 2022

Australian Equities Strategy – Investment Newsletter

Performance *(As at 30th June 2022)*	**Month (%)**	**Rolling 3 Months (%)**	**Rolling 1yr (%)**	**Rolling 3yrs (%)**	**Inception Gross (%)**	**Inception Annualised (%pa)**
JMFG Australian Equities Strategy	**-13.6**	**-18.8**	**-16.3**	**+0.2**	**+56.6**	**+5.8**
All Ords Accumulation Index	-9.4	-12.9	-7.4	+11.9	+72.7	+7.1
Outperformance	**-4.2**	**-5.9**	**-8.9**	**-11.7**	**-16.1**	**-1.3**

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 reasons, 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 the month*

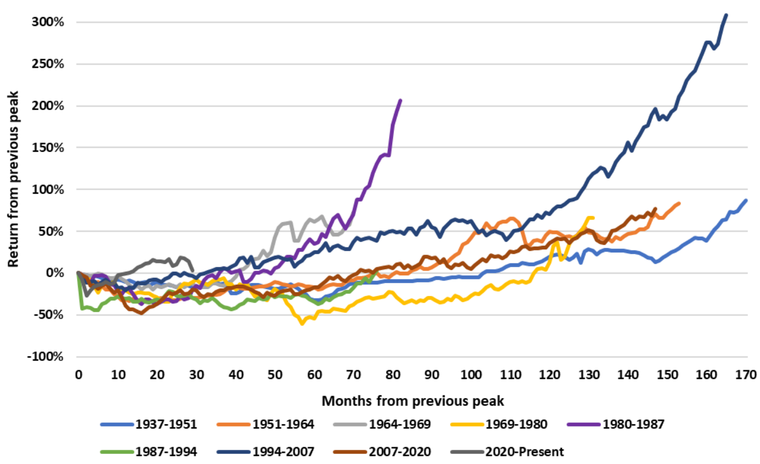
For the month of June, the JMFG Australian Equities strategy fell 13.6%, underperforming the All Ordinaries Accumulation Index by 4.2%. The market decline accelerated in June as significant central bank rate rises globally were applied to reign in high inflation. Much has been made of the US market's worst first half in over 50 years with both the Nasdaq and S&P500 now in technical correction. In this context, the Australian market, down 11.5% this calendar year, has outperformed. Despite moves to mitigate risk in the strategy, higher levels of Materials and high-conviction small-capitalisation holdings contributed to underperformance this month – however, we are confident in the longer-term outlook for these positions.

Small-capitalisation stocks significantly underperformed large-capitalisation stocks by more than 4% for the second month running, which continues the trend of underperformance in each of the last seven months. For the broader Australian market this month, Consumer Staples +0.2% was the only positive sector, while Energy -0.3% was also a significant outperformer. Materials -12.4%, the best performing sector last month, was the worst performer this month. Double-digit declines were also seen in Financials -11.9%, Property -11.6%, and Technology -11.0%. The remaining sectors outperformed the market, albeit delivering negative returns, being HealthCare -3.1%, Communications -3.6%, Industrials -5.0%, Consumer Discretionary -7.4%, and Utilities -7.8%.

During June, further moves were taken to reduce risk within the strategy and cash levels finished the month around 9%, slightly higher than last month-end, reflecting elevated market volatility.

Chart of the Month – *Market Cycles*

All Ordinaries peak-to-peak returns around bear markets



Statistics from market cycles of the All Ordinaries

	Average	Min	Max
Peak to trough (Bear Market)			
Return	-36%	-61%	-20%
Time	23 months	2 months	60 months
Trough to peak (Recovery)*			
Return	240%	85%	415%
Time	99 months	54 months	153 months
Peak to peak (Market Cycle)*			
Return	113%	3%	308%
Time	124 months	70 months	170 months

**Excluding 2020-Present period*

***Based on month end total returns of the All Ordinaries from 1937-Present*

The All Ordinaries Index started 2022 with the worst first-half return since the GFC and speculation grew as to whether we were nearing a bottom or if we were in, or headed for, a bear market. While the outcomes of these arguments are of great importance to investors, predicting such short-term movements in the market is not something that can be done consistently or reliably to aid investment decisions. However, we can look to long-term history for insights into how market cycles have evolved.

In our analysis, we have taken a market cycle to be a period from an all-time high market level as measured by the All Ordinaries Index, prior to a 20% or more fall, through to a subsequent recovery to a new market peak. Under this definition, we have identified 9 market cycles over the past 85 years. This chart shows how returns evolve from a peak through to the market trough and the subsequent recovery. The table below the chart also includes some statistics on these cycles.

This analysis highlights some important points. First, market cycles differ greatly in terms of length and size of returns, therefore peaks and troughs are only identifiable in hindsight. Secondly, holding through a market cycle provides rewarding returns, on average, an investment more than doubles over ~10 years, despite investing at the top of the prior cycle. Thirdly, buying in troughs has historically produced very strong returns in excess of the market cycle, with the market more than tripling on average from the bottom, before reaching another peak. Ultimately, investors who withstand market downturns earn the rewards of the market cycle, while downturns offer investors opportunities to gain exposure at a discount despite the trough being unpredictable. As the wise saying goes "it's time in the market, not timing the market".

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JMFG Australian Equities Strategy – *Key Contributors and Detractors for the Month*

CONTRIBUTORS

PolyNovo (PNV)
PolyNovo hit a 3-year low during the quarter but recovered well with substantial director buying. The main company-specific news was that the CEO search was progressing with a suitable candidate identified and close to being appointed. The stock's removal from the ASX200 Index also forced a decrease in short-selling action, reducing from 10% shorted to a little over 8% shorted, further supporting the price.

Woodside Energy Group (WDS)
Woodside Energy performed strongly during the month up 7.0% as the market digested the merger with BHP Petroleum which included a $1.1 billion share sale from former BHP investors unable to hold Woodside shares. Oil and natural gas prices remained supportive during June before moderating late in the month with the impact on demand from recession fears and China COVID lockdowns outweighing lack of supply from declining inventories and a decade of under-investment.

DETRACTORS

BHP Group (BHP)
BHP reversed its May gains as recession fears caused investor concern for future demand for commodities prices. China COVID lockdowns also negatively weighed on the Iron Ore price. The BHP Petroleum merger with Woodside concluded early in the month. BHP finished the month down 7.5%.

Mach7 Technologies (M7T)
Mach7 continued to come under selling pressure, down 20.3% in June, caught up in the small-cap tech stock sell-off and potential tax loss selling at the end of the financial year. We note that, in July, a major holder disclosed it had been responsible for some of that selling as it continues to reduce its position. On a more positive note, director buying continued into June and a 5-year contract renewal for A$2.8 million was signed, prompting a rally late in June, which has continued into July.

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

PolyNovo is a medical device company based in Melbourne, commercialising a CSIRO developed synthetic biodegradable polymer (NovoSorb) that can be produced in a range of formats with different properties, allowing multiple clinical uses. The first product (BTM) is in the early stages of commercialisation globally for skin trauma patients with full or deep partial thickness burns, surgical and reconstructive wounds, and traumatic wounds. PolyNovo is also developing its NovoSorb polymer for other indications, including Matrix for deeper skin wounds (FDA submission expected CY22), SynPath for the outpatient market to treat diabetic foot ulcers and venous leg ulcers (expected to launch late 2023 once reimbursement established) and SynTrel an application for hernia (FDA filing expected in CY24). Other longer dated opportunities for NovoSorb are in product development including breast reconstruction as well as third party partnerships for other applications. The BARDA burns pivotal trial continues to provide additional revenue and is a potential future commercial opportunity.

PolyNovo's share price a saw meteoric rise through the late 2010s before peaking in December 2020 above $4.00 a share with a market capitalisation of $2.6 billion. Since then, short sellers have steadily increased their selling, as seen in the chart below, and PolyNovo has become one of the most shorted ASX stocks. Despite steadily growing sales for BTM, there are a few potential reasons for the high short position: sales growth slowed due to COVID disruptions in the hospital system; the CEO departed unexpectedly in November 2021; hernia product delays; high valuation; and expectations of a capital raise due to low cash levels. Furthermore, rising interest rates saw high valuation stocks, especially those with no or low earnings, come under increased selling pressure and the significantly reduced market capitalisation saw PolyNovo removed from the ASX200 at the 20 June 2022 rebalance.

Subsequently, several factors have driven a strong rally in the share price over the last few months and short sellers have started to exit. The recent March quarter trading update delivered a return to strong sales growth with a record revenue of $12.3m, up ~60% on last year, driven by expansion in the US, with additional sales staff adding 15 new accounts over the quarter. June quarter results are expected soon in addition to an announcement regarding a replacement CEO. In the meantime, long term director Max Johnston has ably stepped in as interim CEO. Additional cash has been raised through the sale and leaseback of PolyNovo's Melbourne property, supporting the accelerated hiring of sales staff to drive further revenue growth. There has been recent insider buying following the March quarter trading update with the chairman adding 5.7m shares in several purchases through May and early June as well as purchases from two other directors.

A continuation of recent positive results as well as turning cash positive is expected to see continued buying and a further reduction in short positions.