Small Companies Fund

Quarterly Report

March 2015

To Our Unit Holders

Fund Basics			
Unit Price	$2.1193	**Inception Date**	17th September 2003
Distribution Frequency	Annual	**Fund Size**	$485.5M
Number of Stocks in the Portfolio	56	**Benchmark**	S&P ASX Small Ordinaries Accumulation Index

Performance Statistics to 31 March 2015

	3 Month %	1 Year %	3 Year % p.a.	5 Year % p.a.	Since Inception
EGG Small Companies Fund	+10.50%	+8.89%	+8.31%	+7.57%	+11.48%
S&P/ASX Small Ordinaries Accumulation Index	+7.30%	+2.30%	-1.72%	-0.30%	+5.21%
Out performance	***+3.20%***	***+6.59%***	***+10.03%***	***+7.87%***	***+6.27%***

* Fund returns are calculated post fees.

For the quarter ending 31 March 2015, the Eley Griffiths Group Small Companies Fund returned 10.50%, compared to a 7.30% increase in the Small Ordinaries Accumulation Index.

Market Review & Strategy

The Small Ordinaries Accumulation Index was nicely outpaced by the 100 leaders, managing to post a 7.3% gain by the end of March compared to the 10.6% gain registered by the large cap accumulation index. Mining and resources related names were again the main culprits behind the underperformance, continuing the rotation out of the space in favour of quality industrial names.

The RBA's decision to ease rates (-0.25bp to 2.25%) after a 20 month pause drowned out political goings-on in Canberra and underwrote a blistering market advance.

The theory that the RBA had not broken its abstinence for one cut only, quickly found support from the market. The economy's adjustment from one buoyed by resource investment to one centred around an east coast recovery story will not occur without some dislocation. Early indications point to a recovery in residential construction investment, planned infrastructure capex and a tempered revival to consumption and tourism spend.

The RBA would also have been infused by a growing number (totalling 21) of international counterparts who either lowered rates during the quarter, including Canada, India, Russia and Israel or turned 'dovish', including New Zealand and the UK. The US maintained their 'patient' monetary policy standpoint despite mounting suspicions of a pre-emptive strike on rates.

The March quarter reporting season confirmed the continuing trend of weak revenues and heavy cost-out across our domestic corporates.

Results bettered low expectations, analysts net downgraded and PE ratios expanded.

There was little/no surprise in dividend declarations (payout ratios already pitched at high end) but capital management, either through buy backs or cash returns, did figure in the mix.

Retailers reported generally underwhelming results but conceded that recent trading was improving, residential construction groups advised of better conditions and mining and mining service names disappointed the market.

One distinguishing feature of the market has been the pace at which PE ratios have been expanding. The likely prospect that interest rates push lower and remain historically low has emboldened investors to indifference, bidding the stock prices of both good and bad earnings stories higher. Goldman Sachs wrote recently that an index of their '20 cheapest stocks' has never been this expensive (forward PE of 14x vs a 20 year average of 10.5x). Simply, investors are mistakenly buying 'cheap' when in fact higher PE stocks (with concomitant higher earnings certainty) are actually a much safer bet.

In January, the broader sharemarket drew strength from the surprise Japan Post bid for Toll Holdings at a 42% premium to last trade. This is early evidence that offshore business owners are starting to discern value in our market.
Coincidentally, it lined up nicely with increased sightings of international portfolio investors scoping out our market. The Australian market was in grave danger of offering a compelling value proposition! The AUD v USD cross is offering better relative value (closer to the bottom of its recent trading range), monetary policy is accommodative, with rates headed lower, and

our banks and corporates are largely in good fettle. Offshore interest, either from corporates or funds, is set to become influential in local market activity as 2015 unfolds.

By quarter end, secondary equity transactions were increasing in number and were not only being dealt quickly, but were being priced at minima or nil discounts. Some $6.7bn in block trades were transacted in the March quarter. Notable among these, Chevron quit its long held 50% stake in Caltex, APN News & Media saw 30% of issued capital dealt to News Corp and institutions and Gina Rinehart offloaded her 15% position in Fairfax Media. At the time of writing, in excess of 30 initial public offerings were being readied for float.

As a general rule, stock supply and the manner in which it is absorbed is a good barometer of stock market health. It is most probable that forecast stock supply (after adjusting for takeovers and stock buy backs) is unlikely to derail the market's current positive momentum.

Technical Summary

Equities are moving into a seasonally strong month or two. April is comfortably the calendars strongest month. Momentum in the US stock market has swung from large caps (flat for 2015) into small caps (Russell 2000 +4.4% this CY) as investors seek out domestic economic exposures and away from companies in the firing line of a strong USD.

Whilst relative strength indicators are set at neutral, the US market 'investment line' (the 100 day moving average) continues to trend upward.

One of the markets more reliable, longer term oscillators is the Coppock Indicator. It is a slow reacting but dependable measure that only signals the beginning of new bull drives. Patience is key here. Coppock (on a weekly basis) turned bullish in mid December 2014 in the US and it did so for the Australian market too, both big and small caps.

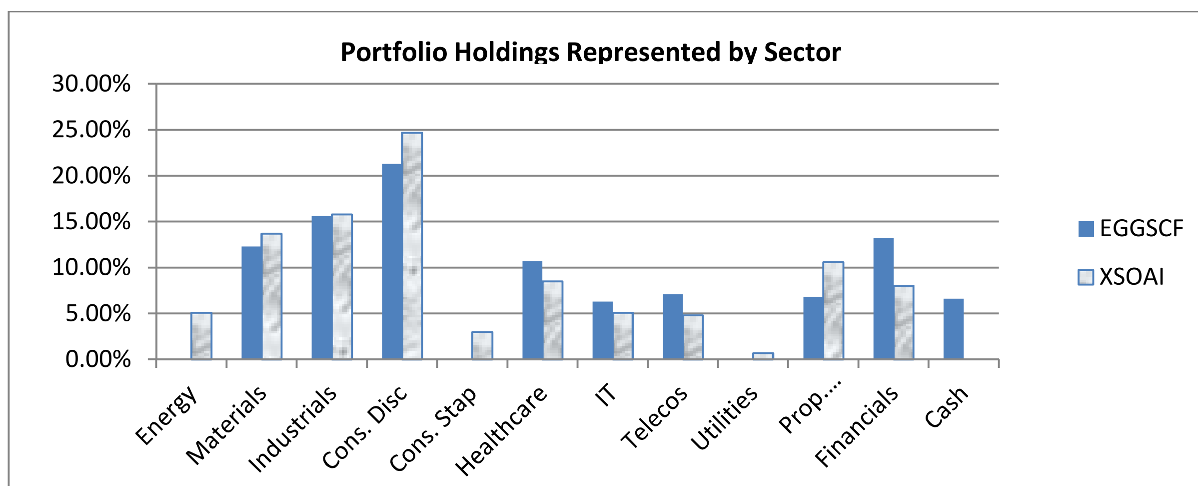
Circa 62% of companies were above the 'investment line' in the Small Ordinaries Index by end of March. This number indicates a broadening of the advance from December quarter, where 33% were trading above the 100 day moving average. This is constructive price action.

The Portfolio

During March quarter, our small company portfolio saw great appreciation from a number of stocks. Prominent amongst these were BT Financial (+36%), Regis Healthcare (+47.8%), Saracen Minerals (+66.7%), Mayne Pharma (+51.3%) and Domino's (+47.5%). A zero weighting to Bradken (-61%) also contributed to performance.

Detractors during the quarter included GWA (-13.1%), Oz Forex (-14.8%) and IRESS (-1.9%). Nil weightings in Northern Star (+54.4%) and M2 Group (+24.7%) also hurt performance.

Top 10 Stocks as at 31st March 2015			
Fletcher Building Limited	3.96%	**Domino's Pizza Enterprises**	2.87%
IRESS Limited	3.95%	**Macquarie Atlas Roads Group**	2.79%
iiNet Limited	3.50%	**Qube Holdings Limited**	2.59%
InvoCare Limited	3.26%	**Healthscope Limited**	2.47%
Slater & Gordon Limited	3.13%	**BT Investment Management**	2.40%



During the March quarter we added several new stocks to the portfolio.

Despite declining the IPO of **Burson Group,** we continued our due diligence on the firm, gaining sufficient confidence to initiate a position in January. Burson is a specialist wholesaler of auto parts to the independent workshop/garage segment, chiefly through eastern Australia. It boasts a defensive revenue model, augmented by a 10-12 pa new store rollout programme that, on our estimates, will run through 2019.

We added to our holding in **Mayne Pharma** during the period in review, both on market and via an equity raising undertaken by the company. The raising was primarily to set up a US specialty brands division, built around the acquisition of the drug 'Doryx' (acute acne treatment). The company presently manufactures Doryx, but in the future will sell and distribute the drug in the US market. Mayne will now have a platform for other drug developments.

Contrary to media reports, EGG retained only a modest shareholding in **Ardent Leisure** at the time of the company's disappointing interim result. Further, we had quit the register by the time the Chairman announced a change to CEO which bought about a share price savaging and a shareholder uprising. Looking through the 'noise', we remain attracted to the group's rapidly growing, US based, Main Event bowling/leisure business. We would note parallels with the highly successful, Dave & Buster's (PLAY:US) business model, listed recently on Nasdaq.

Your manager sold their residual **Tassal** holding during the quarter, as all-too-familiar sell signals began to emerge. Among these, a new capital expenditure cycle, with distending working capital and free cash flow pressures coupled with the likely prospect of supply side expansion from competitor Huon. Acquiring seafood retailer, De Costi, was also puzzling to us.

Outlook

A sense of Déjà vu took hold when it came to framing a discussion around the sharemarkets near-medium term outlook.

I stumbled upon a June 2004 research piece by former GS JB Were analyst, Chris Pidcock, titled "Sensitivity to the US Interest Rate Cycle" and his observations therein were interesting. Investors in June 2004, like now, were fully resigned to a near term US tightening cycle.

Chris's analysis involved 'dusting-off' earlier works on the relative performance of the Australian market during US tightening episodes in 1984, 1987/89, 1994/95 and 1999/00 (2007 was excluded due to the influence of the Asian crisis). Briefly, his conclusions:

- the Australian equity market has generated positive absolute returns during previous US tightening cycles (ex 94/95)
- the Australian market did however underperform Asia (ex Japan) markets during the early periods but came through in later points of the cycle
- banks underperformed in the initial tightening stage, general insurers were mixed and resource names fared well
- REITs tended to be neutral performers, underperforming prior to the first hike.

The Fed's most recent communication suggests a patient stance on rate hikes but a growing band of economists believe the continuing strength of non farm payrolls will outweigh recent softer data, forcing Yellen's hand. One even suggesting to me that the Fed has a number of 'experimental' tools it wants to unleash as a part of the changing Fed position. These might include overnight interest on excess reserves and a reverse repo facility to cap short term rates.

Experience has taught us how important the US high yield bond market is to stock market health. In mid 2007, this important component of the bond market effectively froze over, closing to deals and rollovers that imperilled much of corporate US and beyond. This presaged the market top and ensuing correction that became the 'GFC'.

With this in mind, analysts at Eley Griffiths Group conference-called a Wall Street bond and leverage specialist for his take on the prevailing high yield market. A depressed oil price could seriously threaten the highly geared US shale oil/gas industry, with this sector now representing ~ 20% of the US high yield market. With the events of 2007 in mind, we were relieved to hear his insights.

Excepting shale energy, the high yield bond market is in very good shape. The market is healthy, liquidity is strong and the bid good. The quality of the paper on offer is also sound.

Interestingly, he pointed to recent fund flow data highlighting a movement out of loan/money market funds/ETF's (where rates are floating) into high yield products/ETF's (fixed rates) as an endorsement of confidence and a sign that rates are unlikely to be hiked in the very short term.

Our attention then moved to the forthcoming US Q1 reporting season, where expectations have been lowered very noticeably. As is often the way, earnings downgrades are outpacing upgrades. The market is now expecting CY2015 eps growth of 4% versus 8% a year ago. Observers will be keen to see how debilitating the strong USD has been on earnings. This has the potential to derail the markets advance and is very much front of mind for professional investors.

PE valuations, here and in the US are above 20 year averages (both coincidentally ~14.5X) at 17.0x for the ASX100 and 16.5x for the S&P500. These are far from extreme settings and not unreasonable given the current interest rate trajectory in Australia and the imminent multiplier effects a US economic recovery will have on earnings growth. EGG has calculated the local market's equity risk premium at ~6.3% versus the long term average of ~4.5%, suggesting equities might remain a key tactical allocation amongst funds.

The increasing likelihood of at least another 2 cuts to interest rates locally over the next 12 months will be a great elixir for the Australian stock market, especially small cap cyclicals. Don't rule out a run to the old highs for the local market. That's 6852 the ASX200 and 5534 on the ASX100.

Eley Griffiths Group Ratings			
Morningstar	March 2015	Silver	2nd Highest Rating
Lonsec	February 2015	Recommended	2nd Highest Rating
Zenith	March 2015	Recommended	2nd Highest Rating

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