Small Companies Fund

Quarterly Report

September 2015

To Our Unit Holders

Fund Basics			
Unit Price	$1.874	**Inception Date**	17th September 2003
Distribution Frequency	Annual	**Fund Size**	$401M
Number of Stocks in the Portfolio	58	**Benchmark**	S&P ASX Small Ordinaries Accumulation Index

Performance Statistics to 30 Sept 2015

	3 Month %	1 Year %	3 Year % p.a.	5 Year % p.a.	Since Inception
EGG Small Companies Fund	1.98%	+6.16%	+8.47%	+5.56%	+10.72%
S&P/ASX Small Ordinaries Accumulation Index	-3.90%	-4.90%	-1.22%	-2.54%	+4.27%
Out performance	***+5.88%***	***+11.06%***	***+9.69%***	***+8.10%***	***+6.45%***

* Fund returns are calculated post fees.

For the quarter ending 30 September 2015, the Eley Griffiths Group Small Companies Fund returned +1.98%, compared to a -3.90% move in the Small Ordinaries Accumulation Index.

Market Review & Strategy

The September quarter began with small resource names coming under heavy selling pressure, whilst industrial names performed creditably ahead of the reporting season. Investors pursued momentum names eg **Blackmores, Bellamy's** and **Mantra Group** as well recovery/turnaround stocks such as **SMS Management**, **UXC** and **Pacific Brands**.

Critical to local investor sentiment was the unfolding, troublesome price action in the US stockmarket. Its hidebound trading pattern since February 2015 yielded on August 21, with a decisive sell off in US equities.

It seemed a somewhat delayed reaction to a growing unease about prospective US earnings. Goldman Sachs (GS) were prominent here, revising US earnings growth expectations from circa 10% to flat for 2015. This revision in early August was backed up in late September, with further dialling down in expectations from flat epsg in 2015 to -3%. 2016 estimates were also reduced to a growth rate of 10%.

This faltering in earnings momentum, combined with a growing anxiety around the FOMC's timing of a hike in rates and a rout in Chinese stocks was all it took for investors to head for the door. By mid August, the WSJ was reporting investors had all but given up on China policy maker's ability to manage a soft landing and viewed attempts at stockmarket regulation as feckless. It wasn't long before doubts began to emerge about the durability of other emerging market economies, ushering in weakness in these markets too. A perfect storm was taking hold.

Meanwhile, our reporting season ran its course in August, with results broadly in step with expectations. Profits weren't improving but they weren't deteriorating greatly either. Cost out remains a feature, revenue growth is benign, dividend payments picked up and balance sheets, generally, passed muster.

Analysts tended to downgrade FY16, with GS downgrade/upgrade ratio expanding to 2.7x, up from its 1.5x, 5 year average. Private equity/vendor sell downs 'tail-gated' a number of small company results. Despite prevailing market volatility, these transactions were completed with keen buyer interest at varying price discounts. **Burson's, Spotless**, **Aconex, Isentia and Mantra** were examples of such exits.

Our analysts also noted: a growing belief that the housing cycle is peaking, the bank sector is now facing operating headwinds (margins, volumes, asset quality, regulation), consumer discretionary activity is more robust than feared and there is no relief in sight for mining related service companies.

A lower AUD has seen offshore investors become increasingly active in acquiring both ASX-listed names, as well as privately held businesses or assets. European pension funds, scouting for yield, were buyers of commercial property and Chinese investors continued their pursuit of all forms of real estate. Notable, were their registration of interest in significant portfolios of pastoral assets, such as S. Kidman & Co, Consolidated Pastoral Co and the Tipperary Group.

In the listed space, Equifax (UK) expressed interest in **Veda** ($2.3bn), Brookfield (Canada) bid for **Asciano** ($8.9bn) and yet to list, Swisse Pharma received a $1.7bn bid from Hong Kongbased, Biostime. It was reported that inbound acquisitions (ytd 18 September) tallied US$38bn-their highest since 2011 (US$50bn). Interesting to note that North American investors developed an appetite for Australian gold producers, in response to the rallying AUD denominated gold price (+17% YOY). PE firm, KKR, also revealed they had amassed a 10% stake in **Oz Minerals.**

Perplexing equity markets by late quarter was the FOMC decision at its 16-17 September meeting to leave rates on hold, citing ‘heightened uncertainties abroad and a softer path of inflation…’ The now popular Federal Reserve ‘dot plot’, revealed the new dots pointed to longer run forecasts being lower, meaning rates won’t rise fast or as high as previously expected.

Technical Summary

The ASX200 put in a muted rally through July from 5400 but a mid August sell-off saw price action retrace deeply, all the way back to the ‘bull market’ support line. This trendline rises out of the important 2009 GFC market low of 3121. Its support of our market advance should not be underestimated, having captured mid and late 2011 as well as mid 2012 corrections. The index needs to hold here (4918), as the below chart emphasises.

Despite my bullish prognosis for the Small Ordinaries (XSO) in our June quarterly note to investors, the benchmark was not spared in the recent market rout.. That said, investors should note its relative performance vs the ASX100 has been impressive, outpacing it across monthly, quarter and CYTD time periods. The XSO looks technically sound and enjoying market support around the 1920/30 level. Fewer stocks are above the ‘investment line’ (100 day ma) than in the June quarter, which is not ideal, but I am prepared to be patient in letting the market expand its breadth.

The US investor quandary we referred to in our June report, “Is a top taking shape with an ensuing sell-off to follow or is it congestion, ahead of an upside break?, was resolved up with a powerful downside move in US stocks. The NASDAQ Composite’s eerie failure to take out the 5130 dot.com record highs in March 2000, presaged the broader US equity market correction.

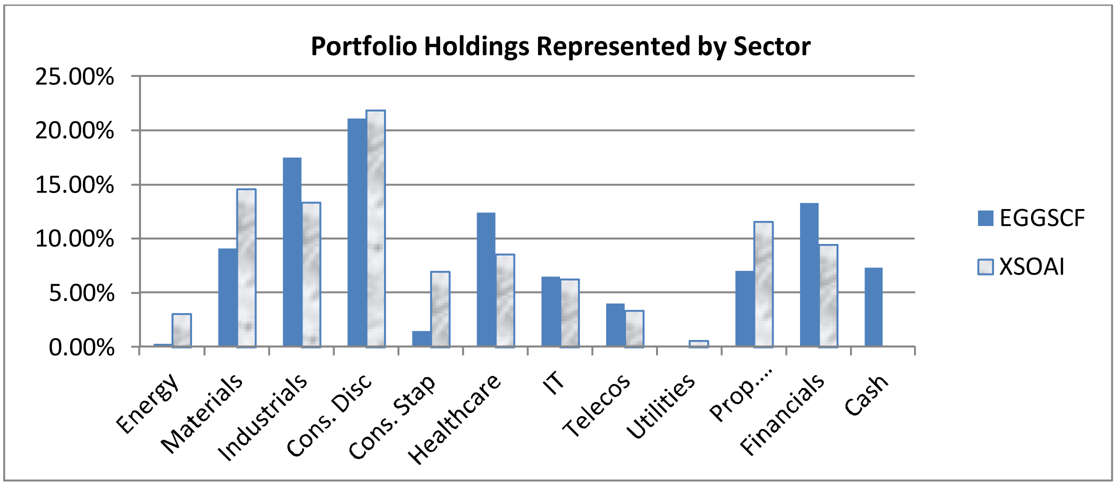
It is a little harder to paint a bullish set up in US stock prices, but the timing is good for seasonal buying support about now.

The Portfolio

During September quarter, our small company portfolio saw strong appreciation from HFA Holdings (+35%), Vitaco Holdings (+29%), Macquarie Atlas Roads Group (+26%), APN Outdoor Group (+24%) and Austal (+24%). Nil weights in Atlas Iron (-73%) and Liquefied Natural Gas (-67%) helped performance.

Detractors during the quarter included AWE (-50%), Independence Group (-35%) and Prime Media Group (-32%). Nil weightings in Pacific Brands (+122%) and UXC (+72%) also hurt performance.

Top 10 Stocks as at 30th September 2015			
Macquarie Atlas Roads	4.24%	**Invocare Limited**	2.72%
Mantra Group	3.97%	**TPG Telecom**	2.63%
IRESS	3.34%	**Platinum Asset Mgt**	2.39%
Veda Group	2.99%	**BWP Trust**	2.35%
Fletcher Building	2.84%	**SAI Global Limited**	2.35%



Having allowed cash levels to swell during the early months of the quarter, your manager got to work acquiring a number of beaten up stocks, as well as incremental additions to favoured names. Private equity sell downs in **Burson**, **Mantra** and **APN Outdoor** afforded us the opportunity to increase our exposure to these well managed businesses.

Collins Foods Limited has endured a checkered past as a listed company, with earnings warnings and management tumult impacting on investor perceptions. An analyst meeting one year ago intimated the beginnings of a strategic reorientation of the business, increasingly towards the strongly performing KFC business. With more than 600 KFC stores across multiple owners in Australia, there are a number of potential acquisition opportunities in the pipeline. Yum!, the US based master franchisor for KFC, has long been tipped as a seller of its store portfolio, preferring investment in other locations, such as Oceania/SE Asia. Identifying an attractive entry point, we initiated a position in Collins Foods during the quarter.

Following a lengthy absence from the register, EGG returned as an investor in **Trade Me**. The company conducts an on line marketplace and classified advertising platform in NZ, with auctions and fixed price sales of new/used goods as well as real estate, automotive and employment verticals. We exited our holding 18 months ago, as they commenced a significant investment year or two. Now nicely behind it, the business is experiencing good lead indicators and a slowing in the rate of cost growth. Priced at 17.0x PE (FY16) with exceptional free cash flow generation and a robust management team, we saw diminished downside risk at four year lows in the share price.

EGG are once again a shareholder in **Regis Resources,** following nearly 12 months of deliberation on the name. Rebasing of production and operating cost expectations in July and increased confidence that free cash flow will perform strongly moving forward, were influential in our thinking. The re-emergence of growth options, through recent tenement deals and exploration success, rounded out our investment case.

Our relatively simple thesis on accommodation provider, **Mantra Group** has also rewarded investors. Operating leverage through price (in CBD) and occupancy (in leisure) combined with industry consolidation opportunities, should see solid earnings accretion over the next 3 years. A softer AUD will also underwrite the positive inbound travel thematic. This holding was increased during the quarter, as mentioned above.

Our rolling selling campaign in **Spotless Group** concluded in August, with the stock quit from portfolio's. EGG were amongst a minority of local investors who subscribed to the IPO in May 2014, believing it to be a fair/reasonable business at an attractive valuation but unduly influenced by professional investor paroxysm. Your manager also accepted **TPG** scrip and cash for its long held **iinet** position, once the ACCC cleared the takeover bid.

Outlook

International influences will hold sway over the direction of the domestic stockmarket through the December quarter and into 2016. These will be more acute than would normally prevail for several reasons.

First, the US Federal Reserve seems committed to hiking interest rates for the first time in nine years when it meets at either of the final two meetings for 2015 (late October or late December). This would occur despite dovish rhetoric from the September FOMC meeting, notable slowing in the labour market (payroll growth disappointing and participation rate the lowest since 1977) and a cooling in overall economic activity (driven by softer trade figures) in the September quarter. Bond markets are pricing a return to benign economic conditions.

Second, the US economy is tipped to reach the Federal debt ceiling in November, when treasury will run out of 'extraordinary measures' to keep the government funded. Reportedly, the government will be left with ~ $30bn in cash on/around November 5. Investors have seen this episode before and will demand to know whether the debt ceiling will be suspended or raised. This could be problematic for markets.

Third, the general vitality of the US stockmarket is clearly in question. Its technical failings have been discussed above and it remains unsettling that fewer and fewer stocks are making new highs, whilst a growing list, plumb 52 week lows. In short, market breadth is deteriorating. The GS S&P500 Sentiment Indicator (based on current futures positions) is now suggesting the lightest net long positioning in 8 years. A sign of reduced buy-side conviction.

Fourth, the US corporate earnings outlook has been waning for several months and a downgrade cycle seems to have nicely asserted itself. Negative earnings momentum will not blend well with firming interest rates.

Fifth, the US credit market has continued to tighten, with the Credit –Suisse High Yield basket now yielding ~ 8.3%, the highest level since the Euro crisis in 2011. The spread to US10T has increased ~ 200bp since the beginning of 2015 and the default rate is also lifting. Traders are genuinely fearful of a credit contagion, spreading from the oil/gas E&P segment to basic industries and beyond. The equity market is yet to fully discount what is unfolding here.

Eley Griffiths Group calculates the local market's equity risk premium (ERP) each quarter. At present it sits at 6.35%, slightly more attractive than the June quarter setting. At the risk of repeating our recent mantra, the Australian sharemarket continues to offer equity investors ample reward for the extra risk over bond returns. Local equities are a BUY at current levels.

The relative outperformance of the XSO versus the ASX 100 looks set to continue, if EGG's interpretation of current PE differentials holds true. At the time of writing, the FY16 PE ratios of small and big caps were at parity at ~ 14.8x. History has taught this manager a thing or two and one dyed-in-the-wool rule is that the market doesn't buy small caps at sizable (15-20%) discounts to big caps. Counter intuitively, investors buy small caps at PER parity and continue this until a full blown premium differential is in place. This process can play out over a lengthy period and we may just be at the early stages of this phenomenon right now.

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