THE ENCYCLICAL

Small Companies Fund

Quarterly Report

December 2015

To Our Unit Holders

Fund Basics			
Unit Price	$2.0969	**Inception Date**	17th September 2003
Distribution Frequency	Annual	**Fund Size**	$412M
Number of Stocks in the Portfolio	57	**Benchmark**	S&P ASX Small Ordinaries Accumulation Index

Performance Statistics to 31 Dec 2015

	3 Month %	1 Year %	3 Year % p.a.	5 Year % p.a.	Since Inception
EGG Small Companies Fund	+11.89%	+20.15%	+11.07%	+6.43%	+11.50%
S&P/ASX Small Ordinaries Accumulation Index	+11.32%	+10.16%	+1.69%	-2.51%	+5.10%
Outperformance	***+0.57%***	***+9.99%***	***+9.38%***	***+8.94%***	***+6.40%***

* Fund returns are calculated post fees.

For the quarter ending 31 December 2015, the Eley Griffiths Group Small Companies Fund returned +11.89%, compared to a +11.32% move in the Small Ordinaries Accumulation Index (XSOAI).

Market Review & Strategy

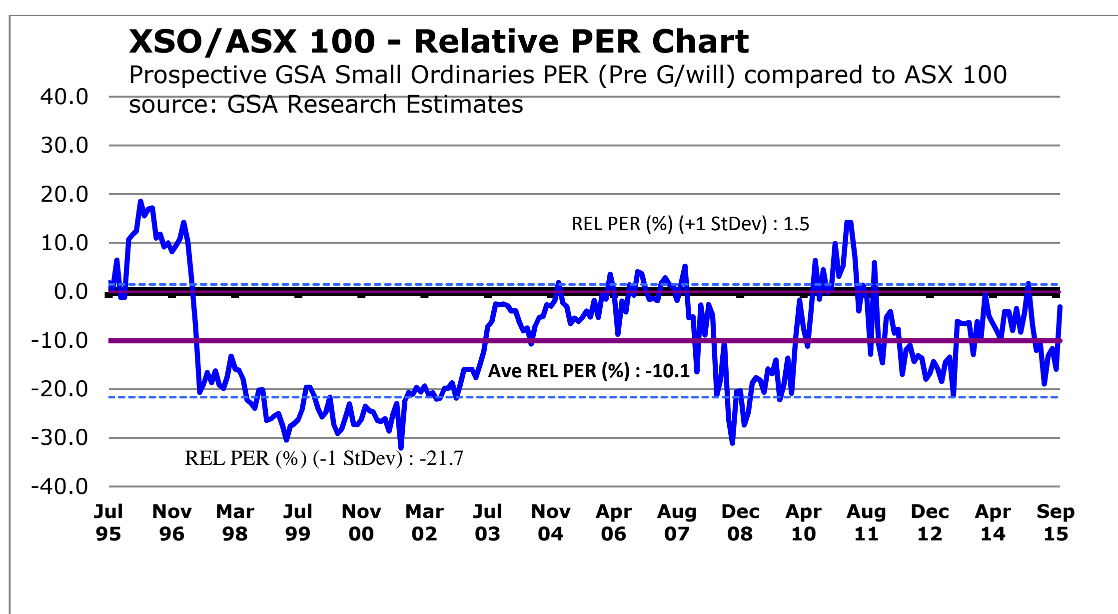
The December quarter continued where September left off, with investor demand for momentum names continuing unabated. **Blackmores, Bellamy's**, **APN Outdoor, M2 Group** and **Mantra Group** were the 'poster-boys' in a market marred by a train of small company earnings downgrades.

The period comprising the AGM season (Oct-Nov) has cemented itself as a volatile window for local equities, with disappointing market guidance in several instances met with a swift requital from investors. **Dick Smith, Billabong, Bradken, MMA Offshore** and **Austal** staged dramatic sell-offs on earnings revisions. Recent Small Ordinaries Index departee's, **Spotless**

Group and **Slater & Gordon** had spectacular share price corrections during the quarter, down -50% and -72% respectively.

Small companies continued to outpace their large cap counterparts, with calendar year outperformance of the XSOAI versus the XTOAI of 8.02%. Eley Griffiths Group analysts have observed a progressive improvement in the quality and performance of many of the Small Ordinaries constituents over the past 12 months. This is in stark contrast to disappointing big cap performers, the banks, the bulk miners and Telstra. These heavy weight stocks drove big cap relative outperformance in years past, but this is now reversing.

We talked briefly about this phenomena in the September quarterly outlook and the chart below highlights how the traditional small cap discount of ~ 15% has disappeared. The FY16 PE ratios of small and big cap stocks are at parity at 15.7x. Perversely, investor appetite for small companies grows coincident with parity and premium markets and not when discounted valuations might appear to provide logical buy set-ups.



It is interesting to note that monthly volumes of the Small Ordinaries Index have regularly traded > $12bn during the quarter in review and, in fact, throughout most of 2015. This level of turnover was last recorded in the darkest months of the GFC in 2008, but remains below turnover months when the Australian market made its all-time high in 2007 (> $16bn not uncommon). The principle being that improving volumes validate the benchmark's strong outperformance.

Initial public offerings continued to attract interest during the quarter with $56bn in issuance for 2015 and capping off the biggest year for equity capital markets since 2009. A number of December listings underwhelmed the market, despite reported solid investor interest. It

appears float promoters have become impudent with valuations, evident in poor after market support and share price resets to levels below IPO issue price. **McGrath** and **Temple & Webster** are cases in point and have traded poorly since float. Added to the list, **IVE Group** and **Wellard** have been moribund since listing, eliciting some passing trade, if a little half-hearted.

Technical Summary

In the last note we stressed the importance of 4918 holding fast on the ASX200, in fact, the bull market in local stocks depends on it. This level was twice tested in mid December and follows 4-5 attempts stretching back to the GFC lows of March 2009. The ‘investment line’ (100 day m.a.) has a downward trajectory and it has hindered several attempts for the index to rally since May 2015.

The Small Ordinaries Index tested the third resistance fan from the November 2007 highs in December. Interestingly this line intercepts the support line from the March 2009 lows, making for a zone of resistance that will test the markets resolve, one way or another. The chart of the Small Industrials Index looks constructive, contrasting with that of the small resources index, which is set for a move to levels not seen since 2001.

Market breadth for small caps continues to disappoint, with only 47% of stocks above the ‘investment line’ versus 61% at end of October. A sustained rally requires greater participation.

The Dow Transportation Index confirmed its bellwether status having set its high in November 2014 and in so doing, indicating the maturity of the US advance. The violent August 2015 correction produced a market bounce during the quarter, but most of the major indices failed at their attempts at the old highs. Most surprising has been the small cap index, the Russell 2000, eliciting minimal support from investors and baying for a retest of the August lows.

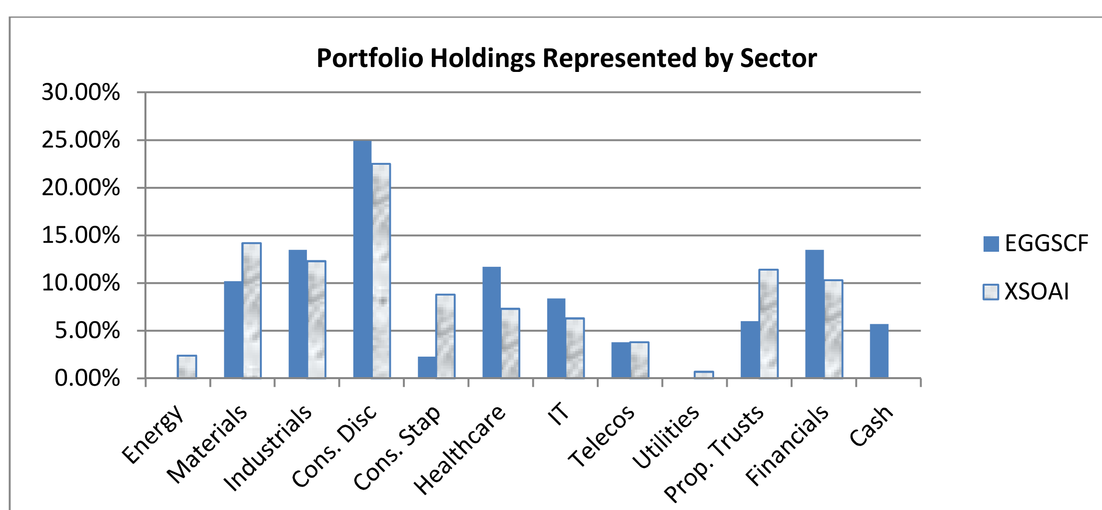
The US technical backdrop points to a more volatile year ahead for US equity investors. This of course needs to be front of mind for equity investors across the globe.

The Portfolio

During December quarter, our small company portfolio saw strong appreciation from APN Outdoor (+58%), Mayne Pharma Group (+37%) and Mantra Group (+26%). Nil weights in Mesoblast Limited (-41%) and Liquefied Natural Gas (-37%) helped performance.

Detractors during the quarter included TPG Telecom (-8%), Medibank Private Limited (-11%) and SAI Global (-8%). Nil weightings in Metcash (+54%) and Bega Cheese (+56%) also hurt performance.

Top 10 Stocks as at 31 December 2015			
Mantra Group	3.68%	**Mayne Pharma Group**	2.84%
IRESS	3.63%	**APN Outdoor**	2.67%
Macquarie Atlas Roads	3.25%	**Auckland International**	2.55%
Fletcher Building	3.08%	**Burson Group**	2.53%
Trade Me Group	2.93%	**Platinum Asset Mgt**	2.43%



Our frequent visits to NZ to review investee companies, as well as to investigate new ideas, saw us add to several existing holdings and add a small position in **Xero** to the portfolio. The software company has developed cloud-based SME accounting software and is now the dominant player in 3 of the 4 geographies in which it operates. Meetings in the US with major competitor, Intuit, gave us confidence that Xero should continue to grow their share of this lucrative market. A market capitalisation of c. $2.5bn suggests a success case is being discounted in the share price, so your manager has been patient in accumulating this name.

We participated in a number of IPO's during the period and, as usual, the conversion ratio of deals reviewed versus those subscribed was modest.

The float of **Link Administration Holdings** was emblematic of an IPO cycle that is very mature and enjoying participation from a wide and deep audience. The company had been in the hands of private equity players, PEP, for over a decade and only after it was bulked up with the Superpartners acquisition, was it deemed ready to be set free. The IPO was the biggest of the year, raising $947m. The group is the largest superannuation fund

administrator in Australia and the investment proposition centres around margin recovery (cost out/technology application/efficiencies) and volume uplift (via consolidation and increased penetration of the superannuation asset pool, with ~ 58% of super admin conducted in house).

A rethink on some of our small REIT positions saw us invest in the **Aventus Property Fund**. The repricing of this homemaker centre REIT IPO to a 7.25% yield enhanced the appeal of this acquisitive owner/manager of large format retail centres. No single operator owns more than 15% of the homemaker/big-box market, with an immediate opportunity to consolidate the industry, whilst driving rate, and occupancy with acceptable levels of leverage.

On-line employment and training operator, Seek Limited, disposed of its interest in **IDP Education** by way of IPO during the quarter. The group is a leading provider of international student placement services in Australasia and a nascent one in the UK, USA and Canada. It also conducts English language testing services (IELTS tests) in SE Asia. IDP is the co-owner of IELTS, along with the British Council and Cambridge University. EGG were immediately attracted to the strong organic growth profile, high free cash flow and capital light nature of the business. The IELTS partnership agreement is a risk to the investment thesis, but we believe this is captured in the 18X PE multiple the business was IPO'ed on.

Several stocks were quit from the portfolio during the period in review. A selling programme for our sole oil/gas exposure, **AWE**, concluded having commenced in late July on the back of the company's Yolla field reserve downgrade. The sombre outlook for the crude oil price added conviction to the decision. Our earlier bullishness for future east coast Australian gas prices (rule of thumb ~ 7% of current Brent price) has also been tempered, with a very bearish outlook for the international LNG market and mounting concerns around who was going to be the ultimate, end buyer for the surfeit.

Long held stock, **Peet Limited**, was sold from portfolios during the quarter. A great management team can only do so much in the face of challenging property development markets in WA and Victoria where the company has a large exposure. Lower priced lots have enjoyed reasonable sell through in this market, but the outlook at best is uncertain. The Flagstone project in SE Qld, will be a significant earnings generator for the business over the next decade and we will continue to follow the group closely.

Outlook

The opening weeks of 2016 have been tumultuous for global equity markets, with the sell off epicentre being the Shanghai Composite Index, down 18% for the year at the time of writing. We have long harboured concerns for the vitality of the US stockmarket through 2016 and our concerns appear to be well placed. Navigating a path through the US market this year will not be short of challenges for investors.

It is reasonable to extrapolate this volatile backdrop across to Australian equities, but investors need to recognise the Australian and US economies are at two vastly different stages of the economic cycle. We can outperform the US stockmarket, but it will be hard to rally if that market goes into a corrective phase. Failure to take out the old highs across big and small stocks, tech and non-tech, growth and defensive, through November-December was a bad sign. Market breadth has actually deteriorated since we aired our concerns in the EGG September quarterly piece. In essence, fewer and fewer stocks are doing the market's heavy lifting. We would also note the deterioration in US corporate balance sheets, the result of buy backs funded by cheap debt, with the express purpose of offsetting poor revenue and earnings growth. Corporate America has essentially used record low interest rates to replace equity with debt. This may prove problematic in the long-term should interest rates and bond markets return to pre-GFC levels.

At its December meeting, the FOMC lifted the federal funds rate range to 0.25% to 0.50% and the median dot-plot (graphical depiction of FOMC member's rate predictions) suggested a 1.00% increase was in the offing for 2016. GS US strategist, Jan Hatzius, is emphatic rates will be hiked again as soon as March, that the fed funds rate will be 1.40% and the 10 year bonds at 3.00% by the close of CY16. Simply, growth is tracking above trend, labour markets are tightening and inflation has a foothold, with declines in energy and healthcare prices washing out of 12 month comparisons. Watch for US unemployment pushing to 4.0%-4.5% (currently 4.9%) and capacity utilisation nudging 82% (now 77.5%) before the Fed needs to really put the foot down.

Martin Zweig writes in his investment classic, *Winning On Wall Street*, moves by the Fed towards easing have a greater positive impact on stocks than the negative effect created by tightening moves… The trend of interest rates is more significant than the level itself." These observations point to the importance of where we are in the economic cycle and to looming changes in investor behaviour. There is a generation of investors in today's markets who have not experienced rising inflation or rising rates! Zweig tracks the US prime rate most closely as it tends to move with a lag and in step with equities. The prime rate is the rate at which banks base their customer lending. It lifted 0.25% after the Fed move to 3.5%. He says wait for the 2nd move or a 1% shift in this rate before acting. We will continue to monitor this.

The health of the high yield (HY) market has been a vexing matter for markets through 2015 and its condition seems to be worsening. HY-IG (Investment Grade) Spreads are now at 4 year highs and more than one observer is claiming this as a limn for recession. The week preceding the FOMC meeting saw investment grade corporate bond mutual fund outflows hit a record $4.5bn (0.65% of IG FUM). Further, equity mutual fund outflows ran at $17.3bn -the biggest in 15 years and 3rd largest on record.

In short, the US market has plenty to contend with. A regime of firming rates will compress PE ratios and snuff out the positive impact of an earnings recovery many are assuming for 2016. Investor disquiet will be real for the early months of 2016.

Locally, we have an economy in transition that is benefiting from a lower AUD, recovering consumer confidence, slowly repairing labour market and with monetary policy settings that likely see interest rate stability through the course of 2016. The execution of fiscal policy will be critically important over the year ahead. The MYFEO indicated the federal government has started to address areas of imbalance, with further adjustments probable in next year's budget, subject to federal election timing.

Corporates, ex mining/energy, are in reasonable health and M&A activity, especially from offshore domiciles, seems set to continue through next year.

Equity supply will continue from March, but is not yet at levels (as a % of market cap) that will trouble the markets cautious advance.

Eley Griffiths Group measures the fundamental health of the sharemarket through the equity risk premium currently being discounted. The equity risk premium (ERP) assesses the relative merit of equities over bonds and whether the compensation on offer justifies the extra risk assumed. At present it sits at 6.22%, slightly more attractive than the September quarter setting and a bullish confirmation on the assumptions we have made. By way of comparison, the US market ERP is currently 5.3%, also an attractive setting.

Australian equities remain an attractive proposition versus offshore markets and we expect small caps to extend their outperformance in 2016.

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	http://eleygriffiths.com.au/news-reports/	

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