THE ENCYCLICAL

Small Companies Fund

Quarterly Report

March 2016

To Our Unit Holders

Fund Basics			
Unit Price	$2.1083	**Inception Date**	17th September 2003
Distribution Frequency	Annual	**Fund Size**	$410M
Number of Stocks in the Portfolio	52	**Benchmark**	S&P ASX Small Ordinaries Accumulation Index

Performance Statistics to 31 March 2016

	3 Month %	1 Year %	3 Year % p.a.	5 Year % p.a.	Since Inception
EGG Small Companies Fund	+0.54%	+9.33%	+10.07%	+6.41%	+11.31%
S&P/ASX Small Ordinaries Accumulation Index	+1.03%	+3.72%	+1.50%	-2.08%	+5.08%
Outperformance	***-0.48%***	***+5.61%***	***+8.57%***	***+8.49%***	***+6.23%***

* Fund returns are calculated post fees.

For the quarter ending 31 March 2016, the Eley Griffiths Group Small Companies Fund returned +0.54%, compared to a +1.03% move in the Small Ordinaries Accumulation Index (XSOAI).

Market Review & Strategy

The quarter began with an aggressive sell off in equities, catalysed by an oil price plunge of almost 20% (intra-month) and a rally in long bonds. US bond market investors began to contemplate a more accommodative trajectory for interest rates v the outstanding FOMC dot plot. This angst was compounded by global central bank positioning (BOJ moves to negative interest rates) and suggestions the PBOC was contemplating a Yuan devaluation.

However, apprehensions were soon to fade as the US dollar sold off and commodities and emerging markets rallied hard, ushering in a risk-on rally from the first days of February. Small resource stocks charged, most notably the gold sector, and even burnt out mining service stocks enjoyed a welcome relief rally. The risk rally displayed the hallmarks of short covering (large ranging price action on moderate volume) with more than a hint of capitulation buying also in the mix.

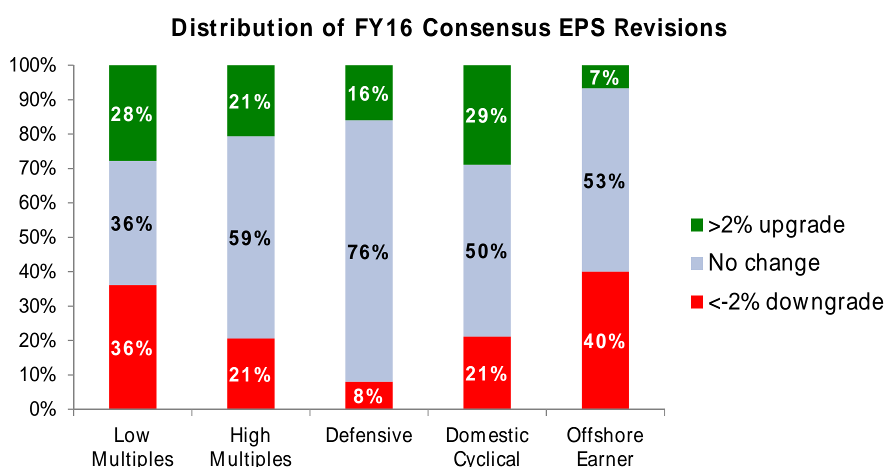
Moreover, the past 6-9 months witnessed the arrival of a cohort of itinerant small cap investors, seeking a safe harbour from volatile bank and major resource names. From time to time, these investor's stray into the less familiar terrain of Australian small companies, away from big caps or international markets. On this occasion, it appears they may have been seduced by positive share price momentum, the afterglow of several successful IPO's and impressive, recent small cap fund manager returns. To a significant extent, their impetuous buying campaigns of a dozen or so names created a blow-off rally into the close of 2015. Momentum had asserted itself as a critical factor for manager outperformance.

Further, reasonable market capitalisation's and the deep liquidity of these momentum names greatly appealed to the itinerants. Prominent amongst this cabal were **Amaysim, iSentia**, **IPH, Bellamy's, Blackmores, Mantra** and **Estia**. Investor delirium brought on inflamed share prices, increasingly detached from underlying fundamentals and discounting unrealistic earnings expectations. The traditional small cap PE discount versus big cap PE was snuffed out and a premium rating returned for first time since early 2011.

February was to prove a cathartic month for the itinerants, as well as a number of managers, as the aforementioned momentum names, and a few others, corrected viciously during the reporting season. This results season was rated the most volatile this author has experienced since starting out managing money in the late 1990's.

Perversely, the reporting season generally met expectations. The number of companies upgrading numbers matched those downgrading, for an average 0.7% improvement in forward estimates.

The chart below from Goldman Sachs summarises the season succinctly. Low multiple stocks saw large earnings downgrades, high multiple names delivered on expectations and offshore earners did not exceed high expectations and saw reasonable downgrading of the balance of FY16.



Looking forward, it is easy to conclude that domestic industrials are better placed than the offshore earners, who are increasingly feeling the full effects of a stronger AUD.

A number of overlooked toilers reported well and enjoyed share price catch-ups. **IRESS, Trade Me** and **GWA** were three such stocks.

Consumer discretionary companies, such as **The Reject Shop**, **Pac Brands** and **Nick Scali**, showed they were adapting well to a lower AUD regime. A number of mining companies demonstrated impressive margin expansion, as mine site productivity combined with input cost austerity to great effect. **Saracen Minerals, Evolution Mining, Independence Group** and **Sandfire Resources** by way of example.

Technical Summary

The investment line (100 day ma) had been guiding the ASX200 lower since June 2015, safe in the knowledge that the bull market support line (rising from the GFC low of March 2009) would undergird price action, should an exaggerated sell off occur. Your manager drew breath when support gave way in early February, on unremarkable volume, and the bull case for Australian equities was potentially in question. The return move (a rally by another name) put the market back on trend but only after a few anxious days.

Interestingly, the Small Ordinaries Index (XSO) fared better through the melee. Constructive. In fact, the XSO is set up as bullishly as any time we can recall. 60% of XSO constituents are presently above their 100 day ma, versus 44% at the end of Feb and 40% in Jan. Worth noting the XSO's 3rd resistance fan was tested (and cleared) in March and a 4th will require overcoming as well. Fan's signal strengthening index momentum, so climbing them indicates a gradual pressure release ahead of the next technical level, in this case breaching 2190/2200. The chart below illustrates this determined advance.

We still find still it too hard to be constructive on the Small Resources Index but favourably disposed to the Small Industrials.

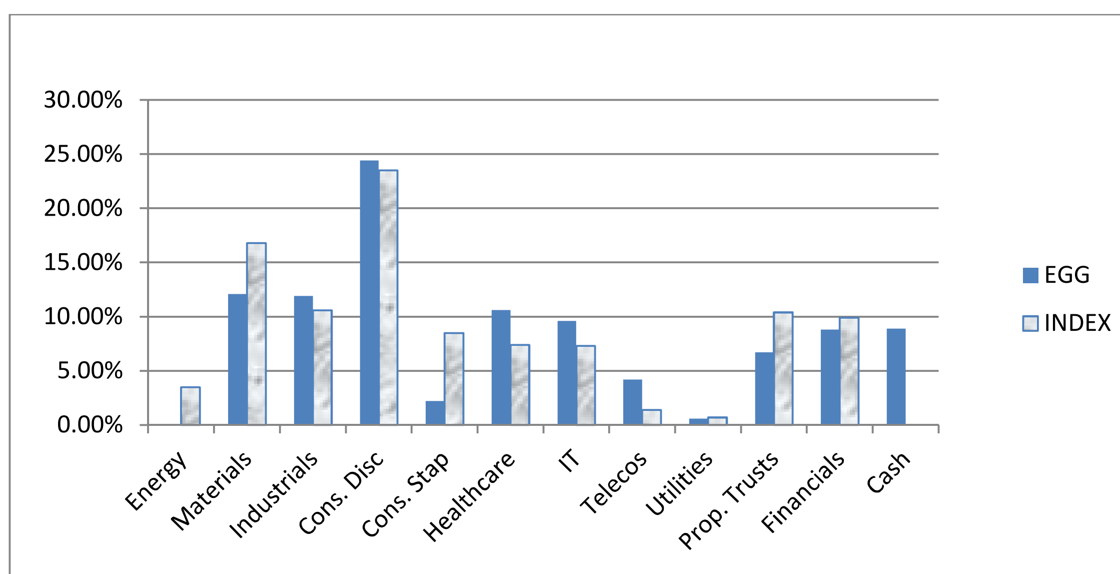
More generally it should be remembered that April is a seasonally strong period for local equities, one of the calendars strongest. Dow theorists will have enjoyed the late January bottom (at a .382 Fibonacci level) in the Dow Transports that may have presaged the current run up in US stock indices.

<u>Breaching the old highs in the OEX, S&P500 and, probably, the DJIA are critical minimums for the US stockmarket to attain before equity investors can become especially bullish the asset class.</u>

The Portfolio

During March quarter, our small company portfolio saw strong appreciation from Saracen Minerals Holdings (+58%), Medibank Private (+39%) and Idp Education (+35%). Nil weights in Dick Smith Holdings (-100%) and Slater & Gordon (-68%) helped performance.
Detractors during the quarter included Cover-more (-29%) and CSG Limited (-29%). Nil weightings in Northern Star (+24%) and OZ Minerals (+28%) also hurt performance.

Top 10 Stocks as at 31 March 2016			
IRESS Limited	4.01%	**Astro Japan Property**	2.73%
Macquarie Atlas Roads Group	3.80%	**Apn Outdoor Group Ltd**	2.66%
Trade Me Group Limited	3.24%	**Premier Investments Ltd**	2.61%
Fletcher Building Limited	3.10%	**Mantra Group Limited**	2.59%
Steadfast Group Limited	2.93%	**Eclipx Group Limited**	2.44%



After a reasonable absence from the register, a position was re-established in agri-chemical manufacturer/distributor, **Nufarm,** during the quarter. A recent overhaul in senior management, combined with a change-out of several regional general managers, has allowed the company to refocus its operating disciplines, at times viewed by the market as a little wayward. Progress has been swift, with an argus-eyed approach to balance sheet management and rationalisation of the manufacturing foot print, product portfolio and group wide procurement practices. Performance improvements of ~ $116m have been identified.

Nufarm has a number of moving parts and operates a truly multinational business, largely in the herbicide segment, so the journey for investors may not take a straight line. Interestingly, offshore M&A in this space has commenced. DuPont and Dow Chemical are merging. Monsanto's approaches to Syngenta, were rebuffed then bettered by ChemChina in a US$43bn takeover bid. Sumitomo are a 23% shareholder in Nufarm and Chinese group Fuhua Group and associates disclosed a ~ 5% stake in late March.

Your manager took advantage of a sharp share price descent to add **Smartgroup Corp** to the portfolio in February. Smartgroup is one of Australia's largest salary packagers and novated lease providers, specialising in the government and health sectors. We like the high cash generation/low capital intensive model and the resultant double digit organic growth rates. Acquisitions to date have been well considered and sensible. We remain alert to a potential shift in the federal government's policy in the area of salary packaging but believe the company's clientele skew (government/health) to be quite defensive.

Evolution Mining was purchased in January, allowing us to add to our gold exposure at a time when the A$ gold price was at a significant high point and the outlook for US$ gold was starting to look interesting. Operationally, management are doing a great job sweating the asset base, exploiting the aforementioned cash cost privation to see quarterly free cash flow generation of c.$100m. This will allow for very meaningful debt amortisation. We believe at this run-rate the company could be debt free in 12 months and able to bolster dividends or consider suitable acquisitions.

Eley Griffiths Group bid farewell to a number of long held names during the quarter. Mounting concerns over the company's ability to price-lead in its Australian market place, prompted us to quit our position in **Invocare**. We also struggled somewhat with the company's US growth ambitions and whether the diversification might be the best course for the company.

Veda Group received a takeover bid from US-based, Equifax, enticing us from the register.

We have gradually reduced our exposure to **Qube Holdings** over time and folded the remainder of our position, ahead of the H1 16 profit result. The materially weaker result was largely overshadowed by the machinations of an agreed (with Brookfield) takeover bid for

transport/rail/ports owner, Asciano. The long term prospects for Qube are highly favourable, but regrettably will be realised beyond the allowable holding period for us (Qube is now an ASX100 stock).

Outlook

Equity Investors have endured myriad challenges since the US stockmarket whipsaws began in August 2015. These volatile windows essentially lined up with the FOMC change to interest rate settings and a respite in the advance of the US dollar. These crosswinds show little sign of abating and will ensure a confounding path ahead, at least in the short term.

The base case for Australian equities (including small caps) remains sound. An ERP of ~ 6.1% makes equities a better bet than bonds. This has been the case for some time. The recent reporting season confirms Australia's corporate vigour, nowhere more impressive than the resources sector, where companies are rapidly adapting to survive the challenges of languid commodity markets.

Our conservative federal government is readying for a second mandate post July 2 and there remains ample scope for interest rate accommodation if/when the RBA feels so inclined.

The technical analysis of equity markets, already detailed in this note, is constructive across a broad range of indicators. The Australian market scrubs up particularly well in this regard, small caps especially so.

In closing, three key elements will need to play out further for global share markets (including ours) to climb the current wall of worry in 2016.

1. *The medium term direction of the US dollar needs to be resolved.*
The US dollar typically trades in long, bull or bear campaigns. Durations of 10 years are not uncommon. This rally is approaching its 5th anniversary, so the current pause/consolidation is entirely normal. This house is viewing the present price action as a consolidation rather than a topping/exhaustion pattern.

Whilst US headline growth momentum may have eased back, there is no escaping the repair of the labour market, with unemployment now through the full employment number (5%) and employment averaging +230k per month, over the last year. Every other day the WSJ details anecdotes of how scarce labour is becoming in certain industries. Not surprising, consumer spending is on the rise and the September 2015 peak in the ISM inventory series suggests a destocking cycle is well under way. This eventually will give rise to a restocking phase.

Core CPI and PCE stats have recently printed at the highest levels seen in a few years, however the US economic recovery viewed through a number of indicators remains brittle. The next hike in rates now seems a second half event. This week's Chicago Fed National

Activity Index suggested the US economy to be operating a notch below trend GDP at present. It is reasonable to posit that the recovering US economy is yet to fully reveal itself. The US dollar will recommence its rally the moment it becomes clearer that all is well with the economic expansion.

2. *Have credit market anxieties passed?*

An aggressive sell off in HY and IG bonds occurred through h2 15, pricing credit spreads at 4 year highs. This coincided with significant ETF outflows, rising to crescendo in December. Scare mongering was rife, the energy sector issues (imminent defaults) had spread to basic industries and the retailer/consumer discretionary space was next. Enter 2016 and spreads have tightened up, primary issuance has been strong, and at acceptable margins, and HY and IG ETF's have rallied sharply on renewed investor inflows, as the hunt for yield returned. Indications, albeit early, suggest credit markets are behaving rationally again.

3. *Where is the US earnings cycle*?

Expectations range from nil to 10% earnings growth for US stocks in 2016. A reasonable spread of outcomes available for investors to ponder. What is irrefutable are the negative impacts a depressed oil price and strong US dollar had on 2015 numbers. Comparable earnings will therefore be relatively easier to cycle over in 2016.

Further, the sizable capex reductions flagged amongst the oil/gas majors last year have now normalised and a new baseline is likely set for 2016 and beyond. A recovering oil price would suggest a positive delta here moving forward (note: Brent's reaction to this month's failed oil-output-freeze meeting in Doha, Qatar was very constructive ie crude rallied ~6%).

You cannot rule out that 2015 was an earnings reset year and there is the possibility that earnings in 2016 overshoot dampened expectations. At the time of writing, around 40% of the S&P500 had reported Q1 earnings, with most bettering expectations. The revenue surprise ratio is as strong as it has been in 8 quarters.

As an aside, it is worth noting that the spread between the S&P500 dividend yield and 10 yr bond yield is close to levels last seen in 2008, supporting the case for US equities.

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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