Quarterly Report
June 2016

THE ENCYCLICAL

Small Companies Fund

To Our Unit Holders

Fund Basics			
Unit Price	$2.2642	**Inception Date**	17th September 2003
Distribution Frequency	Annual	**Fund Size**	$438M
Number of Stocks in the Portfolio	59	**Benchmark**	S&P ASX Small Ordinaries Accumulation Index

Performance Statistics to 30 June 2016

	3 Month %	1 Year %	3 Year % p.a.	5 Year % p.a.	Since Inception
EGG Small Companies Fund	+7.39%	+23.21%	+15.26%	+9.31%	+11.70%
S&P/ASX Small Ordinaries Accumulation Index	+5.85%	+14.40%	+9.13%	+1.00%	+5.50%
Outperformance	***+1.54%***	***+8.81%***	***+6.13%***	***+8.31%***	***+6.30%***

* Fund returns are calculated post fees.

For the quarter ending 30 June 2016, the Eley Griffiths Group Small Companies Fund returned +7.39%, compared to a +5.85% move in the Small Ordinaries Accumulation Index (XSOAI).

Market Review & Strategy

A solid rally through the three months to June was checked late in the period by a shock win for the Brexit camp in the UK plebiscite held June 23. This brought on a dramatic sell-off in the GBP (to 30 year lows) and equities globally, notably in the so-called peripheral European markets. Significantly, it appeared the hidebound US stockmarket was finally ready to overcome impervious overhead resistance until the Brexit news broke, but more about this later under *The Encyclical's* Technical Summary.

Early in the quarter, US investors began to ponder the prognosis for economic recovery, as the release of the Summary of Economic Projections prompted a recast of estimates. The number of Fed officials who anticipated only one rate hike this year had moved from one to

six and the number of projected rate hikes for 2017 and 2018 was revised to three pa. Forecast GDP for 2016 and 2017 were also tweaked lower.

A few months on, the closely followed Chicago Fed National Activity Index was released, highlighting a pronounced slowing in national activity in May. The index comprises 85 weighted indicators, built around four key segments-production/income, consumption/housing, employment and sales/inventories. All segments lost ground versus April and all made negative contributions in May. In essence, the fragile US economic recovery was losing momentum and the building inflation impulse was reducing in intensity. This became an unnerving development for equity investors during the period in review.

Locally, it was a quarter driven by positive gold sentiment, a new found appetite for property trusts and an introduction to lithium/graphite markets and the evolving new world order in EV (Electric Vehicles) and energy storage. Several brokers released 101's on Li, atomic # 3, and investors were given a rapid fire education on the attributes of the lightest known metal on earth. A forecast threefold lift in demand over the next 10 years would be met with a torpid supply response however Australia would grow its share of production moving forward. Not surprisingly, aspiring Li producers/explorers enjoyed solid share price gains (**Galaxy** +94%, **Orocobre** + 65% and **Pilbara Mins** +41%% for the quarter). Pilbara took advantage of the heightened interest and raised $100m in April.

The release of upbeat March quarterly reports from our smaller gold miners through April spurred increased interest from investors, already alert to a firmer AUD gold price. Share price performances amongst gold names were nothing short of remarkable and EGG benefited from several significant investments here. For the June quarter, **Saracen** +48% **Evolution** +53% and **Oceana Gold** +42%.

Interesting to note that the earnings confession season (May-June) produced a couple of large surprises (3PL Learning, Flexi-Group and Cover-More by way of example). Macquarie Securities maintain a thorough revisions register and advised that at June 3, company downgrades for FY16 (ex-resources) numbered ~102, versus 66 in FY15 and in line with FY14 (100). The period June through August typically captures an additional 20% of downgrades in any financial year period according to Macquarie. Earnings upgrades were few in number, reminding investors that earnings momentum remains negative for the small company space.

M&A activity returned to the small company space in the June quarter having been largely absent through 2016 to date. Takeover activity has long been a signal of small cap investing, as underperforming assets transfer to new owners and capital is recycled into other listed

vehicles. Whilst revenue lines have been buoyant, it has been cost cutting that has provided a fillip to earnings growth, possibly negating the need for widespread corporate activity.

Two unloved industrials received bids, including US- based Hanesbrands offer for **Pacific Brands** and Pacific Equity Partners bid for **Patties Foods**. On the resources side, **AWE** was bid for by a Lone Star Fund (US private equity), Teranga bid for **Grython Minerals** and **Galaxy Resources** announced a merger with **General Gold** to consolidate their Mt Cattlin lithium operations.

Technical Summary

Not for some time have the technical underpinnings of the market looked so intricately balanced. US equities, the 10 UST, Gold and the USD are all at points of inflection, where very soon a change in trend might be upon us.

Longstanding resistance for the S&P 500 at 2120 gave way in the first week of July. Backed up by the slow-signalling Coppock Indicator that suggested a significant low likely occurred in February. The investment line (100 day ma) now points upwards and the Williams % R oscillator sits at extreme overbought settings-both endorsing the recent price action to the topside.

Final validity for the upside move might be provided by a return-move, but these do not always occur at important trend line breaks. To recap, a return-move is price action that starts with a break from a trading range (may run for ~ 10 trading sessions) then suddenly a sharp retracement back to the point of break out occurs. From this point a rally out miraculously re-commences. Return-move signals tend to be reliable new trend confirmation signals.

Interestingly, the NYSE Composite Index (all NYSE stocks, mkt cap weighted) at the time of writing, was 4% from its all time high. The Russell 2000 (small cap stocks) also had work to do, being 7% from its all time high, but both indices also saw the Coppock bottom for them in January-February. These set-ups are very bullish for US equities.

Last week, Jeffrey 'the Bond King' Gundlach, of DoubleLine Capital, declared US 10 year bonds being at the 'worst trade location in the history of the 10 year treasury'. 10 UST found support at ~1.35%, a level not seen since the nadir of the European sovereign crisis of March quarter 2012. If this is indeed the low in yields (high in price) then the ramifications for bonds and other asset classes will be profound, given the magnitude of the safety trade presently in place.

Gold has been in a clear bear market since reaching $1924.30 in September 2011. The market's defining downtrend was tested and rejected at $1382 in the first week of July but traders cannot discount a retest of this line in the very near future. Odds are it fails (again) but there remains the possibility of a change in trend.

The USD Index, range bound since early 2015, has enjoyed great resolve from buyers who have not allowed the US dollar to accede to aggressive selling campaigns. Price action favours the upside case moving forward but within the confines of the index's trading range of 93.3-100.

Locally, it is difficult to get too bearish on the ASX200. The index joggle experienced in February is now well behind us, the uptrend out of the GFC is intact and, importantly, price and time remain in balance. The investment line supports the long case.

If the ASX200 continues to look constructive, then the Small Ordinaries Index (XSO) can only be described as outright bullish! This author previously talked at length about 'momentum fans' and the growing conviction investors should get as each fan surrenders itself to the market advance. 'Fans signal strengthening momentum (in bull markets), so climbing them indicates a gradual pressure release ahead of the next technical level…' These fans have told the story of an unfolding rally stretching back to July 2013, albeit one of mild amplitude. Once the XSO took out the swing high of 2266 (May 2015), the index was clear to rally. 70% of stocks are now above their 100 day moving average and momentum oscillators set at overbought (perversely a bullish sign).

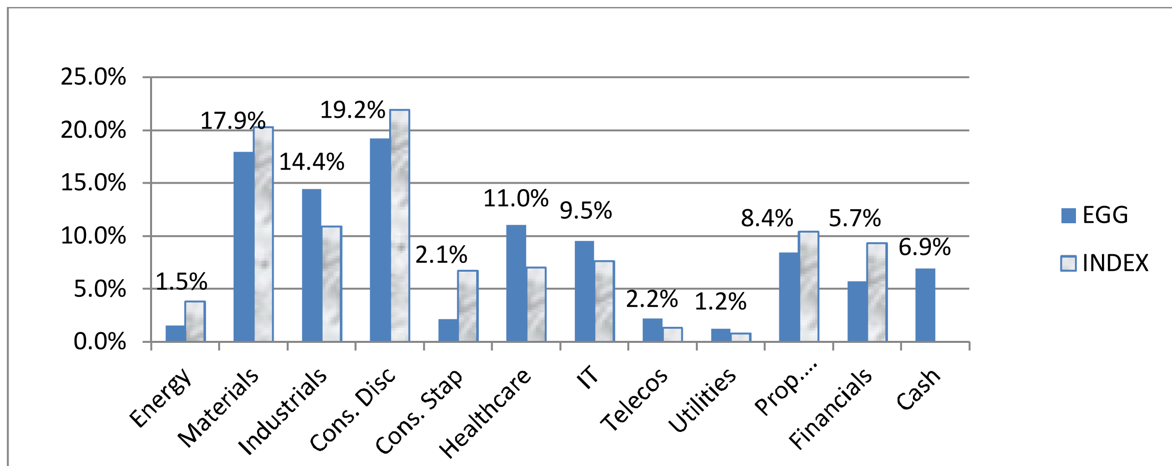
The relative strength chart (small resources v small industrials) below, highlights the growing performance differential between each since the all important trend break in February, with a rising line indicating resource outperformance. This trend, largely driven by gold equities, has been pronounced since early February and has dictated the small ords advance to a considerable extent.

I would remind readers that the last resource outperformance window ran from Jan-August 2014 before unwinding viciously in the subsequent 6 months, as the chart highlights painfully. A move to increased weightings to resource names is further supported by the break on the small resources chart-which only gave a buy signal in the first week of July!

The Portfolio

During the June quarter, our small company portfolio saw strong appreciation from Dacian Gold (+56%), Saracen Minerals Holdings (+28%) and OceanaGold (+23%). Nil weights in 1-Page (-59%), Mesoblast (-58%) and Murray Goulburn (-52%) helped performance.
Detractors during the quarter included Mantra Group (-23%) and BT Investment Management (-17%). Nil weightings in Northern Star (+44%) and Resolute Mining (+138%) also hurt performance.

Top 10 Stocks as at 30 June 2016			
Mayne Pharma Group Limited	4.40%	**Fletcher Building Limited**	2.73%
Macquarie Atlas Roads Group	3.47%	**Steadfast Group Limited**	2.66%
Trade Me Group Limited	3.36%	**Burson Group Limited**	2.61%
IRESS Limited	2.98%	**Apn Outdoor Group Limited**	2.59%
Evolution Mining Limited	2.90%	**Auckland International Airport**	2.44%



June quarter saw us quit our exposure to the aged care sector. We were investors from float in two out of the three aged care providers, **Japara Healthcare** and **Regis Health** (we declined to invest in the more aggressive operator, **Estia Health**). EGG analysts identified three key business drivers: forecast significant growth in legislated funding, sector consolidation (both NFP and profit sectors) and a structural shift in favour of up-front payments by incoming residents.

Each of these stocks performed very strongly through CY2015, as investors came to appreciate the ‘size of the prize’ on offer without discounting the risk of curtailed federal funding and increased sector scrutiny by government agencies. In a relatively short space of time, company balance sheets had gone from being net cash to heavily levered, the cost of asset acquisition targets had increased appreciably and residential property markets had likely topped (the normal funding mechanism for aged care bond is the sale of the family home). The bonding cycle was also maturing, meaning bonds received from incoming residents were increasingly being used to fund outgoing tenants rather than facility expansions.

Long feared changes to the core funding model (ACFI) were unveiled in the federal budget in May and this announcement sealed the fate of our exposure to the space.

EGG added a modest position in **Sims Metal** during the period following its recent removal from the ASX100. The stock has been pinned down in a secular downtrend since 2008 with a track record of poor earnings delivery, mistimed acquisitions and management upheaval, combined with commodity price volatility. We found ourselves attracted to the stock following a recovery in the international scrap price, brought on by supply constraints in the US as well as the absence of significant swing producer, China. The balance sheet is now net cash. A number of competitors, such as Schnitzer and Steel dynamics, have given bullish updates (to both price and volume forecasts) to the market and Sims’ aggressive cost out programme

suggests a markedly lower break-even production volume for the business, facilitating its path to a ROC of 10% by 2018.

Your manager participated in the $918m IPO of **Reliance world Corporation** (@ 21x FY17 PE). RWC designs and manufactures 'behind-the-wall' plumbing fixtures in Australia, US, Canada and increasingly in Europe. The business has its origins in Australia where it predominantly served the wholesale/OEM channel (eg Reece, Tradelink). RWC enjoyed a step-change with the launch of the push-to-connect (PTC) 'Sharkbite' product in 2004 and an exclusive arrangement with US retail hardware retailer, Home Depot. The US now represents > 60% of revenues where PTC represents ~ 8% of market volumes (est 25-30% by value) and RWC has an 80% share. The business has been solely family owned throughout its history, with key management tenure an added feature. Post IPO the Munz family (vendors) will hold a 40% stake.

EGG also increased its resource exposure during the quarter ending June, adding to existing gold holding **Evolution Mining** as well as installing **Dacian Gold, Oceana Gold** and a substantial shareholding in emerging African play, **OreCorp Limited**.

Mineral Resources was a new addition to the fund as well. The group processes ~ 95mt of ore (chiefly iron ore and gold) through purpose built/designed fixed and mobile crushing assets. It owns iron ore assets in its own right in the Pilbara and Yilgarn regions of WA, producing c. 11mt pa. The crushing/processing operations are the group's key area of expertise and have proven to be remarkably resilient through the industry's downturn. The company is guiding to $250m-$280m ebitda in FY16, a number we think they will comfortably beat given the trajectory of the iron price since the H1 result. There is also the prospect of a further ~ $50m pa in earnings to be generated from the Mt Marion lithium project from FY17 onwards.

Outlook

The expression 'Bull markets climb the wall of worry' seems apt right now as equity investors weigh a mounting list of negative events, a global economy devoid of growth and central banks being unable to navigate their way out of the current liquidity trap impacting their economies. This bearish backdrop is further compounded by a monomaniacal lust for safe haven investments: witness the Swiss National Bank's recent 13 year bond issue (maturity June 2029) with a zero per cent coupon.

I would round out my comments on bull markets by suggesting that they end when no one is any longer worried about things. We are clearly not at this point then!

Equity valuations are presently above long term averages, when measured in terms of PE's, but not at extreme settings by any stretch. Tactical allocators should take some comfort in the substantial margin of safety that the prevailing equity risk premium provides in the decision, equity v. bonds. Currently the ERP in the US is ~ 6% and in Australia ~ 6.7%. As I have mentioned in previous *Encyclical's*, fair valuations for stock markets require ERP's somewhere between 4-5%, with 'Sell' equities signalled at =/< 3%.

There is an important caveat to this discussion however, and that is the extreme yields that 10 UST have traded to this past month. Readers of Cullen Roche's excellent blog, **Pragmatic Capitalism,** should note his commentary on US long bonds: 'US 10 year bonds have experienced the kind of price compression that makes them a very poor risk adjusted instrument to hold in coming years…20% annualised returns (from 10 UST) are not only unsustainable but impossible'. Arguably then, the margin of safety offered by equities might be a little overstated but still a long way shy of an ERP sell signal.

Locally, it is reasonable to proffer investors a constructive share market backdrop. The RBA's May Statement on Monetary Policy was particularly dovish and firmed the odds of further rate cuts through 2016. The RBA forecast underlying inflation to be 1.0% lower through the year to December 2016 (cf Feb ests) and, further, that underlying inflation will remain at the bottom of the target range throughout their forecast horizon until mid 2018. We await word on rates at the RBA's August 2 meeting.

The reporting season will more or less commence in week two of August and is customarily a volatile period, notwithstanding the higher number of earnings updates advised this time round. It will be intriguing to see whether Consumer discretionary names were impacted by the recoil in consumer confidence associated with the prolonged election campaign. Resource names should report well (note metals/mining stocks have been in earnings upgrade mode since March quarter) given favourable production quarterlies currently being detailed.

On EGG estimates, small cap valuations versus large are now at a 7% premium. Beyond the traditional discount investors demand but paradoxically, a bullish indicator for the sector.

Whilst small company earnings momentum is skewed negatively, it will be interesting to see how these stocks react to any bad news over August. Downgrade cycles have a few constants and one is that stocks, on average, tend to rally about 75% into their downgrade cycle, the market hankers to buy the last downgrade, the point where sentiment is fully discounted.

In closing, the risk-on rally that has been in train for several weeks feels to us like it has longevity. Observe the manner in which global equity markets stepped over the 'calamity' that Brexit would be for the UK and beyond.

For as long as we have a foreboding FOMC and US professional/institutional investors flush with cash (and hedge fund managers short equities) we can be comfortable the downside case for equities is somewhat limited. The US market is early into its June quarter reporting season and there lies the risk that earnings expectations have been pitched too low.

Australian equities will take our cue from price action in the US as well as further monetary policy accommodation from the RBA and a no-worse-than-inline reporting season.

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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