Small Companies Fund

Quarterly Report

September 2016

THE ENCYCLICAL

To Our Unit Holders

Fund Basics			
Unit Price	$2.3137	**Inception Date**	17th September 2003
Distribution Frequency	Annual	**Fund Size**	$460M
Number of Stocks in the Portfolio	59	**Benchmark**	S&P ASX Small Ordinaries Accumulation Index

Performance Statistics to 30 September 2016

	3 Month %	1 Year %	3 Year % p.a.	5 Year % p.a.	Since Inception
EGG Small Companies Fund	+7.08%	+29.37%	+12.42%	+13.70%	+12.13%
S&P/ASX Small Ordinaries Accumulation Index	+8.50%	+29.16%	+7.07%	+5.27%	+6.04%
Outperformance	***-1.42%***	***+0.21%***	***+5.35%***	***+8.43%***	***+6.09%***

* Fund returns are calculated post fees.

For the quarter ending 30 September 2016, the Eley Griffiths Group Small Companies Fund returned +7.08%, compared to a +8.50% move in the Small Ordinaries Accumulation Index (XSOAI).

Market Review & Strategy

The Small Ords index rallied into the reporting season before conflation of the ECB and BOJ announcements of further monetary stimuli being unlikely in the near term, brought on a sell-off in equity markets. Markets recovered by September end to see small caps +7.3% versus big caps +3.6% for the quarter.

The outperformance by the Small Ordinaries Index (XSO) actually got underway in December 2015, but it wasn't until February 2016 that the performance disparity gained proper traction.

This resulted in the traditional valuation discount closing in March quarter. Today the XSO trades at a ~ 4% premium to the ASX100.

The markets romance with all stocks lithium/graphite took a predictable respite during September quarter. Our June quarter *Encyclical* reported on the corybantic interest in this emerging mining sector. The share price over-shoots were corrected during the period (eg **Galaxy Resources** -34% and **Syrah Resources** -27%) with softer lithium prices courtesy of Chinese traders offloading excess inventories.

Despite this, the market began to feel more favourably disposed towards the China recovery story and their progress with supply-side reform. A number of brokers took to upgrading base metals (ex Cu), coal and the AUD, but most metals/bulks spot prices still sit comfortably above consensus forecasts. The risk to earnings here remains low.

The reporting season absorbed investor attention through August and gave rise to some all-too-familiar frenetic share price action. This occurred despite the belief that a disappointing 'confession season' had already conditioned the market for a soft results period.
Results that beat expectations saw 5-10% rallies and those that missed suffered 20-30% beatings. It was interesting to note value names (eg mining service companies) delivered 2.5x as many earnings beats as high PE names.

On average, eps misses narrowly exceeded beats with forward earnings downgraded by ~ 5-8%. FY17 eps growth currently sits ~ 7% - low for this time of year given the customary negative trajectory of this series as revisions occur over the next 12 months.

Balance sheets finished FY16 in good shape and boards elected to leave payout ratios at previous settings.

Stock supply accompanied several company reporting's in August. A combination of founder and PE selldowns/exits were absorbed by the market and these deals received a mixed reception from investors. Notable were sales in **a2 Milk, Estia, Bellamy's, Macquarie Atlas Roads** and **Corporate Travel**.

The major banks provided their quarterly updates to the market, with the very clear message that credit quality remains sound and impairment activity benign.

It is possible that equity markets moved through a point of inflexion early in the quarter. Bond proxies (REIT's, Utilities and Infrastructure names) began to correct whilst a cross section of cyclical names found investor support. Shallow cyclicals, such as discretionary retailers and consumer facing stocks, rallied through the quarter. Deep cyclicals like Sims (+19%) and mining service companies (eg RCR +65%, MACA +38%) also posted strong performances. Many of these names have lay dormant since 2012.

The rekindling of corporate activity in the small cap space continued from June quarter, with a number of perennial targets attracting attention. **Super loop** proposed a merger with **Big Air Group**, Hitachi bid for **Bradken**, a Barings fund bid for **SAI Global** and Nomura had a tilt at IT services group **ASG Group**. This momentum continued into the early days of October, with **CIMIC** bidding for problem child, **United Group** and Freedom Furniture owners, Steinhoff, approaching **Fantastic Holdings**.

Technical Summary

It is probably apt to start a technical discussion with the **US equity market**, which has wilfully assumed a new trading range, having vacated the previous consolidation 'rectangle' in July this year. I would choose to categorise the movements in the S&P100 and S&P500 as constructive return moves (In the case of the S&P500, the top-side of the 2year consolidation/trading range is now serving as support for the market). 2120 is an important level for the S&P 500 and it needs to hold.

We continue to be anxious about the US market's loss of momentum, as fewer and fewer stocks make new highs and the advance/decline line registers at a dispirited ~1.5-2.0x since July's impulsive move. The slow triggering Coppock Indicator gave a decisive buy signal in February, so we maintain our long position here.

The **DXY**, the US dollar Index (97.9), broke clear of its year-long downtrend in the early days of October and should run on to test 100.6/100.7-important resistance for the contract and just shy of Fibonacci resistance (61.8% retracement of the 2002-2008 USD bear market).

This is a headwind for **gold**, already vulnerable following a breach of its 100 day moving average on October 4. The Coppock low of November 2015 is also endangered. Important to note that ETF's, Van Eck Vector Gold Miners and Junior Gold Miners, have been trading poorly since early August.

Both **Brent** crude and **WTI** are trading constructively, with Coppock indicating a likely significant low occurred in February of this year. Curiously, while we are talking commodities, the **Baltic Freight Index** is now trading at 12 month highs.

The **Small Ords** remains in broad uptrend, but a break in support at 2415 points to an overdue retracement in small cap stocks. Investors should take note of the importance of resistance at

2530 with this index. It has cut short small cap rallies since September 2011 and did not disappoint this quarter. Small resource names are presently consolidating their year-long rally whilst small industrial stocks continue nicely on uptrend.

The Portfolio

During the September quarter, our small company portfolio saw strong appreciation from Ausdrill (+98%), Orecorp (+68%) and RCR Tomlinson (+62%). Nil weights in Syrah Resources (-27%), G8 Education (-18%) and Seven West Media (-27%) helped performance.
Detractors during the quarter included APN Outdoor (-19%) and OceanaGold Corp (-19%). Nil weightings in Resolute Mining (+55%) and Webjet (+65%) also hurt performance.

Top 10 Stocks as at 30 September 2016			
Fletcher Building Limited	3.81%	**Bapcor Limited**	2.73%
Trade Me Group Limited	3.59%	**Nufarm Limited**	2.66%
Macquarie Atlas Roads	3.49%	**IRESS Limited**	2.61%
Mayne Pharma Group Ltd	3.07%	**Independence Group NL**	2.59%
Steadfast Group Limited	3.01%	**Ebos Group Limited**	2.44%

Your manager quit a number of longstanding ASX100 names during the period in review. EGG customarily allows itself up to 2 years holding time for a ASX100 company's inclusion to prosper as a big cap before divesting the position. Our analysts seek to maximise a portfolio holding's value-add ahead of recycling active portfolio space back into superior 'price-for-growth' candidates in the Small Ords. To this end, holdings in **TPG Telecom, Vocus Comms, Medibank Private** and **Domino's Pizza Enterprises** were realised during the quarter.

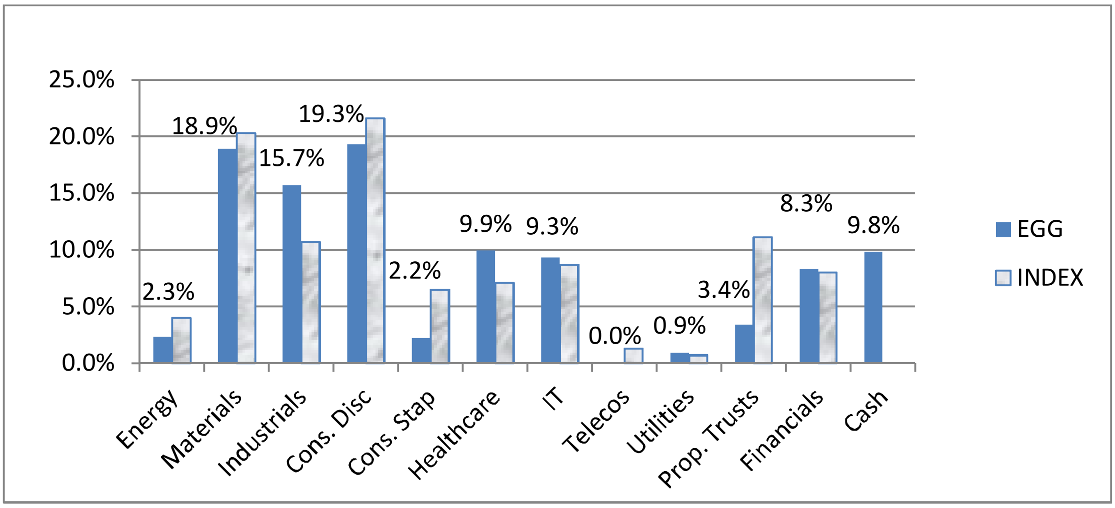
The fund has initiated a position in recent ASX listing, **Michael Hill Jewellery**. The eponymous retailer has an extensive (read mature) and strongly performing Australasian store network but has achieved mixed tidings with its North American diversification. Central to the investment thesis is a project refresh in the US, centralising of management in Canada and a recasting of the group's rollout strategy. Put simply, leaving the US in test mode (no new stores until 2018) and rolling 10-15 new Canadian stores (including mall locations) pa to tally to 100 in 2 years. Canadian market share is improving, comp store sales are strongly positive and margins are trending towards those enjoyed in Australia (16.5% v 10%). A new jewellery format, Emma & Roe (younger/aspirational buyer), is being thoughtfully rolled out in Australia and possibly NZ in h2 17. The model relies on lower average store sales (versus M

Hill) but at superior margins. Once proven-up in Australia, management will introduce the model to the Canadian market.

EGG has been adding to its mining services exposure since May this year. Field insights point to a sector outlook that is unlikely to worsen and when coupled with the privation of recent years, has resulted in reset cost bases and newfound management disciplines across a number of these businesses.

Several candidates have been purchased and during September quarter, **GR Engineering** was added to the portfolio. GR is an engineering company that specialises in the construction of mineral processing plants. It is the foremost operator in the space and was able to maintain a solid operational performance during recent challenging years. The company completed 29 studies in FY16 and is presently engaged in an additional 16. Traditionally, study work is a reliable lead indicator for future revenues, so the year is off to an encouraging start. We rate management highly and are confident the group will perform well looking forward.

We also quit our shareholding in **Mantra Group** not long after their equity raising to fund an expansion into the Hawaiian accommodation market. For some time we had been anxious about the performance of their hotel assets in Brisbane, Perth and Darwin, given soft markets and resultant subdued earnings performance. The stock carried a very full market rating (PE ~ 25x) at the time of sale and would be vulnerable to future earnings disappointment. The addition of a new geography in Hawaii was a slight diversion in strategy and we decided to view its implementation and management from the sidelines for now, despite a high opinion of the executive team.



Outlook

Framing a discussion around the short-medium term direction of the market has been a little more challenging than usual this time around. This is probably because the market is at the early stages of positioning to new leadership.

Our June quarter Encyclical talked to the extreme level of the US 10year bond and the extreme duration risk therein. Since this time questions have been asked of how much might be left of the yield/bond proxy trade.

It is becoming increasingly clear that global central banks are entering the exosphere with what can now be achieved with monetary policy, even with a muted inflation backdrop. The BoJ now owns 1/3 of all JGB's outstanding, simply they have run out of bonds to buy. The bank's chief, Huruhiko Kuroda denounced negative rates for what they are doing to Japanese financial institutions. He suggested they might now target the slope of the yield curve and explore other stimuli.

The ECB has started telegraphing its reluctance to apply further stimulus until year end. Apparently Draghi hadn't even discussed fresh monetary stimulus at its last ECB meeting- commentary to inure the market to a gradual wind-back of QE.

The probability of a US rate hike at December's FOMC meeting is above 50%. Consensus now has 2 rate increases pencilled in for 2017. It is well known that shares can harmonise with a measured increase in bond yields and perform well. It is the violent moves in interest rate markets that unhinge stockmarkets. In fact, once equity investors satisfy themselves that rates are backing up in response to improving economic growth, then equities will be able to rally with greater certainty.

Our thesis that a change in market leadership is underway is borne out by the way in which a modest change in US long bonds over the three months to September end (1.37% to 1.60%) has transmitted to a vigorous sell off in global bond proxy names, Australia included. This highlights how much of a 'crowded trade' these stocks had become. Over-owned, ripe with profit and momentum darlings; these names have seen investors head for the exit in recent months. Throughout this sell off it is no coincidence that cyclical stocks/value names have caught a bid.

We have already seen evidence of cleansed share registers (ie nil institutional holders), elimination of any favourable broker recommendations/opinions (largely the case now) and a cessation in earnings downgrades (earnings upgrades not critical at this stage). All necessary portends for a low in cyclical stocks to occur. It doesn't hurt to have corporate endorsement either (witness bids for **United Group** and **Bradken** as noted)! One of my favourite adages, ‘When the time comes to buy you won’t want to’ springs instantly to mind regarding our recent move into mining services.

As discussed, commodity analysts have reset coal and base metals forecasts upwards. Oil supply/demand is tipped to normalise by early 2017. The sustainability of the equity market’s response will need to be monitored closely.

Seasonally, equities like to bottom September-October, so a traditional buy set up might be at hand for investors. The technical backdrop continues to be positive for equities and our valuation work (current ERP of 6.8% is in line with June quarter) continues to support the case for 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/	