Small Companies Fund
Quarterly Report
December 2016

THE ENCYCLICAL

To Our Unit Holders

Fund Basics			
Unit Price	$2.1777	**Inception Date**	17th September 2003
Distribution Frequency	Annual	**Fund Size**	$443M
Number of Stocks in the Portfolio	58	**Benchmark**	S&P ASX Small Ordinaries Accumulation Index

Performance Statistics to 31 December 2016

	3 Month %	1 Year %	3 Year % p.a.	5 Year % p.a.	Since Inception
EGG Small Companies Fund	-5.88%	+8.83%	+9.58%	+12.04%	+12.13%
S&P/ASX Small Ordinaries Accumulation Index	-2.45%	+13.18%	+6.24%	+4.87%	+6.04%
Outperformance	***-3.43%***	***-4.35%***	***+3.34%***	***+7.17%***	***+6.09%***

* Fund returns are calculated post fees.

For the quarter ending 31 December 2016, the Eley Griffiths Group Small Companies Fund returned -5.88%, compared to a -2.45% move in the Small Ordinaries Accumulation Index (XSOAI).

Market Review & Strategy

The S&P/ASX Small Ords Accumulation Index whipsawed through December quarter to close out -2.45%, versus the S&P/ASX100 Accumulation Index up 5.80%. Through the course of 2016, however, small caps managed to inch out big caps, with the XSOAI ahead of the XTOAI by 1.5%.

The surprise (not to this manager) Trump presidential win instantly spurred a risk-on rally with his pro-growth and reflationary platform giving succour to a market essentially adrift. Animal spirits were enlivened by talk of tax reform, infrastructure spending and the suggestion of

broad ranging deregulation relief. A month later a hawkish FOMC would hike actual interest rates (Fed Funds +0.25%) and projected rates (FOMC dot-plot pointing to 3 x 2017 hikes up from 2 previously). US bonds sold off and the US dollar rallied against all major cross rates. The EURUSD slumped to levels last seen in 2003 and UST 2yrs v German 2yr Bunds traded to a decade high spread.

The annual general meeting (AGM) season ran October through November and can be a fraught window for investors. This years AGM's contained a number of negative earning resets and cautionary statements, and it appeared investor reactions were a little more forceful than in recent years. Retailers, **Adairs** and **The Reject Shop,** disappointed with their updates and were summarily dealt with. Separately, **CSG Group** and **Isentia** flagged significant downgrades that drew investor ire.

News that Chinese destocking (in the case of **Blackmores**) had given way to a sizable channel inventory build in infant formula and dairy nutritionals, sparked a flashpoint for investors. **Bellamy's** revealed a poor trading update and the market 'smelt blood in the water', with management's less than convincing explanation. A stock suspension would follow, as would a share price implosion. **Bega** (contract manufacturer for Bellamy's) sold off and investors set upon **a2 Milk** despite reassuring commentary from management. JP Morgan analysts contend that by AGM season conclusion, consensus forward industrials EPS estimates had been downgraded by ~ 10%. Interestingly, the small Ordinaries PE of 15.5x remained unchanged.

Growth names, large and small cap, continued their rating contraction through December quarter. Their earnings certainty had provided a safe harbour for investors these past 2 years but the unfolding case for higher interest rates and the reality that PE ratios were moving through a contractionary phase impacted on share prices. Names such as **Bapcor, Mantra, APN Outdoor** and **Baby Bunting** bore this out amongst the 'smalls' whilst de-ratings in **CSL**, **Domino's**, **Cochlear** and **Navitas** were notable in the 'bigs'.

The appetite for resources (ex-gold) names continued unabated through the quarter, with lithium stocks recovering from their September quarter funk. Production restraint from OPEC members and non-members made energy counters standout performers amongst resource stocks.

September quarter's *Encyclical* detailed the markets move to new leadership, with investors buying up shallow and deep cyclicals. This was observed through the close of 2016. The proposed dual track sale of **Moly-Cop** in October provided a perfect example of this newfound demand. This $1.5bn mining consumables business would have been unfloatable in October last year but local insto's swarmed the offer, viewing the business to be in the right

sector but hampered by issues relating to the mothership. Collectively they bid 7.0x EBITDA for the Arrium spin-off, only to see a US PE buyer snaffle the business for circa 8.0x.

Technical Summary

The US stockmarket rallied strongly from its seasonal low point in October and is now very overbought. The loss of momentum is worrying, daily trading ranges on the **S&P500** are narrowing and my trusted oscillator is displaying textbook bearish divergence. Not surprising, the same pattern is portrayed in the **S&P100** and **DJIA**. That market is readying for a correction. I've pencilled in 2190 first stop and then 2120 on the S&P500.

The **ASX/S&P 200** looks vulnerable too. The November-January (early) rally marked a spirited attempt to take out a significant resistance line originating from the market highs of November 2007. This line checked the powerful rally in Q1 2015 and appears to have successfully repelled the recent financials-led move. This benchmark trades lower.

The **ASX/S&P Small Ords** is waning too and probably needs to retest 2200 before it can rally with conviction. Strangely, Sub-indices Small Resources and small industrials do not look especially bad technically, so I wouldn't be surprised if the XSO outperforms the XJO in any corrective phase.

The expected rally in the **DXY,** the USD Index, occurred as tipped by Septembers *Encyclical,* clearing resistance at 100.6/100.7 but stalling at Fibonacci resistance at 102 (61.8% of 2002-2008 rally). This is important. It is either a valid failure of price at 'natural' resistance or a return move that will allow for a consolidate-then-rally phase. This derailed gold from October-late December. Clearly a peak in the USD has bullish implications for gold. As a sanity check, the USD as expressed in the 'crosses' (Yen, GBP and EUR) looks vulnerable. Very vulnerable.

Investors need to start watching the **AUD** carefully as it marches towards resistance at 0.78. The significance of the Aussies downtrend from April 2013 should not be estimated, so the break out, as at the week ending Jan 20, is critical. Hold on for a move to 0.78 and then 0.815.

The Portfolio

During the December quarter, our small company portfolio saw strong appreciation from Galaxy Resources (+62%), Collins Foods (+47%) and Sims Metal Management (+40%). Nil weights in Bellamy's Australia (-49%), Paladin Energy (-43%) and Perseus Mining (-39%) helped performance.
Detractors during the quarter included CSG (-43%) and Dacian Gold (-19%). Nil weightings in Corporate Travel (+95%) and UGL (+47%) also hurt performance.

Top 10 Stocks as at 31 December 2016	
Cleanaway Waste Mgmt Ltd	**Independence Group NL**
Fletcher Building Limited	**Premier Investments Limited**
Sims Metal Management	**Ebos Group Limited**
IRESS Limited	**Sigma Pharmaceuticals Ltd**
Nufarm Limited	**Macquarie Atlas Roads Group**

Our portfolio positioning has changed appreciably compared to 12 months ago, as we progressively implemented our revised investment thesis. Our allocation to materials names has been increased and our exposure to bond proxies has been wound back. We have carefully upsized our weightings to a number of the better managed mining services groups through the period in review whilst taking profits on several of our aggressive New Zealand exposures around the time of the October Kiwi market sell-off.

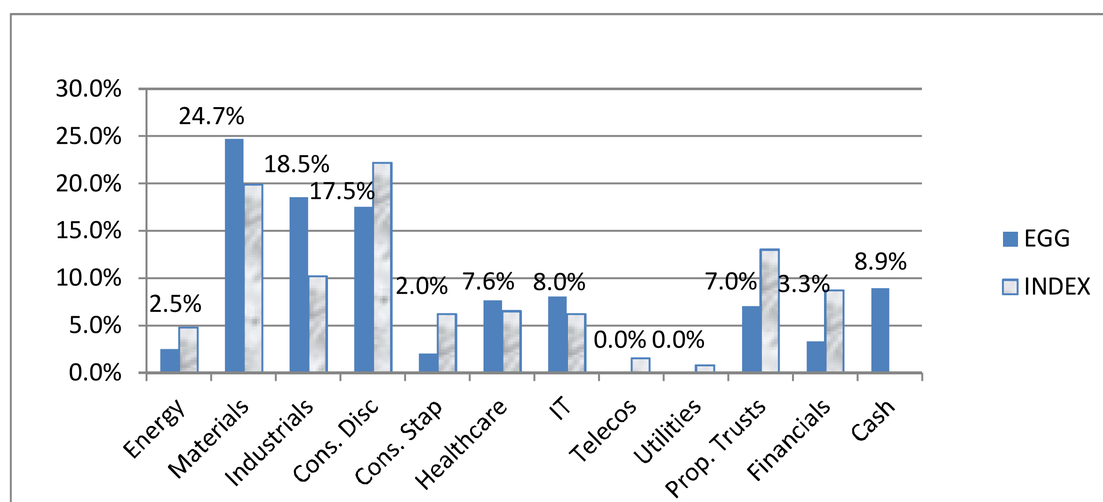
Your manager participated in the IPO of **Autosports Group Limited** and has used recent weakness to add to our position. Autosports is a luxury/prestige car retailer with a portfolio of 11 OEM brands marketed from 27 locations across Sydney/Brisbane. The investment proposition centres around a seasoned motor retailing family, the Pagent's, growing sales and service revenues whilst identifying accretive acquisitions. Over the past 20 years, compound unit growth in prestige auto has tracked at 8.3% pa, nicely outpacing market unit growth of 3% during the period. The case for luxury outperforming system continues to feel good to us and is somewhat reflected in ASG's premium pricing versus the two other listed auto operators.

It is unusual for us to take on a turnaround story but a recovering oil price prompted our team to re-open the **Worley Parsons** file, a company that has recently returned to the small cap space after a decade's absence. Time in the ASX100 has afforded our team the chance of a fair-minded review of the company's predicament. It seems the giant, lumbering roll-up had a bull market balance sheet without a bull market in crude. This has forced an arduous right-sizing process involving working capital management, overhead resets and asset sales. Overhead reduction is reported to be tracking ahead of plan, with the ultimate target being lifted to $350m, $100m to be booked in FY17.

The interplay between changes in revenue and cost is critical to Worley. In FY16, revenue contracted at a faster clip than cost could be removed. We're betting that the two harmonise in FY17, delivering steady earnings and marking the cessation of the earnings downgrade cycle. We are also heartened to learn that industry capex is slowly coming back on, in conventional and unconventional sectors.

Our holding in **Auckland International Airport** had been in place for a little over 3 years and had been an extraordinary outperformer over peers during this time. Our change in thinking re

bond proxies and de-weighting of some of the fund's NZ exposure, prompted us to realize the portfolio position. A decision made somewhat easier by the very full valuation the airport operator trades at (PE ~ 32x and EV/EBITDA ~ 20x).



Outlook

I often begin my outlook commentary with a declaration that shaping an outlook for the market is a little more challenging this time round. Well this time I really mean it!

Political uncertainty with the new mob in DC is clearly elevated on a number of levels. It would be fair to suggest that comfort with the new team is middling, but improving. The Trump platform is insular and with a strong stimulatory intent. It is liberating with a protectionist architecture and is shaping up to be highly provocative to international trading partners. A trade war, notably with China, seems a foregone conclusion. The stockmarket has priced the sum total of this bullishly.

My reading of the situation is that, in the main, long only managers are not set for the continuing reflation trade. Hedge funds neither. This makes for an incredibly supportive market backdrop if Trump actions even part of his plan and gets early traction with some of his initiatives.

The US economy is in its eighth year of economic expansion and marks the third longest campaign in post war history. We will shortly commence the US Q4 2016 reporting season. Expectations have again been lowered (in 10/11 GICS sectors) so room for upside surprise has been created. Top down analysts are budgeting on 10% eps growth for the US market in 2017, following on from a likely flat 2016.

The stripe of the FOMC has moved more hawkish, with 3 hikes implied for 2017 in response to a strengthening economy.

A recent BofAML stock-bond correlation piece sites the taper tantrum, experienced in 2013, as evidence that the equity market will be troubled by a 3% US10 year bond ('Bond King' Jeffrey Gundlach as also pencilled in 3% as his marker). This is a far cry from the 5%, or higher, that has derailed equity market advances in the past. This manager has been monitoring cross-asset (Bond v earnings yields) correlations since the early '90's and recalls the BY/EY fair value yardstick traditionally being at 1.1x, in times of low inflation. Todays 2017 S&P PE stands at 17.5x (or inverted it is an earnings yield of 5.7%), so this would prescribe a fair value US10 year bond of 6.27% versus 2.47% today.

Current Equity Risk Premium (ERP) analysis indicates there is a substantial margin of safety in equities today relative to bonds. In the US, GS calculate the ERP at 4.6% and I calculate the local one at 5.3%. Remember, major market peaks have occurred around 2.5%.

Locally, the reporting season will influence sentiment for the next 6 weeks. Confessions have been few in number since the AGM period and a benign results period is expected.

Distilling all of this into a portfolio that will outperform in 2017 goes something like this. Equities are not overpriced as some commentators suggest. We are convinced that the sectoral rotation of the past 12 months will remain valid, at least, in the medium term.

Cyclical names, including resource stocks, should continue to perform well. Bond proxies of all ilk should be viewed as funding sources. A number of high quality growth names have been sold down to more realistic valuations and we are looking for buy set-up's, possibly occurring during the reporting season.

The small cap/big cap PE premium has receded over the past six to eight weeks (from a 5-6% premium) to being close to parity, influenced by an extraordinary level of portfolio transition activity into year end. This should ebb moving forward, allowing for a premium to reopen. Smalls will require a fuller, longer duration of excess valuation before the small cap cycle will have exhausted itself.

Eley Griffiths Group Ratings

Morningstar October 2016	**Silver** 2nd Highest Rating	**Lonsec** January 2016	**Recommended** 2nd Highest Rating
Zenith February 2016	**Recommended** 2nd Highest Rating	http://eleygriffiths.com.au/news-reports/	

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