Small Companies Fund
Quarterly Report
March 2017

THE ENCYCLICAL

To Our Unit Holders

Fund Basics			
Unit Price	$2.0889	**Inception Date**	17th September 2003
Distribution Frequency	Annual	**Fund Size**	$429M
Number of Stocks in the Portfolio	59	**Benchmark**	S&P ASX Small Ordinaries Accumulation Index

Performance Statistics to 31 March 2017

	3 Month %	1 Year %	3 Year % p.a.	5 Year % p.a.	Since Inception
EGG Small Companies Fund	-4.08%	+3.82%	+7.32%	+7.60%	+12.13%
S&P/ASX Small Ordinaries Accumulation Index	+1.46%	+13.67%	+6.44%	+4.87%	+2.28%
Outperformance	***-5.54%***	***-9.85%***	***+0.88%***	***+7.17%***	***+5.32%***

* Fund returns are calculated post fees.

For the quarter ending 31 March 2017, the Eley Griffiths Group Small Companies Fund returned -4.08%, compared to a +1.46% move in the Small Ordinaries Accumulation Index (XSOAI).

Market Review & Strategy

The Small Ordinaries Index chalked up meagre gains during the March quarter, with several earnings confessions in January unsettling a market already weary from a somewhat disappointing AGM season. Predictably, the reporting season in February held sway over market sentiment during the period in review.

Small resource stocks, the stalwarts of 2016, snapped their winning streak versus small industrial names in early March. Whilst stalled momentum in bulk and nickel prices prompted profit taking in mining stocks, it was really the powerful rallies in several heavily-weighted industrial names in the Small Ords that accentuated the resource underperformance. **NIB**

Holdings, Metcash, Charterhall and **Sol Patts** staged breakneck rallies, possibly indicating that a shift in sectoral momentum had started.

Further, investors were buffeted by a rolling campaign of industry fund redemption and transition activity that had commenced around October and remained active through the quarter. Transition brokers used aggressive price discovery to clear institutional-scale volumes during a seasonally illiquid time of the year, the impact on share prices was acute.

February's reporting season preoccupied buy and sell side players, with results broadly meeting expectations. Earnings revisions were moderate in the main with few changes made to outstanding broker recommendations.

Companies delivering positive earnings momentum were rewarded and those that disappointed were sold off in what was a strongly correlated (results: share price volatility) reporting period. Resource names were the exception here, with many reporting well only to see share prices track lower. Mining service names pointed to stabilising operating environments with improved visibility in future order books.

Curiously, a number of beaten-up small caps sprung back to life as 'scorched-earth' earnings expectations were reset on the back of better than expected results and improved prognoses eg **Seven Group Holdings, NEXTDC, A2 Milk, Austal Ltd and WPP AUNZ**.

Our analysts left the reporting season with a sense the worst has been seen for the WA economy. Feedback from several WA-centric corporates suggested as much. A number of lead indicators point to a bottoming-out in economic activity. Labour market tightening and increased manpower turnover on mining sites are constructive signs. So too are anecdotes of resource companies leasing up Perth office space and word that at least one contrarian institutional property investor is flagging plans to upweight its Perth office/commercial exposure.

March quarter 2017 will be remembered for the flurry of share register raids, long absent in our part of the market. **A2 Milk** emerged with ~ 8% of **Synlait**, the Dar Group amassed a 13.4% stake (stock and swap) in **Worley**, late '80's greenmailer **Ariadne** acquired ~ 7% of **Ardent Leisure**. **Downer** moved on **Spotless Group** ahead of a formal bid and **Premier Investments** snaffled 11% of **Myer**, the latter a move that Premier shareholders (read institutional shareholders) seemed at ease with.

Elsewhere, hedge fund manager, Lone Star made overtures to **Astro Japan Property Group** (EGG holds 5.2%), **Seymour White** received an unsolicited approach from French group, Vinci, and **DWS** bid for long suffering **SMS Management & Software.**

Technical Summary

The Australian market sits on a ‘knifes-edge’ from a technical perspective. Glancing at each of the **ASX100** and **200**, the **All Ordinaries** and the **Small Ordinaries Indices**, they all highlight how delicately poised the local bourse is currently, requiring investor vigilance. These indices either decisively break upwards from current levels or experience stall speed and commence healthy retracements. They have been ensnared in a downtrend whose origin dates back to the November 2007 historic high. Since then the local market has rallied, but a clear underperformer versus the US, UK and NZ markets that have traded to successive all-time highs in recent months.

The ASX200 took out its downtrend (resistance at 5800) on March 28 with a ‘running gap’ (bullish momentum marker) following numerous attempts to break out over nearly 10 years of grinding price action. If momentum is sustained, then a test and break of 6000 is in the offing. This will signal that the next stage of the market advance has commenced with a test of the old high of 6800 (at a minimum) within the next 12 months.

The Small Ordinaries index has much work to do, having underperformed the ASX100 sharply since early October 2016 (Smalls -2.5% v Large +8.7%). There are signs that this underperformance is waning, with a nadir possibly likely seen in the first week of March. Interesting to note that in the US, the same trend is observable, with the **Russell 1000** (big caps) outperforming the **Russell 2000** (small caps) from November 2016, but now waning. We will continue to monitor.

Sectorally, the small resources outperformance (versus small industrial stocks) may also have exhausted itself during early March, following a year long advance when a hard-commodities rally underwrote mining equities globally.

As forewarned in December quarter’s *Encyclical*, the **US dollar index (DXY**) has been unable to break and sustainably hold above 100.7. Three failed rallies since last December, with a series of lower highs, undermines the USD bull case. Performance of the USD-crosses (GBP, Euro & Yen) also support the downside case for the greenback. This is fuel for **gold** bulls whose downtrend line has checked BREXIT and Trump rallies. This downtrend is being challenged as a I write. A sustainable break here would be a very bullish development for gold.

The Portfolio

During the March quarter, our small company portfolio saw strong appreciation from **Orecorp** (+31%), **GR Engineering** (+20%) and **IDP Education** (+19%). Nil weights in **Retail Food Group** (-22%), **ARB Corporation** (-17%) and **Quintis** (-37%) helped performance.
Detractors during the quarter included **Fletcher Building** (-26%) and **Ardent Leisure Group** (-28%). Nil weightings in **Bega Cheese** (+51%) and **Charter Hall Group** (+16%) also hurt performance.

Top 10 Stocks as at 31 March 2017	
Bapcor Limited	**Cleanaway Waste Management Ltd**
Ebos Group Limited	**Independence Group NL**
IRESS Limited	**Nufarm Limited**
Pact Group Holdings Ltd	**Premier Investments Limited**
Sigma Pharmaceuticals Limited	**Sims Metal Management Limited**

The fund's performance has been disappointing in recent months following changes to several portfolio 'tilts' made during 2016. An intentional shift from expensive defensives into value/cyclical names, such as mining service companies, has seen share price momentum here stall recently. Materials names (principally resource stocks) are a bigger component of the portfolio now and this group conceded ground in mid February as nickel and iron ore prices moved lower and a number of heavily-weighted small industrial stocks assumed the ascendancy.

Quality industrial names that were sold/significantly reduced in the latter stages of 2016, such as **Auckland International Airport**, **Steadfast** and **Macquarie Atlas Roads,** have recovered strongly. The fund was impacted by **Fletcher Building's** *mea culpa* on the performance of its construction division, which was disappointing not least for the fact that the admission quickly followed the company's interim result. EGG continue to believe that the global reflation trade has not run course but remain alert to indicators that might suggest a tempering of our present positioning.

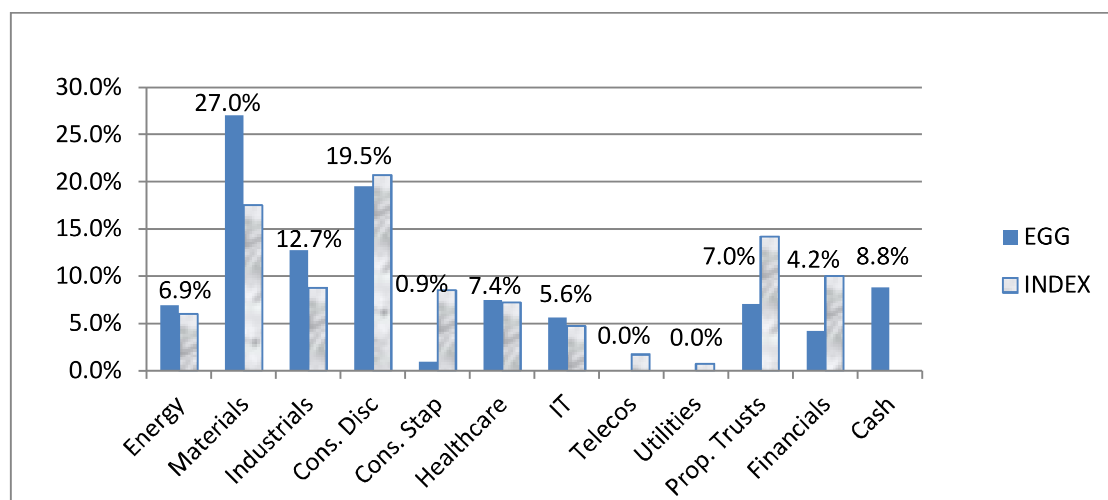
Analysts at EGG continue to like the prospects ahead for **Nufarm,** a significant portfolio position. In recent years the organisation has transformed from one in urgent need of self-help into a vital, professionally managed business ready to pursue new growth horizons. The extraordinary amount of ag chem consolidation occurring globally will result in a number of assets being divested and some of these, all or in part, might make useful additions to Nufarm's portfolio. The company has restored vigour to its balance sheet (a journey not yet complete)

and has seen its share price re-rate appreciably to a point where it is ready to sensibly consider acquisitions.

In the December quarter *Encyclical* we introduced **Worley Parsons** to investors, briefly explaining our investment thesis for the stock. It was surprising to see Dar Group raid the register in February (at $10.35) and again in early April, at $11.50, a price that prompted your manager to lighten its position somewhat. The group remains a major work in progress but now with an acquisitive major shareholder on its register.

Despite the franchise value of **Link's** significant share of the local super admin market, operational headwinds and a full market rating are rarely a great coupling. Whilst the firm is on track to unlock reasonable synergies from its Superpartners acquisition, it will have to endure revenue pressure from the price reductions extended to the five former shareholders of Superpartners. Missing the Pillar acquisition recently was disappointing and will now make for a stronger competitor in Mercer, the asset acquirer. Further, we don't expect price competition in the registry business to abate in the short term. A PE of ~ 23x for epsg of 13% and 30% two years hence felt stretched to us so we folded and moved on.

We disposed of our remaining shareholding in **Mayne Pharma,** concluding a progressive de-weighting of a long-held position. Our exit was influenced by the US Department of Justice investigation into generic drug price fixing across a number of generic pharmaceutical companies, Mayne included. Our concerns rested not so much on the one drug identified within the Maynes portfolio, rather it is the impact the investigation, and its indeterminate duration, would have on drug pricing practices generally for the Maynes portfolio.



Outlook

The discussion penned in this issue's Technical Summary section neatly portrays the near-medium term market outlook. The Australian stockmarket now sits at a point of irresolution that needs to trend one way or the other.

I participated in an *AFR Roundtable* on January 3 2017 where the 2017 outlook for floats and equity raisings was debated. I tipped a subdued start to IPO activity in the year ahead, getting under the skin of the investment banking panellists in the process! This is precisely what has transpired and isn't surprising given the current investor lethargy across the market.

A couple of small-sized IPO's have limped home, but the first sizable IPO for 2017, Bingo Industries, has just transacted towards the lower end of the valuation range and proposes to list on the ASX by May 2. A fervent market would have seen a slew of equity issuance towards the end of February not April! I will concede that continuing investor (private and professional) lassitude is a troubling feature of our market. Bull markets require enthusiastic participants with healthy risk appetites rather than the parsimony of the past 6 months.

Much is made of market valuation and how expensive stocks are globally. I will repeat my polemic that these fears are overplayed.

Regular readers will know that I usually reference Equity Risk Premium (ERP) analysis to divine stock valuations relative to bonds. The ERP for the local market has blown out to ~ 5.9% (~5.3% in Dec qtr) as has the US market at ~5.2% from ~4.6% in the preceding quarter. Remembering that most major corrections in history have occurred in the US at an ERP ~ 2.5% would imply equities continue to be a superior (read safer) bet to bonds.

The outlook for resource stocks will be of particular interest to the market given their very recent underperformance relative to industrial names. These stocks enjoyed the tail wind of analysts upgrading estimates to reflect rallying spot prices through 2016. By the end of the March quarter, commodity prices had corrected and had become headwinds to share prices, as all but thermal coal prices seemed fully discounted in valuations. Arguably, wiggle room in gold and iron ore price assumptions remains, but if the reflation trade is to continue, hard commodity prices will need to start rallying soon.

As is always the case, equity investors are faced with a never-ending inventory of risks to the buy case. Whether it is the FOMC, US Q1 reporting period, fears of a US Government shutdown (if a spending bill fails to pass Congress on April 29) or myriad political events unfolding daily. Investors should train their eye on not unreasonable valuations at present and await resolution of the 'technical' impasse effecting a number of markets at present.

Eley Griffiths Group Ratings

Morningstar October 2016	**Silver** 2nd Highest Rating	**Lonsec** February 2017	**Recommended** 2nd Highest Rating
Zenith February 2017	**Recommended** 2nd Highest Rating	http://eleygriffiths.com.au/news-reports/	

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