Small Companies Fund

Quarterly Report

June 2017

THE ENCYCLICAL

To Our Unit Holders

Fund Basics			
Unit Price	$2.1000	**Inception Date**	17th September 2003
Distribution Frequency	Annual	**Fund Size**	$423M
Number of Stocks in the Portfolio	55	**Benchmark**	S&P ASX Small Ordinaries Accumulation Index

Performance Statistics to 30 June 2017

	3 Month %	1 Year %	3 Year % p.a.	5 Year % p.a.	Since Inception
EGG Small Companies Fund	+0.53%	-2.81%	+7.93%	+10.14%	+10.64%
S&P/ASX Small Ordinaries Accumulation Index	-0.35%	+7.01%	+7.13%	+5.66%	+5.59%
Outperformance	***+0.88%***	***-9.82%***	***+0.80%***	***+4.48%***	***+5.05%***

* Fund returns are calculated post fees.

For the quarter ending 30 June 2017, the Eley Griffiths Group Small Companies Fund returned +0.53%, compared to a -0.35% move in the Small Ordinaries Accumulation Index (XSOAI).

Market Review & Strategy

The hidebound trading pattern of the Small Ordinaries index in March quarter continued through to the close of June, with this seemingly unremarkable performance masking some volatile share price movements.

The benchmark showed the first signs of bettering the ASX100 mid-point through the quarter with small company outperformance being recorded in May and June. Improving risk appetite would see emerging/micro-cap names smartly outpace small caps by the close of June and into the early days of July.

The June quarter will be remembered for the onslaught that retail stocks endured as apprehension surrounding the arrival of Amazon spread through the market. This combined with deteriorating consumer sentiment and earnings updates from retailers **RCG Group** and **The Reject Shop** only served to fuel investor angst. Predictably, hysteria was to dissipate and stocks did manage to claw back some ground by June 30.

Many IT services names performed strongly during the quarter, taking their queue from the 'melt-up' happening on NASDAQ. **Technology One** rallied 12%, **Altium** 13.5% whilst cloud based logistics software group, **Wisetech** (+21%), talked of strong operating momentum from H1 17. **SMS Management** became the subject of corporate interest, with an initial approach from **DWS** thwarted by a binding offer from ASG (itself recently acquired by Nomura Research Institute).

More generally, the US market provided a constructive backdrop for the Australian market as myriad indices registered historic highs every other session. The Q1 results season reported the strongest pace of earnings growth since 2011, confirming that ~11% consensus eps growth for the S&P500 in 2017 was on plan. A revival in financials and telco's would provide succour to US investors, already buoyed by the strength in tech related names.

Westpac's 19% sell down in **BT Investment Management** was the high note in an otherwise lacklustre secondary deal market. **G8**'s relative ease in raising $100m in new equity and **Collins Foods** 'monstered' $44m raising underscored EGG's strong belief that well-reasoned and fairly priced primary deals will be supported by the market. 'Use of funds' is now firmly front of mind for professional investors – and so it should be! This basic principal has eluded bankers in 2017, with several high profile IPO's firing poorly or not even making the starting line (this author suggested as much in a December 2016 AFR roundtable).

Amongst the IPO moraine, EGG analysts identified **Big River Industries** and **Elmo Software** as two worthy investments with the market reception confirming our work, up 26% and 19% respectively.

Technical Summary

This issue I will make frequent reference to the Coppock Indicator. A seldom referenced indicator, analysts that follow it know of its power in detecting medium-long term turning points in markets and buy signals (rather than sell signals) are where it has built its reputation. I find its confirmatory signals to be of great value in thinking about stock/sector positioning

Starting with the base metals complex, it is hard to ignore the constructive price action continuing to unfold in LME markets. In the case of aluminium and copper, the bear market's stretching back to 2007 have now broken, with the Coppock Indicator (in Copper) suggesting a conviction low was struck in December 2016. Zinc is positive, tin also and even nickel is indicating a bottoming process is underway. The complex is on the move, aided and abetted by the drubbed greenback of course.

Crude oil remains in a sorry state. Short covering is responsible for the poor quality July rally. In fact, sellers have made their presence felt in this market since March 2017 and have smothered any serious upward move. The Coppock Indicator appears to be a long way from delivering this market the low (rally point) it requires.

Gold abides its bear market trajectory since September 2011 confirmed by a score of failed challenges to the upside. The metal is again set to test resistance at US$1256. This appears to be on the cards in the weeks ahead and should be monitored. Local gold equities have outperformed the USD gold price through much of 2017 but it is interesting to note this has reversed early into the new quarter.

Regular readers of *The Encyclical* will recognise my refrain on the US dollar: *look at the cross-rates to shape your thinking*. EURUSD, GBPUSD and YENUSD have been basing beautifully for many months and this belies the give-up occurring in the US dollar index (DXY). The DXY needs to hold 93.0 or an accelerated descent will take hold. Consistent with this theme, the AUD continues its bullish impulse, technically significant that it cleared the 0.782 in the past week.

Practically all US equity indices now seem to make new highs every other week. In fact, most western stockmarkets are either at or within the vicinity of historic highs. Unfortunately this is cold comfort for Australian equity longs as the ASX200 is no further advanced than where we left off with last quarter's commentary. Clearing 6000 is as illusory as it has been at any time since 2008. Patience is required as the Coppock indicator did give us one of its rare conviction BUY signals back in August 2015.

Mid caps continue to be the markets sweet-spot and since early May have provided collateral support to small cap outperformance (vs big caps) and emerging/micro cap outperformance (vs Small caps). Small industrial stocks are set to extend their rally with small resource names the wildcard in the mix. **Remember the age-old correlation between small caps and the AUDUSD. With few exceptions, the two normally move nicely in step. The Small Ordinaries Index moves higher from here.**

The Portfolio

During the June quarter, our small company portfolio saw strong appreciation from **Touchcorp** (+30%), **Ausdrill** (+30%) and **Afterpay Holdings** (+27%). Nil weights in **Mayne Pharma Group** (-24%), **Beach Energy** (-28%) and **Myer Holdings** (-31%) helped performance. Detractors during the quarter included **Sigma Healthcare** (-29%) and **Michael Hill International** (-20%). Nil weightings in **St Barbara** (+22%) and **Corporate Travel Management** (+14%) also hurt performance.

Top 10 Stocks as at 30 June 2017	
Cleanaway Waste Mgmt Ltd	Ebos Group Limited
G8 Education Ltd	IRESS Limited
Nufarm Limited	Premier Investments Limited
Saracen Mineral Holdings Ltd	Smartgroup Corporation Ltd
Steadfast Group Limited	The A2 Milk Company Limited

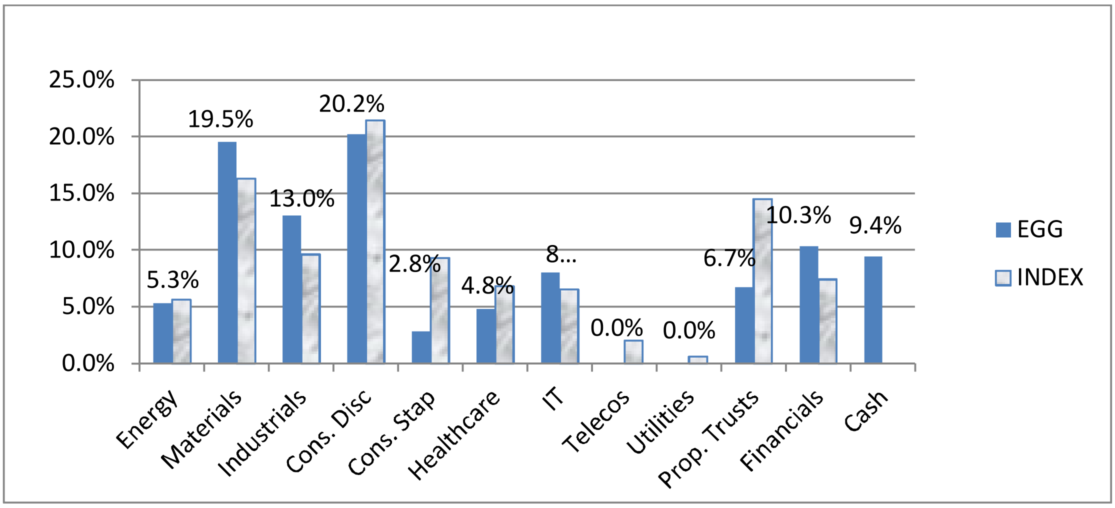
Your manager was active in the June quarter with a number of new stocks added to the portfolio, whilst several long held positions were quit from the list of fund holdings. **Fletcher Building** had been progressively de-weighted from the portfolio for some time and was expunged around the time of its second profit warning. **Tegel** and **Sigma** positions were also exited from the fund.

EGG analysts don't tend to seek out turnaround situations but occasionally opportunities do catch our attention. **G8 Education** has been beset with management credibility issues for many years, not to mention angst around the business' funding model and offshore diversification strategy. The past 2 years has seen a new C-suite installed and the market has warmed to the changes. The aforementioned equity raising (replacing a largely dishonoured equity commitment by a Chinese investor) ensured the groups capital expenditure plans were sure-footed and positioned the group well for forthcoming new facility negotiations with local banks. Despite near term pressures on occupancy and pricing, the successful passing of the Turnbull Governments Childcare funding package ensures a sound medium-long term outlook for the industry. EGG built a position in G8 during the quarter.

The Westpac sell down of its **BT** holding afforded EGG the chance to establish a modest holding in this favoured money manager ahead of its then likely admission to the ASX100. Gonzalez's execution of the group's growth agenda has been outstanding over many years, operating margins have expanded and the earnings outlook for the group looks sound. BT also provided a bullish FUM update in April, notable, given the potential implications of a key personnel departure from Jo Hambro earlier in 2017.

We returned to the register of **iSelect** during the period having gained increased confidence with the performance of CEO Scott Wilson and the measured pace at which he is evolving the group's business model. The company's strategy of developing other emergent industry verticals away their reliance on healthcare, is a logical move and is proof of the value of iSelect's brand equity. The looming insurrection from Australian energy consumers at skyrocketing utility pricing will play nicely into iSelect's hand as higher prices drive customer churn. A stronger balance sheet hints at further capital management and we believe the somewhat fulsome PE rating is offset by an attractive eps growth profile looking out at least three years.

EGG accepted Hitachi's bid for their **Bradken** shareholding during the period in review.



Outlook

Many of the worlds major stockmarket's find themselves in a somewhat extended position just as central banks consider tapering or removing liquidity from the system. Investors haven't missed the fact that major economies are in recovery mode and that an official response is imminent.

One undeniable fact is that equity investors have grown more than a little complacent to the risks of a violent down thrust in markets. Stories abound that 'short vol' strategies on VIX futures (measure of implied future volatility) have become the easiest game in town for return hungry institutions. It appears VIX Futures open interest is approaching record levels. The S&P 500 has traded for more than 12 months without so much as a 5% correction. Even more unnerving that it is the 6th occasion since 1950 that this phenomenon has occurred.

As a manager of some years, I am always alert to the risks inherent in over bought, expensive stock markets (absolutely and relative to bonds) that have diverged dangerously from realistic settings. Complacency on the part of investors breeds bad habits but I feel the fundamentals supporting the current global equity advance remain ok, notwithstanding the observations above.

1. The US yield curve remains positive despite having flattened somewhat from its extreme settings. I watch the UST 10-2yr, 10-fed funds and 10-3mo carefully. Movements in yield curves tend to lead the US earnings cycle by 2-3 quarters normally. Experience has taught me that the curve will invert (turn negative and indicating recession) well before equities commence a major correction. Since 1960, inversions of the UST 10-3mo have presaged every recession recorded-NO false signals. I recall its last inversion happened 18 mo before equities retraced.

2. The equity risk premium (ERP) continues to offer tactical allocators a margin of safety in equities over bonds. In Australia the ERP is currently ~ 5.9% and ~ 5% in the US, nicely on the right side of fair value (~4.5%) and not close to traditional market peak triggers of ~2.4%.

3. Headlines like 'Wall Street latest guessing game is to try to pick the market's peak' (AFR 20/7/17) suggest to me that a few more bears need to be killed off before the market can top out.

4. The technical picture of the worlds share markets remains constructive. The daily value of turnover is high, the breadth (no of stocks participating in the rally) is healthy, rallies are generally occurring in price-and-time balance (NASDAQ 100 the possible exception), and the crucial signs of price action exhaustion (congestion/toping patterns) simply are not to be found in charts of the worlds major indices.

We are in the teeth of the Q2 reporting season in the US and so far there is no indication that an earnings inflection point is close at hand. That might change by season end but so far so good. The market is still gunning for ~ 11% eps growth in 2017. Locally, the reporting season gets started in the first week of August. Earnings updates have been few in number and a relatively benign season is anticipated. Nevertheless this has the potential to be a volatile window for investors.

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/	