THE ENCYCLICAL MARCH QUARTER 2018

To Our Unit Holders

Our Funds' Performance (after fees) to 31 March 2018

	3 Month %	1 Year %	3 Year % p.a.	5 Year % p.a.	Since Inception p.a.
EGG Small Companies Fund	-0.36%	+21.20%	+11.22%	+10.91%	+11.50%
S&P/ASX Small Ordinaries Accumulation Index	-2.79%	+14.99%	+10.67%	+6.45%	+6.34%
Outperformance	***+2.43%***	***+6.21%***	***+0.55%***	***+4.46%***	***+5.16%***

* Fund returns are calculated post fees.

	3 Month %	6 Month %	1 Year % p.a.	5 Year % p.a.	Since Inception p.a.
EGG Emerging Companies Fund	-0.15%	+14.11%	+31.69%		+30.27%
S&P/ASX Small Ordinaries Accumulation Index	-2.79%	+10.52%	14.99%		+16.63%
Outperformance	***+2.64%***	***+3.59%***	***+16.71%***		***+13.64%***

* Fund returns are calculated post fees.

For the quarter ending 31 March 2018, the Eley Griffiths Group Small Companies Fund returned -0.36%, the Eley Griffiths Group Emerging Companies Fund returned -0.15%, compared to a -2.79% move in the Small Ordinaries Accumulation Index (XSOAI).

Market Review & Strategy

A precipitous correction on Wall Street during the final days of January momentarily derailed the rally in the Small Ordinaries Index but a vigorous local reporting season saw stocks claw back significant lost ground by February's close.

A strong job (and wages) print for December ushered in fears of labour inflation and US stock indices sold off accordingly. This was grist for a vicious unwind of the fabled 'low-vol' trade (a popular US institutional strategy of shorting/selling volatility to enhance portfolio performance) and set the tone for caution amongst equity investors through March end.

March quarter will be remembered less for the US stock sell-off but for the highly correlated reporting season delivered by Australian small companies. Companies whose share prices firmed into results and delivered as/better than expected reporting's were well supported by investors and in many instances enjoyed PE re-ratings. **Costa Group, Nine, IDP Education** and **ARB Corporation** being cases in point. Those companies showing moribund share price action ahead of disappointing results fared to the contrary. Witness share price performances from **Super Retail, Myer, Amaysim** and **Insentia**.

There were fewer earnings misses in February, generally revenues and EBITDA grew but often without margin expansion and full year guidance met expectations in the main. Goldman Sachs observed that local leverage (net debt/EBITDA) moved to post GFC lows whilst firms reported their highest levels of return-on-equity (ROE) since this time, a powerful coupling.

Forward estimates for banks/industrials were ticked downward whereas estimates for resource names saw upgrades as better forecast commodity prices offset mounting cost pressures. Interesting to note that gold stocks were the clear outperformers amongst resource counters that turned in disparate performances during the 3 months in review.

Financials found favour with the market following good results from **Flexigroup, Scottish Pacific** and **Afterpay Touch** which all finished the March quarter comfortably ahead of the benchmark. The proposed IPO of Latitude Financial Services will be a good test for this sector, later in the year.

M&A activity returned to small caps with private equity groups bidding for panel shop aggregator **AMA Group** and medical device distributor **Lifehealthcare Group**. Mitsui successfully entered the bidding war for oil/gas producer **AWE** (EGG holding) and Oz Minerals had a tilt at emerging copper producer **Avanco Resources** (EGG holding).

Investors were taken aback by aggressively priced takeover offers for two listed biotechs by leading US corporates. Varian Medical Systems bid for **Sirtex Medical** and Merk bid for oncology group **Viralytics**. The two bids, within weeks of each other, are somewhat reassuring that a sector replete with cynics, fatigued investors and carpetbaggers can also boast listed companies with valid science and/or medical devices and sought after intellectual property.

Technical Summary

Soon after the circulation of our December quarter *Encyclical*, the US stock market delivered one of its most reliable technical indications, a weekly key reversal. Your author had a sense of foreboding as markets closed on February 2, key reversals in the S&P500 and several other key US indices confirmed.

To explain, key reversals occur during wide ranging price action where a weekly high is struck above the previous week's high, whilst a low is achieved that is lower than the prior weeks low. The market then closes on or near this low, normally with above average volume. This version is bearish, the contrary bullish.

The key reversal tells us the correction in share prices is real but the challenge is how long will it last and how deep will it push. CLSA's *Volatility & Selectivity*, April 2018 report corroborates the case for a US market low having occurred. The report cites S&P 500 200 day moving average support, with an ARMS Index (Advance/decline measure) print > 2 and extended put/call ratio open interest within the trend channel as confirmation of a low most likely being in place. It is instructive that the US stockmarket should base as it moves into one of its stronger seasonal windows, the month of April.

As it turns out, my rejoicing at the ASX200's move through 6000 to 6150 in the last *Encyclical* was premature. The subsequent retracement back to 5788 at the time of writing this review indicates a failed break of 8 year index resistance. Worth noting that around that time the five year rally by Japan's Nikkei Index out of the 1989-2012 bear market stalled precisely at the Fibonacci 50% level.

The Small Ords also failed in its attempt to clear the Fibonacci 50% level of resistance, as measured from the November 2007 high to the March 2009 low. Relative to the ASX100, the relative performance continues but with some ground conceded since March 28. It is constructive that the outperformance zenith hit in August 2016 was taken out but the momentum in this series needs to keep to ensure the small cap buy case remains intact.

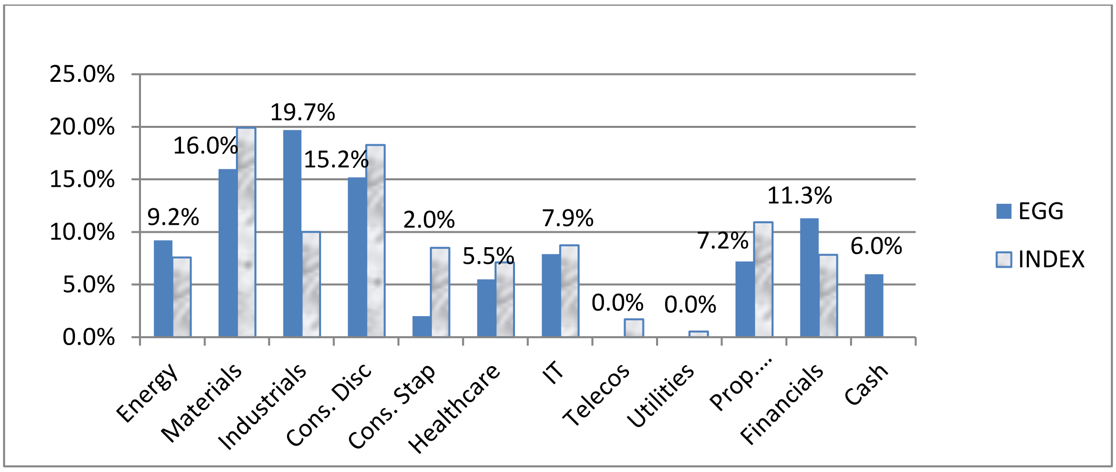
Put simply, developed stock markets across the globe had overreached and were due a pause. Equity markets will require close monitoring to gauge the quality of emergent rallies.

Commodities offer an interesting picture. Base metals partially corrected their rallies at different points of time during the quarter. This is not unexpected given strong technical breaks and the emergence of some trader exuberance in the space. Gold, despite its oscillating price action, looks to be constructive but requiring a close above US$1385/90 before it can prove its worth.

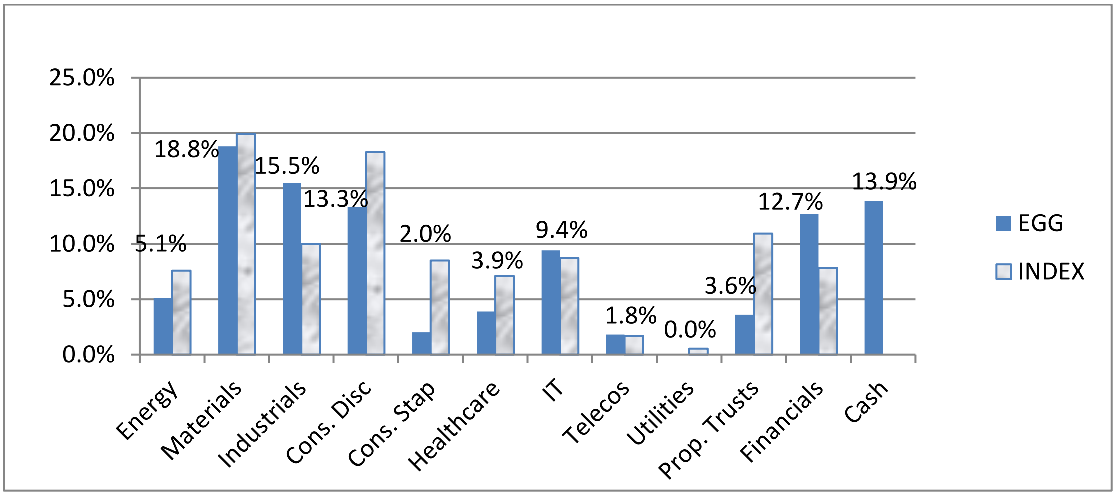
Crude shows little sign of fatigue on the charts and curiously has significantly outperformed US integrated oils and E & P equities over the past 12 months. I must admit to being a little chastened by the CFTC report at March end, highlighting WTI traders being long/short in the ratio of 6:1, typically a contrarian signal.

The Portfolio

The Small Companies Fund was positioned as below:



…and the Emerging Companies fund:



During the March quarter, our Small Companies Fund (SCF) enjoyed the rallies from **Australis Oil & Gas** (+61.7%), **A2 Milk Company** (+55.5%) and education provider **Idp Education** (+22.5%). Our positions in **Metals X** (-30.8%), **iSelect** (-28.7%) and **Galaxy Resources** (-7.2%) detracted from performance. In the Emerging Companies Fund (ECF), positions in **Avanco Resources** (+72.2%), **Noni B** (+30.0%) and **Synlait Milk** (+19.9%) provided a strong updraft. **Impedimed** (-31.0%), **Boom Logistics** (-25.0%) and **Motorcycle holdings** (-22.9%) dragged on the portfolio.

SCF Top 5 Stocks	ECF Top 5 Stocks
Cleanaway Waste Mgt Ltd	Afterpay Touch Group Ltd
Saracen Mineral Holdings Ltd	Emeco Holdings Limited
Seven Group Holdings Ltd	Helloworld Travel Limited
Smartgroup Corporation Ltd	Jumbo Interactive Limited
Whitehaven Coal Limited	Noni B Ltd

One or both EGG funds held the following stocks during the quarter and changes may have been made to portfolio positioning.

In late 2015, emerging dairy manufacturer **Freedom Foods**, made headlines for selling its 10% stake in A2 Milk when the stock was trading <$1 (the stock now ~$12). At the time it was cashing up to begin its ambitious $300m capex program to transform into the most modern, capacity rich plant and dairy beverage manufacturer in Australia. With new and upgraded facilities recently completed at a time when Murray Goulburn has been in crisis, Freedom finds itself in the unique position of being the number 1 provider of UHT plant and Dairy beverages across Australia. In addition to its established manufacturing capacity, its stable of existing and new iconic brands in the health and wellness segment continue to deliver ~30% sales growth. EGG availed itself of the recent capital call to initiate a position, enthused by the combination of an improved balance sheet and expanding operating leverage.

We initiated a position in long-time West African gold producer, **Perseus Mining,** during the quarter. The group is budgeting on production of ~ 260k ounces from 2 operations in 2018, growing to 350k ounces by 2019 upon full commissioning of its Sessingue operation. Production upside might also be accessed via the future exploitation of the Yaoure gold project. Your manager has monitored the company's somewhat variable performance over a number of years but is now more comfortable with the production profile, mine economics and ability to fund brown and greenfield developments.

We have been closely watching **3PL** CEO Rebekah O'Flaherty's measured turnaround strategy since her appointment in mid 2016. Not long after IPO, their hero product Mathletics lost relevance with its core customer base leading to attrition in revenues. This was compounded by a failed US entry and barren new product pipeline. 12 months into the 3yr turnaround plan, the product portfolio has been strengthened, a scalable sales model has been deployed and green shoots began showing in the 1H18 Result. It is apparent that product, customer and geographic expansion is occurring across a reset fixed cost base and EGG initiated a position in response.

A full year earnings downgrade, just three weeks from period end, stunned **G8** shareholders, ourselves included. The issue was a slippage in occupancy rates toward year end as centre supply ramped up and affordability continued to dampen demand. Anecdotes from unlisted competitors suggest the challenging operating environment would likely persist through Q3 CY2018, exacerbated by centre personnel familiarising themselves with the complexities of the new childcare package ahead of its July 1 implementation. Despite our belief that the turnaround being engineered by new management would ultimately gain traction, the high opportunity cost of the position rendered it for the chopping block.

EGG came across mid-tier HR Software company **Elmo** in 2Q17 ahead of its IPO. The company's strategy is to capitalise on under-resourced HR Departments migrating employee records and practices online. High recurring revenue, solid customer adds and an aligned management team appealed. Following a 170% return since IPO, we bid farewell to the Elmo position in 1Q18 post the release of results on valuation grounds. With the stock trading at the time on 10x Sales vs 3x Sales at IPO cf Netflix @ 8x Sales, we felt as though the re-rate had run course.

Following bids announced, or outstanding, positions in **AWE, Avanko** and **Finders** were quit from the portfolio in favour of the acquirers.

Outlook

The noise of recent months will continue impacting on markets into the June quarter but against a backdrop of sound fundamentals.

The US stock market is thrashing about on a partially defined trade war and tech stocks reeling from Facebook's misadventure and threatened government intercession at Amazon. Frustrating in that it follows one of the best reporting seasons ever reported there.

Markets are taking flattening yield curves and a firmer UST10 in their stride, but are growing anxious about recent blow-outs in both the Ted Spread (3 mo LIBOR-T bills) and US LIBOR-OIS (LIBOR less Overnight Index Swaps) spread. Extreme movements here can be a warning of credit market risk. The logical counter to these concerns is that there has been orderly volatility in the Barclays Corporate (high yield bond less US10T) Index. Further, one analyst suggested the moves are most likely attributable to fund remittance back into the US banking system following the recent corporate tax rate change (read: the coast appears clear).

Your manager sees the volatility underway since early February as an outworking of the preceding 12 month rally in share prices. PE ratio's for global stock markets are elevated but so too is confidence around profit cycles in most developed markets.

The equity risk premium in the US market is ~ 4.5% and around 6.6% locally, both supportive of equity positioning in preference to bonds. The 'internals' detailed in the technical summary point to a low most likely having already occurred in the US market.

Eley Griffiths Group Ratings

SCF

Lonsec	**Recommended**	**Zenith**	**Recommended**
February 2018	2nd Highest Rating	February 2018	2nd Highest Rating

ECF

Lonsec	**Highly Recommended**	**Zenith**	**Recommended**
February 2018	Highest Rating	February 2018	2nd Highest Rating