THE ENCYCLICAL

MARCH QUARTER 2018

To Our Unit Holders

Our Funds' Performance (after fees) to 31 March 2019

	3 Mth	1 Yr	3 Yr p.a.	5 Yr p.a.	Since Incept. p.a.
EGG Small Companies Fund	+10.44%	+5.42%	+9.88%	+9.57%	+11.09%
S&P/ASX Small Ordinaries Accumulation Index	+12.56%	+5.78%	+11.40%	+7.97%	6.31%
Outperformance	***-1.82%***	***-0.36%***	***-1.53%***	***+1.60%***	***4.79%***

* Fund returns are calculated post fees.

	3 Mth	6 Mth	1 Yr	2 Yr p.a.	Since Incept. p.a.
EGG Emerging Companies Fund	+9.60%	-3.33%	+11.68%	+21.27%	+20.98%
S&P/ASX Small Ordinaries Accumulation Index	+12.56%	--2.83%	+5.78%	+10.29%	+11.25%
Outperformance	-2.99%	-0.50%	10.42%	+10.98	+9.67%

* Fund returns are calculated post fees.

Market Review & Strategy

A powerful Wall Street 'key reversal' day on December 26 lit the fuse for a heady March quarter rally in Australian stocks. Comments from RBA Governor Lowe in the first week of February that local interest rate movements were 'evenly balanced up or down' were a philtre for investors.

Media outlets pointed to the ASX200 having posted its best March quarter in 30 years.

Significant also that the Small Ordinaries Accumulation Index outpaced the ASX100 for the period, bringing to a close a 6-month window of relative underperformance for the sector. By February month end, close to 20% of the Small Ords constituents had rallied greater than 25%, with IT, energy and consumer discretionary names prominent in the advance; market breadth long absent from the local bourse.

Bears identified the rally as a textbook 'bear trap' (counter trend rally in an unfolding bear market), bulls saw a chronically oversold market largely resolved. This impasse may well be clarified in coming weeks with the US markets ability to reclaim its September highs, critical to sustaining the rally.

The reporting season dominated activity during the period in review. Stable economic conditions underwrote a reasonable results season that exceeded low expectations in the main. Resources and mining related names posted good results whilst housing exposed stocks were pressured. Cost inflation was increasingly evident in reporting's, with a revisions ratio of 2:1 (downgrades/upgrades) resulting in negative earnings adjustments of ~ 2.5% for small companies. EGG small caps outperformed these metrics.

Very few changes to broker recommendations followed results, suggestive of moderate levels of conviction from sell-side operatives

Interesting to note the prevalence of capital management announcements during the season, culminating in $15bn in buybacks being tabled in H1 19- the most in a decade.

M&A momentum, building since September quarter 2018, was maintained. **Villa World** was opportunistically targeted, **IPH** bid for **Xenith IP, AP Eagers** finally moved on **Automotive Holdings** and Canadian agri-giant, Nutrien entered into an agreement to acquire **Ruralco**. In controversial circumstances, **Wesfarmers** bid for out-of-luck **Lynas**.

Investors raised eyebrows at two significant secondary transactions during the quarter. The Munz family quit the **Reliance Worldwide** register (and board membership) in a $365m sale whilst the **ASX** exited its long held 18.6% stake in **Iress.**

At the time of writing a logjam of IPO's of varying quality was beginning to build. This will need to be monitored as the quality and volume of IPO's is normally a reliable market bellwether.

Technical Summary

Stocks

The **S&P 500** key-reversal low on Boxing Day (with attendant outsized, prior day volume surge) and ensuing rally were extraordinary to watch. Our favoured Coppock indicator hook-turned from deeply oversold levels in December, confirming the up thrust.

Disciples of *WD Gann's* work will not have missed the near perfect price and time balance of the rally. The duration of the sell-off (21 September-26 December 2018) virtually squares with the rally time from Dec 26 to today. It is also approaching a 100% retracement in price. Extraordinary stuff and should be monitored as such price/time squaring's often indicate momentary turning points in markets.

The **NYSE Composite** (index of ALL NYSE listed stocks) offers a slightly more measured view of the market. This benchmark did not manage to better the January 2018 highs in September quarter and a resistance line from this level sits menacingly close to today's price action. A closure through this line would be positive for the market and confirm further upside.

The **Nasdaq Composite** and the **Nasdaq 100** are currently perched close to their all-time highs. Constructive behaviour here is now critical. I would draw readers attention to the substantial short position amassed in the Nasdaq 100 futures- 8:1 short at present. It will be interesting to see how this resolves itself one way or the other.

TD Ameritrade's (US on line broker) *Investor Movement Index*, indicates languid retail investor interest in the current market-ammunition for an extending rally.

Now all that remains is a test and valid break of the September high to signal the next up leg of the market.

Closer to home, the **ASX200** has delivered a technically sound performance. It held and bounced from an important intersection of support from March 2009 and resistance from November 2007 during the Dec quarter rout. Clearing the August 2018 high of 6373 would put the benchmark into open water and on course for a test of 6852-our markets all-time high.

Pressure is building with the **ASX Small Ordinaries Index** chart as resource stocks beg a move upward whilst the industrials positive momentum continues. An upside break appears inevitable and possibly within weeks. Interestingly, the Small Ords v ASX100 relative performance chart ticked positive (small caps outperforming) in January and further heavy lifting would see support for small caps confirmed and likely to continue.

Small cap breadth (No of stocks trading above their 100 day m.a.) continues to track in the right direction, with 70% above at the time of writing. Note, immediately prior to the Boxing Day lift off, this number was a derisory 23%

Gold/Currencies

Bullion price action continues to congest and today trades a notch above an important support line out from September 2001. North American gold equities are configured constructively and appear to be working through a significant long term base at present.

The **US Dollar Index (DXY**) is sticky downwards and is not excessively long (COT reports Longs/shorts at 2.8:1) so the unit can comfortably move higher from here.

The **AUDUSD** is feeling stale with shorts outnumbering longs 3:1 (in line with the December quarter positioning) and not so extended that a violent rally might ensue.

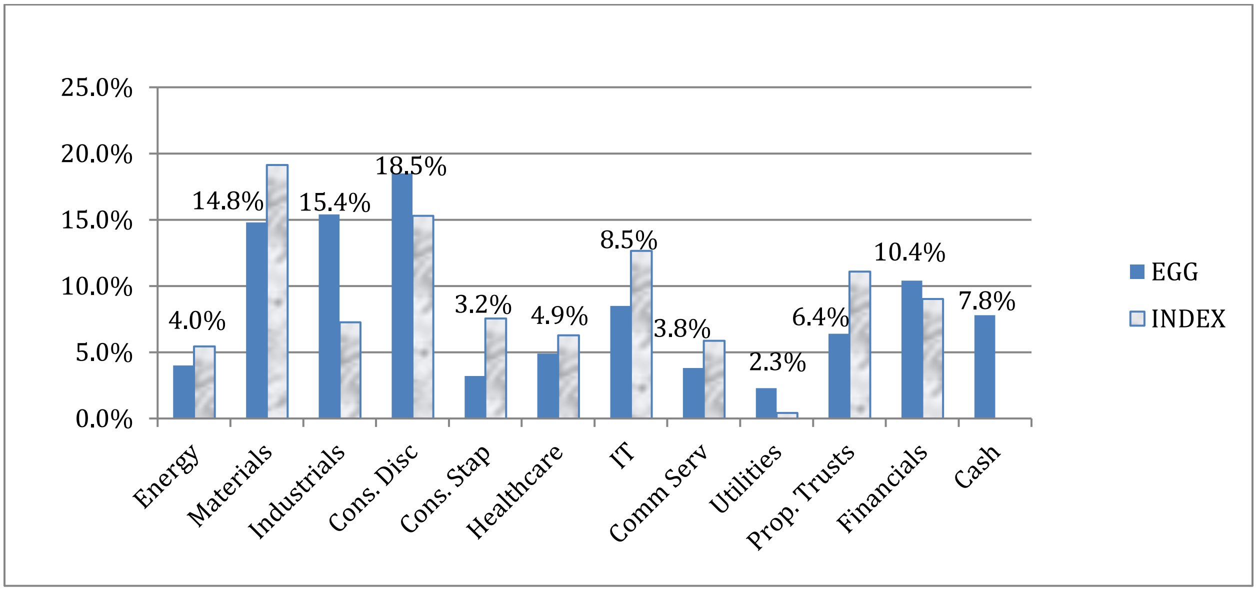
Interesting to observe the price of **Bitcoin** is higher by 60% from its December 2018 low. If nothing else this indicates speculative interest is once again lively.

Oil

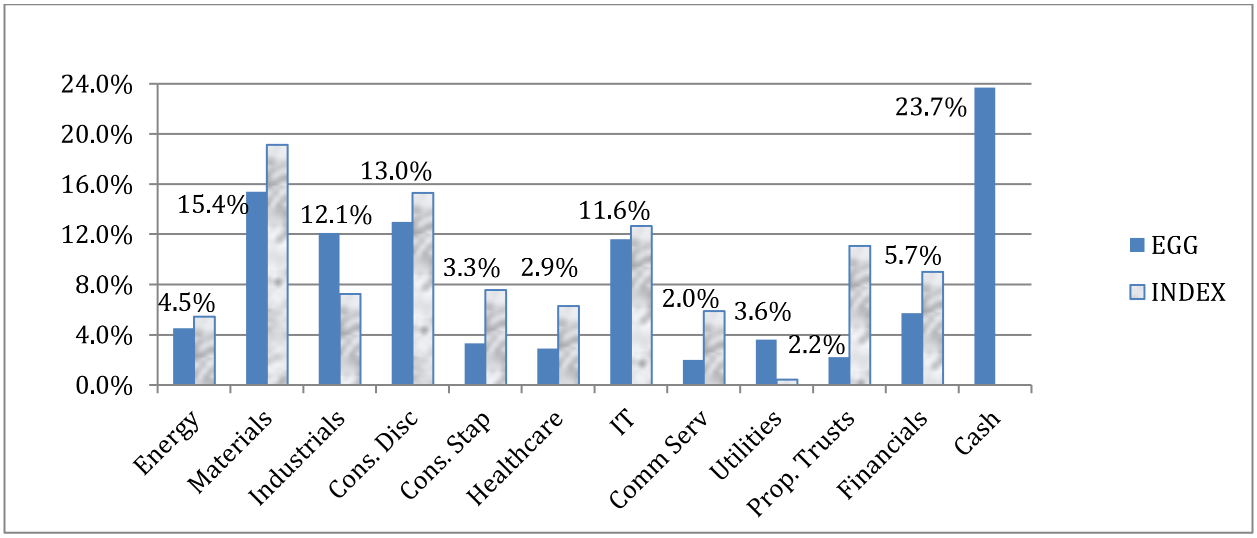
Crude continued to grind higher, recovering the neat trend channel lost during the December quarter rout. Oil has had every opportunity to fail convincingly and it simply has shown no inclination to do so. Naturally this is bullish. The latest Commitment of Traders report (COT) from the CFTC suggests traders are positioned for the bull case (5.4:1 Long/short) so not optimal when shoring up a case for higher prices.

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 **Nearmap**, **Cleanaway Waste Management** and **Afterpay Touch Group**. Our positions in **IMF Bentham** and **Navigator Global Investments** detracted from performance. In the

Emerging Companies Fund (ECF), positions in **Nearmap** and **Galena Mining** contributed to the portfolio. **Helloworld Travel** and **Paladin Energy** dragged on the portfolio.

SCF Top 5 Stocks	ECF Top 5 Stocks
Saracen Mineral Holdings Limited	**Alliance Aviation Services Limited**
Cleanaway Waste Management Limited	**Noni B Limited**
IRESS Limited	**Synlait Milk Limited**
Afterpay Touch Group Limited	**Stanmore Coal Limited**
Ebos Group Limited	**Aurelia Metals Limited**

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

Your manager initiated a position in childcare REIT, **Charterhall Education (CQE**) during the period in review. The group own a sizable portfolio of childcare centres throughout SE Australia. The sector is in the throws of a recovery from a multi-year supply/demand imbalance that has heavily impacted the profitability of operators. CQE has proven adept in managing the cycle lows with essentially full occupancy of its portfolio, static earnings per unit and modest growth in distributions. Management are inherently conservative and announced several acquisitions in March, coincident with a $120m equity raising.

EGG recently returned to the **InvoCare** register. The company reported a marginally better than expected CY18 result in the face of what has been a tough operating environment, including not insignificant disruption to the groups asset portfolio as the company progresses its Protect-and-Grow refurbishment programme. Management expect the number of deaths in FY19 to increase, following a fall in the death rate in FY18. The company enjoyed better trading in its Australian funeral business in Q42018 and into January 2019, so signs of normalisation are at hand. History has shown that a year of lower deaths versus the pcp (two consecutive years is rare and the volume recovery from negative years is pronounced) has resulted in share price underperformance and an attractive medium term buy set up.

When combined with the benefits accruing from Protect-and –Grow (35% of footprint complete and trading inline or above expectations) and the unfolding regional acquisition and greenfield strategy the stock feels sufficiently de-risked to be added to the portfolio.

The investment thesis for a position in **Ruralco** centred around a belief that the rural economy was approaching a low point and that a 10x PE for forecast 8% eps growth p.a. for the next 3 years would screen favourably. The EBITDA bridge to $74m (from ~$70m) for FY19 was an easy get and a constructive AGM update confirmed as much. A bid from agri-giant Nutrien within weeks of purchase surprised, with EGG believing Elders to be the natural acquirer at some point.

A recent addition to the portfolio was capital markets and wealth management software player GBST. Over 18mnths and ~35% into a major investment cycle to re-platform the core architecture of its legacy wealth management system - Composer, green shoots were starting to emerge in February 2019. After a false start with a 3rd party, GBST came clean to the market in August 2017 and flagged a $50mil investment over 3 years was required to ensure the sustainability of its wealth business.

Fast forward to February 1H19 results and green shoots were beginning to emerge. A new client in Canada Life had been won on the premise of what the new version of the wealth management software (‘Composer’) might look like when the investment phase had finished. Concurrently it appears the legacy Australian capital markets business had turned the corner with clients now willing to consider technology upgrades.

With the strategic R&D spend still on budget, albeit only just over a 1/3 done, the market began to give management the benefit of the doubt that guidance would be achieved.

Concurrently it’s Australian listed UK peer Bravura, had benefited in the past 2 years from **GBST**’s misfortunes winning new platform business in the UK. With currency in its own stock, and looking for the next leg of growth, it lobbed an opportunistic bid for GBST last week @ $2.50, valuing the business at just over 1.7x EV/Sales. With the board recommending no action, and earnings only just emerging from the trough, it appears the auction may only just be beginning.

Your manager accepted BGH Capital’s $5.825 bid for our holding in Navitas.

Outlook

The path forward for equity markets will be dictated by a number of cross currents that your manager is well prepared for.

April is a seasonally strong month for equities, historically the best performer in any given year.

The highly publicized (and over-analysed) US yield curve flattening process, and subsequent inversion between 10 year bonds and 3 month treasuries, has likely played on the minds of investors. Despite its reliability over time as an indicator of recession, the inversion's transience (< 24 hours) has ushered in dismissals of its validity from all corners rather quickly!

Irrespective of the debate about the onset of recession, remember equity markets customarily enjoy robust trading in the aftermath of an inversion. The inversion that occurred in September 1998 saw the market peak in March 2000 and the one in January 2006 saw the market top in November 2007 (before the GFC cataclysm). Both enjoyed substantial lead-up rallies.

Despite the outsized rally in stocks, equity risk premiums (4.8% in the US and 7.4% in Australia) continue to convincingly support the case for equities over bonds. A substantial margin of safety exists here for investors. Further, the Fed's late March change of heart saw the 9 member committee decide to play it safe-no rate hikes in 2019 (previously 2 expected) and 1 in 2020, with further balance sheet run-off to stop by September 2019. This is unequivocally supportive of equities.

A recent visit to China by EGG analyst's reports sightings of economic 'green shoots' in response to fiscal and monetary accommodation from the central government and its instrumentalities. There is a growing confidence that a US-Sino trade deal is at an advanced stage and likely to be consummated pre June 30 but there is the risk that it underwhelms given heightened expectations. The Shanghai Composite Index has been a significant outperformer through 2019, correctly anticipating an improving outlook for the China economy.

Offsetting these developments, US corporates are currently reporting their Q1 earnings. Companies will

be cycling a challenging comparative period and also a 3 month period of restrained economic activity. Outlook commentaries will be closely scrutinised for clues on how the US profit cycle is shaping up for

2019, where expectations range from 0-6% profit growth versus ~22% booked in 2018.

The first major US IPO of the calendar year, ridesharing provider, Lyft Inc, disappointed all by finishing its first week of trade down 20%. Uber is not far away, nor is Pinterest and AirBNB amongst other's prepping for IPO. A series of high profile but poorly performing floats would not be helpful to market sentiment.

The looming Federal election and change of stewardship will generate headlines but do little to derail a local stockmarket that is intent on tracking higher. It is however important that Wall Street's September 2018 highs do not curtail the vigorous but maturing US secular bull market.

Eley Griffiths Group Ratings

Small Companies Fund

Lonsec	Recommended	Zenith	Recommended
February 2019	2nd Highest Rating	February 2019	2nd Highest Rating

Emerging Companies Fund

Lonsec	Highly Recommended	Zenith	Recommended
February 2019	Highest Rating	February 2019	2nd Highest Rating

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