

Clime Smaller Companies
Monthly Investment Report
January 2019



Funds Update

Global markets staged a strong rebound during January, recovering a good part of the losses incurred in the last quarter of 2018. World financial markets have been volatile since peaking last September, with three main concerns:

- Tightening US monetary policy,
- President Trump's trade wars, and
- China's economic slowdown.

The US Federal Reserve (the Fed) has been on a well-articulated path of "normalizing" rates following strong economic growth. The most recent rate increase in December was anticipated, but the big question for markets was this: Will the Fed continue on the rate rise path, or pause and wait to see how the economy responds to earlier actions? The answer was delivered in the Fed's January Statement as follows:

"In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate."

While questions remain whether the Fed will apply the right balance between ensuring the US economy continues to grow, and tapping the brakes to protect against the return of inflation, markets have been reassured that Fed Chairman Powell is alert to the risks of "over-shooting" with its rate rises. There is a good chance the Fed will do whatever is needed to maintain steady growth, albeit a bit slower than in 2018.

President Trump's trade measures have been the subject of much discussion, but not all that much has actually happened so far: skirmishes with Canada, Mexico and, mostly, China rather than full-out trade war. The IMF has estimated that to date, announced actions might take around half a percent off growth in the US and China, but these measures have not yet been implemented. The threatened increase in US tariffs on \$200 billion of imports from China, from 10% to 25%, has not yet occurred. It is possible that a deal with China may still be negotiated. Certainly it is difficult to imagine why Xi Jinping and Donald Trump would not want to put this battle behind them.

There are legitimate concerns about China's economic slowdown. China has provided a third of global growth in recent decades. Debt levels in China are uncomfortably high. For decades, the dynamism of the private sector has offset inefficient state-owned enterprises, but this beneficial transition could be reversing under Xi. There are other imbalances which need correction, especially investment which remains unsustainably high.

Yet China has demonstrated resilience and capacity to correct imbalances, and further growth is likely albeit at more moderate rates. China has a superb track record

of managing even the most difficult challenges, and its "command economy" means that it is better able to manage its transition than most other economies.

In Australia, there can be few doubts that the domestic economy is slowing more sharply than expected. A range of data has weakened recently: retail sales have slowed; car sales slumped to a 6 year low; sentiment measures have fallen below average. Households are being forced to curb growth in spending as a result of weak income growth, and confidence has taken a beating from heightened volatility in financial markets and falling house prices. The forthcoming Federal election is certain to make matters even worse.

For the Reserve Bank of Australia (the RBA), the data comes on top of third quarter national accounts that already showed disappointing conditions across the consumer and confirms that the weakness appears to be ongoing. The RBA has left official rates steady at "emergency low levels" of 1.5% for two and a half years. Market expectations have been that the next move in rates would be an increase. But following recent economic weakness, including an acceleration in the fall in house prices across Sydney and Melbourne, it is now equally likely that the next move in rates will be a cut.

Much will hinge on the strength of the jobs market, with unemployment at 5%. Despite the low jobless rate, this has not translated into a significant lift in wages. Some measures of job advertisements have recently turned negative for the first time in three years. If the job market tightened, and inflation picked up, then rates would have to rise. But if the economy is softer than anticipated, and income and consumption growth disappoint, then the RBA would be forced to reassess the situation. At present, the probabilities are finely poised.

While global and local uncertainties remain, we continue to apply our rigorous investment process and retain cash buffers in portfolios to reduce risk and to fund new opportunities. We utilise volatile market conditions to selectively increase exposure to high quality companies when they are trading at attractive prices.

We expect global market volatility to continue for a while longer as asset markets adjust to an incrementally higher cost of money. And yet we are impressed with the range of investment opportunities still available for long term capital. Our view is that the market environment remains supportive of steady but not spectacular growth.

Thank you for your continued support of Clime.

Adrian Ezquerro
Chief Investment Officer

Clime Smaller Companies Fund

The Clime Smaller Companies Fund (CSCF) returned 0.3% (net of fees) during January. The monthly return came in below the major indices, which bounced strongly after a broad market correction in the December quarter.

In general, markets have been increasingly volatile in recent months, owing to the nexus of rising interest rates, elevated leverage, and global trade tensions. Locally, the Royal Commission into Financial Services has also affected risk appetite.

We continue to be disciplined in the application of our investment processes and are utilising more volatile market conditions to invest in what we believe are high quality investments, trading at attractive prices, where we believe risk taken is appropriately compensated.

Although the CSCF fell short of the Small Ordinaries in January, it is worth noting the Small Resources returned 8.1%. The CSCF avoids this sector altogether due to the lower quality and speculative nature of its constituents.

Navigator Global Investments (ASX:NGI) was a detractor during the month. As a result of reduced Assets Under Management on negative December quarter performance coupled with outflows, NGI guided FY19 EBITDA lower to US\$36 million, down from US\$38 million previously.

Despite the set-back we remain positive on the outlook. NGI is highly profitable and well-capitalised with a strong net cash balance sheet. We also hold management in high regard, and remain confident in their ability to deliver growth over the medium to long-term.

Key contributors were Citadel (ASX:CGL) and Jumbo Interactive (ASX:JIN). In early December Jumbo upgraded full-year guidance by 28% to over \$20 million, on the back of a strong run of Jackpots, including a record \$100 million Powerball prize. Positively, the second half kicked off with another \$100 million Powerball Jackpot in January.

Distributions

| Period Ending | Wholesale Units (cents per unit) |
|------------------------------------|----------------------------------|
| 30 June 2018 | 4.3495 |
| 30 June 2017 (Inception 24/4/2017) | 0.1372 |

Snapshot

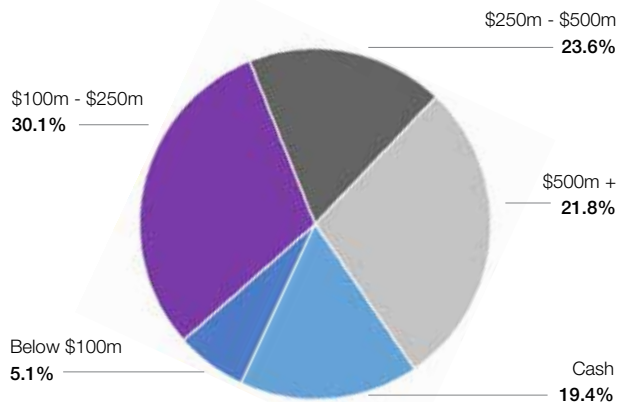
| Portfolio Return (Month) | Portfolio Return (1 Year) | Portfolio Return (Since Inception) | Fund Size |
|--------------------------|---------------------------|------------------------------------|-----------|
| 0.31% | 0.68% | 11.6% p.a. | \$25.7m |

Performance (31/01/19)

| | 1 month | 3 months | 6 months | FYTD | 1 year | Inception* | Inception (Total) |
|------------------|---------|----------|----------|--------|--------|------------|-------------------|
| Portfolio Return | 0.31% | -4.15% | -4.25% | -3.28% | 0.68% | 11.56% | 21.32% |
| Fund Objective ^ | 0.81% | 2.40% | 4.86% | 5.70% | 9.89% | 9.88% | 18.15% |

* Inception: Wholesale Units: 24 April 2017. Performance figures for more than 1 year are annualised, calculated after all applicable fees and taxes. Returns have been calculated based on starting and ending unit prices after taking into account all ongoing fees, and assuming reinvestment of distributions. ^ CPI + 8% p.a. including GST.

Asset Allocation by Market Capitalisation



Prominent Fund Holdings (alphabetical order)

| |
|--|
| Citadel Group Ltd (ASX: CGL) |
| Hansen Technologies Ltd (ASX: HSN) |
| Jumbo Interactive Ltd (ASX: JIN) |
| Macquarie Telecom Group Ltd (ASX: MAQ) |
| Lycopodium Ltd (ASX: LYL) |