



Clime Smaller Companies Monthly Investment Report February 2019



Funds Update

Markets often behave in rather unpredictable ways – more so when the economic backdrop and outlook are difficult to pick. Today commentators are questioning, are we coming to the end of the long growth cycle? Are inflationary pressures starting to emerge? Is the risk of recession increasing?

It is our view that the world has entered a long cycle punctuated by moderate growth periods followed by moderate downturns. Excessive monetary stimulus has taken the world towards a Japanese-like cycle. That is a cycle where the world economy neither overheats nor contracts abruptly.

During the month of February, the global sharemarket index (MSCI ex Australia) was up a strong +3.1%. The Australian sharemarket rose +5.2% (S&P/ASX200), with financials delivering a total return of 8.1% following the release of the Royal Commission report earlier in the month. Offshore, the US was up almost 3% (S&P 500) while China's CSI 300 index rose almost 15% (buoyed by the hopes of a trade deal).

More impressive has been the recovery in the S&P 500 which has gained 16% over the nine weeks to end February. Since its December low, the ASX/S&P 200 was up 13% to the end of February. The strong rebound in markets coincided with a swift pivot from the US Federal Reserve in January. Dovish tones emanating from the Fed rippled across markets; bond yields have drifted lower while equity markets factored in a 'lower for longer' scenario once more.

Not surprisingly, the VIX index, the so-called fear gauge for equities, declined steadily in the first two months of 2019, falling to its lowest reading for four months at the end of February, suggesting that there is little to worry about. But we should not be complacent: there are signs of an increased risk of recession over the next couple of years, particularly in the US. In fact, more than 75% of business economists surveyed by Bloomberg in February expect the US to enter a recession by the end of 2021.

If there is a recession in 2021, and it remains a big "if", that is still some time away and will be well factored into markets if it does occur. Central banks will have prepared themselves to support their economies.

Today there are clear signs of a slowing down in economic momentum, virtually across the globe. Despite Presidents Trump and Xi Jinping postponing the trade war for the moment, one can't hide from the facts. In the US, business conditions declined in the February Philadelphia Fed Survey. In the last month, German manufacturing shrank the most in six years, Italy is in recession, Japan's factory sector contracted for the first time in three years, and South Korean exports have tumbled.

Chinese data show an economy beset with structural headwinds. China has struggled to contain a slowdown even as policy makers ramp up their stimulus measures to fire up growth. Much will depend on how durable the trade truce is, given the breadth of concerns that the US has regarding China's industrial and economic policies. And this

issue will survive Trump – concern with China's trade practices is now bipartisan policy within the US establishment.

Against this somewhat sober background, during February, it was "risk on" for equity investors with rising equity markets, even though global growth is pausing. The stockmarket saying "don't fight the Fed" is showing its value once again. It is a case of bad news is now good news; weaker economic readings mean easier monetary policies and that keeps financial conditions loose.

We are reminded that most expansions don't die of old age, they are killed by aggressive monetary tightening. If aggressive tightening is off the table, recession fears may well be overblown. Of course, the irony is that should strong economic growth re-emerge, it would increase the chances of a Fed rate hike, tightening liquidity and potentially triggering corrections in asset prices, and a return to volatility.

Australian company earnings update

We are through the Australian company reporting season, which has broadly been in line with expectations that were lowered in the "confession season" in the months leading up to February.

Guidance has generally been slightly negative. Sixty percent of changes to forecast earnings have been down, which is the largest downgrade cycle for some years. Aggregate market EPS growth figures for FY2019 have been cut and now stand at +3-4%, with the increase driven by upgrades in the resources sector. Dividends have been a little disappointing. Key themes of the reporting season included commentary around cost pressures, anaemic revenue growth, limited expansion opportunities, and a consumer squeezed by tight credit conditions and a declining housing market.

Being an open economy, what happens in the rest of the world is of vital importance to the domestic economy – and that relates to credit conditions and interest rates, currency movements and commodity prices. Perhaps the paramount issue of broad concern in Australia this year will be whether the housing downturn deepens and causes a recession (it would be the first in 28 years).

A technical recession is defined by two consecutive quarters of negative economic growth. In 2008, with the onset of the GFC, Australia managed (only just) to avoid two consecutive quarters of negative growth. Seasonally adjusted, GDP contracted by -0.5% in the December 2008 quarter following the September 2008 Quarter GDP figure which saw the economy grow at a rate of just +0.1%. Over the year to December 2008, GDP rose by +0.3%, the weakest annual rate since the 1991 recession.

The factors requiring ongoing scrutiny include homebuyer sentiment (reflected in auction clearance rates), bank lending rates (new loan approvals), business and consumer confidence (both are relatively weak and likely to weaken further in the run-up to the

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Federal election), dwelling and construction activity, and, importantly, the labour market. The unemployment rate is 5.0% and closely watched by the RBA. It reached just 4.0% prior to the GFC in February 2008, and has averaged 6.85% from 1978 until 2019. Whether the unemployment rate has found its base and starts rising from here will be highly significant for investor sentiment.

We continued to take advantage of volatile markets over the past few weeks. In doing so, the portfolio has been incrementally repositioned to provide an improved balance of growth and sustainable income. As prices for select securities have approached or exceeded value, we have reduced exposure. Concurrently, we have also acted to deploy capital into other favoured high conviction positions at attractive prices. We retain somewhat elevated cash levels in the portfolio, thus providing “fire-power” for further purchases when opportunity becomes increasingly apparent.

When investing in the markets and the weight of evidence is pointing in one direction, it makes sense to be aggressive and take advantage of clear trends while they're intact. However, when conditions shift and the outlook becomes uncertain, a more neutral approach is appropriate. There are several ways to express a shift in bias from bullish to neutral, including being less aggressive in one's asset allocation, buying downside protection, over-weighting defensive stocks versus cyclicals, and so on. One of the simplest ways is to raise cash and retain a moderately high balance, which is how our portfolios are currently positioned.

Thank you for your continued support of Clime.

Adrian Ezquerro
Chief Investment Officer

Clime Smaller Companies Fund

The Clime Smaller Companies Fund (CSCF) returned 4.1% (net of fees) for February. This was broadly in line with major indices, which have rallied strongly to start the calendar year. Whilst it has been a solid period, we remain measured in our expectations and well-resourced to take advantage of opportunities as and when they present.

Markets in general will likely remain relatively volatile against a backdrop of rising interest rates, elevated leverage, and global trade tensions. These factors will persist for the foreseeable future.

The main detractors for the month were HUB24 (HUB) and Citadel (CGL). Share price weakness provided opportunities to add to both positions. The market reacted negatively to HUB's higher than expected business investment in its 1H19 result. However, the investment is a reflection of the tangible opportunity for accelerated market share gains. CGL's headline growth for 1H19 underwhelmed, however, the revenue mix is improving due to an increasing contribution from its fast-growing Software/SaaS business.

Key contributors were:

- Jumbo Interactive - JIN upgraded guidance for the second time this financial year on the back of a strong run of lottery jackpots. We expect operating momentum to continue over the second half. Management also pointed to a special dividend.
- Audinate - AD8 beat expectations with 51% growth in sales during 1H19 and appears to be at a tipping point with demand for its audio-visual networking technology set to accelerate from here.
- Bravura - BVS had a strong half with revenues up 24% driven by demand for its industry-leading Wealth Management administration system, Sonata. We expect growth to be sustained over the medium term as financial institutions seek to modernise and unify their software solutions.
- Afterpay Touch - APT has made a very strong start in the US and appears to be on track to replicate its Australian business. In just 10 months, APT has reached 1 million users in the US, which should enhance its prospects of signing further major retailers. Although still early in international adventure, the network effect could be taking hold once more.

Distributions

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

Snapshot

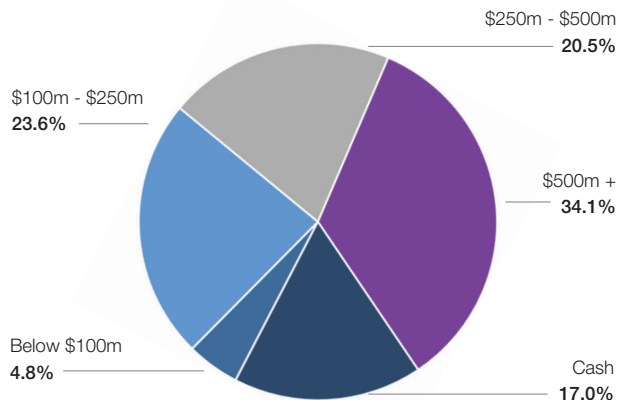
Portfolio Return (Month)	Portfolio Return (1 Year)	Portfolio Return (Since Inception)	Fund Size
4.08%	5.72%	13.6% p.a.	\$27.0m

Performance (28/02/19)

	1 month	3 months	6 months	FYTD	1 year	Inception*	Inception (Total)
Portfolio Return	4.08%	-0.82%	-5.74%	0.67%	5.62%	13.46%	26.39%
Fund Objective [^]	0.72%	2.34%	4.77%	6.46%	9.88%	9.88%	19.01%

* 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)

	Audinate Group Ltd (ASX: AD8)
	Citadel Group Ltd (ASX: CGL)
	Jumbo Interactive Ltd (ASX: JIN)
	Macquarie Telecom Group Ltd (ASX: MAQ)
	Lycopodium Ltd (ASX: LYL)