The Encyclical
December Quarter 2021

ELEY GRIFFITHS GROUP

TO OUR UNIT HOLDERS

Our Fund's Performance (after fees) to 31 December 2021

Returns post fees	1 Month %	3 Months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Incep^ % p.a.
EGG Small Companies Fund	2.25	4.37	21.72	16.45	11.87	11.96	11.51
S&P/ASX Small Ord Accumulation Index (XSOAI)	1.41	2.03	16.90	15.71	11.17	7.98	7.19
Outperformance	**+0.84**	**+2.34**	**+4.82**	**+0.74**	**+0.70**	**+3.98**	**+4.32**

Returns post fees	1 Month %	3 Months %	1 Year %	2 years % p.a.	3 years % p.a.	4 years % p.a.	Incep^ %p.a.
EGG Emerging Companies Fund	0.97	7.33	34.23	26.38	29.09	21.64	24.78
S&P/ASX Small Ord Accumulation Index (XSOAI)	1.41	2.03	16.90	12.99	15.71	9.07	11.85
Outperformance	**-0.44**	**+5.30**	**+17.33**	**+13.39**	**+13.38**	**+12.57**	**+12.93**

**Inception September 2003*
^Inception March 2017

Market Review & Strategy

For the quarter the Eley Griffiths Group Small Companies Fund and Emerging Companies Fund finished +4.37% and +7.33% respectively versus the Small Ordinaries Accumulation Index of +2.03%.

December closed off a calendar year variously described as a year of the risk asset. Developed market stock indices, commodities, hard (excluding precious metals) and soft, cryptocurrencies and carbon prices all performed strongly.

2021 was a year where the S&P500 posted 70 record highs (2nd most in a year since 1928) and a period that the Bloomberg US Aggregate Bond Index would notch up only its 4th negative total return year since 1976.

The quarter enjoyed an orderly advance in global share prices, unperturbed by a dramatic widening in US credit spreads unfolding through the period. The TED spread moved from 20.2bps to 45bps and the BBB/Baa-UST10 from 7bps to 120bps.

Two episodes would however give rise to ephemeral investor concerns and modest index retracements. The first in late November being uncertainty surrounding the omicron variant and its effects on reviving consumer spirits. This angst would be compounded by FOMC chairman Powell, cautioning that the risks of higher inflation have increased and that a faster taper (of bond buying) was now on. The second, being the release of the FOMC minutes on December 15 which confirmed a hawkish policy pivot and disclosed a precise plan of action including a sooner/faster taper and a script for 3 rate hikes in CY22, 3 in CY23 and 2 in CY24.

The equity call on the local market accelerated through the quarter in both large and small caps. **CSL** announced it was raising $6.3bn- Australia's largest ever equity raising when the various **Telstra** IPO's are excluded. **Aristocrat** raised $1.3bn and myriad small/emerging companies joined the jollo, raising funds for asset acquisition, working capital or opportunistic re-charging of balance sheets. Attractive deals met with solid support eg **Playside Studios, Life 360** and **MA Financial Group**-all current EGG investments.

The success of initial public offerings (IPO's) were less predictable with investors becoming increasingly selective as to the deals they would subscribe to. Through the quarter the list of cancelled IPO's grew, the after-market support for completed deals withered and only a handful managed to trade above issue price for any length of time.

Interesting to note that Wall Street was afflicted by an apathetic IPO market too, with the Renaissance IPO ETF finishing the year -12% versus the S&P500 +26.9%. The much vilified SPAC sector still managed to raise US$12bn during the quarter, twice the clip of the prior three months.

The year long momentum in corporate activity endured through the three months to December end. **Woolworths** bid for **API** (since withdrawn) following **Wesfarmers** earlier approach, **Hub24** bid for **Class Limited** whilst **Netwealth** swung at **Praemium**. **Home Consortium** bid for **Aventus Property Group**, **Swick** proposed a merger with **DDH1** as did **Tourism Holdings** (NZ) with **Apollo Tourism & Leisure**. Korean giant **Posco** bid for **Senex** and BGH Capital moved on **Virtus Health**.

The annual general meeting season (October through November) was largely uneventful and in the main concluded without incident.

Technical Summary

Stocks/Bonds

Market internals in late December provided early warning of a pause in the advancing **S&P500** price action. Bearish divergence between the *Williams % R stochastic* and firming prices presaged the sharp correction in the S&P500 in the opening two weeks of the year. The *McClellan Oscillator*, a gauge of advancing versus declining names, highlighted declining stock momentum and moved to the threshold of a sell recommendation. These indications are significant as they align with faltering price action around the market's primary uptrend- a support line projected from the March 2020 lows.

Counter to these forbidding observations is the recent AAII survey highlighting an above average bearish 6 month view of markets from respondents and continuing neutral trader positioning in S&P 500 E-mini's futures contracts (1.4:1 long at quarter end v 1.2:1 at June and September quarter ends). Whilst positioning is not precarious and sentiment remains downbeat further short term softness in stock prices should not be ruled out.

The **S&P/ASX 200** sits hidebound in a consolidation that commenced in June 2021, with 7620/30 capping the upside and 7170 guarding the downside. This rectangle structure needs to be watched carefully as it will yield a powerful move one way or the other when it breaks clear. The longer it persists the more potent the move. Not surprisingly, the **S&P/All Ordinaries** tells the same story. A waiting game for local investors.

The **Small Ordinaries Index** has also opted to consolidate its advance, having not long ago received the most powerful Coppock buy signal (on December 7) since the 'çovid' lows of March 2020. 3600 has proven resolute to rallies since August. In fact, this level has offered resistance since 2007 and continues to do so today. It is worth spending a minute on the Small Ordinaries primary sub-sectors, resources and industrials.

The **Small Resources Index** appears to have completed a long-term basing in price, where the first leg of an unfolding bull market will complete at ~3908. Expect congestion here ahead of the next move to 5130 (NB the failed quarterly key reversal in the **ASX300 Metals & Mining index** in September indicates aggressive accumulation and is unequivocally bullish for resource names in aggregate).

The Small Industrials Index stalled at the all-time high around 3810/30 of June 2007 and is begging a retest of the primary uptrend at 3300 ahead of trend resumption.

Commodities/Currencies

I guess the most reassuring thing one could say about the **Gold** price is how well it has behaved in the face of a strong US dollar. Bulls will focus on the long-term price chart that confirms a valid uptrend being in place. Downside price action seems to be checked from here with support at US$1760/65/oz providing a safety net of sorts for any price slippage. Whilst speculative positioning, at 3.3:1 long is not the ideal precursor to a kick in prices, perhaps the pending direction of the US dollar provides the clue.

A closer analysis of the **US Dollar index** makes for interesting reading. The unit has been consolidating within a rectangle since mid November, 96.90 on the upper bound and 95.50 at the lower. The most recent Commitment of Traders Report details 5.5:1 long positioning for the contract, up from 3.5:1 at September end. This is now a very crowded trade. One market maxim I have learnt over the years is that rising open interest within consolidation patterns is unmistakably bearish (and falling is bullish). Given this is precisely what is playing out in the US Dollar Index futures market at present, we may have a 'blue-flame special' here and fuel for a gold price rally.

For the true believers, **Silver** is starting to look interesting on a long-term chart set up. Recent price action has been somewhat erratic but price holding support at US$21.42/oz on retest and a bullish Coppock turn recently are constructive developments. Silver is capable of big moves when the technicals line up.

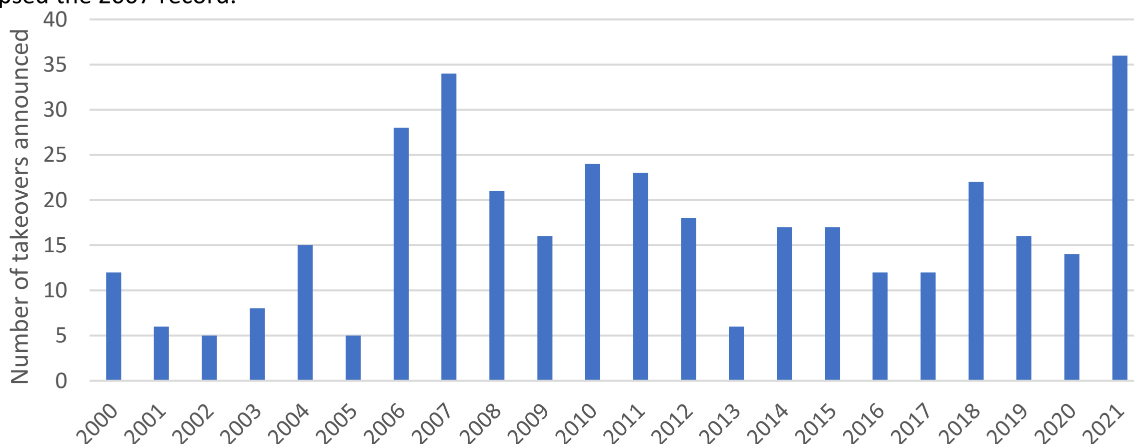
Brent crude closed out the quarter more or less where it started the period – US$78/bbl but only after volatile trading took it to US$86.70 and then into a precipitous move to US$65.70/bbl. The leg down to US$65.70 took it out of its textbook uptrend channel that has guided oil faithfully since March 2020. The rally since quarter end has restored Brent to its channel. Traders should look to Brent's long term chart to be reminded of the significance of the current rally. The bear market that commenced in 2008 is in the process of being extinguished. A close above US$86.70/bbl will be vital to confirm the next stage of the advance to oil's old highs.

The Log

The Log is a new addition to The Encyclical and aims to share different perspectives from the team at Eley Griffiths Group. Last quarter, we looked at how we incorporate the principles of Environmental, Social and Governance (or ESG) analysis to our investment process. In this edition of The Log, we look at mergers and acquisitions and specifically, how likely proposed takeovers are to succeed.

A hot year for Mergers and Acquisitions (M&A)

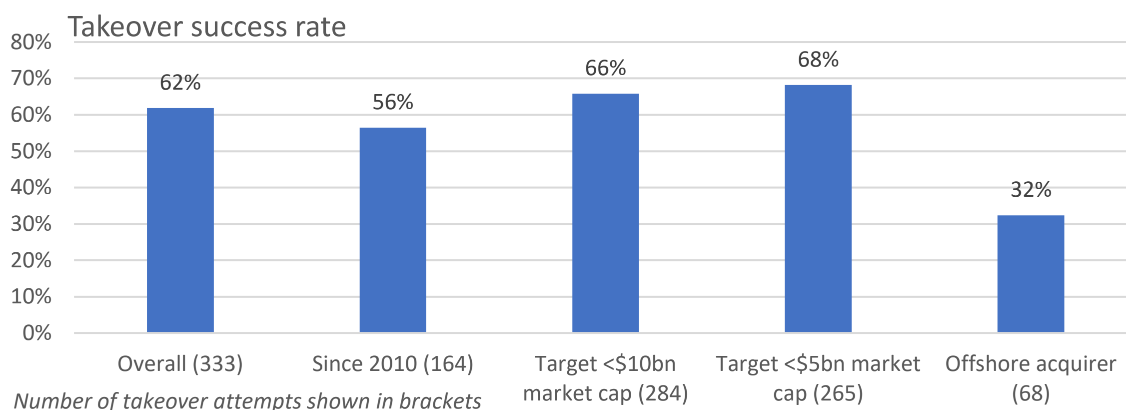
2021 was a hot year for M&A activity as markets continued their COVID recovery and access to debt and equity capital increased. According to data from UBS, the number of takeovers announced where the target's EV was greater than USD 250m, eclipsed the 2007 record.



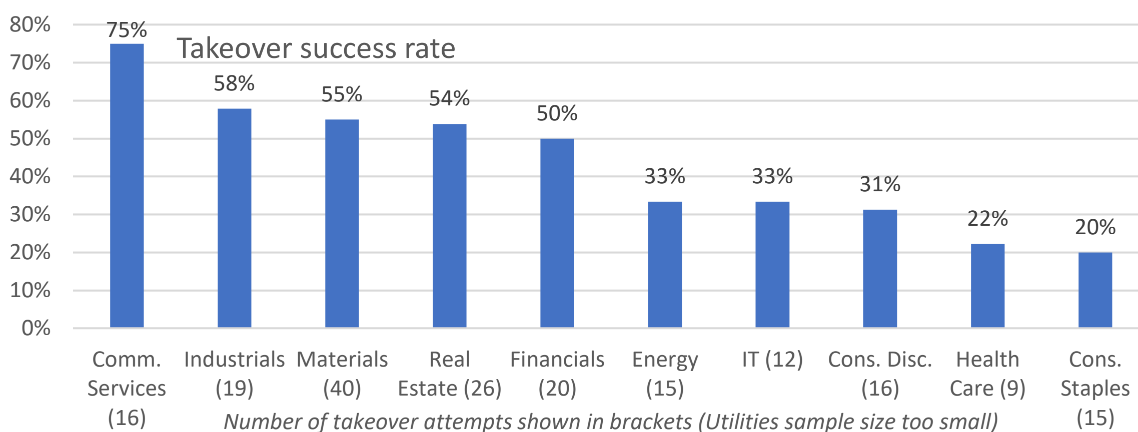
Overcoming uncertainty with takeover statistics

Typically, shareholders of the target company enjoy a takeover premium in the order of 30% but proposed takeovers can fall through, and target companies tend to trade at a discount to the takeover price until the takeover completes, sometimes several months after the initial announcement. This uncertainty creates a conundrum for portfolio managers as to whether to hold a position in a target during the takeover period or not.

So we set out to answer: 1) what percentage of proposed takeovers succeed? and 2) are there any common characteristics that mean a takeover is more or less likely to succeed?



The figure above shows takeover success rates for different groups of takeover attempts in the ASX 300, using data from Bloomberg since the late 90s. Perhaps most surprising, is that only 62% of takeovers have been successfully completed. Since 2010, the success rate has been even lower at 56%. The data also shows that takeovers of smaller companies have been more likely to succeed and that takeovers by an offshore acquirer have been less likely to succeed, possibly due to regulatory hurdles.



The next figure above shows the sector with the highest takeover success rate has been Communication Services, where takeovers have succeeded 75% of the time. The sector with the lowest takeover success rate has been Consumer Staples, where takeovers have succeeded only 20% of the time.

Bringing it all together

The key takeaway is that a position in the target could be reduced in the period after the takeover announcement, depending on the share price relative to the takeover price and the nature of takeover. Holding a larger position in the target makes more sense when the target is small, the acquirer is not based offshore and the target is in the Communication Services, or to a lesser extent the Industrials or Materials sectors. Takeovers where the targets are in the Consumer Staples and Health Care sectors have had lower success rates.

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Outlook

"*In economics, things take longer to happen than you think and then they happen faster than you thought they could*" Rudiger Dornbusch

It seems that 2022 is already presenting more than the usual number of variables for investors to weigh and position for. Financial markets will adapt to the progressive removal of liquidity either via the Feds quantitative tightening or the reality that recovering real economies naturally absorb excess liquidity, previously diverted to risk assets. Participants should ready for a dial up in asset volatility in 2022.

Markets are now well into the teeth of the Fed pivot with an imminent cessation of bond purchases and the commencement of a hiking campaign, possibly as soon as March. There remains the risk that the Feds inflation containment actions are too slow with a campaign for more and quicker hikes than equity investors will be prepared to entertain. Under 'normal' circumstances stock markets perform well during tightening regimes but these are far from normal times.

James Bullard, President of the Fed Reserve Bank of St Louis, in recent days upped his call for 4 hikes from 3 for 2022. Even with rising disquiet around rates it is heartening that current equity risk premiums for both US and Australian stock markets continue to offer a nice buffer to equities positions in preference to bonds.

Eley Griffiths Group remain in the camp that the yield curve 'bear steepener' playing out currently, supporting cyclical and resource names, will persist through the June quarter. Thenceforth, a yield curve 'bear flattener' will ensue in accord with reduced inflationary expectations, a levelling off in earnings and a flight to structural growth/quality stocks.

The wildcard for US corporate earnings is how lasting and damaging global supply chain disruptions and labour market distortions will be on toplines and operating margins as an outworking of the omicron variant. The imminent US Q4 reporting season will see decelerated earnings growth when compared to Q1-Q3 and ideally confirm that the markets 2022 consensus earnings growth rate of 10% is broadly attainable.

Locally, the Australian market will remain captive to offshore bond market machinations as well as our own omicron impacts with concomitant supply chain upheaval and current consumer withdrawal. Throw in a pending Federal election to keep things interesting

With this many variables plus a US mid-term election cycle in play, short term investor sentiment will remain fragile. It remains to be seen whether the reflexivity of earnings growth -> investor confidence/equity fund inflow -> higher share prices can persevere in 2022.

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