

# ASX Small Caps Systematic Monthly Performance Report



May 2019

## Performance Overview

The *Blue Orbit* Australian Small Caps Systematic strategy returned -1.31% during May, underperforming the benchmark S&P/ASX Small Ordinaries Accumulation index which returned -1.25%.

	Month	FYTD	1 Year	2 Years	Inception* (p.a.)
<b>Blue Orbit ASX Small Systematic (paper)</b>	-1.31%	3.07%	4.43%	-	15.31%
<b>S&amp;P/ASX Small Ordinaries</b>	-1.25%	1.00%	2.06%	-	11.93%
<b>Excess</b>	-0.05%	2.07%	2.37%		3.38%

\* Paper portfolio inception date of 31/08/2017, annualised returns.

\*\* All figures calculated using FactSet.

Global markets had a strong retreat in May. After reaching an all-time high at the end of April, the S&P 500 was down 6.8% (in USD) for the month. MSCI World Gross (AUD) fell 4.6%, almost exactly reversing April's gains, with the Australian dollar falling 1.6% against the US dollar.

In contrast, the Australian market was positive with the S&P/ASX 100 up 1.5% for the month. This was driven mostly by the mega caps, with only 4 stocks in the ASX20 posting a negative return. Unfortunately, these strong returns didn't flow through to smaller stocks, a trend reversal over April.

Within small caps, Consumer Staples (-8.2%) and Energy (-7.5%) fared poorly, while Utilities (+7.5%) and Communication Services (+4.5%) gave strong returns. The cross-section of stock returns was again quite large, with the standard deviation now above 12%, well above the long-term median level of around 7%. Rare earths miner Lynas Corp (+54%) and Lithium miner Kidman Resources (+45%) were the two best performing stocks following takeover announcements, both from Wesfarmers. The next best performer was Clinivel Pharmaceuticals (+44%). The worst performer was Costa Group (-30%), continuing its 12 month price re-rating after some production headwinds and strong price returns for several years beforehand. The next worst performers were Liquefied Natural Gas (-29%) and Class Ltd (-24%).

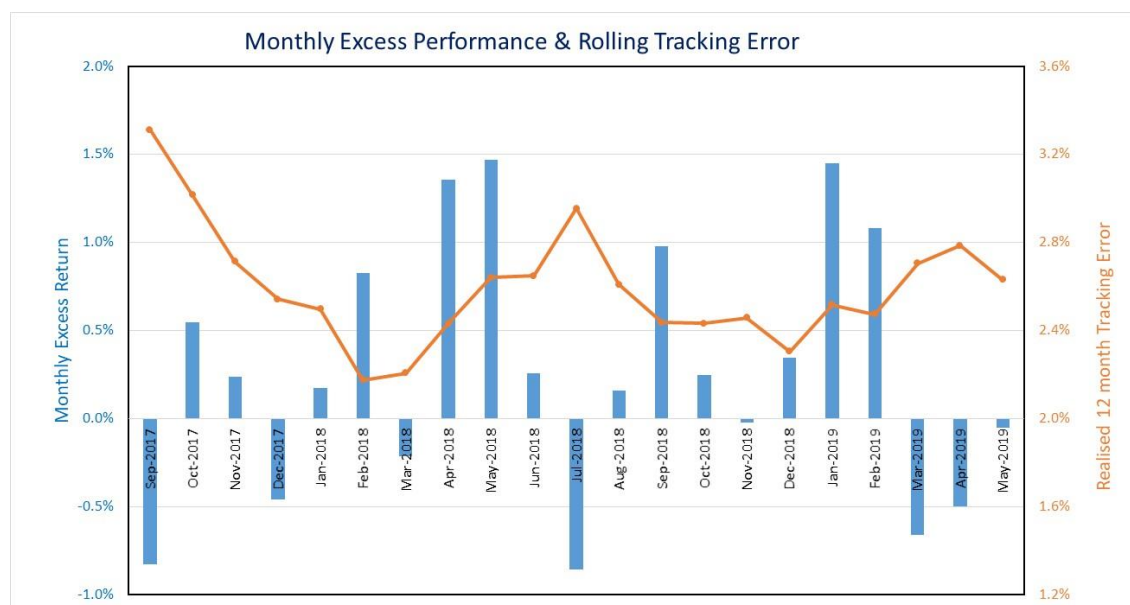


Figure 1

## Portfolio Characteristics As at 31 May 2019

Characteristic	Portfolio	Benchmark
# of Securities	86	197
Market Cap (M)	2,979	2,103
Active Share (%)	49.5	--
Dividend Yield	3.2	2.9
Price/Earnings	17.7	16.4
Price/Cash Flow	13.2	12.3
Price/Book	2.6	1.9
ROA	13.2	8.1
ROE	21.3	12.1
Beta	1.03	1.00

## Smart Beta Factor Attribution for May 2019

Smart Beta Factor	Return	Excess	24 month TE
Small Ords	-1.25%		
Franked Dividends	-0.90%	0.35%	4.10%
Free Cash Flow on Capital Employed	0.16%	1.41%	4.27%
Momentum/Low Volatility	-1.38%	-0.13%	3.00%
Smart Beta Basis Portfolio	-0.71%	0.54%	1.65%
Systematic (Model)	-1.31%	-0.05%	2.53%
Systematic (Live)	-	-	-

### Franked Dividends

The Franked Dividend smart beta portfolio generally outperforms when the Small Ords is down, and in May provided a modest outperformance of 35bp. Sector allocation added value for the month, with small gains across several sectors. Good stock selection added value in Industrials and Consumer Discretionary, but poor stock selection in Materials detracted value. An overweight position in CSR (+15.8%) and underweight to Altium (-12.5%) were the best contributors. Not holding Lynas (+54%) or Clinuvel (+44%) detracted value, as did the overweight position in IOOF (-18.3%).

Companies that are dividend payers returned -2.2% for the month, while non-dividend paying companies returned +2.9%.

### Free Cash Flow on Capital Employed

The FCFoCE smart beta portfolio had a good month, outperforming the benchmark by 1.42% in May. Stock selection contributed close to 1.5%, with a small deduction due to sector allocation.

The majority of outperformance came from good stock selection within Information Technology and Health Care. Large overweight positions in Clinuvel, Lynas, and Hansen Technologies (+29.9%), and not holding Costa Group, together added significant value. Value was lost through overweight positions in Bellamy's (-21%), Sandfire Resources (-12.6%) and St. Barbara (-17%).

Companies that had positive free cash flow returned -1.05% for the month. The portfolio of stocks with zero or negative free cash flows returned -1.95% for the month.

## **Volatility Adjusted Momentum**

The Volatility adjusted Momentum smart beta portfolio was the one factor the underperformed in May. Stock selection added a small amount of value, but sector allocation was a slight bigger detractor. The underweight to Consumer Staples (-8.2%) was balanced by the overweight to Energy (-7.5%)

At the stock level, the best contributors were not holding Costa Group, and overweights to Vocus Group (+17.4%), Clinuvel, and Saracen Minerals (+14.7%). The three largest detractors were the overweight position in Beach Energy, and not holding NIB Holdings (+19.1%) or Lynas Corp.

## **Smart Beta Basis Portfolio**

The Smart Beta Basis portfolio (SBBP) had a modest outperformance of 0.54% in May. Most of the outperformance can be attributed to good stock selection.

At the stock level the best contributors were due to overweight position in Clinuvel Pharmaceuticals, underweight to Costa Group, and underweight to Nufarm (-22%). There were only a few moderate sized detractors – not holding Pilbara Minerals or Kidman Resources, and an overweight position in NIB Holdings.

## **Systematic Portfolio versus SBBP**

The Blue Orbit Australian Small Caps Systematic portfolio underperformed the Smart Beta Basis Portfolio in May by 0.59%. Sector allocation detracted performance of the Systematic Strategy, due to overweighting Information Technology (-1.0%) and underweight to Health Care (7.2%). At the stock level, the three stocks that have been elevated to the S&P/ASX100 contributed 21bp. Overweights to IDP Education, NIB Holdings and Vocus added value.

The biggest difference between the Systematic and SBBP portfolios was that the SBBP does not have liquidity constraints, whereas the Systematic has a theoretical \$1Bn FUM and trade liquidity limits when it is rebalanced. The relative illiquidity of Clinuvel Pharmaceuticals meant that the Systematic portfolio was building a position, and still underweight, whereas the SBBP was able to have a large overweight. The weight difference detracted 39bp from the Systematic, relative to the SBBP.

During May the FCFoCE smart beta portfolio had a large outperformance, Franked Dividends had a moderate outperformance, and Momentum/Low Vol underperformed. This resulted in the SBBP moderately outperforming, with the Systematic losing against this in stock selection.

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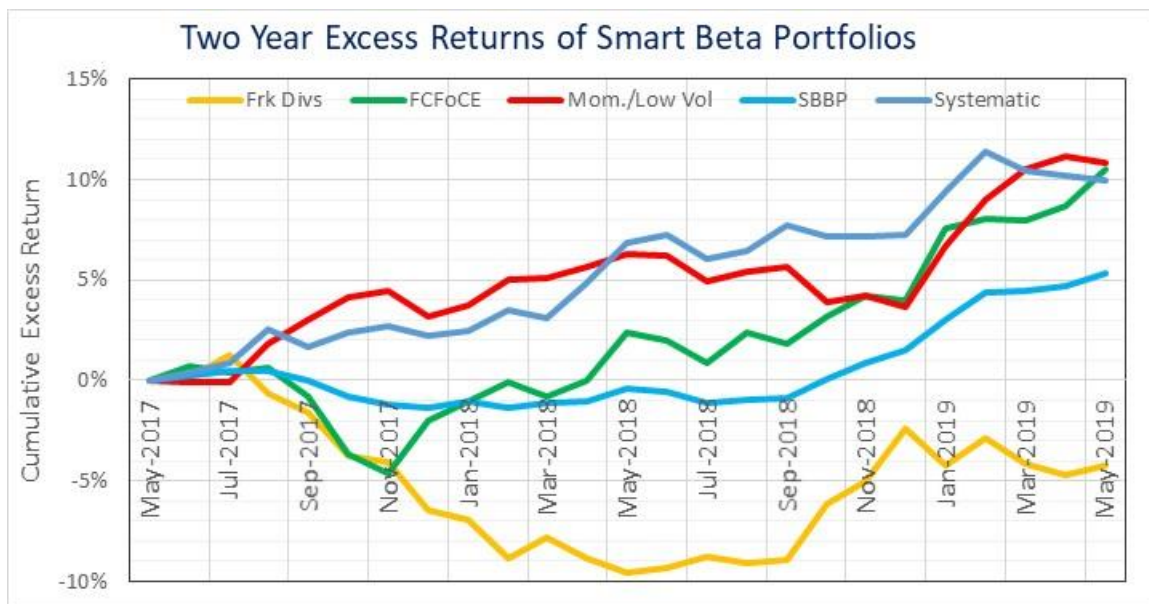


Figure 2

The two-year excess return chart above shows the longer term performance of the smart beta portfolios. After four strong months the Volatility Adjusted Momentum portfolio has had a small pullback. FCFoCE is still trending upward and has now outperformed by 15% over the last 18 months. Franked Dividends has struggled in the global growth environment over the last two years, although had a very strong performance in the last quarter of 2018 when the market had a strong correction.

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## Sector and Stock Attribution

GICS Sector	Aus. Small Caps Systematic			S&P/ASX Small Ordinaries			Attribution Analysis		
	Average Weight	Total Return	Contrib. To Return	Average Weight	Total Return	Contrib. To Return	Allocation Effect	Selection Effect	Total Effect
<b>Total</b>	<b>100.00%</b>	<b>-1.31%</b>	<b>-1.31%</b>	<b>100.00%</b>	<b>-1.25%</b>	<b>-1.25%</b>	<b>-0.14%</b>	<b>0.09%</b>	<b>-0.05%</b>
Communication Services	6.27%	10.90%	0.65%	6.03%	4.46%	0.26%	0.01%	0.37%	0.39%
Consumer Staples	4.62%	-4.79%	-0.22%	7.62%	-8.15%	-0.65%	0.22%	0.16%	0.38%
Health Care	3.16%	6.48%	0.20%	6.67%	0.42%	0.03%	-0.06%	0.19%	0.13%
Consumer Discretionary	19.15%	-0.78%	-0.15%	15.12%	-1.34%	-0.21%	0.00%	0.11%	0.11%
Industrials	7.57%	0.78%	0.05%	7.88%	0.30%	0.02%	0.03%	0.04%	0.07%
Financials	9.63%	-1.30%	-0.13%	9.51%	-1.27%	-0.12%	0.00%	0.00%	0.00%
Utilities	0.20%	10.34%	0.02%	0.41%	7.54%	0.03%	-0.02%	0.00%	-0.02%
Real Estate	9.89%	-0.72%	-0.06%	11.09%	-0.29%	-0.03%	-0.01%	-0.04%	-0.05%
Energy	8.89%	-7.42%	-0.66%	5.10%	-7.47%	-0.39%	-0.24%	0.01%	-0.23%
Information Technology	15.00%	-4.69%	-0.74%	12.23%	-2.45%	-0.34%	-0.01%	-0.34%	-0.35%
Materials	15.21%	-2.05%	-0.26%	18.27%	0.72%	0.15%	-0.06%	-0.41%	-0.46%

Company Name	ASX_SMALL_SYSTEMATIC			S&P/ASX Small Ordinaries			Variation
	Average Weight	Total Return	Contrib. To Return	Average Weight	Total Return	Contrib. To Return	Contrib. To Return
<b>Total</b>	<b>100%</b>	<b>-1.31%</b>	<b>-1.31%</b>	<b>100%</b>	<b>-1.25%</b>	<b>-1.25%</b>	<b>-0.05%</b>
<b>Top 5 Contributors</b>							
Costa Group	0.00%	0.00%	0.00%	0.87%	-30.34%	-0.29%	0.29%
Nine Entertainment Co.	1.70%	18.86%	0.29%	0.00%	0.00%	0.00%	0.29%
IDP Education	3.48%	9.55%	0.32%	1.05%	9.55%	0.10%	0.22%
Saracen Mineral	2.58%	14.70%	0.37%	1.27%	14.70%	0.18%	0.19%
Nufarm	0.00%	0.00%	0.00%	0.72%	-22.13%	-0.18%	0.18%
<b>Bottom 5 Detractors</b>							
Technology One	1.79%	-18.30%	-0.34%	1.05%	-18.30%	-0.20%	-0.14%
Beach Energy	2.83%	-14.79%	-0.43%	1.83%	-14.79%	-0.28%	-0.15%
Breville Group	2.51%	-12.27%	-0.33%	0.86%	-12.27%	-0.11%	-0.22%
Sandfire Resources NL	2.95%	-12.64%	-0.39%	0.54%	-12.64%	-0.07%	-0.32%
St. Barbara	2.93%	-17.39%	-0.51%	0.93%	-17.39%	-0.20%	-0.32%

The Systematic Portfolio underperformed the Small Ords by 0.05%. Sector allocation was a small detractor, with only two sectors providing double figure contribution or detractor. Good stock selection in Communication Services, Consumer Staples and Health Care was balanced by poor selection in Information Technology and Materials.

The five largest contributors were across five different sectors. Two of the stocks were large overweights, two were stocks not held, and Nine Entertainment is still held in the portfolio after it was elevated to the S&P/ASX100.

All five of the largest detractors are large overweight positions, with gold stocks Sandfire Resources and St. Barbara detracting a combined 64bp.

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## Naïve Factor Returns

The following table shows the returns over the last 12 months for some naïve factor portfolios. Each portfolio has stock active weight limits of  $\pm 3.0\%$  relative to the benchmark, as well as 5 times benchmark weight limit.

Month Ending	S&P/ASX Small Ords	Equal Weight	Low Volatility	12 Month Momentum	Price to Earnings	Dividend Yield
30/06/2018	1.06%	1.41%	1.58%	0.86%	0.62%	0.73%
31/07/2018	-1.01%	-0.90%	-0.82%	-2.49%	-1.08%	-0.67%
31/08/2018	2.49%	1.79%	2.06%	5.73%	2.32%	1.67%
30/09/2018	-0.35%	-0.17%	0.17%	-0.63%	-0.04%	-0.20%
31/10/2018	-9.60%	-9.49%	-7.64%	-14.56%	-7.29%	-7.23%
30/11/2018	-0.37%	-0.68%	-0.58%	0.31%	-0.02%	-0.22%
31/12/2018	-4.18%	-3.75%	-2.29%	-6.78%	-1.42%	-1.58%
31/01/2019	5.56%	4.24%	3.54%	7.72%	4.33%	3.57%
28/02/2019	6.78%	7.18%	6.42%	9.02%	6.45%	6.89%
31/03/2019	-0.12%	-0.79%	-0.20%	0.87%	-1.10%	-0.87%
30/04/2019	4.11%	4.32%	3.41%	5.11%	2.49%	3.66%
31/05/2019	-1.25%	-0.39%	-0.18%	0.58%	-1.12%	-1.03%
<b>12 Month Total</b>	2.06%	1.77%	4.90%	3.39%	3.55%	4.14%

All five naïve factors outperformed the Small Ords in May, with four of the five factors underweight Information Technology (-2.45%) and Energy (-7.47%). Momentum has large overweights to these two sectors, but also had a large underweight position in Consumer Staples (-8.2%).

PE and Div Yield only slightly outperformed during May, with no clear trend between cheaper earnings or dividends and better returns. The 12 month returns for the two factors are now ahead of the market.

Equal Weight had a modest outperformance, with larger stocks underperforming. The 12 month return is very similar to the benchmark, with a surprisingly low tracking error.

Low Volatility was also a mixed bag, with high beta stocks underperforming, but so did low to negative beta stocks. The natural underweight position of Low Volatility in Information Technology and Energy added value, but the underweight to Materials was a detraction. Low Volatility is now approaching 3% excess return over the rolling 12 month period.

Naïve Momentum has outperformed again, now five months in a row. The high tracking error relative to the benchmark is quite pronounced, with 12 month return now ahead of the benchmark.

With naïve Low Volatility (+2.84%) and naïve Momentum (+1.33%) outperforming over 12 months, it is interesting to compare their returns to that of the Smart Beta Momentum/Low Volatility. This has an excess return of 3.34%, which is higher than either of the naïve factors. This indicates that the Smart Beta portfolio is in general more efficient at capturing the high momentum/low volatility premium.

## Conclusion

The three smart beta portfolios performed as expected in May: one strongly outperformed, one moderately outperformed, and the third slightly underperformed. This gave a moderate outperformance for the Smart Beta Basis Portfolio, but unfortunately this outperformance was negated by the stronger active positioning of the Systematic Portfolio. This underperformance can be attributed in different ways, but the biggest single factor was low liquidity limited buying Clinuvel Pharmaceuticals to the desired target in the Systematic Portfolio. Over the 21 months of the paper portfolio the Systematic has outperformed the Smart Beta Basis portfolio 13 times and underperformed 7 times (with one equal).

The Blue Orbit Systematic Australian Small Caps strategy uses active weight limits of  $\pm 3.0\%$ , holds around 90 stocks, and targets a hit-rate of around 65%. The diversification and risk controls of the strategy means that extreme moves in a handful of individual stocks will only have a moderate effect on the portfolio relative to the benchmark in any one time period. The strategy instead aims for consistent outperformance of the overall portfolio of stocks over longer time periods.

### Disclaimer

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