Spheria Global Microcap Fund

ARSN 627 330 287 APIR WHT6704AU

Performance as at 31st August 2021

	1 Month	3 Months	1 Year	2 Years#	Inception#
Fund^	**2.8%**	**8.0%**	**46.9%**	**31.1%**	**26.2%**
*Benchmark**	*2.6%*	*4.9%*	*60.3%*	*28.9%*	*22.4%*
Value added	0.2%	3.2%	-13.4%	2.3%	3.8%

^ Spheria Global Microcap Fund. Returns of the Fund are net of applicable fees, costs and taxes. All p.a. returns are annualised.
* Benchmark is the MSCI World Microcap Index in AUD (Net) from 1 July 2021 and prior to that MSCI Kokusai (World Ex-Japan) Microcap Index in AUD.
# Inception date is 1 March 2019.
Past performance is not a reliable indicator of future performance.

The MSCI World Microcap Index increased 2.6% in August. Spheria's Global Microcap Fund, performed slightly better, up 2.8% after fees. All market tiers were stronger, with the large-cap MSCI World up 3.1% and the MSCI World Small-Cap (Ex-Australia) up 3.0%.

Since inception, the Fund has returned 26.2% p/a after fees relative to the benchmark[1] return of 22.4% p/a. Over the same timeframe, the MSCI World has increased 18.2% p/a.

Markets

The market's excitability about a COVID re-opening, immense economic growth and pent-up inflation has waned for now. Questions are being asked by the bond market that perhaps much of the past twelve months reflects Government stimulus and that the underlying economy remains fragile. Recall that while the bond market's absolute level is now the domain of fantasy, conjured by the central bank cartel, there may still be some information from how interest rates change.

Gold is implying a similar scenario. We love the shiny metal for its simplicity. If the market's latest hunch is correct, and the economy is more fragile than first thought, real interest rates are on the way down, favouring gold.

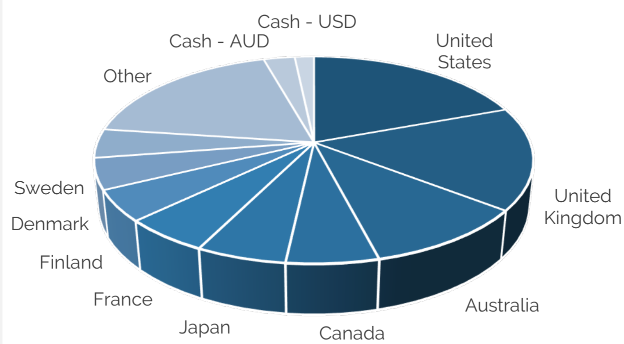
The market's latest thinking showed through in which sectors have been outperforming. IT and Healthcare, less sensitive to the economy, were the best performing microcap sectors in August. Consumer stocks were relatively weak. Our Fund remains underweight the Consumer sector, not because of a macro bet, but because the stock's we owned were implying recent earnings were not only sustainable but even depressed. Given the amount of Government stimulus and the redirection of spending from services to goods, we're not sure. We could not justify the valuations using our mid-cycle cashflow approach and took profit on many of them last quarter.

[1] Benchmark from inception until 30th June 2021 is MSCI Kokusai (World Ex-Japan) Microcap Index. Thereafter from 1 July 2021, new Benchmark is the MSCI World Microcap Index.

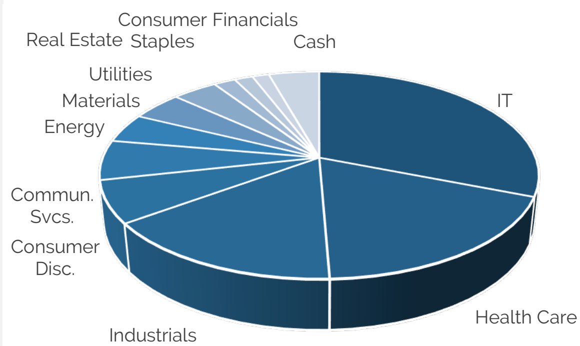
Top 5 Holdings

Company Name	% Portfolio
Fjordkraft (Norway)	3.9%
Poletowin (Japan)	3.4%
Vetoquinol (France)	3.4%
Steelcase (USA)	3.2%
Computer Modelling (Canada)	3.2%
Top 5	**17.2%**

Regional Exposure



Sector Exposure



Source: Spheria Asset Management

Continued on the next page...

Australia & New Zealand were two of the best performing microcap markets in August. Once again, the sharemarket seems to thumb its nose at how various countries are coping with COVID. Italy was the best performing market. That country's microcaps were lifted by some successful software stocks and the company Italian Wine Brands. We would love an excuse to visit this company when COVID allows. Sadly though, we have already done enough "research" in this area and would never be foolish enough to invest in the wine industry for the purpose of generating a return.

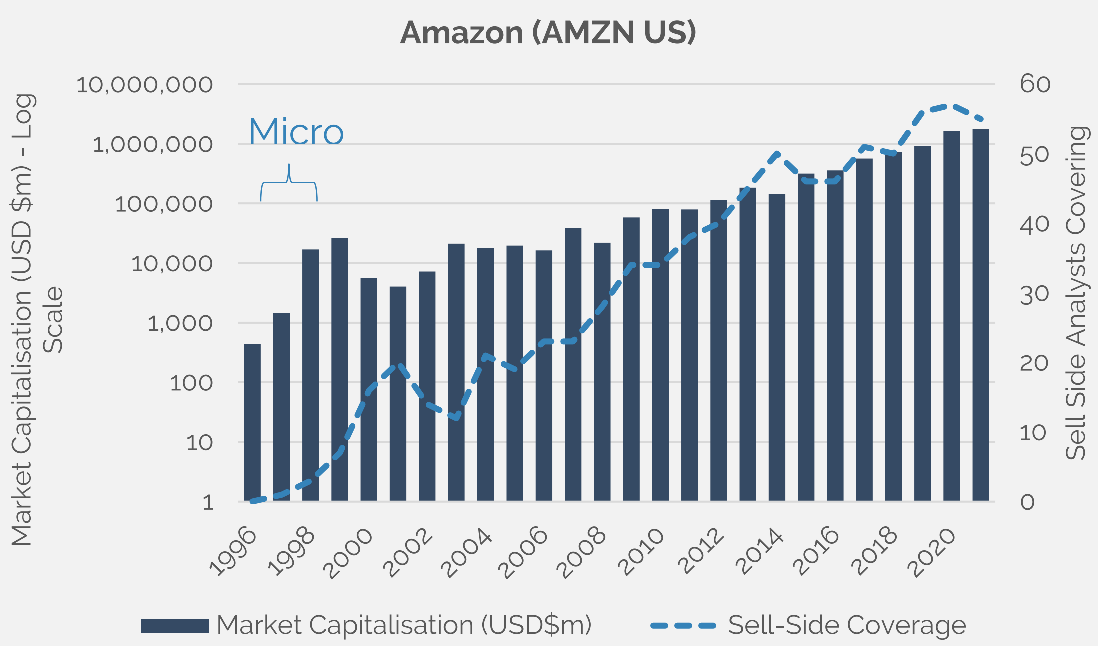
Fund Performance

Plover Bay (1523.HK)

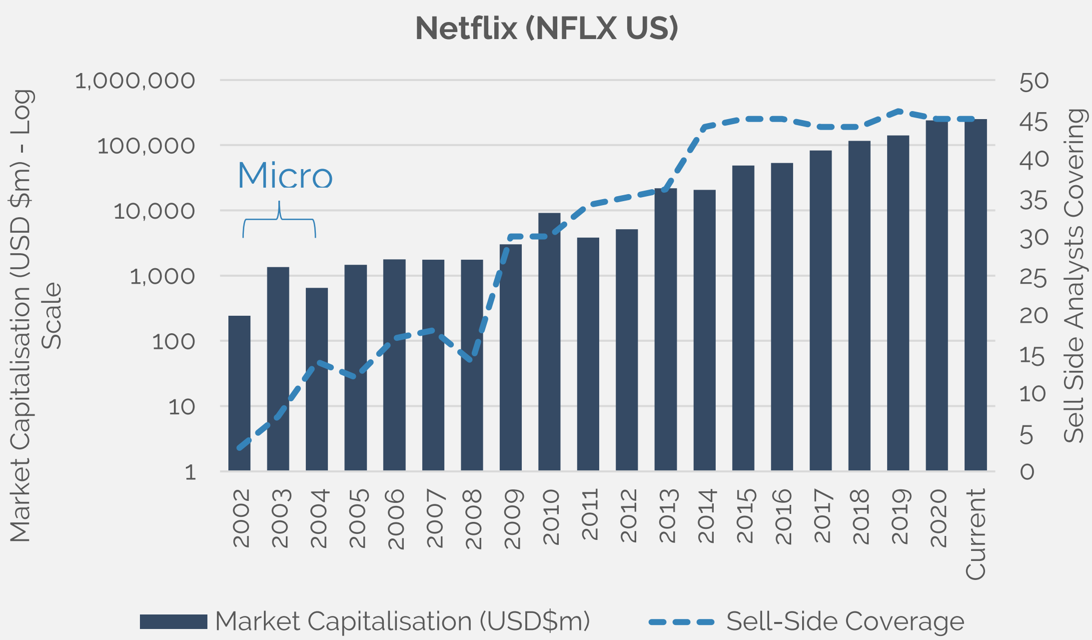
Plover Bay was once again the Fund's top contributor.

As we wrote last month, Plover Bay has established itself as one of the leading players in SD-WAN (software defined wide area network). The company's proprietary SpeedFusion technology combines several data networks to maximise a connection's speed and stability. This is particularly appealing as 5G networks are rolled out since the increased speed and throughput of 5G comes with a shorter range and increased susceptibility to obstructions.

While we are sure that Plover Bay has a bright future, the recent share price increase is symptomatic of the typical growing up process for many microcaps. The pattern is nearly always the same. Take the two examples below.



Continued on the next page...



These two charts illustrate the typical evolution of a successful microcap:

- Very little interest from the sell-side: Even the likes of Amazon had only one analyst covering it when it was a microcap. Likewise, Plover Bay currently has no sell-side firm covering the stock.
- Impressive growth off a low base: Plover Bay has tripled in less than a year. As the above charts show, such stocks normally do something rather impressive that catches the market's attention, and the stock starts to get noticed.
- The best performance has passed: Even for a company like Amazon, its share price will never appreciate again at the same rate as it did from that low microcap base. So by the time other investors have discovered the company, they will have missed the best returns.
- Plover Bay came to our attention using our proprietary screening tools. We visited the company in Hong Kong in late 2019 and became shareholders shortly after that. We can help our investors capture the most lucrative part of a company's journey by searching where others don't.

Inogen (INGN.US)

Inogen detracted the most relative value in August.

The stock has done well in recent months as investors gain a line of sight on a US re-opening, and the increased demand this will provide for Inogen's products. However, that line of sight was blurred during the company's latest quarterly result.

Inogen is the global leader in Portable Oxygen Concentrators (POC). These medical devices act as short-term substitutes for patients requiring oxygen therapy (typically for diseases under the umbrella of chronic obstructive pulmonary disorder – COPD). Mobile patients requiring oxygen can rely on these lightweight and battery-powered devices to concentrate the air around them into oxygen.

Continued on the next page...

However, with US$240 million of cash on the balance sheet, the company has the resources to see this setback through. Inogen is also using this hiatus as an opportunity to re-jig its model further towards patient rentals, which its analysis has shown has much higher conversion rates than outright sales. COVID itself is likely to increase long-term demand since infected patients with co-morbidities such as diabetes, hypertension, or obesity are more likely to require prolonged oxygen therapy in moderate to severe cases.

We continue to believe the future is bright for this company and that the share price instead implies only a subdued recovery from COVID. Fellow investors had started to come around to the same conclusion, with the share price rallying from $30 in August last year to almost $80 before the result. However, the company had to warn investors that the recovery would be delayed since the shortage of semiconductors, a vital input into the devices, means it can not meet demand in the short term. As a result, revenue in the second half of the year is expected to be less than the first half.

Investors who were there for a good time, not a long time, fled the scene quickly. There is much conjecture around when the global semiconductor shortage is likely to be resolved. In addition, rising concern around the Delta strain of COVID has poured more cold water on the share price.

Nevertheless, we continue to see substantial upside once earnings eventually normalise. In this market where many would consider Inogen "dead money", we see it as an appealing risk-reward proposition which we will need some patience to realise. And if the market does not, we expect many corporates will, with this company's leading position in a high growth healthcare segment.

Outlook

During President Eisenhower's farewell speech he warned Americans about the potentially misplaced power of the military-industrial complex. He cautioned that the large US military in conjunction with a rising arms industry may have undue influence over Congress and be at odds with the US's peaceful goals and ability to prosper. His speech cited that annual spending on military security was more than the net income of all US corporations.

While the military-industrial complex sounds sinister, vested interests sink their teeth into every industry. Even investment management. Perhaps there is an investment-industrial complex, designed to favour large companies for the benefit of vested interests?

Investment Banks, working in the shadows, focus their attention on larger firms. A more prominent firm secures leading headlines, larger fees, more brokerage, bigger equity raisings. The Investment Banks publish investment research on these companies. Fund Managers lap it up since it helps keep their cost base down and margins high. Besides, higher market capitalisation companies mean the manager can accept more funds under management and additional fees. Index providers too prefer large companies as their fees are linked to assets under management and index rebalancing of larger firms means more brokerage for the investment banks. Then there are the media. They too have an incentive to toe the investment-industrial complex. Larger companies have bigger advertising budgets, and investment banks provide insider scoops to journalists that helps sell content.

But what about the investor? What advantages do larger companies offer them? Or are they just caught up in this investment-industrial complex?

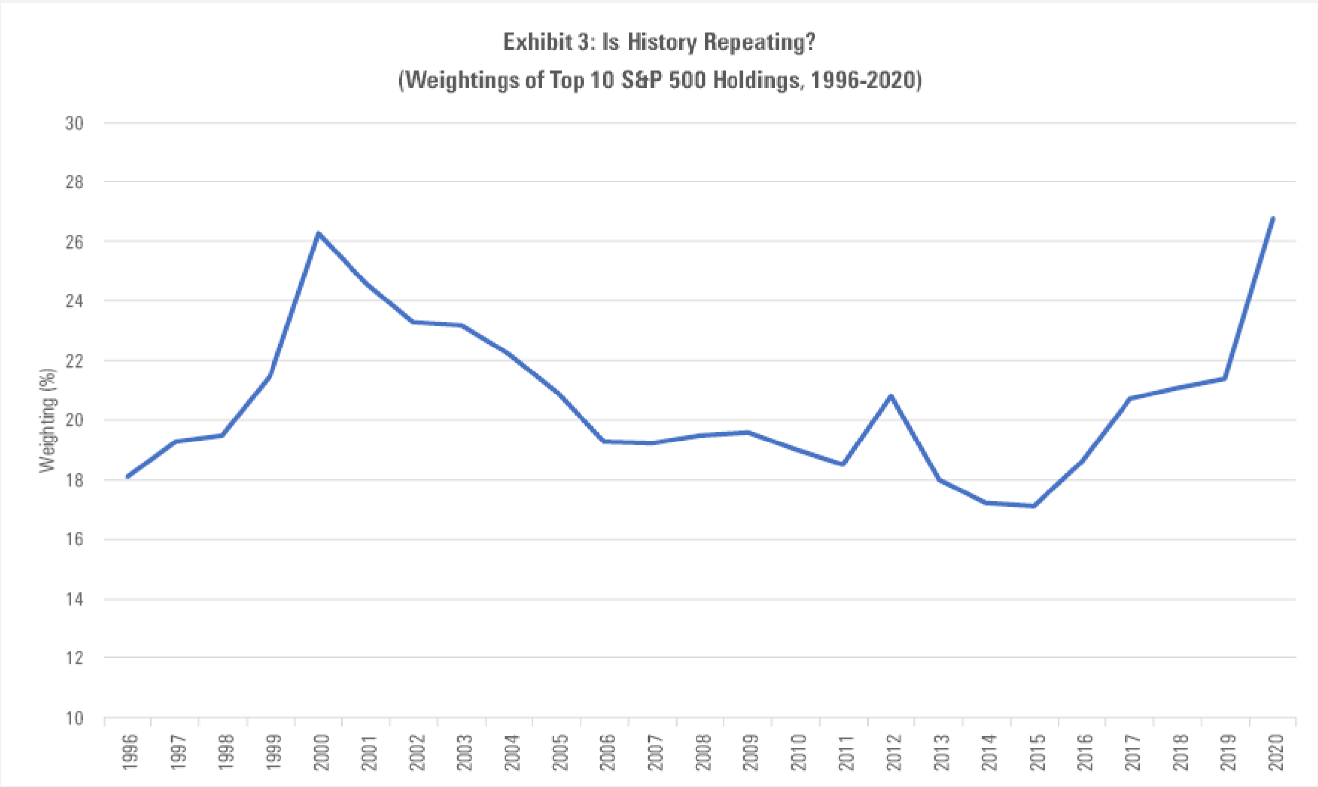
When Spheria & Pinnacle set out to launch a global microcap Fund, it was apparent to us the asset class had huge potential for investors. The vast universe of overlooked companies provided an array of opportunities for fundamental active investors such as Spheria to create wealth for its clients. We expected clients might have to take on some additional risk to get this upside. Hence, our PDS advises a holding period of at least seven years instead of the regular five years attached to a large-cap equity fund.

Continued on the next page...

However, over time, we have amassed evidence that indicates, not only should global microcaps enhance investors' returns, but they could do this while reducing overall portfolio risk. Especially now, where like many experienced market observers, we see signs of excessive valuation and risk-taking. We expect that when this bull terrier market (bull terrier because it won't let go) ends, our global microcap Fund will likely outperform its larger peers on the way down too (it has already outperformed on the way up).

We have recently released a white paper outlining some of the evidence that has informed our conclusion. So let us touch on one: **Global microcaps display astounding outperformance through market crises**.

The most obvious comparison to today's market is the dot-com period. The stretched valuations and extreme market concentration of today are classic dot-com hallmarks.

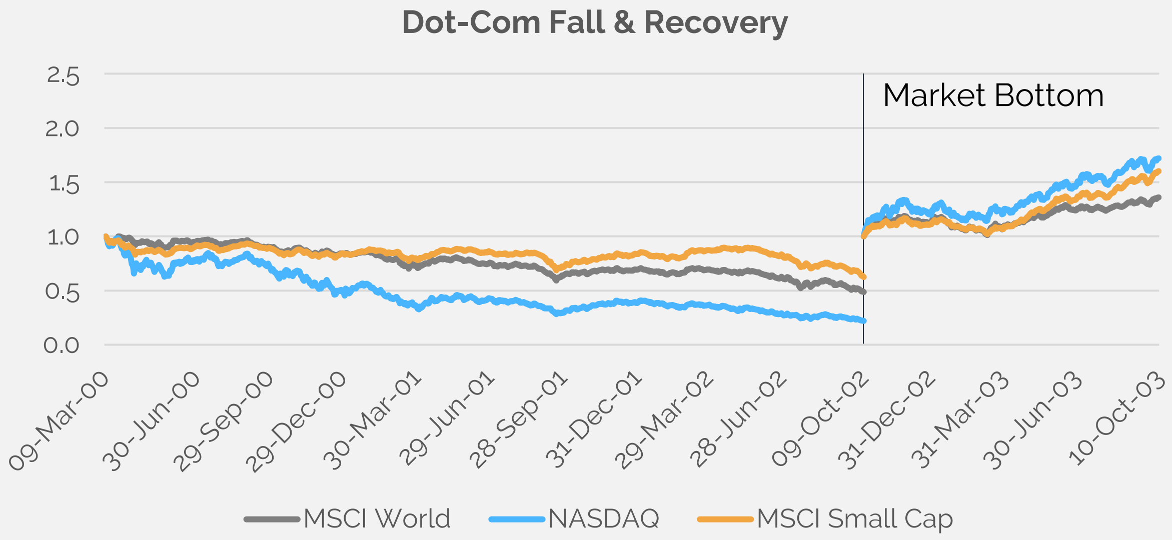


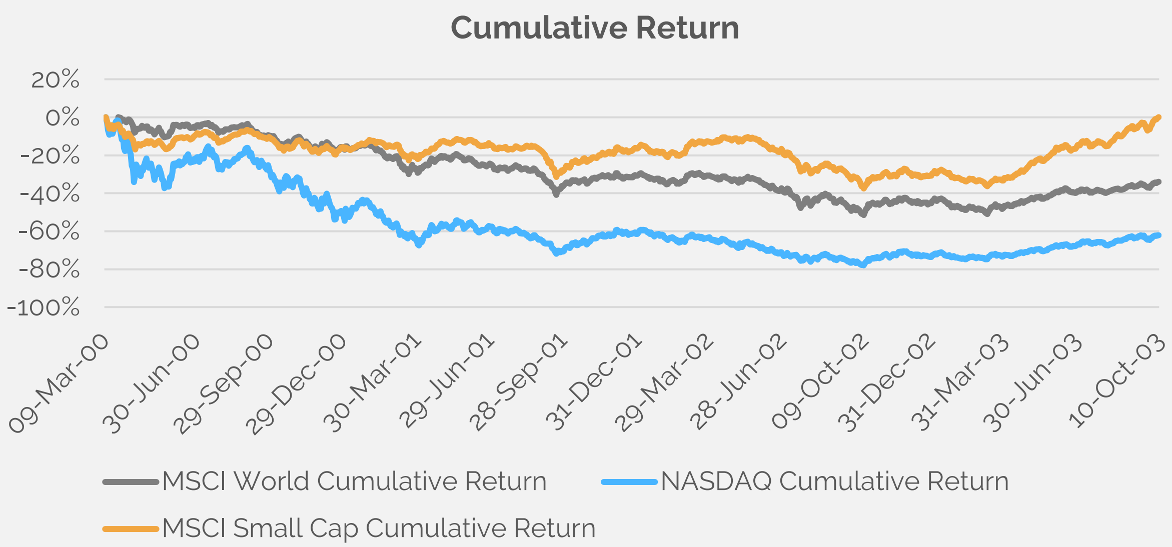
Source: Morningstar Direct

Continued on the next page...

While MSCI did not produce a World Microcap Index back then, we can use the MSCI Small Cap Index (MXWOSC) proxy for microcaps. During the dot-com bust, the MSCI Small Cap Index outperformed its large-cap counterpart, the MSCI World Index (MXWO), by 13.8% as markets fell. On the other hand, the NASDAQ was utterly crushed, down 77.9% from its highs. This dichotomy is partly because the early 2000s recession was mild, and the key reason for the market falling was its stretched valuation.

Having outperformed its larger peers during the decline, the MSCI Small Cap Index also outperformed the MSCI World Index in the recovery.



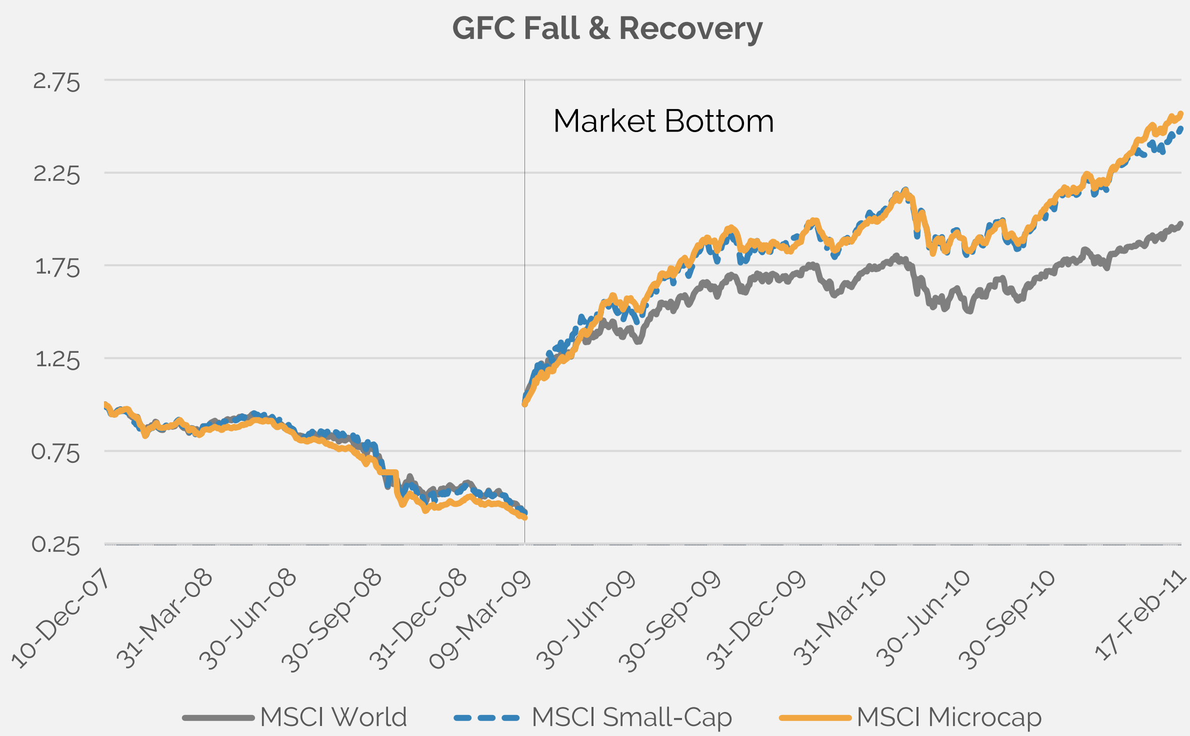


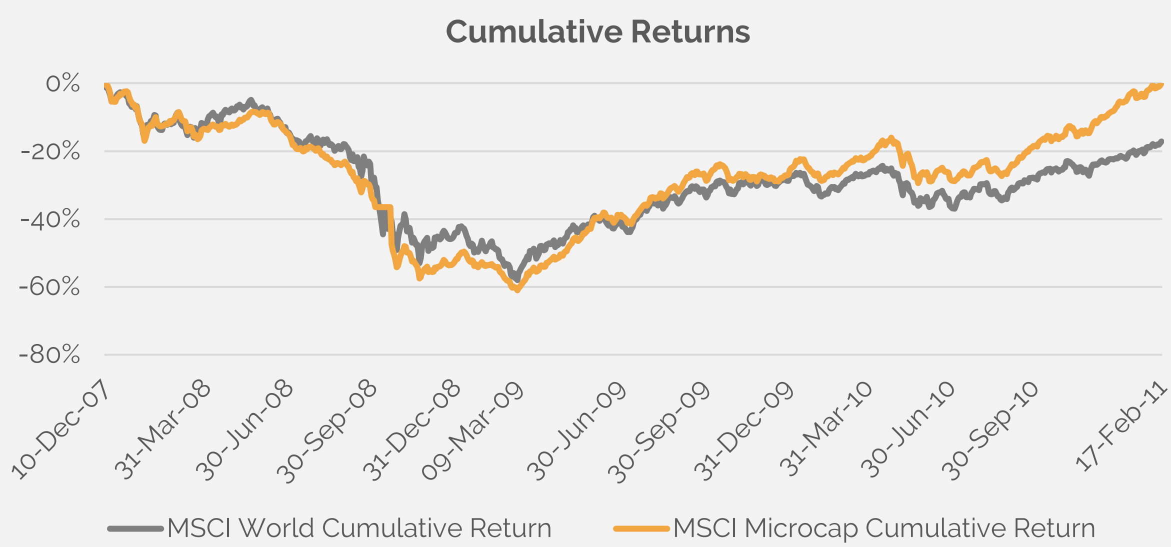
Source: MSCI, Bloomberg, Spheria

As the chart above shows, by October 2003, the MSCI Small Cap Index had recouped its losses. However, the MSCI World Index remained 34.0% underwater, and the NASDAQ was still 62.1% in the red.

The GFC was next, an even more fierce sell-off. From peak to trough, the MSCI World Index of large-cap stocks declined 58% in USD. Despite the perceived riskiness of microcaps, the World Microcap Index fell only marginally more (down 61%). However, from the trough in March 2009 the World Microcap Index had already recovered to breakeven by February 2011. The large-cap MSCI World Index didn't manage the same until December 2013.

Continued on the next page...

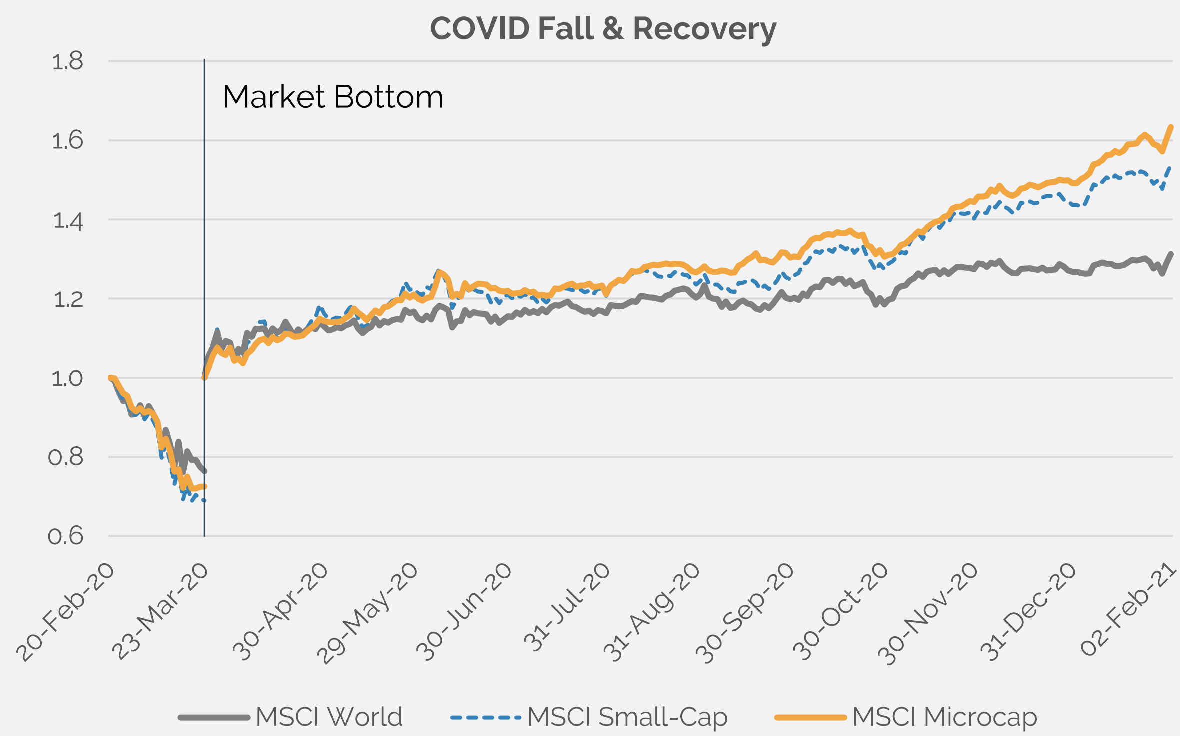


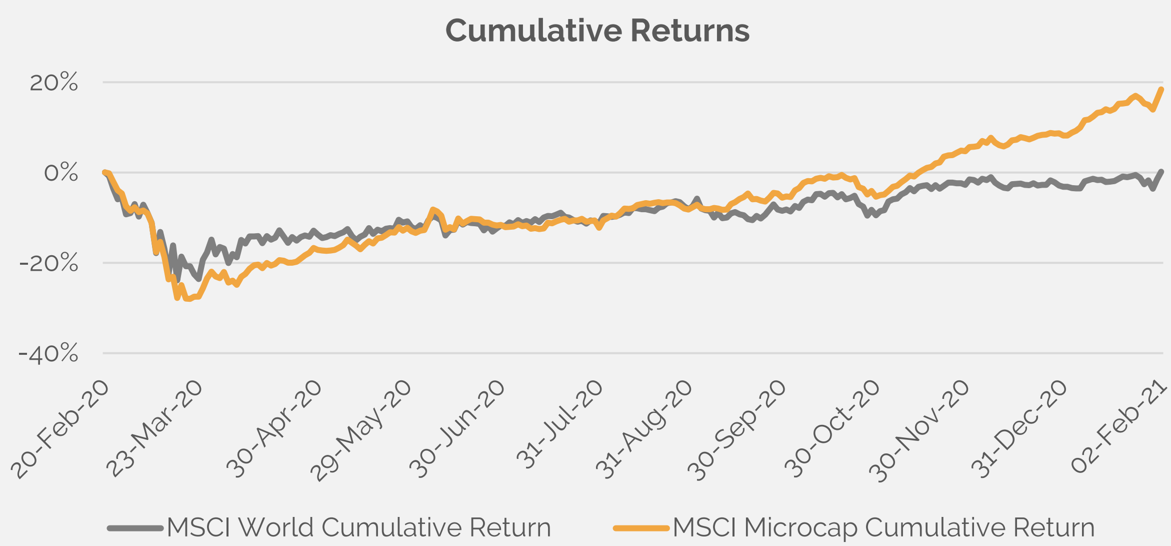


Source: MSCI, Bloomberg, Spheria

And more recently, COVID followed the same pattern. The World Microcap Index fell by 3.9% more on the drawdown but broke even well before its larger peers. The COVID recovery was quick, with the MSCI World Index back to its pre-COVID levels by 2 February 2021. However, by then, the MSCI World Microcap Index was already up 18.4% in USD.

Continued on the next page...





Source: MSCI, Bloomberg, Spheria

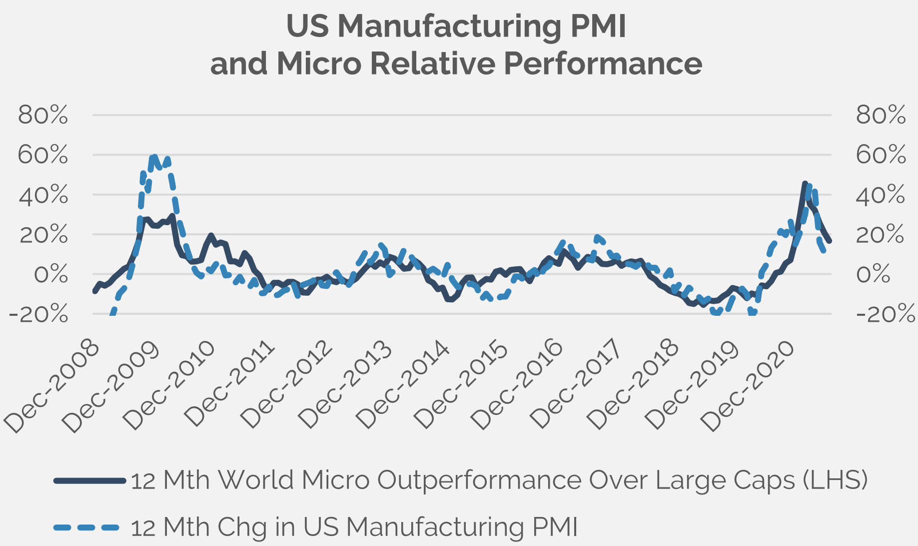
During COVID the Spheria Global Microcap Fund fell 23.1% after fees, less than the large-cap MSCI World Index, which fell 23.6% in AUD. The Fund's performance was also superior during the recovery and had rebounded 27.6% after fees by the end of September, while the MSCI World had recovered 19.8%.

So through each of these crises, microcaps were the first to recoup their losses. For investors, they have been the superior place to "ride it out", taking the guesswork out of the asset allocation decision.

Continued on the next page...

Why do microcaps display this uncanny asymmetry during major market events? Unfortunately, it is difficult to draw a definitive conclusion. We can only offer some hypotheses:

- Microcaps are more nimble. Rightsizing the cost base and responding to a crisis is far simpler than for mega-caps. We saw this during COVID, where we were impressed with the portfolio's companies ability to mobilise quickly to secure the safety of their staff, sure up liquidity, and cut costs if necessary. It is instructive that not a single one of the Fund's holdings raised equity during the depths of COVID or in the months following.
- Secondly, while business cycles display an asymmetry to the downside, the manufacturing cycle tends to step on the gas all at once but tap on the brakes at different rates. The chart below, a favourite indicator of ours, shows this. See how the underperformance of micros is always far more muted than the expansion, as is the profile of the ISM Manufacturing purchasing manager survey.



Source: Bloomberg, MSCI, Spheria

- Less attention. The MSCI World Microcap Index represents approximately 1% of the free-float adjusted market capitalisation of each country. With the focus elsewhere, selling is concentrated on the larger companies on the way down. During the recovery, microcaps may benefit from a "risk-on" mentality and investors looking for leverage to the upside.

Whatever the exact reason, this data builds further on the already compelling evidence supporting the global microcap asset class. So perhaps it is time to rage against the investment-industrial complex.

Source: Busy Beaver Button Museum

Spheria Global Microcap Fund

ARSN 627 330 287 APIR WHT6704AU

	Spheria Global Microcap Fund
Benchmark (universe)	MSCI Kokusai (World ex Japan) Microcap Index in AUD (Net)
Investment objective	The Fund aims to outperform the MSCI World Microcap Index in AUD (Net) over the long term.
Investing universe	Global listed microcap equities predominantly in developed markets with a market capitalisation of US$1.0bn and below at time of purchase.
Distributions	Annually
Fees	1.35% p.a. management fee & 20% performance fee of the Fund's excess return versus its benchmark, net of the management fee.
Cash	Up to 20% cash
Expected turnover	20%-40%
Style	Long only
APIR	WHT6704AU
Minimum Initial Investment	$25,000

Platform availability
HUB24
Macquarie Wrap
Netwealth*
Praemium

* IDPS only

This communication is prepared by Spheria Asset Management Pty Limited (ABN 42 611 081 326, Corporate Authorised Representative No. 1240979) ('Spheria') as the investment manager of the Spheria Global Microcap Fund (ARSN 627 330 287) (the 'Fund'). Pinnacle Fund Services Limited ABN 29 082 494 362 AFSL 238371 ('PFSL') is the product issuer of the Funds. PFSL is not licensed to provide financial product advice. PFSL is a wholly-owned subsidiary of the Pinnacle Investment Management Group Limited ('Pinnacle') ABN 22 100 325 184. The Product Disclosure Statement ('PDS') of the Fund is available at https://spheria.com.au/funds/. Any potential investor should consider the PDS before deciding whether to acquire, or continue to hold units in, the Fund.

This communication is for general information only. It is not intended as a securities recommendation or statement of opinion intended to influence a person or persons in making a decision in relation to investment. It has been prepared without taking account of any person's objectives, financial situation or needs. Any persons relying on this information should obtain professional advice before doing so. Past performance is for illustrative purposes only and is not indicative of future performance. Unless otherwise specified, all amounts are in Australian Dollars (AUD).

Whilst Spheria, PFSL and Pinnacle believe the information contained in this communication is reliable, no warranty is given as to its accuracy, reliability or completeness and persons relying on this information do so at their own risk. Subject to any liability which cannot be excluded under the relevant laws, Spheria, PFSL and Pinnacle disclaim all liability to any person relying on the information contained in this communication in respect of any loss or damage (including consequential loss or damage), however caused, which may be suffered or arise directly or indirectly in respect of such information. This disclaimer extends to any entity that may distribute this communication.

Any opinions and forecasts reflect the judgment and assumptions of Spheria and its representatives on the basis of information available as at the date of publication and may later change without notice. Any projections contained in this presentation are estimates only and may not be realised in the future. Unauthorised use, copying, distribution, replication, posting, transmitting, publication, display, or reproduction in whole or in part of the information contained in this communication is prohibited without obtaining prior written permission from Spheria. Pinnacle and its associates may have interests in financial products and may receive fees from companies referred to during this communication.