Spheria Global Microcap Fund

ARSN 627 330 287 APIR WHT6704AU

Performance as at 31st July 2021

	1 Month	3 Months	1 Year	2 Years#	Inception#
Fund^	3.5%	8.0%	46.6%	29.0%	25.8%
*Benchmark**	-0.1%	5.4%	63.2%	26.1%	21.9%
Value added	3.6%	2.6%	-16.6%	3.0%	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.

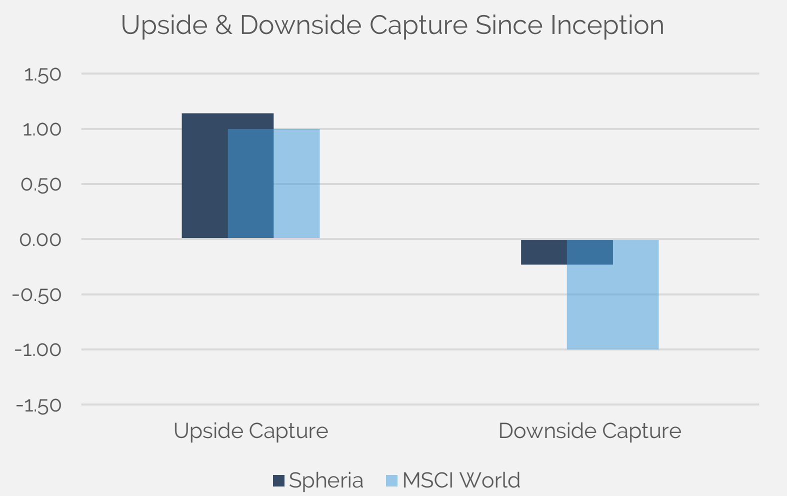
Inception date is 1 March 2019.

Past performance is not a reliable indicator of future performance.

While not quite as chuffed as an Australian Liberal Party Cabinet, we were glad to be "Back in the Black" in July (the Fund last outperformed its Benchmark in April). The Spheria Global Microcap Fund returned 3.5% net of fees, while the MSCI World Microcap Index declined 0.1%.

Large Caps outperformed in July. The MSCI World Index up 4.0%. As we have highlighted many times in this report, Global Microcaps offer terrific diversification benefits for investors. The MSCI World Index has started to power forward just as the World Microcap Index peters out, reversing the trend we have seen since late last year.

Such are the diversification benefits that the Fund offers superior downside capture metrics against the MSCI World Index even when compared to "The Fund Manager Who Can Not Be Named" (hint: its namesake became the first European to reach the East by sailing West. He then got embroiled in a local conflict that killed him and most of his crew, but that story for another day).



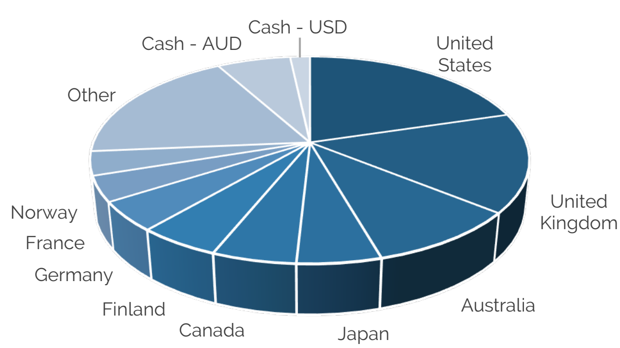
Source: MSCI, Spheria

Since inception, investors are 25.8% p/a better off. This return is ahead of the Benchmark return of 21.9% p/a and the MSCI World Index return of 17.4% p/a.

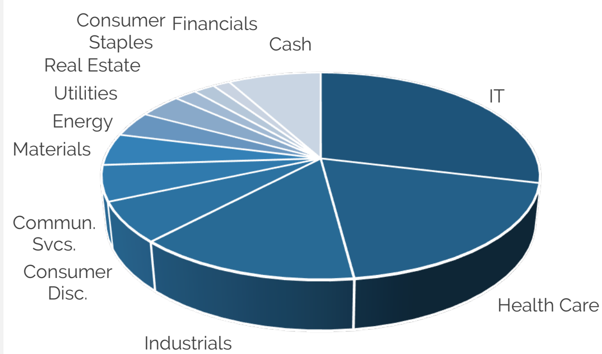
Top 5 Holdings

Company Name	% Portfolio
Inogen (USA)	4.3%
Fjordkraft (Norway)	3.7%
Steelcase (USA)	3.3%
Vetoquinol (France)	3.2%
Poletowin (Japan)	3.0%
Top 5	**17.5%**

Regional Exposure



Sector Exposure



Source: Spheria Asset Management

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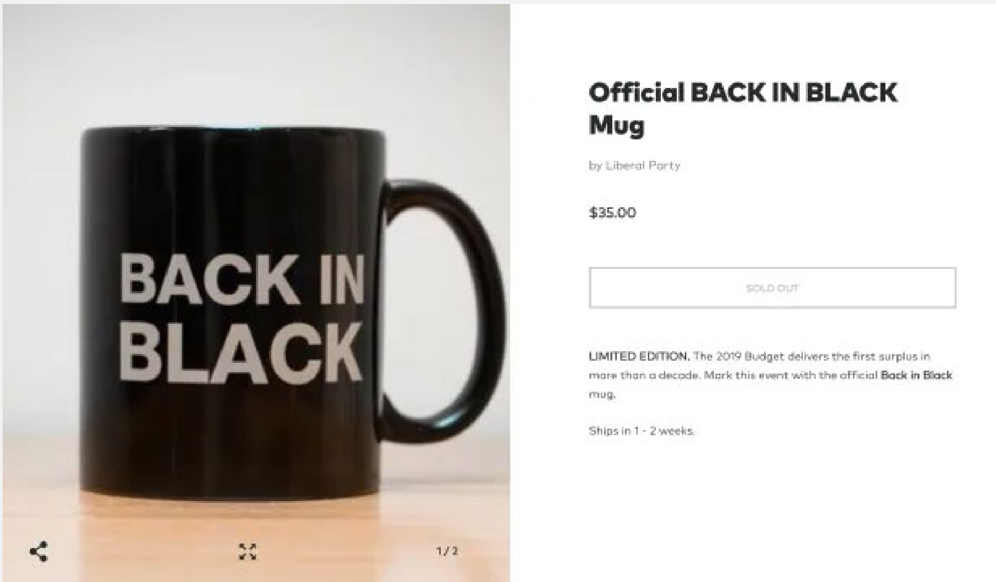

Source: AFR

And yes, we will endeavour to get Spheria Back in Black mugs up for sale on our website as soon as possible.

Markets

Interest sensitive microcaps took a pause from inflation and taper fears. Real Estate and Utilities led microcaps higher. The worst performing microcap sectors were Health Care and Energy.

Our companies management are telling us that inflation pressures are rife, particularly freight, some raw materials such as steel, and semiconductors. Labour pressure is mixed though, with some companies claiming employees are hard to find, while others suggest no signs of difficulty.

Inflation concerns implied by gold and interest rates have subsided, but lack conviction. The US 5yr breakeven implied inflation rate has risen from under 2% at the end of 2020 to 2.21% currently. There are sparks everywhere and plenty of tinder, but history provides little guide to whether things are about to heat up. For us, investors bidding up securities to such an extent that they imply interest rates remain ultra-low forever means this trade can only play out in one direction, but timing is uncertain.

Finland, Sweden & Switzerland were the best performing microcap markets. As we noted last month, this is a relatively expensive pocket of the market, but in the short-term, that means little. The USA was the laggard, down 4.5% in AUD, and Canada fell 3.1%.

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Fund Performance

Plover Bay (1523.HK)

The Fund's best position in July was Plover Bay.

Founded in 2006, Plover Bay (HK:1523) has established itself as a major player in wired and wireless SD-WAN. Unlike a traditional wide area network (WAN) that relies solely on hardware to create a computer network (for instance, across a business, hospital, campus), SD-WAN simplifies this by using software to direct data traffic. This approach lowers cost, increases speed and allows changes to be made easily from a remote location.

Plover Bay takes this a step further. Its SpeedFusion technology can combine several data networks, using them as a contingency to maximise speed and create "unbreakable connectivity". The combined networks can span fixed line, 4G and 5G. As the 5G roll-out progresses in earnest, we expect increasing demand for Plover Bay's products. Recently, Australian company Megaport estimated worldwide SD-WAN infrastructure revenue of US$3.7bn and a CAGR growth rate of 31% p/a from 2018 to 2023.

Adding to the attraction, Plover Bay is building a solid annuity stream from software and maintenance contracts. More recently, it has launched a subscription model providing all the services and equipment required for an SD-WAN network for a monthly fee based on data consumption.

Spheria has owned the stock since 2019. With only one sell-side analyst covering the company, it appears that Plover Bay has suddenly become discovered. While no longer a stand-out bargain, we still see plenty of upside given the market opportunity ahead. Plover Bay pays a dividend yield of 4% and is on 20x FY22 price to earnings.

Computer Modelling Group (CMG.CN)

Computer Modelling Group was the Fund's largest detractor in July.

The Fund has owned Computer Modelling Group (CMG.CN) since its inception. CMG is a software provider to the energy industry. Its software is amongst the best in the world at simulating reservoir recovery processes. CMG is especially capable at unconventional reservoir modelling (e.g., shale).

Aside from the typical Spheria prerequisites we require when investing in a company, several attributes attracted us to CMG:

- Favourable industry structure: CMG shares the majority of the market with Schlumberger. Aside from supporting CMG's impressive margins, this cosy industry structure means that CMG can often lean on oil companies to help fund software development costs. Such is the case with the sizeable CoFlow project with Shell.
- Track-record of investment: the company has a long track record of investing heavily in its products. The temptation would be for management to bank some of its success and reign in R&D spend to lift profits. However, CMG continues to be on the front foot, even during the oil collapse of 2020.
- Exposure to unconventional reserves: the energy industry had been spending little on exploration and capex for some time after the excesses of circa 2011. Our view was that some form of catch-up was on the horizon and unconventional oil would provide the greatest leverage to any recovery.

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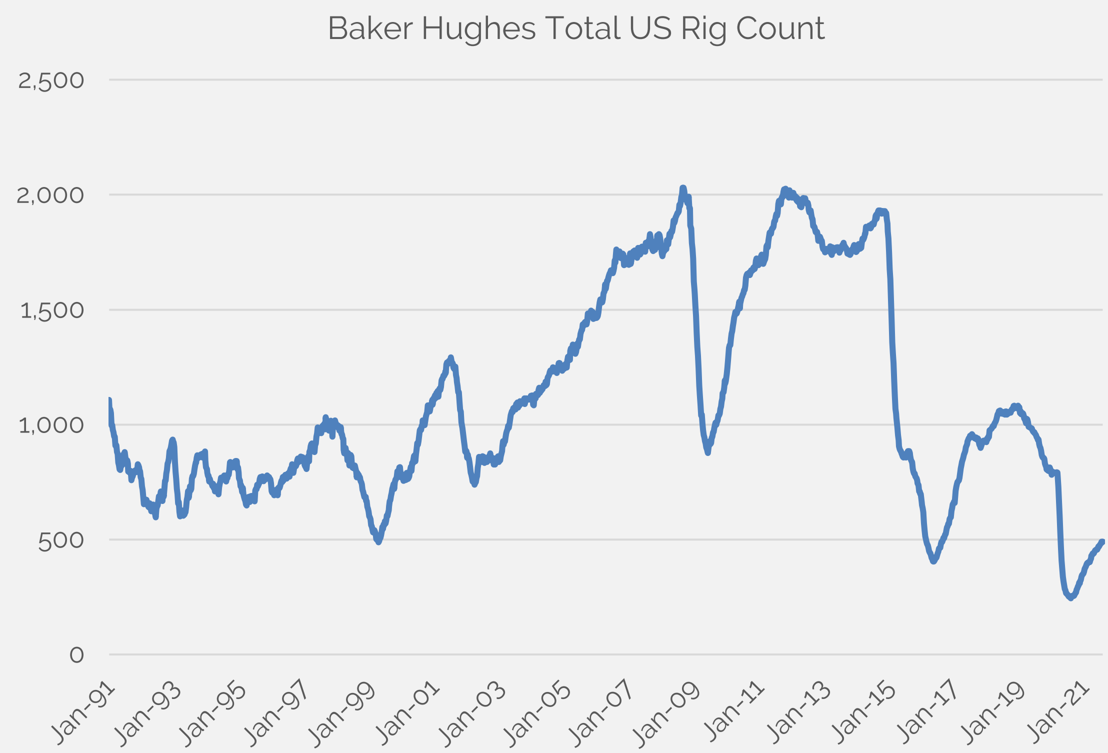

Source: Baker Hughes

While these attributes are likely to aid CMG over the course of the oil cycle, it has been a difficult period for the company since the sharp oil price decline in 2020. We acted decisively following the move by Saudi Arabia, recognising the importance of US shale to CMG, and that the positive operating leverage we had expected going up would work the other way going down.

CMG staff were asked to take pay cuts, and revenue from the US declined almost 30% in the back half of last year. The company has begun cycling through these tough periods, providing a floor to earnings. By using our mid-cycle approach to valuation, the stock is currently far too cheap to ignore.

Outlook

It's all been done before. Just ask the late Gerald Tsai, who pioneered momentum investing in the 1960s. So successful was Mr Tsai that he almost single-handedly turned around the struggling Fidelity. He went on to start his own Funds Management business, which received massive inflows at the time. There is no doubt Mr Tsai, a Chinese-American, and self-made man, was a brilliant investor. However, even an accomplished investor such as Mr Tsai would in the end be humbled by Mr Market.

When the crash came in 1969 (one of the worst on record), his Fund was decimated, losing 90% of its assets over the next few years. One of his successful investments, National Student Marketing, fell from $143 in December 1969 to $3.50 in July 1970. To make matters worse for investors, Mr Tsai had sold his funds management business in 1968!

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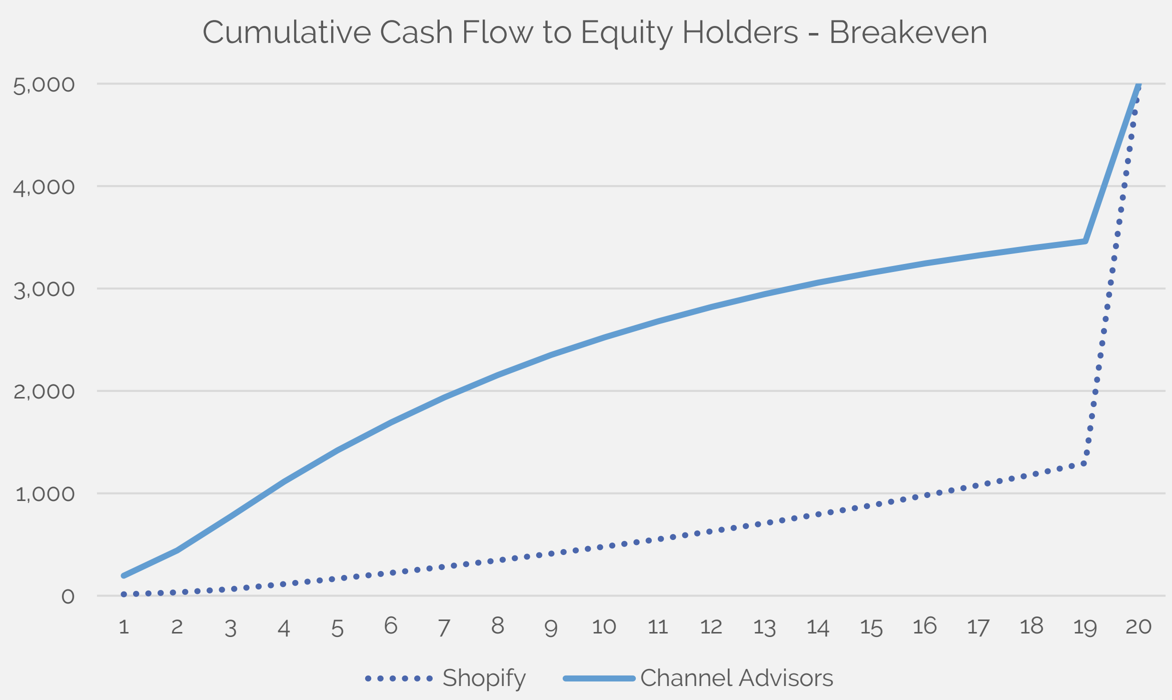
A new breed of investors are this generation's Mr Tsai, convinced that momentum and quality at any price are infallible investment tools. However, to be fair to Mr Tsai, he was onto something new, and there was no clear precedent showing its flaws. But let's leave history to one side, and use some simple logic to show the risk of this type of growth or "disruption" investing.

Let's give an investor $5,000 USD, and ask them to pick between two stocks. First is high flying large-cap stock, Shopify, trading on an FY22 PE of 239x consensus forecast earnings. Second, we have a microcap peer and a holding in the Fund, Channel Advisors, trading on a far more modest 24x FY22 PE.

Both have net cash, so let's take that off the share price. With US$5,000 our investor could buy 3.4 shares of Shopify or 232.5 shares of Channel Advisors. Now let's use consensus forecasts for free cash flow where they are available (the first four years), and then a constant growth rate beyond that.

Using a 20 year DCF (Discounted Cash Flow), we would need to grow Shopify's free cash flow by 12.4% p/a to get our investor's money back. For Channel Advisors, we can assume a 4.6% p/a decline in free cash flow over the remaining 20 year period for our investor to breakeven. The cumulative cash flows in present value terms are shown below.



Notice how much of Shopify's value comes from the last year of our DCF. In the first ten years, investors in Channel Advisors have already reaped half of their investment back in free cash flow. Investors in Shopify will have only received back less than 10%.

There are a few issues with this. Firstly, Shopify's cash-flows are far riskier. Who knows what the future brings? More competition, regulatory risk, new technologies? The further we look forward, the more uncertain it is. There are plenty of investment managers touting their crystal balls, but perhaps The Jetsons will turn out to have a better track record?

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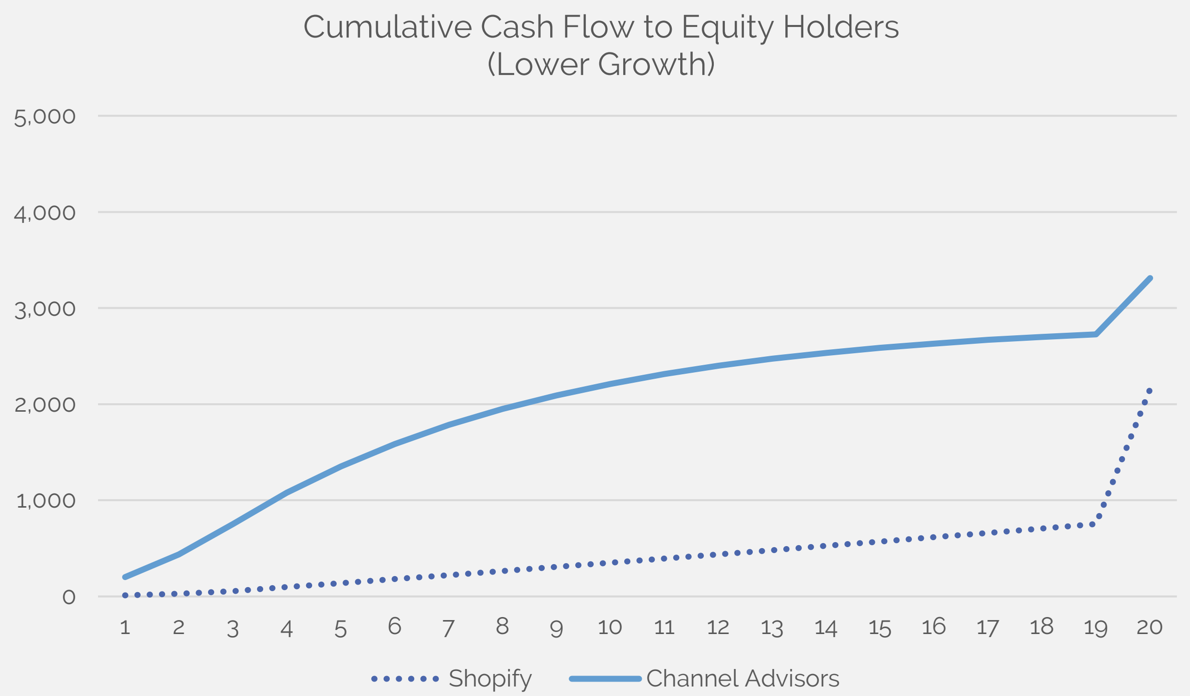
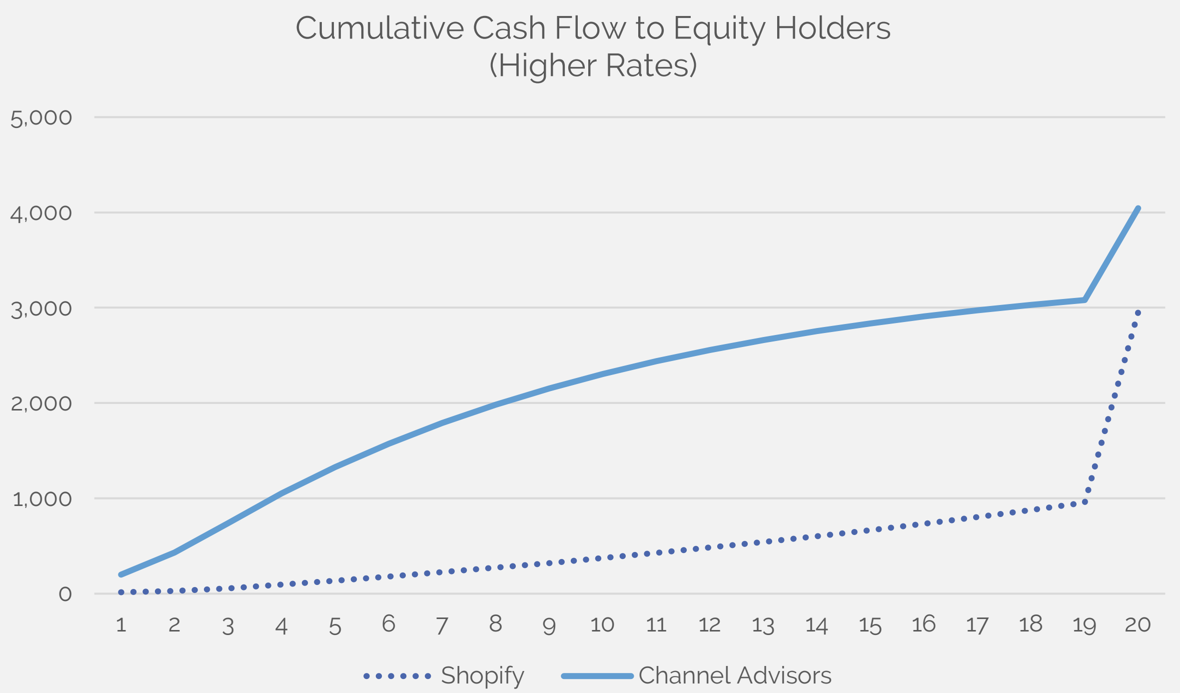
Secondly, such stocks are more sensitive to errors in forecasts. What if Wall Street's superb modelling skills, known for perennially over-estimating future earnings, are wrong? Let's assume both company's growth rates end up being 5% lower. Both companies are worth less, but look how much greater the impact is on Shopify. Investors lose half their money. Better check those forecasts Gerald!



What if the Federal Reserve and its other cartel members stop playing hacky sack with interest rates? The risk to rates is asymmetric. Rates cannot fall much without additional central banks embracing negative interest rates, with the jury still out on its effectiveness. While they sure can rise from such low levels. Look what happens if the discount rate increases by 1%. Again, investors can say goodbye to more of their $5,000 invested in Shopify than in Channel Advisors.



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We don't cover Shopify, it's too large for us. It may grow by the requisite 12.4% using our simple framework, and it may grow by a lot more. But hopefully, we have shown that if managers are buying shares on extreme multiples, they better be prepared to answer some difficult questions when fundamentals return to the fore.

We aim to find great companies, but a large part of the puzzle always lies in the price we pay for an asset. We are not buying shares for what someone might pay for that same share tomorrow. We are buying shares for the future stream of cash flows that will accrue to minority shareholders. It's boring, but it's all been done before.

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	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