Spheria Australian Microcap Fund

ARSN 611 819 651 APIR WHT0066AU

Performance as at 30th September 2020

	1m	6m	1yr	3yr p.a.	Inception p.a.#
Fund^	**3.8%**	**47.2%**	**-3.2%**	**1.7%**	**7.5%**
*Benchmark**	*-2.8%*	*30.9%*	*-3.3%*	*6.5%*	*7.1%*
Value added	6.6%	16.2%	0.1%	-4.8%	0.4%
*Microcap Index***	*-1.0%*	*75.7%*	*4.7%*	*9.4%*	*9.0%*

* Benchmark is the S&P/ASX Small Ordinaries Accumulation Index.

** Microcap Index refers to S&P/ASX Emerging Companies Accumulation Index.

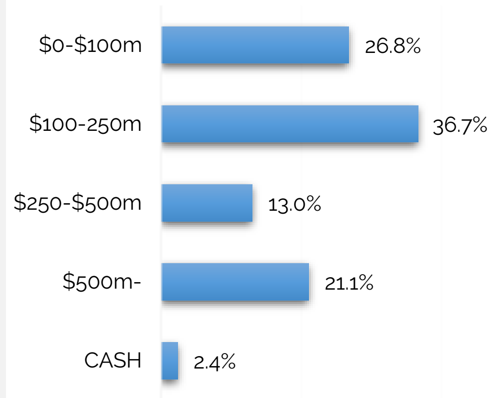
Inception date is 16 May 2016. Past performance is not a reliable indicator of future performance.

Top 5 Holdings

Company Name	% Portfolio
Class Limited	4.8
Mortgage Choice Ltd	4.6
Vita Group Ltd	4.1
Supply Network	3.9
City Chic Collective	3.9
Top 5	**21.3**

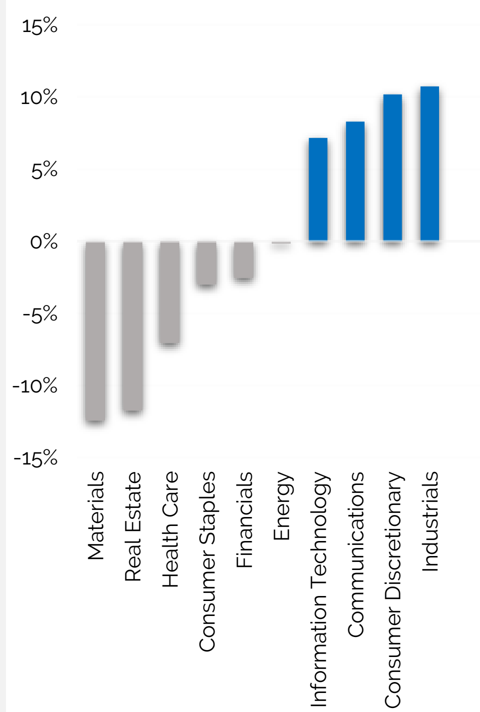
Source: Spheria Asset Management

Market Cap Bands



Source: Spheria Asset Management

Active Sector Exposure



Source: Spheria Asset Management

Commentary

The Spheria Australian Microcap Fund performed strongly over September, returning 3.8% (after fees) to outperform its benchmark by 6.6%.

Markets

Markets pulled back over September with declines paced by high momentum tech stocks, as investors worried over highly stretched valuations and resource stocks as the likelihood of a timely extension to waning US stimulus dimmed due to politicking by President Trump and Congressional Democrats. The fund was a beneficiary of an underweight to high momentum stocks, as well as the trend for many smaller companies to delay their investor roadshows (and hence much of the 'price discovery' process that occurs during result season) until well into September.

Locally we observed some retrenchment amongst a handful of high momentum names trading on very stretched valuation metrics, that either disappointed expectations, had negative newsflow during the month or just rose to unsustainable levels in August. Examples included buy now pay later player ZIP co (Z1P.asx (-33% on Paypal entering the space)), Nearmap (NEA.asx (-23% following a surprise equity raise)), EML Payments (EML.asx (-16%)) and Pointsbet Holdings (PBH.asx (-13%)).

Despite this we continue to observe concerning signs of speculative excess in high momentum names, particularly in areas that are viewed as COVID-19 beneficiaries like E-Commerce, Fintech and Biotech.

The first is that we are seeing a highly elevated number of fresh listings of players in these sectors. Invariably they are listing at sky high multiples of earnings (if positive), sales, book or almost any other metric one chooses to look at. The justification is that these businesses typically have massive total addressable markets, high fixed cost bases and very low incremental operating expenses so these businesses have the *potential* to be highly profitable in the future. While IPOs can be a rich vein of potential outperformance when priced appropriately, in our experience vendors of businesses at IPO (particularly those primarily selling down rather than raising fresh equity) tend to be good market timers given the inherent information asymmetry involved in the sale of a private business.

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This appears to be particularly so when multiple players in an industry list in close succession (e.g. the aged care sector performance since the listing of Regis Healthcare (REG.asx), Estia Health (EHE.asx) and Japara Healthcare (JHC.asx) suggests vendors had far better insight into future funding decisions by the Federal Government than the public market). It is therefore concerning to us to see a wave of primary offerings in these sectors in addition to highly elevated insider sales and secondary offerings by many names in these sectors. As Brad Delong and Larry Summers (renowned economists) note "[t]he rule of thumb in high technology has been that the market leader makes a fortune, the first runner-up breaks even, and everyone else goes bankrupt rapidly." It appears to us that there are many businesses on the ASX (many in the same sectors) that are pricing in success, when logically the likelihood of that outcome occurring is low.

The second is the apparent increase in direct retail participation in the market. We have previously observed that the rise of low or no cost trading platforms like Robin Hood is much higher than normal direct retail investor participation in equity markets in the U.S. Locally we note that low cost platform 'Superhero' ($5 trades), began trading during the month of September and reportedly had added 10 thousand accounts within three weeks. While there are many direct investors with strong analytical skills and investing discipline that have demonstrated strong returns over many years we note that the academic literature suggests on balance retail investors tend to meaningfully underperform broad market indices due to being procyclical, trading excessively and having short holding periods on stocks. Anecdotally, Super Hero investors are reported to have significant overweights in high momentum names (e.g. in the buy now pay later sector) and be actively trading on the advice of unregulated social media investment forums on Reddit and Facebook.

With the rise of passive, quantitative and now direct retail investors in the market it is little wonder valuation disparities appear to be at levels not seen since the dot.com boom. While we don't dispute that low long term interest rates that are currently being seen *ceteris paribus* should lead to higher valuations (in particular for businesses with high growth in the long term), we would note that the reasons for the long term decline in interest rates strongly suggests that all other things are **not** equal. Namely deteriorating demographics, low wage growth rates and the persistent failure of inflation to hit central bank targets suggests an environment where earnings growth is more uncertain than previously may have been the case. With that in mind it may make sense to pay more for a high returning, high growth business with strong barriers to entry and a proven business model than had been the case previously. On the other hand, we would argue that paying more for highly uncertain cashflows from unproven business models makes little sense when the risks to those cashflows is far greater than would have previously been the case. This is particularly the case in our opinion when there remain many 'boring' and relatively unpopular names with proven, high returning and cash generative business models that remain available to purchase in the market at multiples well below their historical relative trading ranges. It is here that we continue to look for opportunities rather than be distracted by stocks which lack fundamental support for their valuations.

Major contributors to performance were:

Mortgage Choice (MOC.ASX) was the largest contributor to performance during the month returning 32%. Mortgage Choice was trading at levels similar to those it hit in early 2019 immediately post the Hayne Commission recommending a regime that would have decimated the broking industry (since comprehensively rejected by the Morrison Government). This and the Government flagging in late September that it would look to abolish the responsible lending regime for mortgages saw the stock re-rated. We note that the stock remains on only 7x EV/EBIT despite being a highly cash generative business that appears to be well positioned to benefit from a substantial reduction in bank's proprietary branch networks.

A2B Australia (A2B.ASX) returned 22% over the month. While the company's short-term performance remains significantly impacted by reduced taxi usage from COVID-19 related restrictions (particularly in Melbourne) the balance sheet is more than strong enough to see A2B through ($24m net cash) and A2B's core mobility market in Australia is gradually improving. The company also began to articulate a measured strategy to grow its payments business into the non-taxi space in Australia and its mobility platform solutions business globally. We believe the market continues to discount an overly bearish outcome on the core mobility business let alone any success on the latter two growth opportunities.

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NZME (NZM.NZ) returned another 23% over September after a 62% gain in August. NZME had reported a very strong 1H20 result in the context of a COVID-19 impacted media market and guided to a solid 2H20 result. The market appears to finally be grasping the opportunity for NZME to monetise their extremely high online readership across NZ by successfully migrating their customer base to an online subscription model. Additionally, NZME are making encouraging progress in establishing a strong number two property portal behind the recently privatised TradeMe, who appears to be obliging by rapidly raising prices to agents. While the stock has returned approximately 150% from its July lows it still screens well trading on only 6x EV/EBIT, with an incredibly dominant position in print journalism, a strong number two position in a duopolistic radio market and has a healthy balance sheet with Net Debt / EBITDA < 1x.

Major detractors to performance were:

GTN (GTN.ASX) was the largest detractor falling 21% over the month (albeit still 17% ahead of its end July lows). While the company continues to be heavily impacted by COVID-19 induced reductions in advertising spend in the four countries it operates in we believe it has ample liquidity to ride out the pandemic. At c4x our estimate of post COVID-19 EPS the position continues to screen well as a recovery play.

City Chic Collective (CCX.ASX) declined 11% over the month as it revealed it was the under-bidder in a bankruptcy auction for the E-Commerce assets of US based Ann Taylor's Catherine's plus size fashion business, despite having been appointed the stalking horse bidder in July. While our analysis suggests the deal would have been highly accretive even at the final price (US$40.8m vs. the stalking horse bid of US$16m) we believe the company showed admirable restraint in preserving capital to instead fund organic growth and alternative M&A opportunities. We continue to see the company as well placed to invest capital at very highly incremental returns.

Gentrack Group (GTK.NZ) declined 21% over the month. While it guided to a better than forecast 2H20 result it also flagged a much lower FY21 result as management reinvest in significant additional software development and increased sales capability. We believe new management (CEO and CFO are newly appointed) are improving the quality of earnings by substantially increasing development investment at the same time as they materially reduce the proportion capitalised to intangibles. We continue to see Gentrack as an interesting recovery play given a net cash balance sheet and an EV/Sales multiple of a mere 1.3x for a pre-dominantly SaaS based business model.

Outlook

We continue to believe our investors are best served by staying true to our investment philosophy to buy cash generative business models, with a track record of solid returns and at sensible valuations having regard to their industry dynamics and positioning. The month saw further recognition of the extent of undervaluation of our portfolio companies, yet despite very strong performance from our names we continue to see material upside on an aggregate basis in our portfolio holdings. Importantly we also continue to find and invest in new names with similar characteristics. Despite a small shift in market sentiment we continue to observe a bifurcation of the market that remains near historic highs amid concerning signs of speculative excess in momentum names. This creates both risk for those investing without discipline and opportunity for investors with the patience to wait out short term market dislocations. We are simultaneously perplexed by the valuation disparities we are observing and excited by the investment opportunities they are presenting us. While it is impossible to predict the future, we remain of the view that a disciplined approach to investment with a focus on the fundamentals stands a good chance of being rewarded with outperformance in a world where observation of fundamentals appears to be increasingly rare amongst equity market participants.

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	Spheria Australian Microcap Fund
Benchmark (universe)	S&P/ASX Small Ordinaries Accumulation Index
Investment objective	The Fund aims to outperform the S&P/ASX Small Ordinaries Accumulation Index over the medium to long term.
Investing universe	Primarily listed companies outside the top ASX 250 listed companies by market capitalisation and companies listed on the New Zealand Stock Exchange with an equivalent market capitalisation
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 • Typically 5% - 10%
Expected turnover	20-40%
Style	Long only
APIR	WHT0066AU
Minimum Initial Investment	$100,000

Platform availability
ASGARD
BT Panorama
BT Wrap
HUB24
IOOF Portfolio Service
Macquarie Wrap
mFund
MLC Wrap / Navigator
Netwealth
One Vue
uXchange