Spheria Global Microcap Fund

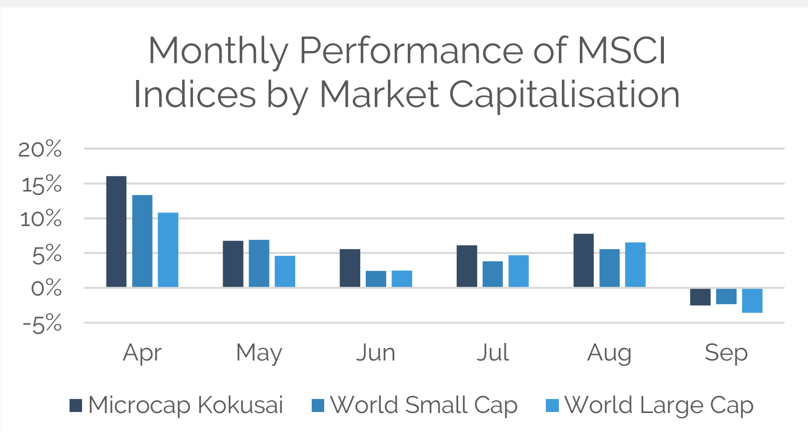
ARSN 627 330 287 APIR WHT6704AU

Performance as at 30th September 2020

	1 Month	3 Months	1 Year	Inception#
Fund^	-0.9%	4.0%	15.0%	12.6%
*Benchmark**	0.6%	7.1%	3.0%	2.5%
Value added	-1.5%	-3.1%	12.1%	10.1%

^ Spheria Global Microcap Fund. Returns of the Fund are net of applicable fees, costs and taxes
* Benchmark is the MSCI Kokusai (World ex Japan) Microcap Index in AUD (Net).
# Inception date is 1 March 2019. Returns are per annum.
Past performance is not a reliable indicator of future performance.

September was a softer month for microcap stocks. Indeed, it was the first month since the depths of the Covid crisis that microcaps have declined. The chart below shows that after the initial bounce in April, microcaps continued to power ahead, outperforming small caps by 12.9% and large caps by 20.4% from the lows. The microcap index has outperformed the MSCI large cap index in each of the last six months.



While the Fund initially did well to keep up with the microcap market, it has struggled to keep pace in recent months as investors leave the safety of companies with solid balance sheets and strong free cash flow to chase growth. During September the Fund declined 0.9% after fees, while the Kokusai Microcap Index rose 0.6%. Since inception, the Fund has delivered 12.6% p/a net of fees relative to the Kokusai Microcap Index which has increased 2.5% p/a.

Markets

The US Federal Government had been supplementing state-provided unemployment benefits with an additional US$600 per week. However, this expired at the end of July. That the market has been so fixated upon whether the US Government can agree on a further stimulus deal suggests that the underlying environment for businesses remains strained.

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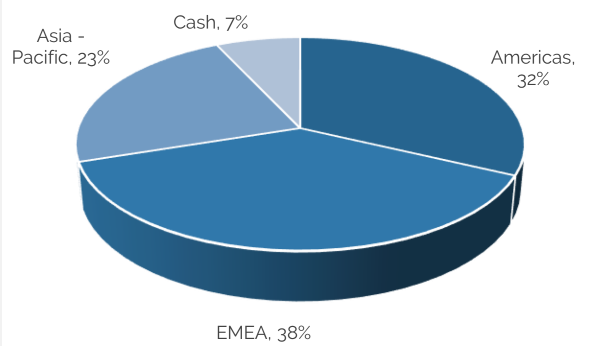
Top 5 Holdings

Company Name	% Portfolio
Sonos (USA)	4.2%
Computer Modelling (Canada)	3.2%
Inogen (USA)	3.1%
Poletowin Pitcrew (Japan)	3.0%
Revolve (USA)	3.0%
Top 5	**16.5%**

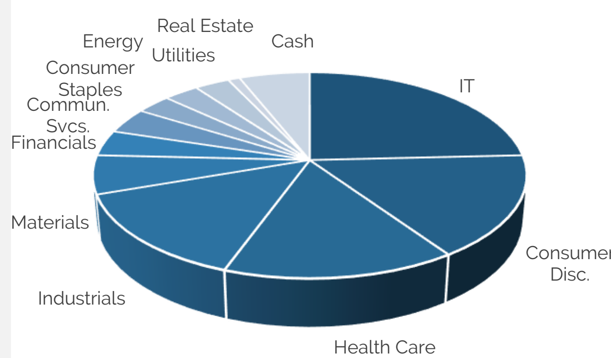
Source: Spheria Asset Management

Regional Exposure by Revenue Source



Source: Spheria Asset Management

Sector Exposure



Source: Spheria Asset Management

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Without further stimulus, a reckoning looms for workers and many small businesses. The EU sovereign crisis following the GFC was an example of politicians playing politics, and ultimately finding a solution that needed to be found. However, when Trump is involved, there is no telling how Thelma & Louise he is prepared to be.

Despite US consumers reliance on Government hand-outs, consumer discretionary stocks led the market, up 3.4%. Indeed since the lows of the market consumer discretionary stocks have been the second best performing sector after materials. The market appears agnostic as to whether that consumer spending is underpinned by disposable personal income, credit growth, or Government funding. We think it is vitally important to differentiate between them, as it goes to the heart of whether that spend is sustainable when we forecast our mid-cycle earnings. The Fund is marginally overweight the consumer discretionary sector, but this includes holdings in a highly specialised service provider to the auto industry for advanced driver assist systems (not leveraged to automotive volumes), a retailer of pet medication, and a personal safety device manufacturer. In these instances the spend is hardly discretionary.

The energy market continues to lag other commodities, perhaps reflecting the specific nature of the Covid pandemic and decreased travel. Microcap energy stocks were off 8.0% in September. We remain underweight the sector and our only exposure is a high returning service provider to the industry.

The UK market has been relatively soft, with UK Microcaps down 2.5% in September. The equity market remains relatively sanguine about Brexit, but it continues to be at the forefront of our minds whenever a UK stock is assessed. We have few domestic focused UK stocks at present, and those we have are relatively defensive or in industries that should at least receive a tailwind from lower interest rates or a falling GBP. Sweden, New Zealand and Finland were the best performing microcap markets. These are all markets where the Fund has decent exposure and collectively these three countries represent 13.6% of the Fund. As investors, we consider ourselves lucky to be able to hunt for opportunities in these innovative countries, which are often neglected by large cap managers.

Fund Performance

The Fund's largest detractor was one of last month's top performers. This online retailer rallied following a strong 2Q20 result. We concurred with the market's assessment and continue to see plenty of upside for this relatively small international retailer. The stock gave up most of its gains on the result. We can only speculate that some investors are preparing for a re-opening and are switching back to bricks and mortar retailers that remain depressed. However, while in the short-term it may not benefit from a vaccine, on a longer timeframe this retailer has a far stronger outlook given its competitive position and the opportunity for further geographic roll-out.

Other detractors included a UK provider of point of sale systems and bill payment solutions for convenience stores, and an Australian plus-size apparel retailer. Positive contributors included a leading equipment supplier to the building industry headquartered in the UK, a US based leader in wireless home speakers, and an owner of a natural soda-ash mine in the USA.

Outlook

We have been highlighting to readers that at present animal spirits are running strong in the equity market. However, equities are not the only ones experiencing indiscriminate buying, credit markets are likewise exhibiting clear risk taking behaviour. The first chart on the following page shows that credit markets are within reach of pre-COVID levels.

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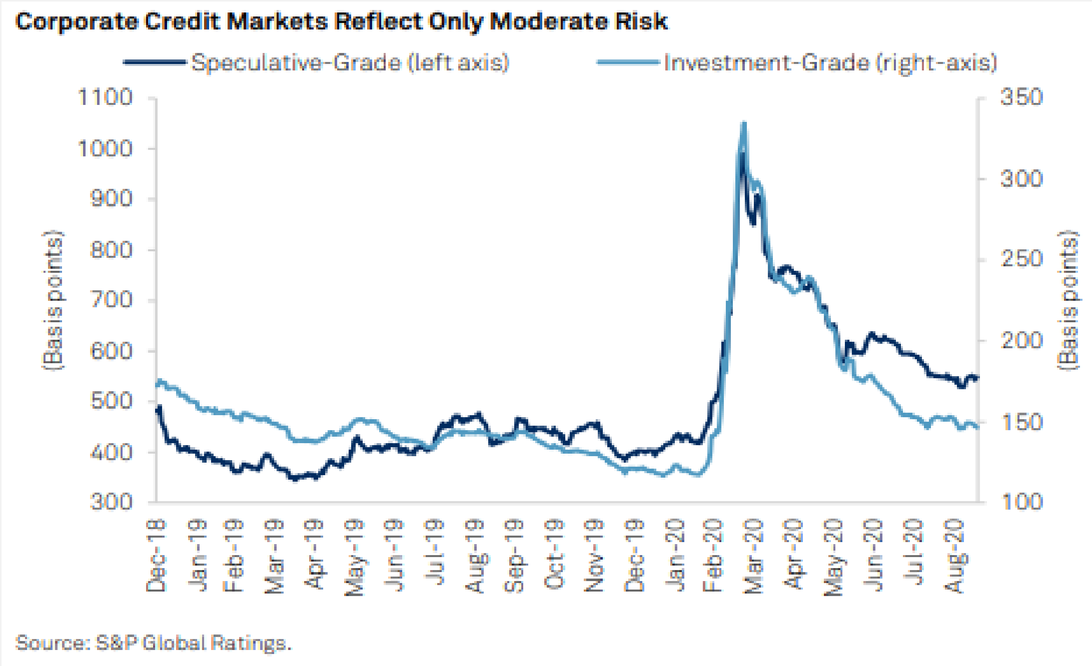
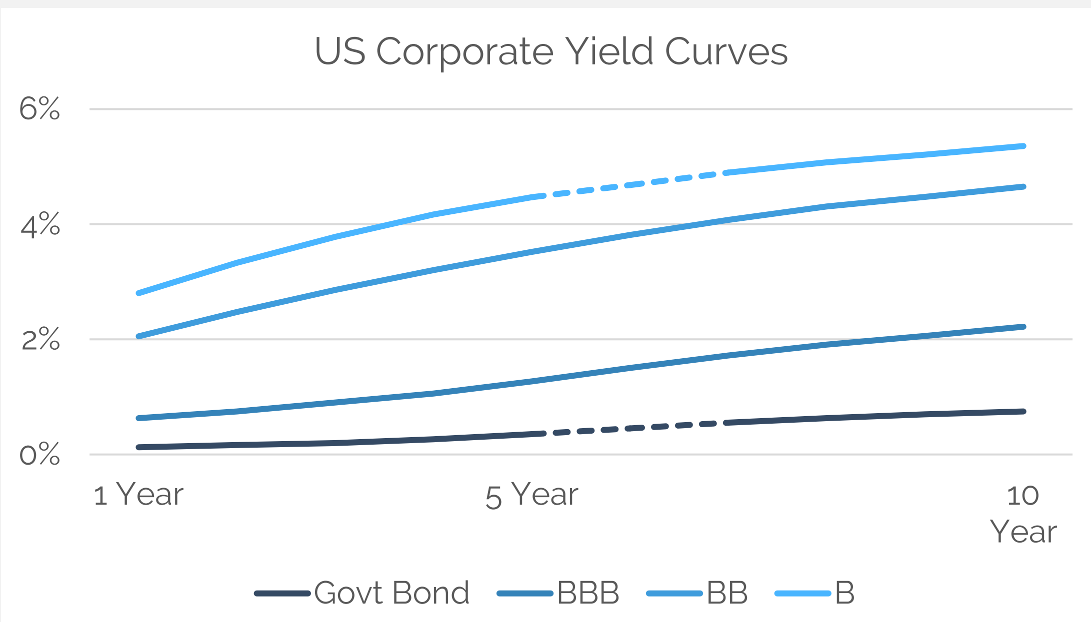


While absolute levels have come down, what is most surprising to us is that the spread between speculative grade and investment grade credit is hardly any wider than pre-COVID. As the chart below shows, the pick-up for investors to transition down the quality spectrum and buy BB and B rated credit is meaningful. For a 10-Year, going from BBB to BB credit gives investors an additional 2.4% yield. From BBB to B, an additional 3.1% yield. Nothing to sneeze at in these times of low interest rates.



Source: Bloomberg, Spheria

But there is a catch. Historically the median default rate for B rated credit is 3.40%, many multiples of what it is for BBB at only 0.07%. Yet investors are still willing to run this risk in the midst of a virus pandemic, US election, and Brexit. As the chart below shows, when things go wrong, they go really wrong for B rated credit.

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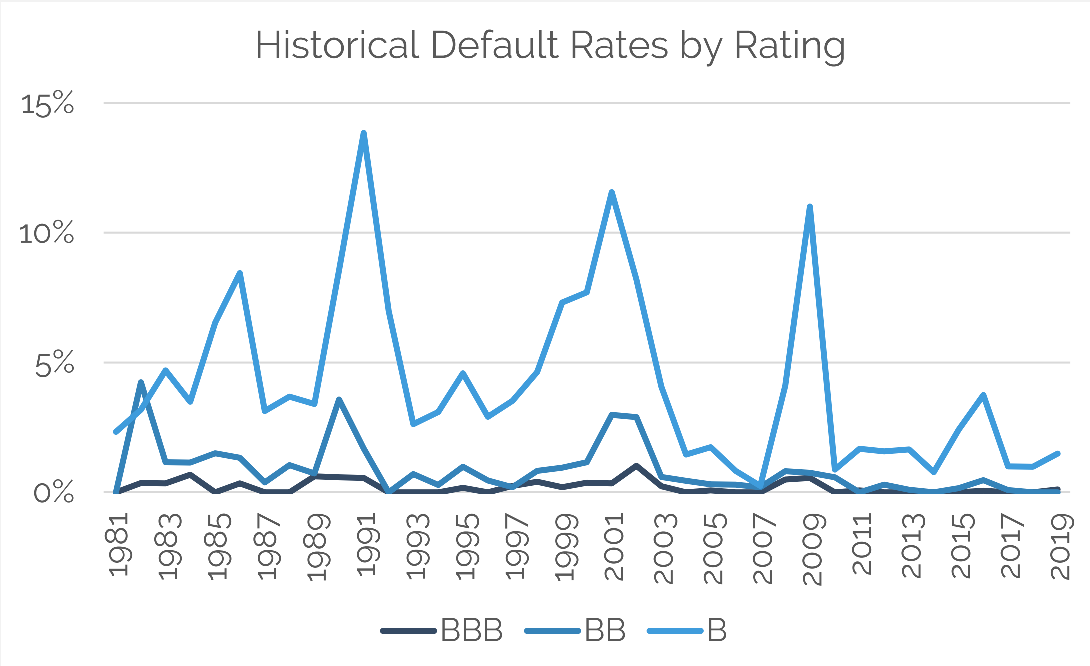
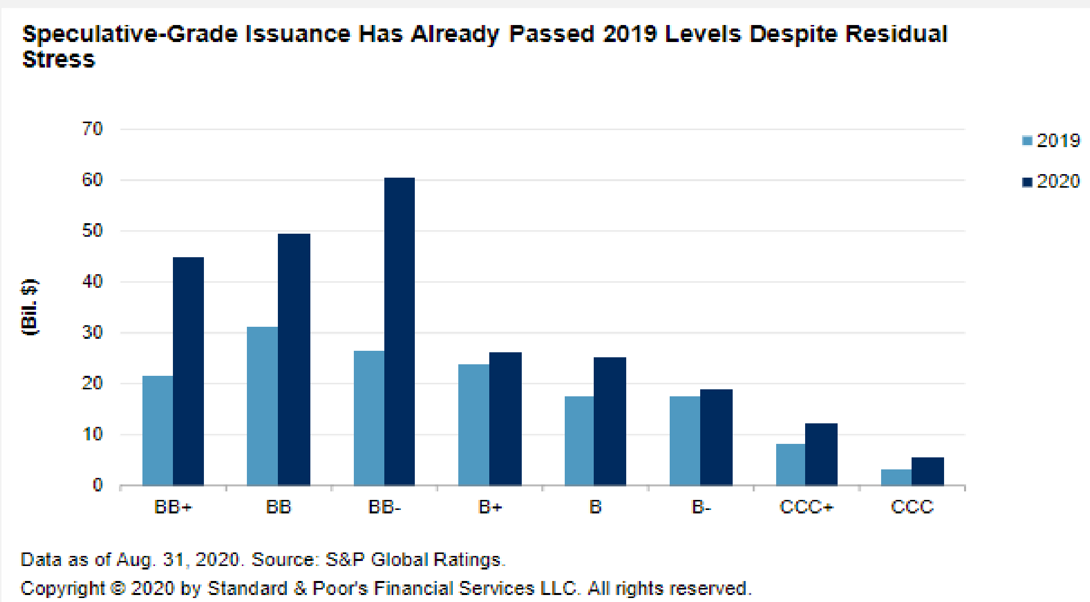


Source: S&P Global Ratings, Spheria

Investor appetite remains strong for speculative grade credit. The chart below shows that companies in this segment of the credit market have already raised more debt during 2020 than during the whole of 2019. While this is partly supply led, with companies shoring up their balance sheets, BB and B rated spreads suggests there is plenty of demand also.



So what ends this risk taking? Most likely it will require a relative increase in the attractiveness of risk-free assets, or the real yields of Treasuries. Since inflation is nowhere to be seen, for now this is a function of central bank policy alone. The market has taken the view that the "Fed Put" (aggressive monetary policy every time markets drop) will remain in place infinitum. As the chart below shows, growth stocks, which benefit the most from low interest rates, have re-rated dramatically. Perhaps the market is right to put its faith in the "Fed Put", but do you want your savings relying on the whim of central bankers?

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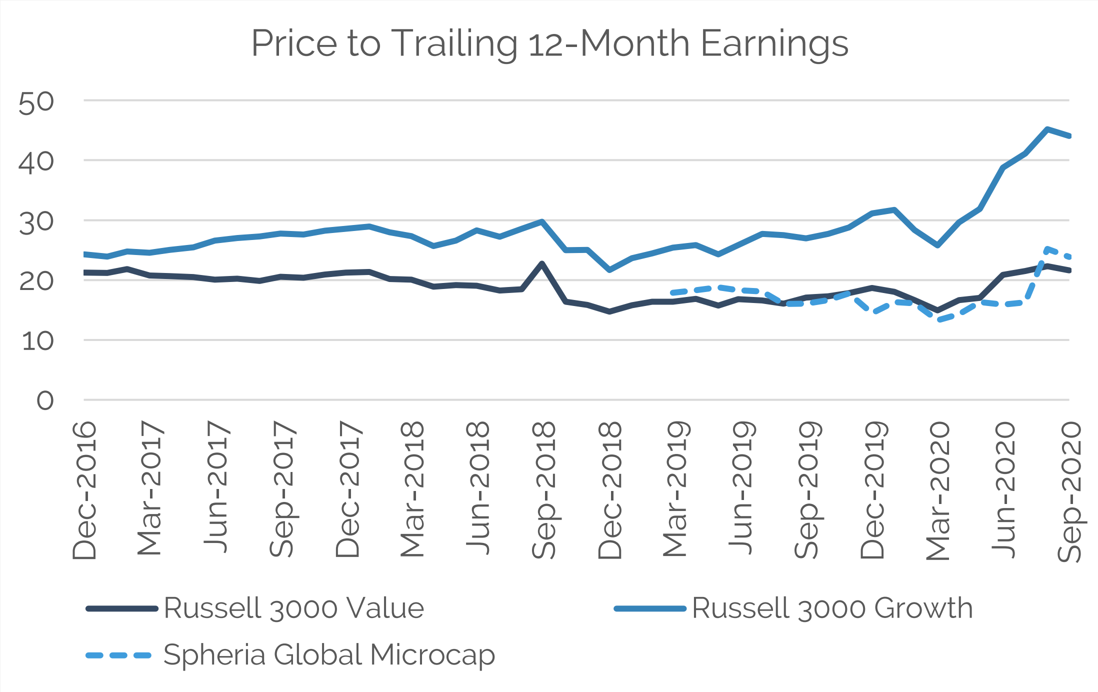

Source: Bloomberg, Spheria

Note: We are using US small cap indices to illustrate the dispersion of value and growth. Such indices are not available for the MSCI Kokusai Microcap Index. The current trailing PE for the MSCI Kokusai Microcap Index is 22.7x.

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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 Kokusai (World ex Japan) 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