

## Performance as at 31st December 2021

	1 Month	3 Months	1 Year	2 Years p.a. <sup>3</sup>	Inception p.a. <sup>3</sup>
Fund <sup>1</sup>	1.3%	1.9%	24.1%	22.7%	22.1%
Benchmark <sup>2</sup>	-0.2%	-2.1%	28.5%	22.6%	18.5%
Difference	1.5%	4.0%	-4.4%	0.1%	3.7%

<sup>1</sup> Spheria Global Microcap Fund. Returns of the Fund are net of applicable fees, costs and taxes.

<sup>2</sup> 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.

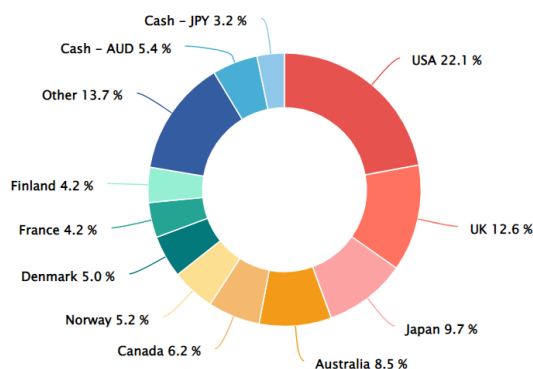
<sup>3</sup> Inception date is 1 March 2019. Past performance is not a reliable indicator of future performance. All p.a. returns are annualised.



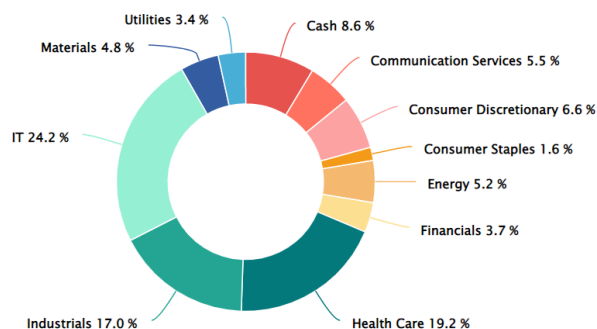
### Overall Commentary

Microcaps in general did not enjoy the Santa rally that large caps did, but the Spheria Global Microcap Fund made it on Santa's nice list and had a solid finish for the year. The Fund returned 1.3% net of fees in December, while the Benchmark fell 0.2%. Large caps did better with the MSCI World up 1.7%, and the MSCI World Smallcap Index rose 1.0%.

### Regional Exposure



### Sector Exposure



Source: Spheria Asset Management

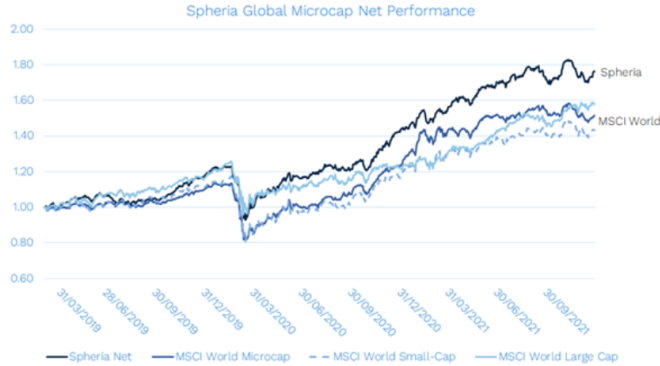
### Global Characteristics

	Average Mcap (USD)	EPS Growth (%)	Trailing FCF Yield (%)	Dividend Yield (%)	Net Debt / EBITDA	FCF Conversion (%)
Spheria	750	51.2	3.5	2.5	-0.7	108.6
World Micro	196	2.0	1.9	2.3	1.0	72.6
World Smalls	2,501	18.2	3.0	1.9	1.9	86.1
S&P500	87,698	30.5	3.7	1.3	0.8	107.2
Nasdaq	7,823	25.7	3.1	0.6	0.2	110.9

EPS= Earnings per Share, FCF = Free Cash Flow, Negative Net Debt / EBITDA figures show a debt free, or net cash balance sheet.

## Further Commentary

Since inception, the Fund has returned 22.1% p/a after fees compared to the Benchmark return of 18.5% p/a and MSCI World Index return of 17.4% p/a.



Source: MSCI, Spheria

## Markets

Microcap defensives fell in December, but materials, financials and industrials rose. This sector performance indicates that investors continue to price in the prospect of increasing interest rates and strong economic growth. Real estate investment trusts (REITs) also did quite well during the month, particularly residential REITs. As the chart below shows, the Central Bank Cartel’s manipulation of interest rates continues to do wonders for the residential property market. We are not in the business of picking residential property cycles, but it is fair to say that for the modest indirect exposure we have to the sector, our “mid-cycle” earnings forecasts are below current levels (i.e. we are factoring in an eventual downturn in activity when valuing such stocks).



Source: Credit Suisse

Hong Kong and the US market were laggards in the microcap world, while the Netherlands, Norway, and Australia did well. It has been a rare occasion that the US market underperforms. The US remains the global home of speculation and risk-seeking behaviour, arguably toppling China, which held the mantle earlier in the cycle.

Looking at the worst performing US microcaps in the benchmark during December is a pertinent reminder that investing in microcaps remains a specialised skill and how an experienced team running a disciplined process around free cash flow valuations can add significant value over the long-run by avoiding large losses.

Company	Ticker	Index Weight	Revenue (\$USm)	EBIT (Adj. - \$USm)	Return (USD)
Cabaletta Bio Inc	CABA US	0.01%	0	-34	-67.3%
Motorsport Games Inc-A	MSGM US	0.00%	19	0	-63.7%
Agilethought Inc	AGIL US	0.01%	0	-1	-57.1%
Excure Inc	XCUR US	0.00%	17	-25	-56.9%
Eqonex Ltd	EQOS US	0.01%	0	-65	-53.4%

It’s no surprise that of these bottom five stocks, not one of them was profitable (although Motorsport Games did produce free cash flow in FY20 before entering a US\$14m deficit so far in FY21).

As we have observed before, microcaps have outperformed small and large cap stocks over time despite the drag from such speculative microcap stocks imploding along the way. Think how well the rest of the microcap universe, which is profitable and producing free cash flow, has done over the long run? By remaining disciplined and avoiding such losses, we are confident the Fund can continue to outperform its larger peers over time.

## Fund Performance

MADER (MAD.AU)



Source: Mader Group

Mader was the top contributing position to performance in December. This Ultratruck for mobile mining equipment continues to gain favour with its mining customers. Mader offers superior response times and service levels for maintaining mining equipment at a lower price than the original equipment manufacturer's (Caterpillar and peers).

Mader's first mover advantage and the large market opportunity in the US is becoming increasingly evident to the rest of the market. In addition, management has also signalled its intention to step up the pace of expansion into adjacencies such as processing infrastructure maintenance, shutdowns and repairs. These two opportunities alone provide a significant growth opportunity, and because of its capital-light nature, shareholders shouldn't have to wait long to be rewarded with increasing free cash flow.

ZYNEX MEDICAL (ZIXI.US)



Source: Zynex Medical

Zynex is a manufacturer and distributor of pain management, incontinence treatment, patient monitoring systems, and rehabilitation devices. Its key product, NexWave, uses long-established technology (low-voltage electric currents) to treat pain symptoms. While the current opioid epidemic in the US means there is demand for alternatives to prescription pain medication, the history of Zynex is the real story.

Zynex's founder, Thomas Sandgaard, left Siemens in the 90s to start his own business, convinced of the opportunity for such pain management devices in the US market. The company floated in 2004 through a reverse merger of a public shell in the OTC market. Given its modest beginnings, the company was run on the smell of an oily rag and never had sufficient capital to unleash its growth potential. For instance, the company relied on contract sales people to distribute its products.

For some time, the pain management industry was enjoying a bonanza from transdermal pain creams, which were reimbursed generously. Unfortunately, the company had become heavily skewed in this direction as its third party sales force chased short-term commissions. In 2013, reimbursement was cut materially for transdermal pain creams. This change was devastating for Zynex who then defaulted on its line of credit and had to endure forbearance from its bank. This near-death experience led to the Zynex we know today:

- Net cash balance sheet.
- In-house sales force expanding prudently.
- Seeking to diversify by using NexWave as the cash cow to bring its new patient monitoring solution to market and supplemented with small acquisitions.

With this new approach, the company is finally well placed to capitalise on some recent serendipity. In 2015 and 2016, Zynex's two largest competitors were forced to leave the market after a DOJ crackdown for over-billing its customers. Zynex has been ramping up its capabilities to capitalise on this void, and growth has accelerated. Revenue has increased from US\$13 million in FY16 to \$US80 million in FY20. Consensus expects US\$181 million by FY22e.

The company still suffers from a negative stigma, but we are convinced that management's actions are evidence that it has learned from past missteps. The opportunity ahead for the NexWave product is being mispriced by the market. Beyond that, the company will most likely have a new FDA-approved product for blood monitoring and then oxygen monitoring, which is currently being ascribed zero value in the share price. Zynex trades on an FY22e EV/EBIT of 11x or PE of 15x.

## Outlook



Source: Facebook

Some members of the Spheria team are avid fans of the sweet science of boxing. While undeniably a barbaric and perhaps antiquated sport, it is difficult not to admire the skill and courage of these athletes. Like soccer, it has lifted many a poor child from the streets, making some of its legends all the more heralded. Recently, Australia tasted its own success with George "Ferocious" Kambosos Jr becoming the undisputed world lightweight champion in late 2021 (pictured above).

But in 2022, who will be crowned champion in equity markets? Let's take a look at the judges' scorecards round by round.

*For an explanation of how boxing fights are scored, see the section below.*

### HOW IS THE FIGHT SCORED?

The modern boxing scoring system is known as the '10-Point Must System'. Here is a basic overview of how it works:

- + Judges score each round individually, on a 10-point scale. Most rounds are scored 10-9, with the boxer who did better scoring 10 and 'winning' the round, with the other fighter scoring 9.
- + If a boxer is knocked down or hurt enough to prompt a standing count from the referee, that fighter loses a point. So, if a boxer dominates a round, controlling and landing better punches throughout and also knocks their opponent down, the end result is a 10-8 round. If a boxer dominates the round but gets caught out and put on the canvas for a knockdown, it's a 9-9 round.
- + If both fighters score a knockdown in the same round, the deductions 'cancel each other out' (so it would probably still be a 10-9 round in favour of the better boxer)
- + A judge is able to award a 10-8 round without a knockdown, if the fighter scoring 10 dominated the round by a huge margin (this is usually only used if a round is total one-way traffic, or perhaps if a fighter was saved from a knockdown because the round expired).
- + Judges are also able to award a 10-10 round, if the round in their eyes was completely even and there was nothing between the fighters.

Source: DAZN



ROUND 1: Rising Real Interest Rates

	Large	Small	Micro	Spheria
Rising Real Interest Rates	9	8	9	<b>10</b>

If 2022 brings rising real interest rates we expect small caps to get knocked down. Small-Caps could suffer on two fronts. Firstly, valuations are well in excess of microcaps at a 19% EV/EBIT premium, leaving them susceptible to the impact rising rates have on future discounted cash flows. Secondly, Small-Caps are by far the most leveraged segment of the market with Net Debt / EBITDA of 1.9x.

Conversely, Spheria would win this round for the same reasons. Our portfolio's modest earnings multiple and net cash balance sheets will hold up well under this scenario.

ROUND 2: Higher Inflation

	Large	Small	Micro	Spheria
Higher Inflation	<b>10</b>	9	9	9

If inflation were to surprise to the upside in 2022 we would score the round to large caps. These large companies typically have greater pricing power and the ability to push cost pressures through to end customers.

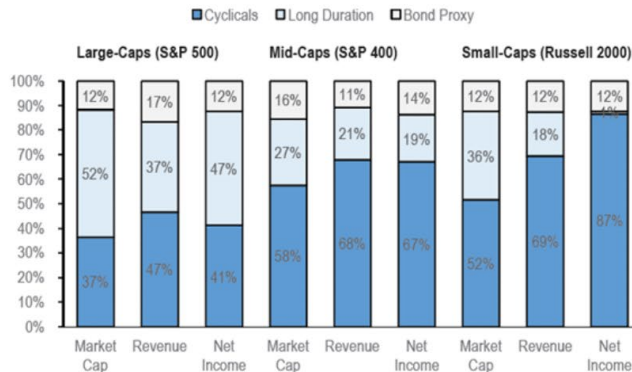


ROUND 3: Slowing Economy

	Large	Small	Micro	Spheria
Slowing Economy	<b>10</b>	9	8	9

Again, another round won by large caps if the economy slows in 2022. Investment banks have been downgrading their growth forecasts in recent months. Treasury yields linger stubbornly low, while economically sensitive commodities such as copper remain elevated. We suspect that growth expectations will continue to slip during the year as the effect of Government stimulus wanes and inflation begins to impact demand.

Microcaps typically underperform as the economy slows. One reason for this is simply the make-up of the universe. Smaller stocks tend to be more cyclically exposed. The chart from JP Morgan below estimates how much of each segment of the US market is cyclical (banks, materials and industrials), long duration (growth stocks such as IT and healthcare) and bond proxy (utilities and infrastructure typically).



Source: J.P. Morgan US Equity Strategy and Global Quantitative Research, Factset, Bloomberg L.P.

However, at present, Spheria's portfolio is positioned relatively defensive. Last year the Fund switched out of consumer and into healthcare stocks. From our bottom-up perspective, valuations became stretched for consumer stocks thanks to Government stimulus. On the other hand, healthcare was shunned as investors switched into stocks that would benefit from a strong economic recovery. So the judges score Spheria a 9 for this round, better than microcaps overall.

## ROUND 4: Fed Taper

	Large	Small	Micro	Spheria
Fed Taper	7	8	9	<b>10</b>

Last month we showed the impact on equity markets from quantitative easing by the Central Bank Cartel and how the largest stocks have been the biggest beneficiaries of this financial engineering. Therefore, if the Fed Taper's more than expected (and make no mistake, equity markets are currently calling the Fed's bluff) large caps are likely to get knocked down twice. Smaller companies, being further distanced from quantitative easing should be less impacted.

### U.S. Large Caps During a Fed Taper



Source: YouTube

Tapering by the Fed should also be the downfall for profitless technology stocks, bitcoin and other examples of rampant speculation. That's why in this scenario, we score Spheria a ten, since parts of the microcap universe will be embroiled in this risk reversal.



### Decision

We have a split decision with two rounds going to large caps and two to Spheria. Come what may in 2022, investors may be best served by blending the Spheria Global Microcap Fund with their existing large-cap exposure. Our expected loser overall is small caps. The small cap segment has been the best performing part of the market since the lows of the GFC and so some give back is expected, especially if interest rates rise. However, over the long-run, we expect that like microcaps, they too will outperform their larger peers as they have historically.

Whatever 2022 brings, we wish our investors a safe and prosperous year ahead. We will do our best to make the latter come true.

*"Greatness is not a measure of how great you are but how great others came to be because of you"*

Cus D'Amato (renowned boxing trainer)

## Platform Availability List

The Spheria Global Microcap Fund is available on the below Platforms. Please check with your platform for minimum investment requirements and fees.

[BT Panorama](#)

[HUB24](#)

[Macquarie Wrap](#)

[Netwealth](#)

[Praemium](#)

Spheria Global Microcap Fund	
Benchmark	MSCI World Micro Cap Index
Investment Objective	Outperform the MSCI World Micro Cap 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
Holdings	Generally 30-80 stocks
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

## Fund Ratings



## Further Information

For more information, please contact Pinnacle Investment Management Limited on 1300 010 311 or email [distribution@pinnacleinvestment.com](mailto:distribution@pinnacleinvestment.com)

## Disclaimer

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