# Performance as at 28th February 2022

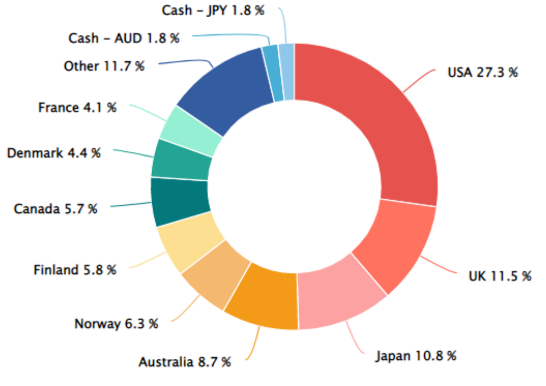
| | 1 Month | 3 Months | 1 Year | 2 Years p.a.[3] | Inception p.a[3] |
|---|---|---|---|---|---|
| Fund[1] | -4.7% | -6.6% | 8.9% | 19.5% | 17.6% |
| Benchmark[2] | -4.3% | -8.3% | 2.1% | 19.6% | 14.1% |
| Difference | -0.5% | 1.7% | 6.8% | -0.2% | 3.5% |

1 Spheria Global Microcap Fund. Returns of the Fund are net of applicable fees, costs and taxes.
2 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.
3 Inception date is 1 March 2019. Past performance is not a reliable indicator of future performance. All p.a. returns are annualised.

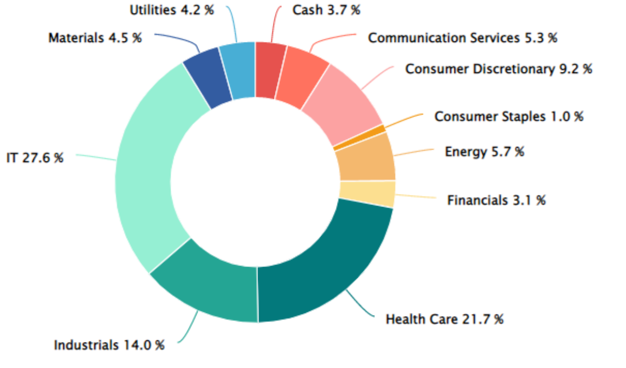
## Overall Commentary

The Spheria Global Microcap Fund returned -4.7% (after fees) during the month of February, underperforming the MSCI World Microcap Index by 0.5%.

## 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 | 673 | 30.4 | 4.5 | 3.1 | -0.5 | 110.6 |
| World Micro | 173 | -6.8 | 1.1 | 2.6 | 0.8 | 67.5 |
| World Smalls | 2,185 | 9.5 | 3.7 | 2.1 | 2.0 | 73.6 |
| S&P500 | 77,712 | 13.3 | 4.6 | 1.4 | 0.8 | 93.9 |
| Nasdaq | 6,396 | 12.5 | 3.6 | 0.8 | 0.2 | 94.8 |

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

## Further Commentary

Ever since Iraq's invasion of Kuwait, and Stormin Norman's impressive blitzkrieg (shock & awe to use American parlance) in the 1990 Gulf War, sharemarkets have mostly shrugged off any conflict.

**Geopolitical Events And Stock Market Reactions**

| | | S&P 500 Index | | Calendar Days To | |
|---|---|---|---|---|---|
| Market Shock Events | Event Date | One-Day | Total Drawdown | Bottom | Recovery |
| Iranian General Killed In Airstrike | 1/3/2020 | -0.7% | ? | ? | ? |
| Saudi Aramco Drone Strike | 9/14/2019 | -0.3% | -4.0% | 19 | 41 |
| North Korea Missile Crisis | 7/28/2017 | -0.1% | -1.5% | 14 | 36 |
| Bombing of Syria | 4/7/2017 | -0.1% | -1.2% | 7 | 18 |
| Boston Marathon Bombing | 4/15/2013 | -2.3% | -3.0% | 4 | 15 |
| London Subway Bombing | 7/5/2005 | 0.9% | 0.0% | 1 | 4 |
| Madrid Bombing | 3/11/2004 | -1.5% | -2.9% | 14 | 20 |
| U.S. Terrorist Attacks | 9/11/2001 | -4.9% | -11.6% | 11 | 31 |
| Iraq's Invasion of Kuwait | 8/2/1990 | -1.1% | -16.9% | 71 | 189 |
| Reagan Shooting | 3/30/1981 | -0.3% | -0.3% | 1 | 2 |
| Yom Kippur War | 10/6/1973 | 0.3% | -0.6% | 5 | 6 |
| Munich Olympics | 9/5/1972 | -0.3% | -4.3% | 42 | 57 |
| Tet Offensive | 1/30/1968 | -0.5% | -6.0% | 36 | 65 |
| Six-Day War | 6/5/1967 | -1.5% | -1.5% | 1 | 2 |
| Gulf of Tonkin Incident | 8/2/1964 | -0.2% | -2.2% | 25 | 41 |
| Kennedy Assassination | 11/22/1963 | -2.8% | -2.8% | 1 | 1 |
| Cuban Missile Crisis | 10/16/1962 | -0.3% | -6.6% | 8 | 18 |
| Suez Crisis | 10/29/1956 | 0.3% | -1.5% | 3 | 4 |
| Hungarian Uprising | 10/23/1956 | -0.2% | -0.8% | 3 | 4 |
| N. Korean Invades S. Korea | 6/25/1950 | -5.4% | -12.9% | 23 | 82 |
| Pearl Harbor Attack | 12/7/1941 | -3.8% | -19.8% | 143 | 307 |
| **Average** | | **-1.2%** | **-5.0%** | **22** | **47** |

Source: LPL Research, S&P Dow Jones Indices, CFRA, 01/06/20

All indexes are unmanaged and cannot be invested into directly.
Past performance is no guarantee of future results.
The modern design of the S&P 500 Index was first launched in 1957. Performance before then incorporates the performance of its predecessor index, the S&P 90.

Source: LPL Research, S&P Dow Jones Indices, CFRA, 01/06/20

However, much like Kuwait, energy supply is the issue in Russia and Ukraine's current conflict. Data from BP estimates Russia is 17% of global gas output and 12% of global oil output. In 2020 Russia produced 10.6m barrels daily, just behind Saudi Arabia at 11.0m barrels daily.

Leading up to Russia's invasion, oil prices were already high, and inflation was elevated. There are many similarities to the 1979 oil disruption following the oil embargo in the early 70's. However, the difference being that growth stocks were riding high leading into the current episode. On the other hand, in the 70's, growth was on the nose following the folly of the 60's roaring bull market and value investing was in vogue.

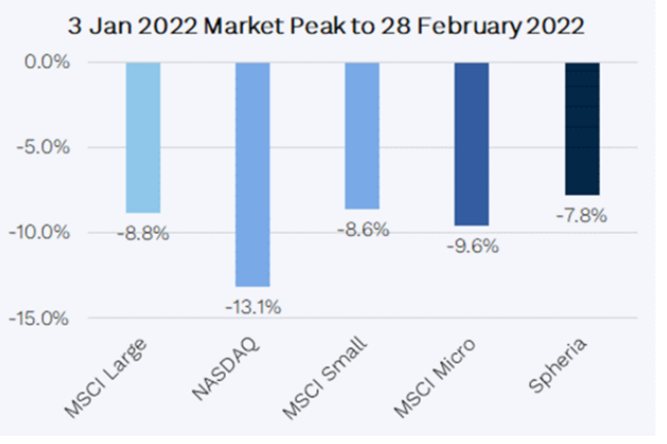
The Goldman Sachs Profitless Technology Index has been decimated. As of 7 March 2022, it is down 59.6% from its February 2021 peak. Surely an oil shock of this magnitude is the final death blow?


Source: Bloomberg

As of 7 March, the NASDAQ is off 20.1% from its November 2021 peak. If Dotcom is any guide, it will halve, then halve again from this point! That's OK. It will only need to gain 500% from that point to recoup its previous high — arithmetic, elegant in its brutality.

The Spheria Global Microcap Fund was not spared in this sell-off, falling 4.7% after fees in February. The MSCI World Microcap Index fell 4.3%, outperforming the MSCI World Index of large cap stocks, which fell 5.4%.

Since the market's peak, the Fund has fallen less than the major MSCI Indices. However, it is early days as far as bear markets go. Using the Dotcom bust as a template, if this sell-off continues, we would expect smaller companies to base out first, finding a floor (albeit a volatile one) while larger stocks and the NASDAQ continue to decline. To understand why, please refer to our outlook section.




Source: MSCI, Spheria. Spheria return net of fees.

## Markets

No prizes for guessing what the best performing sector in February was. Microcap Energy was up 7.2%, beating all others. Quite a rise in contrast to the broader market's decline. Thankfully, the Fund has two very high-quality service providers that rose by a similar amount to the industry.

Health Care underperformed, down 9.9%. While our Fund's stocks did far better than this, the sector's move is surprising. Such a commodity shock as we are seeing in energy, wheat and nickel act as a significant tax on the consumer. Consumers are already facing higher prices from supply chain disruptions. The consumer remains the bedrock of the economy, and there is little doubt that these commodity shocks will impact economic growth. The recent events are becoming the Central Bank Cartel's worst nightmare, rising inflation and declining economic activity.

Markets one would expect to be safe and free from embroiling in any conflict were the best performing: Switzerland (-1%), Singapore (-1%) and Japan (-2%). Countries dominated by high growth companies, a positive until recently, led the decline: Sweden (-15%), Finland (-11%), France (-10%), Denmark (-9%). Despite being the epicentre of greed and excess in this cycle, the US fell only 3.4%.

Even though the US market looks expensive on aggregate, its composition has become highly dispersed. Glamour growth stocks, or those with great stories to tell but little earnings to show, were until recently priced for perfection assuming historically low interest rates forever, and then some for good measure. However, stocks that did not capture the imagination of investors or were not a "going up story" were being increasingly neglected. Given this set of circumstances, we have amassed a fantastic US sleeve of our portfolio, and the Fund is currently 3% overweight that market.

Our mantra is always to rely on our valuation true-north and take advantage of the market's fear and greed, or in this case, nonchalance towards attractive high returning businesses. As a result, since the market's peak, our US stocks are down a subdued 6% compared to the US portion of the MSCI World Microcap Index, which has fallen 12%.

## Fund Performance

### INOGEN (INGN.US)


Source: Our World in Data, Spheria

Inogen was the Fund's top contributor in February, rising while the market fell. Inogen is the market leader in the growing portable oxygen concentrator market. These devices allow patients on oxygen therapy to remain mobile rather than stay attached to a heavy oxygen tank. COVID has been a severe blow as elderly patients have not been mobile, but rather confined to self-isolation. As mobility has resumed, so has demand for Inogen's products. However, a semiconductor shortage has meant the company has struggled to maintain supply. These factors are short-term in nature, and we believe the stock remains severly undervalued over a medium-term outlook.

Interestingly, in such a go-go market, investors are unwilling to be contrarian and accumulate a stock such as Inogen. Money in something like Inogen is seen as "dead money", as investors feel the need to keep pace with a rising market. Strange as it is, investors would rather miss the initial recovery in earnings and the share price rise than risk buying the stock too early. However, this kind of mindset is dangerous, especially when the market runs out of puff. Companies like Inogen are more likely to be held by fundamental and committed investors. Indeed, the stock has held up well despite the broader market malaise. On the other hand, high flying stocks are likely to have a share register full of fickle good time investors who may not be so committed. It sure is slow going exiting a theatre once the show is over, everyone trying to leave through the same door.

## ZYNEX (ZYXI.US)

Zynex was the Fund's largest detractor in February. Zynex dominates the US market in manufacturing and supplying Transcutaneous Electrical Nerve Stimulation (TENS) for pain management and patient rehabilitation. TENS is a well known and safe treatment that physicians have used for decades. The machines are, generally speaking, basic devices, and Zynex's value add does not come from its TENS machines per se.

### What is transcutaneous electrical nerve stimulation (TENS) therapy used to treat?

TENS therapy has been used or is being studied to relieve both chronic (long lasting) and acute (short-term) pain. Some of the most common conditions for which TENS has been used include:

- Osteoarthritis (disease of the joints).
- Fibromyalgia (aching and pain in muscles, tendons, and joints all over the body, especially along the spine.
- Tendinitis (an inflammation or irritation of a tendon).
- Bursitis (inflammation of the fluid-filled sacs that cushion joints).
- Labor pain.
- Low back pain.
- Chronic pelvic pain.
- Diabetic neuropathy (damage to the nerves that connect the brain and spinal cord to the rest of the body).
- Peripheral artery disease ("hardening of the arteries" that circulate blood to the body).

Source: Cleveland Clinic

Zynex instead is about back-office scale, marketing and distribution reach, and managing the complex world of US insurance payers. These obstacles were enough to create a three-player market. However, Zynex's two major competitors' questionable billing practices led to punitive action by the US Department of Justice. This left Zynex with a Steven Bradbury opportunity to capture most of the market.

While the opportunity to shoot fish in a barrel will not last indefinitely, the market is pricing this in at only 8x EV/EBIT. We anticipate with COVID distractions subsiding that Zynex can ramp up faster than the market expects. Furthermore, barriers to entry are likely to be stronger than the market gives the company credit for. Once again, this is an example of a stock lacking lustre because its widget is not revolutionary or disruptive. Yet, any investor who a) discovers this stock of only $US220 million market capitalisation and b) includes valuation as part of their process; will recognise that the company does not need to perform any heroics for an investor's outlay to be recouped in a matter of only three or four years. On top of that, the company remains founder-led, net cash and investors also receive a free option on a new blood monitoring device undergoing FDA registration.

## Outlook


Source: YouTube

"Who Am I?"

Recall the game show, Sale of the Century? This question was the point at which the game's pace slowed down. Tony Barber asked the question and then read out facts to identify a historic personality. For contestants, it was a judgment call between jumping in early when information was scant or waiting for more detail and potentially getting beaten by another contestant's buzzer.

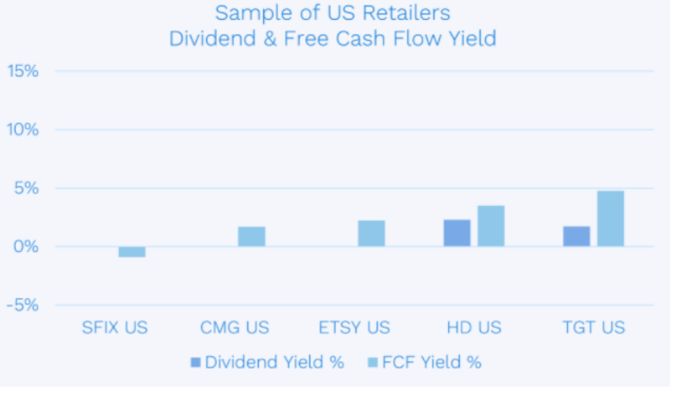
Thanks to the Central Bank Cartel's quantitative easing, it certainly feels like investors have been pressing the buzzer before poor Tony has had a chance to finish his introduction, let alone read the question. Quick, don't miss out on this EV stock or new crypto stock. Investors seemed prepared to worry about the economics later.

But what about on the way down? Are investors as quick to jump in when it might pay to wait?

Let's take a range of US retail stocks, three in the S&P500 you may recognise, and a loss-making small-cap stock: Target (TGT), Home Depot (HD), Etsy (ETSY), Chipotle (CMG), and small-cap Stitch Fix (SFIX).

At what point are these stocks so tempting you must jump in before others do? Which stock would you buy?

OK, ready? Hands on the buzzer.

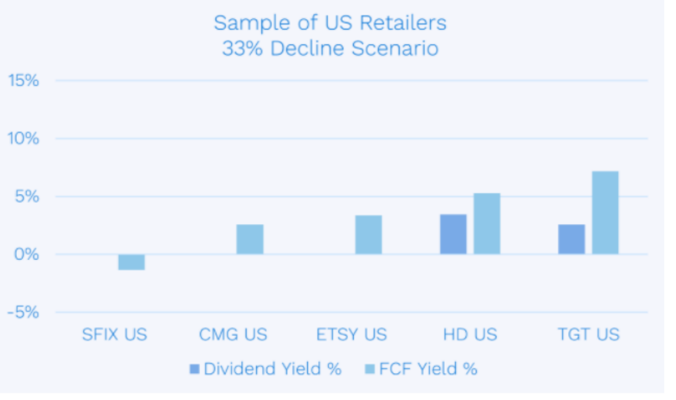



Source: Bloomberg

Surveying the chart above, are you tempted to press that buzzer?

Well a 2% dividend yield from a company like Home Depot is not bad, but then again an investor can now get 2% in US 10-year bonds. The free cash flow yield of Target is approaching 5%, tempting. But as an A-rated S&P or A2 Moody's creditor, I could get a 5.5% yield on a corporate bond maturing 2028. Less yield despite accepting a lower rank down the capital pecking order. Recall too that this is free cash flow yield, not dividend yield, so who knows when equity holders will see the cash. I don't hear any buzzers going off yet.

Let's say stocks decline by one third. Any buzzers being slapped?

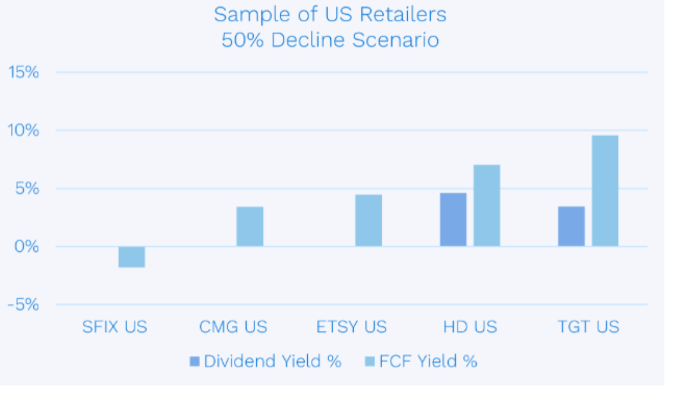



Source: Bloomberg

Hmmm, the chart above is showing that Stitch Fix's negative yield is getting larger. This raises questions about the company's future viability. How long can the company fund its losses and what happens if the shares keep declining and it needs to raise equity? There are certainly no buzzers to buy, but perhaps some panic to sell before others do.

The Target free cash flow yield is now 7% — finally, some reward for being down the capital pecking order. The contestants' fingers are getting itchy. For Chipotle and Etsy, returns are still very modest for investors in today's terms. Any investment still very much rests on their future potential and ongoing growth. However, when investors turn pessimistic and risk-averse, are they willing to buy into this?

Now, let's assume these stocks decline 50%. Hands on your buzzers.




Source: Bloomberg

*BZZZ* Investors are unlikely to resist a nearly 10% free cash flow yield from Target. Home Depot's dividend yield of 5% also looks attractive. 5 Year Home Depot corporate bonds are yielding closer to 2.5%, and given Home Depot's history of growth (8% revenue CAGR over the past 10 years), investors will likely pounce at such an opportunity.

On the other hand, Stitch Fix's negative yield is greater still. ETSY's free cash flow yield has risen to nearly 5%. However, Chipotle still relies on the kindness of strangers, with little impetus drawing investors to buy the stock today.

This simplistic analysis shows that, without a floor provided by strong fundamental cash flow and yield, at what point do investors say enough is enough? Furthermore, as we noted with Inogen, high flying stocks on high multiples are commonly held by fickle investors easily distracted by the next shiny thing.

It's one thing to invest in a rising market, it's another to invest in a declining market. That's why the Spheria investment process is designed to work through the cycle. Is your portfolio prepared for both?

## 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

Zenith RECOMMENDED

## Further Information

For more information, please contact Pinnacle Investment Management Limited on 1300 010 311 or email distribution@pinnacleinvestment.com

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