SPHERIA ASSET MANAGEMENT

Spheria Global Microcap Fund

ARSN 627 330 287 | APIR WHT6704AU

Performance as at 31st January 2022

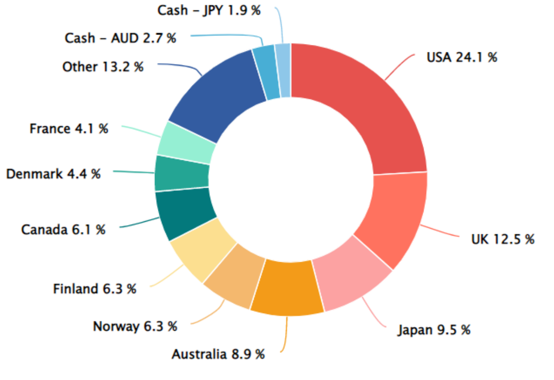
	1 Month	3 Months	1 Year	2 Years p.a.[3]	Inception p.a[3]
Fund[1]	-3.2%	-2.1%	18.1%	18.4%	20.1%
Benchmark[2]	-4.0%	-4.1%	15.3%	18.5%	16.2%
Difference	0.9%	2.0%	2.8%	-0.1%	3.9%

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.

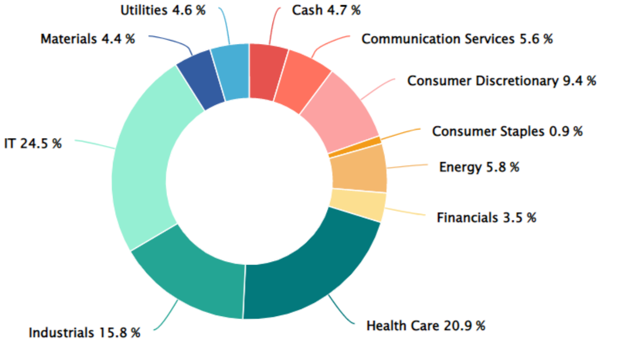
Overall Commentary

January was a reminder that as much as we can analyse and hypothesise about markets, it all boils down to fear and greed in the short-term. Greed turned quickly to fear, and at its trough, the MSCI large cap index fell 7.7% in AUD.

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	697	60.1	3.7	2.8	-0.6	107.7
World Micro	186	-5.0	0.7	2.4	1.0	71.4
World Smalls	2,360	12.8	2.6	2.0	1.9	82.6
S&P500	84,384	38.6	3.8	1.3	0.7	97.4
Nasdaq	7,290	53.4	3.1	0.7	0.1	96.0

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

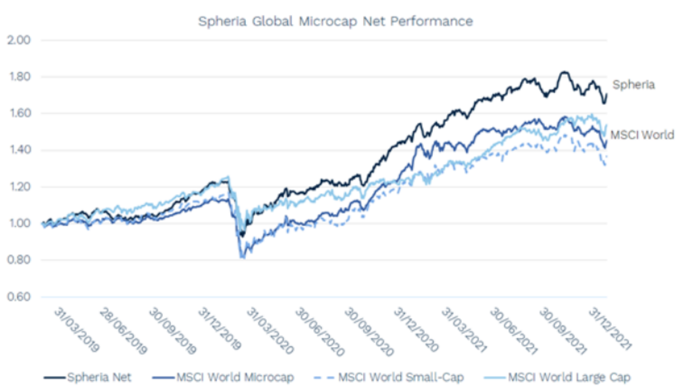
Further Commentary

Once again, Spheria did well in a down market, particularly as investors' focus turned to valuations, a key pillar of our investment process. As we predicted last month, Smalls remain the most vulnerable segment of the market for now due to their stretched balance sheets and relatively lofty earnings multiples.

Source: MSCI, Spheria

Large caps staged a late comeback during the month and finished down only 2.3%. The MSCI World Small Cap Index fell 4.5%, and the Spheria Global Microcap Fund fell 3.2% after fees.

Since inception, the Fund has returned 20.1% p/a after fees, ahead of its benchmark by 3.9% p/a. The chart below shows the Fund's net performance relative to the major MSCI Indices by market capitalisation.



Source: MSCI, Spheria

Markets

Investment bank economists continue to downgrade near-term growth forecasts. These downgrades are little surprise given the lapping of enormous stimulus, omicron, and supply chain problems and price rises blunting demand.

Source: J.P. Morgan

Despite lower growth expectations, bond yields rose, and defensive sectors struggled. Healthcare and IT were the two worst-performing microcap sectors, areas the Fund is overweight. However, looking below the surface, profitless biotechs and tech stocks were the main culprits.

Citing the risk of higher bond yields on long duration assets (those with cash flows further out), the market was ready to shoot any stock on high multiples or with no current earnings. This trend may reverse in quick succession, but if not, it could potentially play out over a long timeframe, anathema for growth investors.

Sweden is home to many high growth companies and was the worst performing microcap market in January. Australia was also weak, with the AUD dipping below 70c against the US dollar during the month. Softer economic growth is not ideal for our cyclical economy and Australia is home to many extreme examples of hypervalued concept stocks as too much money chases too few companies down in this market.

Fund Performance

PAYSIGN (PAYS.US)

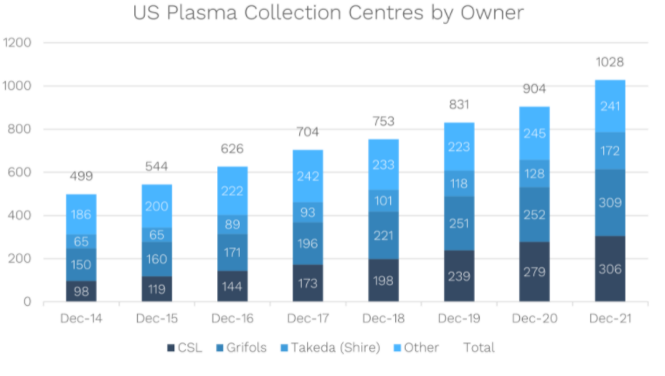
The top contributing stock in January was Paysign (PAYS.US). Paysign is a US payments processing business. Its core segment services the US plasma collection industry, including Australia's CSL Behring. The US is one of the few countries that allows paid plasma donation and supplies 70% of the world's plasma needs.

Source: CSL Plasma

Paysign issues donors with visa debit cards, loaded with donation fees paid by the plasma fractionators such as CSL. Donors can then spend these cards as they would an ordinary visa or cash the card in. Paysign receives cardholder fees, interchange fees as donors use the card, and program management fees for this service.

There are a couple of key attributes which make this industry highly attractive:

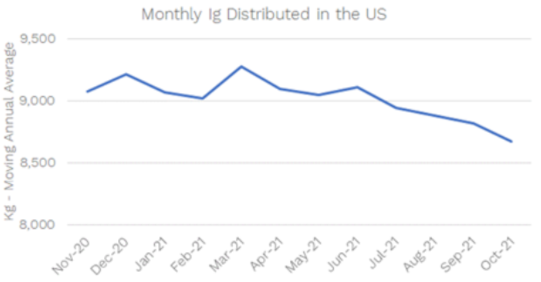
- Three players dominate the donor card market. Paysign and Wirecard are the industry leaders, while Bank of America occupies a relatively minor part of the market. This industry structure has been in place for many years, implying sound barriers to entry. Recently, Wirecard has become insolvent following fraud by its former CEO, COO and some board members. Despite this, the plasma segment of the company has largely retained its market share. This stickiness is a positive sign for incumbents.
- Plasma products, driven by the marginal product – Immunoglobulins (Ig), continue to grow strongly as penetration of Ig grows and new applications are discovered. Because the US carries the burden of supplying the globe's plasma needs, US collection centre roll-out remains strong and has grown at a CAGR of 10.9% over the past seven years. In addition, the industry is currently short plasma and so has been increasing donation fees (from a typical US$45-$50 up to as high as US$70), further spurring growth.



Source: Morgan Stanley

COVID has been unkind for Paysign, and earnings are heavily depressed. Firstly, the stimulus from Government saw a large drop in donors visiting collection centres. Donors need for an extra US$50 from donating plasma was far less as the Government handed out large amounts of direct stimulus to help the economy. COVID and stay-at-home orders also impacted donors' ability to visit centres.

Data from the Plasma Protein Therapeutics Association shows a decline in Ig distributed in the US over the past year. This data understates the impact of the plasma shortage since fractionators have likely switched their precious inventory to the higher priced US market and away from tender markets in Europe. Declining volumes for an industry previously expected to grow at mid to high single digits shows the severity of the shortage.



Source: PPTA

Despite troughing in the middle of last year, collections remain below pre-COVID levels. Nevertheless, plasma fractionators continue to roll out new centres aggressively, signalling their confidence that donations will return and the outlook for plasma as a therapeutic remains healthy (pun intended).

In addition to this cyclical upswing to earnings, Paysign continues to advance its co-pay solutions for pharmaceutical companies. This payment method allows pharmacy companies to supplement patients' co-payments, making drugs more affordable for patients (and thereby circumventing the pharmacy benefit managers' drug pricing schedule which is used to play drug makers off against each other in the form of large rebates to health insurers). The pharmaceutical part of the business is more competitive, but growing rapidly off a low base. The best part is, given how depressed the plasma segment's earnings are and the amount Paysign stock has de-rated, we estimate we are getting this part of the business for free at the current share price. The best things in life are free.

FJORDKRAFT (FKRFT.NO)

Source: ETEnergyworld

When it rains, it pours. While a good thing for Norway's hydropower plants, it has not been an ideal time for Spheria's holding, Fjordkraft. While the Fund enjoyed initial success with the stock, a series of negative impacts has beaten the company down:

- The sell-side analyst from Sparebank went to a sell in February 2021. While one analyst moving to a sell (out of four covering the stock) is not normally that notable in microcaps, this particular analyst was quite sensationalist. Despite having a buy on the company until September 2020, the analyst performed a 180 and warned of increased competition and the threat of lower margins for Fjordkraft. Our analysis identified the relatively high churn in Norways' electricity market. However, we think consolidation and regulatory changes (unbundling) will offset much of this pressure, and our analysis shows that significant margin pressure is already priced into the stock price.
- The Norwegian energy industry came under pressure following a consumer backlash around contract disclosure. Fjordkraft was caught up in this, and apart from negative PR, this also meant that Fjordkraft had to tiptoe around raising prices for its consumers for a short while. Trygg Stromhandel, or safe electricity trading, legislation was introduced to standardise product information and the marketing of electricity. Fjordkraft was among the first retailers certified in Trygg Stromhandel and has appointed a Customer Compliance Officer. While the need for this is disappointing, we see no evidence that Fjordkraft was out of step with industry practice.

- Europe experienced significant power price spikes as French nuclear capacity was taken offline. While the impact on Norway is blunted by limited interconnector capacity and Norway's immense hydropower which can be brought on instantaneously (albeit reservoir levels are relatively low after a dry year), it still resulted in record high reference prices for the local power market. The market became concerned that Fjordkraft's earnings would be crunched as it was caught between rising power prices and fixed-price contracts with customers. Recent bankruptcies from energy retailers in the UK fuelled this concern. However, this issue was a crucial part of our due diligence, and the Fund only invested in Fjordkraft after becoming comfortable with this risk. Pleasingly, despite the power price spikes, the company's consumer segment reported fourth-quarter margins of 38%, and the business segment reported margins of 64% (both above medium-term margin guidance). The core business showed incredible resilience through such volatile power prices. The black mark for Fjordkraft was a recent acquisition in Sweden and Finland, which was severely impacted by the spike in power prices. The market focused on this rather than the core segment's performance. When a stock is down, people look for negatives, and vice versa.

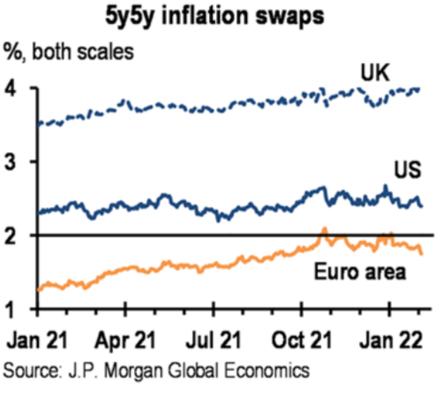
Despite these significant hits to the business, we remain confident in the company's prospects, indeed more so than ever. The stock now trades on an EV/EBIT of 8x and dividend yield of 9.3%. The company is less than one times levered and has a historical free cash flow conversion of 89%. There is little wonder Fjordkraft is now one of the Fund's largest holdings.

However, the market's myopic focus on earnings and price momentum means that absolute valuation support counts for little. Patience may be required to realise this investment thesis as earnings recover and price momentum improves. Alternatively, corporates and private equity are always a factor in microcaps and may help investors realise fair value sooner than expected.

Outlook

In January, growth stocks bore the brunt of market panic as the Central Bank Cartel turned hawkish. Isn't it curious how the Central Bank Cartel all (with the exception of the Bank of Japan) start talking about higher rates to quell inflation when only months earlier they dismissed the risk of inflation?

Furthermore, the bond market remains remarkably sanguine about the risk of inflation. US 10-year yields are only back to where they were before COVID. The 5y5y inflation swap rate, shown below, is a measure of the market's expectation for average inflation between five and ten years from today. As it shows, inflation expectations remain broadly anchored at pre-COVID levels.



Source: J.P. Morgan

While the bond market is not always correct, it certainly has a better record of forecasting than the Central Bank Cartel. Have you seen those Federal Reserve dot plots?

Inflation is a complex economic field because it intertwines money with psychology. Inflation expectations are what matter, not inflation per se. So are the Central Bank Cartel really seeing signs of inflation getting out of hand suddenly? Are a few rate rises going to do anything? We doubt it.

So what might explain the Cartel's hawkish tilt?

Perhaps the Cartel is addressing issues in the plumbing of the money market or eurodollar market. Low and negative rates place a considerable strain on the banking system, and the Cartel may sense these areas need some respite to ensure the smooth functioning of lending and money flow.

Alternatively, the Cartel sees a short window to reload some ammunition for the next economic slowdown. This reloading hypothesis would be consistent with the current flattening of the US Treasury curve.

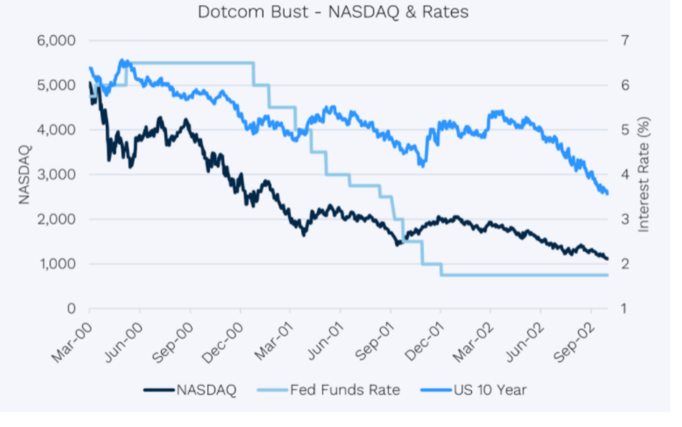
The third and final explanation is that the Central Bank Cartel may see an opportunity to cool multiple asset bubbles frothing at once and spawned by their reckless monetary policy. But do equities need cooling?

Alarmingly, the rise in the NASDAQ is almost akin to that experienced during the most crazed market frenzy in history, the dotcom bubble. Sure, one could argue a number of reasons why it's different this time, but it rarely is.

Source: Bloomberg, Spheria

What should jump out to the reader is that this could be just the beginning. The above chart is indexed to the peak, assuming we reached this cycle's peak in November 2021. The saying, what goes up, must come down, springs to mind.

Growth managers and those invested in long-duration stocks with no earnings will be preying for interest rates to roll over. Perhaps they will get lucky. Growth seems to be slowing, and the yield curve continues to flatten. We doubt this will save the day for growth and concept stocks. The Federal Reserve cut aggressively during the dotcom bust, and Treasury yields fell. Despite this support from rates, the NASDAQ continued to unwind.



Source: Bloomberg, Spheria

Whether we are at the start of a growth rout, or not, Spheria's valuation discipline and style neutral process can continue to add value for its beneficiaries. The Fund added four beaten up growth stocks during January, three of which we had been stalking for some time (see table below), waiting for an entry price that provided a solid return for the risk being taken. The other stock was a UK company that the Fund had sold out of at over £15 only a few months ago to buy back into the £8s during the growth sell-off. We recently added another company which we first initiated on in October 2020 and have been watching closely since.

	Team Initiated Coverage	Stock Purchased
US Stock 1	Sept 2020	Jan 2022
Finnish Stock	Dec 2020	Jan 2022
UK Stock	Aug 2019	Mar 2020 & Jan 2022
German Stock	Dec 2021	Jan 2022
US Stock 2	Oct 2020	Feb 2022

We take pride in the Fund's commitment to valuation discipline, something that appears to be a lost art for many fund managers in this era of QE induced price and earnings momentum.

Our hope is that the Cartel is successful at shaking out the excesses of market speculation. If so, it will present many great opportunities for the Fund, and we can recycle stocks with lower growth, but strong fundamental valuation support (which will outperform when valuations again matter), for fallen companies with high growth that now represent good fundamental value.

Good things come to those who wait.

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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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