Spheria Global Microcap Fund

ARSN 627 330 287 APIR WHT6704AU

Spheria ASSET MANAGEMENT

Performance as at 31st January 2020

	1m	3m	6m	Inception#
Fund^	4.0%	12.9%	16.6%	21.8%
*Benchmark**	2.7%	9.1%	8.7%	10.5%
Value added	1.3%	3.9%	7.9%	11.3%

^ 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.
Past performance is not a reliable indicator of future performance.

The Spheria Global Microcap Fund returned 4.0% after fees in January, outperforming the Global Microcap Index (Kokusai) by 1.3%. Since inception (1st of March 2019) the Spheria Global Microcap Fund has returned 21.8% after fees, outperforming the index by 11.3%.

Markets

Utilities and real estate were the best performing microcap sectors in January, following the lead of bonds which rallied on concerns over the economic impact of the coronavirus. The Fund's trimming of its energy exposure, which we wrote about last month, was fortunately timed with energy the worst performing sector, down 9.3% in AUD terms. Alternative fuels and renewable energy equipment were two of the best subsectors, most likely benefiting from the global attention the Australian bushfires have received as a harbinger of climate change. Our Fund has no direct exposure to this thematic, but we make no apologies for this since our investment approach is based on bottom up investment cases of individual businesses, not betting on thematics which can swing in and out of favour.

The Asia Pacific region lagged in January as a result of its proximity to China and the coronavirus. New Zealand micros fell -1.8%, Singapore -0.5% and Hong Kong -0.1%. Meanwhile, Northern European markets were the leaders, reflecting a more optimistic outlook for the European economy and Germany in particular. Denmark rose 16.5%, Netherlands +9.9% and Finland +9.3%.

Currencies were relatively volatile with the AUD falling from 70.2c to 66.9c during January. While we are not foolhardy enough to forecast currency in this report, we would observe that the Australian economy looks relatively sick compared to most developed economies and the net capital inflow of debt into Australia was negative in 2019 for the first time since 2000.

Fund Performance

The largest contributors to relative performance in January were Alma Media (ALMA.FH), City Chic (CCX.AU) and Swissquote (SQN.SW).

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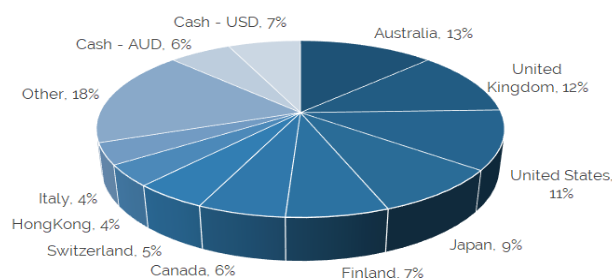
Top 5 Holdings

Company Name	% Portfolio
Computer Model. (Canada)	3.6%
Poletowin Pitcrew (Japan)	3.4%
Coltene (Switzerland)	3.4%
Alma Media (Finland)	3.3%
Sonos Inc (United States)	2.9%
Top 5	**16.6%**

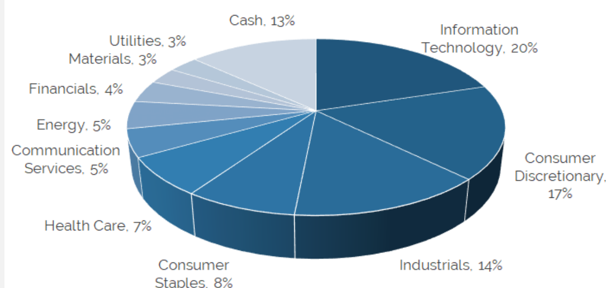
Source: Spheria Asset Management

Regional Exposure



Source: Spheria Asset Management

Sector Exposure



Source: Spheria Asset Management

Swissquote has been a holding in the Fund since inception and we met with company management last year in Zurich. Swissquote is an online provider of trading services, including derivatives and CFDs, and gives clients access to 60 stock exchanges. It has a history of offering its clients the latest financial products and was among the first platforms to offer Bitcoin trading. Its innovation extends to robo-advice where its offering is gradually gaining traction.

In Switzerland Swissquote is seen as the discount player when compared to incumbents such as UBS and Credit Suisse. Relative to European online brokers though Swissquote commands a large premium. It gets away with this courtesy of its Swiss banking license which sets it apart from the competition and means Swissquote's average account size is much larger than its online peers. Since it is targeting a different customer set to the aggressive European discount brokers Swissquote has decided to step on their turf and has recently made an acquisition which opens up access to Europe's consumers. Swissquote also has a presence in the Middle East and has set up an office in Singapore.

After a rocky start to the investment, partly from a drop-off in investor interest in Bitcoin trading, we have stuck with the stock and remain confident in management's long-term strategy for organic growth.

The Fund's worst stocks in January were MCJ (6670.JP), Nichols (NICL.LN) and Sonos (SONO.US).

MCJ traces its roots back to 1998 when in order to differentiate itself from large PC makers of the time such as NEC, Sony & Toshiba, it decided to focus on PCs for gaming. It has built a strong reputation for high-spec gaming PCs with its G-Tune Mouse brand. Using this reputation as a halo the company has used its ecommerce platform to sell mass market PCs. An opportunistic acquisition of Iiyama in 2006, a high-end monitor brand selling into Europe, completed the offering.

MCJ continues to benefit from the growth in PC gaming and is increasingly tackling the SME office market. 30% of revenue currently comes from corporate PC sales and this segment is growing strongly. MCJ differentiates itself with superior after sales support and prices are competitive with the competition. Despite the SME office growth option, the company is priced at only 6x EV/EBIT and has net cash on its balance sheet.

Outlook

There are occasions when equity investors and debt investors are diametrically opposed. Tougher restrictions from debt financiers can limit the free cash flow that trickles back down to equity holders lower down the corporate structure. More often than not though, both types of investors are on the same side and so it is worthwhile keeping a keen eye on what credit markets have to say about the state of corporates. Like equities, spreads in credit markets are suggesting corporates are in good shape and the US economy at least remains robust.

The problem is, like equity markets, credit markets appear to have short memories. Despite the GFC, credit markets are again embarking on an aggressive cycle. US corporate debt has increased 50% from the pre-GFC peak and as a proportion of GDP it now eclipses pre-GFC levels. The leveraged loan market[1] has ballooned to US$1.2 trillion with approximately 80% of this market covenant lite[2]. Similar risk taking by investors has taken place in corporate bonds with 50% of investment grade bonds sitting at the lowest rung before being classified as junk or non-investment grade. The problem with this is that many investor mandates do not allow investments in corporate bonds with a non-investment grade credit rating. Slippage of these BBB- bonds to a lower credit rating is likely to spark forced selling by many investors.

Like equities, part of this increased risk taking is driven by passive investment which mechanically allocates more to BBBs as they become a larger part of the index. The Federal Reserve and other central banks are also to blame, lowering the return on risk-free assets and encouraging yield seeking behaviour. After more than ten years of low interest rates and economic growth it is no surprise that Wall Street has grown complacent.

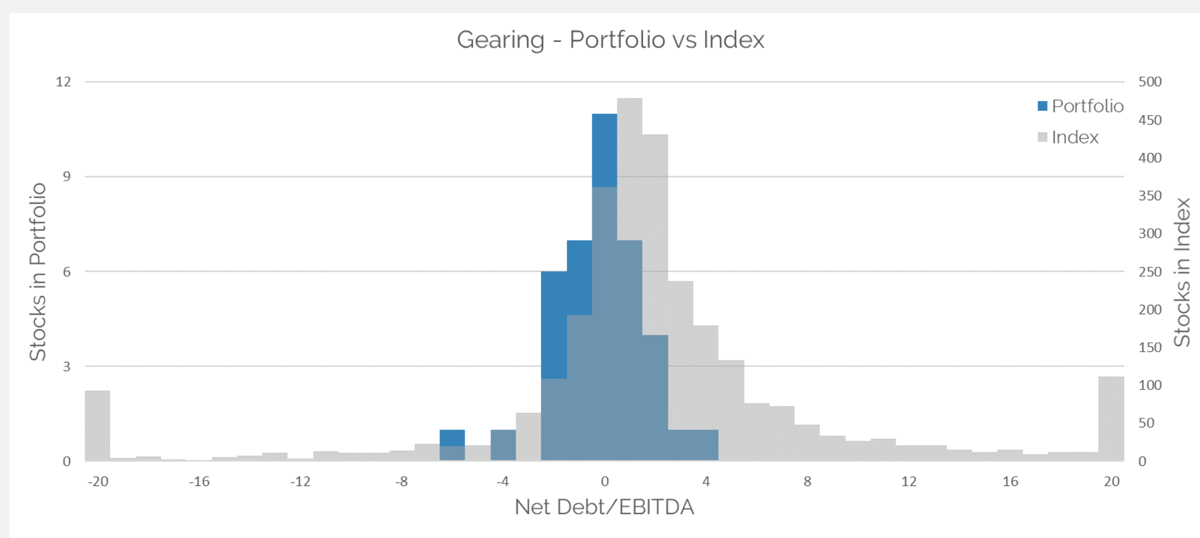
[1] Leveraged loans are commercial loans to non-investment grade or highly geared companies provided by a group of lenders and then syndicated to other banks or institutional investors. The loans are typically for private equity leveraged buyouts or to companies that have run into short-term funding issues. The loans may be packaged into collateralised loan obligations to be sold to investors with different risk preferences.

[2] Covenant lite means the terms of the loan include fewer restrictions to protect the lender. For example, it may exclude covenants around debt serviceability or loan payment terms.

Spheria's investment process includes an analysis of each company's debt structure, including liquidity, which can often be overlooked by equity investors. We always take a conservative stance as part of our investment philosophy, but seldom is it so important as now to retain this discipline after a long economic expansion and during an aggressive credit cycle. Leverage can bring short-term returns through M&A, buybacks and special dividends. It can flatter metrics such as Return on Equity and Dividend Yield, particularly when interest rates are as low as they are currently.

The temptation for management has been irresistible and leverage ratios in corporate America have risen from 1.5x to 2.1x over the last ten years.

The chart below compares the Fund's holdings with the Global Microcap Ex-Japan index. We estimate the index has a leverage ratio of 1.7x. Our portfolio in contrast has a weighted leverage ratio of -0.7x, meaning our weighted average company has net cash. Combined with Spheria's focus on businesses with strong returns on capital and high free cash flow, we are confident that the portfolio's holdings will weather an eventual turn in the credit cycle better than most stocks.



Source: Bloomberg, Spheria

	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

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