Spheria Global Microcap Fund

ARSN 627 330 287 APIR WHT6704AU

Performance as at 31st March 2020

	1 Month	3 Months	1 Year	Inception#
Fund^	-10.5%	-12.9%	1.9%	1.9%
*Benchmark**	-19.5%	-22.3%	-14.8%	-15.3%
Value added	9.0%	9.5%	16.7%	17.1%

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

During March the MSCI Kokusai Microcap Index declined 19.5% in AUD. The Spheria Global Microcap Fund outperformed by 9.0% net of fees, falling 10.5%. Since inception the Fund's return net of fees is 1.9%, compared to a decline of 15.3% for the benchmark.

Markets

There was nowhere to hide in March as lockdowns to stem the spread of the coronavirus had a devastating impact on the global economy. Utilities and Consumer Staples outperformed, falling 1.8% and 9.2% respectively in AUD. These sectors were helped by rallying bonds as the yield on the US 10-year bond yield declined from 1.15% to 0.67% during March. Unfortunately, Consumer Staples are underrepresented in the Microcap Index and there are a lack of high-quality utilities in the space. The worst sectors were Energy (-37.1%) following actions by the Saudis to flood the oil market, Consumer Discretionary (-25.9%) and Real Estate (-22.9%). The closure of retail stores in many key economies and the widespread loss of jobs has hit the consumer and retail sector hard.

Australia and New Zealand were two of the worst-performing microcap markets in March.nVista Group was the largest negative contributor to the NZ market as cinemas around the world were shut, hurting the leading provider of ERP software to cinemas. In Australia, major detractors included pub owners Redcape and Hotel Property Investment, Healthcare providers and IT companies. Switzerland and Hong Kong performed well, helped by a strong currency in both instances.

Fund Performance

The Fund identified the risk posed by COVID-19 relatively early, and while portfolio turnover was modest, we took the opportunity to position the Fund more defensively and raise cash levels. Health Care was the Fund's top contributor to relative performance, followed by a large underweight to Financials and Real Estate stocks.

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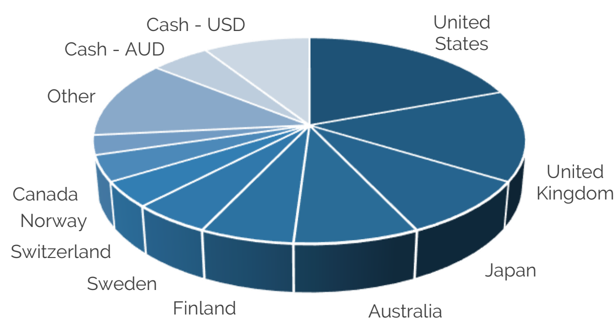
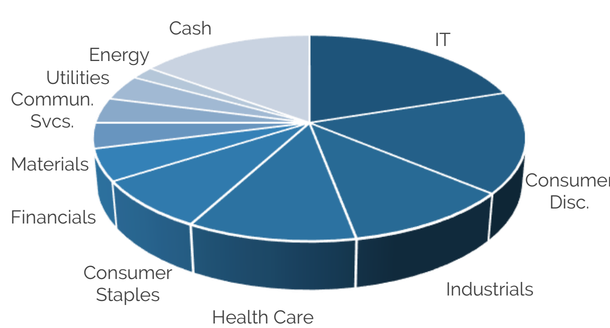
Regional Exposure



Source: Spheria Asset Management

Sector Exposure



Source: Spheria Asset Management

Our top Healthcare stock rose 158% in AUD during March. The diagnostic company in question has been a major beneficiary of COVID-19, and news that it had received expedited approval to sell its COVID-19 test in the USA got the market excited. We exited the position after its share price exceeded our fundamental valuation which factored in a favourable roll-out of the company's products in the US market, the largest diagnostic market globally. In a post-COVID-19 world we could no longer justify the share price, and staying in the position purely to ride the strong share price momentum would be a case of relying on a greater fool theory. Secondly, while COVID-19 testing is lucrative at present, we would hazard a guess that the market has overlooked the impact of lockdowns on the company's remaining portfolio of tests. Industry feedback is that non-COVID diagnostic test volumes have fallen significantly.

Our sense is that there is a great deal of hot money in the stock with many current investors probably not even fully understanding what the company does. We expect that when these investors rush to the next hot thing, we will be able to buy the stock back at a discounted level once more. Even if this is not the case, we are unlikely to suffer seller's remorse since we know valuation discipline will reward our investors in the long run.

Utilities and Energy were our two most troublesome sectors. Our one utility stock in Norway did reasonably well in local currency, but the Norwegian Krone was hurt by falling energy prices. We own only one energy stock after exiting our two other positions before the large oil price sell-off. The remaining company is a software service provider to the industry, not an asset owner. In our view, this stock is one of the highest quality businesses in our portfolio. However, a high proportion of its earnings are dependent on the US shale industry whose long-term viability is being threatened by the actions of the Saudis. We envisage a wide range of scenarios with little conviction behind various probabilities so long as politics remains the overwhelming driver of the oil price in the short term. For this reason, after an initial cut to our position in February at higher prices, we have not yet begun buying back into the stock.

The Fund's overweight to Japan was a major positive contributor in March. For pragmatic reasons we chose to exclude Japan from the Index since it made up a disproportionate part of the Global Microcap Index, representing 29.6%. This even eclipses the US market which represents 23.4% of the index. However, despite choosing an Ex-Japan index, the Fund has consistently held a high single-digit weight in Japan, reflecting a similar country weight to the large cap MSCI World Index (Japan 8.6%), which we deem more prudent.

Japan has been a good source of alpha for the Fund and we are attracted to Japanese companies with a strong position in what is a large domestic market. Japanese companies typically have very strong balance sheets and our holdings generate solid returns and good free cash flow. Management access has been good, even if there are challenges in using translators, but our analysis is helped by favouring companies that disclose investor material in English.

Aside from Canada and NZ, which we alluded to earlier, Germany was a detractor since we were underweight that market and it held up relatively well during the sell-off.

Outlook

When the going gets tough, the tough get going. Having identified COVID-19 as a major threat to the economy relatively early, our team swiftly conducted a number of research initiatives:

- The market remains fixated on trailing earnings per share when assessing whether companies look "cheap". However, those earnings are gone, and in some cases are unlikely to return for some time. To solve this issue we ran an alternative scenario comparing current earnings to trough earnings during the GFC. We also quickly adjusted our house view on major economic variables to retain a key benefit of our investment process - consistency. This ensures all analyst forecasts are premised on the same macro view of the world. Without this, we may end up comparing valuations between an analyst factoring in a dim view of the economy with an analyst reflecting earnings closer to pre-COVID levels.

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- We then ran a scenario analysis to ensure our Fund's holdings had sufficient short-term funding liquidity. Our scenario analysis was designed to ensure our companies could continue to operate during a 12-month lockdown scenario. As a result of this analysis we exited two positions. One stock identified as a liquidity risk had already fallen some way and despite the psychological difficulty in exiting a position that we were losing on, we did so regardless. Our analysis was vindicated when, in the weeks following, the company had to access the market to shore up its balance sheet at prices below those at which we sold. Another stock we exited is regarded as defensive by the market and had outperformed significantly. We also reviewed debt covenants to be prudent, albeit many companies will benefit from a pause in creditor rights. Thus far, none of our companies have raised equity and diluted existing shareholders, although some have cut dividends (which we think is prudent).
- The team has set up teleconferences with our holdings to understand how management is handling the threat from COVID. We have been encouraged by our companies' proactive approach to locking in short-term liquidity and containing expenses.

Even at this pint-sized end of the market we call microcaps, we are able to find real businesses with solid cash flow and conservative balance sheets. The portfolio is a 'sleep-at-night' portfolio and we have confidence it will perform relatively well if COVID-19 lockdowns continue.

Having covered off on the risks, we are now after the rewards and our analysts are busy performing due diligence on new names for the Fund to invest in. Microcaps typically bounce out of economic shocks like the GFC harder than their larger counterparts and we want to ensure we are positioned for this. We have added several new names and reduced our cash weighting. Our latest addition to the portfolio, a high-quality German company, was up 26% in local terms during the first week we held it.

I am very proud of the team's hard work under such extraordinary circumstances and it again reminds me of the importance of a consistent and thorough process that provides the investment team with a true North during times such as this. We have managed to transition our process to a home working environment with success and we are excited about the opportunities the current market volatility presents.

	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