Spheria Global Microcap Fund

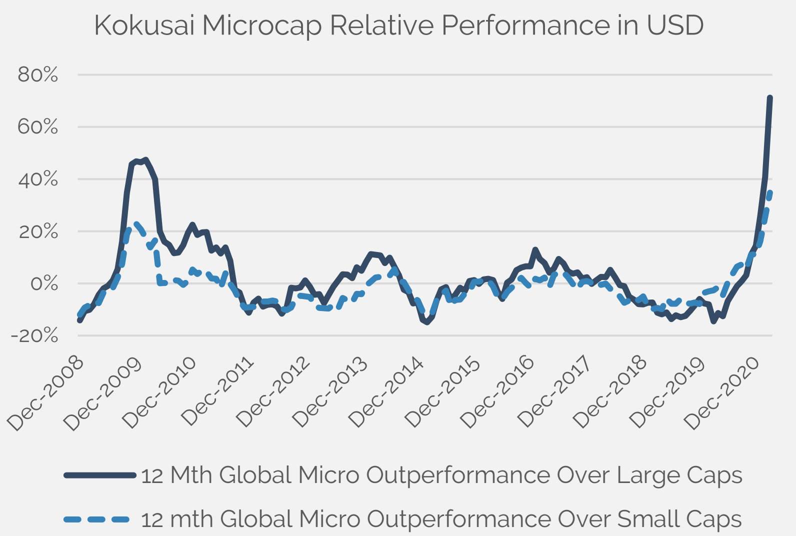
ARSN 627 330 287 APIR WHT6704AU

Performance as at 31st March 2021

	1 Month	3 Months	1 Year	2 Years#	Inception#
Fund^	3.1%	8.4%	51.0%	24.0%	23.0%
*Benchmark**	3.0%	19.0%	79.2%	23.5%	21.4%
Value added	0.2%	-10.6%	-28.2%	0.5%	1.7%

^ 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. Returns are per annum.
Past performance is not a reliable indicator of future performance.

Microcaps delivered their first month of underperformance, relative to their larger cousins, since the March 2020 Covid lows. The last 12 months of microcap dominance (+71.2% over MSCI World Index in USD) eclipsed the GFC recovery when the Kokusai Microcap Index outperformed the MSCI World Index by 47.4% in USD.



Source: MSCI, Spheria Asset Management. Note that, although microcaps underperformed in March, the relative performance improved over a 12-month period as March 2020 rolled off from the annual return.

Despite the end of this reign, the MSCI Kokusai Microcap Index in AUD still delivered a positive return of 3.0%. The Spheria Global Microcap Fund performed in line with the benchmark, returning 3.1% after fees.

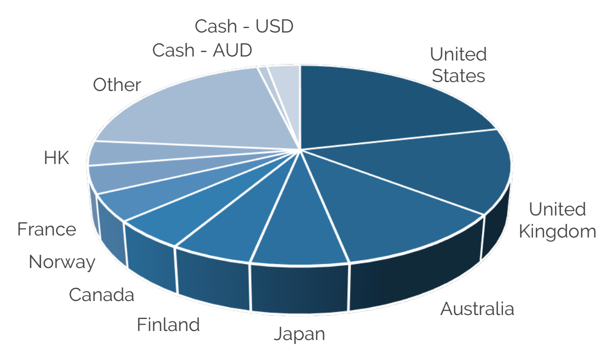
Microcap growth stocks fell behind during March. The US's Russell Micro Growth Index declined 3.2%. This loss of faith in growth stocks occurred during the second half of March, and the Fund outperformed 3.5% during this period (15th - 31st March).

Continued on the next page...

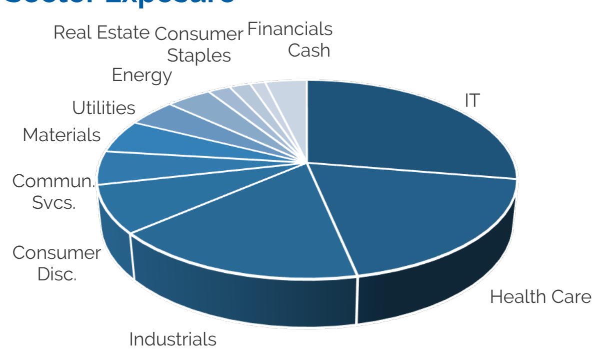
Top 5 Holdings

Company Name	% Portfolio
Fjordkraft (Norway)	4.4%
Poletowin (Japan)	3.7%
Steelcase (USA)	3.4%
Coltene (Switzerland)	3.2%
Vetoquinol (France)	3.0%
Top 5	**17.7%**

Regional Exposure by Revenue



Sector Exposure



Source: Spheria Asset Management

Since inception, the Fund has delivered 23.0% p/a after fees, 1.7% p/a more than the benchmark and 9.8% p/a more than the Small-Cap and Large Cap MSCI indices.

Markets

With value in favour during the second half of March, it was no surprise that Financials led, up 7.5% in AUD. Because of the Fund's focus on low leverage and high free cash flow, the Fund is underweight this sector. Conversely, the growth sector of Healthcare lagged, down 3.5%.

Value stocks benefiting from an acceleration in the economy did especially well. Airport Services, Trucking and Marine, were among the best pockets of the market. Life Sciences, Healthcare Supplies, and Pharmaceuticals all lagged as investors left the safety of these structural growth industries. Oil and Gas drilling lagged with the retreat in the oil price.

Australia was the worst-performing major market in March, down 0.7%. Materials took a breather after leading the cyclical recovery long before bond yields or equity investors had sniffed the prospect of economic growth so strong it could stoke inflation. But it was also companies such as Australia's Novonix, capped at a significant US$720 million that lost their sparkle as the month progressed.

This company is very much in the guise of stocks we warned about last month. Novonix is forecast to make $8m revenue and lose $21m in FY21. And yet, because it is in the hot space of energy storage and has potential leverage to the electrification of industries, investors are willing to pay any price to secure exposure to this thematic. **For the same market capitalisation, our portfolio can deliver investors four different companies earning a combined US$62 million p/a.**

Norway, Italy and Singapore led the market higher. The UK also provided a relatively solid performance, up 5.2% in AUD. Except for growth companies, the UK has increasingly looked like good relative value to other markets. Our latest addition to the Fund from the UK has a significant market opportunity in front of it and yet has a market capitalisation of only US$260 million. Covid has not been helpful, and so this Information Technology stock has not delivered the straight-line earnings performance that growth investors demand. Only one regional broker covers the company, and so we suspect few investors are aware of its longer-term potential.

Fund Performance

<u>Poletowin Pitcrew Holdings</u>

Poletowin Pitcrew Holdings has been one of the Fund's largest holdings since its inception. The company, along with its smaller listed peer, Digital Hearts, dominates the Japanese market to test and verify gaming software. This cosy industry structure allows the company to earn solid margins and high returns. Free cash flow conversion has averaged 98%, and the balance sheet has net cash. Revenue growth has historically been mid to high single digits, with the occasional bolt-on acquisition taking this further. It is the launch of major gaming platforms such as the Nintendo Switch, Xbox Series X and PS5 that keep these companies particularly busy.

Unlike its Japanese peer, Poletowin remains focused on gaming (mobile, platform and PC) and has ambitions to expand internationally in a measured fashion. Meanwhile, Digital Hearts is taking the higher risk but potentially higher return move of expanding into other verticals such as software testing for automotive OEMs. So far, the share market is buying it, putting Digital Hearts on a far higher earnings multiple. Either way, with both companies covered by only one analyst (the same analyst), we suspect shareholders could own either to gain attractive exposure to a profitable and growing industry.

Continued on the next page…

Hamburger Hafen Und Logistik

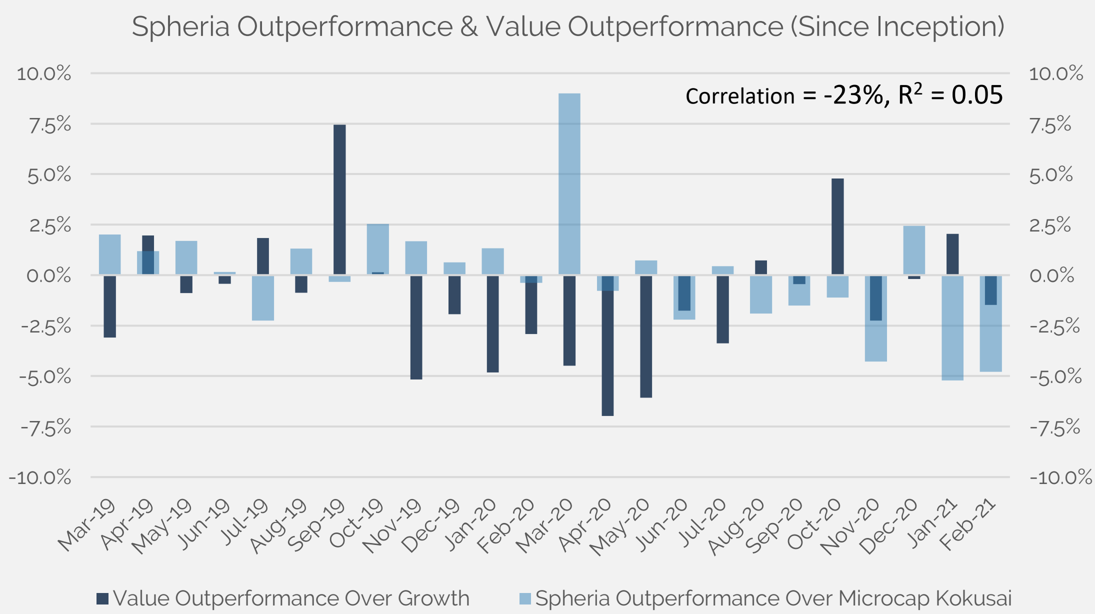
Hamburger Hafen is a prized asset the Fund opportunistically bought during the depths of the Covid crisis. Hamburg port is the third-largest European container port behind Rotterdam and Antwerp. The City of Hamburg owns the port itself, but Hamburger Hafen handles approximately 80% of its throughput. Before Covid, this was equivalent to nearly 9 million TEU (twenty-foot equivalent units of cargo) out of 42 million TEU of containers coming in through the European Northern coast each year. Aside from operating container terminals at Hamburg, it provides a similar service at some other smaller ports such as Odessa in Ukraine and Trieste in Italy. The company also handles intermodal transport (port to rail) and logistics. In combination, these operations produce a return on invested capital (ROIC) of 28% (pre-Covid) and historical free cash flow conversion of 80%.

With such high returns, strong cash flow, and a near-monopoly position, we certainly jumped at the chance to purchase the company. Hamburger Hafen has done well since we acquired shares, but in a recent trading update, the market was unimpressed with the company's outlook. Hamburger Hafen is undertaking a significant restructuring to automate port operations further and reduce labour costs. Once complete, the company promises earnings almost 50% higher than pre-Covid levels by 2025. However, in the short term, this means a large sum of restructuring costs. With the addition of Covid uncertainty and the recent Suez blockage, some caution by management is warranted.

Our analysis suggests that management's cost-saving targets are not unreasonable when compared to global peers. Better yet, the market appears unwilling to give them the benefit of the doubt since earnings have been choppy of late. In what is a rare sight in markets today, we continue to see reasonable valuation upside for such a high-quality asset.

Outlook

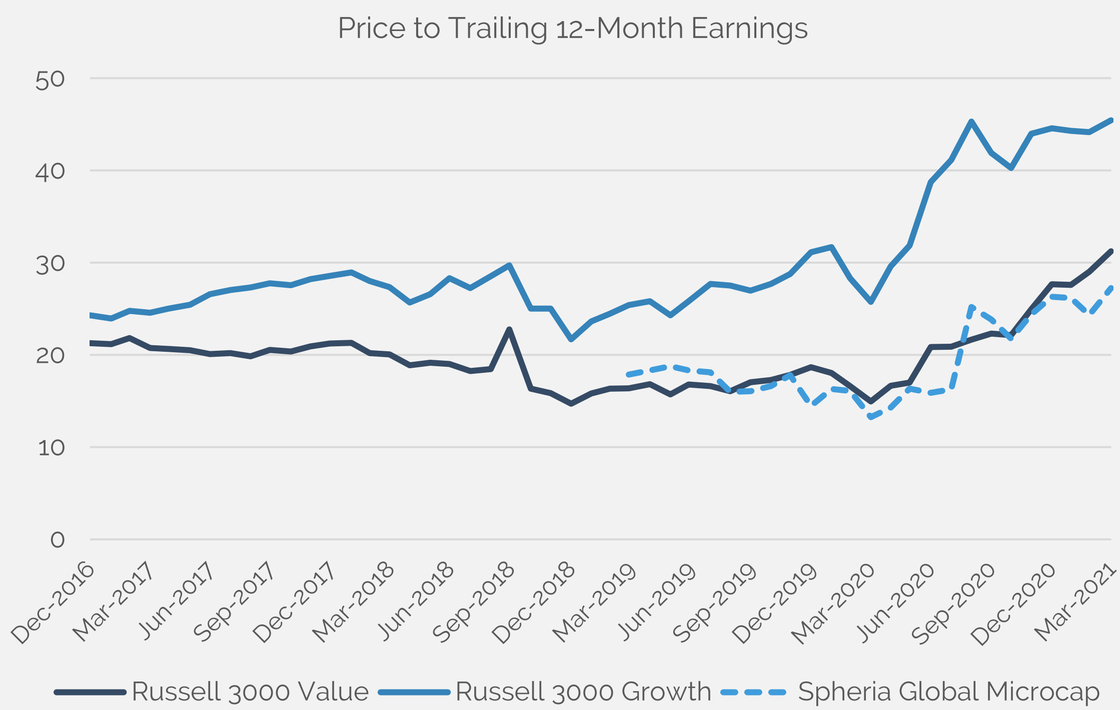
Spheria's investment philosophy is valuation based, not "value". As a result, the Fund can and does own shares on high PEs, so long as we can justify the valuation using defensible and peer-reviewed assumptions. This approach means the Fund has been style neutral and has historically not shown a strong correlation with growth or value factors. The chart below shows that the correlation of the Fund with value stocks (as proxied by the Russell Micro Value Index) is negligible and slightly negative.



Source: Bloomberg, MSCI, Spheria. Correlation and R2 are calculated using natural log differences.

Continued on the next page...

Microcaps have never had a more significant period of outperformance since MSCI Microcap indices began. While much of this is driven by better earnings as the economy reopens, it also reflects a major re-rating in the microcap market's multiples. For value names, this reflects depressed earnings from Covid (i.e. EPS falling, rather than price rising). However, growth stocks, prized for their relatively resilient earnings, re-rated mid-2020 as investors were quick to price in lower interest rates forevermore. While the premium of growth over value has been widening for some time, it became exaggerated after Covid. For now, the outperformance of growth begets inflows, which begets further outperformance.

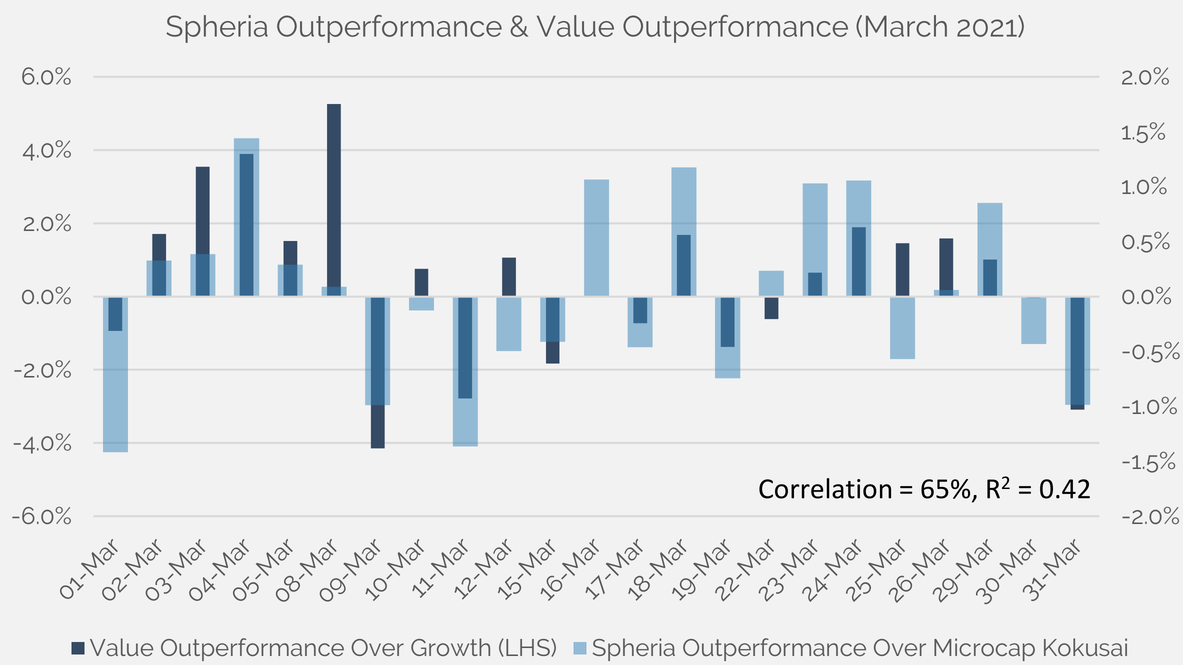


Source: Bloomberg, Spheria.

And what is clear to us is that the growth and quality-at-any-price trade is now as stretched as we have ever seen it. Globally, we are noticing that the phenomenon our Australian Spheria colleagues have witnessed for some time is increasingly prevalent in other markets, like the US. That is, investors are chasing growth and “quality” at such a rate that the remainder of the market is showing pockets of reasonable absolute value. As we expressed last month, we are excited about the cohort of recent additions to the portfolio.

Continued on the next page…

The other aspect of this stretched growth trade is that our portfolio is beginning to become more correlated with value stocks. The chart below shows the Fund's outperformance over the MSCI Kokusai (the benchmark) and the Russell Micro Value's relative performance compared to the Russell Micro Growth. If the bars move together, it means the Fund's outperformance is linked to value stocks outperforming their growth peers. Indeed, this is what is increasingly apparent. Because many growth names have lost all semblance of reality when it comes to valuation, it makes sense that we have become negatively correlated with this basket of stocks as we continue to practice valuation discipline.



Source: Bloomberg, MSCI, Spheria. Correlation and R2 are calculated using natural log differences.

This increased correlation to value will mean we are likely to lag the market when growth performs strongly. However, at this late stage of the market cycle, we expect it will offer superior downside protection (as growth and momentum have a nasty habit of flash drawdowns) and outperformance for our investors.

Spheria Global Microcap Fund

ARSN 627 330 287 APIR WHT6704AU

	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