Spheria Global Microcap Fund

ARSN 627 330 287 APIR WHT6704AU

Performance as at 30th November 2020

	1 Month	3 Months	1 Year	Inception#
Fund^	9.5%	8.4%	15.8%	17.2%
*Benchmark**	13.8%	15.6%	13.5%	10.8%
Value added	-4.3%	-7.2%	2.3%	6.4%

^ 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.

November was a month of mixed news for the Fund. The Fund generated the best returns since inception, up 9.5% net of fees. But November was also its worst relative performance since inception with the Kokusai (World Ex-Japan) Microcap Index achieving an increase of 13.8% (that includes a 5.6% headwind from currency). We have repeatedly contended that there is no better part of the market to get exposure to a recovering economy than Microcaps. During November, in comparison, the MSCI Large-Cap Index achieved 7.5%.

Since inception the Fund has returned 17.2% p/a after fees, outperforming the Index by 6.4% p/a. Over the same time frame, the MSCI Large-Cap Index has returned 12.3% p/a.

Markets

November's rally left hardly any stone unturned. The energy sector was up 26.6%, industrials up 18.7% and consumer discretionary up 16.6%. The laggards were safe havens such as utilities and gold. Positive vaccine news gave investors increased confidence to come out of hiding.

The Fund recently went overweight the energy sector for the first time since Covid's havoc began. While we do not make macro calls, we are inclined to lean against market sentiment and increase weights where we see bottom-up valuation support. Despite progress on the vaccine front, which means a sure rebound in air and road traffic, energy stocks remained unloved. We attribute this to the infatuation with EV vehicles that the market has at present and expectations that a Democratic President may finally make some long-overdue progress on climate change.

However, there are reasons why we think it is a mistake to get too negative on oil. There have been many years of underspend on oil field development; the North American shale industry is in a tenuous state with prices this low; and reduced demand in developed countries could be more than offset by a rising middle class in China and with the economic growth of India.

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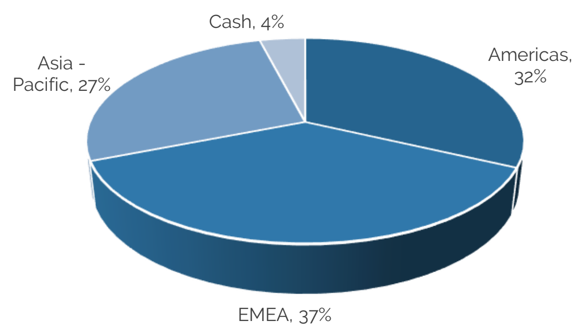
Top 5 Holdings

Company Name	% Portfolio
Fjordkraft (Norway)	3.5%
Revolve (USA)	3.4%
Computer Modelling (Canada)	3.2%
Inogen (USA)	3.2%
Poletowin Pitcrew (Japan)	3.2%
Top 5	**16.5%**

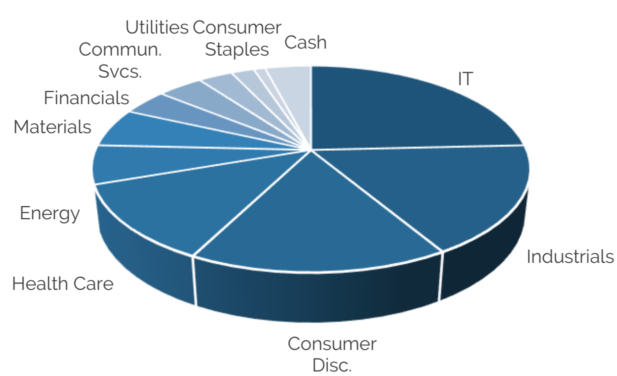
Source: Spheria Asset Management

Regional Exposure by Revenue



Source: Spheria Asset Management

Sector Exposure



Source: Spheria Asset Management

Our exposure to energy is through essential service providers who command a prime position in the value chain, and are not merely commodity price takers. So long as a decent amount of oil volume is produced, these companies will achieve solid cash flow and attractive returns. Particularly at the recent prices we paid for their assets.

The other area of the market we feel we need to lean against is gold. Once again, for the first time, the Fund is overweight the metal. After topping US$2,000 an ounce, the price fell below US$1,800 an ounce in late November. The expected effectiveness of Covid vaccines has given investors reason to leave the safety of the metal. However, as a store of value, it continues to remain superior to Govt treasuries so long as real interest rates remain negative (since Gold, in theory, has a real yield of zero, or marginally negative with storage costs). And real rates must remain negative if the world's economy can ever achieve deleveraging of one form or another. How this plays out remains to be seen, but sometimes it pays to run straight for the ball rather than always trying to anticipate where you think it's going to roll.

From a country perspective, Germany, Norway and the US were the best performing major markets in the microcap universe. The market remains willing to ignore the relative performance of countries in tackling the Covid crisis. This now makes some sense, given a vaccine roll-out is within reach. However, it once again highlights the market's attitude towards risk..

Fund Performance

Sonos

Sonos was the Fund's top relative contributor in November, rising 45% (AUD) in the month. Sonos is the world's leading manufacturer of wireless speakers for home entertainment. Having patented its wireless technology, which allows seamless networking of multiple speakers through a standard Wi-Fi connection, the company has built a reputation for reliability and quality with consumers. While many of its initial patents have now rolled off, the company benefits from somewhat of a network effect as consumers are likely to stay within the Sonos ecosystem and incrementally add more Sonos speakers or replace old ones with other Sonos products. 41% of company sales in FY20 were to existing Sonos households which was up from 37% in the prior year.

Our investment thesis is three-pronged. Firstly, the company was intent on capitalising on its technological advantage by spending immense amounts on brand building advertising. Such was this spend that despite its microcap status the company was procuring Superbowl ads, generally reserved for large multinational companies. While this has made Sonos a household name, the return on that investment is arguable. Having achieved its intent, the company can now divert some of this spend into other areas, including higher margins. We began to capitalise higher margins in our valuation once we saw signs of this transition taking place.

Source : Sonos

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Secondly, the market's expectations for sales growth is modest. These low expectations were despite the company spending heavily on R&D and being able to divert some of its brand-building advertising to product development and in-store support. We see a company with opportunities to increase its product breadth, excellent distribution, and a strong track record of innovation. The recent spike in the share price corroborates this view with better-than-expected sales growth in the recent quarter and a positive outlook as inventory levels remain thin.

Thirdly, we see an opportunity for the company to capitalise on its wireless technology and potentially license out more of its software. Sonos launched a lawsuit against Google in the LA Federal Court in January for allegedly infringing on five patents with its Chromecast device. This action follows a successful case by Sonos against Lenbrook, which agreed to pay royalties to Sonos to end its lawsuit. License payments could form a meaningful part of Sonos' revenue going forward. Analysts are only now starting to consider factoring this into their forecasts.

<u>AB Dynamics</u>

AB Dynamics fell 15.5% in AUD in November (-14.1% in GBP). AB Dynamics is named after its founder, Anthony Best. He retains 19.7% of the company to this day and is the Non-Executive Chairman of the company. Anthony joined Rolls Royce cars in 1960 as a graduate engineering apprentice. He found his way to Moulton Developments where he was the chief engineer working on vehicle suspensions. When the company closed, Anthony decided to found his own company, AB Dynamics.

Today, the company's products are essential tools for the world's leading automotive companies to develop advanced driving assist systems (ADAS). Customers include brands such as BMW, Fiat, Hyundai, Mercedes, Renault and Volvo. Types of products AB Dynamics develops include driving robots to take test cars around tracks (picture below), ADAS targets (obstacles for the ADAS to avoid automatically), simulation software, and lab testing such as noise vibration harshness (NVH) test systems.

Source: AB Dynamics

There are several things to like about this company. AB Dynamics enjoys a strong position in driving robots, commanding around 35% of the market. Market growth is underwritten by ever-stricter regulation and demands from the organisations that assess car safety. The Euro NCAP 2025 roadmap shows how the bar for automotive companies to reduce road fatalities continues to be raised. Hence, AB Dynamics is leveraged to the rate of industry innovation, not the number of cars sold. The chart below shows the company's estimate for market growth by category.

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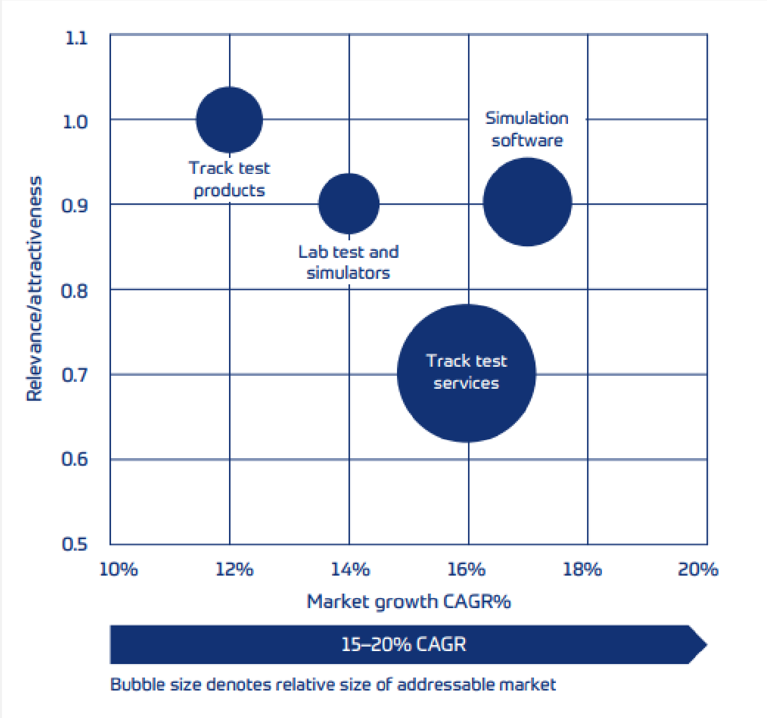

Source: AB Dynamics

28% of revenue is recurring as most customers rely on AB Dynamics to maintain their driving robots and the software required to run them. The company has numerous opportunities for growth, including geographic expansion with the recent establishment of an office in the USA, and product expansion through internal development or bolt-on acquisitions.

The company's recent stumble reflects a delayed impact from Covid. The market had incorrectly concluded that the company was more immune than proved to be the case. However, we see no signs that the long-term growth of the company is compromised.

Outlook

Duration, spreads and convexity. Not terms uttered by equity managers in a typical day. However, the share market has been dominated by macro factors since Covid. Equity managers are increasingly turning into bond investors. Whether they are long or short duration has been the overriding factor behind their relative performance.

Going long duration means your portfolio benefits more than the Index if interest rates fall. In equity terms, this is equivalent to owning more growth stocks. Since growth stocks have more of their earnings in the future, they are more sensitive to interest rates and their impact on the rate those cash flows are discounted back to present value. As interest rates fall, so too does the discount rate, and future cash flows are worth more in today's dollars.

With positive vaccine news, investors are beginning to position short duration (as are bond investors). That is that interest rates will rise and future cash flows will be worth less in present terms. Under this scenario vaccines will underpin a robust macroeconomic rebound, stoking inflation and lifting interest rates. Cyclical stocks and those on low price to earnings, where more of the earnings are near-dated, will do best in this environment.

Value investors have been waiting for this scenario. Since the unwinding of the dotcom boom in the early 2000s, growth stocks (short duration) have been benefiting from the relentless decline in real bond yields. As the chart below shows, the outperformance of growth over value since 2006 easily surpasses the dotcom period in both length and magnitude.

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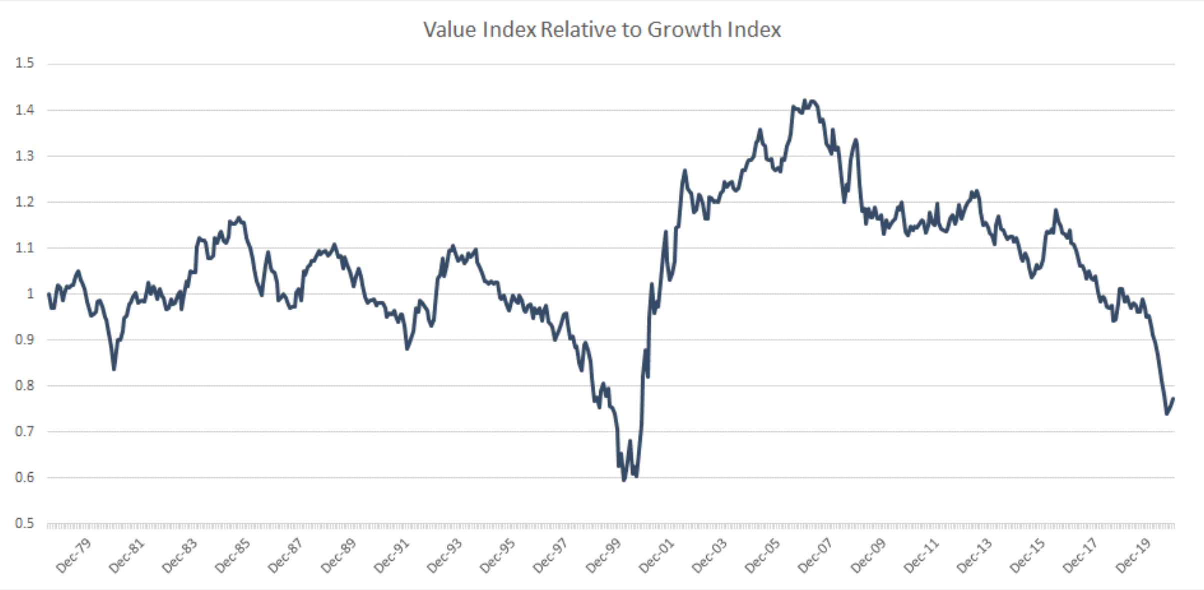
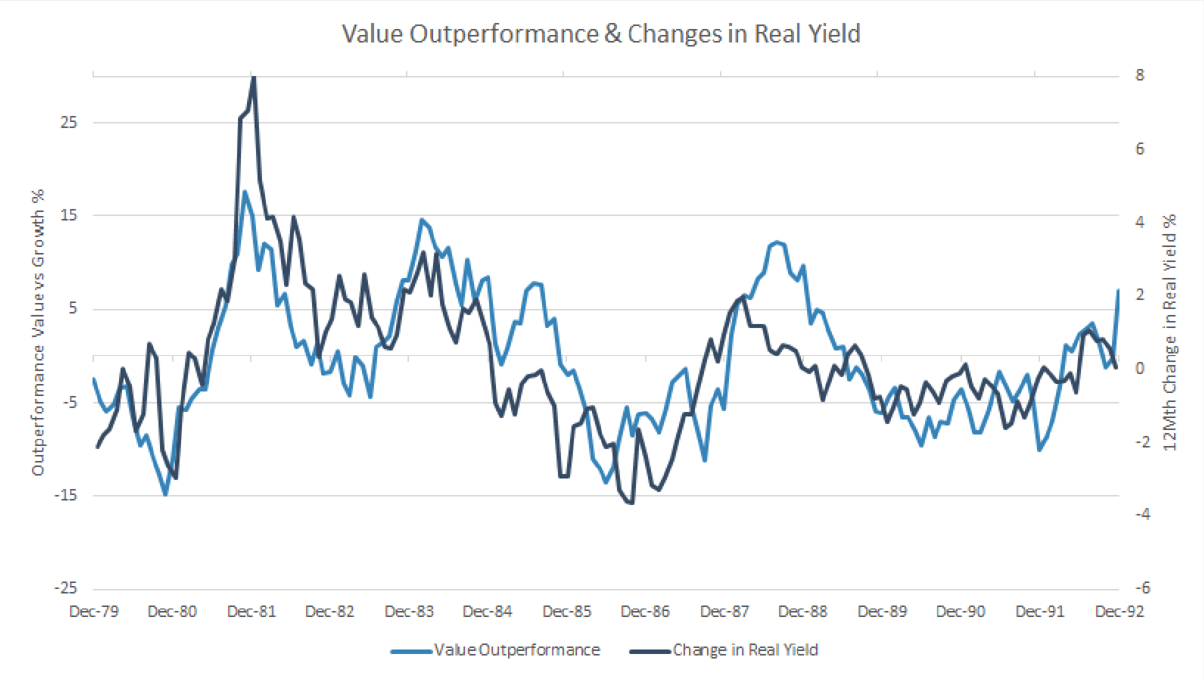


Source: Bloomberg. Wiltshire Value relative to Wiltshire Growth

The problem is, the relationship between interest rates and the relative performance of value and growth stocks is less clear cut than theory would suggest. While over the long-term there is little doubt lower real yields are favourable for growth stocks, over a shorter timeframe the link is more tenuous. In the 1980s the relationship was relatively predictable. As the chart below shows, value outperformed as real yields rose.



Source: Bloomberg, Spheria. Wiltshire Value vs Wiltshire Growth.

However, since the early 90s, the relationship has broken down. And in recent years, the inverse has been more prevalent. That is, growth has outperformed value with rising real yields.

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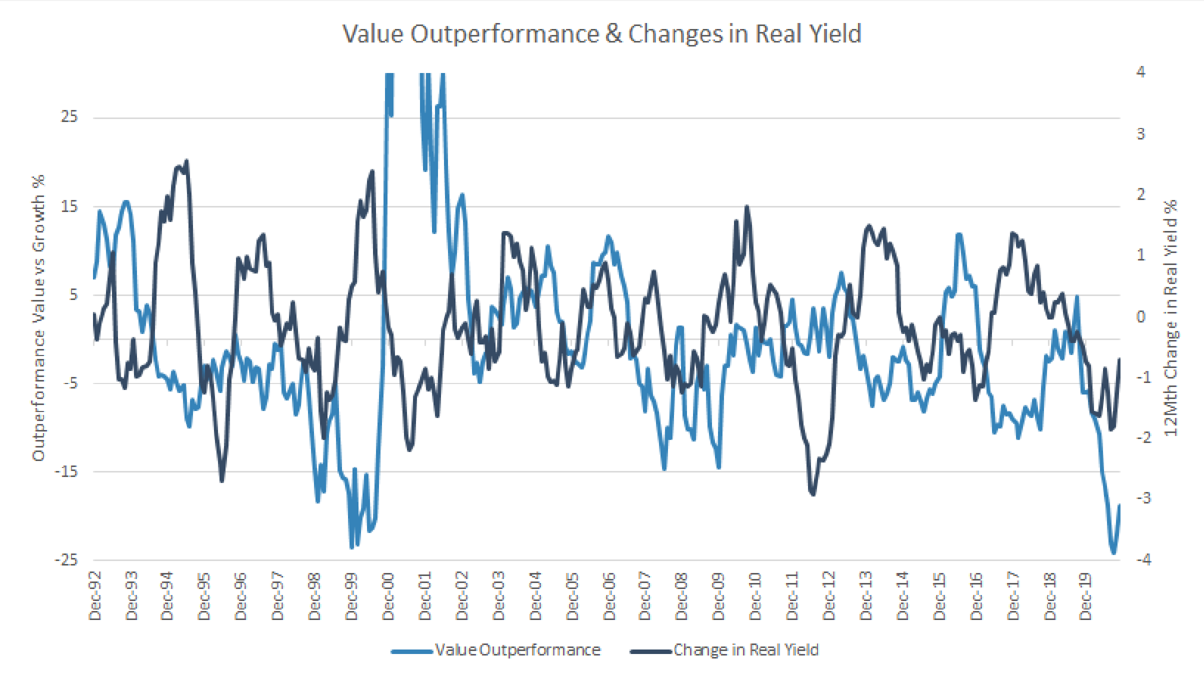

Source: Bloomberg, Spheria. Wiltshire Value vs Wiltshire Growth.

Our conclusion from this look back at history is that timing a rotation out of growth stocks into value is difficult. Spheria's Global Microcap Fund is style neutral. We are valuation focused, but not a value Fund and own both growth and value stocks. Typically, such style neutrality would bias us to value names at this point of the cycle, as growth stocks become too expensive to own. However, with our vast universe, we continue to find reasonably priced growth names for the portfolio. In our view, a balanced portfolio such as ours with low beta will deliver the best risk-adjusted returns through an economic cycle.

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	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