Spheria Global Microcap Fund

ARSN 627 330 287 APIR WHT6704AU

Performance as at 31st July 2020

	1 Month	3 Months	1 Year	Inception#
Fund^	2.3%	8.0%	13.6%	12.9%
*Benchmark**	1.9%	9.2%	-2.6%	-0.7%
Value added	0.4%	-1.2%	16.2%	13.6%

^ 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.

Commentary

The Fund delivered another strong absolute return in July, up 2.3% after fees. This was slightly better than the Microcap Kokusai index, which returned 1.9%. The Australian dollar continues to be a headwind for Australian investors, up 4.2% against the US dollar in July. The Australian dollar's long-term relationship with the gold price remains intact.

The Microcap Kokusai index again outperformed both the MSCI large cap and small-cap indices in July. Since the market lows in March, the Microcap Kokusai index is up 65% in USD (32% in AUD). That is 18% more than the MSCI World Index and 9% more than the MSCI Small Cap Index.

Since inception, the Spheria Global Microcap Fund has returned 12.9% per annum after fees. Over this timeframe, the Fund has outperformed its benchmark by 13.6% per annum.

Markets

The best performing microcap market in July was Sweden, up 10.5% in AUD terms. Like Israel, which we wrote about last month, Sweden occupies a meaningful part of the Kokusai Microcap Index at 5.7% index weight. In our opinion, the composition of the Kokusai Microcap Index is superior to its larger peers because of the exposure it encourages managers to take in innovative countries such as Sweden and Israel. While much debate has centred around Sweden's handling of Covid-19, and Sweden's unemployment rate is the highest in Scandinavia, our holdings are innovative export businesses that face outwards and have little reliance on the domestic economy.

Scandinavia was strong in general, as were the resource-rich countries of Canada and Australia. The US market lagged the broader microcap universe for the first time in a long time. The Fund remains underweight the US market relative to the index by a significant margin, with only 17.9% of the Fund in that market. As the table on the following page shows, on most metrics, we are still better off focusing elsewhere.

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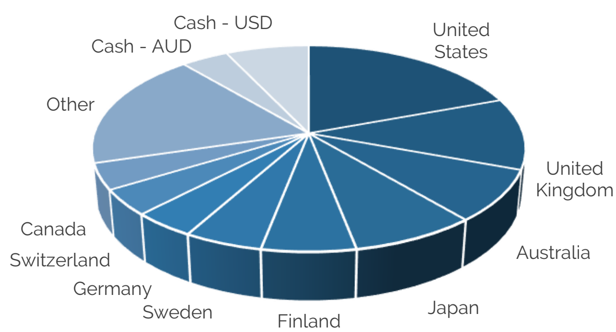
Top 5 Holdings

Company Name	% Portfolio
Poletowin Pitcrew (Japan)	3.6%
Sonos (USA)	3.3%
Fjordkraft (Norway)	3.2%
Computer Modelling (Canada)	3.1%
Revolve (USA)	3.0%
Top 5	**16.2%**

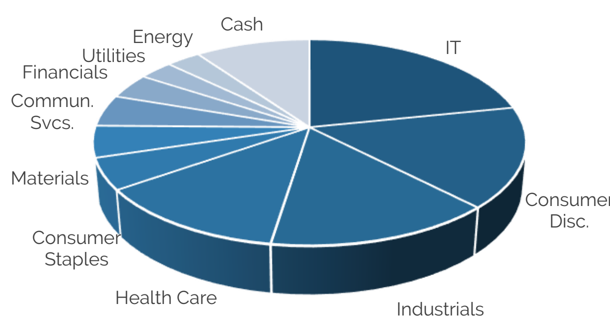
Source: Spheria Asset Management

Regional Exposure



Source: Spheria Asset Management

Sector Exposure



Source: Spheria Asset Management

Segment	PE	EV/EBIT	Div %	FCF %	Net Debt / EBITDA
Kokusai Microcap Index	20.4x	18.7x	1.5%	0.2%	2.1x
USA Constituents	21.2x	21.5x	1.0%	-2.2%	2.6x

In terms of sectors, Financials were the worst performing segment of the market with many regional banks in the index struggling to contend with such a flat yield curve and a deteriorating loan book. Real estate also remains under pressure despite the help this sector receives from lower 10-Year yields. The market has been quick to price in potential lingering structural effects from Covid, and fewer visits to shopping centres and a surplus of office space seem like two pretty sure bets.

However, it has been hospitality and tourism that have sometimes been dealt with the harshest, even though few expect these to remain permanently depressed. Ashford Hospitality Trust, an owner of upmarket hotels, has lost 85% of its market capitalisation since the Covid crisis began. Unfortunately, it now has a market capitalisation of only US$41 million and debt of US$4,153 million. We hope for shareholders and employees of the company they find a way to trade through this dilemma, but it's a pertinent reminder for us why we err on the conservative side of financial gearing.

Mining stocks were again the stars within microcaps during July. However, this time silver, copper, and diversified miners outshone gold stocks. The other performing area of the market was in housewares, home furnishing retail, and home improvement retail. One need only look at the share price of a much larger cousin to see how much people are spending on their homes, now that they've realised they may be stuck there longer than first thought. Home Depot is trading well above its pre-Covid highs.

To that point, Home Depot is one of the most successful long-term growth stories in the US stockmarket. If an investor had purchased the stock at its float price of $12 on 22 September 1981, and reinvested the dividends until the 31st of July 2020, they would have earned an astounding 27.3% per annum. However, it was the company's early years as a microcap where the stock delivered its best returns. From its float, until it passed US$1 billion in market capitalisation, it returned 59.5% per annum. Or if we factor in inflation, it surpassed the US$1 billion mark in 1987, and despite the 1987 stockmarket crash would have delivered 58.4% per annum. While few investment strategies have matched buying and holding a high-quality business, it certainly helps to discover the stock in its formative years before the stock becomes discovered by the wider market.

Fund Performance

With such a broad index of over 4,000 stocks we have the luxury of investing in a largely benchmark unaware fashion. The largest stock in the index typically holds a weight of only 0.20%. Hence, unlike large cap managers, we can focus all our attention on the stocks we want to own, and not worry about the stocks we don't own. It is rare that our performance relative to the benchmark is materially impacted by individual stocks in the index that our Fund does not own (underweight positions). July was an exception.

Eastman Kodak received a much publicised "shot in the arm" after the US Government sent it a letter of interest in a $765 million dollar loan to help Kodak make pharmaceutical ingredients and strengthen its domestic pharmaceutical supply. Latching on to this, shareholders took the company's share price from $2.23 at the end of June, to a closing high of $33.20, before the stock price settled at $21.85 at the end of July. This former microcap minnow, that now has a market capitalisation of US$1.1 billion, has made a loss the last two years. In June, S&P revised its credit outlook to negative, noting $300 million in debt maturities and "persistent weak operating performance".

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The letter of interest to provide a loan from the US Government is intended to help Kodak repurpose and expand existing facilities to be able to provide up to 25% of the US's demand for non-biologic active pharmaceuticals. Investors were willing to add $2.3 billion of market value to the stock on the back of a $765 million investment (an IRR of 275% on our back of the envelope calculations). That's a large implied return without knowing any of the details of the *expected* future supply agreement from the *letter of interest*. Perhaps they are not aware of the difficulties faced by generic pharmaceutical manufacturers over the last five years, and that most of them trade under 5x PE ratio.

But while Eastman Kodak sliced 0.11% from relative performance, it was Tupperware that was our largest underweight detractor, hurting the Fund's relative performance by 0.14%. A great product no doubt, many of us have Tupperware containers so old we would need carbon dating to know when they entered our kitchen. Tupperware's share price began the month at US$4.75, peaked at $16.15 and ended July at $15.43. Its result was better than expected, but its share price had more than doubled before that point.

It seems, investors are currently willing to bet on the kindness of strangers, particularly lenders. The company with a current market capitalisation of US$736 million has debt of US$488 million due 1 June 2021. During its earnings call the CEO said "We indicated that this maturity raises substantial doubt about the company's ability to continue as a going concern." The CEO has outlined a plan to repurchase bonds below par, sell non-core assets and cut costs to remain compliant with covenants. The recent earnings report certainly raises the likelihood that the CEO can find a solution to the company's solvency problems. While not a complete failure of investor common sense, like the Kodak saga, it nevertheless reflects the risk appetite of investors amid a pandemic, a few months out from a US election, and with escalated Sino-US tensions.

While we spent a lot of time discussing stocks we don't own, after extolling the virtues of the kokusai microcap index and how it allowed us to focus solely on companies we do own, we nevertheless thought it a worthwhile exercise to relay some observations that reflect the pent up animal spirits of the market at present. As for what the Fund did own, reporting season has offered up a few surprises both good and bad. But for now, the market is willing to look through Covid and dismiss short-term earnings as transitory. The information value ascribed by the market to the June quarter results is low. We wonder whether the same will be valid for the September quarter?

The Fund's top contributors included an Australian retailer of plus size women's clothing expanding in the US, a Swedish maker of truck pumps and hydraulics, and an Australian junior iron ore producer. Detractors included a US medtech company with a leading position in a high growth category, a chain of Japanese pharmacies helping to consolidate the industry, and a US natural soda-ash producer.

The last of these stocks owns a jewel of an asset. The company owns one of only five major US natural soda ash deposits. US Trona can be mined and refined at half the cost of alternative methods of producing soda-ash such as solvay or hou. Synthetic production in China is much higher up the cost curve than these natural deposits.

The soda ash market continues to exhibit GDP type growth and is used in a wide range of applications, including flat glass, container glass, specialty chemicals, and soaps and detergents. While Covid has seen a drop in soda-ash prices, such a consolidated industry is likely to act rationally, and our holding has already shelved plans to expand its production. We see no reason why Covid will impact soda-ash demand structurally and see the current share price as an excellent opportunity to add to our position.

Outlook

The market gyrates between fear and greed, and as noted above, we are currently firmly in the greed camp. At times such as now, with the lure of rapid capital appreciation, due diligence and a healthy dose of scepticism can be detrimental to one's investment returns. Aside from an increase in risk-taking and expanding the multiples paid for businesses, the other way this begins to show is in investors' tolerance for aggressive accounting.

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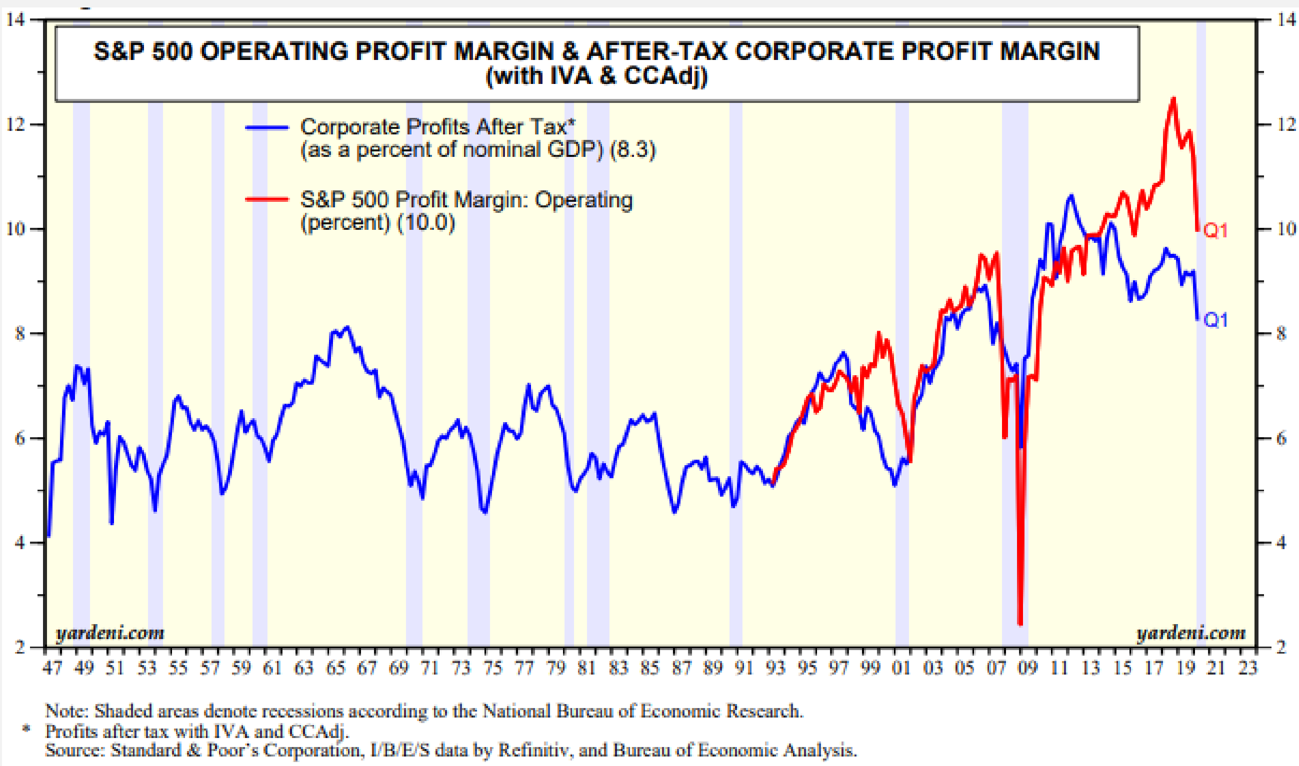
As the chart from Yardeni Research below shows, during periods such as the dotcom boom and now, the gap between margins implied by NIPA (National Income and Product Accounting) and the S&P 500 diverge materially (note, the large US corporate tax cut enacted in late 2017 should have flattered the blue line). NIPA data includes all publically traded and private enterprises across all industries. It includes earnings from small and mid-sized corporations. However, a key difference is also in the accounting policies between the two sets of data. Tax accounting used in the NIPA series, as is no surprise, is harder to fudge (the incentives are also different, i.e. minimising income for tax). For instance, expenses for restructurings are recorded as they are expensed in tax accounting. It is not as simple as a listed company taking a large abnormal provision in one year (below the line – often ignored by analysts), thereby propping up the profit and loss statement in future years.



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What constitutes operating earnings relies on the willingness of investors to accept which charges are deemed special or extraordinary, and how companies choose to disclose them. It is no surprise that when animal spirits are running high, investor willingness to accept adjustments to statutory accounts rises. As an investor, do you want to miss out on a high-growth story because you're a stickler about the accounting? If nobody else cares, why should we? Safety in numbers.

Perhaps the most infamous accounting fraud of our generation is Enron, outlined in Bethany McLean and Peter Elkind's 2003 book, The Smartest Guys in the Room: The Rise & Fall of Enron. It was Ms McLean's 2001 Fortune article, Is Enron Overpriced?, that questioned the company's accounting long before things unravelled. Very few investors even fully understood how the company generated its revenue. Yet the stock was a darling, and those investors too dogmatic to buy it were made to look foolish as its stock soared.

As for the details about how it makes money, Enron says that's proprietary information, sort of like Coca-Cola's secret formula. Fastow, who points out that Enron has 1,217 trading "books" for different commodities, says, "We don't want anyone to know what's on those books. We don't want to tell anyone where we're making money."

McLean, Bethany. "Is Enron Overpriced". Fortune Magazine, March 2001.

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This is an extreme example of how investors' are willing to throw proper due diligence to the wind to chase gains. As history has shown, we expect an unravelling of this cursory focus on accounting will occur at some point during this market cycle. Being conscious of this, our investment process incorporates systematic scrutiny of the financial accounts. To be included, a stock must meet the following hurdles:

- Do we understand how the company makes money?
- Having read the company's accounting policies, how much flex does management have when recognising revenue and expenses and how conservative are its policies?
- Using a consistent framework, are there any indicators of accounting concerns such as rising receivables or building inventories?
- Do the earnings accurately reflect the sustainable cash flow of the business?

We have passed on investments because we thought the accounts were too rubbery. Not that we thought fraud was evident, but that management had too many levers to pull in massaging an earnings result from one period to the next.

Following each earnings result we critique the accounts of our holdings and judge for ourselves whether adjustments are necessary to reflect the true operating performance of the business. Often Spheria's version of profit does not marry up with the company's version.

While we note the aggressive accounting evident this late in a bull market cycle, we would not be surprised if seasoned CFOs use the Covid crisis to replenish some hollow logs. That is, nobody is expecting a great result in the June quarter and investors appear willing to look through it. So why not take the opportunity to kitchen sink numbers to set up for better results in periods ahead? Investors may be surprised how well companies fare over the next year despite a challenging macro economy. But this can only help flatter a company's earnings results for so long. The reality is, the sustainable free cash flow of a business does not change with this trickery, and nor does our valuation.

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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