SPHERIA ASSET MANAGEMENT

Spheria Global Microcap Fund

ARSN 627 330 287 | APIR WHT6704AU

Performance as at 31st October 2021

	1 Month	3 Months	1 Year	2 Years p.a.[3]	Inception p.a[3]
Fund[1]	0.8%	0.2%	44.7%	27.2%	23.2%
Benchmark[2]	-2.0%	0.2%	54.0%	26.4%	19.8%
Difference	2.8%	0.1%	-9.3%	0.8%	3.4%

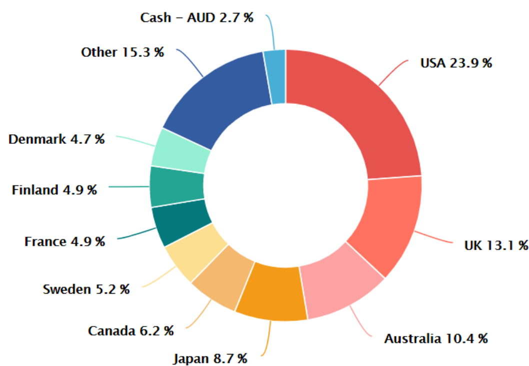
1 Spheria Global Microcap Fund. Returns of the Fund are net of applicable fees, costs and taxes.
2 Benchmark is the MSCI World Microcap Index in AUD (Net) from 1 July 2021 and prior to that MSCI Kokusai (World Ex-Japan) Microcap Index in AUD.
3 Inception date is 1 March 2019. Past performance is not a reliable indicator of future performance. All p.a. returns are annualised.

Overall Commentary

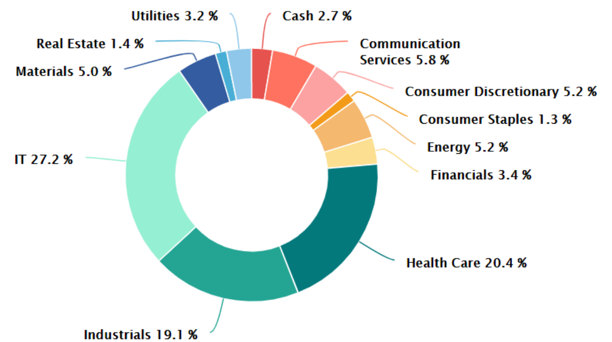
All but the largest stocks were weaker in October. The MSCI World appreciated 1.6%, MSCI Smalls fell 0.4%, and MSCI Micros fell 2.0%. The Fund did relatively well, despite this dynamic, up 0.8% after fees.

Since its inception (1 March 2019), the Fund has delivered 23.2% p/a after fees. This return is 3.4% p/a more than its Benchmark, and 6.9% p/a more than the MSCI World of large cap stocks.

Regional Exposure



Sector Exposure



Source: Spheria Asset Management

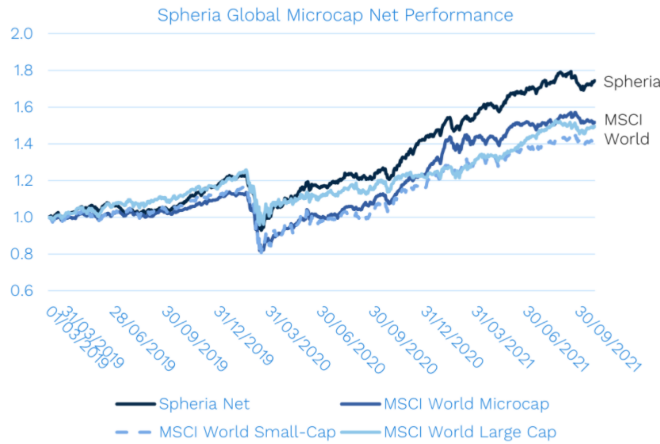
Global Characteristics

	Average Mcap (USD)	EPS Growth (%)	Trailing FCF Yield (%)	Dividend Yield (%)	Net Debt / EBITDA	FCF Conversion (%)
Spheria	798	40.8	3.6	2.3	-0.7	103.3
World Micro	214	0.4	1.6	2.1	1.1	72.5
World Smalls	2,666	21.4	3.2	1.7	1.9	86.4
S&P500	87,585	39.3	3.4	1.3	0.7	107.5
Nasdaq	8,524	33.1	2.8	0.6	0.0	110.7

EPS= Earnings per Share, FCF = Free Cash Flow, Negative Net Debt / EBITDA figures show a debt free, or net cash balance sheet.

Further Commentary

The chart below shows the comparison to the major MSCI Indices.



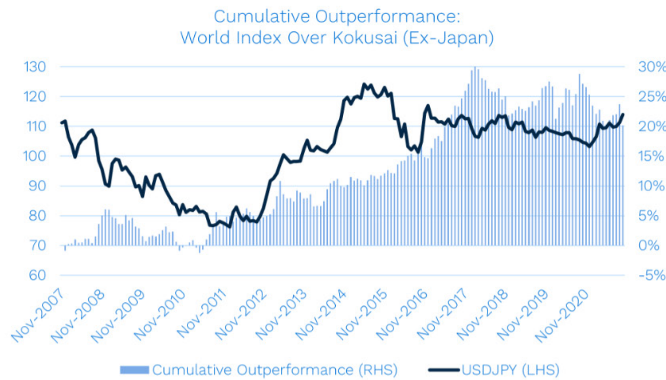
Source: MSCI, Spheria

Markets

Energy and Materials continued their march higher in October. Meanwhile, defensives in Health Care and Consumer Staples lagged considerably, down 7.4% and 4.0%, respectively. There are signs of a near term peak in growth as supply chain issues bite and Government stimulus wanes. Perhaps with the Central Bank Cartel about to begin tapering, investors are increasingly nervous about growth stocks on high multiples and what higher interest rates may mean?

We expect these concerns will evaporate in the coming months. However, the beauty of a style neutral portfolio and huge universe of opportunities is that we don't care and can instead focus on our 3-5 year bottom-up fundamental analysis and valuation. Macro is hard; finding and analysing undiscovered companies is relatively easy if you know how and have the wherewithal to do it.

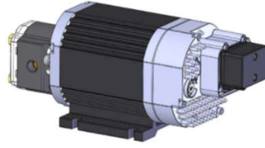
Given the outperformance of materials and energy, it was no surprise to see Canada and Australia as the two best performing microcap markets in October. On the other hand, the market wasn't buying what Japan was selling (safety) and that country's microcaps were down 7.7%. We continue to crawl over Japan, currently owning four stocks there and many more under analyst coverage. The balance sheets in that country are in rude health, and valuations are extremely appealing. The cherry on top is a weaker Yen of late, which provides a significant tailwind to Japanese exporters.



Source: MSCI, Spheria. World Index includes Japan, Kokusai excludes Japan.

Fund Performance

CONCENTRIC (COIC.SS)



Source: Concentric

The Fund's best performing stock this month was Concentric.

Concentric is a Swedish based manufacturer of pumps and hydraulics. Concentric pumps are the market leader and benchmark in lubrication, cooling and fuel pumps for medium and heavy-duty diesel engines, transmission and compressors. Evolving environmental and noise regulations have meant that its truck manufacturing customers have relied increasingly on Concentric to deliver greater efficiency while ensuring the reliability critical for trucks, construction, and agricultural equipment.

The company is a classic Spheria stock. Free cash flow conversion has averaged 109% (earnings before interest and tax, or EBIT, to Free Cash Flow); returns and margins are healthy, reflecting the company's substantial intellectual property and reputation; and the balance sheet has a pile of cash. Furthermore, the team's thesis is that the market is not factoring in any upside from the company's opportunity in e-pumps. E-pumps are electronically driven, rather than driven by the diesel motor. The company estimates that e-pumps could represent 20% of revenue by 2025. In the short term, stricter emission standards will drive the use of e-pumps since they are more efficient. Longer-term, truck fleets' electrification will significantly boost growth since e-pumps will be required for shifting and lubricating transmission or cooling and lubricating the electric traction engine (depending on the powertrain used). Current diesel engines use about three pumps on average. However, electric vehicles may require more pumps (five or more), and each e-pump is more expensive than a conventional equivalent.

Recently, the company has announced that it has acquired EMP, a leading US producer of electric and mechanical water and oil pumps. Concentric is paying US$147 million for EMP but increases Concentric's revenue by more than 50%. It also bolsters the company's electric product capabilities. The market liked the announcement, and the stock price rose 17% as a result. Spheria's analysis of the acquisition suggests this is more than warranted, and the Fund continues to hold the stock.

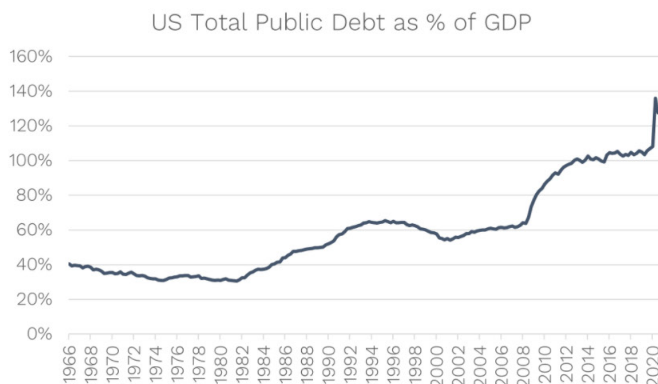
INOGEN (INGN.US)

Inogen was again the Fund's largest detractor. The company remains a victim of COVID lockdowns. However, with economies reopening and the elderly becoming increasingly mobile, the company is set for a much brighter future.

As a reminder, Inogen is the global leader in the manufacture of portable oxygen concentrators. These products can be substituted for oxygen tanks when patients require mobility. The industry continues to grow strongly, and following COVID many more patients have been prescribed oxygen. Normalised for COVID, the company's metrics and valuation are attractive, and the company's balance sheet includes US$220 million of net cash.

Outlook

How do we get out of this mess?

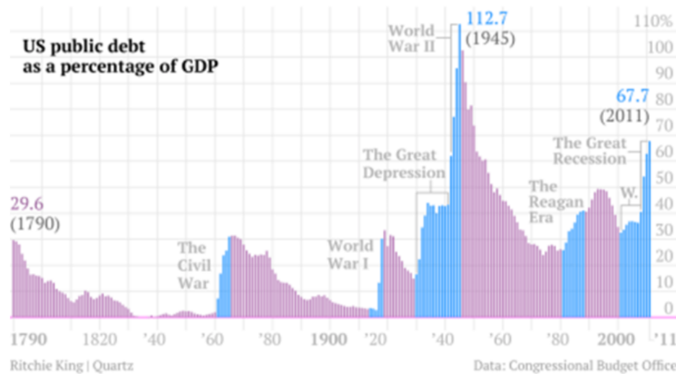


Source: FRED

Is the US ready to become a bad lender? Recall, even the UK, with all its might, was at one stage a serial defaulter to its financiers in the cities of Genoa, Venice and Florence. Following the Napoleonic Wars, the UK's public debt was 260%. This quandary took over 40 years to work through and reduce public debt to 100%. Could today's politicians convince the populace to accept 40 years of austerity?

A theory offered by some commentators is that Western Governments are likely to resort to financial repression. Financial repression is where the Government monopolises lending so that institutions are effectively forced to lend to them. This action suppresses nominal interest rates and allows Governments to pay down debt. Negative real interest rates work as a tax on savers and transfers money from creditors (savers) to borrowers.

While financial repression sounds radical, it has historically been quite common. As the chart below shows, working off excess public debt is not a new phenomenon.



Indeed, after World War II, financial repression was the norm for many advanced economies. The beauty is that this new type of tax works by stealth, slowly eroding savers' assets. Much easier for politicians to get away with than income or sales tax. It can take multiple forms, including legal restrictions on interest rates and control of credit allocation or capital movements.

The IMF has written on this topic multiple times (recently here). The IMF states that "A large role for nonmarket forces in interest rate determination is a key feature of financial repression.". Hold on that sounds familiar. The Central Bank Cartel (CBC) certainly fits the bill of nonmarket forces. Current US 10-year real interest rates are -0.92%.

Savers sure feel like they are being taxed hard, hence why equities are so popular. The problem is, the CBC has already spent a lot of its bullets. The Federal Reserve balance sheet has expanded from $4 trillion to over $8 trillion currently. The balance of outstanding US Treasuries is $21.9 trillion. How much longer can the Fed hold down rates on its own?

It may be that the CBC is simply the first part of the act. Financial repression is most successful when inflation is elevated. The CBC may be doing its best to stoke inflation before macro-prudential regulations take over the repression. As the chart from the IMF below shows, financial repression works gradually over time.

Table 2. Incidence and Magnitude of Liquidation of Public Debt via Negative Real Interest Rates, 1945–1980

Country	Period	Share of liquidation years	Real contractual interest rate (CIR)		
			Average	Minimum	Year
(1)	(2)	(3)	(4)	(5)	(6)
Countries with large buildup of debt during the war					
Australia	1945-1980	44.4	-1.2	-14.1	1952
Belgium[1]	1945-1974	28.0	0.5	-7.4	1974
France[2]	1945-1980	65.4	-6.6	-34.5	1948
Italy[3]	1945-1980	55.6	-4.6	-56.8	1945
Japan	1945-1980	50.0	-2.7	-65.6	1946
United Kingdom	1945-1980	66.7	-1.7	-11.2	1975
United States	1945-1980	50.0	-0.3	-13.6	1946
Countries with no large debt buildup during the war					
Argentina	1945-1980	94.4	-21.5	-73.5	1976
India	1949-1980	50.0	-0.9	-17.9	1974
Ireland	1960-1983	58.3	-1.1	-8.4	1981
South Africa	1945-1980	38.9	-0.4	-5.3	1976
Sweden	1945-1980	55.6	-0.4	-7.9	1952

Notes: Share of liquidation years is defined as the number of years during which the real interest rate on the portfolio is negative divided by the total number of years as noted in column (2).
[1] No data on the composition of debt to calculate CIR available for 1964-1968.
[2] No data on the composition of debt to calculate CIR available for 1953-1958, 1960-1963.
[3] In 1944 (not included in the calculations) inflation peaked at 492 Percent.

Source: IMF

Great, you may think? Low interest rates sound bullish for equities. Well, there is a twist. Whereas the CBC's form of financial repression (QE) has allowed institutions to allocate capital freely, including equity markets, macro-prudential controls are likely to include constraints on credit allocation and restrictions on international capital movements. It may include prudential regulatory measures that require institutions (often pension funds) to hold Government debt in their portfolios. In more extreme cases, it has also included transaction taxes on equities and a prohibition on gold transactions.

Let's take a scenario where regulators force institutions to hold more reserves, constrain the countries capital account, and implement prudential changes to ensure institutions have more Government debt. These actions will result in a switch from equities to Government Debt. The table below may help you decide which equities will suffer most under this scenario.

	Forward EV/EBIT	Passive AUM %	Avg. Insto Holders per Stock
S&P 500	27x	53.8%*	1,589
MSCI World Microcap	17x	No Passive ETF Available	32

*Bloomberg Intelligence. Source: MSCI, Spheria, Bloomberg

Large US tech stocks have been the principal beneficiaries of the CBC's first act of financial repression. However, are investors prepared for the second act? Once again, Global Micros serve as a valuable diversification tool. To reiterate:

- Global Microcaps oscillate around large-cap equities depending on the economic cycle, providing diversification benefits. Adding Global Microcaps can help reduce overall equity portfolio volatility and downside risk.
- Microcaps are less dominated by the US market with only 26% of the MSCI World represented by that country. In contrast, the MSCI World Index has a 67% allocation to the US market, and that market, in turn, is the most concentrated it has been since 2000.
- Microcaps typically trade at an earnings multiple discount to large caps, but the rise in passive investing has stretched that gap in valuation. During the dot-com bust, smaller companies outperformed large caps materially owing to this kind of valuation discrepancy.

One thing is for sure; Governments are going to have to pull something quite spectacular to get us out of this mess. Therefore, we urge investors to consider diversifying into Global Microcaps to prepare for any scenario.

Platform Availability List

The Spheria Global Microcap Fund is available on the below Platforms. Please check with your platform for minimum investment requirements and fees.

HUB24 Macquarie Wrap Netwealth Praemium

Spheria Global Microcap Fund	
Benchmark	MSCI World Micro Cap Index
Investment Objective	Outperform the MSCI World Micro Cap 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
Holdings	Generally 30-80 stocks
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

Fund Ratings

Further Information

For more information, please contact Pinnacle Investment Management Limited on 1300 010 311 or email distribution@pinnacleinvestment.com

Disclaimer

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