Spheria Global Microcap Fund

ARSN 627 330 287 APIR WHT6704AU

Performance as at 31st August 2020

	1 Month	3 Months	1 Year	Inception#
Fund^	2.6%	4.6%	17.1%	14.0%
*Benchmark**	4.5%	8.4%	3.6%	2.3%
Value added	-1.9%	-3.8%	13.5%	11.8%

^ 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 continue to power ahead. August was a replay of June. Microcap markets leapt higher early in the month and the Spheria Global Microcap Fund, which has a lower beta, did not keep pace. The Kokusai Microcap Index returned 4.5%, while the Fund managed a net return after fees of 2.6%.

Since inception the Fund has delivered an after fees return of 14.0% per annum compared to the Index which has risen 2.3% per annum. Over the same time frame, the MSCI World Index (large capitalisation stocks) has returned 10.1% per annum, and the MSCI World Small Cap Index (ex-Australia) has returned 0.1% per annum.

Markets

Investors didn't have to travel far to get the best microcap returns in August with Australia leading the world, up 10.8% for the month. Sweden and Israel, two countries we have spoken about in recent monthlies, also delivered strong returns. Hong Kong and Ireland were the only two countries in the red in AUD terms.

At a sector level, Consumer Discretionary was up 9.4%, while at the other end Utilities were flat and Energy continues to lag, up 1.2%. Davey Day Trader and his legion of Robinhooders are unlikely to pay much attention to these old-world stocks. Recall how neglected the Australian sharemarket was during the dotcom boom? Sharemarket history certainly repeats.

The Casinos and Gaming industry was one of the top performing segments of the market. Home Furnishing Retail also continues to remain healthy. It's comforting to know the Government's stimulus payments are finding their way back into the economy. However, as the chart on the following page shows, a large portion has gone into debt repayments and increased savings.

The current recession is far from a typical one, with stimulus cheques offsetting job losses to lift personal income in the US. This makes forecasting short-term earnings particularly tricky. Fortunately, we value companies using their mid-cycle sustainable free cash-flow, which takes much of this short-term guesswork out of the picture.

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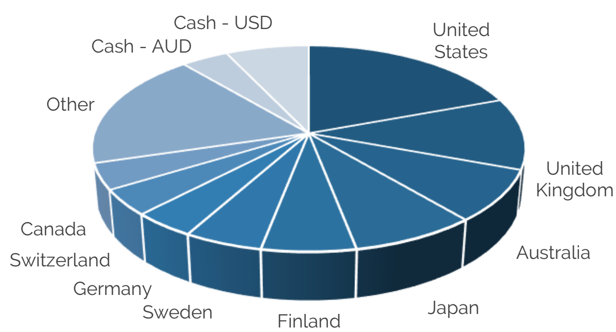
Top 5 Holdings

Company Name	% Portfolio
Poletowin Pitcrew (Japan)	3.7%
Fjordkraft (Norway)	3.6%
Revolve (USA)	3.5%
Sonos (USA)	3.3%
Computer Modelling (Canada)	3.1%
Top 5	**17.2%**

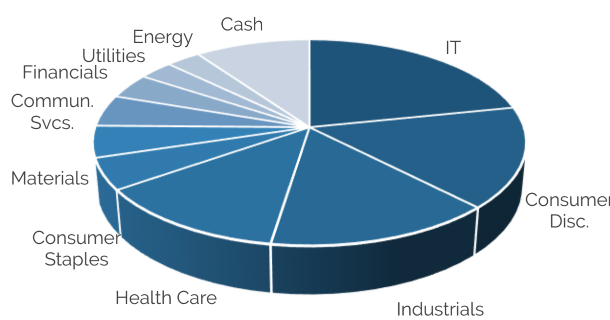
Source: Spheria Asset Management

Regional Exposure

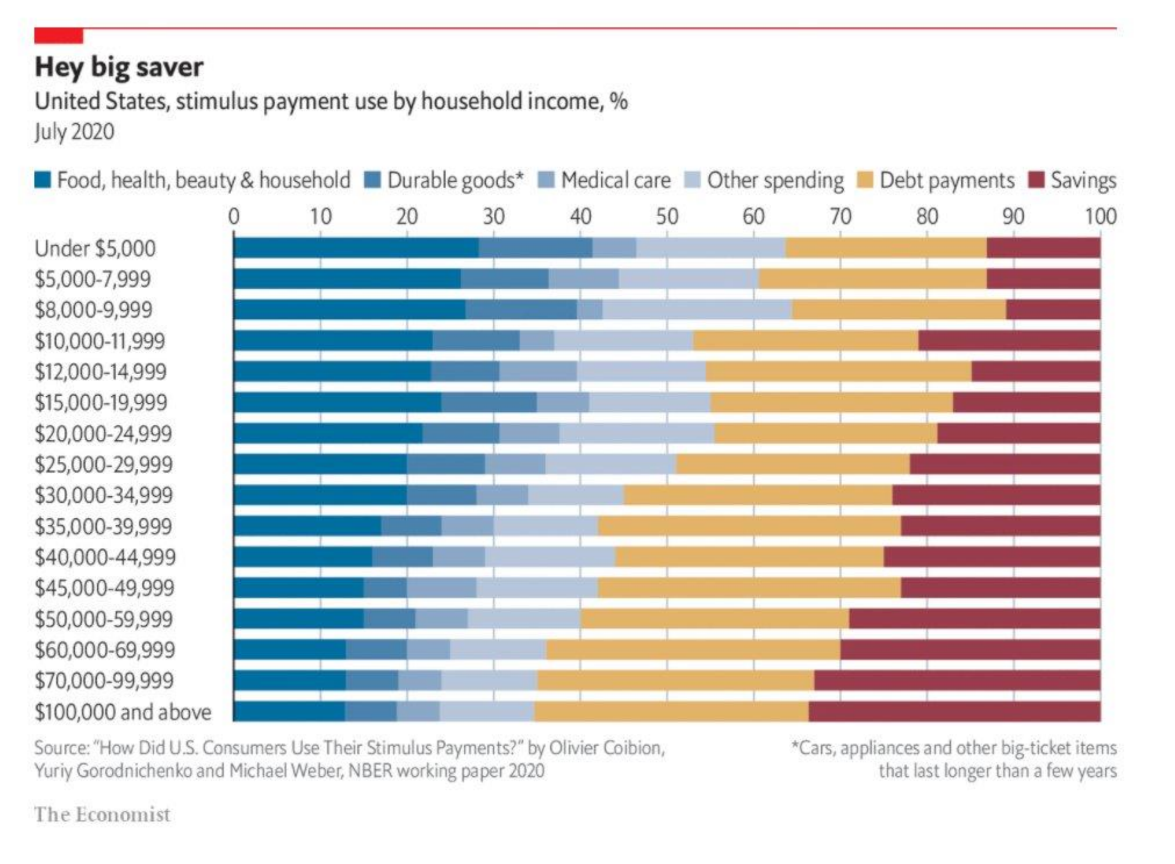


Source: Spheria Asset Management

Sector Exposure



Source: Spheria Asset Management



Technology Hardware, Storage & Peripherals was the worst area of the microcap market, dragged down by Eastman Kodak which fell 73.5% in August (refer to July's monthly). Silver stocks were dumped as investors question what the early release of a vaccine may mean for bond yields. Higher yields will increase the attractiveness of bonds over other safe-haven assets such as silver and gold. Up until recently, investors were expecting US Treasury yields to eventually go negative, effectively delivering a yield to gold and silver for the first time. The metals' biggest drawback historically.

Fund Performance

The Fund found it challenging to keep up with the market in August. We navigated through reporting season reasonably well. Our biggest mistake was buying into a new position whose decline accelerated as the month went on, although the initial position size was modest (1%). This company is net cash and operates in a duopoly market which provides payment services to the healthcare industry. While the company is labelled an IT stock, it has leverage to the structural growth of its healthcare partners. The company has multiple growth angles beyond this, and management is not shy at talking these up. However, as is often the case, hiccups in the core business during Covid have seen investors become less willing to price in these growth options. Our assessment was that we were getting them cheaply, but now we are getting these growth options entirely for free. We have increased the Fund's position accordingly.

The biggest performance detractor was one of our largest portfolio holdings that rose on takeover conjecture. The price it rose to remained below our valuation, and hence we did not feel the need to take profit. These types of swings and roundabouts are commonplace. All we can do is take them in our stride and apply our valuation discipline to the stock as its price changes relative to other opportunities.

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The Fund's top contributors included an Australian SMSF software provider, a German IT consulting business, and a US online apparel retailer. We spoke about the US online retailer recently, and a strong second quarter result helped propel its shares higher. The holding has done well, and it is no longer a microcap stock with a market capitalisation of US$1.39 billion at the time of writing. Nevertheless, we have not yet taken profits since we continue to see material valuation upside.

Our German IT company has also been a solid performer (its market cap remains just over €400m). The company ticks the typical Spheria boxes with historical free cash flow conversion of 104%, a net cash balance sheet and a return on invested capital of 31%. However, it's the company's strategy with a narrow focus on selected industries which differentiates it from generalist consulting firms and IT service providers. Its customer exposure to banking, insurance and healthcare has made its earnings historically resilient with growth continuing through the GFC. COVID has been no exception with a robust second quarter result just reported. Only two regional brokers cover the company and in our opinion their forecasts are too pessimistic. We continue to see good relative value for this stock, particularly given its risk profile.

Outlook

Through Spheria's collective experience of over 100 years of investing, we have never witnessed such a convergence in investor mindset. Market participants believe they have found a winning formula. Making money in the share market is straightforward.

> Step 1. Buy "quality" companies that will compound over time. Put them in the bottom draw. It doesn't matter how much you pay today; you will make money over the long-term.
>
> Step 2. Never sell. Let the stock compound over time. Great companies will continue to grow.

In essence, act like a passive or index investor. Buy the largest stocks and buy more as they go up. Anybody not following this "system" has been squeezed out of the market. Luckily, the steam roller of passive money has not found its way down into microcaps, and we can continue to practice the age-old discipline of fundamental analysis and valuations with relative success. Spare a thought for our large cap brethren.

Market participants are doing what they always do. Extrapolating out recent history and pricing in current conditions as if they will continue forever. As their conviction grows, the price they attach to the risk of alternative outcomes occurring plummets. But how can we as custodians of people's wealth become so reckless? If we abandon healthy respect for risk to chase returns, how are we better than a gambler following a "system"? Valuation discipline has delivered over the long-run, unlike some investment strategies that are in vogue after their success of the last few years.

The chart on the following page shows previous holdings that we have exited on valuation grounds. We have indexed the returns relative to the benchmark and aligned them so that in each case, 1.0 is the point of the Fund's exit. For example, we initiated a position in Stock A (dotted line) at 0.7, and we exited at 1.0. Meaning the stock increased 30% relative to the index before we sold. You can see that our exit of Stock A was well timed. This was a defensive stock which we sold during the height of the Covid pandemic as it had become relatively expensive. Stock E and Stock F are trading about where we exited the stocks relative to the index, and Stock C is about 8% ahead. However, Stocks B and D have charged onwards.

The most extreme example, Stock B (black line), went from 0.17 to 1.0 relative to the benchmark before we sold out. That is up more than five times relative to the broader market. Since then the stock has outperformed a further 38%. It isn't easy to sell a stock when it is going up, and everything seems to be going its way. However, if we don't rely on our process and our valuation discipline, what have we to rely on except for price momentum?

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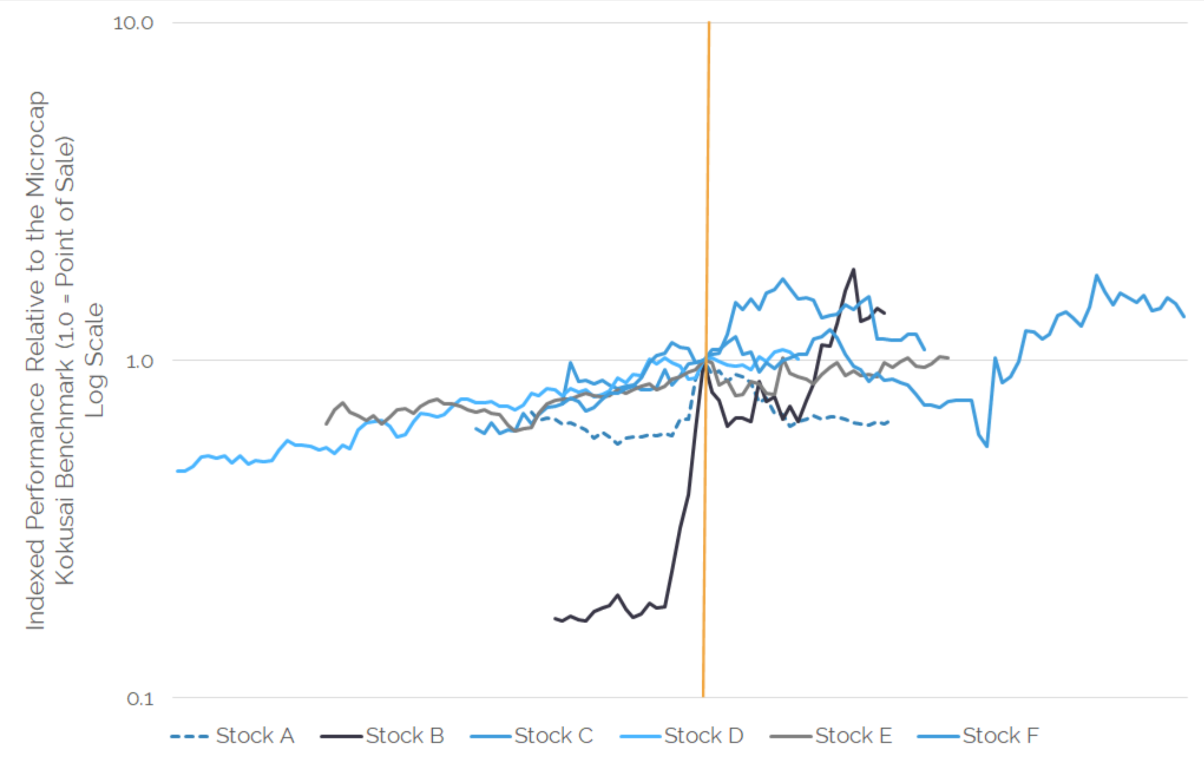

While we use the term discipline, this makes it sound more onerous than it really is, since exiting a stock for us is not as tortured a decision as it is for most managers. In global microcaps we have a universe of over 10,000 stocks around the world to choose from, and a long list of potential candidates vying to get into our relatively concentrated portfolio. Furthermore, we have no concerns about being "underweight" a stock and its continued rise hurting our relative performance to the index. The Kokusai Microcap Index has over 4,000 stocks and each individual stock's weighting is miniscule. So, we have the freedom to act as patient and risk aware investors, conscious of what we are paying for a company, and whether the cash flow to equity holders from that company will deliver an adequate return on our investors' outlay.

	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