Spheria Opportunities Fund

ARSN 144 032 431 | APIR WHT0025AU | mFund SPM03

Performance as at 30th September 2022

	1 Month	3 Months	1 Year	3 Years p.a.	5 Years p.a.	Inception p.a[3]
Fund[1]	-10.4%	-1.8%	-11.7%	4.9%	7.4%	8.6%
Benchmark[2]	-9.2%	2.5%	-15.1%	3.9%	6.8%	7.3%
Difference	-1.1%	-4.4%	3.4%	1.0%	0.5%	1.2%

1 Spheria Opportunities Fund. Returns of the Fund are net of applicable fees, costs and taxes.
2 Benchmark is the S&P/ASX Mid-Small Accumulation Index.
3 Inception date of the current investment strategy is 11th July 2016. The Fund was established in June 2010. Past performance is not a reliable indicator of future performance. All p.a. returns are annualised.

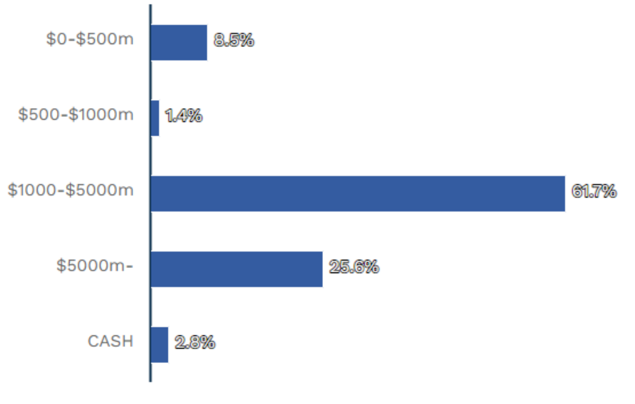
Overall Commentary

The Spheria Opportunities Fund returned -10.4% (after fees) during the month of September, underperforming the S&P/ASX Mid-Small Accumulation Index by -1.1%.

Top 5 Holdings

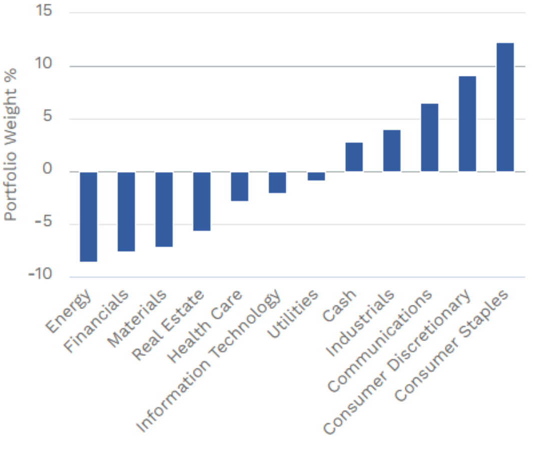
Company Name	% Portfolio
The A2 Milk Company Limited	6.5
Metcash Limited	5.7
REA Group Ltd	5.0
ALS Limited	4.9
Alumina Limited	4.8
Top 5	**26.9**

Market Cap Bands



Source: Spheria Asset Management

Active Sector Exposure



Source: Spheria Asset Management

Markets

Markets struggled over September after the respite in July and August. The Small Ordinaries Accumulation Index declined over 11% with the Mid-Small Index marginally less impacted falling 9.0%. Globally markets were also well down over the month. Bond yields rose in the US and more modestly in Australia such that 10-year yields are now close to 4% in both countries. Other world political events haven't calmed investors nerves either with energy prices re-asserting themselves and a great deal of angst present with companies we have spoken to around rising energy prices for consumers.

Having said this, we have to acknowledge that markets are now down broadly 20-25% year to date with smaller and microcaps worse affected than Australian large caps. A lot of the present risks are known to some extent – inflation, rising rates, high energy prices and macro uncertainty around the Ukrainian situation. The extreme outliers in smaller companies – the large pockets of overvaluation in speculative growth names – have largely come back down to earth. During September for example several smaller company names were suspended and subsequently removed from indices. These stocks included AVZ Minerals (AVZ.ASX), BWX (BWX.ASX) and Firefox (FFX.ASX) which in aggregate represented close to 1.2% of the small cap index. Investors are now talking about valuation and discount rates again and a more sensible economic lens is being used to allocate capital. Whilst the macro environment continues to present risks, it is worth remembering that fortune favours the intelligently brave and much better opportunities appear at times like these than when there is a positive consensus around buying an over-promoted growth market.

With that in mind, and a degree of conservatism in our forecasts, we continue to look for the best opportunities across the market and to try to sensibly rotate our portfolios into opportunities that we either thought were too expensive before and / or had material earnings risks.

Major Contributors for the Month

Positive performance contributions from companies owned included:

Michael Hill International (MHJ.ASX) – rose 7.5% in September, in contrast to the broader market which fell during the month. MHJ announced their annual results at the end of August and as has been the trend for the last two years, continue to drive earnings growth ahead of revenue, seeing margins expand. Despite a significant number of store days being lost due to COVID-19 lockdowns at the start of the financial year, group revenue grew 7% and EBIT grew 11.1%. This was driven by continued store productivity, growth in digital, and a 76% growth in loyalty members. The balance sheet finished the financial year with ~$96m of net cash and as such the company announced a share buy-back of up to 5% of the company's issued capital to deliver further earnings accretion to long term shareholders. Despite the impressive results and strong balance sheet, the company is trading on ~4x EV/EBIT and yielding over 7%.

A2 Milk (A2M.ASX) – fell 2.7% after the share price performed strongly in August. As discussed in last month's commentary, sales continued to grow with full year underlying growth of 11% and 2H22 sales up 16%. Margins also are improving from a low base and the company had exceptional cash flow conversion and now has +NZ$800m of net cash on balance sheet. The group is confident of achieving high single digit revenue growth in FY23 with a further improvement in margins. It also announced a buyback of up to NZ$150m which we view positively.

Monadelphous (MND.ASX) – share price increased 1.1% in September, continuing to trend higher after a solid return in August after the company announced their FY22 results. As discussed in the last commentary, the Maintenance and Industrial Services division grew revenues by 19% and now represents over 60% of group revenue. We view this transformation favourably as it is less risky than construction related revenue and more recurring in nature. We consider Monadelphous as one of the highest quality mining services businesses in Australia and is a second order beneficiary of the capex mining cycle. The stock has $180m of net cash and trading of an EV/EBIT multiple of around 10x.

Major Detractors for the Month

The main detractors to performance were from companies that we did not own during period with the largest three being mining companies:

Pilbara Minerals (PLS.ASX, Not Owned) – increased 25% in September as the sector was one of the only positive performers over the month. We wrote about PLS in the last commentary and several other lithium names over the last year as these companies continue to be propelled higher by the parabolic rise in lithium prices and expectation demand will outstrip supply into the foreseeable future. We remain concerned that the lithium price is unsustainable and will revert to the appropriate incentive price. We therefore feel there are safer and better ways to play the lithium narrative by perhaps investing in the lowest cost producers being brine miners including companies like SQM and Albermarle that will generate strong returns through the cycle.

Whitehaven Coal (WHC.ASX, Not Owned) – share price gained a further 19% in September as thermal coal prices continued to trend higher. As discussed in last month's commentary, the outlook for thermal coal is intuitively appealing given strong long-term demand from Asian markets and some large European markets restarting coal fired plants due to energy shortages before winter. Whilst the transition to renewables is important, there has been little apparent thought given on how to transition networks leading to potential dire economic and social consequences. WHC possesses some of highest quality/lowest impurity thermal coal in the world, is relatively low on the marginal cost curve and has long reserve life. WHC is currently trading on less than 3x free cash flow with $1bn of net cash on balance sheet albeit this valuation is at spot vs. long term thermal and coking coal prices. Whilst not owning WHC has impacted performance we are reluctant to chase the stock at current levels as our medium term coal prices are materially below spot levels.

Flight Centre (FLT.ASX) – fell 20% in September on no news. We believe the share price movement over the month was more a reflection of the macroeconomic environment than stock fundamentals. Consumer discretionary names over the last few months have been heavily impacted on the view that higher interest rates and inflation will crimp consumer spending. Whilst we do agree than some consumer discretionary names, particularly those that benefited from COVID-19, may come under pressure we don't feel the same applies to travel. Consumers have been unable to travel for over two years because of COVID-19 and pent-up demand is extremely strong. As Flight Centre announced at their full year result in August, corporate travel TTV is now trading above pre-COVID and leisure close to 70% of pre-COVID levels. As most economies (except for China) are now open we see the consumers wallet being over indexed to travel and FLT being a key beneficiary of this. The business has now been generating positive cash flow since March 2022 and is trading on ~8x pre-COVID EV/cash EBIT.

Outlook & Strategy

It's always hard to be positive when you are sitting in a morass of negativity about markets. However, most great investors have made money betting against a fearful crowd. Over time, it's been proven that it's hard to time markets as we are overly prone to emotion and secondly that there have been few places to invest that have out earned the market as an asset class. Whilst there are many likely negatives it's worth remembering that we are buying individual businesses with, in some cases, innovative and adaptive management teams who have dealt with challenging environments before. We also need to keep in mind that a lot of the de-rating of reasonable companies has now put many of the companies we own on low to mid-single digit EV/EBIT multiples. Couple this with bullet proof balance sheets and we feel comfortable that returns will reward investors over time. Finally, there is some evidence that the pent-up inflationary forces we are dealing with could abate somewhat which may ease the rise of longer-term interest rates providing the market with some respite in time.

Platform Availability List

If a fund is not available on your preferred platform, please contact us.

Please check with your platform for minimum investment requirements and fees.

FNZ Group HUB24 mFund Praemium
Macquarie Wrap

Spheria Opportunities Fund	
Benchmark	S&P/ASX Mid-Small Accumulation Index
Investment Objective	Outperform the S&P/ASX Mid-Small Accumulation Index over the medium to long term
Investing Universe	Primarily listed companies outside the top ASX 50 listed companies by market capitalisation and companies listed on the New Zealand Stock Exchange with an equivalent market capitalisation
Holdings	Generally 20-65 stocks
Distributions	Half-Yearly
Fees	0.99% p.a. Management fee & 15% performance fee of the Fund's excess return versus its benchmark, net of management fee.
Cash	Up to 20% cash, typically 5% - 10%
Expected Turnover	30% - 40%
Style	Long only, risk aware
APIR	WHT0025AU
Minimum Initial Investment	$25,000

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Fund Ratings

Zenith
RECOMMENDED

Further Information

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

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