Spheria Opportunities Fund

ARSN 144 032 431 APIR WHT0025AU

Spheria ASSET MANAGEMENT

Performance as at 30th September 2019

	1m	6m	1yr	3yr p.a.	Inception p.a.#
Fund ^	**3.6%**	**7.3%**	**5.4%**	**12.3%**	**12.1%**
*Benchmark**	*1.7%*	*7.8%*	*3.7%*	*9.8%*	*10.6%*
Value added	1.9%	-0.5%	1.7%	2.5%	1.5%

^ Spheria Opportunities Fund. Returns of the Fund are net of applicable fees, costs and taxes.

* Benchmark is the S&P/ASX Mid-Small Accumulation Index.

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.

Top 5 Holdings

Company Name	% Portfolio
TABCORP	5.5
Crown Resorts Ltd	4.4
Flight Centre Travel	4.3
Coca-Cola Amatil	4.2
Incitec Pivot	4.1
Top 5	**22.5**

Source: Spheria Asset Management

Commentary

The Spheria Opportunities Fund rose 3.6% for the month outperforming the Benchmark which rose 1.7% by 1.9%.

The S&P/ASX Mid-Small index rose 1.7% over September, partially recovering the August falls. For the first time in what feels like a long time, the markets favoured value-style investments and sold off momentum and growth style names. This thematic was mirrored in all the major global equity indices suggesting that equity market correlations are high at the moment and that similar themes are likely to be driving them in unison. The key drivers appear to be a continued shift toward passive/index investing, the rise of quantitative investing (that is investments driven by computer algorithms with minimal human portfolio management intervention) and a flow out of active and value-style investing. It is hardly a surprise that these themes have garnered widespread praise and support. They are working in the short term and the alternatives, in a global milieu of virtually zero interest rates, are not yielding investors attractive returns. On the other hand it is creating a multitude of distortions in the way capital should be allocated. What do we mean by this?

Capital flows via the market mechanism to seek the highest return – subject to various levels of risk assessment. Return on capital therefore has been the bedrock of capitalism and the flows of capital. Why are stocks like CSL, Realestate.com.au, Seek and Technology One such strong performers over the long run? Because they have consistently invested and reinvested capital in their business with high incremental returns on capital producing excess cashflows for investors and strong organic earnings growth. As global interest rates have effectively collapsed, in order to fix one social ill (namely keep unemployment low) they have unfortunately created another social ill – namely misallocation of capital. The consequence of super low rates for a super long period of time has been to push investor time horizons further and further out such that it has now broadly entered the realms of the speculative. In forecasting company earnings, we explicitly forecast out a time frame of 5 years (mid cycle year). We would admit that as the time horizon extends to the later part of this timeframe there is a reasonably large degree of uncertainty with our forecasts and thus we tend to forecast some conservatism into those numbers to ensure we have a fairly certain base case. As markets have been pushed further into the future to seek (justify!) the valuations for a number of companies which currently lose money, the logic suggests that there is a greater and greater forecast error being implicitly accepted into the investment thesis.

It doesn't take a genius to work out that accepting greater and greater risk by looking further into an uncertain future is unlikely (at least based on history) to produce a good outcome for investors. Nonetheless, this is effectively the bet that a lot of quant and passive strategies are currently making. It is why we think that a focus on reasonably forecastable cashflows combined with attractive valuations will prove to be a much better investment strategy for our clients.

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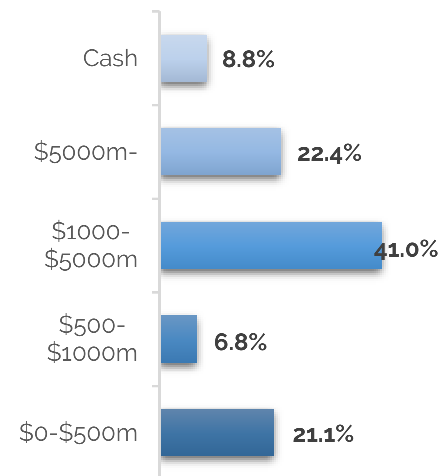
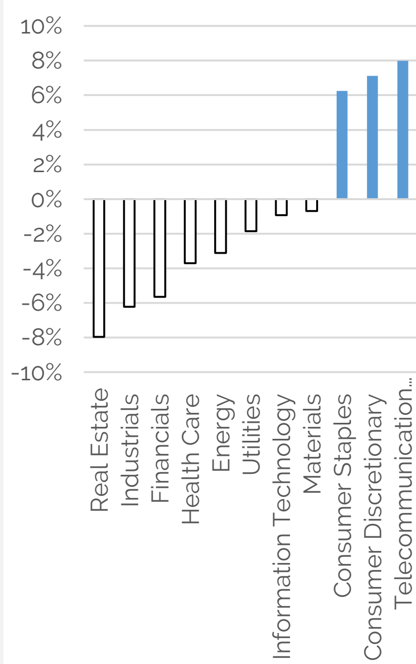
Market Cap Bands



Source: Spheria Asset Management

Active Sector Exposure



Source: Spheria Asset Management

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The part reversal of the momo for longer investment thematic over September seems to suggest most are not positioned for this kind of risk/ timeline re-assessment. There are other signs too that broader opinion might be re-assessing future prospects. The fall in valuation of Unicorns like WeWork (and its well-publicised IPO withdrawal). We visited Singapore recently and learned that unemployment is ticking up over there as a lot of the employment created by other Unicorns (start up businesses valued in excess of US$1.0bn by the private markets) has gone sharply into reverse as they have retreated from the market.

Major positive movers in the portfolio (September reporting period)

Blackmores (BKL.ASX) which rose 18% over the month partly in response to China Mengui's takeover of Bellamy's (BAL.ASX). BAL received a scheme of arrangement takeover offer from China Mengui for $13.25 a share or a 59% premium. BAL, not unlike BKL, had been struggling to gain substantial traction in the Chinese market from local consumers. That isn't to say Chinese consumers weren't purchasing Bellamy's infant formula but by far the bulk of their business comes from Daigou traders who buy the product in Australia and ship directly to friends and family in China. BKL has similarly struggled to gain vital registrations (Blue Cap) in China and lacks a strong local distribution partner which has greatly assisted peers like A2 Milk. BKL recently hired a new CEO in the form of Alistair Symington (ex COTY and P&G) who will hopefully look to address both the distribution issues in China and the bloated cost base. The situation at BKL is very reminiscent of other family owned and run businesses where perhaps some external input could liberate both the revenue growth (in the form of innovation and partnerships) and help control costs. Blackmores has been selling quality vitamins in Australia and SE Asia for over 30 years and has one of the best quality brands in the region for health supplements. A quick margin comparison with its nearest peer (Swisse now owned by Biostine in HK) suggests BKL's current margins are less than half what Swisse is earning.

City Chic (CCX.ASX) continued its recent strong run of performance rising 16%. CCX was named as a Stalking Horse bidder for the online assets of US plus sized retailer Avenue. Subsequently (in early October), CCX successfully bought Avenue's online business for US$16.5m (A$24m) subject to the approval of a US bankruptcy court. Avenue's online revenue in the US is around A$100m, so assuming a modest 8-9% EBIT margin suggests they may have paid around 3-4x EBIT to materially expand their customer base and expand geographically.

Bega Cheese (BGA.ASX) increased 14% over the month. BGA has had a challenging time over the past 12-18 months fighting off Kraft in their foods segment (so far quite successfully) and dealing with a very tight milk supply market in Australia driven by drought conditions just at a time when they are trying to increase their milk supply to expand operations at their recently acquire Koroit facility. Having said this the company is one of the few rational players in the milk processing market and they have a substantial opportunity to recover earnings as milk supply conditions normalise. Other players in the space continue to struggle, namely NZ's Fonterra, who may look to exit their Australian operations potentially allowing for more consolidation in the processing industry in Australia.

Major negative movers in the portfolio (August reporting period)

Blackmores (BKL) – fell 19% after reporting a weak result. Expectations were low going into the result given BKL's lack of traction with its China strategy, and the impact on Daigou trade in Australia due to a Chinese government crackdown on this channel. The market disliked the outlook however. Further weakness in sales is expected in 1H20 as Chemist Warehouse (BKL's largest customer) apparently over-stocked in 2H19. Whilst conditions will remain difficult in the short to medium term given weakness in China and Australia sales, more pertinent is the company is on a path that will drive significant cost out of the business (with a new highly experienced MD appointed) and potentially generate much higher margins more akin to its peers. However, this will be a painful process and potentially costly given the headcount of 1400 people within the business. On a positive note, the Asian division (ex-China) grew sales >30% in FY19 and comprises nearly 20% of group sales and is nearly equivalent to China (in-country) sales.

Afterpay (APT.ASX : not owned) rose 16% over the month after it reported strong revenue growth in its annual results in late August. APT also announced that it was preparing a confidential report to AUSTRAC in relation to the investigation of their AML/CTF (anti-money laundering procedures/ counter terrorism funding) and stated they had detected no issues via their internal systems.

SIMS metal (SGM.ASX) declined 9% on the back of a weak Q1 update. SGM is one of the worlds leading metal recyclers but tends to have strong short-term fluctuations in profitability based on local/ global metal prices and changes in regulations. These are less pronounced on an annual basis. SGM has a history of strong cash flow generation, carries around $250m of net cash on the balance sheet and trades on 10x EV/EBIT. In addition, the business appears to have a very conservative valuation basis for some of its substantial land holdings.

Boral (BLD.ASX; not owned) rallied 14% after being heavily sold of the previous month on the back of poor results. Sentiment towards building materials and the housing sector also continues to improve on the back of interest rate cuts and a rebound in Capital City housing prices.

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	Spheria Opportunities Fund
Benchmark (universe)	S&P/ASX Mid-Small Accumulation Index
Investment objective	The Fund aims to outperform the S&P/ASX Mid-Small Accumulation Index over the medium to long term
Investing universe	Primarily listed companies outside the top 50 ASX listed companies by market capitalisation and companies listed on the New Zealand Stock Exchange with an equivalent market capitalisation
Distributions	Half yearly
Fees	0.99% p.a. management fee & 15% performance fee of the Fund's excess return versus its benchmark, net of the management fee
Cash	• Up to 20% cash • Typically 5% - 10%
Expected turnover	30-40%
Style	Long only, risk aware
APIR	WHT0025AU
Minimum Investment	$25,000