Spheria Australian Smaller Companies Fund
ARSN 117 083 762 APIR WHT0008AU

Performance as at 30th September 2019

	1m	6m	1yr	3yr p.a.	Inception p.a.#
Fund ^	**4.4%**	**2.9%**	**1.3%**	**9.2%**	**10.1%**
*Benchmark**	*2.6%*	*7.0%*	*3.9%*	*8.8%*	*9.2%*
Value added	1.8%	-4.0%	-2.7%	0.4%	0.8%

^ Spheria Australian Smaller Companies Fund. Returns of the Fund are net of applicable fees, costs and taxes.

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

Inception date of the current investment strategy is 11th July 2016. The Fund was established in June 2005. Past performance is not a reliable indicator of future performance.

Top 5 Holdings

Company Name	% Portfolio
Ht&E Ltd.	4.6
Blackmores Ltd.	4.5
GBST Holdings..	4.4
Healius	4.3
Fletcher Building	4.2
Top 5	**22.0**

Source: Spheria Asset Management

Commentary

The Spheria Smaller Companies Fund rose 4.4% for the month of September, outperforming the Benchmark which rose 2.6% by 1.8%.

The small cap index rose 2.6% 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.

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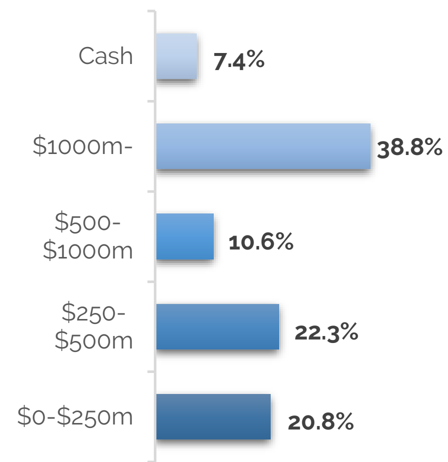
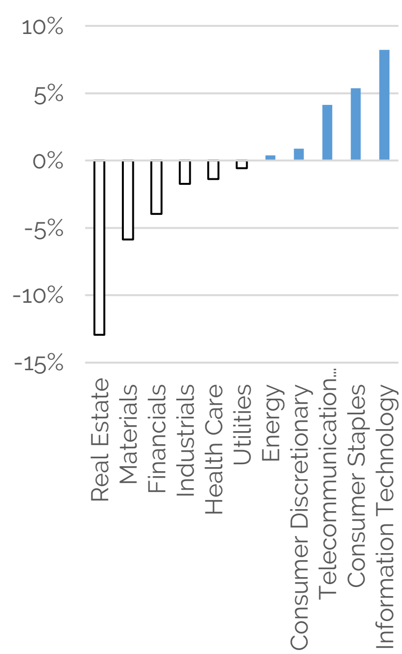
Market Cap Bands



Source: Spheria Asset Management

Active Sector Exposure



Source: Spheria Asset Management

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. 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.

Class Ltd (CL1.ASX) increased 21% over the month after being heavily sold off on the back of their full year results. The company is currently undertaking some reinvestment in R&D and staff hires to reinvigorate revenue growth. In the meantime, customers remain incredibly loyal to the business with an eye watering retention rate at over 99%. We see upside based on a strong market position, great cash flow generation, a net cash balance sheet, undemanding valuation and potential for additional products.

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.

Major negative movers in the portfolio (September reporting period)

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.

BAL (not owned) rose 73% over the month on the back of the earlier mentioned takeover offer.

Independence group (IGO.ASX; not owned) rallied 20% on the back of an Indonesian export ban on unprocessed nickel ore which is likely to tighten global nickel supplies. Nickel prices rose 23% in August in anticipation of the Nickel ban and IGO caught up in September.

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	Spheria Australian Smaller Companies Fund
Benchmark (universe)	S&P/ASX Small Ordinaries Accumulation Index
Investment objective	The Fund aims to outperform the S&P/ASX Small Ordinaries Accumulation Index over the medium to long term.
Investing universe	Primarily listed companies outside the top 100 ASX listed companies by market capitalisation and companies listed on the New Zealand Stock Exchange with an equivalent market capitalisation
Distributions	Half yearly
Fees	1.10% 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 • Typically 5% - 10%
Expected turnover	30-40%
Style	Long only
APIR	WHT0008AU
Minimum Investment	$25,000

Platform availability
ASGARD
BT Panorama
BT Wrap
First Wrap
HUB24
IOOF Portfolio Service
Macquarie Wrap
mFund
MLC Wrap / Navigator
Netwealth
One Vue
uXchange