Spheria Global Microcap Fund

ARSN 627 330 287 APIR WHT6704AU

Performance as at 31st May 2020

	1 Month	3 Months	1 Year	Inception#
Fund^	6.0%	2.2%	12.0%	13.0%
*Benchmark**	5.3%	-8.0%	-3.7%	-3.6%
Value added	0.7%	10.3%	15.7%	16.6%

^ 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.

May was another strong month for equity markets. The MSCI Kokusai Microcap Index appreciated by 5.3%. The Spheria Global Microcap Fund managed to do better, returning 6.0% after fees. The stronger Australian dollar shaved 1.5% from the Index's return, nevertheless the Kokusai Microcap Index outperformed the MSCI World Index (Large caps) by 2.1% in May. Since inception the Fund has returned 13.0% p/a after fees compared to a decline in the Index of 3.6% p/a.

Markets

Biotechnology remained the hot spot in microcap markets, with the industry up 14.0%. Biotechs represent 12% of the index, but as we noted in a previous monthly, we are unlikely ever to have a similar portion of the Fund invested in that area. Not doing so may increase the Fund's divergence from the index, but will also surely reduce the volatility of the Fund, which matters more in our opinion. Much of the biotech hype occurred in the US market. We suspect there was a decent tailwind from the rise in retail equity trading as proxied by the rapid increase in online broker trading accounts (see chart on page 2).

Metals and mining stocks were the other bright spot. Gold miners remain the rock-stars of the mining world. Real estate, banks, and insurance were left behind by investors, suffering small losses. Biotechs booming, while banks and insurers are neglected. There is no doubt animal spirits in the market are running high.

Investors finally rewarded countries that have dealt well with the threat of Covid-19. Norway, Australia, Canada, and Germany led the gains in the microcap universe. Hong Kong and Spain suffered the most significant losses. In the case of Hong Kong, we remain underweight that market. Our two stocks are both exporters, which we feel are more immune to the current tensions in that country. Even extrapolating the current geopolitical ructions to a more severe scenario, such as the breaking of the HKD-USD peg, exporters should be relatively resilient. However, it is a situation we are monitoring closely.

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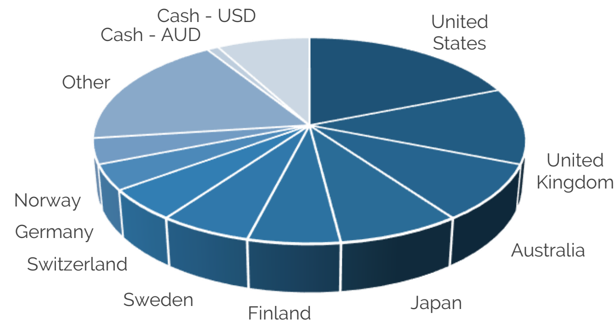
Top 5 Holdings

Company Name	% Portfolio
Fjordkraft (Norway)	4.0%
Sonos (USA)	3.8%
Poletowin Pitcrew (Japan)	3.5%
Coltene (Switzerland)	3.2%
Johnson Outdoors (USA)	3.0%
Top 5	**17.5%**

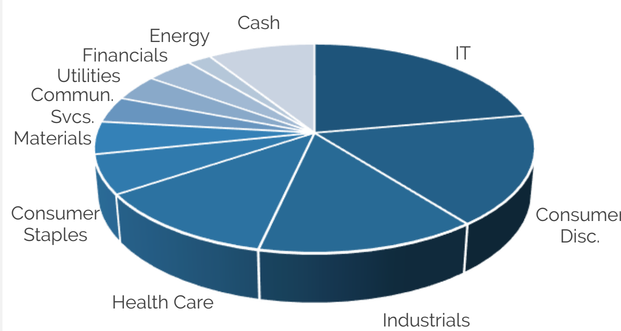
Source: Spheria Asset Management

Regional Exposure



Source: Spheria Asset Management

Sector Exposure



Source: Spheria Asset Management

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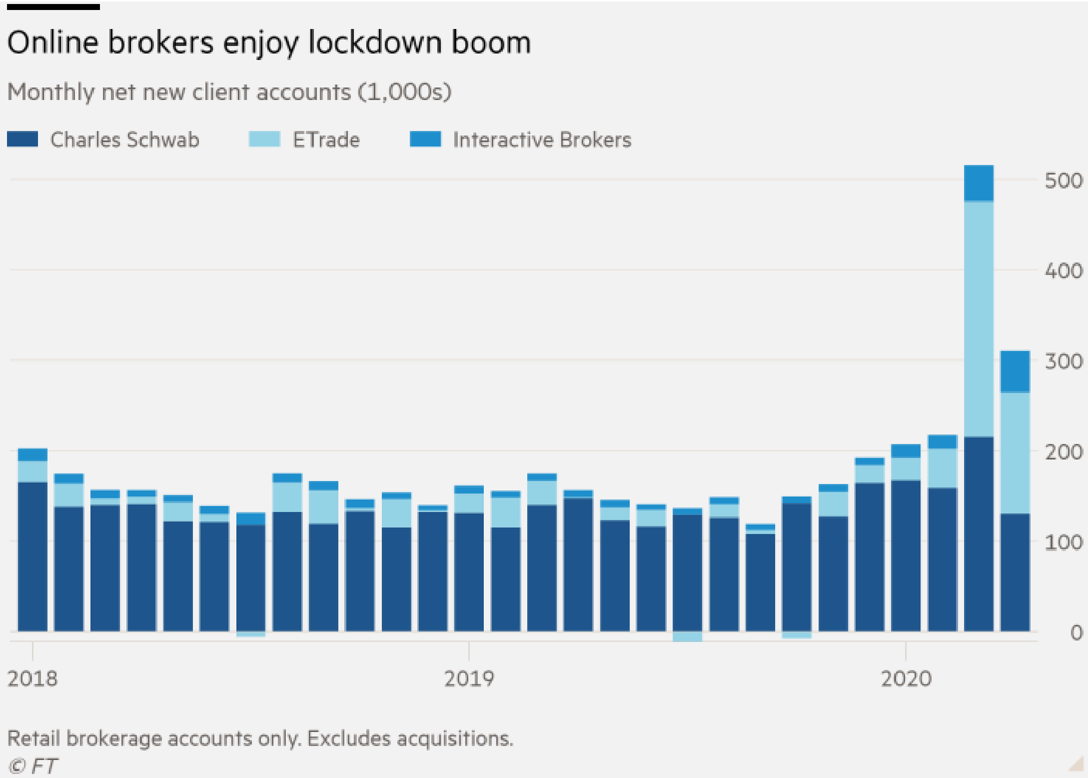

Henderson, R. (2020, May 20). Frustrated sports punters turn to US stock market. Financial Times. Retrieved from http://www.ft.com

Fund Performance

The Fund's largest detractor in May was a medical device company. The company's products allow elderly patients with chronic lung conditions to retain their mobility. Allowing elderly patients to remain mobile is usually a significant benefit to the healthcare system as mobile patients are less likely to be admitted to high-cost healthcare settings. However, during COVID-19, the opposite has been the case with older adults, particularly those with chronic conditions, encouraged to stay home. The stock did well during the March sell-off by virtue of its solid balance sheet with a sizable cash hoard, and because the market expected the recent acquisition of a ventilation solution might provide the company with some upside from the crisis. By the end of March, the share price was trading well in excess of where it was before the crisis took hold.

This optimism did not eventuate, and management poured cold water on the market's hopes for short-term COVID-19 upside when the company reported its first-quarter result. It was fascinating to see the market dump the stock on the back of this news. While biotech stocks surge, investors have no room in their portfolio for a company with a leading position in a high growth medical niche. While on the one hand low interest rates mean the cost of waiting is negligible, the opportunity cost for investors remains enormous if there are hot gains to be made elsewhere. We have used the share price reaction to top up our holding, and our valuation suggests the stock could more than double from current prices.

Another detractor that left us scratching our heads is an Italian company with a long history of growth and reliable returns. While one would typically equate machine vision and mobile computing with high growth technology stocks, this little known Italian company trades at modest multiples more akin to an industrial company. Meanwhile, a German machine vision company of a similar size (Isra vision) is under takeover at a historical multiple of 34x EV/EBIT.

This Italian company has had its issues, backing the wrong horse in mobile computing (Windows, not Android), and it has significant exposure to the auto and packaging industries which have been a drag of late. The stock has failed to bounce with the rest of the market, and the shares are implicitly factoring in severe market share losses and margin erosion into the future.

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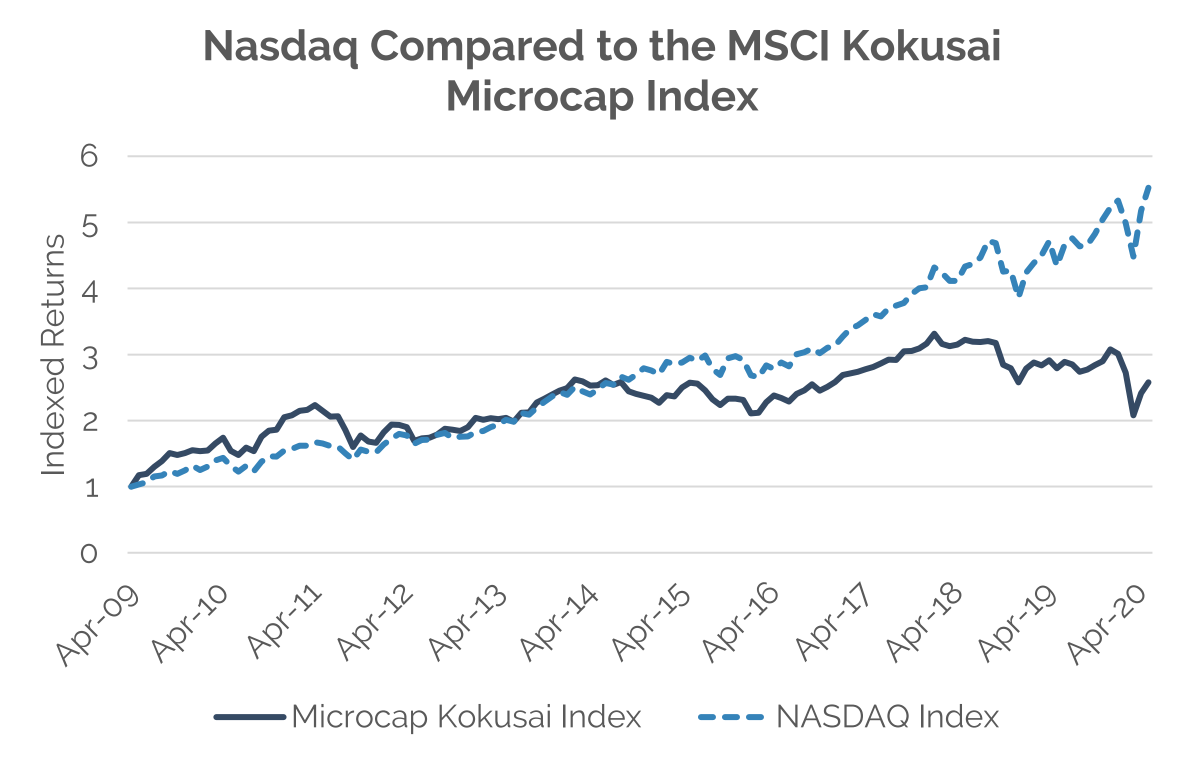
Investors giving up on this company have not studied its history. Its R&D track-record is impressive, being the first company to commercialise the bar code scan and developing that familiar "beep" at the check-out when the scan is accepted. Acquisitions are used to fill in any technological gaps, recently acquiring a minority stake in a Californian visual technology company. Its industry structure is attractive, with two other large, but rational players, and a long-tail of also-rans. In the shorter term the company will benefit from the re-opening of the economy with 47% of revenue from the retail sector, 28% from manufacturing, and 13% from transport and logistics. One thing is sure, this company will translate those extra beeps into free cash flow with a historical EBIT to free cash flow conversion of 117%, which supports our valuation and expected upside.

Having complained about how the market had robbed us in the short-term, we won't labour the point, lest we start admitting where the market may have gifted us some fortune. Our key performance contributors in May were almost exclusively defensive growth stocks with the market not yet ready to take on the risk of cyclicals. While the temptation is to sell into this strength, we still see upside in these stocks, and our conviction is higher here since the earnings are more reliable. In essence, we agree with the market, for now.

In what is becoming a monthly occurrence, the Fund's underweight position to Hong Kong again contributed to outperformance, while an underweight to the US market detracted. The debate is growing in markets about the future of the US dollar. On the one hand, the US savings rate has plummeted, and the country is running a large current account deficit which may force the US$ down. However, as the globe's reserve currency, demand for US dollars may escalate as foreign debt comes due and trade, often denominated in US dollars, returns. These opposing forces are something we are monitoring closely since the Fund has a substantial underweight to the US market. To offset this risk we hold the majority of cash in US dollars to protect our client's purchasing power in the event of major US dollar moves.

Given the uncertainty around the US dollars future, but likely upcoming volatility, we are relieved that the Microcap Kokusai Index has a much smaller allocation to the US market than the large cap or small-cap index. Perversely, microcaps appear to be a relatively safe place for investors when we factor in the US concentration risk of the broader indices and the dominance of passive investing in larger caps which have pushed these stocks to record valuations (Market Cap / GDP).



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Outlook

Investors are keen to look through the COVID-19 crisis, which in most cases really means looking backwards at 2019. Consensus is forecasting a bumper 2021. The S&P500's earnings per share (EPS) is expected to decline 21% this year before growing 28% in FY21. What are sell-side analysts to do? Assuming the world returns to where it was in 2019 seems like the most defensible approach, especially once that becomes the accepted industry norm. While we do not have similar market-wide metrics to track at the microcap level, we note a similarly optimistic tone among analysts in stocks where consensus is available. If there are not widespread downgrades of FY21's EPS as the year progresses, we would be astonished. Particularly as Government's put away the punch bowl of wage subsidies which are helping many companies and their customers at present.

There are exceptions though to the market's bullish outlook, and these are typically stocks that faced challenges before COVID-19 arrived. In these cases, they remain a show-me story for investors. Analysts are unwilling to price in an earnings recovery until some positive momentum is delivered. Hence, in these instances, there has been only a modest share price bounce from the March lows. We have been able to pick up three high-quality growth stocks that have been left behind on this basis. All three stocks have a global customer base with strong growth prospects. These include a Hong Kong based PC gaming peripherals company (mice and keyboards predominantly); a UK based manufacturer of suspension and advanced driver assist system testing equipment; and a US based online retailer of fashion-forward apparel.

As we mentioned earlier in this report, the market's animal spirits appear to be running high. There is a risk that our approach of focusing on robust companies with reliable free cash flow and little to no financial leverage, which served us so well in the March sell-off could be abandoned by investors in the belief that the Fed has their back and the economy is on its way to a full recovery. If this occurs we will take advantage of the pull back in quality names to add to positions.

	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