SPHERIA ASSET MANAGEMENT

Spheria Global Microcap Fund

ARSN 627 330 287 | APIR WHT6704AU

Performance as at 31st July 2022

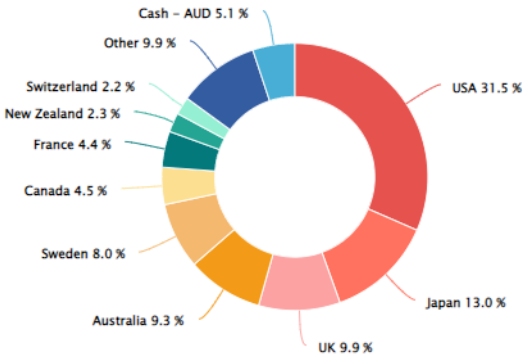
	1 Month	3 Months	1 Year	3 Years p.a.[3]	Inception p.a[3]
Fund[1]	7.5%	-1.4%	-16.2%	11.7%	11.7%
Benchmark[2]	3.6%	-3.9%	-15.7%	10.3%	9.5%
Difference	4.0%	2.6%	-0.6%	1.5%	2.2%

1 Spheria Global Microcap Fund. Returns of the Fund are net of applicable fees, costs and taxes.
2 Benchmark is the MSCI World Microcap Index in AUD (Net) from 1 July 2021 and prior to that MSCI Kokusai (World Ex-Japan) Microcap Index in AUD.
3 Inception date is 1 March 2019. Past performance is not a reliable indicator of future performance. All p.a. returns are annualised.

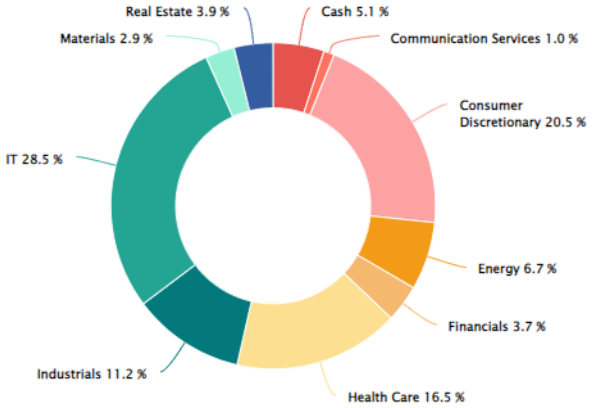
Overall Commentary

The Spheria Global Microcap Fund returned 7.5% (after fees) during the month of July, outperforming the MSCI World Microcap Index by 4.0%.

Regional Exposure



Sector Exposure



Source: Spheria Asset Management

Global Characteristics

	Average Mcap (USD)	EPS Growth (%)	Trailing FCF Yield (%)	Dividend Yield (%)	Net Debt / EBITDA	FCF Conversion (%)
Spheria	1,053	-4.1	6.2	3.2	-1.3	94.1
World Micro	156	-15.0	2.0	2.6	1.0	67.1
World Smalls	2,094	-5.0	2.8	2.3	1.7	73.8
S&P500	76,815	14.3	4.7	1.4	1.0	0.0
Nasdaq	6,318	7.1	3.3	0.7	0.7	114.3

EPS= Earnings per Share, FCF = Free Cash Flow, Negative Net Debt / EBITDA figures show a debt free, or net cash balance sheet.

Some changes to the Spheria Global Microcap Fund

After some feedback from current and potential investors in the Fund we have decided to broaden the market cap spectrum in which the Global Fund can invest. In recognition of this we will be re-branding the Fund. The benchmark, once investors have had a chance to think about the changes we are proposing, will be changed to the *MSCI World Small Cap Index* and we will be lifting the average capitalization of companies we invest in. The largest cap stock in this index is currently US$26.1bn (Interactive Brokers Corporation) and the smallest is just US$72m so there is an enormous range of cap into which we can invest. The average market cap of companies in the MSCI Small Cap Index is US$2.1bn (or around A$3.0bn; approximately equal to the largest company in the Australian Small Cap Index for context) Previously we had limited the market cap to stocks that were mostly under US$1.0bn at the time of investment so this expansion will dramatically lift the universe in which we can invest.

These changes will also improve liquidity of the Fund (not that this has to date been an issue) and most likely mean some of the names the Fund invests in will be familiar. For example, we highlighted last month that we started to transition the Fund and have added brand names like Sonos (the leading Wi-Fi speaker manufacturer), Zillow (the US equivalent to Realestate.com.au) and Burberry (UK-based Luxury goods company). In line with this lift in market capitalization we will be reducing the base fee from 1.35% to 1.1% with the same performance fee as previously.

Travel

Travel has been difficult for the past 2 years with many countries imposing Covid-related travel bans making visiting companies in person a challenge. We, like many others, reverted to Teams and Zoom video meetings to continue to do our investment due diligence. Pleasingly bans are being lifted and we have 2 trips planned for the team in the near future. One to Europe (specifically the UK, France, Germany and Sweden) where we plan to see a number of existing holdings and seek out a few new names for consideration. The second trip planned shortly thereafter is to the US (to NYC and San Francisco) again to visit current holdings and to sniff out new opportunities. We look forward to discussing these trips and highlighting any portfolio changes or new ideas we encounter on these trips.

Screening

Travel is a useful tool for the global fund but by no means the only one at the team's disposal. We make extensive use of quantitative screens. These provide an unemotive way of cutting through the noise and paring back the number of potential new ideas we investigate to those that are highly prospective. A metaphorical gold pan if you will where the material we are panning is higher grade. Ideas get put through the basic process we employ and are further screened out. The team then investigates ideas that pass through a number of these gates. As with Spheria's domestic funds, we are looking for businesses with a strong history of free cash flow generation, modest to no balance sheet gearing and a valuation that means we are buying the business for less than we think it is worth. The expansion in our potential universe is exciting and motivating to the team.

Markets

Global markets rallied strongly in July with some of the worst performing stocks and indices rallying the hardest off the bottom. The biggest driver of markets continues to be inflationary expectations and the flow through effects to long term (10-year bond) discount rates. Although inflation prints around the world continued to show year-on-year growth, there is an increasing expectation that the rate of change in inflation will likely slow. This makes some sense to us given a large part of the inflation base has been driven by energy prices and industrial commodities (Copper, Aluminium and Iron Ore to name the majors). Wage pressures however continue to rise as organised labour pushes for at least no real wage decreases in annual wage negotiations. Wages tend to lag actual inflation, especially during volatile inflationary periods such as those we have just witnessed.

Whilst Central Bankers were doing their darndest to create inflation over the past decade, they are now trying vainly to re-bottle the monster they unleashed, or at least restrain it to target levels. It's not super surprising then that the Australian Government has announced a wide-ranging review of the RBA's objectives and the interaction of monetary policy with fiscal and macroprudential policy, including during times of crises. This is no small review. The Fed and ECB had the sense to do their own reviews without waiting for respective Governments to figure out the need. All have made some fairly drastic policy errors during the Covid crisis. The purchasing of 10-year government bonds by all must rank up there as one of the least necessary and most expensive unconventional acts. Having said that, the decline in 10-year bonds from around 3.65% at the end of June to circa 3% by the end of July, has started to chase away the bears. This was a turbulent rebound with investors picking up the pieces to put risk on.

Major Contributors for the Month

BML (4694.JP) – share price continued to rally over July adding to its already significant contribution to the fund's return. As we outlined last month, BML is the second largest player in the Japanese pathology market with a leading position in routine testing for general practitioners. The company also competes with hospital labs who are under pressure for volume as Japan transitions to more treatment in the community setting. BML's focus on high volume general testing for smaller clinics, including regional areas, has thus underpinned solid growth in volumes and its large central lab provides a competitive advantage which has underwritten stable margins over time. BML also has been a significant beneficiary from COVID testing in recent years, however, we forecast this to abate. Excluding this we have BML trading on 3x EV/EBIT and it has A$1bn of net cash on its balance sheet.

Concentric (COIC.SS) – rallied 22% over July. Concentric is a Swedish-listed but England-based pump manufacturer. They produce oil, water, fuel, and hydraulic pumps. Many of their pumps are specified as OE (original equipment) for truck and bus engine manufacturers. As a result, these pumps have to be extremely well engineered to last many hours under extreme workloads. What excites us about COIC – other than its historically strong earnings and cash flow generation – is the growth into new pump technologies. Specifically, as bus and truck engines either go electric or more likely hybrid over the medium term, Concentric are able to produce electronically driven pumps to enable this engine tech shift. These pumps are meaningfully more efficient (since they are not belt-driven they are not always "on" which reduces drag on the power trains). The upside is that these pumps are much more complex and costly which should significantly increase the size of the market in which Concentric operates – potentially by a factor of 10-fold over time. COIC made a significant acquisition a year ago of a US competitor called EMP which had around half the sales of Concentric at the time and around a quarter of the EBITDA. We would expect COIC management to be able to lift margins and potentially expand their customer relationships on the back of this deal. COIC has very modest net debt and trades on around 12x forecast EV/EBIT.

Sonos Inc (SONO.US) – was the creator and now market leader of Wi-Fi connected speakers. What differentiates Sonos from other hardware manufacturers is the ecosystem they have created. They make a high-quality, long-lasting product protected by numerous patents. The network effect of the business is strong. As you buy one speaker, adding additional Sonos speakers greatly enhances the value of the whole. You can control sound in various rooms and locations from one single central app. As a result, around 46% of their new product registrations are to existing Sonos users. They believe their penetration in the global sounds market is extremely low at around 2% of all sounds systems or probably closer to 9% if you only count more affluent households. Sonos share price recovered over July rallying 20%. Sonos now trades on around 10x our forecast EV/EBIT one year forward. Sonos has a very strong balance sheet with around SU$600m of net cash at the end of this fiscal year.

Major Detractors for the Month

Core Labs (CLB.US) – declined a further 5% last month as the oil price declined about 6% from very high levels intra-month. As a leading provider of proprietary and patented reservoir description, the business is highly linked to oil and gas exploration and development spend. They remain a leader in the space with enviable market share both in the US and internationally. The balance sheet is modestly geared, and we forecast a return to levels of profitability last seen in FY19 over the next two to three years, which is not fully reflected into the share price.

OTC Markets (OTCM.US) – declined over 5% in July. OTCM is a leading provider of SEC regulated Alternative Trading Systems. These are termed OTC markets (over the counter) in the US. They own the 'pink sheet' market in the US and 2 other OTC markets (OTCQX and OTCQB markets). OTCQX is called the best market and provides a US listing for many large foreign corporates who are regulated on their own home exchanges. Some examples here include Deutsche Telecom, Danone, Roche and Adidas to name a few. The OTCQB is a Venture market with some regulatory oversight, and the Pink sheets is a market with the lightest regulation. As with other exchanges they provide data services and trading systems to market participants for which they charge fees. OTCM is founder lead, has a net cash balance sheet and compounded revenue growth at 12% CAGR over the past decade. Cash flow conversion has been exemplary and there are regulatory tailwinds which are enabling the business to grow. OTC trades on around 17x our forecast EV/EBIT and should have a number of double-digit growth years ahead of it.

Tracsis (TRCS.LN) – declined a modest 5% over July. Tracsis is UK listed software and technology business which provides rail planning and performance software as well as software for rail time tabling. TRCS has grown both organically and via modest sized acquisitions over the past few years. As with many of the businesses we look for globally, TRCS has a history of strong cash generation and decent returns on capital. There was limited news flow to drive the modest underperformance over July.

Outlook & Strategy

We are genuinely excited by the changes we are making to the Global Fund and believe the expansion of the market cap we are able to invest in should provide further opportunities for us to find and own excellent businesses. The underlying investment philosophy we have used in our domestic market should also yield attractive longer-term results for our clients globally. As global markets deal with inflation, our view is that investors are likely to return to solid cash flow earning businesses and the heady days of the last few years could well line future investment textbooks on what to look out for at market tops. We look forward to updating you on further changes as we make them to the Spheria Global Opportunities Fund.

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Platform Availability List

The Spheria Global Microcap Fund is available on the below Platforms. Please check with your platform for minimum investment requirements and fees.

BT Panorama | HUB24 | Macquarie Wrap | Netwealth | Praemium

Spheria Global Microcap Fund	
Benchmark	MSCI World Micro Cap Index
Investment Objective	Outperform the MSCI World Micro Cap 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
Holdings	Generally 30-80 stocks
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

Fund Ratings

Zenith APPROVED

Further Information

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

Disclaimer

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Link to the Product Disclosure Statement
Link to the Target Market Determination
For historic TMD's please contact Pinnacle client service Phone 1300 010 311 or Email service@pinnacleinvestment.com
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