Spheria Global Microcap Fund

ARSN 627 330 287 APIR WHT6704AU

Spheria ASSET MANAGEMENT

Performance as at 31st December 2020

	1 Month	3 Months	1 Year	Inception#
Fund^	7.6%	17.7%	21.4%	21.1%
*Benchmark**	5.2%	20.9%	17.0%	13.3%
Value added	2.4%	-3.2%	4.4%	7.8%

^ 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.

Sharemarkets continued their rise into year-end. The MSCI Kokusai Microcap Index (Ex-Japan) increased by 5.2%. The Spheria Global Microcap Fund managed to do better, up 7.6% after fees. While 2020 will be remembered as a challenging year for many, it was nevertheless a rewarding year for investors in the Fund with a return of 21.4% after fees. Since inception the Fund has returned 21.1% p/a after fees, 7.8% p/a better than the Index. .

Markets

The party continues. In December, the Energy sector was the best performing segment of the market up 12.9% in AUD. All sectors were positive, but despite all the hype in tech stocks, older segments of the market rallied hardest – Coal and Consumable Fuels; Precious Metals; Agricultural and Farm Machinery. The market's infatuation with electronic vehicles came through in the Electrical Equipment industry, which rose 19.9%. Disappointment with the vaccine roll-out and continued Covid outbreaks saw Airlines and Road & Rail companies underperform the most.

One of our favourite parts of the world for investing, Scandinavia, had another strong month with Finland and Sweden leading microcaps higher. Few countries were left behind, and the US continued to outperform despite its economic and political issues. .

Fund Performance

City Chic Collective

City Chic Collective was the largest contributor to relative fund performance in December, returning 46% over the month after acquiring the E-Commerce and wholesale operations of UK plus-sized fashion retailer Evans from bankrupt retailer Arcadia Group for A$41m in cash. While the deal is at a higher implicit multiple than the Catherine's plus-sized fashion acquisition that fell over in September, we believe it is a better strategic fit since Evans does not cross over with an existing portfolio holding, making it complementary.

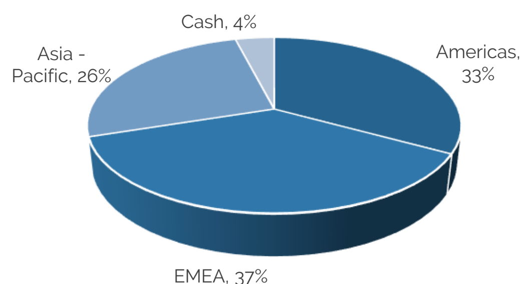
Continued on the next page…

Top 5 Holdings

Company Name	% Portfolio
Inogen (USA)	3.6%
Poletowin Pitcrew (Japan)	3.5%
Computer Modelling (Canada)	3.2%
Fjordkraft (Norway)	3.1%
Revolve (USA)	3.0%
Top 5	**16.4%**

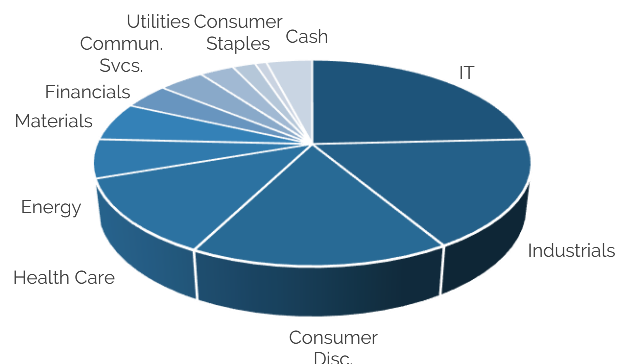
Source: Spheria Asset Management

Regional Exposure by Revenue



Source: Spheria Asset Management

Sector Exposure



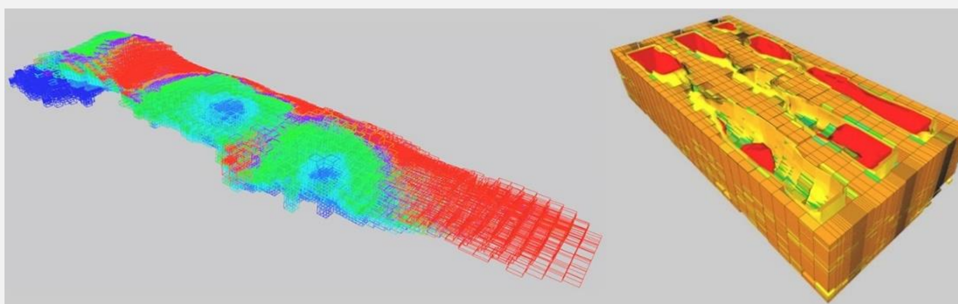
Source: Spheria Asset Management

This acquisition will help City Chic accelerate its organic roll-out of the City Chic brand in the UK and Europe.

Computer Modelling Group

Computer Modelling Group, or CMG, was the largest relative detractor for the month. The stock has been in the portfolio since inception. The Canadian software company develops sophisticated software for modelling oil reservoirs helping asset owners optimise extraction. Barriers to entry are high and CMG operates in a quasi-duopoly with Schlumberger. However, rather than maximising short-term profits in such a concentrated industry, management remains committed to a heavy R&D program that gives us confidence in the company's long-term earnings sustainability.

CMG Software (GEM & STARS)



Source: Computer Modelling Group

Adding further to the appeal, CMG's software is incredibly 'sticky' since clients must renew the annual payment for the software over the life of the reservoir. This stickiness results in 93% of software revenue being derived from recurring annual SaaS payments or software maintenance revenue. The company has a net cash balance sheet, and free cash flow generation has been strong over the company's history with average free cash flow conversion of 101%.

In the short-term, weakness in the oil industry will no doubt hamper earnings. However, the oil industry's investment level has been depressed for some time, and while the boom in US shale has been a bonus for the company that is unlikely to persist, CMG is well diversified with a strong customer base in Asia and the Middle East. Using our mid-cycle approach, we continue to see attractive relative value in this company.

Outlook

Since the Covid lows in March, the Kokusai Microcap Index is up 119% in USD to the end of the year. While our portfolio was able to bounce strongly out of Covid, keeping up with the Index has become more difficult since the middle of the year. Our perception of the market is that investors have a "risk-on" frame of mind and in many cases are acting as if they can't possibly lose in the share market. There is plenty of evidence that investors have their foot to the floor when it comes to taking risk. Among these are Bitcoin, SPAC IPOs, increased retail use of call options, and passive investing.

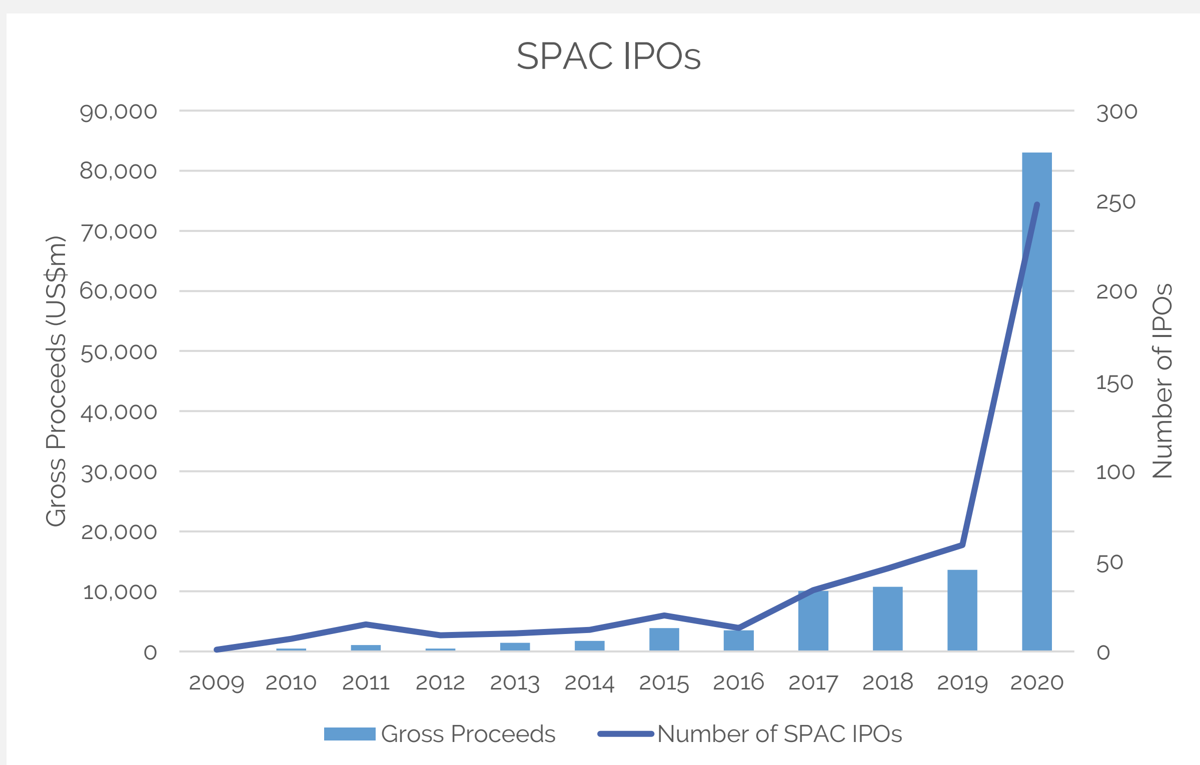
Bitcoin is not our area of expertise; we'll stick to equities. However, it is a useful gauge of risk appetite since unlike shares, there is no future expected cash flows other than the balloon payment that comes upon sale to another market participant. No buyer, no value.

There are microcap stocks exposed to Bitcoin, such as US company Riot Blockchain, for those who find Bitcoin's volatility too passe. The former US biotech company now aims to be one of the largest and lowest cost bitcoin miners in North America. The one analyst covering it expects revenue of US$10 million and a loss of -US$20 million in FY20. The market capitalisation currently sits at an astounding US$1.8 billion.

Continued on the next page...

SPACs are another example of elevated risk-taking. SPAC stands for Special Purpose Acquisition Company and involves investors handing over capital before even knowing what they are buying. SPACs raise money in an initial public offering and use the proceeds to acquire a privately held operating business not identified at the time of listing. Why undertake this structure? The key reason is that the promoter, often a high-profile investor or former executive, typically receives 20% of the SPAC's equity. Investment banks are also only too happy to oblige as it is a new source of fees and a much easier route to raise money for clients than a traditional IPO. Yes, private equity is pleased too, since they are often the sellers of the companies these SPACs acquire.

So it's great for the bankers, private equity firms, SPAC promoters and management teams, but why would investors agree to this? Well, this is less clear. Especially since investors start the venture 20% in the red by granting equity to the SPAC promoter. Some high-profile SPACs such as Nikola have been rocky, and SPACs have been used for pump and dump scams in the past. Despite these risks, investors are clamouring for more. The chart below shows the extent of the increase. In 2020 248 SPACs IPO'd with a combined amount raised of US$83 billion. That's $83 billion in blank cheques.



Source: SPAC Insider

Will investors be adequately compensated for the risk they are now taking in investments such as those mentioned above? We very much doubt it. However, the market continues to price smaller companies at a discount, reflecting a greater perceived risk and lower liquidity. The chart on the following page shows the discount microcaps still trade at relative to larger companies despite their higher long-term growth prospects.

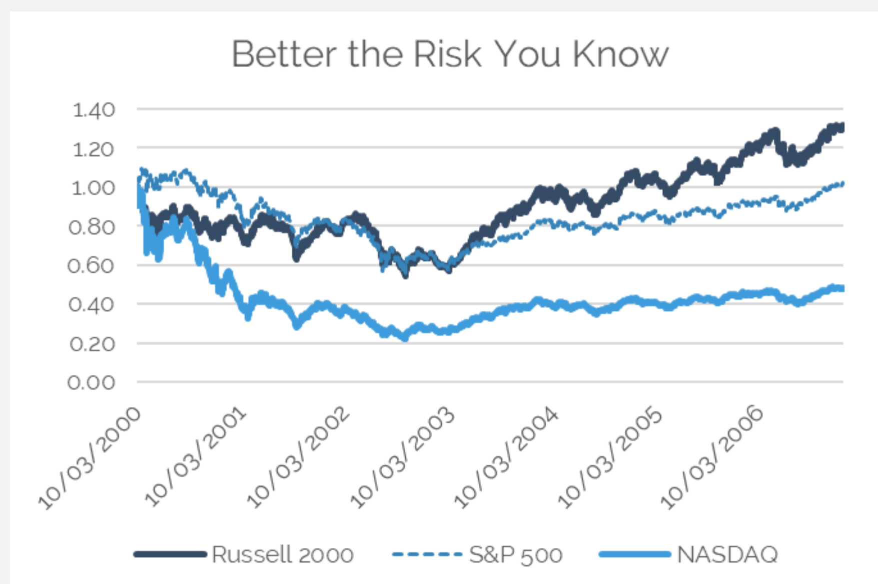
It is comforting to see that the market is still pricing smaller companies at a substantial discount. This discount has widened in recent years, partly fuelled by a wave of money into passive funds which push up only the largest stocks.

Continued on the next page...

Metric	Kokusai Microcap	MSCI World Smalls	S&P 500	NASDAQ
PE	**20.6**	24.7	28.2	31.7
EV/EBIT	**18.9**	22.4	25.5	28.0
Price/Book	**3.7**	4.7	8.1	9.7
FCF Yield %	0.3%	3.4%	**4.3%**	3.1%
Dividend Yield %	1.3%	1.3%	**1.4%**	0.6%
Gearing	2.3x	2.7x	0.9x	**-0.1**
EPS Growth %	2.7%	-3.2%	7.4%	**14.9%**

Source: Bloomberg, MSCI, S&P. As at 11 January 2021.

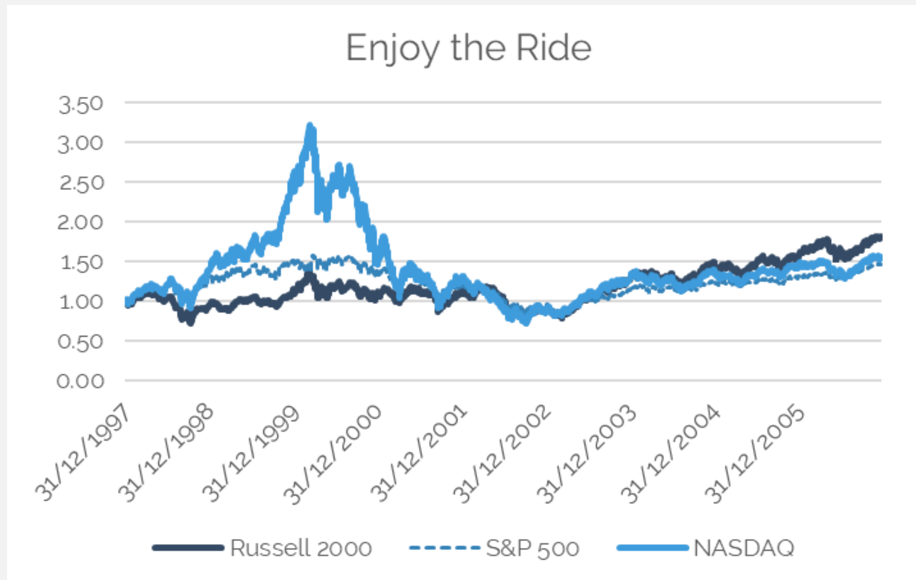
The riskiest investments are those where investors perceive no risk at all. This was the mindset of the day when the NASDAQ was soaring in the late 90s. Confidence only grew as the market went higher that we were in a new paradigm. However, from its peak on the 10th of March 2000 to its lows on the 9th of October 2002, the NASDAQ declined 78%. Smaller companies, despite their perceived risk, declined 46% peak to trough. The S&P500 declined 44% peak to trough.



Source: Bloomberg

So severe was the sell-off that even if investors were wise enough to ride the NASDAQ for more than two years prior to its peak, and having successfully tripled their money, were in the end no better off than an investor in the Russell 2000 if they did not sell out

Continued on the next page...



Source: Bloomberg

Many would argue that today's market bears little resemblance to the Dotcom bubble. Yes, the by-products of increased risk-taking are different. However, the mindset of investors is the same. The greater fool theory is pervasive; risk is under-priced; and current conditions are being extrapolated into perpetuity. However, smaller companies of the kind we invest in do not require a greater fool to deliver a return. Three-quarters of the portfolio pays a dividend (portfolio dividend yield is 2.3%), its free cash flow yield is 5.0% and the weighted average company has net cash on its balance sheet.

During these heady times we believe investors should stick with the devil they know. Smaller companies continue to trade at lower multiples, fair compensation for their immaturity and lower liquidity. Furthermore, our process emphasises strong balance sheets and high free cash flow generation, the asset class's main deficiencies. As an investor, are you being compensated for the risk you are taking?

	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

This communication has been prepared by Spheria Asset Management Pty Limited ABN 42 611 081 326 ('Spheria'), Corporate Authorised Representative 1240979 of Pinnacle Investment Management Limited (AFSL 322140).). Interests in the Spheria Global Microcap Fund ARSN 627 330 287 (the 'Fund') are issued by Pinnacle Fund Services Limited (ABN 29 082 494 362 AFSL 238371), the Responsible Entity. The Responsible Entity is not licensed to provide financial product advice. You should consider the Product Disclosure Statement ('PDS') in its entirety before making an investment decision. The current PDS of the Fund can be found at www.spheria.com.au/funds. Spheria is the investment manager of the Fund.

Spheria and Pinnacle Fund Services Limited believe the information contained in this communication is reliable, however, no warranty is given as to its accuracy and persons relying on this information do so at their own risk. To the extent permitted by law, Spheria and Pinnacle Fund Services Limited disclaim all liability to any person relying on the information in respect of any loss or damage (including consequential loss or damage) however caused, which may be suffered or arise directly or indirectly in respect of such information contained in this communication. This communication is for general information only. The information is not intended as a securities recommendation or statement of opinion intended to influence a person or persons in making a decision in relation to investment. It has been prepared without taking account of any person's objectives, financial situation or needs. Any person considering action on the basis of this communication must seek individual advice relevant to their particular circumstances and investment objectives.

Any opinions or forecasts reflect the judgment and assumptions of Spheria on the basis of information at the date of publication and may later change without notice. Any projections are estimates only and are contingent upon matters outside the control of Spheria and therefore may not be realised in the future. Past performance is not a reliable indicator of future performance.

The information contained in this communication is not to be disclosed in whole or part or used by any other party without the prior written consent of Spheria.