

Performance as at 30th November 2021

	1 Month	3 Months	1 Year	2 Years p.a. ³	Inception p.a. ³
Fund ¹	-0.2%	-2.7%	31.8%	23.6%	22.3%
Benchmark ²	0.1%	-2.3%	35.4%	24.0%	19.2%
Difference	-0.3%	-0.4%	-3.6%	-0.4%	3.2%

¹ Sphera 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.

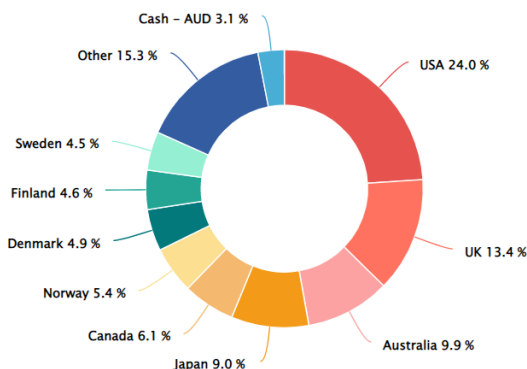
³ Inception date is 1 March 2019. Past performance is not a reliable indicator of future performance. All p.a. returns are annualised.



Overall Commentary

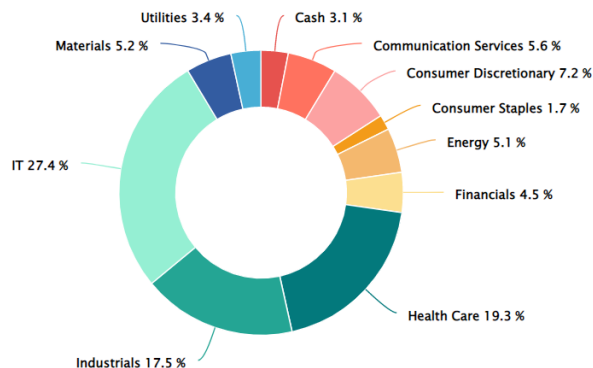
November was a tale of two halves. At one point, the Sphera Global Microcap Fund was up 4.8% but ended the month down 0.2% after fees. Investors fled microcaps for the perceived safety of large caps as fears grew around a scenario of slowing economic growth and rising inflation. Once again, this highlights the diversification benefits of this great asset class, acting complementary to large-cap global equities.

Regional Exposure



Source: Sphera Asset Management

Sector Exposure



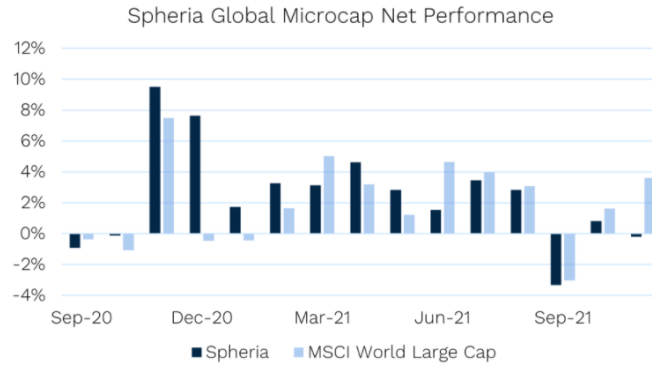
Global Characteristics

	Average Mcap (USD)	EPS Growth (%)	Trailing FCF Yield (%)	Dividend Yield (%)	Net Debt / EBITDA	FCF Conversion (%)
Sphera	714	51.7	3.5	2.6	-0.6	107.3
World Micro	194	5.6	1.9	2.3	0.9	72.6
World Smalls	2,493	18.7	3.0	1.9	1.9	85.5
S&P500	87,263	39.0	3.6	1.3	0.7	107.4
Nasdaq	8,173	32.1	2.9	0.6	0.0	110.6

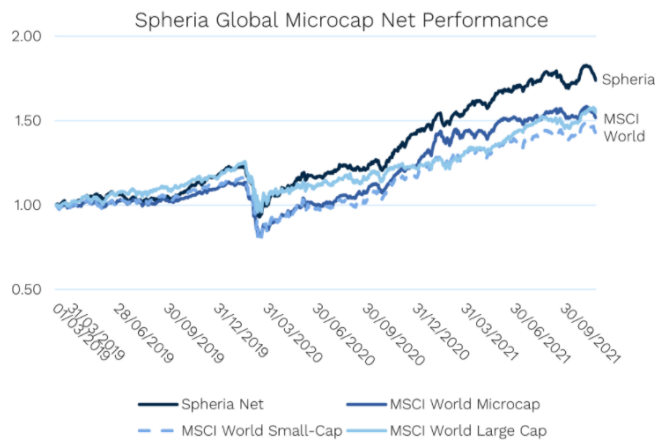
EPS= Earnings per Share, FCF = Free Cash Flow, Negative Net Debt / EBITDA figures show a debt free, or net cash balance sheet.

Further Commentary

As the chart below shows, in late 2020 and early 2021, it was microcaps doing the heavy lifting for investors' portfolios. In recent months though, large caps have taken up the lead.



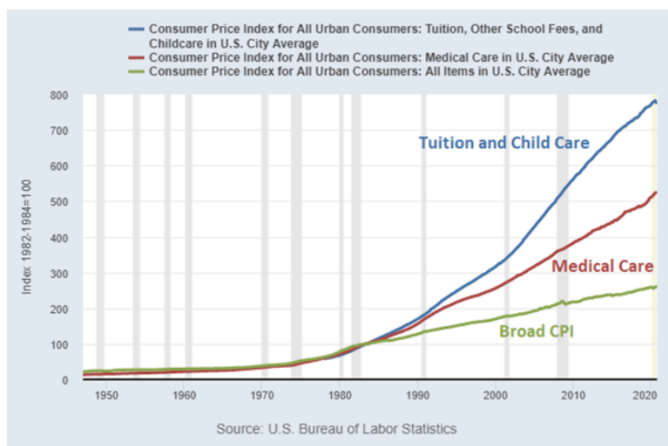
The Fund's negative November return was only just below the Benchmark, which rose 0.1%. Since its inception (1 March 2019), the Fund has delivered 22.3% p/a after fees. This return is 3.2% p/a more than its Benchmark and 5.1% p/a more than the MSCI World Index of large cap stocks. The chart below shows the comparison to the major MSCI Indices.



Source: MSCI, Sphera

Markets

The Omicron COVID variant spelled disaster for oil prices, and the microcap energy sector fell 5.8%. Health Care was the next worst performing segment of the market. One reason may be that with fears of rising inflation, investors may prefer to run the gauntlet of passing through price increases with consumers rather than face off against fierce insurers and Government payers who typically pay the healthcare bills. Perhaps this has merit, but keep in mind that Healthcare has been one of the few sectors dealing with inflation for some time. As the chart below shows, service parts of the US economy have not experienced the deflation exported by China's manufacturing.



The current disruption from supply shortages and logistics bottlenecks is an issue for sectors that have long had a deflationary environment. This is quite the adjustment for management teams. Don't be surprised if some companies underestimate the price elasticity (how volumes change with price) of their products and are saddled with excess inventory and margin headaches.

Real Estate and Financials led the market higher. Real estate's performance is difficult to reconcile since surely, much like Energy, a new COVID variant is not a welcome development for those assets. As for Financials, signals that the Central Bank Cartel could be even closer to tapering is a welcome relief for the sector. What will be interesting to see is how the credit cycle progresses now that Government assistance and moratoriums on evictions and the like have lapsed.

Israel was the best-performing country for microcaps in November, up 6.5%. That market is home to an extensive array of software and technology companies and we continue to trawl the market for research targets. On this front, it is not unusual for us to conduct our due diligence and conclude that while we like the company, the price is not right, or the investment case is unclear. However, that work is not lost, and we continue to build a list of companies we would like to buy at the right price. We take pride in our valuation discipline and will stalk companies for as long as it takes to buy them at the right price.

Fund Performance

PLOVER BAY (1523.HK)



Source: Plover Bay Technologies

Hong Kong based Plover is a manufacturer of wired and wireless SD-WAN (Software Defined Wide Area Network). SD-WANs use software to direct data traffic, simplifying a company's network setup and even allowing remote adjustments. SD-WANs lower cost and increase network speed. Plover Bay's SpeedFusion technology combines multiple data networks, including 4G and 5G, to create "unbreakable connectivity". SpeedFusion can hop seamlessly from data network to data network. For instance, if the Optus signal weakened, the system would automatically switch over to Telstra quickly enough that the user would not even notice the transition.

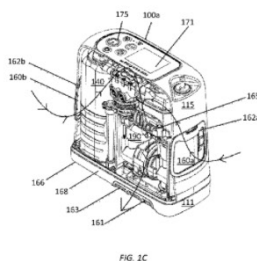
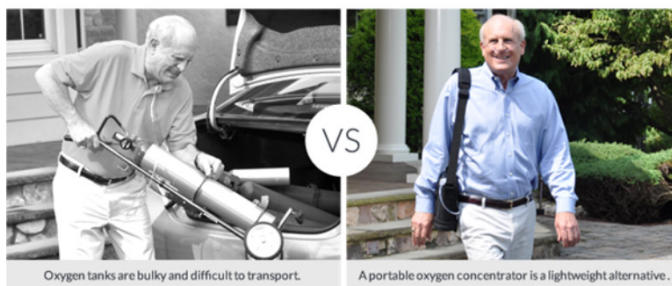
Recently, Australian company Megaport estimated worldwide SD-WAN infrastructure revenue of US\$3.7bn and a CAGR growth rate of 31% p/a from 2018 to 2023 for the industry. Plover certainly seems to be benefiting from this demand and put out an upbeat earnings update during November. The company announced that it had already surpassed last year's entire revenue by 18% by the end of October. This was inline with our analyst's forecast but the market reacted positively since the company is not covered by any sell-side analysts. For more information please read our recent insight article published on Livewire [SD-WAN and the future of 5G: What it is, how to get exposure](#).

Sphera has owned the stock since 2019 and it has since more than quadrupled. We have reduced the Fund's position size, since the stock's valuation is no longer as attractive, but remain a holder.

INOGEN (INGN.US)

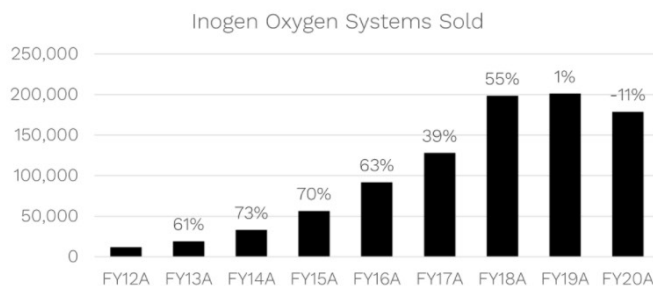
Inogen continues to be a thorn in our side. However, as fundamental investors, we have to accept that the share price does not necessarily reflect the underlying health of a business. Bring up a share price chart of Inogen, and one would think this is a business in decline. However, let's dig beneath the surface to give you a sense of why we continue to think this stock is a fantastic opportunity for our investors.

Inogen is the global leader in Portable Oxygen Concentrators (POCs), a mobile alternative to tanks for those on long-term oxygen therapy.



Source: Inogen, USPTO

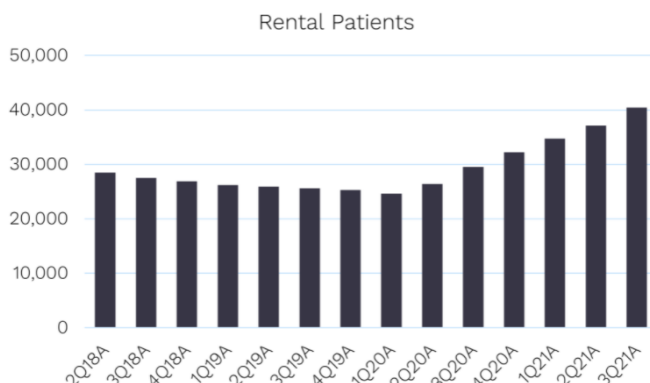
Firstly, let's zoom out and take a look at how this business has done over the long-run. The chart below shows the number of oxygen systems sold since FY12. You'll notice the exceptional growth of this business off a low base, averaging 60% growth from FY13 to FY18. FY19 was impacted by the loss of a large home medical equipment customer and some disruption to the sales force. The dip in FY20 is understandable since Inogen's users are elderly mobile patients confined at home during COVID.



The company estimates that penetration rates for Portable Oxygen Concentrators (POCs) are only 21%, leaving significant room for further growth. Given this ongoing penetration upside, industry growth remains strong. While the market for oxygen therapy is a low single-digit growth market, the POC market should continue to grow at a double-digit rate. However, in the short-term, growth will overshoot this because of a significant catch-up phase following the trough of COVID.

Pleasingly we have seen a solid rebound to date with second-quarter system growth of 23%. Unfortunately, semiconductor chip shortages constrained the third quarter, so system growth was a more moderate 6%.

The other positive takeaway from recent results is the success of the rental sales model. In the past, Inogen used a mix of home medical equipment distributors, direct to consumer sales, and direct to consumer rentals where patients rented the device for a period rather than buying it outright. Analysis by the company has revealed that the rental model has a higher conversion rate with customers and robust economics. As the chart below shows, with a renewed focus on this business model, Inogen has shown strong momentum.



Further to this, reimbursement has become a tailwind for the company. Average rental revenue per patient has increased from \$243 in the third quarter of 2018 to \$342 in the third quarter just passed. This price rise flows directly through to gross margins with an increase of over 6% on last year.

With a market capitalisation of US\$736 million and a net cash balance sheet of US\$218 million, the company can be bought for only US\$518 million. Interestingly, Resmed, a company with a market capitalisation of \$38.7 billion, tried to enter the market for POCs and failed miserably.

25 October 2018 Resmed Earnings Call

"The issue here on these POC devices is really getting the right balance of features that make it the most usable product. So we've got a really good battery life, we've got a great weight, and a really good oxygen output, that let's people be mobile and to use the device with confidence...We'll talk to you in 90 and 180 and 360 days about how the Mobi rollout goes, and I think we'll start to see that really pick up."

The updates never came. Perhaps Resmed will try entering the market via some other route?

Finally, but not least of all, the company is one of the better US companies we have discovered for its ESG initiatives. Recently, we spent an hour with the company CFO exclusively discussing ESG issues and getting comfort on the following topics:

- Supply chain risk
- Intellectual property
- Medicare Reimbursement
- Environmental practices and disclosures
- Diversity
- Cyber security

The company's awareness and response on these topics was impressive and gave us greater confidence in the sustainability of the business. This forward thinking view of ESG issues wider reflects management's long-term and disciplined approach to building shareholder wealth. We remain confident investors in the Fund will be rewarded by this holding.

Outlook



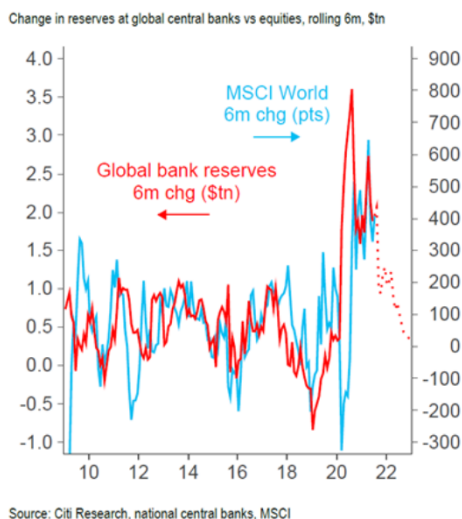
Source: Vintage News Daily, The Washington Post, Library of Congress, NBC News

Since its inception in 1792, the New York Stock Exchange has been a witness and barometer of human history. Humanity has had to endure its fair share of setbacks throughout this relatively short time span. However, we have always bounced back. The stockmarket has been a leveraged play on human ingenuity and determination. The stockmarket has survived depressions, world wars and pandemics, and thrived through it all. Over the long-run we will win; we always do.

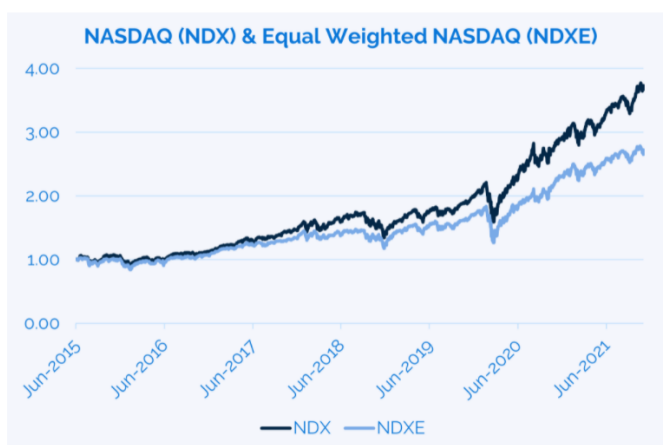
But is the stockmarket still a reflection of human endeavour? Recent research by Bank of America Global Research shows that since 2010 earnings have only explained 21% of S&P500 returns. So if not profits, what else might be explaining moves in the S&P500. Perhaps no surprise to frequent readers of these monthlies, we can point the finger squarely at the Central Bank Cartel. Bank of America Global Research estimates that the Federal Reserve balance sheet can explain 41% of changes S&P500 market cap changes (52% of the 79% not explained by earnings).



Citi Research shows this even more eloquently and for the broader MSCI Index. The chart below shows the uncanny relationship between changes in the reserves created by the Central Bank Cartel (in this case BoC, Riksbank, RBA, SNB, BoE, BoJ, ECB, and Fed) and rolling six-month returns for the MSCI.



We hypothesise that most of this Central Bank Cartel liquidity has flowed into large cap equities. We can see this by the widening gap in the regular market cap weighted index relative to an equal-weighted equivalent. That is, an equal weighted index free from passive investment distortions where large stocks mechanically attract more of the inflows.



Source: Bloomberg, Spheria

Since June 2015, the market cap gap between index weighted and equal weighted Indices for the S&P500 is an astonishing \$5.3 trillion. Despite being a smaller Index, the NASDAQ shows a gap of \$7.1 trillion. This reflects the popularity of passive ETFs in this universe of technology stocks. Alarming, since June of 2020 this gap has widened an additional \$4.7 trillion, about the same quantity the Fed has expanded its balance sheet during the pandemic.

With the Central Bank Cartel attaching a fire hose of liquidity to the financial system, it is clear that the outlet has been into large-cap stocks via passive ETFs. After all, why would anyone sell a Treasury security to the Cartel unless they thought they could earn a higher return elsewhere. For every dollar of Quantitative Easing, it implies there is a dollar flowing into a riskier (presumably higher returning) asset.

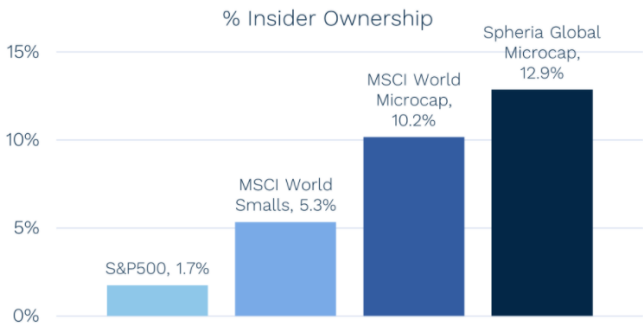
So the sharemarket is no longer a play on human endeavour but rather a play on unelected bureaucrats experimenting with financial theory. Yes, this activity does trickle down the market cap spectrum so that Global Microcaps are not immune from its influence.

However, we would make the following points about global microcaps. Firstly, the valuation gap is now quite astounding. With all that liquidity flowing into large caps the earnings multiples are looking increasingly egregious. Within Global Microcaps, we can construct a portfolio with similar growth and stronger balance sheets but at a fraction of the price (16x EV/EBIT relative to the S&P500 27x EV/EBIT).

	Average Mcap (USD)	EV/EBIT	EPS Growth (%)	Trailing FCF Yield (%)	Dividend Yield (%)	Net Debt / EBITDA	Cash Conversion (%)
Spheria	703	16.0	45.7	3.5	2.6	-0.6	107.1
MSCI World Micro	191	16.7	3.6	2.0	2.4	0.9	72.7
MSCI World Small	2,464	19.9	18.8	3.1	1.9	1.9	85.8
S&P500	85,817	26.8	39.0	3.6	1.3	0.7	107.3
Nasdaq	8,031	32.9	32.7	3.0	0.6	0.1	110.6

Source: MSCI, Bloomberg, Spheria

Secondly, and getting back to the markets most compelling attribute, its reflection of human ingenuity and determination, the global microcap market is still the best place to see this dynamic in action. As the chart below shows, nowhere will you find a universe of stocks with greater insider ownership, often founder-led businesses with the entrepreneurial spirit which makes equities so successful over the long-run.



Source: Bloomberg, MSCI

We remain concerned about the distortions we are seeing from ultra-low interest rates, quantitative easing and passive investing. For these reasons, we implore investors to consider the diversification benefits of Global Microcaps. Not only has this large and undiscovered universe of stocks delivered returns of 3%-6% in excess of large caps over history, but it can provide powerful diversification benefits to an equity portfolio:

- Significant valuation discount to large-cap stocks, as the table above highlights.
- Low correlation to the MSCI World and other leading large-cap managers (see table below).
- Reduced weighting to the US sharemarket, representing only 23% of the Spheria Global Microcap Fund and 26% of the World Microcap Index.
- Spheria Global Microcap downside capture ratio of 0.34 relative to the MSCI World Index.

	Spheria	T. Rowe Price	Hyperion	Magellan	MSCI World
Spheria Global Microcap Fund	1.00				
T. Rowe Price Global Equity Fund	0.69	1.00			
Hyperion Global Growth Fund	0.52	0.89	1.00		
Magellan Global Fund Open Class	0.58	0.90	0.85	1.00	
MSCI World Large Cap Index	0.71	0.93	0.84	0.92	1.00

Source: MSCI, Spheria, T Rowe, Hyperion, Magellan.

Correlation on daily returns for the period 1 March 2019 (Spheria Global Microcap inception) to 31 October 2021.



Spheria Global Microcap Fund

ARSN 627 330 287 | APIR WHT6704AU

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



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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