Spheria Global Microcap Fund

ARSN 627 330 287 | APIR WHT6704AU

Performance as at 30th September 2021

	1 Month	3 Months	1 Year	2 Years p.a.[3]	Inception p.a[3]
Fund[1]	-3.3%	2.9%	43.3%	28.4%	23.6%
Benchmark[2]	-0.4%	2.1%	58.7%	27.8%	21.4%
Value Added	-2.9%	0.8%	-15.3%	0.6%	2.2%

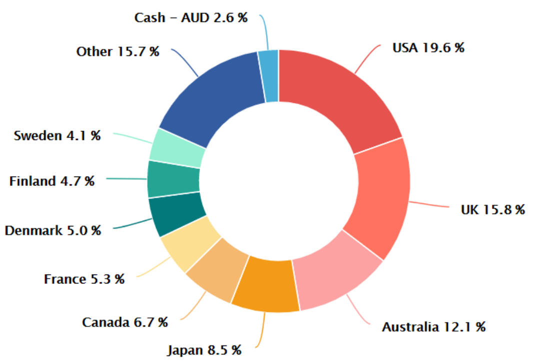
1 Spheria Global Microcap Fund. Returns of the Fund are net of applicable fees, costs and taxes.
2 Benchmark is the MSCI World Microcap Index in AUD (Net) from 1 July 2021 and prior to that MSCI Kokusai (World Ex-Japan) Microcap Index in AUD.
3 Inception date is 1 March 2019. Past performance is not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

Overall Commentary

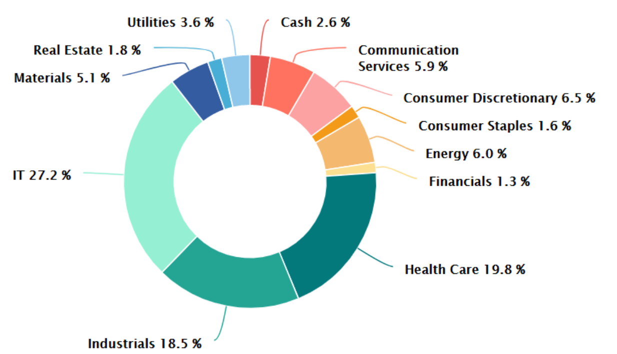
The MSCI World Microcap Index resisted the trend of sharemarket weakness in September, falling only 0.4%. Meanwhile, the MSCI World fell 3.0%, and the MSCI World Small Cap Index fell 2.0%.

The Spheria Global Microcap Fund fell 3.3% after fees. This is disappointing and unusual for the Fund to underperform in a down market. Until this month, the Fund's downside capture has been 0.37 against the MSCI World Microcap and 0.23 against the MSCI World Index. This means that since inception, when the Indices fell, the Fund fell only 37% and 23% of the Index decline respectively.

Regional Exposure



Sector Exposure



Source: Spheria Asset Management

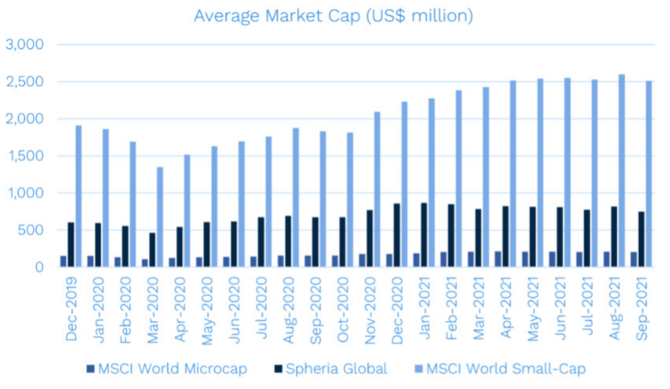
Global Characteristics

	Average Mcap (USD)	EPS Growth (%)	Trailing FCF Yield (%)	Dividend Yield (%)	Net Debt / EBITDA	FCF Conversion (%)
Spheria	739	39.4	3.7	2.4	-0.7	103.8
World Micro	206	-2.4	2.1	2.2	1.1	72.4
World Smalls	2,510	19.1	3.5	1.8	1.9	86.2
S&P500	82,008	41.4	3.5	1.3	0.7	108.5
Nasdaq	7,839	37.2	3.2	0.7	0.0	113.2

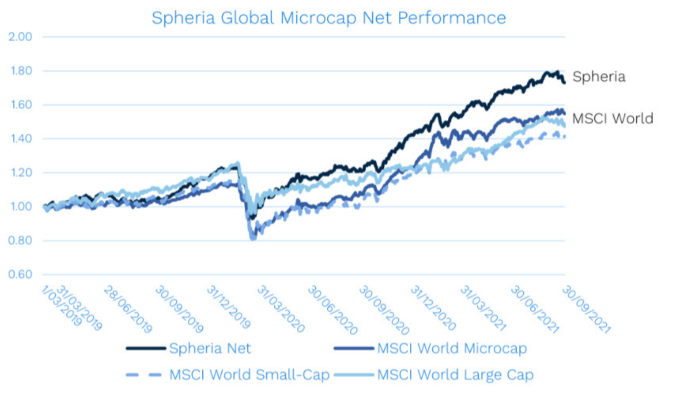
EPS= Earnings per Share, FCF = Free Cash Flow, Negative Net Debt / EBITDA figures show a debt free, or net cash balance sheet.

Further Commentary

Notably, larger stocks fared worse in September. Only the smallest of companies were spared in the sell-off. The Spheria Global Microcap Fund invests predominantly in larger and more liquid stocks than the average Benchmark constituent. This size bias appears to be the primary reason for the Fund's underperformance this month.



Since its inception, the Fund has delivered 23.6% p/a after fees, 2.2% ahead of its Benchmark. The chart below shows the comparison to the major MSCI Indices.



Markets

Larger companies underperformed, value stocks were in favour, and Treasury yields rose.

The Central Bank Cartel are increasingly vocal about the need to reign in Quantitative Easing (QE), whereby Central Banks use seigniorage (creating money) to buy fixed-income assets, predominantly Treasuries and Mortgage-Backed Securities.

The impact of QE is debatable, let alone the merit of it. It is true that you can lead a horse to water, but you can't make it drink. The Central Bank Cartel's answer to this is to put that poor horse in a pond and fill it with water until its head is covered!

The Federal Reserve may announce a reduction in QE as early as November. However, much uncertainty remains. In addition to the Central Bank Cartel, Government Fiscal policy has also introduced enormous distortions to the system since early 2020. The recent end to COVID related US Fiscal support has left a gaping hole in the global economy. Meanwhile, there are signs of wage inflation in the US, while freight and material costs seem to have peaked. See why we are not top-down macro investors?

The other major economic news has been the rise in oil prices. We sensed the market's disdain for the sector earlier this year as Global Warming became a focal point for investors. As a result, we accumulated two high-quality service providers to the industry at desirable prices relative to our mid-cycle valuations. More would have been nice though, with the sector up 16.4% in September.

Financials, which we are heavily underweight, were also positive, up 0.9%. We are structurally underweight this sector since we look for conservatively geared companies with solid free cash flow. Banks are highly levered and are typically capital hungry if growing. If interest rates rise and the yield curve steepens, the banking sector will be one of the biggest beneficiaries (funding short and lending long). However, this may also be the death knell for many an overpriced growth stock and companies that rely on debt markets for financing. Net-net, we expect the portfolio to benefit from this scenario relative to the broader Benchmark.

Despite the strength of energy, the Nordics were among the worst performing microcap markets in September. Japan and the Antipodes were the strongest microcap countries. The Nordics, while expensive overall, have begun to show a similar trend to other pricey markets – bifurcation. The hot stocks are trading at nosebleed multiples. Still, many other companies have been left behind because they lack excitement or because single-digit growth is now considered pedestrian by investors. In many instances, these neglected companies are trading at an attractive value.

One of our Nordic stars is Danish company, North Media. Labelled a value stock and trading on 10x PE, plenty of online growth and technology are hidden under the bonnet.

Source: North Media Subsidiary: Bekey

Fund Performance

MADER (MAD.AU)

Mader Group was the most significant contributor to the Fund rising 40% over the month. Mader offers fixed plant and equipment maintenance to mining companies in Australia and abroad saving customers a significant amount compared to the relatively expensive maintenance costs provided by equipment Original Equipment Manufacturers (OEM's). In late August, Mader reported a strong set of FY 21 numbers, considering the impacts of covid and the market's fears around wage inflation in the West. In addition, they provided guidance for 20-30% earnings growth in FY22 as the group continues to expand successfully into the USA, where to date there has been limited competition. MAD has a strong ROIC of over 40%, modest gearing and still trades on only 9x FY22 EV/EBIT despite the significant share price move over the month.

INOGEN (INGN.US)

Inogen was again the Fund's largest detractor, down 26% in AUD during September. The shares ended September at par with our average entry price in the company. The market cap for this high-growth industry leader is now only US$730 million, excluding the cash on the balance sheet.

Since our view has not changed, we repeat last month's commentary below.

The stock has done well in recent months as investors gain a line of sight on a US re-opening, and the increased demand this will provide for Inogen's products. However, that line of sight was blurred during the company's latest quarterly result.

Inogen is the global leader in Portable Oxygen Concentrators (POC). These medical devices act as short-term substitutes for patients requiring oxygen therapy (typically for diseases under the umbrella of chronic obstructive pulmonary disorder – COPD). Mobile patients requiring oxygen can rely on these lightweight and battery-powered devices to concentrate the air around them into oxygen.

COVID has been a challenging period for the company with its target customer, mobile elderly patients, staying home and not requiring the flexibility of a POC for travel or other functions. However, with US$240 million of cash on the balance sheet, the company has the resources to see this setback through. Inogen is also using this hiatus as an opportunity to re-jig its model further towards patient rentals, which its analysis has shown has much higher conversion rates than outright sales. COVID itself is likely to increase long-term demand since infected patients with co-morbidities such as diabetes, hypertension, or obesity are more likely to require prolonged oxygen therapy in moderate to severe cases.

We continue to believe the future is bright for this company and that the share price instead implies only a subdued recovery from COVID. Fellow investors had started to come around to the same conclusion, with the share price rallying from $30 in August last year to almost $80 before the result. However, the company had to warn investors that the recovery would be delayed since the shortage of semiconductors, a vital input into the devices, means it can not meet demand in the short term. As a result, revenue in the second half of the year is expected to be less than the first half.

Investors who were there for a good time, not a long time, fled the scene quickly. There is much conjecture around when the global semiconductor shortage is likely to be resolved. In addition, rising concern around the Delta strain of COVID has poured more cold water on the share price.

Nevertheless, we continue to see substantial upside once earnings eventually normalise. In this market where many would consider Inogen "dead money", we see it as an appealing risk-reward proposition which we will need some patience to realise. And if the market does not, we expect many corporates will, with this company's leading position in a high growth healthcare segment.

Outlook

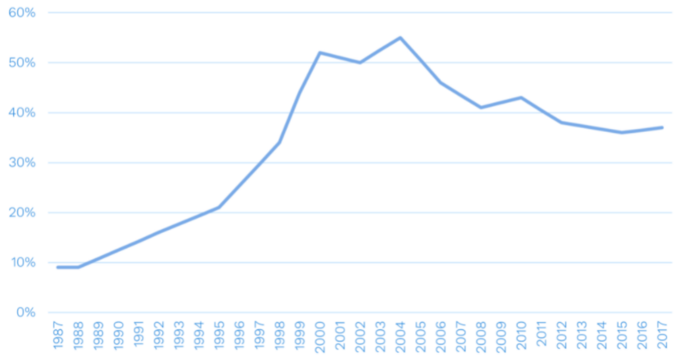
African Rock Pythons, one of the largest snakes on the planet, are renowned for their ability to lie in ambush waiting for their unfortunate prey. This patient approach to hunting means they can go months without eating.

Not so equity investors, who are getting used to regular feeds. Since the GFC, the most disappointing year for investors has been 2018, when the S&P fell a harrowing 6%. Stocks are "hip" again. Taxi drivers, sorry, we mean Uber drivers, are keen to talk stocks.

It's interesting to contrast today with periods of the past. In the 1980s, share ownership by average Australians was still low (9% of adults), but growing rapidly, as the 80s "entrepreneurs" sprinkled their magic. These charlatans burned many first-time investors.

The dot-com period was too irresistible and brought these investors, and many more, into the fold. Direct share ownership in the 90s exploded. Unfortunately, the dot-com wreck again let them down. However, a peak in demutualisations and Government privatisations in Australia kept investors hanging around a little longer.

Australian Share Ownership: Dot-Com Peak



Source: ASX, Deloitte

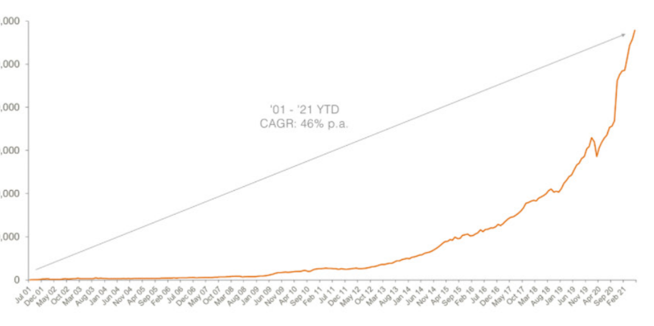
Retail investors licked their wounds, and it was once more unto the breach. But, this time, financial wizards such as Storm Financial lulled them into a false sense of confidence. Margin lending was the tonic for certain wealth, and levels soared into the GFC.

Margin Lending in Australia

Source: ABS

What of sentiment now? Like direct shares in the 1990s and margin lending in the 2000s, passive ETFs appear to be displaying a similar dynamic. Retail investors seem increasingly convinced they are a sure bet.

Exchange-Traded Products



Source: ASX, Chi-X, BetaShares

The three charts above evidence a well-known phenomenon, investors swing between fear and greed. But what stops an investor from getting overly excited at the top and pessimistic at the bottom?

In our opinion, an investment “True North” is critical. And a disciplined institutional-grade investment process such as ours to implement it. As a reminder, our philosophy is:

- **Valuation Matters:** Applying a consistent cash-flow based valuation framework that allows comparison between stocks and over time. Ensuring one does not buy at the top and sell at the bottom.
- **Free Cash Flow Conversion is Critical:** The insistence that companies convert accounting earnings to cash profit. This approach minimises downside risk by avoiding companies that rely on capital markets for their growth.
- **Avoid Financial Leverage:** Having a low tolerance for heavily financially levered businesses, especially those with high operating leverage.

The downside of this discipline is that our Pinnacle friends need to work harder to convince investors of the merits of this Fund. You see, we would love to share stories about a Fund full of stocks with disruptive technology and “network effects”, destined to be the next Uber or Amazon. But, unfortunately, our valuation discipline means we have had to pass on exciting opportunities in machine vision, disruptive pet food, software, ophthalmic technology, and payments processing.

Suppose we can not support a valuation based on the projected cash flow to equity holders, using peer-reviewed assumptions, and cognisant of the risks of delivering (including ESG). In that case, we do not purchase the securities. **A good company is not necessarily a good investment. The price one pays matters.**

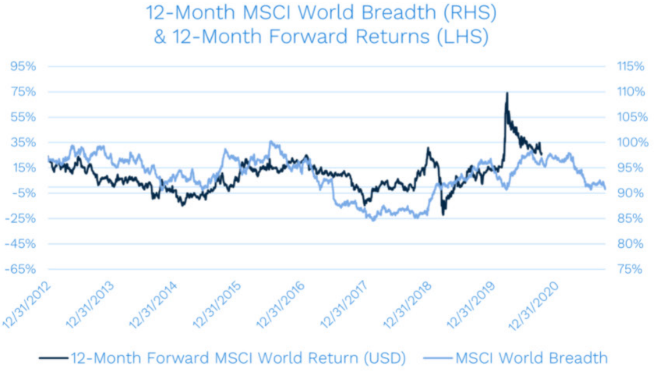
While this wet blanket mentality feels like a handicap now, think about what this approach might mean when sentiment is at the other extreme? Perhaps amid a dot-com wreck or GFC? This same valuation discipline will encourage us to purchase these same companies when others are selling them. When there is fear around because earnings momentum has weakened, or the hot money that previously held such companies are heading for the exits, our valuation discipline will give us the clarity to see through this panic and acquire such businesses.

How close are we to such a scenario? It is near impossible to tell. There are many indicators of market sentiment. However, one of the simplest but most effective of them is market breadth. Market breadth measures how broad an Index advance is or the ratio of stocks rising to stocks declining.

When market breadth is high, it suggests the market has a head of steam. Money is flowing in, and equities are in vogue. Investors are keen to buy equities, and they’re not too fussed about which ones. So high market breadth implies investors are erring towards greed and complacency.

When breadth is weak, investors are buying selectively and are in the market for individual stock names rather than the asset class as a whole. Low market breadth indicates a level of investor skittishness or fear.

The MSCI World has been strong the past few months. However, market breadth has been weakening. As the chart below shows, this reduction in breadth (lighter line) suggests the market may not have the confidence to march higher over the coming year.



Source: MSCI, Bloomberg, Spheria. 12-Month forward returns in USD.

With equity markets looking increasingly fragile, we have been spending more of our time stalking companies we would like to buy at the right price. Like an African Rock Python, we’re looking forward to a belly full of quality feed.

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.

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 RECOMMENDED

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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