Spheria Australian Microcap Fund

ARSN 611 819 651 APIR WHT0066AU

Spheria ASSET MANAGEMENT

Performance as at 31st July 2021

	1m	6m	1yr	3yr p.a.	5yr p.a.	Inception p.a.#
Fund^	**3.1%**	**22.1%**	**80.6%**	**15.0%**	**14.3%**	**15.4%**
*Benchmark**	*0.7%*	*11.8%*	*32.3%*	*9.2%*	*9.6%*	*10.9%*
Value added	2.4%	10.3%	48.3%	5.8%	4.8%	4.5%
*Microcap Index ***	*2.8%*	*10.6%*	*53.1%*	*16.8%*	*11.2%*	*13.9%*

^ Spheria Australian Microcap Fund. Returns of the Fund are net of applicable fees, costs and taxes

* Benchmark is the S&P/ASX Small Ordinaries Accumulation Index. All p.a. returns are annualised.

** Microcap Index refers to S&P/ASX Emerging Companies Accumulation Index.

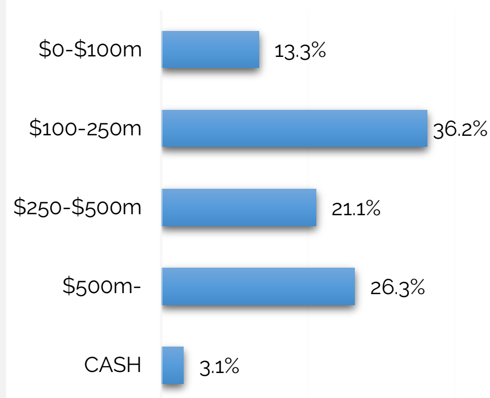
Inception date is 16 May 2016. Past performance is not a reliable indicator of future performance.

Top 5 Holdings

Company Name	% Portfolio
Supply Network	4.8
Class Limited	4.7
Vista Group Int Ltd	4.6
Michael Hill Int	4.4
Seven West Media Ltd	4.1
Top 5	**22.7**

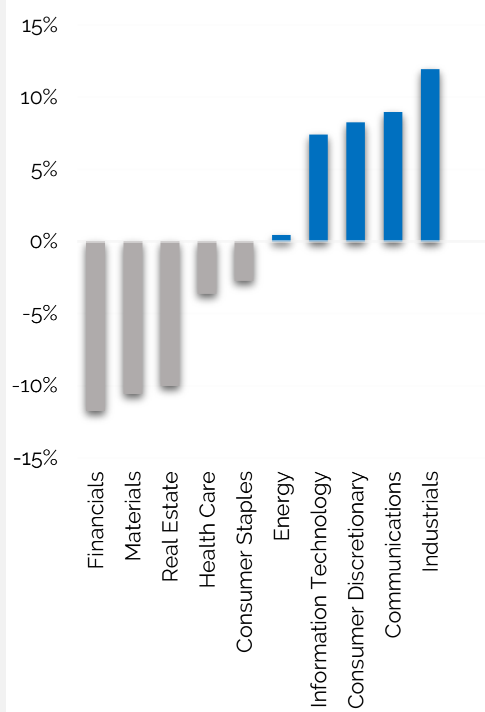
Source: Spheria Asset Management

Market Cap Bands



Source: Spheria Asset Management

Active Sector Exposure



Source: Spheria Asset Management

Commentary

The Spheria Australian Microcap Fund returned 3.1% (after fees) during the month of July, outperforming the ASX Small Ordinaries Accumulation Index by 2.4%.

Markets

Markets rose modestly over July as the market digested the likely positive news from reporting season – lead by some strong early earnings reports in overseas markets countered by the outbreak of the Delta Strain of Covid 19 locally which has seen many States re-initiate lockdowns. New age metal stocks continued to be a highly favoured area for investors with Galaxy Resources (GXY.ASX) , Orecobre (ORE.ASX) and Pilbara Minerals (PLS.ASX) all up strongly despite strong performances in previous months. Mining services as a group saw some recovery as the investors re-appraised the inflationary costs impacts against relatively cheap valuations and a recovering topline. At the other end of the ledger were some e-commerce names. These had benefitted enormously from last year's lockdown and are finding it hard to lap extremely high comparable sales and profit margins. For many of these internet retailers last year customers flocked to their websites and they grew substantially with less than usual marketing spend. As the consumer market normalizes the cost of customer acquisition has grown substantially with attendant rise in overall marketing costs squeezing margins.

Enter the Matrix

With rates having declined again since the blip in February this year, the market has returned to its matrix-like state. Many investors appear to be ignoring risk or it is deemed irrelevant. In a forgiving market, emboldened by seemingly endless Central Bank liquidity, the reddit army marches on seeking justice against an unknown and largely imaginary enemy. We liken this state to the choice Morpheus offered Neo in the Matrix Movie. Will you take the Blue Pill and re-enter your slumber plugged into the machine or the Red Pill and unplug?

Red-Pill like thinking requires you to unplug from the slumber many investors appear to be in and look at reality. We are in an extremely unusual set of market conditions, largely set by Governments and Central Banks in reaction to firstly the GFC and then the outbreak of Covid. Ultra-loose

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monetary conditions were a likely cure for the 2008 GFC which, after all was a financial crisis. However, we have used the same prescription to cure the "patient" of an entirely different set of circumstances with Covid. Nevertheless, rates at zero or negative levels are not likely to remain a long-term possibility. Alternatively, if they are the new reality there are multiple other repercussions with which the market is yet to grasp. These would include a rapid debasement of monetary purchasing power (aka inflation), a spike in assets likely to protect wealth – viz property, gold, artworks and collectibles and probably severe social repercussions. Sound familiar? Blue-pill thinking is the unthinking adoption of this status quo without thinking about the attendant consequences. Blue-Pill thinking is following the herd into whatever is deemed growthy, disruptive and innovative without any heed to business fundamentals or sustainability of the business.

We went back and analysed the top 10 performing microcaps in each of the past 7 years to see whether the Sturm und Drang surrounding the best performing short term names proved warranted over time. In most of these years well under 50% of the top 10 made money and in many 8 or 9 of the top 10 names lost money. Inevitably, if they didn't subsequently earn money or cash flows these erstwhile fireworks morphed into damp squibs. In every year Over the ensuing timeframes (of 2 years or longer) the money-losing high-flyers vanished back into the ether from which they came in many cases literally costing investors everything they invested - Its expensive if you're the last one grasping at straws.

Flipping the analysis on its head we decided to go back and look at the starting point of the subsequently best performing microcaps over a 10-year period. 9 out of 10 of these names were money making and the consistent trend amongst these names was that they had growing earnings and cash flows and were creating sustainable and durable businesses. As we have said before we prefer to work with probabilities rather than improbabilities. Why gamble on low probability stocks when you can win consistently on higher probability stocks. Cash flows are the beating heartbeat of any great long-term business and eventually all durable businesses generate cash flows.

Major Contributors for the Month

Maxitrans (MXI.ASX) was the largest contributor to the Fund over the month rising 51% over the month. MXI is a truck trailer manufacturer with a leading share of trailer manufacturing in Australia coupled with a truck parts business called MaxiParts. During the month they announced the sale of their Trailer division for $30m and the sale of the underlying properties for a further $18m. As part of this process the company will pay a special full franked dividend of 12.5c a share. The remaining business, selling parts, is the stronger of the two businesses and is likely to be re-rated by the market. We continue to see value in MXI post the disposal with the business trading on sub 10x eb/ebit with a net cash balance sheet.

NZME (NZM.NZ) rose 31% over the month on no incremental newsflow from the company. NZM continues to undergo a cyclical recovery across its media operations (Radio, print and digital) in NZ and is rapidly digitizing its earnings stream. Along with many newspaper businesses, the stronger mastheads have managed to migrate their businesses online and raise paywalls. News consumers have learned that you generally get what you pay for. NZM operates the largest newspaper in NZ – the NZ Herald – with a daily audience of over 1.2m readers. We expect to see continued migration of this user base online and to eventually accept a paywall for higher quality journalism. NZM has also reduced its outstanding debt balances and is developing a strong online property portal (Oneroof) to compete with TradeMe property. The company continues to trade on an extremely attractive valuation of around 4.5x EV/EBIT.

Horizon Oil (HZN.ASX) rose 15% over the month. HZN strengthened on the back of the continued strength in the oil price and an increase in its share capital return from 1.4c to 3c per share of which we engaged with the board earlier in the month in order to help achieve such outcome (subject to shareholder approval at an upcoming EGM). HZN remains a reasonably low-cost oil producer – with cash costs hovering around US$20/bbl and has net cash of US$31m following strong cash generation and the receipt of some option conversions. Whilst oil shares tend to

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trade on low multiples on account of their limited resource span, Whilst oil shares tend to trade on low multiples on account of their limited resource span, HZN is trading on an EV to current years spot operating cashflow of 1.5x despite having around 5 years of operating life based on last reported 2P reserves (less FY21 production).

Major Detractors for the Month

Orecobre (ORE.ASX – not owned) Rallied 25% in sympathy with other Lithium producers on improving Lithium prices over July. Whilst we are cognisant of the tremendous demand for Lithium metal for the current generation of car and storage batteries, we believe at over 5x the invested capital based that ORE is pricing in a perfect future. Lithium remains a fairly abundant material with a relatively flat cost curve. With the multitude of announced and new projects coming to market our view is that super abnormal returns for miners are unlikely to remain sustainable.

Ainsworth Gaming (AGI.ASX) retraced almost 15% over July on limited newsflow. AGI has been one of the strongest performing shares in the fund over the past year and seems to have fallen in sympathy with the increased Covid Delta variant outbreak in Australia and abroad.

Pilbara Minerals (PLS.ASX – Not owned) detracted as the lithium miner rallied 19% over the month on a continued recovery in Spodumene (Lithium Concentrate) and Lithium Carbonate prices. Although PLS has substantial reserves of Lithium Oxide they are currently barely breaking even as their current cost of production remains high. We continue to hold the view that many of these Lithium mining names look over-valued on longer term assumptions and the inevitable supply response to high lithium prices and demand. .

Outlook & Strategy

As the market goes through various fixations with sectors and themes our view remains that ultimately earnings and cash flows derive long term valuation and returns. We are clearly at an interesting juncture in time with rising environmental concerns coupled with a likely once in a generation energy transition (or transitions) likely to open up new business streams and opportunities. Mankind is, to give us some credit, a reasonably creative species especially given enough incentive. On the other hand, as the research above demonstrated, new areas, ideas or disruptive business models must eventually make earnings and cash flows to warrant share price performance or meet the market's eventual contempt.

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	Spheria Australian Microcap Fund
Benchmark (universe)	S&P/ASX Small Ordinaries Accumulation Index
Investment objective	The Fund aims to outperform the S&P/ASX Small Ordinaries Accumulation Index over the medium to long term.
Investing universe	Primarily listed companies outside the top ASX 250 listed companies by market capitalisation and companies listed on the New Zealand Stock Exchange with an equivalent market capitalisation
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 • Typically 5% - 10%
Expected turnover	20-40%
Style	Long only
APIR	WHT0066AU
Minimum Initial Investment	$100,000

Platform availability
ASGARD
BT Panorama
BT Wrap
HUB24
IOOF Portfolio Service
Macquarie Wrap
mFund
MLC Wrap / Navigator
Netwealth
One Vue
uXchange