SPHERIA ASSET MANAGEMENT

Global Microcaps: **Exploring the Features of This Unique Asset Class**

Global Microcaps is a largely overlooked and misunderstood asset class in Australia. Its awareness has been stymied by the limited amount of manager capacity available in this market. Nevertheless, sophisticated clients who have secured an allocation in offshore markets have been drawn to its superior potential for wealth creation and diversification benefits. Some see it as a liquid alternative to private equity, while others recognise the opportunity it provides skilful managers to outperform within a large universe of undiscovered stocks.

Spheria Asset Management, one of the country's most successful microcap managers, is thrilled to bring this asset class to Australia, paving the way for its clients to join a select group of investors with access to this unique part of the equity market. Investors will benefit from the following features:

- Global Microcaps can reduce a portfolio's volatility while enhancing returns. Blending the Spheria Global Microcap Fund with leading large cap equity funds has historically increased an equity portfolio's return while lowering volatility and downside risk.
- The Global Microcap asset class performs particularly well during crises. As a result, this equity market segment invariably leads the market recovery while having a drawdown comparable with its larger peers.
- Given the large universe of poorly covered companies, an active manager can construct a portfolio with large-cap quality but at a fraction of the valuation multiple.
- Unlike its larger counterparts, the USA does not dominate the Global Microcap universe, providing diversification benefits as US Index concentration reaches dot-com levels.

Finally, we summarise Spheria's approach to investing in this asset class and why their proven process and philosophy provides investors with exceptional downside protection and lower volatility.

Larger Stocks Than You Suspect

The Spheria Global Microcap Fund targets companies listed in developed markets with a market capitalisation below US$1 billion. The portfolio's average market cap is currently US$840 million (~$A1.2 billion)[1]. This is approximately the size of well-known companies such as Kogan, Nearmap, Domain Holdings, and Blackmores for some Australian market context. These stocks are in the ASX200 and are commonly classified as small-caps domestically, not microcaps.

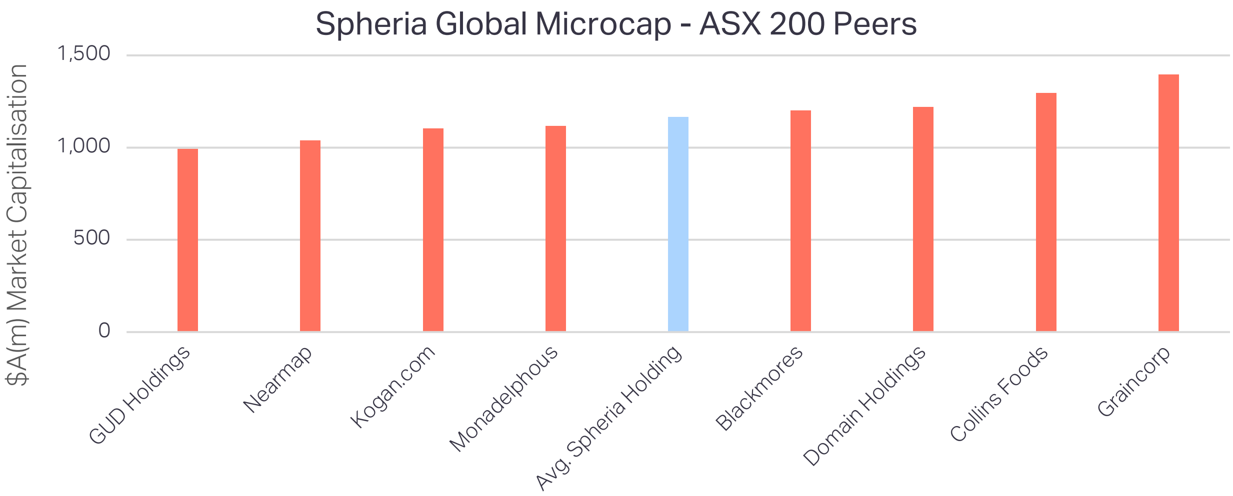

Figure 1. Average market capitalisation of the holdings in the Spheria Global Microcap Fund compared with the market capitalisation of similar sized companies listed on the ASX. Source: Spheria, Bloomberg.

A Perfect Match with Global Large Cap Fund Managers

Microcaps are the best performing segment of the equity market over the long run[2]. Further, given the large universe of overlooked stocks, the potential for outperformance by an active manager is far greater than in larger stocks. However, this enhanced return is often perceived to come with greater risk. The volatility of returns for the World Microcap Index, in isolation, is indeed slightly higher than the Large Cap Index[3]. However, in a portfolio context, World Microcaps have relatively low correlation to other assets.

The table below shows the correlation between various asset classes. Firstly, it is worth noting that the correlation between World Microcaps and World Large Caps is well less than one, at 0.92. The table also shows that the World Microcaps Index has a lower correlation to other asset classes than large caps. The only exception is Global High Yield.

[1] As at 31 July 2021.

[2] Source: Credit Suisse Investment Returns Yearbook 2020.

[3] Standard deviation of index returns since the inception of MSCI World Microcap Index have been: Daily Annualised Micro 14.4%, Smalls 18.9%, Large 17.8%. Monthly Annualised: Micro 19.5%, Smalls 19.3%, Large 16.5%.

	Global Treasuries	Global IG Debt	Global REITs	Global High Yield	Global Infrastructure	World Microcaps	World Large Caps
Global Treasuries	**1.00**						
Global IG Debt	0.97	**1.00**					
Global REITs	0.38	0.50	1.00				
Global High Yield	0.33	0.51	0.76	1.00			
Global Infrastructure	0.41	0.55	0.84	0.82	**1.00**		
World Microcaps	0.23	0.39	0.72	0.83	0.85	**1.00**	
World Large Caps	0.24	0.40	0.81	0.81	0.90	0.92	**1.00**

Past performance is not a reliable indicator of future performance.

Figure 2. Cross-asset correlations calculated using monthly returns over the period of 31/12"2007 to 30/07/2021. Source: Bloomberg.

These low correlations show that adding Global Microcaps can function to reduce a portfolio's systematic risk. Focusing on equities specifically, Global Microcaps can help lessen an equity portfolio's volatility and yet enhance returns.

Figure 3 shows the benefits of combining the Spheria Global Microcap Fund with three of Australia's leading global large cap products.

When blended with Magellan and Vanguard, there is a significant improvement in both risk and return. Annualised returns increased by an average of 2.6%, with a reduction in the standard deviation of 2.0%. While blending with Hyperion slightly reduced returns (not unexpected since Hyperion's returns have been market-leading), this is where we see the most significant reduction in standard deviation, a decline of 4.0%.

We show in Figure 4 the aggregate effect of adding the Spheria Global Microcap Fund, assuming an investor typically holds several global large cap fund managers in their portfolio. In this instance we have assumed an equal allocation between Hyperion, Magellan, Vanguard, and the Spheria Global Microcap Fund. Once again, in aggregate, adding Spheria enhances returns and reduces volatility and downside risk[4]. Many investors may be under the misconception that adding Global Microcaps to an equities portfolio may increase risk, but this is rarely the case.

[4] Downside risk calculated as the annualised standard deviation of days with returns below the average daily return

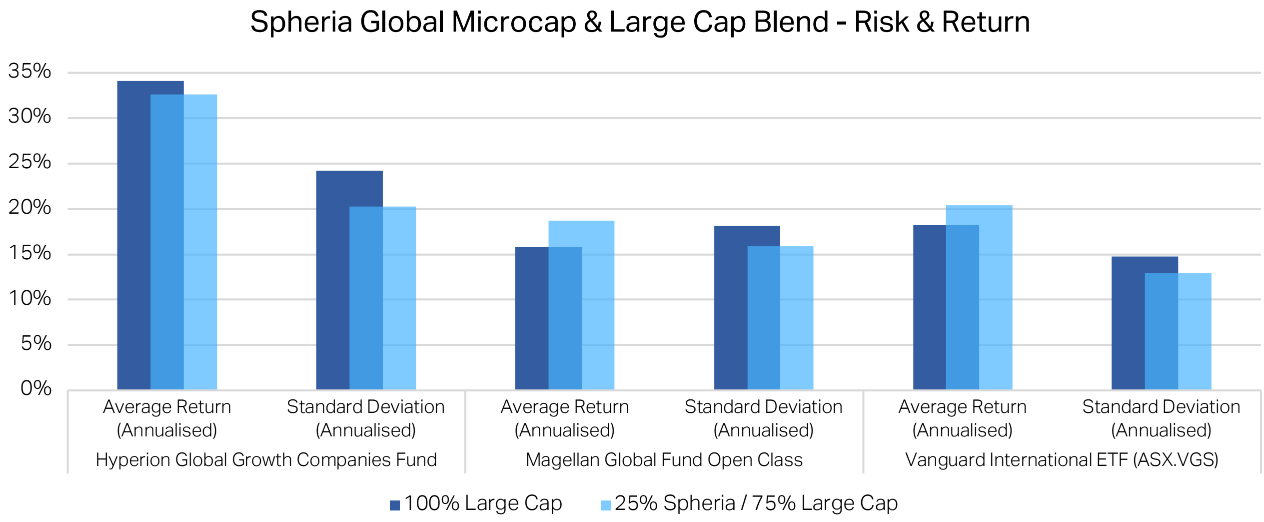

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Figure 3. Comparison of average return and standard deviation of holding 100% in a large cap product vs blending 75% of each large cap product with 25% Spheria Global Microcap Fund. Holding period is 1 March 2019 to 31 July 2021. All returns are annualised and net of fees. Source: Morningstar, Spheria.

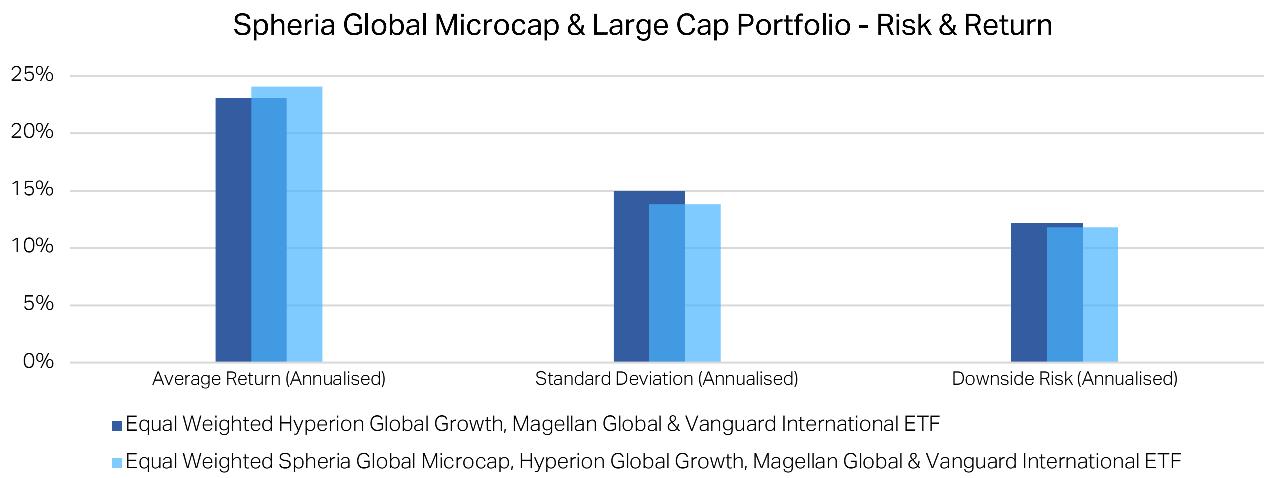

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Figure 4. Average return, standard deviation, and downside risk of equal-weighted portfolios of three large cap products and the Spheria Global Microcap Fund. All returns are annualised and net of fees. Holding period 1 March 2019 to 31 July 2021. Source: Morningstar, Spheria.

Looking at the period since the Fund's inception, we see improvements in all three metrics for investors. Adding Spheria provides a 1.0% increase in returns, a 1.2% decrease in standard deviation, and a 0.4% decrease in downside risk. These metrics are quoted net of fees.

Global Microcaps have their own distinct cycle that oscillates around larger stocks, fluctuating with the pace of economic growth. This cycle disparity enhances their diversification benefits when paired with large caps and other asset classes.

Unparalleled Opportunity to Invest in a Recovery, Without the Downside

Global Microcaps offer investors an unparalleled opportunity to invest in an economic or market recovery. They have led markets out of the dot-com crash, the GFC, and COVID. But, what's most remarkable, is that throughout these crises, the World Microcap Index underperformed only marginally on the way down. The asymmetry Global Microcaps experience around large market events provides investors a powerful asset allocation enhancement. By adding Global Microcaps to an equity portfolio, returns can be enhanced by simply "riding it out". This helps alleviate some of the burden investors may face in trying to time allocations to equities during such volatility.

Let's begin with an exploration of the dot-com bust in the early 2000s. The World Microcap Index began in November 2007, but we can use the Russell 2000 in the US as a proxy for smaller companies. The chart below demonstrates that the Russell 2000 fell by less than the leading S&P500 during the dot-com bust, and considerably less than the NASDAQ (-78%).

Despite this outperformance on the way down, the Russell 2000 also led the rebound. The Russell 2000 had recouped any losses by November 2004. However, the S&P500 remained 23.9% under water and the Nasdaq 59.7% in the red.

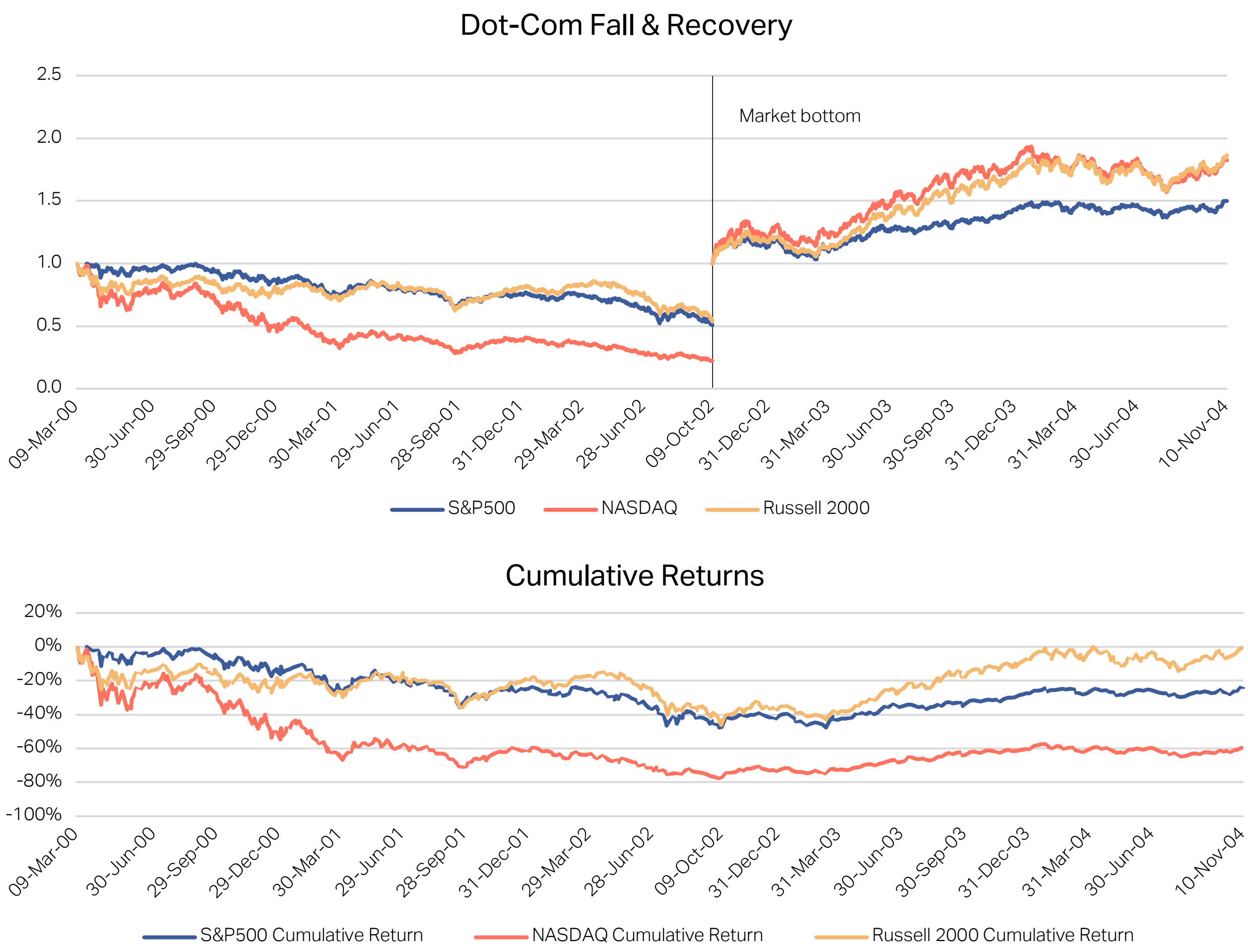
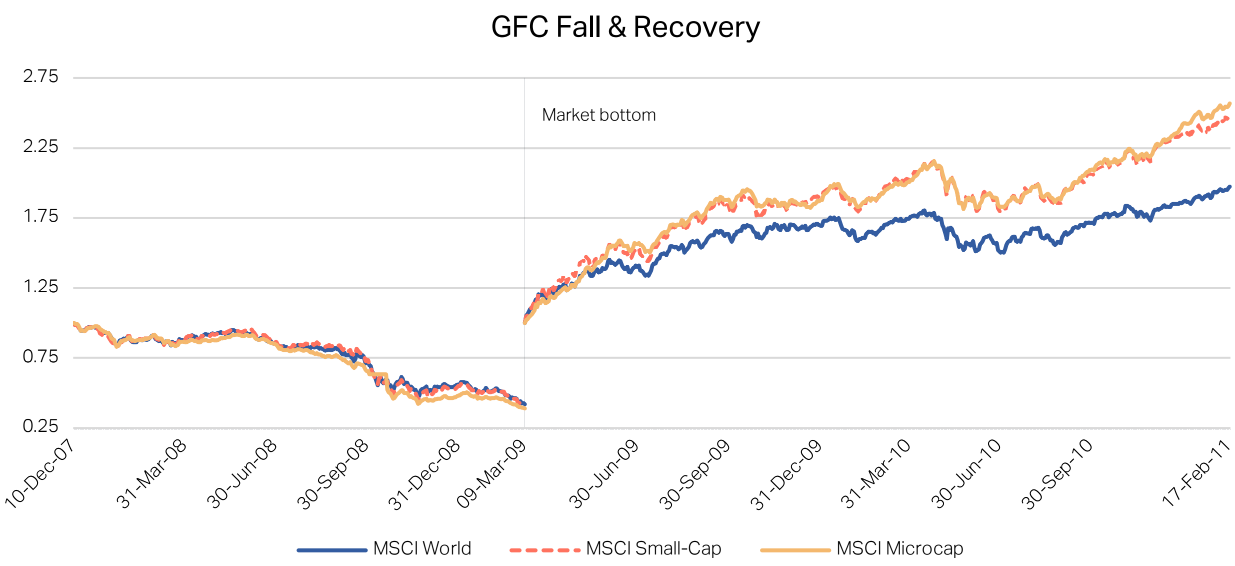


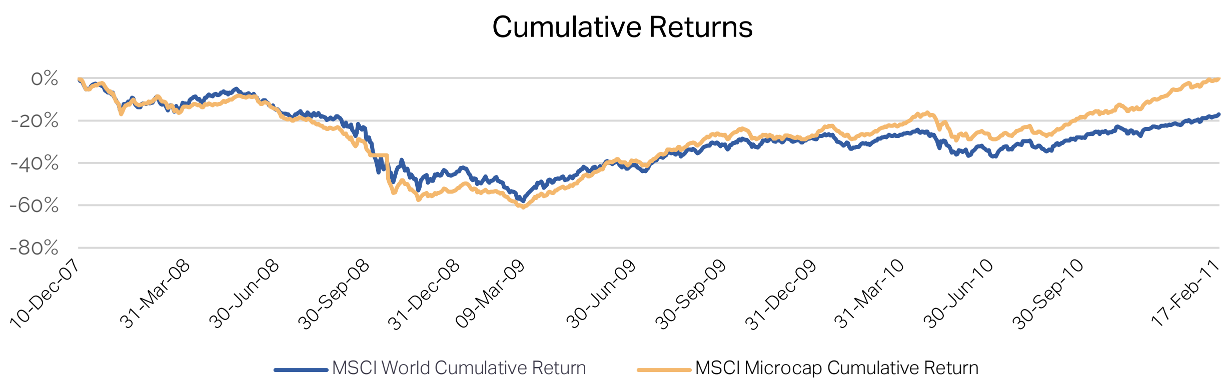
Figure 5. Returns on the S&P500, NASDAQ and Russell 2000 for the period of 9 March 2000 to 10 November 2004. Market bottom 9 October 2002. Source: Bloomberg.

An alternative data source to explore this period is the Wilshire Indices. These are even more flattering to microcaps. These indices suggest that US Microcaps only fell 45% compared to 47% for small-caps and 49% for large caps. Microcaps bottomed far earlier in December 2000, while small-caps and large caps did not trough until October 2002. By the end of 2004, the Wilshire Microcap Index had already recovered 161% from its lows[5].

The dot-com experience shows that Microcaps are particularly appealing during a period of heightened market valuations since they typically trade at a discount to larger stocks. However, the drawback of microcaps can be a heightened sensitivity to economic shocks.

The GFC illustrates that this is a favourable trade-off. The underperformance of Global Microcaps during the GFC was only marginal before the asset class lead the market's recovery higher. From peak to trough, during the GFC, World Microcaps declined 61% in USD, slightly more than the World Large Cap Index decline of 58%. However, from the trough on 9 March 2009, microcaps had recovered fully by February 2011. The large cap MSCI World Index did not breakeven until December 2013.



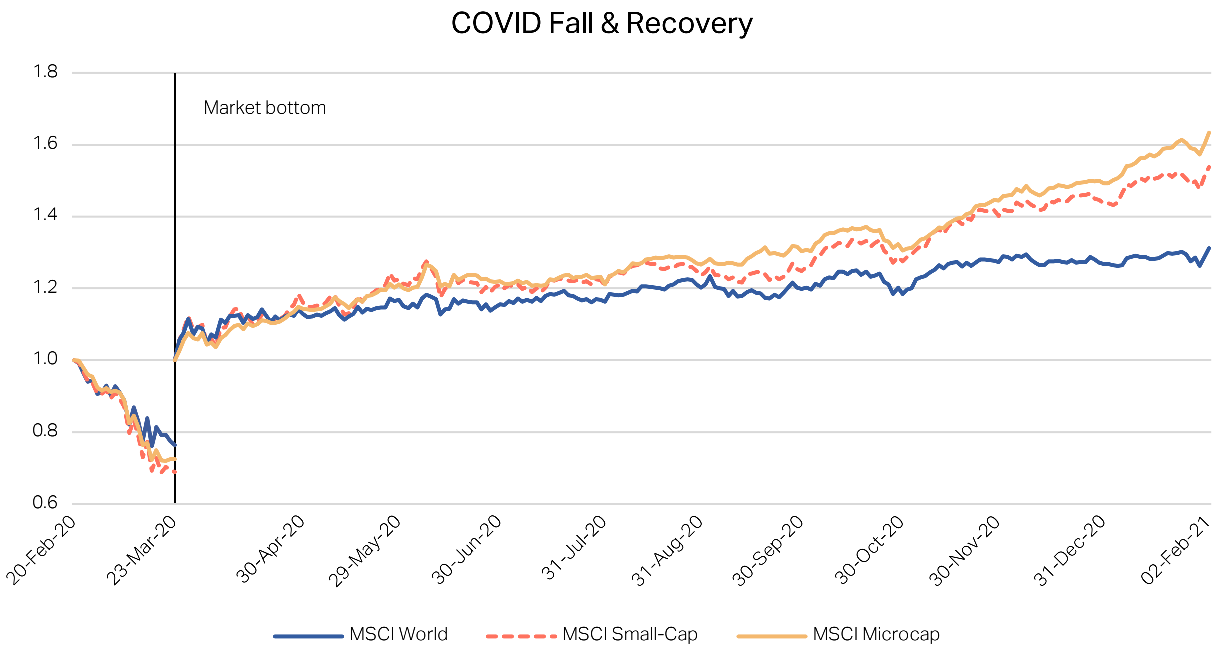


Past performance is not a reliable indicator of future performance.

Figure 6. $US returns on the MSCI World Large Cap Index (MSCI World), MSCI World Small-Cap Index (MSCI Small-Cap) and MSCI World Microcap Index (MSCI Microcap) for the period of 10 December 2007 to 17 Feb 2011. Market bottom 9 March 2009. Source: MSCI, Bloomberg.

[5] Source: Bloomberg

And again, during Covid, we saw the same pattern. The World Microcap Index underperformed the World Large Cap Index by 3.9% on the drawdown, but from the lows had already outperformed its larger counterpart by 10.5% when September 2020 finished. The World Large Cap Index had fully recovered by early February 2021, one of the sharpest rebounds on record. However, by that time, the MSCI World Microcap Index was already up 18.4% from its pre-COVID levels.



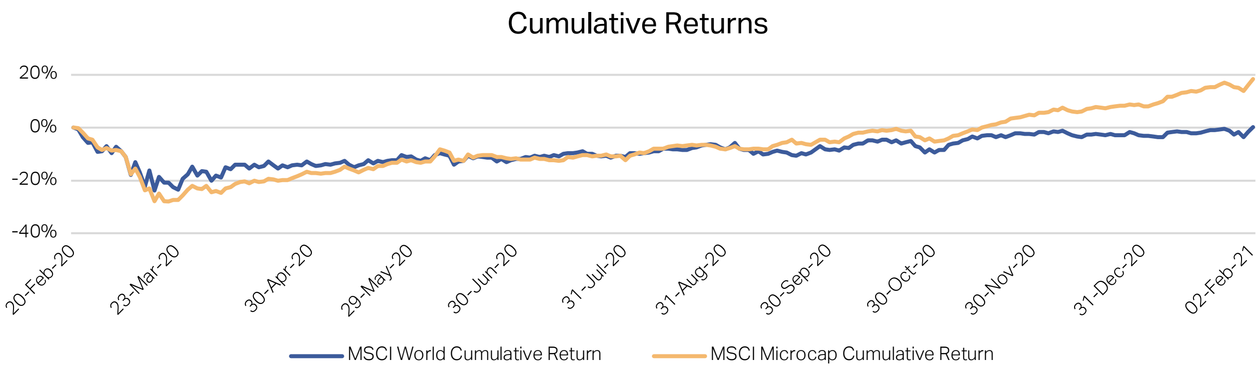


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Figure 7. $US returns on the MSCI World Large Cap Index (MSCI World), MSCI World Small-Cap Index (MSCI Small-Cap) and MSCI World Microcap Index (MSCI Microcap) for the period of 20 February 2020 to 2 February 2021. Market bottom 23 March 2020. Source: MSCI, Bloomberg.

We will detail Spheria's investment approach later, but suffice to say, its investment process and philosophy are focused on risk mitigation. Given the long-term outperformance of larger stocks by microcaps, and the superior growth these companies achieve off a low base, Spheria assess that there is no requirement to take on needless risk given these return tailwinds.

During the Covid drawdown[6], Spheria's Global Microcap Fund outperformed even the large cap MSCI World Index after fees. The Fund was not caught flat-footed during the rebound either, securing an after fees return of 27.6% by September end. In comparison, the MSCI World Index had rebounded 19.8%.

Portfolio/Index	Peak-to-Trough Drawdown
Spheria Global Microcap	-23.1%
MSCI World Microcap	-27.5%
MSCI World Small Cap	-31.0%
MSCI World Large Cap	-23.6%

Figure 8. Holding period $A returns from the peak-to-trough period of 20 February 2020 to 23 March 2020 for the Spheria Global Microcap Fund net of fees, MSCI World Microcap Index, MSCI World Small-Cap Index, and MSCI World Large Cap Index. Source: Spheria, MSCI, Bloomberg.

Compared to the far larger MSCI World Microcap Index, the Spheria Global Microcap Fund displays impressive downside capture[7]. This risk control is a combination of Global Microcaps diversification benefits and the conservative Spheria investment philosophy and process.

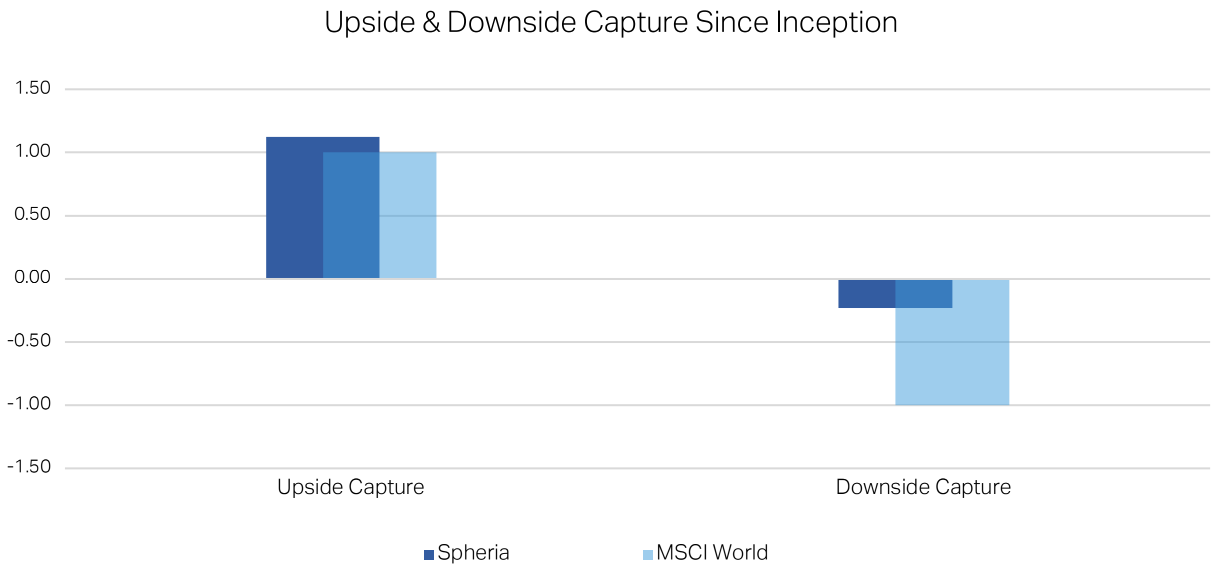

Figure 9. Upside and downside capture of the Spheria Global Microcap Fund relative to the MSCI World Index for the period of 1 March 2019 to 31 July 2021. Source: Spheria, MSCI.

[6] Peak-to-trough defined as 20 Feb 2020 to 23 March 2020.

[7] Upside/downside capture calculated as the ratio of the Spheria Global Microcap Fund's return versus the benchmark during periods where the benchmark has increased for upside capture and decreased for downside capture, calculated using monthly return data. Source: MSCI, Spheria.

A Solution to a Crowded Trade

The US market has led global indices higher since the GFC. The MSCI World Index is now dominated by the country, accounting for 67.7%. The MSCI World Small-Cap Index is only slightly more diversified, with the US constituting 58.8%. Magnifying this lack of diversity is the increased concentration of the US market. As Morningstar notes below, this is now the most concentrated US market in most investors' careers.

S&P 500 Top 10 Weightings

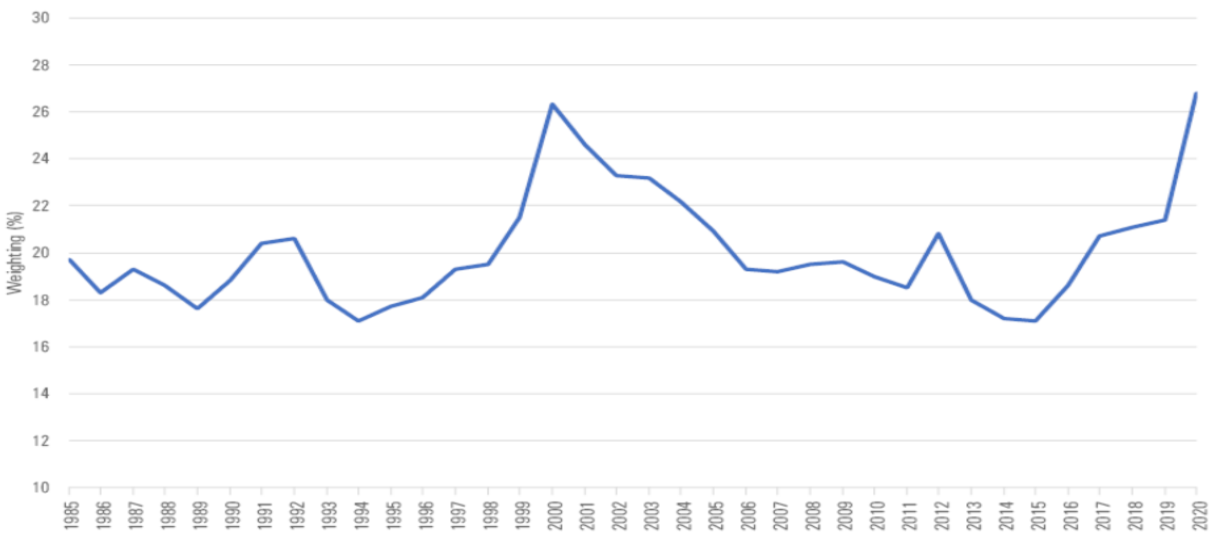

Figure 10. Weightings of the top 10 holdings in the S&P500 from the period of 1985 to 2020. Source: Morningstar.

For investors concerned about this concentration risk, Global Microcaps offers a compelling alternative. The World Microcap Index has only a 25.6% weighting to the US market. Spheria's Fund, seeing better opportunities elsewhere, has an even lower weighting of only 20.3%. Less reliance on the US market makes way for meaningful allocations to highly innovative countries such as the UK, Germany, Japan, Sweden, Norway, Finland, Switzerland, and Israel.

Portfolio/Index	US Weighting
Spheria Global Microcap	20.3%
MSCI World Microcap	25.6%
MSCI World Small Cap	58.8%
MSCI World Large Cap	67.7%

Figure 11. Comparison of United States weighting of the Spheria Global Microcap Fund, MSCI World Microcap Index, MSCI World Small-Cap Index and MSCI World Large Cap Index. Source: Spheria, MSCI.

The US outperformance of other global markets, fuelled by the rise of passive funds, has stretched the earnings multiples for US large caps. The charts below[8] show the significant premium US markets are trading to the rest of the world and smaller peers. As a result, investors are increasingly heeding the risk of market over-valuation and exploring alternatives.

Despite the Spheria Global Microcap Fund's significant discount on valuation multiples, there is no trade-off in quality. The table below highlights the investment metrics of each Index and the Spheria Global Microcap Fund. Because the Global Microcap universe is so vast and the companies so poorly covered, an active manager like Spheria does not need to compromise when constructing a portfolio. In addition, the extensive Benchmark (6,200 securities) results in a high active share, eliminating any temptation for a manager to hug the Index.

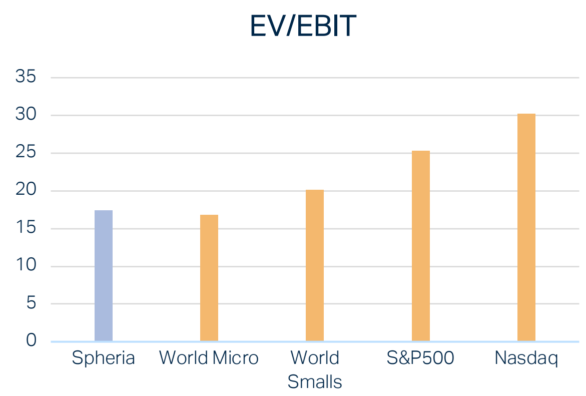

Figure 12. EV/EBIT and Price/Book ratios of the Spheria Global Microcap Fund, MSCI World Microcap Index, MSCI World Small-Cap Index, S&P500, and NASDAQ. Source: Spheria, Bloomberg.

	Average Mcap (USD)	EPS Growth (%)	Trailing FCF Yield (%)	Dividend Yield (%)	Net Debt / EBITDA	Cash Conversion (%)
Spheria	840	41.2	4.1	2.4	-0.5	116.5
World Micro	198	-4.2	2.6	2.3	1.0	73.2
World Smalls	2,470	18.6	3.6	1.8	1.9	86.2
S&P500	82,539	44.0	3.4	1.3	0.7	109.6
Nasdaq	7,974	37.4	3.2	0.7	0.0	115.1

Figure 13. Weighted average metrics of the Spheria Global Microcap Fund, MSCI World Microcap Index, MSCI World Small-Cap Index, S&P500, and NASDAQ. Source: Spheria, Bloomberg.

As the table shows, the Spheria Global Microcap Fund metrics are on par, or even better than the largest US companies, despite the discount in trading multiples. In particular, it highlights Spheria's hallmark philosophy of focusing on companies with strong free cash flow conversion. The far-right column shows that this metric is typically a differentiator between smaller companies and larger ones. However, Spheria's process ensures that the Fund's companies have the same quality and sustainable earnings as companies in the S&P500. From a risk perspective, the portfolio's balance sheet is net cash, and its free cash flow yield is superior to all Indices displayed.

8 All metrics as at 19 August 2021. EV/EBIT uses current EV and 1-year forward analyst EBIT estimates. Price/Book uses current share price and previous financial year end book value.

Spheria Asset Management – Over 100 Years of Combined Experience

The Spheria Asset Management team is one of Australia's most experienced and respected small-cap and microcap fund managers. The Australian Microcap Fund has returned 15.4% p/a since its inception in May 2006, comfortably outperforming its Benchmark by 4.5% p/a. This proven investment process is now available across a much larger universe in the Spheria Global Microcap Fund.

Portfolio Manager Gino Rossi has many years of investment experience across firms such as Citigroup, Credit Suisse Asset Management and Renaissance Asset Management. He is supported by a team of dedicated equity analysts and Investment Chair, Marcus Burns. Marcus is the co-Portfolio Manager on the domestic funds and brings many years of international and microcap investment expertise.

Spheria's investment process is differentiated on several fronts and has produced exceptional risk-adjusted returns to date:

- Capital preservation: Valuation discipline protects the downside. Each company is valued using a consistent model and discounted cash flow framework. The portfolio has a net cash balance sheet.
- Lower volatility: The Fund is style neutral, resulting in a low beta and consistent performance.
- Active management: The Fund is relatively concentrated compared to peers with approximately 50 holdings, and active share is typically in the high 90s.
- Differentiated portfolio: Most new stock ideas come from the firm's proprietary machine learning screens. As a result, the Fund's holdings are unlikely to have significant cross-over with other managers.

Net Performance as at 31st August 2021

Period	1 month	3 month	1 year	2 years (pa)	Since Inception (pa)	Inception Date
Spheria Global Microcap Fund	2.8%	8.0%	46.9%	31.1%	26.2%	1/03/2019
Benchmark	2.6%	4.9%	60.3%	28.9%	22.4%	
Outperformance	0.2%	3.2%	-13.4%	2.3%	3.8%	
MSCI World Small Cap (Ex-AU)	3.0%	7.9%	43.8%	18.3%	15.7%	
Outperformance	-0.2%	0.1%	3.1%	12.8%	10.5%	
MSCI World Large Cap	3.1%	12.1%	31.3%	18.2%	18.2%	
Outperformance	-0.2%	-4.1%	15.6%	13.0%	8.0%	

Figure 14. Spheria Global Microcap Fund performance table. Benchmark was the MSCI Kokusai Microcap Index Net in AUD until 30 June 2021 and is now the MSCI World Microcap Index net in AUD. Inception date is 1 March 2019. MSCI World Small Cap (Ex-AU) and MSCI World Large Cap stated in AUD. Past performance is not a reliable indicator of future performance. All returns are calculated on an annualised basis using exit price to exit price with distributions reinvested. Returns of the Fund are net of applicable fees, costs, and taxes.

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