LONGWAVE AUSTRALIAN SMALL COMPANIES FUND
A CLASS REPORT ARSN 630 979 449

LONGWAVE CAPITAL

**MONTHLY REPORT** JANUARY 2022

## FUND PERFORMANCE TO 31 JAN 2022

| | 1M | 3M | 6M | 1yr | 3yr p.a. | 5yr p.a. | SI³p.a. |
|---|---|---|---|---|---|---|---|
| Net Fund Performance[1] | -7.4% | -6.3% | -3.6% | 7.5% | | | 8.2% |
| Benchmark Performance[2] | -9.0% | -8.0% | -4.6% | 6.7% | | | 7.5% |
| Excess Return | 1.6% | 1.7% | 1.0% | 0.9% | | | 0.8% |

**1.** Return net of 0.89% p.a. management fee. **2.** S&P/ASX Small Ordinaries Accumulation Index. **3.** Inception date: 31 Oct, 2019. Past performance is not a reliable indicator of future performance, p.a performance is annualised.

The Longwave Australian Small Companies Fund decreased by 7.4% during January 2022, outperforming the 9.0% decrease in the S&P/ASX Small Ordinaries Accumulation Index benchmark by 1.6% over the month.

## IS THE (LIQUIDITY) PARTY OVER?

Inflation, interest rates and liquidity. The equity market is finally taking notice that all three of these issues are very real. The most speculative stocks were the biggest beneficiaries of recent liquidity abundance and are now most at risk should liquidity retreat – which is exactly what bond markets and most central banks are confirming.

In short, the Fed has signaled the liquidity party in SPACs, tech, crypto, concept stocks and promotions is now over. Please go home.

Investment results are best considered over a full cycle, and in the case of monetary policy and liquidity we are now seeing what the other half of that looks like. In the past two years we have often been asked if our definition of quality costs us the ability to participate in innovation. Putting aside how early you need to be in the innovation cycle to capture outstanding returns we question whether much of what passed as innovation by companies and alpha by investors was anything more than just a liquidity bubble.

I guess we will only know for sure once this cycle completes, but it does make a mockery of the popular growth stock returns narrative, which may be explained almost completely by sentiment and not at all by superior business performance.

## GENERATING POSITIVE RETURNS IN A DEFLATING BUBBLE

Many investors draw parallels between this market to the tech bubble and aftermath in the early 2000s. We think this a very instructive analogy, but a more recent period may also hold lessons for small cap investors navigating the next few years.

For six long years, from December 2010 to December 2016, the S&P/ASX Small Ordinaries index delivered investors zero total return as the resources and mining services bubble – which had grown to a huge weight in the index – crested and painfully deflated. Because there was such high divergence in returns before and then during this deflation period, many active small cap managers were still able to generate reasonable absolute returns (5-10% or more per annum) from 2010 to 2016. The trick of course was to avoid getting caught up in the deflation of market values for those stocks that had run up hard in the commodity super cycle (after the peak the small resources index declined by 17.5% per annum from Dec 2010 to Dec 2016) and invest in previously unpopular, overlooked and under-valued companies (the small industrials index increased by 8% per annum over the same period).

Today, dispersion in the small cap market is similarly extreme. This means active managers have many compelling investment opportunities away from stocks exposed to liquidity withdrawal and excessive valuation. Microcap stocks are probably the most at risk given their high prices, lack of profitability and sensitivity to liquidity conditions. Microcaps in January 2022 remind us of small resources in December 2010.

For many months we have discussed what these opportunities look like – and for a sample of names readers can always refer to the top 10 fund holdings – but to reiterate what we believe will allow investors continuing to generate returns worthy of staying invested in equities, below is a list of attributes to consider:

- A proven business model and aligned management who can reinvest excess cashflow into sensible growth opportunities (organic and/or M&A)
- Cash generative business with a high return on equity

## TOP 10 HOLDINGS

| **Name** (Alphabetical) |
|---|
| Brickworks Ltd |
| Corporate Travel Management Ltd |
| CSR Ltd |
| Fletcher Building Ltd |
| Iluka Resources Ltd |
| Janus Henderson Group PLC |
| Mainfreight Ltd |
| News Corp |
| Spark New Zealand Ltd |
| Viva Energy Group Ltd |

## FUND AND BENCHMARK SECTOR WEIGHT (%)

| | Fund | BM² |
|---|---|---|
| Communication Services | 8.2 | 5.6 |
| Consumer Discretionary | 16.3 | 14.9 |
| Consumer Staples | 3.4 | 4.8 |
| Energy | 8.2 | 4.9 |
| Financials | 10.9 | 10.6 |
| Health Care | 4.9 | 6.2 |
| Industrials | 10.2 | 7.4 |
| Information Technology | 6.6 | 10.1 |
| Materials | 21.6 | 20.6 |
| Real Estate | 7.4 | 15.0 |
| Utilities | 0 | 0 |
| Cash | 2.5 | 0.0 |

## STOCK ATTRIBUTION (ALPHABETICAL)

| **Top 5 - Contributors** |
|---|
| Chalice Mining Ltd |
| Megaport Ltd |
| Novonix Ltd |
| Pinnacle Investment Management Group Ltd |
| Zip Co Ltd |

| **Bottom 5 - Detractors** |
|---|
| Brainchip Holdings Ltd |
| Fletcher Building Ltd |
| Janus Henderson Group PLC |
| Mainfreight Ltd |
| Viva Energy Group Ltd |

*CONTINUED*

- Strong balance sheet
- Clean accounting – no excessive expense capitalisation, aggressive revenue recognition or high equity dilution
- An ability to grow organically
- Strong or improving sustainability (ESG) characteristics
- Possibly a boring industry that has been ignored for the past few years
- Reasonable or even cheap valuation

At the end of January, our portfolio is composed of companies that have in aggregate grown EPS at 15% per annum for the past three years but have been de-rated (PE multiples have declined) as the market was more interested in paying up for "liquidity party" stocks. Our current portfolio look-through return on equity is almost 20% and after price declines in January the P/E multiple is now around 13x. Expressed as a pre-tax earnings yield, our portfolio is offering almost 9% more than the Australian 10yr government bond – a metric worth watching as bond yields rise.

Innovation is not over. We will always be on the lookout for genuinely innovative companies that solve customer problems in novel ways and have an economic competitive advantage that captures this value for shareholders. Hopefully the current turmoil and the upcoming reporting season provides more of these opportunities for the fund.

February 1st, 2022 marks the first three years of the Longwave Australian Small Companies fund performance. Few strategies can outperform in every short-term market environment. Even fewer can do so applying a long term, low turnover investment strategy where the goal is not to keep churning the portfolio into the stocks *du jour*. We are often asked "in what market environment would your investment approach struggle?". Before COVID, we had said a period like the dot-com bubble in the late 1990s was one in which we would likely struggle to outperform, as fundamentals and valuation took a back seat to sentiment and liquidity. Given the lessons of this period were recent and accessible to investors we thought it unlikely to recur anytime soon. We were wrong. The period from April 2020 to November 2021 ended up being exactly that type of market. So more than 50% of the first three years of our fund performance has been in a period quite hostile to our investment approach. We managed to tread water rather than sink in relative performance terms, holding the portfolio in good stead as we likely move into a market better suited to our fundamental quality and valuation based approach.

## PORTFOLIO POSITIONING AND PERFORMANCE

January performance was marked by sharp declines across risk assets globally, led downward by those perceived most vulnerable to a liquidity withdrawal and a re-pricing of risk. That Australian microcaps still managed to fall less than small caps continued 10 months of microcaps bucking the global trend of re-pricing high risk, illiquid and unprofitable businesses. We have no idea how long Australian microcaps can resist the liquidity re-pricing and we are wary of assuming it continues.

Contributors to fund performance was dominated by the long list of stocks we don't own for reasons of poor quality, unfavourable valuation or both such as Megaport, Zip Co, Novonix, Chalice Mining, Pointsbet, Imugene, Redbubble, Dubber and Temple & Webster. Many of these names fell 20 – 40% in a month, but even after this price adjustment few of them are attractive enough to buy under our investment process.

Detractors included Brainchip (+109%, not owned) and some of our larger positions that couldn't avoid the widespread sell off, despite already being attractively valued and having no internal liquidity issues. These names include Mainfreight, Janus Henderson, Viva Energy, Fletcher Building and Adairs (which did have a trading update during the month highlighting the near-term financial pain inflicted by Omicron over the Christmas trading period).

During February we expect volatility from external and macro influences to be replaced or at least joined by volatility from financial reporting. Given the huge dispersion in prices over the last few months, there may be more than a few opportunities.

| Fund characteristics | |
|---|---|
| NAV | A$1.1278 |
| Redemption unit price | A$1.1244 |
| Inception Date | 31 Oct, 2019 |
| Minimum Investment | A$25,000 |
| Management Fee | 0.89% p.a. |
| Performance Fee | - |
| Buy / Sell Spread | 0.30% / 0.30% |
| Benchmark | S&P/ASX Small Ordinaries Accumulation Index |
| Distribution frequency | Half-yearly |
| Portfolio FUM (A$m) | 5.2 |
| No. of Holdings: | 126 |
| Portfolio Managers | David Wanis, Jai Beathe & Melinda White |
| Strategy FUM (A$m): | 182.8 |

## INVESTMENT OBJECTIVE

The Fund aims to outperform the S&P/ASX Small Ordinaries Accumulation Index over the long term.

The Fund aims to provide long-term capital growth through investment in a diversified portfolio of high-quality Australasian small companies (outside S&P/ASX 100 Index at time of investment or expected to be within six months).

## INVESTMENT STYLE

Longwave's investment philosophy is underpinned by the belief that the stocks of high-quality small companies outperform the benchmark over time, and as such, an active approach to investing in high-quality stocks provides value to investors who might otherwise have invested passively. Longwave believes in the value of a deep and fundamental understanding of the securities in which we invest.

Recommended
Lonsec Research

Zenith
APPROVED

Signatory of:

PRI Principles for Responsible Investment

LONGWAVE CAPITAL

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