

FUND PERFORMANCE (AFTER FEES) TO 31 MAR 2024

	1M	3M	6M	1yr	2yr p.a.	3yr p.a.	SI ³ p.a.
Net Fund Performance ¹	3.7%	6.3%	14.3%	15.6%	5.3%	8.0%	8.1%
Benchmark Performance ²	4.8%	7.5%	16.7%	13.8%	-0.6%	2.7%	4.7%
Excess Return	-1.0%	-1.2%	-2.4%	1.8%	5.9%	5.3%	3.5%

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 Small Companies Fund increased by 3.7% during March 2024, underperforming the 4.8% increase in the S&P/ASX Small Ordinaries Accumulation Index benchmark by 1.0% over the month (after fees).

THINGS YOU SEE IN A RECOVERY

For 26 months we have been tracking the [anatomy of a small cap drawdown](#). All the signs have been there that we were closer to the end than the beginning of small cap underperformance for some time, specifically:

- > **Duration of drawdown:** The prior longest was post the tech bubble bursting in 2000 at 18 months, and the current episode surpassed that length in mid 2023,
- > **Magnitude of drawdown:** in the GFC we saw 20-25% small cap index underperformance. In the tech wreck we saw 35%. This time we got to around 25-30%,
- > **Liquidity:** on multiple measures, the liquidity of the small cap market collapsed. Trading volumes dropped around 50% from peak (early 2021) to trough (late 2023). Weighted average bid-ask spreads for stocks in the Small Ords index widened from 27/28 bps (mid 2021) to 40bps (mid 2023),
- > **Capital markets:** IPO activity completely dried up,
- > **Client allocations:** By 2023 it seemed like everyone was underweight small caps and most people were not interested in adding back. This included large cap managers who tend to move in and out of the small cap market – and who for the past two years have been actively tilting large (there is a reason CBA is at record levels).
- > **Macro fear:** the single biggest fear holding back most investors was the view that a recession was highly likely and if it occurred small caps would get smashed. This may be true, but recession forecasting has a bad track record and there surely is the chance we don't get one? There is also a chance we still do. We offer no view here.
- > **Valuations:** Valuation multiples on small caps compressed relative to large caps. We could never see this as starkly in Australia as some commentators suggested (it was clearer overseas) and we are a bit wary of torturing data to make the story fit. Even if valuations were not at "generational low levels" they were certainly more attractive, particularly relative to the growth options many small caps have.

It started to get old. Investors who have been through multiple cycles rightly (in our view) figured this was just another one and when the market gives you opportunities you probably should take them. Having reached a low in October 2023, small caps have recovered and are now running line-ball with large cap returns over the past year. Some signs that life is returning to the small cap market and we could be in the midst of a recovery include:

- > **Earnings are OK:** the most [recent reporting season](#) confirmed what many companies had been telling investors during the latter part of 2023. The environment remains challenging (inflation, interest rates, consumer sentiment etc) but not collapsing. In some of the more economically sensitive sectors, earnings were much better than expected 6-9 months ago, and across the board earnings expectations mostly held up,
- > **M&A activity has picked up sharply:** One of the clearest signs that values are compelling is control buyers are willing to cross a 30% spread (ie: pay the control premium) to take companies private while public market investors watch from the sidelines.

TOP 10 HOLDINGS

Name (Alphabetical)
Auckland International Airport Ltd
Beach Energy Ltd
Brickworks Ltd
Corporate Travel Management Ltd
Harvey Norman Holdings Ltd
HUB24 Ltd
Mainfreight Ltd
Netwealth Group Ltd
Super Retail Group Ltd
Webjet Ltd

FUND AND BENCHMARK SECTOR WEIGHT (%)

	Fund	BM ²
Communication Services	3.7	4.4
Consumer Discretionary	25.2	16.7
Consumer Staples	1.1	2.6
Energy	8.3	8.0
Financials	11.6	10.1
Health Care	4.9	6.1
Industrials	16.0	8.2
Information Technology	6.2	6.3
Materials	16.4	24.4
Real Estate	5.0	13.2
Utilities	0	0
Cash	1.6	0.0

STOCK ATTRIBUTION (ALPHABETICAL)

Top 5 - Contributors
Beach Energy Ltd
Imdex Ltd
MMA Offshore Ltd
Netwealth Group Ltd
Webjet Ltd

Bottom 5 - Detractors

Alumina Ltd
Bellevue Gold Ltd
Life360 Inc
Paladin Energy Ltd
Sandfire Resources Ltd

- > **Early signs of life in IPOs:** Will the Reddit IPO in the US signal the re-opening of the market? Maybe. We do know that there are a lot of privately held companies itching for some exit liquidity – whether they are over-seasoned VC funds, pre-IPO funds that were expecting to list years ago or private equity funds needing to turn their marked positions into real cash (and bankable carry). If the quality of issues is anything like what we saw last cycle (2020/21) we are unlikely to participate in much, but the noise, excitement, and FOMO it creates does tend to spill over into small caps more generally.

WHY DOES THIS MATTER?

Active small caps generate significant alpha, not just relative to the passive small cap benchmark but also to large caps (both passive and active). This alpha is not evenly distributed over time, and a significant portion of a through-the-cycle excess return from small caps comes in the early stages of a recovery.

If we look at the prior cycle recoveries from 2003 and 2009 respectively, we saw **small cap index outperformance of large caps by 20% (2003) and 30% (2009) within the first six months**. In both cases, the active small cap managers tended to pace the index in the first phase of the recovery then **continue to outperform both small and large indices for the next 3 years**. It is a domestic sample size of two, and the drawdown experience has shown that every cycle is different, but research across cycles and across markets (many samples) confirms this pattern. Sharp small cap outperformance in the early stages of a recovery is very common. Missing this can undermine the through the cycle benefits of actively investing in small caps.

Timing this cycle is outside our process. More specifically, members of the Longwave investment team undertook significant research earlier in our careers on timing models for Australian small vs large caps and found nothing that worked better than having a small cap strategy designed to perform through the cycle held as a strategic allocation and diversified to other asset allocations in the total portfolio.

So that is what we believe.

- > The benefits of active small caps to long-term returns are clear.
- > The ability to time Australian large vs small through cycles is very very hard.
- > Therefore, hold a strategic allocation to a small cap strategy that can perform well through the cycle, and most market regimes (value / growth, bull / bear, industrial / resources, inflation / deflation) and stick to the plan. [Simple but not easy](#).

PORTFOLIO POSITIONING AND PERFORMANCE¹

We have been on the road post reporting-season seeing a range of companies in our portfolio, and also some that are operating in the same sectors. What struck us in this series of meetings was an element of company lifecycle that is one of the more universally elegant and exciting aspects of investing in smaller companies.

[We've talked before](#) about the stages of a company lifecycle and how these stages are also characterized by particular cultural or company traits, along with financial characteristics. One of the traits that struck us this month was how nimbleness and innovative thinking has led a range of different businesses in Australia to find market niches (some which have become globally relevant), exploit them, and as a result either benefit financially from larger sector-specific events (AQZ) or become global leaders in their field (PWH, REA).

Nimbleness is a nebulous concept, but we think it turns up in smaller companies for a range of reasons. The smaller you are, the harder it is to survive. The result of this is that whole teams of people learn in real-time how to do more with less but still meet customer expectations. When presented with lots of constraints, a team of can-do people will often see an opportunity that a bigger team (company) can't. Management structures tend to be flatter by sheer dint of a smaller workforce. This results in innovative ideas flowing up and down the decision-making chain more freely.

With patience and time, exploiting these initially small niches can pay off handsomely. A global market can eventually morph towards an initially innovative way of doing things (REA, DHG), making the original innovators global leaders. Or, in the case of Power Holdings, growth in one niche (motor sports cooling plates) can eventually give the company the resources to innovate and penetrate in another, bigger global market (aerospace). This is just one feature, that can make small-cap investing so rewarding.

Fund characteristics	As at 31 Mar 2024
NAV	A\$1.1844
Redemption unit price	A\$1.1808
Inception Date	31 Oct, 2019
Minimum Investment	A\$25,000
Management Fee	0.89% p.a.
Performance Fee	-
Risk/Return profile	High
Buy / Sell Spread	0.30% / 0.30%
Benchmark	S&P/ASX Small Ordinaries Accumulation Index
Distribution frequency	Half-yearly
Portfolio FUM (A\$m)	17.8
No. of Holdings:	115
Portfolio Managers	David Wanis, Jai Beathe & Melinda White
Strategy FUM (A\$m):	791.7

INVESTMENT OBJECTIVE

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

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.



Signatory of:



Supporter of:



¹ Illustrative only and not a recommendation to buy or sell any particular security.



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Link to the Product Disclosure Statement: [WHT9368AU](#)

Link to the Target Market Determination: [WHT9368AU](#)

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