LONGWAVE AUSTRALIAN SMALL COMPANIES FUND

A CLASS REPORT ARSN 630 979 449

LONGWAVE CAPITAL

MONTHLY REPORT NOVEMBER 2022

FUND PERFORMANCE (AFTER FEES) TO 30 NOV 2022

	1M	3M	6M	1yr	2yr p.a.	3yr p.a.	SI³p.a.
Net Fund Performance[1]	3.9%	3.3%	2.0%	-2.1%	7.0%	5.7%	6.8%
Benchmark Performance[2]	4.9%	-0.8%	-3.4%	-14.0%	0.9%	2.6%	3.0%
Excess Return	-1.0%	4.1%	5.3%	11.9%	6.1%	3.1%	3.8%

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 Small Companies Fund increased by 3.9% during November 2022, underperforming the 4.9% increase in the S&P/ASX Small Ordinaries Accumulation Index benchmark by 1.0% over the month (after fees).

SMALL CAP MYTH BUSTING

As we look back on 2022, we remind investors not all beliefs they hold are true. We have highlighted some of the most common and strongly held small cap beliefs we encountered in our conversations with investors this year and why we think they may be wrong.

More Concentration = Higher Returns

Beyond around 30 stocks the benefit to volatility of adding more stocks is limited. But the belief that this extends to a) risks beyond volatility – itself a poor measure of true risk and b) returns within the small cap universe is assumed, and in our view false. The belief in volatility reduction from more stocks translating to other outcomes is the closest thing we have seen to a Mandela Effect in equity markets.

We highlighted this empirically in 20 years of small cap fund returns analysis published in September this year.

Why broader portfolios can perform as well as more concentrated portfolios is driven by the positive skew in individual stock returns – which is even more pronounced in small caps than large. This means the median stock return is lower (sometimes much lower) than the average stock return. Index returns look more like the average due to their breadth. Concentrated portfolios, if they happen to miss the small number of big winners (or in small caps catch too many of the big losers), will fall short.

Investors can test this for themselves mathematically with a simple toy model, empirically observe it in fund returns (as above) or think about the way success and failure works in the real world. There are also many studies over more than 25 years confirming this effect.

High Conviction = Low Stock Numbers

As small cap investors we have a very large potential investment universe to choose from – more than 1,000 stocks in most years and over 1,200 stocks today. This universe is far more dynamic (names entering and exiting) than the almost static large cap opportunity set (ASX100). We also work within a far more skewed universe – bigger winners and bigger losers. Finally, it is well known that broker stock coverage in small caps is much lower than large caps. This also extends to professional investors – where the ratio of investment analysts to individual stocks in large caps is 10-50x greater.

Small caps are different to large caps in many ways.

To us conviction is less about an arbitrary number of stocks in a portfolio, rather it reflects unwavering commitment to our quality investment philosophy. We have the conviction to pass on more than 90% of stocks in our universe failing our quality hurdles. This can be painful at times (like mid 2020 to late 2021) when low quality, speculative investing was wildly popular. Conviction requires discipline to say no.

In order to capture long term returns, conviction also requires a willingness to hold companies as they compound over many years (patience) and be willing to sell holdings when the investment thesis breaks and we are wrong (humility).

In our view, a 100 quality stock portfolio, deliberately selected and actively managed from 1,200 opportunities can be higher conviction than 30 stocks selected from the ASX 100. Given more concentrated small cap portfolios have other downsides and no higher returns, we wonder what we are really missing by not holding fewer names?

CONTINUED

TOP 10 HOLDINGS

Name (Alphabetical)
Auckland International Airport Ltd
Beach Energy Ltd
Brickworks Ltd
Fletcher Building Ltd
Janus Henderson Group PLC
Mainfreight Ltd
New Hope Corp Ltd
News Corp
Spark New Zealand Ltd
Viva Energy Group Ltd

FUND AND BENCHMARK SECTOR WEIGHT (%)

	Fund	BM²
Communication Services	7.0	5.1
Consumer Discretionary	16.5	13.7
Consumer Staples	2.4	4.2
Energy	9.0	5.8
Financials	11.6	11.1
Health Care	3.7	6.6
Industrials	15.6	7.8
Information Technology	4.0	7.9
Materials	19.2	24.6
Real Estate	7.9	13.3
Utilities	0	0
Cash	3.2	0.0

STOCK ATTRIBUTION (ALPHABETICAL)

Top 5 - Contributors
Auckland International Airport Ltd
Beach Energy Ltd
Imdex Ltd
Janus Henderson Group PLC
National Storage REIT

Bottom 5 - Detractors
Bellevue Gold Ltd
Capricorn Metals Ltd
Chalice Mining Ltd
Seven Group Holdings Ltd
Webjet Ltd

Small Cap Alpha only comes from Informational Edge

Investment edge comes in many forms, as we discussed in October using the Behavioural, Analytical, Informational and Technical (BAIT) framework.

All small cap investing edge is informational remains a persistent myth. More company meetings = more alpha. More broker meetings = more alpha. More conferences = more alpha. We believe alpha should be sought from all sources of edge, and often those overlooked – such as behavioural edges – can be more durable.

2022 highlighted ignored behavioural or analytical considerations had built up in many investor portfolios during 2020 and 2021 and the adjustment this year was painful.

Value or Growth is the driver of long-term investment performance

Value and growth are labels used to cluster the temporary character of stocks and the styles of fund managers who hold them. A whole industry forever tries to figure out which is better – or which is better right now. In reality, long term returns are driven by the fundamental performance delivered by businesses – EPS growth and dividend yield. Changes in valuation or P/E multiples - which is most of what value vs growth is about - is a total sideshow. Investors in equities should be investing for at least five years, by which time the noise from value or growth has likely cancelled out and only fundamental return drivers remain.

Rather than value or growth, quality is our laser focus and conviction in small cap investing. It is quality that delivers demonstrably superior long term EPS growth and over the past 15-20 years higher dividend yields as well.

There are short cuts to big alpha

Every year there is a new fad - SaaS, crypto, green metals, SPACs, etc. Boring, proven approaches that work slowly but with high probability over time are overlooked. Real, profitable high-quality business. Cash flow. Strong balance sheet. No funny accounting. Shareholder friendly behaviour by management and directors. Reasonable valuation. Long holding periods. Low portfolio turnover. Humility. Low costs and fees. Humans are hard wired for stories which creates behavioural blind spots for investors due to the narrative fallacy. The seduction of narratives and themes is persistent.

Myths are widely held but false beliefs. We believe these five myths are either objectively false or have a high probability of being false. Beliefs are often so strongly held they are resistant to disconfirming evidence or facts. The beauty of strongly held but untrue ideas is they become a source of durable behavioural alpha for those that side with reality. Over the long run, the market prices reality – even if short run prices reflect narratives. Resistance means that most people who read our commentary as contrary to their existing beliefs will sooner dismiss our views than change. This is good news for us as long-term investors as our investment edge will likely remain intact.

PORTFOLIO POSITIONING AND PERFORMANCE[1]

We continue to have a constructive view on small caps given the distance travelled so far this cycle and the compelling value on offer within our quality holdings. Every investor we speak with and commentator we read is certain a recession is guaranteed and positioned accordingly. Markets have a habit of not doing the one thing that all investors agree on.

The S&P / ASX Small Ordinaries Accumulation Index is up almost 12% since the end of September and although we have mostly kept up, there are a few areas this month (within resources and A-REITs) where we don't hold some big gainers. Maybe this is nothing more than a bear market rally – however the performance has been quite broad across stocks and sectors and unlike the similar rally from late June to early August, this one has not been concentrated in low quality , speculative stocks.

Most investors will probably hold their current allocations until early 2023, by which time they have time to consider if share price movements, inflation data and interest rate policy justify a more positive approach to small caps.

Fund characteristics	
NAV	A$1.0697
Redemption unit price	A$1.0665
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)	6.1
No. of Holdings:	115
Portfolio Managers	David Wanis, Jai Beathe & Melinda White
Strategy FUM (A$m):	167.4

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.

Recommended Lonsec Research

Zenith APPROVED

Signatory of:

PRI Principles for Responsible Investment

Supporter of:

TCFD TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

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