LONGWAVE AUSTRALIAN SMALL COMPANIES FUND

A CLASS REPORT ARSN 630 979 449

LONGWAVE CAPITAL

MONTHLY REPORT JULY 2022

FUND PERFORMANCE TO 31 JUL 2022

	1M	3M	6M	1yr	2yr p.a.	3yr p.a.	SI[3]p.a.
Net Fund Performance[1]	8.0%	-8.8%	-2.7%	-6.2%	10.4%		5.7%
Benchmark Performance[2]	11.4%	-9.9%	-6.6%	-10.9%	8.6%		3.5%
Excess Return	-3.4%	1.1%	3.9%	4.7%	1.9%		2.2%

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 increased by 8.0% during July 2022, underperforming the 11.4% increase in the S&P/ASX Small Ordinaries Accumulation Index benchmark by 3.4% over the month.

DÉJÀ VU ALL OVER AGAIN

"The main purpose of the stock market is to make fools of as many men as possible"

Just as the consensus had agreed that growth stocks were dead, inflation was out of control, and bond yields were only going up – these all reversed sharply in July.

With a backdrop of limited new fundamental information on company performance and outlook (which is normal in the month before reporting season) macro moves and some early US company results were enough to drive the small cap market to its best monthly return since Nov 2020 and best relative to the ASX300 since May 2020.

Fear of recession remains. The infection of earnings forecasts by economists and strategists is making some earnings revisions of less use to bottom-up investors. When a broker decides that a recession is now certain, and the sector analysts dutifully push through the expected hit to revenue and earnings, it looks like we are getting the downgrades from recessionary forces. They are a facsimile of the real thing. 'Real' earnings revisions come when management see something in the specific business drivers which differs to what analysts may have expected, and it changes the path of probabilities for future growth. Forcing these downgrades because investors lack the patience to see how the economy unfolds and businesses respond – and because everyone knows that everyone knows a recession is a sure thing – is misleading.

The linkage between inflation expectations and bond yields is fair enough. For the first time since early last year, there are signs some inflation lead indicators such as commodity prices are softening enough in the short term for the market to believe inflation may have peaked and bond yields may have overshot. The ongoing linkage between bond yields and speculative small cap stocks is however surprising – because a lot of the damage done to these company share prices in the past nine months has more to do with their weak business models and ability to generate long term cash flow. We are pragmatists and in any given month almost anything can happen with asset prices having little to do with long term fundamentals.

We mentioned a few months ago we were actively looking for potential new opportunities in stocks which had fallen a lot since late 2021. We are disappointed to report that in many cases we found companies were less appealing from a long term quality perspective than we hoped, and concerningly in some cases the management narrative around their long term potential had fallen with their share prices.

Although a few new opportunities made it into the portfolio, in July we did act on the improved value offered to us among numerous stocks we already own. Since the beginning of the year our cash weight had been increasing, mostly a result of takeover proceeds (Class Ltd, Senex, API, Western Areas) as well as the required selling down of positions in companies entering the ASX100 (eg: Iluka, Steadfast). Until late June and early July we held these proceeds in cash rather than immediately redeploying across the portfolio or into new opportunities.

As we alluded to in the report last month, despite the fears over inflation and a recession, we felt earnings downgrades were heavily discounted into prices. The upside to our estimated mid cycle valuations had increased significantly. In early July we reduced our cash holdings down from 4-6% back to our policy target of 2%.

Beyond understanding the economic, inflation and interest rate exposures in each business, it is tempting for investors to allow macro views creep into the portfolio at the sector or asset allocation level. This is not part of our process.

TOP 10 HOLDINGS

Name (Alphabetical)
Beach Energy Ltd
Brickworks Ltd
Corporate Travel Management 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	BM[2]
Communication Services	7.5	5.2
Consumer Discretionary	14.5	13.1
Consumer Staples	3.6	5.0
Energy	10.5	4.9
Financials	11.6	11.9
Health Care	4.3	6.0
Industrials	13.9	7.2
Information Technology	5.4	9.1
Materials	19.0	22.2
Real Estate	8.0	15.2
Utilities	0	0
Cash	1.8	0.0

STOCK ATTRIBUTION (ALPHABETICAL)

Top 5 - Contributors
Brickworks Ltd
Janus Henderson Group PLC
Mainfreight Ltd
New Hope Corp Ltd
Whitehaven Coal Ltd

Bottom 5 - Detractors
Eagers Automative Ltd
Liontown Resources Ltd
Megaport Ltd
Pinnacle Investment Management Group Ltd
Telix Pharmaceuticals Ltd

CONTINUED

Our investment process is simply the repeatable implementation of our philosophy to own a diversified portfolio high quality small companies. This works well through time and across market and economic regimes as superior economic profits accrue to high quality, growing small companies – and will be reflected in returns to shareholder subject to not overpaying for the privilege. A clear process enforces discipline without the need to predict macroeconomics.

RECESSIONS AND SMALL CAPS

Given the chorus of views around recession and small caps, we have reviewed research on relative performance (proxied using the size factor) during different parts of the business cycle across global markets. The key conclusion, not surprisingly, is that small caps underperform large caps leading into an economic contraction. Given markets are forward looking, most of the underperformance (4-6% on average vs the market) comes six months prior to the contraction (recession) and usually co-incident with a pre-recession slowdown (*Factor Returns' Relationship with the Economy? It's Complicated. Research Affiliates, November 2020*). This pattern of returns was also confirmed in other studies.

The research also showed that the strongest and most statistically significant part of the cycle for small cap returns is the post-recession recovery stage – which means if investors are going to try and time a recession and get out, they need to be confident of being able to get back in – which presents both a timing and liquidity challenge.

Things get complicated very quickly when investors consider other variables which strongly influence the performance of small caps relative to the market beyond just the economic cycle, including but not limited to; the shape of the bond yield curve, tightening or loosening central bank liquidity and bank lending conditions, relative valuation of small caps vs large caps, sector composition differences between indices, recent relative performance of small caps. There will be additional confounding factors such as large differences in the higher quality, lower leverage, and more attractive valuation of our portfolio relative to the small index.

"The ability to predict economic regimes and alter factor allocations accordingly produces ***less successful results despite being intuitively pleasing."***

"We find that the relationship between factors and economic stages ***generally fits*** *with intuition. Because data are limited, however,* ***we do not have sufficient observations of economic significance.****"*

If investors want to ignore all this and look at a sample size of one (1) in Australia, the 2007 – 2009 period saw small caps underperform the market (ASX300) by 24% at their worst quarterly drawdown (Q2 2007 to Q1 2009) – underperformance which was mostly recovered by Q4 2010.

At the end of Q2 2022, small caps had underperformed the ASX300 by 14% from the quarterly peak in Q3 2021. Whether this underperformance reflects recession (earnings) fear or the fact that in Q3 2021 the small cap index was trading at very high multiples which have since compressed is debatable.

Fortunately, we will get some respite for all the macro debates in August as we see the numbers and speak to management to understand how companies are performing and we can put the economists on mute for a few weeks.

PORTFOLIO POSITIONING AND PERFORMANCE

Portfolio underperformance during July is relatively easy to explain. All the stocks we don't own which contributed to much of our outperformance in June moved sharply higher in July as the go-to exposures for the falling bond yield play book.

Stock and sector positioning is largely unchanged – other than the investment of about 4% cash early in the month broadly across the portfolio. We expect more cash to come from the proceeds of the UnitiGroup (UWL) acquisition. One stock in our portfolio we are hoping not to receive cash for right now is Tassal Group (TGR) – who received a A$4.85 cash bid in late June. We believe Tassal is at the end of a heavy three-year capex program, seeing much higher global and local salmon prices and an improved industry structure post the privatisation of Huon. The full year result should allow management and the board to reject the offer from Cooke Inc more confidently by showing investors the improving free cash flow and higher trending ROIC resulting from these business, industry and product pricing changes.

Fund characteristics	
NAV	A$1.0165
Redemption unit price	A$1.0135
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)	5.8
No. of Holdings:	120
Portfolio Managers	David Wanis, Jai Beathe & Melinda White
Strategy FUM (A$m):	178.8

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

Supporter of:

TCFD TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES