# LONGWAVE AUSTRALIAN SMALL COMPANIES FUND

A CLASS REPORT ARSN 630 979 449

LONGWAVE CAPITAL

MONTHLY REPORT SEPTEMBER 2022

## FUND PERFORMANCE (AFTER FEES) TO 30 SEP 2022

| | 1M | 3M | 6M | 1yr | 2yr p.a. | 3yr p.a. | SI³p.a. |
|---|---|---|---|---|---|---|---|
| Net Fund Performance[1] | -6.5% | 2.8% | -13.1% | -13.2% | 5.5% | | 3.6% |
| Benchmark Performance[2] | -11.2% | -0.5% | -20.8% | -22.6% | 0.5% | | -0.6% |
| Excess Return | 4.7% | 3.3% | 7.7% | 9.3% | 5.0% | | 4.2% |

**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 decreased by 6.5% during September 2022, outperforming the 11.2% decrease in the S&P/ASX Small Ordinaries Accumulation Index benchmark by 4.7% over the month (after fees).

## MAKING INDEBTEDNESS GREAT AGAIN

Only 12 months ago, an Australian investment grade corporate borrower could refinance their debts for a total interest cost of 1.3% per annum (based upon the Bloomberg AusBond Credit 0+ index – a basket of ~400 investment grade corporate issuers issuing three-to-four-year bonds).

Today that same group of companies would have to pay over 5% to issue a similar bond. Now 5% doesn't sound like a large number, but corporates haven't faced a cost of borrowing at rates this high since mid-2012. More than a decade. The norm over that decade has been a continual fall in the cost of debt and for some companies, a business model or a balance sheet dependent on low and falling interest rates. This change has happened so quickly markets and corporate issuers have barely had time to adjust. There are some parallels to commodities and inflation that remind investors of the lags in the real economy. Patience is needed.

Since late 2021, calls that inflation had peaked were hard to take seriously when commodity prices (a key input to inflationary pressures) were still rising rapidly. Despite peaking in June 2022, and having declined by 18% since, the flow through impact to inflation was still being felt in September and probably through to year end.

Likewise, suggesting rising borrowing costs are not a problem while they are still sharply rising feels premature. We probably won't know until 1Q 2023 how much pain these higher rates will cause companies (and consumers). It may even take longer given contractual lags. A chief financial officer may look at the profile of a company's debt maturity and conclude this is a 2024 or even a 2025 problem and have some comfort about interest rates perhaps having peaked and fallen by then. We suspect however that the CEOs, who care more about share prices, are going to find that this is a Q4 2022 and 1H 2023 problem as investors price balance sheet risk (and the need for some companies to de-lever) with more urgency.

When assessing the reasonableness of leverage and the risk attached to it, our experience has been the analytical tools used by credit investors – the very people buying the corporate bonds issued – are superior to those used by most equity investors. For that reason, when we assess the leverage risk of a potential investment, we use many of those credit investor tools. It often highlights balance sheet risks before the equity market sees it and has kept us out of trouble on many occasions.

We currently have a watchlist of about 50 small cap names that have balance sheets that could present meaningful risk to equity holders in the next 12-18 months. These account for 25-30% of the S&P/ASX Small Ordinaries Index by weight. At the aggregate level, the leverage characteristics of the index are not as robust as you would like heading into a period of higher rates (already baked in) and lower growth (possibly even a recession). Small cap index aggregate Debt / EBITDA sits at 3x (vs 1.7x for the ASX300) and Debt / Assets is at 28% (vs 24% for the ASX300).

Our portfolio is much more conservatively geared. Less than 5% of our portfolio is invested in stocks on the watchlist mentioned above – and we continually weigh up whether we are compensated for this risk. Our overall portfolio is much less levered than the market with aggregate Debt / EBITDA of 1.3x and Debt / Assets less than 20% - more conservative than both the Small Ords index and the ASX300.

In our experience, small cap investors continually take unrewarded risks. Usually for behavioural reasons, which end up harming their long-term investment returns.

*CONTINUED*

## 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 | BM² |
|---|---|---|
| Communication Services | 7.4 | 5.3 |
| Consumer Discretionary | 14.3 | 13.6 |
| Consumer Staples | 2.3 | 5.0 |
| Energy | 10.7 | 6.1 |
| Financials | 11.0 | 11.4 |
| Health Care | 4.1 | 6.3 |
| Industrials | 13.9 | 8.0 |
| Information Technology | 4.5 | 8.1 |
| Materials | 18.9 | 23.4 |
| Real Estate | 7.1 | 12.9 |
| Utilities | 0 | 0 |
| Cash | 5.7 | 0.0 |

## STOCK ATTRIBUTION (ALPHABETICAL)

| Top 5 - Contributors |
|---|
| Core Lithium Ltd |
| Flight Centre Travel Group Ltd |
| Link Administration Holdings Ltd |
| New Hope Corp Ltd |
| Whitehaven Coal Ltd |

| Bottom 5 - Detractors |
|---|
| Corporate Travel Management Ltd |
| Fletcher Building Ltd |
| HT&E Ltd |
| Mainfreight Ltd |
| Viva Energy Group Ltd |

## BAITING THE INVESTMENT EDGE HOOK

Michael Mauboussin offers a useful framework to help identify and understand sources of investment edge. The framework proposed that edge is sourced from one (or more) of four potential areas. **Behavioural, Analytical, Information and Technical. Or BAIT**. We summarise the key concepts from Mauboussin below:

**Behavioural:** A behavioural inefficiency exists when an investor, or more likely a group of investors, behave in a way that causes price and value to diverge. Behavioural inefficiencies may be at once the most persistent source of opportunity and the most difficult to capture. The persistence stems from human nature, which does not change rapidly.

**Analytical:** An analytical inefficiency arises when all participants have the same, or very similar, information and one investor can analyse it better than the others can. An analytical edge versus other investors can arise from having more analytical skill, weighing information differently, updating views more effectively, operating on a different time scale, or anticipating a change in the market's narrative.

**Information:** An information inefficiency arises when some market participants have different information than others and can trade profitably on that asymmetry. An informational edge can take a few forms. The first is to legally acquire relevant information that others don't have. Second, inefficiencies arise from limited attention. Finally, anticipating the impact of information can confer edge.

**Technical:** A technical inefficiency arises when some market participants have to buy or sell securities for reasons that are unrelated to fundamental value. An example of technical edge is to be on the other side of forced sellers or buyers. Second is to consider securities perturbed by investor fund flows. The final opportunity is to step in when traditional arbitrageurs have limited access to capital.

In the previous discussion about leverage, we would observe limited information edge in the observation of current indebtedness and the direction of interest rates. Most information is in the public domain. There are quite a few potential analytical edges – as the information itself can be looked at simply (debt reported on the balance sheet) or in a more complex way (reference notes to the accounts, other debt-like structures, hedges, bond terms, covenants etc). The analytical lens of an equity or a credit investor may also confer an edge. Members of the Longwave team have had real world institutional credit investment experience which is not common in small cap equity investment teams and we believe this offers an analytical edge here. Will there emerge a technical inefficiency should a wave of equity recapitalisations sweep the market? Maybe.

Finally there is a behavioural edge – recognising the biases which contribute to when investors take unrewarded leverage risk in small cap stocks, and ensuring we identify and control those biases ourselves. This is a hard and ongoing challenge as we are also susceptible to those same biases. **It requires discipline, process, teamwork and self-awareness in order to capture the behavioural alpha.**

## PORTFOLIO POSITIONING AND PERFORMANCE[1]

September was another difficult month for small caps, as rising interest rates and fears of recession again dominated. Some rare bright spots contributed to the portfolio in the resources sector (energy, copper, gold) as well as strong results from Premier Investments (retail) and Brickworks (building materials and property investment).

Performance suffered from companies whose perceived high exposure to slowing growth in sectors such as transport, travel, housing, retail and media overwhelmed what we believe are longer term competitive advantages for the specific companies we hold in these sectors.

As discussed two months ago, recessions – or more specifically the slowdown just prior to an actual recession – are the worst environment for small cap performance. We once again repeat what we noted at the time: *"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".* We still have no edge in recession forecasting and focus our efforts on where we do believe our edge resides: in information, analysis and disciplined, repeatable behaviour.

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

| Fund characteristics | |
|---|---|
| NAV | A$0.9681 |
| Redemption unit price | A$0.9652 |
| 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) | 5.5 |
| No. of Holdings: | 117 |
| Portfolio Managers | David Wanis, Jai Beathe & Melinda White |
| Strategy FUM (A$m): | 170.5 |

## 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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