MONTHLY REPORT MAY 2023

FUND PERFORMANCE (AFTER FEES) TO 31 MAY 2023

	1M	3M	6M	1yr	2yr p.a.	3yr p.a.	SI[3]p.a.
Net Fund Performance[1]	-3.7%	-1.8%	-1.3%	0.7%	0.6%	9.0%	5.4%
Benchmark Performance[2]	-3.3%	-1.3%	-2.5%	-5.8%	-5.2%	4.5%	1.9%
Excess Return	-0.5%	-0.5%	1.2%	6.5%	5.8%	4.5%	3.6%

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 decreased by 3.7% during May 2023, underperforming the 3.3% decrease in the S&P/ASX Small Ordinaries Accumulation Index benchmark by 0.5% over the month (after fees).

THE SMALL CAP COMPANY LIFECYCLE SWEET SPOT

Small caps are different to other parts of the market partly because of where most small cap companies are in their company lifecycle. Many founders describe their businesses as 'their children' or 'another child in the family' and this is no accident. Businesses are literally 'birthed' from an idea on a sheet of paper. They evolve (sometimes fast, sometimes slowly) through early life-stages and into established businesses. Like children, they follow a common pattern of life-stages; they often learn by doing but learn different things at different stages of life.

We think Damodaran's framework of the six stages to a business's life cycle is a helpful lens through which to look at small cap businesses. Very early in its evolution (Start-up phase) a business will be not much more than an idea that appears to meet an unmet customer need. The business reaches its "Young Growth" stage as it moves into a more defined business model and is starting to show real potential for future revenue and earnings. During the High Growth stage, the business is really hitting its stride and is firmly recognisable as a growth business. Stages 4 to 6 (Mature Growth, Mature stable and Decline) are characteristic of bigger corporations.

We can map Revenue, Earnings, Free cashflow, debt and equity issuance profiles onto the different life stages. 'Startup" and Young Growth phases are characterised by none to minimal revenue and negative free cashflow. Businesses in this part of their lifecycle rely on the equity or debt markets for continued funding of their operations. Because the unit economics of their business aren't yet proven, they're more fragile on multiple different fronts. During the High Growth stage, unit economics are proven, revenue growth hits its stride and the free cashflow in the business is positive, allowing companies to reinvest in their growth. The Mature Growth phase sees slowing revenue growth, but a continuation in fast profit growth. At stability (Mature stable), a company will see a stabilisation of revenue and profit growth and due to lower re-investment requirements in the business, this stage is sometimes referred to as "cash cow".

NUMBERS NOT NARRATIVE

Stocks in the small cap universe range from barely out of start-up phase to Decline stage. What makes small cap stocks fundamentally different, however, is the prevalence of businesses that are in the early and growth stages of their lifecycle. From an equity investors' perspective, the very early stages (start-up and young growth) are characterised by high risk of failure or excessive dilution. Failure can come in many forms: unit economics can turn out to be entirely different to what was originally targeted, customer adoption may take a different path to what was forecast, equity or debt markets can suddenly close, requiring a complete strategic pivot.

There are other aspects of these early life-cycle stages that make small cap businesses fundamentally different to large-caps. Their underlying businesses tend to be less diversified. They may have weaker governance structures in the business, and they may still have founder owners who effectively control the company.

TOP 10 HOLDINGS

Name (Alphabetical)
Auckland International Airport Ltd
Brickworks Ltd
Corporate Travel Management Ltd
Fletcher Building Ltd
Janus Henderson Group PLC
New Hope Corp Ltd
News Corp
Spark New Zealand Ltd
Super Retail Group Ltd
Viva Energy Group Ltd

FUND AND BENCHMARK SECTOR WEIGHT (%)

	Fund	BM[2]
Communication Services	7.3	5.2
Consumer Discretionary	17.2	16.1
Consumer Staples	2.3	4.4
Energy	7.6	5.5
Financials	13.9	9.2
Health Care	4.0	7.6
Industrials	17.5	7.4
Information Technology	3.0	5.5
Materials	19.7	25.9
Real Estate	6.1	13.1
Utilities	0	0
Cash	1.4	0.0

STOCK ATTRIBUTION (ALPHABETICAL)

Top 5 - Contributors
Austal Ltd
De Grey Mining Ltd
Fletcher Building Ltd
Janus Henderson Group PLC
News Corp

Bottom 5 - Detractors
Accent Group Ltd
Lovisa Holdings Ltd
New Hope Corp Ltd
Super Retail Group Ltd
Telix Pharmaceuticals Ltd

CONTINUED

The unfortunate aspect of these earlier and more fragile life-cycle stages is that they are also the most exciting. Company founders in the very early lifecycle stages are compelling story tellers, and it's easy to get carried away in the sophisticated and compelling narrative. Narrative investing is made all the more easy given the limited amount of observable information (profits) to verify the narrative against.

This fragility means investors in small-caps need to be particularly careful about controlling for risk of failure. What we've learnt over 25 years of investing in small caps is that despite the wonderful stories of early investments that pay off 10-times for their investors, as investors we get paid to wait until a business is in what we think of as the sweet spot of its lifecycle. This is when a business has already come through the very early stages of startup and young growth and has hit the point where they have the highest probability of survival along with the highest growth period in their business. This sweet spot corresponds to Damodaran's High Growth life-cycle stage. Looking for characteristics in the financial statements of small cap companies that correspond to this life-cycle sweet spot, we think, helps control for some of the narrative investing bias that can easily creep into investment processes.

THE TIME DILATION EFFECT IN COMPANY LIFECYCLE IS REAL

Time dilation is the phenomenon where two objects moving through gravitational fields of different intensities experience different rates of time-flow. The concept is used to great effect in the movie Interstellar (we are fans). Just like the crew from Endurance, some companies move through their life stages very quickly and others move quite slowly. Just because a business was founded more than 20 years ago, doesn't necessarily mean its automatically in its mature or decline lifecycle stage.

For instance, Austal Ships is a small cap stock founded 30 years ago that has slowly achieved a firm place in the US Navy continuous shipbuilding program. It has a low level of base profitability and a sizeable future growth profile from its forward order book with the US Navy.

NOTHING WRONG WITH CASH COWS AT ATTRACTIVE PRICES

There are exceptions to the rule and our investment process allows the Longwave portfolio to hold more mature businesses. In a more diversified portfolio seeking to achieve more consistent alpha, there is a place for mature stable businesses with defendable strategic moats at attractive prices. For example, the opportunity to buy an asset like Auckland Airport at a price 25-30% below pre-pandemic levels, with the lowest leverage in 20 years (and while Sydney Airport was being taken private at very close to a record price) was a compelling opportunity we took in 2022.

PORTFOLIO POSITIONING AND PERFORMANCE[1]

During May a number of consumer discretionary stocks downgraded earnings expectations for FY23. The common theme is that previously positive sales growth trends have reversed in the last 8 weeks of trading and margins are softening. We are cognisant of the pressures on the consumer and are happy that the stocks we hold in that sector are well placed to trade through the next 12 months better than peers. Our portfolio underperformed the market in May given our slight overweight to consumer discretionary and underweight Technology offset by our underweight to the Materials and overweight to the Communications sectors.

Notable positive stock performers in our portfolio this month were News Corp (better than expected 3Q result confirming our thesis that the Dow Jones business and cost out programs will protect against cyclical impacts in the business) and Janus Henderson (after reporting positive net inflows for the quarter).

Fund characteristics	
NAV	A$1.0307
Redemption unit price	A$1.0276
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)	7.1
No. of Holdings:	123
Portfolio Managers	David Wanis, Jai Beathe & Melinda White
Strategy FUM (A$m):	158.9

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 RECOMMENDED

Signatory of:

PRI Principles for Responsible Investment

Supporter of:

TCFD TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

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