LONGWAVE AUSTRALIAN SMALL COMPANIES FUND

A CLASS REPORT ARSN 630 979 449

LONGWAVE CAPITAL

MONTHLY REPORT JUNE 2023

FUND PERFORMANCE (AFTER FEES) TO 30 JUN 2023

	1M	3M	6M	1yr	2yr p.a.	3yr p.a.	SI³p.a.
Net Fund Performance[1]	1.2%	0.1%	2.9%	13.6%	-0.3%	9.4%	5.7%
Benchmark Performance[2]	0.0%	-0.5%	1.3%	8.4%	-6.6%	5.2%	1.8%
Excess Return	1.2%	0.6%	1.6%	5.1%	6.3%	4.2%	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 1.2% during June 2023, outperforming the 0.0% increase in the S&P/ASX Small Ordinaries Accumulation Index benchmark by 1.2% over the month (after fees).

THE (POOR) CASE FOR INDEXING SMALL CAPS

The debate on active vs passive continues to create headaches for many categories of active managers – particularly in highly competitive parts of the market such as large caps. In large caps, 80-90% of managers underperform their index on a 10-year horizon, and the index itself has become even lower cost to own, with Large Cap ASX200 ETFs available to retail investors at 4 basis points (0.04%).

As persistent as the difficulty has been for large cap managers to outperform low-cost indices, there has been persistence in the ability for small cap managers to outperform their benchmarks. This can be observed both here in Australia and globally. The most popular survey for comparing these funds is the S&P Index vs Active analysis – or SPIVA. As robust as their methodology is in general, we do observe two biases in their small cap survey that overstate how well indexed small caps do against active managers.

The two major biases in the survey are:

1) SPIVA compares small cap managers against the S&P / ASX Mid Small Index – which is a blend of small and midcaps. SPIVA take their active fund returns and categories from Morningstar. Active small cap funds are classified by Morningstar as Australia Fund Equity, Mid/Small (Value / Growth or Blend) - but the category benchmark applied to these funds by Morningstar is S&P/ASX Small Ordinaries index, not the S&P/ASX MidSmall index. This MidSmall index has outperformed the Small Ords Index by 2.9% per annum over the past 5 years, and by 3.8% per annum over the past over 10 years (to Dec 2022). MidSmall is probably not the most appropriate benchmark for the majority of the small cap funds they compare – although it would be for the few funds in the Australian Mid Cap category.

2) SPIVA compares net of fee small cap fund returns against an index without any fee applied. This may be fair enough when comparing large cap funds as an investor can access the benchmark (in this case the S&P / ASX 200 Index) for 4bps. The only two available small cap index funds (ETFs) benchmarked to the S&P/ASX Small Ordinaries Index charge 50bps and 55bps respectively.

SPIVA switched indices in 2011 or 2012, but in 2010 the last scorecard using the Small Ords Index showed only 29% of active small cap funds underperforming the benchmark over 5 years. The difference between the MidSmall index and a Small Ords ETF net of fees is 3.4% p.a over five years and 4.3% p.a over ten years. Correcting for these, we think 60-70% of active small cap funds would outperform the appropriate, net of ETF fee index.

Globally we also see consistent SPIVA results where active small cap managers do better than the index. The bias of small cap index ETF costs is consistent in all markets (UK, Japan, Canada, India cost between 50 and 74bps). The exception to both performance and fees is the US, where small cap managers struggle (89% underperforming over 10 years), and where you can buy a small cap index ETF for 6bps.

WHAT IS DIFFERENT ABOUT SMALL CAPS?

There are several reasons we believe active small cap managers can generate alpha in excess of their benchmarks in greater numbers than their large cap peers.

CONTINUED

TOP 10 HOLDINGS

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

FUND AND BENCHMARK SECTOR WEIGHT (%)

	Fund	BM²
Communication Services	7.3	5.0
Consumer Discretionary	15.6	15.8
Consumer Staples	2.2	4.4
Energy	7.4	5.8
Financials	14.5	9.7
Health Care	4.0	7.7
Industrials	17.1	8.0
Information Technology	2.9	5.2
Materials	19.5	25.5
Real Estate	6.0	12.9
Utilities	0	0
Cash	3.5	0.0

STOCK ATTRIBUTION (ALPHABETICAL)

Top 5 - Contributors
Austal Ltd
Flight Centre Travel Group Ltd
Lake Resources NL
McMillan Shakespeare Ltd
Weebit Nano Ltd

Bottom 5 - Detractors
Adairs Ltd
Auckland Intl Airport Ltd
Corporate Travel Management Ltd
Paladin Energy Ltd
Viva Energy Group Ltd

We have discussed these in detail before, but to summarise a few again:

Larger number of opportunities: Australian small cap investors are often choosing from hundreds, if not over 1,000 potential investment opportunities in their investible universe. Most large cap managers are limited to around 150 potential investments (the ASX 100 plus maybe 50 ex100 names).

A much more dynamic market: Using the Small Ords and ASX100 indices as examples, we can see the difference in dynamics between market segments. Around 40% of the Small Ords index (by weight) changes over most three-year periods. New IPOs, microcaps moving up, new industries emerging, large caps moving down, demergers and spin-outs. On the same metric, less than 10% of the ASX100 is new between most three-year periods. It is a much more static universe.

Fewer investors chasing each opportunity: Using fund manager surveys as an example, there are more large cap funds in the market (probably three times as many as small cap funds) and each large cap investment team tends to be 2-3 times as large. This means there are 6-10x as many investors analysing large caps as there are small caps.

Putting these together, in large caps you have a market which is smaller, which doesn't change much and has a very large number of highly sophisticated, intelligent and motivated competitors chasing alpha. Not surprisingly a sustainable edge here is hard to find. Small caps are the opposite – a very large market of opportunities, which is always changing and has a much smaller number of investors competing for ideas. The difference in competitive intensity is more than an order of magnitude between them.

Other differences in the small cap market include:

Small cap life cycle: As we discussed last month, small caps have a much earlier life cycle than large caps, with many included in the index before they have proven their business models and unit economics in a commercially viable and sustainable way. This makes failure and extremely negative performance a more common feature in small caps.

Higher small cap skew: as previously discussed, small caps have greater skew than large caps, and the drag of losers on portfolio returns (per the life cycle point above) is exacerbated in this market. This can sometimes be underestimated by large cap investors fishing in the small cap pond.

PORTFOLIO POSITIONING AND PERFORMANCE[1]

We are finally seeing RBA rate increases (another 25bps on June 6th) have an impact on the Australian consumer. We heard from companies and then saw in trading updates an abrupt decline in consumer spending across multiple categories. We saw downgrades across the market in late May and early June from Dusk Group (May 19th), City Chic (May 22nd), Universal Stores (May 25th), Adairs (June 2nd), Baby Bunting (June 6th), Dominos Pizza (June 13th), Best & Less (June 20th), and Harvey Norman (June 28th). Despite some sharp one-day falls, for many consumer exposed names the risk of higher interest rates to lower sales and earnings has been priced into stocks for some time. Consumer discretionary was one of the poorest performing sectors in June, but not by much. Outside of Corporate Travel (whose last two announcements to the market have been positive), consumer discretionary was not much of a feature in portfolio performance during the month. We continue to see attractive opportunities in high quality businesses in this sector over a three to five year horizon, opportunities which are available mostly because the market time horizon is currently so short and multiples are so compressed due to uncertainty.

Hidden beneath the focus on interest rates and recession forecasting has been a deterioration in the quality of the small cap index over the past six months. The ROE of the index has been declining (now below 15%), financial leverage has been increasing (Debt / EBITDA now >3.5x) and valuations have been getting worse (forward p/e ratio now close to 18x). Active investors can create very different portfolios given the breadth of opportunity, with our own portfolio generating an ROE over 19%, debt / EBITDA of less than1.5x and trading on around 13x forward earnings. Looking at the two portfolios – ours and that of the index – gives us continued confidence that active investment in small caps will likely continue to be a more rewarding way to invest.

Fund characteristics	
NAV	A$1.0328
Redemption unit price	A$1.0297
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)	7.2
No. of Holdings:	123
Portfolio Managers	David Wanis, Jai Beathe & Melinda White
Strategy FUM (A$m):	160.9

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.