LONGWAVE CAPITAL

MONTHLY REPORT DECEMBER 2023

FUND PERFORMANCE (AFTER FEES) TO 31 DEC 2023

	1M	3M	6M	1yr	2yr p.a.	3yr p.a.	SI[3]p.a.
Net Fund Performance[1]	7.2%	7.5%	8.6%	11.8%	1.5%	5.9%	7.1%
Benchmark Performance[2]	7.2%	8.5%	6.4%	7.8%	-6.2%	0.9%	3.1%
Excess Return	-0.0%	-1.0%	2.2%	4.0%	7.7%	5.0%	3.9%

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 7.2% during December 2023, underperforming the 7.2% increase in the S&P/ASX Small Ordinaries Accumulation Index benchmark by 0.0% over the month (after fees).

SIMPLE BUT NOT EASY

Investing is simple but not easy. We largely know what to do, what to ignore, the right time horizon to focus on for superior long-term results, but we seem to not be able to get out of our own way. And by we, I mean pretty much all human decision makers, investors, allocators and stock pickers.

In simple terms, actively managed Australian small caps out-perform large caps (active or passive) over the long term. This outperformance is not linear nor consistent every year, which means the path to superior long run performance is marked with periods of underperformance. This underperformance has been the story of 2023 (and 2022!) but the long term remains intact.

In 2023 we covered much of what investors need to know about the whys and hows of long-term small cap outperformance:

> **Long term Australian small cap outperformance**: Active Australian Small Caps have been one of the best performing places to invest over the past three decades.

> **Why Small Caps are different**: Investors often forget that small caps are younger and more fragile than their large cap brethren. They are also less well covered and more dynamic businesses.

> **Why active management works in small caps**: Active management is under pressure in many parts of the market – and for good reason as the delivered performance hasn't justified the fees. Small caps continue to be a part of the market where it really does pay to be active, and there are structural reasons why this will continue.

> **The importance of quality**: Quality is a common term with a multitude of ways to be defined. This is a feature, not a bug.

> **Human Behaviour and decision making**: Artificial Intelligence (AI) captured the imagination of the world in 2023. Experience in the Chess world gives some clues how investors may best respond and integrate technology into fundamental investing.

> **Mythbusting our way to higher long term returns with lower risk**: The myths we specifically highlighted were:
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> - More concentrated portfolios deliver better returns. This is one of the most persistent myths in funds management and it is just not true,
> - High conviction is about low stock numbers,
> - Small Cap alpha only comes from Information Edge,
> - Value, or Growth, is the factor that works best in Small Caps,
> - Thematic investing is a short cut to high alpha in Small Caps.

NOT EASY BUT WORTHWHILE

The worthwhile goal of active investment in Australian Small Caps is the superior long-term compounding of wealth that can be achieved. Activity for the sake of looking busy is one thing that feels like it should help but does not improve investment returns.

CONTINUED

TOP 10 HOLDINGS

Name (Alphabetical)
ARB Corp Ltd
Auckland International Airport Ltd
Beach Energy Ltd
Brickworks Ltd
Corporate Travel Management Ltd
CSR Ltd
Mainfreight Ltd
Sims Ltd
Super Retail Group Ltd
Webjet Ltd

FUND AND BENCHMARK SECTOR WEIGHT (%)

	Fund	BM[2]
Communication Services	4.3	4.8
Consumer Discretionary	22.1	17.4
Consumer Staples	1.2	3.0
Energy	7.9	7.0
Financials	11.1	9.8
Health Care	6.2	7.9
Industrials	15.8	8.2
Information Technology	5.2	5.6
Materials	18.3	23.9
Real Estate	4.8	12.5
Utilities	0	0
Cash	3.2	0.0

STOCK ATTRIBUTION (ALPHABETICAL)

Top 5 - Contributors
Auckland International Airport Ltd
Corporate Travel Management Ltd
GQG Partners Inc
Sims Ltd
Super Retail Group Ltd

Bottom 5 - Detractors
Adbri Ltd
Charter Hall Long Wale REIT
Flight Centre Travel Group Ltd
Link Administration Holdings Ltd
Sandfire Resources Ltd

As a quality investor, looking to buy and hold companies that can compound value over the long term, our portfolio turnover is relatively low. Given we have not previously discussed this, we thought some numbers may illustrate what this looks like.

Our portfolio turnover in 2023 was 38% and while this was low by the standards of active small cap managers (average around 60%, with many above 80% per annum), it is also inflated by some factors outside our control. Every year we sell companies due to external factors that ordinarily (based upon the performance of the business) we would continue to hold. In 2023, 8.5% of our turnover was due to index changes (we are not allowed to own ASX100 stocks) and the delisting of the Janus Henderson CDI (forcing us to sell). 1.6% of our portfolio turned over from companies we own that were the subject of takeovers. We also have some portfolio turnover driven by changes in weight between companies in the portfolio due to changes in relative valuation appeal.

It is also worth noting that the underlying small cap index turnover is around 25% per annum, far higher than the 1-2% p.a turnover seen in an ASX300 ETF.

Name turnover – how many companies enter and exit the portfolio in a given year – was 26% in 2023, which was slightly higher than prior years, when it had averaged closer to 15-20%.

PORTFOLIO POSITIONING AND PERFORMANCE[1]

2023 was a reasonable year for the portfolio. Net returns were double digit (11.8%) and were 4.0% ahead of the S&P/ASX Small Ordinaries Index after fees. This result was better than most, but not as good as some – which has tended to be the case with our investment approach over many years. Longer-term results have also been satisfactory, with 3.9% per annum excess return since inception and more than double the total returns available from the index.

During the year Small Resources underperformed Small Industrials by13%, largely reversing the 15% outperformance in the prior year. In both years, Lithium was a major driver on the way up, and more recently on the way down. It could have been worse for resources and lithium, as the small cap sector heavy weight – Liontown Resources – escaped into the ASX100 in September above A$3 while under takeover, and subsequently collapsed almost 50% as the deal was thwarted and lithium prices fell sharply. There were a couple of resources bright spots – iron ore and gold which we own and uranium, which we don't – that helped prevent a worse outcome.

Within industrials, the standout sector performer was Healthcare with Neuren, Pro Medicus and Telix doing the heavy lifting. We own two of those three names. Despite repeated calls for a recession, Consumer Discretionary also performed very well. Travel names did well as earnings continue to recover post pandemic. Within the retail sector, expectations of an earnings collapse saw stocks pricing a significant valuation discount to the market to capture this. As is often the case in markets, the bad news got discounted into prices multiple times, so when AGM updates finally showed the consumer slowing down (negative like-for-like growth), most retail stocks went up. Some by a lot. Despite a late run for the line on falling bond yields, small A-REITs were the worst performing sector in 2023.

In the U.S Small caps dramatically outperformed large caps during the last six weeks of 2023, but here at home it was a much broader rally with small caps performing in line. The bad news is small caps are still not outperforming large, however the good news is that investors have not yet missed the opportunity to get set and take advantage of the longer term benefits of active small cap investing.

We made deliberate changes to the portfolio reflecting how much the opportunity set changed between the end of 2022 and the end of 2023. By the end of the year, higher growth companies had become increasingly undervalued and investors were overpaying for earnings certainty and stability. 50% of our portfolio top 10 stocks changed over the 12 month period, with most of that change happening in the last four months of the year (hence the slight increase in turnover discussed above). We are not in the business of providing year-ahead targets, but our portfolio remains of high quality (ROE of 19%) with strong balance sheets (debt / EBITDA of 1.5x) and attractively priced (P/E ratio of 13.9x, EV/EBITDA of 8.1x).

Fund characteristics	
NAV	A$1.122
Redemption unit price	A$1.1186
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)	14.5
No. of Holdings:	114
Portfolio Managers	David Wanis, Jai Beathe & Melinda White
Strategy FUM (A$m):	737.5

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 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.