LONGWAVE AUSTRALIAN SMALL COMPANIES FUND

A CLASS REPORT ARSN 630 979 449

LONGWAVE CAPITAL

MONTHLY REPORT JANUARY 2024

FUND PERFORMANCE (AFTER FEES) TO 31 JAN 2024

	1M	3M	6M	1yr	2yr p.a.	3yr p.a.	SI³p.a.
Net Fund Performance[1]	0.8%	14.6%	4.9%	6.0%	5.8%	6.4%	7.1%
Benchmark Performance[2]	0.9%	15.8%	3.7%	2.1%	-1.2%	1.3%	3.3%
Excess Return	-0.1%	-1.2%	1.2%	3.9%	7.1%	5.1%	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 0.8% during January 2024, underperforming the 0.9% increase in the S&P/ASX Small Ordinaries Accumulation Index benchmark by 0.1% over the month (after fees).

THE FIRST FIVE YEARS AT LONGWAVE

As we mark the five-year performance anniversary of the Longwave Australian Small Companies Fund, we review what we set out to achieve for our investors and how markets have evolved. Specifically:

Small caps are a valuable source of alpha in client portfolios; however, the index has been a poor way to capture this. We aim to deliver an outcome that allows investors to capture the long-term benefits of active small cap investing. Our goal was (and remains) to outperform the S&P / ASX Small Ordinaries Index and also outperform the median active manager (so second quartile of peers or better) through a 5 to 7 year investment cycle.

Although active small cap funds on average have delivered good results for investors (better than the small cap index, large cap index and large cap active managers), they almost universally build highly concentrated portfolios – either by stock numbers or by concentration to a theme, sector, or style. This results in a more volatile path of returns, delivering a wild ride for investors. Our goal was (and remains) to build more diversified and more robust portfolios which could deliver our performance goal in a wider range of market environments and reduce performance volatility.

We also believe that what matters to investors in the long run are the net returns they realise. Net of fees. Net of taxes. Net of trading costs and commissions. Our goal here is to focus on long-term investing and the compounding of value from the companies we own, rather than furious trading activity trying to capture every wriggle in the market and timing the prices of individual stocks. This has meant our portfolio turnover of around 40% p.a is at the lower end of active small cap funds (that range between 20% and 160% with the average around 65% since 2017 - *Source: Zenith Investment Partners*). As we flagged last month, portfolio turnover is normally elevated in small cap funds due to the highly dynamic nature of the universe (new opportunities emerging) and the need to exit companies once they grow to a certain size in order to preserve the small cap focus and not drift up in the market cap spectrum. In Longwave's case, that means selling our investments in companies within a reasonable time (six months) after they are promoted into the ASX100 and re-deploying those funds back into the small cap universe in search of the next generation of winners.

We believe our approach is helping to democratise the benefits of active small cap investing to a wider range of potential investors. Investors who have told us they haven't invested in small caps due to the wild ride of performance. Or the excessive turnover. Or the high fees – which are increasingly in focus.

It is interesting to look back at the Longwave seed portfolio from 1 Feb 2019 and see how things have changed over that time. At inception:

> We held a diversified portfolio of 94 stocks,
> Our largest sector over weights were Consumer Discretionary and Materials, and our largest under weights were Real Estate (which we tend to be underweight in most market environments) and Industrials,
> Our portfolio had a higher ROE and lower leverage than the small cap index, but traded on a similar P/E ratio with a lower EV/EBITDA,

TOP 10 HOLDINGS

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

FUND AND BENCHMARK SECTOR WEIGHT (%)

	Fund	BM²
Communication Services	4.2	4.8
Consumer Discretionary	22.1	17.6
Consumer Staples	1.3	3.2
Energy	8.1	7.6
Financials	11.8	10.1
Health Care	5.8	7.9
Industrials	15.6	8.2
Information Technology	5.3	5.7
Materials	17.9	22.5
Real Estate	4.7	12.4
Utilities	0	0
Cash	3.3	0.0

STOCK ATTRIBUTION (ALPHABETICAL)

Top 5 - Contributors
Bellevue Gold Ltd
Corporate Travel Management Ltd
GQG Partners Inc
Netwealth Group Ltd
Sayona Mining Ltd

Bottom 5 - Detractors
Boss Energy Ltd
Megaport Ltd
Nanosonics Ltd
Paladin Energy Ltd
Telix Pharmaceuticals Ltd

CONTINUED

- Around 10% of the original portfolio was exited through takeovers,
- Of those companies still listed, 31% of the original portfolio has since been promoted to the ASX100 and as such is no longer part of our investment universe or portfolio,
- Many of the big winners from 2019 are still part of our portfolio today – companies such as Super Retail Group (+200% total return from 1 Feb 2019 to 31 Jan 2024), CSR (+220%), PWR Holdings (+240%), Nick Scali (+240%), Lovisa (+290%) and Pro Medicus (+720%) – although we suspect Pro Medicus will head into the ASX100 in 2024,
- Of course, it wasn't all plain sailing, and a number of stocks didn't do so well, although of the disastrous performers (such as Appen, Platinum Asset Mgt, St Barbara, Bravura, Cooper Energy) we exited most along the way.

Investors get conflicting messages on how to handle winners and losers in a portfolio. On the one hand, we are counselled to be price sensitive as if there is an absolute law of price reversion which leads to advice like 'buy-low and sell high' and 'If you liked it at $1 you must love it at $0.50'. On the other hand, we are told 'losers average losers' and to 'let your winners run'. The reality is that it depends. Not a very satisfying answer – but a lot of investing is like that.

Peter Lynch said it best *"Some people automatically sell the "winners"—stocks that go up—and hold on to their "losers"—stocks that go down—which is about as sensible as pulling out the flowers and watering the weeds. Others automatically sell their losers and hold on to their winners, which doesn't work out much better. Both strategies fail because they're tied to the current movement of the stock price as an indicator of the company's fundamental value."*

ACTION BIAS

We have written many times about behavioural biases that underpin a lot of alpha available in markets, and Action Bias is yet another. Investors feel like they are exerting control and reducing uncertainty by 'doing something' in their portfolio. It could be in response to their internal research, or it could be in reaction to a company event. It could originate internally from the investment team, or from other stakeholders.

A common interaction we have in communicating an unfortunate near term development in a portfolio company to clients, researchers and consultants is the question "what are you DOING about it?" Even long-term compounders, that ultimately win for their investors over time, face near term setbacks. Excluding COVID, every one of the six winning stocks we highlighted above had business issues and share price drawdowns of at least 40% over our holding period. Of course, buying more on these drawdowns is obvious in hindsight, and in some cases, we were smart enough to do that at the time as well, however sometimes the desire to DO SOMETHING can lead to selling on a short-term setback and missing the ultimate long-term gains.

There are lots of myths in investing and the need to be seen to DO SOMETHING – which is how portfolios end up with 150% per annum turnover – is one that doesn't always benefit the performance of investors over the long run.

PORTFOLIO POSITIONING AND PERFORMANCE[1]

Not even two months after detailing our first 20-year stock idea, Nanosonics had a trading update showing soft near term (1H F24) growth in their Trophon capital sales. The stock promptly dropped 25-30% and was our biggest performance detractor in January. This volatility in near term capital sales is something Nanosonics has seen before, with a 35% y/y decline in F2018 and a 20% decline over the two years to F2021. Our focus is not on the near-term sales volatility rather it is on the long-term prospects of the business to continue penetrating the market for Trophon devices, selling consumables to the installed base and potentially expanding new disinfection innovations. At this stage we remain of the view that the longer-term thesis remains intact, and we work hard to control our bias to do something which may harm capturing these long-term returns.

Fund characteristics	As at 31 Jan 2024
NAV	A$1.1226
Redemption unit price	A$1.1192
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)	15.3
No. of Holdings:	114
Portfolio Managers	David Wanis, Jai Beathe & Melinda White
Strategy FUM (A$m):	743.2

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

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