Clime Smaller Companies Fund

Quarterly Investment Report

September 2019

Integrity Transparency Conviction

Market Commentary

Introduction

Markets were volatile over the last quarter, reflecting investor concerns about the US-China trade war and slowing global growth. The mood of the global economy and financial markets is deteriorating: globalization and international trade is under threat; geopolitical risks are rising; negative real interest rates are advancing; and fears of recession are growing. In our view, a recession in the next year or two is far from inevitable, but the risks are greater than at any time since the GFC, and rates are likely to remain at ultra-low levels for a protracted time. For investors, this probably means lower expected returns from their investment assets.

The global economy has been patchy at best: the US and China have slowed to around-trend growth, but Germany, the world's fourth largest economy and the manufacturing powerhouse of Europe, is struggling. Unemployment rates in advanced economies are generally at decade lows, but there are few signs of any inflationary pressures. Markets see accommodative monetary policy as the only solution: cheap money is the means by which "the can is kicked down the road", putting off structural problems until tomorrow. With central bank policy rates so low, advanced economies will be poorly-equipped to counter a recession if one does occur. With the prices of risk assets up over the year, patience has proven to be a virtue so far, and risk taking has been rewarded. However, while we remain steadfast in our view that judicious stock picking will continue to add value, we expect broader asset returns will be below their long-term historical averages over the next few years.

Manufacturing sector struggling

Manufacturing activity is contracting across advanced economies, pointing to the impact of President Trump's trade policies. In the US, a key indicator measuring manufacturing activity in September recorded its lowest level in more than a decade, while global data showed the sector was declining amid fears that trade tensions will escalate further. Output was lower than a year earlier across all 36 advanced economies and sentiment indicators suggest the most geographically widespread manufacturing downturn for seven years.

The global Purchasing Managers' Index in September recorded its fifth month below the 50 mark, the level that divides expansion from contraction. This is the longest period that indicator has been so low since 2012. The PMI for the eurozone fell to 45.7 last month, its lowest reading since October 2012. The Institute for Supply Management index of US manufacturing activity fell more than expected to 47.8, its worst reading since June 2009.

As noted above, Germany is already confronting recessionary conditions, being the most vulnerable large economy to international trade. Germany's leading economic research institute has cut their forecast for economic growth for this year and next, blaming in part "the falling worldwide demand for capital goods." German GDP growth for the year is now forecast at just 0.5%. It can be argued that German industry is now in recession, and this will start to impact the service providers catering to those companies.

In the face of uncertainty and the unpredictability of President Trump, many companies are putting off investment decisions. Others are reckoning with the consequences of higher costs. Although manufacturing is only a small part of the global economy, it is one of the most volatile sectors and often acts as a leading indicator of global economic swings. The World Trade Organization has halved its estimate for trade growth this year, blaming "escalating trade tensions" for the cuts which it said would leave world trade volumes growing only 1.2% this year.

Financial markets

Financial markets have been rattled over the escalating trade war between the US and China as both imposed tariffs and counter-tariffs on imports. Yet despite that, the lack of income returns from cash or fixed deposits has mostly kept shareholders in the markets. Investors' search for "safety" has pushed bond yields to unprecedented low levels, with the yield on 30-year German Bunds turning negative for the first time ever. The US yield curve inverted once again, with yields on 2 year bonds briefly rising above those on 10 year bonds.

There are three factors markets are monitoring. First, markets abhor policy uncertainty, and geopolitical risk is on the rise: President Trump is a wild-card for markets, and inherently unpredictable; and events such as Brexit and the attack on Saudi oilfields are unsettling. Second, the risk of the trade war morphing into a more widespread global currency war is increasing as the US and China compete for global hegemony. And third, political pressures on central banks are mounting. The Federal Reserve has delivered a rate cut and ended quantitative tightening, but President Trump continues to pressure Chairman Powell to do more. Clearly Trump will want rates as low as possible, and the markets as high as possible, at least until the November 2020 Presidential Election.

Investment implications and central banks

What are the investment implications of these various factors? The fall in bond yields is concerning. The capital markets are being supported by ultra-dovish central banks, determined to do whatever they can to extend the economic cycle. To date, expectations of aggressive monetary easing have limited equity market downside in this highly uncertain environment: perhaps this could be called "the Powell Put".

Central banks might help to extend the cycle, but the power of any new measures, such as further lowering rates to almost zero, or purchasing ever more quantities of government bonds, will be less potent than in the past. Eventually, the artificially low cost of capital will either create bubbles in asset prices (we see it in bond markets already) or distort the behaviour of financial markets in ways we do not yet fully understand.

After a decade, central banks are still not observing the inflation they have targeted. Quantitative easing's boost to asset prices has quite possibly become counterproductive – widening wealth disparities, reducing yields and further lowering inflation. All this has been seen before – in Japan, which remains caught up in a decade-long deflationary spiral.

Global equity valuations look attractive when compared with the returns available from cash or bonds, but not when compared with their long term average earnings multiples. Using traditional valuation measurements such as earnings or cashflow multiples suggest equities are mildly overpriced, particularly if the global economy faces further risks of slowing. And yet even though equity valuations are "short of compelling", there are few alternatives that look attractive in this environment.

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Is more easing making the world weaker?

Cutting interest rates from already very low levels might suppress demand rather than stimulate it. In the decade since the GFC, central banks have implemented unprecedented monetary stimulus, both conventional and unconventional, in an effort to boost demand. However, these latter efforts have been largely ineffective and may even have been counterproductive.

On the positive side, lower rates make it cheaper to borrow, thus encouraging investment. Higher asset prices create a wealth effect, which encourages consumption. On the negative side, lower rates reduce income for savers. There are also psychological effects: businesses and consumers worry that if central banks keep lowering rates, there must be a recession in the offing, which undermines confidence. If potential borrowers anticipate further rate cuts down the line, they will defer their borrowing to a later date, thus the lowering of rates can be self-defeating.

On balance, it could be argued that further monetary easing may make the global economy weaker rather than stronger. Because of these offsetting effects, the overall impact of monetary stimulus is difficult to measure. In the US, for example, the shrinking importance of the manufacturing sector - which has fallen from 30% of jobs in the 1950s to 9% today - has reduced the benefit of lower rates in promoting capital spending.

Federal Reserve easing can help boost American exports by pushing the US dollar down, but this does not work if other central banks are trying to do the same thing. Note that the RBA Governor gave as one of his reasons for cutting Australian cash rates the importance of matching overseas cuts in order to keep the AUD from rising and compromising our export competitiveness.

The Australian economy is growing - slowly

The Australian economy is still growing – but very slowly, as evidenced by recent gross domestic product data. In fact, GDP growth is now the weakest since the GFC. Were it not for a big jump in exports due to the high iron ore price and strong government spending, the results would have been worse. The RBA's Governor Lowe remains optimistic that the growth rate will improve, yet he still felt it necessary to lower rates three times this year, justifying the cuts by pointing to the following factors:

- The Australian economy has been going through a soft patch. Over the year to June, GDP grew by just 1.4%, the slowest year-ended growth for some years. The RBA was surprised by the extent of this slowdown.
- While Australia has been less directly affected by the US-China trade disputes than some other countries, there is an indirect effect through slower global growth and increased global uncertainty.
- Over the past year, there has been no growth in consumption per person - unusual when employment is strong. Household disposable income has been increasing only slowly, reflecting subdued wage increases and growth in taxes.
- Slow growth in household income has led people to reassess their spending on discretionary items, which has been weak.
- As housing prices have fallen, there has been a sharp decline in housing turnover to the lowest level in 20 years. With fewer people moving homes, spending on furniture and household appliances has been soft.
- The drought has contributed to slower growth. In some areas, conditions have been the driest on record. Farm output in Australia has fallen for the past two years and there has been a sharp drop in farm income as farmers try cope with increased costs for feed and water.
- Over the past year, the Wage Price Index increased by just 2.3%. This is a pick-up from recent years, but the lift in wages growth has stalled recently.
- Low wages growth is one of the factors contributing to low inflation. Over the year to June, inflation was 1.6%, in both headline and underlying terms.

Continued jobs strength is somewhat surprising, given the soft economic conditions, weak retail indicators and fundamental headwinds, particularly in the construction sector. The lack of improvement in unemployment adds voice to the call for even further RBA rate cuts by the end of the year. However, the RBA may prefer to receive more data on how the stimulus to date is being received, alongside an update of their forecasts before moving rates again.

Oil shock quickly reversed

The attacks on 14 September on Saudi Arabia's oil facilities have put the oil market back in focus for investors and policy makers alike. The event was reported to have been the largest single supply disruption in the oil market for half a century, crippling half of Saudi oil production and temporarily halting production of approximately 5% of global oil production.
Surprisingly, the supply shock caused by the attacks had a relatively muted impact on the major equity and fixed income markets, and it remains to be seen what long-term impact, if any, the Saudi attacks will have on oil prices. At one end of the spectrum, the 1974 and 1990 oil price shocks had enormous long term consequences on inflation, interest rates and markets. This time, the response seems to have been amazingly short-lived and prices quickly reversed.

Concluding words

Your Manager is responding to the issues discussed above by adjusting portfolios and mitigating potential harm in many different ways. We are generally holding somewhat elevated levels of cash in most portfolios as a risk mitigation tactic, as well as to take advantage of volatility to invest in attractive stocks at discounts to value, should such discounts materialise over time. Our asset allocation and stock selection strategies will ensure that portfolios are well guarded against global market volatility. Furthermore, we are still finding ample opportunities to invest in high quality companies with sustainable competitive advantages – companies that we expect to grow and perform well through the economic cycle.

Bear markets generally coincide with recessions for good reason: during recessions, corporate earnings fall and investor appetite to embrace risky equities reduces. Yet in a world with such low rates available on savings, some argue that there is no alternative to investing in the capital markets.

In any event, and few can be confident in predicting the future, there are practical, sensible solutions to ensure investment portfolios are resilient. Strategies such as diversifying across asset classes, including cash (even if the return from cash is only marginal); ensuring asset allocation is fit for purpose; by focusing on high quality companies; and maintaining a focus on sustainable yield. These strategies have stood the test of time and will continue to do so in the future.

Adrian Ezquerro
Head of Investments

Clime Smaller Companies Fund

Portfolio Commentary

The Clime Smaller Companies Fund (CSCF) returned +12.0% (Wholesale Class, net of fees) for the September quarter, ahead of the Benchmark return of +8.3%. Pleasingly, a broad range of portfolio constituents contributed to the result.

The August reporting season broadly underwhelmed versus expectations, particularly within the large cap cohort of the Australian market. Downgrades outnumbered upgrades, with softer earnings forecast from many companies.

Nevertheless, the S&P/ASX 200 Accumulation Index rose 2.4% for the quarter but small caps performed strongly. Reflecting underlying conditions, the December quarter kicked-off with another cut to the RBA cash rate, to a new low of 0.75%.

Whilst it is difficult to predict broader market moves from here, our view is that judicious stock selection within the smaller company space will continue to yield superior results. We see plenty of opportunity outside the major indices and enter the December quarter with several portfolio holdings well-positioned for growth.

Spotlight on RPM Global

We have held mining operations software provider RPMGlobal (ASX code: RUL) since June 2017 and we recently had another results update meeting with the company. Although the pick-up in financial (and thus share price) performance was slower than we initially expected, the business has made solid progress in establishing building blocks for future success.

Over the last 7 years, RUL has transformed its software business from a desktop to an enterprise solution for mine planning, scheduling, budgeting and execution. More recently, equipment maintenance and mine design products were added to the product suites.

RUL's software integrates with Enterprise Resource Planning systems (predominantly SAP within miners), allowing master data – a single source of truth – between corporate and operations at mine sites. This enables efficient remote resource planning and coordination at various levels of a mining operation, ultimately saving time and money and reducing risk.

With RUL's product suite nearing completion, FY2020 will see a marked transition from a development focus to a sales and marketing focus. Mining is known as an IT-laggard industry and miners have traditionally lumped software into their annual budgets. RUL's strategies to increase adoption and smooth out its revenue profile are starting to bear fruit.

Firstly, although RUL's enterprise solution covers the operational spectrum from mine design to budgeting to execution, RUL is able to sell by module to individual mine sites.

Secondly, the company has refined a subscription sales model over the last 2 years to reduce the financial impact of traditional license sales and improve sales conversion.

The product modularity and subscription model together remove key impediments to adoption, enabling RUL to execute a "land and expand" strategy: by mining company, by mining site and by operational division.

We are seeing strong early adoption and there is potentially a long way to go. FY2019 finished with annual recurring revenue (ARR) from subscriptions of $4.3 million, up 230% on last year. 1Q20 saw ARR increase to $7.1 million, up another 65%.

Although some of the uplift in subscriptions reflects moving perpetual license customers, the majority represents new business. Note RUL will continue the perpetual license model in developing jurisdictions.

According to management, the software suite has approximately 3% to 4% product penetration across the coal, copper and iron ore verticals. With 1Q20 annual recurring revenue (maintenance and subscription) totalling $30 million, management's product penetration estimates imply an addressable market well in excess of $1 billion. Given a narrow competitive field – RUL is largely supplanting excel based practices in several instances – there are good prospects for the business to capture the remaining opportunity as miners standardise processes to lift productivity.

At the time of writing, RUL is capitalised at $167 million with $28 million of cash on the balance sheet and no debt. After accounting for its adjacent mining Advisory segment, we think the software business is materially undervalued at between 3 and 4 times recurring revenue. Considering software peers trade at 10 times revenue, we see a substantial payoff on successful execution.

New Portfolio Additions

We added two new positions during the quarter. A key focus of the Fund is on niche leaders that have secular growth tailwinds. We identified these characteristics in global litigation funder IMF Bentham (ASX code: IMF) and Australian medical imaging group Integral Diagnostics (ASX code: IDX). Both have the potential to be much larger businesses in the future.

IMF Bentham

At inception in 2001, IMF was a pioneer of litigation funding in Australia, itself a bellwether jurisdiction in the specialised niche. It is now a leading player globally, and in some geographies is once again introducing third party dispute financing to the legal community.

IMF's track record puts the business in good stead to deliver offshore. Of the approximately 200 cases funded to completion, IMF has an 89% success rate and generated an average return on invested capital (ROIC) of close to 134%. The average time to case completion is 2.6 years. These are strong economics.

Historically, the downside to the business, however, was the unpredictability and lumpiness of earnings due to the size and timing of case judgements and settlements.

To address this issue and ready the business for the next phase, in 2015 IMF commenced a strategy to transition from funding litigation cases from its own balance sheet to fund vehicles, in which it co-invests and manages. These special purpose vehicles enable IMF to significantly diversify and grow its business, in terms of geographic footprint and the number and size of cases in which it invests. Over time, this evolution in capital structure should yield higher and more consistent revenues and earnings.

In 2017, IMF launched three funds investing in US and non-US litigation cases. Then, in the last twelve months, IMF accelerated the strategy by launching two much larger funds which more than doubled its capacity in terms of funds under management to almost $2 billion. These two funds each carry options to increase to $1 billion, subject to demand. The new funds will take a few years to mature, however at prevailing prices we see a healthy payoff on successful execution.

On the near horizon, there are several large case investments held on the balance sheet that are close to completion, each with the potential to deliver a step-change to earnings for FY2020.

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Integral Diagnostics

IDX provides diagnostic imaging services from 67 sites with 106 radiologists across Victoria, Queensland, Western Australia and New Zealand.

MRI utilisation in Australia remains well below the OECD average at 16 per 1000 people per annum, versus the OECD ex-USA average of 25-30 (and the USA is higher again). Closing the utilisation gap on OECD peers supports long term diagnostic imaging growth in Australia above the growth rate of health care in general.

IDX is a best of breed operator, offering a comprehensive diagnostic imaging service and occupying leading local positions around Australia. With 7% to 8% market share, we see the business playing a prominent role in industry consolidation. Acquisition efficiencies are realised by building ‘hub-and-spoke’ distribution with hospitals as hub sites supported by a surrounding referral network of specialty centres, and by improving clinical workflows via IDX’s technology platform.

The $104 million acquisition of Imaging Queensland (IQ) during the quarter fits this strategy and builds out IDX’s exposure in Gladstone, Rockhampton and the Sunshine Coast.

Government policy is supportive for industry funding, with additional funding provided in the recent budget including the reintroduction of indexation, which will take effect during FY21.

Despite a forecast annual earnings growth rate of about 16% over the next three years, which is not reliant on broad economic conditions, IDX is trading at an undemanding multiple of 17 times earnings and an expected fully franked yield of 4.1%.

Other Portfolio News

Wellcom Group

In a good outcome for the Fund, in late July creative production and marketing services company Wellcom (ASX code: WLL) announced it had entered a Scheme Implementation Agreement under which it will be acquired by Korean advertising agency, Innocean Worldwide Inc.

The acquisition, likely to be approved by shareholders in 2Q20, is at $6.70 per share. This represented a 28% premium to last close before the announcement. There are additional fully franked dividends totalling 21 cents per share to be paid on or before implementation of the scheme, including a special dividend of 10 cents per share and a final dividend of up to 11 cents per share. All up, the takeover will deliver a 32% return.

Electro Optic Systems

During 1Q20 defence and space technologies company Electro Optic Systems (ASX code: EOS) was shortlisted in the final two for the Australian Army’s $15 billion LAND 400 armoured vehicle program. EOS is teamed exclusively with Korea’s Hanwha to provide EOS’s T2000 turret to Hanwha’s Redback vehicle, amounting to potentially $1 billion of work for EOS.

Electro Optic Systems is poised for a financial step-change with a number of growth initiatives within its Defence business coming to fruition. EOS has best-in-class products within a narrow competitive field. The Defence segment has tendered for contracts totalling more than $3 billion, with more in the pipeline.

On our analysis, the Defence business alone justifies the majority of EOS’s market value, implying valuation optionality in EOS’s Space business, which is of strategic importance to the US and its allies. The Space operation locates, classifies, and tracks space objects with accuracy and sensitivity exceeding current standards. It also has proprietary high-powered laser technology capable of displacing objects in space from the ground.

We believe the Space division has potential future value beyond the Defence segment, supported by significant investments in Space Force by the US, which will have a US$14bn annual budget when fully established in 2 to 3 years, as well as the Australian government’s new plans to triple the size of the domestic space sector to A$12 billion by 2030.

Helloworld Travel

In September, travel services provider Helloworld Travel (ASX code: HLO) released initial FY20 earnings guidance ahead of its AGM in November, providing clarity to the market after omitting guidance in its FY19 result.

The delay caused some concern; however it was simply due to timing of commercial arrangements. As it turned out, management’s expectations for FY20 of EBITDA between $83 million and $87 million were in line with previous consensus forecasts.

Despite further evidence of solid execution, shares declined over the quarter. Guidance implies underlying earnings growth of 20%, with growth initiatives supported by $18 million net cash on the balance sheet (as at 30 June). Yet for much of the quarter, HLO traded at an attractive free cash flow yield of about 10%.

We believe HLO’s franchise model puts the business in a good position to lead industry consolidation over the coming years.

On this front, HLO finished 1Q20 by announcing a $28 million acquisition of corporate travel management company TravelEdge Group. Consideration equates to 6 times EBITDA, so TravelEdge will be immediately earnings per share accretive. Including TravelEdge’s total transaction volume (TTV) of $300 million, HLO’s corporate travel segment TTV increases to $2.4 billion, and Group TTV increases to over $6.5 billion.

Looking further out, there are internal growth opportunities such as improving brand awareness by bringing more operators under the Helloworld brand and enhancing value to agencies via HLO’s new ResWorld mid-office system.

Eventually these opportunities and management’s track record will be better recognised in the market. For now, there are attractive dividends to be collected while we wait.

Manager Alignment

We take the opportunity to reiterate a philosophical cornerstone of our investment process: alignment. We seek to invest in companies that have products and/or services that we believe in, backed by highly capable and aligned management teams. Furthermore, we hold ourselves to account when considering the core value of alignment. We invest alongside our clients, and upon the same terms as clients. Accordingly, several members of the Clime investment and executive team are meaningfully invested in the Fund.

Prominent Fund Holdings *(alphabetical order)*

Afterpay Touch Group Ltd (ASX: APT)

Audinate Ltd (ASX: AD8)

Electro Optic Systems Ltd (ASX: EOS)

Hansen Technologies Ltd (ASX: HSN)

Macquarie Telecom Ltd (ASX: MAQ)

Jonathan Wilson
Portfolio Manager

Adrian Ezquerro
Head of Investments

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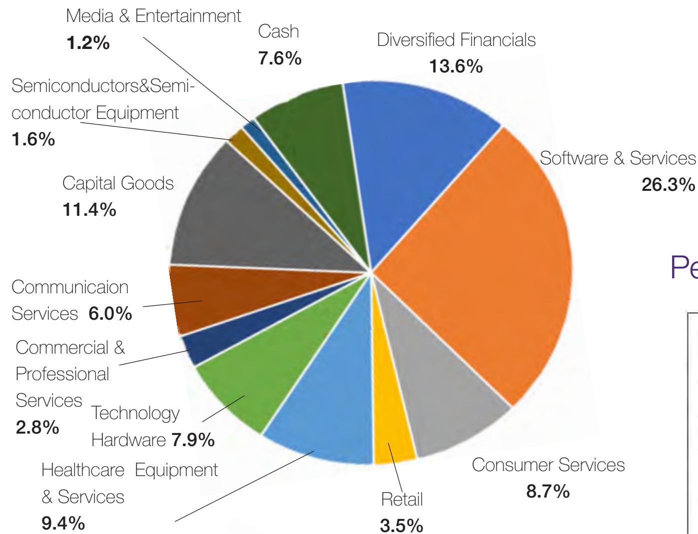
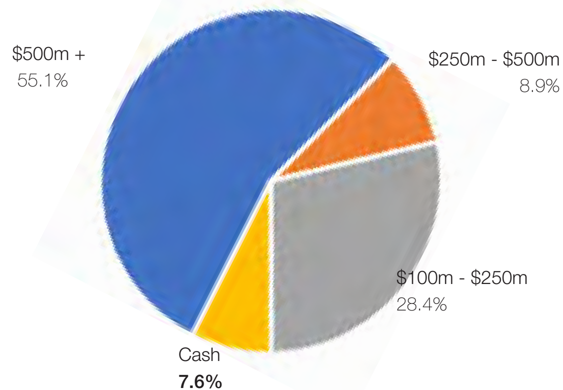
Asset Allocation by Sector



Asset Allocation by Market Capitalisation



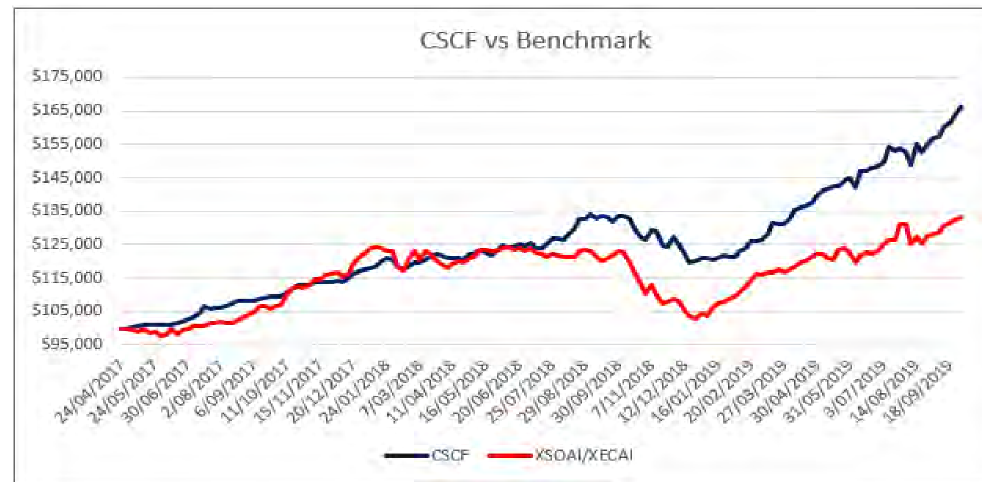
Distributions

Period Ended	Wholesale Units (cents per unit)
30 June 2019	8.2837
30 June 2018	4.3495

Snapshot

Portfolio Return (Quarter) Wholesale	Retail Fund Size	Wholesale Fund Size	Portfolio Return (Inception p.a.) Wholesale
12.0%	$1.0m	$35.4m	23.2%

Performance (30/09/19)



	1 month	3 months	6 months	FYTD	1 year	2 year	Inception*	Inception (Total)
Retail Portfolio Return (net of fees)	6.1%	-	-	-	-	-	7.6%	7.6%
Wholesale Portfolio Return (net of fees)	6.0%	12.0%	25.2%	12.0%	24.4%	23.0%	23.2%	66.1%
Benchmark^	4.2%	8.3%	10.8%	8.3%	16.1%	13.0%	12.4%	32.9%
Active Return	1.9%	3.7%	14.4%	3.7%	8.3%	10.1%	10.8%	33.2%

* Inception: Wholesale Units: 24 April 2017, Retail Unis: 24 July 2019. Performance figures for more than 1 year are annualised, calculated after all applicable fees and taxes. Returns have been calculated based on starting and ending unit prices after taking into account all ongoing fees, and assuming reinvestment of distributions.
^ blended benchmark comprising 50% of the Small Ordinaries Accumulation Index and 50% of the Emerging Companies Accumulation Index, from 1 July 2019, CPI trimmed mean +8% p.a. from 24 April 2017

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