

THB US Micro Cap Fund

Quarterly Report – June 2019

Market commentary

The Russell Microcap® Index (Index) returned +2.2% (AUD) in Q2.

Real Estate (+8.1%) was the best performing sector in Q2 followed by Utilities (+7.2%) and Financials (+5.2%). Energy (-10.1%) was the worst performing sector, followed by Communication Services (-6.6%) and Materials (-4.7%).

US Equities ended the quarter higher as markets digested strong current economic data, but remained concerned about the outlook due to slowing global growth and tariffs. Trade negotiations with China and the Federal Reserve's pivot on interest rates were driving factors for the market this quarter.

Sentiment/optimism indicators are picking up post the year end malaise caused by the government shutdown. The NFIB Small Business Optimism Index has seen four months of sequential increases. The all time high of 108.8 took place in August 2018 and it registered 105.0 for May. US consumers continue to power the economy with The University of Michigan consumer sentiment index rising to a 15 year high of 102.4. Consumers remain buoyed by the strong labor market as the jobless rate hit a 50-year low of 3.6%. The US consumer and small business are the backbone of the economy and both segments appear to be looking through the noise of trade negotiations and remaining focused on the strong underlying economy. Tax reform and deregulation are benefiting both.

Portfolio commentary

The THB US Micro Cap Fund returned + 2.4% in AUD (net of fees) in Q2, outperforming the Index by 0.3%.

Positive contribution came from selection in Consumer Discretionary (+0.6%), Materials (+0.6%), and Health Care (+0.5%). Negative contribution came mainly from selection in Industrials (-0.9%), Financials (-0.5%), and underallocation to Real Estate (-0.2%).

THB's top five performing stocks (from a contribution standpoint) were Circor International, Inc. (Industrials, +0.5%), PAR Technologies (Information Technology, +0.4%), Rudolph Technologies, Inc. (Information Technology, +0.3%), Ultra Clean Holdings, Inc. (Information Technology, +0.3%), and U.S Physical Therapy, Inc. (Health Care, +0.3%).

The bottom five performing stocks (from a contribution standpoint) were Argan, Inc. (Industrials, -0.4%), ePlus Inc. (Information Technology, -0.3%), MarineMax, Inc. (Consumer Discretionary, -0.3%), TimkenSteel Corp (Materials, -0.2%) and PRGX Global (Materials, -0.2%).

Micro cap stocks are trading at an historic high valuation discount relative to large capitalisation equities and there are many reasons why the gap should close. Small business optimism near record levels, robust cash flows stemming from tax reform/ deregulation and increasing levels of merger and acquisition activity create a very positive environment for the asset class. US large cap equities have traded to historic highs while small and micro cap equities have lagged

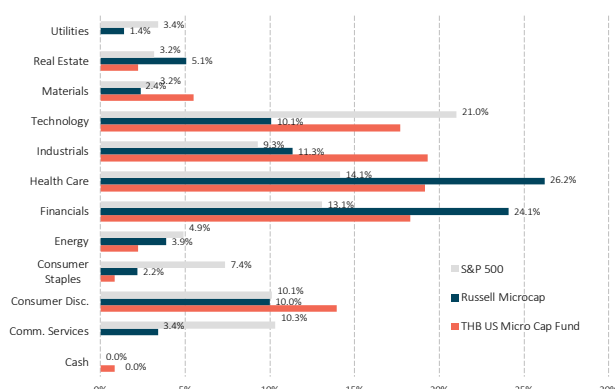
Fund details	
Benchmark	Russell Microcap® Index ³
Inception date	5 September 2014
Fund size	A\$294 million

Performance ¹ – 30 June 2019			
	Fund ²	Russell Microcap®	Difference
1 month	4.4%	4.9%	(0.5%)
3 months	2.4%	2.2%	0.3%
1 year	(3.8%)	(5.6%)	1.8%
2 years p.a.	8.7%	8.5%	0.2%
3 years p.a.	15.7%	13.4%	2.2%
Since inception p.a. ²	12.6%	12.9%	(0.3%)

1. Performance figures are presented in AUD on a net, pre-tax basis and assume the reinvestment of distributions. Past performance is not an indicator of future performance.

2. Fund inception date was 5 September 2014 however inception performance is calculated from 1 October 2014.

Sector allocation⁴



3. The Russell Microcap Index is a capitalisation weighted index of 2,000 stocks that captures the smallest 1,000 companies in the Russell 2000 and 1,000 smaller US based listed stocks.

4. Portfolio holdings and allocations are subject to change and should not be considered as investment recommendations to trade individual securities. The securities identified and described do not represent all of the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified were or will be profitable. There is no assurance that any securities discussed herein will remain in the portfolio at the time you receive this report, or that securities sold have not been repurchased. There can be no assurance that investment objectives will be achieved. A full list showing every holding's contribution to the overall account's performance during the measurement period and calculation methodology is available upon request.

Portfolio commentary (continued)

and remain 15-20% below record levels. Using Small Cap (Russell 2000) as a proxy, periods like the current one have only occurred three times in the last 40 years (January 1985, February 1991 and November 1998) and each saw small caps catch up to large cap and reach record highs themselves. THB continues to believe that micro cap equities present a compelling opportunity for investors due to the strong US economy and trough (relative) valuation levels.

The recent portfolio additions discussed below highlight the inefficiencies present within the market and how active managers can take advantage of market pullbacks like the one experienced in Q4 2018.

Stocks in focus

Circor International (CIR)

Circor International (NYSE: CIR) has a diversified flow and motion control product portfolio with recognised, market-leading brands that fulfill mission critical needs for the energy, industrial and aerospace markets. The company acquired the Fluid Handling business of Colfax Corporation (NYSE: CFX) in December 2017, adding specialty pumping solutions such as screw pumps and centrifugal pumps. The acquired business had an attractive revenue mix, higher EBITDA margins and aftermarket exposure which reduced significantly the cyclicality of Circor's legacy businesses and improved its earnings potential. THB believed that the market underappreciated the value of the transformed company.

THB took advantage of the Q4 market pullback and purchased Circor in December at \$22 per share. In May this year, Crane Co (NYSE: CR) announced an all-cash proposal to acquire Circor for \$45 per share. The proposal represented a 47% premium over the prior day's closing price and 100% premium to the December 2018 price. In response, Circor's management team rejected the offer and issued an open letter to shareholders presenting a detailed plan to deliver substantial earnings growth over the next 18 months. The company committed to improving EBITDA margins by approximately 400 basis points and increasing EBITDA by 37% from 2018 to 2020. These recent developments solidified THB's thesis that the company is currently undervalued, owns attractive assets and has the potential to generate substantial operational improvements over the next two years.

Renewable Energy Group (REGI)

Renewable Energy Group (NASDAQ: REGI) is the largest North American pure play advanced biodiesel producer. It operates 13 biomass-based diesel plants with a total of 622 million gallons effective capacity. In 2018, REGI produced 502 million gallons of cleaner fuel delivering over 4 million metric tons of carbon reduction. The company differentiates with its multi-feedstock capabilities that allow it to optimise its production to the lowest cost feedstock streams depending on the market conditions. In 2018, REGI was able to generate \$0.38 per gallon margin advantage as a result. The company is a beneficiary of a favourable government policies, including increasing EPA volume mandate for biomass-based diesel and \$1 biodiesel tax credit (BTC) supporting the industry. It generated 83% of its sales to regions with higher value markets due to carbon reductions policies.

Longer term, it is well positioned for growth driven by:

- the increasing demand for lower carbon emission fuels as a growing number of states implement some form of Low Carbon Fuel Standards (LCFS) policies similar to California,
- its strategy to expand downstream penetration resulting in higher blend and margin capture,
- a recent JV with Phillips 66 to construct a new 250 million gallon plant. REGI is significantly undervalued trading at a large discount to its net book value of \$20 per share.

REGI is a prior holding in the US Micro Cap strategy. THB owned the company and sold it last year at \$26 per share as it neared its price target. The current pullback has allowed THB to reenter the stock at \$15 per share.

Portfolio statistics¹

As at 30 June 2019		
	Fund	Russell Microcap®
Weighted avg market cap	US\$631m	US\$714m
Price/sales	1.0x	0.9x
Price/book	1.8x	1.8x
Dividend yield	0.7%	1.2%
Number of securities	100	1,557
Standard deviation	15.4%	17.0%
Sharpe ratio	0.6	0.5
Beta	0.9	
Tracking error	5.4	
Information ratio	0.2	

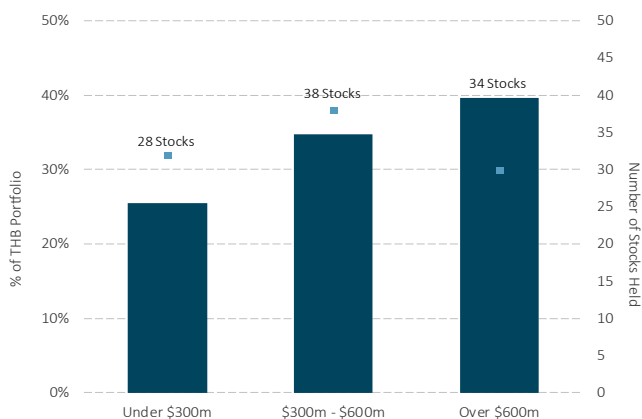
1. Portfolio statistics are reported in USD. Source: THB Asset Management

Top 10 holdings

Stock	Sector	Weight
PAR Technology	Technology	3.0%
Johnson Outdoors	Consumer Disc.	2.6%
Mesa Laboratories	Health Care	2.5%
Old Second Bancorp	Financials	2.3%
UFP Technologies	Materials	2.2%
Graham Corp	Industrials	2.0%
US Physical Therapy	Health Care	2.0%
Rudolph Technologies	Technology	2.0%
First Busey Corp	Financials	1.9%
Methode Electronics	Technology	1.9%

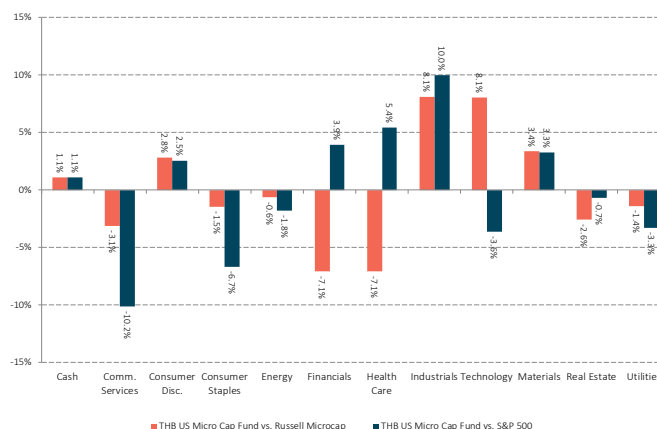
Source: THB Asset Management

Companies by market capitalisation



Source: THB Asset Management

Active sector positioning



Source: THB Asset Management

Investment strategy

THB Asset Management (THB) is an employee-owned boutique investment management firm based in Connecticut specialising in smaller company strategies. THB's US Micro Cap strategy is based on the belief that there are inefficiencies in the micro cap segment of the market due to lack of analyst coverage, difficulty in identifying value and the impact that management skill has on the direction of smaller companies. THB utilises a disciplined, fundamental bottom-up approach that blends both qualitative and quantitative methods to construct a well-diversified portfolio of companies that possess attractive operating metrics, yet with comparable valuation to the Russell Microcap® Index.

BROOKVINE

THB
Asset Management

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