THB Asset Management
A VICTORY CAPITAL® INVESTMENT FRANCHISE

THB US Micro Cap Fund

Quarterly Report – Q3 2021

Market commentary

The Russell Microcap® Index (Index) returned -1.2% (AUD) in Q3 2021.

Financials (+4.0%) was the best performing sector, followed by Materials (+2.9%) and Real Estate (+0.9%). Consumer Discretionary (-14.0%) was the worst performing sector followed by Health Care (-8.8%) and Information Technology (-7.4%).

US equities were mostly lower this quarter following the positive returns of the preceding two quarters. The strong performance leading into this period normalised as a confluence of fears hit the markets regarding the Delta variant, geopolitical risks, monetary support/trajectory and inflation. The very recent pandemic scarring, combined with strong performance, can lead to reactionary fear-based pullbacks. Taken in context, a pullback makes sense, is healthy, and should be viewed opportunistically. The solid economic foundation comprising incredibly liquid consumers, a tight labour market, record-high consumer net worth, and accommodative monetary policy remains fully intact. Uncertainty regarding China and relations with Western countries is creating opportunities for smaller domestic companies.

Employment data, wage inflation, and how that may impact monetary policy is still unclear, except for a positive directional trend for overall employment levels. The US U-6 unemployment rate fell to 8.5%, which is slightly above pre-pandemic levels of 6.9% in January 2020 and 8.0% in January 2019. Official unemployment rate data may mask underlying strength of the labour market, as a record 51% of small businesses (a broad measure of the US economy) stated that they had unfilled labour positions they could not fill; 92% of respondents cited the main reason as few or no qualified applicants. Due to a tight job market, pockets of worker shortages and wage inflation are appearing and shifting demographics within the labour force. The shifting elements and demands of the labour market should be a long-term positive for high-quality small and medium businesses. Firms which foster strong culture will be able to maintain and possibly expand (at the expense of weaker competitors) their labour force.

Portfolio commentary

The THB US Micro Cap Fund returned -1.8% AUD (net of fees) in Q3 2021.

The portfolio saw positive contribution from stock selection in Health Care (+2.9%), selection in Information Technology (+1.1%), and overallocation to Information Technology (+1.0%). Negative contribution came mainly from stock selection in Communication Services (-1.6%), underallocation to Health Care (-0.6%), and stock selection in Financials (-0.6%).

THB's top five performing stocks (from a contribution standpoint) were Grid Dynamics Holdings, Inc. (Information Technology, +1.0%), Perficient, Inc. (Information Technology, +1.0%), Apollo Medical Holdings, Inc. (Health Care, +0.6%), Joint Corp. (Health Care, +0.4%), and ePlus, Inc. (Information Technology, +0.4%).

The bottom five performing stocks (from a contribution standpoint) were EverQuote, Inc. Class A (Communication Services-0.7%), Hyster-Yale Materials Handling, Inc. Class A (Industrials,-0.7%),

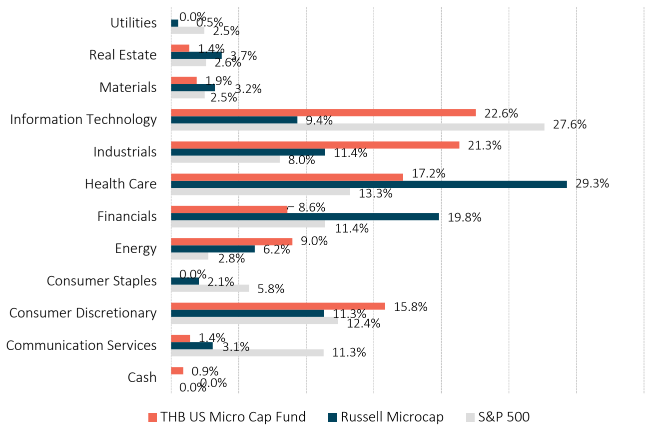
Fund details	
Benchmark	Russell Microcap® Index[3]
Inception date	5 September 2014
Fund size	A$88.6 million

Performance[1] – 30 September 2021

	Fund[2]	Russell Microcap®	Difference
1 month	(3.6%)	(1.8%)	(1.8%)
3 months	(1.8%)	(1.2%)	(0.6%)
1 year	54.5%	59.8%	(5.3%)
2 years p.a.	22.1%	25.3%	(3.2%)
3 years p.a.	11.3%	12.3%	(1.0%)
5 years p.a.	16.2%	15.8%	0.4%
Since inception p.a.[2]	14.7%	15.5%	(0.8%)

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. Figures in the table may not sum correctly due to rounding.
2. Fund inception date was 5 September 2014 however inception performance is calculated from 1 October 2014.

Sector allocation[4]



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)

TPI Composites Inc. (Industrials,-0.6%), TETRA Technologies, Inc. (Energy,-0.5%) and Bassett Furniture Industries, Inc. (Consumer Discretionary,-0.5%).

During the quarter, THB's portfolio companies announced 18 acquisitions and four new share repurchase authorisations. One of companies, ECHO Global Logistics, was acquired by The Jordan Co LP at a 50% premium.

Specialisation

Specialisation is not easy to quantify but is a change which is developing across multiple industries and creating sizable opportunities for small and medium sized companies. Decades of corporate vertical integration are being unwound as a confluence of factors force companies to rethink traditional methods of product production, marketing and distribution. Secular economic changes accelerated by the pandemic, combined with increasing diseconomies of scale, are quickly reshaping corporate structures.

Key drivers of these changes include complexity of products produced, need for shortened development/production times, and labour force requirements. Diverse industries such as semiconductor chip production, pharmaceuticals, medical equipment and industrials are utilising specialist companies in multiple ways. Such usage is creating sizable avenues of growth for existing small and medium sized companies as previously captive revenue is released outside of larger corporations.

The increasing need for very specialised human capital, shortage of such workers, and pockets of wage inflation are driving more companies to seek specialists to perform or aid in the production and/or development of their products. An example would include very specific, critical design elements of a semiconductor chip. A smaller company which has decades of IP related to semiconductor chip power management and the labour force needed for such design integration could provide their services to a much larger semiconductor chip manufacturer. The very specialised labour pool needed for this production is much better managed at a streamlined, focused company. Management is one issue; finding and retaining such talent (keeping them happy, shared culture) may present other problems for very large corporations. As the need for very specialised workers increases, finding and retaining such talent may be a job better suited for smaller, more nimble firms. For example, the human resources department at a large manufacturing corporation may not have the correct HR personnel to understand and source a large software design team. Post-pandemic, human capital is seeking higher wages, flexible work/life balance and other benefits, further complicating a difficult situation. Such friction points within corporate structures should continue to drive more opportunities to smaller, high-quality firms.

Needs for decreased production time to market, increasing numbers of SKUs, and more complex supply chains are creating new revenue sources for companies across multiple industries. Producing complex products in a shorter duration is driving demand for specialised production facilities, design teams, data sets and analytics. Pharmaceuticals and drug development are areas experiencing high levels of specialisation. The drug development process is a complex process that is highly regulated and must be tightly controlled. Once a drug is developed, tested and passes trials, it then must be manufactured in facilities which have been inspected and approved by various government agencies. Companies within this industry are relying on specialised partners in order to streamline their discovery and production processes.

One holding which is benefiting from the acceleration of these trends is ***Grid Dynamics.*** Grid Dynamics is enabling companies to expedite their digitalisation process. They are an emerging leader in enterprise-level digital transformations in Fortune 1000 companies. Grid Dynamics offers close collaboration to provide digital transformation initiatives that span strategy consulting, development of early prototypes and enterprise-scale delivery of new digital platforms. The company has built vertical specific expertise serving customers in several industries such as Retail, Technology, Consumer Packaged goods (CPG)/manufacturing, and Finance. For example, the company has worked closely with a large U.S. retailer to develop a strategic omnichannel transformation program including consumer experience, product discovery, analytics and inventory optimisation. Grid Dynamics is in the early stages of growth and is well positioned for the long term given its strong technical capabilities, its focus on next-generation technologies, and the secular tailwinds for digital transformation services.

Energy Transition

The rapid adoption of green energy technologies and various standards of lowering carbon emissions is creating a wealth of investment opportunities, but also unintended consequences. There is little doubt that our future will be one with much lower carbon emissions, but the path may be less linear than anticipated. When the laws of supply-and-demand combine with government intervention and varying degrees of consumer adoption, a somewhat chaotic process is sure to follow.

Creating all the machinery and products needed for a lower carbon, greener future will also require massive amounts of materials whose production and extraction will require significant amounts of traditional energy. For example, the average wind turbine contains approximately 900 tons of steel and 2,500 tons of concrete. Extracting, processing and delivering these materials in a period of reduced supply is creating upward movements in prices across the commodity complex. The S&P GSCI Commodity Index has reached a five-year high. Beyond steel and cement, large amounts of rare metals such as lithium will be needed for EV batteries. Each new EV battery weighs approximately 1,000 pounds.

The combination of all of these factors is creating a dynamic situation with many shades of gray instead of black and white. Beyond investments in green energy production, opportunities are emerging as materials producers seek ways to lower their emissions, demand for battery materials increases, and "old energy" companies reposition their intellectual property and assets for a lower carbon future.

The story of the pandemic and its impact on the world economy, governments and businesses is unfolding before us, creating risks and new opportunities. Many positives, such as the strong consumer and robust corporate profits, remain intact—but unplanned risks such as supply shortages, labour shortages and corresponding price increases loom on the horizon.

Much of the official economic data continues to point to differing trajectories for the economy. Broad economic data is always noisy, and the Covid-19 pandemic period has only amplified that noise. The best course is to focus on the companies, listen to what they are saying, and watch what they do. Through that lens, THB's positive view of the economy remains fully intact. THB is witnessing companies pursue transformational mergers, repurchase their own shares, and invest capital to expand their businesses. Companies are investing to improve efficiencies, expand production and shore up supply chains. According to S&P Global, world corporate capital expenditure is expected to increase by 13% this year, with growth in all regions and sectors. The nimble nature of smaller companies is well suited for this time of change in the US and world economies.

Portfolio statistics[5]

As at 30 September 2021	Fund	Russell Microcap®
Weighted avg market cap	US$1,042m	US$770m
Price/sales	1.2x	1.7x
Price/book	2.1x	2.2x
Dividend yield	0.5%	0.9%
Number of securities	93	1,774
Standard deviation	21.1%	21.2%
Sharpe ratio	0.6	0.6
Beta	1.0	
Tracking error	6.4	
Information ratio	0.1	

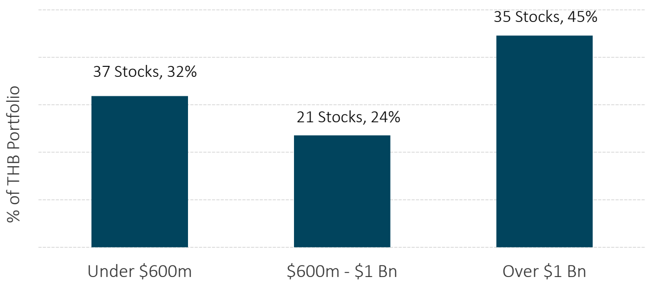
5. Portfolio statistics are reported in USD. Source: THB Asset Management

Top 10 holdings

Stock	Sector	Portfolio weight
Perficient	Technology	3.2%
First Busey Corporation	Financials	3.0%
Grid Dynamics Holdings	Technology	2.5%
ePlus inc	Technology	2.4%
Transcat Inc	Industrials	2.3%
PAR Technology	Technology	2.3%
Movado Group	Consumer Disc	2.0%
Joint Corp	Health Care	2.0%
RPC Inc	Energy	1.9%
BioLife Solutions Inc	Health Care	1.8%

Source: THB Asset Management

Companies by market capitalisation



Source: THB Asset Management

Investment strategy

THB Asset Management (THB), an investment franchise of Victory Capital Management Inc., is a dedicated micro and small cap specialist investment franchise based in Connecticut, USA. Founded in 1982, THB Asset Management has 39 years' experience investing in micro and small cap companies. 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.

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