THB Asset Management
A VICTORY CAPITAL® INVESTMENT FRANCHISE

THB US Micro Cap Fund

Quarterly Report – Q1 2022

Market commentary

The Russell Microcap® Index (Index) returned -10.5% (AUD) in Q1 2022.

Energy (+32.8%) was the best performing sector followed by Materials (+14.8%) and Real Estate (-0.6%). Health Care (-18.1%) performed the worst, followed by Information Technology (-14.7%) and Consumer Discretionary (-14.6%).

US Equities were broadly lower this quarter as participants digested persistent levels of higher inflation, tighter monetary policy, as well as simmering geopolitical tensions that culminated with Russia's invasion of Ukraine on February 24. The invasion of Ukraine had been weighing on the markets throughout February, and most indices have recovered to levels above the invasion day lows. Western countries reacted swiftly to the invasion and unleashed a host of sanctions against Russia and also effectively unplugged Russia from the world banking system by disallowing transactions via the SWIFT system. In addition to mandatory governmental sanctions, a significant number of major brands and corporations have voluntarily decided to exit or cease operations in Russia. These sanctions and actions have served to amplify preexisting inflationary drivers such as energy prices and supply chain disruptions.

The Federal Reserve raised interest rates and struck a more hawkish tone, intending to bring inflation under control. Value outperformed growth across all market-cap spectrums this quarter as the Russell 2000® Value Index and Russell Microcap® Value Index returned -2.40% and-3.45%, respectively, versus the Russell 2000® Growth Index and Russell Microcap® Growth Index returns of-12.63% and -13.71%, respectively.

Portfolio commentary

The THB US Micro Cap Fund returned-10.0% in AUD (net of fees) in Q1 2022.

The portfolio saw positive contribution from stock selection in Health Care (+2.7%), overallocation to Energy (+1.1%), and stock selection in Energy (+1.1%). Negative contribution came mainly from overallocation to Information Technology (-1.1%) as well as stock selection in Materials (-1.0%) and Industrials (-0.8%).

THB's top five performing stocks (from a contribution standpoint) were RPC, Inc. (Energy, +2.3%), Lantheus Holdings, Inc. (Health Care, +0.9%), TETRA Technologies, Inc. (Energy, +0.8%), Renewable Energy Group, Inc. (Energy, +0.4%), and Clean Energy Fuels Corp. (Energy, +0.4%).

The bottom five performing stocks (from a contribution standpoint) were Grid Dynamics Holdings, Inc. Class A (Information Technology, -1.6%), BioLife Solutions, Inc. (Health Care,-0.7%), Ultra Clean Holdings, Inc. (Information Technology,-0.6%), Century Communities, Inc. (Consumer Discretionary,-0.5%) and M/I Homes, Inc. (Consumer Discretionary,-0.5%).

We may look back on the invasion of Ukraine as a time marker when a new geopolitical and economic era began. In the short span of a few weeks, seismic geopolitical changes have taken place which will have a sizable impact on global economies, industries, and markets for years to come.

Fund details	
Benchmark	Russell Microcap® Index[3]
Inception date	5 September 2014
Fund size	A$79 million

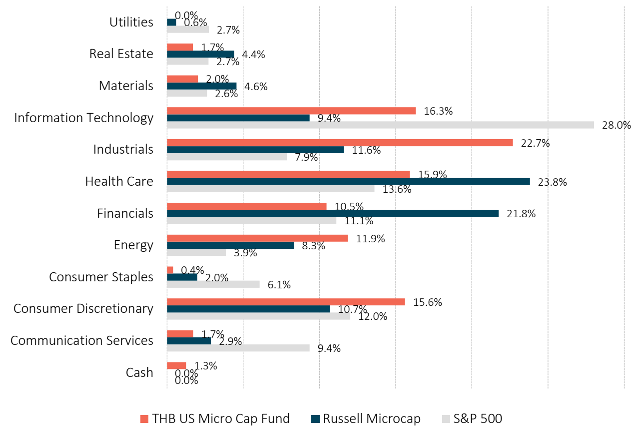
Performance[1] – 31 March 2022

	Fund[2]	Russell Microcap®	Difference
1 month	(2.3%)	(2.0%)	(0.3%)
3 months	(10.0%)	(10.5%)	0.5%
1 year	(12.3%)	(9.7%)	(2.6%)
2 years p.a.	30.8%	26.4%	4.4%
3 years p.a.	10.4%	10.9%	(0.6%)
5 years p.a.	9.9%	10.2%	(0.3%)
Since inception p.a.[2]	11.8%	12.2%	(0.4%)

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)

Globalisation as we knew it ends

Years of Western countries' appeasement and ignorance regarding the issues surrounding questionable trading partners and practices likely peaked with the invasion of Ukraine. The revanchist tendencies of Mr. Putin set in motion changes that were hard to imagine a month prior. With a single action, he has united NATO and the EU, ended decades of Swiss neutrality, doubled the German defense budget, severely damaged and isolated the Russian economy for years to come, united the US Democrats and Republicans in their common support for Ukraine, and managed to possibly damage his "no limits" friendship with China.

The next era of globalisation will likely encompass trading blocs and regions versus full global integration. Countries will value self-sufficiency above other considerations and trade primarily with countries with shared values and politics. Looking inward (versus outward to low-cost manufacturing locations) will likely be a long-term positive shift for domestic workers and industries.

Inflation will not be homogenous

Inflation will not be homogenous across all goods, services, and wages. Unexpected winners and losers will emerge as secondary effects ripple through the economy and difficult-to-predict adaptations occur. Inflation is a point-to-point metric capturing shorter term (12-month to 18-month) directional changes. This is of course important, but sometimes misses the longer-term backdrop. Certain prices and wage groups have experienced a decade-plus of flat to declining movement. The recent "spikes" may be partially caused by current events but are also reflective of the secular declines witnessed during the prior periods. As the new era in geopolitics is ushered in, previous inflation trends may change and not reverse so quickly.

Globalisation was a key deflationary factor in the global economy, creating its own set of countries, industries, and companies which experienced significant benefits as globalisation roared ahead. One group that did not win during the globalisation was the American factory worker. As jobs were shipped overseas, workers lost any expectation of wage increases. Jobs were scarce and workers were plentiful, allowing corporations to keep wages consistently flat during a fairly strong economic period.

As peak globalisation occurs, many companies are aiming to shore up complex supply chains and move production back onshore. Such simultaneous actions by varying groups of industries are increasing the demand for this cohort of workers in an already tight labour market. Due to the secular nature of changes taking place, the recent increase in wages may not recede as quickly as anticipated.

Inflationary effects on certain goods will surely recede. The laws of supply and demand still hold true, and producers will move to take advantage of sharply higher prices with increased supply. Additionally, the rate of price change for certain goods will moderate slowing overall inflation. This relationship breaks down when multiple forces inhibit the anticipated supply response, as we are currently experiencing with the global energy markets.

En-flation

Hydrocarbons impact many aspects of our economy, and rising oil and gas prices will make controlling inflation even more difficult. The breadth of energy's impact on our economy makes taming overall inflation very challenging. Factories run on energy, and hydrocarbons are a key raw material in many products we use each day. Additionally, labour-intensive industries such as farming use vast amounts of energy to plant and harvest the foods we eat. Rising energy prices will be passed along in the form of higher prices for food and services, impacting large parts of our economy.

Fossil fuels have generally experienced boom-and-bust cycles largely anchored to the cyclical elements of supply and demand. Societal, governmental, and investment changes, such as ESG considerations and decarbonisation, have altered the typical supply response. Investors and banks are reducing exposure to the industry, and the companies themselves are diverting cash flows from exploration (supply growth) to dividends and share repurchases.

The supply problem is further complicated by where reserves are located. As Russian oil went under sanctions, the countries with slack capacity (such as Iran, Venezuela, and Saudi Arabia) were talked about as areas from which to source increased supply. Iran and Venezuela already occupy spots on the list of top five most sanctioned countries in the world, and Saudi Arabia's production facilities were recently attacked by Yemen rebels (Houthi). It should be clear that global slack energy capacity is not located in ideal or stable areas, and as certain European countries are quickly learning, this should not be viewed as a long-term supply solution.

Fossil fuels, as the world has suddenly witnessed, have not been relegated to the dustbin of history just yet. As expected, the journey to a greener, lower carbon future will require hydrocarbons and not be as linear as some would hope.

Wars are inflationary

History has shown that wars are generally inflationary, and we are currently experiencing three "wars" across different fronts; war in Ukraine, the war against climate change, and the very recent battle against Covid-19. Wars typically require large amounts of "stuff" in a short time frame. Depending on the actual war, food, machinery, ammunition, clothing, fuel, technological solutions, and vehicles are some examples of what is needed. Governments have historically printed money to finance wars, and the same is happening today. Governments across the world are increasing their budgets to fight these three wars.

Potential rate increases

It is quite likely that the Federal Reserve's monetary tightening will not be able to bring all elements of inflation lower. The economy is very strong; rates (even considering the seven expected rate hikes) will still be low; banks have plenty of capital to lend; overall financial conditions are accommodative; and certain elements of inflation appear more secular versus cyclical, as described above. This makes the Fed inflation target of 2% unlikely to be achieved in the medium term. The economy may have to run hot for longer than the Fed desires, with inflation in the 3%–4% range. Their actions will be determined by their patience level with higher levels of inflation and if they want to cause a recession to bring the Consumer Price Index lower. The cadence and existing scope of rate hikes will indicate which path they plan to pursue.

Why small-caps work during inflationary periods

Smaller cap stocks have historically performed well during inflationary periods. This relative outperformance is likely due to a host of factors. The structure of the underlying businesses, industry representation of the benchmarks, and labour force composition are some of the reasons which contribute to their ability to prosper during higher levels of inflation. Additionally, smaller companies typically have sizable market shares of lower total addressable market sizes. Put simply, smaller companies sell mission-critical, niche parts or services that go into much larger products or projects. This structure generally affords them a large degree of pricing power.

Inflationary opportunities in today's markets

Every market cycle, even with similar drivers such as inflation, will have differing sets of companies that prosper. THB's investment process seeks out companies with traits such as low levels of debt, pricing power, high operating margins, and high returns on capital. Many of these traits are also shared by businesses which should prosper during inflationary periods.

Considering today's economic structure and inflation backdrop, THB sees a host of attractive opportunities. Some are textbook inflation hedges, and others are more tangential and situational to today's environment. These opportunities include:

- Commodity producers: energy, metals, chemicals, wood products, fertilisers, aggregates, and food producers
- Commodity producer ecosystem: companies that sell to or that service commodity producers will benefit from the higher volumes and increased revenue from their customers. These include oil service companies and machinery producers
- Distributors: companies that distribute various goods (machinery, food, technology, chemicals) stand to benefit from inflation, assuming they are able to hold margins. They will experience higher gross margin revenue over some element of fixed costs
- People businesses/services: In the current very tight labour market, having an intact team that can provide various services will be in high demand. Customers may not have the ability to find and retain personnel needed to perform certain services. Companies which can provide them in a timely, efficient manner should do well
- Technology companies: broad wage and goods inflation will spur capital investment into projects which increase efficiency and productivity. Software, services, and hardware will all be needed.

The big picture(s)

Getting buried in the news cycle and overloaded with real-time data can cause a loss of perspective. History is not a perfect guide or predictor of the future, but it can offer valuable insights. Wall Street has an expensive tendency to extrapolate current trends into infinity, utilising phrases such as "new paradigms" to ignore the past.

Our recent history has been formed with the backdrop of a four-decade bull market in bonds and ever decreasing levels of interest rates. The recent decade was dominated by a large-cap/mega-cap cycle and the only measure of risk was standard deviation, with little concern for preservation of future purchasing power. Many strategies formed during this period are based on these assumptions, making ultra-low volatility, single-digit annualised returns appear very attractive.

Predicting the direction of interest rates is an incredibly difficult parlor game, and exact clarity on the timing and causes of inflation still remains a mystery. Currently inflation is real (duration yet to be determined), globalisation (sizable deflationary force) is ending, interest rates recently touched 40-year lows, and the Federal Reserve is on a path of raising rates. It should be safe to assume that interest rates will likely be heading higher over the near term and possibly longer.

The current environment has been based on the premise that higher levels of interest rates result in a bad environment for stocks. However, prior cycles do highlight that stocks and bonds CAN move in opposite (stocks higher, yields higher) directions for an extended period of time. One could argue that the backdrop of one of the longest secular bull markets in US history has some resemblance to today. That bull market took place from 1941 and lasted until 1968, while the 10-year US Treasury yield increased from 1.95% to 7.8%. Similar to today, the US was building out infrastructure and domestic manufacturing, fought multiple wars (WWII, Korea, Vietnam), and experienced episodic bouts of higher inflation.

Cycles

Recent history has been marked by a decade of large-cap/mega-cap dominance. It is impossible to determine whether this was caused by or coincident with ultra-low interest rates and/or globalisation. A longer-term analysis of the small-cap and large-cap markets reveals the cyclical nature of the performance cycles and durations.

The large-cap/small-cap cycles tend to be long and likely driven by a confluence of market and economic factors. Having touched on inflation earlier, another important element may be antitrust enforcement and views within the country. The period from 1940 to 1980 experienced high levels of antitrust enforcement and strong support for a robust competitive environment. Until very recently, there has been scant enforcement or challenges to mergers.

This trend appears to be changing. Recently, mega-cap technology companies have been able to unite Republicans and Democrats in their support of higher scrutiny of their questionable business practices and tactics which possibly unfairly quelled any competition. Unionizations are on the rise, and the Department of Justice is taking a much tougher stance toward mergers. This cycle of antitrust enforcement may be turning in a different direction.

Stocks in focus

During the quarter, THB's portfolio companies announced 20 acquisitions and six new share repurchase authorisations.

THB added two holdings to the portfolio which it believes will benefit from higher levels of regulation for water treatment and increasing levels of domestic energy production.

Hawkins Inc. (HWKN)

Founded in 1938, Hawkins is a leading specialty chemical and ingredient company serving the water treatment, health & nutrition, and industrial end-markets. The company has shifted its business from bulk distribution to higher-margin value-added manufacturing and blending, which today comprises 90% of total sales.

Hawkins has built a dense infrastructure, with 49 facilities in 24 states in the US, which allows them to provide full-service solutions to customers and grow market share. The company is benefiting from multi-year demand drivers for its products. Stringent regulatory requirements for wastewater disposal from both municipal and industrial sources are growing their water treatment business. Enhanced consumer focus on health and wellness, accelerated by the Covid-19 pandemic, is driving demand for nutritional and dietary ingredients.

Solaris Oilfield Infrastructure (SOI)

Solaris Oilfield Infrastructure designs, manufactures and rents specialised equipment to manage the delivery, handling, and storage of proppant and chemicals at the well site. Its solutions are gaining share due to their high uptime performance (>99%), throughput optimisation, and the all-electric design. Their new product called "AutoBlend™" is an all-electric, automated delivery and blending system that can reduce frac personnel on location by up to 80%, providing significant savings and safety improvements to its customers. Its solutions have a high renewal rate, as they comprise less than 1% of the total monthly well costs.

The company has a strong balance sheet with no debt and returns $19 million to shareholders annually in the form of dividends. The management team is aligned with shareholders, with ~15% ownership of shares outstanding.

Portfolio statistics[5]

As at 31 March 2022		
	Fund	Russell Microcap®
Weighted avg market cap	US$924m	US$815m
Price/sales	1.1x	1.5x
Price/book	1.9x	1.8x
Dividend yield	0.7%	1.1%
Number of securities	96	1,777
Standard deviation	20.7%	21.0%
Sharpe ratio	0.5	0.5
Beta	0.9	
Tracking error	6.3	
Information ratio	0.1	

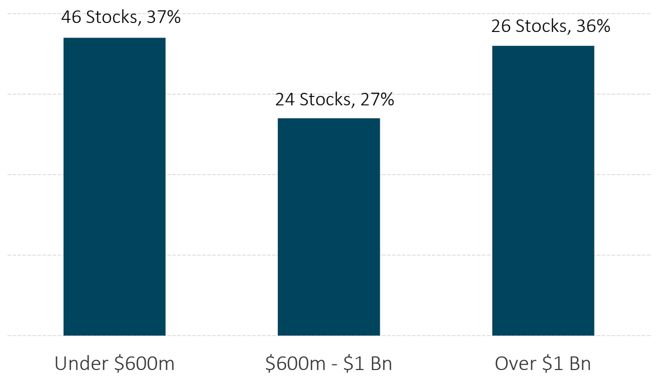
5. Portfolio statistics are reported in USD. Source: THB Asset Management

Top 10 holdings

Stock	Sector	Portfolio weight
First Busey Corporation	Financials	3.2%
Transcat Inc	Industrials	3.1%
RPC Inc	Energy	3.1%
ePlus inc	Technology	2.6%
TETRA Technologies Inc	Energy	2.6%
Movado Group Inc	Consumer Disc	2.4%
Greenbrier Companies Inc	Industrials	2.3%
Old Second Bancorp Inc	Financials	2.1%
LeMaitre Vascular Inc	Health Care	1.8%
Heritage Financial Corporation	Financials	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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