Australian Small Caps Systematic Alpha Fund (Wholesale)

March Quarter Performance Report as at 31 March 2020

Fund performance

As at 31 March 2020	3 Month	FYTD	1 Year	Since Inception[2]
Blue Orbit Australian Small Cap Systematic Alpha Fund[1]	-31.10%			-31.29%
Benchmark[3]	-26.72%			-25.30%
Excess Return	-4.38%			-5.99%

1. Returns shown are Net of Fees. Returns shown for the Lead Series (October 2019).
2. Inception Date is 11 October 2019.
3. Benchmark is the S&P/ASX Small Ordinaries Accumulation Index.

Market Commentary

The March quarter will always be remembered as the time that COVID-19 swept around the world with several million people becoming infected, causing countries to close their borders and impose social distancing, quarantines, and even full lockdowns. Central Banks and Governments enacted their emergency responses, pumping trillions of dollars into financial markets and directly into businesses and households. Even with the unprecedented monetary and fiscal spending the impact on the economy was significant, with US GDP falling 4.8% in the quarter. The response in the equity markets was a massive sell-off, with investors fleeing the equity markets for the safety of cash. The S&P500 was down 20% for the quarter, FTSE100 down 24.8%, All Ordinaries down 23.9%, and the Australian Dollar fell 12.5% against the US Dollar.

What might be remembered in less detail is how the quarter was experienced in equity markets. January, for example, saw some mixed results in equity markets, with the S&P500 down 0.16%, NASDAQ up 1.99%, FTSE100 down 3.4%, and Japan up 1.9%. Australian markets experienced January's usual low volumes throughout the month and pick-up after Australia Day. With dividend and reporting seasons fast approaching, the ASX100 was up 5.07%, and the Small Ordinaries up 3.38%. In January COVID-19 was seen to potentially be a big issue for China, and for some companies with Chinese customers and supply chains.

February's reporting season saw somewhat larger stock swings than usual. Investors appeared to be still searching for growth, and punished companies whose results did not meet their expectations. Stock price swings of ±20% on announcement day seemed fairly common. Each day during February, the COVID-19 statistics were headline news, but the market kept moving higher. Global markets peaked on 20th February, before starting their rapid fall. The ASX100 had risen 2.24% for the month by then, with the Small Ordinaries 2.52%. From late February onwards, investors who had bought into the "dividend run up" were sorely disappointed, as many companies deferred or cut dividends completely.

Within the Small Ordinaries, the fall in the markets from 20th February to 23rd March started across the board. For the first week, all sectors were sold off proportionately, with only Real Estate and Communication Services providing some downside protection to investors. Note the very low standard deviation of sector returns.

GICS Sector	1 Jan to 20 Feb	20-FEB to 28-FEB	28-FEB to 11-MAR	11-MAR to 23-MAR	23-MAR to 31-MAR
Total	6.58%	-11.42%	-11.05%	-24.42%	15.46%
Communication Services	3.64%	-7.44%	-8.47%	-31.61%	13.53%
Consumer Discretionary	5.45%	-13.59%	-15.13%	-37.02%	21.75%
Consumer Staples	5.99%	-10.36%	0.89%	-1.62%	5.01%
Energy	-9.11%	-13.62%	-20.13%	-21.85%	17.61%
Financials	10.08%	-12.70%	-17.78%	-29.40%	14.71%
Health Care	11.64%	-11.88%	-11.64%	-13.05%	16.30%
Industrials	4.95%	-15.52%	-13.75%	-29.25%	16.80%
Information Technology	5.20%	-10.44%	-8.81%	-17.96%	22.03%
Materials	5.62%	-12.39%	-11.57%	-19.07%	14.02%
Real Estate	10.15%	-5.97%	-5.66%	-34.83%	15.61%
Utilities	7.46%	-11.64%	-12.48%	-26.80%	11.06%
Standard Deviation	5.24%	2.64%	5.53%	9.98%	4.52%

In early March, the defensive sectors stood tall, with Consumer Staples posting a positive return, and Real Estate again beating the benchmark. Flight cancellations and strong supply from oil producers saw the oil price fall, along with the Energy sector. Consumer Discretionary continued its poor run, along with Financials and Industrials. Australian businesses started closing their doors from 16th of March. This accelerated the market fall, losing another 24% in under two weeks. After holding on for several weeks Real Estate finally fell, as shops shut and businesses that could allowed staff to work from home. Again, Consumer Staples provided a safe haven, dropping only 1.6%, nearly 12% better than the next best sector in Health Care.

After the US Federal Government finally signed off on a $2Tn emergency funding bill on 20th March, the markets rallied strongly. The perception was that governments would continue to write cheques to ensure economies would get through the pandemic. Stocks and sectors that had been hardest hit over the last month rallied the strongest, companies whose very survival had been under threat a few days earlier, especially those in the tourism and hospitality industries. This reversal is best illustrated by the rapid rebound of the Consumer Discretionary and the Real Estate Sector.

Alpha Signal Attribution

The Blue Orbit Systematic Alpha process is built from three individual underlying Alpha Signals, developed using proprietary internal quantitative research processes. The three individual Signals are well diversified with low to negative correlations, and designed to outperform in differing market environments.

The Diversified Alpha Signal is the combination of the individual underlying Alpha Signals, and is used as the main alpha input to construct the portfolio.

The Systematic Alpha Model is the target model portfolio that the strategy is traded towards. This model is a theoretical target, and its returns do not include fees or transaction costs.

Alpha Signal Returns	3 Months Return	3 Months Excess
S&P/ASX Small Ordinaries - Total Return	-26.72%	
Blue Orbit Alpha Signal Returns *		
Quality Alpha Signal	-31.66%	-4.93%
Trend Alpha Signal	-28.49%	-1.77%
Defensive Alpha Signal	-29.07%	-2.35%
Diversified Alpha Signal	-30.30%	-3.57%
Systematic Alpha Portfolio (Model)	-31.42%	-4.70%

** Returns shown are for theoretical, calculated signal and factor portfolios, and are not live or investible products. Returns are calculated using Factset, and do not include any fees or transaction costs.*

The three individual Alpha signals all underperformed over the March quarter, leading to the underperformance of the Diversified Alpha Signal and the Fund itself. From the inception of the paper portfolio on 31st August 2017, the only quarter that Quality, Trend and Defensive all underperformed was Q4 2017.

In the majority of market environments, the three Alpha signals have a low to negative correlation, and we expect underperformance in any individual signal to be offset by outperformance in one or both of the other signals. However, during the crisis period in March and the market meltdown, the correlations between the signals and their individual correlations to the overall market became positive, as panic selling and the rapid rebound rally hit across all sectors of the market.

This increased correlations between the signals is a highly unusual event, only happening sporadically during short crisis periods in the GFC in our back tested modelling. Although we have passed the high point of market volatility seen in March, current volatility levels (as measured by VIX and looking at daily and intraday moves) are still significantly higher than the longer term averages. Taking this into account, we have looked to make minor adjustments to the alpha signals and weighting to ensure that the portfolio is positioned for the medium term market dislocations ahead.

Generally in a market downturn, we would expect Trend's underperformance to be offset by outperformance in the Defensive signal. This has held up through the majority of observations through the back test, paper portfolio and live portfolio period. This calibration was designed to protect during a majority of expected market downturns, however has not performed as well during a crisis driven market shock. This has accelerated the implementation of an existing item on the research agenda, to improve the Defensive Alpha signal performance in more extreme market downturn scenarios.

Additionally, the current COVID-19 related market crisis has accelerated the implementation of another research agenda item, around improving the performance of the Trend alpha signal in market turning points, and around times of increased volatility.

The Fund was rebalanced in March, with these minor improvements to the signal methodology and weighting implemented as part of our response to the ongoing crisis. These are outlined in more detail below.

Defensive Alpha Signal

This signal has been improved through an overlay of a quality score. This score is a modified version of the Piotroski F-Score, which uses nine measures of financial quality to identify companies that are struggling. The overlay modifies the weight of companies in the Defensive Signal, and treats defensive sectors differently to cyclicals. The net result of this improvement is that during months when the market is down there should be relative increases in returns, which is balanced by a small decrease in return during up months. This enhancement also slightly decreases the correlation of active returns relative to the other signals.

Reducing the Timeframe of Trend

Our Alpha Trend Signal historically uses a variation of 12-month momentum, with volatility adjustments. Momentum generally works well when the current environment is similar to the last 12 months, which was clearly not the case in March 2020. We have shortened the reference timeframe for Trend to the latest four months, and then skewed the weighting more towards the most recent months. Our back tests showed that in other rapidly changing and crisis environments, such as 2008 and 2009, this change would have significantly improved the signal performance, as it is quicker to adapt to the 'new normal' as markets shift direction.

Second Torpedo Finder

With certain industries and companies shutting down, in particular tourism and hospitality, we have added a second Torpedo Finder to focus on companies who might be in distress, who have a real threat to their survival. This Torpedo Finder has identified several companies in immediate danger, and these positions have been exited. We also identified several companies who are at risk of needing to raise emergency capital in the next few months to avoid insolvency. If we were overweight, these positions were sold down to benchmark weight. We are continually to this list, particularly for companies as they raise capital.

Sector Active Weights

The sector active weight limits have been reduced from ± 5.0% to ± 3.0%. The Gold sub-industry active weight limit has been reduced from ± 2.0% to ± 1.0%. These limits are applied during portfolio construction. Following a rebalance the sector active weights are allowed to drift, before we then trim them back toward these limits. The same approach is used for the stock active weight limits.

Naïve Factor Returns

Naïve Factor Returns	3 Months Return	3 Months Excess
S&P/ASX Small Ordinaries - Total Return	-26.72%	
Naïve Factor Returns *		
Naïve Dividend Yield Factor	-29.03%	-2.31%
Naïve Equal Weight	-31.51%	-4.79%
Naïve Low Volatility Factor	-30.27%	-3.55%
Naïve Momentum Factor	-29.08%	-2.36%
Naïve PE Factor	-28.34%	-1.62%

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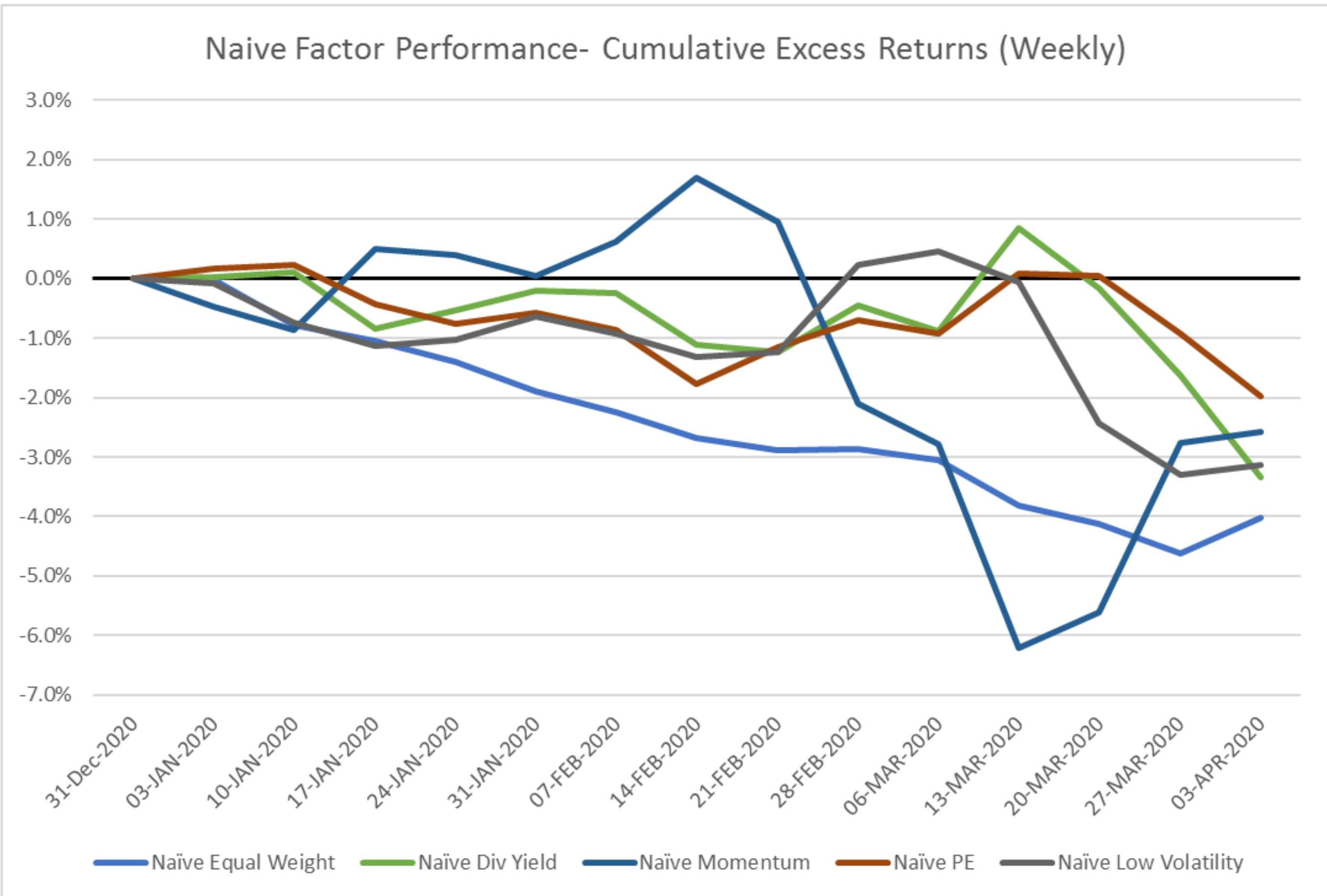

Source: Blue Orbit. Factset

All Naïve factors underperformed over the March quarter, with Equal Weight the worst performer as smaller capitalisation stocks were sold off. Naïve Momentum was the worst hit in mid-March, when it recovered from a -6% drawdown to finish the quarter only -2.4% lower. Low Volatility performed reasonably well into the market drawdown, however fell over 3.5% in March to finish as the market rallied.

Naïve valuation factors performed well at the start of the drawdown period in late Feb, however both weakened significantly into the March month end market rally.

Overall, the market rotation between factors was highly volatile over the March quarter, with all naïve factor strategies underperforming over the month of March.

Conclusion

The Coronavirus has impacted global markets with unprecedented speed and ferocity, and we are still waiting to see the longer term impacts on the global economy. Although the initial storm of extreme volatility has passed and some price recovery has been seen, the market and economy still have many headwinds to fact until the virus is contained. While looking to maintain the long-term alpha proposition of the model, the severity of the current crisis has highlighted the need to implement minor model adjustments to adapt to the new normal we are seeing in markets globally. We expedited the testing and implementation of the most urgent and relevant items from our research agenda into our process, to protect the Fund and best position it for the coming months ahead.