

Global Markets Rally as US Economy Shows Signs of Life

Market Report

Global macro-economic factors drove equity markets sharply higher in the month of March after a lacklustre start to the new calendar year. The March rally came after we had the biggest "correction" since the bear market lows were seen a year ago during which the Australian market fell almost 10% in the space of 20 trading days in January and February.

The local market performed well below many of our international peers for the quarter with UK FTSE up 5.5%, the US S&P 500 up 5.2% and the Japanese Nikkei up 4.9%. This relative underperformance (+1.4%) surprised many analysts given that the Australian economy continues to be the envy of most of the Western world.

The catalyst for the global rally was signs of an emerging US recovery which have allayed widespread concerns about a US double dip recession. US consumer confidence was higher and personal spending rose for a fifth consecutive month. US retail sales also continued their modest recovery while US industrial production and capacity utilisation both rose more than expected. Despite the emergence of China in recent years, the US economy still remains the global behemoth and bellwether.

A sustainable US recovery continues to be critical to the prospects of a long-term global recovery.

On the domestic front, the resources sector added to the strong returns seen in February as commodity prices, particularly bulk commodities, rose strongly over the quarter. Investors also reacted positively to new contractual iron ore prices announced in late March with diversified miners **BHP** and **Rio Tinto** up 6.1% and 11.2% respectively for the month, erasing losses recorded earlier in the quarter.

Renewed confidence in March saw investors move back into cyclical stocks, reversing last month's defensive shift. Over the quarter, most sectors remained relatively flat with Energy -1.3%, Industrials -1.1%, Consumer staples -0.8%, Materials +0.2%, Consumer discretionary +1.0%, Utilities +1.2% and Financials +1.4%. Telcos were the clear laggard, down 12.8%. This was driven by Telstra's disappointing operational update in February combined with the ongoing concerns about regulatory risk, which saw the stock down 13% for the quarter. Healthcare was the best performing sector, up 3.3% for the quarter, with **Ramsay** (+28%), **Resmed** (+18%) and **CSL** (+12.1%) the best performers.

OC Performance*	1 Mth	3 Mths	6 Mths	1 Yr	3 Yrs	5 Yrs	Since Incep
OC Premium Equity Fund	6.1%	4.1%	15.1%	74.4%	-12.8%	0.4%	10.4%
Small Inds Accum	3.4%	-1.3%	0.5%	54.3%	-11.9%	1.3%	4.9%
OC Dynamic Equity Fund	5.9%	3.9%	17.3%	83.4%	-12.5%	0.7%	11.9%
Small Inds Accum	3.4%	-1.3%	0.5%	54.3%	-11.9%	1.3%	5.1%
OC Concentrated Equity Fund	4.1%	5.3%	23.8%	136.8%	5.8%	11.5%	15.8%
Small Inds Accum	3.4%	-1.3%	0.5%	54.3%	-11.9%	1.3%	5.8%
OC 200 Equity Fund	5.4%	1.7%	5.7%	44.9%	1.8%		12.4%
200 Accum	5.7%	1.4%	4.8%	41.7%	-2.4%		8.8%

Performance figures are based on the hard close unit prices as at 31/03/2010

Market Report cont.

Corporate activity returned in the Energy and Materials sectors in March. Shell and Petrochina bid for **Arrow Energy**, **Peabody** bid for **Macarthur Coal** and **Newcrest** launched a takeover for **Lihir Gold**. Combined with rising commodity prices, this put a rocket under these sectors in March with the expectation of further corporate activity driving most stocks in this space higher.

The IPO market returned to life after a long hiatus following up **Katmandu** and **Myer** Floats in the December quarter. We met with several prospective listings including, **Rubicon Water**, **Contract Aviation**, **Legal Fund**, **Miclyn Express**, **Gerard Lighting** and **Mastermyne**. These companies were of varying quality and we remain cautious of companies without a listed track record looking to list on high multiples. Several of these pro-

spective IPOs including **Rubicon Water** and **Legal Fund** have been pulled after a lukewarm reception from institutional investors.

On the domestic economic front, the Reserve Bank of Australia (RBA) lifted the cash rate another 25 basis points (bps) to 4.25% in early April following its 25 bps move in March. The RBA shifted its focus to housing prices noting that the "market for established dwellings is still characterised by considerable buoyancy". We have now had five hikes since October 2009 and the futures markets are pricing in the likelihood of more rate rises in coming months as domestic growth continues to accelerate and housing prices continue to advance. Overall the economic news released during the quarter painted a rosy picture for Australia with real GDP rising 0.9% in Q4 2009, well ahead of most of our Western peers, and unemployment remained well contained at 5.3%.

OC200 Fund

The OC200 Fund outperformed the S&P/ASX 200 Accumulation Index over the quarter and continues to track consistently ahead of the Index. The OC200 Fund increased 1.7% for the quarter, ahead of the S&P/ASX 200 Accumulation Index which added 1.4% over the same period. The OC200 Fund is now 44.9% higher than it was 12 months ago.

Within the Index, the best performing sectors during the March quarter were again the Financials sector and the Healthcare sector. Whilst the Fund was overweight financials, we were underweight the more defensive Healthcare sector and this dragged our performance back toward the Index.

During the quarter, the Fund added to its existing holding in **Ten Network Holdings (TEN)**, and re-initiated positions in **Tattersalls (TTS)** and **Toll Holdings (TOL)**. We like the exposure

TEN offers to the recovering media space and we consider the entry **TTS** has made into the NSW lotteries market to be opportune and well priced. **TOL** was oversold on an interim result that disappointed the market and we took this opportunity to re-enter an A grade business at a reasonable valuation.

We sold down existing holdings in **Woolworths (WOW)** and **Wesfarmers (WES)** and exited our position in **CSL**. Whilst these businesses all continue to have outstanding franchises we neutralised/sold our positions in **WES** and **CSL** on valuation grounds, both having had strong share price rallies over the quarter. Additionally, we moved to an Index weighting in **WOW** on the basis that its defensive qualities may lead it to underperform the benchmark during the anticipated further strong performance of the market in the short to medium term.

OC Concentrated Fund

The Concentrated Fund delivered another strong quarter of growth rising 5.3%. Whilst the performance was again underpinned by solid contributions from its core holdings, the February reporting season provided a number of instances where the Fund could trade profitably on company results.

McMahon and **Wesfarmers** each reported very strong interim numbers and provided opportunities for the Fund to capitalise on their rising share prices immediately post reporting. Conversely, a disappointing result from **WDS** and a surprise negative market update from **Chemgenex** presented the chance for the Fund to trade profitably in some oversold positions caused by the resultant panic selling.

Resources were topical during the quarter and the Fund benefited from positions held across the spectrum, including **Atlas** (Iron ore), **Discovery Metals** (Copper), **Silver Lake** (Gold) and **Berekeley** (Uranium).

The incubation section of the Fund continued to add to performance. Most of its holdings, in particular **Logicams**, **Finbar** and **Oaks Hotels**, all performed strongly during the period. These businesses all fit into the primary criteria for the incubation section of the Fund – they are considered undervalued and under-researched by the market and we consider they have the potential for strong future growth. The Fund's short positions all made positive contributions and included **AJ Lucas** (operational issues), **Aquarius Platinum** (political risk) and **Myer** (valuation/macro headwinds).

OC Premium Fund

The Premium Fund had a strong quarter with few disappointments. The Fund finished the March quarter up 4.1%, ahead of both the Small Industrials Accumulation Index which fell 1.3% and the All Ordinaries Accumulation Index which rose 1.5%. The Fund is now up 47.6% for FY2009. This is well ahead of the Small Industrials Accumulation Index which is up 26.6% and the All Ordinaries Accumulation Index which is up 27.9%.

The quarter was notable for avoiding the myriad profit downgrades that occurred in the small industrial space including **Sigma, AJ Lucas, AWB Limited, Crane Group, Neptune Marine, Nomad Building, Programmed Maintenance Services, Southern Cross Electrical** and **WDS** to name a few. This is pleasing given that a major focus of the investment team has been on de-risking the portfolio following the GFC and focusing on simple, transparent businesses with quality management. We continue to avoid companies with large second half earnings skews or industries where we have not yet seen tangible evidence of an earnings turn-around but which have been priced for a FY11 recovery (eg housing).

Newly listed specialty retailer **Katmandu** was a strong performer, up 17% for the quarter following the release of its maiden result. Sales and earnings are trending ahead of prospectus forecasts and the strong like-for-like sales growth goes a long way towards alleviating concerns over the cannibalisation impact of the store roll-out program. Katmandu continues to trade at a discount to its high-growth specialty retail peers and we believe that the on-going store roll-out program will drive

above average earnings growth and provide some insulation from a slowing retail environment.

The Fund benefitted from a number of new positions added during the quarter including **Ausenco, Adelaide Brighton, Clough, Sedgman Limited** and **SMS Management and Technology**. These stocks are high quality mid cap companies with strong competitive positions and clean balance sheets. We believe that they had been sold down to attractive entry prices. Pleasingly all five have rallied since being added to the portfolio and still appear to be reasonably priced.

During the quarter we sold our holdings in **Iress, The Reject Shop** and **TPG Group** following strong share price performance. Although all three are well run businesses, the share prices had reached our respective valuation targets.

The key under-performer for the quarter was **Hastie Group** which fell 19.5%. Sentiment towards the non-residential construction space remains poor and the company's UK based Rotary operations continues to struggle in the tough economic environment. Nevertheless, Rotary accounts for less than 20% of Hastie's earnings and recent contact with management has confirmed that domestic operating conditions are improving. Although sentiment is poor in the sector, Hastie trades on a low PE of 6.9 x FY11 earnings and a fully franked yield of 7.9%. We believe that the stock remains cheap given its medium term prospects.

OC Dynamic Fund

The Dynamic Fund performed roughly in line with the Premium Fund for the quarter rising 3.9%. The Fund is now up 54.3% for FY2009.

The key trading position was the Fund's holding in **Virgin Blue** which rallied 21% during the quarter. Virgin Blue is a highly leveraged airline which is in the early stages of a turnaround. Whilst the half year result was well ahead of analyst expectations, the stock is highly leveraged to economic conditions and the fuel price and is not considered suitable for the more conser-

vative Premium Fund. Management's cost cutting initiatives over the past 18 months are starting to bear fruit and domestic yields continue to improve in the business. We expect Virgin Blue to continue to perform well into the next quarter, although we do not expect that it will become a core holding.

Outlook

Early signs that a US economic recovery is under way have been a key driver of global equity markets over recent weeks. Further validation of a US recovery in the form of positive economic data points would likely see equities continue to perform solidly in the near term.

The US equity market is critical to the Australian equity market returns as the absolute direction of global equity markets is invariably determined by the US in "big" economic cycles such as the one we are currently in. The correlation of the Australian equity market with the US has reached an all-time high of 0.96, further illustrating that the direction of returns in the Australian market is closely aligned with the US at present.

Significantly, the US Federal Reserve has consistently reiterated its decision to keep the Fed Funds Rate at historic low levels for an extended period, thereby continuing the monetary stimulus which has been in play since November 2008.

The following statement from the FOMC on 16 March 2010 illustrates the Fed's intent: *"The Committee will maintain target range for the federal funds at 0 to 0.25% and continues to anticipate that economic conditions...are likely to warrant exceptionally low levels of the federal funds rate for an extended period"*.

The outlook for US earnings per share (EPS) growth has strengthened considerably in recent months. Following three consecutive years of negative growth, CY10 and CY11 are forecast to deliver 30% and 20% EPS growth respectively according to consensus forecasts. This is stronger than even the Australian market, predominately because the US is coming off a lower base.

This bodes well for the Australian market and reinforces our view that solid equity returns will continue into the medium term. The ASX 200 Index is a currently trading on a one year for-

ward PE multiple of 14.5 x earnings, in line with its historical average. This means that, prima facie, the Australian market is not expensive notwithstanding the strong performance of equities over the past 12 months.

Pleasingly, the recent reporting season showed signs that margins had started to recover and that ought to drive a strong earnings recovery from many Australian companies into FY11. Revenue growth was still negative for the first half results released in February but that trend ought to reverse coming into the new financial year. Our discussions with company management indicate that revenue growth ought to turn positive again in the FY11 year and, combined with ongoing margin improvement, this ought to see operational leverage kick in for many listed businesses. Should this play out equity market returns should continue to be strong over the next 12 months.

We reiterate our view that the corporate sector remains an attractive space in which to invest with business spending increasing and subdued analyst expectations. We flag **SMS Management & Technology**, **Talent 2 International**, **Clough** and **The Mac Services** as having strong leverage to a recovery in corporate spending. We also remain attracted to the media space, in particular **Ten Network Holdings**, given the pick-up in advertising volumes and expenditure which is currently underway. There is growing evidence that retail will continue to slow as interest rates continue to rise and government stimulus money is wound back. Whilst we have reduced our exposure to this space, we remain attracted to well managed store roll-out stories including **Katmandu** and **JB Hi-Fi**.

We have been extremely active over the past month visiting a wide variety of listed companies around Australia looking for under-valued stocks to add to the portfolio. The overall message from company management is noticeably more positive than six months ago and this bodes well for an on-going recovery in company earnings and, in turn, the equity market.

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* Past performance is not a reliable indicator of future performance. The Total Returns of the OC Funds over specified periods are shown in the above table. This table contains information regarding Total Returns to 31 March 2010. Total Returns are calculated after taking into account performance fees. Where OC Funds generates a return on the OC200 Fund over and above the performance hurdle (S&P/ASX200 Accumulation Index) in a quarter, a performance fee of 10.25% of all profits above this level is charged to the Fund directly. Where OC Funds generates a return on The Premium and Dynamic Funds over and above the performance hurdle of 15% in any financial year, a performance fee of 20.5% of all profits above this level is charged to the Funds directly. Where OC Funds generates a return on the Concentrated Fund over and above the performance hurdle of 0% in any financial year (subject to a high water mark), a performance fee of 10.25% of all profits above this level is charged to the Fund directly. Between 1 July 2004 and 30 June 2009 where OC Funds generated a return on the Concentrated Fund over and above the performance hurdle of 0% in any financial year (subject to a high water mark), a performance fee of 20.5% of all profits above this level was charged to the Fund directly. Before 1 July 2004, performance fees were not paid out of the Funds but billed by OC Funds directly to investors. In this table, the Total Returns for the period prior to 1 July 2004 have been adjusted to reflect the paid performance fees as if the fees were paid out by the Funds. The Total Return performance figures quoted are historical, calculated using end of month mid prices and do not allow the effects of income tax or inflation. Total Returns assume the reinvestment of all distributions. The performance is quoted net of all fees and expenses. The Indices do not incur these costs. This information is provided for general comparative purposes. Positive returns, which the Funds are designed to provide, are different regarding risk and investment profile to index returns.

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