Quarterly Investment Review

30 September 2011

Equity Markets Fall On The Back Of Macro-Economic Concerns

FUNDS MANAGEMENT

Market Report

The Australian market continued its downward trajectory in September with the S&P ASX 200 Accumulation Index finishing the month down 6.1%, completing a second quarter of negative equity market returns (-11.6%) following on from the June quarter (-4.0%).

Throughout September, the direction of global markets was bound to the wavering hopes of a Eurozone debt resolution. Talk of a hard landing in China perpetuated fears of a slowdown in global growth and this contributed to plummeting commodity prices. On top of all this, the actions taken by policy makers in the US ("Operation Twist") failed to inspire markets.

International markets broadly reflected the nervousness we felt in the Australian market with the US S&P 500 down 4.8%, the UK FTSE down 4.6% and the Hong Kong Hang Seng off some 14.3%, no doubt reflecting the market's view on China. The Japanese Nikkei was a relative outperformer, down 2.8% for the month.

The Reserve Bank of Australia (RBA) continues to hold rates at 4.75% but the markets are now factoring in a 100% chance of a rate cut on the first Tuesday in November, the first move since the RBA increased rates on the same Melbourne Cup Day 12 months earlier. These global and local machinations are playing havoc with our dollar which traded in an 11 cent range during the month (USD $1.076 down to $0.966).

OC Premium Fund

The tough macro backdrop impacted the performance of the Premium Equity Fund and it finished the quarter down 12.3%. The Small Industrials Accumulations Index and the Small Ordinaries Accumulation Index also suffered double digit falls and were down 10.5% and 11.8% respectively. This was a disappointing outcome which was not helped by the extreme market volatility and the rotation away from perceived riskier assets such as equities.

During the quarter the performance of the domestic markets (and indeed the Funds) has been largely driven by global macro-economic issues as opposed to stock specific factors. As reported in the August Monthly Review most of our core stock positions reported earnings in line, or above, our expectations. Despite this, few were rewarded by share price appreciation in a "risk-off" environment where many investors, spooked by the macro news coming out of the US and Europe, reduced their allocation towards equities, and in particular small cap names, in favour of the safety of cash.

On a positive note, **CSG** announced that it had received an indicative proposal at $1.20 to acquire all the shares in the company by way of an off-market takeover offer. Although very little has been disclosed by way of detail, we believe that the buyer is a global multi-national player. The CSG board has not formed a view with respect to the proposal and has engaged Macquarie Bank as corporate advisors. The implied PE ratio at the take-out price is 8.5x FY12 which compares to its listed domestic peers at 9.7x.

OC Performance*	1 Mth	3 Mths	6 Mths	1 Yr	3 Yrs	5 Yrs	Since Incep
OC Premium Fund	-6.9%	-12.3%	-19.4%	-5.8%	1.9%	-6.1%	8.5%
S&P/ASX Small Inds Accum	-6.8%	-10.5%	-14.7%	-8.0%	-2.2%	-5.7%	3.2%
Added Value	-0.1%	-1.8%	-4.7%	2.2%	4.1%	-0.4%	5.3%
OC Dynamic Fund	-8.0%	-14.5%	-21.4%	-7.7%	2.0%	-5.9%	9.5%
S&P/ASX Small Inds Accum	-6.8%	-10.5%	-14.7%	-8.0%	-2.2%	-5.7%	3.4%
Added Value	-1.2%	-4.0%	-6.7%	0.3%	4.2%	-0.2%	6.1%
OC Concentrated Fund	-8.5%	-15.2%	-24.1%	-4.7%	20.7%	7.6%	12.2%
S&P/ASX All Ords Accum	-6.3%	-11.3%	-15.5%	-8.4%	0.0%	-0.4%	7.5%
Added Value	-2.2%	-3.9%	-8.6%	3.7%	20.7%	8.0%	4.7%

*Performance figures are based on the hard close unit prices as at 30/09/2011

Since making the announcement, CSG has also received other confidential approaches from parties expressing an interest in acquiring the company. We believe that the bid is opportunistic and undervalues the company given that an adequate premium for control has not been offered. Nonetheless we have trimmed our position given the high weighting that the stock represents in the Fund and because there is no certainty that any of the approaches will eventuate in a change of control transaction.

On a disappointing note, Telstra advised **Service Stream** that it intends to scale back volumes under its Access and Associated Services (AAS) Contract. The scale back relates to the ticket of work business and is expected to reduce revenue in FY13 by $100m and EBITDA by an estimated $5.8m, although the company itself provided no guidance on the impact of the contract scale back. The stock price fell 20% on the announcement and has consequently impacted Fund performance. Earlier in the month, Service Stream had announced that its Syntheo Joint Venture with Lend Lease had secured a major fibre servicing contract with NBN to commence immediately for the construction of the fibre network in Western Australia for $174m, with an option for a further two years. We had already anticipated Service Stream winning the later contract and have trimmed our position in the stock following the disappointing and unexpected outcome on the Telstra AAS contract.

Cash Converters also negatively impacted portfolio performance after the federal government proposed new regulations in its payday lending business and its suitor, EZCORP, subsequently withdrew its proportional bid for the company. Whilst we trimmed our position at higher levels, at current prices (5.5x FY12 PE) we believe the stock represents good value. Our consultation with industry players suggest that a watering down of the proposed regulations into something far more palatable is probable given that the current proposal would effectively wipe out the pay-day lending industry and may lead to an increase in illegal pawnbroking activities and petty theft.

The turbulent market has given us the opportunity to purchase some quality companies at reasonable prices. In September we added **Navitas**, a global leading education provider with defensive qualities and excellent cash-flow generation, to the portfolio. More recently we added **JB Hi-Fi**, a low cost retailer of branded entertainment products, at the compelling valuation of 10x FY10 earnings. Although JB Hi-Fi operates in the tough consumer space, it is a business which continues to win market share, has significant store rollout potential and a very strong balance sheet.

OC Dynamic Fund

The Dynamic Equity Fund was down 14.5% for the September quarter. It is not unusual for the Dynamic Fund to underperform the Premium Fund in declining markets as it tends to be more fully invested and hold a small number of Emerging Leaders positions which often get sold down on low volume in an environment such as this. Indeed the underperformance versus the Premium Equity Fund during the quarter was due to two Emerging Leaders holdings, namely **Allmine Group** and **G8 Education**. When equity markets recover, the Dynamic Equity Fund will typically outperform the more conservative Premium Equity Fund.

Allmine Group continued to drift lower during September despite announcing a solid result and a positive update on its pipeline of projects. We attribute this to general market conditions impacting a smaller market capitalisation stock; as mentioned above many of these types of stocks were sold down during the quarter on low trading volume. The business is exposed to the booming commodities space and has a strong relationship with China Nonferrous Metal Industry's Foreign Engineering and Construction Co which is providing a strong pipeline of projects to underpin FY12 earnings.

G8 Education continues to be hampered by the ongoing dispute regarding its recent Singapore acquisition. We understand a positive outcome in relation to this matter is forthcoming and the market will soon be able to refocus on the quality of the business model rather than other distractions.

OC Concentrated Fund

The OC Concentrated Equity Fund finished the September quarter down 15.2%, underperforming the All Ordinaries Accumulation Index which finished the month down 11.3%. The Concentrated Equity Fund is down 4.7% over the past year, ahead of the All Ordinaries Accumulation Index which is down 8.4%.

In the Core Fundamental section of the portfolio, Service Stream (mentioned above) was the key detractor from performance. **Mineral Resources**, **Ausenco**, **Gerard Lighting** and **Global Construction Services** all traded lower despite recording solid profit results in August. The takeover approach for CSG at $1.20 (mentioned above) was a welcome piece of good news in an otherwise tough market.

In the Emerging Leaders section of the portfolio, Allmine and G8 Education (mentioned above) negatively impacted the portfolio performance.

The Alpha Plus section of the portfolio had a win during the month with a takeover bid being launched for Mongolian resources play, **Hunnu Coal**. The bid was at a nice premium to our entry level and we took the opportunity to take profits and move on.

Our success here was moderated by other positions moving against us in a choppy market but we are comfortable these names represent solid fundamental value with the likes of **Ridley Corporation** and **Miclyn Express Offshore** outperforming in the more stable market environment we have been experiencing in recent weeks.

Outlook

Global macro-economic issues have continued to drive equity markets significantly lower in recent weeks. The Australian equity market is now priced on a similar risk premium as was applied in the depths of the GFC in late 2008 when the world was gripped by a major credit crisis. This is clearly a bearish state of affairs and has been driven by concerns surrounding the three dominant macro themes that we have repeatedly addressed in the OC Quarterly Investment Review over the past 18 months namely:

- European sovereign debt concerns;
- the state of the US economy; and
- the state of the Chinese Economy.

We will briefly address each of these in turn before touching on the Australian economy and our view on domestic equities.

With a Greek sovereign default of some magnitude now considered a near certainty, signs of a coordinated policy response from European Union governments to recapitalise the banking system appears increasingly likely. This is a major step in the right direction by the Europeans after being in denial for months about the gravity of the situation facing them. A better capitalised European banking system is critical if Greece defaults on its debt. It would allow the banks to make the necessary write-downs and avoid the contagion that would almost certainly lead to another global credit crisis; a scenario which has been weighing heavily on equity markets in recent weeks and months.

Recent economic news out of the US, including employment data, has been better than expected. It is perhaps a sign that whilst the US economic recovery may have stalled for now, it is not speeding unchecked towards a double dip recession. The commentary over the past month from most economists has been that the US looks increasingly like it is heading back into recession. This too has weighed on global equity markets given that stock prices tend to pre-empt actual economic conditions by around nine months. Market sentiment is very poor at present and further positive data points out of the US in the coming weeks, supportive of the view that a recession will be avoided, would likely see equities rally strongly.

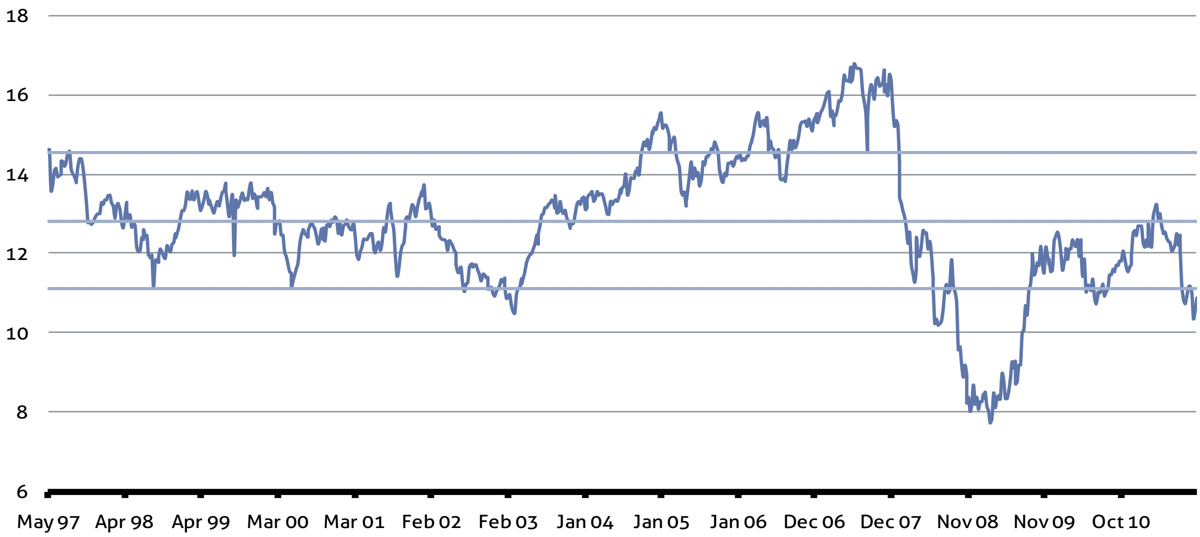
The stalling of economic activity in Europe and the US has further increased the importance of continued growth in the emerging markets – especially China. In recent weeks concerns have begun to surface about the growth trajectory of China, the global powerhouse that it so important to the commodities boom that is fuelling the Australian economy. Although China is slowing, it continues to grow at an impressive rate of 8.7% per annum. Chinese policymakers have tightened their stance in recent months, mainly via more stringent loan guidelines for banks. This action, coupled with falling commodity prices, should lead to a reduction in inflationary pressures which would help to appease the concerns of the central government. Such a scenario ought to result in a soft economic landing for China which would be highly supportive of long-term commodity prices and the economic well-being of Australia.

On the domestic front, the Australian economy remains sound, although the performance of different sectors of the economy continues to vary leading to a so called "two speed economy". Within the OC Funds investment universe, we continue to see positive earnings momentum from mining services companies via their link to the commodities and resources sectors. In contrast, the outlook for companies exposed to consumer discretionary and the housing market remains challenging, although interest rate rises appear firmly off the agenda following an increase in unemployment from 5.1% to 5.3% in September.

Following a significant pull-back in equity prices, valuations are now very cheap compared to historical averages. The average 12 month forward Small Industrials PE ratio is 10.9x compared to a 10 year average of 12.8x (as per the graph below). Most domestic companies have realigned their cost bases over the past 12-24 months and balance sheets overall are in good shape.

As we speak, global equity markets are pricing in some dire outcomes that we believe are unlikely to fully come to fruition. Whilst the timing of an equity market recovery is very difficult to forecast we are confident that investors who take a long-term view from here will be handsomely rewarded.

Small Cap Industrials P/E ratio



Source: Goldman Sachs Research Estimates, IBES

Fund Holdings^

* Largest Holdings	OC Premium	OC Dynamic	OC Concentrated
Increased			
Reduced			

Fund holdings only available to OC unitholders

*Largest holdings in alphabetical order

Fund Stats

Contributions	OC Premium	OC Dynamic	OC Concentrated
Positive			
Negative			

^If you are an OC Funds unit holder, please contact us directly if you would like a complete list of Fund holdings.

Outlook

Fund holdings only available to OC unitholders

Investment Team
Rob Frost
Rob Calnon
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OC FUNDS MANAGEMENT

* 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 30 September 2011. Total Returns are calculated after taking into account performance fees. 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.