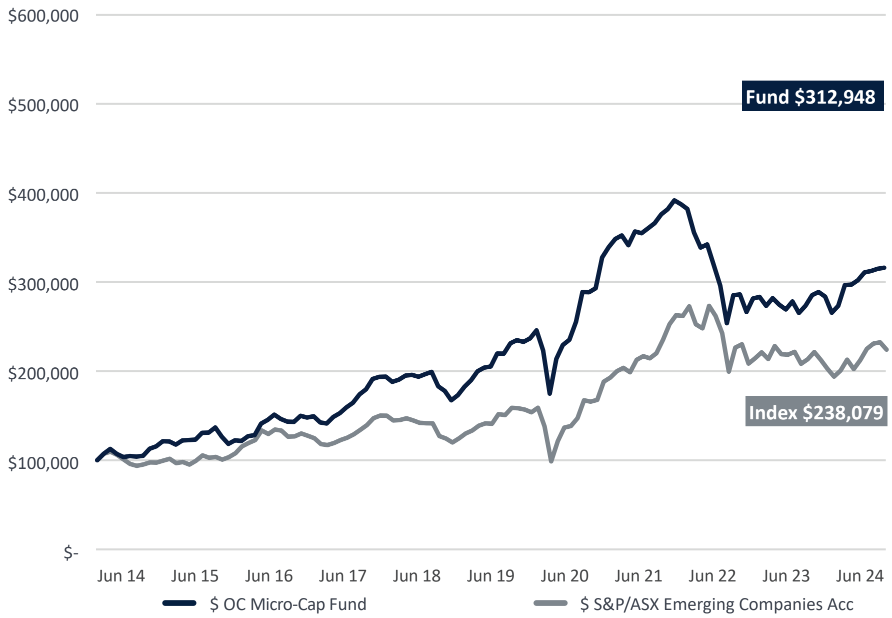
OC Micro-Cap Fund
Fund Update | 30 June 2024

1.7% Fund up 1.7% for the quarter

15.6% Returned 15.6% over the past 12 months

We remain confident the Fund is well placed to deliver strong long-term returns

Performance comparison of $100,000 over 10 years*



Total returns

At 30 June 2024†	1 mth %	3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	10 yrs % p.a.	Incep. % p.a. (Nov 2003)
OC Micro-Cap	0.4	1.7	15.6	-4.3	9.0	12.1	12.4
S&P/ASX Emerging Comp. Accum	-3.7	-0.5	5.3	1.6	10.3	9.1	5.7
Outperformance	**4.1**	**2.1**	**10.3**	**-5.8**	**-1.4**	**3.1**	**6.7**

Inception date for the Fund is 21/11/2003. Inception date for the Index is 31/12/2003. The performance reflects the performance of the OC Micro-Cap Fund since the change of strategy on 31 October 2016 and the performance of the OC Concentrated Equity Fund prior to that date. Performance is after fees applicable at the time. The total return performance figures quoted are historical, calculated using end-of-month net asset value per unit after fees and do not allow for the effects of income tax or inflation

Performance review

Global equity markets had a mixed quarter, although the resilient US market again rallied, with the US economy remaining robust and inflation continuing to moderate in the world's biggest economy. The US Nasdaq and S&P 500 index maintained their gains in the second quarter (although the DOW Jones Industrial Average stalled), despite concerns about persistent inflation which has tempered expectations on the timing and pace of rate cuts in the world's biggest economy since the start of the year. Markets were bolstered by solid Q1 CY2024 earnings out of the US, predominantly driven by a select group of high-performing mega-cap stocks. Investor enthusiasm around artificial intelligence (AI) continues to underpin the big cap technology sector, with another strong result from chip maker NVIDIA during the quarter, and an impressive recovery from Apple fuelling further gains in the technology space.

The domestic micro-cap space had a tough June quarter with a raft of negative stock specific news-flow from consumer facing companies and weakness in the Materials sector driving the index lower. The S&P/ASX Emerging Companies Accumulation Index was down 0.5% for the quarter. Pleasingly, the OC Micro-Cap Fund fared significantly better, posting a positive return of 1.7% for the June quarter.

Despite the weak end to FY24, the domestic micro-cap space bucked inflationary pressures and a slowing economy to finish the financial year in positive territory with the S&P/ASX Emerging Companies Accumulation Index finishing up 5.3% in FY24. The OC Micro-Cap Fund finished well ahead of the benchmark, posting a strong return of 15.6% for the financial year.

In recognition of the investment managers strong and consistent performance, the OC Premium Small Companies Fund was awarded the prestigious 2024 Money Management Fund Manager of the Year Award in the Australian Small Cap Equity Fund of the Year category during the quarter. The Money Management Fund Manager of the Year Awards, a benchmark of excellence within the Australian financial services industry, celebrates the top-performing fund managers who demonstrate superior investment performance and a commitment to providing value for their clients.

The OC Premium Small Companies Fund's success underscores the managers consistent track record for success in managing small-cap investments. It marks the fifth time since 2018, when the OC Dynamic Equity Fund won the award, that OC Funds has been nominated in the category. The investment manager's commitment to its robust investment process, prudent risk management, and disciplined portfolio construction approach has resulted in significant value creation for our investors.

Frontier Energy (FHE, +38.2%) moved higher during the quarter as the broader market gained an appreciation for the company's large-scale WA based solar project in an increasingly tight domestic energy market. FHE is developing the Waroona Renewable Energy Project ('the Project') located 120km from Perth in Western Australia which has the potential to become one Australia's largest standalone renewable energy projects, with FHE controlling 868 hectares of adjoining freehold land whilst also holding approvals for a connection from this land onto the WA electricity network (SWIS) with a terminal adjacent to the Project. FHE published its Stage 1 definitive feasibility study earlier this year outlining a project that consists of a 120MW solar farm and an 80MW 4-hour battery, which is now advancing toward a Final Investment Decision later in 2024. FHE has short listed banks to finance its project, engaged with the WA government owned electricity network operator (Western Power) to design and procure long lead time items for its project inter-connection with the grid, and remains well positioned to deliver renewable energy into a 'short' WA electricity market in the medium term. We have held FHE for some time now and believe the best years are ahead for this micro-cap stock.

Diagnostics imaging business **Capitol Health (CAJ, +31.3%)** broke out of its year-long trading range on the announcement it had entered into a 'process and exclusivity deed' to explore a merger proposal with ASX listed Integral Diagnostics (IDX). Under the conditional, non-binding indicative merger proposal, IDX would acquire 100% of CAJ's issued capital (at an approximately +30% premium to its recent trading levels) in exchange for IDX scrip via a scheme of arrangement. Long touted as natural merger partners with highly complementary business footprints, CAJ and IDX seem to have finally reached mutually acceptable terms for a tie up, albeit the deal is subject to a period of four weeks exclusive confirmatory due diligence and customary regulatory and board endorsement hurdles. The road out of COVID-19 has not been a smooth one for imaging businesses (dealing with staff and patient absenteeism and elective surgery bottlenecks) so a business merger brings significant synergy benefits for both sets of shareholders at an ideal time. These synergies could be as high as A$10m per annum on a pre-tax basis and include head count reduction, head office saving and procurement benefits. The merger would create a highly scalable platform and is expected to be EPS accretive for the combined business in FY26. We have been invested in CAJ since its recapitalisation in the depths of COVID-19 (mid-2020) and are pleased to see it finally reach what we have long considered to be a natural deal with its larger listed peer. The Fund will be voting for the transaction in the absence of a superior alternate offer.

Navigator Global (NGI, +23.8%) rallied during the quarter after providing the market with a profit upgrade for FY24. Navigator is an alternative fund manager which has US$26B of ownership adjusted assets under management which has grown at the rate of c.7% over the year to March 2024. NGI owns minority interests in large scale alternative fund managers that tend to have closed ended funds and/or relatively longer tenured client relationships. These managers invest across both private credit as well as liquid alternative strategies such as quantitative investing, commodities and volatility trading. These underlying fund managers enjoyed strong CY23 performance and the distributions to NGI for the June 2024 half were therefore stronger than expected, with FY24 EBITDA for NGI c.13% ahead of consensus analyst forecasts. The Fund has retained its position in NGI given the undemanding valuation of the stock and the quality of underlying cash flows from these alternative fund manager stakes, the returns from which ought to be uncorrelated with the broader equity market.

Cyclical stocks overall had a tough June quarter as trading updates from consumer exposed companies revealed a deterioration in discretionary spending. This combined with tax loss selling potentially impacted the share price of port logistics and warehousing business **Silk Logistics (SLH, -16.6%)** which softened despite the absence of material company specific news. CEO and founder Brendan Boyd retired due to medical reasons and was replaced by Executive Director and Chief Customer Officer John Sood who is also a co-founder of SLH. We remain supportive of SLH given an attractive valuation and expect sentiment toward the company to rebound with the delivery of a solid result in August.

Refrigerated transport operator **Lindsay Australia (LAU, -19.2%)** downgraded FY24 earnings by c.11% largely due to the impacts of wet weather in the second half of FY24. Horticulture growers who are customers of LAU in North Queensland were impacted by Cyclone Jasper which was the wettest tropical cyclone in Australian history. LAU has a history of short weather-related setbacks which tend to normalise over time. As a result, we have retained a small position in the stock given the valuation remains attractive. LAU has a healthy balance sheet and the outlook for free cash flows and dividends also remains solid.

Outlook

Global markets defied higher interest rates and elevated inflation to strengthen over the course of FY2024 with investor sentiment buoyed by the performance of the US tech behemoths, the so called 'Magnificent Seven' tech stocks, resilient labour markets and the expectations that key central banks will soon commence a rate cutting cycle. Growth, on balance, is slowing across the globe, although moderating inflationary pressures in the US has investors hoping the US Federal Reserve (The Fed) can still orchestrate a soft landing. The Canadian and the European Central Bank have become the first central banks of major economies to cut rates with a backdrop of falling inflation and rising unemployment the catalyst for these cuts. Domestically, services inflation looks entrenched or possibly even accelerating again. This is making the job of the Reserve Bank of Australia (RBA) a difficult one in view of the weakening economy and stubbornly resilient labour markets. We are now expecting two potential rate hikes in Australia in the back half of the calendar year to get the inflation genie back in the bottle.

In late June, the US Fed's preferred measure of inflation, the core personal consumption expenditure index (Core PCE), which strips out volatile food and energy items, increased 0.1% in May marking the smallest advance in six months. At the same time, data from the Bureau of Economic Analysis indicated that consumer spending on goods has rebounded which is a positive signal given that the data indicated that US GDP growth had slowed sharply to 1.6% on an annualised basis in the March quarter. Overall, the US economy is on a solid trajectory with moderate growth, slowing inflation and a labour market which is returning to normal after the tight conditions of the past few years. The Fed kept the federal funds rate on hold in mid-June, as was widely expected. But recent inflation data, including the benign Core PCE print in late June, has been encouraging and likely paves the way for the rate cutting cycle to commence in the back half of the year for the US economy.

In Australia, the economic picture is a more challenging one with a per capita recession entrenched, households under pressure and inflation reaccelerating. Australian GDP expanded by a tepid 0.1% in the March quarter, or 1.1% on an annualised basis with net migration, which is now moderating, cushioning the slowdown. The squeeze from higher interest rates on household incomes and discretionary spending is delivering an economic slowdown, although the impact of this slowdown continues to affect cohorts of the population quite differently. Younger Australians with mortgage or rent pressures are cutting back the most, whilst older cohorts, who are more likely to be outright homeowners and have large savings buffers, continuing to spend on luxury items such as overseas travel given that they have been the beneficiaries of rising house prices and higher rates.

The elephant in the room domestically is the stubbornly high inflation rate. Domestic inflation again surprised on the upside in May with the CPI exceeding consensus expectations at 4.0%, up from 3.6% the previous month. At best inflation is sticky, at worst it is once again accelerating. Stage 3 tax cuts, cost of living relief (energy bills) and improvements in real wages will support household finances in the second half of the year, making the job of taming inflation incrementally more difficult for the RBA. Additionally, the unemployment rate remains low at 4.0% and both the Federal and State governments have recently laid down expansionary budgets which will likely add to cost pressures. Reserve Bank Governor Michelle Bullock has said the "narrow path" to a soft economic landing was getting "narrower" and reiterated that the board was cognisant of upside risks to inflation. Recent inflation data has left the RBA with a difficult predicament, and we expect the RBA board to increase rates in the coming months in a bid to stamp out inflation. We do note that market commentators are divided on the direction of rates domestically with many believing the RBA will be reluctant to raise further given the weakening economy and elevated recession risk. For context, money market traders are pricing in a 40% chance of a 0.25% rate rise in August, and a 60% chance by September. The ultimate decision will likely be determined by economic data released between now and the August board meeting, with the June quarter consumer price index, released at the end of July, likely to prove highly influential.

In terms of current positioning, the Fund remains quite defensive with the portfolio underpinned by a raft of stocks that can grow outside of the economic cycle (e.g. Propel Funeral Partners and Infomedia). We also prefer stocks with pricing power that can weather sticky services inflation (e.g. GenusPlus Group and Aspen Group).

Experienced investors and long-term readers will appreciate that we have now entered the 'black out' period between the end of the financial year for many companies (30 June) and the delivery of company financial results in the August reporting season. During this intervening period, company management teams go into lock down and avoid investor communication ahead of the release of their full year results announcements. Ahead of this period, the investment team was busy, travelling widely and communicating directly with all our holdings to ensure that our investment thesis remains intact and that the key assumptions underpinning our financial forecasts remain accurate.

We would like to thank our investors for their support over the past financial year. The investment team remains invested along-side you all, and we remain committed to working diligently to deliver strong investment returns in the new financial year.

Top 5 holdings#

Company	ASX code
Aspen Group	APZ
Cedar Woods Properties	CWP
Genusplus Group Ltd	GNP
Keypath Education	KED
Pacific Current Group	PAC

The top 5 portfolio holdings are in alphabetical order and may not be representative of current or future investments.

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† The total return performance figures quoted are historical, calculated using hard-close end-of-month mid-prices and do not allow for 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 index does not incur these costs. This information is provided for general comparative purposes.

* The performance comparison of $100,000 over 10 years is for illustrative purposes only. All returns shown are based on Australian dollar figures. Past performance is not a reliable indicator of future performance. The total returns shown are prepared on an ongoing basis (i.e. they include all ongoing fees and expenses and assume reinvestment of all distributions). They do not take personal taxation into account. The comparison with the S&P/ASX Emerging Companies Accumulation Index is for comparative purposes only. Index returns do not allow for transactional, management, operational or tax costs. An index is not managed and investors cannot invest directly in an index.