OC Micro-Cap Fund
Fund Update | 31 March 2024

4.8%

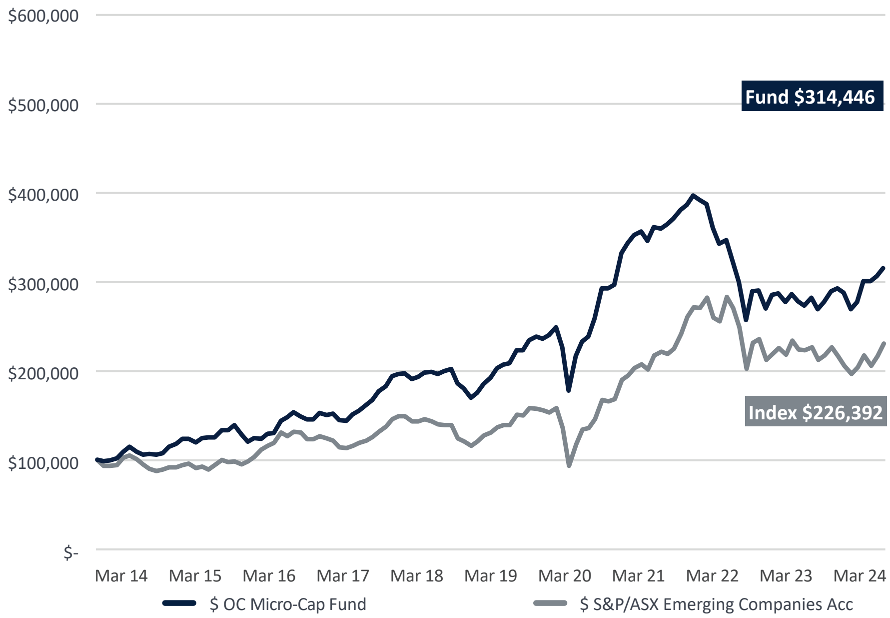
Fund up 4.8% for the quarter

15.4%

Returned 15.4% p.a. for 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 31 March 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	2.9	4.8	15.4	-3.1	10.3	12.2	12.5
S&P/ASX Emerging Comp. Accum	6.3	6.0	3.2	4.5	11.8	8.5	5.8
Outperformance	**-3.4**	**-1.2**	**12.3**	**-7.5**	**-1.4**	**3.7**	**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

The domestic micro-cap index strengthened into the start of the new calendar year with confidence and liquidity beginning to return to the space after a protracted downturn. Whilst the reporting season across micro-cap companies was overall mixed, the Fund's core portfolio holdings, on balance, reported results in line with market expectations, however investor appetite for the more speculative end of the market saw the micro-cap index outperform the Fund during the quarter. The OC Micro-Cap Fund finished the quarter up +4.8% which was behind the S&P/ASX Emerging Companies Accumulation Index (+6.0%).

The OC Micro-Cap Fund has navigated the challenging macro-economic environment of the past 12 months relatively well posting a return of +15.4% over the period. This is well ahead of the S&P/ASX Emerging Companies Accumulation Index which has returned +3.2% over the same time horizon.

Keypath Education (KED +79.4%) rallied hard off a low base as a result of strong operating momentum, triggering the management team to upgrade its FY24 guidance from a US$3-$5m loss to a profit of up to US$2m. KED partners with universities in the US, Australia, Malaysia and Singapore to offer online post graduate education. Recent cohorts of courses have included better globally ranked universities and more unique online course offerings, such as a higher proportion of healthcare programs which typically include work placements. While it can take four years for a course to reach its full potential, the mature courses are now achieving contribution margins averaging 49%, proving out the viability of the business model. We anticipate the maturity of the larger 2021 cohort of courses in 2025 to materially improve the cash flow generation of the business and, as such, we remain supportive shareholders of the company.

Clarity Pharmaceuticals (CU6, +45.2%) share price traded better in the March quarter as it continued to deliver outstanding clinical data and the broader radio-pharmaceutical sector was buoyed by ongoing M&A enthusiasm. CU6 is a clinical stage radio-pharmaceutical company developing next generation 'theranostic' products (incorporating both imaging and therapy), based on its proprietary SAR technology platform. The SAR Technology is ideally suited for use with copper isotopes, enabling superior imaging and therapeutic characteristics of radio-pharmaceutical products and addressing the current manufacturing and logistical limitations in the growth of the radio-pharmaceutical sector in oncology. CU6's current pipeline of products in clinical and preclinical stages include SARTATE, for the treatment of neuroblastoma and diagnosis of neuroendocrine tumours, SAR-Bombesin, a pan-cancer treatment product (including for breast cancer) and SAR-bisPSMA for the diagnosis and treatment prostate cancer. CU6 appeals to us as its SAR technology platform allows for multiple products to be developed in parallel with news flow across trials constantly being released. In recently released trial results, CU6's COBRA trial identified lesions in patients where the existing standard of care failed to identify any lesions at all and some of these identified lesions were very small (less than 2mm in diameter). Additionally, CU6's SECuRE trial has advanced six participants to the highest dose escalation level, following favourable safety outcomes at lower dose levels (with only mild or moderate adverse events).

Globally, there have been three blockbuster multi-billion dollar deals announced in the radio-pharmaceutical sector in the past six months, with majors such as AstraZeneca, Eli Lilly and Bristol Myers Squibb acquiring early stage CU6 'peer' companies and this has served to buoy the entire sector, including CU6. Whilst we have been a supporter of CU6 since IPO, as is typical when we hold stocks with strong share price performance, we will manage our position on a valuation/weighting basis. As a result of our reduced holding in the company we had capacity to participate in the discounted capital raising which was announced at the end of March which provides funding for CU6 to complete its current clinical trials out to CY26. We continue to look forward to CU6 delivering more positive clinical results over the balance of CY24.

Lotus Resources (LOT, +40.3%) enjoyed a strong start to CY24 as the positive sentiment toward ASX uranium stocks continued with spot Uranium pricing touching US$100/pound in March. Outside of the broader enthusiasm for the uranium sector, LOT also conducted a targeted $30m share placement in February. The funds raised will be enable LOT to accelerate its restart works at the Kayelekera mine in Malawi (currently on care and maintenance) and advance works at its Lethakane project in Botswana. With the majority of the equity placement taken by a single institutional holder, and the balance of the placement limited to just a handful of other institutions, the stock traded well post the raise. The post raising share price performance was also, no doubt, supported by the announcement that LOT was to be included in S&P/ASX 300 Index in mid-March which typically drives further demand for stock by institutional investors and index tracking funds. In other company specific news, LOT announced during the quarter that it had appointed debt advisors to arrange funding to support the planned restart of its Kayelekera mine in late 2025. The mine is targeting 2.4 million pounds per annum of production for 10 years at an estimated cost of less than half the current spot price, which should deliver sound economic outcomes for LOT shareholders over the life of the project. Also in March, the Malawian Mining Minister visited the Kayelekera mine and declared her support for the project saying the government is 'committed to seeing Kayelekera back in production as soon as possible'. This is a positive signal as the company and the Malawian Government look to finalise the critical Mine Development Agreement. We are highly encouraged by developments at LOT during the quarter and remain comfortable with our position in the company.

Dusk (DSK, -24.0%) is a specialty homewares retailer which was down for the quarter after delivering a disappointing half year update in the February reporting season. DSK is a smaller retailer which predominantly has physical stores in suburban and regional locations and has a limited online presence. DSK outperformed during the COVID-19 pandemic as customers elected to spend more time at home and redirected travel spending into other discretionary purchases (such as DSK's candles range). In subsequent periods, this trading performance has mean reverted faster than expected as cost of living pressures have increased, and, additionally, DSK's margins have decreased in an inflationary cost and labour environment. Whilst DSK has a strong balance sheet and trading conditions should recover in time, we have elected to exit this small position as any recovery in sales or reduction in the cost of doing business are likely to be longer dated.

We currently favour retailers with a store roll out strategy which are executing well in a tough macro environment such as **Universal Store (UNI, +29.8%)** which was up for the quarter after a robust interim result and trading update. Despite operating in a highly competitive environment, with key peers Glue and General Pants Co. discounting heavily, Universal Store was able to deliver both top line performance and gross margin improvement. In particular, UNI has demonstrated improving like-for-like sales growth in the important second quarter (Christmas trading) in addition to showing positive like-for-like sales to start the third quarter. UNI's Perfect Stranger brand, which is still early in its roll out strategy, reported a strong trading update to begin the second half, and announced it will add up to eight stores in the coming months (to its existing network of 11 stores). UNI benefits from a strong retail management team which is executing on a sustainable growth strategy of rolling out stores under the Universal and Perfect Stranger banners over the medium term.

Outlook

Global growth continues to moderate, although falling inflation, robust jobs markets and a resilient consumer has tempered recessionary fears. Expectations of a soft landing in key economies such as the US and Australia are now the consensus view, as are interest rate cuts in the back half of the year, the caveat being that inflation will need to continue to moderate further for central banks to begin the easing cycle.

The February reporting season, and subsequent management meetings, has kept the OC investment team busy in recent weeks. According to the Goldman Sachs strategy team 32% of small ordinaries constituents beat consensus estimates whilst 46% fell short. This is better than historical averages and a marked improvement from the past two years. The sell-side is usually overly exuberant with their forecasts in small-caps, but they were closer to the mark than usual in February. Cost out was a highlight across the small companies' space, with solid cost control in many instances cushioning the impact of a slowing top line and inflationary pressures. The UBS strategy team suggested that a third of companies releasing results indicated that cost pressures have now passed peak intensity, which bodes well for the coming 12 months.

In the US, a combination of solid economic growth, low unemployment and falling inflation remains consistent with a soft landing playing out. US economic growth remains solid and at its late March meeting the US Federal Reserve (the Fed) slightly upgraded both its growth and inflation forecasts. The Fed has stuck with its guidance of three lots of 25 basis point rate cuts this year, which are expected to commence as soon as June. They did emphasise that the projections are not a predetermined plan, and that the individual forecasts are subject to change based on incoming data for inflation and the labour market. With strong recent March jobs data indicating that the US economy had added 303,000 jobs during March (the unemployment rate dipped to 3.8%), this week's US inflation print will be closely scrutinised. Further confirmation that services inflation remains sticky would likely derail the likelihood of near-term rate cuts in the US, an outcome that would clearly be a negative for equities, in particular growth stocks.

In Australia, the economy is cooling more rapidly. Gross Domestic Product (GDP) expanded by a tepid 0.2% in the December quarter, or 1.5% on an annualised basis. Strong net migration has cushioned the slow-down but, adjusting for population growth, Australia remains mired in a 'per capita recession'. The squeeze from higher interest rates on household incomes and discretionary spending is delivering an economic slowdown, and consumer spending is slowing. Two key data prints late in the quarter have nevertheless tempered prior expectations of rate cuts before the back end of the year with the unemployment rate unexpectedly dropping to 3.7% in February (well below consensus expectations of 4.0%) and headline inflation holding steady at 3.4% for a third consecutive month in February. Services and non-tradables inflation remain elevated and trimmed mean inflation, the Reserve Bank of Australia's (RBA) preferred measure of price changes, rose slightly to 3.9% in February from 3.8% according to the Australian Bureau of Statistics (ABS). Whilst the economy is slowing, it will be difficult for the RBA to cut rates until the labour market eases, and inflation resumes its trajectory towards the 2-3% target band. As a result, the Fund remains underweight domestic cyclical exposures, many of which staged relief rallies during the quarter.

Over recent months, we have added several quality companies to the portfolio which have strong secular growth drivers and topped up existing positions where our conviction in their outlook has strengthened. An important focus at present remains on investing in quality business models at reasonable valuations that ought to have resilient earnings in a slowing economy. From a macro perspective, we think that margin pressures are likely to continue for cyclical businesses, despite inflation moderating, which increases the appeal of quality (profitability and low leverage) for investors.

The Fund has a number of investments in businesses poised to benefit from the decarbonisation of the economy which we believe presents a significant investment thematic over the coming years. We are entering a period of rapid technological change and the associated investment will be driven by increased and renewed electrification (including of infrastructure) which is expected to become widespread and impact a broad range of industries. The portfolio has holdings exposed to this secular tailwind including value added electrical component distributor IPD Group (IPG) and electrical contractor GenusPlus (GNP). Demand for data storage and analysis is also expected to grow which translates directly into the demand for data centres which IPG is also well positioned to benefit from. The Fund is set to benefit from this mega-trend, through its holdings in businesses with quality operations (including IPG and GNP), and also through other names which should likewise have decarbonisation tailwinds such as our preferred Uranium exposure, Lotus Resources.

Post our reporting season management catchups, we will once again head out on the road with an extensive company visitation program planned in the coming two months. We thank our investors for their ongoing support and remain committed to our goal of generating strong long-term risk-adjusted returns for our clients.

Top 5 holdings#

Company	ASX code
Aspen Group	APZ
Cedar Woods Properties	CWP
Pacific Current Group	PAC
Peter Warren Automotive	PWR
SRG Global Ltd	SRG

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.