FUNDS MANAGEMENT

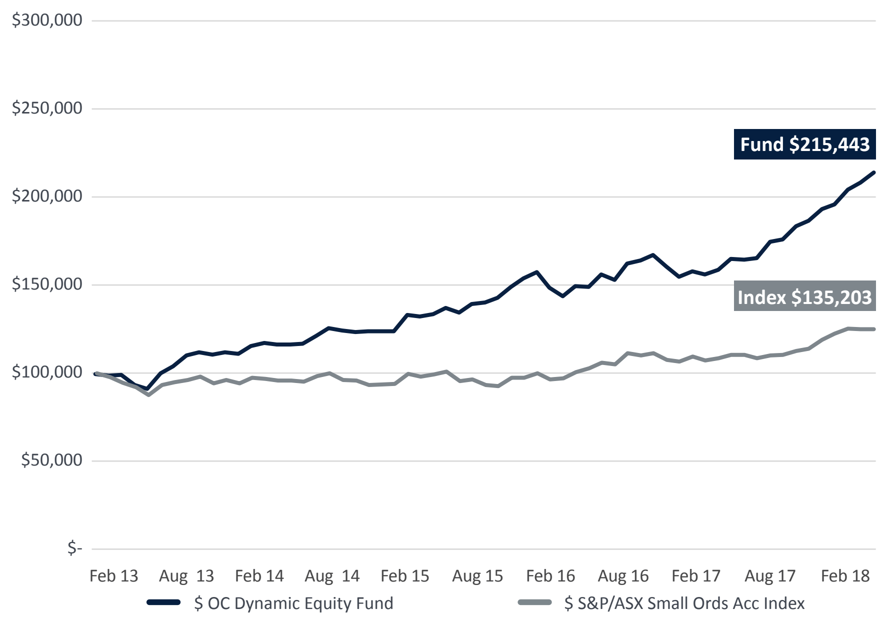
OC Dynamic Equity Fund
Fund Update | 28 February 2018

2.8% Fund up 2.8% for the month

16.7% Returned 16.7% p.a. for the past five years

We remain confident the Fund will continue to deliver attractive long-term returns

Performance comparison of $100,000 over 5 years*



Total returns

At 28 February 2018	1 mth %	3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	7 yrs % p.a.	10 yrs % p.a.	Incep. % p.a. (Dec 2000)
OC Dynamic	2.8	9.3	35.1	17.3	16.7	15.6	10.8	13.7
S&P/ASX Small Ords Accum	0.0	2.7	20.8	10.8	6.2	2.7	1.1	6.3
Outperformance	**2.8**	**6.6**	**14.3**	**6.5**	**10.4**	**12.9**	**9.7**	**7.3**
S&P/ASX Small Ind Accum	-0.1	1.0	17.7	9.1	9.0	9.0	4.5	6.7
Outperformance	**2.9**	**8.2**	**17.4**	**8.2**	**7.6**	**6.6**	**6.3**	**7.0**

Performance review

While February started with a sharp global stock market correction, which at one point saw the US S&P 500 down 10%, equity markets recovered strongly over the remainder of the month and the Australian small-cap benchmark, the S&P/ASX Small Ordinaries Accumulation Index finished the month flat (+0.0%). Against this backdrop, the OC Dynamic Equity Fund had a strong month finishing up 2.8%, an outcome that was driven by an excellent reporting season for the Fund.

Pleasingly, a number of our core holdings upgraded earnings expectations for the full financial year at their interim result including **NEXTDC (NXT, +17.0)**, **Seven Group Holdings (SVW, +12.6%)**, **Bravura Solutions (BVS, +7.9%)**, **Reliance Worldwide Corporation (RWC, +0.94%)** and **QMS (QMS, +1.0%)**. Several other stocks rallied strongly after providing positive outlook statements which exceeded consensus expectations including portfolio stalwarts **A2 Milk (A2M, +47.5%)** and **Appen (APX, 18.1%)** and a relatively new addition Corporate **Travel Management (CTD, +25.7%)**.

Just as importantly, the Fund managed to avoid most of the poor performers in the small-cap index during the month including a number of relatively high profile stocks that delivered disappointing results such as **BWX (BWX, -34.0%)**, **IPH (IPH, -33.8%)**, **Myer Holdings (MYR -31.3%)** and **Wisetech Global (WTC, -31.3%)**. **Super Retail Group (SUL, -19.9%)** was the only material disappointment for the Fund and the stock was sold almost immediately which limited the losses for the Fund given its share price continued to fall over the balance of the month after reporting.

The A2 Milk Company (A2M, +47.5%) was a stand-out performer during the month as the company continues to evolve from a branded Australian and New Zealand liquid milk and infant formula business to become a global nutrition firm. A2M re-rated significantly during the month after it reported another high quality result which once again exceeded market expectations. The company continues to grow market share in the large Chinese infant formula market and following a period of strong revenue growth in the UK and North America, management has been able to demonstrate a clear pathway to profitability in those large markets. In a strong endorsement of the brand, A2M also announced it entered into a strategic relationship with global diary giant, Fonterra, which encompasses a range of supply, distribution, sales and marketing arrangements in targeted markets. Clearly this will expand the company's distribution channels including in SE Asia and the Middle East and may also result in the creation of new and innovative milk products. We continue to view A2M as a high quality global growth story in a growing market, although we trimmed our weighting in the stock following strong share price appreciation.

Appen (APX, +18.4%), the speech and search technology company operating in the field of artificial intelligence announced a full year result that once again exceeded consensus expectations and provided earnings guidance for CY18 that also exceeded analyst consensus. Following the recent acquisition of Leapforce Inc, a US based competitor, APX is the clear global leader in the development of high quality, human annotated datasets for machine learning and artificial intelligence. APX now has operations in Australia, the US, the UK and the Philippines and its customers include the world's leading technology companies, automakers and governments. APX is a standout domestic exposure to gain leverage to the boom in Artificial Intelligence (AI) and we expect it to continue to demonstrate strong organic growth in the coming years. We trimmed our weighting into the share price appreciation but the stock remains a core holding in the portfolio.

NextDC (NXT, +17.0%), the data centre operator re-rated after reporting a strong result, including record sales in 1H18 with contracted MWs increasing 9.2MW to 39.2MW (+30.6%). NXT's 1H18 revenue grew 30% to $73m and EBITDA increased 41% to $33.6m with strong operating leverage continuing to be in evidence as each incremental dollar of revenue produced an additional 60¢ of EBITDA. Even after bringing forward costs into 2H18, which are associated with new growth projects, full-year guidance was still upgraded and the company provided positive outlook commentary on the existing pipeline of opportunities. NXT remains our preferred play on the cloud computing thematic with the explosive growth in data usage likely to continue for some years to come.

Super Retail Group (SUL, -19.9%), the specialty retailer delivered a result below our expectations with the problematic leisure division again the key culprit. In this division we saw EBIT margin fall 115 basis points to 5.5% and the sub-scale Ray's portfolio contribute a $3.5m EBIT loss. The result was overshadowed by the acquisition of Macpac for A$135m from Private Equity on a multiple of 9x FY18 pro-forma EBITDA. Macpac is a vertically integrated retailer of own-branded apparel, equipment, and accessories with 52 stores across Australia and New Zealand. SUL intends to consolidate the underperforming Ray's business with Macpac under the Macpac brand.

We consider this a risky strategy given SUL's poor performance in its leisure division, poor acquisition track record, structural issues facing apparel brands and management's inexperience in brand ownership. The price of 9x EBITDA appears full and immediate synergies are modest, in a category that is highly competitive. The Fund exited the stock in the days following the result and the stock is no longer held in the portfolio.

Axsesstoday (AXL, + 20.9%) reported a strong interim result and once again upgraded its full year earnings forecast. As a reminder, AXL is a rapidly growing equipment finance provider which offers leasing solutions across the hospitality and transport sectors. The company has been a stand-out performer since listing in December 2016 and has upgraded its earnings forecasts several times over that period. AXL again exceeded our forecasts on all key metrics at its interim result including revenue growth, loan book growth and operating profitability whilst maintaining bad debts and arrears at relatively benign levels. AXL continues to diversify its funding sources and expects to announce material progress on a securitisation package in the second half of CY18. We continue to hold AXL as a core position in the Fund.

Millennium Services Group (MIL, -36.2%) delivered a very disappointing update with full year guidance being re-set some 25% below expectations driven by essentially poor management and strategy execution. Management has told us the reduced full year earnings expectations are due to delays in the realisation of efficiency gains from roster management initiatives and robotic cleaning strategy not yet yielding anticipated benefits. We consider staff management and efficiency gains are a core competency in a low margin cleaning/security services business such as MIL and are not encouraged by these excuses. Additionally, MIL is going through a period of transition with key CEO/CFO roles changing in the last 12 months, a concerted effort to move into the security sector (through the hiring of key SecureCorp personnel) and executives from the recently acquired Airlite business stepping up to implement their proven and successful systems across the broader Millennium Group. Whilst these changes may or may not be successful, we will look to minimise our exposure in the near term with a view to revisiting our investment thesis in the future.

Outlook

Fortunately, our synopsis on the pullback in global markets at the start of February (see our January Report) turned out to be on point with the short and sharp fall turning out to be a healthy correction that presented a buying opportunity for savvy investors rather the beginning of something more sinister.

Despite the rebound, the market remains keenly attuned to commentary from the US Federal Reserve on monetary policy, in particular, new Fed boss Jerome Powell, who late in February struck a mildly hawkish tone suggesting the possibility of four US interest rate rises this year. As a result, equity markets are again under pressure in early March, spooked by concerns that inflation might pick-up and central banks may be forced to tighten policy further and faster than had been anticipated.

The focus remains on the US in recent days where the merry-go-round of Trump administration key advisers continues with news that Trump's chief economic advisor, Gary Cohn, has quit his position in protest as Trump stepped up his threats of imposing tariffs of 25% and 10% on foreign steel and aluminium. Mr Cohn had earlier led the charge on the tax cut proposal approved by Congress in December, but lost the internal struggle against more protectionist voices over trade tariffs. The former Goldman Sachs president was seen by markets as a safe pair of hands and his departure is viewed by many as a signal that protectionists may be gaining ascendancy in the White House.

Should Trump pursue a nationalist agenda and introduce widespread trade tariffs he risks inciting a global trade war which would be devastating for global growth and ultimately asset prices, including equities. The European Union has already responded, preparing punitive steps on some iconic US made goods and brands (such as Levi Jeans and Harley Davidson motorcycles) should Trump go through with his threats. Whilst we ascribe a low probability that a full-scale trade war eventuates, we are keeping a close eye on policy developments out of Washington, especially given Trump has almost unfettered powers when it comes to trade and does not need the approval of Congress to implement tariffs.

On the domestic front, fourth quarter GDP growth in Australia came in a little weaker than the consensus analyst estimates at +0.4% quarter-on-quarter (q/q). The prior quarter was revised up slightly from +0.6%q/q to +0.7% q/q, though the annual rate nevertheless came in a fraction lower than expectations at +2.4%. The details were soft and will consolidate the sense that the RBA will need to lower its sights on the forecast recovery back to 3% growth this year. Interest rates were again kept on hold at 1.5% by the RBA at its monthly interest rate policy meeting. While the global growth backdrop continues to improve, the conundrum for central banks around the world is that inflation is being kept low, particularly by soft wages growth which continues to be constrained in Australia at just 2.1%.

Despite this backdrop, the reporting season was on balance positive for the Fund and we remain confident our portfolio will continue to outperform. Indeed, the February reporting season has heightened our conviction that the key themes underpinning our portfolio will continue to outperform over the medium-term.
These include:

- companies exposed to the large pipeline of east coast-based infrastructure projects, particularly in areas such as road, rail, transport, telecommunications and renewables with **RCR Tomlinson**, **Bingo Industries**, **Seven Group Holdings** and **NRW Holdings** all expected to be beneficiaries to varying degrees;
- companies that are benefiting from the exponential growth in data consumption and our increasing dependency on data in the informational age, including **NextDC**, **Speedcast**, **Netcomm Wireless** and **Appen**; and
- companies exposed to a solid US economy and other offshore growth markets including **Fisher & Paykel Healthcare**, **Speedcast**, **Webjet, Hansen**, **A2 Milk** and **Link Administration Holdings**.

Following the reporting season lull, there is again an elevated level of IPO activity among small caps with a raft of businesses expected to come to market in the coming months. At present, we are undertaking due diligence on several prospective floats including **Latitude Financial** (expected to be the biggest IPO since Medibank Private), **Smiles Inc**, **Unlock'd** and **Data Exchange** to name a few. We will share our thoughts on some of these names in the coming months after meeting with key management, competitors and, in most instances, undertaking site visits.

Top 5 holdings#

Company	ASX code
Bapcor Limited	BAP
Bingo Industries Ltd	BIN
Eclipx Group Ltd	ECX
Speedcast International Ltd	SDA
Webjet Limited	WEB

#Alphabetical order

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* The performance comparison of $100,000 over 5 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 Small Ordinaries 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. There is no guarantee these objectives will be met.

The top 5 portfolio holdings are in alphabetical order and may not be representative of current or future investments. The securities listed may not represent all of the portfolio's holdings and may represent only a small percentage of the strategy's portfolio holdings. Future portfolio holdings may not be profitable.