FUNDS MANAGEMENT

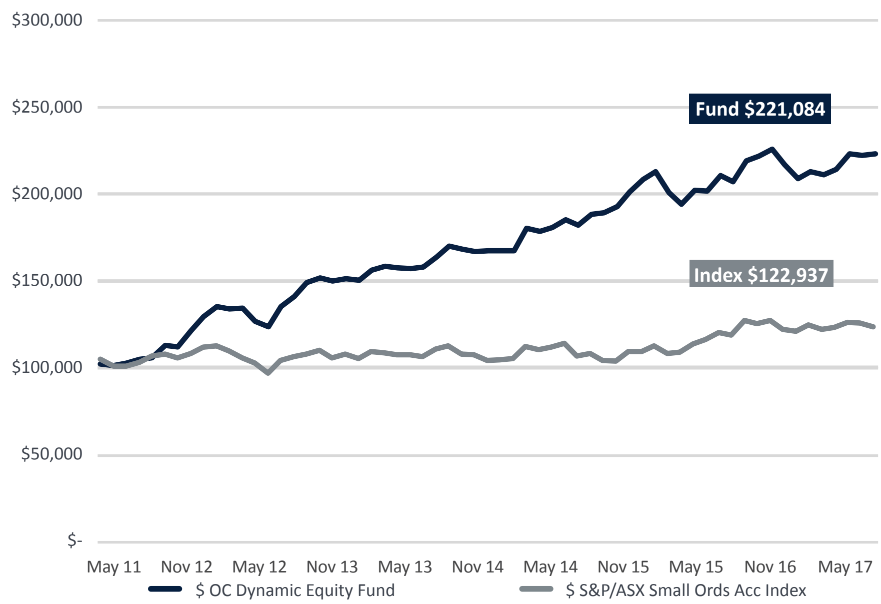
OC Dynamic Equity Fund
Fund Update | 31 May 2017

0.5%
Fund up 0.5% for the month

17.3%
Returned 17.3% 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 31 May 2017	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	0.5	4.2	6.0	12.6	17.3	15.2	4.4	12.5
S&P/ASX Small Ords Accum	-2.1	0.3	3.5	6.0	4.2	3.1	-2.1	5.4
Outperformance	**2.5**	**3.9**	**2.5**	**6.6**	**13.1**	**12.2**	**6.5**	**7.1**
S&P/ASX Small Ind Accum	-2.8	1.8	1.6	7.7	10.5	8.7	0.4	6.0
Outperformance	**3.3**	**2.3**	**4.5**	**4.9**	**6.8**	**6.5**	**4.0**	**6.5**

Performance review

The OC Dynamic Equity Fund posted a solid month in challenging market conditions, returning 0.5% in the month of May. This was comfortably ahead of both the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrials Accumulation Index which were sold off 2.1% and 2.8%, respectively, during May.

The lacklustre performance of the domestic small companies index was driven, in part, by a raft of earnings downgrades that impacted numerous small-cap names over the month including **Pact Group**, **Automotive Holdings Group**, **AP Eagers**, **Vita Group**, **Sigma Healthcare**, **RCG Group**, **Select Harvests** and **Asaleo Care**. The so-called 'earnings confession' season ahead of the end of financial year is often a treacherous time for investors and this year has proved no different.The Fund was relatively unscathed with news flow across our holdings, on balance, positively skewed despite a profit downgrade from Fund holding, **Apiam Animal Health**, discussed below.

Appen Limited (APX, +38.0%) – the speech and search technology services company was an outstanding performer in May after announcing a material upgrade to its full-year earnings guidance. APX is a global leader across its two divisions namely content relevance, which provides smart data to improve the relevance, and accuracy of search results and language resources, which provides data used in speech-recognition technologies (e.g. Apple's Siri) and other machine-learning technologies. APX counts nine of the world's 10 largest technology companies as clients and continues to add new clients and increase margins. APX is well placed to continue to benefit from the rise of machine learning, as well as voice-based technologies. Despite the quantum of the upgrade (EBITDA is now expected to be 40-50% above CY16, up from previous guidance of mid-to-high teens EBITDA growth), we see further scope for earnings upgrades over the balance of the calendar year based on the current order book and the strong operational momentum across the business.

Netcomm Wireless (NTC, +32.1%) - bounced strongly after news filtered out that NBN Co is set to announce an expansion of its Fibre-to-the-Distribution point (FTTdp) roll-out to one million homes, up from the 700,000 homes currently announced. NTC would be an obvious beneficiary as it is the incumbent technology provider to NBN Co in enabling the deployment of FTTdp technology. NBN Co CEO, Bill Morrow, told a senate estimates hearing the focus on FTTdp was about enabling a greater portion of the network the ability to deliver speeds in excess of 100 Mbps in the future. Some analysts are speculating NBN Co may go even further and replace a larger portion of the remaining Fibre-to-the-Node (FTTN) roll-out with the superior FTTdp technology. While this would likely prove to be a windfall from NTC, it is not in our current estimates. NTC has a strong pipeline of opportunities across tier-one customers, such as Nokia, across fixed-wireless telecommunications and other machine-to-machine solutions and remains a core holding in our portfolio.

Fisher and Paykel Healthcare (FPH, +10.1%) - portfolio stalwart, FPH, continues to deliver for investors after announcing another typically strong full-year profit result, up 18% over the previous year. Both major product groups, hospital and homecare, delivered record operating results and gross margin continued to expand, up a further 205 basis points during the year due to a favourable product mix and increased volumes from the lower-cost Mexican manufacturing facility. The only blemish was the escalation in litigation costs (NZ $20.7m), the result of several ongoing patent disputes involving competitor, ResMed, which will impact further in FY18. We have reduced our weighting slightly on the back of the strong share price appreciation but continue to hold the stock as a core portfolio position given our forecast of relatively low-risk double-digit earnings growth (ex-litigation costs) over the medium term.

Updater, Inc. (UPD, +13.2%) - US-based technology company, UPD, enjoyed another strong month as the broader market becomes more comfortable with the value of the platform that continues to be built out by management. UPD offers home movers a service to complete tedious and time-consuming tasks efficiently (such as updating/changing addresses) and at the same time allows businesses to communicate with these consumers in a timely manner. This opportunity for businesses to effectively market to consumers during the moving process is considered highly valuable as people tend to make important, long-term decisions when they are moving house (for example, around choosing insurance products and utility providers). UPD is growing its market penetration of the US mover market with its last published benchmark at +9%; but we would currently estimate penetration to be comfortably +10% and growing rapidly with a CY17 target of 15%. Since the end of the month, UPD has announced the signing of a pilot program with US behemoth, AT&T. AT&T is world's largest telco and one of the largest listed corporations in the US with a market capitalisation of approximately US$237bn. It has a leading position in the US fixed-line telephony market and also in subscription TV (cable), broadband internet and mobile. We estimate AT&T has the second largest marketing budget in the US and is among the top 10 advertisers globally. For a company of AT&T's size and complexity to sign a pilot program with UPD is a strong endorsement of UPD's platform. With further updates on market penetration and pilot programs expected over the balance of CY17, we remain excited by the future prospects of Updater.

APN Outdoor (APO, -14.9%) and **Ooh!Media (OML, -4.0%)** – advised the market the proposed merger between the parties had been terminated following an earlier release by the ACCC outlining its preliminary view the merger would likely result in a "substantial lessening of competition in the supply of out-of-home advertising services". We were not surprised by this outcome and had decreased our weighting in both APO and OML respectively, ahead of the ACCC's determination. While the deal made compelling strategic sense on paper, we had flagged our doubts it would receive the green light from the competition regulator (see December 2016 Fund Update) despite the supreme confidence of both management teams and their respective army of lawyers. The competition regulator took a narrow view of the out-of-home media market which effectively circumvented any possibility of a commercially acceptable deal proceeding. The Fund exited the balance in APO as soon as the ACCC Statement of Issues was released at around $5.20. The stock has subsequently fallen to around $4.60, most likely due to uncertainty surrounding management tenure including whether MD, Richard Herring, will remain and rumoured senior sales staff departures, as well as lack of news flow around two material contracts held by APO, which are currently out for re-tender. We have retained our holding in OML which has subsequently released solid earnings guidance to the market. We remain confident OML looks well positioned to continue to grow its earnings in the coming years as a stand-alone entity and the stock remains attractively priced.

G8 Education (GEM, -8.9%) – it was an eventful month for the childcare centre operator after Chinese-backed, CIGF Investment Partners International (CIPI), failed to settle its second tranche payment of $149m share subscription agreement, capital which is necessary for GEM to execute on its subsequently announced strategic growth plan. The company undertook a hastily organised placement at $3.20 to fill the void which, although at a material discount to CIPI's prior commitment at $3.88 per share, nevertheless leaves the business fully funded to deliver on its 49 development centres, pay down its existing debt and potentially assist in securing a club bank facility in the near term. As part of this process, GEM issued a trading update which was well received by the market (EBIT on track to meet the consensus range of mid-high $170m), despite a 3.4% decline in occupancy (rolling 12-month basis) and some slippage in the acquisition pipeline. The Fund had reduced its position in GEM back in March (above $4.10 a share) on valuation grounds and we used the placement to once again increase our holding now the stock is significantly de-risked from a balance sheet perspective.

Eclipx Group (ECX, -5.1%) – released a HY17 result in line with expectations and reaffirmed its full-year earnings guidance of between $65.5m and $67.0m FY17 NPATA. What caught the market off-guard was the announcement of an agreement to acquire Grays eCommerce Group (GEG) by way of a scheme of arrangement. GEG is an online market place with a B2B business (industrial and commercial assets, plant and equipment and vehicle) and a B2C business (wine, hardware and white goods). While the strategic fit is not immediately obvious, discussions with management have convinced us of the merit of the transaction which revolves around: a) the ability of ECX to cross-sell finance and insurance products into GEG's auto purchasers, b) distributing ECX's financing products into GEG's commercial equipment purchasers, c) broadening ECX's vehicle disposal channels to enhance end-of-lease vehicle outcomes, and d) leveraging GEG's 750,000 active users into ECX's consumer segment (particularly Right2Drive and Carloans). Management is targeting a $20m synergy run-rate within 12-24 months which may ultimately prove conservative. ECX management has a strong track record of executing value-adding acquisitions and presented our investment team with a compelling investment case we consider to be worthy of our ongoing support as shareholders.

Apiam Animal Health (ASX, -43.3%) - is a production animal health business OC has held as an emerging leaders stock since it IPO'ed in December of 2015. AHX is a vertically integrated business providing a range of products and services to support the health and wellbeing of production animals (i.e. beef and dairy cattle, sheep, poultry and pigs). Unfortunately, despite having exposure to various favourable industry thematics, AHX has not yet been able to capitalise on its market-leading position. It disappointed the market with soft earnings guidance during the month, including blow-outs in systems implementation budgets, and we have lost confidence in management's ability to execute on what we consider to be a sound business strategy around consolidating the leading industry players in the sector. While we believe the issues management have encountered in recent times are far from terminal for AHX, and the lower earnings guidance may ultimately prove to be too conservative, we will stand aside from the stock until we see concrete evidence the business is back on track.

Outlook

One month is a long time in markets with the domestic outlook deteriorating in May, especially from a sentiment perspective, notwithstanding RBA Governor Philip Lowe's relatively upbeat assessment of the overall economy in the RBA's official June Monetary Policy Decision statement. As expected, the RBA left the cash rate unchanged at 1.5% and the accompanying statement remained relatively upbeat.

The RBA's statement included an incrementally positive view that business conditions have improved, capacity utilisation has increased and business investment has picked up (outside of mining areas). The RBA suggested it is not concerned about a soft March quarter GDP print, dismissing it as "quarter-to-quarter variation in growth numbers" and reiterating its view that "economic growth is still expected to increase gradually over the next couple of years to a little above three per cent".

This is somewhat at odds with our anecdotal feedback from corporate Australia which suggests economic conditions have become more challenging domestically, particularly in the consumer discretionary space or in sectors of the economy exposed to the housing market where early signs of softening are becoming apparent in the key Sydney and Melbourne markets. The OC team has been extremely active of late, meeting with over 100 companies during the month of May and very few comments from cyclically exposed companies align with the RBA's view that business conditions have improved in Australia of late. Rather, most are suggesting operating conditions in Australia remain challenging and highly competitive, albeit most do not believe that environment will deteriorate further into the new financial year.

Long-time readers will be aware we have been cautious on the domestic economy for some time and we have positioned the portfolio accordingly. We have commented in the past that part of the beauty of domestic small-cap investing is the stock universe is highly diversified. Irrespective of the prevailing macro-economic conditions, there are usually pockets of opportunity where stocks are performing well operationally or where value is still apparent. In that sense, it is a great universe for stock pickers like us.

As is often the case for OC, the portfolio remains underpinned by a raft of high-quality companies that can grow their earnings largely outside of the economic cycle including **Fisher & Paykel Healthcare**, **Hansen Technologies**, **IDP Education** and **The Citadel Group**. The Fund also holds several companies with long-term structural growth drivers including outdoor media stocks **oOh! Media** and **QMS Limited**, as well as **The A2 Milk Company**.

We also own a raft of companies exposed to the increasing use and value of data which remains relatively unaffected by domestic economic conditions. Data has been called the oil of the 21st century: an immense, untapped, valuable asset that powers the digital economy. The Fund has a number of holdings benefiting from the exponential growth in data consumption and our increasing dependency on data in the informational age including **NextDC**, **Speedcast**, **Appen Limited** and **Netcomm Wireless**.

Despite our caution on the retail space, we still have selective exposure to the consumer discretionary sector via **Bapcor Group** and **Super Retail Group**. Each of these stocks has been sold down materially on news of Amazon's entry into the Australian market (see April 2017 Fund Update). Each of these businesses has unique characteristics that will allow them to compete and continue to prosper notwithstanding Amazon's arrival in 2019 and we believe they have been oversold.

IPO activity has slowed of late with a number or recent prospective IPOs such as **Wesfarmers** spinning out **Officeworks**, hydro-tap company **Zip Water** and pub operator, **Dixon Hospitality**, all being pulled from the market after failing to excite fund managers with their lofty price expectations.

We would not be surprised to see corporate activity accelerate in the coming months with private equity firms cashed up, interest rates low and several companies looking vulnerable following disappointing operating performance in recent times. Telecommunications company, **Vocus**, is a case in point having recently been bid for by US private equity giant, KKR.

The adage 'sell in May and go away' again proved profoundly wise with the Australian market selling off during the month. The Fund remains conservatively positioned with a cash balance around 6% but recent stock price falls have seen us begin to deploy some capital into stocks we had previously considered to be too expensive.

Top 5 holdings#

Company	ASX code
Bapcor Limited	BAP
Blue Sky Limited	BLA
Mineral Resources Limited	MIN
Speedcast International Ltd	SDA
Webjet Limited	WEB

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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.