OC Dynamic Equity Fund

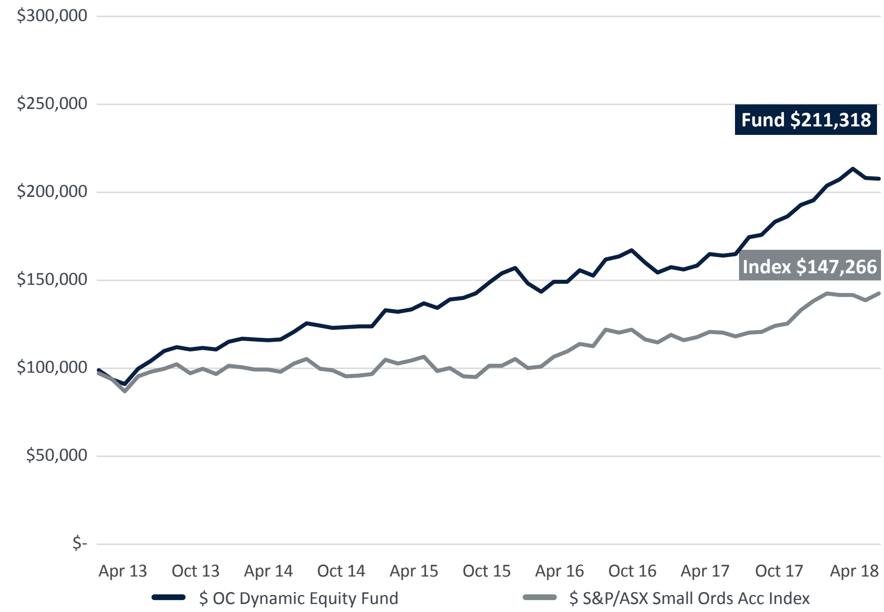
Fund Update | 30 April 2018

-0.1% Fund down 0.1% for the month

16.2% Returned 16.2% 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 30 April 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	-0.1	0.2	27.0	16.1	16.2	15.2	11.5	13.4
S&P/ASX Small Ords Accum	2.8	0.4	18.4	11.1	8.0	3.1	1.3	6.3
Outperformance	**-2.9**	**-0.2**	**8.5**	**5.0**	**8.2**	**12.1**	**10.2**	**7.1**
S&P/ASX Small Ind Accum	1.5	-0.4	11.9	9.3	9.0	8.9	4.8	6.6
Outperformance	**-1.6**	**0.6**	**15.1**	**6.8**	**7.2**	**6.3**	**6.7**	**6.8**

Performance review

April was a challenging month for the Fund from an index relative perspective following a period of strong performance. The Fund finished April down 0.1% versus the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrials Accumulation Index which were up 2.7% and 1.5% respectively during the month.

The disappointing relative performance was due partially to the strong performance of resource stocks, with base metal and oil prices rising, which helped to drive the S&P/ASX Small Resources Accumulation Index up 6.9% for the month. Long-term holders will be aware that the Fund does not invest in single commodity, single mine resource stocks due to their elevated risk profiles. From a stock specific perspective, the poor performance of Blue Sky Alternative Investments, which the Fund has now exited, was the major source of under-performance during the month.

The Fund continues to have strong medium and long-term performance which is well ahead of both the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrials Accumulation Index.

Let's start with the elephant in the room, **Blue Sky Alternative Investments (BLA, -70.4%)** which was under siege during April following the release of a stinging negative thesis from short seller Glaucus Research Group. The news for BLA went from bad to dire during the month as the Australian Financial Review and, to a lesser extent, The Australian released successive negative articles, obviously fed to them in a well-orchestrated campaign by Glaucus and other short-sellers, designed to undermine the credibility of management, question the company's governance, valuation techniques, the quantum of fees they charged for projects and disputing their quoted assets under management.

BLA management tried to rebut these damning assertions and released further information around their funds under management breakdown by asset class and provided greater transparency around historical asset exits. But there was blood in the water and each negative press article served to tarnish the Blue Sky brand further. We spoke to one of BLA's largest institutional investors early in the month who invests significant amounts of capital with the group across two asset classes. This investor provided strong testimony about BLA including "rigorous independently verified valuations", strong historical returns and well-regarded management. But from a reputational perspective the damage had been done. Several financial planning groups contracted by OC Funds during the month, all previously big users of BLA product, provided a consistent message: *"we liked BLA, their returns for clients on realised assets have been strong but given the damage to BLA's reputation, it means that we will not be using their product again any time soon".*

The Fund began to exit the position mid-month and, as it continued to plummet, the stock was further pressured by a material operational earnings downgrade when the company acknowledged that it would be unable to launch new products any time soon. Managing Director Rob Shand subsequently resigned, offering himself up as the scape goat for the perceived lack of transparency in the BLA model, but it was too little too late for the company and its credibility. We have exited our holding and it was a painful process, explaining a large portion of the Fund's underperformance in April.

AMA Group (AMA, -11.0%) was also an underperformer during the month after announcing that it had received a takeover proposal from Blackstone Private Equity to acquire the vehicle panel repair business for $0.86 per share and that it intended to demerge the automotive component, accessory and procurement business ("ACAD business") which existing shareholders would continue to own in a listed structure. Surprisingly, the board of AMA has unanimously recommended shareholders vote in favour of both transactions, in the absence of a superior proposal.

We believe that Blackstone's offer materially under values the well regarded panel repair business which has strong relationships with key insurance groups and significant runway to grow in coming years. In our view (as echoed by the broader market given the negative share price reaction) the board seems determined to give away the company's crown jewel for no takeover premium. Furthermore, the rump of the business, namely the ACAD business, has been materially overvalued by the board in our view. The Board has valued the ACAD business at 31.9-35.9 cents per share by applying the same 10.7x FY18 EV / EBITDA multiple which Blackstone has placed on the higher quality panel repair business. The market clearly disagrees with this valuation, given that AMA's current share price of $0.97, implies a value of around $0.11 cents per share for the ACAD business. At the current price of $0.97, we believe there is limited downside to the AMA share price and we will be seeking to engage with the board to discuss why other options, such as demerging both the panel business and the ACAD business and leaving both separately listed, have not been considered or put to shareholders.

It was not all bad news, however, with the Fund benefitting from renewed market interest in the outdoor advertising space during the month with **Ooh!Media Limited (OML, +6.1%)** and **QMS Media (QMS, +5.5%)** all contributing to performance. The Outdoor Media Association (OMA) announced that out-of-home advertising revenue in Australia for the March 18 quarter was A$203.1m, up +8.7% on the prior corresponding period following a decline in the rate of revenue growth seen in 4Q17. This provided the initial catalyst for renewed interest in the sector with all three stocks looking over sold from a valuation perspective. Shortly thereafter, it was announced that OML had proposed a non-binding indicative bid to Here, There & Everywhere (HT1) to acquire the out-of-home division, Adshel. Whilst these talks have stalled, we do expect consolidation in the outdoor space in the coming year and would not be surprised to see our major outdoor exposure, QMS, attract the interest of a larger domestic or international player due to their strategically attractive digital assets.

Speedcast (SDA +15.2%) continues to re-rate as the market becomes more comfortable with an improving outlook for the Energy and Maritime divisions as the balance sheet de-levers following the successful integration of the Harris Caprock and Ultisat acquisitions. Speedcast is a provider of end-to-end remote communications and IT solutions utilising a network of satellites/teleports to ensure connectivity for a global customer base operating in industries such as offshore oil rigs and maritime shipping (including cargo and cruise ships). The company looks well positioned to generate organic growth across each of its energy, maritime, enterprise and emerging markets and government divisions in the coming years, and we expect further value adding acquisitions to help drive shareholder returns. The company has undertaken a proactive early refinancing of its debt facilities to extend its funding and provide flexibility for corporate opportunities.

Outlook

"Sell in May and go away" is an adage often uttered in market circles coming into the penultimate month of the financial year due to May's dubious honour as being statistically the worst performing month of the year for the stock market. But we see few reasons to be overly bearish and much to be upbeat about with respect to domestic small cap stocks.

The OC Funds team has just returned from the Macquarie Conference in Sydney, which is the best attended Australian equities conference annually, both in terms of presenters (with 110+ ASX 300 companies attending) and investors (with a huge contingent of domestic and global fund managers present). The conference is particularly useful given its proximity to the end of financial year with companies far enough into the financial year to typically provide the market with at least some kind of commentary on year to date trading. In previous years, it has often worn the moniker of the "downgrade conference" given that companies have often used this forum to temper market expectations about earnings coming into the end of the financial year.

Whilst there were negative earnings revisions announced at the conference, including from JB Hi-Fi, Invocare, Super Retail Group, and Gateway Lifestyles to name a few, the general tone was overall optimistic with most companies confident of growing their earnings in FY18 and again into FY19. Pleasingly, none of the Fund's holdings revised their earnings downwards at the conference (18 presented), and several re-rated on the back of quality presentations from their management team, in particular **Bapcor**, **Mineral Resources**, **Bingo Industries** and **The Citadel Group**, which are all core Fund holdings.

Aside from the retailers who are still doing it tough and companies leveraged to the east coast housing cycle, the overall tone from small companies at the conference was generally positive. In particular, companies exposed to the east coast infrastructure pipeline or the mining cycle were particularly upbeat citing a pick-up in activity levels in recent months and strong medium-term opportunities. Fund holdings **Mineral Resources**, **Seven Group Holdings** and **NRW Holdings** all gave bullish presentations on this thematic.

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has thus far shone a harsh light on the unconscionable practices of the financial services sector, particularly AMP and the major banks. Some of the revelations are breath-taking and the lack of accountability from many of these institutions around acting in the best interests of clients, amongst other things, is staggering. This helps to illustrate why we consider alignment of interest as such an important part of our investment process. We typically look for management with incentive schemes heavily aligned with shareholders and we also value 'skin in the game' in terms of investee managers with equity alignment.

In a similar vein, we offer our Fund investors strong alignment of interest with the investment team, given that the investment team are major shareholders in the business and we invest material amounts of our own capital into the Fund along-side our investors. From this perspective, where our clients prosper from strong Fund performance, we also do well.

Fortunately, the Fund has no direct exposure to any companies thus far tainted by the Royal Commission, although it remains to be seen how any fall out might impact the broader financial services sector, including wealth managers and non-bank lenders, in terms of future compliance and new regulations. As such, we are keeping a close eye on proceedings.

The US economy continues to perform strongly with labour markets buoyant (unemployment is steady at around 4.1%), wages are rising and inflation has reached the Federal Reserve's (the Fed) target of 2% but with little evidence of a breakout. Fed officials see 2% inflation as consistent with an economy experiencing healthy demand for goods and services and, in early May, the Fed voted unanimously to leave rates unchanged, giving little indication that they are worried about a sudden, rapid escalation in prices or an abrupt slowdown in economic growth that could alter its gradual pace of rate increases.

Whilst US trade policy and geo-political stability remain wildcards that could derail equity markets, the news has been positive on both fronts in recent weeks.

The risk of a trade war between the US and China has kept the market on a knife's edge until recently, although this has dissipated somewhat since Chinese President Xi's offered an olive branch to Trump in a keynote speech at the recent Boao forum after days of escalating rhetoric between the US and China over trade. President Xi has pledged to "considerably reduce" tariffs on foreign cars sold in China this year, meeting a key demand of Trump and tempering concerns about an escalating trade war.

On a geopolitical front, the remarkable inter-Korean summit, held in late April, has raised hopes of the conclusion of a peace treaty between the two countries which would bring to a formal end the Korean War (where hostilities ceased just under 65 years ago in July 1953). North Korean leader Kim Jong Un and South Korean President Moon Jae-in also vowed "complete denuclearisation" of the Korean Peninsula in the first inter-Korean summit in more than a decade. Whilst some scepticism remains as to how this will be achieved, the language of unity after the threat of catastrophic war just a year ago is remarkable. Trump has further confirmed that he will meet the North Korean leader at a date and location yet to be revealed. The meeting would be unprecedented and, should it occur, will be the first ever meeting between a sitting US president and the incumbent leader of North Korea.

Clearly both these developments have served to calm the nerves of the market but we take nothing for granted when it comes to both Sino-American relations and developments on the Korean Peninsula. Nevertheless, we remain cautiously optimistic about further positive development on both fronts which will allow the market to remain focussed on the outlook for company earnings which look increasingly positive from a domestic small cap perspective.

Top 5 holdings#

Company	ASX code
Bapcor Limited	BAP
Bingo Industries Ltd	BIN
Eclipx Group Ltd	ECX
Mineral Resources Limited	MIN
Nextdc Ltd	NXT

#Alphabetical order

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