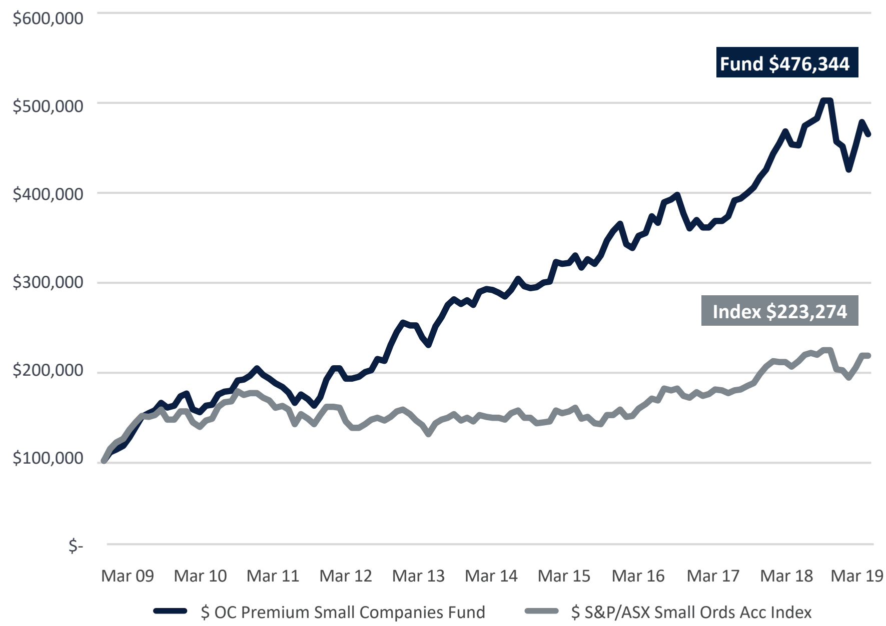
OC Premium Small Companies Fund
Fund Update | 31 March 2019

Fund up 9.2% for the quarter
9.2%

Returned 16.9% p.a. for the past ten years
16.9%

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

Performance comparison of $100,000 over 10 years*



Total returns

At 31 March 2019†	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 Premium	-3.0	9.2	2.6	9.8	9.8	12.7	16.9	11.1
S&P/ASX Small Ords Accum	-0.1	12.6	5.8	11.4	8.0	4.5	8.4	6.0
Outperformance	**-2.9**	**-3.4**	**-3.2**	**-1.6**	**1.8**	**8.2**	**8.6**	**5.1**
S&P/ASX Small Ind Accum	0.4	12.7	7.8	9.4	8.6	9.4	12.0	6.4
Outperformance	**-3.4**	**-3.5**	**-5.2**	**0.4**	**1.2**	**3.3**	**4.9**	**4.7**

Performance review

Global markets bounced sharply in the March quarter after the US Federal Reserve signalled that it was done hiking interest rates and several other major central banks subsequently turned more dovish, including the Reserve Bank of Australia. Following the global lead, the Australian small-cap indices rebounded strongly, with the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrials Accumulation Index up 12.6% and 12.7%, respectively, for the quarter.

The OC Premium Small Companies Fund also bounced in the March quarter, up 9.2%, albeit our performance lagged the small-cap indices. The Fund was conservatively positioned entering the new calendar year with cash holding approaching 15% which we felt was prudent given the softening outlook for global growth and the Australian economy and consequently the sharp bounce in the market impacted the Fund's performance from a relative perspective.

The Fund continues to have strong long-term performance having returned +16.9% per annum over the past 10 years, which is well ahead of both the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrials Accumulation Index, which have returned +8.4% and +12.0%, respectively, over the same time horizon.

During the quarter, most of the small-cap universe released their first half results and one could be forgiven for concluding that corporate Australia is performing exceedingly well given the strong bounce in the market. But the reality is that only 44% of companies in the S&P/ASX Small Ordinaries Index grew EPS over H1 FY19, which is the weakest period of growth since H1 FY11[1]. In fact, the February reporting season was slightly disappointing versus consensus expectations with the index strength likely driven by a dovish pivot from the US Federal Reserve and/or expectations that a Sino-US trade deal may be close, rather than by underlying company fundamentals.

Leading technology names in the small-cap universe continued to perform strongly during the quarter with **Appen Group (APX, +73.7%), Afterpay Touchcorp (APT, +68.9%)** and **Altium (ALU, +48.9%)** each hitting all time share price highs. As mentioned in the February Monthly Review, the Fund has been progressively reducing our weightings in each of these names as their share prices

(1) Goldman Sachs Research, FactSet, Bloomberg.

have approached our valuation (despite our valuations consistently being increased over the past year due to upside earnings surprises). All three stocks are now large components of the small ordinaries index (APT number 1, ALU, number 2 and APX number 14) so each contributed materially to the strong performance of the index during the quarter.

Appen Group re-rated during the quarter after it comfortably beat consensus market expectations and its own upgraded earnings forecasts for CY18. APX management have done in exceptional job at consistently upgrading and beating their earnings forecasts since we added the stock to the portfolio over two years ago. The acquisition of their largest content relevance peer, Leapforce, appears to be tracking well given the margin expansion delivered during the year and we expect further scale benefits and operating efficiencies to be achieved in CY19. APX's earnings guidance for CY19 again looks conservative leaving significant room for earnings upside if it continues to execute operationally.

In March, APX announced the acquisition of Figure Eight (F8), a San Francisco-based Artificial Intelligence (AI) platform developer for initial consideration of US$175m, plus potential earn-out consideration of up to US$125m. F8 is a leading machine learning platform which uses automated annotation tools to transform unstructured text, image, audio and video data into customised high-quality AI training data. Whilst the Leapforce acquisition added scale to APX's operations, the F8 acquisition will provide APX with the technology, platform and expertise to deliver increasing volume, quality and speed which ought to improve operating leverage across the business by improving the efficiency of the Appen 'crowd'. The F8 deal is strategically sound and high quality but we note it is EPS negative in the short to medium term. The Fund subscribed for stock in the capital raising but has subsequently reduced its holding into the share price strength as the share price continues moves closer to our valuation. We believe that APX is an outstanding tech play with a material competitive advantage in the development of high-quality data-sets for machine learning and AI, an area which should continue to grow rapidly in the coming years as technology advances.

Afterpay Touch delivered good news on multiple fronts during the quarter and continued its march toward becoming the dominant "buy-now, pay-later" operator in both Australia and the US, with a UK launch imminent. Firstly, the widely discussed Senate committee handed down its report, 'Credit and hardship: report of the Senate inquiry into Credit and financial products targeted at Australians at risk of financial hardship'. The four key recommendations of the committee are pragmatic and compliance with them should not be an issue for APT. Given that ASIC has already completed its review of the sector without material adverse findings, the share price re-rated following the release of the report as the risks to APT's Australian business from onerous new regulations or oversight has now been vastly reduced. Secondly, the Australian business continues to show increasing momentum with key metrics such as customer growth rate, net transaction margin trajectory and net transaction losses all trending positively. Finally, the US business continues to scale rapidly and looks well placed to replicate the success of the model in Australia, albeit on a much larger scale. We recently visited the company's US operations in San Francisco and were impressed by the depth of talent the company had attracted and its progress in building the dominant "buy now, pay later" platform in the US.

Altium produced one of the stand out results of the February reporting season and continues its march towards becoming the dominant player in the software used by engineers to design printed circuit boards (PCBs). ALU sold a record number of new licences during the half, with a major positive surprise coming out of the key Chinese market where revenue increased 49%. Octopart, the electronic parts search and directory business, grew by an impressive 80% year-on-year and continues managements strong track record on delivering growth through value accretive acquisitions. ALU does not provide specific earnings guidance, rather it provides 'aspirational targets'. Management reiterated its FY20 target of US$200m revenue and an EBITDA margin of 'at least 35%' which now looks conservative. It also introduced a new 'aspirational' revenue target of US$500m for FY25 and talked to an EBITDA target greater than 40% which is indicative of the operating leverage that the business can achieve as it continues to scale. On our visit to the company's Palo Alto office in California in late March, we gained comfort around recent product launches including Altium 365 and Altium Designer 19 which ought to accelerate ALU's market share gains in the core PCB business where it is taking share from key competitors such as Cadence Design Systems and Mentor Graphics Corporation.

Eclipx Group (ECX, -73.7%) was the key detractor for the quarter after a disappointing trading update forced corporate suitor McMillan Shakespeare (MMS, -13.7%) to advise that the completion of the merger agreement between the two parties was unlikely. The Scheme Implementation Agreement was subsequently terminated in early April. It is a disappointing outcome for the Fund which had retained its holding in the company, despite the recent earnings downgrade, given our expectation of a favourable outcome on the corporate transaction with MMS.

Grays Online and Right2Drive continue to disappoint and are now in a formal sales process with management confirming potential interest from a number of parties. While a sale would likely be at well below book value, given the deterioration in both businesses over the past 12-months, a favourable outcome would likely relieve the pressure on the company's balance sheet and re-rate the stock given that the current depressed share price is pricing in the risk of a breach in corporate debt covenants.

We are disappointed with the loss that unit holders have sustained and we certainly did not foresee the speed or extent of the ECX business deterioration. We have been in active discussions with ECX's Chairman and are comfortable that the right operational structures are now in place to extract cost from the business and ensure that the asset sales program results in a solid outcome for shareholders. The core fleet leasing and novated business remains the jewel in the crown of ECX and we are confident that it will be sold in a competitive process that will maximise value for shareholders.

Helloworld Travel (HLO; -29.3%) fell after posting a 1H19 result which now sees the company requiring strong second half earnings growth to meet full year guidance. At the February result, management outlined the drivers of earnings growth in the 2H19, which include the annualization of a recent acquisition, override or volume incentive payments and accretive changes to the process of paying airline partners. Whilst we see full year earnings guidance as achievable, the market took a more pessimistic view and marked the share price down.

Furthermore, the stock was driven lower after newswires reported that the Minister for Finance, Matthias Cormann, was not charged by HLO for private airfares booked to Singapore. This oversight on the part of HLO raised eyebrows in certain parts of Canberra as HLO provides travel management services to the Australian Government under a contract which is due for renewal. The loss of this contract would see a material earnings impact for HLO and the market has sold the stock down aggressively as the likelihood of renewal is discounted by market participants. Management maintain that FY19 earnings guidance is achievable and that it remains optimistic that the Government travel contract will be extended. MD Andrew Burnes has been acquiring shares on market recently.

Outlook

The market bounced in the March quarter as domestic equity market participants climbed a wall of worry to cast aside concerns about a global economic slowdown, the unresolved Sino-US trade dispute, Brexit uncertainty and a softening domestic retail, property and consumer environment to close the quarter up strongly. This was in stark contrast to the last quarter of CY18 when a mood of extreme caution saw most liquid asset classes sell off materially. The circuit breaker appears to have been an abrupt turnaround by the US Federal Reserve ("the Fed") on interest rates policy, as well as widespread market optimism that the trade differences between the US and China will soon be resolved.

Without doubt, the dovish pivot from the Fed was the catalyst for improved risk appetite from equity investors during the quarter. The US Federal Reserve has now signalled that its done raising rates in the near-term and would be 'patient' about any future decisions on reducing its bond holdings. The return of the so called "Fed Put" has no doubt emboldened investor risk appetite and alleviated concerns that the Fed was hiking too quickly and could drive the US economy into recession. On the heels of the Fed's dovish rhetoric, the European Central Bank pushed out a planned rate hike and central banks from Canada and Australia also issued commentary suggesting that they had turned more dovish in their outlook for interest rates.

The Sino-US trade dispute has been topical for some time now and is still garnering daily headlines with ongoing rumours that a trade deal between the two super powers is getting closer. Chinese Vice Premier Liu He will meet Trump at the White House on Thursday in what is believed to be a further push to resolve some of the more contentious issues. Negotiations seem to have come down to three key points of contention:

1. The US wants China to purchase more American exports and has already won Beijing's assurances that they will do so;
2. The US wants assurances around intellectual property (IP) protection, namely that China will stop stealing US IP and further that it will enforce IP protection laws against those who do;
3. The US wants to prevent forced technology transfer to China which occurs when foreign multi-nationals are pushed to provide strategically significant technology to Chinese entities (that they do not control) so they can do business in the massive Chinese market.

Whilst the direct impact on the Australian small cap stock universe of a protracted trade war is minimal, given that few companies are directly affected by the current tariffs, the second order effects of these tariffs may have a significant impact on our market. For instance, a protracted trade war would likely drag heavily on global growth which would have a material impact on many companies including those exposed to commodity prices such as the resource companies or mining services stocks. In this context, it is not surprising that global markets have rallied, including domestic small-caps, on optimism that Washington and Beijing may be close to reaching a binding trade agreement.

On the domestic front, the Reserve Bank of Australia (RBA) remains relatively upbeat about the prospects for our economy, although it has modestly downgraded its

GDP forecasts for 2019 and 2020 to 3.00% and 2.75% (from its prior forecast of 3.25% and 3.00%) respectively. Clearly the RBA remains heartened by the strong labour market (unemployment is forecast to be 4.75% over the next few years) and the benign level of inflation, with the bank recently downgrading inflationary expectations to 2.25% by the end of 2020. Interest rates appear to be on hold for some time following RBA governor Philip Lowes' dovish shift to an "evenly balanced" stance on the direction of rates, although the bond markets are now starting to price in an interest rate cut later this calendar year.

We are a little more circumspect about the domestic economic outlook. Pleasingly, there remain areas of strength, such as public infrastructure and mining construction, and the portfolio has a healthy exposure to these thematics. Furthermore, the employment market is sound and inflation is well contained and unlikely to break out any time soon. However, the consumer is doing it tough with negligible real wages growth and falling house prices and tight credit conditions weighing on the outlook for domestic consumption.

The mounting pressures in the residential property market are well publicised and the International Monetary Fund has recently sliced its Australian growth forecast from 2.8% to 2.1%. The IMF's lead analyst for Australia, Dr Thomas Hembling, said residential property had fallen further than had been anticipated and was generating a drag on the rest of the economy, although he noted that it should be offset somewhat by other drivers such as infrastructure spend.

The RBA has downplayed the risks of the slowdown in economic growth, arguing the "wealth effect" on consumer spending from falling house prices will be limited to cars and furniture. But our interactions with company management in recent months suggest it is more widespread and will likely have a more pronounced impact on consumer behaviour in the coming months, including on discretionary items such as travel and leisure activities. It remains to be seen whether increasing levels of public infrastructure spend, stimulatory tax cuts (promised by both major political parties in the run up to the May federal election) and non-mining business investment can pick up the slack.

The federal budget was an unusually subdued event from a market perspective with the Australian Labor Party the overwhelming favourite to win the upcoming election, which will take place on Saturday May 18. Unless there is an abrupt change in voter sentiment, it seems unlikely the Liberal-National coalition will be given a mandate by the Australian people to implement their newly announced budget policies.

If the polls are accurate and Bill Shorten is elected Australia's next Prime Minister, the most obvious implications will be in the following areas:

- the housing market, with the limiting of negative gearing to investment in new housing only;
- personal income taxes (positive for low income earners, negative for higher income bracket tax payers);
- the halving of the Capital Gains tax (CGT) discount for all assets purchased after a yet-to-be determined date; and
- elimination of franking credit cash refunds, which will likely impact some individuals and many superannuation funds.

The implications for the portfolio are minimal and we will give a more comprehensive update following the federal election.

The Fund has been conservatively positioned over the quarter with cash holdings exceeding 10%, which impacted our relative returns given the sharp rebound in the small cap index during the quarter. We have resisted the urge to chase the market given the slowing global economic environment, albeit we have been selectively deploying capital into several new investment positions during the quarter.

Following our post-reporting season management catch-ups, we are again out on the road with an extensive list of companies, competitors and sites to visit. Recent weeks have seen members of the team in the US and China, meeting with an impressive array of ASX listed companies, their competitors and industry peers for comparative purposes. 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
Mineral Resources Ltd	MIN
Nextdc Limited	NXT
Reliance Worldwide	RWC
Seven Group Holdings	SVW
Webjet Limited	WEB

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 soft 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. Soft close unit prices are interim unit prices struck at month end before all transactions for the month have been completed. Performance data available on the OC website, ocfunds.com.au, however, is based on hard close unit prices which are struck after all transactions for the month have been completed.

[*] 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.

Past performance is not a reliable indicator of future performance. Positive returns, which the OC Premium Small Companies Fund (the Fund) is designed to provide, are different regarding risk and investment profile to index returns. A performance fee of 20.5% is payable annually on any excess performance (after deducting the management fee) above the benchmark, S&P/ASX Small Ordinaries Accumulation Index, to 30 June. A performance fee is only payable where the Fund has returned 5% or more since the last performance fee was paid. This document is for general information purposes only and does not take into account the specific investment objectives, financial situation or particular needs of any specific reader. As such, before acting on any information contained in this article, readers should consider the appropriateness of the information to their needs. This may involve seeking advice from a qualified financial adviser. Copia Investment Partners Ltd (AFSL 229316, ABN 22 092 872 056) (Copia) is the issuer of the OC Premium Small Companies Fund (ARSN 098 644 976). A current PDS is available from Copia located at Level 25, 360 Collins Street, Melbourne Vic 3000, by visiting ocfunds.copiapartners.com.au or by calling 1800 442 129 (free call). A person should consider the PDS before deciding whether to acquire or continue to hold an interest in the Fund. Any opinions or recommendation contained in this document are subject to change without notice and Copia is under no obligation to update or keep any information contained in this document current.