OC FUNDS MANAGEMENT

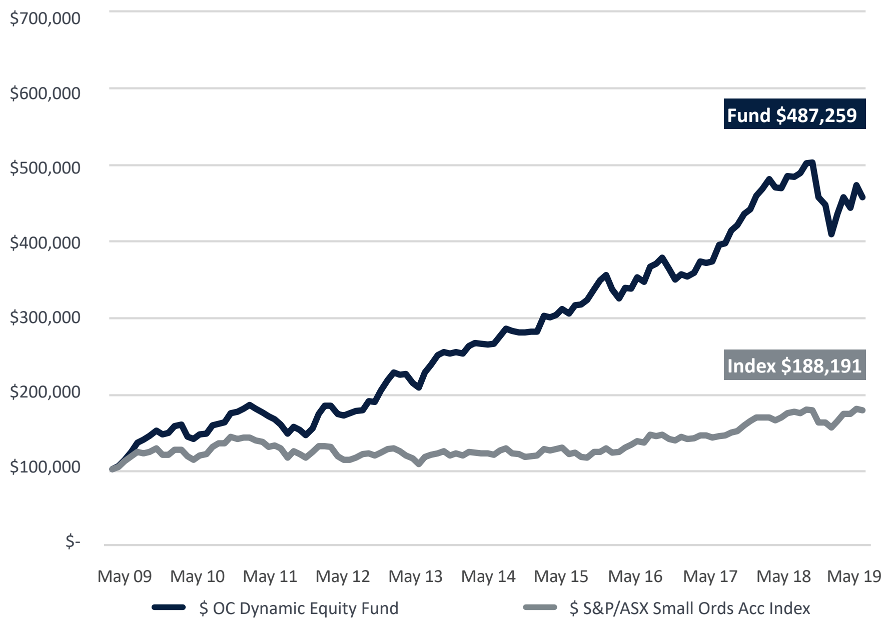
OC Dynamic Equity Fund
Fund Update | 31 May 2019

-3.3% Fund down -3.3% for the month

17.2% Returned 17.2% p.a. for the past ten years

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 May 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 Dynamic	-3.3	0.1	-5.8	9.3	11.9	15.4	17.2	12.4
S&P/ASX Small Ords Accum	-1.2	2.7	2.1	9.8	8.8	6.7	6.5	6.2
Outperformance	**-2.1**	**-2.6**	**-7.9**	**-0.6**	**3.1**	**8.7**	**10.7**	**6.1**
S&P/ASX Small Ind Accum	-1.3	5.3	7.3	9.2	9.9	11.3	10.9	6.8
Outperformance	**-2.0**	**-5.3**	**-13.2**	**0.0**	**2.0**	**4.1**	**6.3**	**5.6**

Performance review

The OC Dynamic Equity Fund gave back most of its outperformance from the month of April finishing May down 3.3%. This performance was behind the Small Ordinaries Accumulation Index and the Small Industrials Accumulation Index which were down 1.2% and 1.3% respectively for the month. The underperformance of the Fund was driven by a combination of stock specific issues, which are discussed below, as well as the Fund not holding large Index constituent, **Vocus Group (VOC, +17.4%)**, which received a takeover approach late in May at a significant premium to its last traded price.

The Citadel Group Limited (CGL, -37.1%) was the key disappointment for the Fund during the month after it provided earnings guidance for the year ending 30 June 2019 which was well below consensus expectations. The IT services provider flagged two key reasons for the earnings miss. Firstly, CGL noted key customer spend fell significantly in the lead up to the federal election (the federal government comprises a high portion of CGL's customer base) as the government went into 'care-taker' mode during the election campaign. The company did not anticipate the scale of the drop-off and did not adjust its cost base accordingly and the resultant negative fixed cost leverage was significant. Secondly, CGL has made a strategic pivot away from managed services contracts, which typically include a large up-front licence fee, toward a Software as a Service (SaaS) style recurring revenue model which has seen revenues and margins fall this year. Under a SaaS model, these earnings ought to become higher quality, stickier revenue streams going forward. SaaS is now 35% of CGL's total revenues and is a growing part of the business which we believe bodes well for a future potential re-rating of the stock. Whilst clearly disappointing, we believe that the quantum of the sell-off is overdone and have retained our holding.

Reliance Worldwide Corporation (RWC, -24.8%) revised its earnings guidance lower during the month citing moderating growth rates as market specific factors negatively impacted the group's performance. The key issues contributing to the revised outlook included: 1) the sharper than expected decline in the Australian residential market; 2) the delay in launching new product ranges in APAC; 3) weaker sales in the US owing to the absence of a significant 'freeze event'; 4) lower sales in EMEA segment due to the exit of certain product categories and lower demand levels in these markets; and 5) US channel partners lowering inventory levels. The timing of the update was disappointing given that the Fund was in the process of exiting its position following a revision to our own earnings forecasts based on the deterioration of the domestic residential market and the absence of a North American freeze event during the most recent northern winter. We had materially reduced our position prior to the announcement of the downgrade and we have subsequently exited the balance of our holding.

SG Fleet (SGF, +30.6%) bounced strongly during the month following its presentation at the Macquarie Equities Conference in Sydney which indicated that the company would deliver an improved second half result, despite a challenging industry back drop. SGF is a provider of fleet management services and novated leases and the business has faced a raft of challenges including a weak consumer environment and weak new vehicle sales which had led the market to become too bearish about the company's full year prospects. Whilst the operating environment remains challenging and client decision making is slow, contracts are being renewed at stable margins, the sales pipeline is healthy and residual values in automotive remain strong. Major shareholder, South African listed, Super Group, continues to creep its shareholding higher (currently 59.2%) and the company remains well placed to participate in industry consolidation in the coming years. Any such consolidation ought to offer large synergies to SGF given the benefits of scale in both fleet management and novated leasing.

Lovisa Holdings (LOV, +13.1%) share price bounced, along with most other domestic retail stocks, following the Coalition's unexpected federal election victory. LOV has built a highly successful, vertically integrated business model through which it develops, designs, sources and merchandises 100% of its Lovisa branded products. The company has more than 320 stores across Australia, New Zealand, Singapore, Malaysia, South Africa, Spain, France, the USA and the United Kingdom and franchised stores in the Middle East (Kuwait, the United Arab Emirates, Saudi Arabia, Oman and Bahrain) and Vietnam.

Whilst the domestic business remains an important driver of LOV's near-term earnings, we are most excited about the company's expansion in the key US, UK and French markets which are now in full roll-out mode. These markets have the potential to increase store numbers well beyond 1,000 in the medium term and the short pay back period of store roll-outs mean that it can potentially be funded without raising further equity capital. We recently visited several Lovisa stores in California and they each appear to be generating strong foot traffic and our discussions with the store managers and customers increased our conviction around a successful US roll-out. We have recently increased our holding in the company.

Outlook

"Sell in May and go away" so the saying goes, and it was again a challenging month across global equity markets in May. The simmering trade dispute between the US and China re-escalated and combined with political tensions between the US and Iran re-emerging and the threat of US tariffs on Mexican goods, global markets went firmly into "risk-off" mode.

A major cause of investor angst is the deteriorating relationship between the two global super-powers, the US and China, which has raised concerns about the trajectory of global growth at a time when the leading indicators were beginning to suggest that key regions, such as China and Europe, may be set to rebound.

The US reignited hostilities in mid-May when it announced that it would raise the duties charged on US$200 billion of Chinese imports from 10% to 25%. China retaliated with new tariffs of up to 25% imposed on US$60 billion worth of US goods which came into force at midnight on June 1. Arguably, of greater concern is the broadening of the conflict with both countries announcing measures that could be construed as being hostile toward the sovereign interests of the other. The US kicked things off with the blacklisting of Chinese tech giant, Huawei, on national security grounds. China responded with a series of measures including announcing plans to blacklist US firms and individuals it deems 'harmful' to the country's interests, issuing a US travel alert citing 'harassment' of citizens by US law enforcement agencies and noting the high frequency of shootings, robberies and theft in the country and also signalling that it may limit exports of rare earth minerals which are vital for many US technology industries.

Both sides have offered a more conciliatory tone since early June with the Chinese government saying it is willing to work with the US to end the trade war and Trump indicating he would delay his decision on whether to carry out his threat to hit Beijing with tariffs on least US$300 billion in Chinese goods until after a meeting with Chinese counterpart, Xi Jinping, at the G20 summit in Japan later this month.

Policymakers from the US Federal Reserve, the European Central Bank, the Bank of Japan and other central banks across the globe have signalled their willingness to cut rates if growth were to stagnate. Whilst this has tempered the fall in equity markets in the near term, it is certainly not a panacea for the broader issues. With interest rates almost universally low across the globe, central bankers may once again be forced to deploy unconventional policy tools, such as quantitative easing, in the event of a coordinated global slowdown.

On the domestic front, the Coalition Government was returned to office during the month contrary to the expectations of pre-election polls and the equity markets. The significant relief rally in retail, property, health insurance and financial services stocks suggests that the markets had been widely anticipating an ALP victory. Many of the ALP's policies were expected to have a negative impact on the domestic market, particularly the removal of franking credit refunds, the removal of negative gearing on established housing, a reduction in capital gains tax discounts, proposed industrial relations reforms, including minimum wages increases, and the 2% cap on private health insurance increases.

The Morrison government's re-election has given a much-needed sentiment boost to the domestic economy and anecdotal feedback from company management post the election suggests there has been a spike in activity in areas such as retail and travel and the outlook for the property market has improved considerably, albeit off a low base. The Government has budgeted for $7 billion in tax cuts, to be delivered through July-October 2019, which ought to provide a sugar hit to the consumer. Not surprisingly, the retail space has been a very strong performer since the election.

In a further win for the property market, APRA announced that it will remove the interest rate serviceability floor on mortgages that was previously set to "at least 7%". This metric will be replaced with an interest rate buffer measure of 2.5% which ought to increase the maximum borrowing capacity of buyers by an average of ~8%.

The other major domestic news was the RBA's widely anticipated decision to lower the cash rate by 25 basis points to 1.25% at the start of June. The cut was the first change to monetary policy settings since August-2016 and had been well telegraphed by RBA in its quarterly statement of monetary policy released in early May. In this statement, the RBA downgraded its forecast of economic growth, inflation and consumption and further delayed its expectations of any improvement in unemployment. Whilst the policy outlook doesn't have an explicit easing bias, it is still dovish and markets are anticipating that the RBA will cut a further 25 basis points near term, with two cuts a distinct possibility.

Whilst the RBA's cut will be a welcome relief to many, our enthusiasm is tempered given that the reduction is a clear reaction to a deteriorating domestic economy, with consumer spending weak, inflation below trend, real wages growth stagnant and unemployment showing signs that it may be starting to rise. We have long argued that the RBA's domestic growth targets are overly ambitious, and with the international trade dispute likely to slow in global economy, we expect further policy action from the RBA in the coming months.

Adjusted for inflation (1.3%), real interest rates are now negative, and we have some doubt as to whether further rate cuts will be effective in stimulating the economy from this point. Should growth moderate further, we would not be surprised to see the RBA utilise some less conventional policy tools that have been used offshore (such as quantitative easing) in a bid to stimulate the economy. Notwithstanding the Coalition victory and monetary stimulus, the Fund remains underweight domestic cyclical exposure.

We would like to once again thank our investors for their continued support of the Fund. We remain confident that we can generate strong risk-adjusted investment returns over the long-term.

Top 5 holdings#

Company	ASX code
The A2 Milk Company	A2M
Mineral Resources	MIN
Nextdc Limited	NXT
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.

CONTACT COPIA

1800 442 129 | clientservices@copiapartners.com.au | copiapartners.com.au

John Clothier	General Manager, Distribution	0408 488 549 | jclothier@copiapartners.com.au
Iain Mason	Director, Institutional Business	0412 137 424 | imason@copiapartners.com.au
Mani Papakonstantinos	Distribution Manager	0439 207 869 | epapakonstantinos@copiapartners.com.au
Matthew Roberts	Distribution Manager	0438 297 616 | mroberts@copiapartners.com.au
Jude Fernandez	Distribution Manager	0414 604 772 | jfernandez@copiapartners.com.au
Sam Harris	Distribution Manager	0429 982 159 | sharris@copiapartners.com.au