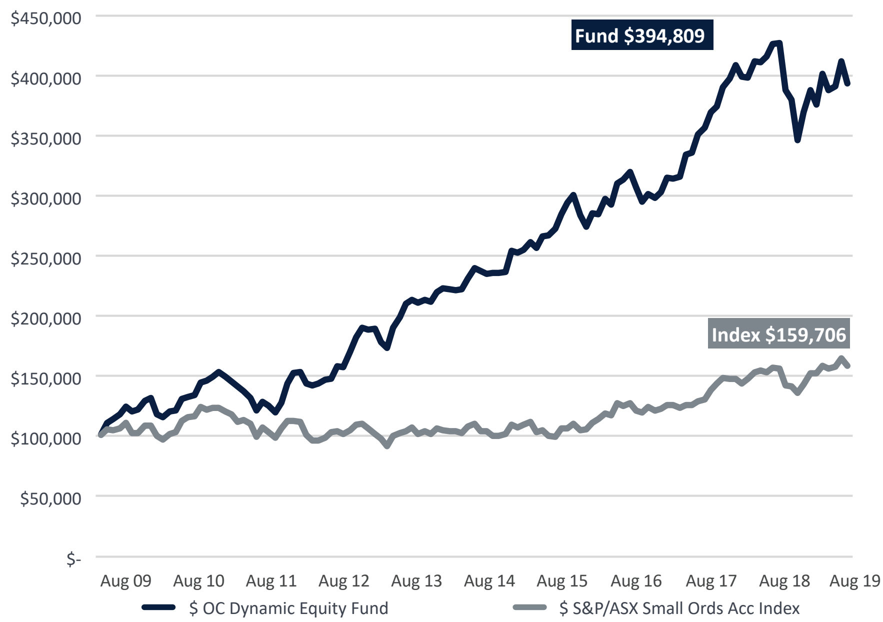
OC Dynamic Equity Fund
Fund Update | 31 August 2019

-4.4% Fund down -4.4% for the month

14.8% Returned 14.8% 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 August 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	-4.4	1.5	-7.7	8.0	10.5	15.2	14.8	12.3
S&P/ASX Small Ords Accum	-3.9	1.4	0.9	8.4	7.8	7.2	4.8	6.2
Outperformance	**-0.5**	**0.1**	**-8.7**	**-0.5**	**2.7**	**8.0**	**10.0**	**6.0**
S&P/ASX Small Ind Accum	-3.0	1.0	3.1	8.2	8.9	11.0	8.7	6.8
Outperformance	**-1.3**	**0.5**	**-10.8**	**-0.3**	**1.6**	**4.3**	**6.1**	**5.5**

The total return performance figures quoted are historical, calculated using end-of-month mid-prices and do not allow for the effects of income tax or inflation.

Performance review

The August reporting season was a challenging one across the board in Australian small-caps with just 38% of stocks in the Small Ordinaries Index delivering positive EPS growth in the second half of FY19+, the lowest number in a decade. In contrast, the majority of the OC Dynamic Equity Fund portfolio reported earnings growth during the year and reported results in-line with or above our expectations. Notwithstanding this, the Fund finished August down 4.4%. This was behind both the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrials Accumulation Index which were down 3.9% and 3.0% respectively for the month.

Overall, we were comfortable with the operating performance of the Fund's core holdings during FY19 and remain upbeat about their prospects, albeit we were disappointed to have posted a negative return during the month.

We caution investors from reading too much into short term share price movements, especially with the rise of quantitative trading and passive ETFs which can cause short-term distortions in the market. Importantly, we are comfortable that our portfolio is well positioned heading into the new financial year, and we have added to positions in several of our core stock holdings where we feel that the long-term business fundamentals are not being accurately reflected in those company's share prices.

We held high hopes for **Baby Bunting (BBN, +26.8%)** coming into the full year result and the company did not disappoint, delivering an impressive result. FY19 has comprehensively dispelled any lingering concerns the market may have had about online competition from Amazon, or the challenges of running a largely bricks and mortar retail baby goods network following the bankruptcy of its four largest competitors over the prior few years. BBN now has some 'clear air' following the failure and shutdown of a string of its major national competitors. It was apparent from the result that BBN has picked up significant market share from the exit of these groups and it has demonstrated growth in gross margin with the stabilisation of industry conditions following a protracted period of discounting as exiting competitors liquidated inventory. Store roll-out will remain a positive driver into the future for BBN, with about six stores per annum expected to be being opened in coming years and the larger format shopping centre stores, such as Chadstone, trading ahead of expectations. We expect continued strong growth in revenue and earnings into the medium term driven by ongoing market share gains, private label and exclusive offers, which are underpinning strong margin trends and further store roll-out. BBN continues its march towards being the 'category killer' in the national baby good space and management are doing a fine job.

Online retailer **Kogan.Com (KGN, +25.9%)** re-rated after releasing a result that was largely in-line with expectations but captured the markets attention with a robust trading update and additional information on new growth verticals. KGN has experienced strong growth in the high gross margin exclusive channel via extended ranging of white good products. Pleasingly, the recently launched Kogan marketplace generated gross sales of A$7.1m in the month of July which is likely to be a high margin, capital efficient revenue stream. Further verticals such as NZ mobile and credit cards are also likely to contribute to the business in the future and the company now has multiple growth avenues.

Buy now, pay later juggernaut **Afterpay (APT, +15.9%)** continues to outperform market expectations and delivered another fine set of key operating metrics at its FY19 result. Group revenue continues to track ahead of consensus expectations and net transaction profit margins and gross losses are all trending in the right direction, auguring well for the future profitability of the group. In particular, gross losses have fallen from an already well contained level of 1.5%, to just 1.1%, driven largely by strong repeat usage of the product from within the more mature Australian market where recalcitrant or non-paying users have now, in many cases, been barred from the service. We expect this number to track upwards in the next 12 months given the rapid growth in the less mature US and UK markets where the quality of the user base is not yet as seasoned as it is in Australia. Critically, US momentum continues to accelerate and the US finished June at a run-rate of $1.7 billion in sales. APT has also announced a strategic collaboration with Visa in the US market and, although there are limited details on the deal available, it can be expected to enhance the customer and retailer offering. The recent UK launch has exceeded expectations to date with customer adoption rates ahead of even those seen in the US in early days. This once again highlights the power of the Afterpay business model and its ability to resonate with both consumers and merchants across different geographies.

Portfolio stalwart, **The A2 Milk Company (A2M, -20.9%)**, had a challenging month and was sold off heavily at its full year result after announcing that its FY20 gross margin would flatline, largely as a result of increased marketing investment geared towards building the company brand internationally for the long term. Analyst consensus had been factoring in ongoing operating leverage into FY20 and investors took a dim view of management's strategy of increasing investment to build market share in the US and Chinese markets over the longer term.
As investors, it is sometimes difficult to reconcile the trade-off between tangible short-term gains versus a longer-term strategic investment. In FY20, management will spend almost NZ$200m in FY20 marketing the A2 brand in the world's two largest consumer markets with an eye to the future and we view this as a sensible strategy given the quantum of the opportunity in both of those markets. In the US, A2M recorded an EBITDA loss of NZ$44m in FY19 but revenue grew by an impressive 160% to NZ $36.4m and the company is making steady progress in building brand awareness and increasing distribution with A2M products now stocked in 13,100 stores.

Over recent years, A2M has grown from a New Zealand based micro-cap stock into an ASX100 company and, despite the rapid growth, the increase in share price has not been linear. We continue to back management's strategy which ought to deliver a strong medium-term growth trajectory for the business. We will be attending the A2M's strategy day in Shanghai later this month and we are also meeting with a raft of associated businesses to better understand the opportunity that lies ahead for A2M, particularly in the US and China.

Costa Group (CGC, -20.7%) sold off on the announcement of its half year result which highlighted uncertainties in recent trading conditions. We recently re-initiated a position in CGC, following the substantial share price fall at the time of the late May earnings downgrade by the company, however we were underwhelmed by the August trading update which indicated operations were tracking to the bottom end of the May guidance range. Key issues include the ongoing impact from lower pricing in mushrooms driven by lower demand, issues with one strain of 'crumbly' raspberries and a potential bumper blueberry crop which will likely put downward pressure on prices. These factors have combined to create a subdued outlook for the second half of this year. Nevertheless, next year ought to see strong growth as some of these one-off headwinds abate and the benefits from production expansions begin to be realised. We retained our modest position in CGC, in the face of the brutal market treatment of the stock at the time of the result, and the share price has rebounded strongly during the first week of September.

Appen Group (APX, -15.6%) was another long-term holding to be sold off during the month after its recent acquisition, Figure Eight (F8), lowered its revenue forecasts less than six months after being acquired by the group. F8 is a leading machine learning platform which uses automation tools to transform unstructured text, image, audio and video data into customised, high-quality, AI training data. It is expected F8 will provide APX with the technology, platform and expertise to deliver increasing volume, quality and speed, which ought to improve operating leverage across the APX business by improving the efficiency of the APX 'crowd'.

The transaction itself caused some disruption within the F8 business, with lower second quarter sales and a drop in customer renewals, as sales staff chased larger, longer lead time accounts which has in turn driven a tempering of near-term growth expectations for the F8 business. On a positive note, the key content relevance division of APX, which remains the major driver of revenue and profitability for the group, continues to perform strongly with revenue up 48% year-on-year and margin continuing to expand. Our analysis suggests that consensus earnings forecasts for APX in CY20 may be too low and, should business momentum continue, we would not be surprised to see the company exceed both its own guidance and consensus forecasts at its full year result, as it has done in the past three years.

Viva Leisure (VVA; +15.6%) is a regional gym network, primarily based around Canberra and the ACT, which moved higher during the month after reporting its inaugural result as an ASX listed company following its IPO in June. VVA's result was ahead of its FY19 prospectus forecast, particularly with respect to key metrics being active members (approximately 57,000) and locations (42). At the result, VVA also confirmed it is on track to exceed its FY20 prospectus forecast in terms of locations, with 15 green fields sites identified to be rolled out and a further 24 locations in discussions to be acquired. The organic opportunities and the inorganic pipeline combined have the potential to add considerable bulk to both the network and earnings power of VVA and we estimate should drive +70% EBITDA growth in FY20.

Outlook

August began with Trump's escalation of trade hostilities and ended with the new UK Prime Minister, Boris Johnson's suspension of the UK parliament; equity markets in the month went decidedly 'risk-off' as economic, financial and geo-political risks fuelled renewed volatility and a flight to safety. Global bond yields fell over the period, amid fears that the Sino-American trade war could tip the US economy into recession, with the US 10-year yield dropping 52 basis point over the course of the month. Indeed, the flood of money into safe-haven assets has pushed more than $US17 trillion of bonds into negative yield territory. Persistent low and negative rates across advanced economies have also propelled the gold price to record highs given there is now virtually no opportunity cost in holding the yellow metal.

Concerns around global economic slowdown have recently intensified as manufacturing gauges remained downbeat across the globe. The ISM US Manufacturing Purchasing Managers' Index fell to 49.1 in August (where a reading below 50 indicates the sector is shrinking), the lowest since 2016. Furthermore, the US and China each enacted new tariffs against the others imports effective from the end of August which caused a major blow to confidence with other PMI's around the world, including Germany, Japan and South Korea, joining the US Index in signalling a contraction of activity.

These soft readings come ahead of policy meetings at the European Central Bank and the Federal Reserve later this month and bond markets are pricing in further monetary easing to tackle the downturn. China is also forging ahead with its own form of stimulus, announcing that it would loosen restrictions on bank lending as it grappled with the effect of its trade war with the US. The People's Bank of China has cut its reserve requirements for all banks by 0.5% which will free up long-term funding of around 900 billion yuan (A$184 billion), which banks can use to increase lending in China as policymakers attempt to reinvigorate the Chinese economy.

In recent days, investor nerves have been temporarily calmed by hopes of a breakthrough following the announcement that Washington and Beijing are set to resume stalled trade talks in October. Nevertheless, falling expectations for consumer price growth, plunging bond rates and flatter and, in some countries (including the US), inverted yield curves all point to mounting doubts among the investment community over the effectiveness of monetary policy in reflating the economy.

On the domestic front, concerns that economic growth may have contracted in the June quarter had some market participants calling for further rate relief as early the recent September RBA Board meeting. But news of Australia's first current account surplus since 1975, which was driven by an export surge in iron ore, coal and gas, tempered expectations ahead of the board's September meeting. The economy grew +0.5% in the three months to June and Australia's annual economic growth has slowed to a limp at +1.4%, the lowest rate since the aftermath of the GFC when Australia was fighting the threat of recession with massive doses of fiscal and monetary stimulus.

Despite the soft GDP print, the combination of tax and interest rate cuts, house price stabilisation in Melbourne and Sydney, continued high levels of spending on infrastructure and a more positive outlook for investment in the resources sector has led the RBA governor to signpost that the economy may be reaching a gentle turning point. We remain a little more circumspect and believe that economic growth will print below the RBA's 2.75% target for CY19. Markets are still pricing in two further near-term interest rate cuts, with consensus expectations of a further 25 basis point cut at the November 2019 meeting and another 25 basis point cut by May 2020.

The Australian small cap market declined over the August 2019 reporting season, driven by a combination of deteriorating macro-economic indicators and negative earnings revisions at a corporate level. Goldman Sachs Investment Research found that the ratio of consensus EPS downgrades to upgrades hit the highest level since the GFC across the small-cap universe. Indeed 51% of companies had consensus EPS cuts of greater than 2.5%, well above the 38% average over the past decade. Just 15% of stocks saw consensus earnings upgrades of greater than 2.5%, well below the 10-year average of 22%. Prima facie this would usually be indicative of a rapidly deteriorating economic back-drop. Tempering this somewhat is that fact that the sell-side has become increasingly renowned for overly bullish forward earnings assumptions leading up to year end in recent years and widespread forward earnings revisions during the full-year results period are now quite common-place.

Some of the more interesting observations from the August reporting season include the following:

1. Contrary to subdued investor expectations, discretionary retail was one of the surprise packets with most companies in the space delivering financial results largely in-line with guidance, positive outlook statements and modest FY20 EPS upgrades. Both JB HiFi and Super Retail Group highlighted that recent trading has been assisted by expansionary fiscal and monetary policy, with smaller ticket purchases benefiting from tax cuts and government handouts. Sales growth for retailers such as Adairs Limited and fund holdings, Baby Bunting Group and Lovisa Holdings, has been robust, lending further weight to the suggestion that economic stimulus is flowing directly to the consumer. It will be interesting to see whether this is just a temporary boost or the start of a broad recovery in consumer spending.

2. There are data points now emerging to suggest that the residential housing market has bottomed and may even be enjoying moderate price growth again after a sustained contraction. Despite national new listing volumes decreasing 20 per cent in July, Domain Holdings Australia has called out some encouraging signs of buyer activity starting to spike, including increased attendance at "open for inspections". Recent auction clearance rates have strengthened considerably, particularly in the key Melbourne and Sydney markets, and property analytics business, CoreLogic, reported solid price growth in both these markets in August.

3. Federal and State infrastructure project pipelines remain solid. Core portfolio holdings, including Bingo Industrials and Seven Group Holdings, have reported improved earnings visibility thanks to infrastructure projects starting to commence along the eastern seaboard after lengthy delays. The real economy is expected to continue, benefiting from $100 billion in Federal infrastructure spend over 10 years, along with $93 billion investment committed by the NSW government and $107 billion of Victorian government capital projects commencing or underway.

The Fund remains "cashed up" at present, with a cash balance in-excess of 10%, providing ample flexibility to capitalise on any pull back in the market in the coming months. Whilst this level is well above our typical cash weighting of around 4-6%, we feel it is prudent in view of the elevated financial, political and geo-political risks which could provide a cheaper entry point into stocks in the coming months and the somewhat stretched valuations of some of the quality names in the small-cap space.

Post our reporting season management catch-ups, we will once again head out on the road with an extensive company visitation program planned in the coming weeks. 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
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.

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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 10 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 Dynamic Equity Fund (the Fund) is designed to provide, are different regarding risk and investment profile to index returns. Total returns are calculated after taking into account performance fees. Where OC Funds Management generates a return on the OC Dynamic Equity Fund over and above the performance hurdle of 15% in any financial year, a performance fee of 20.5% of all profits above this level is charged to the Fund directly. 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 Dynamic Equity Fund (ARSN 098 644 681). 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.