OC Dynamic Equity Fund

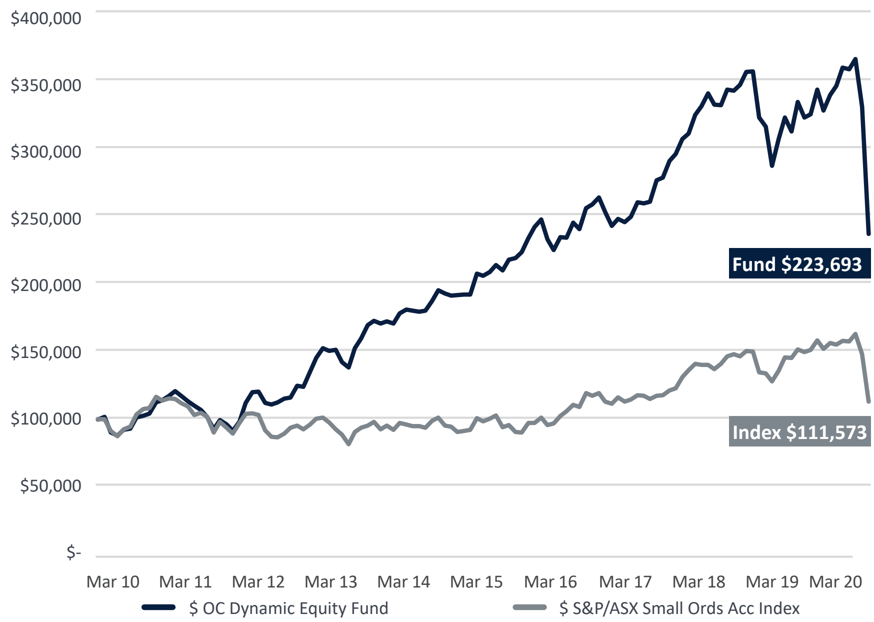
Fund Update | 31 March 2020

-33.1% Fund down -33.1% for the quarter

2.7% Returned 2.7% p.a. for the past 5 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 March 2020†	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	-27.6	-33.1	-23.5	-3.0	2.7	6.3	8.4	10.1
S&P/ASX Small Ords Accum	-22.4	-26.7	-21.0	-1.3	2.5	1.9	1.1	4.5
Outperformance	**-5.2**	**-6.3**	**-2.5**	**-1.7**	**0.2**	**4.4**	**7.3**	**5.6**
S&P/ASX Small Ind Accum	-23.3	-26.9	-19.3	-1.2	2.3	4.2	5.0	5.1
Outperformance	**-4.3**	**-6.2**	**-4.3**	**-1.8**	**0.4**	**2.2**	**3.4**	**5.0**

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 Novel Coronavirus (COVID-19) has rapidly morphed into a fear induced financial crisis that has seen the global stock indices, including the ASX, move into bear market territory (a retreat of more than 20% from its high), at the fastest rate ever. COVID-19 will materially weaken the global economy with severe supply and demand side implications and the world will face at least six months of severely curtailed economic activity and an uncertain path to recovery. Since mid-February, markets have moved rapidly to price in a major global recession, although a very strong policy response from central governments and central banks in Western countries such as Australia and the US over the past fortnight have brought a degree of stability back to both equity and credit markets and the ASX has bounced solidly off its lows.

Like many other investors, we initially underestimated the likelihood of global contagion occurring from COVID-19 and with hindsight the portfolio was poorly positioned heading into the crisis with overweight positions in the travel, technology, financial and mining services sectors, which had all been set to grow strongly in CY20 and beyond. We have subsequently repositioned our portfolio, but the speed of de-rate in these sectors hurt our performance during the quarter. Combined with the portfolio's minimal direct exposure to gold, a safe-haven asset which is a material component of the Small Ordinaries Index1 that has performed solidly, the Fund underperformed the S&P/ASX Small Ordinaries Accumulation Index[1] during the March quarter.

We are disappointed to have returned investors -33.1% during the March quarter and we share in our investors pain as members of the investment team are material investors in the Fund as well. Nevertheless, we remain confident in our ability to navigate the challenges of the coming months and point to our excellent track record following prior market dislocations. Post both the GFC and the FY12-13 small cap downturn, the Fund outperformed the small cap market by a significant amount in the eventual rebound.

The OC Funds portfolio has been rapidly repositioned, and we now hold a mix of quality businesses, that are strong

[1]The fund does not invest in single commodity, or single mine, resource stocks in its Core Fundamental sleeve due to their elevated risk profiles. This precludes us from investing in the gold stocks within the ASX small company's universe outside of trading positions; this has been a successful strategy for the Fund over the long-term.

cashflow generators which will recover rapidly once the crisis passes, combined with oversold companies that, in our opinion, the market has discounted too heavily. We also have a high cash balance (~14% at 31 March) in the portfolio which will allow us to participate in many of the heavily discounted emergency capital raises that we expect to be an important feature in the coming June quarter.

Despite the brutal sell-off across the ASX small-cap index, there have been a handful of beneficiaries from the COVID-19 crisis in the OC Funds portfolio during the quarter, including **NextDC Limited (NXT, +35.6%)** and **Fisher and Paykel Healthcare (FPH, +36.7%)**.

NextDC, a data centre operator exposed to the explosive growth in data being stored in the cloud, performed strongly during the quarter with the current self-isolation period and consequential increase in working remotely likely to accelerate the structural shift towards cloud adoption. Indeed, NXT has seen a step-up in demand for its premium data centre services particularly from its hyperscale cloud computing customers. Whilst this is unlikely to be a material near-term driver of earnings for the company, NXT expects further contract wins in both Sydney and Melbourne near-term from both hyperscale and enterprise customers and we note that cloud behemoths, such as AWS and Microsoft, are reportedly seeing large spikes in demand for their services. The company could, at the margin, see some near-term slowdown from high margin retail and small enterprises customers impacted by COVID-19, but we believe the longer-term structural cloud adoption trend will accelerate in the coming years. Early in April, NXT successfully raised $672m via a fully underwritten institutional placement which the Fund participated in. The purpose of the raise is to accelerate the construction of its S3 data centre facility in Sydney and fund other growth initiatives due to increased customer demand. Pleasingly, the capital raising removes any lingering questions over funding of near-term growth and we view it as a sensible decision by a high-quality management team.

Fisher & Paykel Healthcare, our long held respiratory equipment manufacturer, which we wrote about in the February monthly, upgraded its earnings outlook again during March. The company has benefited from the increased demand for hospital respiratory hardware used in ICUs, COVID-19 specialty units and, increasingly, hospital wards the world over. The company has also benefited from the depreciation of the NZD against both the US dollar and Euro. While the company expects some slowdown in the homecare sleep apnoea business as a result of fewer studies during the COVID-19 outbreak, this has not impacted the company to the extent expected during the March financial year. The outlook for the manufacturer remains strong, while clearly hospitals will continue to require more respiratory equipment for managing COVID-19 during the company's next financial year (to March '21), we expect the pandemic will also accelerate the usage of this equipment in other areas of the hospital (outside of the ICU), a trend that was already occurring. This will also drive long term consumable revenue for the masks, hoses and accessories used with this equipment.

The impact of the COVID-19 was acutely felt in the March quarter by core Fund holding, **Webjet (WEB, -71.1%)**, which has been caught in the cross fire of the drastic measures taken to slow the spread of virus and which have brought the global travel industry to a standstill. We clearly underestimated the extent to which governments across the globe would impose social distancing measures including closing borders, grounding flights and banning group gatherings which has had a devastating impact on airline and travel stocks across the globe. WEB faced a nightmare scenario with revenues disappearing almost overnight and customer cancellations peaking as high as 95%. Suddenly liquidity became a major issue for WEB as the group's negative working capital position unwound ferociously and bad debt risk spiked from its commercially distressed customers. The company has responded with a material cost cutting program and a large equity raising including a pro rata rights issue and an institutional placement which will raise around $332m. WEB is one of the quality players in the global B2B travel space and, following the capital raising, the company is well positioned to strengthen its competitive position once the crisis passes given many of its smaller competitors are unlikely to survive. The Fund participated in the capital raising in early April and the stock price has performed solidly on relisting with liquidity issues now off the table and a balance sheet strengthened sufficiently to see it through the crisis.

The Citadel Group (CGL -51.3%) was sold off heavily during the quarter despite having a core business that is largely exposed to high quality counterparties such as State and Federal governments, hospitals and health care providers who ought to be resilient during the COVID-19 crisis. In February, CGL announced the acquisition of Wellbeing Software Group (Wellbeing), a UK based provider of radiology and maternity software solutions that manage patient workflow and data. Wellbeing will sit within CGL's health division and ought to be complementary to the company's existing pathology and oncology solutions. To fund the acquisition, the company undertook a $127m capital raising and arranged a $90m debt facility. The timing of the acquisition was unfortunate given the valuation for the deal was agreed in a pre-COVID-19 world and many shareholders, OC Funds included, lobbied management to have the deal renegotiated to reflect current market valuations. Management had unfortunately waived their ability to renegotiate or exit the deal due to their desire to secure exclusivity on the transaction and the deal is to proceed on the original terms. Several disgruntled funds have sold down their positions in frustration which has seen the share price fall significantly.

Valuation of the Wellbeing transaction aside, the good news is that the acquisition is a high-quality software business that ought to prosper through the COVID-19 crisis. Indeed it has just announced a collaboration with AI technology provider, behold.ia, to fast-track the diagnosis of COVID-19 in NHS hospitals using artificial intelligence analysis of chest X-rays. The CGL management team has also recently reiterated full-year earnings guidance for the core business making CGL one of the few listed companies we expect to be largely unscathed by the global pandemic, from an FY20 earnings perspective. Whilst the company now has debt for the first time in many years, we do not view the balance sheet as stretched and the resilient earnings stream ought to see these borrowings quickly amortise in the coming years. We expect the share price recovery that started two weeks ago to continue in the coming months as the portion of higher quality software and SaaS style earnings increases post the acquisition and the market gains a better appreciation of the resilience of the CGL business model to the COVID-19 environment.

The Fund exited several holdings during the quarter, including companies that we believe will require additional capital to survive the COVID-19 induced downturn. Whilst we pride ourselves on transparency with our investors, we would prefer to keep these stock exits undisclosed for the time being as we do not wish to potentially jeopardise our ability to reinvest in these businesses when they recapitalise.

Outlook

The COVID-19 pandemic has brought the global economy to the brink of a standstill and is a true 'black swan' event, a rare, unpredictable event with serious and unavoidable effects. There will be no easy pathway through the pandemic, as policy makers have to balance competing priorities, being:

- an appropriate health policy approach, which will necessitate physical distancing and other short-term measures which will undoubtedly harm economic activity, against
- the reality of a market-based economy, which requires highly interconnected trade and cross border commerce in order to function in an orderly manner.

Clearly the necessary health response to COVID-19 will materially weaken the global economy; we are just unsure how much damage it will do and how long it will go on for, although the world is likely facing at least six months of severely curtailed economic activity. But once the health issues are brought under control, the economy can accelerate rapidly and equity markets, being forward looking, will likely recover well in advance of the overall economy.

In many sectors such as travel, hospitality and entertainment we have seen a near total collapse in demand as government enforced shutdowns and border closures are forcing entire industries (that were until very recently well capitalised, vibrant and thriving) into shutting their doors to customers and entering sudden battle for survival. The COVID-19 fallout is expected to hit 86% of all businesses in Australia in the coming months and 96% of accommodation and food services according to official statistics. This is a common trajectory being mirrored across much of the world with the global economy staring into the abyss of the biggest collapse in demand since the 1930s. The extraordinary quantum of the recent response from governments and central banks over the past fortnight has been reflective of the gravity of the COVID-19 crisis and the challenges that may lie ahead. These policy decisions and support packages ought to lay a foundation for an eventual economic recovery that will likely present investors with some incredible investment opportunities in the months and years ahead.

The United States, the linchpin, of the global economy has been hit particularly hard by COVID-19. It is now the global epicentre of the pandemic, surpassing the number of reported cases in China and even Italy and Spain, the hardest-hit European nations. This is partially due to the lackadaisical approach of the Trump administration which initially dismissed the health threat posed by COVID-19 and failed, amongst other things, to forewarn the public and implement timely distancing measures. It has also shone a harsh light on the shortcomings of the US healthcare system where medical supply and equipment shortages and vast undertesting has allowed the virus to spread rapidly.

The US Federal Reserve (the Fed) initially rushed to cut interest rates, but this response did little to appease investors as easier monetary policy and increased liquidity is unlikely to be a panacea for a crisis of this type. But in a stunning turn of events, the US Federal Reserve later committed to doing everything it can to save the financial system, including buying as much government debt as it deems necessary, as well as lending to small and large businesses and local governments to help them avert a liquidity crisis. These efforts have now gone beyond the extraordinary measures taken by the Fed in the depths of the GFC and have been critical in ensuring the orderly functioning of the global financial system.

The US government followed the Federal Reserve in a 'whatever it takes' policy approach that has averted economic gridlock in the US. The US $2.2 trillion relief package from the Congress is targeted in a manner to avoid a short-term liquidity issue for many businesses becoming a longer-term solvency issue. The challenge will be to get the procedures in place quickly to ensure that money is received by those facing liquidity issues in a timely manner. Clearly the US economy is under significant pressure with the latest US employment data foreshadowing what is likely to be a dramatic spike in the unemployment rate in the US in the coming six months, as well as an equally steep fall in economic activity.

Our own Central bank, the RBA, has reached the limit of its conventional monetary tools, with the cash rate at 0.25% and having made the statement that it has 'no appetite for negative rates in Australia'. The RBA has already injected almost A$9b into commercial bank funding lines and has announced that it will use the full extent of its monetary policy arsenal to stem the economic fallout from COVID-19, including through the implementation of quantitative easing in this country for the first time.

The opening gambit for the Australian Federal government was a A$17.6 billion package to guard against more severe economic impacts of the COVID-19 outbreak. The package was front-loaded in order to instil confidence in businesses and households and help firms keep people employed. As the crisis has intensified, the Federal Government has acted decisively to announce a raft of support measures to assist businesses, individuals and families to mitigate the crippling impacts of COVID-19. These measures now total almost A$220b or a staggering 15% of Australian GDP and more government sponsored fiscal support is expected in the coming months. The most significant of these is the A$130b 'JobKeeper' wage subsidy program that will help cushion the blow from a forced economic hibernation with around six million people eventually expected to receive the payment. It is a stunning 'game changer' for the domestic employment landscape and will hold shuttered companies and inactive workers together and ought to help avert unemployment reaching levels not seen in this country since the Great Depression of the 1930s.

No doubt spending on this scale will impose a large economic burden on Australia in future years and it is extremely fortunate that our great nation entered the crisis is in a relatively strong financial position compared to most of its Western counterparts. The Morrison government's aim is to keep Australia's long-term productive capacity intact so that we can re-start the economy rapidly when the health crisis passes. Although costly, it is likely cheaper and certainly more humane than the enormous financial and social burden that would come with the mass failure of businesses and unemployment levels of 20% or higher.

The news is not all grim from an Australian perspective. Our nation seems to be well ahead of the curve of most of its Western peers in slowing the spread of COVID-19 and there are signs that the spread of the virus is stabilising in Australia. Total cases are around 5,500, as of the first weekend in April, and the daily increase has continued to plateau at around 5% in recent days, materially lower that the 30% jumps seen just two weeks ago. A combination of a proactive Federal and State government approach, including the introduction stringent distancing measures, a largely obedient population and a strong health care system where widespread early COVID-19 testing has been amongst the highest per capita of anywhere in the world, is showing promising signs of 'flattening the curve'. We remain hopeful of averting a public health catastrophe on the scale of those currently playing out in the likes of Italy, Spain, the UK and even the USA where the human and economic costs of COVID-19 will likely be devastating and may linger for many years to come.

The reaction to COVID-19 in the domestic equity market has been severe, and at times the sell-off has seemed indiscriminate, with intra-day volatility reaching levels not seen even in the depths of the GFC, with even the biggest stock on the ASX, CSL Limited, experiencing an intra-day share price swing in excess of a staggering 20%. Clearly this creates opportunity for long-term fundamental investors such as OC Funds and we have been actively repositioning our portfolio to best capitalise on opportunities that invariably present themselves during a crisis such as this. Key areas of focus for OC Funds, from an investment perspective, include:

- investing in quality businesses that are strong cashflow generators and will recover rapidly once the COVID-19 health crisis passes;
- avoiding over-geared businesses given the severe dislocation in credit markets and uncertainty over the ability of companies to refinance or raise new debt in the current environment; and
- seeking out oversold companies that the market has discounted too heavily, which will survive the crisis and are unlikely to raise capital.

Additionally, we are also sitting on a war-chest of cash and expect a raft of capital raisings from distressed businesses in the coming weeks which will need to secure liquidity via the equity markets, often at heavily discounted prices, to ensure they survive and can prosper once the COVID-19 storm has passed. We are in daily contact with the investment banking and equity capital market (ECM) teams from all the major brokers and have been positioning ourselves, as best we can, to be an active participant in the recapitalisation deals we deem to be compelling. We have already participated in the raisings of Webjet, Kathmandu and Ooh! Media Limited in early April (which are already 59%, 55% and 15% in the money respectively upon relisting) and have subscribed for shares in the raising for Flight Centre and Southern Cross Media which launched on Monday. Additionally, we are currently undertaking due diligence on several other deals which we have been 'wall-crossed' on by corporate teams and we have been told to prepare for a 'conga-line' of companies to approach us for capital over the coming weeks by one prominent investment banker.

We reiterate from last month that as investors, we are trying to remain dispassionate and not get caught up in the wave of hysteria that can accompany rapidly falling markets and doomsday like headlines that inevitably accompany a pandemic. Despite the large human cost, our role as fund managers is to respond appropriately to ensure the best investment outcomes for our clients. Just as fear is the greatest enemy of markets, so too can it be an investor's worst enemy. We caution investors to keep a long-term perspective and not to panic and sell irrationally, which admittedly can be difficult given the extreme volatility we are seeing in the market. It is a common adage, but perhaps appropriate for the times: 'it is time in the market that counts, not timing the market'.

Market timing is notoriously difficult. We have frequently been asked by clients whether we have reached the bottom yet, and our honest response is that we do not know. Unfortunately, no one rings a bell to signal the bottom of the market. Our view is that markets will likely bottom some time close to when investor panic or pessimism reaches a peak. We do not know if that point has been reached yet, but the only certainty for investors who cash out now will be the crystallisation of the significant falls of recent weeks. The economy will ultimately recover, and the market snap-back will be sharp. In the meantime, most Australian companies are reasonably well placed to weather the storm given their healthy balance sheets which are in much better shape, on balance, than during the GFC. The infection rate in our country is starting to track towards a promising trajectory meaning that containment in Australia seems like a genuine possibility. When this crisis passes, many will benefit from the likely tailwinds of unprecedented fiscal stimulus, record low interest rates and a population eager to engage in commercial and social activities.

The OC team is amongst the most experienced in the Australian small-companies space with over 60 years of collective investment experience and we remain invested in the Funds as committed, long term holders. We are confident in our ability to generate our investors strong returns, as we did exiting the GFC, once the crisis passes and markets inevitably recover. We wish all our investors and their families good health and good spirits in these trying times.

Top 5 holdings#

Company	ASX code
Appen Limited	APX
Bravura Solution Ltd	BVS
Nextdc Limited	NXT
Seven Group Holdings	SVW
Steadfast Group Ltd	SDF

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.

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