FUNDS MANAGEMENT

OC Premium Small Companies Fund

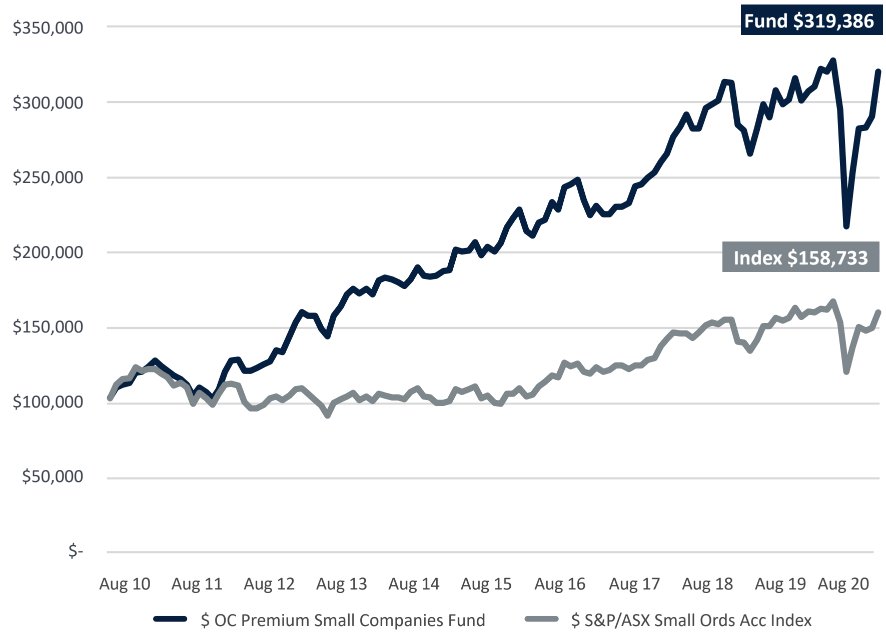
Fund Update | 31 August 2020

10.3% Fund up 10.3% for the month

12.3% Returned 12.3% p.a. for the past 10 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 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 Premium	10.3	13.6	6.4	8.8	10.0	10.3	12.3	10.9
S&P/ASX Small Ords Accum	7.2	6.6	2.1	8.0	10.5	6.9	4.7	5.9
Outperformance	**3.1**	**6.9**	**4.3**	**0.8**	**-0.5**	**3.3**	**7.6**	**5.0**
S&P/ASX Small Ind Accum	9.6	6.9	0.7	7.9	9.3	8.1	8.8	6.3
Outperformance	**0.7**	**6.6**	**5.7**	**0.9**	**0.7**	**2.2**	**3.6**	**4.5**

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

Performance review

The market continued to rally over the August reporting season with investors taking a 'glass half full' approach in casting aside another hard lockdown in Victoria and clusters of COVID-19 cases in both NSW and Queensland, as well as poor economic data across the globe, to instead focus on company results that exceeded our low expectations and rising vaccine hopes. The OC Premium Small Companies Fund returned +10.3% during August which comfortably exceeded both the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrials Accumulation Index which were up a buoyant +7.2% and +9.6% respectively for the month.

In the OC Fund's portfolio, **Redbubble Limited (RBL, +49.2%)** backed-up its stellar performance in July after releasing a result ahead of analyst forecasts which demonstrated an acceleration of the positive operating trends of the past few months. RBL is a leading global online marketplace that enables independent artists to sell their designs on products that are manufactured and delivered via third party fulfillers. RBL is undoubtedly a beneficiary of the structural shift towards e-commerce which has been accelerated by COVID-19. The RBL Managing Director, Martin Hosking, talked to the power of the 'fly wheel effect' which can occur when a two-way marketplace (such as RBL) gains scale and momentum. The conundrum for most two-way marketplaces is that without sellers there are no buyers and without buyers there are no sellers. But once a two-way marketplace hits critical mass, the growth rate can ramp up dramatically (Seek, carsales.com and REA Group are three such examples listed on the ASX). This is what we are currently seeing on the two RBL platforms: the e-commerce boom is driving more consumers to purchase which in turn is incentivising more artists to sell their wares on the Redbubble and TeePublic platforms. With the 'fly-wheel effect' gaining momentum we expect increasing product releases and strong operating leverage. This will be accentuated by a renewed focus on the operating cost base and should mean that FY21 is a breakout year for the business, both in terms of revenue growth, cashflow generation and profitability. We remain holders of the stock despite the strong recent share price performance.

Baby Bunting (BBN, +30.0%) again rallied following the delivery of an outstanding full year result which demonstrated both the strength of the operating model in a challenging operating environment and the company's bona fides as a potential 'category killer' with a large competitive moat in the baby good space. Financial metrics were strong across the board with highlights including online sales growth (including Click and Collect) of +39.1% in the year which comprised +14.5% of total sales in FY20 (vs +11.8% in FY19) and also sales of higher margin private label/exclusive products which grew to 36.5% of sales, up 48% year on year. The sale of baby goods, including cots, prams, nursery furniture and babywear, has proven to be quite inelastic from a demand perspective and the online channel, including Click and Collect, has captured a good portion of any shortfall of in-store sales. It seems that BBN has taken further share from competitors in the COVID-19 lockdown with some remaining competitors (including Target which has announced store closures) suffering financial stress. Market share gains and excellent store profitability metrics has seen BBN lift its long-term store target to +100 (from its current 56 store network) and the company has flagged potential bricks and mortar entry into the NZ market, both of which ought to help the business sustain a solid long-term runway of growth.

Costa Group (CGC, +15.7%) rallied strongly late in the month following its result which outlined a potential end to the run of adverse events the company has faced over the past two years. The company's result was somewhat underwhelming with the larger than anticipated impact of northern NSW drought mitigation measures flowing through to lower production of berries and tomatoes but the impact of extreme heat on the South Australian citrus crop appears to be less than previously expected, with the slightly later timing of this crop to push this benefit into the second half. COVID-19 also created a significant short-term cost impost with the company having to charter large aircraft and quarantine seasonal workers to move them around between crops in response to the lack of incoming migrant seasonal workers. CGC is expected to recover from these transitory factors and, furthermore, the outlook features strong growth from the overseas berry operations in Morocco and China (serving local regional markets), the increased production from expanded mushroom operations, new berry genetics and processes to increase yield. Over the longer term CGC is also expected to benefit from increased tomato and citrus production and improved drought resilience measures. The anticipation of these future benefits has seen the market move from focusing on near-term uncertainties to the visible growth outlook and set investors looking to re-enter this previously shunned name. We have retained our holding which we had increased leading into the result and remain comfortable holders of the stock.

Fund holding **Codan (CDA; +32.1%)** demonstrated its resilience in the face of the highly disruptive COVID-19 pandemic by reporting a strong full year result which was roundly applauded by the market. Adjusting for a non-cash writedown of prior capitalised expenditure, CDA actually delivered a result 10% above analyst expectations which was largely driven by CDA's market leading metal detectors division. Concerns that CDA's supply chain and distribution channels would be impacted by COVID-19 were swept aside as the company delivered on FY20 sales expectations. Another highlight of the result was CDA's cash conversion at +100% which flowed through to an already impressive balance sheet with almost $100m cash on hand. A genuine quality small cap, OC was fortunate to have established a portfolio holding in CDA during the market rout of late March, but with the stock having rallied +100% off our entry point we have exited our position purely on valuation grounds.

Appen Group (APX, -2.6%) was sold off on its result after rallying to all-time highs earlier in the month, most likely on the expectations from some of a profit upgrade which did not come to fruition. Long-term Fund holders will be quite familiar with the tech name which provides training data to help build and continuously improve the world's most innovative artificial intelligence systems. At the full year result in February, APX management guided to a material increase in sales and marketing expenditure in the first half of CY20 which would weigh on margins but ultimately lead to strong growth in the second half and beyond, along with a recovery in margin as operating leverage returned to the business. A couple of sell-side analysts chose to ignore this directive from APX management and consequently had H1 earnings expectations that did not reflect this investment and were subsequently too optimistic. Having failed to read the 'tea-leaves' these analysts have gone bearish and are talking down the company's prospects.

APX has seen some COVID-19 related headwinds including a slow-down in ad-related content relevance work from its major tech clients but we do not believe this will be sufficient to result in a full year earnings miss. The book of 'work in hand' released by the company at its half year result, when taken with the usual seasonal ramp-up into the fourth quarter (the business typically has a H1/H2 skew of 45/55%) and the operating leverage which ought to come with costs not materially increasing into the H2, should see a full year result within the guidance range. We believe this sets up APX for a strong CY21 with a higher starting margin run-rate and a robust revenue outlook with the ad-market likely to be recovering from the COVID-19 induced slowdown. Additionally, APX has several strong growth avenues including its China business which is accelerating rapidly off a very low base, potential US Federal government work (now that it is an eligible prime contractor), and a number of pilot projects underway in the automotive space which could grow to become material in coming years with the increasing investment being made in autonomous vehicles. APX remains a core holding for the Fund as we are attracted to its leading position in a high growth market and its consistent ability to deliver on its forecasts over a sustained period.

Outlook

In the July Monthly Review, we commented that "*Many of the Fund's holdings have recently provided trading updates to the market meaning that the FY20 results are largely known*" and "*[W]e therefore do not expect too many earnings surprises in the August reporting season*". That fortunately provided to be largely accurate with result surprises for Fund holdings falling mostly on the positive side of the ledger. A combination of very good continuous disclosure from our companies in the months leading up to results and diligent analysis from our team meant that most of the uncertainty heading into results related to the outlook for trading into the new financial year. Again, this mostly surprised on the upside with outlook statements, where offered, generally better than expected, albeit frequently tempered by the well documented challenges facing the domestic and global economy brought about by the COVID-19 health crisis. Not unexpectedly, given the host of unknowns that remain, including the likelihood of further lockdowns, the duration of government stimulus and the success or otherwise of pivotal upcoming Stage 3 vaccines trials, the majority of listed companies chose not to offer numerical guidance into the new financial year.

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

- Evidence of some of the structural trends accelerated by COVID-19 such as data usage, cloud computing and the acceleration of digitalisation and e-commerce were manifested in the FY20 results with beneficiaries, including Fund holdings **Kogan.com**, **NextDC** and **Redbubble** each releasing strong results.
- Contrary to subdued investor expectations when the pandemic spread back in March, reporting season for the consumer discretionary sector was overwhelmingly positive, particularly for home related retailers (electronics, furniture, homewares etc). Government stimulus, coupled with lockdown restrictions limiting spending on usual options such as travel and entertainment, proved to be a boon for most listed retailers. Overall, they fared significantly better than smaller unlisted SMEs given many have omni-channel offerings and often faced less onerous lockdown restrictions being deemed 'essential services'.
- Companies facing hard lockdown restrictions, on balance, preserved cash better than expected and many now have an extended liquidity runway having raised capital which ought to see them thrive in a lower competition environment once the pandemic passes. Companies such as **IDP Education**, **Corporate Travel Management** and **Eagers Automotive** each demonstrated outstanding cost control and are positioned to rebound strongly with diminished competition from unlisted competitors who lack access to funding to survive, or have been forced to significantly reduce their operations which could limit future growth.

From an economic perspective, central bank and government stimulus has thus far insulated us from the dire scenarios that seemed likely back in March. With campaigning for the US Federal election (scheduled for Tuesday 3 November) now in full swing, the world's biggest economy continues to surprise on the upside in terms of economic data. The unemployment rate has fallen to 8.4%, again exceeding consensus forecasts, and manufacturing and housing data continued to rebound, despite the second wave of COVID-19 cases still yet to be subdued. In a major policy shift, the US Federal Reserve has abandoned its policy of targeting inflation at 2% and will instead tolerate inflation modestly above this level in an effort to stimulate spending, employment and investment. This will likely mean lower interest rates for longer which ought to continue to be supportive of risk assets such as equities.

The Australian economy is officially in recession after the Australian Bureau of Statistics (ABS) revealed that June quarter GDP fell 7%, the biggest drop since records began in 1959. Despite this, the number was better than feared with an unprecedented raft of government stimulus and accommodative monetary policy from the RBA thus far warding off a more dire economic outcome, including the Treasury's own forecast which in March which contemplated a collapse in GDP of more than 20%.

The fortune of Australians, and Australian states, is very much divided at present with Victoria widely seen as the outlier. With the state now subject to a sustained second wave of COVID-19 infections, the Andrew's government's 'health first' approach means Victoria has been subject to one of the strictest lockdowns globally, according to the Oxford University stringency index. This clearly has negative implications for businesses exposed to Victoria, particularly where they are not operating in 'essential services', and we have skewed our portfolio away from these companies accordingly.

The Federal government has extended (a diluted form of) JobKeeper wage subsidies until at least March 2021 and hinted that tax cuts worth $20 billion could be brought forward to help the nation's recovery from the pandemic. Fortunately, economic activity is slowly ramping back up across most of the country and our policy makers in Canberra are keen to encourage spending and job creation and our central bank, the RBA, "continues to consider how further monetary measures could support the recovery".

Growing hopes of a COVID-19 vaccine have certainly been supportive of strong equity markets over August and the US Centers for Disease Control and Prevention has gone so far as to ask US states to be ready to distribute a vaccine as early October. Some experts think it is even possible that a vaccine will be available ahead of the US election (in early November). There are now seven candidates in Phase 3 trials globally and several credible candidates have demonstrated a promising immune response in small scale, early trials.

Whilst an effective vaccine has been touted by some as a 'silver bullet' to the economic woes brought about by the pandemic, this is not likely to be immediately the case. A vaccine is most unlikely to be 100% effective, it must be manufactured on a mass scale and distribution of it will likely be, at least initially, limited; even if these challenges can be overcome many people are saying they will not take the vaccine fearing unknown side effects. Consequently, even if a vaccine is approved in the coming months, the range of potential economic outcomes is still broad which makes stock picking in this environment somewhat challenging.

With a host of unknowns and range of potential outcomes around a vaccine, portfolio management is no simple exercise. As a result, we are not putting all our eggs in the one basket and the Fund continues to hold a range of stocks (e.g. **Redbubble** and **Kogan**) that will continue to benefit from the structural shifts accelerated by the pandemic, as well as some recapitalised industry leaders (e.g. **Eagers Automotive** and **Bapcor**) that will survive and prosper longer-term even if near-term vaccine efforts prove to be unsuccessful.

Fortunately, the Australian small-cap index is a highly diversified stock universe that holds ample opportunity for stock pickers like us. Irrespective of the economic conditions there will still be stocks that perform well operationally, and we will seek out the ones that are trading below our internal valuations. We remain confident that we can continue to deliver our investors strong returns over the long term and thank you all for your ongoing support.

Top 5 holdings#

Company	ASX code
Appen Limited	APX
Bapcor Ltd	BAP
Kogan.Com Ltd	KGN
Mineral Resources.	MIN
Nextdc Limited	NXT

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

[†]The total return performance figures quoted are historical, calculated using cum-distribution end-of-month hard-close 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.
[*] 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.