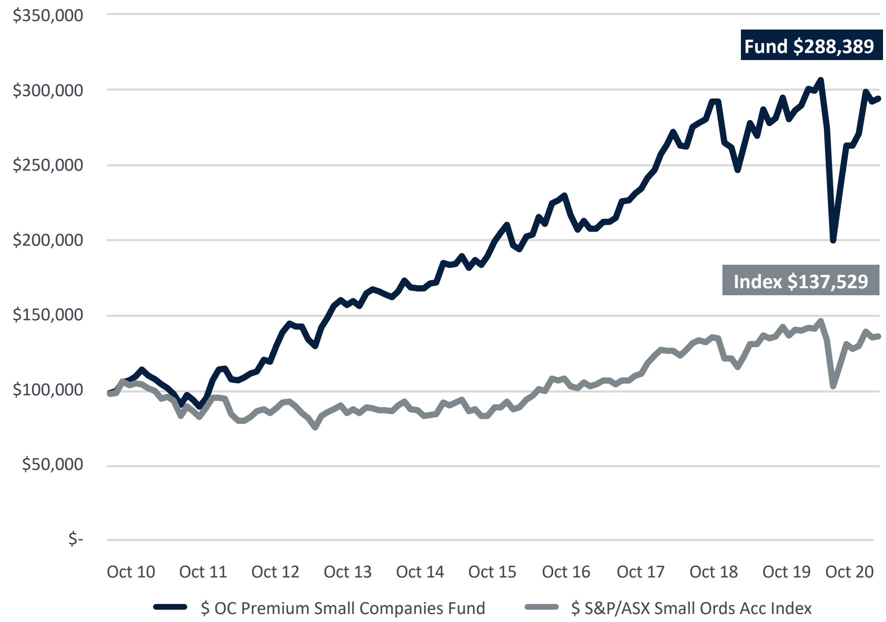
OC Premium Small Companies Fund
Fund Update | 31 October 2020

0.6% Fund up 0.6% for the month

11.2% Returned 11.2% 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 October 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	0.6	8.4	1.5	6.7	7.9	8.9	11.2	10.7
S&P/ASX Small Ords Accum	0.5	4.7	-2.4	4.6	8.6	5.9	3.2	5.7
Outperformance	**0.1**	**3.7**	**3.9**	**2.0**	**-0.6**	**2.9**	**8.0**	**4.9**
S&P/ASX Small Ind Accum	0.6	7.7	-3.6	4.9	7.5	6.8	7.8	6.2
Outperformance	**0.0**	**0.7**	**5.1**	**1.8**	**0.4**	**2.1**	**3.4**	**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

October was a month that played out in two halves across the Australian small-cap equities space with the S&P/ASX Small Ordinaries Accumulation Index rallying sharply in the first two weeks of the month following the expansionary Federal budget laid out early in the month, before selling off later in the month as the US 10-year treasury yield spiked in anticipation of a Democrat clean sweep in the US elections. The OC Premium Small Companies Fund mirrored this pattern, finishing the month up +0.6%. This was marginally ahead of the S&P/ASX Small Ordinaries Accumulation Index and in-line with the S&P/ASX Small Industrials Index which returned +0.5% and +0.6% respectively for the month.

The AGM season entered full swing in October and the Fund benefitted from two core holdings providing very strong earnings updates ahead of their respective shareholder meetings, namely **Eagers Automotive Group (APE; +18.7%)** and **Steadfast Group (SDF; +11.3%)**. APE announced a strong trading update for the nine months to 30 September with profit before tax (PBT) of $96.6m, a +45.4% increase on the prior corresponding period (pcp) which was a material turnaround given the company reported $40.4m PBT at the first half result which was down 23.7% on the pcp. APE looks very well placed to continue to outperform given a material cost out program ($100m per annum within 3 to 5 years) and a cyclical recovery which look increasingly likely to play out after a protracted downturn. SDF too defied the uncertain economic outlook by upgrading its full year earnings forecast following an excellent first quarter performance. The company upgraded its EPS forecast range by 5% from 5%-10% to 10%-15% which highlights the resilience of its insurance broking and underwriting agency business. Both APE and SDF are led by quality management teams who have strong long term track records of best-in-class performance in their respective industries and they remain core holdings in the Fund.

AMA Group (AMA; +15.0%) which runs the largest national network of collision repair workshops was a key contributor again during the month following its strong recent share price performance. The company was sold off aggressively at the start of the pandemic as the market fretted over its stretched balance sheet which came under pressure as government imposed COVID-19 restrictions led to a significant reduction in kilometres travelled, both locally and interstate, and consequently a reduction in vehicle repair volumes. But with the winding back of COVID-19 restrictions, vehicles are returning to the road and there are also several other factors driving a stronger earnings outlook for AMA. Some of these factors include a reluctance by individuals to take public transport (meaning more overall vehicles on the road) and more costly repairs driven by the increased sophistication of vehicles which are now leading to higher average repair revenues following a recent renegotiation of agreements between AMA and key insurer clients. The easing of local travel restrictions in Victoria should further benefit AMA which now looks well placed to meet its bank facility obligations without any costly changes. At its full year result in August, AMA flagged potential non-core asset sales which would leave the company well placed from a balance sheet perspective to resume its greenfield rollout, as well as continue to consolidate the collision repair market.

Select Harvests (SHV; +10.6%) was added to the portfolio during the month as we took advantage of the almond grower's capital raising to re-establish a portfolio position at a favourable price. The company is purchasing an additional 1,566ha of almond orchards in Piangil, north-western Victoria, which will see their harvest volume increase +20% in FY '21 (and eventually by +30% as trees continue to mature). The SHV business and the global almond market are both well known to, and understood by, the OC investment team with an important consideration in our decision to invest now being the current pricing environment and outlook for almonds globally. While Californian almond prices fell dramatically during the June quarter due to COVID-19 related demand concerns and a bumper US crop, the sell-through rate of the US crop has actually increased. As a result, the almond price has begun to recover over the past month, a trend we expect to continue, particularly in the premium grades that SHV is well exposed to. The long-term growth trend in almond export volumes from the major exporting markets (USA & Australia) will likely help satisfy the increasing demand growth from markets like India and China, although a resumption of the conditions that existed prior to the onset of COVID-19 pandemic would also clearly be beneficial. The acquisition of the Piangil orchards will also deliver additional synergies in the hands of SHV, with the potential for increased utilisation of the SHV processing facilities and improved harvest practices likely to improve nut quality and therefore overall crop yields.

OptiComm (OPC; +11.1%) has been a strong performer since the Fund acquired a stake via a selldown from legacy Japanese holder, Fujikura, in April at A$4.40 per share. Over the last four months, OPC's share price has moved higher as it has been at the centre of a protracted bidding war between listed competitor, Uniti Group, and industry super fund, Aware Super. OPC is a builder and owner of fibre to the home telecommunications network infrastructure which provides wholesale fibre access to around 74,000 homes, predominantly in greenfield broadacre subdivisions but also in new multi dwelling unit (MDU) developments. OPC is a smaller, higher quality version of the NBN and, as such, has a monopolistic network with high quality subscription earnings and contracted growth in subscribers which is set to double recurring earnings over the medium term. In June, OPC entered into a binding Scheme Implementation Deed, whereby listed rival, and existing Fund holding, **Uniti Group (UWL; -16.8%)**, would acquire all of the issued capital of OPC by way of a Scheme of Arrangement. The initial consideration was a mix of cash and scrip which implied a value of $5.10 per OPC share in addition to a 10 cent per share fully franked special dividend. The resulting business would be a fibre infrastructure building duopoly (with NBN) and would enjoy cost savings and contracted recurring revenue growth over the medium term. We consequently increased our position in UWL as we saw it as the ultimate beneficiary of such a combination. Counter bidding interest from Aware Super saw the UWL bid lifted twice more before they finally won out with a bid equivalent to A$6.67 in cash and scrip. In early November, the UWL offer was endorsed by shareholders (and Aware dropped out of the race), and the combined UWL/OPC business will result in a consumer last mile fibre building duopoly between UWL and NBN.

Jumbo Interactive (JIN; -13.0%) is an online reseller of Australian lottery tickets with sales highly leveraged to the size of the jackpots, as players normally spend more on lottery tickets when large jackpots are on offer. JIN recently provided a 1Q21 trading update which indicated its total transaction value was flattish for the period which was driven by a lower number of large jackpots on offer versus the prior corresponding period. In late September, JIN also signed a binding term sheet with Lotterywest (WA), to provide its online software platform and services for up to 10 years. This should be an opportunity for JIN as only 14.5% of WA lottery sales are presently transacted online, which is around half that of the Eastern states markets which are licensed by Tabcorp and generally benefit from the assistance of JIN as an online reseller. We think JIN will enjoy sustainable earnings growth over the medium term given the structural shift of lottery tickets to online in addition to a reflation of the jackpot cycle (which should be assisted by restructuring of the OzLotteries game). JIN earnings will also be driven higher by future contract signings in the "Powered by Jumbo" charity lottery software system business. We remain comfortable with our position in JIN.

Outlook

There has been a tsunami of political, economic, geo-political and COVID-19 related news flow in recent weeks and the market has consequently been extremely volatile. Throw in the seasonal AGM commentary and outlook statements and a continued wave of IPO activity and early signs that the M&A cycle is heating up with takeovers being lobbed for Link Administration Holdings and Coca Cola Amatil, as well as rumours of an impending bid for wagering giant Tabcorp Holdings and it has been an extraordinarily busy time in equity markets.

Garnering the most attention has been the knife's edge US election, the outcome of which will help shape the future of the world's largest economy for years to come at a time when the country remains deeply divided and mired in the biggest health crisis in a generation. Over the weekend, former Vice President Joe Biden of the Democratic Party claimed victory after the Associated Press and television networks declared him the winner in the state of Pennsylvania; he now looks set to be inaugurated as 46th President of the United States of America. The contest was far closer than either the polls or the so-called political experts predicted. As was widely anticipated, President Trump has refused to concede the election and has accused the Democrats of widespread electoral fraud, mounting lawsuits in several states and even threatening to challenge the validity of the result in the US Supreme Court.

President elect-Biden has pledged to unify and heal a deeply divided nation in a victory speech that laid out a mandate to control the coronavirus, secure better healthcare, achieve racial justice and root out systemic racism and to tackle climate change. But President elect-Biden will likely have to do so with a gridlocked government, with the Democrats controlling the House of Representatives, albeit with a slimmer majority than they previously had, and the tight Senate race likely not to be decided until early January when Georgia's two runoff races will be held, given that no candidate in either contest in the state reached the required 50% threshold of votes required under Georgia state law to win. The so called 'Blue Wave' of Democratic support failed to materialise across the US and the election result is so close that a recount is necessary in Georgia and President Trump is seeking legal avenues to either a recount or to invalidate certain ballots in Pennsylvania and Wisconsin.

Markets globally cast aside the uncertainty (which is typically a major bugbear for investors) and surged on what has been variously described as a 'nirvana' or 'goldilocks' type outcome with the gridlocked Congress close to the ideal scenario for many investors. A Biden presidency is likely to be more predictable but none of the Democrats' more progressive policies like tax hikes, large public spending and widespread regulatory reform are likely to pass into legislation.

The US 10-year Treasury yields had surged to over 0.9% on the prospect of a Democrat clean sweep but has fallen back towards 0.8% following the election. Long duration growth stocks such as technology and healthcare companies have been amongst the immediate beneficiaries. The Australian equity market was sold off into the election, but it too has rallied strongly with technology names including NEXTDC and Appen Group, two key portfolio holdings, leading the way.

With large government stimulus packages likely to be off the agenda in the US near term given the Democrats lack outright control of the Congress, markets remain heavily reliant on the US Federal Reserve (Fed) to continue to support them. Given the choice between large government stimulus and ongoing Fed liquidity, markets prefer the latter as they are more supportive of asset price inflation. Federal Reserve officials did not disappoint last week keeping interest rates near zero and making no change to asset prices and also signalling a willingness to provide further support to the economy should it be necessary.

Our own central bank, the Reserve Bank of Australia (RBA), fired its own $100b 'monetary bazooka' in early November dropping the official cash rate to just 0.10% (and promising to keep it there for at least the next three years) and announcing that it will buy $100b of bonds in the coming six months. This so called 'Quantitative Easing' by the RBA is designed to make the structure of interest rates in Australia lower, to make it cheaper for businesses, households and governments to borrow and invest, and to keep the Australian dollar lower and support economic growth and jobs recovery. The domestic economy recovery remains extremely fragile and we face huge economic challenges as we seek to emerge from the second COVID-19 lockdown and wean ourselves off government stimulus programs like Jobkeeper and Jobseeker. The RBA's move has been widely applauded by business leaders and households alike and these measures, once considered to be highly unconventional, are now seen as critical to an ongoing economic recovery.

Unlikely to help our domestic economy is the rapidly deteriorating relationship with our most important trading partner China, which has lurched from strained to dismal in recent weeks. Beijing has accused Canberra of behaving like America's "roughnecks" and threatened to inflict even greater pain on several key export markets. "Australia will pay tremendously for its misjudgement" read a scathing critique in the state-sanctioned China Daily. The warning was stark: "With Australia mired in its worst recession in decades, it should steer clear of Washington's brinkmanship with China before it is too late". China looks set to be backing up the rhetoric with the Chinese state media reporting that a $6 billion ban on several key Australian products is imminent including coal, barley, copper ore and concentrate, sugar, timber, wine and lobster. Indeed, lobster exporters have already felt the wrath of Beijing with tonnes of live lobsters left stranded for days at airports and clearance houses early last week waiting to be inspected by Chinese officials.

The breakdown of diplomatic relations with China poses a serious political and economic dilemma for the Morrison government which has been forthright in its condemnation of the Chinese handing of COVID-19 and been vocal about Chinese military posturing, particularly in the South China Sea. China currently accounts for over 30% of Australia's export markets and therefore further deterioration could be very painful for our economy. The Fund currently has limited direct exposure to Chinese export markets or Chinese trade, aside from Mineral Resources who exports iron ore to China, but which seems safe due to China's heavy reliance on Australian ore to fuel their growth engine. Nevertheless, we will continue to monitor developments closely because the second order impacts could clearly have broader reaching implications for our economy than at an individual stock level.

On a more positive domestic note, Australia is once again the envy of much of the world with COVID-19 cases tracking toward zero in most states and the summer weather approaching which may help subdue the virus. This is in stark contrast to much of the rest of the world, including Europe and North America, where the virus continues to wreak havoc. We are at a critical juncture in the vaccine hunt with two companies in pivotal stage three trials expected to report critical findings in the coming month or so, namely Pfizer/BioNTech and Moderna. The University of Oxford/AstraZeneca trial is reportedly not far behind and CSL will this week commence production on the yet to be approved Oxford/AstraZeneca vaccine. The Federal government last week announced it has hedged its bets by investing in a further two vaccine projects (Pfizer/BioNTech and Novavax) to secure another 50 million doses.

We remain cautiously optimistic of some positive vaccine trial results near term but do not believe that a vaccine will be an immediate panacea to the economic damage caused by the pandemic which is now deeply entrenched and therefore difficult to remedy. We reiterate that an approved vaccine is 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 quite broad.

The corporate pipeline, which only briefly slowed due to the US election uncertainty, is burgeoning once again with a wide array of companies making a run at the local bourse ahead of the summer lull. Leading the charge are some of the year's largest prospective floats including software analyst business Nuix, a company that produces a software platform for indexing, searching, analysing and extracting knowledge from unstructured data and Queensland coal terminal owner Dalrymple Bay Infrastructure, both of whom the OC team has already met. Of late, we have been quite selective about which IPOs we support, particularly in light of the early stage of many of the offerings and the scant financial details that we are being shown with the majority of prospectuses either containing no or just six months of financial forecasts.

Despite the uncertainty around the economic recovery and the likely success of a Coronavirus vaccine, the OC team remains confident that the portfolio will continue to deliver strong investment returns over the long-term. We thank our investors for their ongoing support through what has been an incredibly busy and at times wildly volatile year in financial markets.

Top 5 holdings#

Company	ASX code
Bapcor Limited	BAP
Mineral Resources Limited	MIN
NEXTDC Limted	NXT
Steadfast Group Limited	SDF
Worley Limited	WOR

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 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.