FUNDS MANAGEMENT

OC Dynamic Equity Fund

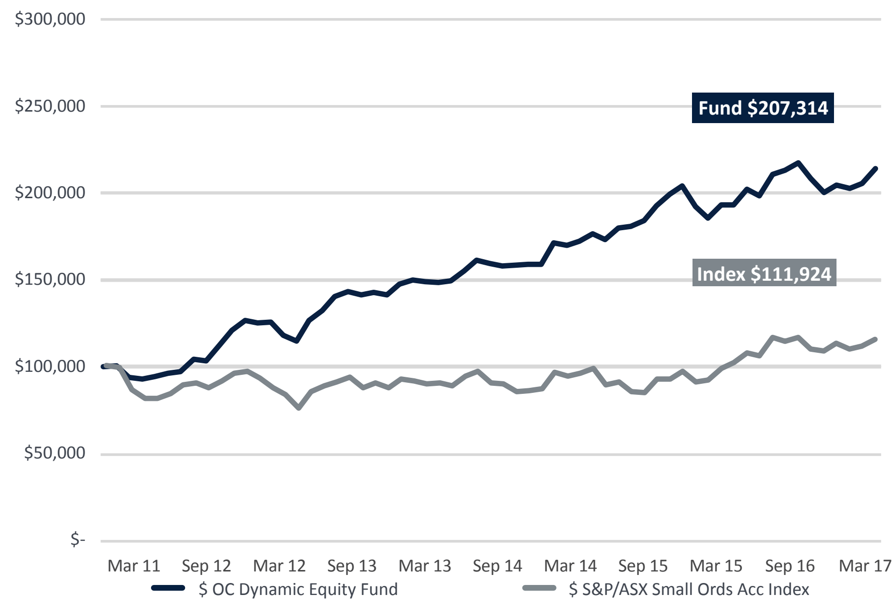
Fund Update | 31 March 2017

4.7% Fund up 4.7% for the quarter

15.8% Returned 15.8% p.a. for the past five years

We remain confident the Fund will continue to deliver attractive long-term returns

Performance comparison of $100,000 over 5 years*



Total returns

At 31 March 2017	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	4.1	4.7	10.5	12.3	15.8	13.7	5.1	12.7
S&P/ASX Small Ords Accum	2.7	1.5	13.7	6.4	2.3	2.2	-0.8	5.6
Outperformance	**1.4**	**3.3**	**-3.2**	**5.9**	**13.5**	**11.6**	**6.0**	**7.0**
S&P/ASX Small Ind Accum	4.2	2.0	9.5	8.0	9.4	7.7	1.4	6.2
Outperformance	**-0.2**	**2.8**	**1.0**	**4.3**	**6.3**	**6.0**	**3.7**	**6.4**

Performance review

The OC Dynamic Equity Fund finished the March quarter up a solid 4.7%. This was ahead of both the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrials Accumulation Index, which were up 1.5% and 2.0%, respectively. Most of our holdings are performing strongly from an operational perspective and we remain upbeat on the outlook for our portfolio. The Fund remains well ahead of both of these indices over a five-year horizon having returned 15.8% p.a. versus 2.3% p.a. for the S&P/ASX Small Ordinaries Accumulation Index and 9.4% p.a. for the S&P/ASX Small Industrials Accumulation Index.

While market volatility remained low in the first quarter of 2017, there was plenty happening beneath the surface in the small-cap universe. We saw an ongoing shift in style preference from growth stocks into value stocks during the quarter, resulting in a number of high-quality growth names continuing to de-rate including **Technology One (TNE, -9.2%)**, **Altium (ALU, -6.1%)** and **Hansen Technologies (HSN, -12.5%)**. The Fund used this as an opportunity to re-acquire Altium having sold out earlier in the financial year on valuation grounds and we also used the material pull-back in the HSN share price to increase our holding in the company.

Earnings downgrades and companies that missed consensus earnings expectations were in most instances sold down aggressively by the market during the quarter and there were plenty of examples across the small-cap stock universe. Unfortunately, the Fund was not immune to these disappointments which led to our exit from both **Aconex (ACX, -22.5%)** and **Vocus (VOC, +11.6%)** after they failed to deliver on our expectations.

There were several major mandates lost by our small-cap peers during the quarter which resulted in heavy transition manager selling in some small-cap names. Often this selling was quite aggressive which, coupled with the multiple de-ratings in many growth stocks, afforded the Fund the opportunity to purchase some high-quality companies that had previously been considered expensive, including **IDP Education (IEL, +13.8%)** and **NextDC (NXT, +8.8%)**. Both of these stocks have rallied strongly following our purchases.

On a pleasing note, several of our larger Fund holdings surprised on the upside and posted profit upgrades during the quarter including **Mineral Resources (MIN, -11.3%)**, **Webjet (WEB, +8.3%)**, and **A2 Milk (A2M, +34.3%)**.

Despite a healthy 25% earnings upgrade, the **Mineral Resources** share price pulled back during the quarter presumably due to investor concerns about a likely fall in the iron ore price given growing stockpiles in China. Even if we factor in quite bearish iron ore forecast assumptions into our financial model, we still expect MIN management to upgrade earnings again this financial year and consensus earnings look far too low for FY18. We think the market is significantly underestimating the potential of MIN's high-quality Wodgina Lithium Project which may start producing cash as soon as this month through its Direct Shipping Ore (DSO) operation and its high-quality contract crushing operations, which have several strong prospects that could drive shareholder value. Fighting against sentiment in the short term can be a fruitless pursuit, but it creates opportunities for fundamental investors with a long-term investment horizon (including us) to buy quality businesses below their intrinsic value. We added to our position in MIN during the quarter.

Webjet remains one of our largest holdings and the company once again exceeded market expectations by upgrading its earnings forecast for the full year, which resulted in it bucking the trend of quality growth stocks de-rating during the quarter. WEB's domestic B2C booking engine continues to grow strongly ahead of the market and the structural shift to online travel bookings is continuing. International and mobile bookings are accelerating as people are becoming increasingly comfortable booking international travel online and becoming more comfortable booking using a mobile device. Recent acquisition, Online Republic, is producing excellent early results and the sale of Zuji was completed at a price that leaves the balance sheet in a strong net cash position. But we are most excited about the company's rapidly growing B2B WebBeds operation, which looks poised to become a strong profit contributor in the coming years. WEB has gained a solid competitive position in Europe and the Middle East, while the North American operations are on a rapid trajectory to profitability. The strategic partnership with Thomas Cook in Europe ought to accelerate the company's growth in FY19 and beyond, and the launch of FIT RUUMs, the company's Asian B2B offering, offers yet another engine for growth. There are few companies in our stock universe that offer so many avenues to growth and the management team, led by John Guscic, is developing an enviable reputation for exceeding expectations. This is one growth stock we comfortably own with a long term view.

CleanTeq Holdings (CLQ, +94.1%) performed well in March capping off an outstanding quarter for the stock. CLQ owns a world-class, shallow, high-grade scandium/nickel/cobalt deposit west of Parkes in outback NSW. The core elements within this deposit are critical 'future economy' minerals including cobalt (for use in lithium-ion batteries), for which the world's rapidly evolving battery manufacturing industry has no reliable western world supplier, and scandium (for use in light-weight alloy strengthening such as in jet aircraft), with CLQ recently signing a collaboration agreement with French giant, Airbus. The cobalt price continued to rise during the quarter and has been a key driver of the share price. Additionally, the company formed a strategic partnership with Chinese conglomerate, Pengxin International Mining Company, to fast track the development of its Syerston Nickle-Cobalt-Scandium project. This involved Pengxin making a $81m investment in CLQ at $0.88 per share and the Shanghai-listed company also assisting in the procurement of Chinese project financing for Syerston. While we have a high degree of confidence in management's ability to get the project financed and into production in the coming years, the valuation equation is starting to look less compelling and we have exited our position into the share price strength.

Updater, Inc. (UPD, +51.1%) - had a strong quarter on the back of ongoing penetration of the US mover market and the strong validation of its product from its pilot program with US insurance major, Liberty Mutual. UPD offers home movers a service to complete tedious and time consuming tasks efficiently (such as updating/changing address) but it also allows businesses to communicate with these same consumers in a timely manner. Earlier in the quarter, UPD announced it had surpassed the tipping point of market penetration for its product by processing just over 7% of all homes moves in Q4 of CY16. UPD has a CY17 target of 15% market penetration and, with its current trajectory, we see this goal being achieved. The pilot program with Liberty Mutual clearly demonstrated that 'pre-movers' exposed to Updater communications were more likely to purchase insurance products than those not exposed to these communications. The rate of purchase uplift was around 93%, higher than pre-movers not exposed to Updater communications and this is expected to be higher with a product targeted at reducing the churn rate for existing customers. The uplift rate can be stated with 95% confidence, with results independently audited. One of the reasons this result is so appealing to the market is that insurance is but one vertical in a suite of verticals that UPD will ultimately target including banking, utilities, big box retail and pharma, cable, satellite and internet. With further updates on market penetration and pilot programs expected in the present quarter, we remain excited by the prospects of UPD in FY18 and beyond.

Alternative milk company, **a2 Milk (A2M, +34.3%)**, performed strongly during the quarter after posting an outstanding interim result, well ahead of both our and consensus analyst forecasts. The A2M share price also benefited from a perceived relaxation in the regulatory environment in the key Chinese market late in the quarter. A2M's products come from dairy cows that produce only the A2 type of beta-casein protein, whereas most dairy contains A1 and A2. As with several other companies offering infant formula and health foods, the 'daigou' traders - individuals and small businesses that buy product from retail shelves for re-sale in China - have played an important role in the growing success of A2M. The brand continues to resonate strongly in the important Chinese market and much of the popularity to date has come from simple word of mouth. For instance, Chinese mothers in Australia communicating with family and friends back home. The company continues to make strong progress towards its objective of building a global brand based on the health and digestive benefits of nutritional products containing only the A2 protein. As well as being highly profitable in Australia and New Zealand and growing rapidly in China, A2M is now profitable in the UK and is investing heavily in the US market, particularly in the fresh milk space, where it has secured important distribution agreements that are showing positive early signs.

Trouble plagued **Ardent Leisure (AAD, -21.8%)** was a major disappointment for the Fund during the quarter, fresh from its safety incident at Dreamworld last October. As mentioned in our February report, the weak trading update from the key US-based, Main Event business, was the catalyst for the underperformance with the sales decline in the first half for centres open more than two years continuing into the second half. The severe share price reaction was due to the perceived importance of the Main Event roll-out for the prospects of the group with management last year announcing the accelerated roll-out of the format in the US following the sale of the gyms business and the marinas. While disappointing, we retained our holding on the basis the share price decline had been overdone. Late in the quarter, Ariadne, an investment company associated with corporate raider, Gary Weiss, and Queensland property developer, Kevin Seymour, emerged with a stake of just under 6% in AAD. This has refocused investor attention on the value of the assets. Despite rumours of a potential takeover offer, it seems more likely that Ariadne's initial focus will be to unlock the value of the AAD assets and they are seeking to engage the board and management in discussions to that effect. According to Mr Weiss, he believes "*the intrinsic value of Ardent to be higher than its market capitalisation*". We also share this view notwithstanding the recent underwhelming performance of the group. Further slippage in the performance of the Main Event business would cause us to reassess our investment in the company.

Netcomm Wireless (NTC, -27.9%) was marked down heavily during the quarter following the departure of its long-serving Managing Director, David Stewart, who announced his retirement in November 2016. NTC is a technology company which (among its suite of products) develops and supplies broadband products that are sold globally to major telecommunications carriers, network providers and systems integrations. NTC is a key supplier to Australia's own NBN where it has recently signed a major fibre-to-the-curb (FTTC) contract, in addition to its existing NBN fixed-wireless contract, which has been in place since June 2011. NTC has also signed a master purchase agreement to supply one of the two largest US-based telecommunications carriers (presumably AT&T) with fixed wireless devices required to connect households and businesses to a fixed rural broadband network which is being developed by the carrier. The AT&T contract has the potential to be company making and ought to generate strong profitability and cash flow in FY19 and beyond. NTC recently received an initial $28m order on its NBN FTTC contract for delivery mid this calendar year and several other orders of this magnitude are expected out of NBN over the balance of FY18. The company has a strong pipeline of opportunities with tier-one customers, such as Nokia, across fixed wireless telecommunications and other machine-to-machine solutions. We believe the noise around Stewart's departure has overshadowed an otherwise strong outlook for the company and we have used the share price weakness to increase our holding in the company.

Outlook

Entering the second quarter, investor attention is turning to whether political developments in the US, particularly disharmony within the Republican party, will undermine the strengthening global economic outlook. President Trump received a major political setback when he failed to garner the support from his own Republican party for flagship health care reform bill which was subsequently withdrawn. This has cast some doubt over whether President Trump actually has the political support to undertake widespread fiscal reform and infrastructure spending, the presumption of which has fuelled the strength in capital markets since he became President-elect back in November 2016.

In view of these recent political developments, the very low volatility in equity markets (the VIX index, a common measure of market volatility, is closing in on its lowest quarterly average since late 2006) is somewhat surprising. That said, the US economy has now largely met the Federal Reserve's goals of full employment and stable prices and investor and business confidence has soared since Trump won office late last year, buoyed by his vows to cut taxes, lift infrastructure spending and ease regulations. Federal Reserve Chair, Janet Yellen, has given an upbeat assessment of the US economy suggesting the Fed has “confidence in the robustness of the economy and its resilience to shocks”.

At OC, we remain more cautious about the global outlook given that the market, taking its cues from the US economy, has seemingly priced in an optimistic outcome despite there being considerable uncertainty about the timing, size and character of policy changes that may eventually pass through Congress. This means we are showing restraint and are not ‘chasing the market’ despite the fact we have opportunistically added several new positions during the quarter including **IDP Education**, **iSelect**, **NextDC** and **Super Retail Group**.

In terms of the domestic economic outlook, our observations from the past few months have been mixed with strengths and weaknesses tending to be company specific rather than being driven by underlying macro-economic trends. That said, the domestic economy appears to be on a solid footing and the RBA still expects growth of around 3% this year, albeit recent commentary seems to temper this view and points to weaker labour market outcomes of late.

Much has been written in the press and by the RBA of late about the property boom and risks associated with the domestic housing market. A series of new macro-prudential policies from APRA announced in March are targeted towards addressing risks in the housing market and seeking to avoid a ‘hard loading’. While we don’t see an immediate catalyst to this unwinding given low interest rates and a robust employment market, we are cautious on a longer-term view and have limited exposure in our portfolio.

Corporate activity has spiked in recent weeks with serial underperformers **Spotless Group** and **SMS Management & Technology** receiving takeover bids at material premiums and Myer gaining new strategic shareholders on it’s register (Soloman Lew’s Premier Investments). Furthermore, and as mentioned previously, the **WorleyParsons** register was raided by Dubai-based, Dah Group, just days after our untimely exit from our holding due to concerns about the company’s escalating debt levels. Speculation about takeover activity in small-cap names has been an almost daily event in recent weeks with Fund holdings, **Ardent Leisure** and **Mantra Group**, among names rumoured to be having the ruler run over them. We tend not to invest in stocks purely on the likelihood of a takeover, and hold no insights into whether a bid for either will indeed eventuate.

It has been a challenging 12 months for the Fund, which has resulted in a rare period of underperformance versus the S&P/ASX Small Ordinaries Accumulation Index, although our absolute performance remains positive. The period of underperformance has been driven, at least in part, by various factors including:

- our aversion to investing in single-commodity/single-mine resource stocks, which we consider too risky
- our heavy underweight position in bond-proxy stocks, which have soared in a low-interest rate environment, and
- some stock-specific issues, which we have addressed in the portfolio.

It has been a solid 12 months for the Fund and we remain confident our stable and aligned investment team can continue to deliver investors excellent investment returns over the medium to long term.

April is a busy month for the team. Having just returned from an overseas trip incorporating Hong Kong, Singapore and Malaysia, we are in Perth, Brisbane, the Gold Coast and Sydney over the balance of the month visiting existing holdings and their competitors, as well as seeking out new investment ideas for the portfolio.

Top 5 holdings#

Company	ASX code
a2 Milk Company Ltd	A2M
Bapcor Ltd	BAP
Mineral Resources Limited	MIN
Speedcast International Ltd	SDA
Webjet Limited	WEB

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[*] The performance comparison of $100,000 over 5 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. There is no guarantee these objectives will be met.

[#] The top 5 portfolio holdings are in alphabetical order and may not be representative of current or future investments. The securities listed may not represent all of the portfolio's holdings and may represent only a small percentage of the strategy's portfolio holdings. Future portfolio holdings may not be profitable.

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