OC Premium Small Companies Fund

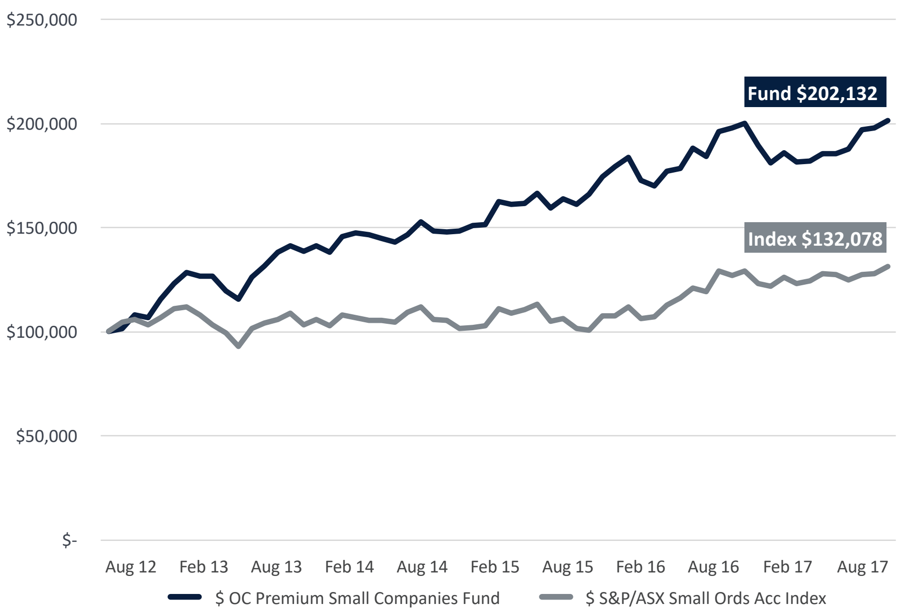
Fund Update | 31 August 2017

1.8% Fund up 1.8% for the month of August

15.2% Returned 15.2% 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 August 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 Premium	1.8	7.3	1.8	9.8	15.2	13.9	4.3	11.2
S&P/ASX Small Ords Accum	2.7	5.1	3.2	5.7	5.7	3.4	-1.1	5.5
Outperformance	**-0.9**	**2.1**	**-1.4**	**4.1**	**9.5**	**10.5**	**5.4**	**5.7**
S&P/ASX Small Ind Accum	1.7	3.9	1.6	7.0	10.7	9.2	1.2	6.0
Outperformance	**0.1**	**3.3**	**0.3**	**2.8**	**4.5**	**4.7**	**3.1**	**5.2**

Performance review

The month of August was dominated by stock-specific news which came as the majority of ASX-listed companies released their annual results and accompanying outlook statements. The OC Premium Small Companies Fund had a solid August returning 1.8% in a month where most of our holdings released results in line with or ahead of market expectations. This was marginally ahead of the S&P/ASX Small Industrials Accumulation Index which was up 1.7%, but behind the S&P/ASX Small Ordinaries Accumulation Index which was up 2.7%, with the performance of the latter being boosted by the strong performance of small resources stocks (the S&P/ASX Small Resources Accumulation Index returned 7.1% for the month).

The Fund maintains its strong long-term track record having returned 15.2% p.a. over the past five years. This is well ahead of both the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrials Accumulation Index which are up 5.7% and 10.7% p.a., respectively, over the same time horizon.

Blue Sky Alternative Investments Limited (BLA, +15.8%) reported a strong FY17 result at the top end of the guidance range after profitably exiting several private equity investments, adding to its credibility, particularly in the private equity space. The company has built up an enviable track record across its key asset classes having delivered returns of 15.9% p.a., net of fees, to investors since its inception in 2006. BLA has what we consider to be the imperatives of a successful asset management business, namely a solid reputation, excellent investment returns, quality investment professionals and a very strong distribution team and network. Fee-earning assets under management (AUM) finished FY17 at $3.25b and we expect this to continue to accelerate towards management's target of $5b in AUM by 30 June 2019. Unlike typical ASX-listed fund management businesses that tend to focus heavily on equity investment, BLA has the bulk of its exposure in asset classes that typically have little correlation with the stock market, including real assets (e.g. water and agricultural assets), student accommodation in Australia and the US, retirement assets and US commercial property. The outlook for the business is strong and we are particularly upbeat about the prospects of the US Cove property JV which we believe has some high-quality projects run by outstanding people and could add materially to the earnings of the group in the coming years.

Pacific Current Group Limited (PAC, +15.4%), the fund manager which appeared on the negative side of our performance ledger for much of FY16 and H1 FY17 continued its renaissance which began with the much-needed simplification of its corporate structure (see our January 2017 monthly report), gathered momentum with its accelerating fund inflows (see our April 2017 monthly report) and the bolstering of its balance sheet in June 2017. Pleasingly, PAC continued its re-rating after reporting a full-year NPAT of $16.6m, which materially exceeded both our own and consensus market estimates for the stock. The key underpinnings of the strong result were significant cost reductions (with pro-forma annual expenses down from $29.8m to $18.6m), strong FUM growth or stabilisation in FUM for its core boutique managers and outstanding growth from new boutique manager GQG, which grew FUM to over US$6b from a standing start. Despite more than doubling its share price since bottoming in October 2016, PAC is well positioned to continue to outperform given the strong inflow momentum across several key boutiques, the solid balance sheet which positions it for M&A and the undemanding FY18 PE multiple of ~14 x on which it trades.

Reliance Worldwide Corporation Limited (RWC, + 9.0%) was added to the portfolio mid-month following share price weakness ahead of its full-year result. RWC is a global plumbing supplies business specialising in reliable and premium branded water flow and control products including the market leading “SharkBite” push-to-connect fittings. We consider RWC to be a high quality global growth business with a structural growth opportunity given the push-to-connect category that RWC derives much of its revenue is a relatively immature and high growth category in the overall plumbing fittings market. The company subsequently released a strong set of FY17 results, with revenue, EBITDA and NPAT all exceeding prospectus and consensus forecasts. After a strong re-rating, the Chairman and major shareholder, Jonathan Munz, reduced his shareholding from 30% to 10% in an underwritten sell-down process which took some of the gloss off the stock’s re-rating. Nevertheless, RWC continues to trade +10% on our entry price and we remain confident the ongoing roll-out of SharkBite to Lowe’s in the US will help underpin strong near-term earnings growth and that the well-established and diversified business will be a long-term investment for the Fund.

Hansen Technologies Limited (HSN, - 16.0%) continued to de-rate following the release of its FY17 result which showed margins had retreated to the lower end of the company’s 25-30% guidance range and organic growth had slowed to 2% on a constant currency basis, below management’s 4-8% target range. It has been a disappointing few months for the company which was under pressure in July following an equity placement at a discount to fund the acquisition of Enoro (see our July 2017 monthly report) and the release of guidance that was below analyst expectations. Notwithstanding these near-term negatives, we continue to view Hansen as a quality business with solid cash flows and a sticky customer base that can grow its earnings irrespective of the underlying economic conditions in the markets in which it operates. We expect organic growth to normalise in FY18 to its long-term average of around 4-8% and we back the high calibre management led by Managing Director, Andrew Hansen, to utilise the strong balance sheet to continue to make value-adding acquisitions as they have consistently done over many years.

Netcomm Wireless Limited (NTC, - 16.8%) was under pressure in August despite releasing a FY17 result that was in line with our expectations and mildly ahead of consensus forecasts. The share price pressure likely stems from the lack of material news around contract wins and some slippage in consensus profit expectations for the FY18 year. NTC is expected to significantly ramp up the deployment of its Fibre-to-the-Distribution point (FTTdp) technology as the NBN Co accelerates its roll-out to one million homes which ought to underpin strong profit growth in FY18. Nevertheless, we have slowed our assumed pace of the NBN fixed wireless take-up near term as the actual results have been slower than anticipated. Furthermore, the market has tempered its expectations around the FY18 contribution for the AT&T fixed wireless contract given AT&T is widely expected to move at a glacial pace until the Connect America Fund Phase II action for an additional $2b funding has been decided. Despite not announcing any new material client engagements in recent months, NTC retains a strong pipeline of opportunities across fixed wireless communications and other machine-to-machine solutions, including prospects with multiple tier-one customers and remains a holding in the Fund.

Outlook

The August reporting season was relatively benign with few clear trends apparent at the coal face of corporate Australia. The 1.7% rise in the S&P/ASX Small Industrials Accumulation Index belied the fact that consensus FY18 EPS revisions over the month were, on balance, negative. Indeed, of the 130 stocks that saw consensus FY18 EPS revisions within the S&P/ASX Small Industrials Index, just 36 companies saw upgrades with the balance of 94 downgrades.

One consistent comment from company management was that the consumer remains under pressure and discretionary spending remains subdued. Indeed, the recently released national accounts show consumers are certainly not flush with cash following a rise of just

0.6% in real household disposable income over the past year. Rising house prices will have no doubt softened the blow for Sydneysiders and Melburnians, although those markets appear to be cooling now and are unlikely to continue to provide a tailwind via the "wealth effect". With the outlook for wages growth remaining low and household debt elevated, the outlook for the consumer appears challenging at best. We view this as the biggest challenge for the domestic economy over the next 12 months and will likely mean the cash rate will remain on hold at 1.5% for most of financial year 2018.

Although 2Q GDP growth of 0.8% is an acceleration on the muted Q1 result, it was still marginally below consensus expectations. The current 1.8% annual GDP growth is the lowest level we have seen since 2009 when we were still dealing with the aftermath of the GFC.

The RBA has maintained its conviction that growth in the Australian economy will gradually pick up over the coming year with the decline in mining investment soon to run its course, non-mining investment continuing to improve, residential construction activity remaining at a high level and retail sales having picked up recently. It is our view that the RBA's 3% GDP forecast for 2018 looks overly optimistic and we expect it will be revised downwards during the year, with a constrained consumer likely to weigh on the outlook.

Conditions in the global economy continue to remain robust with major global economies, including the US and China, showing ongoing signs of strength. In China, growth is being underpinned by increased spending on infrastructure and property construction which, in turn, is fuelling commodity price rises which is good for both resource companies and Australia's national accounts. The US outlook remains clouded by political inertia which is stalling the proposed implementation of tax cuts and infrastructure spending which would otherwise support above-trend growth. US growth momentum, nevertheless, remains solid led by a consumer rebound, an uptick in capital spending and a labour market at full employment. The US Federal Reserve continues its path towards monetary policy normalisation, although the latest drop in US Treasury bond yields, which comes amid uncertainty on whether the damage from Hurricanes Harvey and Irma will slow economic growth, suggests we may see a pause in the short term.

Escalating tension on the Korean Peninsula has kept the market on a knife's edge in recent weeks as ongoing sabre rattling from President Trump and Kim Jong Un continues to create an environment of uncertainty. North Korea followed up a successful test of an intercontinental ballistic missile in early July with its sixth and most powerful nuclear test in early September and the region remains a tinder box that could explode into outright war at any moment. Indeed, UN Secretary General Antonio Guterres has called the ongoing showdown over North Korea's nuclear and missiles program as the world's worst crisis "in years". Our portfolio remains conservatively positioned and we have cash to deploy should an environment of fear create a buying opportunity.

Despite the softness in the domestic consumer environment and global geopolitical uncertainty, we remain comfortable our portfolio will perform well over the coming year. The Australian small-cap index is a highly diversified stock universe that holds ample opportunity for stock pickers like us. Irrespective of the current economic and political conditions, there are still stocks that are performing well operationally and are trading below our internal valuations. We remain confident we can continue to deliver our investors strong returns over the long term.

Top 5 holdings#

Company	ASX code
Bapcor Limited	BAP
Bingo Industries Ltd	BIN
Blue Sky Alternative Investments Ltd	BLA
Super Retail Group Ltd	SUL
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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