OC FUNDS MANAGEMENT

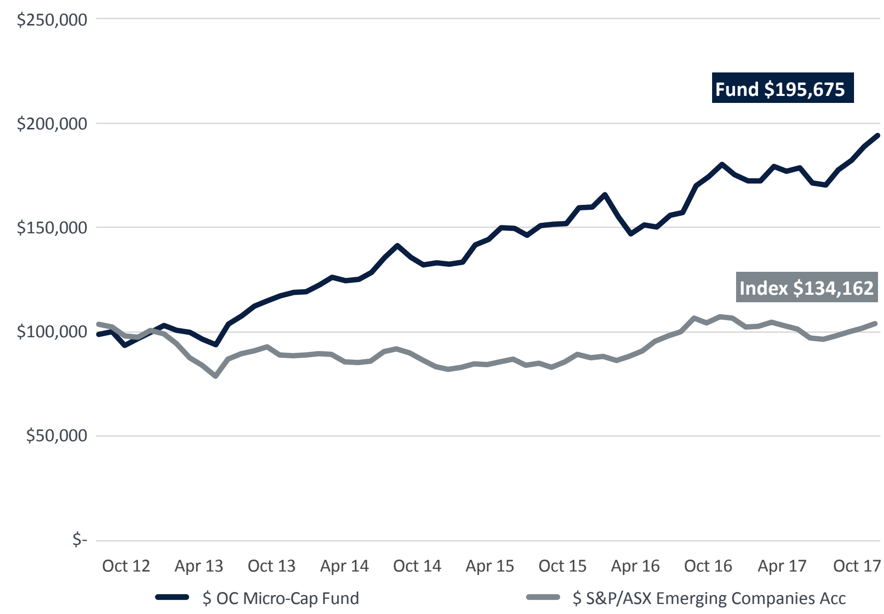
OC Micro-Cap Fund
Fund Update | 31 October 2017

5.6% Fund up 5.6% for the month

19.1% Returned 19.1% p.a. for the past five years

We remain confident the Fund is well placed to deliver strong long-term returns

Performance comparison of $100,000 over 5 years*



Total returns

At 31 October 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. (Nov 2003)
OC Micro-Cap	5.6	13.7	18.7	18.7	19.1	12.2	10.3	14.0
S&P/ASX Emerging Comp. Accum	4.3	10.2	0.7	11.0	1.3	-1.4	-3.0	N/A
Outperformance	**1.3**	**3.5**	**18.0**	**7.7**	**17.8**	**13.7**	**13.4**	**N/A**

Inception date for the Fund is 21/11/2003. Inception date for the Index is 31/12/2003. The performance reflects the performance of the OC Micro-Cap Fund since the change of strategy on 30 September 2016 and the performance of the OC Concentrated Equity Fund prior to that date. Performance is after fees applicable at the time.

Performance review

The Australian micro-cap market had a strong October with the S&P/ASX Emerging Companies Index up 4.3%. Pleasingly, the OC Micro-Cap Fund outperformed the benchmark with a return of 5.6% for the month.

The prevailing mood in micro-caps caps at present is very much 'risk-on' and some stocks and sectors have become quite momentum driven with prices reaching new highs almost every day. In such an environment, it is not uncommon for the OC Micro-Cap Fund to underperform the Index, although this was not the case in October. As our long-term investors will be aware, our fundamental bottom-up process focuses more on long-term inherent value and operational risk and less on short-term price momentum. Consequently, in such markets there may be periods where the Fund could underperform the market.

The father of value investing, Benjamin Graham, explained the equity market by saying that in the short run, it is like a voting machine, tallying up which firms are popular and unpopular. But, in the long run, the market is like a weighing machine, assessing the substance of a company. His message is clear: what matters in the long run is a company's actual underlying business performance and not the investing public's often fickle opinion about its prospects in the short-term.

The Fund had a number of strong performers during the month including B**ubs Australian (BUB, +63.9%)**, **Catapult Group (CAT, +45.8%)**, **Clover Corporation (+19.7%)** and **Hub24 (+11.3%)**.

Bubs Australia Limited (BUB, +63.9%) performed strongly during the month after it released an encouraging quarterly report and then announced it was launching on Chemist Warehouse Tmall Global. Bubs Australia produces a premium range of Australian made organic baby food and specialty infant milk formula products and listed on the ASX earlier in 2017. Readers will recall that the Fund was an investor in the IPO at $0.10 cents per share (cps) and then in September we re-initiated a position in the business when it raised additional capital at $0.45 cps (it closed the month at $0.79 cps). BUB is a good example of a stock that is exposed to a "hot" thematic (being the Chinese consumer) and so is enjoying considerable share price momentum despite still being at a relatively early stage of development. BUB's quarterly demonstrated the rapid growth the business is experiencing with first quarter sales +109%, gross margins improving +119% and sales to China +274% for the quarter (versus the same period last year). BUB's launch on Tmall Global is particularly timely given its new range of organic baby cereals and teething rusks are expected to be very well received during the peak period of Singles Day shopping on November 11. E-commerce giant Alibaba's Tmall is the largest B2C retail platform in Asia, enabling businesses to sell directly to hundreds of millions of shoppers throughout China. We continue to hold a position in BUB, despite its very strong share price performance, but as always will be vigilant around factors that could negatively impact its outstanding growth potential.

Catapult Group (CAT, +45.8%) recovered somewhat during the month after a torrid 2017 (now -23.0% calendar year to date). CAT is a global sports analytics company that provides elite sporting organisations and athletes with detailed, real time data and analytics to monitor and measure athletes. After its IPO just under 3 years ago, CAT enjoyed market darling status rising several hundred percent before reality kicked in earlier this year as investors became frustrated with CAT's extended period of product development and investment which was coming at the expense of earnings and profitability. CAT finally delivered an encouraging quarterly report during the month, and combined with an apparent end to the relentless selling we have seen in the name, the stock had a nice bounce from its lows in late September. The CAT quarterly demonstrated strong cash receipts and good cost control and investors are looking for a continuation of this trend in coming quarters. The Fund exited the holding following strong share price appreciation, although we will continue to monitor the company's performance.

Baby Bunting (BBN, -12.5%) – the specialty retailer of baby goods was under pressure during the month in a difficult retail environment after flagging that competitor distress and subsequent store closures which have been impacting both the company's inventory position and creating short-term margin pressure due to clearance activity. Around 19 specialty baby goods stores have shut down in recent months with 15 inside the catchment area of a BBN store. Although most competitors have already ceased operations, we expect H1 FY18 gross margins to be adversely impacted. A similar event occurred in late 2015 when 'My Baby Warehouse' went into administration leading to the closure of 11 bricks-and-mortar stores and an online site. While this created near-term challenges, including margin pressure as inventory was cleared at discounted rates, it ultimately led to an improved industry structure for BBN over the longer term. We expect a similar scenario to play out in this instance with BBN likely to be in a stronger competitive position after the excess inventory from the discontinued operators is cleared.

Pacific Current Group (PAC, -8.7%) – was sold off early in the month after announcing it had sold its 40% stake in core Australian boutique fund IML to Natixis Global Asset Management for approximately $120m. While the sale leaves a hole from an earnings perspective and consequently reduces our valuation, it leaves the balance sheet in excellent shape (~$100m net cash) and management has reported it has a large pipeline of opportunities under active consideration. PAC management has shown an ability to make sensible and accretive acquisitions in the past and has commented that the subset of opportunities outstrips its available cash post the IML deal. The stock recovered somewhat over the balance of the month after the company subsequently reported strong Q1 FY18 fund flow, with total FUM of $69.6b, up 12.2% primarily driven by $7.0b of net inflows and market performance of $1.7b. Several of PAC's boutique managers are receiving strong fund inflows including GQG, Aperio, EAM and ROC and this is the key earnings driver of the stock. Management commented that the pipeline of institutional flows is robust and we therefore expect FUM flow to remain strong in the near term. PAC is currently trading on a cash-adjusted PE of ~12x and is well placed to re-rate should management deploy its excess cash in a sensible manner as they have done in the past.

Outlook

The Australian equity market shrugged off ongoing geopolitical tension and the latest round of political turmoil (the government losing its narrow majority after the Deputy Prime Minister, as well as others, were found to be ineligible for Parliament due to their dual citizenship status) and broke out of its narrow range to post its strongest gains for the year. Synchronised global economic growth, combined with low inflation and low interest rates, has strengthened investors' conviction that the global equity rally will continue to grind higher. Furthermore, renewed confidence in Trump's tax plan and continued record low volatility underpinned ongoing strength in the US market from which we seem to be taking as our investment lead.

In the US, Trump has nominated Jerome Powell, a former private equity executive at Carlyle Group and current member of the Federal Reserve, as the new Chairman of the US Central Bank. The choice of Powell is a departure from a long tradition of reappointing 'Fed' chairs to a second term, regardless of party affiliation. Mr. Powell, a Fed governor since 2012, is a Republican with deep roots in the party's establishment and in the finance industry. He has steadily supported Ms Yellen's approach to monetary policy and financial regulation, creating an expectation he would be unlikely to attempt large or sharp changes in the Fed's course. He also seems to have more business-friendly instincts on financial regulation, which will put him in line with the Trump administration's overall view that Barack Obama's time in office was far too unkind to Wall Street. Overall, his appointment ought to continue to be supportive of financial markets and we would expect him to continue on the course of gradual monetary tightening set by Janet Yellen.

On the domestic front, the RBA kept interest rates unchanged at 1.5% at its November meeting. Overall, the economy remains a mixed bag with wage growth remaining low and consumer confidence subdued, whereas business conditions continue to improve, employment has grown strongly in recent months and inflation remains in-check. The housing market appears to have finally peaked with out-of-cycle rate hikes and macro prudential tightening finally starting to impact. Housing price growth was flat in October (the Sydney market actually down -0.5%) and we remain cautious on the outlook. The portfolio remains underweight domestic housing exposure.

Our key conviction calls at present remain in companies exposed to the large pipeline of east coast-based infrastructure projects, particularly in areas such as road, rail, transport, telecommunications and renewable energy. Our site visits and management meetings during the month heightened our conviction in that call and the portfolio is well represented by companies that ought to benefit from an uptick in spending in these areas.

October and November is the time most Australian listed companies host their Annual General Meetings (AGMs) and this typically involves management providing an operational update, either in the form of specific earnings guidance or commentary on trading conditions, including the outlook for the business. Thus far, commentary from our portfolio holdings has been positive overall with our stocks seemingly trading broadly in line with our expectations. There have been, however, several earnings downgrades in the small-cap universe (e.g. **iSentia**, **Vita Group**, **Thorn Group**, **Zenith IP Group**, **Specialty Fashion Group**, **Prime Media**), although the Fund has escaped AGM season thus far unscathed.

The IPO market has sprung back to life and there are several new investment opportunities we are analysing at present including People Infrastructure, a Queensland-based workforce management company, Riverlea, the largest domestic pork producer and workforce management services provider, Tandem. In addition, the Fund recently subscribed for the upcoming Propel Funeral Partners IPO, albeit we were heavily scaled back due to the overwhelming demand for stock. Propel Funeral Partners is the second largest provider of funeral, cemetery, crematoria and related service in Australia and New Zealand. The company is well managed and operates in an industry with attractive fundamentals and which is ripe for further consolidation.

The OC team is busy travelling most of November visiting current and prospective holdings, unlisted competitors and industry experts. One of the team will be heading to the US to meet with the local management of several of the Fund's holdings including **Pacific Current** and **Updater**. We would like to thank our investors for their ongoing support and look forward to reporting back to you again next month.

Top 5 holdings#

Company	ASX code
Appen Ltd	APX
Family Zone Cyber Safety Ltd	FZO
Jumbo Interactive Ltd	JIN
Millennium Services Group Ltd	MIL
Updater Inc	UPD

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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 Emerging Companies 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.