OC Micro-Cap Fund

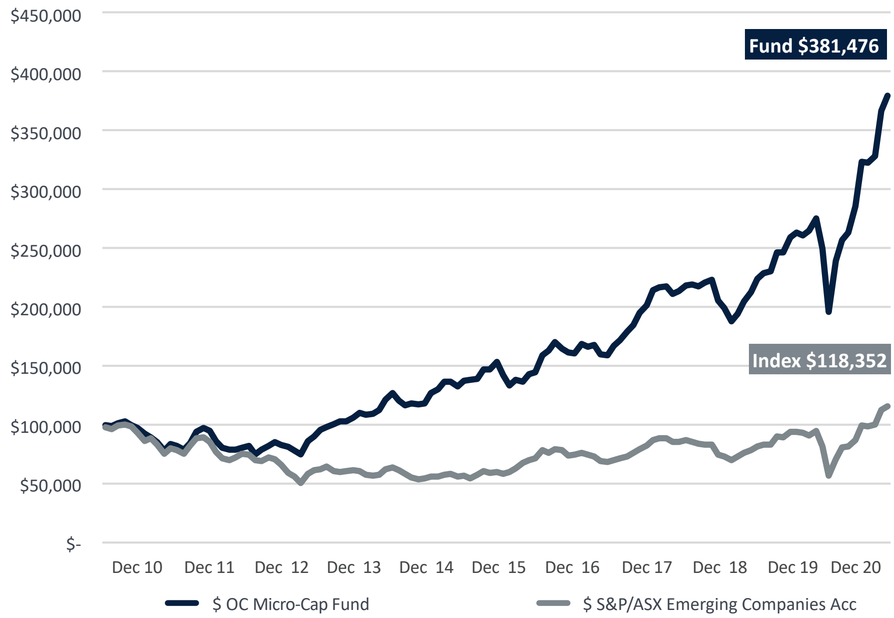
Fund Update | 31 December 2020

17.5% Fund up 17.5% for the quarter

19.8% Returned 19.8% p.a. for the past 5 years

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

Performance comparison of $100,000 over 10 years*



Total returns

At 31 December 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. (Mar 2003)
OC Micro-Cap	3.5	17.5	43.1	21.0	19.8	20.6	14.4	15.6
S&P/ASX Emerging Comp. Accum	2.6	17.4	27.1	10.0	14.3	10.0	1.7	NA
Outperformance	**0.9**	**0.1**	**16.0**	**10.9**	**5.5**	**10.6**	**12.7**	**NA**

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

Performance review

The OC Micro-Cap Fund continued its strong recent momentum in the December quarter with the Fund finishing the period up +17.5%. This was in-line with the S&P/ASX Emerging Companies Accumulation Index which was up a solid 17.4% for the quarter.

It capped what has been a remarkable calendar year, in many respects, for equity market participants. We started the year with the panic selling of February and March as gravity of the COVID-19 crisis dawned on the market with the ASX moving into bear market territory (a retreat of more than 20% from its high), at its fastest rate ever. But this quickly gave way to a sharp and sustained recovery in markets as central banks and governments took extraordinary measures to shore up their economies and banking systems, while several credible vaccine candidates emerged offering optimism that COVID-19 may soon be in our rear-view mirror.

The OC Micro-Cap Fund itself performed strongly over the calendar year returning +43.1% for investors (S&P/ ASX Emerging Companies Accumulation Index +27.1%). Pleasingly, the Fund significantly outperformed the micro-cap index during the equity market sell-off at the commencement of the COVID-19 pandemic and then it went onto recover its draw-down and moved significantly higher over the balance of the year. Early in the pandemic we repositioned the Fund including adding companies that were resilient and innovative structural winners, who could control their own destiny and who could continue exploit their competitive advantage, taking share from lower-tech incumbents, and grow independently of the economic cycle. Coupled with the numerous recapitalisations that the Fund participated in over the balance of the year and the myriad successful IPOs that we supported, it was a strong overall year for Fund investors.

Telix Pharmaceuticals (TLX, +127.7%) was a standout performer during the quarter after announcing a series of positive updates on clinical trials, regulatory approval processes, new drug submissions, licence and commercial partnerships and an acquisition. TLX is a Melbourne based late-stage biopharmaceutical company with international operations focused on the development of diagnostic and therapeutic products using Molecularly Targeted Radiation (MTR). The company is developing a portfolio of clinical-stage oncology products to diagnose and treat various forms of prostate, kidney and brain cancer that address significant unmet medical needs.

Perhaps most significantly, TLX announced a strategic partnership with China Grand Pharmaceutical and Healthcare Holdings (CGP) for the greater China market. The terms include up to US$225m in regulatory and commercial milestones payments, including: i) an equity investment of US$25m at A$1.69 per share; ii) US$25m upfront payment, up to US$225m in milestone payments and royalties; and iii) up to US$65m on clinical costs for development of TLX591 and TLX250. The partnership is a clear positive, allowing TLX to enter the Chinese market potentially sooner than the company had planned. In addition, the US$50m received upfront by the company reduces TLX's Phase 3 funding overhang. We see CGP's investment as a vote of confidence in TLX's pipeline by a company with experience in nuclear medicine (CGP acquired ASX listed oncology and nuclear medicine business Sirtex Medical in 2018). TLX has an impressive late-stage portfolio with numerous catalysts in 2021 including regulatory approval and commercialisation of TLX591-CDx (prostate cancer imaging) which has revenue potential in the hundreds of millions of dollars and a tier-one US-based partner, Cardinal Health, ready to sell its product in the US. We have trimmed our holding into recent share price strength but remain excited about the outlook for this well managed company.

Lithium play, **Galaxy Resources (GXY, +98.5%)**, enjoyed a strong quarter of share price performance as the market came to grips with President-elect Biden's ambitious '2050 net zero emissions' target. As a key component in batteries that power electric vehicles, lithium will play a critical role in the achievement of this objective. GXY raised additional capital during the quarter to advance its flagship Sal de Vida project and is now well capitalised to achieve its first production later in 2022. GXY is one of a small group of stocks we hold in the portfolio to gain exposure to certain 'net zero emissions' resources thematic that we believe will become increasingly important as the global economy looks toward sustainable avenues for growth. Other stocks exposed to this broad thematic include Namibian uranium project re-start, **Lotus Resources, (LOT, +60.3%)**, US based cobalt project developer, **Jervois Mining (JRV, +27.9%)**, and WA based shovel ready nickel project **Mincor Resources (MCR, +30.0%)**. On the resources front, we also added Brazilian based oil producer, **Karoon Energy (KAR, +37.7%)**, during 2020 when it was trading at a substantial discount to its cash backing; KAR is +100% on our mid-year entry point.

The corporate activity around childcare operator **Think Childcare (TNK, +90.6%)** seemingly reached a conclusion in late December and OC took the opportunity to exit its position at a significant premium to our entry price. TNK was the subject of competing bids from a local operator, Busy Bees, and a private equity firm, Alceon. The private equity group appear to have outplayed Busy Bees in this instance when it acquired a 19.23% blocking stake in TNK on market and then launched a formal proposal for the remaining equity in TNK at $1.75 per share. We believe this is the end game for TNK and have exited our position at $1.75 with a view to deploying our capital into further micro-cap opportunities.

The remaining childcare exposure in the portfolio, **Evolve Education (EVO, +70.2%)**, enjoyed a strong quarter of share price performance following a solid operating update in October which illustrated how the predominantly NZ based company was emerging in excellent condition position post its COVID-19 induced lockdowns. The company also issued $35m of medium-term notes during the quarter and consolidated its shares on a 1:8 basis. We believe EVO is well positioned for the ongoing expansion of its Australian beachhead in 2021 and we remain holders of the stock.

During the quarter, OC participated in numerous IPOs with notable new investments from the month of December including Booktopia Group **(BKG, +13.0%)**, **Doctor Care Anywhere (DOC, +50.0%)**, **Sovereign Cloud (SOV, +37.3%)** and **GenusPlus (GNP, +6.2%)**. In summary:

- BKG is Australia's leading online book retailer and will use the $25M raised at its IPO to drive further business efficiencies (particularly in its distribution centre-warehousing operations) and for ongoing revenue growth opportunities.
- DOC is a UK based tele-health provider with plans to expand its offering into continental Europe and potentially in the Asia-Pacific region. The COVID-19 health crisis has accelerated patients switch to accepting online medical advice (rather than face to face consultations) and DOC is well placed to capitalise on this opportunity to deeply penetrate its potential customer base.
- GNP is a WA based electrical contractor with national operations that installs and maintains power and telecommunications transmission and distribution infrastructure. GNP has a long track record as a family business, enjoys high barriers to entry, low capital intensity and strong industry tailwinds.
- SOV, at $100m market capitalisation, is on the smaller side for our Fund to participate in as an IPO but we believe the company has tremendous potential. SOV provides a private cloud infrastructure environment for sensitive information controlled by customers such as the Australian government and the ADF and is levered to increasing value and use of data.

Each of these IPO investments made it through our rigorous screening process and we can see them all developing into longer term holdings for the Fund. We also participated in several other successful IPOs during the quarter and will continue to assess further opportunities in the IPO and pre-IPO pipeline early in 2021 with a solid pipeline developing.

Outlook

The year 2020 will be remembered in the decades to come. The COVID-19 pandemic precipitated a global health crisis that was the catalyst for lockdowns which triggered the strongest economic contraction in modern history. Equity markets went into a tailspin only to bounce sharply and we ended 2020 with most equity bourses globally near record highs. Global policy makers swiftly launched a combination of huge fiscal stimulus, ultra-accommodative monetary policy and debt payment holidays, which averted an economic catastrophe not seen in most of our lifetimes. We now enter 2021 with a degree of optimism despite COVID-19 still casting a dark shadow over much of the globe, thanks largely to the efficacy of the policy response globally and, more recently, positivity with respect to near-term vaccine rollouts which ought to see many of our most vulnerable citizens vaccinated in the coming six months.

Recent COVID outbreaks in Melbourne and Sydney and the emergence of new COVID-19 variants that spread more rapidly are a reminder for Australians that the pandemic remains very real and that the road to vaccine-induced immunity will likely be a bumpy one. It seems that the current outbreak is being managed without the need to revert to hard Victorian style lock downs which could jeopardise the strengthening national recovery. The key obviously is the curtailment of community transmission which seems to be under control following the reintroduction of activity limits and renewed mask requirements, as well as more vigilant contact tracing. Fortunately, January is a seasonally quiet time for businesses and the warmth of summer ought to make social distancing easier to manage. If the current outbreak can be promptly suppressed, we remain optimistic that the domestic economy will recover the economic output it lost during 2020 by some time in the second half of 2021.

Australia's unemployment rate fell to 6.8% in November after Victoria's COVID-19 restrictions were lifted with more than 740,000 jobs being added to the economy is the past six months. Consumer and business confidence levels (figures announced prior to the recent COVID-19 scare) have rebounded to levels above pre-COVID-19 levels, retail sales are strong, around 75% of jobs that had been lost have now been reinstated and consensus economic growth for the 12 months to the end of June 2021 is expected to be about 7.5% on consensus economist estimates. The RBA's more conservative forecast is a more modest GDP growth rate of 6% for June 2021, dipping to a still healthy 5% over the calendar year. No doubt the road to vaccine induced immunity will have its twists and turns and the ability of the virus to mutate into strains that spread more rapidly or are resistant to the approved vaccines are front of mind for us. In recent positive news, the Prime Minister, Scott Morrison has confirmed that Australians will have a COVID-19 vaccine earlier than first thought with the roll-out to our most vulnerable citizens now scheduled to commence as early as mid-February.

The US economy, for its part, has stayed resilient through the pandemic. Consumer spending has nearly returned to pre-COVID-19 levels, while average personal incomes of US households surpassed pre-pandemic levels in September, even after the first round of fiscal support expired. These and other factors suggest a sustainable US recovery (even amid a difficult winter with COVID-19 still rife) with projected GDP growth of around 6.0% in 2021.

Whilst President-elect Joe Biden is now on his way to the White House, all eyes globally have been on the Georgia run-off elections which will determine control of the US Senate. Whilst the result has not been formally declared, the Democrats look to be on the cusp of winning by the narrowest possible margin. If the result is validated, the US Senate will be split 50-50 between the Republicans and the Democratic caucus and the incoming Vice-President Kamala Harris will be able to cast tie-breaking votes. This will make a tremendous difference to the US legislative agenda given the Democrats will control the Senate's schedule, essentially determining what policies can be put forward for a vote by the chamber. With the exception of fiscal related measures, which can pass with a simple majority using the budget process, other legislation will still require co-operation from Republicans because they require 60 votes in the Senate. Where Senate control can make a real difference is in the area of stimulus relief. The Republican controlled Senate had refused to boost stimulus cheques from $600 to $2000 last month, and that is now much more likely to go ahead.

From a market perspective, bond yields have rallied on a likely Democrat victory in the Senate, with the yield on 10-year US Treasuries now breaching 1.00%, its highest level since March, as inflation comes back into focus given the increased likelihood additional stimulus spending and larger government borrowing. A Democrat controlled Congress is also likely to push through further fiscal stimulus and infrastructure spending which will ought to be positive for equity markets. Long duration growth assets such as technology stocks and healthcare have pulled back on the prospect of higher bond yields.

The Fund has reduced its exposure to tech stocks in recent months, although we remain upbeat on the prospects of online book e-tailer Booktopia Group, software development company Bigtincan Holdings and subscription-based meal kit service Marley Spoon Limited.

Overall, the global economy looks set for an ongoing macroeconomic recovery as we enter 2021 underpinned by a combination of large fiscal and monetary stimulus and a low interest rate environment which is likely to persist into the medium term. With the US Federal Reserve and our own RBA promising to keep interest rates low even if inflation trends back above its 2% target, and with the roll-out of several vaccines over the coming months the global economy ought to continue to recover. Inflation is obviously a key risk we are watching for vigilantly, but the prevailing environment ought to be supportive of equity markets in the foreseeable future.

We remain upbeat on the prospects for the OC Funds portfolio heading into the new calendar year and remain confident in our ability to achieve consistent strong long-term returns for our investors. Many people have had a challenging time in calendar year 2020 and we wish our readers all the best for a safe, prosperous, and healthy year ahead.

Top 5 holdings#

Company	ASX code
Booktopia Group	BKG
Frontier Digital Ventures Ltd	FDV
Galaxy Resources Limited	GXY
Propel Funeral Partners Limited	PFP
Telix Pharmaceuticals Limited	TLX

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 soft-close end-of-month 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 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.