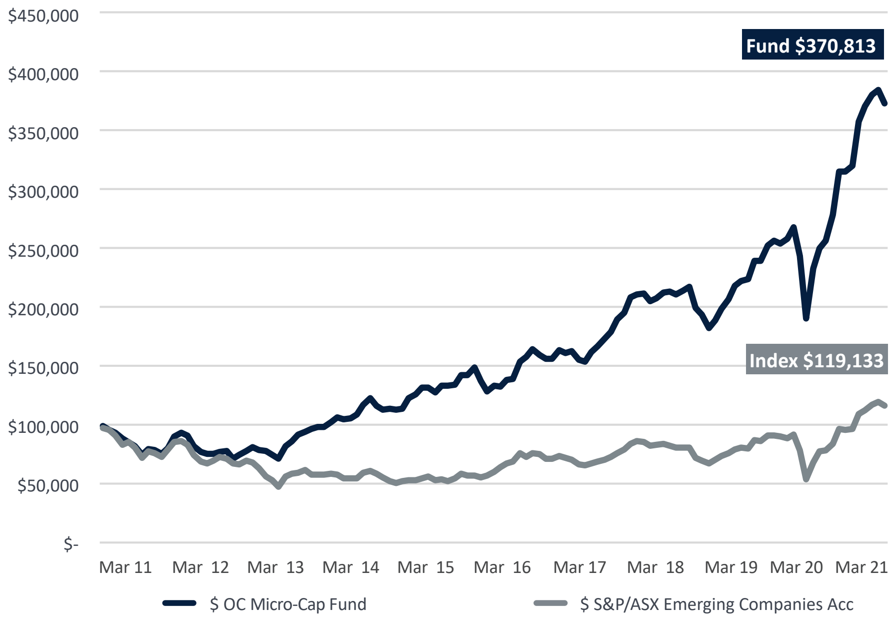
OC Micro-Cap Fund
Fund Update | 31 March 2021

0.6% Fund up 0.6% for the quarter

22.6% Returned 22.6% 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 March 2021†	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	-3.1	0.6	94.7	21.9	22.6	19.4	14.0	15.4
S&P/ASX Emerging Comp. Accum	-2.6	3.2	113.0	11.9	14.0	10.3	1.8	NA
Outperformance	**-0.5**	**-2.6**	**-18.3**	**10.0**	**8.6**	**9.1**	**12.3**	**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

Global markets continued to bounce in the March quarter with a combination of unprecedented monetary and fiscal stimulus from governments and central bankers, accelerating vaccine rollouts in most countries and positive economic data supportive of a continued upwards trajectory in stocks. Following the global lead, the Australian micro-cap index tracked higher, with the S&P/ASX Emerging Companies Accumulation Index up 3.2% for the quarter, ahead of the OC Micro-Cap Fund which returned 0.6%.

The OC Micro-Cap Fund has bounced strongly out of the COVID-19 induced equity market pummelling of the March 20 quarter, with the Fund up 94.7% over the past year. Whilst the Fund lagged the S&P/ASX Emerging Companies Accumulation Index over the past 12 months (+113.0%), this was largely due to the significant bounce in stocks at the riskier end of the Index, mostly unprofitable and cash-flow negative companies that were sold down heavily during the COVID-19 pandemic. With the benefit of hindsight, it would be easy to say we ought to have taken on more risk during the past 12 months. However, long term investors will be aware that capital preservation for our clients is one of OC's key investment mantras and we felt this level of conservatism was warranted given the significant uncertainty that persisted throughout much of the past 12 months.

Notwithstanding, the OC Micro-Cap Fund remains one of the best performing long-only domestic equity Funds over the past one, three and five years and has once again been shortlisted for the prestigious Money Management Fund Manager of the Year 2021 award in the Australian Small/Mid Cap Equities Space.

Pivotal Systems Corporation (PVS, +38.3%), the producer of high precision gas flow control equipment for use in semiconductor manufacturing performed strongly over the quarter as the cyclical sector recovery received more attention globally. The impact of COVID-19 on semiconductor orders created a problematic backdrop to 2020, resulting in shortages of chips in several industries including automotive manufacturing. However, the macro backdrop has changed significantly with semiconductor manufacturers responding to increased demand, including from the crypto-mining industry with bitcoin miners aggressively seeking equipment stockpiles to capitalise on the higher price of the cryptocurrency. As a result, semiconductor fabricators are resuming expansion programs leading to flow on orders for related equipment. This has coincided with a broader sector rotation from high growth companies at high prices into cyclical companies with depressed earnings and lower valuations. We have gradually added to this position over the past six months and remain comfortable holders at this point in the cycle.

Aged care provider **Estia Health (EHE, +21.5%)** rallied over the quarter with an ongoing COVID-19 recovery and the conclusion of the Royal Commission into Aged Care boosting sentiment. The market is forward looking, and aged care occupancy ought to begin to improve as aged-care residents and workers are vaccinated and as low local transmission instances appease incoming residents and their families. The Royal Commission set out 148 recommendations, some in conflict with others, and the government is expected to outline policy action in response around the time of the federal budget. None of the recommendations look particularly troubling for the listed providers while some would be substantial improvements to the status quo. With this outlook of greater regulatory certainty, the market has moved to put the difficult 2020 year in the past and start to focus on the potential for better times ahead.

MNF Group (MNF, +18.8%) reported a solid 1H21 result during the quarter. MNF is a telco software business which enables their customers to use phone numbers for voice communication over the internet. Wholesale customers such as Microsoft Teams, Zoom, Carsales, Ring Central and Aussie Broadband lease phone numbers from MNF which enables internet enabled voice communication. This business experienced structural tailwinds during the pandemic, but MNF also surprised the market at the FY20 result six months ago with some unexpected operational headwinds as well. Over this half, the tailwinds appeared to be more meaningful and MNF reaffirmed its FY21 guidance. MNF also announced a strategic review of their lower growth Retail or Direct business which could lead to greater focus on the core high growth Wholesale business. We view MNF as a quality growth micro-cap business with founder management and retain it as a holding in the Fund.

Global document productivity and e-signing software company **Nitro Software (NTO, -23.7%)** came under considerable pressure during the quarter despite posting a full year result that was ahead of its Prospectus forecast. In late February, NTO posted annual recurring revenue (ARR) of $27.7m (ahead of both the Prospectus and recently upgraded company forecasts), as well as demonstrating a step-up in customer growth. The share price sell-off during the quarter was likely the result of two interacting forces: 1) the sharp sell-off in small technology stocks brought about by the spike in the 10-year treasury yield during the quarter (discussed in the February Monthly Review); and 2) investors being reluctant to purchase the stock ahead of a mooted sell-down by two cornerstone investors, Starfish Ventures and Battery Ventures, who came out of escrow post the full year result. At times, the market can be somewhat irrational short-term and at one stage NTO's share price was in free fall around early March as buyers deserted the screens amid the sharp tech sell-off and a perceived stock overhang. We try to remain rational and opportunistic at such times and the Fund stepped into the market and purchased heavily discounted stock at around $2.20 in early March, well below our internal valuation and also comfortably below the current share price of $2.73.

Over the quarter, the OC team took the opportunity to capitalise on the strong share market (and some surging share prices) to exit portfolio positions which had either reached our valuation expectations or where we assessed we could deploy the capital more effectively elsewhere. Mask manufacturer **Cleanspace Holdings (CSX, -71.0%)** had been a strong performer for the Fund since its IPO in October 2020, but we saw the business as being reasonably fully priced, with the market perhaps looking past any potential slowing in demand for CSX masks in a vaccinated environment. We consequently exited our position before a late March quarterly update disclosed materially lower revenue than expected.

Other recent IPO's where we chose to take profits have included **Dusk Group (DSK, +53.0%)**, **Pentanet (5GG, +206.0%)** and **Little Green Pharma (LGP, +23.9%)**. We sold our position in SME financier **Earlypay (EPY, +21.6%)** as the share price recovered following the disappointment of two failed takeover bids in 2020. EPY, previously known as CML Group, is a solid SME financing business but given liquidity constraints, we think there are superior investment opportunities elsewhere. We also exited our position in **Primero Group (PGX, -2.7%)** following its takeover by **NRW Holdings (NWH, -31.3%)**; and we immediately exited our position in the NRW scrip that we received as consideration for the takeover as it is not considered a micro-cap stock. The Fund exited another mining services business **Emeco Holdings (EHL, -16.7%)** as its share price surged +50% to what we saw as unsustainably high levels, above our valuation. Micro-cap investing requires constant portfolio vigilance and can go through periods of reasonably high portfolio turnover, but we deem this as necessary to drive strong ongoing Fund performance.

Outlook

As we enter the June quarter, equity markets have stabilised and are once again trending higher following a sharp spike in treasury markets in the March quarter that stoked fears that central banks would be forced to act ahead of plan to subdue inflationary forces. Surging bond yields took much of the focus away from an otherwise strong February reporting season in the Australian small-cap space, where positive earnings surprises had outweighed negative revisions, despite the significant COVID-19 disruptions suffered by many companies in our stock universe. It is pleasing to see that corporate Australia is emerging from the COVID-19 pandemic in better shape than even the most optimistic forecasts at the start of the FY21 financial year. Balance sheets overall are in good health, with many companies raising fresh capital following the onset of COVID-19 and profit growth is recovering and, in some cases, accelerating.

The domestic economy looks well placed to navigate the winding up of the highly successful JobKeeper program which ended last month and the strength in job vacancies in the labour market means there is solid opportunity for those who lose employment from the end of JobKeeper. The March unemployment data showed that the unemployment rate had fallen to 5.8%, far exceeding consensus expectations. Furthermore, the ANZ Job Advertisement report, which measures the change in the number of jobs advertised in the major daily newspapers and websites covering the capital cities, showed job advertisements in early April had reached the highest level in a dozen years, indicating a robust employment market for workers coming off the JobKeeper scheme. Indeed, this report which was released last week put job vacancies 23% higher than they were on February 1, 2020.

The resurgent domestic housing market shows no signs of cooling with a 2.8% surge in dwelling values nationally in March representing the fastest monthly growth in 32 years. Sydney led the charge with a 3.7% gain in March with buying activity in that state intensifying amid stock shortages. With interest rates at record lows and the jobs market improving, the outlook for housing remains robust which is clearly positive for the domestic economy due to the positive 'knock on' effects from a strong housing market including resurgent construction activity and the 'wealth effect' of households being more willing and able to consume more in a rising house price environment. Despite the ongoing pick-up in economic activity, the Reserve Bank of Australia (RBA) held the cash rate at 0.1 per cent in early April. This further confirmed that its yield curve control program, which aims to keep three-year Australian government debt tethered to the same rate, will remain in place for bonds that mature in April 2024.

Sentiment in the global economy is also improving reflecting optimism around the pace of vaccinations and an economic recovery that is playing out much quicker than most had anticipated. The International Monetary Fund says in its latest forecast that it expects the world economy to expand 6 per cent in 2021, up from the 5.5 per cent it had forecast in January. This would be the fastest rate of expansion for the global economy in IMF records dating back to 1980. In the US, the economic outlook too continues to strengthen with the jobs market accelerating in February, retail sales jumping after $US600 relief cheques were distributed during the quarter, and with President Biden signing his $US1.9 trillion economic relief package into law.

With the global economy recovering ahead of expectations, inflation remains the single biggest tail risk for the economy and for asset prices including equities. Treasury markets, in particular the 10-year bond rate, have been in clear focus during the past quarter as market participants look for signs of inflation. The fear has been that rising treasury yields seem to be signalling that inflationary pressures are building even though the global economic recovery is still in its early stages and that interest rates may have to rise sooner than our central bankers would have us believe. Clearly this would have the potential to derail markets that have become accustomed to the 'lower for longer' rhetoric on interest rates from our central bankers.

The key question remains whether we are witnessing the beginning of an inflationary wave which could force the hand of policy makers and necessitate interest rates rising at a time when the global economy is still relatively early in its recovery phase. This would have clear negative implications for equity markets. Or are our central bankers, including the US Federal Reserve ('the Fed') and the RBA, indeed correct in that any near-term price rises will prove to be transitory in nature (driven by supply bottlenecks and short-term stimulus that will fade) given that the labour market remains significantly underutilised and the risk of sustained inflation is therefore very low.

The Fed continues to project near-zero interest rates at least through 2023 despite upgrading its US economic outlook with Chairman Jerome Powell noting in the past month that the Fed remains 'a long way from their goals' and that they 'will be patient if [they] see a transitory rise in inflation' and further that they '[e]xpect any inflation rise to be of a base effect, but not to be large or persistent'. Both the Fed and RBA have made it clear that they will wait to see that inflation is sustainably above their targeted range (2% and 2-3% respectively) before considering adjusting policy, which is a marked departure from typical central bank policy settings which are usually proactive, as opposed to reactive.

These are indeed unchartered waters and the wave of fiscal and monetary stimulus unleashed on the global economy since the onset of COVID-19 is unprecedented which makes predicting inflationary outcomes based upon historical references somewhat challenging. It seems clear that inflation is likely to accelerate somewhat in the coming months, simply given the base effects from last year's coronavirus-hit data. A surge in post-lockdown spending and supply chain disruptions caused by COVID-19 restrictions could exacerbate price pressures in some areas. However, wages growth remains subdued and labour markets are yet to recover, despite showing a strong positive trajectory in jobs data. Furthermore, the same powerful secular forces that have kept inflation in check for decades remain present. These include technological innovation which has arguably accelerated as a result of the pandemic and ought to continue to drive deflationary productivity gains across the economy.

Overall, we are not convinced that sustained inflation is likely in the near term. Rather, we view rising long-term treasury yields as the natural consequence of a reflationary environment and that some price rises are a natural and healthy part of the economic recovery. We expect that treasury yields will likely continue to rise in the near-term but remind our investors that even with the recent increases in bond yields, the long-term bond yields remain at historically very low levels.

Rather than 'bet the farm' on the likely gyrations of the bond markets, which seem to be determining whether growth or value stocks are outperforming on any particular day, we have structured the OC Funds portfolio with a healthy mix of COVID-19 reflation and cyclical recovery trades, as well as retaining some exposure to quality growth names including global document productivity and e-signing software company Nitro Software which continue to have strong structural tailwinds. That said, we have reduced our exposure to growth names during the quarter including software development company Bigtincan Holdings Ltd.

We have seen a very strong start to the year in terms of merger and acquisition activity, particularly in the small-cap space including SG Fleet announcing the acquisition of Leaseplan ANZ and EML Payments Ltd acquiring Sentenial Group in the past week alone. An ongoing economic recovery, low funding costs and solid corporate balance sheets, coupled with accelerating structural changes in the post-pandemic economy ought to be supportive of a strong year ahead for M&A activity. Throw into the mix cashed up private equity players hungry for deals and we expect to be busy assessing corporate deals in the months to come.

With travel restrictions winding back, the OC team will be out on the road in the coming month with trips planned to Sydney, Brisbane and Perth to visit existing and prospective investments. We have certainly missed the face-to-face interaction with key management and visiting company operations and understanding the 'nuts and bolts' of a business has always been an important part of our investment process. We would like to thank our investors for their ongoing support, and we remain confident in our ability to continue to generate strong investment returns for our clients over the long-term.

Top 5 holdings#

Company	ASX code
Booktopia Group	BKG
MNF Group Ltd	MNF
Monash IVF Group Ltd	MVF
Probiotec Limited	PBP
Propel Funeral	PFP

The top 5 portfolio holdings are in alphabetical order and may not be representative of current or future investments.

CONTACT COPIA

1800 442 129 | clientservices@copiapartners.com.au | copiapartners.com.au

John Clothier	General Manager, Distribution	0408 488 549 | jclothier@copiapartners.com.au
Iain Mason	Director, Institutional Business	0412 137 424 | imason@copiapartners.com.au
Mani Papakonstantinos	Distribution Manager	0439 207 869 | epapakonstantinos@copiapartners.com.au
Matthew Roberts	Distribution Manager	0438 297 616 | mroberts@copiapartners.com.au
Jude Fernandez	Distribution Manager	0414 604 772 | jfernandez@copiapartners.com.au
Sam Harris	Distribution Manager	0429 982 159 | sharris@copiapartners.com.au

[†]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.