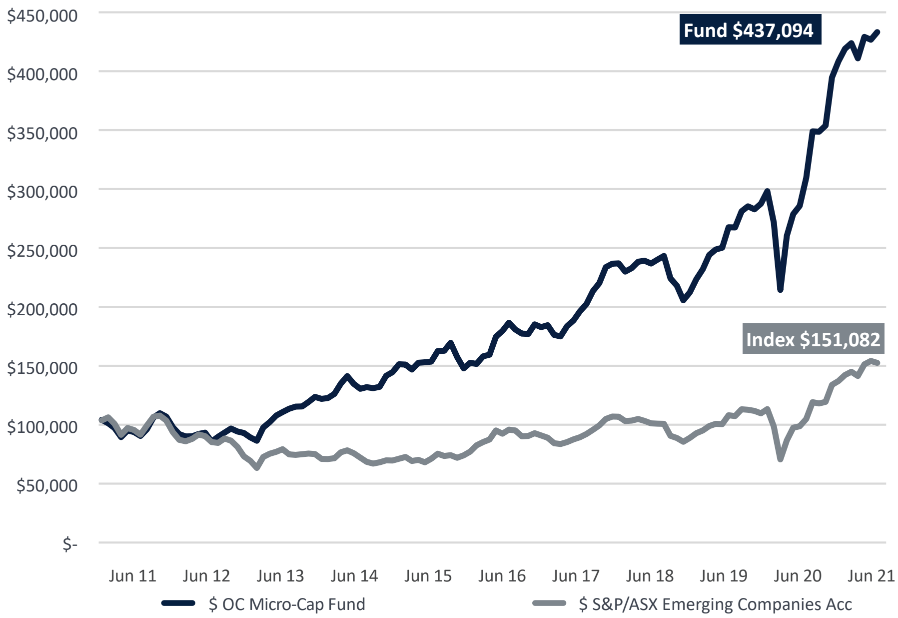
OC Micro-Cap Fund
Fund Update | 30 June 2021

5.5% Fund up 5.5% for the quarter

22.8% Returned 22.8% 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 30 June 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	1.5	5.5	52.9	22.4	22.8	20.0	15.9	15.5
S&P/ASX Emerging Comp. Accum	-1.2	8.3	59.2	14.9	12.7	12.4	4.2	NA
Outperformance	**2.7**	**-2.8**	**-6.3**	**7.5**	**10.1**	**7.5**	**11.7**	**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 finished the June quarter up +5.5%, which was behind the S&P/ASX Emerging Companies Accumulation Index (+8.3%) despite solid outperformance by the Fund in the month of June. FY21 was in many ways an extraordinary year with markets casting aside monumental health and economic challenges brought about by COVID-19 to post equity returns which were nothing short of spectacular. The S&P/ASX Emerging Companies Accumulation Index rallied some +59.2% over FY21 which was the best return from the Index since 2007.

The OC investment team had entered FY21 with a degree of trepidation with the COVID-19 health crisis in full swing across the globe and markets trading well off their nadir of late March 2020. The coordinated policy response to the pandemic from central banks and governments globally unleashed an unprecedented wave of stimulus that ultimately laid the foundations for a global economic recovery that is still gathering momentum as we enter the new financial year.

The OC investment team drew on 60+ years of investment experience to navigate the many challenges thrown at us in FY21 and we were pleased with the performance of our Funds over the year. The OC Micro-Cap Fund returned +52.9% for FY21, which although slightly behind the micro-cap index for the financial year, was sufficient to see the Fund come runner up in the Money Management Fund Manager of the Year in the Australian Small/Mid Cap Equities category.

Much of the heavy lifting for the Fund was done following the outbreak of COVID-19 in Q4 FY20 when we abruptly repositioned the Fund away from global growth names which were under severe pressure at the time into a portfolio of stocks which was overweight structural beneficiaries of COVID-19 such as meal kit provider Marley Spoon Limited, as well as opportunistic recapitalisation plays that had been oversold. It was this initial rotation that underpinned the strong returns for investors in the first half of FY21.

The release of the vaccine efficacy data in November 2020 by Pfizer/BioNTech and Moderna was the catalyst for another significant portfolio pivot by the investment team which significantly reshaped the make-up of our portfolio heading into the second half of the financial year. At this time, COVID-19 recovery trades replaced technology and e-commerce names as our preferred themes, and we continued to weight the portfolio into reflation beneficiaries and cyclical recovery stories over much of the balance of FY21. Significantly, our decision to retain a handful of preferred technology names including Nitro Software, Rhipe and Eroad Limited has more recently served our investors well as long bond yields have moderated and technology stocks have staged a recovery into the end of FY21.

Telix Pharmaceuticals (TLX, +42.3%) continued to be a standout performer for the Fund during the quarter on the back of further key milestones being achieved, including positive early-stage clinical outcomes across multiple indications, further strategic alliances and partnerships being cemented, positive feedback from regulatory bodies and key index inclusions including both the S&P/ASX 300 Index and the MSCI Global Small Cap Index. As a reminder Telix is a late-stage bio-technology company specialising in cancer imaging and treatment via molecular targeted radiation. It has a robust pipeline of near-term material opportunities in the growing field of radiopharmaceuticals which is attracting far greater attention from investors and regulators alike and which received further validation in early June when competitor Novartis announced late-stage clinical trial success. During the quarter TLX announced some extremely positive clinical developments, as well as reporting a positive reception from the FDA at its scheduled Late Cycle Meeting regarding the ongoing review of the NDA for its prostate cancer PET tracer Illuccix. TLX announced that the FDA indicated that there were "no outstanding substantive review issues" with the submission. We expect TLX to have strong news flow in the second half of CY21, with its most immediate opportunity expected to be the FDA and EU approval of its Illuccix® prostate cancer imaging product which represents a revenue opportunity in excess of $100m per annum and has several advantages over current radio imaging assets (ease of use, accuracy) and is currently used on an investigative/compassionate use basis with almost 10,000 patient doses sold in the US and EU in CY20. We regard the TLX management highly and continue to believe the company has the potential to be a highly profitable business within three years.

During the quarter, the Fund initiated a position in **Japara Healthcare (JHC, +73.0%)** which proved timely as JHC received a takeover proposal offer which subsequently turned into a two-horse race in mid-June when a separate party lobbed a competing bid. JHC offers 5000 aged care living places across a portfolio of 50 homes throughout the east coast of Australia. JHC's share price had been battered in 2020 as it faced off against a bruising Royal Commission into Aged Care Quality and Safety and also battled the ravages of COVID-19 which extracted a heavy toll right across our nation, but particularly in aged care communities. JHC came onto our radar as an investment worth reconsidering around its first half result in February as JHC management demonstrated a clear pathway for the company to emerge from these twin challenges. We believe JHC provides an essential service to the community, and it looked like the company's shares had been oversold by the market. Fortune sometimes favours the brave and in April Calvary Health (Little Company of Mary Health Care Ltd) proposed a non-binding, conditional, indicative takeover for JHC at $1.04 per share by way of Scheme of Arrangement. Following a strong trading update in May, where JHC said its occupancy was at 89%, Calvary Health increased its proposal for JHC to $1.20 per share. The race for JHC became competitive in June when the Bolton Clarke Group, an Australian not for profit provider of home care, retirement living and residential aged care, entered the race for JHC with a proposal priced at $1.22 per share. We continue to hold our position in JHC and look forward to watching the takeover battle unfold in the coming months.

Eroad Limited (ERD, +43.3%) was up strongly during the quarter after announcing an operational update and the winning of an enterprise customer in Australia. ERD is a transportation technology company which helps trucking transport companies, mainly in NZ and the US, manage truck fleets, improve safety and comply with various regulatory fuel tax regimes. The product comprises both vehicle-installed hardware and software as a service which generates high quality recurring revenue with +95% customer retention.

Given the impacts of the pandemic in the US, ERD delivered softer new subscriber growth in the December quarter which lowered the expectations of the market ahead of the March update and its annual result. The March update, whilst still below pre-pandemic trading conditions, nevertheless demonstrated a recovery in new subscription growth. Furthermore, ERD reported the first sales of its new dashcam product which bodes well for ARPU growth, particularly in the key US market. ERD also announced a large enterprise customer win in Australia which should assist in scaling ERD's nascent presence in Australia. ERD has also flagged acquisitions in the coming financial year.

Nitro Software (NTO, +33.6%) rallied over the quarter with the document productivity and e-signing company recovering from its March quarter sell-off. There were several positive catalysts for the stock during the quarter including clearing the overhang of the pre-listing cornerstone investors (Starfish Ventures and Battery Ventures), the reporting of a solid first quarter result, the reconfirmation of earnings guidance and the acquisition of smaller Apple focussed PDF tool, PDFpen.

As discussed in our April monthly update, Nitro's price had been sold off in March under pressure from a perceived stock overhang and the rotation away from tech companies as long bond yields in the US lifted. This allowed us to increase our stake in the company at a temporarily reduced price. The US$6m acquisition of PDFpen marks the first acquisition for the company since IPO and will serve to springboard the core NTO capability onto Apple operating systems including Mac and iOS, beyond the in-browser e-signing already offered by NTO. PDFpen also has potential to expand NTO tablet user offerings with support for Apple Pencil and other Bluetooth stylus devices. We believe NTO is well positioned for growth and continue to hold the stock across the suite of small and micro-cap funds.

Gym owner and operator **Viva Leisure (VVA, -39.0%)** was down for the quarter after the AFR reported on a legal dispute between VVA, as the franchisor of the Plus Fitness network, and a number of dissatisfied Plus Fitness franchisees. The dispute relates to the potential for competition between franchisee owned gyms and nearby VVA owned gyms. Given the dispute pertains to the Plus Fitness franchisee network which generates only a relatively small proportion of VVA revenues, the share price reaction was larger than expected. Furthermore, the focus of the roll out of further VVA corporate gyms is less likely to conflict with the predominantly NSW based Plus Fitness franchisees given VVA will likely open new gyms in Victoria and Queensland.

Later in the quarter, VVA announced guidance for FY21 earnings which were broadly in line with market expectations. In particular, corporate owned gyms were growing members at mid-teens rate (%) with stronger margins experienced in high intensity group class format HIIT Republic. HIIT Republic enjoys nearly double the revenue per member than that of a 'big box' gym. Furthermore, better margins were achieved in the second half of FY21 with improving margin trajectory for FY22 which would be further improved by any acquisitions of mature gyms. Recent lockdowns in Victoria, NSW and Queensland late in the quarter are unlikely to be helpful for the short-term operational performance of the network. Despite recent VVA share price performance, we remain confident that these lockdowns are temporary and visitation, membership numbers and margins for VVA are likely to recover.

Evolve Education Group (EVO; -29.3%) traded lower during the quarter as it followed a capital raise at the start of the quarter with a disappointing trading update in June. Downgrading earnings expectations so soon after a capital raising (A$21.7m for acquisitions) is a cardinal sin in capital markets and is sure to shake the confidence of any investor and the share price fall reflected this. EVO operates 115 early education centres in New Zealand and is focussed on expanding its Australian footprint of centres (currently 20). In the June trading update, EVO delivered a bullish update on its Australian operations with occupancy tracking at +87% (and a little lower in Queensland) which is very encouraging for this early in the year as childcare centre occupancy tends to build toward 85-90% over the course of the calendar year. However, the NZ update was more subdued (70% occupancy) with the operations being significantly impacted by COVID-19 border closures causing teacher shortages across the sector. Under the NZ childcare model, this shortage of available teachers, which are often sourced from outside NZ, has had a material impact on EVO's ability to hit the higher government funding bands and this funding shortfall has had a direct financial impact on EVO. The company expects this negative financial dynamic should self-correct once international borders re open and, in the meantime, EVO is looking to achieve material cost savings via streamlining centre based and support office costs. We have retained our position in EVO as the Australian business is doing very well and we see the challenges in NZ as temporary.

Outlook

As we enter the new financial year, the inflation hawks have momentarily retreated and bond markets have calmed since early June as recent data prints have lent credence to the US Federal Reserve (the Fed) and Reserve Bank of Australia's (RBA) contention that the recent inflationary pressure will prove to be transitory in nature. Nevertheless, the trend of inflationary pressures and the likely speed of interest rate normalisation remains a contentious and polarising debate and one which is likely to continue to dominate economic discourse for some time to come.

The US core Consumer Price Index (CPI) – which excludes the volatile food and energy prices – came in well ahead of economists' expectations at +3.8% in May, albeit off a low base at the beginning of the pandemic. This is the highest since June 1992 and well above the central bank's target of 2%. Additionally, the core personal consumption expenditures price index (PCE), the US Fed's preferred inflation gauge, increased +3.4% in May from a year earlier. Nevertheless, many of the price pressures seem to have come about as a result of supply chain bottlenecks brought about by the pandemic as manufacturers and suppliers try to ramp up production capacity to meet new demand. Shortages, exacerbated by regional droughts in the US, have led to the rapid escalation in prices for products ranging from computer chips to lumber, plastics, grains and meat and poultry. Fed officials see these factors abating in coming months and the evidence in the bond market clearly suggests that Wall Street has made up its mind and the consensus view is that the rise in US inflation and other global inflationary pressures will be transitory.

The global economy seems to be on a sustained pathway to recovery and the global rollout of COVID-19 vaccines has fuelled a wave of economic optimism at a time when the market is awash with liquidity provided by record low interest rates and central bank quantitative easing, along with government stimulus programs. The International Monetary Fund is now forecasting the world economy will expand by +6.0% in 2021, up from its +5.5% forecast in January as vaccines are rolled out and as advanced economies spend aggressively to counter the damage caused by the pandemic. Against a backdrop of strong global growth and emerging inflationary pressures, we remain focussed on the outlook for interest rates given that lower bond yields have been a key driver of multiple expansion across equity markets in recent years.
The US Federal Reserve in a major policy shift at their mid-June monetary policy meeting indicated that they would likely speed up the pace of policy tightening, opened talks on how to slow down (taper) the rate of bond buying program, and said that the COVID pandemic was no longer a core constraint on US commerce with the US economy now forecast to grow at a stunning 7% this year. Signalling that rates normalisation may happen sooner than expected, Fed officials moved their first projected rate increase from 2024 to 2023, with 13 of 18 policymakers projecting an increase in borrowing costs that year, and 11 seeing two 25 basis point rate increases. Seven of the Fed officials see rates moving higher next year, opening the possibility of even more aggressive tightening in the US.

The RBA has remained steadfast in its position that the cash rate is “unlikely” to rise “until 2024 at the earliest” but has opened the door to tapering earlier by announcing they will make a decision at the July meeting on extending QE and shifting the maturity of the yield control curve (where it buys three-year bonds in order to keep benchmark borrowing rates low and help drive further employment growth) from the Apr-24 to the Nov-24 bond. The RBA said repeatedly that the conditions necessary for a rate rise were inflation “sustainably within the 2 to 3 per cent target range”, and a labour market that was “tight enough to generate wages growth that is materially higher than it is currently”. These conditions are still not present and the RBA may therefore defer any decision on tapering from the July meeting until later in the calendar year. Markets nonetheless are looking through the RBA’s commentary and pricing in a much more optimistic view on economic growth by indicating that the cash rate is set to lift as soon as late next year. Bank bill futures in Australia now imply a cash rate of 1.1% by June 2024, which would equate to at least four 25 basis point rate hikes over this time horizon.

Although the global economy remains on the pathway to recovery and the vaccine rollout is gathering space in most developed countries, much of Australia has once again been plunged into lock-down with up to 12 million people currently behind closed borders or in city lockdowns which extend across four states. Having weathered the initial COVID-19 onslaught and successfully rebooted the economy, it seems our state governments are once again pursuing an elimination strategy in part driven by fear of the more infectious Delta variant, but also due to an underperforming national vaccine rollout which is lagging significantly behind other developed nations. With major Federal support programs such as JobKeeper having ended and other COVID-19 offsets such as rental and interest holidays now a thing of the past, we can only hope that the current wave of lockdowns end abruptly, or the economic and mental health damage inflicted on the vulnerable will be severe.

In such an environment it can be difficult to position a stock portfolio with ‘lockdown’ and ‘reopening’ beneficiaries whipping around at the whim of the national and global COVID-19 tally. As investment managers, we look through the ‘noise’ of the media and near-termism and structure the portfolio with quality stocks that we believe will perform strongly over the next 12 to 24 months. The OC portfolio remains tilted toward companies that ought to be beneficiaries of a return to sustained economic growth, price pressures and higher yields, commonly referred to as ‘reflation trades’. We have also added to holdings in sectors such as financials and cyclical areas of the economy that are levered toward an ongoing economic recovery as the vaccine is progressively rolled-out globally. That said, we still retain several high-quality growth exposures in the portfolio including **Nitro Software**, **Rhipe** and **Eroad Limited** all of which have been strong performers over the past month as bond yields have moderated and tech stocks rebounded.

We have now entered the ‘black-out’ period between the end of June and the August reporting season. Most companies will cease communication with investors around operational performance until they report and corporate activity including IPOs and secondary market placements will likely moderate significantly. As such, limited stock-specific news is typically released in the month of July. July is likely to provide some welcome respite from company meetings for the investment team after a very busy period since the start of the COVID-19 pandemic and several team members are taking long overdue breaks. We would like to thank our investors for their support and encouragement over the past financial year and we remain committed as ever to continue to work diligently to deliver strong returns for you all in the coming years.

Top 5 holdings#

Company	ASX code
Booktopia Group Limited	BKG
Cedar Woods Properties Limited	CWP
MNF Group Ltd	MNF
Monash IVF Group Ltd	MVF
Propel Funeral Partners Limited	PFP

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.