FUNDS MANAGEMENT

OC Dynamic Equity Fund

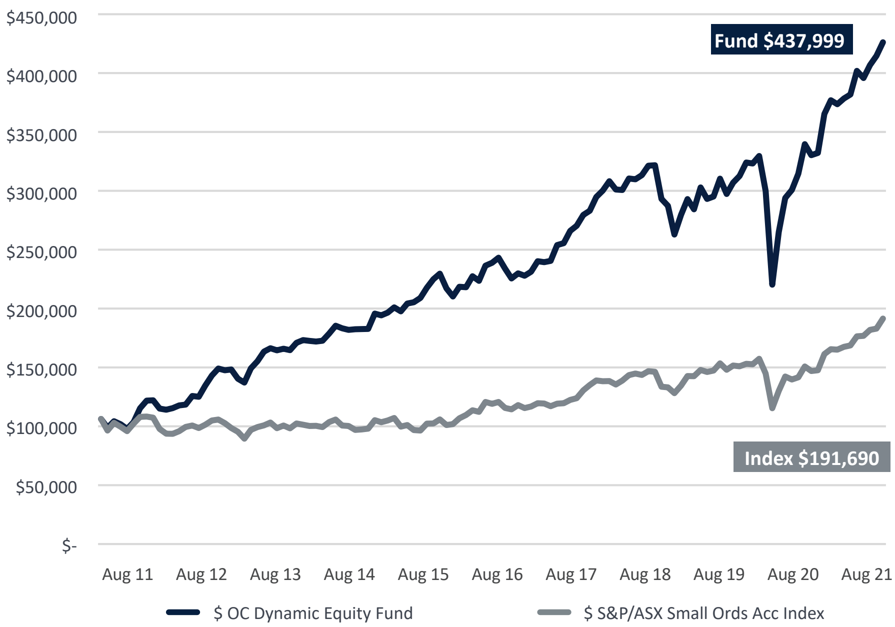
Fund Update | 31 August 2021

2.8% Fund up 2.8% for the month

16.0% Returned 16.0% p.a. for the past 10 years

We remain confident the Fund will continue to deliver attractive long-term returns

Performance comparison of $100,000 over 10 years*



Total returns

At 31 August 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. (Dec 2000)
OC Dynamic	2.8	7.9	26.4	10.2	12.8	13.2	16.0	13.0
S&P/ASX Small Ords Accum	5.0	8.9	29.5	10.1	11.0	9.8	6.7	7.1
Outperformance	**-2.1**	**-1.1**	**-3.1**	**0.1**	**1.8**	**3.4**	**9.2**	**6.0**
S&P/ASX Small Ind Accum	6.1	9.2	27.8	9.9	10.3	10.1	11.0	7.4
Outperformance	**-3.3**	**-1.3**	**-1.3**	**0.4**	**2.5**	**3.1**	**5.0**	**5.7**

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

Performance review

The August reporting season brought a continuation of the positive momentum in equities with the domestic small-cap market shrugging off the impacts of the COVID-19 Delta variant and protracted lockdowns in both NSW and Victoria, as well as news that both the Reserve Bank of Australia and US Federal Reserve will likely begin to taper bond purchases later in the year, to surge to fresh highs. The markets looked through the COVID-19 restrictions and instead focussed on a likely reopening of the economy in the coming months as vaccination levels surge with so called 're-opening' trades exposed to global growth amongst the best performers for the month of August.

The OC Dynamic Equity Fund returned +2.8% in August, which lagged both the S&P/ASX Small Ordinaries Accumulation Index and the S&P/ASX Small Industrials Accumulation Index which were up +5.0% and +6.1% respectively for the month. The underperformance versus the Index was partially due to a lack of exposure to the two largest stocks in the Small Ordinaries Index, lithium miners Pilbara Minerals (PLS, +26.0%) and Orocobre (ORE, 11.5%) which tracked higher as the Spodumene price rallied, and partially due to not owning a handful of global reopening beneficiaries such as Lovisa (LOV, +25.3%), Nanosonics (NAN, +24.7%) and City Chic Collective (CCX, +15.0%) which spiked as optimism grew around the global economy rebounding from COVID restrictions. On balance, we were comfortable with the results of the Fund's holdings in August and remain optimistic about their prospects for the year ahead.

Uniti Group (UWL, +24.4%) had another strong month featuring a solid FY21 result in August combined with an FY21 exit run rate EBITDA, ahead of market consensus expectations. At their result, UWL reported that its recently acquired OptiComm asset was outperforming market expectations due to strong growth in active users combined with demand for higher speed tiers increasing Average Revenue Per User (ARPU), revenue run rate and margins. Furthermore, the contracted pipeline of new ports to be constructed, which will drive future growth, also expanded materially. To recap, the expanded OptiComm business which UWL acquired in late 2020 is the most significant fibre distribution asset outside of the NBN. These are monopolistic telco assets with low customer churn and growing ARPU (due to increasing demand for internet speed). We expect UWL will continue to expand its market share in 'last mile' fibre infrastructure through new exclusive greenfield deals with large developers given that Telstra is now enabled as a UWL reseller. The interest in the sector from investors also remains elevated given a number of recent transactions for telco infrastructure assets, such as the acquisition of a 49% interest in the Telstra mobile towers infrastructure business for 28x FY21 EV/EBITDA (after leases) in late June by a consortium of superannuation funds. Post the takeover of Vocus Group by private equity, the expanded UWL business, including the OptiComm acquisition, stands out as the most significant small cap fibre infrastructure business listed on the ASX.

Steadfast Group (SDF, +14.0%) was a strong contributor over the reporting period with the company announcing the acquisition of their largest network broker, Coverforce. The acquisition was funded by a well-supported institutional placement and scrip consideration (in the form of SDF shares) issued to the vendors. The immediate earnings accretion and potential for future synergies saw the placement keenly sort after by new and existing holders and the SDF share price has continued to rally following the placement as investors built on their positions. The result itself contained no significant surprises with all key metrics continuing to point in the right direction, demonstrating a quality business in a supportive operating environment, despite the universal challenges created by COVID-19. We maintained our long-term holding in SDF through the transaction and stock issuance, encouraged by the steady performance of the business and the potential for further value adding acquisitions.

Global multi-boutique asset management business **Pacific Current Group (PAC, +9.1%)** rallied strongly in August buoyed by robust market conditions and a solid FY21 earnings result. PAC has investments in 15 boutique asset management businesses spanning a range of geographies and asset classes including equities, credit, infrastructure, private equity and real assets. The total funds under management controlled by asset managers within the Pacific Current group increased +15.4% in the quarter ended 30 June 2021 and the company has flagger further solid in-flows in the coming financial year from a diverse range of existing products.

The star manager in the PAC stable is GQG Partners ("GQG"), in which PAC holds a small 5% equity interest. GQG is a global asset manager founded and led by renowned portfolio manager Rajiv Jain. Since its foundation in 2016, GQG has enjoyed spectacular growth in funds under management as well as exceptional investment performance and the company now manages approximately US$85b across global equities, US equities, international equities and emerging market equities. The PAC share price rallied again in early September on reports that GQG is planning to undertake an Initial Public Offering (IPO) on the ASX in the December quarter. OC Funds is engaged in a non-deal roadshow process for the proposed listing of GQG and has met with the management team this week. We are therefore bound by confidentiality around the non-public details of the proposed IPO. Suffice to say, GQG is one of the fastest, if not the fastest growing fund managers of global scale and is a world-class funds management business. Whilst PAC holds only a small minority stake in GQG, the proposed listing is an exciting development for PAC shareholders. It will offer much greater transparency into the valuation of this affiliate investment which is continuing to see phenomenal growth in its funds under management.

Bapcor Limited (BAP, -9.8%) was sold down by the market in August despite announcing a full-year result that exceeded both company and consensus earnings forecasts. BAP managed to navigate COVID-19 lockdowns and supply chain challenges to record revenue growth of +20% which delivered pro forma EBIT growth of +39% and NPAT growth of +47% due to the strong operating leverage in the business. The recent rolling lockdowns have impacted near-term trading in the trade and retail businesses in NSW and Victoria, which were called out as trading up to 30% lower than the same time last year. Consequently, BAP provided somewhat underwhelming guidance for FY22 of underlying earnings "at least at the level of FY21", which is obviously dependent on the longevity of lockdowns and other government-imposed restrictions. It is now expected that H1 FY22 earnings for BAP will print below H1 FY21 which came as a disappointment to the market, despite being caused by temporary factors. OC Funds had reduced our position in BAP into the earnings announcement and we have retained our remaining holding post the result. BAP is a resilient business that is very well managed, and we expect trading conditions to bounce back strongly and sentiment towards the stock to improve once the COVID-19 restrictions ease.

Mineral Resources (MIN, -10.1%) took a breather during the month after the FY21 result fell short of consensus expectations and the iron ore price retreated from stratospheric recent highs. During the month of August, the spot price of 62% grade iron ore retreated around 25% as the COVID-19 Delta variant impacted the Chinese economy and as the Chinese Central Government took measures to rein in steel output and rumours swirled around potential production curbs later in the year to reduce air pollution ahead of the Winter Olympics in February 2022. In FY21, MIN reported a record $1.9b underlying EBITDA which was around 5% less than consensus expectations, although still up +148% year-on-year. On the day of the result, the market seemed to rightly look through the earnings miss and instead focussed on incremental details of the transformational opportunities that the company has flagged in both iron ore and lithium. We expect MIN is pregnant with significant news flow over the coming few months which has the potential to transform the company into a much larger, lower cost iron-ore producer and a world-class producer of lithium hydroxide along with its joint venture partners Albemarle Corporation and Ganfeng Lithium. MIN remains a core portfolio holding in the Fund and we expect that the stock will weather the near term challenges of a lower iron ore price as further details of potentially transformational expansion projects are released to the market.

Outlook

The August reporting season was broadly positive in domestic equities with investors looking through lockdowns in NSW and Victoria to instead focus on optimism around the likely reopening of our two largest state economies once vaccine targets are met (expected to be 70% to 80% vaccination rates), which is currently projected to occur in October and November respectively. Earnings per share (EPS) across the ASX 200 grew an impressive +28% in FY21, although an elevated number (~45%) of companies still missed consensus expectations, which is well above historical averages. Few companies were bold enough to offer earnings guidance for FY22 with most pointing to uncertainty around lockdowns and government-imposed restrictions for their reluctance to forecast for the year ahead.

The OC Investment team has met with more than 100 companies over the past month and there are some key themes that consistently emerged from our discussions. These included:

- Supply Chain Issues – delays, shortages and rising costs in the supply chain of companies, predominately caused by COVID-19, were called out by many industrial and mining business and are expected to persist well into the new calendar year.
- Inventory Build – industrial businesses called out inventory shortages brought about by supply chain issues and forward planning retailers have consequently built inventory well ahead of the usual seasonal Christmas peak.
- Labour Shortages – despite millions of workers being sidelined due to COVID-19, labour shortages were widely cited as an issue. This was particularly so in the WA mining and mining services sectors due to border restrictions slashing the pool of skilled labour, and also in industries that are reliant on foreign workers such as horticulture, childcare and panel repair.
- Inflationary Pressures – partially a corollary of the above three issues, inflationary pressures in the form of rising freight costs, raw material inputs, electrical components, food and labour costs were often called out by management.

Whilst the above challenges would ordinarily be taken in a dim light by investors if they were long-term or structural issue, they have largely been brought about by the challenges of operating within the confines of COVID-19 induced restrictions. As such, the market has rightly viewed most of them as being transitory in nature and they ought to begin to unwind once vaccination levels grow and the world gets back to some level of normality. It is less clear whether inflationary pressures will totally subside, but bond markets and policy settings of our central bankers are currently reflecting the view that these pressures too will prove to be largely temporary in nature.

No doubt quantitative easing programs from central banks have been a crucial factor in providing invaluable liquidity to markets and keeping interest rates low at a time of great upheaval in the global economy. Indeed, the US Federal Reserve's willingness to do 'whatever it takes' to support markets through the COVID-19 crisis has been credited with helping to save the global economy from plumbing a very dark abyss. It should therefore be no surprise that the market had become somewhat apprehensive about a potential premature withdrawal of support by the US Federal Reserve ("the Fed") given the ongoing pain inflicted by the COVID-19 Delta variant, notwithstanding the strengthening employment and economic backdrop in the US which has continued to defy the health statistics.

It was therefore a cause of great relief for markets when the Fed Chairman Jerome Powell decoupled the discussion around reducing bond purchases ("tapering") and that of interest rate hikes at the widely anticipated virtual speech that he delivered at the Kansas City Fed's annual Jackson Hole Symposium. The US economy has now made "substantial further progress" toward the Fed's inflation objective that its governors said would be a pre-condition of tapering bond purchases and the labour market had also made "clear progress". Governor Powell has indicated that if "the economy evolved broadly as anticipated", the Fed would likely start tapering bond purchases later this year. But in an important call-out, he said that this move would not necessarily result in higher interest rates in the near term. Markets had been concerned that a sudden withdrawal of liquidity through tapering, when combined with rate hikes, would not only derail the economic recovery and hit company earnings at a time when the COVID-19 Delta variant still loomed large, but could also undermine what has been an important underpinning of asset price expansion in recent years, namely record low interest rates.

Our own RBA Governor Philip Lowe echoed the positive sentiment of the Fed at the RBA board meeting last week whilst also confirming it would taper, reducing the pace of weekly bond purchases from $5b to $4b "until at least February 2022". With June quarter GDP printing at a relatively healthy +0.7% earlier in September, it now seems likely that Australia will be spared a double dip recession reinforcing the incredible resilience of our domestic economy. Whilst GDP is expected to materially decline in the September quarter (economists predict the economy could contract up to 4%) and the unemployment rate is forecast to track higher in the coming months, the latest downturn is expected to be only temporary. As vaccination rates increase towards key state set thresholds (70-80%) and restrictions are eased, the Australian economy is once again expected to bounce back with the RBA expecting that the economy will "again be growing in the December quarter".

Whilst the pathway out of COVID-19 Delta variant lockdowns and health consequences of an economic reopening when infection rates are still high are still somewhat unclear, the domestic economy is likely to enter the new calendar year with renewed momentum. The RBA has reaffirmed its important commitment to maintain interest rates at its 0.1% target to 2024, in effect extending the accommodative financial conditions that have been so supportive of equity markets since April 2020. Whilst there are some notable challenges for listed companies, including those talked about earlier in the outlook, we remain upbeat overall about the prospects of companies in our portfolio and have recently increased our exposure to some more cyclical businesses.

Post our reporting season management catch ups, we have an extensive company visitation program planned in the coming weeks to catch up with companies who have piqued our interest over the last few weeks. The corporate pipeline is again building, and we are already in early-stage due diligence on several IPO candidates that may list in the back end of CY21. We thank our investors for their ongoing support and remain committed to our goal of generating strong long-term risk-adjusted returns for our clients.

Top 5 holdings#

Company	ASX code
Eagers Automotive	APE
Mineral Resources	MIN
Pinnacle Investment	PNI
Sealink Travel Grp	SLK
Uniti Group Ltd	UWL

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 hard-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 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.