OC Dynamic Equity Fund

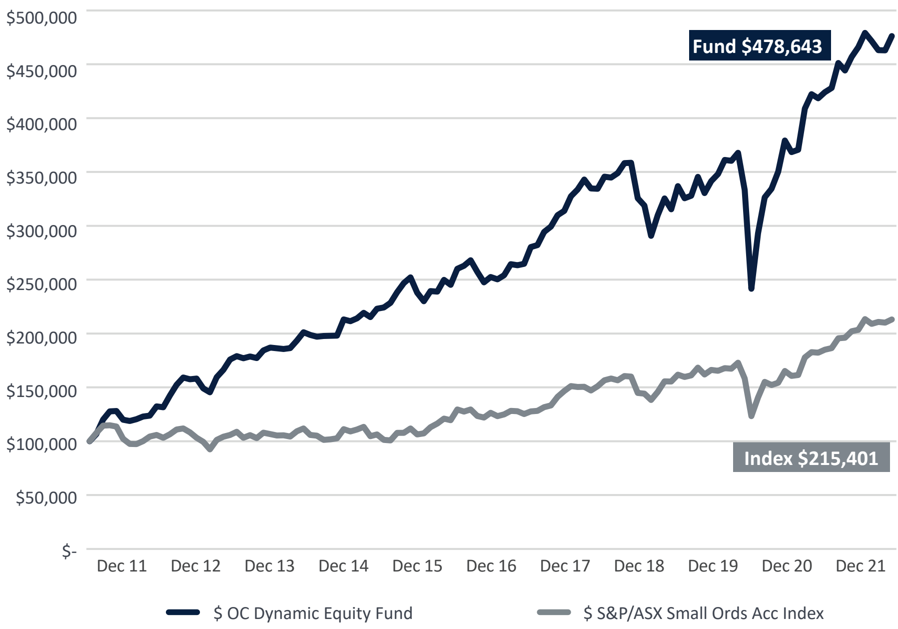
Fund Update | 31 December 2021

1.0% Fund up 1.0% for the quarter

17.0% Returned 17.0% 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 December 2021[†]	1 mth %	3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	10 yrs % p.a.	Incep. % p.a. (Dec 2000)
OC Dynamic	2.9	1.0	12.8	17.9	13.6	17.0	12.8
S&P/ASX Small Ords Accum	1.4	2.0	16.9	15.7	11.2	8.0	6.9
Outperformance	**1.5**	**-1.0**	**-4.1**	**2.2**	**2.4**	**9.0**	**5.9**
S&P/ASX Small Ind Accum	0.8	-1.2	13.7	14.4	10.2	11.5	7.1
Outperformance	**2.1**	**2.2**	**-0.9**	**3.5**	**3.4**	**5.5**	**5.7**

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

Performance review

The domestic small cap market continued to track higher in December, brushing aside the rapid spread of the highly infectious Omicron COVID-19 variant across the globe and a hawkish pivot by key central banks, including the US Federal Reserve, to round out the quarter on a positive note. Resource stocks again did the heavy lifting in December rounding out a strong quarter in which the S&P/ASX Small Resources Accumulation Index was up 14.2% which was well ahead of the S&P/ASX Small industrials Accumulation Index (-1.2%) as the lithium price continued to surge and gold tracked higher for quarter. The broader S&P/ASX Small Ordinaries Accumulation Index rounded out the December quarter up 2.0%. The strength in single commodity/single mine resource stocks which the OC Dynamic Equity Fund typically avoids as core positions presented a material headwind for the Fund versus the small ordinaries index during the quarter, although it still finished the quarter in the black, up 1.0%

Australian Clinical Labs (ACL, +37.2%) was again a standout performer over the quarter on the back of positive news flow including two further material earnings upgrades, a strategically sensible acquisition and record COVID-19 testing volumes. ACL is now forecasting H1 FY22 NPAT of between $116.3m and 128.0m which is a staggering 533.4% above its Prospectus forecast of $22.9m at the mid-point. The upgrade reflects not only the strong ongoing demand for COVID-19 testing but also a continuation in the expansion of margins seen in FY21, reflecting excellent cost control, scale and operating leverage. In mid-November, ACL announced it had entered into a binding agreement to acquire Medlab Pathology, the fifth largest private pathology provider in Australia, for total consideration of $70m ($60m upfront; $5m on completion in CY22; $5m subject to non-Covid revenue retention hurdles). The acquisition appears to be well priced (3.9x FY21 normalised EBITDA (pre-AASB 16)) and a solid strategic fit for ACL given that it will materially boost ACL's presence in NSW and QLD where ACL was underweight relative to its national market share. ACL expects to realise synergies of at least $10m over a 18-24 month period and the transaction will be funded by cash on hand and existing debt facilities.

In a further positive development, large private equity shareholder Crescent Capital (Crescent) (34.7%) undertook not to sell any shares on market before H2 CY22 at the earliest, despite its pending partial escrow release next month. This is significant as it removed a perceived stock overhang which had been weighing on the ACL share price. Like OC Funds, Crescent believes that COVID-19 testing is now a permanent fixture in our lives meaning that pathology providers such as ACL will remain critical in providing testing services for years to come. Additionally, Crescent believes that pathology volumes will remain elevated for some time, regardless of COVID-19 testing, as there remains a considerable level of undiagnosed medical conditions which will require clinical testing services following nearly two years of COVID-19.

Over the past week the requirement for PCR testing has been moderated by changing government requirements around travel and close contacts with lateral flow rapid antigen testing (RAT) now a government sanctioned alternative in certain circumstances. Despite the well documented short- comings of RAT, it was a necessary step to alleviate the enormous pressure on the pathology industry with wait times for testing and results having blown out to unacceptable levels under the sheer volumes of people seeking PCR testing. As Omicron cases inevitably moderate, ACL's PCR testing volumes too will moderate. But with COVID-19 testing likely a fixture in our lives for years to come and with pent up demand for regular pathology testing for elective surgeries and other illnesses that have declined during COVID-19 related lockdowns likely to provide some offset, we remain comfortable holders of ACL.

Telix Pharmaceuticals (TLX, +28.5%) was once again a strong contributor for the Fund during the quarter on the back of further key milestones being achieved, especially around its prostate cancer imaging product Illuccix. As a reminder, Telix is a late-stage bio-technology company specialising in cancer imaging and treatment via molecular targeted radiation (MTR). MTR is on the cusp of revolutionising treatment of certain cancers, thereby avoiding the deleterious effect of chemotherapy and radiation therapy on healthy tissue surrounding certain tumours. Late in the quarter TLX announced that it had received US FDA approval for its lead prostate cancer imaging product, Illuccix which was approved for both Primary Staging and Biochemical Recurrence. This is a significant milestone for TLX, validating one of the cornerstones of its companion diagnostic and therapy approach to using MTR for prostate cancer. TLX recently updated its Illuccix USA total addressable market (TAM) estimate to US$725M (from US$575M) and has aspirations to capture 40% of that within three years from commercial launch. Illuccix US approval ought to move TLX out of the "concept stock" basket into significant profitability with a well thought out manufacturing and distribution platform that will enable the speedy commercialisation of the product. Illuccix looks set to win significant market share due to the accessibility of its radioisotope Gallium-68 and the ease of use and accuracy of its imaging product versus key competitor Lantheus (Pylarify) who may be constrained by the limited availability of cyclotrons. Illuccix was also approved by Australia's TGA in early November and is progressing marketing authorisation applications in 14 European countries, plus Canada and other jurisdictions.

TLX has a robust pipeline of additional material opportunities in the growing field of radiopharmaceuticals which is attracting far greater attention from investors and regulators. In particular, TLX-591 is currently being developed as a second-line therapy used for patients with PSMA-expressing metastatic castration resistant prostate cancer (mCRPC). TLX591 represents TLX's largest opportunity with a A$5.2b TAM. TLX's pipeline also includes opportunities in renal imaging product (TLX-250) with a TAM (A$627m) due for launch in 1H23 as well as glioblastoma (TLX-101) and hematolgic oncology (TLX-66). Given the depth of the R&D pipeline and the cost of clinical trials, we would expect TLX to raise additional capital in the near term to fund these opportunities. Few pre-commercial biotech companies have been able to assemble such a collection of partners that should underpin clinical development (Genesis Care), manufacturing (GRAM) and distribution (Cardinal, Pharmalogic) across most of their products. These partners not only serve to put the commercial infrastructure in place to facilitate a rapid and global launch of their products but also helps add credibility to TLX as a highly attractive entrant into the growing radiopharmaceuticals space.

Mineral Resources (MIN, +25.0%) bounced back strongly in the December quarter following a challenging start to FY22 when the stock was sold off on the back of a steep fall in the iron ore price. Regular readers will be familiar with our bullish investment thesis on the company which centres around material expansion opportunities which could result in a step-change in earnings for each of the iron ore, lithium and mining services divisions, as well as a significant opportunity to commercialise a sizable recent natural gas discovery in the Perth basin.

Positive news flow from MIN during the December quarter included the long awaited capital expenditure and operating expenditure metrics around its Ashburton iron ore development project, as well a status update on its South West Creek project. When commercialised, we expect Ashburton to be MIN's largest and most profitable mining services contract, with annual revenues of around $850m over the life-of-mine. Later in November, MIN also announced that it had entered into an agreement with Hancock Prospecting Pty Ltd and Roy Hill Holdings Pty Limited (together 'Hancock') to jointly develop and operate a new iron ore export facility at the Port Headland's Stanley Point Berth 3 in South West Creek. Under the agreement, MIN and Hancock will form a JV to seek to obtain necessary approvals and agreement with the Pilbara Ports Authority and (subject to approval) develop and operate the iron ore export facility at Port Headland's Stanley Point Berth 3. MIN has stated that it intends to develop the South West Creek hub to export 30Mtpa of iron ore.

During the quarter MIN also provided an update on downstream processing opportunities in its lithium operations where we expect it to move up the value chain and eventually convert all of its significant spodumene production into high value lithium hydroxide. The lithium market has been very strong for some time now with shortages in the critical battery metal driving significant uplifts in the price of both spodumene and lithium hydroxide as well as the share prices of listed companies that have exposure to the commodity. Despite its solid bounce during the quarter, we continue to believe MIN's lithium strategy is vastly under-appreciated by the market and could, by itself, underpin the current share price once the necessary regulatory and environmental approvals are in place and once the market better understands the finer details of its MARBL JV with global lithium major Albemarle. We believe MIN remains catalyst rich in the coming months, with strong medium-term upside as the market gains a greater appreciation the company's expansion opportunities.

PEXA Group (PXA, +20.8%) Australia's property settlement exchange platform enjoyed a solid quarter following a somewhat lacklustre debut the previous quarter after an accelerated IPO process which trumped a bid from private equity giant KKR at the eleventh hour. PXA provided a positive update at its AGM in November which showed that billable transactions were 1.36 million, up 40% year on year, putting the company well on track to meet or exceed its Prospectus forecasts. In a further development domestically, delays to interoperability of exchanges (which will introduce a level of competition to PXA) seems increasingly possible with the first test transaction set to take place in September 2022. It remains to be seen whether the CY23 go-live date for full interoperability is realistic with some members of the working group maintaining that CY24 is a more feasible timeframe.

While PXA's business continues to advance toward maturity in Australia, its UK start-up business is also showing encouraging signs with significant interest from local industry participants and positive engagement with local regulators and government bodies. As the UK investment case has become more broadly accepted and understood by the market, with expanded broker coverage and further industry calls with UK experts, PXA stock has seen incremental buying from institutional investors. In addition, PXA's 43% owner, Link Administration Holdings (LNK, +13.8%), received a takeover offer in December from strategic suitor Dye & Durham who was also a bidder for the entire PXA business in the dual track process prior to the IPO. Dye & Durham is a leading global provider of cloud-based software and technology solutions and has strong technical skills and a highly complementary client base to PXA across law firms, financial services institutions and government organisations. Close collaboration with Dye & Durham could help accelerate PXA's entry and adoption in new markets including the UK, and also enhance PXA's ancillary revenue streams including in the Pexa Insights and PX Ventures verticals where Dye & Durham's data and insights could provide significant value add when combined with PXA's own proprietary data.

PDF productivity and digital signature company **Nitro Software (NTO, -31.6%)** was sold off aggressively by the market in the second half of the December quarter. On 10th November, NTO undertook a significant capital raising to fund the €70m acquisition of European e-signing business, Connective. The Connective business has market leading e-signing and electronic identification technology with 1000 customers across 12 European countries where stricter regulatory requirements require identity checks to be performed for e-signing. These capabilities will accelerate NTO's expansion into high-trust enterprise grade e-signing applications and the deal was well supported by shareholders with the company's share price rallying immediately following the deal, hitting an all-time high on 17th November. Several factors thereafter conspired to drive the NTO stock price significantly lower over the balance of the quarter. Technology stocks were sold off heavily across the board as the spectre of inflation raised the likelihood of interest rate rises which saw long-duration risk assets such as technology shares begin to sell-off. This sell-off coincided with the retail rights offer component of the Connective acquisition raising and led to a shortfall of 59% for underwriters which subsequently put pressure on the stock over the balance of the quarter as underwriters sold down NTO stock to de-risk their position. Lastly, US peer **Docusign Inc (DOCU Nasdaq, -40.8%)** issued weak fourth quarter earnings guidance in early December citing an "eventual step down from peak levels of growth achieved during the high of the pandemic". The growth rate in Q4 for DOCU is expected to be around ~30% whereas for the past six quarters it had been growing +40%. Whilst softer industry commentary from DOCU has some read through for NTO, it is important to note that DOCU's revenue model is mainly geared to e-signature volumes, whereas NTO's revenue model is mainly driven by time-based subscriptions.

As long-term investors, we don't let short term price moves spook us and remain comfortable with the growth strategy for NTO over our forecast period. Whilst we have prudently trimmed our holdings in technology names in recent months given rising bond yields, we believe that the NTO business has strong secular tailwinds of document digitalisation underpinning it with penetration rates of e-signatures and PDF documents likely to continue to grow off a relatively low base for many years to come, even as the global economy emerges from COVID-19 restrictions.

Outlook

Equity markets closed out calendar year 2021 on a strong note with a late December 'Santa Rally' capping another strong year. It was a year in which markets shrugged off new COVID variants, protracted lockdowns, supply chain disruptions and rising inflation with investor risk appetite fuelled by government stimulus, vaccines rollouts and record low interest rates. The global economy and our own domestic economy look to be well positioned as we enter the new calendar year with economic growth forecasts above trend, unemployment tracking lower in most countries, household savings rates elevated and corporate earnings in good shape, despite the widespread disruptions currently being cause by the highly infectious Omicron COVID-19 variant. Notwithstanding this, the outlook for the market is somewhat clouded by the trajectory of inflation which looks to be more entrenched than our central bankers have previously acknowledged, and interest rates hikes in the coming months have the potential to take some of the gloss off an otherwise rosy economic outlook.

Inflationary concerns have been front of mind for almost all market participants in CY21, OC Funds included, with the escalation in long bond yields potentially seen as a harbinger of an overheating global economy which may eventually require central bank intervention in the form of near-term interest rate rises to quell the threat of inflation. The US CPI rose at 6.8% in November, the fastest annual pace in almost 40 years and significantly above consensus expectations. In Australia, underlying inflation is now at 2.1% and likely heading higher. Both the Reserve Bank of Australia (RBA) and the US Federal Reserve (the Fed) have recently admitted what now seems obvious; namely that inflationary pressures appear to be stubborn and will persist for longer than they originally anticipated. The emergence of the Omicron variant has further disrupted global supply chains and sidelined infected workers and whilst the economic impact of Omicron is likely to be temporary, cost pressures across the economy are unlikely to moderate any time soon. COVID-19 related disruption of the supply of goods and labour, matched with strong consumer demand, has sent prices of a wide range of goods and services soaring forcing central banks to become more hawkish around monetary policy.

In a significant policy pivot, the US Fed has now moved to get ahead of the inflation narrative and announced that it will likely dial back its bond purchases in the coming months and it put markets on notice that US rates could rise before the economy reaches full employment. Minutes from the Fed's mid-December meeting, released in early January, indicated that officials are increasingly worried about inflation against a backdrop of a strong economy, noting that the jobs market is now approaching full employment. "While participants generally continued to anticipate that inflation would decline significantly over the course of 2022 as supply constraints eased, almost all stated that they had revised up their forecasts of inflation for 2022 notably, and many did so for 2023 as well," the minutes said. Fed officials were unanimous in expecting they would need to begin raising rates this year, according to anonymous projections published after the meeting. That marked a significant hawkish shift from the previous round of forecasts in September, which had shown the FOMC at the time was evenly divided on the question rate rises.

It is now the consensus view in the market that the Fed will begin to raise rates as soon as March this year and the Fed's so-called dot plot, which the US central bank uses to signal its outlook for the path of interest rates, shows officials expect to raise the Fed funds rate three times this year and a further three times in 2023, based on median projections. While officials did not make any determination about when the Fed will start rolling off the nearly $8.3 trillion in Treasuries and mortgage-backed securities it is holding, some officials thought the Fed should start shrinking its balance sheet relatively soon after beginning to raise rates, the minutes said. Clearly this is another means by which the Fed can tighten financial conditions to cool the US economy.

Our own RBA seems behind the curve on interest rates and inflation. Domestic money markets (Interbank futures) are now pricing in the first interest rate hike in Australia July 2022, a stance which Governor Dr Philip Lowe has dismissed as an overreaction. The RBA has continued to rebuff suggestions of a likely surge in inflation over the coming months, singling out Australia's unique circumstances and noting that the "starting point for inflation and wages growth are lower in Australia than they are in many other countries", several of whom have moved rates higher in the past month. The minutes from the RBA's December board meeting added to the case for a "hard stop" to its $4bn-a-week bond-buying program, particularly after November's blockbuster employment figure, and indicated that board members would base their February decision on intervening labour and inflation data. "The risk to the recovery posed by the Omicron variant would also be more apparent by that time," the minutes read. Rates aside, the domestic economy looks solid heading into 2022 having navigated several lockdown periods. We now have a very high vaccination rates and a strong labour market, household and corporate sector meaning we are positioned for above trend growth heading into CY22.

Notwithstanding a robust domestic economic outlook, there is still much uncertainty about the coming months including the impact of Omicron on the health care system and the economy, the trajectory of inflation and the pace of interest rate hikes, as well as the impact of the withdrawal of central bank stimulus programs. These variables are difficult to forecast, especially given there are no historical frames of reference to look to for clues as to how things will play out given the unprecedented nature of the pandemic and record stimulus programs that followed. It does, however, seems likely that the days of record low rates and ample central bank liquidity may be coming to an end barring further economic upheaval.

An additional unknown is the impact of exploding Omicron cases which are starting to hurt businesses in a non-lockdown period as industries including retail, logistics and hospitality are forced to shut down or wind back operations as their workers and customers fall sick or are forced to isolate. This is adding to pressure on supply chains, already stretched from the pandemic, limiting the supply of goods and food with Coles and Woolworths already warning of shortages and rationing across some products. History suggests this variant will pass and the economy will rebound but how the pandemic will play out over the balance of the year is largely unknown.

Against this backdrop, the Fund has prudently increased its cash holdings heading into the new calendar year by further reducing our exposure to high growth stocks which will likely come under pressure if interest rates rise abruptly. To be clear, we are not bearish but do feel that some caution is warranted until the central banks gets a better handle on inflation. The economic outlook is still robust and whilst the central banks are shifting gears and tapering quantitative easing, the economy can certainly handle the cash rate rising off 0.1%. By way of example, the 10-year Treasury Yield in Australia is still just 1.85% despite the emerging inflationary pressures and even if rates were to rise seven times in this tightening cycle, the cash rate would still be below 2% which is historically still very low. Assuming the economy continues to recover, and corporate earnings remain robust, equities are likely to remain an attractive asset class to invest in relative to most alternatives in such an environment. As always, the portfolio remains liquid so we can rapidly reposition if the economic environment or market conditions necessitate such a move.

Mercifully, market activity and corporate deal making has slowed after the frenetic pace of the last quarter with many market participants taking summer holidays. We wish all our readers good health and prosperity as we enter calendar year 2022 and we thank you all for your ongoing support of OC Funds Management.

Top 5 holdings#

Company	ASX code
Aust. Clinical Labs	ACL
Mineral Resources	MIN
Steadfast Group Ltd	SDF
Seven Group Holdings	SVW
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.
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