FUNDS MANAGEMENT

OC Premium Small Companies Fund

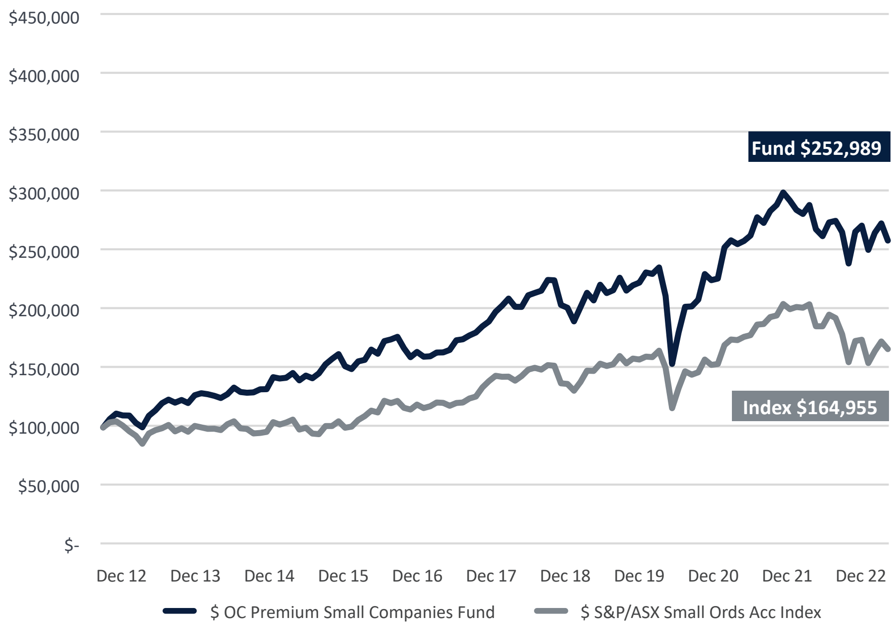
Fund Update | 31 December 2022

3.1% Fund up 3.1% for the quarter

9.8% Returned 9.8% 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 Dec 2022 †	1 mth %	3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	10 yrs % p.a.	Incep % . p.a. (Dec 2000)
OC Premium	-5.3	3.1	-10.3	3.9	5.4	9.8	10.2
S&P/ASX Small Ords Accum	-3.7	7.5	-18.4	1.4	2.9	5.1	5.5
Outperformance	**-1.6**	**-4.4**	**8.1**	**2.5**	**2.5**	**4.6**	**4.7**
S&P/ASX Small Ind Accum	-3.4	6.6	-21.8	-2.0	1.9	6.6	5.5
Outperformance	**-1.9**	**-3.5**	**11.4**	**5.9**	**3.5**	**3.2**	**4.7**

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

Performance review

Equity markets across the globe endured a challenging December rounding out a tough year for most asset classes across the globe. Stocks, bonds and property all suffered material falls in 2022 as the era of cheap money came to an abrupt halt with central banks ratchetting up interest rates in response to rampant inflation and reversing accommodative policies that had underpinned asset price strength in recent years. Stock markets across the globe fell steeply with several key bourses finishing at or near bear market territory including the US Nasdaq Composite (-33.1%), the US S&P 500 (-19.4%), China's blue chip CSI Index (-21.6%), and the MSCI All-Country World Index (-19.8%).

Despite underperforming the small-cap indices in the December quarter, the OC Premium Small Companies Fund posted a credible return of -10.3% for the calendar year in challenging market conditions. Whilst we never like posting negative absolute returns for our investors, the Fund significantly outperformed the S&P/ASX Small Industrials Accumulation Index (-21.8%) and the broader S&P/ASX Small Ordinaries Accumulation Index (-18.4%) which both fell sharply over the year. The Fund's outperformance has come despite the strong relative performance of single commodity/single mine resource stocks, in particular coal miners and unprofitable lithium stocks, which are typically screened out of our process due to their elevated risk profiles and poor ESG credentials. In 2022, the top six performers in the small-cap Index (by contribution) were all single commodity resource stocks, namely coal mining trio New Hope Corporation, Whitehaven Coal and Coronado Global Resources, Canadian iron ore miner Champion Iron, African gold miner Perseus Mining and domestic oil and gas exploration and production company Beach Energy.

We remain conservatively positioned from a Fund perspective entering the new calendar year (+10% cash) as we expect the global economy to slow considerably as interest rate hikes start to bite. That said, we have been selectively adding some quality stocks to the portfolio at compelling entry points and expect the current market volatility to present us with the opportunity to buy some quality businesses in the coming months that will help underwrite our performance in the years to come.

Telix Pharmaceuticals (TLX, +53.7%) re-rated materially during the quarter after announcing a series of positive commercial, regulatory and trial/study related milestones. These included:

- Positive Phase III ZIRCON study results for TLX's renal imaging agent (TLX250-CDx) with the trial meeting both primary and key secondary endpoints. This opens up a total addressable market (TAM) of +US$500m annually with no competing product currently approved in the space and with the company expected to move towards FDA approval in late CY23 and commercial launch in H2 CY24;
- Second quarter of commercial sales for Illuccix, TLX's PET imaging agent, surprising on the upside in the critical US market. TLX reported Illuccix sales in the US of US$36.4m in Q3 CY22 versus US$13.6m in Q2 CY22, which was around 10% ahead of consensus expectations;
- Regulatory approval for Illuccix in the Canadian market for prostate cancer imaging, the first PET imaging agent to be granted regulatory approval in that market; and
- The approval by the Chinese regulator of an application to commence a pivotal phase 3 study for Illuccix in China for the imaging of recurrent prostate cancer.

TLX significantly reduced its cash burn during the third quarter with quarterly net operating cash outflows of A$5.3m, a material improvement on A$25.8m in the previous quarter and the company now looks to be controlling costs well. Importantly, we now expect TLX to be EBITDA positive in FY23 and profitable in FY24. Following a capital raising of $175m in January 2022, TLX remains well funded to execute on its robust pipeline of additional material opportunities in the growing field of radiopharmaceuticals which is attracting far greater attention from investors and regulators.

Kelsian Group (KLS, +19.0%), a multinational bus and ferry service operator, rebounded solidly during the quarter, aided by a series of positive announcements. Firstly, KLS announced the acquisition of Horizons West Bus and Coachlines. The acquisition complements KLS's existing Perth operations and expands its business in the region from a substantially public transport operation to now including education and corporate services. Shareholders didn't have to wait long before more good news hit the wires with the company announcing two new, long duration, maritime contracts to operate ferry and barge services from Gladstone to Curtis Island for major LNG producers. Then to top off the trifecta, in late December, Transport for NSW announced that KLS' subsidiary Transit Systems had been awarded the contract to run bus services in southwestern Sydney. While KLS has operated the services in so-called 'Region 3' since 2013, the new expanded contract also includes additional services previously known as 'Region 13'. The expansion and retention of this contract until 2030 helps to restore faith in the robust long-term outlook of the bus division, after a number of tenders were unsuccessful earlier in the year. We remain attracted to the resilience of the cashflows for the company which are underpinned by substantial contracts, often with government counterparties, over long durations. The contracts generally have mechanisms for the pass through of fuel and wage inflation and, for the most part, do not carry significant farebox risk. This means KLS is paid the same amount regardless of the number of passengers with the risk of passengers not catching the bus generally worn by the Government. 2023 will bring further tender opportunities in Sydney, Singapore, Auckland and Manchester to name a few. While KLS is unlikely to win all of them, they provide optionality in addition to the growth from recent acquisitions and vertical expansions which should provide additional earnings and synergy benefits.

Mineral Resources Limited (MIN, +17.4%) was once again a standout performer for the Fund during the quarter, as the market continued to re-rate the business as the quality of its lithium assets became more broadly recognised. In early October, the company held a site tour of its WA based hard-rock lithium assets which was well attended by both sell-side analysts and domestic and global fund managers alike. We have long viewed MIN's tier-one lithium assets as being under-valued. These assets include: a) Wodgina Mine (40% ownership with global specialty chemicals company, Albemarle); b) Mt Marion Mine (50% ownership with Chinese lithium producer, Ganfeng); and c) Kemerton lithium hydroxide converter (40% ownership with Albemarle). MIN is continuing its negotiations with Albemarle to restructure the ownership of Wodgina (MIN increase ownership to 50%) and Kemerton (MIN decrease ownership to 15%) for nil cash payment in a deal that could be a precursor to a US listing of the MIN lithium business, although we note that the Managing Director, Chris Ellerson, has played down this possibility in the past month.

Notwithstanding the impressive performance from MIN in CY22 (up 39.6%), we remain bullish on the company's prospects into CY23. We are particularly excited about material expansion opportunities which could result in a step-change in earnings for each of the iron ore, lithium and mining services divisions in the coming years, as well as a significant opportunity to commercialise a sizable recent natural gas discovery at the Lockyer Deep

1 onshore gas project in the Perth basin. On the latter, MIN has recently launched a takeover bid for its Joint Venture (JV) partner Norwest Energy (NWE) which, if successful, will give MIN full control and marketing rights at the JV's Perth Basin assets. MIN is extremely bullish on the prospects of its relatively nascent natural gas business and plans to drill two Lockyer Deep exploration/appraisal wells in FY23, and two other exploration wells in other acreage in FY23. Lockyer Deep and Red Gulley are both planned to be brought into production in FY24. The company sees natural gas as a critical pathway to underpin its transition to greener energy sources and management is particularly excited about the prospects of its quality Perth basin assets where the company has the broadest exploration acreage of any listed player. More specifically, management are hopeful that the Perth basin assets will ultimately cornerstone a fourth highly profitable gas division for the company in the coming years. Whilst we believe MIN remains catalyst rich in the coming months, we have continued to prudently trim our holding during the quarter as the share price moved higher. This is to ensure that our weighting in the company continues to appropriately reflect the risk versus return characteristics of the investment.

APM Human Services International (APM, -29.6%) was a poor performer for the Fund during the quarter despite the positive news that the key domestic Disability Employment Services ('DES') program has been extended by the Australian government for two years and that it has gained market share on both its DES contract and its major Workforce Australia contract as a result of recent performance-based contract reallocations from the government. APM is a founder led Australian based international health and human services provider with strong environmental, social and governance (ESG) credentials. The company supports more than one million people of all ages and stages of life through its service offerings which includes vocational training and employment assistance, allied health and psychological intervention, medical, vocational rehabilitation and community-based support services.

APM's stock came under pressure in the December quarter after being a solid performer in the September quarter following a strong full year result in FY22. It seems that at least two institutional holders of APM shares lost mandates late in the quarter and their stock was sold on market at a time when liquidity was low. This downward pressure on the stock late in the quarter was further exacerbated by negative earnings revisions to FY23 forecasts by sell-side analysts on the back of: a) a higher assumed interest rate expense going forward due to recent movements in bank bill swap rates and the consequent impact on APM's floating rate debt; and b) a disrupted contribution in H1 FY23 from the Workforce Australia contract (APM recently lost four regions but gained 13 new regions in the contract reallocation) given that it takes about six months for new contracts to gain traction and generate significant revenue and outcome fees. The later point, as well as the recent DES contract reallocations where APM won share, ought to underpin a stronger second half for APM in FY23, as well as drive solid earnings growth for the company into FY24. Despite the share price fall, we remain attracted to the outlook for APM and have increased our weighting in the stock. In an environment of significant global uncertainty and cost pressures, APM offers quality contracted revenues with government bodies; moreover, demand for APM's services ought to prove to be largely uncorrelated with the broader business cycle. We expect APM to grow its EPS at more than 10% CAGR over the next three years and the stock is trading on an attractive PE multiple of around 10.5x FY24 and a 5.2% FY24 dividend yield. It remains a core portfolio position for the Fund.

Outlook

As we enter the new year, the critical question is undoubtedly how much the global economy will slow as a result of the interest rate increases that have been necessary to combat inflationary pressures and whether it will bring about a recession. Key central banks including the US Federal Reserve (the Fed), the European Central Bank (ECB) and our own Reserve Bank of Australia (RBA) have made it abundantly clear that the battle against inflation is not yet won and that there are more rate increases to come. To be clear, notwithstanding signs of weakening activity and moderating inflation, central bankers will continue to tighten monetary policy. The ability of the economy to absorb further rate hikes remains to be seen with the lagged impact of monetary policy meaning that the worst of the economic slowdown likely still lies ahead of us. The challenge, therefore, for the central banks as we enter 2023 is to return inflation to an acceptable level without breaking the economy and causing a hard landing.

Equity markets have held up well in the second half of CY22 given the macro-economic and geopolitical pressures, but with the economy likely to slow at an increasing rate, we expect company earnings for cyclically exposed businesses to come under increasing pressure in the months ahead. This will make our job as stock pickers a crucial one in CY23.

In the key US economy, the Consumer Price Index (CPI) printed at +7.1% in November, cooler than had been expected for the second consecutive month, although household staples such as shelter and food remained among the largest contributors to consumer price rises. Whilst it is off recent highs, inflation is nevertheless proving "stickier" than the Fed would have hoped suggesting that more rate pain lies ahead. In mid-December, the Fed hiked the benchmark federal funds rate to a range between 4.25% and 4.5%, a 15 year high. Fed Chair Jerome Powell said recent cooling of inflation was a "welcome reduction" but "it will take substantially more evidence to give confidence that inflation is on a sustained downward path".

The US economy has until recently remained resilient with the unemployment rate near record lows (3.7% in October), although signs of consumer softness and a moderation in housing activity suggest that economic activity is likely to cool rapidly and leading indicators such as consumer sentiment, mortgage demand and lending standards foreshadow that the US consumer is likely to weaken further in the near term. Fed officials now expect the federal funds rate to peak between 5.0% and 5.5% in calendar 2023, implying a further 75 basis points in rate rises from here. We remain of the opinion that it will be a difficult task for the Fed to orchestrate a soft landing for the US economy against a backdrop of rapid rate hikes, elevated and sticky core inflation and a slowing economy. The OC Funds portfolio consequently remains underweight US exposure heading into the new year.

On the domestic front, while the housing market has responded to swift monetary policy tightening, the broader economy and inflationary pressures are taking time to adjust. Notwithstanding a falling residential property market and deteriorating consumer confidence, the domestic economy, including the jobs market, remains on solid footing. In early December, the RBA increased the cash rate a further 25 basis points to 3.1%. Whilst the RBA remains more dovish compared to other central banks, there is an expectation that the current pace of rate hikes will continue until mid-2023, with expectations of the RBA cash rate peaking around 3.6%.

While forward indicators across certain sectors are suggesting inflation may be moderating, we are yet to be convinced that inflation can be tamed without impacting company earnings into CY23. Whilst the path to a soft-landing in Australia has narrowed, a near 50-year low unemployment rate of 3.4% and a healthy but falling household savings rate still leaves domestic consumers in a solid position even after allowing for near-term inflationary pressures, rising interest rate rises and a softening housing market. Australia still looks better positioned than many of its global peers to avoid a recession, although we expect that a material slow-down in the global economy is making the RBA's task incrementally more difficult.

Despite the economic challenges that lie ahead, which have been well documented in our recent monthly reviews and by central banks and the mainstream financial media, the sell-off across our core small-cap investment universe has been severe over the past 12 months. This has led to some attractive investment opportunities beginning to emerge, notwithstanding the economic outlook. We have begun selectively adding quality stocks such as Domino's Pizza Enterprises, Johns Lyng Group, Webjet Group and, most recently, Corporate Travel Management to the portfolio over the past quarter. Our overriding focus at present remains on investing in quality businesses at reasonable valuations that ought to have resilient earnings in a slowing economy.

As we enter the new year our preferred portfolio exposures include:

- companies that can grow their earnings outside of the economic cycle, including Johns Lyng Group and APM Human Services Limited;
- companies with pricing power that are well positioned to pass on cost pressures to their customers or outperform in an inflationary environment, including PEXA Group and Kelsian Group; and
- quality companies with solid long-term growth profiles or structural growth, that have been sold down to attractive entry points, such as Domino's Pizza Enterprises and Temple & Webster Group.

Following a busy year for the investment team, January typically provides some welcome respite as we enter the blackout period for companies with either June 30 or December 31 financial year ends. This effectively means that communication from companies to investors is limited to non-financial matters until the release of results in February.

We would like to thank our investors for their support through what has been a difficult year across equity markets and a challenging year for many people personally with the spate of natural disasters impacting the country, as well as ongoing COVID-19 related challenges. We wish all our investors and their families good health and good spirits as we enter the new year. As managers and investors in the Fund, we are upbeat on the prospects for the OC Funds portfolio heading into the new calendar year and we remain confident in our ability to achieve consistent strong long-term returns.

Top 5 holdings#

Company	ASX code
APM Human Services	APM
Eagers Automotive	APE
GQG Partners	GQG
Mineral Resources	MIN
Seven Group Holdings	SVW

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
Mani Papakonstantinos	Distribution Manager	0439 207 869 | epapakonstantinos@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
Greg Black	Distribution Manager	0407 063 433 | gblack@copiapartners.com.au

† The total return performance figures quoted are historical, calculated using cum-distribution end-of-month soft-close 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.