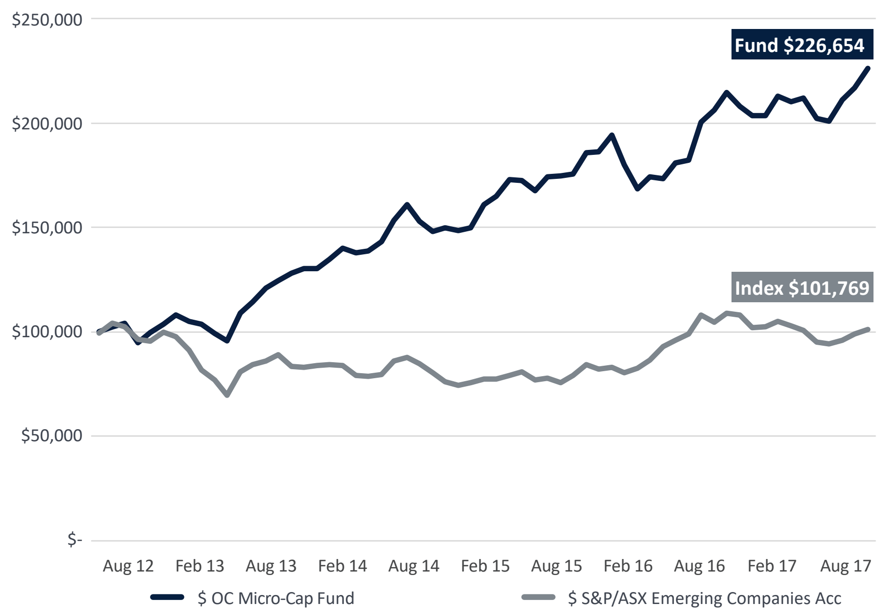
OC Micro-Cap Fund
Fund Update | 31 August 2017

4.2% Fund up 4.2% for the month of August

17.9% Returned 17.9% p.a. for the past five years

We remain confident the Fund is well placed to deliver strong long-term returns

Performance comparison of $100,000 over 5 years*



Total returns

At 31 August 2017	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. (Nov 2003)
OC Micro-Cap	4.2	12.7	9.6	12.1	17.9	13.1	10.4	13.4
S&P/ASX Emerging Comp. Accum	2.3	7.7	-3.5	5.0	0.4	0.1	-2.4	N/A
Outperformance	**1.9**	**5.0**	**13.1**	**7.1**	**17.5**	**12.9**	**12.7**	**N/A**

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.

Performance review

The month of August was dominated by stock-specific news which came as the majority of ASX-listed companies released their annual results and accompanying outlook statements. The OC Micro-Cap Fund had a strong August returning 4.2% in a month where most of our holdings released results in line with or ahead of market expectations. This was comfortably ahead of the S&P/ASX Emerging Companies Accumulation Index which was up 2.3% for the month.

The Fund maintains its strong long-term track record having returned 17.9% p.a. over the past five years. This is well ahead of the S&P/ASX Emerging Companies Index which is up just 0.4% p.a. over the same time horizon.

Pacific Current Group Limited (PAC, +15.4%), the fund manager which appeared on the negative side of our performance ledger for much of FY16 and H1 FY17 continued its renaissance which began with the much-needed simplification of its corporate structure (see our January 2017 monthly report), gathered momentum with its accelerating fund inflows (see our April 2017 monthly report) and the bolstering of its balance sheet in June 2017. Pleasingly, PAC continued its re-rating after reporting a full-year NPAT of $16.6m, which materially exceeded both our own and consensus market estimates for the stock. The key underpinnings of the strong result were significant cost reductions (with pro-forma annual expenses down from $29.8m to $18.6m), strong FUM growth or stabilisation in FUM for its core boutique managers and outstanding growth from new boutique manager GQG, which grew FUM to over US$6b from a standing start. Despite more than doubling its share price since bottoming in October 2016, PAC is well positioned to continue to outperform given the strong inflow momentum across several key boutiques, the solid balance sheet which positions it for M&A and the undemanding FY18 PE multiple of ~14 x on which it trades.

Kogan.com (KGN; +38.8%) was a stand-out performer amid the doom and gloom of the retail space with several highlights from its inaugural full-year result as a listed company. On the back of three earnings upgrades leading into the result, KGN again provided upside surprise for investors delivering EBITDA ahead of guidance, very strong EBITDA cash conversion of +80% and positive commentary around current trading conditions. We believe the much-vaunted arrival of Amazon in Australia could be a positive for a retailer such as KGN as it will provide an additional channel into which KGN can sell its private label offering. Furthermore, KGN has recently announced new lines of business including internet and insurance. These verticals will be high-margin businesses as Kogan will act more like an agent using existing distribution channels for the sale of these products ensuring a large proportion of sales will drop straight through to the bottom line (like in Kogan Mobile, where the gross margin is 100%). We expect further commentary from management in the near term to confirm the strong market position of KGN and have retained our position despite the recent strong share price performance (+100% since June 2017).

Imdex Limited (IMD; +23.3%) share price moved strongly during the month as it reported its full-year numbers and provided a bullish outlook on its short to medium-term prospects in key markets. IMD is a provider of drilling fluid products, downhole instrumentation and geo-analytic services to exploration, development and resources production companies and so is highly leveraged to any uptick in key commodity prices such as gold and/or base metals. We know and understand the IMD business well, having been a holder of the stock during previous cyclical upswings, and we remained in touch with management throughout the most recent cyclical lows to ensure we were well positioned to identify the early stages of the next cycle. We reinitiated our position in IMD at much lower share price levels over the last six to 12 months as evidence built around the strengthening business outlook. Given key leading indicators (such as IMD's instruments on hire data) are trending strongly positive and commodity prices continue to firm, we believe IMD is well positioned to continue to outperform over the medium term.

Updater, Inc (UPD; +47.0%), the US technology company improving the moving process for the 17 million US households relocating each year, had another positive month on the back of further announcements confirming its strategy was well on track for monetisation in 2018. In mid-August, UPD announced its market penetration had surpassed its previously stated 15% year-end goal some five months early, with its July estimated market penetration coming in at 15.7%. This surge in penetration was on the back of several leading US realtors joining the platform and UPD now aims to capture 35% market penetration which will solidify its long-term defensible position as the leading US relocation technology business. Later in the month, UPD announced its first "go-to-market" vertical would be in the highly lucrative insurance sector and that it was adopting a dual-channel approach to this market. UPD will not only offer its platform for leading US insurers to attract and retain customers, but will now also move itself up the value chain by creating its own insurance business that will, among other things, distribute property and casualty insurance policies on behalf of many major US insurance carriers. UPD management consistently under promises and over delivers and we look forward to the continuing evolution of this exciting early-stage business.

Netcomm Wireless Limited (NTC, - 16.8%) was under pressure in August despite releasing a FY17 result that was in line with our expectations and mildly ahead of consensus forecasts. The share price pressure likely stems from the lack of material news around contract wins and some slippage in consensus profit expectations for the FY18 year. NTC is expected to significantly ramp up the deployment of its Fibre-to-the-Distribution point (FTTdp) technology as the NBN Co accelerates its roll-out to one million homes which ought to underpin strong profit growth in FY18. Nevertheless, we have slowed our assumed pace of the NBN fixed wireless take-up near term as the actual results have been slower than anticipated. Furthermore, the market has tempered its expectations around the FY18 contribution for the AT&T fixed wireless contract given AT&T is widely expected to move at a glacial pace until the Connect America Fund Phase II action for an additional $2b funding has been decided. Despite not announcing any new material client engagements in recent months, NTC retains a strong pipeline of opportunities across fixed wireless communications and other machine-to-machine solutions, including prospects with multiple tier-one customers and remains a holding in the Fund.

Outlook

The August reporting season was relatively benign with few clear trends apparent at the coal face of corporate Australia. The 2.3% rise in the S&P/ASX Emerging Companies Accumulation Index belied the fact that consensus FY18 EPS revisions over the month were, on balance, negative. Indeed, of the 130 stocks that saw consensus FY18 EPS revisions within the S&P/ASX Small Industrials Index, just 36 companies saw upgrades with the balance of 94 downgrades. While we don't have corresponding statistics for the S&P/ASX Emerging Companies Index, there is little doubt there were consensus downgrades on average across the broader micro-cap index during August.

One consistent comment from company management was that the consumer remains under pressure and discretionary spending remains subdued. Indeed, the recently released national accounts show consumers are certainly not flush with cash following a rise of just 0.6% in real household disposable income over the past year. Rising house prices will have no doubt softened the blow for Sydneysiders and Melburnians, although those markets appear to be cooling now and are unlikely to continue to provide a tailwind via the "wealth effect". With the outlook for wages growth remaining low and household debt elevated, the outlook for the consumer appears challenging at best. We view this as the biggest challenge for the domestic economy over the next 12 months and will likely mean the cash rate will remain on hold at 1.5% for most of financial year 2018.

Although 2Q GDP growth of 0.8% is an acceleration on the muted Q1 result, it was still marginally below consensus expectations. The current 1.8% annual GDP growth is the lowest level we have seen since 2009 when we were still dealing with the aftermath of the GFC.

The RBA has maintained its conviction that growth in the Australian economy will gradually pick up over the coming year with the decline in mining investment soon to run its course, non-mining investment continuing to improve, residential construction activity remaining at a high level and retail sales having picked up recently. It is our view that the RBA's 3% GDP forecast for 2018 looks overly optimistic and we expect it will be revised downwards during the year, with a constrained consumer likely to weigh on the outlook.

Conditions in the global economy continue to remain robust with major global economies, including the US and China, showing ongoing signs of strength. In China, growth is being underpinned by increased spending on infrastructure and property construction which, in turn, is fuelling commodity price rises which is good for both resource companies and Australia's national accounts. The US outlook remains clouded by political inertia which is stalling the proposed implementation of tax cuts and infrastructure spending which would otherwise support above-trend growth. US growth momentum, nevertheless, remains solid led by a consumer rebound, an uptick in capital spending and a labour market at full employment. The US Federal Reserve continues its path towards monetary policy normalisation, although the latest drop in US Treasury bond yields, which comes amid uncertainty on whether the damage from Hurricanes Harvey and Irma will slow economic growth, suggests we may see a pause in the short term.

Escalating tension on the Korean Peninsula has kept the market on a knife's edge in recent weeks as ongoing sabre rattling from President Trump and Kim Jong Un continues to create an environment of uncertainty. North Korea followed up a successful test of an intercontinental ballistic missile in early July with its sixth and most powerful nuclear test in early September and the region remains a tinder box that could explode into outright war at any moment. Indeed, UN Secretary General Antonio Guterres has called the ongoing showdown over North Korea's nuclear and missiles program as the world's worst crisis "in years". Our portfolio remains conservatively positioned and we have cash to deploy should an environment of fear create a buying opportunity.

Despite the softness in the domestic consumer environment and global geopolitical uncertainty, we remain comfortable our portfolio will perform well over the coming year. The Australian micro-cap index is a highly diversified stock universe that holds ample opportunity for stock pickers like us. Irrespective of the current economic and political conditions, there are still stocks that are performing well operationally and are trading below our internal valuations. We remain confident we can continue to deliver our investors strong returns over the long term.

Top 5 holdings#

Company	ASX code
Jumbo Interactive Ltd	JIN
Millennium Services Group Ltd	MIL
National Veterinary Care Ltd	NVL
Pacific Group Ltd	PAC
Updater Inc	UPD

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* The performance comparison of $100,000 over 5 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. There is no guarantee these objectives will be met.

The top 5 portfolio holdings are in alphabetical order and may not be representative of current or future investments. The securities listed may not represent all of the portfolio's holdings and may represent only a small percentage of the strategy's portfolio holdings. Future portfolio holdings may not be profitable.