



Ophir Asset Management
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Dear Fellow Investors,

Welcome to the **July 2018 Ophir Letter to Investors** – thank you for investing alongside us for the long term.

Month in Review

While offshore markets shrugged off continuing trade war tensions and a late stage sell-off across a handful of US technology names, Australian equity markets instead delivered a more mixed performance for July - the majority of market participants likely preferring to sit on their hands ahead of the full-year results season in August. Following a stronger finish to the financial year in June, the larger cap end of the market again found support this month, **with the ASX 200 eclipsing 6300 points for the first time since 2008**. Smaller capitalised businesses struggled to keep pace with the larger end of town, however, as concerns around stretched valuations across parts of the small and mid-cap growth names saw a number of the more recent high flyers experience profit taking. The ASX Small Ordinaries Accumulation Index fell -1.0% in aggregate for the month, underperforming the ASX 100 by -2.6%.

	1 month	6 Months	FYTD	5 year p.a.	Inception p.a.
Ophir Opportunities Fund^	1.7%	5.4%	1.7%	28.9%p.a.	35.9%p.a.
Benchmark*	(1.0%)	4.2%	(1.0%)	9.3% p.a.	8.4% p.a.
Value Add (Gross)	2.7%	1.2%	2.7%	19.7% p.a.	27.5% p.a.
Fund Return (Net)	1.5%	4.8%	1.5%	23.2% p.a.	28.4% p.a.

* S&P/ASX Small Ordinaries Accumulation Index (XSOAI)

	1 month	6 Months	FYTD	2 Year p.a.	Inception p.a.
Ophir High Conviction Fund^	1.1%	13.0%	1.1%	16.2%p.a.	31.1% p.a.
Benchmark*	0.2%	4.4%	0.2%	3.7% p.a.	14.8% p.a.
Value Add (Gross)	0.9%	8.6%	0.9%	12.6% p.a.	16.4% p.a.
Fund Return (Net)	0.8%	10.7%	0.8%	13.7% p.a.	25.4% p.a.

* 50% S&P/ASX Small Ordinaries Accumulation Index (XSOAI), 50% S&P/ASX Midcap 50 Accumulation Index (XMDAI)

Despite weakness at the index level, both Ophir portfolio's delivered pleasing results for the month, with the **Ophir Opportunities Fund returning +1.5% after fees for July and the Ophir High Conviction Fund +0.8%**. The month of July can be notorious for seeing an elevated level of negative company news flow ahead of the results season in August and July 2018 certainly didn't disappoint in that regard. While the total number of downgrades across the smaller-cap corners of the market has been elevated (a total number of 30 profit warnings have now been delivered across the ASX since 1st June), the number sits broadly in-line with the experience coming into August results season in 2017.

Across the downgrades, no obvious trends have yet emerged as the key drivers for earnings disappointments, with the bulk of 'misses' announced this month coming primarily as a result of

more company-specific issues. While still early days, it has been interesting to note that of the 30 businesses that have announced earnings downgrades for the financial year to date, only five have substantial operations overseas, with the remainder coming from domestic-facing companies. Regular readers of these Letters would be aware that **we currently maintain a fairly significant skew in both portfolios towards businesses with offshore growth opportunities** (almost a third of the companies currently held within the Ophir High Conviction Fund, for example, derive more than 25% of their revenues from overseas operations) and we continue to expect that the ‘offshore earners’ as a broad category will likely feature heavily across the positive earnings surprises announced this reporting season.

Valuations, however, remain elevated across small and mid-cap companies and the margin for error for businesses with high earnings expectations is slim. We are certainly expecting an interesting reporting period and look forward to providing an update on the overall health of the companies across each portfolio at the conclusion of the results period in September. Ahead of the frantic month ahead, we have provided some thoughts below on our general expectations for August and how we are currently positioned coming into the reporting period.

While investment returns across both portfolios versus their respective benchmarks this month has been pleasing, we weren’t able to completely avoid some of the negative company news flow. Portfolio holding **The A2 Milk Company (A2M)**, for example, came under some pressure after providing a trading update that beat previous guidance for revenue for FY18 though missed the market’s expectations for profit margin for next year. While the adjustment created some near-term volatility in the stock, the overall strategy remains sensible to us and we continue to remain excited about the opportunities ahead for the company. The business is essentially choosing to re-invest a larger proportion of its gross profit next year back into marketing-related activities in order to grow the business and A2 brand into China and we’re looking forward to a further update on these initiatives at their result in August.

Elsewhere, health food manufacturer **Freedom Foods (FNP)** saw some selling pressure following the company guiding to lower than expected revenues for FY18 – although the business is still growing at a healthy +35% year-on-year (with the annualised run rate for the second half materially higher again). The miss came largely as a result of a timing issue regarding stocking levels of new product in supermarkets which the company has guided to now be fully resolved. We continue to be attracted to the three-year growth outlook ahead of the business with strong momentum in sales continuing into China and new product launches domestically.

A Six Year Anniversary for the Ophir Funds

Early August will provide a small moment of reflection for us as we reach the six-year anniversary of the Ophir Opportunities Fund and the third year of inception for the Ophir High Conviction Fund. **Pleasingly both funds have delivered investors in excess of +25% returns per annum after all fees to date** – a terrific result for the investment team and our investor base. While we are certainly thrilled to have delivered strong absolute returns for investors, it has been equally fulfilling to have both funds currently acknowledged as the top performing fund in their respective category versus the Mercer fund manager surveys over the period from their inception to June 30 2018.

The delivery of consistent outperformance requires a confluence of factors to come together for investment teams and often isn’t only a function of just effective stock selection. While we have certainly been happy with the outcome of our investment process over the last six years, we have been equally privileged to benefit from the support of a loyal and understanding investor base spanning Australian superannuation funds, family offices, adviser groups and private investors.

Investment managers strive every day to deliver the best possible risk-adjusted return on the capital that is provided to them, however this effort is certainly made a great deal easier when the pool of capital entrusted to them is long-term in nature and wholly understanding of the investment process employed. Strong investment returns are rarely delivered in a straight line and having an investor (and capital) base that is understanding and supportive through the inevitable periods of short-term underperformance has certainly contributed to the success of both funds to date.

Fund managers often suffer somewhat unfairly through periods of underperformance when they are forced to meet the redemption requests of investors that have lost confidence in their ability to continue to provide a suitable return on their investment over the long term. Unfortunately, human psychology dictates that these withdrawal requests often come at exactly the same time as the market is experiencing a broader-based sell-off, therein requiring investment managers to sell good companies cheaply to fund the capital calls.

Obviously, it is through periods of market dislocation that some of the most profitable investments can ultimately be made, **although these opportunities only exist to those fund managers with available capital to deploy**. Having access to long-term pools of capital provides investment managers with an exceptionally lucrative competitive advantage over their competitors – both in avoiding the negative effects of selling good companies cheaply and in providing an ability to purchase high quality assets at a discount. To date, we have been fortunate to avoid the negative impacts of these ‘redemption cycles’ (allowing us to take advantage of a number of market sell-offs over the last six years) and we thank investors wholeheartedly for providing us with the ability to invest through the cycle.

Finally, we were thrilled to meet with investors this month across Sydney, Melbourne and Brisbane as part of our **Ophir ‘Meet the Manager’ Information Evenings**. It was certainly humbling to have attracted such a high level of interest at these events and we hope those that attended found the evening valuable. We very much enjoyed the questions, interaction and the opportunity to spend time with our investors in an informal setting.

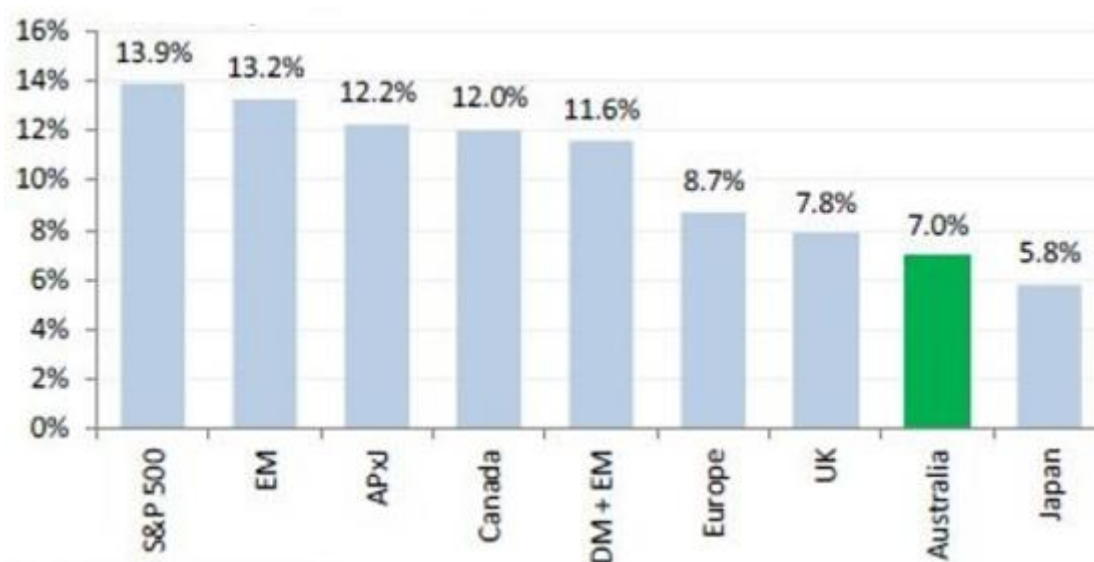
We are intending on visiting **Adelaide** and **Perth** following reporting season next month and we will provide details of those events on the website once dates and venues are finalised (under ‘Events’ [here](#)). For those that were unable to make it and would like to discuss the material presented, please feel free to touch base with Investment Director Rob Saunders on (02) 8188 0397 or rob.saunders@ophiram.com.

Looking into the August Reporting Season

The broader economic backdrop coming into the 2018 reporting season remains fairly buoyant, albeit without the significant tailwinds currently being enjoyed across other global developed markets. While current estimates for overall earnings per share (EPS) growth for FY18 across the ASX 200 sit at a reasonable +7%, that number looks decidedly pedestrian when compared to the US stock market experience in recent quarters. With the US 2Q18 quarterly reporting period finishing this month, earnings growth across the S&P 500 will average just under +25% year-on-year, with top line revenue growth in excess of +10% on the prior period.

While a large proportion of the US growth number is essentially derived from the benefits of a one-off corporate tax cut, underlying economic growth across the US continues to remain elevated, with corporate profits still expected to grow at twice that of Australian corporates for the next 12 months. As mentioned previously, we continue to retain a strong exposure across both Funds to businesses with offshore growth options, where we continue to see a significantly healthier near-term outlook versus domestic-facing counterparts.

Regional / Country 12-Month Forward Earnings Per Share (EPS) Growth Estimates



Source: Morgan Stanley

The Australian economy, whilst not enjoying the significant growth acceleration of other regional markets at present, continues to find some benefit from the continued East Coast infrastructure build-out and favourable commodity pricing environment. Overall business confidence remains relatively firm, albeit one needs to remember that confidence surveys tend to have a habit of simply tracking the underlying performance of the overall stock market. Consulting firm Deloitte recently released their 2Q18 CFO survey, highlighting that almost 75% of Australian CFO respondents currently identify themselves as either “optimistic” or “highly optimistic” about the future financial prospects for their companies. With the ASX again touching 10-year highs, business conditions remaining broadly favourable and monetary policy highly accommodative, there is arguably plenty for company CFO’s to be optimistic about.

Unfortunately, while management optimism is certainly a positive development, **overall cash earnings across the ASX in aggregate remain fairly benign**. With the bulk of earnings growth across the ASX still derived from a select number of industries rather than any broader-based cyclical expansion (primarily resources, construction and a number of selective niche/ ‘new-world’ small cap growth businesses), the earnings drag created by domestic-facing companies continues to

weigh on overall share market returns. Across the ASX 100, for example, current estimates for overall earnings growth from industrial businesses (i.e. excluding financials and resources) for FY18 is expected to be a relatively meagre +1.8%. While this has been skewed lower by a number of large negative contributions from index heavyweights such as QBE and Telstra, **the overall thematic of larger capitalised businesses in Australia struggling to deliver material and sustainable earnings growth continues to remain pervasive.**

Unsurprisingly, the recovery in fortunes across the Australian resources sector will provide the bulk of the earnings contribution this year, with the ASX 200 Miners expected to deliver approximately +20% EPS growth for FY18, while the ASX 200 Energy sector will see an average +50% increase. Strong underlying commodity prices and the resultant surge in free cash flow generation has seen the resources sector enjoy continued market leadership for the last two years, with Australian resources stocks having now outperformed the ASX 200 by +63% since the start of 2016.

With a limited number of opportunities available (ex-resources) to access companies generating attractive levels of earnings growth, an increasing amount of capital from the larger end of the market has understandably ventured onto the registers of the more growth-heavy small and mid-cap company space. Share price momentum across some areas of the smaller-cap market (particularly businesses sitting in the higher growth/ higher quality categories) has been incredibly strong in recent months, with company valuations suitably elevated as a result. **Earnings expectations for growth-type businesses are high and there is an obvious risk that companies that fail to deliver on lofty market estimates may become acutely exposed** to the negative effects of short term and momentum-focused capital heading for an exit.

As a result, we are entering the August reporting season with some degree of caution. Elevated earnings expectations and an ever-increasing amount of capital engaged in momentum-style investment strategies (i.e. those that seek to aggressively own businesses in earnings upgrade or upward price momentum cycles) undoubtedly sets the stage for some likely disappointments. Indeed, the continued strong performance of a number of businesses across the small cap growth spectrum has led some to conclude that the outperformance of higher-quality, higher-growth businesses has reached its peak and market leadership across the small cap space will likely rotate to lower-quality, value-type companies from here.

ASX Small Ordinaries 'Growth' Performance Relative to 'Value'



Source: Factset, UBS Investment Research

If share price performances through July are any indication, the market has begun to position for this somewhat, with smaller-cap "growth" businesses seemingly underperforming the value end of the market this month for the first occasion since the beginning of the year (albeit the bulk of this

underperformance likely came in response to the significant price declines experienced by a number of the high-growth US-listed technology names that were aggressively sold off this month after failing to meet lofty market estimates – see Facebook, Netflix, Twitter et al).

While we certainly share the concerns of the market that valuations (and/ or market expectations) for certain companies and sectors within the smaller cap space have become increasingly stretched, **we would caution against implementing a wholesale rotation within portfolios toward cheaper, lower-quality businesses at the current stage of the cycle**, primarily for two key reasons:

1) **Remember it's often not earnings that miss estimates, but *estimates* that miss earnings.**

High quality businesses often fall victims to their own success – elevated growth numbers, high operating margins and new product or territory rollouts understandably create excitement and invariably market expectations grow overly optimistic about the prospect for a company's near-term earnings as a result.

This is a natural part of later-cycle market activity, although it often creates the detrimental effect of creating exceptionally high earnings hurdles for a company management team to deliver (and equally significant near-term earnings risks for investors within the company). The end result is often manifested in a business delivering strong overall results in an absolute sense (be it versus their competitor set or their own historical financial results), but succumbing to significant share price declines in the short term as the results are deemed a 'miss' versus consensus analyst estimates.

In such cases, there is rarely anything wrong with the underlying business itself, other than underlying expectations becoming too elevated resulting in short-term/ momentum-style capital promptly exiting the register¹ following the earnings 'disappointment'. While certainly not a pleasant experience in the short term for holders, **it is hard to argue that such events are synonymous with the 'end of the growth cycle'** but are rather a necessary adjustment in some cases to overly elevated expectations.

Ultimately, we continue to believe that in a low-growth environment, it will be the businesses that can generate meaningful earnings growth regardless of the underlying cycle that will continue to provide meaningful shareholder returns over the long term. While we have taken the decision in recent months to lighten positions in some higher-growth businesses where we feel the risk of missing elevated market expectations is high, we're ultimately hopeful that any resultant share price sell-off **may provide compelling opportunities to redeploy this capital back into these companies** at a time when valuations rebase and the risk/ reward equation is more favourably tilted in our favour.

2) **Traditional value stocks are not currently *that cheap*.**

Historically speaking, the best time to aggressively own a large amount of beaten-up, low-quality and cyclical-style businesses is generally at the absolute bottom of an economic cycle, when valuations are excessively low (on both relative and absolute measures), balance sheets are impaired and any improvement in underlying fundamentals has the ability to significantly re-rate valuations from their depressed state.

It has long been our belief that it is difficult to generate consistent long-term returns through an economic cycle by continually investing in low-quality businesses. Granted,

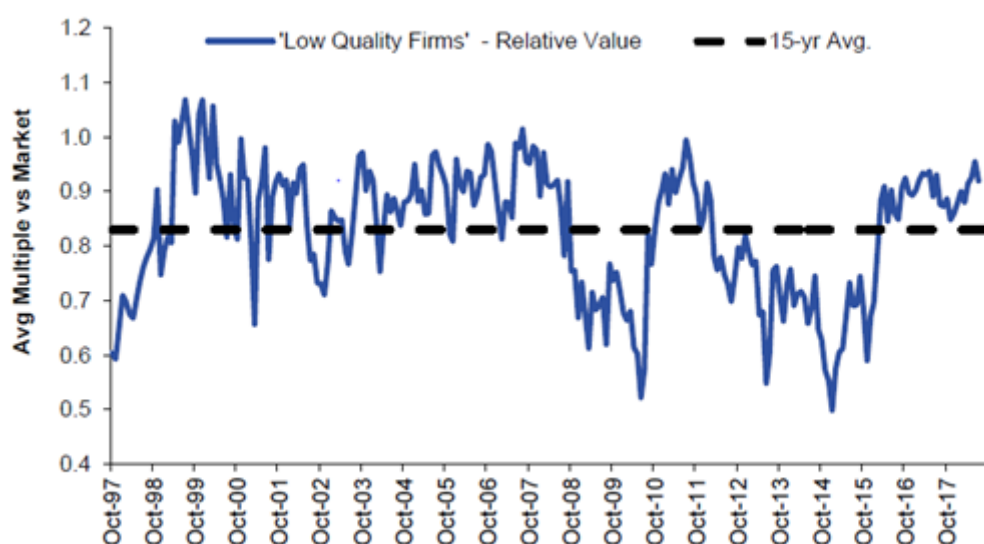
¹ While we cannot profess to have a thorough workable understanding of the operating metrics of a business like Facebook, to see a business lose \$120bn in market capitalisation this month after reporting revenue growth of +42% year-on-year and 22m additional daily users would likely provide an outsized example of this event this month.

there are opportunities through the cycle where the downside risk of owning lower-quality companies is negated by the sizeable returns on offer, however it is difficult to see how this opportunity currently exists on a wholesale level across Australian industrial small caps.

Rather than finding ourselves at the beginning of a cyclical recovery, equity markets in Australia instead sit at 10-year highs, the global economic growth recovery is now maturing and balance sheets, as a whole, are in good condition. In our own minds, the economic requirements needed to drive a valuation re-rate in lower-quality and cyclical businesses ultimately looks hard to identify at this point.

Perhaps a greater headwind to a re-rate of earnings multiples across the value end of the market is the fact that **cyclical and lower-quality businesses also don't currently present as being overly cheap**. Businesses identified as 'Low Quality' (as measured by 12-month forward PE, EV/EBITDA and Price/Book metrics) currently trade at a premium to their 15-year historical averages and towards the top end of their average valuation trading range.

Discount to the Market of 'Low Quality'² Stocks



Source: Factset, Goldman Sachs Investment Research

Ultimately, investors always have a natural affinity toward deploying capital into companies with lower relative valuations (particularly when considering the significant premiums at which higher-growth businesses currently trade), however **one needs to be careful to avoid the classic 'value-trap' scenario**: most often occurring when capital is deployed into mediocre businesses based solely on appealing relative valuations rather than an identified catalyst for an increase in future earnings growth or valuation multiple.

Cheap shares can stay cheap for a long time and the opportunity cost of having capital tied up in a lower-quality business (which, by their nature, have an elevated tendency to deliver any number of value destructive outcomes) can provide a significant drag on overall portfolio earnings.

This presents a conundrum that the vast bulk of Australian equity market participants are currently attempting to solve – high quality businesses trading at stretched multiples, whilst lower-quality businesses don't immediately screen as being overly attractive either. Our own response (as regular

² 'Low Quality' stocks are used here to demonstrate a basket of value-type businesses, as measured by an average 12-month forward P/E, EV/EBITDA and Price/Book.

readers of these letters will be aware) has been to selectively reduce or exit positions in companies where we feel valuations are stretched, earnings risk is elevated and near-term catalysts for a further re-rating are hard to identify. In some cases, we have been happy to rotate this capital into businesses that trade closer to average market multiples and where we remain highly confident in their ability to deliver on earnings.

In the absence of conviction that the current cycle presents a compelling opportunity to add a material amount of cheaper, lower-quality businesses into the portfolios, for now we are just as happy to retain any proceeds from realised investments in cash until a suitable opportunity presents itself. With reporting season starting shortly and expectations high, we are certainly looking forward to exploiting any potential opportunities that may present themselves through the period and we look forward to providing an update on this front next month.

As always, thank you for entrusting your capital with us.

Kindest regards,

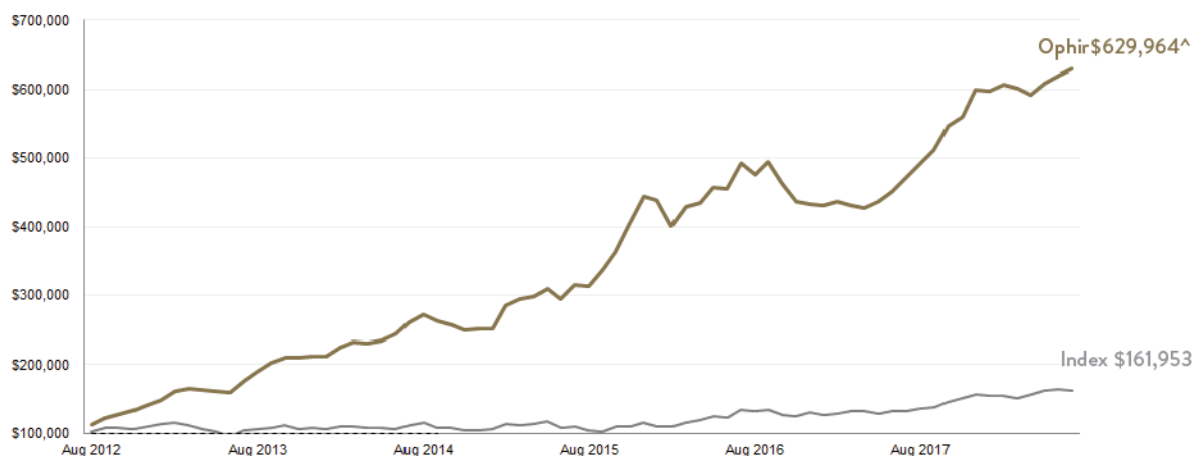
Andrew Mitchell & Steven Ng

Co-Founders & Portfolio Managers

Ophir Asset Management

The Ophir Opportunities Fund

Growth of A\$100,000 (pre all fees) since Inception



* Chart represents gross value of \$100,000 invested since inception and assumes dividends reinvested.
Please note past performance is not a reliable indicator of future performance.

The **Ophir Opportunities Fund** returned +1.7% for the month, outperforming the benchmark by 2.7%. Since inception, the Fund has returned +530.0%, outperforming the benchmark by 468.0%.

	1 Month	1 Year	5 Year (p.a.)	Inception (p.a.)	Since Inception
Ophir Opportunities Fund (Gross)	1.7%	33.4%	28.9%p.a.	35.9%p.a.	530.0%
Benchmark*	(1.0%)	22.6%	9.3%p.a.	8.4%p.a.	62.0%
Gross Value Add	2.7%	10.8%	19.7%p.a.	27.5%p.a.	468.0%
Net Fund Return	1.5%	31.7%	23.2%p.a.	28.4%p.a.	348.1%

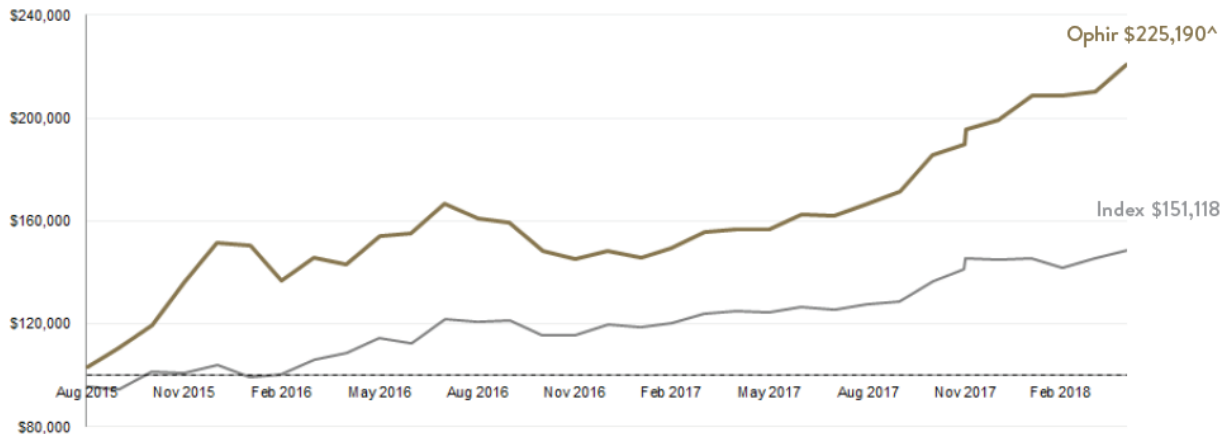
* S&P/ASX Small Ordinaries Accumulation Index (XSOAI)

	Buy Price	Mid Price	Exit Price
July 2018 Unit Price – Opportunities Fund	2.4950	2.4862	2.4775

Key contributors to the Opportunities Fund performance this month included **Afterpay Touch (APT)**, **Noni B Limited (NBL)** and **Pinnacle Investment Management Group (PNI)**. Key detractors included **Experience Co Ltd (EXP)**, **Freedom Foods Group Ltd (FNP)** and **Johns Lyng Group Ltd (JLG)**

The Ophir High Conviction Fund

Growth of A\$100,000 (pre all fees) since Inception



* Chart represents gross value of \$100,000 invested since inception and assumes dividends reinvested. Please note past performance is not a reliable indicator of future performance.

The **Ophir High Conviction Fund** returned +1.1% for the month, outperforming the benchmark by 0.9%. Since inception, the Fund has returned +125.2%, outperforming the benchmark by 74.1%.

	1 Month	1 Year	2 Year(p.a.)	Inception (p.a.)	Since Inception
Ophir High Conviction Fund (Gross)	1.1%	39.2%	16.2%p.a.	31.1%p.a.	125.2%
Benchmark*	0.2%	20.2%	3.7%p.a.	14.8%p.a.	51.1%
Gross Value Add	0.9%	19.0%	12.6%p.a.	16.4%p.a.	74.1%
Net Fund Return	0.8%	35.2%	13.7%p.a.	25.4%p.a.	96.9%

* 50% S&P/ASX Small Ordinaries Accumulation Index (XSOAI), 50% S&P/ASX Midcap 50 Accumulation Index (XMDAI)

	Buy Price	Mid Price	Exit Price
31 July 2018 Unit Price – High Conviction Fund	1.9343	1.9286	1.9228

Key contributors to the High Conviction Fund performance this month included **Afterpay Touch (APT)**, **Cleanaway Waste Management Ltd (CWY)** and **Flight Centre Travel Group (FLT)**. Key detractors included **The A2 Milk Company Ltd (A2M)**, **Freedom Foods Group Ltd (FNP)** and **Regis Resources Limited (RRL)**.

This document is issued by Ophir Asset Management (AFSL 420 082) in relation to the Ophir Opportunities Fund & the Ophir High Conviction Fund (the Funds) and is intended for wholesale investors only. The information provided in this document is general information only and does not constitute investment or other advice. The content of this document does not constitute an offer or solicitation to subscribe for units in the Funds. Ophir Asset Management accepts no liability for any inaccurate, incomplete or omitted information of any kind or any losses caused by using this information. Any investment decision in connection with the Funds should only be made based on the information contained in the Information Memorandum and/or Product Disclosure Statements.