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Dear Fellow Investors,

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

### Month in Review

Despite June producing a fairly difficult month for global equities, the Australian share market shrugged off concerns of pending trade wars and slowing global growth to close out the 2018 financial year with its strongest relative monthly performance of the year. Depending on one's point of view, **Australian share market participants this month either cheered the ASX 200 eclipsing its previous all-time high from January 2008, or commiserated at the fact that the high water mark had taken over ten years to overcome.** With no specific economic data or country-specific news flow for the month, the driver of renewed inflows into Australian shares in June has likely come from some capital rotation out of the struggling emerging market economies (the Argentine stock exchange, for example, this month registered a decline of -22%) while another month of Australian Dollar weakness (-2.2% in June) is making Australian businesses more attractive to global investors in US dollar terms.

As a consequence, the larger cap end of the market ended the financial year with its tail firmly in the air, the ASX 200 closing out June +3.0%, registering its strongest quarterly performance (+7.6%) since 1Q 2015. While small and mid-cap equities managed a positive absolute return in aggregate for June, they underperformed large caps from a relative sense this month – the ASX Small Ordinaries finishing the month with a rise of +1.1%.

	1 month	6 Months	FYTD	5 year p.a.	Inception p.a.
<b>Ophir Opportunities Fund<sup>^</sup></b>	<b>1.9%</b>	<b>3.4%</b>	<b>37.0%</b>	<b>31.1% p.a.</b>	<b>36.1% p.a.</b>
<b>Benchmark<sup>*</sup></b>	1.1%	4.7%	24.3%	11.6% p.a.	8.7% p.a.
<b>Value Add (Gross)</b>	0.8%	(1.3%)	12.8%	19.6% p.a.	27.5% p.a.
<b>Fund Return (Net)</b>	1.8%	2.7%	35.3%	25.2% p.a.	28.6% p.a.

<sup>\*</sup> S&P/ASX Small Ordinaries Accumulation Index (XSOAI)

	1 month	6 Months	FYTD	2 Year p.a.	Inception p.a.
<b>Ophir High Conviction Fund<sup>^</sup></b>	<b>0.9%</b>	<b>13.9%</b>	<b>37.0%</b>	<b>19.7% p.a.</b>	<b>31.7% p.a.</b>
<b>Benchmark<sup>*</sup></b>	1.6%	3.8%	19.2%	5.1% p.a.	15.2% p.a.
<b>Value Add (Gross)</b>	(0.7%)	10.0%	17.8%	14.6% p.a.	16.5% p.a.
<b>Fund Return (Net)</b>	1.0%	11.5%	33.4%	17.3% p.a.	25.9% p.a.

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

While Australian small and mid-cap companies lagged their larger cap counterparts this month, the June quarter completed what has been a fairly halcyon fiscal year for listed businesses across the small and mid-cap company space. The ASX Small Ordinaries finished the 2018 financial year

+24.2%, comfortably outperforming the ASX 100 Index by some 12.2% (and the MSCI Global Small Cap Index by 6.74%, in Australian dollar terms.).

**Pleasingly, both the Ophir portfolios have delivered strong returns for the FY18 period.**

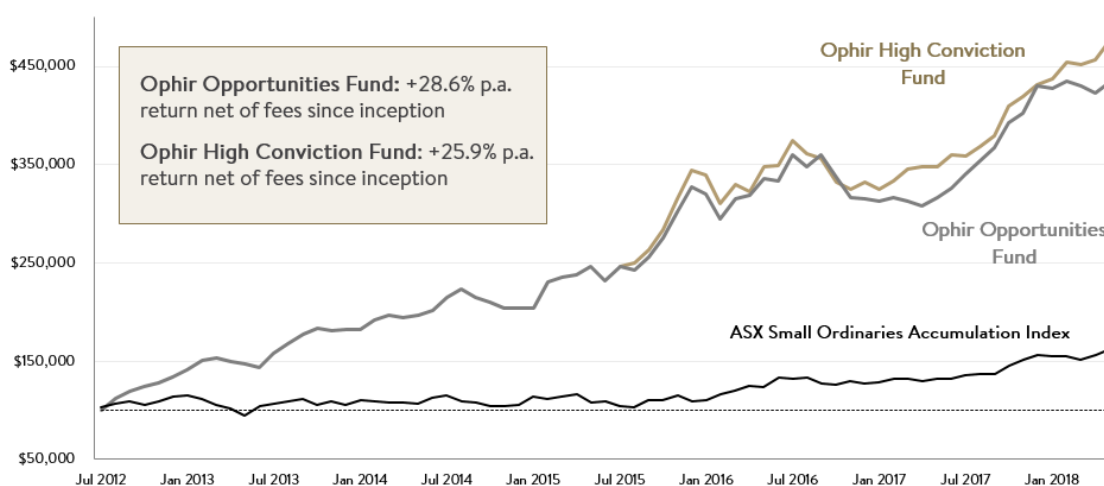
While the Opportunities and High Conviction Fund's operate slightly different investment strategies, both portfolios' this year ultimately generated quite similar performance. Investors with capital allocated in the Ophir Opportunities Fund at the start of July 2017 have earned a +35.3% return on their investment over the last 12 months (net of all fees), while the Ophir High Conviction Fund has delivered investors a net return of +33.4%.

As investors that have met with us directly will be aware (or those have attended one of our Ophir information evenings), **we have deliberately structured the Ophir business to provide us with what we feel is the best possible environment to generate strong portfolio returns over the long term.** These measures include significant co-investment from ourselves and the Ophir staff within the funds (alongside unitholders) and limiting the amount of capital that we manage in each strategy. We're certainly pleased that these measures - along with a consistent investment process - have delivered investors a meaningful return on their capital for the 2018 financial year.

While strong investment returns are encouraging, as is the case with all years there have been areas for improvement and missed opportunities. While we will take time to reflect on these, we are equally excited at a number of opportunities and companies that we feel will provide investors with attractive returns into FY19. We'll discuss and review the 2018 Financial Year in a little more detail later this month (and will also detail a number of new opportunities and learning experiences in the pending Ophir 'Meet the Manager' evenings later this week in Melbourne, Sydney and Brisbane - more details [here](#)).

As the Opportunities Fund approaches its 6-year anniversary in August this year and the High Conviction Fund its third year since inception, **we are pleased that both funds have maintained an annualised net return to investors in excess of +25% net of all fees since their respective inceptions.**

**The Ophir Fund's – Net Return on \$100,000 Since Inception**



*Chart above represents the net return on \$100,000 invested since inception in the Ophir Opportunities Fund (August-2012). For graphical purposes, the Ophir High Conviction Fund has been added to illustrate net performance of the Fund assuming an investment of equal size as the Opportunities Fund investment at the fund's inception date (August-2015).*

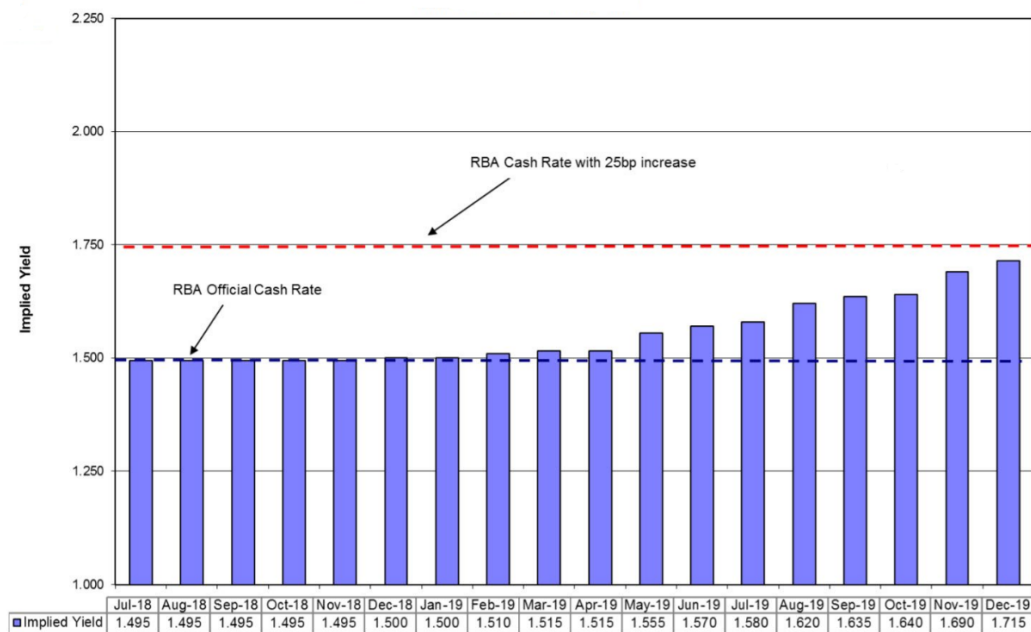
Turning to a **review of the June month**, while uncertainty over trade relations between the United States and China impacted global equity market sentiment this month, the cross-border tensions caused more volatility in Australian currency markets than local equities. All-out trade wars are obviously not an ideal environment in which strong global economic growth can be maintained and

commodity-linked currencies unsurprisingly came under pressure through the month (the Australian dollar retreating in June to an 18-month low). While a lower AUD will serve to bolster operating margins for local producers, exporters and businesses that generate revenue overseas, the rapid decline in the currency will also likely create some earnings translation headaches for businesses with offshore cost bases.

Pockets of the Australian retail sector, for example, look particularly exposed at present given many purchase goods and/or raw materials from offshore in US Dollars to then re-package for sale locally in Australian dollars. While some of this move can be recouped by retailers via price rises to the end consumer (and/or via hedging contracts), with the AUD/USD cross rate having now moved ~5% since the average of the February reporting season, **it's likely the retail space will see some impacts from margin erosion in the pending August reporting period.**

Pressure on the AUD has been further compounded this month following increasingly cautious commentary from the Reserve Bank around the outlook for domestic growth and what that likely will translate to in terms of interest rate expectations nearer term. Consensus estimates for the timing of an RBA rate hike continue to be pushed out later into the decade (given household consumption, wages growth and broader inflation all continue to look fairly muted), while current interest rate futures markets are not pricing in a full 25 basis point rate hike until late-2019.

### ASX 30-Day Interbank Cash Rate Futures Implied Yield Curve



Source: ASX

A lower-growth domestic environment has been (and continues to be) the key catalyst for the incredibly strong performance generated by Australian growth-orientated businesses this year, with the growth-heavy Australian small and mid-cap equity indices particularly benefiting from the ongoing clamour for earnings growth. As a result, a number of higher-growth small-cap businesses (many of whom generate minimal or no earnings at present) have seen a fairly robust expansion in their valuation multiples, with the market in many cases appearing happy to simply play the 'consensus upgrade' strategy of owning businesses with an ability to beat current market estimates (be it for sales, customer growth, subscribers etc) with the view the underlying equity will re-rate as a result.

This is the classic 'momentum trade' and is often synonymous with later stage bull market activity. As a strategy, it can create material returns for investors over the short term, although the potential

for meaningful capital loss when the momentum swings against you is equally high. **The level of investment capital chasing earnings momentum across the small and mid-cap equity space at present is elevated** and investors should be cautious of the ramifications of holding high growth, high-momentum businesses where underlying value isn't underpinned by more traditional valuation metrics (be it earnings, tangible assets, cash on balance sheet etc).

An added complication is the growing presence of quantitative-driven investment strategies that seek to identify companies that display certain style 'factors' that the market is currently rewarding, regardless of underlying fundamentals. Given momentum-based factors (earnings revisions, consensus revisions, price momentum) have delivered material alpha this year (whereas value-based factors have delivered negative results), we would expect that a material amount of quantitative money is camped on the register of a number of these higher-growth businesses. This phenomenon seems particularly concentrated across a number of the mid-cap tech-related businesses, with names like Altium (ALU), Appen (APX), WiseTech Global (WTC) and Netwealth (NWL) all currently demanding excessively high double-digit multiples of earnings.

### **Monthly Style-Factor Returns – ASX Small Ordinaries**

Type	Factor Name	last month	3 months	6 months	1-Year
<b>Value</b>	Earnings Yield (fwd)	-0.3%	1.8%	0.1%	7.5%
	Dividend Yield (fwd)	-0.2%	-0.1%	-2.0%	-7.6%
	Book Value Yield	0.8%	-0.6%	0.9%	-4.0%
	FCF Yield	0.5%	1.1%	3.2%	2.0%
	Value Composite	0.8%	1.5%	0.2%	2.1%
	Intrinsic Value	-0.7%	0.9%	0.2%	2.5%
<b>Quality</b>	High Quality	0.5%	4.6%	4.7%	10.1%
	Delta Quality	0.2%	2.9%	4.0%	7.7%
<b>Momentum</b>	Composite Momentum	0.5%	2.2%	2.6%	9.1%
<b>Composite Valu</b>	Earnings Revisions (3m)	0.6%	1.6%	0.9%	6.7%
	Price Momentum (12m)	-1.2%	1.2%	1.4%	8.3%
<b>Growth</b>	Forecast EPS Growth	0.5%	1.7%	1.2%	10.6%
	Fundamental Growth	-0.2%	3.9%	4.9%	13.4%
<b>Size</b>	Large Caps	0.1%	1.0%	1.2%	3.0%
<b>Risk</b>	Low Beta (12m)	1.9%	3.3%	3.7%	6.4%
	Low Volatility (6m)	1.1%	-2.3%	-2.2%	-9.5%
	Risk Alert	1.6%	1.1%	0.8%	0.8%
	Bear Ideas	0.1%	0.9%	1.1%	3.8%

*Source: UBS Quant*

While this isn't an issue while earnings expectations are being met and/or exceeded, the flight of capital from these businesses following an earnings disappointment will inevitably create some volatility. We have experienced previously (in 2016) the effects that non-natural owners of higher growth, smaller-capitalised businesses can have on equity prices in the short term – somewhat ironically, this concentration of shorter-term investment capital may **open up some opportunities to own good quality businesses at more attractive entry prices should near-term momentum turn.**

Our own investment process certainly favours growth-orientated businesses, albeit as investment managers we are ultimately style-agnostic and are happy to deploy capital into any number of opportunities where we feel we can earn a reasonable return on our investment. While the allure of growth can be seductive, there is little benefit in deploying capital into businesses when valuations are excessive and the risk/reward equation is skewed heavily away from us. **Valuation, in our view, must always remain at the core of the investment process** and while exiting the register of good quality, higher growth businesses can sometimes be emotionally difficult (given one often grows a close affinity with management teams they have supported from an early stage and/or the evolving growth in a business itself), retaining a discipline in recycling capital when valuations become

stretched has enabled us to (fortunately) avoid a number of the 'Fallen Angels' of 2018 (Domino's Pizza, Technology One, Class Super et al).

Delayed interest rate hike expectations not only contributed to a weaker Australian dollar, but also is creating further downward pressure on Australian bond yields, with the Australian 10-year government bond finishing June four basis points lower at 2.63%. While a lower long bond yield can theoretically support broader equity market valuations, the decoupling of the Australian bond market from other developed markets in recent months is symbolic of the growth challenges facing the domestic economy. February of this year marked the first occasion in 18 years that US 10-year bonds yielded more than Australian 10-year government bonds – a phenomenon that, at the time, had only occurred on 35 separate trading days in the last 30 years. That spread has continued to widen, however, with the US 10-year yield finishing June at 2.83% - its widest negative spread this century.

### Differential between Australian and US 10-year Government Bond Yields



*Source: Reserve Bank of Australia*

The dichotomy of fortunes between the US economy and Australia's at present is fairly stark and is likely proving a factor in an increasing amount of domestic investor capital existing the local bourse in pursuit of opportunities offshore. We commented post our recent visit to the US that overall business and investor confidence continues to grow and we continue to believe the momentum that is building in the economy will continue for some time. While the official federal funds rate is rising, 'real' interest rates (official cash rates less inflation) remain negative while overall monetary policy continues to remain incredibly loose.

If anything, the key near-term risk to the US growth story at present is simply in it overheating, given the economy is already running at full capacity. The US ISM Manufacturing Index (a measure of US manufacturing activity), for example, hit 60.2 in June – a four month high and close to the highest reading in the series this cycle. Of interest to us was the measure of 'supplier-deliveries' jumping to 68.2, its second-highest reading since 1979. As a result of bottlenecks being created by rapidly increasing demand for goods and materials and little capacity to deliver a response to this demand, **the likelihood of a US business receiving a goods order on-time currently is the second worst it has been in almost 40 years.**

That's quite an incredible statistic, particularly when one considers the accelerated progression in logistics and delivery technology that has been progressed over the last 40 years. While bottlenecks are obviously not an ideal outcome from an efficiency perspective, the data would support the view that there is little slack in the US economy at present and businesses with an exposure to the domestic recovery look well placed for the medium term.

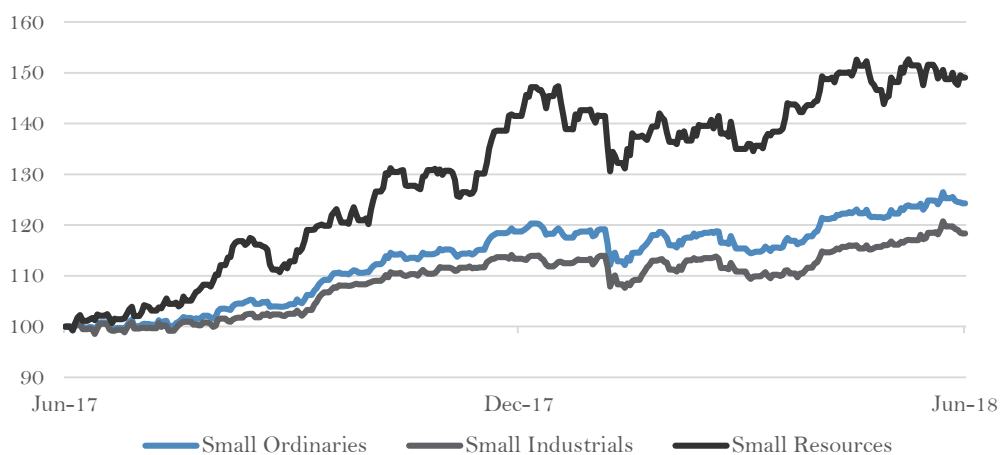
We have held a strong skew in both Ophir portfolios for some time towards businesses generating earnings offshore, with US-facing businesses (and USD earners) currently holding the lion's share of this allocation. While recent corporate histories of Australian businesses venturing offshore doesn't enthrone positivity – more than \$6.1bn in value has been destroyed by Australian businesses from offshore losses and write-downs in the last two years alone – the majority of recent notable failures have been at the larger cap end of the market (QBE, NAB, Wesfarmers/Bunnings). **Offshore expansions offer the opportunity to exploit far larger end-market opportunities, however these tend to come with a number of increased risks.** In this regard, we tend to favour businesses that have dominated in their local market for some time and then use this experience to hone their skills prior to taking on an international opportunity.

Modern day lay-by provider **AfterPay Touch Group's (APT)** recently announced expansion into the United States, for example, follows the business already demonstrating a sound ability to successfully (and rapidly) grow market penetration into online and in-store retail payment transactions in Australia. From its inception in 2015, the business already speaks for greater than 25% of all online fashion retail transactions in Australia – growing its transaction value from \$37m in FY2015 to over \$2bn this year. While moving into an offshore market that is ~15x times that of the Australian market will require careful planning and execution for the US-based management team, the experience acquired from having already rapidly scaled up in a similar consumer market (i.e. online) will inevitably prove exceedingly valuable. Pleasingly for the business, having only officially launched in the US in May this year, the service has already been picked by over 240 different retailers (a run rate of ~40 new retailers added each week) – a positive early sign.

The recovery of fortunes across the listed miners has been a significant feature across global markets this financial year, however increasing trade tensions in June combined with some further evidence of a slowing in the global growth story saw some quelling of enthusiasm in recent weeks. Spot base metals markets (often viewed as the more leveraged plays on the Chinese growth story) bore the brunt of some softening in sentiment, with zinc (-6.7%), aluminium (-6.3%) and copper (-3.9%) all succumbing to near-term profit taking over the month.

While ASX-listed mining equities equally experienced some compression in prices through June as a result, the net effect on total returns for the financial year from the resources space was fairly negligible. The ASX Small Ordinaries Resources Index finished the financial year with a total return of +49.04%, while the larger cap ASX 100 Resources Index delivered an equally stellar +39.25%.

#### **Total Return FY18 – Small Ordinaries, Small Resources and Small Industrials**



Source: JP Morgan Research

Global commodity markets and listed mining equities have been the most obvious beneficiary of synchronised global expansion through FY18, however the outlook for the commodity complex from here is a little more complex. While growth prospects for the United States continue to remain robust, European growth rates have slowed in recent months (though still growing year-on-year), while a number of emerging economies are experiencing fairly material difficulties from a rising US Dollar and oil-related cost inflation.

Recent volatility across Chinese financial markets adds an additional layer of complexity to the outlook for commodity markets, though it is still too early to determine if the current gyrations are indicative of a pending slowdown in broader demand. While not attracting the frenzied media headlines of previous equity market sell-offs, **the Chinese equity market formally entered bear market territory this month** (having fallen more than 20% since its peak in January), while the Chinese yuan suffered its worst monthly fall on record. A continuing crackdown on aggressive lending practices (and over-leveraged real estate development) is seeing some liquidity drain from the system as overall credit availability has tightened. While still early days, it is worth noting Chinese fixed asset investment this month fell to its lowest level of growth since the series was started in 1996, while Chinese industrial production numbers slowed to a 22-year low.

While this hasn't impacted bulk commodity markets as yet (iron ore was modestly lower for June, while both thermal and coking coal markets continue to remain well supported), there are already some signs of caution in other sectors. Most notable this month was Chinese conglomerate HNA Group's withdrawal of a \$400m offer to purchase **Automotive Holdings' (AHG)** refrigerated logistics business – a deal that was initially announced in November of last year and subsequently terminated this month following the heavily indebted HNA suffering near-term “liquidity issues”.

The Australian resources sector has experienced the negative impacts of large-scale Chinese credit withdrawal before (see bulk commodity price performance through 2014-15), however the sector is in far better shape currently from both a balance sheet perspective and overall supply/demand fundamentals to cope with any near-term issues. At present, we retain the bulk of our exposure to the resources space via industrial companies that benefit from an improving mining sector (e.g. mining services and contractors) – we have outlined previously our investment thesis for our holding in **Seven Group Holdings (SVW)**, the owner of Australia's largest Caterpillar distributor Westrac and equipment hire business Coates (view [here](#)).

While HNA's withdrawal lowered the level of completed M&A deals for the 2018 financial year, the trend towards an increased level of corporate transactions activity has continued this month. Announced inbound and domestic M&A in Australia has already exceeded US\$55bn for the calendar year to date, reflecting an +85% increase on total deal value on the same period last year. June activity remained strong with a number of deals announced across multiple sectors, including resources (contested bid from Fortescue / Hancock bidding for **Atlas Iron**), retirement villages (Hometown America / Brookfield competing for **Gateway Lifestyle**), infrastructure (CK Infrastructure bidding for **APA Group**) and outdoor media (**oOh! Media** bidding for **Here, There & Everywhere's** Adshel business, plus JCDecaux bidding for **APN Outdoor**).

**A heightened level of M&A transactions is a thematic we expect to continue into FY19**, not least as a result of the Australian dollar continuing to make valuations of Australian-listed businesses increasingly attractive to foreign acquirers (note the three largest announced takeover deals this month were all initiated by an offshore buyer). With corporate balance sheets globally now fully repaired and the bulk of aggressive cost-out campaigns completed, confident management teams will be increasingly willing to deploy capital into new growth initiatives – particularly while the cost of capital remains so cheap. Equity markets globally have been increasingly willing to reward the equity prices of businesses undertaking M&A – a factor that will provide comfort (and likely spur into action) corporate boardrooms with growth ambitions and we expect the trend to continue into the new fiscal year.

Looking forward, we continue to remain highly optimistic about the opportunities ahead for the companies held in both Ophir portfolio's and for emerging Australian businesses more broadly. While opportunities for growth from 'newer world' businesses continue to remain large, valuations in many cases have begun to factor in a lot of the upside and we continue retain a strict adherence to valuation and in ensuring that we remain confident in the near term trajectory for earnings.

While domestic growth is sluggish relative to global developed markets, the economy is beginning to show some signs of improvement and **this may create some investment opportunities in more cyclical industrial businesses over time** (some of which provide a far more compelling risk/reward metric at current valuations when compared to the higher-growth end of the market). While quality of business can sometimes be lower when assessing more value-orientated companies, **we have taken the opportunity recently to recycle some capital from businesses on premium valuations without near-term catalysts into a small number of opportunities that are displaying favourable valuation optionality.**

Where attractive options for capital deployment aren't available, we are equally happy at this stage to keep our powder dry and retain a cash holding to deploy into opportunities that may arise in the coming reporting period. As a result, cash levels across both portfolios are presently slightly above average, with the Opportunities Fund currently holding a ~7% cash weighting and the High Conviction Fund ~11% (both on a post-distribution basis).

As always, we very much appreciate your support and thank you for providing us with the opportunity to be a steward of your investment capital this financial year. We look forward to working hard to continue to deliver strong returns on your investment and hope to see you at the Ophir events in early July.

**Thank you for entrusting your capital with us.**

Kindest regards,

Andrew Mitchell & Steven Ng

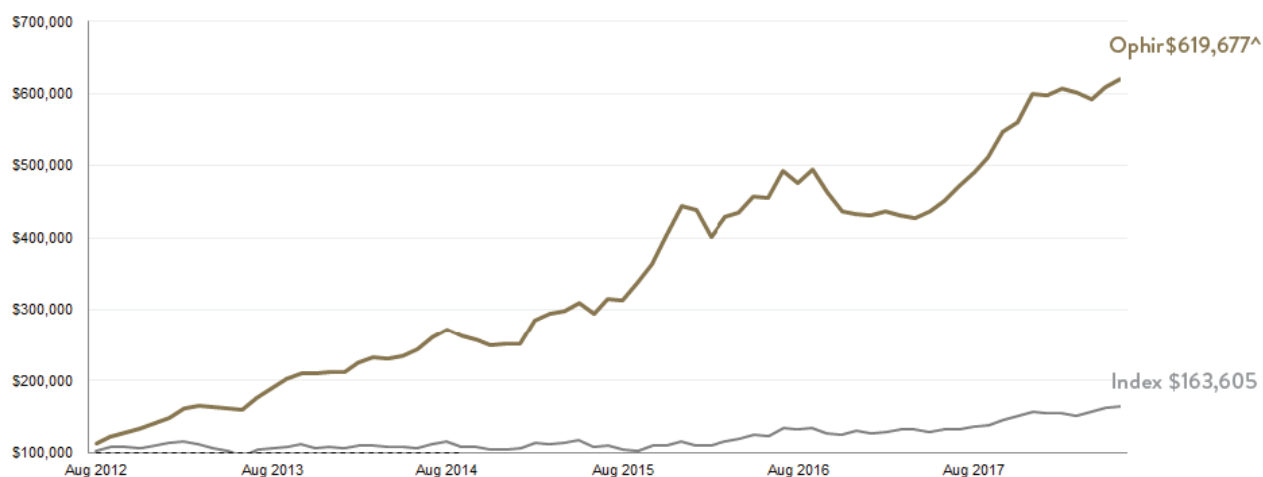
Co-Founders & Portfolio Managers

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 +1.9% for the month, outperforming the benchmark by 0.8%. Since inception, the Fund has returned +519.7%, outperforming the benchmark by 456.1%.

	1 Month	1 Year	5 Year (p.a.)	Inception (p.a.)	Since Inception
<b>Ophir Opportunities Fund (Gross)</b>	1.9%	37.0%	31.1%p.a.	36.1%p.a.	519.7%
Benchmark*	1.1%	24.3%	11.6%p.a.	8.7%p.a.	63.6%
Gross Value Add	0.8%	12.8%	19.6%p.a.	27.5%p.a.	456.1%
Net Fund Return	1.8%	35.3%	25.2%p.a.	28.6%p.a.	341.3%

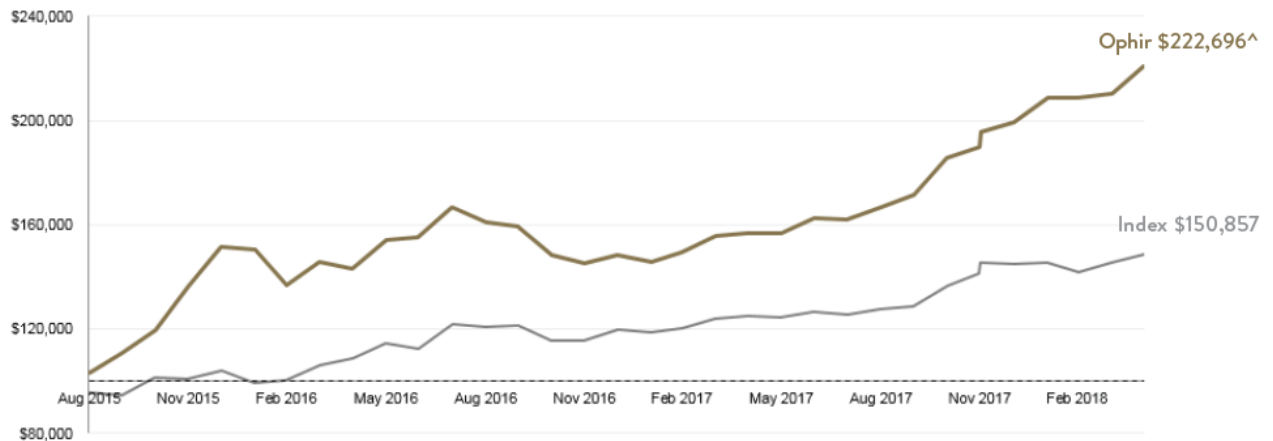
\* S&P/ASX Small Ordinaries Accumulation Index (XSOAI)

	Buy Price	Mid Price	Exit Price
<b>June 2018 Unit Price – Opportunities Fund (cum dist.)</b>	2.8942	2.8841	2.8740

Key contributors to the Opportunities Fund performance this month included **Afterpay Touch (APT)**, **Freedom Food Ltd (FNP)** and **Vista Group Int Ltd (VGL)**. Key detractors included **Integrate Research Limited (IRI)**, **Johns Lyng Group (JLG)** and **RCR Tomlinson Limited (RCR)**

# 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 +0.9% for the month, underperforming the benchmark by 0.7%. Since inception, the Fund has returned +122.7%, outperforming the benchmark by 71.8%.

	1 Month	1 Year	2 Year(p.a.)	Inception (p.a.)	Since Inception
<b>Ophir High Conviction Fund (Gross)</b>	0.9%	37.0%	19.7%p.a.	31.7%p.a.	122.7%
Benchmark*	1.6%	19.2%	5.1%p.a.	15.2%p.a.	50.9%
Gross Value Add	(0.7%)	17.8%	14.6%p.a.	16.5%p.a.	71.8%
Net Fund Return	1.0%	33.4%	17.3%p.a.	25.9%p.a.	95.3%

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

	Buy Price	Mid Price	Exit Price
<b>30 June 2018 Unit Price – High Conviction Fund (cum dist.)</b>	1.9440	1.9382	1.9323

Key contributors to the High Conviction Fund performance this month included **Afterpay Touch (APT)**, **Freedom Food Ltd (FNP)** and **Xero Ltd (XRO)**. Key detractors included **Ausdrill Limited (ASL)**, **Challenger Limited (CGF)** and **RCR Tomlinson Limited (RCR)**

*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.*