Ophir Asset Management
Level 2, 139 Macquarie Street
SYDNEY NSW 2000

Dear Fellow Investors,

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

Month in Review

While the Australian equity market begun the 2018 calendar in a fairly benign fashion, global equity markets instead embraced the New Year in much the same manner in which they finished 2017. With a continuation of the 'Goldilocks' environment of improving global growth, stronger corporate earnings and relatively low inflation expectations, the majority of both developed and emerging equity market indices initially enjoyed an incredibly strong start to the year. In the case of the US equity market, in particular, the opening month proved nothing short of spectacular with the S&P 500 notching up 13 separate closing highs through the month, with the mega-cap Dow Jones index at one point had registering an intra-month gain of over +7.5% (or more than half of the ASX 200's total return for calendar year 2017).

	1 month	6 Months	1 Year	5 year p.a.	Inception p.a.
Ophir Opportunities Fund^	**(0.3%)**	**26.6%**	**38.8%**	**32.1% p.a.**	**38.4% p.a.**
Benchmark*	(0.5%)	17.7%	22.4%	6.4% p.a.	8.3% p.a.
Value Add (Gross)	0.2%	8.9%	16.4%	25.7% p.a.	30.0% p.a.
Fund Return (Net)	(0.4%)	25.7%	36.9%	24.8% p.a.	30.3% p.a.

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

	1 month	6 Months	1 Year	2 Year p.a.	Inception p.a.
Ophir High Conviction Fund^	**1.9%**	**23.2%**	**37.0%**	**15.1% p.a.**	**31.8% p.a.**
Benchmark*	(0.3%)	15.2%	22.1%	7.1% p.a.	16.0% p.a.
Value Add (Gross)	2.2%	8.0%	14.9%	8.0% p.a.	15.8% p.a.
Fund Return (Net)	1.6%	22.2%	34.9%	13.6% p.a.	26.0% p.a.

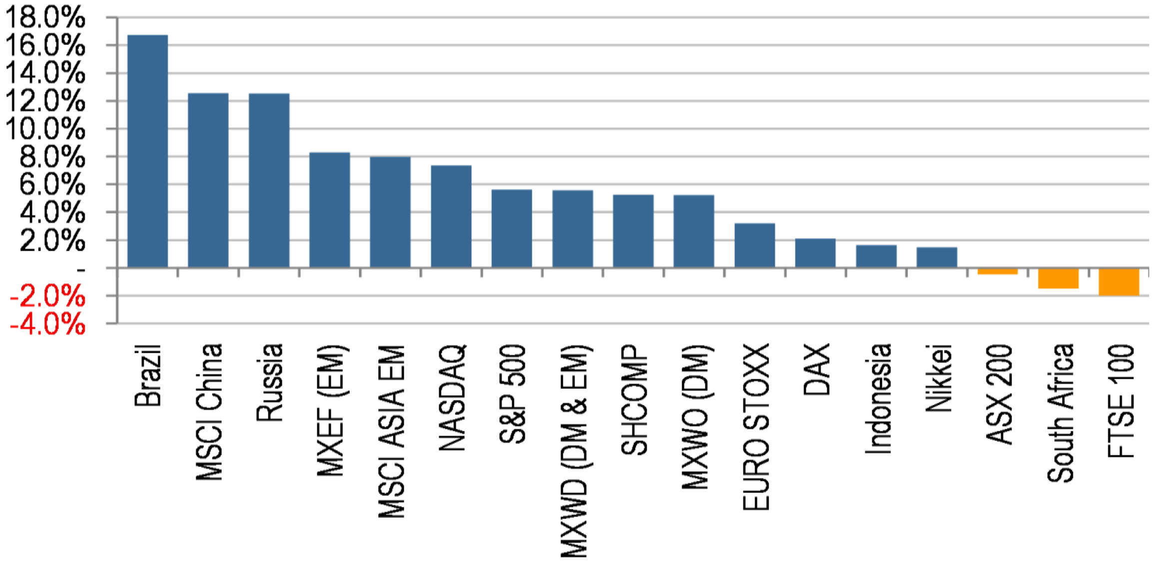
* 50% S&P/ASX Small Ordinaries Accumulation Index (XSOAI), 50% S&P/ASX Midcap 50 Accumulation Index (XMDAI)

This sheer momentum of capital inflows into the US equity market should be taken in context with what has since been a fairly sizable equity market shake-out through the opening weeks of February. Prior to January 26 this year (the last recorded high for the S&P 500), the index had not experienced a 5% pullback for some 575 days. From the beginning of the 2018 trading year through to January 26, only 3 trading days on the S&P 500 produced a negative return, with the cumulative points loss over those three days amounting to just 17 points.

In a fairly extraordinary case of intermarket relationship outcomes, **only once in the last 20 years have US equity markets started the year in better shape (2001) or bond markets started off worse (2009).** Seeing both occur in the same month is a fairly incredible event and perhaps provides some explanation to investors, on reflection, for the ferocity in which markets ultimately gave back some of their gains in the opening weeks of February.

While global equity markets started 2018 well, Australian equity markets continued their trend of relative underperformance, with both Australian large cap equities (ASX 200 -0.5%) and smaller caps (ASX Small Ordinaries -0.6%) delivering negative absolute returns for the month. Across developed markets, only the FTSE 100 turned in a lower performance for January, with the UK equity index weighed down by a stronger British Pound over the month and continuing political uncertainty surrounding their eventual extraction from the European Union.

Global Equity Market Returns – January 2018



Source: JP Morgan

While the Australian market - particularly across larger caps - has struggled to attract global capital inflows for some time, the relative underperformance of the ASX 200 versus both developed and regional counterparts (Hong Kong's Hang Seng Index, for example, finished January +9.9%) is noteworthy. Australian economic data releases, including both retail sales and labour force data, broadly surprised on the upside through January, while spot commodity markets again remained well supported. Despite iron ore continuing to hold above $70/tonne, crude oil increasing +7.1% for the month and the US dollar index falling to levels not seen since 2014, global capital allocators continue to remain somewhat unexcited about the prospects for the Australian equity market nearer term.

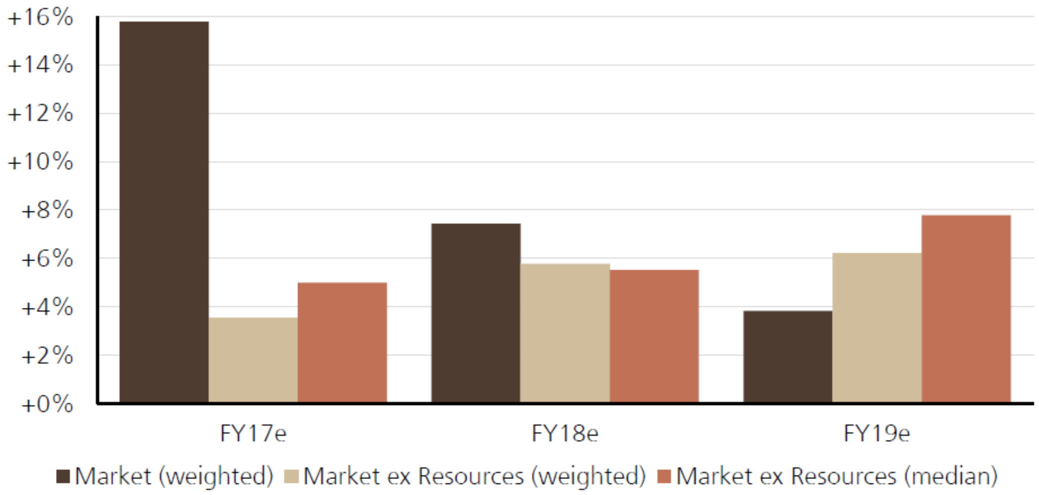
This lack of enthusiasm may stem from the relatively lukewarm earnings profile currently on offer for Australian domestic-facing companies versus global peers. As we head into the results season for the first half of the 2018 financial year, the consensus estimate for FY18 earnings per share (EPS) across the ASX 200 is approximately ~8%. While certainly not a miserly figure in an absolute sense (given it sits ahead of longer term averages), the growth rate does sit below the ~14% EPS growth delivered by global equity markets last year, and a discount to the expected ~10% EPS growth expected for the calendar year ahead (pre any improvement from pending US tax cuts).

Given the competitive pressures facing traditional large cap retailers and the difficult operating environment for the index-heavy banking and finance sectors, the lack of growth options available to Australian investors at the larger cap end is not a new thematic. **It is somewhat unfortunate that the bulk of earnings growth generated this year in Australian large caps will not come from a new wave of highly innovative, new-world businesses**. While this has been the experience for a number of developed equity markets in more recent years, Australian investors will again fall largely reliant on the recovering fortunes of the decidedly older-world (and highly cyclical) resources sector to generate the bulk of the ASX 200's EPS growth.

The market will, however, take earnings growth wherever it can find it and (as we have written in recent Letters) the resources sector continues to display signs of strong and continued recovery. Feedback from our mining and energy contacts (and the companies that service the sector) continues to remain increasingly ebullient, whilst the US reporting season has recently confirmed that the larger miners are beginning to deploy capital once again. As a result, the vast bulk of the expected earnings growth generated across the larger cap indicies will be derived from the sector, with EPS growth across the ASX 200 resources space expected to be in excess of 30% for FY18.

Were one to exclude the growth contribution from the resources space and the ASX 200 EPS expectations fall to a relatively muted 5-6%, with EPS growth for the ASX 200 Industrials likely to deliver just 3%. Given the persistent regional investor concerns around unsustainable Australian housing growth, the impact from a slowing China and/or a relatively constrained domestic consumer and one can perhaps forgive global investors for continuing to seek growth options in large caps names elsewhere in the region.

<u>Australian Market EPS Growth – Market ex Resources</u>



Source: UBS Investment Research, Factset Consensus

Across the small and mid-cap company space, the outlook remains somewhat more buoyant and the sector continues to remain an appealing prospect to those looking to deploy growth capital. Growth expectations across smaller capitalised businesses continue to remain elevated versus larger cap peers, helped both by the continuing success of relatively new businesses operating within new and unique sectors in addition to a greater (and growing) portion of smaller Australian companies expanding aggressively into higher growth markets offshore.

While ~20% of the ASX Small Ordinaries Index is still represented by the resources space (and a further ~10% by the mining services and contracting businesses that derive their revenue from them), the opportunities available to investors across the smaller cap industrial names remains attractive. At present, expected EPS growth for the ASX Small Industrials sits at almost double that of their larger cap peers for FY18 and we look forward to gaining an insight into how these businesses are performing at their pending semi-annual reports.

For the month of January, both Ophir Fund's delivered outperformance versus their respective benchmarks, however only the High Conviction Fund (+1.9%) delivered a positive absolute return, with the Opportunities Fund finishing the month marginally lower (-0.3%). While January remained largely directionless for the most part, the team is excited to be entering the pending semi-annual reporting period in February to gain an update on how our current portfolio companies are faring.

<u>A Word on Recent Market Volatility</u>

While January essentially provided investors with a continuation of the 'Golidlocks' environment of resilient markets and lower market volatility, the opening weeks of February has provided a far different experience. Given the recent moves in global stock markets, we felt some mention should be made in this Letter of recent market movements and our current view of events.

Our December Letter to Investors provided some broad insights into our expectations for the year ahead, including the not overly heroic prediction of some normalisation in both global interest rates and equity market volatility over the year. In theory, then, it should have been of no surprise to us to see this normalisation occur, however admittedly our original expectations for this mean reversion included an assumption that any return to more normalised market activity would be far more gradual.

In our view, the fairly significant moves in global equity markets through the opening weeks of February have been the cause of a market-driven event, rather than the beginnings of some more sinister shift in the underlying economic outlook. Recent history would show us that it is generally through periods of a rapid shift in market momentum (often triggered by a far less nefarious event – in this case, a relatively minor adjustment in bond yields in the response to stronger than expected US wage growth data) that results in some obscure – and often highly geared – investment product that inevitably implodes. While direct investors in the underlying product are generally limited to a relatively small subset of the professional investment community, the contagion from these product explosions are often felt for a period of time across more traditional financial products and asset classes.

In this most recent example, global equity market investors in recent weeks have been rapidly introduced to the relatively opaque world of 'risk parity' hedge funds and hyper-geared 'short volatility' investment strategies that had grown in popularity through the previous 2 years of excessively calm equity markets. We are reminded of an old joke from 2007 from a market commentator that remarked in the early days of the US mortgage meltdown that they "thought US subprime was a steak restaurant in Texas" and similarly it is difficult for us to profess to have a meaningfully specialised understanding of the underlying mechanics of these products.

What we can surmise is that **ultimately a large portion of the market had been positioned for a period of continued low volatility** that, as a result of stronger than expected US bond yields through the opening weeks of February, ultimately saw these positions needing to be unwound. The US equity market subsequently suffered a ~6% fall through the period from February 2nd to February 5th, with global equity markets falling equally heavily in response. Such a rapid de-rating without any underlying change in fundamentals (remembering rising US bond yields inherently are a *good* outcome as they tend to indicate a broadly improving economy) is often far more reflective of a poorly positioned market rather than a collapse in economic fundamentals and we feel this has likely been the case in recent weeks.

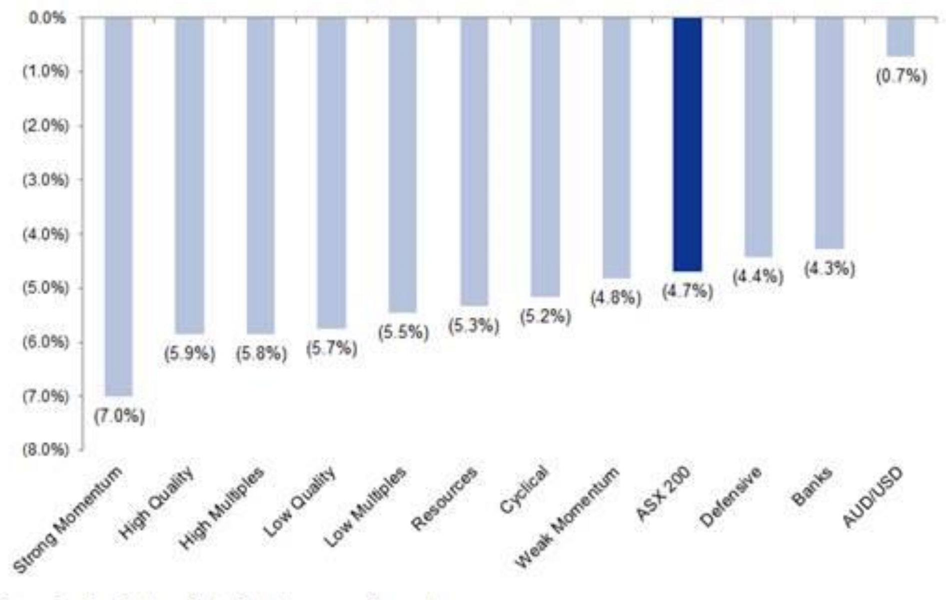
CBOE Volatility Index (VIX)

We are reminded that despite the equity market de-rating, US corporate earnings have remained strong whilst economic data has remained similarly buoyant over the period. While equity market movements have been outsized in recent weeks, they haven't remotely compared to movements experienced across products tied to underlying volatility. The CBOE Volatility Index (VIX), for example, registered an upward movement of +20 points on February 5th - its largest one-day move in the history of the index – to close at its highest level since 2011. An obscure product named the VelocityShares Daily Inverse VIX – effectively a leveraged product used by investors to bet on continued low volatility across the S&P 500 – subsequently saw its value fall more than 90% in a single session.

These are incredible moves and while most of the damage has likely been felt by investors in those specific underlying products, the resultant re-pricing of volatility risk has ultimately created some near-term nervousness for equity market investors. Without delving into the complete mechanics, the VIX index is ultimately a market mechanism that attempts to measure broader expectation for future volatility of the S&P 500. With the index now sitting in the high 30's, this ultimately implies the market is pricing in expectations of ~2% daily moves in the S&P 500 futures – a fairly bold assumption given the equity market sell-off on February 5th was S&P 500's first 2% move in a day since 2016. Hence one can understand a shorter-term period of heightened investor concerns while both volatility and equity market risk is re-priced.

During periods of more acute market sell-offs, it is often helpful for bottom-up investors to monitor the levels of equity market dispersion to determine whether the selling is either broad-based (i.e. low dispersion) or more discerning of underlying companies or sectors (i.e. high dispersion – where the market is essentially fearful of one or more particular subsets of the market). In the case of the sell-off across the Australian market over February 5th to February 6th, the data is fairly telling – according to Goldman Sachs' numbers, **the dispersion of returns across the ASX 200 was the lowest experienced of any sell-off over the past decade**, highlighting that the majority of selling came largely at an index level and was largely indiscriminate of underlying company fundamentals.

ASX 200 Equity Market Dispersion: February 5th - February 6th

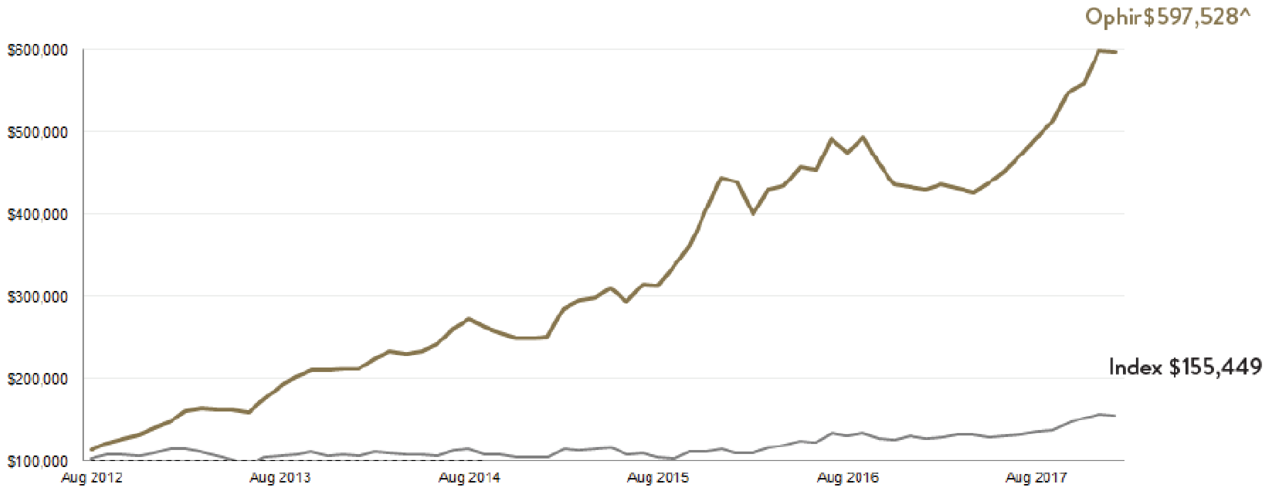


Source: FactSet, Goldman Sachs Global Investment Research

These kinds of events can ultimately create a good many number of opportunities for the active investor, given the market can often 'throw the baby out with the bath water' and there can be opportunities to buy high quality companies at increasingly favourable prices. We have selectively deployed some capital into businesses in the opening weeks of this month where we have felt both the entry price has been compelling and that we have some degree of certainty around the pending earnings results. With the ASX Small Ordinaries retracing ~6% from its mid-January highs at the time of writing, we are continuing to monitor a number of additional potential opportunities to selectively add to a number of existing businesses where we feel the risk-reward equation is working in our favour.

The Ophir Opportunities Fund

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



The **Ophir Opportunities Fund** returned -0.3% for the month, outperforming the benchmark by 0.2%. Since inception, the Fund has returned +497.5%, outperforming the benchmark by +442.1%.

	1 Month	**1 Year**	**5 Year (p.a.)**	**Inception (p.a.)**	**Since Inception**
Ophir Opportunities Fund (Gross)	(0.3%)	38.8%	32.1%p.a.	38.4%p.a.	497.5%
Benchmark*	(0.5%)	22.4%	6.4%p.a.	8.3%p.a.	55.4%
Gross Value Add	0.2%	16.4%	25.7%p.a.	30.0%p.a.	442.1%
Net Fund Return	(0.4%)	36.9%	24.8%p.a.	30.3%p.a.	327.8%

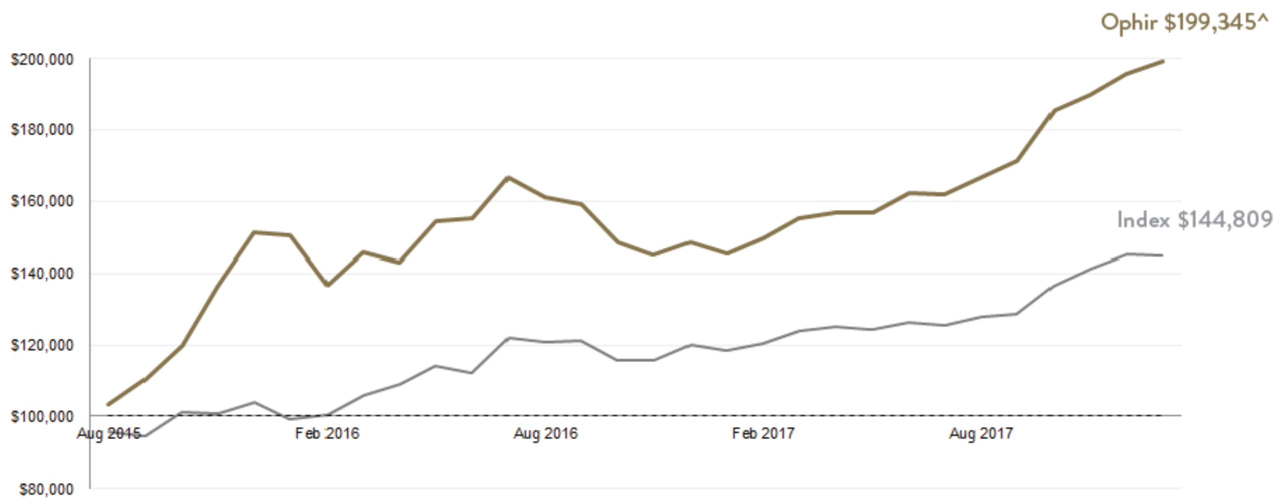
* S&P/ASX Small Ordinaries Accumulation Index (XSOAI)

	Buy Price	**Mid Price**	**Exit Price**
January 2018 Unit Price – Opportunities Fund	2.8055	2.7957	2.7859

Key contributors to the Opportunities Fund performance this month included **Afterpay Touch Group Ltd (APT), Citadel Group Ltd (CGL)** and **Pinnacle Investment (PNI).** Key detractors included **Experience Co Ltd** (EXP) **Melbourne IT Limited (MLB)** and **Metal X Limited (MLX).**

The Ophir High Conviction Fund

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



The **Ophir High Conviction Fund** returned 1.9% for the month, outperforming the benchmark by 2.2%. Since inception, the Fund has returned +99.3%, outperforming the benchmark by +54.5%.

	1 Month	1 Year	2 Year(p.a.)	Inception (p.a.)	Since Inception
Ophir High Conviction Fund (Gross)	1.9%	37.0%	15.1%p.a.	31.8%p.a.	99.3%
Benchmark*	(0.3%)	22.1%	7.1%p.a.	16.0%p.a.	44.8%
Gross Value Add	2.2%	14.9%	8.0%p.a.	15.8%p.a.	54.5%
Net Fund Return	1.6%	34.9%	13.6%p.a.	26.0%p.a.	77.9%

* 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 January 2018 Unit Price – HC Fund	1.7706	1.7654	1.7601

Key contributors to the High Conviction Fund performance this month included **Afterpay Touch Group Ltd (APT), A2 Milk Company Limited (A2M)** and **Flight Centre (FLT).** Key detractors included **Credit Corp Group Limited** (**CCP**)**, Nextdc Ltd (NXT)** and **Pro Medicus Limited (PME).**