Highly Recommended
**Recommended**
Approved
Not Rated
Redeem

# Product Assessment

## Smallco Investment Fund

**Report data as at 31 May 2020**
**Rating issued on 09 Jun 2020**

### APIR Code
ASC0001AU

### Asset / Sub-Asset Class
Australian Shares
Long Short

### Investment Style
Variable Beta

### Investment Objective
To achieve high absolute returns for investors.

### Zenith Assigned Benchmark
S&P/ASX 300 (Accum)
Bloomberg AusBond Bank Bill Index

### Net Returns (% p.a.)

| | 5 yrs | 3 yrs | 1 yr |
|---|---|---|---|
| Fund | 11.23 | 10.32 | -5.41 |
| Benchmark | 4.35 | 4.48 | -6.52 |
| Median | 4.39 | 4.43 | -5.27 |

### Income (% p.a.)

| | Income | Total |
|---|---|---|
| FY to 30 Jun 2019 | 13.48 | 9.80 |
| FY to 30 Jun 2018 | 11.10 | 27.50 |
| FY to 30 Jun 2017 | 8.50 | 9.50 |

### Fees (% p.a., Incl. GST)
Management Cost: 1.55%
Performance Fee: 18.64% of the unit price increase over each 6-month period subject to the recoupment of all prior negative performance.

### VIEWPOINT

The Fund, managed by Smallco Investment Manager Limited (Smallco), provides investors with an exposure to a high conviction, long/short portfolio of Australian smaller companies. The Fund does not typically invest in stocks from the resources sector, biotechnology sector and other structurally challenged industries. In addition, we note that Smallco is highly selective with short selling, and thus it is rarely utilised. Zenith has a high regard for Smallco given its experienced team of investment professionals and robust investment process.

Established in 2000 by Rob Hopkins and Bill Ryan, Smallco is a Sydney-based boutique fund manager that specialises in managing Australian equity strategies. As at 30 April 2020, Smallco managed approximately $A 730 million firmwide. In response to negative market movements and outflows, Smallco reopened the Fund to new investment in April 2020, after being hard closed since January 2017.

The investment team of seven is led by Hopkins, who is supported by Ryan, Andrew Hokin, Paul Graham, Craig Miller, Adam Simpson and Han Xu. Whilst Hopkins is the lead portfolio manager for the Fund, a consensus approach to decision making is employed for the purposes of portfolio construction. All team members hold stock coverage responsibilities, with a number of key sectors allocated across the team. Outside of the key sectors, team members are given the freedom and flexibility to cover any stocks in any sector.

Smallco's investment philosophy centres on the belief that equity markets are inefficient and that rigorous fundamental research can identify opportunities to generate excess returns. Smallco targets quality companies likely to exceed consensus earnings expectations or out of favour companies expected to at least meet earnings expectations. By targeting these features, Smallco aims to invest in companies it believes will double in value over a three-year investment period.

The portfolio construction process is primarily driven by fundamental analysis conducted by the investment team. Smallco constructs the Fund through a benchmark unaware approach. Portfolio guidelines, stock liquidity and downside risk are considered to avoid unnecessary risks within the process.

Whilst Smallco is permitted to vary the Fund's net equity exposure between 0% to 150%, given the long-biased nature of the Fund, its net equity exposure has typically oscillated around 80%. Smallco does not make tactical asset allocation decisions, with the Fund's net equity exposure primarily a result of available investment opportunities, both long and short. Zenith is comfortable with Smallco's portfolio construction approach, believing it ensures a strong connection between the output of the security selection process and the resultant weight of the stock in the portfolio.

Zenith notes that Smallco has continually worked to enhance its investment approach, including the introduction of a quality rating system after the Fund experienced a significant drawdown (since fully recovered) during the Global Financial Crisis. Zenith views Smallco's process enhancements favourably.

### FUND FACTS

- High conviction portfolio holding between 25 and 35 securities
- Portfolio turnover expected to be approximately 40% p.a.
- Long-term net equity exposure of 80%, with short selling used highly opportunistically
- Small cap bias with exposure to S&P/ASX 100 limited to 20% of the Fund at time of acquisition

**ABSOLUTE RISK (SECTOR)**

VERY HIGH
HIGH ▶
MODERATE
LOW
VERY LOW

**RELATIVE RISK (FUND WITHIN SECTOR)**

VERY HIGH
HIGH ▶
MODERATE
LOW
VERY LOW

**INCOME DISTRIBUTIONS PER**

MONTH | QUARTER | 6 MONTH | ANNUM (selected)

**INVESTMENT TIMEFRAME**

1-2 YRS | 3-4 YRS | 5-6 YRS | 7+ YRS (selected)

## APPLICATIONS OF INVESTMENT

### SECTOR CHARACTERISTICS

The Zenith "Australian Shares – Long Short" sector consists of long/short funds investing across the market cap spectrum of the Australian equity market. These funds can short sell equities and/or SPI futures to capture excess return opportunities and manage risk. Over the long term, Zenith expects quality long/short funds to outperform the S&P/ASX 300 Accumulation Index given a manager's ability to generate excess returns from short selling.

Each long/short manager uses vastly different investment processes. Some managers are fundamentally driven, others use quantitative tools, and others have trading style biases. Funds in this sector employ active extension or variable beta investment styles. Active extension funds can be used in place of a traditional long-only fund where the investor wishes to increase the "activeness" of their fund allocations in equities. That is, the fund can build a higher conviction portfolio by shorting stocks that it thinks will underperform and use the proceeds to invest long in stocks that may outperform. Variable beta funds can be used by investors to reduce the market risk of investing with a long-only fund that must be close to fully invested. Variable beta funds can decrease their market exposures to protect against market falls (by increasing shorts or cash holdings). In general, investing in quality variable beta funds should provide investors "smoother" returns than simply investing in the index.

Zenith benchmarks all funds in this sector against the S&P/ASX 300 Accumulation Index. However, many managers in this category benchmark their funds against the S&P/ASX 200 Accumulation Index. Both indices are market-capitalisation weighted, resulting in companies with the largest market capitalisations receiving the heaviest weightings within the index. Over the longer term, Zenith believes there will be minimal difference between the return profiles of these indices.

The Australian share market, as represented by the S&P/ASX 300 Index, is highly concentrated and narrow. Technically, a company is considered large cap if it falls within the S&P/ASX 50 Index, with companies falling between the S&P/ASX 50 and S&P/ASX 100 considered mid cap. All stocks outside of the S&P/ASX 100 Index are considered small capitalisation stocks.

As at 31 May 2020, the Financials and Resources sectors combined represented a significant portion of the S&P/ASX 300 Accumulation Index, with the Financials sector accounting for approximately 27% of the Index, and Materials approximately 20%. The split between Industrials and Resources stocks was approximately 80%/20%. The top 10 stocks represented approximately 43% of the weighting of the Index, and the top 20 stocks represented over 57% of the Index.

### PORTFOLIO APPLICATIONS

In general, compared to most other asset classes, equities offer investors the opportunity for higher capital growth over the longer term with some income. However, this higher growth is also often associated with higher volatility. Therefore, it is recommended that investors adopt a longer timeframe when investing in equities.

Investors should also be cognisant of the fact that the Australian equity market is relatively concentrated, with the Materials and Financials sectors dominating the market. The market also only represents approximately 1% of global equity markets (in terms of market capitalisation). Therefore, to mitigate this concentration risk it is highly recommended that investors diversify their investments across asset classes, both domestically and globally.

Unlike a traditional long-only Australian equities fund, the Fund utilises a long/short investment strategy, providing Smallco with greater flexibility to add value for investors. The short-selling capability enables the Fund to profit during a market downturn and, therefore, potentially offers a different return profile to most long-only Australian equity funds. However, Zenith notes that Smallco is highly selective with short selling, and thus it is rarely utilised.

As a variable beta strategy, the Fund has the ability to hold high levels of cash and conversely exhibit low net equity exposure, enabling Smallco to potentially protect the portfolio in poor market conditions. Conversely, the Fund may potentially lag long-only strategies during market rallies.

Although Smallco has the ability to alter the net equity exposure over a wide range, Zenith notes that the Fund's net equity exposure will generally be determined as a result of available investment opportunities rather than a tactical asset allocation overlay. The Fund's net equity exposure will typically oscillate around the long-term average of 80%. As a result, Zenith notes that the Fund will generally exhibit similar risk/return characteristics to long-only funds.

Investors should be aware that the Fund may target its return objective with leverage. However, the gross exposure (total long plus total short exposure) of the Fund is expected to remain lower than peers at approximately 80%. Zenith believes this is an important measure for investors to understand as it is indicative of the actual leverage in a portfolio, which may amplify losses should Smallco fail to deliver added value from both its long and short components (i.e. gross leverage of greater than 100% magnifies the level of success and failure).

Investors should also note that the Fund will invest predominantly in small capitalisation companies and will not invest in resources and biotechnology companies. Accordingly, Zenith believes that the Fund may be suitable as a satellite holding within a well-diversified Australian equities portfolio and has the potential to enhance a portfolio's risk/return profile.

The Fund's portfolio turnover is expected to be approximately 40% p.a., which Zenith considers to be low. Smallco was not able to provide any insight on the proportion of expected turnover attributed to the resizing of existing positions and that which is due to initiating and closing positions. Given this expected level of turnover, the majority of the Fund's returns are expected to be delivered via capital appreciation in the unit price, rather than through the realisation of capital gains in income distributions. In addition, realised capital gains are highly likely to be eligible for the capital gains tax discount. As such, holding all else equal, the Fund may be more appealing to investors who are high marginal tax rate payers as it will result in superior after-tax return outcomes.

## RISKS OF THE INVESTMENT

### SECTOR RISKS

Funds within the "Australian Long Short" sector are exposed to the following broad risks:

**BUY/SELL SPREAD INCREASES:** Global markets are experiencing significant volatility due to the COVID-19 situation. As a result, the cost of transacting has risen significantly. In addition, funds employing currency hedging have also been impacted with an increase in foreign exchange transaction costs.

In response to this, many managers have been frequently adjusting the buy/sell spreads for many funds, often daily. In some cases, the adjustments have been material. Zenith encourages all advisers/investors to reconfirm the buy/sell spread on each fund prior to making any investment decision and prior to issuing trade instructions. As markets stabilise, Zenith expects spreads to revert to historical levels, however, this may take several months.

**MARKET & ECONOMIC RISK:** A risk to the performance of funds in the sector is a sustained downturn across the Australian share market. In addition, changes in economic, social, technological or political conditions, as well as market sentiment could also lead to negative fund performance. This risk can be significantly reduced by investors adhering to the Fund's prescribed investment timeframe.

**SPECIFIC SECURITY RISK:** This is the risk associated with an individual security. The price of shares in a company may be affected by unexpected changes in that company's operations such as changes in management or the loss of a significant customer.

**LIQUIDITY RISK:** This is the risk that a security or asset cannot be traded quickly enough, due to insufficient trading volumes in the market. When trading volumes are low, buyers/sellers can significantly impact the price of a security when attempting to quickly enter/exit a material position.

**STYLE BIAS RISK:** Australian equity managers will either employ a Growth, Value or Neutral (combination of Value & Growth) styled approach to investing. Each style is conducive to certain market conditions i.e. Growth should outperform Value in an upward trending market and vice versa in a downward trending market. As with Market Risk, investors should adhere to the fund's investment timeframe to avoid short-term market movements and style impact.

**CAPACITY RISK:** High levels of funds under management (FUM) can present additional challenges to an Australian equity manager, as high FUM has the potential to hamper the manager's ability to trade efficiently and/or be forced to disclose substantial shareholdings to the market (most common in smaller companies).

**SHORT RISK:** Australian long/short funds have the ability to borrow securities and sell them on market (i.e. shorting). Given that such securities will need to be returned to the lender eventually, the short seller may be required to re-purchase the securities on market at a higher price, thereby incurring a loss. Such losses can potentially be unlimited given that there is no theoretical limit on how much the price of a security can rise.

**REGULATORY RISK:** The ASIC Regulatory Guide 97 'Disclosing Fees and Costs in PDSs and Periodic Statements' came into effect on 1 October 2017 and seeks to establish a common framework for disclosing fees with respect to registered managed investment schemes issued to retail investors.

In January 2019, ASIC released a Consultative Paper (CP), seeking feedback with respect to proposed changes to the existing fee and cost disclosure regime. The consultation period ends in April 2019, following which, ASIC will collate feedback and structure final recommendations, notifying of an intended implementation period.

In its current form, RG97 is not expected to impact the actual costs (or net returns) on existing investments. Rather, the guide is focused on providing increased transparency with respect to the costs of management. Given this, it is feasible that under RG97, investors become more sensitive to the costs charged and seek lower cost alternatives, potentially leading to fund outflows.

### FUND RISKS

Zenith has identified the following key risks of the Fund. Although Zenith believes the risks noted are all significant, we have listed them in order of importance. In addition, we have not intended to highlight all possible risks.

**KEY PERSON RISK:** Zenith views key person risk at Smallco to be moderate to high, as per any boutique manager. Zenith believes Rob Hopkins, Bill Ryan and Andrew Hokin are critical members of the investment team and a departure would be a significant loss to the firm, triggering an immediate review of the Fund's rating. However, Zenith acknowledges the material equity stake all three members maintain in the business and we believe that this mitigates the risk of a departure over the medium term. In addition, we believe there is sufficient depth in the team to take over daily management of the Fund should Smallco experience a material departure. Zenith notes that there have not been any departures from the firm since its inception.

**CAPACITY RISK:** Excessive levels of funds under management (FUM) can inhibit a manager's ability to trade portfolio positions effectively and may therefore limit outperformance potential. As at 30 April 2020, Smallco managed approximately $A 730 million firmwide. Overall, Zenith does not believe the Fund is currently impacted by capacity limitations.

In response to negative market movements and outflows, Smallco reopened the Fund to new investment in April 2020, after being hard closed since January 2017. Zenith notes that Smallco has a strong track record of prudently managing capacity, having previously closed the Fund at conservative levels of FUM. Notwithstanding this, Zenith will continue to monitor Smallco's level of FUM and corresponding excess return generation closely to ensure that increasing levels of FUM do not begin to negatively impact performance.

**RELATIVE PERFORMANCE RISK:** Zenith notes that the Fund is more concentrated than many Australian equities peers. Zenith believes that a concentrated portfolio has greater exposure to stock-specific risk than more diversified strategies and, as such, investors should be cognisant that the Fund may experience capital volatility in excess of a more diversified strategy. In addition, given that the Fund follows a benchmark unaware investment approach, its performance may diverge substantially from the benchmark and peers.

**BUSINESS RISK:** Whilst Zenith acknowledges that Smallco is profitable at current levels of FUM, we note that it has a relatively concentrated client base, with a material proportion of firmwide FUM sourced from a single client. Whilst the loss of this client could materially impact the firm's profitability and longevity, Smallco has noted that, at current levels of FUM, they would remain profitable if this were to occur.

**TEAM FOCUS RISK:** While Zenith believes Smallco's team is sufficiently resourced and experienced, we note that the team is also responsible for the Smallco Broadcap strategy. As such, Zenith believes that the team's research focus may be diluted. However, we note that there is a high level of overlap between the strategies, which somewhat mitigates our concerns.

**LEVERAGE RISK:** Investors should be aware that the Fund may target its return objective with leverage. Zenith believes this is an important measure for investors to understand as it is indicative of the actual leverage in a portfolio, which may amplify losses should Smallco fail to deliver added value from both its long and short components (i.e. gross leverage of greater than 100% magnifies the level of success and failure).

However, the gross exposure (total long plus total short exposure) of the Fund is expected to remain lower than peers at approximately 80%, with short selling used opportunistically. Notwithstanding this, Smallco has the ability to borrow up to 30% of the Fund's Net Asset Value (NAV) and allow the gearing level to passively drift to 50%. However, Zenith notes that gearing is rarely implemented, with Smallco last utilising its gearing facility in 2006.

**COUNTERPARTY RISK:** The Fund's custody and counterparty contracts are subject to potential default risk. In particular, the Fund is exposed to counterparty risk with its securities lender, Macquarie. Assets of the Fund are required to be transferred to Macquarie when borrowing stock for short selling. Assets up to the required collateral amount are held on Macquarie's balance sheet and are not segregated from other Macquarie assets. Should Macquarie become insolvent, there is a risk that the assets posted by the Fund may not be recoverable.

## QUALITATIVE DUE DILIGENCE

### ORGANISATION

Established in 2000 by Rob Hopkins and Bill Ryan, Smallco Investment Manager Limited (Smallco) is a Sydney-based boutique fund manager that specialises in managing Australian equity strategies. Smallco's boutique structure allows for equity participation amongst the broader team, which Zenith believes is a positive as it allows for closer alignment of interests between the investment team and investors in the Fund and also serves as a staff retention mechanism.

Although Smallco previously engaged Gateway Financial Marketing for the provision of retail distribution services, we note that this partnership ended in early 2020. Zenith believes Smallco would benefit from distribution support, allowing the investment team to focus on research and portfolio management efforts.

As at 30 April 2020, Smallco had approximately $A 730 million in funds under management.

As at the same date, Smallco managed approximately $A 150 million in the strategy, all of which was in the Fund.

### INVESTMENT PERSONNEL

| Name | Title | Tenure |
|---|---|---|
| Rob Hopkins | Managing Director/ Portfolio Manager | 20 Yr(s) |
| Bill Ryan | Executive Director / Portfolio Manager | 20 Yr(s) |
| Andrew Hokin | Portfolio Manager | 12 Yr(s) |
| Paul Graham | Portfolio Manager | 6 Yr(s) |
| Craig Miller | Portfolio Manager | 15 Yr(s) |
| Adam Simpson | Portfolio Manager | 2 Yr(s) |
| Han Xu | Portfolio Manager | 1 Yr(s) |

The investment team of seven is led by Rob Hopkins, who is supported by Bill Ryan, Andrew Hokin, Paul Graham, Craig Miller, Adam Simpson and Han Xu.

Hopkins has over 30 years of industry experience. Prior to founding Smallco, Hopkins was the Head of Small Companies Research at Macquarie Equities, BT Alex Brown, ANZ Securities and Macintosh. Hopkins also held various roles at other sell-side firms.

Ryan has over 20 years of industry experience. Prior to founding Smallco, Ryan worked together with Hopkins at ANZ Securities for a number of years.

Hokin has over 25 years of industry experience and joined Smallco in July 2007. Prior to joining Smallco, Hokin held a senior position within Macquarie Equities. Zenith believes Hokin has improved the rigour of the investment process since his arrival, whereby a quality rating system was introduced to the security selection process.

Graham joined Smallco in June 2014 and has over 20 years of industry experience. Prior to joining Smallco, Graham held senior positions at a number of prominent sell-side firms such as Nomura, Credit Suisse and Citigroup.

Miller has over 10 years of industry experience and joined Smallco in June 2005. In addition to his analytical responsibilities, Miller is responsible for a significant portion of the firm's business management requirements, which includes business development, client servicing and compliance.

Simpson and Xu are the latest additions to the team, having joined Smallco in July 2017 and November 2018, respectively. Prior to joining Smallco, Simpson worked at Macquarie for a period of 15 years where he was most recently the Head of Emerging Leaders Research at Macquarie Equities. Xu worked previously as an analyst at Ellerston Capital for three years and, prior to that, a sell-side analyst at UBS for nine years. Zenith notes that Smallco has continued to bolster team resourcing, which we view favourably.

All team members hold stock coverage responsibilities, with a number of key sectors allocated across the team. Outside of the key sectors, team members are given the freedom and flexibility to cover any stocks in any sector.

Whilst Hopkins is the lead portfolio manager for the Fund, a consensus approach to decision making is employed for the purposes of portfolio construction, with all team members being involved in the process.

The team has remained stable, with no staff departures since the inception of the firm. Where applicable, each team member is entitled to a profit-sharing arrangement that is commensurate with their equity/shadow equity holding, which Zenith believes provides a strong incentive to remain with the firm at least in the medium term.

Overall, Zenith considers Smallco's investment team to be highly experienced and well resourced to manage the Fund.

## INVESTMENT OBJECTIVE, PHILOSOPHY AND PROCESS

Instead of providing a specific return target or timeframe, the Fund aims to achieve high absolute returns for investors. Smallco seeks to achieve the Fund's investment objective through utilising a relatively concentrated, long/short strategy that is predominantly invested in Australian small capitalisation companies.

Zenith would prefer to see the delineation of a specific outperformance target, as opposed to a descriptive, qualitative objective. Zenith believes this would provide investors with greater transparency with regards to returns expectations and level of risk embedded in the Fund.

Smallco's investment philosophy centres on the belief that equity markets are inefficient and that rigorous fundamental research can identify opportunities to generate excess returns. At the core of the investment process is the use of fundamental research to identify attractive investment opportunities that are trading at a discount to their intrinsic value.

Smallco targets quality companies likely to exceed consensus earnings expectations or out of favour companies expected to at least meet earnings expectations. By targeting these features, Smallco aims to invest in companies it believes will double in value over a three-year investment period. The resultant portfolio is expected to exhibit growth characteristics.

Whilst the Fund's investment process is predominantly fundamental in nature, Smallco also seeks to add value via a macroeconomic overlay that is used as a source of idea generation and feedback loop.

## SECURITY SELECTION

Smallco focuses its research on stocks with market capitalisations between $A 100 million and $A 500 million, as it believes this is a segment of the market that is both relatively under researched and possesses sufficient liquidity. In addition, Smallco maintains coverage on a selection of larger cap (constituents of the S&P/ASX 100 Index) and micro cap stocks (stocks with a market capitalisation of less than $A 100 million). However, Zenith notes that Smallco's traditional core competency is in the research of small capitalisation securities.

Smallco is generally cautious when investing in stocks with market capitalisations of less than $A 100 million, given their higher level of earnings forecast risk and generally less developed financial discipline and reporting. In addition, Smallco typically excludes stocks from the resources sector, biotechnology sector and other structurally challenged industries from further due diligence as it believes their earnings are too difficult to forecast with sufficient accuracy.

The Fund applies a negative ethical screen over its investment universe, which is administered internally by the investment team. Smallco will not invest in companies with a principal business interest in tobacco, gaming, alcohol and/or armaments/cluster munitions. While Zenith believes the use of the screen is honourable, we note the definitions of the exclusions are at the discretion of Smallco as opposed to an independent external Socially Responsible Investing (SRI) expert.

Smallco seeks to identify quality companies that exhibit the following characteristics:

- Strong cash flow
- High Return on Funds Employed (ROFE)
- Attractive earnings outlook
- Strong competitive advantage
- Strong board and good management

Company visits and meetings with senior management form a key part of the security selection process. The aim of the research process is to produce an internally-generated target price that reflects the company's long-term intrinsic value. Target prices are compared against current market prices to determine a stock's level of attractiveness.

Smallco's valuation process incorporates a combination of the following metrics that are based on three-year forecasts:

- Price-to-cashflow
- Price-to-earnings ratio (PE Ratio)
- Earnings before interest, taxes, depreciation and amortisation (EBITDA)

To aid idea generation and to serve as a feedback loop, Smallco informally utilises a macroeconomic overlay to make an assessment of the economy.

A quality rating system is utilised to prevent the portfolio from holding an excessive number of lower quality stocks. Every stock considered by the investment team is assigned a numerical rating from 0 to 10 based on its quality and cyclicality, with 10 being the most attractive. Smallco introduced the quality rating system after the Fund experienced a significant drawdown during 2008 and 2009.

Candidates for the Fund's short positions are a by-product of the idea generation process for long positions. For a stock to be considered as a short-selling candidate, it must typically fulfil the following criteria:

- Potential return of 20% to 30%
- Operating in a structurally-challenged industry
- A catalyst or event (e.g. reporting season) where the company is likely to disappoint relative to market expectations in the short term

However, we note that Smallco is highly selective with short selling, and thus it is rarely utilised in the Fund.

Portfolio holdings and potential candidates for inclusion or short selling are subject to a rigorous peer-review process as part of the monthly portfolio review.

Overall, Zenith believes the security selection process adopted by Smallco is sufficiently robust and that the research conducted by the investment team is comprehensive.

## PORTFOLIO CONSTRUCTION

The portfolio construction process is primarily driven by fundamental analysis conducted by the investment team. Smallco constructs the Fund through a benchmark unaware approach, with the number of positions and weightings a function of investment opportunities rather than the relative benchmark composition.

The portfolio construction approach allows for the team's best ideas based on their risk/return profiles and the team's conviction levels to be represented in the Fund. Portfolio guidelines, stock liquidity and downside risk are considered to avoid unnecessary risks in the Fund.

The size of an individual position is mainly dependent upon its target price and the quality rating. As a guide, initial position sizes of 3%, 5% or 7% will be implemented based on a combination of these two factors.

The Fund's positions will predominantly be in small cap stocks, with exposures to S&P/ASX 100 stocks limited to 20% of the portfolio. This limit does not apply to small cap positions that have graduated into the S&P/ASX 100 Index due to strong performance.

Short positions are only initiated opportunistically and where they are sufficiently compelling based on the output of the security selection process. As such, Zenith notes that short selling is rarely utilised in the Fund.

As part of the portfolio construction process, an overall weighted average quality rating is calculated for the portfolio. The weighted average portfolio rating is not permitted to fall below 4; Smallco's assessment of the market average. In addition, Smallco employs a 25% limit on the Fund's total exposure to companies rated 3 or less. Zenith believes the presence of the quality rating system promotes discipline and mitigates the risk of the portfolio being overly exposed to lower quality stocks.

Zenith notes that, in 2016, the Fund's investment strategy was changed to allow the Fund's exposure to illiquid stocks to increase to 30%, which was previously 25%. Smallco defines an illiquid holding as a holding in which it owns greater than 75% of the security's average monthly market volume. Given the Fund typically holds a material exposure to small capitalisation securities, Zenith believes the previous limit of 25% was more appropriate.

The Fund typically holds between 25 and 35 securities, with portfolio turnover expected to be approximately 40% p.a. While the Fund can hold a maximum of 50% in cash, it has averaged approximately 20%. Zenith believes that actively managed equities funds should remain fully invested and that the asset allocation decision should be left to the individual investor.

Portfolio holdings will be sold, reduced or reviewed under the following circumstances:

- Smallco's valuation target has been achieved
- The investment thesis for a stock changes
- Availability of superior investments
- To avert a breach in any of the Fund's portfolio construction constraints

Short positions are subject to stop-loss limits. Whilst Zenith notes that the use of stop-losses promotes sell discipline, they can potentially lead to the portfolio crystallising losses at an inopportune time.

Whilst Smallco is permitted to vary the Fund's net equity exposure between 0% and 150%, given the long-biased nature of the Fund, its net equity exposure has typically oscillated around 80%. Smallco does not make tactical asset allocation decisions, with the Fund's equity exposure primarily a result of available investment opportunities, both long and short. Zenith notes that this differs from some of the Fund's peers, where tactical allocations between equities and cash can be made to suit the prevailing market conditions as an additional source of value add.

Smallco also has the ability to employ explicit leverage within the Fund. The portfolio may be geared up to 30% actively and allowed to drift passively to a maximum of 50%. Zenith notes that Smallco has been relatively conservative in its application of gearing, which has not been used since 2006.

Zenith is comfortable with Smallco's portfolio construction approach, believing it ensures a strong connection between the output of the security selection process and the resultant weight of the stock in the portfolio.

## RISK MANAGEMENT

| Portfolio Constraints | Description |
|---|---|
| Security Numbers | 25 to 35 |
| Absolute Stock Weight (%) | max: 20% (max. 10% at time of purchase) |
| Short Exposure (%) | max: 30% (allowed to drift passively to 50%) |
| Sector Exposures | Must hold stocks across at least 4 sectors |
| Exposure to Illiquid Stocks (%) | max: 30% |
| S&P/ASX 100 Exposure (%) | max: 20% |
| Stop Loss - Hard (%) | max: 7% (Typically covered at 2%) |
| Leverage (%) | max: 30% (Allowed to drift passively to 50%) |
| Cash (%) | max: 50% |
| Expected Portfolio Turnover (%) | 40% p.a. |
| ESG Constraints - Excluded Sectors | Alcohol, Armaments/Cluster Munitions, Gaming, Tobacco |

The Fund's formal risk management constraints, as outlined above, are broad and provide Smallco with significant scope to achieve its investment objective.

Investors should be aware of the concentrated nature of the Fund and relatively generous limit relating to maximum individual security weights. Given the Fund is invested predominantly in small capitalisation securities, Zenith believes a more conservative position limit should be in place.

Smallco defines an illiquid holding as a holding in which it owns greater than 75% of the security's average monthly market volume. Zenith believes that Smallco's assessment of stock liquidity is not as conservative as peers. Investors should be aware that during a significant market event the liquidity profile of the Fund could be low, leading to potential capital impairment.

Smallco's detailed fundamental approach to stock selection, including the quality rating system, acts as the main tool for mitigating the risk of poor stock selection.

Stop-losses are applied at the individual stock level. A hard limit is applied where the loss from an individual short position equates to 7% of the portfolio. Whilst Zenith believes this limit is relatively broad and potentially exposes the Fund to an excessive loss from a single position, we note that loss-making short positions are typically removed at the 2% level.

Formal internal meetings occur on a monthly basis to monitor the portfolio's characteristics, exposures and market events. However, given the flat investment team structure, Zenith notes that communication amongst the team occurs on an ongoing basis.

Notwithstanding the issues noted above, Zenith believes Smallco's risk management processes are adequate, particularly given the detailed due diligence conducted as part of the security selection process. However, investors should be aware there is a significant reliance on the judgement and skill of Smallco's investment team in managing investment risk.

### Environmental, Social and Governance (ESG)

Although the portfolio has specific exclusions, as outlined in the table above, ESG considerations are not evaluated as a key part of the investment process. Zenith believes that qualitative analysis of a company's operations is crucial on a forward basis, given that a company's performance with regards to ESG considerations is increasingly being reflected in the company's share price. While Zenith believes the use of the screen is honourable, we note the definitions of the exclusions are at the discretion of Smallco as opposed to an independent external ESG expert. Overall, while we do not believe Smallco considers ESG factors to the same extent as peers, we are comfortable with its approach.

## ADMINISTRATION AND OPERATIONS

***Operations***

The Compliance Committee is responsible for the operational risk framework.

***Service Providers***

*Securities Lender*

Macquarie

*Administrator*

Link Fund Solutions

*Custodian*

JP Morgan

*Auditors*

Crowe Horwath

***Pricing***

The Fund's assets and liabilities are usually valued each business day. Generally, listed securities are valued using the last available market close price quoted on the relevant exchange. Other assets are valued at their recoverable value with liabilities valued at cost.

***Personal trading***

Personal trading is allowed, however prior approval must be gained from the principals.

***Compliance***

Smallco holds an Australian Financial Services Licence (AFSL). Smallco has lodged the Fund's compliance plan with ASIC and established a compliance committee with a majority of external members.

## INVESTMENT FEES

*The sector average management cost (in the table below) is based on the average management cost of all flagship Australian Shares - Long/Short funds surveyed by Zenith.*

A management cost of 1.55% p.a. (including expense recoveries) applies to this Fund. The Fund also has a performance fee of 18.64%, payable on any increase in the net asset value of the Fund, subject to the recoupment of all prior negative performance. The performance fee is calculated and paid semi-annually.

Zenith believes the performance fee for the Fund is poorly structured due to the lack of an appropriate benchmark. Given the Fund will typically exhibit equity-like risk/return characteristics, an appropriate benchmark is required to ensure that any performance fees payable are justified. As it currently stands, Zenith believes that the hurdle applied to the performance fee is too low and not commensurate with the Fund's risk profile.

Overall, Zenith believes the Fund's fee structure is expensive, relative to peers, given its stated objectives. In addition, we believe that investors have not been sufficiently compensated by way of risk-adjusted performance given the fees paid over the past three years (ending 30 June 2019).

There is also a 0.45% buy/sell spread applicable to all applications and redemptions. Zenith believes the buy/sell spread is high on an absolute and relative basis. As such, we believe there is scope for this to be reduced.

*(The fees mentioned above are reflective of the flagship version only, fees may differ when the product is accessed through an alternative investment vehicle such as platform).*

| Fees Type | Fund | Sector Average (Wholesale Funds) |
|---|---|---|

| | | |
|---|---|---|
| Management Cost | 1.55% p.a. | 1.15% p.a. |
| | Description | |
| Performance Fee | 18.64% of the unit price increase over each 6-month period subject to the recoupment of all prior negative performance. | |
| | Buy Spread | Sell Spread |
| Buy / Sell Spread | 0.45% | 0.45% |

## PERFORMANCE ANALYSIS

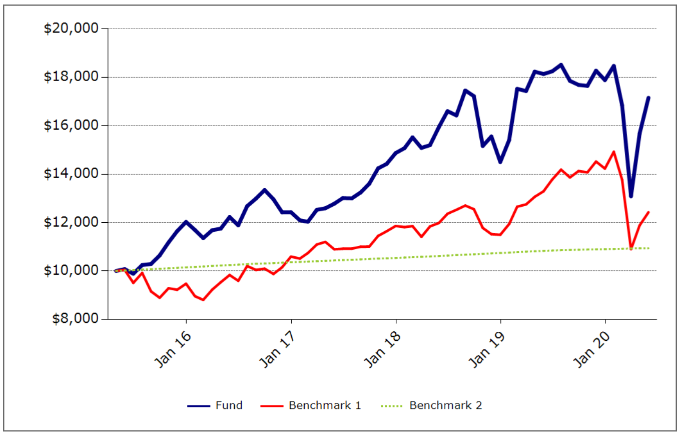
Report data: 31 May 2020, product inception: Jan 2001

### Monthly Performance History (%, net of fees)

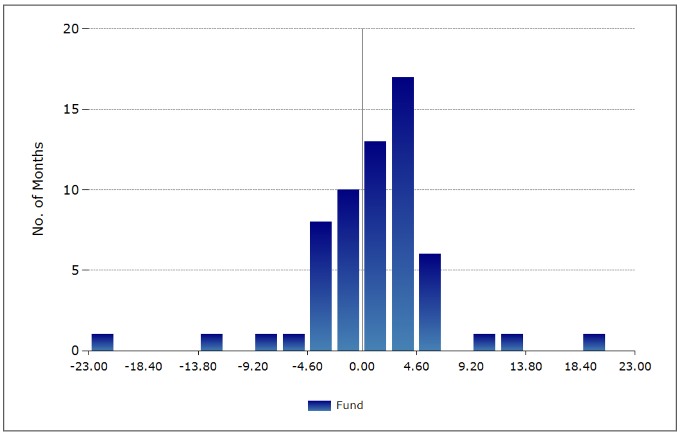
| | JAN | FEB | MAR | APR | MAY | JUN | JUL | AUG | SEP | OCT | NOV | DEC | FUND YTD | BENCHMARK YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2020** | 3.28 | -8.80 | -22.29 | 19.74 | 9.45 | | | | | | | | -4.07 | -12.67 |
| **2019** | 6.24 | 13.74 | -0.52 | 4.59 | -0.52 | 0.60 | 1.48 | -3.58 | -0.93 | -0.23 | 3.57 | -2.14 | 23.32 | 23.78 |
| **2018** | 1.36 | 2.97 | -2.82 | 0.77 | 4.93 | 4.10 | -1.05 | 6.28 | -1.35 | -11.95 | 2.58 | -6.77 | -2.47 | -3.07 |
| **2017** | -2.70 | -0.48 | 4.08 | 0.53 | 1.49 | 1.83 | -0.10 | 1.88 | 2.71 | 4.69 | 1.29 | 3.09 | 19.66 | 11.95 |
| **2016** | -2.77 | -2.87 | 2.87 | 0.56 | 4.09 | -2.82 | 6.67 | 2.48 | 2.71 | -2.88 | -4.14 | 0.03 | 3.34 | 11.80 |

Benchmark: S&P/ASX 300 (Accum)

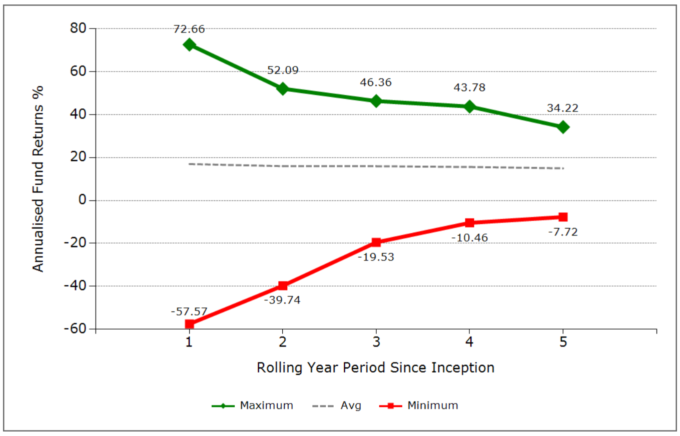
### Growth of $10,000




### Monthly Histogram




### Minimum and Maximum Returns (% p.a.)




### ABSOLUTE PERFORMANCE ANALYSIS

| Return | Incpt. | 5 yr | 3 yr | 1 yr |
|---|---|---|---|---|
| Fund (% p.a.) | 13.60 | 11.23 | 10.32 | -5.41 |
| Benchmark (% p.a.) | 7.51 | 4.35 | 4.48 | -6.52 |
| Benchmark 2 (% p.a.) | 4.06 | 1.77 | 1.58 | 0.97 |
| Median (% p.a.) | 8.58 | 4.39 | 4.43 | -5.27 |
| **Ranking within Sector** | **Incpt.** | **5 yr** | **3 yr** | **1 yr** |
| Fund Ranking | 1 / 3 | 2 / 18 | 3 / 22 | 13 / 23 |
| Quartile | 1st | 1st | 1st | 3rd |
| **Standard Deviation** | **Incpt.** | **5 yr** | **3 yr** | **1 yr** |
| Fund (% p.a.) | 18.32 | 19.32 | 23.46 | 33.13 |
| Benchmark (% p.a.) | 13.58 | 15.15 | 16.62 | 25.78 |
| Median (% p.a.) | 15.45 | 15.44 | 17.43 | 25.93 |
| **Downside Deviation** | **Incpt.** | **5 yr** | **3 yr** | **1 yr** |
| Fund (% p.a.) | 11.37 | 12.14 | 15.08 | 21.73 |
| Benchmark (% p.a.) | 8.75 | 10.99 | 12.91 | 20.28 |
| Median (% p.a.) | 9.55 | 10.90 | 12.83 | 19.76 |
| **Risk/Return** | **Incpt.** | **5 yr** | **3 yr** | **1 yr** |
| Sharpe Ratio - Fund | 0.52 | 0.49 | 0.37 | -0.19 |
| Sortino Ratio - Fund | 0.84 | 0.78 | 0.58 | -0.29 |

*To ensure consistency, Zenith rates all Australian equities funds against a standard benchmark (S&P/ASX 300 Accumulation Index). However, Smallco benchmarks itself against the S&P/ASX Small Ordinaries Accumulation Index.*

*All commentary below is as at 31 May 2020.*

Instead of providing a specific return target or timeframe, the Fund aims to achieve high absolute returns for investors.

Zenith would prefer to see the delineation of a specific outperformance target, as opposed to a descriptive, qualitative objective. Zenith believes this will provide investors with greater transparency with regards to returns expectations and to the level of risk imbedded in the Fund.

The Fund has demonstrated material outperformance relative to the benchmark and the median manager over the medium to long term.

The Fund has produced investment returns with an absolute risk (as measured by Standard Deviation) higher than the benchmark over all assessed periods.

## RELATIVE PERFORMANCE ANALYSIS

| Alpha Statistics | Incpt. | 5 yr | 3 yr | 1 yr |
|---|---|---|---|---|
| Excess Return (% p.a.) | 6.09 | 6.88 | 5.84 | 1.10 |
| % Monthly Excess (All Mkts) | 57.94 | 53.33 | 52.78 | 33.33 |
| % Monthly Excess (Up Mkts) | 57.43 | 55.26 | 60.00 | 42.86 |
| % Monthly Excess (Down Mkts) | 58.82 | 50.00 | 36.36 | 20.00 |
| **Beta Statistics** | **Incpt.** | **5 yr** | **3 yr** | **1 yr** |
| Beta | 1.01 | 1.02 | 1.25 | 1.20 |
| R-Squared | 0.56 | 0.64 | 0.79 | 0.87 |
| Tracking Error (% p.a.) | 12.10 | 11.65 | 11.65 | 12.85 |
| Correlation | 0.75 | 0.80 | 0.89 | 0.93 |
| **Risk/Return** | **Incpt.** | **5 yr** | **3 yr** | **1 yr** |
| Information Ratio | 0.50 | 0.59 | 0.50 | 0.09 |

*All commentary below is as at 31 May 2020.*

Zenith seeks to identify funds that can outperform in over 50% of months in all market conditions, as we believe this represents consistency of manager skill. The Fund has achieved this outcome over the medium to long term.

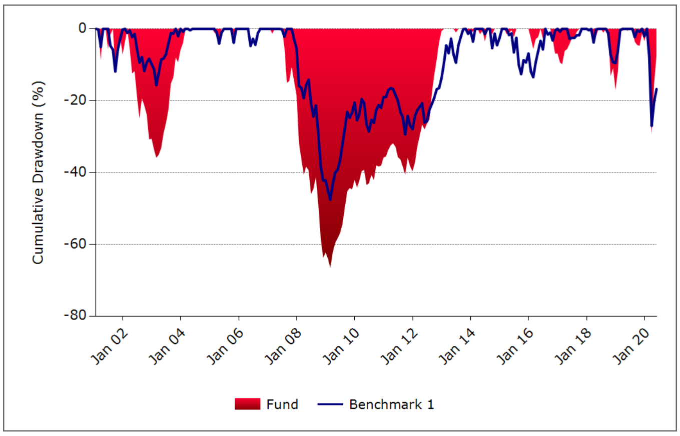
The Fund has displayed a significantly stronger consistency of outperformance during falling market conditions since inception.

## DRAWDOWN ANALYSIS

*Drawdown analysis assesses the relative riskiness of a Fund versus the benchmark, in reference to capital preservation. The maximum Drawdown is recorded as the percentage decline in the value of a portfolio from peak to trough (before a new peak is achieved). All Drawdown analysis is calculated commencing from the inception date of the Fund in question, and Drawdown analysis for the Fund and benchmark(s) are calculated independently. That is, the largest drawdown for the Fund and benchmark(s) will not always refer to the same time period.*

| Drawdown Analysis | Fund | Benchmark |
|---|---|---|
| Max Drawdown (%) | -66.63 | -47.55 |
| Months in Max Drawdown | 20 | 16 |
| Months to Recover | 47 | 56 |

| Worst Drawdowns | Fund | Benchmark |
|---|---|---|
| 1 | -66.63 | -47.55 |
| 2 | -35.91 | -26.97 |
| 3 | -29.30 | -15.65 |
| 4 | -16.93 | -13.46 |
| 5 | -10.58 | -11.85 |




*All commentary below is as at 31 May 2020.*

The Fund experienced drawdowns that were more severe than those of the benchmark in 2002 and 2008. However, the Fund subsequently recovered from its maximum drawdown more swiftly than the benchmark.

Zenith notes that the drawdowns occurred prior to the introduction of the quality rating system in July 2008, which seeks to prevent the portfolio from holding an excessive number of lower quality stocks. Zenith notes that the Fund has generally demonstrated a propensity to protect investor capital in declining markets since the introduction of the quality rating system.

## INCOME/GROWTH ANALYSIS

| Income / Growth Returns | Income | Growth | Total |
|---|---|---|---|
| FY to 30 Jun 2019 | 13.48% | -3.68% | 9.80% |
| FY to 30 Jun 2018 | 11.10% | 16.40% | 27.50% |
| FY to 30 Jun 2017 | 8.50% | 1.00% | 9.50% |
| FY to 30 Jun 2016 | 7.20% | 13.00% | 20.20% |
| FY to 30 Jun 2015 | 7.00% | 8.70% | 15.70% |
| FY to 30 Jun 2014 | 0.90% | 20.50% | 21.40% |
| FY to 30 Jun 2013 | 1.12% | 56.86% | 57.98% |
| FY to 30 Jun 2012 | 1.39% | 13.15% | 14.54% |

The Fund does not target specific income levels.

Where applicable, distributions are paid annually. Zenith would prefer a more frequent distribution profile to alleviate potential issues involved with large distributions at 30 June.

The Fund's portfolio turnover is expected to be approximately 40% p.a., which Zenith considers to be low. Smallco was not able to provide any insight on the proportion of expected turnover attributed to the resizing of existing positions and that which is due to initiating and closing positions. Given this expected level of turnover, the majority of the Fund's returns are expected to be delivered via capital appreciation in the unit price, rather than through the realisation of capital gains in income distributions. In addition, realised capital gains are highly likely to be eligible for the capital gains tax discount. As such, holding all else equal, the Fund may be more appealing to investors who are high marginal tax rate payers as it will result in superior after-tax return outcomes.

## REPORT CERTIFICATION

Date of issue: 9 Jun 2020

| Role | Analyst | Title |
|---|---|---|
| Author | Tom Goodrich | Investment Analyst |
| Sector Lead | Jacob Smart | Senior Investment Analyst |
| Authoriser | Bronwen Moncrieff | Head of Research |

## ANALYST DISCLOSURE

As at the time this report was issued, the Analyst, report Authoriser and/ or the Sector Lead holds interests in either the product, the product issuer or a relevant related party. The Analyst/Authoriser/Sector Lead certifies that the extent of the holding is non-material in nature and has been undertaken in accordance with Zenith's Trading Policy and RG79.149(c).

## RATING HISTORY

| As At | Rating |
|---|---|
| 9 Jun 2020 | Recommended |
| 12 Jun 2019 | Recommended |
| 14 Jun 2018 | Recommended |
| 31 May 2017 | Recommended |
| 9 Jan 2017 | Recommended |
| 21 Jun 2016 | Recommended |
| 12 Jan 2016 | Recommended |
| 2 Jul 2015 | Recommended |

Last 5 years only displayed. Longer histories available on request.

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