Lonsec

Recommended

Product Review
Smallco Investment Fund

ISSUE DATE 06-09-2018

About this Review

ASSET CLASS REVIEWED	AUSTRALIAN EQUITIES
SECTOR REVIEWED	AUSTRALIAN LONG SHORT
SUB SECTOR REVIEWED	VARIABLE BETA
TOTAL FUNDS RATED	8

About this Fund

ASIC RG240 CLASSIFIED	YES
FUND REVIEWED	SMALLCO INVESTMENT FUND
APIR CODE	ASC0001AU
PDS OBJECTIVE	NO FORMAL OBJECTIVE – THE MANAGER AIMS TO GENERATE HIGH COMPOUND RETURNS BY INVESTING IN THE SECURITIES MARKET, ALTHOUGH RETURNS ARE NOT GUARANTEED
INTERNAL OBJECTIVE	ABSOLUTE RETURNS (AFTER FEES)
STATED RISK OBJECTIVE	N/A
DISTRIBUTION FREQUENCY	ANNUALLY
FUND SIZE	$360M (JULY 2018)
FUND INCEPTION	31-10-2000
MANAGEMENT COSTS	1.56% P.A.
PERFORMANCE FEE	18.64% (OF THE ADJUSTED NET ASSET INCREASE ABOVE THE PREVIOUS HIGH WATER MARK)
RESPONSIBLE ENTITY	SMALLCO

About the Fund Manager

FUND MANAGER	SMALLCO
OWNERSHIP	100% SMALLCO STAFF
ASSETS MANAGED IN THIS SECTOR	$870M (JULY 2018)
YEARS MANAGING THIS ASSET CLASS	18

Investment Team

PORTFOLIO MANAGER	ROB HOPKINS, BILL RYAN, ANDREW HOKIN, PAUL GRAHAM, ADAM SIMPSON & CRAIG MILLER
INVESTMENT TEAM SIZE	6
INVESTMENT TEAM TURNOVER	VERY LOW
STRUCTURE / LOCATION	SYDNEY

Investment process

STYLE	GARP
TYPICAL STOCK NUMBERS	25-35
NET MARKET EXPOSURE RANGE	50-150% (TYPICALLY 90%)
TYPICAL CAPITALISATION BIAS	SMALL-TO-MID
GEARING LIMIT	UP TO 50%
STOCK LIMITS	MAXIMUM OF 10% OF FUND VALUE AT COST, MAXIMUM OF 20% OF FUND VALUE (AT CURRENT VALUATION)
SECTOR / INDUSTRY LIMITS	EXPOSURE TO A MINIMUM OF 4 GICS SECTORS

Fund rating history

SEPTEMBER 2018	RECOMMENDED
SEPTEMBER 2017	RECOMMENDED
NOVEMBER 2016	RECOMMENDED

What this Rating means

The **'Recommended'** rating indicates that Lonsec has strong conviction the financial product can generate risk adjusted returns in line with relevant objectives. The financial product is considered an appropriate entry point to this asset class or strategy.

Strengths

- Boutique investment culture supported by strong alignment with high personal equity ownership of key investment personnel.
- High conviction, benchmark unaware approach with a strong focus on companies within the $100m-$500m market capitalisation bracket.
- The Fund has displayed a strong track record since its inception.
- Disciplined approach to capacity management.

Weaknesses

- The Fund's fee load is considered expensive relative to peers, with a 1.56% p.a. management fee and a 18.64% performance fee earnt on any positive performance.
- The Fund makes minimal use of shorting, which may be a weakness for investors searching for capital preservation in a decreasing equity market environment.
- The Fund has persistently had a cash weight of greater than 14% since 2013.

Fund Risk Characteristics

	LOW		MODERATE		HIGH
BUSINESS SUSTAINABILITY RISK			●		
CAPITAL VOLATILITY					●
SECURITY CONCENTRATION RISK				●	
SECURITY LIQUIDITY RISK				●	
LEVERAGE RISK			●		

Risk categories are based on Lonsec's qualitative opinion of the risks inherent in the financial product's asset class and the risks relative to other financial products in the relevant Lonsec sector universe.

BIOmetrics

Aggregated risks

	1	2	3	4	5	6	7
STD RISK MEASURE						●	

A Standard Risk Measure score of 6 equates to a Risk Label of 'High' and an estimated number of negative annual returns over any 20 year period of 4 to less than 6. This is a measure of expected frequency (not magnitude) of capital losses, calculated in accordance with ASFA/FSC guidelines.

	LOW	MODERATE	HIGH
RISK TO INCOME		●	

ANALYST: MATTHEW O'NEILL | APPROVED BY: SAM MORRIS

Smallco Investment Fund

Features and benefits

	LOW		MODERATE		HIGH
COMPLEXITY				●	
ESG AWARENESS	●				

Fee profile

	LOW	MODERATE	HIGH
FEES VS. UNIVERSE			●
FEES VS. ASSET CLASS			●
FEES VS. SUB-SECTOR			●

Fee BIOmetrics are a function of expected total fee as a percentage of expected total return.

What is this Fund?

- The Smallco Investment Fund ('the Fund') is a concentrated, 'benchmark unaware' Australian equity product with a small capitalisation focus. The Fund has a flexible investment mandate, including the ability to short, gear, have a large weighting to ex-100 stocks and/or high levels of cash. It also has a mild ethical overlay which excludes companies with a principal business activity in alcohol, armaments, gambling and tobacco. Lonsec notes that the Fund does not have a specific performance objective target.
- The Fund is managed by Smallco Investment Management Ltd ('Smallco' or 'the Manager'). Smallco believes they are able to source investment opportunities with above-average return potential by conducting rigorous fundamental analysis into a company's earnings and cash generation abilities, management quality and industry characteristics. Smallco prefers to use 'bottom-up' analysis as opposed to macroeconomic research when sourcing investment ideas and constructing the underlying portfolio.
- The Manager particularly targets companies in the $100m-500m market capitalisation range, believing there are greater inefficiencies in this part of the market. That said, the Fund has the discretion to hold up to 20% of the portfolio in 'top-100' stocks.
- The Fund generally avoids sectors with more cyclical earnings such as retail, building materials and resources. That said, there are occasions where it will make investments in cyclical sectors and stocks based on a 'top-down' view. It also avoids companies with embryonic business models (such as biotechs), believing earnings are too hard to forecast.
- As stipulated in the Fund's mandate, it is able to hold up to 50% of all capital in cash. The allocation to cash will be primarily determined by the number of attractive investment opportunities in the investment universe (i.e. limited opportunities would warrant an increased cash weighting). At the time of Lonsec's most recent review, the Fund had 17.5% allocated to cash (30 May 2018).
- The Fund has the ability to short stocks, although these positions are expected to be opportunistic rather than a systematic part of the portfolio. The Fund was not shorting any stocks at the time of review, which was similar to last years' review.
- The Manager has the ability to borrow up to 30% of the Fund's Net Asset Value (NAV) via a margin lending facility. Gearing will never exceed 50% of the total assets of the Fund. Lonsec notes that gearing facility has rarely been utilised over the Fund's history, and has mainly been employed to manage the Fund's short exposure.
- The Manager charges a Management Cost of 1.56% p.a. and is entitled to a performance fee, payable six monthly, calculated as '18.64% of the adjusted net asset increase above the previous high water mark'.
- Lonsec notes the lack of any hurdle for payment of the performance fee other than positive absolute performance above the high water mark. While the Fund does not have an explicit return target, Lonsec would prefer to see a performance fee hurdle which is commensurate with its investment style and performance objectives. Further, despite its broad mandate, the Fund has rarely used its ability to short and gear the Fund which is not reflective of its higher fee in comparison to the Manager's alternative offering, the Smallco Broadcap Fund (SBF), whose portfolio manager is Andrew Hokin. Whilst the SBF is managed utilising a consistent investment style to the Fund, it does not have the ability to use leverage nor short securities, and thus charges a lower management cost and performance fee.

Using this Fund

This is General Advice only and should be read in conjunction with the Disclaimer, Disclosure and Warning on the final page.

- The Fund is subject to equity market risks and movements (both positive and negative) in the prices of the underlying securities in the portfolio. Investors should therefore be aware of/comfortable with the potential for the Fund to experience periods of negative returns which result in capital losses being incurred on their investment. As such, the Fund will generally sit within the growth component of a diversified portfolio.
- Investors should note that this Fund has the ability to gear. Gearing magnifies the positive and negative returns from investments relative to an un-geared portfolio.
- Advisors should consult the Lonsec Risk Profile Review and/or the Lonsec Risk Profile Definitions document(s) for guidance on appropriate allocations to Australian equities within a diversified portfolio. Lonsec recommends that equity investments are suitable for investors with an investment-time horizon of at least five years.
- In Lonsec's view, the unconstrained nature of the Fund means it is best used as a 'satellite' strategy to complement large cap exposures in client's portfolios, and can be blended with 'benchmark aware' or low relative risk targeted products.

Suggested Lonsec risk profile suitability

SECURE	DEFENSIVE	CONSERVATIVE	BALANCED	GROWTH	HIGH GROWTH
		●	●	●	●

For guidance on appropriate asset allocations and risk profiles, refer to the latest Lonsec Strategic Asset Allocation Review and Risk Profile Definitions on our website.

Smallco Investment Fund

Changes Since Previous Lonsec Review

- Lonsec has not been advised of any changes to the investment team or process since the previous review of the Fund.

Lonsec Opinion of this Fund

People and resources

- The Smallco investment team consists of six investment professionals, with three of the most senior members of the investment team having previously worked alongside each other at ANZ Securities. While the team tends to adopt a collective decision making philosophy, Rob Hopkins is the portfolio manager of the Fund and is ultimately accountable for its performance. Hopkins possesses over 30 years' investment experience, and Lonsec considers his investment skill set to be well aligned to Smallco's fundamental bottom-up stock selection process.
- Hopkins sits alongside the five remaining members of the investment team, namely Bill Ryan, Andrew Hokin, Craig Miller, Paul Graham and Adam Simpson. All members of the investment team, with the exception of Miller, focus exclusively on investment-related activities. The investment team exhibits notable tenure working together at the Manager and/or at other asset management firms. To this, Simpson, the most recent hire, previously worked with Hokin at Macquarie for approximately five years. This practice suggests greater likelihood of enhanced team and cultural fit noting Graham also previously worked with Hopkins and Ryan at ANZ Securities. While on aggregate the size of the investment team appears smaller than some peers, Lonsec judges the scale of resourcing to be appropriate for the investment process.
- Despite the size of the team, Lonsec notes the team benefits from above-average depth of investment experience (22 years). This is further supported by the fact the Manager tends to gravitate towards small and mid cap names.
- Smallco also has several part-time resources, covering accounting, compliance, information technology, and database management. Administration of the Fund is outsourced to White Outsourcing, whilst JP Morgan provides custody services. Given the Manager's boutique structure, Lonsec considers this to be a prudent approach allowing the key investors to focus solely on investment-related matters.
- Lonsec observes a highly performance-driven culture at Smallco, one which to date has proven to be conducive to a stable environment with a clear alignment of interests between the investment team and end investors. Hopkins and Ryan remain large equity owners of the business and, pleasingly, equity stakes have been afforded to other investment team members strengthening their engagement with the firm. Additionally, there is a high level of staff co-investment and a performance fee structure in place. Lonsec is pleased to note that there have been no departures from the investment team since inception (2000).
- Lonsec considers 'key person risk' in co-founders Hopkins and Ryan to be high, given their integral involvement in Smallco's investment process and the broader business. To this end, Lonsec acknowledges the equity ownership structure to be a significant mitigating factor and notes Andrew Hokin's tenure at the Manager and involvement in the investment process. Nonetheless, Lonsec would view the departure of these individuals to be a material event. That said, Lonsec notes the co-portfolio manager structure serves to aid key investor continuity.
- Succession planning poses a difficult issue for investment firms, in particular, boutique investment firms reliant on one or two founding investment identities. While there is no indication of any key departures, Lonsec believes it is appropriate that the Manager continues to plan for the ongoing leadership of both the business and key investment strategies. Lonsec, however, acknowledges the Manager's recent recruitment effort, culminating in the hires of Graham and Simpson, ameliorates some concerns around succession planning but nonetheless highlights the recency of the hires and will therefore continue to monitor these aspects in future reviews.
- Pleasingly, given the growth in FUM in recent years, the profitability of the firm has continued to improve and at current levels is no longer a concern. Lonsec continues to be impressed with the firm's longevity and commitment to expanding going forward. The firm's retail-only-focus and elevated price point does assist in supporting business health.

Research and portfolio construction

- The investment philosophy is centered on identifying companies that are likely to exceed consensus earnings estimates in the medium-term given pricing inefficiencies are likely to be more prevalent in small to mid cap names. This leads Smallco to seek out a core group of quality companies, trading at a price below which Smallco considers their true underlying value, through a criteria that favours companies with high cash generation ability; attractive earning outlooks; and strong competitive advantages. Considering Smallco's long-standing quality investment style, which is reasonably pervasive across the small cap specialist peer group, Lonsec believes Smallco offers a competitive advantage in researching stocks in the $100-$500m market capitalisation bracket.
- The investment process is considered to be pragmatic and bespoke to Smallco's philosophy through a focus on understanding the key drivers of earnings. Engagement with company management features prominently and underpins the internal research effort with two investment team members assigned for each meeting. Lonsec highlights the strong emphasis placed on meeting with company management believing this to be conducive to high conviction, concentrated approaches. Lonsec has reviewed the Manager over a number of years and has a strong level of conviction in Smallco's 'bottom-up' research process.
- Smallco leverages the use of 'sell-side' research in the preliminary stages of the investment process, primarily to expedite the process of familiarisation with new companies and industries. Lonsec notes, however, internally generated research is the driver of investment decisions. Valuation analysis involves the amalgamation of multiples-based valuation tools

(Price to Cash Flow, Price to Earnings and EBITDA ratios etc.) which are forecast to a standardised, three-year, time horizon. Smallco's dual coverage approach to stocks extends to financial modelling and is considered to promote robustness in challenging key inputs into models to assist in proving/disproving investment theses. Lonsec considers this to be a positive and encourages procedural rigour to the investment process.

- Portfolio construction is primarily driven by Smallco's 'Quality Rating System' model to aid in limiting exposure to lower quality names trading at 'attractive' prices. Lonsec considers the portfolio construction process to be robust, with a clear link between the team's conviction in each stock, the assessment of its risk, and its weight within the portfolio. The high conviction nature of the investment process means only the Manager's best ideas are included in the portfolio. Nonetheless, in times of limited opportunities, the Manager will tend to increase its weighting in cash. Lonsec assesses the asset allocation decision between cash and equities to be more 'art than science' in comparison to some multi-asset products which might incorporate some form of systematic determination, such as a valuation trigger.
- The portfolio will tend to be concentrated at stock and sector level, with initial individual stock positions of up to 10% allowed on purchase, up to a limit of 20% based on current valuation. That said, Lonsec notes some consideration has been given to diversification, with a requirement the portfolio has exposure to a minimum of four Global Industry Classification Standard (GICS) sectors.
- Positions are pared as they approach the Manager's assessment of their intrinsic value and are typically sold when they surpass the Manager's predicted value or there is a negative change in the company's fundamentals. However, Lonsec notes the flexibility around sell discipline with the Manager having displayed a tendency to tolerate holding growth stocks with high valuations if their 'fundamental growth story' is still judged to be positive. Notwithstanding, Lonsec considers the Manager to be more pragmatic in reducing stock weights as they approach the investment team's predicted valuation relative to some of its peers and is more active in selling positions judged to be 'lower quality' and/or positions with more cyclical earnings.
- Whilst the Manager has the flexibility to short sell and gear, the gearing facility is rarely used (last used August 2007) and the level of shorting in the context of peers in the sector is relatively marginal. Candidates for shorting are fundamentally driven (i.e. fundamental analysis indicates that the stock is overvalued) and are included only when an identifiable catalyst exists, indicating it is likely to disappoint market expectations in the short-term. Lonsec considers this approach to be consistent with its overall investment philosophy. Nevertheless, the shorting aspect of the process is less frequently featured in the Fund comparable to typical long-short competitors. The opportunistic nature of this aspect is evident in the Manager's shorting of CYBG PLC (ASX: CYB) with the market turning negative on the stock during the aftermath of Britain's referendum to leave the European Union.
- The ability of the Fund to hold up to 50% of its NAV in cash adds a defensive tilt to the portfolio and is utilised when investment ideas are not readily present. The Fund has averaged a cash balance of around 18% since Lonsec's previous review with the Manager having previously demonstrated the ability to utilise the extent of its cash limit (e.g. during the GFC). Nonetheless, Lonsec notes that the persistently high cash weight has been a drag on performance since inception and although Lonsec has been encouraged by the Manager's disciplined approach to capacity management, the high cash level may be an indication of capacity/liquidity concerns.

Risk management

- Lonsec believes that the Manager has adequate risk controls in place to manage the long and short side of the portfolio although notes that risk management is largely embedded within the Manager's 'bottom up' investment process. On the short side, a shorting agreement stipulates trading rules, there is a maximum stop loss of 7% for each position, and prior to entering each new short, a trading schedule is prepared detailing the 'sell' and 'buy back' prices for the stock in question. Lonsec considers this to be a prudent discipline.
- On the long side, the Manager's 'Quality Rating System' assigns a score to each stock in the portfolio from which the Manager calculates a weighted average quality rating for the portfolio. An internal portfolio construction rule requires the portfolio to meet a minimum quality score. Lonsec believes the use of these scores assists the Manager in avoiding unintended risk within the portfolio, enhancing sell discipline, and ensuring exposure to lower quality and cyclical stocks are controlled.
- The Fund also employs a separate 25% limit on total exposure to what are assessed as 'low quality' companies. Smallco has a relatively broad definition of what constitutes 'low quality', which includes most non-major resource and mining service stocks and others considered to be in structurally impaired industries.
- The Fund may be geared up to 30% actively via a margin lending facility. This may passively increase to a maximum of 50% (i.e. this can occur in a situation in which the Fund's equity declines). Gearing is primarily used to manage the portfolio's short exposure. The Manager has historically been relatively conservative in its application of gearing (as well as shorting) and has generally only geared the portfolio if a distinct opportunity arises. The Fund has not used gearing in the last eleven years (August 2007). Further, the Fund can invest up to 30% of the portfolios NAV in 'illiquids'. While Losnec considers these allocation to be generous, these are in line with the Manager's tight capacity management.

Funds Under Management

- Since Lonsec's previous review, the Manager has 'hard' closed both the Fund and the Smallco Broadcap Fund, effective as of 1 February 2017 with \$820m under management. As at July 2018, firm wide FUM approximated \$870m.

Smallco Investment Fund

- Historically, Lonsec has pleasingly observed prudent discipline by the Manager in relation to FUM/ capacity management, having previously closed the Fund to investors when capacity was reached. Pleasingly, the Manager has continued to display prudent judgement through the Fund's recent 'hard' closure. Lonsec supports Smallco's discipline on this aspect which should serve to preserve the appeal of the offer.

Performance

- The objective of the Fund is to generate positive absolute returns over a rolling three-year time period. Given the relatively high equity exposure (c. 80%) and the shorting capabilities of the Fund, Lonsec considers this objective to be relatively conservative. Nevertheless, the Fund has been comprehensively able to achieve its stated objective over the assessed period (all figures net of fees to 31 July 2018).
- The Fund has an impressive long-term track record, returning 17.2% p.a. over 10 years, outperforming the Lonsec assigned benchmark, the S&P/ASX 300 Accumulation Index ('the Benchmark') and the Lonsec 'Australian Long Short – Variable Beta' peer group median by 10.3% p.a. and 7.4% p.a., respectively.
- Near-term performance has improved markedly relative to last years review with the Fund delivering 26.4% (after fees) over the 12-months to 31 July 2018, outperforming the Benchmark and the Lonsec peer median by 11.7% and 12.8% respectively. Key contributors over the year include Altium, Webjet Limited and Appen. Conversely, the main detractors from performance were GTN Ltd, iSentia Group and Sirtex Medical Limited.
- Despite the Fund's strong positive returns over longer periods, Lonsec notes that the Fund incurred a significant drawdown during the GFC. Lonsec looks favourably on total return type strategies displaying conservative drawdowns, as it tends to be a reflection on a manager's commitment to preserving unit holders' capital. However, Lonsec notes the timing of this drawdown and highlights the Manager has not experienced a drawdown of similar magnitude since. Furthermore, Lonsec notes the Manager has improved the robustness of its investment approach and significantly expanded analyst resourcing since then.
- Pleasingly, the Fund has continued to exhibit a higher Information Ratio than Lonsec's 'Australian Long Short – Variable Beta' peer median across all assessed periods. Lonsec looks favourably on products generating relatively high information ratios, believing it be a reflection of manager skill. Overall, the Manager has delivered strong absolute performance outcomes.

Overall

- Lonsec has maintained the Fund's rating at **'Recommended'** at the most recent review. The Fund continues to benefit from an experienced investment team applying a high conviction, benchmark unaware philosophy resulting in differentiated small cap exposure versus many competitors. Despite the strong long-term performance, Lonsec notes the fee load remains one of the most expensive compared to peers in this sector with a 1.56% p.a. management fee and a 18.64% performance fee earnt on any positive performance.
- Lonsec stresses the suitability of this strategy is limited to investors able to withstand significant 'small cap' exposure, potential gearing, stock concentration and high weightings to cash.

People and Resources

Corporate overview

Smallco Investment Management Ltd ('Smallco' or 'the Manager') is a specialist funds management organisation whose headquarters are located in Sydney, Australia. The group was formed by Rob Hopkins and Bill Ryan in 2000 under a boutique ownership structure. The equity of the firm is still privately held amongst the senior members of the investment team.

Smallco commenced operations in October 2000 and has a specialist focus on investing in smaller Australian listed companies. Smallco has approximately $870 million of funds under management (FUM) across three strategies: the Fund, a family office mandate, and the Smallco Broadcap Fund.

Size and experience

NAME	POSITION	EXPERIENCE INDUSTRY / FIRM
ROB HOPKINS	MANAGING DIRECTOR	33 / 18
BILL RYAN	EXECUTIVE DIRECTOR/ PORTFOLIO MANAGER	22 / 18
ANDREW HOKIN	PORTFOLIO MANAGER	23 / 11
PAUL GRAHAM	PORTFOLIO MANAGER	22 / 4
ADAM SIMPSON	PORTFOLIO MANAGER	16 / 1
CRAIG MILLER	PORTFOLIO MANAGER	13 / 13

The Smallco investment team comprises six investment professionals with an average of approximately 22 years of investment experience. The team is led by Rob Hopkins (Managing Director) and Bill Ryan (Executive Director). Hopkins, who has 33 years of industry experience, previously led small companies research at brokerage firms Macquarie Equities, BT Alex Brown, ANZ Securities, and Macintosh Securities. Ryan, with 22 years of industry experience, previously worked at ANZ Securities.

Hopkins and Ryan co-founded Smallco in April 2000 and are the majority owners in the firm. All key investment personnel have either equity ownership or profit share arrangements.

The Fund is managed by Hopkins, Ryan and Hokin, while Hokin also manages the Broadcap Fund. Craig Miller is responsible for research and providing support to the portfolio managers. Miller also serves as the firm's day-to-day business manager, allowing Hopkins and

Smallco Investment Fund

Ryan to focus on investment management. Graham contributes research for all products.

Research Approach

Overview

INVESTMENT STYLE	GROWTH-AT-A-REASONABLE-PRICE (GARP)
STOCK UNIVERSE	ASX 500
STOCKS FULLY MODELLED	115
LIQUIDITY	MINIMUM MARKET CAP-$100M
TOP-DOWN	5%
BOTTOM-UP	95%
RESEARCH FOCUS	FUNDAMENTAL
QUALITATIVE ANALYSIS	MANAGEMENT QUALITY, COMPETITIVE POSITIONING, RETURN ON FUNDS EMPLOYED (ROFE), EPS GROWTH, CASH GENERATION
KEY RESEARCH INPUTS	COMPANY MEETINGS, MANAGEMENT, COMPETITORS, SUPPLIERS, INDUSTRY ANALYSIS
BROKER RESEARCH	MANAGER RELIANCE LARGELY SKEWED TO INTERNAL RESEARCH. BROKER RESEARCH IS USED TO SUPPLEMENT INTERNAL RESEARCH
VALUATION APPROACH	PRICE-TO-EARNINGS RATIO, EBIT MULTIPLES, EBITDA MULTIPLES, PRICE-TO-CASH-FLOW MULTIPLE

The investment universe is initially screened for a minimum market capitalisation of $100 million. The Manager then applies a Porter-style 'Quality Rating System' filter with each stock considered achieving a numerical rating (between 0 to 10) based upon both its quality and cyclicality. The refined investment universe comprises of approximately 115 stocks which are considered candidates for further bottom-up, fundamental research. An overall weighted-average rating is produced for the portfolio based on the 'Quality Rating System' with the requirement of the weighted-average score of the portfolio to remain above '4' – the Manager considers this to be the market average. Additionally, the Manager imposes a 25% limit on exposure to companies rated 3 or less. At the time of review the portfolio weighted average of the Fund was 4.6. Given the skill set of the investment team and fund design, the Manager excludes investment in resource stocks is generally sceptical of investment in biotechnology companies and companies with cyclical earnings. Further, a light green ethical overlay is applied which excludes companies whose principal business interest involves alcohol, tobacco, gambling equipment or facilities and armaments.

Meetings with company management form part of the Manager's bottom-up research process with the aim of identifying companies likely to exceed consensus earnings estimates. Company meetings provide a forum to prove/disprove the investment thesis with two members of the investment team assigned to each stock in the refined universe. This extends to the valuation of each company in the refined universe.

The Manager believes in the relationship between earnings and above average returns, and will reflect this by continually assessing earnings upgrade potential and 'market surprises'. Broker research is used in the research process but is limited to supplementing the internal research effort. 'Sell-side' research is predominantly utilised by the Manager to complement the company meeting program. For example, where a 'sell-side' analyst has recently met company management or to assist the Manager in becoming acquainted with a new company or industry.

Top-down and macroeconomic analysis does not feature heavily in the investment process and is rather used as a feedback mechanism to assist in concentrating the Manager's bottom-up research effort.

Valuation

The valuation process comprises of an amalgamation of multiples-based accounting ratios such as Price-to-Cash-Flow, Price-to Earnings and EBITDA ratios. Multiple accounting ratios are implemented to compare a company's current trading price against the Manager's assessment of a company's intrinsic value.

Short Selling

On the short side, Smallco aims to identify companies that are trading at a significant premium to valuation and that have an identifiable situation that will likely cause the stock to underperform market expectations over the short-term. Given this short-term focus, short positions are usually covered within a six month period. Ideas for the short side generally come from the same target universe as the long side's 'research universe' and may be identified during the process of searching for potential long positions.

The Manager ideally seeks an identifiable trigger when selecting short candidates – ie. companies displaying both poor fundamentals and a perceived overvalued share price versus Smallco's valuation. The Manager adopts a cautious approach with regards to short positions, with hard stop loss limits in place (7% limits).

Portfolio Construction

Overview

FUND BENCHMARK	N/A
INTERNAL RETURN OBJECTIVE	ABSOLUTE RETURNS
INTERNAL RISK OBJECTIVE	N/A
PORTFOLIO APPROACH	BENCHMARK UNAWARE, CONCENTRATED
INVESTMENT STYLE	GARP
PORTFOLIO DECISIONS	CONSENSUS
EXPECTED PORTFOLIO TURNOVER	40% P.A.
TYPICAL NUMBER OF HOLDINGS	25 -35
MARKET CAPITALISATION BIAS	SMALL TO MID CAP
% OF PORTFOLIO IN TOP 10 HOLDINGS	52.6% (MAY 2018)
CASH RANGE	0-50% OF NAV

Decision making

Portfolio construction is the joint responsibility of Hopkins, Ryan and Hokin, with decision making based on the 'consensus' view amongst the team.

The Manager aims to populate the portfolio with 25 to 35 of the most attractive stocks (primarily based on the stock's current discount to valuation) as identified during the research phase, whilst also taking into account the risk guidelines in place. Portfolio turnover will typically approximate 40% p.a. with the ability for the Manager to allocate 50% of the portfolio's net asset value (NAV) to cash in times of limited opportunities.

The Manager engages in a moderate amount of short selling to complement its long positions. Shorts on stocks are considered opportunistic with the ability to short up to 30% of the total assets of the Fund.

Position sizing is primarily dependent on a company's discount to the Manager's assessment of its intrinsic value and the resulting score from Smallco's proprietary 'Quality Rating System'. The portfolio and stocks' liquidity; the risk of sustained capital loss and the likely investment outcomes are additional factors considered in position sizing. In general, positions of 3%, 5% or 7% will be taken on the basis of the above-mentioned factors with ability of a position to extend up to 10% (at cost) and 20% (at current valuation).

Buy/sell drivers

At a high level, stocks which trade below the Manager's assessment of their intrinsic value coupled with companies that possess sound management; have high cash generation ability; a strong competitive position and an attractive earnings outlook are candidates for inclusion into the portfolio. In comparison, stocks are sold when they reach the Manager's target price or if there is a negative change in a company's fundamentals.

Stock sales can arise where the Manager considers a stock to be overvalued and where an identified scenario exists which is likely to result in a negative surprise to the market.

Risk Management

Risk limits

SEPARATE RISK MONITORING	NO
STOCK LIMITS (ABSOLUTE)	MAXIMUM OF 10% OF FUND VALUE AT COST, MAXIMUM OF 20% OF FUND VALUE (AT CURRENT VALUATION)
SECTOR LIMITS (ABSOLUTE)	EXPOSURE TO A MINIMUM OF 4 GICS SECTORS
CASH	MAXIMUM 50% OF NAV
SHORTING	30% ACTIVE (50% PASSIVE). TYPICALLY <25% WITH HARD STOP LOSS LIMITS
GEARING	30% ACTIVE (50% PASSIVE)
DERIVATIVES	NOT PERMITTED

The Fund is managed with broad range of risk limits at the security and sector level in absolute terms. Position sizes are limited to 10% of the portfolio's NAV at cost and to a maximum of 20% of NAV at current valuation. Sector exposures comprise of a minimum of four GICS sectors. Further limits implemented include restricting the exposure to securities considered by Smallco to be 'illiquid' to a maximum of 30% of NAV.

Short positions can actively comprise up to 30% of the total assets of the Fund with stop loss limits in place at the security level and up to a maximum of 7% of the portfolio per short position.

Gearing limits are in place with the ability of the Fund to gear up to 30% of the portfolio's NAV (active) and with the ability of this to passively increase to 50%.

Fundamental research and the Manager's proprietary 'Quality Rating System' attempts to identify key risks of candidates which pass the initial screening with the 'in-house' rule of a maximum of 25% of total exposure to companies rated '3 or less' enforced. Therefore, risk is accounted for and is managed through Smallco's fundamental research process with the resulting sizing of positions primarily driven by the 'Quality Rating System' and factors such as liquidity risk of sustained capital loss, and likely investment outcomes.

Risk monitoring

Smallco monitors a range of performance statistics, such as attribution of the long side versus the short side, win/loss ratio and absolute return ratio. Diversification, risk, quality, cyclicality, and liquidity controls in place are monitored daily by Craig Miller, Portfolio Manager.

Fund performance and positions vis-a-vis its risk parameters are formally considered at the quarterly Board meeting where in particular, diversification at the stock and sector level; and liquidity are considered.

Gearing

The Fund may borrow money to increase the Fund's investments. The Fund's gearing will never be more than 50% of the net asset value of the Fund. Under normal circumstances the Fund is expected to be between 80% and 130% invested i.e. between 20% in cash and 30% geared. At 30% geared, this would provide exposure of approximately $1.30 for every $1.00 invested in the Fund. Lonsec notes that the Manager has indicated that the gearing facility is only in place to be used opportunistically and that the default position of the Fund is to be ungeared most of the time. The Fund hasn't used this gearing facility since August 2007. Gearing adds additional risk to an investment; please refer to 'Gearing and Leverage Risk' below.

Risks

An investment in the Fund carries a number of standard investment risks associated with investment markets. These include performance, liquidity, counterparty, market and tax risks. These and other risks are outlined in the PDS and should be read in full and understood by potential investors. Lonsec considers the following to be the major risks:

Equity market

Investments in equity markets are subject to numerous factors which may have an impact on the performance of an investment (both positive and negative). Unexpected changes in economic, technological, structural, regulatory or political conditions can have an impact on the returns of all investments within a particular market.

Gearing and leverage risk

The Fund may gear up to a maximum of 50% of its net asset value. Gearing adds additional risk to an investment, as it amplifies losses (as well as gains). As such, advisers should ensure that their clients are comfortable with the risks associated with gearing.

The Fund is permitted to 'short-sell' stocks (i.e. borrow and sell a stock it does not own) as well enter into cash borrowings. Combined with the ability to gear, the Fund's maximum gross equity market exposure is 200%.

Smallco Investment Fund

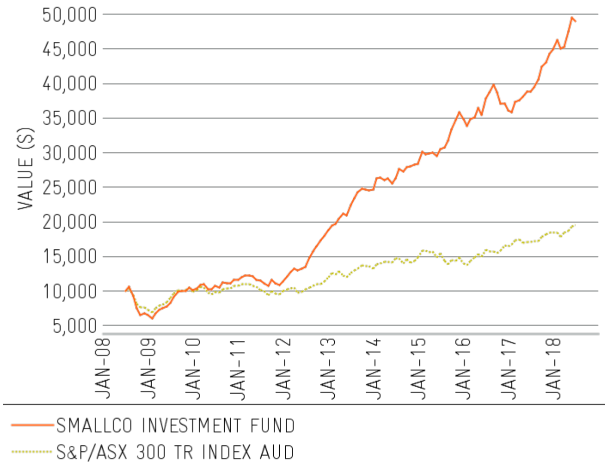
Quantitative Performance Analysis - annualised after-fee % returns (at 31-7-2018)

Performance metrics

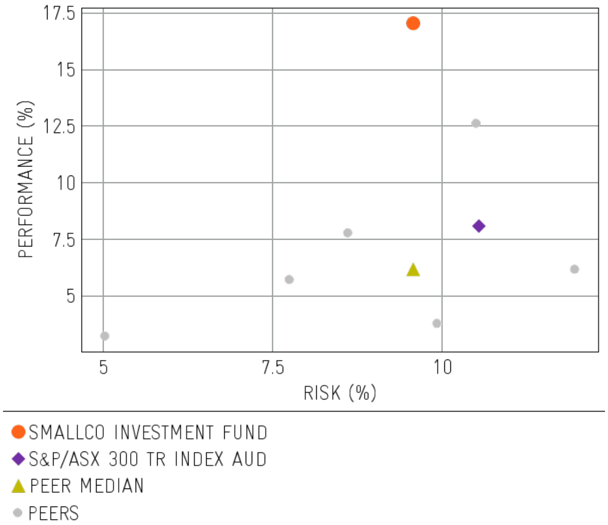
	1 YR		3 YR		5 YR		10 YR	
	FUND	PEER MEDIAN	FUND	PEER MEDIAN	FUND	PEER MEDIAN	FUND	PEER MEDIAN
PERFORMANCE (% PA)	26.36	13.52	17.05	6.18	16.96	9.00	17.22	9.79
STANDARD DEVIATION (% PA)	7.94	8.62	9.57	9.57	9.28	9.28	15.32	15.32
EXCESS RETURN (% PA)	11.66	-1.29	8.96	-1.81	7.81	-0.17	10.29	2.74
OUTPERFORMANCE RATIO (% PA)	75.00	50.00	61.11	50.00	58.33	51.67	60.83	52.50
WORST DRAWDOWN (%)	-2.82	-5.02	-9.82	-9.82	-9.82	-9.82	-43.23	-38.99
TIME TO RECOVERY (MTHS)	2	NR	7	7	7	7	13	6
SHARPE RATIO	3.09	1.29	1.58	0.49	1.59	0.73	0.91	0.52
INFORMATION RATIO	1.71	-0.37	0.87	-0.22	0.84	-0.02	1.08	0.30
TRACKING ERROR (% PA)	6.82	7.16	10.25	8.29	9.27	8.29	9.53	9.10

FUND: SMALLCO INVESTMENT FUND
LONSEC PEER GROUP: AUSTRALIAN EQUITIES - AUSTRALIAN LONG SHORT - VARIABLE BETA
BENCHMARK USED: S&P/ASX 300 TR INDEX AUD
CASH BENCHMARK: BLOOMBERG AUSBOND BANK BILL INDEX AUD
TIME TO RECOVERY: NR - NOT RECOVERED, DASH - NO DRAWDOWN DURING PERIOD

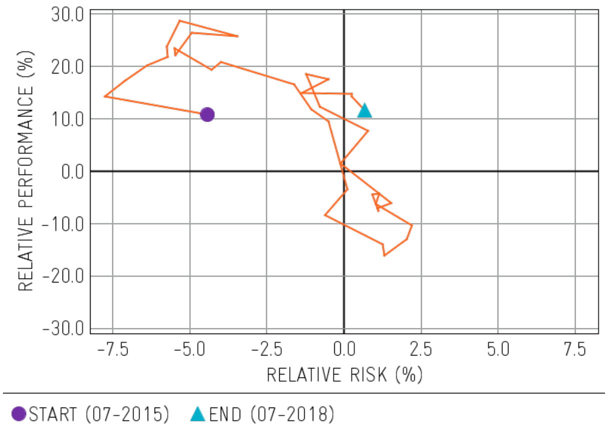
Growth of $10,000 over 10 years



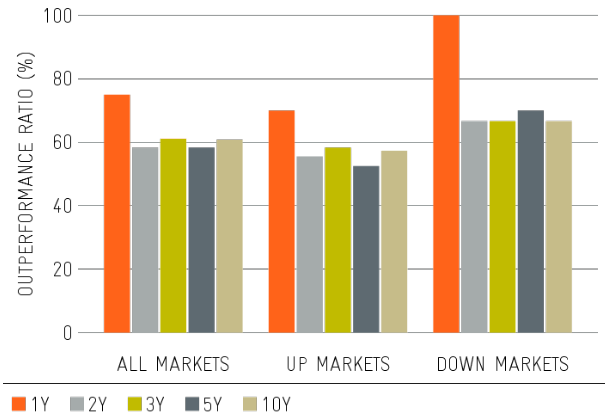
Risk-return chart over three years



Snail trail



Outperformance consistency



ANALYST: MATTHEW O'NEILL | APPROVED BY: SAM MORRIS

Smallco Investment Fund

Glossary

Total return 'Top line' actual return, after fees

Excess return Return in excess of the benchmark return

Standard deviation Volatility of monthly Absolute Returns

Tracking error Volatility of monthly Excess Returns against the benchmark (the Standard Deviation of monthly Excess Returns)

Sharpe ratio Absolute reward for absolute risk taken (outperformance of the risk free return (Bank Bills) / Standard Deviation)

Information ratio Relative reward for relative risk taken (Excess Returns / Tracking Error)

Worst drawdown The worst cumulative loss ('peak to trough') experienced over the period assessed

Time to recovery The number of months taken to recover the Worst Drawdown

Snail Trail A trailing 12-month relative performance and relative risk measurement over the benchmark. The trail is generated using a 12-month rolling window over the specified period

About Lonsec

Lonsec Research Pty Ltd (Lonsec) is an investment research house with specialist areas of expertise, that was originally established in 1994 and the current entity was registered on 23 June 2011. From 1 July 2011, Lonsec became a fully owned subsidiary of Lonsec Fiscal Holdings Pty Ltd, a privately owned entity with a multi-brand strategy of providing leading financial services research and investment execution. Lonsec believes that professional financial advisers need informed opinions on the best investment strategies and financial products to provide real value for their clients. To meet this need, Lonsec has in place an experienced research team, which draws on a robust research process to undertake in-depth assessment of managed fund products.

Analyst Disclosure and Certification

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