

About this Review	
Sector reviewed	<b>Hedge Funds – Australian Equity Long/ Short</b>
Total Funds rated	11
Date of this Sector Review	June 2009
About this Fund	
Fund reviewed	<b>Smallco Investment Fund</b>
Fund Size (\$ million)	\$55
Responsible Entity	Smallco Investment Manager Ltd
Fund Commenced	November 2000
Retail Fee (p.a.)	N/A
Wholesale Fee (p.a.)	1.60% + performance fee of 18.64% of net asset increase above previous highwater mark
Structure Availability	Platforms, Wholesale
About the Fund Manager	
Fund Manager	Smallco Investment Manager Ltd
Ownership	Wholly owned by the founding portfolio managers
Assets managed this sector (\$ million)	55
Years managing this asset class	8.5
Investment Team	
Team size dedicated to this Fund	3.5
Key Portfolio Managers/Analysts	Rob Hopkins, Bill Ryan & Andrew Hokin
Turnover/Team Ratio (past 2 yrs)	0%
Investment Process	
Style	GARP
Targeted Value Add & Tracking Error	n/a
Typical Stock Numbers	25-35 (total)
Typical Net Market Exposure	50% – 150%
Typical Portfolio Turnover (p.a.)	25% - 40%
Gearing limits	Up to 50% max
Franking Level (FY08)	35%
Tax efficiency - Income in Total Distribution (FY08)	100%
Discount Gains in Total Capital Gains (FY08)	0%
Stock Bet Limits	Max of 10% of Fund value at cost, max of 20% of Fund value (incl. appreciation)
Sector Bet Limits	Exposure to a minimum of 4 GICS sectors
Fund Rating History	
June 2009	Recommended
August 2008	Highly Recommended
August 2007	Highly Recommended
June 2006	Upgraded to Highly Recommended

## What this Rating means

➤ The Recommended rating indicates that Lonsec has conviction that the fund or product can achieve its objectives and, if applicable, outperform peers over an appropriate investment timeframe. The manager or product has a number of competitive advantages in people, process and product design. The investment is a recommended entry point to access this asset class or strategy.

## 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 an absolute return style, small cap focussed long/ short Australian Equities Fund and as such will generally sit within the growth assets component of an investor's portfolio. The Fund is suitable for higher risk profile investors with a five year plus time horizon. Lonsec's model portfolio asset allocation (traditional assets only) is 5% within the Balanced, 6% within the Growth and 10% within the High Growth risk profiles respectively.
- The Fund is relatively concentrated (25 – 35 stocks) and may utilise a broad range of strategies including short selling, gearing and cash in order to adjust the Fund's net equity position in line with the investment manager's market outlook. At various stages through the market cycle, the performance of the Fund may therefore have a low correlation with traditional equity benchmarks. Lonsec recommends that investors consider all these relevant risks prior to investing.

## Changes since Last Review

- There have been no changes to the team or investment process since the last review of the Fund in August 2008.
- On a business level there have been a number of developments. Firstly, Andrew Hokin, Senior Fund Manager, and Craig Miller, Business Manager, have entered a 10% profit share agreement following a mutually agreed reduction in base salaries. Lonsec believes that this is a positive development on two levels. The base operating costs have been reduced through the pay reductions and the two team members are now increasingly tied into the profitability and success of the business.
- Secondly, the manager has been appointed to manage a private \$70 million mandate. The mandate differs from the Smallco Investment Fund (SIF) in that it incorporates large cap stocks (70% banks), with 15% managed according to the SIF mandate and a 10% allocation to cash. Andrew Hokin will cover the additional bank stocks and Smallco envisages that it will take up approximately 20% of Hokin's time and

10% of the remainder of the team's time to manage the private mandate. In terms of stock coverage the new mandate equates to an additional 15 stocks to be modelled and another 15 stocks to monitor.

➤ SIF remains the manager's core focus with the revenue generated from the product being significantly higher than that of the private mandate. Furthermore the manager has ensured that there is a clear allocation policy as to the order in which stocks are bought and sold within the two investment strategies.

## Lonsec Opinion of this Fund

### Philosophy (Style)

➤ The Fund is unique in nature, being a concentrated, Australian equity small cap-focused, long/short Fund with a mild ethical overlay and the ability to gear. The Fund also does not invest in resource stocks, although this is a 'soft' limit.

➤ The manager describes itself as having an absolute return focus, having the ability to enhance returns through shorting. However, in practice the Fund will experience negative returns in certain market environments as the Fund has a 'long' bias and therefore is exposed to market beta. Up to 30% of the portfolio may be invested in short positions.

### People and Resources

➤ Lonsec believes that the manager's investment team has the necessary experience and sufficient size to manage this Fund. The team members have various industry backgrounds including buy and sell side experience, accounting backgrounds and business management. Key team members have also worked together in previous roles.

➤ The investment team has been stable with no departures to note since the inception of the Fund in 2000. The change in remuneration structure i.e. the introduction of a profit share agreement for Craig Miller and Andrew Hokin following a mutually agreed reduction in base salaries, exemplifies the team's commitment to the business. Rob Hopkins, Managing Director and Bill Ryan, Executive Director, remain key equity owners in the business owning 58.8% and 41.2% of the company respectively. All key staff also co-invest into the Fund. Lonsec considers the overall remuneration and ownership structure of the business to be conducive to team stability and provides a clear alignment of interest between the business and investors as the performance of the Fund will drive the profitability of the business due to the performance fee structure of the Fund.

➤ The performance fee structure has a high water mark i.e. the manager only receives the fee if previous highs are exceeded. While performance fee structures can be expensive, the relatively high hurdle rate for the fee to be triggered somewhat offsets the cost.

➤ In past reports Lonsec has raised concerns about the risk to the profitability of the business given the manager's single

product focus and the fact that a significant portion of the manager's revenue is reliant on performance fees generated from the product. The decrease in base salaries for two members of the investment team (in return for profit share) was a clear step to decrease the businesses operating costs amidst a difficult market environment. Lonsec believes that the risk to the businesses profit continues to exist, however the recent establishment of a private mandate should ease concerns over profitability. Furthermore the manager has indicated that the business is cashflow positive and has approximately \$1million in net tangible assets. Hopkins and Ryan have also indicated that they will inject additional funds into the business from their own assets if the need arose.

➤ Administration of the Fund has been outsourced to White Outsourcing, whilst ANZ Banking Group Limited provides custody services and the borrowing facility. Given the manager's boutique structure, Lonsec considers this to be a prudent approach.

### Research and Portfolio Construction

➤ Lonsec considers the manager's investment process to be logical and consistent with their investment philosophy. The investment process has been applied consistently since the inception of the Fund. The manager seeks companies that are expected to double EPS over the next three years and therefore strong consideration is given to companies with an attractive earnings outlook, strong competitive advantage and high Return on Funds Employed (ROFE). Lonsec believes that in terms of the recording of research notes and the use of standardised valuation templates the process adopted by Smallco is structured ensuring consistency of the research effort.

➤ Following its appointment to manage a separate private mandate, the manager's research coverage has extended to include additional S&P/ ASX 100 companies. Whilst Smallco has indicated that this extra research coverage is of 'modest' time commitment, the SIF (despite remaining a key focus for the team), is no longer their sole focus. Lonsec had previously considered the firm's single product strategy to be a positive feature of the boutique, and has therefore reassessed its view in this regard.

➤ Lonsec believes Smallco's portfolio construction process to be sound, with appropriate consideration given to diversification and risk. For example, whilst the portfolio is primarily constructed via the manager's bottom up stock research and is the main contributor to portfolio risk and return, the portfolio is required to have exposure to a minimum of 4 Global Industry Classification Standard (GICS) sectors in order to ensure adequate diversification.

### Risk Management

➤ Lonsec believes that the manager has clear risk controls in place to manage the long and short side of the portfolio. In terms of shorting the manager sets maximum stop losses for each short position (7%). The manager has a shorting agreement in place which stipulates trading rules for short positions.

➤ The portfolio may be geared up to 30%. Gearing will be primarily used to manage the short exposure of the portfolio. The manager is relatively conservative in its application of gearing (as well as shorting) and will generally only gear the portfolio if a distinct opportunity arises. By way of example the last time the portfolio was geared was approximately two years ago.

➤ The manager is conscious of stock liquidity particularly when instigating short positions. Lonsec believes that managing stock liquidity is critical within small caps as certain stocks can be illiquid and therefore can be difficult to exit. The manager monitors stock liquidity upon initiating a stock position and on an ongoing basis. The manager will typically focus on stocks with a market capitalisation of \$100 million to \$500 million. With recent market falls Lonsec has noted that certain stocks have fallen below \$100 million market cap and that the manager has been unable to trim or exit certain stocks as a result of the stock becoming illiquid. Lonsec believes that this is a key risk within the fund as significant positions in illiquid stocks where the manager does not have a high conviction in the stock can adversely impact performance.

### Performance

➤ Quantitative performance has been poor on a relative and absolute basis to the S&P/ASX 300 Accumulation Index as at 31 May 2009 over all periods assessed (1,2,3 and 5 years).

➤ As stated previously the Fund invests primarily in small cap stocks and applies a mild ethical overlay. The Fund will also generally not invest in resource stocks. As a result of the restricted mandate the Fund will generally underperform the broader market index in periods where the market favours large cap stocks or/and when cyclical resource stocks are performing well.

### Capacity

➤ The Fund was originally closed to new investors in January 2007. The Fund has since reopened in October 2008 following falls in the market and the subsequent fall in the Fund's overall funds under management. The manager has communicated to Lonsec that it is looking to increase marketing activities around the product, potentially through mail outs. Lonsec believes that the manager has excess capacity to cater for increased flows. The manager has not set a hard capacity target but has indicated that a capacity limit of approximately \$300 million is plausible (previously hard close limit of \$200m). Lonsec believes that the manager has shown discipline in managing their capacity in the past and at this stage is not concerned about the manager becoming an 'asset gatherer' at the detriment to performance.

### Overall

➤ Lonsec has revised the rating on the Smallco Investment Fund to Recommended from Highly Recommended. The change in rating reflects Lonsec's reduced conviction in the Fund relative to other highly rated products within the domestic long/short equities rated fund universe. The change in rating is driven by a number of factors. Business risk has somewhat heightened with the market downturn, however

pleasingly the manager has been able to attract additional funds through a private mandate and the business is currently cashflow positive. On the flip side, this fund no longer remains the manager's sole focus. The illiquidity of certain stocks within the portfolio is a key risk for the Fund and is something Lonsec will monitor. It is important to stress that liquidity of small cap stocks in volatile markets tends to fluctuate significantly.

➤ Lonsec continues to have solid conviction in the Fund. The manager offers a unique investment strategy within the small caps universe incorporating long only stock selection with opportunistic application of short selling and gearing. Lonsec believes that a key strength of this Fund is the team managing the portfolio which consists of experienced investment professionals. The investment process is clear and transparent and has been applied consistently since the Fund's inception. The boutique structure of the business has resulted in a high alignment of interest between the business and investors.

## People & Resources

### Size and Experience

The Smallco investment team consists of four members, Rob Hopkins, Bill Ryan, Craig Miller, and Andrew Hokin. Hopkins and Ryan co-founded the company in April 2000 and own 58.8% and 41.2% of the company respectively. Additionally, Smallco also has several part-time resources, covering accounting, compliance, information technology, and database management.

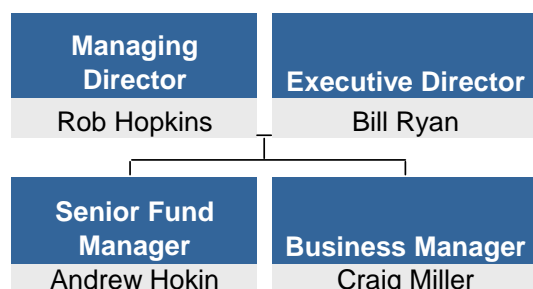
Hopkins is Managing Director of Smallco, and has 24 years industry experience, including previous senior analyst roles at Macquarie Equities, BT, ANZ Securities, and McIntosh. Hopkins' experience is primarily in small cap stocks, and worthy of note is that during his time at each of the brokers listed above, their small cap teams were consistently rated in the top three in Australia (per industry surveys). Also worthy of note is that Hopkins and Ryan worked together at ANZ Securities prior to establishing Smallco.

Ryan is an Executive Director of Smallco and has 14 years industry experience. Prior to establishing Smallco, Ryan spent approximately two years at ANZ Securities and two years as a 'Professional Investor'. Before entering funds management, Ryan owned and managed several wheat and sheep enterprises.

Miller joined Smallco in June 2005. Miller spends roughly 50% of his time researching stocks and providing support to portfolio managers Hopkins, Ryan and Hokin; with the remainder of his time spent on business management, administration and marketing. Miller has ten years experience in accounting and taxation; however, this is his first role in funds management.

Hokin is the most recent appointment to the team having joined Smallco as a Senior Fund Manager in August 2007. Hokin has approximately 15 years broking research experience having previously covered stocks in a variety of sectors including Small Caps, Banks, Diversified Financials, Developers, Utilities and Property Trusts. Recently Hokin's stock coverage has expanded to incorporate banks. The increase in stock coverage is the result of Smallco winning a private mandate which is skewed towards banks.

## Team Structure



## Turnover

There have been no departures from the investment team since the Fund's inception in 2000. There was one appointment in August 2007 being Andrew Hokin.

## Key Person Risk

Lonsec considers key person risk in both Hopkins and Ryan to be high, given that they are the predominant members of the investment team and have worked together in developing the Smallco investment process. Lonsec would view the departure of either to be a material event, which would likely negatively impact the Fund's rating.

## Remuneration / Alignment of Interests

Hopkins and Ryan are the owners of the business, therefore their total remuneration is driven by the profitability of the business (which in turn will be primarily influenced by the performance of the Fund). Hopkins and Ryan also have a significant amount of personal wealth invested in the Fund.

In addition to the ongoing management fee, Smallco is also entitled to a performance-based fee. This performance fee, payable six monthly, is calculated as '18.64% of the adjusted net asset increase above the previous high water mark'. This means that in order for the manager to receive a performance fee, the Fund must have produced a new all time 'end-of-six-month high'.

Since the last review the manager has reviewed the remuneration structure for Hokin and Miller. Both have mutually agreed to a reduction in base salaries in return for a 10% profit share agreement. Miller and Hokin have a 10% and 9% option on sale proceeds of the manager respectively.

## Investment Style / Objectives

### Style

Smallco adopts a bottom-up investment approach, seeking to exploit mispriced securities within the small cap sector through both long and short positions. The manager has particular focus on companies within the \$100M-\$500M market capitalisation range, which it considers to be the 'sweet spot' of the Australian equities market (i.e. small enough to be relatively under-researched, but large enough to be a feasible business). Given Smallco's focus on investing in companies with strong growth outlooks, whilst still seeking to acquire them at relatively attractive valuations, the investment style is best described as GARP (Growth at a Reasonable Price).

Smallco has an absolute return focus, and therefore does not explicitly target a return objective or tracking error range. Smallco believes that given the long-biased nature of the Fund, performance (in an absolute sense) is most likely to be weaker during a declining market with an environment of weakening economic conditions. As a result of the small cap focus of the Fund and the concentrated nature of the portfolio, Fund performance is also expected to be more volatile compared to mainstream Australian equity funds.

## Investment Philosophies and Beliefs

Smallco believes that traditional 'long only' investing can be enhanced through the moderate use of shorting and gearing. In addition, Smallco believes that greater absolute returns can be achieved by adopting a 'benchmark unaware' approach and by investing in a concentrated portfolio of good companies as opposed to a large number of mediocre holdings.

## Research Approach

### Overview

Investment Style	GARP
No. of stocks in universe	300. Note the new private mandate has increased the manager's investment universe by 30 stocks from last year and has increased the number of stocks fully modelled by 15
No. of stocks fully modeled	115
No. of stocks partially modeled	80
Key Screens	<p><b>Quantitative:</b></p> <ul style="list-style-type: none"> <li>Market cap \$100 to \$500 million</li> <li>Return on Funds Employed (ROFE)</li> <li>Valuation measures include PE, price to cash flow, price earnings and EBITDA ratios</li> <li>EPS to double over 3 years &gt; 26%pa</li> </ul> <p><b>Qualitative:</b></p> <ul style="list-style-type: none"> <li>Strong management – very important for Smallco to background check and meet management</li> <li>Exclude businesses with negative profits or negative cash flow i.e. biotech</li> <li>Competitive advantage</li> <li>Exclude resource stocks and stocks whose primary business profits are from 'additions and armaments' (i.e. tobacco, alcohol, or gambling related)</li> </ul>

	companies)
Top-Down	0%
Bottom-Up	100%
Qualitative Analysis	Refer above
Research Inputs	Fundamental research
Use of broker research	In over 95% of cases the manager conducts their own forecasts. Smallco only relies on broker forecasts if they are very confident in the analyst involved.

## Valuation Approach

Stocks are valued using a range of metrics with standard templates utilised across all stocks.

Metric	P/E, EBIT, EBITDA, Price to Cashflow
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## Short Side

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 course of searching for potential long positions. Brokers are also used as a source of idea generation, with Smallco believing that brokers typically have much higher conviction in their 'sells' as compared to 'buys'.

Whilst the manager ideally seeks companies with both poor fundamentals and a perceived overvalued share price, stocks may be opportunistically shorted based solely on the stock displaying a significant premium to 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

Portfolio construction is the 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. For example the Fund maintains holdings across at least four GICS sectors. Stocks that appear most attractive, and in which the manager has the greatest conviction, will have the largest weightings in the portfolio. To this end, stocks will generally fall into one of three categories, with a category one stock indicating a weighting of approximately 7.5%, category two 5%, and category three 3.5% (although these are only guidelines).

As a result of the manager's emphasis on ROFE, the portfolio has typically displayed a bias towards financial services and computer software stocks, and will generally

have little exposure to manufacturing stocks or cyclicals. The manager is not compelled to short stocks as this is considered to be a more opportunistic source of 'alpha' for the manager.

Hopkins, Ryan and Hokin are together responsible for portfolio construction. Attribution of analysts' individual stock calls is not undertaken by the manager but Lonsec considers this to be reasonable given the small team structure and boutique nature of the manager. Fund performance and positions vis-a-vis its risk parameters are formally considered at the quarterly Board meeting.

## 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. Given that this is the only product managed by Smallco, and that it is concentrated in nature, the portfolio managers are able to monitor the portfolio closely and on a frequent basis. The diversification and liquidity controls in place are formally monitored on a quarterly basis by the Smallco Board.

## Gearing

The Fund may gear up to a maximum of 50% passively and 30% actively, of total portfolio value. That said, the manager has indicated to Lonsec that its gearing facility is used opportunistically, and that its target is to be ungeared at most times. 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 additional risks associated with gearing.

## Funds Under Management

Over the last 24 months, market movements and fund outflows have contributed to the manager's decline in FUM from its peak of approximately \$220 million in mid 2007 to approximately \$55 million in May 2009. At current levels of FUM, Smallco is one of the smaller managers within the Lonsec Australian long/short equity universe. Outside of the Fund, the manager has taken on the management of a \$70 million private mandate. The private mandate largely invests in banks (70%) with the remaining funds being invested in SIF (15%), cash (10%) and 5% in other stocks.

The manager has demonstrated a commitment to capacity management by closing the Fund to new investors in January 2007 upon reaching its target of \$200 million. The Fund was subsequently reopened in October 2008.

The manager has indicated that the Fund's target capacity is approximately \$300 million.

## Other

Smallco was established in April 2000. At current levels of FUM (including the private mandate) the manager is at 'break even' profitability and currently has no debt. Lonsec notes that Smallco's financial viability is largely dependent on fees received as a result of managing this Fund and therefore the business risk associated with this manager is higher relative to Lonsec assessed peers in this sector.

**Quantitative Performance Analysis**  
**Annualised after-fee % Returns as at 31 May 2009**

	1 Year		2 Years		3 Years		5 Years	
	Fund	Peer Group	Fund	Peer Group	Fund	Peer Group	Fund	Peer Group
Performance (% pa)	-31.3	-27.0	-35.2	-18.4	-16.3	-6.2	2.2	5.5
Standard Deviation (% pa)	34.4	22.9	27.9	19.7	25.0	17.9	21.0	15.6
Excess Return* (% pa)	-2.1	2.2	-16.4	0.3	-11.9	-1.7	-4.3	-1.0
Outperformance Ratio (%)	58.3	52.8	37.5	56.0	47.2	50.8	56.7	49.0
Worst Drawdown (%)	-45.0	-35.7	-66.6	-44.3	-66.6	-46.4	-66.6	-45.7
Time to Recovery (months)	na	0.0	na	0.0	na	0.0	na	0.0
Sharpe Ratio	-1.1	-1.5	-1.5	-1.2	-0.9	-0.7	-0.2	0.0
Information Ratio	-0.1	0.3	-1.1	0.3	-0.9	-0.1	-0.4	0.0
Tracking Error (% pa)	15.1	11.0	15.1	9.7	13.2	8.7	11.4	7.8

Fund: Smallco Investment Fund

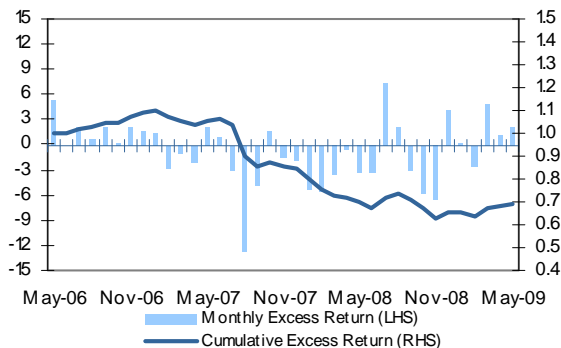
\*Benchmark: S&P/ASX 300 Accumulation Index

Peer Group: Average among Lonssec rated Australian long/short equity fund universe

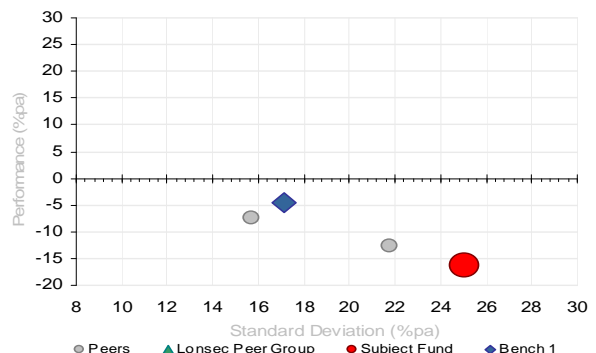
It should be noted that Lonssec's Australian long/short equity fund universe is a relatively broad universe, which includes both absolute return focus funds and beta 1 or 130/30 type products.

Lonssec uses the S&P/ASX300 index for comparison purposes for the Australian long/short equity universe. This index may not be the benchmark used by individual Funds for performance targets. For example, Smallco adopts a more benchmark unaware absolute return focus.

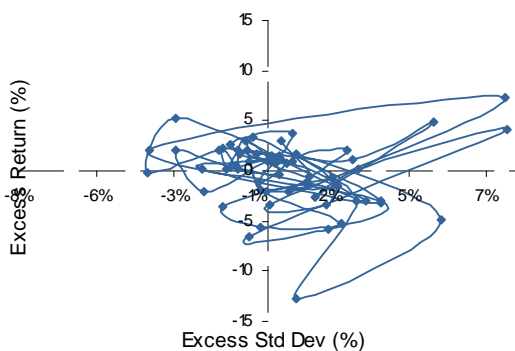
**Cumulative Performance over three years**



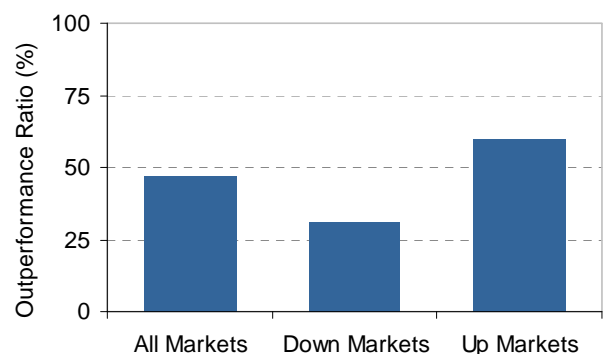
**Risk-return Chart over three years**



**Snail Trail over five years**



**Outperformance Consistency over three years**



ukasz de Pourbaix  
 Release Authorised by: Paul Pavlidis

Glossary	
<b>Absolute Return</b>	'Top line' actual return, after fees
<b>Excess Return</b>	Return in excess of the benchmark return
<b>Standard Deviation</b>	Volatility of monthly Absolute Returns
<b>Tracking Error</b>	Volatility of monthly Excess Returns against the benchmark (the Standard Deviation of monthly Excess Returns)
<b>Sharpe Ratio</b>	Absolute reward for absolute risk taken (outperformance of the risk free return (Bank Bills) / Standard Deviation)
<b>Information Ratio</b>	Relative reward for relative risk taken (Excess Returns / Tracking Error)
<b>Worst Drawdown</b>	The worst cumulative loss ('peak to trough') experienced over the period assessed
<b>Time to Recovery</b>	The number of months taken to recover the Worst Drawdown

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**Date Prepared: June 2009**  
**Analyst: Lukasz de Pourbaix**  
**Release Authorised by: Paul Pavlidis**

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