

About this Review	
Sector reviewed	<b>Hedge Funds – Australian Equity Long/ Short</b>
Total Funds rated	12
Date of this Sector Review	June 2010
About this Fund	
Fund reviewed	<b>Smallco Investment Fund (SIF)</b>
Fund Size (\$ million)	\$77 (March 2010)
Responsible Entity	Smallco Investment Manager Ltd
Fund Commenced	November 2000
Retail Fee (p.a.)	N/A
Wholesale Fee (p.a.)	1.40% + performance fee of 18.64% of net asset increase above previous high-water 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)	77 (March 2010)
Years managing this asset class	10
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 (FY09)	25%
Tax efficiency - Income in Total Distribution (FY09)	100%
Discount Gains in Total Capital Gains (FY09)	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 2010	Recommended
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.

## Fund Risk Characteristics

	Low	Moderate	High
Capital Volatility			▲
Corporate Risk			▲

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

## 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 product 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.

➤ 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 its 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 has been no material change to Smallco's investment personnel or investment process.

## Lonsec Opinion of this Fund

### Philosophy (Style)

➤ The Fund is a concentrated, Australian equity small cap focused long/short product with a mild ethical overlay and ability to gear. Although a 'soft' limit, the Fund does not invest in resource stocks.

- The manager describes itself as an absolute return manager with an ability to enhance returns through shorting. However, in practice given the Fund's 'long' bias and exposure to market beta it can experience negative returns in certain market environments. Up to 30% of the portfolio may be invested in short positions. The manager will typically implement stock specific or outright short positions.
- Given the concentrated and long-biased small cap nature of the Fund, performance (in an absolute sense) is likely to be more volatile compared to other mainstream Australian equity funds.

### Corporate Update

- At the time of the 2009 review, Lonsec had some reservations regarding risks to the profitability of Smallco given the manager's single product focus and the level of reliance on the performance fees generated from this product and its susceptibility to market conditions (FUM flows, market performance). This risk has since been partly mitigated by a reduction in operating costs via the introduction of a profit share agreement and the diversification of revenue via an additional private large cap mandate. A recovery in the share market and the stabilisation of Smallco's FUM outflows (positive 50% increase in FUM) has further mitigated these concerns. At the time of this review, Smallco indicated that the business was profitable and that if profitability fell critically Hopkins and Ryan would inject additional funds into the business. Given the manager's surplus funds on account Lonsec believes this will be unlikely to happen.

### People and Resources

- Smallco's investment team has been stable since inception with no departures to note since 2000. Lonsec believes the current team possesses the necessary size and industry experience to successfully manage the Fund to its mandated philosophy. The team contributes a diversity of skill sets and experience from buy/sell side, accounting and business management related backgrounds.
- Lonsec acknowledges Smallco's performance driven business model believing it provides a conducive and stable environment with a clear alignment of interests between the investment team and end investors. 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. Pleasingly as at 31 March 2010 all staff remained materially co-invested.
- 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 its 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 in 2009 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 its 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.
- The small cap market space is less liquid and more volatile than the large cap Australian market. Lonsec believes that this is a key risk to fund performance given the concentrated small cap nature of the manager's style. Lonsec believes that managing stock liquidity is critical as the exit of certain stocks in this space are subject to liquidity and may at times be done at significant cost. Mitigating this is the manager's monitoring of stock liquidity upon initiating a stock position (in particular shorts) and on an ongoing basis.

### Performance

- The Fund returned 50.8% over the year to April 2010 representing an outperformance of the benchmark of 18.3% and outperformance of the Lonsec peer group average by 23.0%. That said, performance absolute, benchmark and peer relative over the three to five year period has been disappointing. Given the recent volatility across financial markets (small cap in particular) these performance characteristics are not entirely unexpected. The Fund is a

concentrated, Australian equity small cap focused long/short equity product with ability to gear. Hence, Fund performance is typically expected to be more volatile to that of the benchmark and broader Australian equity peers.

➤ Given the manager's mandate (soft limit 'no resources') the Fund is generally expected to underperform the broader market in periods where the market favours large cap stocks or/and when cyclical resource stocks are performing well.

➤ The Fund does not target a specific performance objective hence assessment as to whether this to date has been achieved cannot be made.

### Capacity

➤ At \$77 million in FUM Lonsec does not consider the manager to have any capacity issues. Lonsec is pleased with the manager's historic commitment to capacity management having closed the Fund to investors when it reached perceived capacity. As at 31 March 2010 Smallco estimated its capacity to be 0.5% of the Small Industrials Index or approximately \$300 million. The Fund currently remains open to new investors.

### Overall

➤ Lonsec has maintained the Fund's 'Recommended' rating. Lonsec's rating is supported by an investment process with a ten year track record that has remained transparent and consistently applied by an experienced and committed investment team. The team's stability and remuneration structure highly aligned with end investors are other notable features of this offering.

➤ Lonsec believes this Fund offers investors access to a unique investment strategy within the small caps universe incorporating long only stock selection, opportunistic short selling and gearing.

## People & Resources

### Size and Experience

Team Member	Sector/Responsibilities	Smallco (yrs)	Exp (yrs)*
Rob Hopkins** Managing Director	Media, Utilities, Infrastructure, IT, Healthcare	10	25
Bill Ryan** Executive Director	Internet, IT, Retail, Agriculture	10	15
Andrew Hokin Senior Fund Manager	Banks, Media, Healthcare	2.5	16
Craig Miller Senior Fund Manager/Analyst	Fund Managers, Property	4.5	5
	<b>Average</b>	<b>6.7</b>	<b>15.2</b>

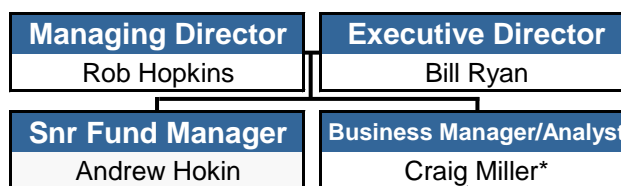
\*Industry Experience

\*\* Co-Founders of Smallco

Hopkins and Ryan co-founded the company in April 2000 and own 58.8% and 41.2% of the company respectively.

Worthy of mention is that 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.

### Team Structure



\* 50% stock analysis responsibilities 50% business management

Smallco also has several part-time resources, covering accounting, compliance, information technology, and database management.

### Turnover

There have been no departures or additions to the investment team over the last two years. The team has remained highly stable since inception.

### Key Person Risk

Lonsec considers the key person risk in co-founders Hopkins and Ryan to be high, given their integral involvement in the Smallco investment process and the broader business. 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'.

The manager has also revised the remuneration structure of 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's bottom-up investment style is best described as GARP (Growth at a Reasonable Price). As an absolute focused manager Smallco believes that greater returns can be achieved by adopting a 'benchmark unaware' approach and investing in a concentrated portfolio of good companies and then enhancing their returns through moderate shorting and gearing.

#### Investment Philosophies and Beliefs

Smallco seeks to exploit under-researched mispriced securities within the \$100M-\$500 million market capitalisation range. Smallco gives particular focus to companies with a strong growth outlook, with relatively attractive valuations.

## Research Approach

Overview	
<b>Investment Style</b>	(GARP) Growth at a Reasonable Price
<b>No. of stocks in universe</b>	300-330+
<b>No. of stocks fully modelled</b>	115-130+
<b>No. of stocks partially modelled</b>	80
<b>Company Visits</b>	150+
<b>Initial Stock Filters</b>	<ul style="list-style-type: none"> <li>• Market cap \$100-\$500 million</li> <li>• Exclude businesses with negative profits or negative cash flow i.e. biotechs</li> <li>• Exclude resource stocks (soft limit)</li> <li>• Exclude stocks whose primary business profits are from 'addictions and armaments' (i.e. tobacco, alcohol or gambling related companies)</li> </ul>
<b>Top Down</b>	0-10%
<b>Bottom Up</b>	90-100%
<b>Qualitative Analysis</b>	<ul style="list-style-type: none"> <li>• Management quality</li> <li>• Competitive positioning</li> <li>• Return on Funds Employed (ROFE)</li> <li>• EPS to double over 3 years &gt; 26%pa</li> <li>• Cash generation</li> </ul>
<b>Research Inputs</b>	<ul style="list-style-type: none"> <li>• Management</li> <li>• Competitors</li> <li>• Suppliers</li> <li>• Industry Analysis</li> </ul>
<b>Use of Broker Research</b>	<p>Manager reliance largely skewed to internal research. Smallco will only use broker research to supplement internal research and only when it is confident in the broker analyst.</p>

## Valuation Approach

<b>Primary</b>	P/E, EBIT multiple, EBITDA multiple, EBUTDA Price to Cash flow multiple
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Stocks are valued using a range of metrics with standard templates used across all sectors.

## 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.

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.

The manager is not compelled to short stocks as this is considered to be a more opportunistic source of 'alpha' for the manager.

Fund performance and positions vis-a-vis its risk parameters are formally considered at the quarterly Board meeting.

The manager has ensured that there is a clear allocation policy as to the order in which stocks are bought and sold within this Fund and the broader large cap mandate.

### 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. 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

As at 31 March 2010 Smallco managed \$77 million in the Australian long/short equities space. 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 private mandate (approximately \$113 million) which predominantly invests in banks (70%) with the remaining funds being invested in SIF stocks (15%), cash (10%) and 5% in other stocks.

### Other

Smallco was established in April 2000. At current levels of FUM (including the private mandate) the manager is profitable with no debt. Given the performance orientated business model Smallco's financial viability is largely driven by the fees received through the management of this Fund. Therefore the business risk associated with this manager is higher relative to some other larger Lonsec assessed peers in this sector.

**Quantitative Performance Analysis**  
**Annualised after-fee % Returns as at 30 April 2010**

	1 Year		2 Years		3 Years		5 Years	
	Fund	Peer Group	Fund	Peer Group	Fund	Peer Group	Fund	Peer Group
Performance (% pa)	50.8	27.8	-0.7	-2.8	-13.7	-3.9	4.5	7.7
Standard Deviation (% pa)	13.5	13.2	27.7	19.7	26.4	18.3	21.8	15.8
Excess Return* (% pa)	18.3	-4.7	2.3	0.3	-9.8	0.1	-3.9	-0.7
Outperformance Ratio (%)	66.7	40.8	58.3	49.6	47.2	53.3	55.0	51.2
Worst Drawdown (%)	-3.8	-5.0	-45.9	-35.3	-66.6	-43.0	-66.6	-42.7
Time to Recovery (months)	2.0	1.0	-	2.5	-	1.9	-	2.7
Sharpe Ratio	3.5	1.8	-0.2	-0.4	-0.7	-0.5	-0.1	0.2
Information Ratio	2.5	-0.8	0.2	0.1	-0.7	0.2	-0.3	0.0
Tracking Error (% pa)	7.3	5.8	12.0	9.0	13.7	8.7	11.5	8.2

Fund: Smallco Investment Fund

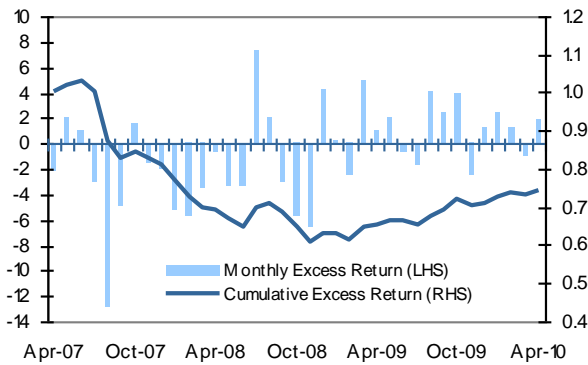
Benchmark: S&P/ASX 300 Accumulation Index

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

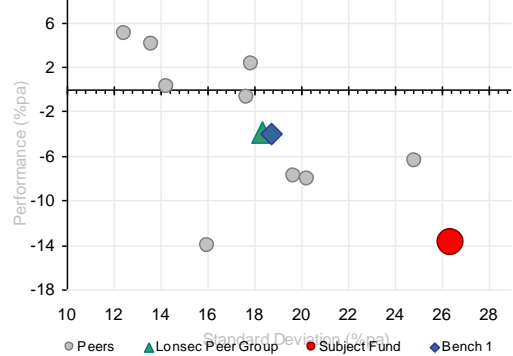
It should be noted that Lonsec's Australian long/short equity fund universe is relatively broad, which includes both absolute return focus funds and beta 1 or 130/30 type products.

Lonsec 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.

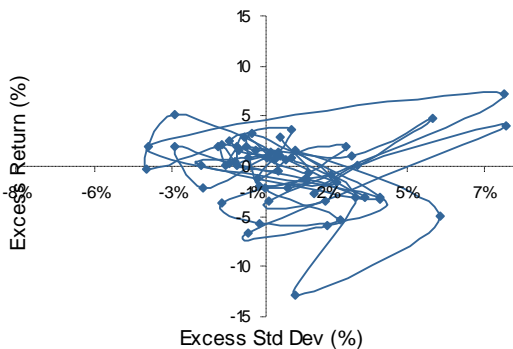
**Cumulative Performance over three years**



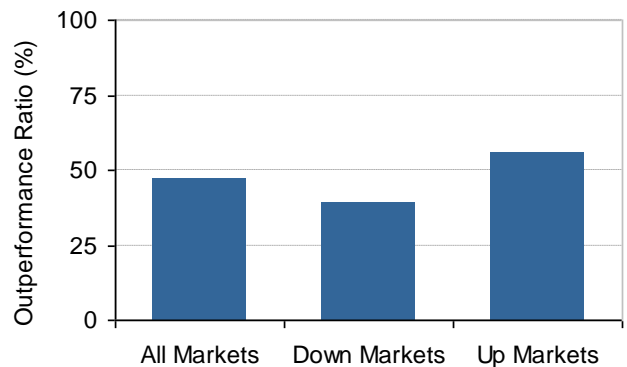
**Risk-return Chart over three years**



**Snail Trail over three years**



**Outperformance Consistency over three years**



## Glossary

<b>Absolute Return</b>	'Top line' actual return, after fees
<b>Excess Return</b>	Return in excess of the benchmark return (Alpha)
<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 2010**  
**Analyst: Vladimir Gagovic**  
**Release Authorised by: Paul Pavlidis**

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