Lonsec

5 Highly Recommended

Product Review
Smallco Broadcap Fund

About this Review

ASSET CLASS REVIEWED	AUSTRALIAN EQUITIES
SECTOR REVIEWED	AUSTRALIAN LARGE CAP
SUB SECTOR REVIEWED	GROWTH
TOTAL FUNDS RATED	21

About this Fund

ASIC RG240 CLASSIFIED	NO
FUND REVIEWED	SMALLCO BROADCAP FUND
APIR CODE	ASC0003AU
PDS OBJECTIVE	TO ACHIEVE RETURNS 5% P.A. ABOVE THE S&P/ASX 300 ACCUMULATION INDEX AFTER FEES ON A ROLLING THREE-YEAR BASIS
INTERNAL OBJECTIVE	5% P.A. ABOVE THE S&P/ASX 300 ACCUMULATION INDEX ON A ROLLING THREE-YEAR BASIS (AFTER FEES)
STATED RISK OBJECTIVE	INFORMATION RATIO >1 ON A ROLLING THREE-YEAR BASIS
DISTRIBUTION FREQUENCY	ANNUALLY
FUND SIZE	$200M (JULY 2018)
FUND INCEPTION	01-07-2008
MANAGEMENT COSTS	1.2% P.A.
PERFORMANCE FEE	15% (OF ANY OUTPERFORMANCE OF THE S&P/ASX 300 ACCUMULATION INDEX)
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	ANDREW HOKIN
INVESTMENT TEAM SIZE	6
INVESTMENT TEAM TURNOVER	VERY LOW
STRUCTURE / LOCATION	SYDNEY

Investment process

STYLE	GROWTH AT A REASONABLE PRICE (GARP)
TYPICAL STOCK NUMBERS	20-30
BENCHMARK	S&P/ASX 300 ACCUMULATION INDEX
TYPICAL CAPITALISATION BIAS	ALL CAP
STOCK LIMITS	15% (AT TIME OF PURCHASE); 20% (CURRENT VALUATION)
SECTOR / INDUSTRY LIMITS	EXPOSURE TO A MINIMUM OF FOUR GICS SECTORS. 20% (SOFT)
CASH LIMIT	0-50% OF NAV

Fund rating history

SEPTEMBER 2018	HIGHLY RECOMMENDED
SEPTEMBER 2017	HIGHLY RECOMMENDED
OCTOBER 2016	HIGHLY RECOMMENDED

What this Rating means

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

Strengths

- Quality investment team led by a well-regarded Portfolio Manager in Andrew Hokin who possesses considerable experience in small and mid-cap investing.
- Boutique investment culture supported by strong alignment with high personal equity ownership of key investment personnel.
- The Fund's consistent outperformance since inception, and its ability to adhere to its performance objectives.
- Disciplined approach to capacity management.

Weaknesses

- The Fund's fee load is considered expensive relative to peers, with a 1.2% p.a. management fee and a 15% performance fee of any outperformance of the S&P/ASX 300 Accumulation Index.
- 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		●	

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		●	

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Smallco Broadcap Fund

ISSUE DATE 06-09-2018

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 Broadcap Fund ('the Fund') is a concentrated, 'benchmark unaware' Australian equity product with the ability to have material exposure to stocks with a market cap of less than $1 billion (maximum 40%). Additionally, the Fund has the flexibility to hold up to 50% in cash if no appropriate investment opportunities are identifiable or market risks are deemed to be too high.
- 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 portfolio.
- The Fund aims to outperform the S&P/ASX 300 Accumulation Index by 5% p.a. (net of fees) over a rolling three-year time period. Despite the 'all cap' approach, typically the Manager will aim to target small to mid cap stocks, believing a greater level of inefficiency exists in this portion of the market.
- 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.
- The Management Cost for the Fund is 1.20% p.a. Smallco may also be entitled to a performance-based fee. This performance fee, payable quarterly, is calculated as 15% of any outperformance of the S&P/ASX 300 Accumulation Index subject to a high water mark.

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.
- 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.
- The Fund is a 'long only' Australian equity product which has the flexibility to be able to invest up to 50% of the Fund in cash. As such the Fund will sit within the growth component of a diversified investment portfolio. As a 'growth' style product, Lonsec considers it suitable for blending with other Australian Equity strategies including benchmark aware, style biased, or long/short products.
- Given the Fund's relatively high conviction/ concentrated nature, and the ability to invest up to 40% in stocks with a market cap of less than $1 billion (typically 25-40%), Volatility (as measured by Standard Deviation of returns) may be higher than traditional benchmark aware Australian Equity products. Lonsec suggests the Fund should only be considered for those investors that are willing to accept returns that can differ significantly from the broader market.

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.

Changes Since Previous Lonsec Review

- The Fund paid an out-of-cycle distribution of 20c per unit (representing slightly less than 10% of the net asset value of the Fund) effective 31 December 2017. This is part of the Manager's ongoing effort to manage capacity.
- 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, Andrew Hokin is the Portfolio Manager of the Fund and is ultimately accountable for its performance.
- Lonsec believes Hokin has made a strong contribution to managing the Fund bringing appropriate technical knowledge on both the market

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and stocks to his portfolio management duties. In Lonsec's view, Hokin has also been instrumental in strengthening the rigour of the Manager's investment approach, particularly through the introduction of improved quality factor assessment, 'Quality Rating System'. Hokin appears highly motivated for managing this investment vehicle and is viewed as a key attraction of the offer.

- Hokin sits alongside the five remaining members of the investment team, namely Bill Ryan, Rob Hopkins, 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 in spite of the 'all cap' nature of the strategy.
- 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).
- As is typical for a small investment team that is reliant on intrinsic knowledge of the investment universe to construct the underlying portfolio, Lonsec notes there is a high degree of 'key person risk' in Hokin. This also extends to co-founders Hopkins and Ryan given their integral involvement in the Smallco investment process and the broader business. To this end, Lonsec acknowledges the equity ownership structure to be a significant mitigating factor, while also noting Hokin's tenure at Smallco. 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. This is supplemented by opportunistic 'value' ideas where a 6-12 month re-rating trigger exists. 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 $100m-$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.

- The portfolio construction process is consultative but is ultimately led by Hokin who is responsible for constructing a portfolio reflecting the Manager's highest conviction ideas. Whilst a co-portfolio manager structure is implemented, Lonsec is pleased that Hokin has discretion over the final portfolio as this aids in increasing accountability to investors. 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 in design and observes a clear link between the team's conviction in each stock, the assessment of its risk, and its final weight within the portfolio.
- The portfolio will tend to be concentrated at a stock and sector level, with the ability for individual stock positions to comprise 15% of the portfolio's net asset value (NAV) at cost. Whilst Lonsec acknowledges the infrequent use of this limit over the life of the Fund, relative to peers, Lonsec highlights the potential for the positioning of the underlying portfolio to be rather aggressive when conviction levels in names increase. However, 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 20% 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.
- 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.
- This Fund is a direct derivative of Smallco's flagship Australian equity strategy, the Smallco Investment Fund. Given the strong cohesion and interdependencies of the investment team, the active allocations of the two portfolios are typically somewhat similar.

Risk management

- Lonsec considers Smallco's risk management to be appropriate given the 'benchmark unaware' nature of the strategy, noting that risk management is largely embedded within the Manager's stock selection process.
- The Fund's design means that there are minimal formal portfolio risk controls, in line with other 'benchmark unaware', high conviction strategies. The potential level of stock concentration in the portfolio is high, with a single holding in the portfolio being able to represent up to 20% (at current valuation) of the Fund's NAV. Further, exposure to any one sector can also be significant. Although sector exposures are monitored closely by the Manager, portfolio construction sector constraints are considered to be flexible. The constraint requires the Fund to have exposure to a minimum of four Global Industry Classification Standard (GICS) sectors with a 20% absolute ('soft') limit.
- 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. Further, the Fund can hold up to 40% of the portfolio in stocks with a market cap of below $1 billion and 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 its sister Fund, the Smallco Investment Fund, effective as of 1 February 2017 with $820 million under management. As at July 2018, firm wide FUM approximated $870 million.
- Historically, Lonsec notes the Manager has displayed prudent discipline in relation to FUM/capacity management, having previously 'soft' closed both the Fund and the Smallco Investment Fund in March 2016. Pleasingly, the Manager has continued to display prudent judgement through the Fund's recent 'hard' closure and payment of an out of cycle distribution of 20c per unit (representing slightly less than 10% of the net asset value of the Fund) effective 31 December 2017. A further testament to this discipline is the target fund size of this strategy, determined on the basis of preserving its ability to meaningfully invest in stocks below $1 billion market cap, being adhered to. Lonsec supports Smallco's discipline on this aspect which should serve to preserve the appeal of the offer.

Smallco Broadcap Fund

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

Performance

- The objective of the Fund is to outperform the S&P/ASX 300 Accumulation Index ('the Benchmark') by 5% p.a. over a rolling three-year period. Over this period, the Fund delivered on its rolling return objective returning 13.3% p.a. outperforming the Benchmark by 5.2% p.a. (all figured after fees as at 31 July 2018). The Fund also significantly outperformed Lonsec's Large Cap Growth peer median over the same time period. Furthermore, Lonsec highlights that the Fund has a solid long term performance track record, delivering 19.3% p.a. over 10 years, outperforming the Benchmark by 12.4% p.a.
- Near-term performance has improved markedly relative to last years review with the Fund delivering 22.4% (after fees) over the 12-months to 31 July 2018, outperforming the Benchmark and the Lonsec peer median by 7.7% and 4.0% respectively. Key contributors over the year include Altium, Webjet Limited and Wisetech Global Ltd. Conversely, the main detractors from performance were GTN Ltd, iSentia Group and Sirtex Medical Limited.
- Lonsec notes that the Fund has not delivered on its risk objective of maintaining an Information Ratio above one over a rolling three-year period (0.66). However, over a rolling three, five and 10 years, the Fund has generated an Information Ratio which is notably higher than the Lonsec Peer Group median. Lonsec looks favourably on investment vehicles delivering high Information Ratios, believing it to be a reflection of manager skill.

Overall

- Lonsec has maintained the Fund's rating at **'Highly Recommended'** at the most recent review. This rating reflects Lonsec's strong conviction in the investment team and in particular lead Portfolio Manager, Andrew Hokin. Lonsec considers Hokin to be a high quality investor noting his experience investing in small and mid cap stocks, and his overall contribution in shaping Smallco's investment process.
- The Fund provides a differentiated offering to investors underscored by its all cap structure, 'benchmark unaware' mindset and high conviction approach. Further, the Fund has continued to display prudent discipline in relation to capacity management which serves to preserve its investment appeal.
- Lonsec highlights the fee load remains at the upper end compared to peers in this sector and notes the performance fee objective is less onerous to achieve than some peers. Nonetheless, investors have been duly compensated with some impressive long-term performance.
- Lonsec stresses the suitability of this offering is limited to investors who are able to withstand significant stock concentration, a high weighting to cash (at times) and material 'small/mid cap' stock exposure.

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 Investment 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 Hokin with the assistance of stock specific input from the other members of the Smallco investment team. Hokin has been with the Manager since July 2007 and has held prior roles at brokerage firms Day Cutten and Macquarie Securities prior to joining Smallco. Lonsec notes that in addition to managing this Fund, Hokin also co-manages the Smallco Investment Fund (SIF) with Hopkins and Ryan.

Smallco Broadcap Fund

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Research Approach

Overview

INVESTMENT STYLE	BENCHMARK UNAWARE, GROWTH AT A REASONABLE PRICE (GARP)
STOCKS IN 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 4.7. Given the skill set of the investment team and the investment philosophy, the Manager will tend underweight resource stocks and be sceptical of investment in biotechnology companies and companies with cyclical earnings.

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.

Portfolio Construction

Overview

FUND BENCHMARK	S&P/ASX 300 ACCUMULATION INDEX
INTERNAL RETURN OBJECTIVE	BENCHMARK + 5% P.A. OVER ROLLING THREE-YEAR PERIOD (NET OF FEES)
INTERNAL RISK OBJECTIVE	INFORMATION RATIO >1 OVER ROLLING THREE-YEAR PERIOD
PORTFOLIO APPROACH	BENCHMARK UNAWARE, CONCENTRATED
INVESTMENT STYLE	GARP
PORTFOLIO DECISIONS	PORTFOLIO MANAGER DRIVEN
EXPECTED PORTFOLIO TURNOVER	50% P.A.
TYPICAL NUMBER OF HOLDINGS	20-30
MARKET CAPITALISATION BIAS	ALL CAP
% OF PORTFOLIO IN TOP 10 HOLDINGS	49.8% (MAY 2018)
OBSERVED ACTIVE SHARE	80.2% (MAY 2018)
CASH RANGE	0-50% OF NAV

Decision making

Portfolio construction is the responsibility of Andrew Hokin, however, given the collective decision making philosophy at the firm, consensus views will also have some influence on positioning.

The Manager aims to populate the portfolio with 20 to 30 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 50% 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. Further, the mandate allows stocks with a market capitalisation below $1bn to represent up to 40% of the portfolio's NAV.

Position sizing is primarily at the discretion of Hokin with sizing 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 15% (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.

Smallco Broadcap Fund

Risk Management

Risk limits

SEPARATE RISK MONITORING	NO
STOCK LIMITS (ABSOLUTE)	15% (AT COST); 20% (AT CURRENT VALUATION)
SECTOR LIMITS (ABSOLUTE)	EXPOSURE TO A MINIMUM OF FOUR GICS SECTORS. 20% (SOFT)
CASH	MAXIMUM OF 50% OF NAV
TRACKING ERROR	NOT TARGETED
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 15% 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. A 'soft' limit is in place in relation to sector exposures of 20% of NAV.

Further limits implemented include restricting the exposure to securities considered by Smallco to be 'illiquid' to a maximum of 30% of NAV and limiting exposure to companies with a market capitalisation below $1bn to 40% of NAV.

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, including quarterly attribution relative to the S&P/ASX 300 Accumulation Index. 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.

The Manager is not permitted to short stocks or use gearing in this Fund.

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 Investment Memorandum 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.

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Smallco Broadcap Fund

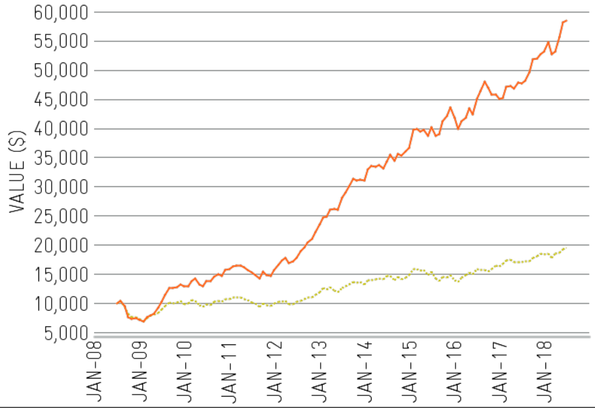
Quantitative Performance Analysis - annualised after-fee % returns (at 31-7-2018)

Performance metrics

	1 YR		3 YR		5 YR		10 YR	
	FUND	PEER MEDIAN	FUND	PEER MEDIAN	FUND	PEER MEDIAN	FUND	PEER MEDIAN
PERFORMANCE (% PA)	22.41	18.42	13.26	9.94	15.78	10.33	19.32	8.63
STANDARD DEVIATION (% PA)	8.12	7.82	9.97	10.69	9.80	10.71	15.20	14.02
EXCESS RETURN (% PA)	7.70	3.83	5.18	1.70	6.63	0.87	12.39	1.69
OUTPERFORMANCE RATIO (% PA)	66.67	66.67	61.11	52.78	65.00	53.33	74.17	56.67
WORST DRAWDOWN (%)	-3.67	-3.51	-8.35	-9.49	-8.35	-10.46	-33.75	-30.88
TIME TO RECOVERY (MTHS)	2	2	5	6	5	8	6	10
SHARPE RATIO	2.53	2.06	1.13	0.71	1.38	0.73	1.06	0.39
INFORMATION RATIO	1.20	1.20	0.66	0.52	0.98	0.36	1.71	0.46
TRACKING ERROR (% PA)	6.40	2.82	7.85	3.57	6.76	3.32	7.25	3.55

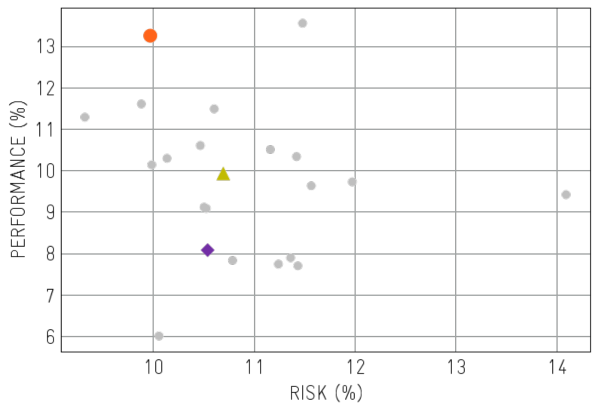
FUND: SMALLCO BROADCAP FUND
LONSEC PEER GROUP: AUSTRALIAN EQUITIES - AUSTRALIAN LARGE CAP - GROWTH
BENCHMARK USED: S&P/ASX 300 TR INDEX AUD
CASH BENCHMARK: BLOOMBERG AUSBOND BANK BILL INDEX AUD
TIME TO RECOVERY: NR - NOT RECOVERED, DASH - NO DRAWDOWN DURING PERIOD

Growth of $10,000 over 10 years



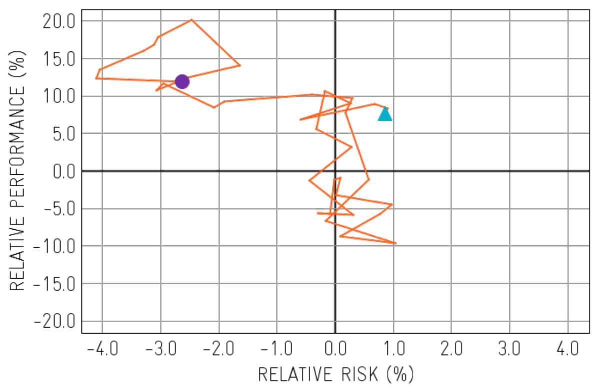
SMALLCO BROADCAP FUND
S&P/ASX 300 TR INDEX AUD

Risk-return chart over three years



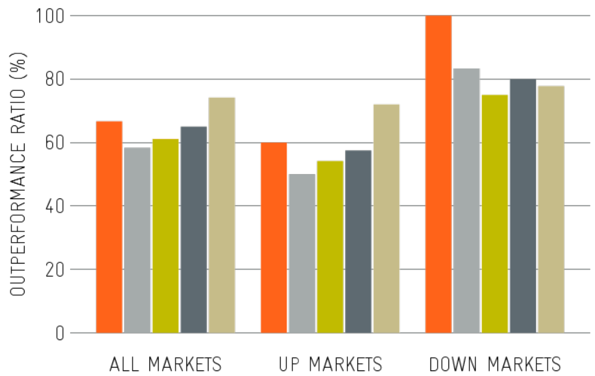
SMALLCO BROADCAP FUND
S&P/ASX 300 TR INDEX AUD
PEER MEDIAN
PEERS

Snail trail



START (07-2015) END (07-2018)

Outperformance consistency



1Y 2Y 3Y 5Y 10Y

Lonsec

Smallco Broadcap 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

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