

# Kinetic Wholesale Emerging Companies Fund

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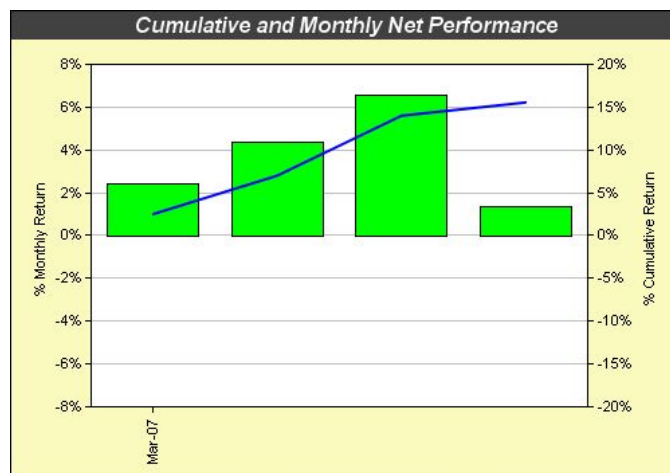
Kinetic Investment Partners (Kinetic) was the first partnership struck under the Challenger Financial Services (Challenger) boutique model having emerged out of the latter's acquisition of HSBC Asset Management in 2005. Already having an in-house small company capability meant that in order to retain Richard Sharp and Jonathan Findlay, Challenger needed to find an alternative structure. Kinetic was established with \$140 million in ex HSBC mandates and through its "tie-up" with Challenger gained a back office and sales / marketing solution in exchange for releasing 19.9% in equity. Funds under management now stands at approximately \$680 million and in Zenith's opinion this is close to capacity which we consider to be approximately 0.5% of the Small Ordinaries market capitalisation or \$775 million as at July 2007. The Manager has already "soft closed" its institutional business, that is, it can take new inflows from existing clients but not from new investors.

The co-founders of the Kinetic business are highly regarded by Zenith having jointly managed small company mandates under its current investment process since September 2003. Over this period they have carved out impressive absolute and risk adjusted performance numbers which see them sit within the top quartile relative to their peers. Furthermore Sharp and Findlay have 21 years and 13 years market experience respectively which means they are highly credentialed. Kinetic has also recently added a third member to its investment team with the appointment of an analyst (Anthony Porto), which goes towards addressing the issue of the Manager being too "top heavy" and spreads the analytical / modelling load.

The investment process occurs within a highly collegiate based environment (both portfolio managers involved in most company visits and model inputs) which is regarded as a strength although such a structure reinforces the requirement for additional team resources. Valuation focuses on cash flow return on investment (CFROI) which is ultimately distilled down into a 12 month expected return. This is supplemented with "Porter" style analysis, assessment of management and management strategy, and an evaluation of any "catalyst for change", which may lead to a re-rating of the company. Kinetic does not formally rank or score any component part of its qualitative assessment nor does it set any boundaries on portfolio construction based on the investment process. To this extent, the process is subjectively driven and dependent upon the skill of the key investment professionals. Zenith would like to see a greater linkage between process and portfolio construction and some greater rigour added to the assessment of qualitative factors.

Overall the Fund is rated as a solid offering and has been awarded an Approved rating given the solid experience of the investment team at both Kinetic and HSBC and their ability to deliver under a "tried and tested" investment approach.

| Key Features                     | Description                        |
|----------------------------------|------------------------------------|
| APIR Code                        | HOW0036AU                          |
| Asset Class                      | Australian Shares                  |
| Sub-Asset Class                  | Small Companies                    |
| Investment Style                 | Neutral                            |
| Benchmark                        | S&P / ASX Small Ordinaries (Accum) |
| Recommended Investment Timeframe | 5 + years                          |
| Director, Portfolio Manager      | Richard Sharp                      |
| Director, Portfolio Manager      | Jonathan Findlay                   |
| Investment Team Size             | 3                                  |



## Performance Analysis

| Performance Statistics       | Since Inception | 3 Mths (%) |
|------------------------------|-----------------|------------|
| Performance - Fund           | 15.47           | 12.73      |
| Performance - Benchmark      | 15.31           | 10.83      |
| Performance - Median Manager | -               | 11.58      |

Inception Date: Mar 2007

The Fund was launched in March 2007 and while in its current format has only a limited track record, the individuals

comprising the investment team have been managing money under this investment approach since September 2003. Co-founders Richard Sharp and Jonathan Findlay worked together at HSBC from September 2003 to September 2005 and then upon formation of Kinetic in October 2005.

Examining the 3 year track record of the ex-HSBC fund run over the period ending May 2007 gives a good insight into the capabilities of the individuals and it shows that it ranks in the top quartile within the Zenith universe on both an absolute and risk adjusted basis.

### Investment Personnel

| Name             | Title                       | Time with Manager |
|------------------|-----------------------------|-------------------|
| Richard Sharp    | Director, Portfolio Manager | 1 Yr(s)           |
| Jonathan Findlay | Director, Portfolio Manager | 1 Yr(s)           |
| Anthony Porto    | Investment Analyst          | 0 Mth(s)          |

### Business Update

Kinetic Investment Partners (Kinetic) was formed in October 2005 by Richard Sharp and Jonathan Findlay following HSBC Asset Management's sale to Challenger Financial Services (Challenger). Both Sharp and Findlay had worked together as HSBC's Small Companies team since September 2003 and they were the first fund manager to sign with Challenger's boutique partnership program. The mechanics of this structure were largely influenced by the fact that Challenger had an existing capability in this asset class. Kinetic is 80.1% owned by its founders and 19.9% owned by Challenger. The Board comprises three individuals Richard Sharp, Jonathan Findlay and Rob Adams (CEO, Challenger Wealth Management).

Following the formation of Kinetic approximately \$140 million followed in mandates (\$100 institutional / \$40 million retail). Despite the "tie up" with Challenger until recently Kinetic remained largely as an institutional orientated small companies' manager. This shift coincided with the move to a "soft close" on institutional mandates (\$600 million spread across 5 clients) and launch of a new retail fund in March 2007.

With almost 2 years of trading under the Kinetic brand the Manager is arguably on a firmer footing than some of the more recent additions to the Challenger boutique model given it is profitable and is approximately 70% towards its goal of \$1.0bn in funds under management.

### Investment Team

The Kinetic investment team comprises three investment professionals - Richard Sharp (Director, Portfolio Manager), Jonathan Findlay (Director, Portfolio Manager) and Anthony Porto (Investment Analyst).

Both directors come highly credentialed with strong depth of experience on the "buy side". Sharp and Findlay have 21 years and 13 years market experience respectively and importantly have been co-managing small company funds since 2003. Prior to co-establishing Kinetic, Sharp was with HSBC for 11

years in both a large and small company analyst capacity (including managing the HSBC Small Companies Fund). He has also held positions with Norwich as an economist in the UK and as an industrial equity analyst in Australia. Findlay's asset management experience includes "stints" at HSBC (small companies' team, 2003 - 2005), Glebe Asset Management (portfolio manager for Small Companies Fund, 2001 - 2003) and National Australia Asset Management (portfolio manager Aust & Japan equities, 1999 - 2001). Porto is the junior member of the team having commenced his career in 2005 as an investment banking analyst at Credit Suisse, before moving to Kinetic. The addition of the third member to the team has added some much needed "analyst grunt" with this role expected to have heavy involvement in modelling (Manager currently manages 100 company models but would like to expand this to 120) and likely include the dealing function (currently undertaken by Findlay).

In Zenith's opinion the team is highly credentialed and well experienced and ranks amongst any of its peers to this extent. While running a three man investment team puts Kinetic on a "par" with many of its competitors, a further consideration when assessing Kinetic level of resourcing is its collegiate investment decision making approach, the model intensive nature of the investment process and its high company visitation program (with both directors typically present).

In terms of continuity and stability of investment team Kinetic has been "rock solid" with the two co-founders having worked together since September 2003. While Sharp typically assesses all industrial stocks and Findlay examines all resource stocks, decision making occurs in a very collegiate manner which is regarded as a strength.

### Investment Process

Inefficiencies in small companies is the central tenet behind the Kinetic investment philosophy which the Manager believes arises from two principle sources:

- Given the large number of stocks in the small companies sector and the relative lack of attention from the investment community good investment opportunities can be discovered; and
- Many investment methodologies do not pay enough attention to specific risk and the return profile of the sector. The process seeks to circumvent this issue through the adoption of cash flow analysis which minimises the risk of accounting manipulation and changes in accounting standards. The focus is on companies which create shareholder wealth by increasing their return on assets and investing capital in a way that generates returns above the cost of capital.

Given Kinetic's cash flow return in investment (CFROI) methodology it does not target a specific investment style.

### Security Selection

The investment process starts by filtering the universe, which comprises any stock outside the S&P / ASX 100 index with a minimum market capitalisation of \$25 million. Kinetic applies a primary screen based on liquidity, in-house investment ideas and macro views which narrows the universe from 1000+ companies to an investible universe of approximately 300 - 400 stocks. These screens are subjectively driven which in Zenith's opinion is difficult to efficiently manage for a small team and we would prefer to see greater structure and formal application applied.

A secondary screen seeks to cull the list down to between 150-250 companies based on preliminary analysis of key drivers of success and industry structure along with, where applicable, broker and externally sourced research. With this analysis Kinetic considers the economic cycle, industry / sector factors, company specific factors and whether the industry structure has any exploitable niches, level of industry competition, barriers to entry / exit, regulation, growth outlook and product differentiation.

Arriving at its final investible universe Kinetic then conducts company visits which allow a full appraisal of fundamental research including in further detail those factors considered in the secondary screen. It also assesses management and management strategy which examines the coherency of the management team, consistency of application, track record, corporate governance and focus on shareholder wealth creation. An evaluation of any "catalyst for change" examines both positive factors (development new technology, regulatory approval, exploration success, award of contract) and negative factors (management instability, competitor activity, litigation, and change in regulation) and their potential effect on any re-rating of the company.

Following the company review, if it is agreed that the fundamentals warrant further investigation then Kinetic will fully model the company's financials and value the business using the cash flow return on investment (CFROI) methodology. This is typically modelled out over a 3-4 year period although where relevant and the Manager will conduct longer dated modelling (i.e. biotech 5-10 years) and supplement the CFROI with a discounted cash flow valuation (DCF). The end result of the valuation stage is a 12 month expected return (i.e. the difference between Kinetic's valuation and the current market price) which allows all companies to be ranked on this measure. Between 100-120 companies are fully modelled and ranked, which forms the basis of the Manager's Active Research List.

Kinetic undertakes approximately 400 company visits in total per annum including an estimated 250 "one-on-one" visitations which are typically attended by both portfolio managers.

The output from the primary analysis and company visitation program is not formulated in any fashion and forms part of the qualitative "consideration". Zenith would prefer to see these components scored and ranked similar to the valuation assessment as we believe this would add rigour and discipline to the approach.

### Portfolio Construction

Kinetic believes there are innate difficulties in devising a formula driven stock weighting process within small companies. While Zenith doesn't disagree with this statement, we believe use of guidelines (rather than formulaic results) can add rigour to the construction process and tighten risk management. The Kinetic portfolio construction process is as qualitatively driven as any manager we have reviewed and as a consequence highly dependent on the skill of its portfolio managers. Neither a stock's expected return ranking or the output from the fundamental research, individually or combined, quantifies whether a company can be included in a portfolio or at what weight. This decision is purely subjective and provided it doesn't breach a maximum absolute or active stock weight (7.5%) then it is allowed.

The actual weighting applied to each company is a function of the following components:

- Fundamental factors (or qualitative inputs);
- Valuation, market capitalisation and liquidity (or quantitative inputs); and
- Risk factors (portfolio guidelines, tracking error, managing risk etc).

Number of stocks in the portfolio will typically fall in the 55-65 range while expected portfolio turnover of 50%-60% per annum suggests an average holding period of 2 years. Individual holdings are unlikely to be below a 0.5% weight (IPO's being the exception) as deemed not to be a meaningful position. The tracking error on the portfolio has averaged approximately 6.0% through the cycle and is expected to fall typically within the 5.0% - 10.0% per annum band, although this is not a measure the Manager specifically targets.

### Risk Management

| Portfolio Constraints                        | Description                                |
|--|--|
| No. of securities                            | 30 to 70                                   |
| Maximum active position (%)                  | 0% to 7.5%                                 |
| Maximum holding (%)                          | 0% to 7.5%                                 |
| Maximum holding of a company (%)             | 0% to 7.5%                                 |
| Minimum market capitalisation                | \$25 million                               |
| Maximum market capitalisation                | Must be outside S&P / ASX 100              |
| Cash (%)                                     | 0% to 10%                                  |
| Maximum time to sell if enters S&P / ASX 100 | 6 months                                   |
| Tracking error                               | Not targeted, expected b/w 5.0% -10.0% p.a |

Kinetic believes the small companies market carries with it a high degree of stock specific risk which it manages through the following:

- A focus on free cash flow from a valuation due diligence perspective;
- Stock and portfolio level risk analysis;
- Use of portfolio guidelines;
- Monitoring of pre / post risk compliance, analysis of risks both internally and through use of third party risk management technology.

Portfolio guidelines are limited to a maximum active stock position, a maximum holding of a company and a maximum absolute weight. Not unlike many of its small company product peers this fund is not bound by any formal sector constraints or any tracking error limits although these are monitored through the IMPACT system. In Zenith's opinion while such scope ensures a portfolio manager is not constrained in their ability to deliver "alpha", the investor is largely "in the hands of the Manager" in terms of ensuring adequate diversification.

In terms of risk management assessment systems, Kinetic uses Dimension (to provide pre and post trade compliance), Impact (to consolidate all relevant portfolio and stock level information) and BARRA (which is the primary risk tool).

## Risks of the Fund

Zenith has identified the following key risks associated with the Fund although this is not meant to be an exhaustive list of all risks:

- **Capacity risk** - managing \$680 million represents 0.43% of the market capitalisation of the Small Ordinaries index. While this still provides Kinetic ample "head room" on their stated capacity level of \$1.0bn, this number is close approaching the 0.5% mark which we consider a level in which some influence of size may start to be felt;
- **Key man risk** - the key partners involved in Kinetic are Richard Sharp and Jonathan Findlay and any event which caused either one of these individuals to no longer be involved in the business would have an immediate and dramatic impact. We do however believe the risk of a departure is extremely low given collectively they own 80.1% of the equity in the business;
- **Market risk** - any downturn in the equity markets will impact directly upon the fortunes of the Fund. In falling market conditions there tends to be a "flight to quality and size" and small caps are often the first part of the equity market to come under pressure; and
- **Manager risk** - Kinetic fails to deliver on its stated return objective of outperforming the S&P / ASX Small Ordinaries Accumulation index over rolling five-year periods.

## Applications of the Fund

From a portfolio perspective, Zenith believes the Fund is best used in combination with a large company Australian equities fund in order to achieve sound diversification and exposure to all market segments.

While the Fund is not specifically managed against the S&P/ASX Small Ordinaries Accumulation Index its performance objective is to outperform that index over rolling 5 year periods. As a result, investors should expect the performance of the Fund to have some correlation with the performance of the underlying index.

As a small companies fund, Zenith believes the Fund is most appropriate for those investors seeking a growth based investment and are prepared to invest for at least 5 years to maximise their potential for optimal results.

## Fees

The fees on this Fund are reasonable when comparable with competitors in this sector although towards the top end particularly from a performance fee rate perspective (15% typically the norm).

The base fee is set at 1.15% p.a. while the performance fee is set at 20% of the performance (after base fee) above the S&P/ASX Small Ordinaries Index. Pleasingly, the performance fee is only payable when the absolute return of the Fund is positive for the period and the Fund outperforms its previous high water mark. Zenith regards performance fee calculation periods of quarterly as too short and we would prefer to see an annual frequency in place. Furthermore the ability to essentially "wipe the underperformance slate clean" after 3 years means Manager and investors interests are not aligned and this feature is considered a major negative. A buy sell spread on +/- 0.40% exists on all withdrawals and applications to cover transaction costs.

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