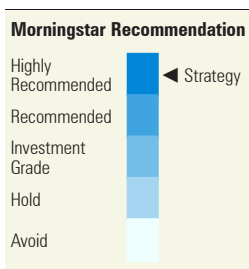


# Kinetic Small Companies



**Role in Portfolio:**

Supporting Player

**Risks:**

- Performance fee will erode returns
- Investing heavily in micro-caps can constrain liquidity

**Morningstar Analyst:**

Zac Wallis

**Morningstar Take**

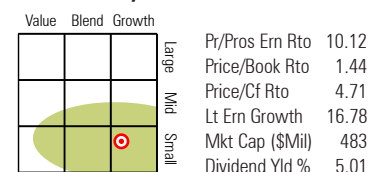
Kinetic Small Companies continues to be one of the very best domestic small-cap strategies on offer. The stockpicking abilities of co-founders Richard Sharp and Jonathan Findlay and the rigour shown in their fundamental assessment of stocks is what makes this better than most. Sharp and Findlay established Kinetic in 2005 after Challenger acquired previous employer HSBC Asset Management Australia. Both have many years' experience and tenure together dating back to 2003. The duo own equal 40.05 percent stakes in Kinetic, which gives us great comfort about the longevity and consistency of the management here. This approach centres on finding undervalued companies, and identifying those which can demonstrate a catalyst for re-rating. The team employs cashflow return on investment as the primary valuation tool, although also uses discounted cashflow metrics. The fund manager will not invest in a company without kicking the tyres, and team members spend a lot of time on the road visiting companies and getting to know management. Kinetic doesn't pigeonhole itself to any particular investment style, but the portfolio does have a growth tilt. It's also less top-heavy than many peers, making stock-specific risk less of an issue here. Another differentiating feature is that the team is more willing to search among smaller-sized companies than most competitors, Kinetic having one of the lowest average market-caps in the peer group. It's worth remembering that this end of the market can be very volatile, as performance in 2008 showed. One reservation we do have, albeit a small one, is the fee structure. Kinetic charges a 1.15 percent annual fee and then hits investors with a 20.0 percent performance fee on any excess above the net return. We think this is a bit on the nose, even if competitors do it as well. Aside from this, though, the people and process behind Kinetic Small Companies are truly top-notch, and this is one of the pre-eminent small-cap vehicles available.

**Strategy/Process**

Kinetic's investment process combines detailed modelling and fundamental analysis. The shop does not target any specific investment style, but looks for companies undervalued on a cashflow return on investment basis that can demonstrate a catalyst for change. The starting point is an investment universe of about 1000 companies outside the ASX100 with a minimum market-cap of A\$25.0 million. From this initial list, the team sets out to identify investment opportunities by applying a set of primary filters (macroeconomic indicators, liquidity screen, and so forth) and secondary filters (a mix of proprietary and external research) to whittle the research list down to a manageable 250 - 300 names. The team visits each of these companies to gain further insights into their businesses, before arriving at an active research list of 100 – 120 companies. Kinetic's fundamental research includes evaluation of management and strategy and key business drivers, as well as industry structure. An important factor here is determining a catalyst for change, both positive (such as new technology developments) and negative (like management instability). Valuation is based primarily on cashflow return on investment or discounted cashflow. This yields an absolute valuation for each company. Stock weights are largely an outcome of valuation, fundamental research, risk/return analysis, and liquidity. The end result is a reasonably-diversified portfolio of 45 - 70 names, and annual turnover of 50.0 percent is moderate.

**Flagship Fund: WS Small Companies Fund**

**Investment Style** 30 Jun 2010



**Stock Sectors** 30 Jun 2010

Sector	%
<b>Information Economy</b>	<b>11.75</b>
Software	2.15
Hardware	0.00
Media	3.89
Telecommunications	5.71
<b>Service Economy</b>	<b>46.84</b>
Healthcare Services	13.65
Consumer Services	8.06
Business Services	17.34
Financial Services	7.79
<b>Manufacturing Economy</b>	<b>41.42</b>
Consumer Goods	3.69
Industrial Materials	26.42
Energy	8.61
Utilities	2.69

**Top 10 Stock Holdings** 30 Jun 2010

Company	%
SAI Global Limited	3.56
Campbell Brothers Limited	3.20
PanAust Limited	3.18
Beach Energy Limited	2.96
IOOF Holdings Limited	2.86
Healthscope Limited	2.85
SMS Management & Technology Limited	2.70
Pharmaxis Ltd	2.41
Mesoblast Ltd	2.35
Mineral Deposits Limited	2.29

**Asset Allocation** 31 Dec 2010

Asset Class	%
Domestic Equity	94.88
Int'l Equity	0.00
Listed Property	1.75
Unlisted Property	0.00
Mortgages	0.00
Dom Fixed Interest	0.00
Intl Fixed Interest	0.00
Cash	3.37
Other	0.00

**Portfolio Stats**

Mgr Bmark: S&P/ASX Small Ordinaries Accumulation Index  
 No. Stocks: 30 - 70  
 Max Weight: 7.50%  
 Min Weight: Zero  
 Expd Track Error %pa: 5.0 - 10.0  
 Expd Turnover %pa: Moderate, around 50.0

**People Stats**

Lead Managers: Richard Sharp, Jonathan Findlay  
 Appointed: 2005, 2005  
 Years Experience: 24, 17  
 Team Size: 3  
 Average Years Experience: 16  
 Average Years Tenure: 5

**Role in Portfolio**

Supporting Player. This strategy should be used as part of a broader Australian equities allocation.

**People**

Kinetic was founded by co-portfolio managers Richard Sharp and Jonathan Findlay in 2005 after Challenger acquired their previous employer, HSBC Asset Management Australia. Sharp has more than two decades' investment experience in both Australia and the UK, and has managed the former HSBC Small Companies Fund (now the Kinetic strategy) since 1994. Findlay has worked for more than 15 years in the industry, holding a number of senior roles in domestic and Japanese equities before joining Sharp at HSBC. Anthony Porto is the team's third member, arriving as an investment analyst in late 2007 after a few years in investment banking at Credit Suisse. As majority owners, Sharp and Findlay are rewarded from business profitability, linked closely to the performance of this strategy.

**Performance**

Kinetic Small Companies has rewarded investors over the long term. (This was previously the HSBC small companies offering, and best represents Kinetic's long-term track record.) Kinetic has been a very consistent performer through the cycle, outpacing both the S&P/ASX Small Ordinaries Index and our peer group average more often than not. Kinetic was hit hard in 2008 and underperformed significantly as liquidity dried up. Returns subsequently rebounded strongly in 2009 and 2010 when liquidity returned. Investors should expect this strategy to be more volatile than both the index and rivals given Kinetic's liking for fishing among the minnows. The best-performing stocks in the portfolio over the year to 31 December 2010 included Sphere Minerals, Mesoblast, and Thorn Group. Stock calls that hurt returns were bets on Nexbis, Hastie Group, and Beach Energy.

**Parent**

Kinetic Investment Partners is a boutique investment firm, 80.10 percent owned by Richard Sharp and Jonathan Findlay, and 19.90 percent owned by Challenger. Kinetic managed A\$568.0 million in assets at 30 November 2010.

**Fees**

Wholesale investors pay an ongoing fee of 1.15 percent per annum, as well as a performance fee of 20.0 percent of the net return above the benchmark. This is about average for a wholesale small-cap fund.

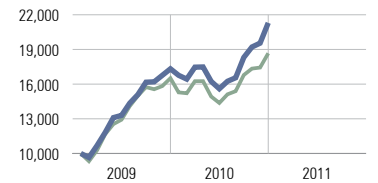
**Top 5 Funds by Net Assets**

	Ticker	Net Assets (\$Mil)	Quartile Rank 3yr	Total Ret 3yr
Kinetic Wholesale Emerging Companies Fund	15318	36.06	■	-4.40
Kinetic Wholesale Small Companies Fund	3287	12.37	■	-5.27

**Flagship Fund: WS Small Companies Fund**

**Performance** 31 Dec 2010 Fund Index

Growth of \$10,000 **\$21,301**



	1Yr	3Yr	5Yr	10Yr
Quartile Rank	■	■	■	■

Total Ret%	22.96	-5.27	7.85	11.71
Income Ret%	2.79	9.93	11.14	16.46
Growth Ret%	20.17	-15.20	-3.29	-4.75

Index%	13.05	-5.89	5.54	9.27
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Index: S&P/ASX Small Ords Accum  
 Category: Australia Mid/Small Growth

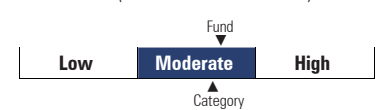
**Performance Analysis** 3 Years to 31

December 2010

Value Add vs Cat Index%	0.62
Tracking Error	6.82
Information Ratio	0.09

**MPT Statistics** 31 Dec 2010

	3Yr%	5Yr%	10Yr%
Beta	0.95	0.97	0.92
Alpha	0.19	2.95	2.97
R Squared	0.94	0.75	0.73
Sharpe Ratio	-0.44	0.10	0.41

**Risk Meter** (3 Year Standard Deviation)

All figures and stats relate to the Flagship Fund, and all performance figures are shown as % per annum, net of fees.

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