

About this Review	
Sector Reviewed	<b>Small Cap Australian Equities</b>
Total Funds Rated	28
Date of this Sector Review	April 2009
About this Fund	
Fund Reviewed	<b>Souls Australian Small Companies Fund</b>
Fund Size (\$M)	35.5
Responsible Entity	Souls Funds Management Limited
Fund Commenced	May 1998
Retail Fee (p.a.)	0.7% Plus Performance Fee
Wholesale Fee (p.a.)	0.7% Plus Performance Fee
Structure Availability	Retail, Wholesale, Platforms
About the Fund Manager	
Fund Manager	Souls Funds Management Limited
Ownership	Washington H Soul Pattinson (WHSP) 61%; Pitt Capital Partners 23%; Key Staff 14%
Assets Managed This Sector (\$M)	208
Years Managing This Asset Class	10
Investment Team	
Team Size Dedicated to This Fund	2
Portfolio Manager	Frank Villante
Additional Support (Large Cap Analysts, Dealers, etc.)	4
Turnover/Team Ratio (past 2 yrs)	0%
Investment Process	
Style	Core/Style Neutral
Targeted Value Add above Index	+5% Over Rolling 3 Years
Typical Tracking Error (p.a.)	6% - 10%
Typical Stock Numbers	20-50
Capitalisation Bias**	Small 45% Micro Cap 54%
Franking level (FY08)	35%
Tax Efficiency - Income in Total Distribution (FY08)	37%
Discount Gains in Total Capital Gains (FY08)	100%
Maximum of Portfolio in any One Stock	10% Absolute
Maximum of Portfolio in any One Sector	No Restrictions
Maximum of Issued Capital of any One Stock	10%
Maximum Cash Holding	15%
Minimum Capitalisation (\$M)	20
Maximum Size Limit of Fund (\$M)	600-700
Fund Rating History	
April 2009	Recommended
June 2008	Recommended
March 2007	Recommended
February 2006	Downgraded to 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.
- Small cap funds invest in a market that is less liquid and more volatile than the large cap Australian equity market. This Fund should be used to complement large cap exposure in clients' portfolios, rather than replace it, up to 8% of the total portfolio depending on client risk preferences. Lonsec's model portfolio asset allocations are 6% within the 'Growth', and 8% within the 'High Growth' risk profiles respectively.
- The Fund is subject to equity market risk and movements (both positive and negative) in the share prices of the underlying securities in the portfolio. Investors should therefore be aware that the Fund may experience periods of negative returns and that there is a risk of potential capital losses being incurred on their investment

## Changes since Previous Lonsec Review

- The investment process has been enhanced. Stock reviews now include a category called 'Milestones', which highlights critical factors that underpin the investment case for each company
- ESG (Environmental, Social and Governance standards) has been formally incorporated in the managers fundamental research effort
- Souls is now a signatory to the UN-PRI (United Nations' Principles for Responsible Investment) and is a member of the Investor Group on Climate Change (IGCC) and Responsible Investment Association of Australia (RIAA)

## Lonsec Opinion of this Fund

### Philosophy/Style

- The Fund is a style neutral 'bottom-up' Australian equity offering with an objective to generate in excess of 5.0% above the index (S&P/ASX Small Ordinaries Accumulation Index) over a rolling three year period. Whilst not formally targeted, the manager expects to operate within a tracking error range of 6.0%-10.0% pa over a similar period
- The manager seeks to invest in a portfolio of stocks that are trading below what is considered 'fair value'. Souls are more "benchmark unaware" in their portfolio construction approach; the portfolio is more concentrated than peers with a greater bias towards microcap stocks. Investors should note that the microcap market is less liquid and has higher volatility than the small caps market

➤ Investors should be aware that it remains the style of the manager to exhibit a volatility of returns significantly higher than that of the general market. Periods of significant outperformance or underperformance of the broader market should also not be unexpected by investors

### People and Resources

➤ Souls has competitive advantages in the quality of the investment team, alignment of interest with unit holders and available capacity within the Fund

➤ Lonsec considers Soul's investment team to be suitably resourced and experienced. Lonsec is particularly impressed with lead portfolio manager, Frank Villante and consider him to be a high quality investor with a successful track record in managing small caps

### Research and Portfolio Construction

➤ Lonsec considers Soul's investment process to be robust and repeatable. Features of Soul's investment process are the use of "price floors" to manage downside risk for each stock, and clearly articulating "milestones" or catalysts for each stock idea

➤ With a focus on value and quality, it is expected that this manager will likely underperform during extreme market rallies when prices move irrationally away from fundamentals, or during markets driven by short-term earnings momentum

➤ Souls approach to equity research is structured, focusing on in-depth analysis of a relatively small number of stocks, rather than the systematic coverage of the broader market. The team spends little time focusing on variables that are difficult to model or predict. The manager tends to utilise broker models allowing the team more time to focus on company research rather than maintaining models

➤ The manager does not employ a standard valuation methodology across all companies but rather aims to adopt valuation techniques that best reflect the uniqueness of each specific business and industry. Lonsec considers this approach to be acceptable given the peer review process in place and the testing of each company's investment rationale

### Risk Management

➤ The portfolio is constructed from the bottom up and in this respect the manager employs 'soft' stock limits on the Fund. Sector exposures are a residual of the bottom up process and therefore there are no hard sector or industry limits in place. The lack of traditional risk constraints at the sector level can result in significant under or overweight relative to the benchmark, but as stated previously this is consistent with the manager's relatively benchmark unaware approach to investing

### Capacity

➤ With FUM at \$208 million, Lonsec does not currently consider the manager to have any major capacity issues. Pleasingly, Souls have been active in their management of the Fund's capacity and have indicated that their target capacity is approximately \$600 million

### Performance

➤ The Fund returned negative 38.3% for the one year period assessed. Whilst disappointing, this was more reflective of the declines experienced in the broader equity market. When measured against the index over the same period the Fund outperformed by a considerable 14.8%. Long-term absolute performance of the Fund has been marginally positive, with the Fund returning 2.4% p.a. over the five year period ending 28 February 2009. Over the same period the Fund outperformed the benchmark (as measured by the S&P/ASX Small Ordinaries Accumulation Index) by 3.0% p.a. and performed broadly in line with the Lonsec peer group average.

➤ To date the Trust has met its stated performance target over the three year period assessed. Consistent with the manager's style of investing, the Fund's Tracking Error has been significantly above that of the Lonsec peer group average over all time periods assessed

### Overall

➤ Lonsec has retained the Fund's 'Recommended' rating at this review cycle. This rating is supported by Lonsec's high regard for portfolio manager, Frank Villante, the manager's robust investment process and available FUM capacity. The Fund is not rated higher due to the relative attractiveness other higher rated managers assessed by Lonsec. Lonsec would also prefer to see greater equity ownership and co investment by the investment team going forward.

## People & Resources

### Size and Experience

Team Member	Position	Souls (yrs)	Exp (yrs)
Frank Villante	CIO/Portfolio Manager	5	24
Andreas Stephens	Analyst	9	11
Mike Byrne	Large Cap PM/Analyst	3	15
Paul Biddle	Analyst	4	15
Anoop Kalra	Analyst	3	15
Scott Armstrong	Analyst	1	15

The Souls investment team comprises two dedicated small cap specialists; Frank Villante (lead portfolio manager) and Andreas Stephens (analyst). Stephens is dedicated to small caps research, although he does also cover two sectors for the large cap team.

Frank Villante has 24 years of investment experience, including 12 years of equities portfolio management at NRMA and BT Funds Management (large and small caps) before joining Souls in January 2004.

Whilst the team appears less resourced than some peers, Villante and Stephens are supported by the other four large cap analysts at Souls who contribute 20% of their time to small caps research.

### Team Structure

The investment team is structured logically, with a healthy balance between consensus decision-making on stocks and ultimate accountability with Villante as portfolio manager.

In practice the decision to select stocks is consensus-driven; stocks are agreed by all members and it is unlikely a stock

would be included in the portfolio if any member had a particular concern. Small cap stock responsibilities are shared between the portfolio manager and analysts, with Villante ultimately responsible for allocation of stock research responsibilities.

## Turnover

Over the last two years there have been no departures from and one addition to the small caps team. Lonsec does not currently have any concerns regarding team stability, but rather considers stability to be a key strength of the manager.

## Key Person Risk

Lonsec considers key person risk in Villante to be very high. However, this is not uncommon in small caps management and is mitigated by material equity ownership. Senior staff members also have equity in Souls and Lonsec considers this to be an important factor mitigating the risk of key staff departures.

## Remuneration / Alignment of Interests

Remuneration is a combination of salary and bonus for staff, with 40% of variable remuneration based on analyst stock calls, 20% on portfolio outperformance, and the remaining based on subjective factors. The majority of the investment team have an equity stake in Souls, alongside Villante. Lonsec views staff ownership positively, as it may further align the interests of the investment team to the end investor.

At the time of this review, the manager's remuneration structure was under review. Lonsec views positively any continued effort in enhancing alignment of interests with investors through improvements to the structure of investment team remuneration.

## Investment Style

### Style and Philosophy

Souls is an active 'bottom-up' manager which aims to invest in a portfolio of stocks that are trading below what is considered 'fair value' (e.g. the intrinsic value calculated from the present value of expected future cash flows). The manager applies multiple valuation methodologies on companies to determine 'fair value', based mainly on forecasts of free cash flow, enterprise value and earnings growth. In-house qualitative research forms a critical part of the investment process, allowing team members to gain a greater understanding of how companies operate, their financial performance, management quality, company strategy and business model.

## Research Approach

### Overview

Investment Style	Style Neutral
No. of Stocks in Universe	80 post screens
No. Stocks fully modelled	30
Initial Filters	Quality of accounts, business model, management, initial return potential, listed property and investment companies
Top-Down	0%
Bottom-Up	100%
Qualitative Analysis	Industry, business model, management strategy, board composition
Research Inputs	Company meetings, Broker models, customers, suppliers, other stakeholders

Companies are researched according to a standard template that requires the analyst to address qualitative and quantitative issues.

Company research is summarised in a 3-5 page 'Stock Review', which is used as the basis for peer discussion for stock selection. The Review includes a valuation matrix, growth projections and financial strength summary, plus qualitative commentary on the business model and an investment summary. Recently included in this is a section on 'milestones', which aims to identify catalysts and business objectives required/expected for the valuation gap to be closed by the market.

### Valuation Approach

Souls apply multiple valuation methodologies on companies, and Lonsec considers this a logical approach given the differences in industry structures. Historically, DCF was the primary valuation tool. However, Villante has implemented a broader approach to company valuation, and today's Stock Reviews will include a range of valuation methods. Souls will use the most appropriate 'fair value' result from its multiple valuation methods (including DCF, enterprise value, and price to earnings).

## Portfolio Construction

### Overview

Portfolio construction is completely bottom-up and 'benchmark unaware', based purely on absolute stock conviction. A by-product of this process can be large stock and (unintentional) sector bets away from the index benchmark. This may at times lead to periods of extreme volatility versus the index. Stock selection blends the consensus decision-making, formal guidelines linking research conviction to stock weightings and some portfolio manager discretion that is supported by past experience. While Villante is ultimately responsible for portfolio construction, stocks are not selected in isolation and in practice, the stock decisions (whether or not to invest) is determined formally at the team's weekly meeting.

The final portfolio is reasonably concentrated and will typically hold approximately 30-40 stocks. Portfolio turnover is typically expected to be within the range of 20.0%-50.0%.

### **Risk Limits and Monitoring**

Risk is managed mainly through fundamental research of companies and the implementation of risk limits at the portfolio construction stage. Tracking Error is not tightly controlled in this Fund, but is expected to range between 6% and 10% over a three-year period.

### **Funds under Management**

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As at 31 December 2008, Souls managed \$208 million in the small caps market making it one of the smaller managers assessed by Lonsec in this sector. At the time of review, Souls indicated that their small cap capacity was approximately \$600 million, based on analysis of the S&P/ASX Small Ordinaries Index against the Fund's constraints. At current FUM Lonsec does not consider the manager to have any major capacity issues. Rather, Lonsec believes that the relatively small size of the Fund (compared to a number of its peers) to be an advantage, as it should allow the manager to move in and out of the market in a more nimble manner.

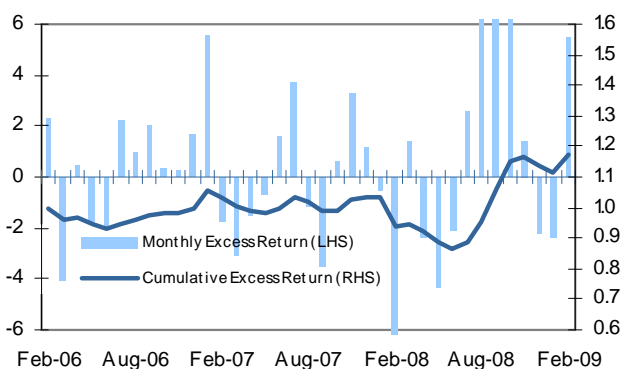
## Quantitative Performance Analysis

### Annualised after-fee % returns as at 28 February 2009

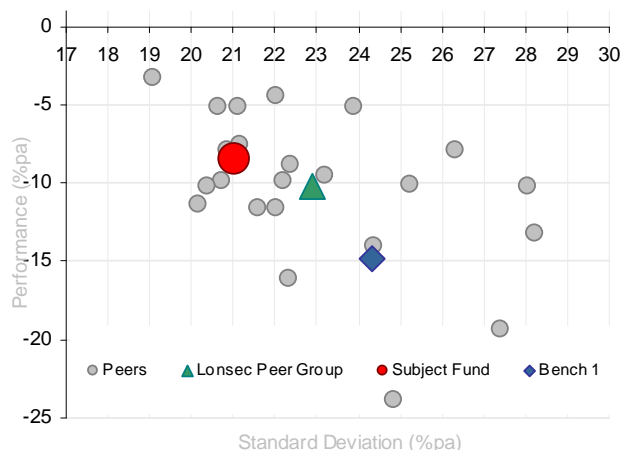
	1 Year		2 Years		3 Years		5 Years	
	Fund	Peer Group	Fund	Peer Group	Fund	Peer Group	Fund	Peer Group
Performance (% pa)	-38.3	-45.7	-24.7	-26.7	-8.5	-10.2	2.4	2.4
Standard Deviation (% pa)	24.1	27.5	22.3	25.1	21.0	22.9	18.6	19.8
Excess Return (% pa)	14.8	7.4	6.5	4.5	6.3	4.7	3.0	2.9
Outperformance Ratio (%)	58.3	59.9	50.0	57.5	55.6	56.8	55.0	55.2
Worst Drawdown (%)	-38.3	-46.7	-51.2	-55.5	-51.2	-55.5	-51.2	-55.5
Time to Recovery (mths)	-	-	-	-	-	-	-	-
Sharpe Ratio	-1.9	-1.9	-1.4	-1.3	-0.7	-0.7	-0.2	-0.2
Information Ratio	0.8	0.7	0.4	0.5	0.5	0.6	0.3	0.5
Tracking Error (% pa)	17.4	11.6	15.5	10.0	13.5	8.9	11.8	7.8

Fund: Souls Australian Small Companies Fund, Peer Group: Average among Lonsec rated Australian Equity (Small Cap) manager universe Benchmark: S&P/ASX Small Ordinaries Accumulation Index

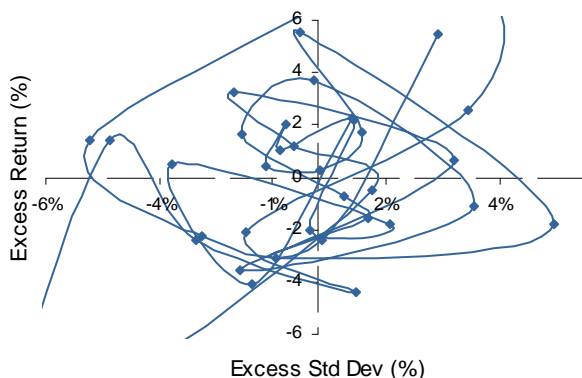
### Cumulative Performance over three years



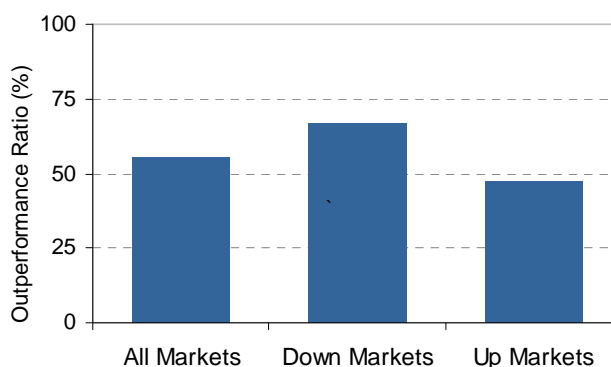
### Risk Return over three years



### 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: April 2009**

**Analyst: Lin Ngin**

**Release Authorised by: Paul Pavlidis**

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