

Souls



Morningstar Take

Souls' Australian Small Companies strategy is a worthy long-term small-cap allocation. Just expect some volatility. Lead portfolio manager Frank Villante's been in charge of this approach since 2004. He's a seasoned stockpicker who's been investing in small-caps for some time, and we think he's among the better small-cap portfolio managers. The analyst team's also been beefed up since he came on board, and now totals six members, most of whom have been together for over three years now. Analysts all have both large- and small-cap responsibilities. Souls has a conservative valuation ethic, and a liking for strong cashflow generators. The team's stockpicking conviction is driven by internally-generated fundamental research, and evaluation of future cashflows and earnings growth. There's a relatively flexible stockpicking method here which enables the house to choose stocks on the basis of potential upside, rather than style. Picking firms with significant payoff has tilted Souls' portfolio in the direction of the more inefficient micro-cap market segment. This preparedness to venture down the market-cap ladder, along with the relatively concentrated portfolio of 30 – 40 companies, make this one of the more aggressive small-cap strategies available. Souls pays little attention to the benchmark, which has hurt returns on a relative basis over the short term. Results at the time of writing looked patchy, although on closer inspection, this strategy has been a noteworthy performer for long-term investors – at the end of 2007, it had beaten the market every calendar year since 1998 bar one, 2005. We like Souls' strict quality tests, although given its hunting ground, investors here need to be able to handle choppy performances at times. But for those looking for a genuine high-octane small-cap strategy with a highly-capable lead manager, Souls is a more than respectable offering.

Role in Portfolio:

Supporting Player

Risks:

- Bias towards micro-cap names heightens liquidity and volatility risks
- Concentrated portfolio increases stock-specific risks
- Flexible stockpicking approach and concentration leads to returns that will differ from the market

Head of Research:

Anthony Serhan, CFA

Morningstar Analyst:

Chris Douglas

Strategy/Process

Souls' research process centres on the search for undervalued companies with improving cashflow and profit potential. Starting with the small-cap universe, Souls uses a fairly standard filter to screen out companies with poor quality of accounts, an unsustainable business model, and a shoddy board and management. Analysts devote a significant amount of effort to understanding and stress-testing the risks associated with a company's cashflow and profit drivers, including in-depth assessments of management quality, franchise quality (through standard Porter analysis), and financials. The team uses a number of valuation tools. These include a discount cashflow-based tool as well as relative valuation measures like enterprise value, earnings and dividends. The valuation method most appropriate for each particular stock is chosen to highlight intrinsic value. The shop has its own Data Analysis & Ranking Table (DART), a database of all the listed stocks in Souls' universe, containing broker numbers, valuation models, and forecasts. Villante and his colleagues use this to highlight anomalies and opportunities where analysts can focus their research. There's a relatively flexible stockpicking approach here, which enables the house to choose stocks on the basis of potential upside, rather than style. Little adherence is made to the benchmark when constructing the portfolio, and there will at times be large sector exposures. Turnover is modest at 30.0 – 50.0 percent per annum, while the final outcome is a relatively concentrated portfolio of 30 – 40 stocks.

Role in Portfolio

Flagship Fund: Aust'n Small Companies Fund

Investment Style 31 Dec 2007

Value	Blend	Growth		
			Large	Pr/Pros Ern Rto 15.64
			Mid	Price/Book Rto 1.62
			Small	Price/Cf Rto 13.17
				Lt Ern Growth 15.10
				Mkt Cap (\$Mil) 462
				Dividend Yld % 4.31

Stock Sectors 31 Dec 2007

	%
Information Economy	5.95
Software	4.99
Hardware	0.00
Media	0.96
Telecommunications	0.00
Service Economy	71.42
Healthcare Services	7.16
Consumer Services	14.14
Business Services	36.02
Financial Services	14.09
Manufacturing Economy	22.62
Consumer Goods	6.63
Industrial Materials	11.38
Energy	4.61
Utilities	0.00

Top 10 Stock Holdings 31 Dec 2007

	%
ASG Grp Ltd	5.61
SMS Management & Technology Ltd	5.54
Skilled Grp Ltd	5.15
GWA International Ltd	4.75
Reece Australia Ltd	4.62
Campbell Brothers Ltd	4.47
Data#3 Ltd	3.83
BSA Ltd	3.48
ARB	3.43
WHK Grp Ltd	3.41

Asset Allocation 30 Jun 2007

	%
Domestic Equity	94.60
Int'l Equity	0.00
Listed Property	0.00
Unlisted Property	0.00
Mortgages	0.00
Dom Fixed Interest	0.00
Intl Fixed Interest	0.00
Cash	5.40
Other	0.00
Not Classified	0.00

Portfolio Stats

Mgr Bmark: S&P/ASX Small Ordinaries Accumulation Index
 No. Stocks: 30 - 40
 Max Weight: 10.0%
 Min Weight: Zero
 Expd Track Error %pa: Not targeted explicitly, around 6.0 - 8.0
 Expd Turnover %pa: Moderate, 30.0 - 50.0

People Stats

Lead Manager: Frank Villante
 Appointed: January 2004
 Years Experience: 23
 Team Size: 6
 Average Years Experience: 15
 Average Years Tenure: 3

Supporting Player. This strategy is more aggressive than most, and holds a number of small illiquid names, so we think it's best-used in a supporting role.

People

Souls' investment team is headed by Chief Investment Officer Frank Villante, who joined the firm in January 2004. He has well over 20 years' investment experience including portfolio management roles with BT's Smaller Companies Fund and the large-cap portfolio at NRMA Investments. At six members the investment team is comparatively well-resourced, although many only came on board during the middle of this decade. Among these arrivals was Mike Byrne, who serves as lead portfolio manager for the shop's large-cap strategy. Andreas Stephens, Paul Biddle, Anoop Kalra, and Scott Armstrong round out the investment team. All have solid backgrounds, while the latter two also worked with Villante at BT. Analysts cover both small- and large-cap companies in their sectors. Key team members have equity stakes in Souls, and their incentive-based pay is linked to performance, aligning the investment professionals' interests with those of their customers.

Performance

This strategy's long-term performance record deserves more credit than the numbers to 31 March 2008 on the sidebar show. While Souls has lagged many peers and finished in the bottom quartile over all time periods, investors in this strategy have actually been looked after pretty well. Frank Villante has beaten the market in three of the last four calendar years. 2005 was a particularly poor showing, however, which has dragged down the longer-term numbers, while the first three months of 2008 have also not been as good. This strategy does invest down the market-cap, one of the key reasons it's suffered in 2008 to date, and a reminder that returns will over time be volatile. Contributors to performance over the year to 31 March 2008 included ARC Energy, AWB, and consumer products manufacturer GWA International. Performance detractors included positions in Coffey International, digital media company BSA, and Treasury Group.

Parent

Souls Funds Management is 67.0 percent owned by ASX-listed Washington H. Soul Pattinson, staff own 26.0 percent, and outside minorities seven percent. The firm had A\$360.0 million in small-cap mandates at 31 January 2008.

Fees

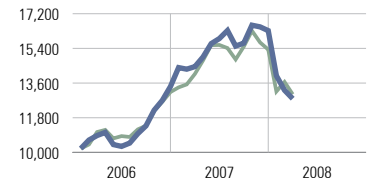
Souls' Australian Small Companies Fund comes with a competitive 0.70 percent management fee, which compares favourably to peers. The firm also levies a 20.0 percent performance fee on any index outperformance, subject to a high watermark.

Top 5 Funds by Net Assets

	Ticker	Net Assets (\$Mil)	Quartile Rank 3yr	Total Ret 3yr
Souls - Australian Small Companies Fund	6419	64.80	☐☐☐☐	9.47
CFS FC WS Pens - Souls WS Aust Small Companies	12402	19.39	NAv	--
CFS FC WS PersSuper-Souls WS Aust Small Companies	12401	14.10	NAv	--
CFS FC PersSuper- Souls Australian Small Companies	12393	11.25	NAv	--
CFS FC WS Inv-Souls WS Australian Small Companies	12400	11.21	NAv	--

Flagship Fund: Aust'n Small Companies Fund

Performance 31 Mar 2008 Fund Index
 Growth of \$10,000 **\$12,589**



	1Yr	3Yr	5Yr	7Yr
Quartile Rank	☐☐☐☐	☐☐☐☐	☐☐☐☐	☐☐☐☐
Total Ret%	-11.68	9.47	21.82	18.65
Income Ret%	8.98	11.45	10.85	11.03
Growth Ret%	-20.66	-1.98	10.97	7.62
Index%	-7.62	15.72	22.10	14.95

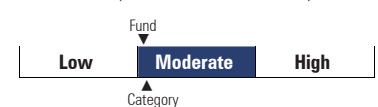
Index: S&P/ASX Small Ords Accum
 Category: Aust Mid/Small Blend

Performance Analysis 3 Yrs to 31 March 2008

Value Add vs Manager Bmark%	-6.24
Tracking Error	9.96
Information Ratio	-0.63

MPT Statistics 31 Mar 2008

	3Yr%	5Yr%	7Yr%
Beta	0.83	0.90	0.85
Alpha	-3.80	1.55	4.77
R Squared	0.63	0.62	0.67
Sharpe Ratio	0.21	1.09	1.02

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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