STANDARD & POOR'S

Souls - Australian Small Companies Fund

FUND RATING ★★★★☆

Analysts: Justine Gorman; James Gunn

Products Facts

Manager	Souls Funds Management Limited	**Fund type**	Retail	**Boutique**	Yes
APIR code	FAM0101AU	**Specialisation**	—	**Multimanager**	No
Fund status	Open	**Peer group**	Australian Equities - Small Cap	**Inception date**	May 31, 1998
Min. investment (A$)	25000			**ICR (% pa)**	0.7

Standard & Poor's View

S&P rates this fund four stars, reflecting our high conviction that the manager will consistently generate risk-adjusted returns in excess of both its relevant investment objectives and its peers.

Souls Funds Management's capability in Australian small-cap management is highly regarded by S&P because of the strength of its fundamental research and investment process. Portfolio manager Frank Villante has extensive small companies experience and brings a high level of enthusiasm to the group. Mr. Villante ensures a rigorous approach is taken to company research and identification of company performance milestones. New process enhancements include environmental, social, and governance (ESG) criteria to reduce exposure to regulatory risk, or issues arising from inadequate corporate governance. Souls minimises downside risk by setting a floor price on each stock which acts like a loss limit in the event the stock disappoints. This is a distinguishing feature compared to peers.

Souls has reduced the fund's rolling three-year alpha target from 5% per year to 3% per year. Considering the manager's relatively unconstrained portfolio construction appoach, S&P considers the revised investment objective less challenging for the manager. The fund has outperformed its benchmark by a considerable margin over the short, medium and longer term. Performance relative to peers has been strong over the short to medium term, as the manager's valuation and earnings sustainability-focused approach has proven beneficial in the bear market.

The team has been relatively stable; however, the manager did lose an analyst/ dealer last year, with this work now being undertaken by the investment team. S&P considers the separation of portfolio management and dealing duties to be best practice.

Product Features

The Souls Australian Small Companies Fund aims to provide investors with attractive returns over the medium to longer term. The fund's investment objective is to outperform the S&P/ASX Small Ordinaries Index by 3.0% per year, over rolling three-year periods. Investors should be aware that the manager has lowered its expected outperformance target since the last S&P review from 5% per year to 3% per year.

The fund typically invests in between 30-40 small-cap stocks, listed outside the S&P/ASX 100 Acc. Index. Up to 50% of the portfolio can be invested in companies with a market capitalisation of less than A$50 million, and up to 10% of the portfolio can be invested in companies not listed on the ASX, but no unlisted companies have been included in the last five years. Investors should note that there are no sector limits, and any sectoral bias will be as a result of the stock selection process. S&P considers this portfolio to be relatively concentrated and is managed on a benchmark-unaware basis. Investors should therefore be willing to accept higher short-term volatility. Relative to the S&P/ASX Small Ordinaries Acc. Index, the fund's expected tracking range is 8% to 12% per year. The fund has a minimum initial investment of $25,000.

Since the last S&P review, the manager has introduced ESG considerations into the process, whereby labour standards, environmental, social, and ethical factors are taken into account if the manager believes they may affect the value of any investment.

The fund has a management fee of 0.70% per year. The manager also applies a performance fee of 20% per year on the excess return over the S&P/ASX Small Ordinaries Acc. Index, less the ongoing fees, on a half-yearly basis. The performance fee is calculated and accrued daily based on the net asset value (NAV) of the fund and paid at the end of each half-yearly period. Underperformance in any half-year period must be recovered in the subsequent periods before a performance fee can be earned. The performance fee is estimated at 0.65% per the PDS dated Apr. 27, 2008, and based on th longer-term outperformance of the fund. Actual outperformance may differ from the estimated performance and therefore the actual fee could be different.

The bid/offer spread on the fund is 0.40%/0.40%, this cost represents the investor's share of the transaction costs, incurred when the trust is purchasing or selling assets. This cost is built into the unit price. S&P considers the fee structure reasonable given the capacity-restricted nature of the small-cap market and the need for the manager to preserve the high alpha strategy. That said, the performance fee of 20% of the excess return, is at the higher end of performance fees within its peer group, although the management fee component of 0.7% per year is reasonable, relative to peers.

Fund Objectives

Benchmark	S&P/ASX Small Ordinaries Accum Index
Target return (% p.a.)	Outperform the benchmark by 3%pa over 3 yrs

Investment Style

The manager employs a valuation driven, bottom-up approach to identifying Australian small-cap stocks for its portfolio. Fundamental stock analysis is the foundation of the investment process, identifying stocks that are generally under-researched or out of favour with the market and hence undervalued. Having said that, it also favours companies with solid business models and strong management that operate in profitable industries. Companies are assessed using a disciplined and systematic process, which provides a transparent portfolio construction and risk control framework. Its approach is style-indifferent, in that there is no predetermined bias to either growth or value factors. From time to time the portfolio may display a growth or value tilt.

The portfolio mandate allows the manager to invest a significant portion of the portfolio in micro-cap stocks. This can increase liquidity risk for investors, as the manager could be forced to sell out of positions at a significant discount to market value. Portfolio turnover is relatively low at around 20% - 25% per year.

Passive						**Active**
Value						**Growth**
Small Cap						**Large Cap**

Investment Team

Mr. Villante is the chief investment officer and portfolio manager for the Souls Australian Small Companies Fund. He joined Souls in January 2004, bringing 24 years of industry experience, including investment analysis and portfolio management stints at NRMA Investments and Bankers Trust. Mr. Villante heads a team of five experienced investment analysts and is the portfolio manager for the fund. As well as exclusively covering small companies, he also focuses on challenging the analysts and acting as a sounding board. S&P views the depth of experience and stability of the investment team as a positive feature, because it reduces Mr. Villante's inherent "key person" risk.

The analysts' research coverage is broadcap. Within the analyst team, Dr. Andreas Stephens is principally (80%) focused on small company research, and others have time allocated approximately 80%/20% to large-/small-cap segments of the market. Souls believes having analysts with broad market capitalisation coverage improves the quality of its industry-level knowledge, which is especially important for assessing companies in the small-cap market. Mr. Villante has worked with three of the other team members prior to their time at Souls. Dr. Andreas Stephens has 11 years' industry experience, with 10 years spent at Souls. Dr. Stephens covers the infrastructure and utilities sectors as well as smaller companies industrial stocks. Paul Biddle has 15 years' industry experience, including four with Souls. Mr. Biddle covers alcohol, building materials, developers, banks, other financials, and paper and packaging. Mike Byrne also has 15 years' industry experience, and has been with Souls for nearly four years. Mr Byrne covers chemical, diversified industrials, oil and gas, resources, steel, telecommunications, and technology. He is also the portfolio manager for the large-cap funds. Anoop Kalra has 15 years' industry experience, and has also been with Souls for nearly four years. Mr. Kalra covers the insurance, gaming and wagering, healthcare, and media industries. Scott Armstrong, who is the latest addition to the team, bring 15 years' experience. Mr. Armstrong commenced his investment career at BT in 1992, followed by shorter tenures at Zurich Scudder and Jenkins Investment Management. He has both research and portfolio management experience. The industries he covers at Souls include; agriculture, beverages, consumer discretionary, developers, discretionary retail, diversified industrials, food, REITs, and transport. Overall, the investment team members have an average of 16 years' experience.

Since the last S&P review, the group has lost its chief executive (CEO) and one of its founders Vincent Parrott, who has been replaced by Neil Schafer, former CEO of Wilson HTM Investment Group. Mr. Schafer brings over 20 years' experience in the investment and finance industry. In another departure, Tom Millner who had performed both analytical and dealing functions, left the group in November 2008. His research coverage has been absorbed by other members of the team, and the dealing function is now undertaken by Mr. Villante for the small-cap fund and Mr. Byrne for the large-cap funds. S&P considers the separation of duties between the portfolio management and dealing functions to be best practice in the industry.

Staff performance bonus is measured on both quantitative and qualitative metrics. The quantitative measure includes ability to find high alpha-generating stocks. Qualitative measures include idea generation and knowledge sharing, quality research, and their overall contributions to the business. The bonus pool consists of 50% of the pre-tax profits of the business. Mr. Villante was awarded equity in Souls Funds Management Ltd. on joining the group, with additional equity being awarded if performance hurdles were met. The allocation of equity has recently ceased. The issue of equity ownership is currently under review by the Souls board.

New						**Experienced**
Small						**Large**
Unstable						**Stable**

Investment Process

The investable universe comprises stocks listed outside of the S&P/ASX 100 Index. A qualitative filter excludes companies on the basis of Souls' knowledge and assessment of its financial statements (typically three to five years of financial history will be required). The quality of the management and composition of the target company's board are key factors in Souls' assessment, these individuals being stewards of the company's capital. If the manager cannot understand a company's business model, because of its lack of transparency, it will also be excluded from the investable universe. Souls can identify some non-index stocks in the course of its research or from broker suggestions, which may be included in its investment-grade universe.

In-depth research is then conducted on companies that Souls has highlighted as potentially suitable investments. To thoroughly understand the company, a Porter-style analysis is conducted to understand the industry dynamics and the company's potential for growth. Souls will hold discussions with customers, suppliers, competitors, and other industry groups to better gauge industry trends. Although broker-sourced data is used to provide consensus information, data will be modified if Souls believes it to be an inaccurate reflection of a company's value. Variances between consensus broker valuations and those developed by Souls can represent good investment opportunities. S&P considers this to be where active managers can significantly add value. Souls will quantify the company's intrinsic value using a three-phase growth model applied to the company's free cash flow, focusing on a medium-term investment outlook. Additional sources of value will be used to supplement the model, including enterprise value-to-EBITDA, price-to-book, return-on-equity, and profit margins. The level of a company's debt usage is also a valuable indicator of the company's ability to grow its business in the future. Analysts will update inputs into the valuation model as new information becomes available.

Since the last S&P review, Souls has incorporated an ESG assessment of companies into its process. Souls considers the impact ESG factors may have on a company's performance and therefore its valuation. Poor performance against environmental factors could expose companies to regulatory risk and may detract from value. S&P considers this addition a sensible "next step" in the manager's investment process, having already included corporate governance issues in its assessment of management. Souls is a signatory to the UN Principles of Responsible Investing (UN PRI), and the Investor Group on Climate Change (IGCC).

Once the modelling has been performed, the analyst will prepare a stock review to present to the team. The stock review includes an assessment of the multiple valuation metrics relative to the market, an outline of the reasons for investment, and what milestones need to occur to ensure the investment idea plays out over time. Souls will monitor the milestones and action may be taken by the manager if they are not being realised. The analysts keep a chronological file note detailing a company's earnings results, corporate announcements, and meetings with senior management. An assessment of the stock's liquidity over the past 12 months enables the manager to determine how easily a position can be taken or sold out, if required. The analyst will also estimate the stock's expected return based on their target price estimate and level of confidence they have in the company actually making this return on investment. These two factors are the centrepiece of the portfolio construction process.

The portfolio construction process is very structured and easy to implement. Souls has constructed a portfolio return matrix which will indicate a stock's overweight position based on a combination of expected return potential and the level of conviction the team has that this return will be realised. Return potential is categorised as "Tier 1", if its return potential is 40%+, "Tier 2" if 25% to 40%, "Tier 3" if 15% to 25%. A level of confidence is given to each return estimate of either "High", "Strong", or "Modest".

Souls manages downside risk by setting a price floor for each holding, which limits potential loss to capital invested.

Although a stock's target price may be reached, selling out of the position will not necessarily be automatic. Before selling, the valuation model and return conviction are reviewed. As the price of a stock moves closer to its target price, its portfolio weight may be trimmed down by the manager and the redeemed funds used to invest in other stock with greater upside potential. Earnings surprises, and changes to management or business models can also trigger the sale of holdings.

Performance

The fund aims to outperform the S&P/ASX Small Ordinaries Accumulation Index by 3% per year (before fees) over rolling three-year periods.

Over the 12 months to Dec. 31, 2008, the fund performed well against its benchmark and the peer-group median. The fund produced a return of negative 46.0%, against a benchmark of negative 53.2%, and a peer-group median return of negative 48.0%.

The manager benefited from several overweight positions, most notably GWA International, ARB Corporation, and Salmat Australia. At the sector level, the manager's overweight holdings in industrials and financials, and underweight positions in energy and materials were positive for performance.

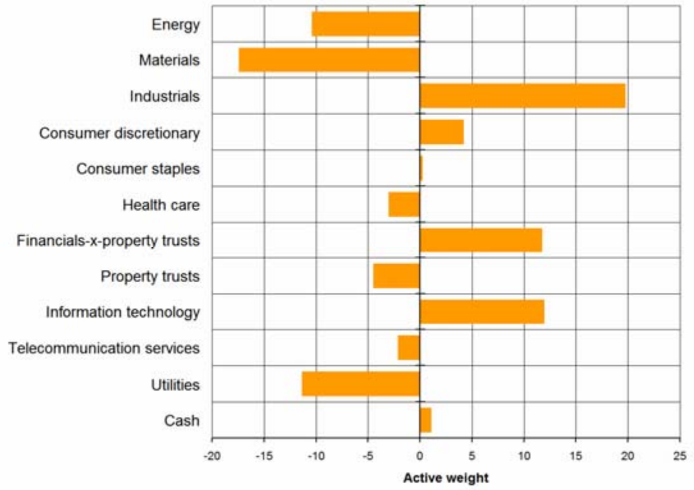
Strong performance was also achieved by the fund over the medium and longer term. The fund produced a strong relative result for the three years to Dec. 31, 2008, with a net-of-fee return of negative 3.9%, compared to the benchmark of negative 9.7%. The median return for the peer group was negative 5.5%. Positive returns for the team over the five years to Dec. 31, 2008, achieved an annualised return of 6.1% on the fund, against the benchmark of 2.2%, and the median return of 6.3%.

Performance Measures

Average portfolio turnover (%)	20 - 25
Typical number of stocks in portfolio	30-40

Source: Souls Funds Management Limited.

Sector Exposure Versus Fund Benchmark (at May 4, 2009)



Source: Souls Funds Management Limited.

Risk Management

The fund may invest in all industry sectors. No sectoral limits apply to the management of the portfolio, with sectoral bias being the result of the stock selection process. Stock risk factors are filtered or captured in the qualitative assessment of the company. Portfolio risk management is managed using general portfolio guidelines: diversification by requiring a minimum of 20 stocks, limiting maximum exposure to a stock in terms of holding size, capitalisation, and exposure to unlisted companies. The manager does not have a minimum capitalisation floor on stock held in the portfolio. The maximum cash level is 15%. Souls does not use derivatives in the management of its portfolios.

A compliance committee, consisting of two-thirds independent membership, oversees the functions of the compliance officer, and reports to the Souls funds management board. The compliance officer is responsible for monitoring for mandate breaches, and conducts internal audit reviews.

Management Group Profile

Souls Funds Management Ltd. is a boutique investment manager, specialising in Australian equities, and offering its capabilities to wholesale investors, high net worth clients, and to the retail market through platforms (master trusts and wraps). Souls was initially known for its small-cap management, but has since introduced a number of larger cap strategies to its suite of funds.

The funds management organisation dates back to 1998, through the formation of Flinders Asset Management Pty. Ltd. Flinders became Veritas Investment Management Ltd. in 2002. In September 2003, Washington H. Soul Pattinson (the parent) became majority stakeholder in Veritas Investment Management, renaming the funds management business Souls Funds Management Ltd.

Washington H. Soul Pattinson has been described as an ideal parent, viewing its holding in Souls as a long-term investment. At December 2008, the parent owned 67% of Souls, Souls staff held 26%, and outside investors the remaining 7%. The allocation of staff equity has ceased, but is currently under review.

Market Share

Souls aims to market its capabilities to wholesale investors, high net worth clients, and through platforms, to the retail market. At December 2008, Souls' total funds under management (FUM) in the Australian small-cap sector is A$260 million, a decrease of around 40% from the time of S&P's last review in September 2007, when FUM stood at A$425 million. This decline in FUM is in line with the market decline over this period. Souls has advised S&P that it has not lost any wholesale clients over this time.

Analyst(s): Justine Gorman; James Gunn.
Release authorised by: Mark Hoven.

FUND RATING

S&P Fund Rating Reference Information

Australian Equities - Small Cap (at May 12, 2009)

Reference Material

Sector Reports
www.standardandpoors.com.au/funds

Reader's Roadmap
www.standardandpoors.com.au/funds

Glossary
www.standardandpoors.com.au/funds

Guide to S&P Qualitative Fund Ratings
www.standardandpoors.com.au/funds

Fund Rating Team Biographies
www.standardandpoors.com.au/funds

Fund Rating Peer Groups by Sector

Australian Equities
Large Cap Diversified
Large Cap Income
Large Cap Indexed
Large Cap Industrials
Long Short
Small Cap
Specialist
Australian Fixed Interest
Cash
Cash Enhanced
Fixed Interest
Fixed Interest Income
Mortgages
Mortgages High Yield
Mortgages Conventional
Mortgages High Yield Hybrid
Mortgages Hybrid
Australian Property
Direct Commercial
Direct Development
Direct Diversified Direct
Direct Industrial
Direct Residential
Direct Retail
Direct Rural
Direct Specialised
Diversified Fixed Interest Listed

International Equities
Diversified Equities
Emerging Markets
Emerging Markets Asia ex Japan
Emerging Markets China
Emerging Markets India
Large Cap Diversified
Large Cap Income
Large Cap Indexed
Large Cap Industrials
Long Short
Long Short Specialist
Long Short Regional
Regional Japan
Regional UK/Europe
Regional US
Regional Asia
Small Cap
Specialist Healthcare
Specialist Information Technology
Specialist Resources

International Fixed Interest
Diversified Fixed Interest
Diversified Fixed Interest Income
Fixed Interest
Fixed Interest High Yield
Fixed Interest Income
Mortgages
Mortgages High Yield
Mortgages High Yield Hybrid
Mortgages Conventional
Mortgages Hybrid
International Property
Direct Commercial
Direct Development
Direct Diversified Direct
Direct Industrial
Direct Residential
Direct Retail
Direct Rural
Direct Specialised
Diversified Property
Listed

Alternative Assets
Commodities
Multi-Sector
Private Equity Listed
Private Equity Unlisted
Infrastructure Listed
Infrastructure Unlisted
Alternative Strategies
Single Strategy Funds Multimanager
Single Strategy Funds Single Manager
Multi-Strategy Funds Multimanager
Multi-Strategy Funds Single Manager
Multi-sector
Capital Guaranteed
20
40
60
80
100
Equity
Other

Fund Rating Philosophy

A star rating is a forward-looking qualitative assessment of a manager's ability to consistently generate risk-adjusted fund returns (net of fees) in excess of both its relevant investment objectives and its peers.

Fund Rating Process

In assigning a star rating to a fund, Standard & Poor's evaluates: the size, skill, and stability of the manager's investment team; the clarity, implementation, and risk management of the investment process; the fund's objectives, fee structure, and portfolio characteristics; and the manager's business management.

Fund Rating Definitions

FUND RATING ★★★★★	Standard & Poor's has very high conviction that the manager will consistently generate risk-adjusted fund returns in excess of its relevant investment objectives and relative to its peers. .
FUND RATING ★★★★☆	Standard & Poor's has high conviction that the manager will consistently generate risk-adjusted fund returns in excess of its relevant investment objectives and relative to its peers.
FUND RATING ★★★☆☆	Standard & Poor's has conviction that the manager will consistently generate risk-adjusted fund returns in excess of its relevant investment objectives and relative to its peers.
FUND RATING ★★☆☆☆	Standard & Poor's has conviction that the manager will not generate risk-adjusted fund returns in excess of its relevant investment objectives and relative to its peers.
FUND RATING ★☆☆☆☆	Standard & Poor's has high conviction that the manager will not generate risk-adjusted fund returns in excess of its relevant investment objectives and relative to its peers.
FUND RATING ON HOLD	Issues that may affect the fund's management have emerged; and the fund rating is temporarily suspended, pending clarification.
FUND RATING SELL	Significant issues exist that potentially will adversely affect the fund's performance. Investors should consider obtaining advice on switching or redeeming funds.

Fund Rating Subscript

— NEW —	The investment process, fund manager, or the fund has a relatively short history, or the analytical team has changed significantly, but a relevant and demonstrable track record is shown on similar funds.

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