

Souls Australian Small Companies Fund

30 Jun 2009

The Souls Australian Small Companies Fund (the Fund) offers investors a pure exposure to the small and micro cap universe of the Australian equities market. The Fund aims to generate 5% above the ASX/S&P Small Ordinaries Index over a rolling 3 year periods by maintaining a benchmark unaware and relatively concentrated portfolio.

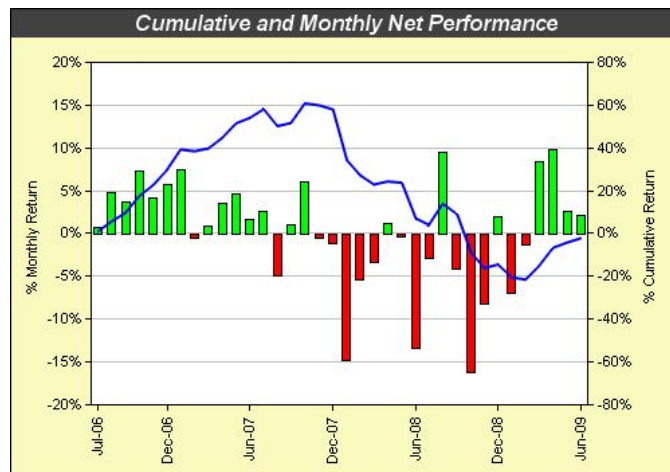
Souls Fund Management was established in 2003 following Washington H. Soul Pattinson (ASX ticker: SOL) acquiring a majority stake in boutique fund manager Veritas Investment Management Limited. Souls operate as an autonomous business with the parent company providing a medium to long term commitment of financial resources and capital support. The Souls investment team of 6 is led by Frank Villante (Chief Investment Officer). Villante joined Souls in 2004 and has over 23 years investment experience in a range of analytical and portfolio management roles. Zenith regards Villante highly as a small cap manager. He is well supported by Andreas Stephens (Analyst) with the 4 remaining investment professionals allocating approximately 20% of their time to the Fund. Zenith views the team size as adequate and highly experienced in comparison to its peers.

The security selection process is built on the premise that markets are not perfectly efficient at times leading to stocks not accurately reflecting their intrinsic value. The Manager casts a wide net over 300 securities (excluding the ASX top-100) and non-listed opportunities to identify companies that exhibit cashflow stability, a strong business model and a committed board and management. The filtered universe is disseminated amongst the investment team (majority allocated to Villante and Stephens) with an in-depth stock analysis conducted. The research focuses on the company's financial performance history, senior management capabilities, and a solid business model. Each analyst utilises a range of data sources to gain insight sourced from company management, suppliers, competitors, customers and other stake holders plus the use of broker analyst data. A range of valuation factors are utilised dependent on the characteristics of the industry and primarily include: discount to cashflow (DCF), price to earnings (P/E) and enterprise valuation (EV). Analysts will utilise broker models primarily or construct models internally where there is a significant level of discrepancy amongst broker models. The quantitative and qualitative analysis conducted culminates into a Stock Review document that tabulates the analyst's level of stock conviction, potential portfolio exposure, growth projections, stock milestones and a social, governance & environmental summary. All stock research and communication conducted is documented and updated accordingly in a permanent File Note. In Zenith's view the stock selection process is thorough and detailed and flows fluidly into the portfolio construction process.

The portfolio construction process is a by-product of the stock research process. The analyst's level of conviction (High, Strong and Modest) and stock return potential (40%+, 25%-40% and 15-25%) are tabled in the Stock Review document that returns a portfolio target weight, determined by the portfolio return matrix. The target weighting is then subjectively overlaid by Villante based on the stock's liquidity and current portfolio positioning. The portfolio is benchmark unaware and reasonably concentrated consisting of between 20 to 50 securities (normally around 35), with a tracking error range of 8% to 12%. Risk is managed throughout the investment process from the initial filtering process to the in-depth analysis applied to the research universe. The portfolio manager reviews the portfolio in accordance with the risk parameters in place on a weekly basis through an internally designed risk management system. The portfolio is constructed in accordance to specific constraints, based on stock exposure (1% to 10%), exposure to unlisted companies (max. 5%) and cash (0% to 15%).

The Fund has delivered, since inception a strong record of outperformance in comparison to benchmark which is a testament to the manager's ability to identify alpha opportunities across the full spectrum of the small and micro cap universe. In Zenith's view the Fund would suit "wealth accumulation" investors with an allocation of approximately 20-25% of the domestic equity allocation within a well diversified portfolio. The Fund is viewed as an exciting prospect in the Small Cap space which is evident in the assigned RECOMMENDED rating.

Key Features	Description
APIR Code	FAM0101AU
Asset Class	Australian Shares
Sub-Asset Class	Small Companies
Investment Style	Neutral
Benchmark	S&P / ASX Small Ordinaries (Accum)
Recommended Investment Timeframe	5 + years
CIO & Small Cap Portfolio Manager	Frank Villante
Investment Team Size	6



Performance Analysis

Performance Statistics	5 Yrs (% p.a.)	3 Yrs (% p.a.)	1 Yr (% p.a.)
Performance - Fund	6.30	-0.84	-8.79
Performance - Benchmark	5.58	-6.38	-28.57
Performance - Median Manager	8.00	-4.20	-21.98

The Fund's investment objective is to outperform the S&P/ASX Small Ordinaries Accumulation Index by 5% per annum (before tax and management fees) over a rolling 3 year period, with an expected tracking error between 8%-12%.

The Fund has a long term track record (10+ years) with a strong level of outperformance above benchmark over this time period. The Fund aims to generate outperformance above benchmark through bottom-up stock research, aimed at identifying alpha opportunities through the full spectrum of the small and micro cap universe, while maintaining a reasonably concentrated portfolio.

Consistency Analysis

Consistency Statistics	5 Yrs	3 Yrs	1 Yr
History of Monthly Excess Return (%)	48.33	52.78	50.00
History of Monthly Excess Return (Rising Mkts %)	42.50	40.91	16.67
History of Monthly Excess Return (Falling Mkts %)	60.00	71.43	83.33

The Fund's outperformance statistics illustrate the Managers ability to generate outperformance above benchmark in falling market conditions consistently over a 1, 3 and 5 year period. The style neutral approach indicates the Fund's ability to deliver outperformance above benchmark in all market conditions, which has eventuated over the medium term (3 years).

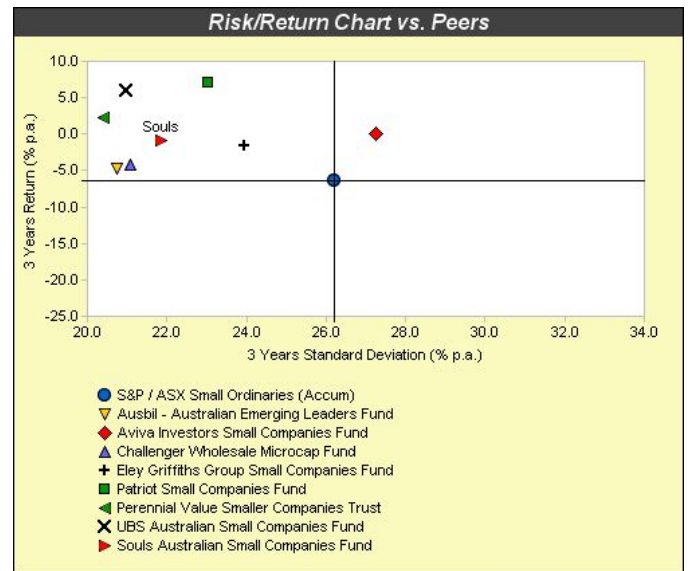
Zenith envisages the Fund delivering outperformance above benchmark in accordance with the Fund's investment objective over the medium to long term.

Risk / Return Analysis

Risk / Return Statistics	5 Yrs	3 Yrs	1 Yr
Information Ratio - Fund	0.06	0.41	1.14
Information Ratio - Median Manager	0.29	0.26	0.53
Sharpe Ratio - Fund	0.01	-0.33	-0.55
Sharpe Ratio - Median Manager	0.08	-0.44	-0.92
Standard Deviation (% p.a.) - Fund	18.90	21.85	26.09
Standard Deviation (% p.a.) - Median Manager	19.33	23.03	30.13
Tracking Error (% p.a.) - Fund	11.81	13.51	17.40
Tracking Error (% p.a.) - Median Manager	7.50	8.99	11.75

The Fund has demonstrated an ability to outperform the benchmark and median manager, as illustrated by the Information and Sharpe ratio, over the medium term. The Fund's absolute risk (as measured by Standard Deviation) has been marginally below the median manager over all time periods although the figure is high in relative sense depicting the significant level of volatility within the small and micro cap universe over this period.

The Fund has maintained a tracking error within its estimated range of between 8% and 12% over a long term period (5 years). This high tracking error exemplifies the Fund's benchmark unaware investment approach.



Investment Personnel

Name	Title	Time with Manager
Frank Villante	CIO & Small Cap Portfolio Manager	5 Yr(s)
Andreas Stephens	Analyst	9 Yr(s)
Mike Byrne	Analyst	3 Yr(s)
Paul Biddle	Analyst	4 Yr(s)
Scott Armstrong	Analyst	1 Yr(s)
Anoop Kalra	Analyst	3 Yr(s)

Souls Funds Management

Souls Fund Management (Souls) was established in 2003 following Washington H. Soul Pattinson (ASX Ticker: SOL) acquiring a majority stake (83%) in the boutique fund manager Veritas Investment Management Limited. The majority of remaining equity stake is held by senior investment staff and associates of the business.

SOL with a market capitalisation of \$2.46 billion (as at 30 May 2009) operates in a range of industries including building products, telecommunication, pharmaceutical and financial services. Souls operate as an autonomous business with the parent company providing a medium to long term commitment of financial resources and capital support.

Investment Team

The Souls investment team consists of 6 investment professionals, led by Frank Villante (Chief Investment Officer and Souls Small Companies Portfolio Manager) with over 23 years industry experience. Villante joined Souls in 2004 after working previously at the NAB, Bridges, Son & Shepherd, and NRMA investments in a range of analytical and portfolio management roles. In Zenith's view Villante is a highly experienced and capable small cap portfolio manager.

The 5 remaining members of the investment team divide their time between the Fund and the Souls Select Australia Share Fund. Andreas Stephens (Investment Analyst) has over 11 year's industry experience and is primarily responsible for covering small cap stocks and is primary back-up on a majority of the small cap research universe. Mike Byrne, Paul Biddle, Anoop Kalra and Scott Armstrong allocate approximately 20% each to the Fund. Villante and Stephens collectively monitor and research approximately 70% of the research universe and are back-up analyst's for around 85%. In Zenith's view the investment team is adequately resourced and highly experienced.

The Fund's investment universe encompasses over 300 stocks plus micro cap opportunities (<\$50 million market capitalisation), that are initially filtered based on a range of quantitative and qualitative factors (i.e. financial strength, business model and management capabilities) to approximately 200 stocks. All stocks have a primary and back-up analyst, with both contributing to the process including management meetings and on-site assessments. Villante conducts all micro cap stock evaluations subjectively based on alpha opportunity. Zenith views the resource capabilities of the Fund as adequate based on its current level of funds under management (FUM) of \$225 million (31 May 2009). In Zenith's

view additional resources would be preferable if there was a significant leap in FUM going forward.

The Souls investment team has incurred only one departure since inception with Tom Millner departing in 2008; however Scott Armstrong was hired in February 2008 to provide large cap analytical support.

The investment team is remunerated by salary and bonus potential. The bonus incentive is based on the individual's contribution to the investment administration, team debate, the quality and quantity of research and the generation of ideas. The bonus return can range from 50% to 100% of base salary with approximately 60% of the bonus directly related to stock recommendations and investment result of key products. The Souls Board has also introduced a long term incentive plan which enables total staff equity to increase to approximately 48% subject to the achievement of performance hurdles.

In Zenith's view the team is currently well resourced and managed by a seasoned investment professional with a significant level industry and sector experience.

Investment Process

The Fund's investment objective is to deliver a return of 5% p.a. above the benchmark over rolling 3 year periods, with an estimated tracking error range of between 8% - 12%. The investment style is best described a neutral (blend of growth and value elements) which is a bi-product of the multifaceted valuation approaches utilised.

The Manager believes at times the market is inefficient, as stock prices do not accurately reflect the securities true intrinsic value. The view is built on a range of factors which include: investors are swayed by emotion and sentiment; not all investors possess the same level of knowledge and information; and investors predominantly possess a short term timeframe. Through a disciplined stock selection and portfolio construction process the manager aims to exploit these market factors in identifying alpha opportunities.

Security Selection

Initial Filter

The Fund's investment universe encompasses all stocks within the Small Ordinaries Index (200 stocks - which are continuously monitored and ranked) plus micro cap stocks and non-listed companies of interest which possess significant investment opportunity (to date the Manager has not incorporated a non-listed opportunity). The Manager excludes all listed property trusts and investment companies. Micro cap and non-listed opportunities are identified through broker research, the media and industry conferences that are assessed and filtered subjectively by Villante.

The initial filtering process focuses on the following factors:

- Quality of Accounts: cashflow quality, avoiding accounting engineering;
- Business Model: durable, robust and competitive business model; and
- Board and Management: successful track record of value creation, board commitment, alignment of interest with shareholders.

The investment universe will reduce to approximately 200 stocks, marked for further research, which includes micro cap and non-listed opportunities.

Security Research

The research universe is then disseminated amongst the investment team. An initial assessment of a company's business segment, operating environment and industry growth projections is conducted with data and information gathered from a range of sources including company suppliers, customers, competitors, and other stakeholders plus the use of broker analyst data.

The Porter Model framework is applied to assess the company's business model which must be clearly articulated. The factors examined include: defining a company's competitive advantage; barriers to entry; power of suppliers and buyers; and product substitution or technological deficiencies.

The financial accounts are assessed based on at least 5 years historical data as well as 2-3 years forecast. Financial statements which exhibit quality, minimise use of provisions and a high level of consistency are favoured with companies terminated from the research universe for accounting engineering. Broker models are utilised primarily; however internal models are constructed where a significant dispersion between broker forecasts are present. In Zenith's view the use of broker models is not ideal and we would prefer stock models to be constructed internally, however we are cognisant of the investment team size and the magnitude of investment universe monitored.

The subjective evaluation of company management and board is determined by one-on-one meetings (over 300 in 2008) in order to assess skill sets, track record, and work load, alignment of interest and record of board meeting attendance.

The research process culminates in the production of the Stock Review document which incorporates a stock assessment, valuation and pricing breakdown, profit and loss potential, proposed portfolio weighting (subject to stock liquidity), and growth projections. The document also incorporates a summary of the analyst's recommendation of the stock, business model factors, Social & Environmental, Milestones (important for long term value creation) and Catalysts that are expected to drive stock price performance immediately.

The Stock Review output will be presented to the investment team by the primary analyst for debate and discussion with all decisions based on consensus; however as portfolio manager Villante maintains ultimate discretion.

In addition to the Stock Review output, all stock specific research is formally documented within a company File Note, which includes all stock specific information including management meetings, press and brokerage releases, plus historical financial information.

Security Valuation

The Manager utilises a blend of valuations metrics as detailed below in the evaluation and assessment of the research universe:

- Discounted Cashflow (DCF);
- Price/Earnings (P/E);
- Enterprise Valuation (EV);
- Return on Equity (ROE);
- Comparative dividend yields;
- Debt and gearing; and

- Margins and profitability.

The range of valuation tools are subjectively applied based on the industry and stock under assessment. Zenith views the use of multiple valuation factors as a positive in order to gain the most accurate stock information via the use of the most appropriate tool.

The statistical output for each prospective stock is tabulated within the Stock Review template; while the investment universe is continually monitored, ranked and discussed within the weekly team meeting.

In Zenith's view the security selection process is comprehensive and well structured which moves fluidly into portfolio construction phase.

Portfolio Construction

The portfolio construction process is a by-product of the stock research process. The Stock Review document outlines the stock's characteristics including expected return, analyst's return confidence, portfolio target weight (based on the portfolio return matrix), index weight and recommended portfolio weight. The stock characteristics are then applied to the Portfolio Return Matrix.

The Portfolio Return Matrix sets guidelines for establishing and managing portfolio positions based on a combination of potential return and return confidence. The matrix is designed to allocate a portion of the portfolio, based on a tiered system, to stocks which exhibit a positive return potential (based on discount to fair value) and the return confidence of the Analyst as High, Strong or Modest.

- Tier 1 (40%+ potential return) - High (7% allocation), Strong (5%) and Modest (2%);
- Tier 2 (25-40% potential return) - High (5%), Strong (4%) and Modest (1%); and
- Tier 3 (15-25% potential return) - High (3%), Strong (2%) and Modest (0%).

The Portfolio Return Matrix is not rigid and the portfolio manager maintains ultimate discretion in stock selection and portfolio weight allocation, although the average initial weighting allocated would be the target weight assigned. Factors which are taken into consideration by the portfolio manager at the time of purchase or sale of a stock are liquidity, stocks index weight, seasonal trends, and a change of management or board members.

The portfolio is constructed based on bottom-up stock research, benchmark unaware approach which may ultimately lead to unintentional sector tilts away from the index. The concentrated portfolio will generally hold 20 to 50 securities, with a tracking error ranging from 8% to 12%. Zenith is comfortable with the portfolio construction process which is built on the best ideas of the investment team.

Risk Management

Portfolio Constraints	Description
Cash (%)	0% to 15%
Security Numbers	20 to 50
Unlisted securities (%)	0% to 5%
Market Cap > \$200 million	20 to 100
Market Cap < \$200 million	0 to 80
Market Cap < \$50 million	0 to 50
Tracking error (% p.a.)	Range between 8% to 12%

The risk management process is implemented at a stock specific level and overlaid by the general portfolio constraints applied. The initial filtering process is aimed at identifying stocks that exhibit financial stability, a strong business model and a solid board and management. An in-depth analysis is applied to the research universe based on a long-term performance track record in addition to numerous meetings with senior management to gain an understanding of the business model and direction going forward.

The portfolios risk constraints in place (as detailed in the table above) include minimum and maximum exposure limits for individual stocks, stock exposure based on market capitalisation, and unlisted company exposure and cash holdings. The portfolio manager reviews the portfolio in accordance with the risk parameters in place on a daily basis through an internally designed risk management system. The portfolio is reviewed against the Global Industry Classification Standard (GICS) to assess sector tilts on a monthly basis.

The portfolios ability to invest up to 50% of the portfolio into micro cap stocks (market cap of less than \$50 million) provides Zenith with concerns, given the level of illiquidity in stocks of this size. The level of illiquidity will only increase in conjunction with growth in FUM; therefore Zenith would prefer tighter parameters around micro cap portfolio exposure to reduce the identified risk.

Risks of the Fund

As is the case with all Australian equities based products, the biggest risk to this fund is a sustained downturn in the Australian small / micro cap universe, which could lead to negative performance. This risk can be significantly reduced by investors adopting a medium term (3+ years) investment time frame when investing in this fund.

The style neutral approach should protect the Fund from market conditions that favour value or growth elements. The Fund is still subject to market forces and in conjunction with maintaining a low cash weighting, the Fund will show a strong correlation with markets. Again investors should be prepared to invest for the medium to longer term to smooth out this volatility.

The Fund's level of FUM of \$225 million (as of 31st May 2009) does not present an issue in regards to the Managers ability to efficiently enter and exit stock positions. The Manager has indicated the Fund's FUM capacity is approximately \$700 million, which equates to approximately 1.0% (as of 31 May 2009) of the ASX/S&P Small Ordinaries Accumulation Index.

Zenith considers the key person risk within the Fund as significant with Villante as Portfolio Manager and Chief Investment Officer; his departure would constitute a review of the Fund and its rating. While Zenith believes an equity position in the firm renders his medium-term departure as highly unlikely, it must be stated that Villante is of vital importance to the Firm.

Applications of the Fund

The Fund offers a pure exposure to the small and micro cap universe with an added ability to invest in unlisted opportunities. The Fund risk / return profile would best suit those investors seeking absolute rather than relative returns in the Australian small companies sector. The Fund aims to maximise absolute investment returns irrespective of those returns achieved by the market which is in line with its investment approach of not constraining itself relative to index weights and allowing a tracking error range of 8% to 12%.

The Manager is aware of the attraction of after tax returns, therefore the portfolio turnover is approximately 25% to 30% per annum, with an average holding period of 3-4 years. The Fund's tax awareness approach would be idle for investors on higher marginal tax-rates.

In Zenith's view the Fund would suit "wealth accumulation" investors with an allocation of approximately 20-25% of the domestic equity allocation within a well diversified portfolio.

Fees

The Management Fees for the Fund are 0.70% p.a. with a performance fee associated with the Fund. The Performance fee is 20% of outperformance over the ASX/S&P Small Ordinaries Accumulation Index, which is paid half yearly and accrued daily and is based on a high watermark (based on positive performance and recouped loss of performance). Zenith views the management and performance fees as competitive and in line with its asset class peers.

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