

Patersons Wholesale 80:20 Equity Fund

31 Aug 2008

The Paterson Wholesale 80:20 Equity Fund's key point of difference is through its portfolio construction where it seeks to blend an exposure of large cap, S&P / ASX 200 stocks with mid to small cap and event driven opportunities, which typically sit outside this index. This core and satellite approach is designed to provide investors with stability but without limiting the possibility of enhanced returns. The constraints on the allocation to each of these components is as the name suggests, a minimum 80% to the large cap component and a maximum 20% to the growth orientated portion. The Manager expects 1/3rd of the excess performance to come from large caps and 2/3rds from its more opportunistic driven investing.

The investment process is highly disciplined and well structured with both quantitative and qualitative factors feeding into an Investment Strength Score (ISS) for each stock. This forms the backbone of a Focus List of 75 - 100 stocks, where further due diligence is undertaken including a discounted cash flow (DCF) valuation. All stocks are then plotted on a chart incorporating this analysis to determine an Investment Radar of stocks which are expected to deliver a high expected return and exhibit qualities of high investment strength. The Portfolio will comprise between 30 and 50 stocks, is expected to generate circa 35% per annum turnover and is managed to a 4% - 6% p.a. tracking error target. Risk management guidelines are numerous and cover all appropriate categories (diversification, liquidity, size etc).

The investment team is headed by portfolio manager, Murray McGill, a highly regarded investment professional who has in excess of 20 years investment market experience and is the third largest shareholder in Paterson Securities Ltd (PSL). While McGill's track record in managing discretionary managed accounts since 2002 appears strong, this is his first foray into pooled investment funds and as such no historical fund performance exists. The other key member of the investment team is Steve Suleski (Head of Research) who rejoined the Group in 2006 (previously with Patersons Ord Minnett, 1994 - 2000) following 4 years as the Head of Industrial Research at Euroz Securities. The investment team is small relative to competitors and to combat this research input from PSL and external brokers is sought. In Zenith's view Paterson Asset Management's (PAM) ability to leverage off PSL's 15 person strong investment team is of critical importance and while on the surface this appears to offer sufficient depth it is largely ex 150 stock and resource focused and to this extent presents some coverage and resourcing shortcomings.

Overall Zenith rates the Paterson Wholesale 80:20 Equity Fund as sound and has assigned it an Approved rating. We would however like to see a longer fund performance track record and some investment team and coverage issues addressed before a higher rating could be considered.

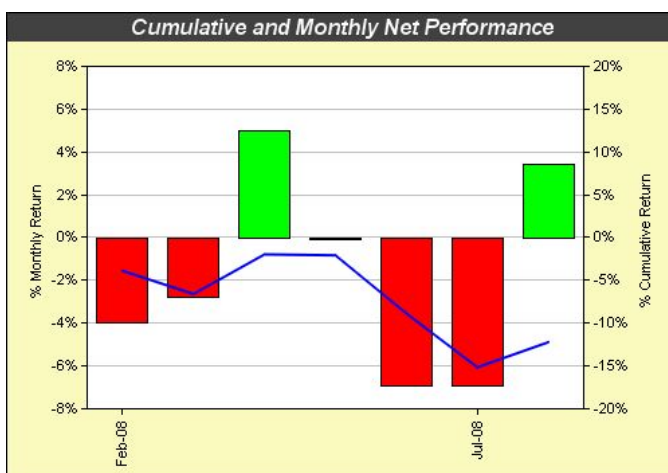
Key Features	Description
APIR Code	PML0001AU
Asset Class	Australian Shares
Sub-Asset Class	Large Companies
Investment Style	Growth
Benchmark	S&P / ASX 300 (Accum)
Recommended Investment Timeframe	5 + years
Managing Director	Howard Knight
Portfolio Manager	Murray McGill

Performance Statistics	Since Inception	3 Mths (%)
Performance - Fund	-8.94	-2.43
Performance - Benchmark	-6.53	-1.74
Performance - Median Manager	-	-1.86

Inception Date: Feb 2008

Investment Personnel

Name	Title	Time with Manager
Howard Knight	Managing Director	1 Yr(s)
Murray McGill	Portfolio Manager	20 Yr(s)
Steve Suleski	Head of Research	9 Yr(s)
Pat Holywell	Investment Analyst	2 Yr(s)



Organisational Background

Patersons Asset Management (PAM) is a newly created subsidiary of Patersons Securities Limited (PSL), having only begun investing in February 2008. Like many of its competitors PSL is attempting to evolve its business from being a traditional stockbroking business into a more dynamic and diverse financial services company with asset management one of its key competencies.

PAM is 90% owned by PSL and 10% by entities associated with its Managing Director, Howard Knight. In turn Knight owns 4.68% of PSL. The PAM investment team comprises three key individuals, Howard Knight (Managing Director), Murray McGill (Executive Director) and Steve Suleski (Head of Research). McGill is also an indirect shareholder in PAM through his 9.63% stake in PSL. While Knight is the "new kid on the block" within the Patersons group as one of the key drivers behind PAM's launch, both McGill and Suleski have been with PSL since 1988 and 2006 respectively. Both moved across to PAM upon its commencement and appear to be natural fits into the business given the complementary skill sets, McGill in portfolio management and Suleski in equity research.

Key Personnel

The three key individuals have an average 17 years experience in financial services which holds them in good stead. The only query on this experience is the type, with both McGill and Suleski coming from stockbroking backgrounds and having no experience with a funds management firm. Not so for Knight, prior to joining PAM he held positions as the Head of Lehman Brothers Investment Management Division in Asia / Pacific and as Head of Alternative & Quantitative Investments for UBS Global Asset Management (Singapore).

McGill joined PSL in 1988 and is an Executive Director, Member of the PSL Board and its third largest shareholder. With 20 years equities experience he is the ideal candidate as Portfolio Manager for the Fund. Prior to making the internal move from PSL to PAM, McGill was managing 24 discretionary portfolios and the approximately \$180 million in Individual Managed Account business. While the performance from these portfolios has been attractive relative to benchmark, the biggest query still remains whether this track record can be repeated in a funds management environment. Of McGill's variable remuneration package 50% of it is linked to funds under management growth in the Fund and 50% of it to out performance above benchmark, which Zenith believes is an appropriate split.

Suleski rejoined PSL in 2006 having worked with Paterson Ord Minnet Ltd for 6 years from 1994 to 2000. Between 2001 and 2005 he led the industrial research team at Euroz Securities as its Executive Director. Pat Holywell joined Patersons in 2007 with a background as a senior audit analyst before becoming a member of the investment team in April 2008.

Supporting this three person PAM investment team is the research team of PSL, which totals 15 investment professionals, who cover approximately 150 ASX listed companies. While on face value this depth of research team would rival many asset management research capabilities, its area of expertise / specialisation is skewed. A total of 7 of the 14 analysts cover the resources sector and the focus is on small to mid cap stocks (i.e. ex 100). While this bias may suit Patersons positioning in the stockbroking arena, it results in some shortcomings in its application to a funds management business. For example, only 20 of the 63 stocks on PAM's Investment Radar are covered by PSL and fall within their area of competency or strength. Furthermore 7 of the top 10 holdings within the Fund are not covered by PSL yet represent 57% of the portfolio. This means a lot is falling upon the two person dedicated research team of Murray McGill and Steve Suleski. Zenith would prefer to see greater formal linkage with PSL as currently they don't attend the PAM weekly research meeting and the most significant non "ad hoc" contact comes via McGill's attendance at the PSL daily morning meeting. One

of the areas PAM is expected to leverage off PSL strength is in the area of Corporate Finance. PSL is a significant player in terms of new equity issuance for mid / small cap and resource stocks and while PAM envisages only taking up 15% of transactions offered, this could be an important source of value add for the 20% opportunistic, event driven portion of the portfolio.

While the average level of experience within the PSL research team is solid at 7.9 years, 50% of the team having been with PSL for 2 years or less. The research team is located in 3 different offices (Perth - 10 people, Melbourne - 2, Sydney - 3), which Zenith has found can stifle information and communication flow. Head of Research is Mark Simpson, who joined PSL in 2007 having spent the previous 13 years in Hong Kong as an equity analyst, country manager and market strategist at Deutsche Bank and Macquarie.

Overall the PAM investment and PSL research teams are rated as solid and while Zenith believes it has all the hallmarks of being a structure which will deliver on its objectives it has some weaknesses and we would like to see it deliver on adding value through fund performance.

Investment Process

The investment philosophy which underpins the Patersons Wholesale 80:20 Equity Fund is the belief that investors should have exposure to both quality and opportunity in their portfolio. The Fund seeks to achieve this through a minimum 80% exposure to stocks from within the S&P / ASX 200 index, which it deems as "quality", and up to 20% invested in smaller companies, special situation and growth investments, which it regards as the "opportunity" component.

The Manager's investment style is expected to have a slight growth bias while its portfolio construction process is bottom-up driven. The Fund is a concentrated portfolio of 30 to 50 stocks and seeks to deliver outperformance of 3% - 5% p.a. above the S&P / ASX 300 Accumulation Index.

Security Selection

The investment process begins with a quantitative screen on the Fund's investment universe, which it regards as all stocks with a market capitalisation of greater than \$35 million and listed or soon to be listed on the Australian Stock Exchange. The key quantitative filter metrics used are as follows:

- Earnings Growth (revenue, earnings before interest tax or EBIT and earnings per share or EPS);
- Distributions (dividends and payout consistency);
- Efficiency / Quality of Earnings (return on equity, margins and cashflow to EPS); and
- Financial Leverage / Stress (debt to equity, net debt to assets and EBIT to interest cover).

This process narrows the universe down to a Focus List of companies that the Manager believes have the highest likelihood of significantly increasing shareholder value. This List will typically comprise of 75 - 100 stocks. The quantitative filter also forms a 50% weight in the Investment Strength Score (ISS), which seeks to rank all stocks on the Focus List. The remaining 50% is made up of the following qualitative criteria:

- Volatility (volatility of EPS growth and 12 month rolling share price changes relative to sector and to benchmark);

- Industry Structure / Competitors (competitive position and barriers to entry within the industry);
- Management (senior management turnover, corporate governance, management equity incentive); and
- Sector Score (underlying sector outlook, risk characteristics).

The next stage in the investment process is to compare a stock's current share price with its discounted cashflow (DCF) valuation. The DCF valuation is calculated by PAM using in-house methodology and assumptions, and utilises raw data sourced from PSL, other third party brokers, or by PAM directly. For ASX 100 companies where research coverage is extensive PAM typically sources raw data from consensus broker forecasts which may be weighted towards brokers PAM believes can add the most value to its process. Zenith regards this lack of internal coverage of the ASX 100 as one of the major shortcomings within PAM's investment process.

The ISS and the valuation for each stock are then plotted on a chart to determine their relative attractiveness. This chart is referred to as the Investment Radar and those stocks either in the top right quadrant (that is high investment strength and high expected return) or above a plotted fair value curve are favoured. At the time of our review the Investment Radar comprised 48 stocks.

Overall the investment process is well structured and operates within a disciplined and logical framework.

Portfolio Construction

Forming the very foundation of this product is its portfolio construction technique with a minimum 80% to be held in mid / large cap companies from within the S&P / ASX 200 index being complemented by a 20% small cap / special situation exposure. The portfolio will comprise between 30 and 50 stocks, of which 20 to 30 will form part of the "80" portion of the fund, that is ASX 200 companies and between 10 and 20 will be companies outside the ASX 200 and hence be considered as part of the "20" component of the fund.

Companies with the highest ISS relative to their valuation are selected for inclusion in the portfolio. It would be unusual for the portfolio to invest in stocks which fall below the "fair value curve" and if this was to occur it would form part of the opportunistic, event driven 20% component.

The Manager has indicated that under its concentrated portfolio approach each stock will typically have a minimum 0.5% weight in the portfolio. This initial minimum allocation is a qualitative judgement, rests largely with Murray McGill as portfolio manager and can sit above a 0.5% weight. Generally speaking the sum of each stocks minimum allocation will equate to 50% of the portfolio and the remaining 50% is optimised for risk adjusted returns within the fund's 4%-6% tracking error target.

Portfolio turnover is expected in the vicinity of 35% per annum while the fund seeks to be fully invested but has the discretion to hold up to 10% in cash in order to take advantage of new investment opportunities and for general liquidity purposes.

Buy / sell orders are initiated by the portfolio manager after a daily portfolio review or following the weekly investment committee meeting. PAM has negotiated a competitive brokerage rate with PSL which is used as a benchmark on rate negotiation with external brokers.

Overall the portfolio construction process utilised by PAM is disciplined, structured and transitions seamlessly from the investment process.

Risk Management

Portfolio Constraints	Description
Invested in ASX 200 and cash (%)	80% to 100%
ASX 200 stock holdings	20 - 30
Invested outside ASX 200 (%)	0% to 20%
Ex ASX 200 and Event Driven stock holdings	10 - 20
Stocks in portfolio	30 - 50
Minimum no. sectors	min: 3
Minimum sector exposure	10% in 3 sectors (aggregated if weight <10%)
Maximum single sector exposure (%)	max: 60%
Minimum investment	lesser of \$1m or 0.5% of fund assets
Maximum single stock exposure	10% of issued capital
Minimum Market Capitalisation	\$35 million
Trading Liquidity	Max 5 times rolling 6 month daily volume
Borrowing	Up to 20% of gross asset value

The Fund operates within a host of risk management constraints covering liquidity guidelines, stock and sector diversification, positioning limits and risk or volatility constraints.

The Fund's "80:20" philosophy is formally constrained to ensure the portfolio remains true to label. A minimum 80% must be held in ASX 200 exposure while a maximum 20% exposure is allowed outside the ASX 200. This exposure diversification is also managed via stock number limits with 20-30 stocks expected to come from the ASX 200 index and 10-20 from outside the ASX 200 and within the classification of event driven. In line with the Fund's concentrated focus the portfolio will comprise between 30 - 50 stocks with each position representing a minimum 0.5% weight.

Portfolio guidelines exist based on market capitalisation ranges based on whether a stock is inside or outside the ASX 200, for the former it places a maximum 5% deviation from index weight whereas on the later an absolute 5% limit is used.

The Fund applies a minimum market capitalisation of \$35 million for a stock to be eligible for investment while a maximum 10% of issued capital limit applies on any single stock position. The Fund must not be exposed to a stock position where it represents more than 5 times the rolling 6 month daily trade volume to ensure liquidity is maintained.

To ensure adequate sector diversification the Fund must be exposed to a minimum 3 GICS sectors, hold a minimum 10% weight in each of these (sectors are aggregated where index weight less than 10%) and carry a maximum 60% weight in any single sector. The Fund may use options, futures and

derivatives to manage investment risk within the portfolio however these will not be used for the purpose of gearing.

contributions and withdrawals also known as the buy / sell spread. This equates to 0.165% or a 0.33% "round turn".

Risks of the Fund

The following is not meant to be an exhaustive list of all the risks associated with the Fund, for that investors should refer to the PDS, but outlines some of the major risk perceived by Zenith:

- **Performance** - the Fund was launched in February 2008 and hence has only a limited track record. While PAM has produced 5 year pro-forma numbers on the aggregate performance of separately managed accounts managed by McGill (June 2002 - June 2007), this only carries a low level of weight in our assessment as we prefer to see actual "runs on the board";
- **Key man risk** - the portfolio manager for the Fund is Murray McGill, who is a seasoned market veteran with 20 years at Paterson's, the last 10 years of which have been managing discretionary investment portfolios for high net worth clients. Zenith rates McGill highly and he is regarded as the critical linchpin in this process;
- **Business risk** - this is PSL's first foray into asset management and while Zenith believes the organisation is committed to the goal of building the business, the Australian market is littered with stockbrokers who have unsuccessfully made the transition from "sell side to buy side";
- **Market risk** - the fortunes of the Australian share market will have a significant bearing and impact on the returns generated by the Fund. The value and returns from this investment may fluctuate significantly over short time periods and as such investors should adopt a minimum 5-7 year time horizon;
- **Investment risk** - the Managers investment decision making with regard to portfolio positioning and stock selection will be a key driver on the returns delivered to investors. Their success in this endeavour will impact on their performance relative to comparable equity products; and
- **Liquidity risk** - the Fund offers daily liquidity with proceeds typically paid within 10 business days. The Fund does however within the Constitution have the ability to allow up to 3 months in paying a withdrawal request.

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Applications of the Fund

The Fund through a disciplined framework delivers investors a product design with a difference. Its 80:20 philosophy is relatively unique and combines a concentrated portfolio exposure to large caps, which are expected to deliver approximately 1/3rd of the value add, with an exposure to an opportunistic, event driven small cap component, which is the real performance kicker and expected to deliver 2/3rds of the total excess return.

While Zenith rates highly PAM's investment process and portfolio construction given its disciplined and structured approach, its lack of formal performance history and in-house coverage of the top 100 means that investors need to be aware that the Fund has some shortcomings.

Fees

The Fund has a contribution fee of up to 4.4% (which can be reimbursed by your financial adviser) and costs are expected to total 0.974% p.a. An additional transaction charge exists on