Product Assessment

Report as at 19 Jun 2024

RECOMMENDED

Smallco Investment Fund

Rating issued on 19 Jun 2024 | APIR: ASC0001AU

Investment objective

To achieve high absolute returns for investors by utilising a relatively concentrated, long/short strategy that is predominantly invested in Australian small capitalisation companies.

Manager	Smallco Investment Manager
Distributor	Smallco Investment Manager
Sector	Australian Shares \ Long Short
Investment Style	Variable Beta
RI Classification	Aware
Absolute Risk	High
Relative Risk	High
Investment Timeframe	7+ Years
Benchmark	S&P/ASX 300 (Accum)
Min Investment Amount	$40,000
Redemption Frequency	Daily
Income Distribution	Annually
Fund Size (31 May 2024)	$516.44M
Management Cost	1.55% p.a. Incl. GST
Performance Fee	18.64% of the unit price increase over each six-month period, subject to the recoupment of prior negative performance.
Buy / Sell Spread	0.45% / 0.45%
Inception Date	31 Jan 2001

Fund facts

- Holds between 25 and 35 securities
- S&P/ASX 100 exposure limited to 20% of the Fund (at purchase)
- Portfolio turnover expected to average 30% p.a. over a market cycle

Viewpoint

The Fund, managed by Smallco Investment Manager Limited (Smallco), offers a high conviction, long/short exposure to Australian smaller companies. Smallco does not typically invest in the resources sector, biotechnology sector and industries it deems to be structurally challenged. In addition, Smallco is highly selective with regard to short selling and, as such, it is rarely utilised. Zenith has a high regard for Smallco given its experienced investment team and robust investment process.

Established in 2000 by Rob Hopkins and Bill Ryan, Smallco is a Sydney-based boutique fund manager that specialises in managing Australian equity strategies. As at 31 May 2024, Smallco managed approximately $A 846 million firmwide. In response to negative market movements and outflows, Smallco reopened the Fund to new investment in April 2020, after being hard closed in January 2017.

The investment team of seven is led by Hopkins, who is supported by Ryan, Adam Simpson, Andrew Hokin, Paul Graham, Craig Miller and Han Xu. Simpson is the lead portfolio manager for the Fund, having assumed responsibility from Hopkins in 2021. Despite this, portfolio construction follows a consensus approach. All team members hold stock coverage responsibilities, with a number of key sectors allocated across the team. Outside of the key sectors, team members are given the freedom to cover stocks in any sector. Overall, Zenith considers Smallco's investment team to be highly experienced and well resourced to manage the Fund.

Smallco's investment philosophy is centred on the belief that equity markets are inefficient and that rigorous fundamental research can identify opportunities to generate excess returns. Smallco targets quality companies that are likely to exceed consensus earnings expectations and under-appreciated companies expected to meet or exceed earnings expectations. Smallco aims to invest in companies with the potential to double in value over a three-year investment period.

Meetings with senior company management form a key part of the security selection process. The aim of the research process is to produce an internally-generated target price that reflects the company's long-term intrinsic value. Target prices are compared against current market prices to determine a stock's upside. Zenith believes the security selection process adopted by Smallco is sufficiently robust and that the research conducted by the investment team is comprehensive.

The portfolio construction process is primarily driven by fundamental analysis conducted by the investment team. Smallco constructs the Fund through a benchmark-unaware approach. Portfolio guidelines, stock liquidity and downside risk are considered to avoid unintended risks.

Smallco is permitted to vary the Fund's net equity exposure between 0% and 150%. However, Zenith notes that the Fund's net equity exposure has has typically remained at approximately 80%. Smallco does not make tactical asset allocation decisions, with the Fund's net equity exposure primarily a result of available investment opportunities, both long and short. Zenith is comfortable with Smallco's portfolio construction approach, believing it ensures a strong connection between the output of the security selection process and the resultant weight of stocks in the portfolio.

Fund analysis

Fund characteristics

Constraint	Value
Security Numbers	25 to 35
Absolute Stock Weight	Max: 20% (Max: 10% at time of purchase)
Short Exposure	Max: 30% (May drift passively to 50%)
Sector Exposure	Must hold stocks across at least 4 sectors
Exposure to Illiquid Stocks	Max: 30%
S&P/ASX 100 Exposure	Max: 20% at time of purchase
Leverage	Max: 30% (May drift passively to 50%)
Cash	Max: 50%

Investment objective and philosophy

The Fund's investment objective is to achieve high absolute returns for investors by utilising a relatively concentrated, long/short strategy that is predominantly invested in Australian small capitalisation companies.

Zenith would prefer to see the delineation of a specific outperformance target, as opposed to a descriptive, qualitative objective. Zenith believes this would provide investors with greater transparency with regard to return expectations and the level of risk embedded in the Fund.

Smallco's investment philosophy is centred on the belief that equity markets are inefficient and that rigorous fundamental research can identify opportunities to generate excess returns. Smallco targets quality companies likely to exceed consensus earnings expectations or under-appreciated companies expected to meet or exceed earnings expectations. Smallco aims to invest in companies with the potential to double in value over a three-year investment period.

Whilst the Fund's investment process is predominantly fundamental in nature, Smallco also seeks to add value via a macroeconomic overlay that is used as a source of idea generation and feedback loop.

Portfolio applications

In general, compared to most other asset classes, equities offer investors the opportunity for higher capital growth over the longer term with some income. However, this higher growth is also often associated with higher volatility. Therefore, it is recommended that investors adopt a longer timeframe when investing in equities.

Investors should also be cognisant of the fact that the Australian equity market is relatively concentrated, with the Materials and Financials sectors dominating the market. The market also only represents approximately 2% of global equity markets (in terms of market capitalisation). Therefore, to mitigate this concentration risk it is highly recommended that investors diversify their investments across asset classes, both domestically and globally.

Unlike a traditional long-only Australian equities strategy, the Fund utilises a variable beta long/short investment strategy, providing Smallco with additional flexibility to add value for investors. Specifically, the ability to short sell and hold high levels of cash can reduce the Fund's net equity exposure. However, Zenith notes that Smallco is highly selective with short selling and it is rarely utilised.

Although Smallco has the ability to vary its net equity exposure, it has, over the long term, oscillated around 80%. As a result, Zenith notes that the Fund will generally exhibit similar risk/return characteristics to long-only funds.

The Fund is likely to exhibit characteristics in common with other more traditional growth-orientated offerings. Manager-specific risk can be mitigated by blending the Fund with other Australian equity funds. As such, the Fund could be blended with style-neutral or value-orientated Australian equities products to achieve a more diversified exposure to the Australian equity sector.

The Fund is typically heavily weighted towards small capitalisation companies and will typically exclude or be underweight large segments of the market (resources sector, biotechnology sector and industries Smallco deems to be structurally challenged). Accordingly, Zenith believes that the Fund may be suitable as a satellite holding within a well-diversified Australian equities portfolio and has the potential to enhance a portfolio's risk/return profile. Furthermore, Zenith believes investors should be prepared to invest with an investment time horizon of at least seven years to maximise the potential for optimal results.

The Fund's portfolio turnover is expected to average approximately 30% p.a. over a market cycle, which Zenith considers to be low. Smallco has indicated that approximately 65% of the expected turnover is attributed to resizing existing positions and approximately 35% is due to initiating and closing positions. Given this expected level of turnover, the majority of the Fund's returns are expected to be delivered via capital appreciation in the unit price, rather than through the realisation of capital gains in income distributions. In addition, realised capital gains are highly likely to be eligible for the capital gains tax discount. As such, holding all else equal, the Fund may be more appealing to investors who are high marginal tax rate payers as it will result in superior after-tax return outcomes.

Fund responsible investment attributes

Key Information	Description
Zenith RI classification*	Aware
Has Responsible Investment Policy	No
Negative screens**	**Full/Partial**
Alcohol	Full
Armaments	Full
Gaming	Full
Tobacco	Full
PRI Status	
PRI Signatory	No

*Zenith RI Classification scale:

- Traditional
- Aware
- Integrated
- Thematic
- Impact

***Data has been supplied by third parties. While such information is believed to be accurate, we do not accept responsibility for any inaccuracy in such data.*

Absolute performance

Performance as at 31 May 2024

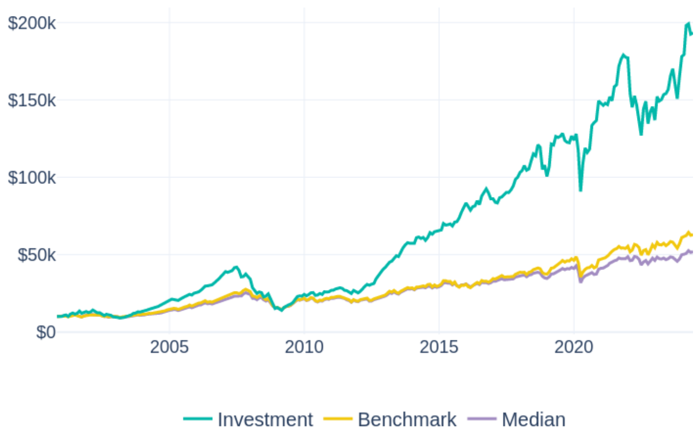
Monthly performance history (%, net of fees)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	BM YTD*	BM2 YTD**
2024	0.72%	10.47%	0.55%	-3.34%	0.43%								8.61%	3.21%	1.82%
2023	11.14%	-1.93%	0.67%	2.13%	0.44%	1.70%	5.56%	2.86%	-5.64%	-6.16%	9.46%	7.94%	30.04%	12.13%	3.85%
2022	-13.03%	-5.75%	5.09%	-4.02%	-6.41%	-7.36%	13.60%	3.37%	-9.68%	5.69%	2.26%	-5.94%	-22.71%	-1.76%	1.25%
2021	-1.09%	0.95%	-0.57%	3.41%	-1.63%	6.03%	0.76%	7.56%	2.60%	1.57%	-0.82%	-0.24%	19.66%	17.55%	0.03%
2020	3.28%	-8.80%	-22.29%	19.74%	9.45%	-2.39%	1.87%	12.89%	1.37%	0.99%	9.29%	-0.89%	19.41%	1.74%	0.37%

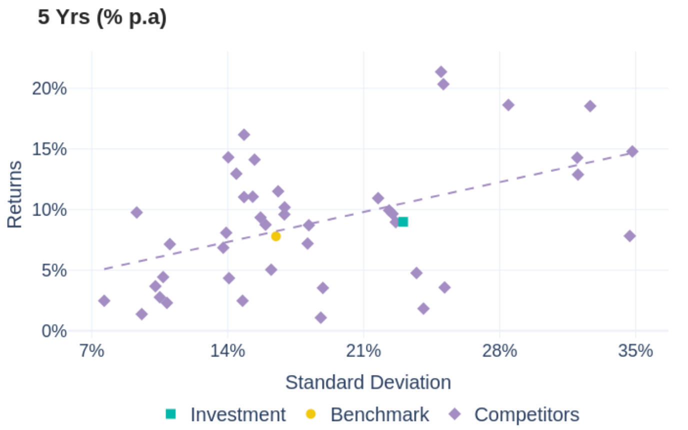
**S&P/ASX 300 (Accum)*

***Bloomberg AusBond Bank Bill Index*

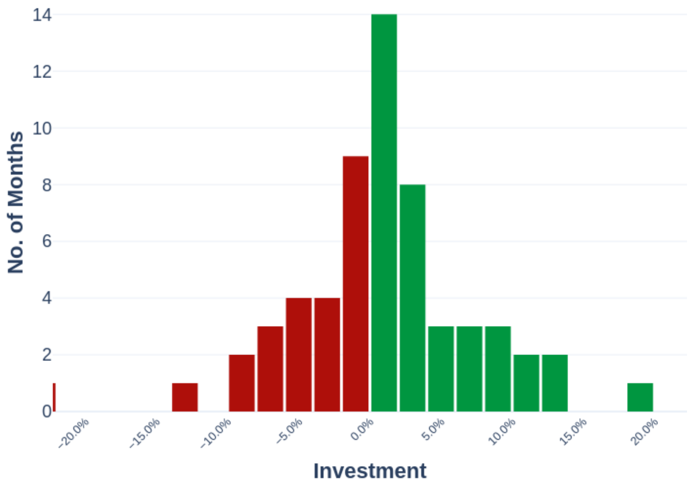
Growth of $10,000



Risk / return



Monthly histogram



Minimum and maximum returns (% p.a.)

Absolute performance analysis

Instrument	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Investment	**25.47%**	**8.95%**	**8.99%**	**12.21%**	**13.38%**
Income	4.25%	3.66%	6.88%	7.47%	5.36%
Growth	21.22%	5.29%	2.11%	4.74%	8.02%
Benchmark	**12.82%**	**6.54%**	**7.80%**	**7.79%**	**8.12%**
Median	**11.02%**	**4.62%**	**5.97%**	**6.02%**	**7.23%**
Cash	**4.28%**	**2.31%**	**1.59%**	**1.84%**	**3.68%**

Ranking within sector (p.a.)

Ranking within Sector	1 Yr	3 Yrs	5 Yrs	Inception
Fund Ranking	4 / 38	14 / 35	16 / 32	1 / 5
Quartile	1st	2nd	2nd	1st

Absolute risk

Instrument	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Standard Deviation (% p.a.)					
Investment	18.32%	20.79%	23.03%	18.68%	18.49%
Benchmark	11.00%	13.52%	16.49%	14.04%	13.46%
Median	8.75%	10.79%	14.47%	11.95%	12.35%
Downside Deviation (% p.a.)					
Investment	8.99%	13.27%	15.04%	11.86%	12.27%
Benchmark	5.65%	8.75%	12.21%	9.99%	9.41%
Median	4.43%	7.31%	11.12%	8.80%	8.69%

Absolute risk/return ratios

Instrument	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Sharpe Ratio (p.a.)					
Investment	1.16	0.32	0.32	0.55	0.52
Benchmark	0.78	0.31	0.38	0.42	0.33
Median	0.77	0.21	0.30	0.35	0.29
Sortino Ratio (p.a.)					
Investment	2.36	0.50	0.49	0.87	0.79
Benchmark	1.51	0.48	0.51	0.60	0.47
Median	1.52	0.32	0.39	0.47	0.41

For consistency purposes, Zenith benchmarks all funds within this sector against the S&P/ASX 300 Index. Investors should be cognisant that the Fund will retain a strategic overweight to small capitalisation companies relative to Zenith's internal benchmark. Smallco does not benchmark itself against an index.

All commentary below is as at 31 May 2024.

The Fund aims to achieve high absolute returns for investors by utilising a relatively concentrated, long/short strategy that is predominantly invested in Australian small capitalisation companies.

Zenith would prefer to see the delineation of a specific outperformance target, as opposed to a descriptive, qualitative objective. Zenith believes this will provide investors with greater transparency with regards to returns expectations and to the level of risk embedded in the Fund.

The Fund has demonstrated material outperformance relative to Zenith's assigned benchmark and the median manager over the long term.

The Fund's volatility (as measured by Standard Deviation) has been higher than Zenith's assigned benchmark over all assessed periods, which is consistent with Zenith's expectations given the Fund's exposure to small capitalisation companies.

The Fund's Sharpe Ratio has been higher than that of the benchmark since inception, which indicates that investors have been sufficiently compensated for its risk.

Investors should be aware that Smallco does not target a specific level of income returns, with distributions made annually where possible. Zenith would prefer a more frequent distribution profile to alleviate potential issues involved with large distributions at 30 June.

Relative performance

Excess returns

Statistic	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Excess Return	12.65%	2.41%	1.19%	4.42%	5.26%
Monthly Excess (All Mkts)	41.67%	47.22%	40.00%	47.50%	55.12%
Monthly Excess (Up Mkts)	50.00%	52.38%	41.03%	46.75%	54.14%
Monthly Excess (Down Mkts)	25.00%	40.00%	38.10%	48.84%	56.86%

Capture ratios (% p.a.)

Statistic	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Downside Capture	120.60%	125.69%	113.20%	87.47%	83.69%
Upside Capture	158.05%	129.38%	114.12%	109.73%	110.24%

Tracking error (% p.a.)

Instrument	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Investment	11.81%	12.72%	12.89%	11.92%	12.22%
Median	2.66%	3.34%	2.97%	2.94%	2.60%

Information ratio

Instrument	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Investment	1.07	0.19	0.09	0.37	0.43
Median	-0.68	-0.58	-0.62	-0.60	-0.34

Beta statistics

Statistic	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Beta	1.31	1.24	1.17	1.02	1.03
R-Squared	0.62	0.65	0.70	0.59	0.56
Correlation	0.79	0.81	0.84	0.77	0.75

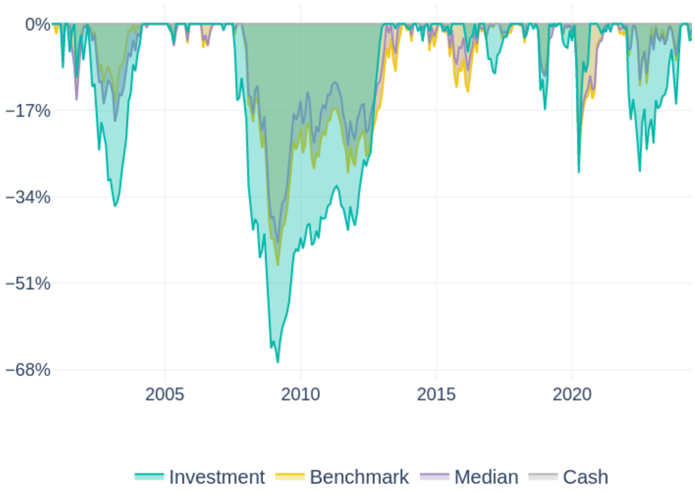
All commentary below is as at 31 May 2024.

Zenith seeks to identify strategies that can outperform in over 50% of months in all market conditions, as we believe this represents consistency of manager skill. In addition, we view a strategy's ability to produce stronger upside capture ratios relative to downside capture ratios as an attractive feature. The Fund has achieved both outcomes since its inception.

The Fund has displayed stronger consistency of outperformance during falling market conditions since inception.

Drawdown analysis (since inception)

Drawdown analysis assesses the relative riskiness of a Fund versus the benchmark, in reference to capital preservation. The maximum Drawdown is recorded as the percentage decline in the value of a portfolio from peak to trough (before a new peak is achieved). All Drawdown analysis is calculated commencing from the inception date of the Fund in question, and Drawdown analysis for the Fund and benchmark(s) are calculated independently. That is, the largest drawdown for the Fund and benchmark(s) will not always refer to the same time period.



All commentary below is as at 31 May 2024.

Consistent with the Fund's strategic overweight to small capitalisation companies relative to Zenith's internal benchmark, drawdowns have typically been greater than those of the benchmark.

Fund commentary

Fund risks

Zenith has identified the following key risks of the Fund. Although Zenith believes the risks noted are all significant, we have listed them in order of importance. In addition, we have not intended to highlight all possible risks.

Key person risk: As with any boutique manager, Zenith views key person risk at Smallco to be high. Zenith believes Rob Hopkins, Bill Ryan, Adam Simpson and Andrew Hokin are critical members of the investment team, with a departure being a significant loss to the firm, triggering an immediate review of the Fund's rating.

Zenith acknowledges the material equity stake of all four members in the business and we believe that this mitigates the risk of a departure over the medium term. In addition, we believe there is sufficient depth in the team to take over the daily management of the Fund should Smallco experience a material departure. Zenith notes that there have not been any departures from the firm since its inception.

Capacity risk: Excessive levels of funds under management (FUM) can inhibit a manager's ability to trade portfolio positions effectively and may therefore limit outperformance potential. As at 31 May 2024, Smallco managed approximately $A 846 million firmwide. Overall, Zenith does not believe the Fund is currently impacted by capacity limitations.

In response to negative market movements and outflows, Smallco reopened the Fund to new investment in April 2020 after being hard closed since January 2017. Zenith notes that Smallco has a strong track record of prudently managing capacity, having previously closed the Fund at conservative levels of FUM. Notwithstanding this, Zenith will continue to monitor the strategy closely to ensure that increasing levels of FUM do not begin to negatively impact performance.

Relative performance risk: Zenith notes that the Fund is more concentrated than many Australian equities peers. Zenith believes that a concentrated portfolio has greater exposure to stock-specific risk than more diversified strategies and, as such, investors should be cognisant that the Fund may experience capital volatility in excess of a more diversified strategy. In addition, given the Fund follows a benchmark unaware investment approach, its performance may diverge substantially from the benchmark and peers.

Team focus risk: While Zenith believes Smallco's team is sufficiently resourced and experienced, we note that the team is also responsible for another Australian equity strategy. As such, Zenith believes that the team's research focus may be diluted. However, we note that there is a high level of overlap between the strategies, which somewhat mitigates our concerns.

Leverage risk: Smallco may short sell stocks and use the proceeds to increase its long exposure. This increases an investor's exposure to Smallco's stock-specific decisions, which can magnify returns and losses. The maximum gross exposure of the Fund is limited to 150% of the value of the Fund's net assets (i.e. the sum of the Fund's long and short exposures). However, the gross exposure of the Fund has historically remained lower than peers at approximately 80%, with short selling used opportunistically. Notwithstanding this, Smallco has the ability to borrow up to 30% of the Fund's Net Asset Value (NAV) and allow the gearing level to passively drift to 50%. However, Zenith notes that gearing is rarely implemented, with Smallco last utilising its gearing facility in 2006.

Counterparty risk: The Fund's custody and counterparty contracts are subject to potential default risk. In particular, the Fund is exposed to counterparty risk with its securities lender, Macquarie. Assets in the Fund are required to be transferred to Macquarie when borrowing stock for short selling. Assets up to the required collateral amount are held on Macquarie's balance sheet and are not segregated from other Macquarie assets. Should Macquarie become insolvent, there is a risk that the assets posted by the Fund may not be recoverable.

Security/asset selection

Smallco focuses its research on stocks with market capitalisations between $A 100 million and $A 500 million, as it believes this segment of the market is both relatively under-researched and possesses sufficient liquidity.

Smallco is generally cautious when investing in stocks with market capitalisations of less than $A 100 million, given high level of earnings risk and generally less developed financial discipline and reporting. In addition, Smallco typically excludes resources stocks, the biotechnology sector and other industries it deems to be structurally challenged as it believes such earning streams are too difficult to forecast with sufficient accuracy.

Smallco seeks to identify quality companies that exhibit the following characteristics:

- Strong cash flow
- High return on funds employed
- Attractive earnings outlook
- Strong competitive advantage
- Strong board and good management

Meetings with senior company management form a key part of the security selection process. The aim of the research process is to produce an internally-generated target price that reflects the company's long-term intrinsic value. Target prices are compared against current market prices to determine a stock's upside.

Smallco's valuation process incorporates a combination of the following metrics that are based on three-year forecasts:

- Price-to-cashflow
- Price-to-earnings
- Earnings before interest, taxes, depreciation and amortisation

To aid idea generation and to serve as a feedback loop, Smallco utilises a macroeconomic overlay to make an assessment of the economy.

A quality rating system is utilised to prevent the portfolio from holding an excessive number of lower quality stocks. Every stock considered by the investment team is assigned a numerical rating from 0 to 10 based on its quality and cyclicality, with 10 being the most attractive. Smallco introduced the quality rating system after the Fund experienced a significant drawdown during 2008 and 2009.

Candidates for the Fund's short positions are a by-product of the idea generation process for long positions. For a stock to be considered as a short candidate, it must typically fulfill the following criteria:

- Potential return on the short position of 20% to 30%
- Operating in a structurally-challenged industry
- A catalyst or event (e.g. reporting season) where the company is likely to disappoint relative to market expectations in the short term

Portfolio holdings and potential candidates for inclusion or short selling are subject to a rigorous peer-review process.

Overall, Zenith believes the security selection process adopted by Smallco is sufficiently robust and that the research conducted by the investment team is comprehensive.

Responsible investment approach

Smallco does not have an established responsible investment policy.

Smallco incorporates environmental, social and governance (ESG) considerations into its investment process, with a particular focus on governance. Zenith believes that this qualitative analysis of a company’s operations is crucial on a forward basis, given that a company’s performance with regard to ESG considerations is increasingly being reflected in its share price. Overall, while we do not believe Smallco considers ESG factors to the same extent as peers, we are comfortable with its approach.

Portfolio construction

The portfolio construction process is primarily driven by fundamental analysis conducted by the investment team. Although Simpson is the lead portfolio manager for the Fund, portfolio construction follows a consensus approach. Smallco constructs the Fund through a benchmark-unaware approach, with the number of positions and weightings a function of investment opportunities.

The portfolio construction approach allows for the team's best ideas, based on their risk/return profiles and the team's conviction levels, to be represented in the Fund. Portfolio guidelines, stock liquidity and downside risk are also considered.

The size of an individual position is dependent upon its target price and quality rating. As a guide, initial position sizes of 3%, 5% or 7% will be implemented based on a combination of these two factors.

The Fund's positions will predominantly be in small cap stocks, with exposure to S&P/ASX 100 stocks limited to 20% of the portfolio. This limit does not apply to small cap positions that have graduated into the S&P/ASX 100 Index due to strong performance.

Short positions are only initiated opportunistically, where they are sufficiently compelling based on the output of the security selection process. As such, Zenith notes that short selling is rarely utilised in the Fund.

As part of the portfolio construction process, an overall weighted average quality rating is calculated for the portfolio. The weighted average portfolio rating is not permitted to fall below 4, Smallco's assessment of the market average. In addition, Smallco employs a 25% limit on the Fund's total exposure to companies rated 3 or less. Zenith believes the presence of the quality rating system promotes discipline and mitigates the risk of the portfolio being overly exposed to lower quality stocks.

Zenith notes that in 2016, the Fund's investment strategy was changed to allow the Fund's exposure to illiquid stocks to increase to 30%, previously 25%. Smallco defines an illiquid holding as one in which it owns greater than 75% of the security's average monthly market volume. Given the Fund typically holds a material exposure to small capitalisation securities, Zenith believes the previous limit of 25% was more appropriate.

The Fund typically holds between 25 and 35 securities. Whilst cash can be held up to a maximum of 50%, it has averaged approximately 20%. Zenith believes that actively-managed equities funds should remain fully invested and that the asset allocation decision should be left to the individual investor.

Portfolio holdings will be sold, reduced or reviewed under the following circumstances:

- Smallco's valuation target has been achieved
- The investment thesis has changed
- Availability of superior investments
- To stay within the Fund's portfolio construction constraints

Short positions are subject to stop-loss limits. Whilst Zenith notes that the use of stop-losses promotes sell discipline, they can lead crystallisation of losses at an inopportune time.

Whilst Smallco is permitted to vary the Fund's net equity exposure between 0% and 150%, it has typically been appoximately 80%. Smallco does not make tactical asset allocation decisions, with the Fund's equity exposure primarily a result of available investment opportunities, both long and short. Zenith notes that this differs from some of the Fund's peers, where tactical allocations between equities and cash can be made based on the prevailing market conditions.

Smallco also has the ability to employ explicit leverage within the Fund. The portfolio may be geared up to 30% and allowed to drift passively to a maximum of 50%. Zenith notes that Smallco has been relatively conservative in its application of gearing, which has not been used since 2006.

Portfolio turnover is expected to average approximately 30% p.a. over a market cycle, which Zenith considers to be low.

Zenith is comfortable with Smallco's portfolio construction approach, believing it ensures a strong connection between the output of the security selection process and the resultant weight of stocks in the portfolio.

Risk management

The Fund's formal risk management constraints are broad and provide Smallco with significant scope to achieve its investment objective.

Investors should be aware of the concentrated nature of the Fund and relatively generous limit relating to maximum individual security weights. Given the Fund is invested predominantly in small capitalisation securities, Zenith believes a more conservative position limit should be in place.

Smallco defines an illiquid holding as a stock in which it owns greater than 75% of average monthly market volume. Zenith believes that Smallco's assessment of stock liquidity is less conservative than peers. Investors should be aware that during a significant market event, the liquidity profile of the Fund could be sub-optimal leading to potential capital impairment.

Smallco's detailed fundamental approach to stock selection, including the quality rating system, acts as the main tool for mitigating the risk of poor stock selection.

Stop-losses are applied at the individual stock level. A hard limit is applied where the loss from an individual short position equates to 7% of the portfolio. Whilst Zenith believes this limit is relatively broad and potentially exposes the Fund to an excessive loss from a single position, we note that loss-making short positions are typically removed at the 2% level.

Formal internal meetings occur on a monthly basis to monitor the portfolio's characteristics, exposures and market events. However, given the flat investment team structure, Zenith notes that communication amongst the team occurs on an ongoing basis.

Overall, Zenith believes Smallco's risk management processes are adequate, particularly given the detailed due diligence conducted as part of the security selection process. However, investors should be aware there is a significant reliance on the judgement and skill of Smallco's investment team in managing investment risk.

Investment fees

	Fund	Sector Average
Total Fees and Costs (RG 97)	3.42% p.a.	2.25% p.a.
Management Fees and Costs	1.55% p.a.	1.19% p.a.
Transaction Costs	0.01% p.a.	0.45% p.a.
Performance fees as at 30 Jun 2023	1.86%	0.70%
Performance fees description	18.64% of the unit price increase over each six-month period, subject to the recoupment of prior negative performance.	
Management Cost	1.55% p.a.	1.17% p.a.
Buy / Sell spread	0.45% / 0.45%	0.25% / 0.25%

All fees and costs are inclusive of GST unless indicated otherwise. The Performance Fee shown is the performance fee disclosed in the PDS. It is calculated by taking the average performance fees charged over the last five financial years (or less if the investment or performance fee mechanism has not been in place for five financial years).

The sector average management cost is based on the average management cost of all flagship Australian Shares - Long Short products surveyed by Zenith.

The Fund has a performance fee of 18.64%, payable on any increase in the net asset value of the Fund, subject to the recoupment of all prior negative performance. The performance fee is calculated and paid semi-annually.

Zenith believes the performance fee for the Fund is poorly structured due to the lack of an appropriate benchmark. Given the Fund will typically exhibit equity-like risk/return characteristics, an appropriate benchmark should be used to ensure that any performance fees payable are justified. As it currently stands, Zenith believes that the hurdle applied to the performance fee is too low and not commensurate with the Fund's risk profile.

Additionally, Zenith believes there is scope for the payment period to be extended, with an annual frequency being the preferred structure. We are of the view that a longer payment frequency is better aligned with the Fund’s longer-term investment objectives.

Overall, Zenith believes the Fund's fee structure is expensive, relative to peers, given its stated objectives. In addition, we believe that investors have been insufficiently compensated by way of risk-adjusted performance given the fees paid over the past three years (ending 30 June 2023).

Zenith believes the buy/sell spread is high on an absolute and relative basis. As such, we believe there is scope for this to be reduced.

The fees mentioned above are reflective of the flagship version only. Fees may differ when the product is accessed through an alternative investment vehicle such as platform.

About the fund manager

Organisation

Established in 2000 by Rob Hopkins and Bill Ryan, Smallco is a Sydney-based boutique fund manager that specialises in managing Australian equity strategies. Smallco's boutique structure allows for equity participation amongst the broader team, which Zenith believes is a positive, as it allows for closer alignment of interests between the investment team and investors in the Fund, while also serving as a staff retention mechanism.

Although Smallco previously engaged Gateway Financial Marketing for the provision of retail distribution services, we note that this partnership ended in early 2020. Zenith believes Smallco would benefit from distribution support, allowing the investment team to focus on research and portfolio management efforts.

As at 31 May 2024, Smallco had approximately $A 846 million in funds under management.

As at the same date, Smallco managed approximately $A 516 million in the strategy, all of which was in the Fund.

Investment personnel

Name	Title	Industry Experience (yrs)	Tenure (yrs)	Location
Adam Simpson	Portfolio Manager	21	6	Sydney, Australia

Name	Title	Industry Experience (yrs)	Tenure (yrs)	Location
Rob Hopkins	Portfolio Manager	38	24	Sydney, Australia
Bill Ryan	Portfolio Manager	28	24	Sydney, Australia
Andrew Hokin	Portfolio Manager	29	17	Sydney, Australia
Craig Miller	Portfolio Manager	19	19	Sydney, Australia
Paul Graham	Portfolio Manager	29	9	Sydney, Australia
Han Xu	Portfolio Manager	16	5	Sydney, Australia

The investment team of seven is led by Rob Hopkins, who is supported by Bill Ryan, Adam Simpson, Andrew Hokin, Paul Graham, Craig Miller and Han Xu.

Founding members, Hopkins and Ryan, established Smallco in 2000. Previously, Hopkins was the Head of Small Companies Research at Macquarie Equities, BT Alex Brown, ANZ Securities and Macintosh. Ryan worked together with Hopkins at ANZ Securities for a number of years.

Miller joined Smallco in June 2005. In addition to his analytical responsibilities, Miller is responsible for a significant portion of the firm's business development, client servicing and compliance responsibilities.

Prior to joining Smallco in July 2007, Hokin held a senior position within Macquarie Equities. Zenith believes Hokin has improved the rigour of the investment process since his arrival, introducing a quality rating system to the security selection process.

Graham joined Smallco in June 2014 having held senior positions at Nomura, Credit Suisse and Citigroup.

Simpson and Xu are the latest additions to the team, having joined Smallco in July 2017 and November 2018, respectively. Prior to joining Smallco, Simpson worked at Macquarie Equities for a period of 15 years where he was most recently the Head of Emerging Leaders Research. Xu previously worked as an analyst at Ellerston Capital for three years and, prior to that, a sell-side analyst at UBS for nine years. Zenith notes that Smallco has continued to bolster team resourcing, which we view favourably.

Simpson is the lead portfolio manager for the Fund, having assumed responsibility from Hopkins in 2021. Despite this, portfolio construction follows a consensus approach.

All team members hold stock coverage responsibilities, with a number of key sectors allocated across the team. Outside of the key sectors, team members are given the freedom to cover stocks in any sector.

The team has remained stable, with no staff departures since Smallco's inception. Where applicable, each team member is entitled to a profit-sharing arrangement that is commensurate with their equity/shadow equity holding, which Zenith believes provides a strong incentive to remain with the firm.

Overall, Zenith considers Smallco's investment team to be highly experienced and well resourced to manage the Fund.

About the sector

Sector characteristics

The Zenith 'Australian Shares – Long Short' sector consists of long/short funds investing across the Australian equity market cap spectrum. Managers in this sector can short-sell equities and/or SPI futures to capture excess return opportunities and manage risk. Over the long term, Zenith expects rated long/short products to outperform the S&P/ASX 300 Accumulation Index (after fees), given a manager's ability to generate positive excess returns from short selling.

Long/short managers can utilise fundamentally driven and/or quantitatively driven investment processes with a variety of trading biases. Managers in this sector employ active extension or variable beta investment styles. Active extension funds can be used as an alternative to traditional long-only funds where the investor wishes to increase their exposure to equities. That is, the manager can build a higher conviction portfolio by shorting stocks it believes will underperform and using the proceeds to invest long in stocks that it believes will outperform. Variable beta funds can be used by investors seeking dynamically adjusted market exposure management. Variable beta managers can decrease their market exposures to protect against market falls (by increasing shorts and/or cash holdings) or increase their market exposures, with leverage, to generate higher returns.

Zenith benchmarks all funds in this sector against the S&P/ASX 300 Accumulation Index. However, many managers in this sector benchmark themselves against the S&P/ASX 200 Accumulation Index. Both indices are market-capitalisation weighted, resulting in companies with the largest market capitalisations receiving the highest weightings within the index. Over the longer term, Zenith believes there will be minimal difference between the return profiles of these indices.

The Australian equities asset class, as represented by the S&P/ASX 300 Index, is highly concentrated and narrow. Zenith considers a company to be a large-cap company if it falls within the S&P/ASX 50 Index, with stocks falling within the S&P/ASX 51 to 100 considered mid-cap companies. Furthermore, Zenith considers stocks that fall within the S&P/ASX 101 to 300 to be small-cap companies.

As at 31 May 2024, the Financials and Materials sectors combined represented a significant portion of the S&P/ASX 300 Accumulation Index, with the Financials sector accounting for approximately 30% and Materials approximately 23%. In addition, the top 10 stocks represented approximately 46% of the Index and the top 20 stocks represented approximately 60%.

Sector risks

Funds within the 'Australian Shares – Long Short' sector are exposed to the following broad risks:

Market and economic risk: A sustained downturn across the Australian equity market is a risk to the absolute performance of funds in the sub-asset class. Additionally, changes in economic, social, technological or political conditions, as well as market sentiment, could also lead to negative fund performance. This risk can be significantly reduced by investors adhering to a fund's prescribed investment timeframe.

Specific security risk: This is the risk associated with an individual security. The price of common shares in a company may be affected by unexpected changes in company operations such as changes in management or the loss of a significant customer.

Liquidity risk: This is the risk that a security or asset cannot be traded promptly, due to insufficient trading volumes in the Australian equity market. When trading volumes are low, buyers/sellers can significantly impact the price of a security when entering or exiting a position.

Style bias risk: Australian equity managers employ different investment styles such as Growth, Value or Neutral (a combination of Value and Growth). Each style is conducive to certain market conditions. This risk can be significantly reduced by investors adhering to a fund's prescribed investment timeframe.

Capacity risk: High levels of funds under management (FUM) can present additional challenges to an Australian equity manager. High FUM has the potential to restrict a manager's ability to trade efficiently and/or be forced to disclose substantial shareholdings to the market (most common in smaller companies).

Regulatory Risk: All investments carry the risk of being affected by changes to government policies, regulations and laws. Security prices in which funds may have exposure are also subject to certain risks arising from government intervention in the Australian equity market. Such regulation or intervention could adversely affect fund performance.

Short risk: Australian long/short funds can borrow securities and sell them on the equity market (otherwise known as short selling). Given such securities will ultimately need to be returned to a lender, funds that short-sell securities may be required to re-purchase such securities at a higher price, thereby incurring a loss. Such losses can potentially be unlimited given that there is no theoretical upper limit on security prices.

Zenith rating

Report certification

Date of issue: 19 Jun 2024

Role	Analyst	Title
Analyst	Stephen Colwell	Senior Investment Analyst
Sector Lead	Tom Goodrich	Senior Investment Analyst
Authoriser	Bronwen Moncrieff	Head of Research

Analyst Disclosure

As at the time this report was issued, the Analyst, report Authoriser and/ or the Sector Lead holds interests in either the product, the product issuer or a relevant related party. The Analyst/Authoriser/Sector Lead certifies that the extent of the holding is non-material in nature and has been undertaken in accordance with Zenith's Trading Policy and RG79.149(c).

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Rating history

As At	Rating
19 Jun 2024	Recommended
15 Jun 2023	Recommended
23 Jun 2022	Recommended
17 Jun 2021	Recommended
09 Jun 2020	Recommended
12 Jun 2019	Recommended

Last 5 years only displayed. Longer histories available on request.

In March 2021, Zenith implemented a new ratings methodology for products classified as Traditional Index. Any rating issued from this date forward for Traditional Index products only reflect this change in methodology, with the relevant Traditional Index ratings being Index Approved, Index Recommended and Index Highly Recommended. Ratings issued for Traditional Index products prior to March 2021 are retained for historical purposes in line with our regulatory requirements and were issued in line with Zenith's Fund Research Methodology. Further information in relation to Zenith's Traditional Index Research Methodology and Traditional Index Ratings can be found on the Zenith website.

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This report refers to the Australian unit trust for the fund, and the fund and benchmark returns are all in AUD.

Zenith has charged Smallco Investment Manager a fee to produce this report.