

K2 Australian Absolute Return Fund



Performance for period ending 31 Mar 2012 (* % p.a. net)							
Product	Status	APIR Code	3 Mth	1 Yr*	3 Yr*	5 Yr*	
Wholesale	Active	KAM0101AU	7.1	-7.3	10.2	3.4	
Wholesale Analysis			1 Yr*	2 Yr*	3 Yr*	5 Yr*	7 Yr*
Performance (%pa)			-7.3	-0.6	10.2	3.4	7.5
Standard Deviation (%pa)			9.3	9.4	11.0	11.4	10.5
Excess Return** (% pa)			-1.0	0.8	-1.2	5.5	2.2
Outperformance Ratio** (%)			58.3	50.0	41.7	51.7	42.9
Worst Drawdown (%)			-13.4	-13.4	-13.4	-23.0	-23.0
Time to Recovery (mths)						9.0	9.0
Sharpe Ratio			-1.3	-0.6	0.5	-0.2	0.2
Information Ratio**			-0.2	0.2	-0.2	0.7	0.3
Tracking Error** (%pa)			5.3	4.7	4.7	7.5	7.0

**Benchmark Used: S&P/ASX 300 Accumulation Index

Lonsec Opinion of this Fund

- Lonsec has maintained the rating for the K2 Australian Absolute Return Fund as 'Recommended', considering it to be an attractive offering for investors seeking an equity-based product, with a capital preservation focus.
- Lonsec has confidence in K2's investment process and the quality of the key personnel executing it. The team's stability and boutique corporate structure are other notable features of this offering.
- K2 believes that there is no 'one' uniform style that works across the entire investment cycle. The Manager therefore adopts a flexible 'rotational' approach where the investment team targets the style best suited to the market conditions at that point in time.
- K2's rotational investment style is achieved via a flexible multiple portfolio manager approach, in which K2 allocates capital to each individual portfolio manager. These individual portfolios are then blended into a final portfolio.
- Capital is allocated based on the portfolio manager's experience, performance track record, suitability of their individual investment style to the prevailing market conditions and market outlook (reflected in the setting of the Fund's net equity position). Whilst this approach is in contrast to the industry norm of having a single portfolio manager and research conducted within a consistent framework, Lonsec acknowledges that K2's approach is logical, recognising the diversity of investment skills amongst the team.
- Detracting from a higher rating are some reservations regarding the level of autonomy given to the relatively less experienced investment team members and the relatively less structured research approach.
- Moreover, Lonsec notes the fee structure is relatively expensive compared to other Australian long/short and long only equity offerings. Investors should also be cognisant of lower tax effectiveness of the product given the high level of portfolio turnover.

Quarterly Portfolio Snapshot

The K2 Australian Absolute Return Fund underperformed against the All Ordinaries Accumulation Index over the March 2012 quarter. The main contributors to performance were ANZ, Ausdrill and Fortescue Metals; whilst the main detractors were BHP, Challenger and Coca Cola Amatil. During the quarter positions were established in BHP, AMP and Fortescue Metals; with positions in Woolworths, David Jones and Challenger being sold down.

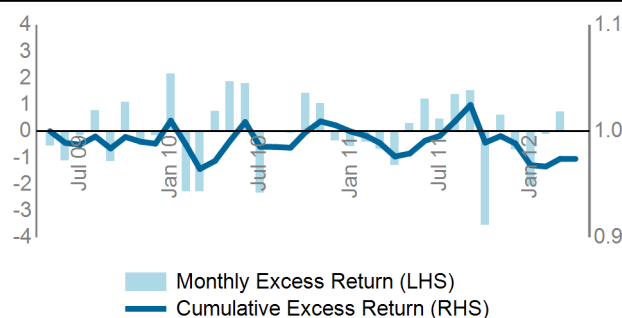
Investment Process

The CIO sets the net equity exposure of the Fund based on his macroeconomic outlook and thematic market analysis. This 'top-down' analysis is then combined with fundamental 'bottom-up' research to generate investment ideas. Within the established net equity position of the Fund each of the Fund's individual portfolio managers have the autonomy to research and pick stocks based on their own investment style and methodology. The level of autonomy afforded to the portfolio managers means that ideas are generated in different ways and from a mixture of internal and external sources.

Performance Analysis - Wholesale

It should be noted that K2 does not measure Fund performance relative to a benchmark, but adopts an absolute return focus targeting a 15% p.a. return through a full cycle.

Performance



Analyst Disclosure & Certification

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Date Prepared: 27 Apr 2012
Analyst: SMorris
Release authorised by: PPavlidis

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K2 Australian Absolute Return Fund



About this Review	
Sector reviewed	Hedge Funds – Australian Equity Long/Short
Total Funds rated in this sector	13
Date of this Sector Review	May 2011
About this Fund (as at April 2011)	
Fund reviewed	K2 Australian Absolute Return Fund
Fund Size	\$574.1m
Responsible Entity	K2 Asset Management Ltd
Fund Commenced	October 1999
Retail Fee	1.50% + 20% performance fee*
Wholesale Fee	1.50% + 20% performance fee*
Structure Availability	Platforms, Retail, Wholesale
About the Fund Manager	
Fund Manager	K2 Asset Management Ltd
Ownership	100% owned by K2 Asset Management Holdings Ltd (ASX code: KAM)
Assets managed in Australian Equities	\$574.1m
Years managing this asset class	11 years
Investment Team	
Team size dedicated to this Fund	4 (all analysts)
Key Personnel	Campbell Neal, David Poppenbeek
Departure/Team Size Ratio (past 2 yrs)	0%
Investment Process	
Style	Absolute Return/ Rotational
Targeted Value Add	15% p.a.(net) over a 3-5 year cycle
Typical Tracking Error	n/a
Typical Stock Numbers	50-70
Net Market Exposure	Average: 65% Range: -30-100%
Typical Portfolio Turnover	Approx. 500% p.a.
Risk Limits	Stock bets: +/-10.0% (long); 5% absolute (short)
Franking Level (FY10)	85%
Tax efficiency - Income in Total Distribution (FY10)	1.2%
Discount Gains in Total Capital Gains (FY10)	5.4
Fund Rating History	
May 2011	Recommended
November 2008 to May 2011	Recommended

*Applies when the Fund's performance exceeds net 6% above the high water mark.

What this Rating means

➤ The '**Recommended**' rating indicates that Lonsec has conviction that the fund or product can achieve its objectives and, if applicable, outperform peers over an appropriate investment timeframe. The manager or product has a number of competitive advantages in people, process and product design. The investment is a recommended entry point to access this asset class or strategy.

Fund Risk Characteristics

	Low	Moderate	High
Capital Volatility			▲
Corporate Risk			▲

Risk categories are based on Lonsec's qualitative opinion of the risks inherent in the product's asset class and the risks relative to other products in the relevant Lonsec sector universe.

Using this Fund

➤ **This is General Advice only and should be read in conjunction with the Disclaimer, Disclosure and Warning on the final page.**

➤ The Fund is an absolute return style long/short Australian equities product and will generally sit within the growth assets component of an investor's portfolio, with an investment time-horizon of five years plus.

➤ The Fund may utilise a broad range of strategies including short selling, derivatives and cash in order to adjust its net equity position in line with the investment manager's market outlook. At various stages through the market cycle, Fund performance may have a low correlation with traditional equity benchmarks. Lonsec recommends that investors consider all these relevant risks prior to investing.

➤ This is a high turnover strategy as such the relative returns are expected to have a low level of tax effectiveness.

Changes since previous Lonsec Review

➤ There have been no changes to the Manager's investment team or process since Lonsec's last review.

Lonsec Opinion of this Fund

Philosophy (Style)

➤ The K2 Australian Absolute Return Fund is a long-biased long/short Australian equity product managed with an absolute return focus.

➤ K2 believes that there is no 'one' uniform style that works across the entire investment cycle. Rather the Manager adopts a flexible 'rotational' approach where the investment team targets the style best suited to the market conditions at that point in time.

- K2's rotational investment style is achieved via a flexible multiple portfolio manager approach, in which K2 allocates capital to each individual portfolio manager. These individual portfolios are then blended into a final model portfolio.
- The Manager seeks to preserve capital by typically implementing an average net market exposure of around 65% through a full market cycle. Where equity buying opportunities cannot be identified the default investment position of the Fund is cash, which reflects the opportunistic nature of the strategy. Given the investment approach, the Fund should outperform the broader market in down markets.
- The Fund is not managed relative to traditional Australian equity benchmarks. (e.g. the S&P/ASX 300 Index) Investors should therefore note that performance is not likely to track mainstream indices.

People and Resources

- Overall, Lonsec considers K2's investment team to be both deeply experienced and high quality, exhibiting a strong mix of skills including top-down macroeconomic analysis and bottom-up stock picking. The key people involved in the Fund are David Poppenbeek and Campbell Neal. In particular, Lonsec believes Neal provides valuable stock picking skills in the small to mid-cap space
- In addition to the Fund's four portfolio managers, the Fund also relies on CIO Mark Newman's top down analysis. Newman's input plays an important role in determining the net equity position of the Fund.
- Lonsec prefers to see a separation of investment management and business related duties. This structure has been adopted by most of K2's investment team, with the exception of Neal, who also has day-to-day business management duties in his role as COO. Lonsec, however, acknowledges that this has been the case since the inception of the Fund in 1999.
- In total, the K2 investment team consists of ten members (including dealing resources). The Australian investment team exhibits solid levels of investment management experience with an average of 16 years experience. Lonsec believes the Manager is appropriately resourced to implement the Fund's investment strategy.
- Senior Portfolio Manager and Head of the Australian Absolute Return Fund, David Poppenbeek oversees the stock selection of the Fund in conjunction with Newman. Poppenbeek boasts a considerable 20 years industry experience from a number of analytical equity roles and six years direct portfolio management experience.
- Lonsec believes Poppenbeek is building a strong track record in portfolio management, adding further depth to the team's research capability.
- Lonsec considers key person risk in both Newman and Neal to be high. Mitigating this risk is Newman and Neal's significant equity ownership and co-investment in K2. As such, Lonsec believes that this is a risk worth taking, given the unlikely event of the departure of either of these key

members. However, in saying this, the rating of the Fund would be reviewed if either were to depart.

- K2's strong alignment of interests with investors is demonstrated by the high level of staff ownership in the business, the co-investment in the Fund and the setting of conservative FUM targets.

Research and Portfolio Construction

- A relatively unique aspect of the investment process is that each portfolio manager is allocated a percentage of the Fund's capital to invest (with the flexibility to redistribute capital upon quarterly review). Capital is allocated based on the portfolio manager's experience, performance track record, suitability of their individual investment style to the prevailing market conditions and market outlook (reflected in the setting of the Fund's net equity position). Whilst this approach is in contrast to the industry norm of having a single portfolio manager and research conducted within a consistent framework, Lonsec acknowledges that K2's approach is logical, recognising the diversity of investment skills amongst the team.
- It is important to note that each member of the team has autonomy to select stocks based on their individual research approach and investment style for the capital they have been allocated. In this context the research approach adopted by K2 is less formal compared to other Lonsec assessed peers in this sector (i.e. minimal standardised research templates used, no single valuation methodology adopted). Lonsec believes that such a research approach needs to be carefully monitored to minimise 'valuation' inconsistencies across sectors. All stock decisions are subject to ongoing review by Poppenbeek and peer review by the team.
- Despite the autonomy given to the investment team, Lonsec believes each individual is highly accountable for their performance. Variable remuneration, as a percentage is 100% linked to their stocks calls and clear targets on the required Return On Capital Employed (ROCE). Each member of the team has their individual basis point contribution to fund performance formally monitored, which serves as a transparent means to measure individual performance. In addition, stock decisions are subject to ongoing review by the CIO and peer review by the broader investment team.

- Lonsec believes that the 'hard' portfolio construction rules in place are sufficient to control potential individual stock risk within the portfolio. For example the Manager classifies all positions as either a 'trade', a 'core portfolio', a 'high alpha' or a 'short', with maximum portfolio exposure limits assigned to each depending on their classification. (Refer to Portfolio Construction section on page 4 of this report.)

Risk Management

- K2 is an absolute return manager and therefore risk management is implied in its capital preservation objective and via the setting of the net equity position of the Fund based on its macroeconomic outlook.
- The Manager has also developed a range of 'stop loss' guidelines or 'triggers' on both the long and short side in

which the portfolio managers are required to sell positions when these triggers are hit. Lonsec believes this is prudent, particularly on the 'short' side, in order to minimise potential losses from adverse price movements.

Performance

- The Fund had an absolute return of 9.2% p.a. over the five years to 31 March 2011. While this reflected outperformance of the S&P/ASX 300 Accumulation Index of 6.0% p.a., the Fund has failed to meet its performance objective of 15% p.a.(net) over a 5-year period
- The Fund's performance is also strong in terms of risk, with the worst drawdown being less than all other funds in the Lonsec peer group and lower standard deviation of returns over five years compared to the peer group average.

Overall

- Lonsec has maintained the rating for the K2 Australian Absolute Return Fund as 'Recommended', considering it to be an attractive offering for investors seeking an equity-based product, with a capital preservation focus.
- Lonsec has confidence in K2's investment process and the quality of the key personnel executing it. The team's stability and boutique corporate structure are other notable features of this offering.
- Detracting from a higher rating are some reservations regarding the level of autonomy given to the relatively less experienced investment team members and the relatively less structured research approach.
- Moreover, Lonsec notes the fee structure is relatively expensive compared to other Australian long/short and long only equity offerings. Investors should also be cognisant of lower tax effectiveness of the product given the high level of portfolio turnover.

People & Resources

Team Structure

In total, the K2 investment team consists of nine investment professionals, with five being responsible for the management of this Fund. The table below outlines the structure and responsibilities of the investment team.

In terms of portfolio management, K2 operates a relatively 'flat' team structure with each member of the investment team responsible for research and stock selection.

K2 employs a number of staff responsible for the operational, administrative and sales and marketing functions of the firm. Also in place are specialist external providers to act as the Fund's administrator as well as an external custodian/ prime broker.

Turnover

The investment team has exhibited high levels of stability over the last two years having had no departures.

Remuneration / Alignment of Interests

Portfolio manager variable remuneration is 100% linked to their stock recommendations and the meeting of predetermined targets on the required return on capital employed. In addition, K2 investment staff and directors are the majority owners of the business. Lonsec believes that these factors contribute to a high alignment of interests with investors.

The Fund is also subject to a performance fee of 20% which applies when the Fund's total return exceeds net 6.0% above the high water mark. This further helps to promote an alignment of interests with investors.

K2 Investment Team

Team Member	Title	Sector/Responsibilities	K2	Industry Exp
Mark Newman	Chief Investment Officer	Asian & International asset allocation	11	25
Campbell Neal*	Senior Portfolio Manager	Australia, New Zealand and Thailand	11	11
Rob Hand	Head of Asian Strategy	Hong Kong, China, Taiwan and India	9	21
David Poppenbeek *	Head of Australian Strategy	Australia and New Zealand	6	6
Nick Griffin	Head of International Strategy	Europe and USA	5	8
Roger Watson	Portfolio Manager	Asia	3	3
Nick Reddaway	Portfolio Manager	USA and Europe	3	10
Josh Kitchen*	Portfolio Manager/Dealer	Australia and New Zealand	11	11
Nick Leitl*	Portfolio Manager/Dealer	Asia, Australia and New Zealand	5	5
Jeff Thompson	Portfolio Manager	Europe	1	15

*Australian Absolute Return Fund investment team

Investment Style

Style

K2 adopts an absolute return focus in order to preserve capital and maximise risk adjusted returns through all market cycles. K2 believes that there is no one uniform style that works across the entire investment cycle and therefore does not target a specific investment style. Rather the manager's investment style is a function of market conditions with a focus to maximise risk-adjusted returns. This approach could best be described as 'rotational'.

Investment Philosophies and Beliefs

The investment team adopts a mixture of top down and bottom up analysis to identify mispriced stock opportunities (on both the long and short side) and catalysts that move securities towards and away from fair value.

Research Approach

Overview	
Investment Style	Rotational – Absolute Return
Investment universe	ASX/NZ All Ordinaries
Fully modelled stocks	120
Company Visits	100+
Initial Stock Filters	No formal stock screening although a proprietary quantitative tool assists in narrowing down the investable universe.
Top Down Weight	0-20%
Top Down Analysis	Newman in conjunction with each strategy head determines the Fund's asset allocation subject to macro variables: economic growth, real interest rates, credit availability, liquidity
Bottom Up Weight	20-80%
Bottom Up - Qualitative Analysis	Qualitative factors vary and are subject to the individual research and investment style of each manager. Most commonly analysed are company earnings, valuation, management and catalysts affecting fair value.
Research Inputs	<ul style="list-style-type: none"> • Management • Industry contacts • Technical analysis • Stock modeling, • Independent research houses • FACTSET • Broker research
Use of Broker Research	Idea generation

CIO Mark Newman in conjunction with Strategy Head, David Poppenbeek sets the net equity exposure of the Fund based on his macroeconomic outlook and thematic market analysis. This 'top down' analysis is then combined with fundamental 'bottom up' research to generate investment ideas. Within the established net equity position of the Fund each of the

Fund's five portfolio managers are allocated capital to invest and have the autonomy to research and pick stocks based on their own investment style and methodology. The level of autonomy afforded to the portfolio managers means that ideas are generated in different ways and from a mixture of internal and external sources.

Valuation Approach

Primary	No single valuation methodology is consistently used across all stocks.
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Portfolio Construction

Overview

The final portfolio is constructed in a benchmark unaware fashion by aggregating the four individually managed portfolios. The stock investments are categorised into trade, core, high alpha or short positions. A description of each is as follows:

- 'Trade' positions reflect the Manager's short term expectations and are generated from any source within the macro economic view.
- 'Core' positions are more analysis intensive and are afforded a longer time frame to achieve return targets.
- 'High alpha' positions are considered special situations where a higher level of risk is accepted with the expectation of a higher return.
- 'Short' positions are initiated based on stock specific events or momentum.

In constructing the portfolio the manager implements a number of 'hard' portfolio construction rules based on both the long and short side depending on the stock classifications. Portfolio construction rules for the various levels of market volatility are summarised below;

Classification	Volatility (High)	Volatility (Low)
Trade	7.5% Max	10.0% Max
Core	7.5% Max	10.0% Max
High Alpha	10.0% Max	10.0% Max
Short	0% (Small Cap) – 5.0% Max	5.0% Max

The Fund's net market exposure can range from -30% to 100% and has averaged a 65% over a full market cycle. The Fund holds approximately 50-70 stocks (including short positions).

The portfolio is actively traded, a factor which results in a high proportion of distributed income, including realised capital gains. Portfolio turnover is expected to be relatively high in the range of 500% p.a.

Risk Monitoring

In addition to the portfolio construction rules, K2 has in place a number of 'stop loss' rules or 'triggers' to ensure stocks are sold upon any adverse movements in their share price. This is summarised below.

Category	Trigger	Action
Trade	0%** loss after 30 days	Sell*
	20% loss	Sell*
	20% fall from peak	Sell*
Core	20% loss	Sell*
	20% fall from recent high	Sell*
High Alpha	40% loss	Sell*
	40% loss from recent high	Sell*
Short	20% loss from cost	Buy [#]

* Approval required to retain for another 30 days. Once a forced loss, cannot buy back unless PM calls a meeting and receives unanimous approval

**Formally 5%

[#] In practice, covered at 10% loss from cost

FACTSET and additional in-house systems are used to monitor the risk metrics of the portfolio and measure performance attribution.

Funds Under Management

As at April 2011 K2 managed a total of \$574.1 million in the Australian long/short equities. This level of FUM represents a 'high point' in the Manager's 11-year history but is still below the Manager's stated capacity limit.

Since Lonsec's last review K2 has revised its Australian Absolute Return Fund capacity from \$500 million to \$1 billion to reflect the change in market conditions post the global financial crisis. K2 considered liquidity and the increase in market capitalisation of its investable universe in determining this capacity limit. Capacity management is an area Lonsec will continue to monitor closely, particularly given the Fund's high portfolio turnover requires the ability to remain nimble.

Quantitative Performance Analysis								
	1 Year		2 Years		3 Years		5 Years	
	Fund	Peer Group	Fund	Peer Group	Fund	Peer Group	Fund	Peer Group
Performance (% pa)	6.6	6.0	20.1	19.2	10.7	2.1	9.2	3.3
Standard Deviation (% pa)	9.6	10.9	11.0	12.4	11.8	17.3	11.0	15.8
Excess Return (% pa)	2.8	2.2	-1.2	-2.1	9.6	1.0	6.0	0.1
Outperformance Ratio (%)	41.7	56.8	33.3	48.1	44.4	52.2	46.7	52.9
Worst Draw down (%)	-7.0	-9.1	-7.9	-10.0	-14.4	na	-23.0	na
Time to Recovery (mths)	4.0	4.1	4.0	4.2	8.0	9.8	9.0	2.4
Sharpe Ratio	0.2	0.0	1.4	1.1	0.5	-0.2	0.3	-0.1
Information Ratio	0.7	0.7	-0.3	-0.1	1.2	0.3	0.8	0.1
Tracking Error (% pa)	4.2	4.5	4.4	5.7	8.3	8.0	7.5	7.5

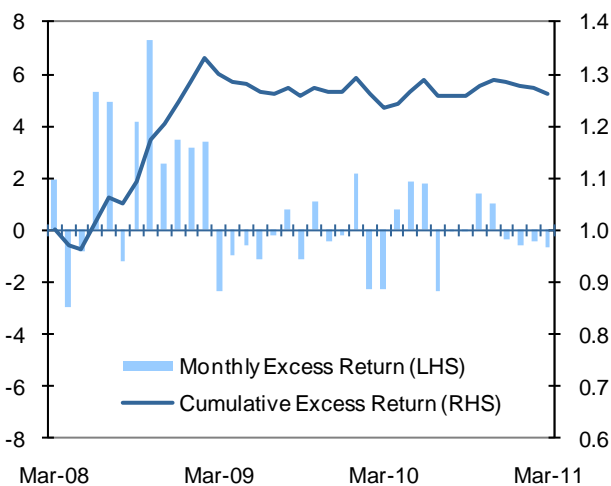
Benchmark: S&P/ASX 300 Accumulation Index Figures to (Mar-11)

Fund: K2 Australian Absolute Return Fund

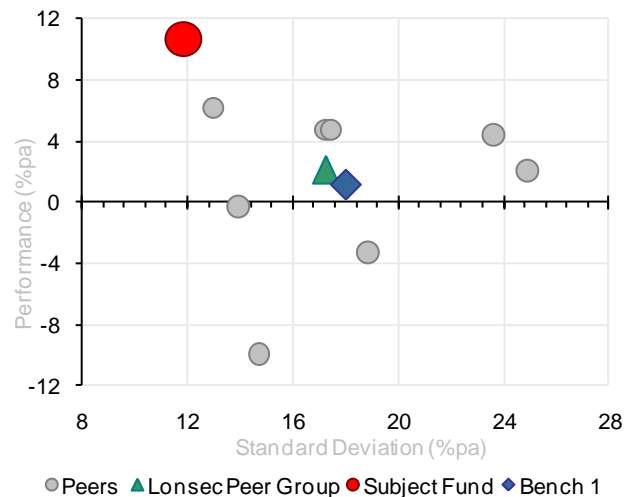
Peer Group: Average among Lonsec rated Australian long/short equity fund universe. It should be noted that Lonsec's Australian long/short equity fund universe is a relatively broad universe, which includes both absolute return focus funds and beta 1 or 130/30 type products.

Lonsec uses the S&P/ASX300 index for comparison purposes for the Australian long/short equity universe. This index may not be the benchmark used by individual funds for performance targets. For example, K2 does not measure fund performance relative to traditional benchmarks but adopts an absolute return focus.

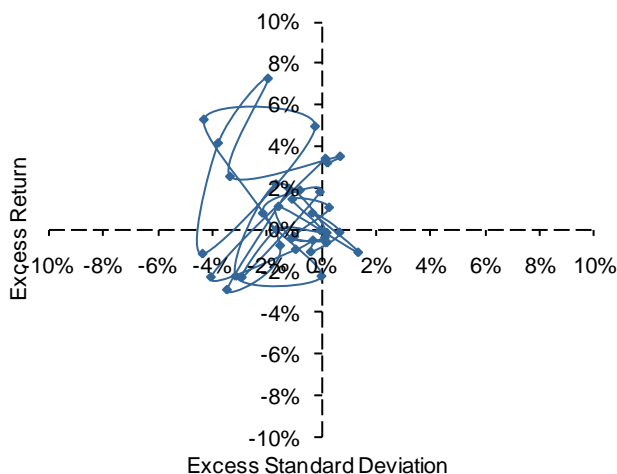
Cumulative Performance over three years



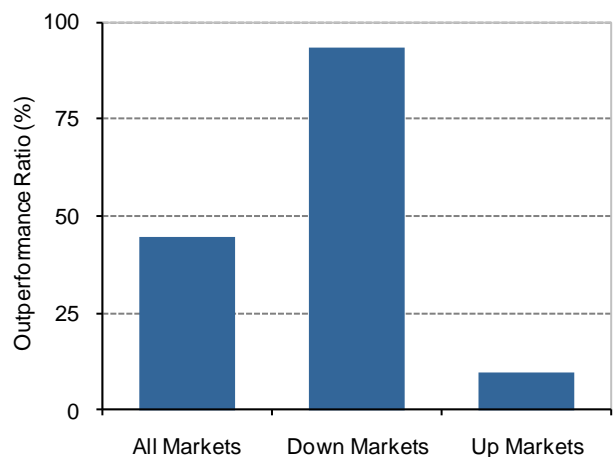
Risk-return Chart over three years



Snail Trail over three years



Outperformance Consistency over three years



Glossary	
Absolute Return	'Top line' actual return, after fees
Excess Return	Return in excess of the benchmark return (Alpha)
Standard Deviation	Volatility of monthly Absolute Returns
Tracking Error	Volatility of monthly Excess Returns against the benchmark (the Standard Deviation of monthly Excess Returns)
Sharpe Ratio	Absolute reward for absolute risk taken (outperformance of the risk free return (Bank Bills) / Standard Deviation)
Information Ratio	Relative reward for relative risk taken (Excess Returns / Tracking Error)
Worst Drawdown	The worst cumulative loss ('peak to trough') experienced over the period assessed
Time to Recovery	The number of months taken to recover the Worst Drawdown

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Date Prepared: May 2011

Analyst: Sam Morris

Release Authorised by: Fawaz Rashid

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