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The case for active management in Australian small caps

Leigh Cronin, August 2010

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Agenda

- Emerging companies: valuable for the economy, valuable for the investor
- Exploiting the available information efficiency is key
- The small cap universe sees efficient capital allocation to drive performance
- Cross sectional volatility highlights available returns differential
- The scorecard for active small cap managers
- Is there a limit to funds under management?
- Are fee budgets used efficiently when directed to small cap managers?
- Conclusions

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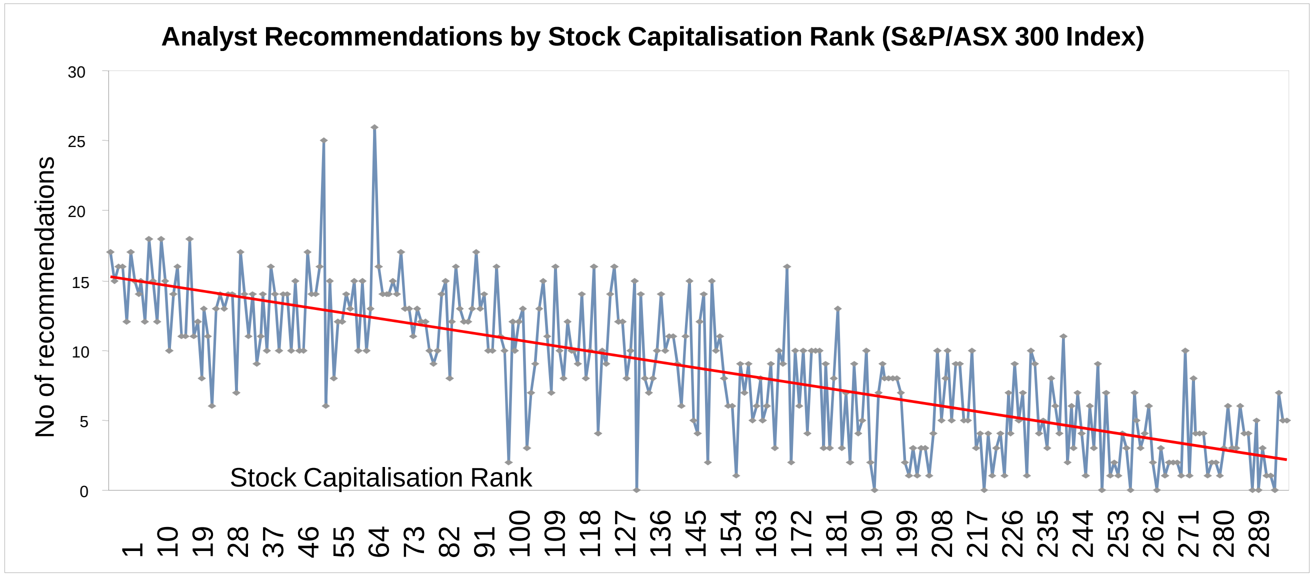
Valuable for the economy and for the investor

- Emerging companies are critical for job creation and innovation
- Focussed, nimble, innovative
- Less diversified businesses, more leveraged exposure to the real economy
- Earlier stages of their growth and development = potential for significant growth
- Less intensively researched segment = greater scope for pricing inefficiencies

Exploiting information inefficiency is key

- Smaller caps segment mounts a strong case to counter efficient mkt hypothesis
- Inefficiencies from various behavioural biases and/or inefficiencies of knowledge
- Small caps sector less intensively researched by brokers and broader market
- A disciplined research driven investment process, undertaken by highly experienced managers critical to discovering and exploiting the available opportunities



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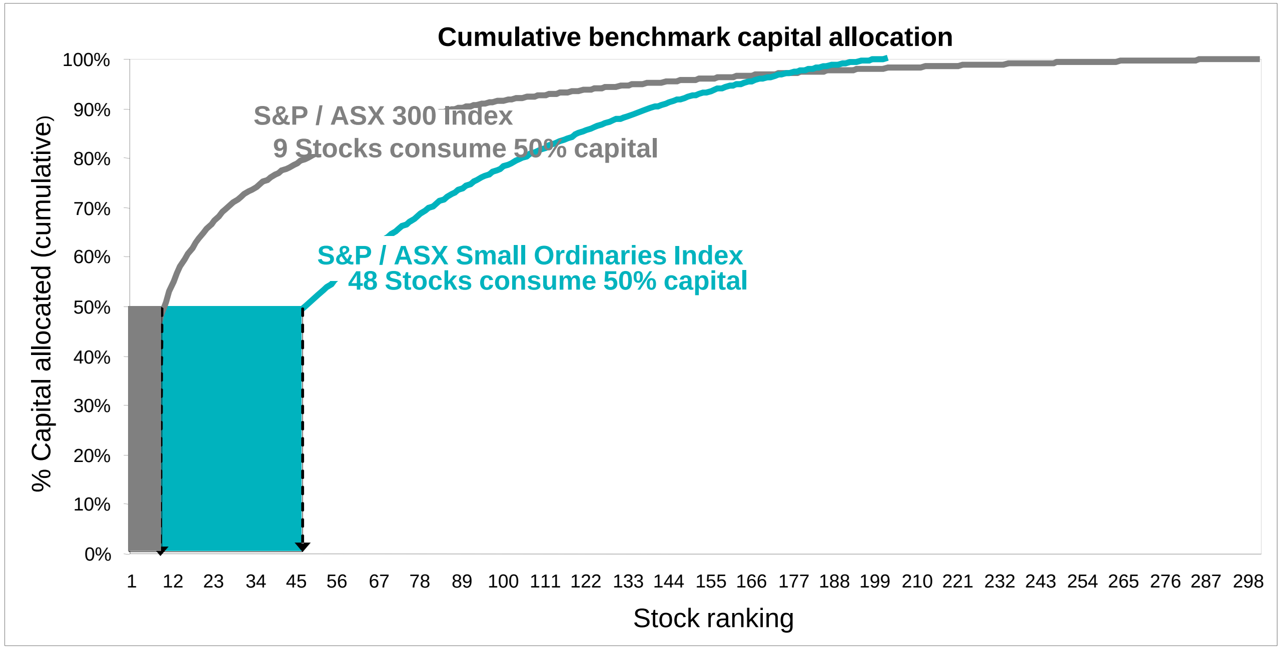
Portfolio capital is efficiently allocated

- Excess returns requires meaningful active risks to be taken
- Largest 10 companies within the S&P/ASX Small Ordinaries Index = 16% of benchmark v. 52% of the S&P/ASX 200 Index (Top 5 is 37%)
- Largest stock is 2.2% (BHP 12.4%). Dispersed benchmark, active risk taken



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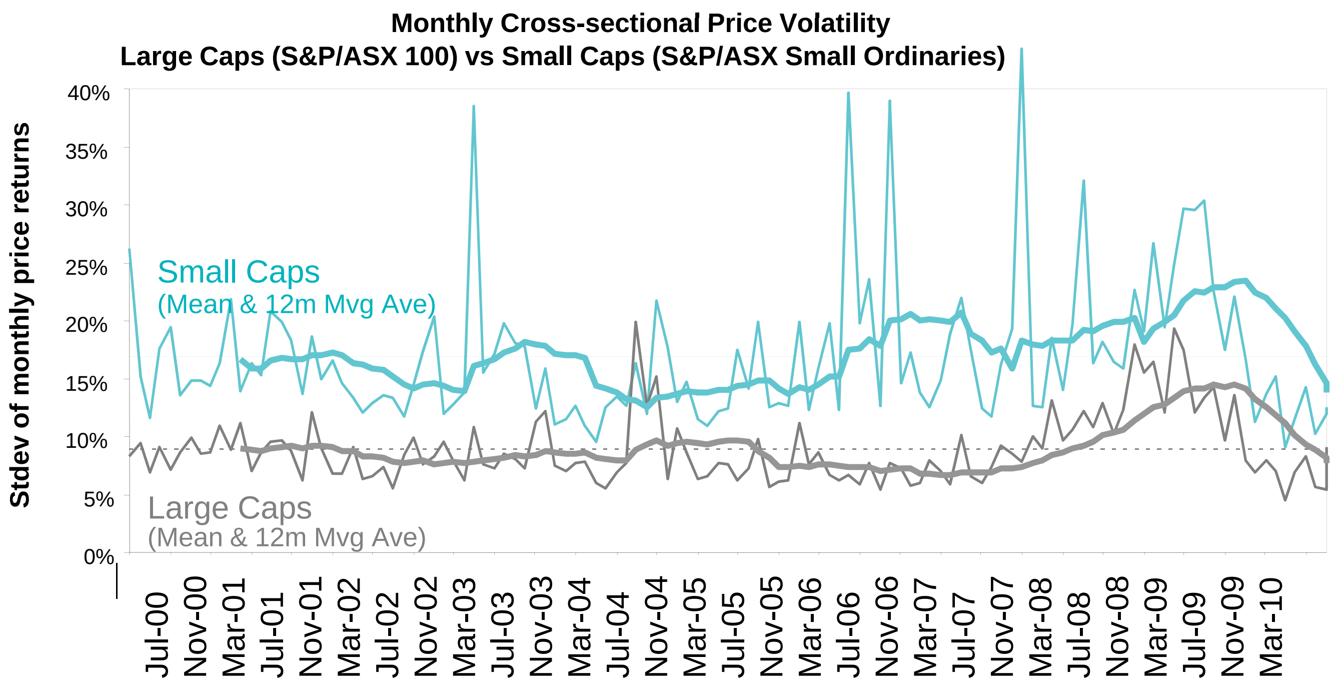
Cross sectional volatility = returns differential

- Persistent, significant dispersion differential between small and large cap stock returns
- Combined with proportionate active risk allocation = potential returns differential to exploit
- Well resourced, experienced, disciplined managers are well placed to exploit



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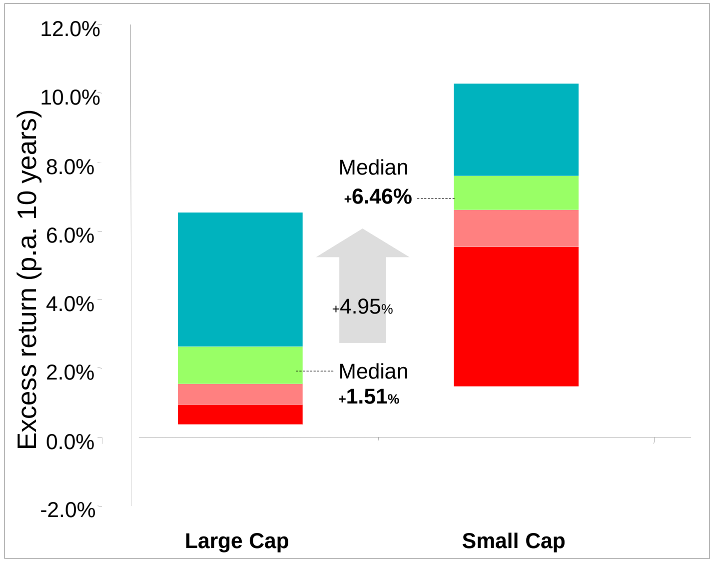
The scorecard for active small cap managers

- Median small cap manager has exceeded benchmark by 6.5% p.a over 10 years
- This compares to more modest 1.5% excess return for the median large cap manager
- Worst small cap manager = stronger excess returns than median large cap manager
- 1st and 2nd quartile small cap managers = 50% by number (15% for large cap)

Manager dispersion by manager quartiles



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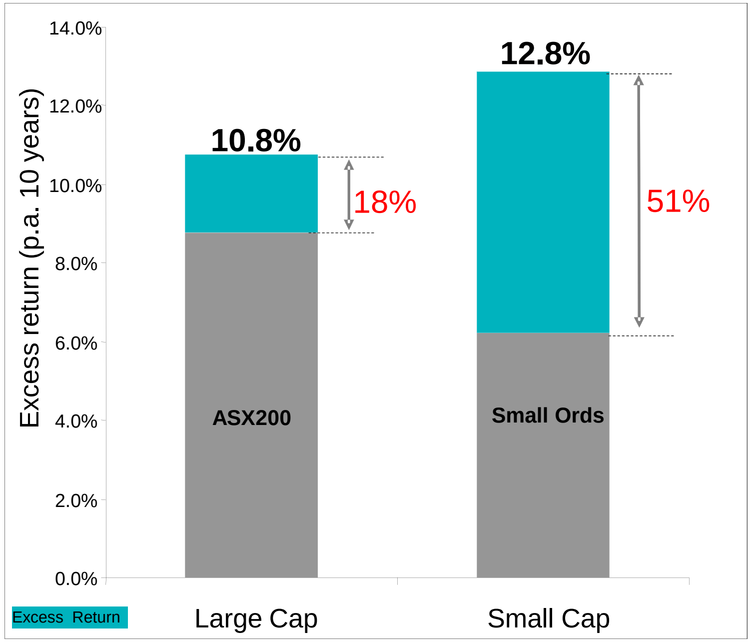
The scorecard for active small cap managers

- Significantly higher proportion of total return from excess return small caps vs large
- 51% of total return for small caps = excess. 18% of large cap total return = excess
- Highlights extent of value generated by active small cap managers



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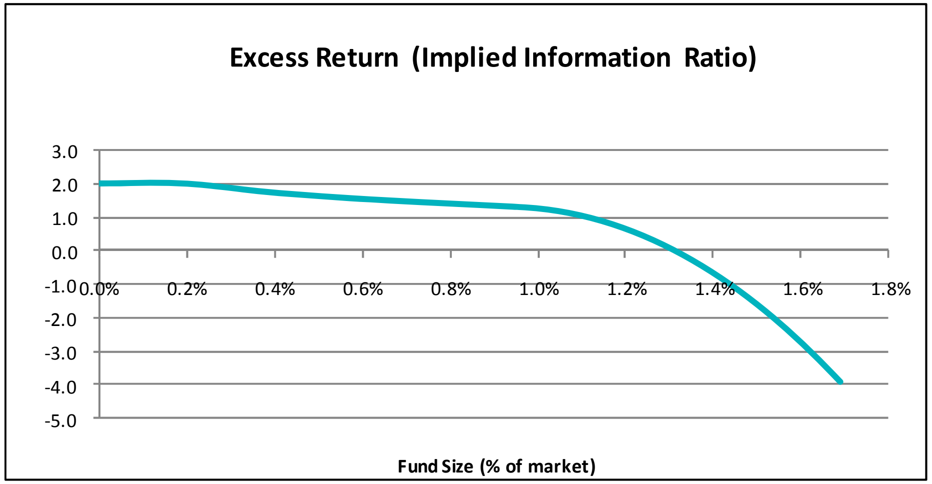
Is there a limit to funds under management?

- There is an inverse relationship between FUM size and the ability for small cap managers to consistently generate excess risk adjusted returns
- Practical limits around investible universe + market impact / implementation costs
- Of relevance is the proportionate consumption of daily turnover volume, or liquidity
- Potentially some restrictions around permissible % ownership of investee company



Source: Macquarie

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Are fee budgets being used efficiently?

- Fee budgets are directed to active research and proprietary insight within a segment with greater informational inefficiencies
- Capital allocation is efficient with the fee budget clearly directed towards specific alpha return generating opportunities (ie. not paying active fees for passive decisions)
- Persistent excess cross-sectional volatility exists to confirm that excess return opportunities are there to be systematically exploited
- The historical results of small cap investment manager excess and total return generation support a solid net return opportunity for investors
- Given relationship between funds under management (FUM) and excess returns, performance fee structures would appear to provide for a greater alignment of interests

Conclusions

- Given the more limited broker coverage, the smaller companies space favours the proprietary insight of experienced teams of investment managers

- The construct curve of the smaller companies benchmark strongly favours active management and ensures an efficient allocation of investor capital

- The dispersion of available stock returns highlights the extent of alpha generating opportunities for active managers

- Over time active small cap managers have indeed been shown to systematically generate excess returns for investors, and by some considerable margin

- There is an inverse correlation between the amount of FUM and excess returns. Performance fee structures should ensure that interests are sufficiently aligned

Fairview Equity Partners Emerging Companies Fund

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Why Fairview?

- Experienced and well resourced team enables comprehensive access to the smaller companies universe
- Compelling manager and investor alignment and firm FUM capacity constraints
- Benefits of early access associated with low maturity of the Fund
- Core active manager with strong process & risk controls provides for more consistent returns in all types of investment cycles

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Performance to 31 July 2010

Return & Risk metrics and portfolio summary statistics

Return	3 Months	12 Months	Since Inception*
Fairview Emerging Companies Fund	-5.1%	22.7%	21.4%
S&P/ASX Small Ordinaries Accumulation Index	-7.0%	7.3%	8.0%
EXCESS RETURN**	**1.9%**	**15.4%**	**13.4%**

* Annualised, Inception date: 8 October 2009

** Returns are net of fees and before taxes

Risk Metrics	Tracking Error	IR Ex post	Beta	Yield	F.11 PER
Fairview Emerging Companies Fund	9.0%	2.0	1.1	3.0%	9.3x

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Fairview Equity Partners Emerging Companies Fund

Fund Attributes	
Investment Objective	The Fund aims to provide long term capital growth and some income by investing primarily in a diverse portfolio of smaller companies listed, or expected to be listed, on the Australian Securities Exchange.
Fund availability	Directly and on most major platforms
Max. active stock weight	5%
Ratings	Zenith Investment Partners Pty Ltd: Highly Recommended, Recommended, Approved, Not Approved, Redeem; STANDARD & POOR'S FUND RATING ★★★☆☆ NEW; LONSEC Recommended
Target tracking error	5-7%
Target excess return	Vicinity of 5% gross
Proposed FUM capacity	$500-$600 million
Target portfolio turnover	40-60% p.a.
Number of stocks	25-55 (Current 50)

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