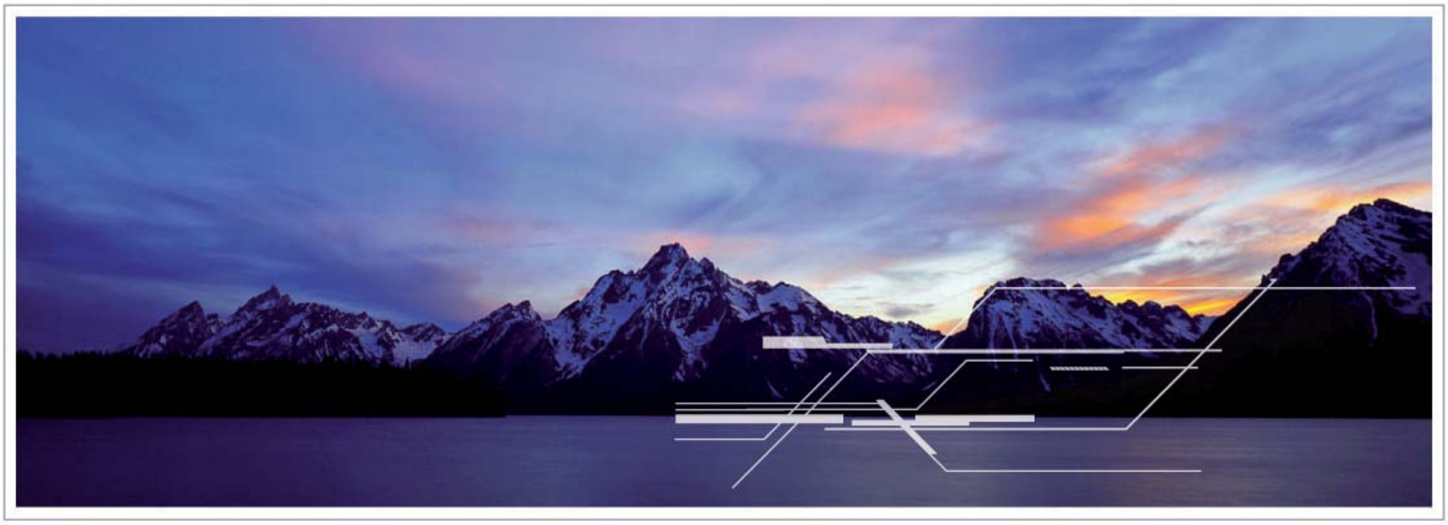

Zenith Sector Review

International Shares

September 2012

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1 INTRODUCTION

1.1 Background

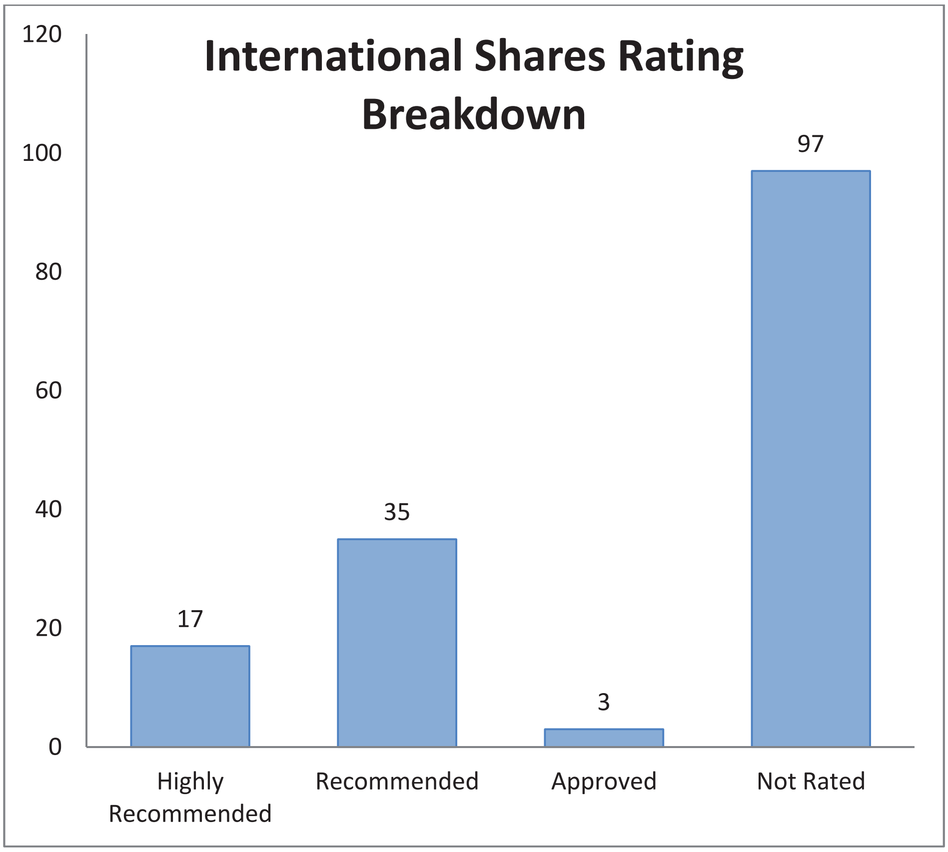
This report provides the output of Zenith's 2012 International Shares Sector Review. In this years review we have incorporated Global (Unhedged), Global (Hedged), Global Small Companies, Country (ex-Australia) and Global Regional Funds. This represents the largest sector review undertaken by Zenith, encompassing an initial universe of 152 funds.

The report highlights some key themes and issues facing the sector, a review of market performance, and also an outline of the universe screening and qualitative due diligence process that assisted Zenith in constructing its International Shares Recommended List.

The report should be read in conjunction with the Zenith research subscriber website (www.zenithpartners.com.au). This service provides access to up to date Fund Surveys, Fund Filters, Fund Charting, Model Portfolio Reports and individual Fund Reports (Product Profiles, Quantitative Reports, Product Assessment Reports - the latter being the primary output of Zenith's due diligence on funds that reside on Zenith's Recommended List).

1.2 Summary of Findings

From an initial universe of 152 International Shares products: 17 were rated "Highly Recommended", 35 "Recommended", 3 Approved and 97 "Not rated".



All funds rated "Approved" or above at the completion of the review are listed below.

2. KEY THEMES AND ISSUES

2.1. Gradual changes in approach to global portfolio management

Zenith believes that one of the biggest changes in global equity portfolio management over the last two decades has been how much top-down (think country, economic) factors have influenced the global equity portfolio construction decision making process. Going back 10, 15 or 20 years it was not unusual for country allocation decisions to be the focus of the portfolio construction decision making process. Research teams were aligned to reflect this and were typically assigned specific country coverage responsibilities. While there are certainly still investment managers, and global equity funds that operate using a predominantly top-down investment approach, in Zenith's experience, managers using this approach now fall into the minority. The emphasis of the global equity investment research and thought process has generally moved away from country allocation to that of a global sector focus, resulting in a company being primarily considered in the context of its peers within a sector regardless of the company's geographic location. Large equity investment managers with global research platforms have also gradually restructured their research teams to reflect this by constructing global sector specialist research teams, often across multiple office locations.

Country factors are definitely not ignored though. Global equity managers, or any investment manager for that matter, would typically consider top down issues as a part of the individual stock level research process, especially in light of the gfc, ongoing fallout as a result of the gfc, the European crisis etc, but the important question now being asked is "How does the stock rate within a sector on a cross border comparison basis?

It is interesting to note that the change from country to global sector specialist focus has not been truly 'global', with the division between developed markets and emerging markets largely remaining in place - although this division is definitely beginning to blur. Barriers that may once have existed, and imposed distance or a lack of connectivity in a global sense and therefore encouraged the separation between developed and emerging countries, are decreasing. The development of technology such as the internet, almost instant access to global events, the increased ease of travelling considerable distances are just a few factors that have played an important part in making the world become a smaller place. As a result, many developed market domiciled company's now generate an increasing level of revenues from emerging market consumers, and many emerging market domiciled companies are increasing their level of exports to developed market countries.

Zenith believes the flow through impact of this change is becoming evident in the portfolio construction approach and fund construction constraints for many managers. While there are differences that remain at a country level, such as differing listing requirements, sovereign risks, political environments etc, it would appear that where a company is domiciled is becoming less and less relevant. The overriding factor driving the stock research process is moving towards where a company's source of revenues or target market demand is coming from – not where a company is domiciled or listed.

At a fund or product level, Zenith is beginning to witness a gradual change in the underlying benchmark for global equity funds from the MSCI World Index to the MSCI All Country World Index – in other words, a broadening of a fund's potential investable universe. The MSCI All Country World Index is effectively a combination of the MSCI World and MSCI Emerging Markets indices. The expanded opportunity set this presents is clearly evident in the following table that highlights the constituent countries for the MSCI World Index (developed markets), the MSCI Emerging Markets and the MSCI All Country World Index (developed and emerging markets).

	MSCI World	MSCI Emerging Markets	MSCI ACWI
# of countries	24	21	45
Australia	*		*
Austria	*		*
Belgium	*		*
Canada	*		*
Denmark	*		*
Finland	*		*
France	*		*
Germany	*		*
Greece	*		*
Hong Kong	*		*
Ireland	*		*
Israel	*		*
Italy	*		*
Japan	*		*
Netherlands	*		*
New Zealand	*		*
Norway	*		*
Portugal	*		*
Singapore	*		*
Spain	*		*
Sweden	*		*
Switzerland	*		*
United Kingdom	*		*
United States	*		*
Brazil		*	*
Chile		*	*
China		*	*
Colombia		*	*
Czech Republic		*	*
Egypt		*	*
Hungary		*	*
India		*	*
Indonesia		*	*
Korea		*	*
Malaysia		*	*
Mexico		*	*
Morocco		*	*
Peru		*	*
Philippines		*	*
Poland		*	*
Russia		*	*
South Africa		*	*
Taiwan		*	*
Thailand		*	*
Turkey		*	*

Another related gradual change has been in the amount of a fund that can be invested in emerging market domiciled companies. Funds that may have once had a restriction on holding emerging market domiciled stocks may now be allowed to hold a portion of the portfolio in emerging markets, or funds that may have already had an emerging market allocation limit in place may have increased this limit.

In line with the move from country to global sector focus, Zenith believes the move to a truly global approach would appear to be the next logical step in the evolution of the global equity process. Product development in the global equity space is moving in that direction as well, especially with the introduction of investment strategies that specifically focus on the theme of the emerging consumer.

Zenith has had discussions with several managers that either have pure emerging consumer funds in development or have mandates that are currently being run for institutional clients or in other regions that are moving in this direction. For example, funds that focus on companies that are likely to benefit from the change in consumption patterns or aspirations as individuals move up the wealth scale. (To be fair this is a theme that many global managers are incorporating into their funds as well.) This could be as simple as the purchase or consumption of very basic goods, often domestically sourced or focused at lower levels of household income, right through to luxury and foreign sourced items at higher income levels. The investment focus of these funds is on finding companies that derive a moderate and/or growing level of total revenues, sales or earnings from the emerging consumer. Where the company is domiciled is essentially ignored.

As an individual investing in a global equity fund, the points mentioned above are all factors to be monitored and considered closely. There may come a time when you don't need to have separate global and emerging market funds - one fund might be able to provide you with exposure to both.

2.2. Economic Outlook

The majority of managers covered as a part of this review adopt a bottom-up, fundamentally driven approach to research, stock selection and portfolio management. No matter what asset class, style or investment approached used to manage a fund, the major point of focus for any portfolio manager or research analyst over the last few years has been the global financial crisis and the ongoing fall out from an overly indebted developed world. While all concerned would like to see the situation fixed in the short-term, this would appear rather unlikely. Rather than re cover what is already so widely reported, we think it is worth noting a comment we heard multiple times during our meetings with managers. “Given it took 10 years to get into this mess, it’s probably going to take at least that long again to get it sorted out!

2.3. Sector, Region and manager performance

The following table lists out performance for the MSCI World ex Australia Index (in $A) in addition to regional and sector returns.

Performance (in $A) as at 31 July 2012	1 mth	3 mths	6 mths	1 yr	2 yrs	3 yrs	4 yrs	5 yrs
MSCI World ex Aust $A	-1.56%	-3.89%	3.16%	2.33%	-0.09%	0.12%	-2.90%	-6.34%
Regional Performance (in $A)	**1 mth**	**3 mths**	**6 mths**	**1 yr**	**2 yrs**	**3 yrs**	**4 yrs**	**5 yrs**
North America	4.09%	-0.64%	3.55%	1.42%	21.37%	21.93%	6.16%	4.72%
Pan Europe	3.84%	-2.81%	-2.01%	-15.81%	9.57%	11.37%	-2.31%	-2.24%
Japan	0.21%	-5.52%	-4.62%	-16.21%	7.18%	7.77%	-2.11%	-3.02%
Pacific ex Japan	9.48%	0.97%	1.91%	-7.70%	17.14%	20.46%	7.06%	5.99%
Emerging Markets Asia	4.73%	-4.31%	-4.15%	-17.15%	9.79%	14.69%	5.60%	3.10%
Emerging Markets EMEA	5.23%	-3.87%	-3.83%	-18.37%	9.53%	17.61%	-0.13%	2.25%
Emerging Markets LatAM	4.04%	-7.57%	-11.32%	-17.95%	4.06%	14.94%	0.84%	5.78%
Sector Performance (in $A)	**1 mth**	**3 mths**	**6 mths**	**1 yr**	**2 yrs**	**3 yrs**	**4 yrs**	**5 yrs**
Consumer Staples	0.24%	1.81%	12.63%	16.76%	7.18%	6.13%	5.48%	2.61%
Health Care	-0.55%	1.80%	9.51%	14.12%	8.31%	3.48%	2.31%	-0.47%
Telecommunication Services	0.06%	5.90%	11.45%	6.77%	2.33%	1.37%	0.44%	-3.86%
Utilities	-4.16%	-1.44%	2.76%	1.00%	-6.37%	-6.08%	-8.48%	-7.49%
Consumer Discretionary	-2.70%	-6.84%	3.88%	4.41%	4.41%	5.28%	3.74%	-3.87%
Information Technology	-2.11%	-6.43%	4.63%	11.16%	3.30%	2.94%	1.39%	-2.61%
Industrials	-1.83%	-5.11%	-0.60%	-0.62%	-1.10%	2.51%	-3.06%	-7.01%
Materials	-3.36%	-10.49%	-10.00%	-16.49%	-6.37%	-3.62%	-8.63%	-8.06%
Energy	0.60%	-4.76%	-2.27%	-4.57%	2.79%	0.00%	-4.74%	-4.75%
Financials	-2.57%	-5.91%	1.68%	-5.77%	-10.50%	-7.99%	-11.80%	-16.47%

Please note the Regional returns are not constituents returns of the MSCI world ex Australia but the stand alone MSCI regional return.

Clearly, the market environment over the last 12 months has been difficult, with the MSCI World ex Australia ($A) index generating a modest positive return of 2.3%. When performance is viewed by region, the majority of regions shown above have experienced declines in the range of 15% to just over 18%. The US managed to generate a positive return of almost 1.5%, and was therefore a key driver of the overall positive return for the MSCI World ex Australia Index given the overall weight of the North American region in the index.

When performance for the MSCI World ex Australia Index is viewed by sector, the dispersion of returns over the last 12 months is much more evident. The financials sector continued to post negative returns. The energy and materials sectors have suffered with the decline in resource demand and commodity prices. On the positive side, sectors such as consumer staples, consumer discretionary, healthcare and technology have all fared well.

While certain investment styles (core, value, growth for example) are better suited to different market environments, if the unhedged global equity universe of funds rated by Zenith is considered, the market environment has generally been tough for all managers in an absolute sense, irrespective of style. If the universe is considered from a style relative perspective, value managers have generally outperformed their core and growth style counterparts over the short, medium and long-term (5 years).

2.4. Strength of the A$ and hedged vs unhedged returns

Although covered in previous reviews, the continued strength of the A$ and the decision to be unhedged or hedged remains a significant point of focus for investors.

For the past few years we have covered various aspects of currency hedging, concluding:

- A 50/50 blended approach is optimal for Australian investors;
- Terms of trade and interest rate differentials are major drivers of movements in the A$.

Listed out in the following tables are the returns for both the unhedged and hedged MSCI World ex Australia indices. While the strength in the A$ has been broad based against all major currencies, the A$/US$ cross-rate has been used as the basis for discussion given the importance of the US market to a global equity portfolio (based on the weighting within the underlying MSCI index).

Table 1: Annualised Index Returns as at 31 July 2012

	1 Yr (% p.a.)	2 Yrs (% p.a.)	3 Yrs (% p.a.)	4 Yrs (% p.a.)	5 Yrs (% p.a.)
MSCI World ex Aust $A	2.33	-0.09	0.12	-2.9	-6.34
MSCI World ex Aust Hedged $A	4.14	10.33	11.01	1.64	-1.3
Difference	-1.81	-10.42	-10.89	-4.54	-5.04

Table 2: Rolling Annual index Returns as at 31 July 2012

Fund Name	31/07/12 1 Yr(% p.a.)	31/07/11 1 Yr(% p.a.)	31/07/10 1 Yr(% p.a.)	31/07/09 1 Yr(% p.a.)	31/07/08 1 Yr(% p.a.)
MSCI World ex Aust $A	2.33	-2.45	0.53	-11.43	-18.9
MSCI World ex Aust Hedged $A	4.14	16.88	12.38	-21.98	-12.25
Difference	-1.81	-19.33	-11.85	10.55	-6.65

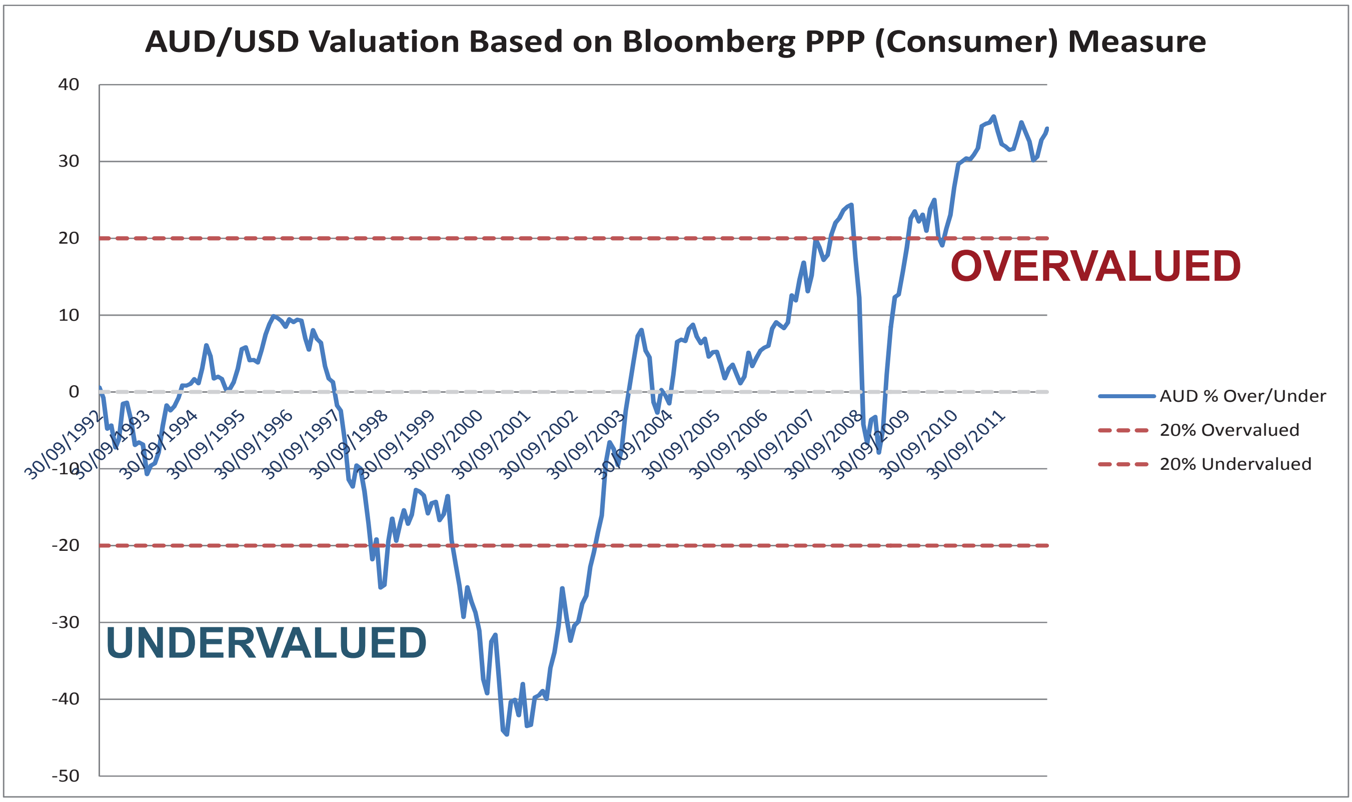
As can be observed in the above tables there has been a marked difference in performance between hedged and unhedged international portfolios over the last few years, with the hedged index generally outperforming the unhedged index, which may have prompted investors to reconsider their currency hedging.

If annualised returns for the MSCI World ex Australia $A Index and the MSCI World ex Australia $A Hedged Index are considered, investors would have enjoyed substantially better returns by being fully hedged over the past five years. In fact, as can be observed in the Rolling Annual Index chart, over the past five years investors would have been better off being hedged every year, with the exception of the 12 months ending July 2009.

However, the A$ is a highly volatile currency and can rapidly reverse course. That is, there will be times when unhedged portfolios outperform hedged portfolios, just as there will be times when hedged portfolios outperform unhedged portfolios (as has been the case in recent years, particularly as seen in the 2008 to 2009 period).

The following chart uses Purchasing Power Parity (PPP), to show how undervalued or overvalued the currency is at a point in time.

AUD valuation (%) versus USD – based on Bloomberg PPP (Consumer) Measure



All other things being equal, the more overvalued the currency is, the greater risk there is to a hedged fund given the potential for the currency to depreciate to the long run average. If the currency is undervalued, the risk is greater for an unhedged fund given the potential for the currency to appreciate to the long run average.

Zenith continues to believe investors are best served by adopting the 50/50 Unhedged/Hedged approach.

2.5. Environmental, Social and Governance (ESG)

Environmental, Social and Governance (or ESG) issues have the potential to add or detract from performance, with poor ESG practices particularly placing a company at risk. Zenith believes the Governance component of ESG has historically been well covered by investment managers via an assessment of areas such as company management (quality and track record), Board structure and composition, and compensation and incentive packages. Environmental factors such as climate change, sustainability, nuclear energy and hazardous waste, and Social factors such as human rights, consumer protection and animal welfare have sometimes been taken into consideration, although in Zenith's view, not to the same extent as the Governance factors.

In Zenith's view, the focus on the "E" and "S" side of ESG has increased considerably over the past few years and is now at the point that the majority of managers interviewed for this review formally incorporate E, S and G considerations into their research, security selection and portfolio management processes as a matter of course.

Several managers on Zenith's Recommended List are now a signatory to the UN-PRI (the United Nations-backed Principles for Responsible Investment Initiative). The UN-PRI is a network of international investors working together to put the following six Principles for Responsible Investment into practice:

- The incorporation of ESG issues into investment analysis and decision-making processes
- To be active owners and incorporate ESG issues into the firm's ownership policies and practices
- To seek appropriate disclosure on ESG issues from the entities in which the firm invests
- To promote acceptance and implementation of the Principles within the investment industry
- To work together to enhance the effectiveness in implementing the Principles, and

- To report back on activities and progress towards implementing the Principles

Zenith expects the increased emphasis on ESG issues by all managers is likely to continue.

2.6. What Zenith is doing?

Zenith believes it is not unreasonable to expect that the market environment will continue to be volatile going forward, with the global economic situation providing a significant headwind. Given that outlook, what is Zenith doing? Zenith's focus remains unchanged – that is, we are looking for high quality funds that we believe have a higher likelihood of outperforming over the long-term. Our focus is therefore on finding high quality portfolio management and research analyst teams, using a logical and consistent investment approach to pick stocks and construct portfolios that are likely to outperform.

Zenith's annual sector review results in the reappraisal of each fund's rating. While the shelf life of that rating is 12 months, it is important to note that we do not view the rating as a 'set and forget' rating for the next 12 months. We sit down formally with each manager on our Approved List once a year (our preference is to do that in the manager's office as you will see in the meeting register table listed out in the Due Diligence section of the report) to carry out a full review. In addition, we aim to maintain a continual dialogue and review of our incumbent approved list managers and managers that are potential additions throughout the year by holding additional meetings in person, via video or teleconference or exchange emails with managers. Internally, we also monitor each fund closely to ensure each fund is performing as per expected.

Details on the ratings outcomes of this review, funds that have been placed on Zenith's Approved List and any changes to the Approved List over the last 12 months are listed out in the following sections of this report.

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