Product Assessment

Zenith Investment Partners Pty Ltd

Highly Recommended
Recommended
Approved
Not Approved
Redeem

Selector Australian Equities Fund

31 May 2006

Selector Funds Management ("Selector") is a "boutique" in the true sense of the word, it comprises just two investment professionals, these individuals control 86% of the equity and the firm is an Australian equities specialist. Established in 2003 by co-founders Tony Scenna and Corey Vincent, Selector offers three products, which are in essence mirror images of one another, yet are pitched at the retail (this product), wholesale and institutional markets. Still in its infancy Selector is yet to gain any real market traction and as such funds under management is less than $15.0 million.

Like many of its peers it has a distribution / responsible entity "tie up" with a third party (DDH Graham) which allows the investment team to concentrate on "managing the money", which Zenith regards as best practice. With a 12 months track record now "under its belt" the Fund's absolute and risk adjusted performance numbers look solid. This style of Fund however will not suit all investors given it comprises a concentrated portfolio (15-25), is benchmark indifferent, can carry significant stock specific risk (max. 20% single stock) and can experience bouts of high volatility (max tracking error 15% p.a.).

The investment process has all the component parts and is well structured but is highly intuitively based from a filter / screening perspective and Zenith would prefer to see some greater rigour around how the valuation and "road map" (qualitative & quantitative scoring) analysis are brought together and flow through to the portfolio construction process.

While the investment team is well experienced and the skill sets are complementary (blending both "buy" and "sell" side), it comprises only the two founders which leaves it "thin on the ground" and covering all aspects of analysis, portfolio management and dealing. Zenith would prefer to see an additional junior analyst form part of the team which would give Selector some much needed "research grunt" given its top heavy structure while a further resource in an operational role would alleviate the business issues and sales / marketing from the investment team. Resourcing is an issue which faces all boutiques and is typically addressed as funds under management grows. Analysis undertaken by Zenith has highlighted the importance of adding the third and fourth investment professional to a boutique given the significant additional depth of resourcing and efficiency gains its brings.

Overall Zenith believes the Selector Australian Equities Fund is a solid offering but we would prefer to see some additional enhancements made to team and process before elevating it beyond its current Approved rating.

Key Features	***Description***
Asset Class	Australian Shares
Sub-Asset Class	Large Companies
Investment Style	Neutral
Benchmark	S&P / ASX 300 (Accum)
Recommended Investment Timeframe	5 + years
CIO & Portfolio Manager	Tony Scenna
CEO & Portfolio Manager	Corey Vincent
Investment Team Size	2

Cumulative and Monthly Net Performance

Performance Analysis

Performance Statistics	***1 Yr (% p.a.)***	***6 Mths (%)***	***3 Mths (%)***
Performance - Fund	42.52	16.62	6.23
Performance - Benchmark	27.33	9.97	2.40

Since inception the Fund has posted strong absolute performance, outperforming the S&P / ASX 300 Accumulation index by a significant margin. This is a benchmark Zenith applies to all Australian equity funds for consistency purposes and has been used in all quantitative analysis. It should be noted that internally Selector measure itself against the All Ordinaries Accumulation index (for performance fee purposes) although its portfolio construction pays little attention to the index as their process is "benchmark indifferent".

At the time of our review the portfolio comprised 18 stocks - two in the ASX top 50, six in the ASX 50-100, two in the ASX 100-200 and eight ASX ex-200. The portfolios top five holdings comprised Cochlear (11.2%), Pharmaxis (10.5%), Petsec Energy (9.2%), Kagara Zinc (9.1%) and SAI Global (6.7%). The Fund's smallest holding was a 1.6% weight in Macquarie Infrastructure Group, which illustrates the concentrated nature of the portfolio and the fact that all holdings are held at significant weights (75% of the stock holdings are held at weights of 3.0% or above). The portfolio held a significant healthcare (23.8%) and pharmaceutical (10.5%) bent and large cash holding (14.0%).

Consistency Analysis

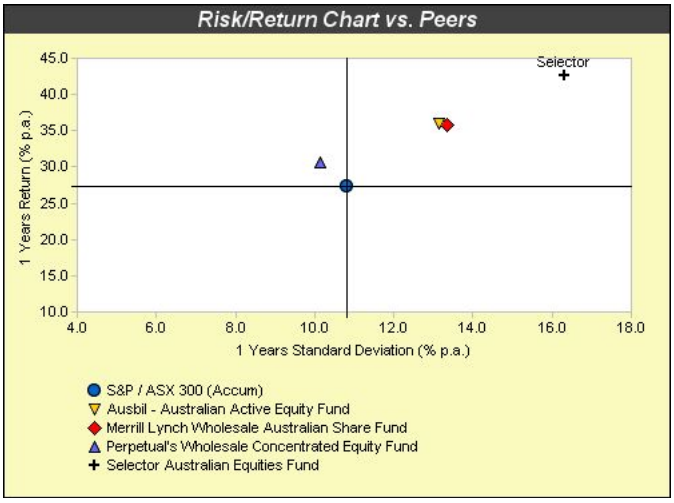
Consistency Statistics	*1 Yr*	*6 Mths*	*3 Mths*
History of Monthly Excess Return (%)	58.33	66.67	66.67
History of Monthly Excess Return (Rising Mkts %)	60.00	60.00	50.00
History of Monthly Excess Return (Falling Mkts %)	50.00	100.00	100.00

The consistency analysis is too short to draw any meaningful conclusions although the 1 year number which holds some relevance highlights monthly out performance above 50%, which Zenith views as evidence of persistence of manager skill. While we would like to examine the split between out performance in rising versus fallings markets over a longer time frame, the analysis to-date suggests a slight growth bias within Selector's investment process.

Risk / Return Analysis

Risk / Return Statistics	*1 Yr*	*6 Mths*	*3 Mths*
Information Ratio - Fund	1.41	1.35	0.75
Sharpe Ratio - Fund	2.25	1.46	0.37
Standard Deviation (% p.a.) - Fund	16.32	9.45	13.07
Tracking Error (% p.a.) - Fund	10.81	4.94	5.11

Given Selector is indifferent to the benchmark within its portfolio construction process, the Sharpe ratio is regarded as the most appropriate measure of its risk adjusted performance. A Sharpe ratio above 1.0 is an excellent result as it indicates the fund is delivering a greater amount of out performance (above the risk free rate - cash) for every unit of risk.



Investment Personnel

Name	*Title*	*Time with Manager*
Tony Scenna	CIO & Portfolio Manager	3 Yr(s)
Corey Vincent	CEO & Portfolio Manager	3 Yr(s)
Martin Greenberg	Chairman	3 Yr(s)

The two key principals within Selector are its founders Tony Scenna and Corey Vincent. Their backgrounds are complementary with Scenna coming from a "buy side" / funds management background while Vincent has spent much of his career on the "sell side" / stock broking. Scenna joined Perpetual Trustees in 1983 and before leaving 5 years later to establish Harper Bernays (individual equity portfolios for high net worth clients) with a former Perpetual colleague he was assistant portfolio manager of the flagship Industrial Fund. He then spent 14 years with Harper Bernays, the last 8 years as Managing Director and portfolio manager (circa $100m FUM when Scenna departed)

Corey Vincent's foray into funds management is his first although he does have considerable experience establishing businesses in the industry (jointly established Cameron Stockbrokers in 1994 and held a 25% stake, established VBM Capital in 2001 held 70% equity before exiting in 2005).

The investment process adopted at Selector leverages off Scenna's background and is of an "ex Perpetual" origin with a focus on quality of management, clear recurring earnings streams, low debt to equity and simple business structures. While described as style neutral, in Zenith's view the process has a slight "growth" bias.

Having operated under a consistent methodology since 1983 Zenith foresees very little "process risk" despite the Managers relative infancy. In Zenith's view both investment professionals bring complementary skills to the equation and while the arrangement with DDH Graham will largely remove all administration duties, which will allow Selector to concentrate on "managing the money", it is in this area we believe it remains under resourced. Adding a third and fourth investment professional is regarded by Zenith as the natural next phase in the life of a boutique and in Selector' case could add some much needed research grunt at a junior level to the investment team and introduce a dedicated operational role to allow Scenna and Vincent to focus solely on investment decision making.

Investment Process

Selector's business philosophy is built around some basic fundamental tenets - focus on the details, understand the business and never lose sight of the "big picture". While these tenets could be seen as "motherhood" statements or clichés, there is evidence that they are consistent with the underlying investment process. Selector is clearly a long term investor with its process willing to wear some "bumps and bruises" along the way in order to capture the prevailing sustainability of profits even if stock prices move in the opposite direction to fundamentals.

A key driver of its analysis is a focus on earnings and potential earnings growth while paying little attention to market "noise" and its over emphasis on the short term. Selector's investment style can be best described as bottom-up, benchmark indifferent and style neutral.

The objective of the Selector Australian Equity Fund is to generate over a 3-5 year time frame a compound growth rate of 15% per annum with volatility (measured by ex ante tracking error) expected in the 9-12% range although not targeted.

Security Selection

The Selector investment process starts with an examination of its investment universe, which comprises any listed Australian stock. It will typically not invest in property trusts, hybrids and debt structured investments and is required to seek approval of the Board on companies of a market capitalisation of below $50 million it wishes to invest in. Furthermore in line with the Managers simple philosophy it tends not to invest in complex company structures difficult to analyse (i.e. has stated unlikely ever to be invested in BHP, RIO or NCP).

The process of narrowing its research effort based on this initial universe is entirely subjective and reliant upon the experience of portfolio managers Tony Scenna and Corey Vincent. Filtering is principally done through "first cut" analysis undertaken through the Manager's company visitation program, review of annual reports, attendance at annual general meetings, broker meetings, conferences and tapping into a network of "other" sources. Given the "boutique" size of Selector (only 2 investment personnel) Zenith would prefer to see a formal filter in place to ensure opportunities are not missed. This could be coupled with the existing approach to ensure the current flexibility, which attempts to tap into the expertise of the key personnel, is not lost. While the Manager does pay attention to the "big picture" from a domestic and global macro economic sense (growth, inflation, corporate debt levels, interest rates, input costs, currencies, commodities etc) and is mindful of these issues, it is bottom-up stock selection which is the key driver of the investment process.

The starting point on Selector's company assessment is its company report, which is also referred to as the "Road Map". The Road Map introduces a discipline, repeatable and consistent aspect to the investment process which requires the formal scoring (0 or 1) of 9 qualitative factors and 11 quantitative factors. It is not regarded as a "black box stock picker" but rather a tool and component in the overall investment process. Key aspects of the Road Map assessment include an assessment of management qualities, owner qualities, business focus, growth opportunities, strength of business and balance sheet. This assessment is undertaken following each company review and allows the Manager to build up a historic "log" on a company which can be reconciled. Selector does not expect every company to score well under this review.

The Road Map is also used as a source of ongoing assessment on companies and is often used as an alert / catalyst on whether companies are hitting previously forecast milestones, used to identify fundamental / strategy change and to track any moves / trends in Selector's scoring of its criteria.

The bottom-up financial model built on a company sits outside the scope of Road Map and is the key valuation metric tool used by Selector. A discounted cash flow model (DCF) is not built, as the Manager does not believe long term numbers can be accurately forecast. The key criteria examined are the earnings profile and ratio analysis. Selector seeks to identify businesses with strong or improving ratios - namely return on equity (ROE), return on capital employed (ROCE), return on assets (ROA) and debt to equity. Selector's preference is to invest in stocks with little or not debt (avoids companies with high debt or equity issuance dependency and capital intensive businesses), a return on capital employed of 15% p.a, return on equity of 20%+ p.a. and a return on assets which justifies investment. The other key consideration in the process is the earnings profile of each stock, in particular earnings revisions and earnings per share (EPS) growth over 3 to 5 years. Can a company double its EPS over 5 years?

One of the key qualitative considerations is quality of management, which Selector views as critical. Key attributes sought in key company decision makers are integrity, drive and focus. The research effort at Selector is undertaken on a collective basis with no formal sectoral split of responsibilities. Both Scenna and Vincent will typically attend all company visits, which promotes cross fertilization of ideas, but Zenith questions the ability to cover a wide range of companies on this basis.

Overall the investment process is solid and robust with a standard template on company analysis supporting the Manager's boutique status. The investment process is not overly cumbersome, other than coverage of a large universe, yet addresses all the salient points.

Portfolio Construction

Portfolio construction is the "bringing together" of the three phases of the investment process - the macro view, the Road Map and the bottom up valuation assessment. Zenith would prefer to see greater linkage between the Road Map and valuation and some tighter guidelines on setting allowable active weights based on the outcomes from these two components of the process.

Scenna and Vincent manage the portfolio jointly and formally meet on a monthly basis. Each brings to this meeting an independently derived recommended model portfolio (comprising stock holdings and weightings) which Zenith rates highly as it ensures the views from both parties are tabled and discussed rather than the decision making being dominated by the "loudest voice". In practice, the differences tend to be weighting recommendations only with agreement on stock and strategy issues.

Given Selector is a long term investor, its portfolio turnover is low relative to its peer universe (circa 20%-30% p.a.). Selector runs a concentrated portfolio of 15-20 stocks and as a consequence it will typically take a significant position in a stock following its inclusion in the portfolio. If however the Manager is awaiting confirmation of a catalyst and / or a valuation shift it will typically build in 1% increments on an initial position. While intuitively the higher the conviction the Manager has on a stock the greater the weight in the portfolio, Zenith would prefer to see a linkage between this "conviction", the underlying work which is used to arrive at this view and portfolio weight. A portfolio matrix approach comprising Road map and valuation vs. stock price would ensure a tighter and more robust portfolio construction model.

All dealing is jointly shared by Scenna and Vincent. In Zenith's view this is problematic given the stretched resources sees them both acting as analyst, portfolio manager and dealer.

Risk Management

Portfolio Constraints	*Description*
Single stock holding	Maximum 7.5% (at cost)
Single stock holding	Maximum 20% (on price appreciation)
Two stock holdings	Maximum 35% (on price appreciation)
Tracking error (% p.a.)	max: 15% p.a. Typically range 9%-12% p.a.
Security Numbers	15 to 25
Weight - GICS Rel. Index (%)	None
Unlisted securities (%)	max: 5%
Cash (%)	0% to 20%
Portfolio Turnover (% p.a.)	Typically less than 30% p.a.
Liquidity	Max 15% holding in stocks with market capitalisation <$50 million
Gearing (%)	No
Short Selling (%)	No

The Fund is benchmark indifferent and has an "absolute" return orientation. As a consequence no formal risk management constraints exist on stock and sector weights relative to the index. It does however enforce a 5% limit on individual stocks (7.5% on high conviction holdings) based on cost at purchase. Discretion exists to move to 20% based on price appreciation.

In Zenith's view this "price appreciation" limit is too high and to potentially have 1/5th of the portfolio in a single stock carries too much stock specific risk. The Manager also has a 35% limit on two holdings. Selector is an "all caps" manager and as such the listed market is its investible universe although it can hold up to a maximum 5% in unlisted holdings. The Manager does not use "shorts" or derivatives within its mandate. A liquidity constraint of a maximum 15% of the portfolio comprising stocks with a market capitalisation of less than $50 million also exists.

Tracking error is typically not targeted although the portfolio is constrained to a maximum limit (ex ante) of 15%. A tracking error constraint at this level is significantly higher than its mainstream peers (3-5 times). Cash is constrained within a 0-20% range.

While the Fund's risk management parameters are very broad, in Zenith's view they are generally in line with the fund's objectives and strategy.

Risks of the Fund

As is the case with all Australian equities based products, the biggest risk to this Fund is a sustained downturn in the Australian shares sector. This risk can be significantly reduced by investors adopting a medium to long-term (five+ years) investment time frame when investing in this Fund.

Other key risks to be considered include:

- The Manager is still in its infancy (established 2003) and despite the fact that both key investment professionals have significant funds management / stock broking backgrounds, as a new firm they have only a short track record;
- The portfolio is concentrated by design (15-25 stocks), up to 20% in single stock allowed, benchmark indifferent and volatility (tracking error) is not managed. As a consequence investors need to be aware that the Fund will likely exhibit greater volatility than mainstream equity funds and performance may differ significantly from that of the market; and
- Given the investment team comprises only two investment professionals (its co-founders) there is a high level of "succession risk" relative to its mainstream peers who run much larger teams and can more readily fill any vacancy. To counteract this however we believe "boutiques" have less keyman risk from a potential departure perspective as the key personnel are typically the owners of the business and thus "locked in" through equity.

Applications of the Fund

1 year Excess Correlation Table	
Fund Name	***Excess Correlation***
Ausbil - Australian Active Equity Fund	0.18
Merrill Lynch Wholesale Australian Share Fund	0.27
Perpetual's Wholesale Concentrated Equity Fund	0.03

Selector is yet another "boutique" targeting the retail market and like many of its peers it has a "tie-up" with a distribution partner, DDH Graham. This relationship alleviates much of the marketing and administration burden. While there are a number of high profile boutiques who have posted strong long term performance since their inception (Platinum, IML, Orion, 452 etc), investors need to be reminded that just like mainstream managers it will be the quality of the underlying personnel and the process which will ultimately drive returns not the fact they are a "boutique".

Boutique managers tend to appeal to investors who are more interested in absolute rather than relative performance given many of their products tend to have less restrictive investment mandates. The Selector Australian Equities Fund is no different given its benchmark agnostic approach which should complement a mainstream fund which tends to more closely track an index.

Operating a style neutral approach the Fund will blend with both value and growth orientated vehicles given it has no particular style persuasion. The Fund can hold up to 20% cash (14% at time of review) so investors need to be mindful of the fact that they may not always be fully invested if using this product.

Author: David Smythe
Director
Email: david.smythe@zenithpartners.com.au
Ph: (03)9642 3320
Fax: (03)9642 3319