S&P FUND RATING ★★★★☆

K2 Select International Absolute Return

Analyst(s): Tom Mills; Michael Armitage

Standard & Poor's View

Standard & Poor's Fund Services rates this fund four stars. This reflects our high conviction that the manager will consistently generate risk-adjusted returns in excess of relevant investment objectives and relative to peers.

At the firm's inception in 1999, K2 focused on Australian and Asian strategies, before expanding into international markets with this offering in 2005. Although the investment team is based in Australia and has relatively greater experience in Australian and Asian investing, it includes individuals with overseas investment experience, and has added to its international portfolio-management team since our previous review. We have conviction that K2 can successfully apply its expertise and process to international investing.

The investment approach combines a flexible mandate that has the ability to adapt to differing market climates, with a level of diversification among the different portfolio managers' trading styles. The fund's long/short mandate allows K2 to take advantage of both rising and falling markets, and given its proven stock-picking abilities, this is a clear attraction. The manager actively adjusts net equity exposure based on its strategic outlook, and tactical views. Net exposure typically is long, but K2 has the flexibility to alter this according to its view on the markets at any given time.

Although the fund's performance since inception is slightly below its 15% absolute return objective, having suffered a large drawdown during the global financial crisis, it has a creditable track record, achieving net annualised returns of 13%, and comfortably exceeding the index while controlling volatility of returns. We consider that K2 is capable of maintaining strong absolute performance in the future.

A 20.5% performance fee is charged on the fund, but unlike the other K2 funds, there is no hurdle other than exceeding the fund's high water mark. Although the performance fee serves to align the portfolio managers with investors, we consider the lack of a suitable hurdle to be a detracting feature of this offering.

Investor Suitability

- The offering may be considered as a core alternative equity holding in a larger portfolio.
- This is a long/short strategy with a focus on absolute returns and can be expected to reduce drawdowns in negative markets.
- Portfolio turnover of around 400% a year is very high and will affect after-tax returns.
- This product may be suitable for investors with an investment time horizon of at least three to five years.
- Investors should be aware that this fund invests in Australian as well as overseas stocks.

Key Strengths

- K2's process effectively blends top-down and bottom-up analysis and is well structured to deliver absolute returns in various market environments.
- The multiple-portfolio-manager approach provides diversification of styles and returns.
- Staff are strongly aligned with the performance of the fund and the broader business.

Key Weaknesses

- The manager has set a low performance fee hurdle for this product. This is a less challenging hurdle than is the norm and we consider it a detracting feature of this product.

Risks

- The fund's currency exposure is not always fully hedged, which may result in loss beyond equity market exposure.
- The fund can take short positions, which have an unlimited loss potential, although the manager adheres to disciplined stop-loss limits.
- Loss of key principals, who play a critical role in the investment process, is considered a minimal risk due to the high level of equity ownership and staff co-investment in the funds.

APIR code	ETL0046AU	**Investment manager**	K2 Asset Management Ltd
Fund status	Open	**Redemption policy**	Daily
Inception date	Dec. 31, 2004	**Distribution frequency**	Annual
Responsible entity	K2 Asset Management Ltd	**Return objective (%)**	15
Peer group	Alternative Strategies - Equity Beta Variable	**Average portfolio turnover (3yrs) (%)**	400
Benchmark	MSCI World NR AUD	**Maximum cash holding (%)**	100
Investment style	Absolute Return		
Multi manager	No		
Fund Size ($A)	242.0 .mil (at July 31, 2011)		
Minimum investment (A$)	20000		
ICR / MER (%)	2.21	**Release authorised by**	Leanne Milton

Objectives, Fees and Features

The fund targets an absolute return of 15% per year, after fees, over a three- to five-year cycle, with volatility at or below the benchmark.

K2 charges a 1.5375% management fee, and a 20.5% performance fee is applied to returns above the fund's high water mark. Unlike other K2 funds, which must exceed both their high water marks and a net 6% performance hurdle, no hurdle rate is attached to the Select International fund's incentive fee. Although the performance fee provides an incentive to the portfolio managers, we consider the lack of a suitable hurdle to be a negative. We also feel that the fund's performance fees could be structured better to reflect the net long exposure, and prefer to see net long managers being benchmarked against an equity index, or a combination of equity and cash indices, or a cash index plus an appropriate hurdle.

A buy/sell spread of 0.4%/0.4% applies to applications and redemptions. Daily subscriptions and redemptions are offered.

Fund Objectives

Target return (% p.a.)	15
Target volatility (% p.a.)	Lower than MSCI World Index

Source: K2 Asset Management Ltd.

Fund Fees

Indirect cost ratio	2.2 (as at 30/06/2010, including GST)
Management fee (% p.a., including GST)	1.5375
Reclaimable expenses (%p.a.)	N/A
Other fees (note, swap, fx, etc.)	N/A
Performance fee (% p.a.)	20.5
High water mark (Y/N)	Yes
Hurdle rate	Zero
Buy/Sell spread	0.4/0.4

Source: K2 Asset Management Ltd.

Investment Philosophy and Style

K2 is an absolute return manager with a focus on preservation of investor capital. It invests on a long/short equity basis in international markets, but the fund is considered long-biased. K2 adopts a flexible net equity exposure ranging from 100% net long to cash to 30% net short.

In May 2010, K2 altered its constitution so that leverage cannot be used in its funds. This did not represent a change in its approach, for while it previously had the ability to do so, in practice the manager did not make use of its capacity to gear the funds. The fund's net invested position will not exceed the net asset value. The fund uses a blend of both top-down and bottom-up analysis. The multi-style through the multiple-portfolio-manager approach seeks to minimise exposure to any single investment style and deliver attractive returns through a range of market conditions.

Investment Team

K2's investment team comprises 10 portfolio managers, six of whom are portfolio managers for the international fund. The team is well-resourced in our view, and has sufficient levels of back-up, ensuring each geographic region has more than one individual who can make investment decisions. Although the investment team has gained much of its experience in Australian and Asian investing, it contains members with broader international experience and is in our view capable of applying its insights to international investing.

K2 does not employ dedicated research analysts, and portfolio managers are responsible for conducting all research. The portfolio managers are supported by two systems analysts, who contribute to the investment process by maintaining and developing stock screening and other tools used by the portfolio managers.

Mark Newman, chief investment officer (CIO), is a member of the asset-allocation committee responsible for allocation of capital and the expected return to be generated by each portfolio manager. This is reviewed quarterly. The net equity exposure range committee for Select comprises Mr. Newman, Campbell Neal, and Nick Griffin. The first two are permanent members, with the third position reviewed semi-annually. This committee determines the net equity exposure range for the fund fortnightly on the basis of internal and external analysis and an assessment of key macroeconomic variables. In this regard, the reliance on Mr. Newman has been reduced. Mr. Newman has 25 years' experience in funds management and is one of the founding principals of K2. Previously, he was a director of HSBC Asset Management for 10 years and CIO Asia of the Abu Dhabi Investment Authority for four years.

Mr. Griffin is head of international strategy. He joined K2 in 2005 and has 16 years' finance industry experience, including nine years in funds management. Before K2, Mr. Griffin spent six years as a global oil and gas analyst with Deutsche Bank in the U.K. Before that, he was an investment manager with CFS in Australian equities. As head of international strategy, Mr. Griffin helps Mr. Newman determine the net equity exposure range of the international fund based on current market conditions.

In addition to Mr. Newman and Mr. Griffin, portfolio managers Mr. Neal, Roger Watson, David Poppenbeek, and Jeff Thomson also contribute to the International Fund. Mr. Thomson was the most recent member to join the team, in early 2011. Mr. Thomson has 15 years' finance industry experience, beginning his career as a sell-side analyst, before working for 11 years in funds management roles in Europe. He has managed European and global long/short portfolios, including a global financials fund, and has specialist analyst experience covering the financial, property, media, and telecommunications sectors. We consider Mr. Thomson a good quality addition to the team, adding to its international investment experience. He is portfolio manager, Europe and U.S.

Nick Reddaway, who was a portfolio manager on the Select International strategy, departed from K2 in June 2011. He had been with K2 for three years. This has led to Mr. Thomson increasing his capital in the strategy. We do not view Mr. Reddaway's departure as a concern in terms of team culture or resourcing. Prior to this, the last departure occurred in 2008.

We consider the international portfolio-management team to be suitably skilled in stock picking, with each team member providing an independent thought process and investment style to the portfolio. Although portfolio managers exhibit a level of independence, research is somewhat influenced by Mr. Newman's macroeconomic outlook and view. Each portfolio manager is given significant autonomy in their portfolio buy/sell decisions.

K2 does not have dedicated research analysts, although it has two dedicated systems analysts, Maciej Swida and Andrew Poppenbeek, who develop and maintain the systems underpinning the investment process. Andrew Poppenbeek, who joined K2 in February 2010, previously worked as a quantitative analyst at MIR Investment Management, and has made considerable enhancements to the stock filtering system that the portfolio managers use.

Key Investment Personnel

Name, Position	Years*	Experience†
Mark Newman, chief investment officer, senior portfolio manager, Asia	11	25
Nick Griffin, head of international strategy, Europe and U.S.	6	16
Campbell Neal, senior portfolio manager, Australia and Asia	11	24
Rob Hand, senior portfolio manager, Asia	9	21
David Poppenbeek, senior portfolio manager, Australia	6	20
Roger Watson, portfolio manager, Asia	4	14
Jeff Thomson, portfolio manager, Europe and U.S.	<1	15
Average tenure with current firm	7	N/A
Average industry experience	N/A	18

**Years with current firm. †Years of relevant industry experience.*

Alignment and Accountability

Portfolio managers receive a base salary, plus a performance bonus determined by their contribution to fund performance, as long as the funds achieve a performance fee. Portfolio managers are assigned a basis point budget at the start of each financial year, based on their allocation of capital (which is reviewed quarterly), both of which are determined by the head of strategy and CIO. Performance is assessed over a 12-month period, based on each member's return on capital employed. This links portfolio managers' remuneration to the success of their stock picks, and aligns them with the interests of investors. Payment of 25 percent of any bonus is offered as equity, vesting over a three-year period. This effectively provides a rolling lock-in incentive to portfolio managers.

As a listed entity, K2 is able to attract staff by offering equity ownership. There is a very high level of staff ownership—86%—which further aligns the investment team with K2's performance. Around 70% of the equity is held by the founders.

There is a high level of staff co-investment, and each director has a significant proportion of their own capital invested in the K2 funds. None of the K2 directors invests in shares outside the company funds, aligning interests and ensuring efforts are focused on the business.

Inexperienced — Experienced
Small — Large
Unstable — Stable

Investment Process

Overview

K2's multi-portfolio manager, flexible investment style enables it to tailor its approach according to the current phase of the economic cycle, with the aim of maximising risk-adjusted returns in any market conditions. Its investment approach is a blend of top-down and bottom-up research, including macro and thematic analysis, as well as fundamental bottom-up stock analysis.

K2's top-down assessment of the economic environment plays a significant role in determining its portfolio construction and investment style. For example, as the cycle picks up from a trough, it will remove shorts and add beta and momentum stocks. Later in a market recovery, it will add small-cap and high alpha stocks.

Weekly investment meetings are used to discuss and propose the fund's net exposure guidelines. Net exposure can be adjusted if needed, for example if a significant event or correction occurs. To a large degree, the exposure guidelines are set by the asset-allocation committee as a result of the CIO's macroeconomic input to the meeting, drawing on his current views of macroeconomic conditions and outlook, but all team members provide input to the discussion, with the head of each strategy presenting a formal view at the monthly strategy meeting.

The meeting also results in style and sector biases being established, providing a basis for portfolio managers to invest allocated capital. K2 has developed a systematic approach to allocating capital to portfolio managers based on their short- and long-term performance, as well as their track record in different parts of the market cycle. This system is designed to allocate capital according not only to past performance, but also with some regard for each manager's propensity to outperform in a given market environment. Capital is reallocated among portfolio managers quarterly.

Portfolio Construction

K2 does not use a single investment approach to stock picking; rather, each portfolio manager brings his own style and methodology of investing to the portfolio. Each portfolio manager invests in a disciplined and consistent manner. They also have the autonomy to allocate allotted capital as they see opportunities arise, both long and short, in accordance with their individual investment process. Having individual investment processes for each portfolio manager provides some diversification benefits, with returns not reliant on a single process.

Portfolio managers attempt to identify market themes or catalysts that would enable K2 to exploit perceived undervalued and overvalued stocks. Long portfolio positions are split into three categories: core positions, trade positions, and high-alpha positions. Trade positions are held for a limited time, largely reflecting a short-term momentum or trade focus, while core positions are held for longer and usually require a deeper understanding of company fundamentals. High-alpha refers to investments in biotech or small resources where tighter constraints are required. Although portfolio managers invest autonomously, they adhere to K2's portfolio-construction rules regarding position sizes.

The team uses a mixture of top-down and bottom-up styles of stock picking, and rotates among growth, momentum, value, and income investing, ultimately using the style best suited to the markets at any given time. K2's ability to adapt and react to different market environments is an attractive feature of the fund and allows it to generate returns through all market cycles. Portfolio turnover is subject to net exposure and market cycle; however, it is typically in the range of four to five times each year. The stop-loss triggers, used for risk-management of long and short positions, form part of the sell discipline. A long trade position that is unprofitable after 30 days is automatically reassessed, with approval needed to retain it for another 30 days. This ensures that positions are justified and that ideas must compete for capital.

Risk Management

High emphasis is placed on preservation of capital, which is largely reflected in the fund's net exposure. In managing this, K2 can use tools such as short selling and allocating capital to cash. A large cash allocation would be the result of limited investment opportunities in the market.

Formal risk controls largely encompass stop-loss limits, which apply to both long and short positions. These provide some comfort if a stock rapidly moves against the portfolio manager. Portfolio-construction rules limit position sizes according to stock size, beta, and liquidity. Sector and regional exposures, although not formally constrained, are discussed informally among the team to avoid any concentration in a particular industry or country.

K2 has initiated various levels of portfolio stress testing, allowing the managers better prediction of risk and return outcomes of portfolio buy and sell decisions. The portfolio is monitored live, showing portfolio positions relative to stop-loss guidelines. Significant emphasis is placed on the liquidity of portfolio stocks, with K2 reluctant to enter stocks that have poor liquidity. Generally, over 90% of the portfolio can be liquidated within 48 hours, an attractive risk-management feature. Overall, we feel that K2 provides appropriate risk procedures and controls for the portfolio given its investment style.

Monthly Net Exposure of the Fund

Source: K2 Asset Management Ltd.

Risk Constraints

Maximum gross exposure	100
Maximum net exposure	100
Maximum position	10
Maximum cash holding (%)	100
Average portfolio turnover (1 yr) (%)	400

Currency Management

Currency positions are hedged opportunistically. If K2 establishes a case for a currency to weaken, it will apply a hedge to that position back to Australian dollars. Otherwise, K2 will hold naked currency positions in the portfolio. Mr. Newman actively manages and determines the hedged position with the help of macroeconomic discussions with the team; however, it is ultimately his decision. The hedged position typically ranges between 50% and 100%. Investors are exposed to currency risk.

Product Features

The fund invests in international listed equities (including Australia) in a portfolio of 80–120 stocks. The fund seeks to add alpha via its short positions, and will invest in cash for capital preservation. K2 adopts a flexible net equity exposure. Investors should be aware that turnover is expected to be around 400%.

K2 uses the London branch of Morgan Stanley & Co. International as the fund's prime broker. In 2010, K2 moved to a custody agreement with custodian Morgan Stanley Private Bank National Association (MSPBNA). K2 states that MSPBNA is bankruptcy independent from Morgan Stanley's U.S. prime broker and U.K. broker/dealer organisations, and that prime broker client assets would not be available to creditors of MSPBNA. We take a positive view of the separation of prime brokerage and custodial functions.

Additionally, investors should understand that the fund may borrow shares to sell short. Typically, the fund will post collateral for this credit facility with the prime broker. The prime brokerage agreement enables the prime broker to re-lend or re-hypothecate these securities, presenting credit risk for investors in the fund. We view K2's exposure to this risk as low due to their limited use in short selling of securities.

Performance

K2 seeks to achieve an absolute return, implying a positive return in all market conditions, but unlike many other absolute return managers, it states a target return of 15% per year over a three- to five-year investment cycle for the international fund, net of fees.

The international fund began investing in January 2005 and now has a track record of over six years. Since inception, the fund has produced positive absolute returns in each calendar year barring 2008, when the fund returned -22.44%, compared with the benchmark return of -26.76%. This was disappointing given the fund's absolute return objective, and its ability to use cash to protect capital in a bear market. However, we note that the fund has nevertheless produced an absolute return of 12.9% per year (net of fees) from inception to March 31, 2011, outperforming the benchmark by 11.8% per year. This is an impressive achievement given the fund's average net exposure of 69%, and demonstrates K2's ability to add alpha.

Since inception, the fund's standard deviation has been slightly greater than that of the index. Over the year to March 31, 2011, fund volatility was more pronounced relative to the index, reflecting average net exposure of 88%, higher than the long-run average exposure.

S&P considers that K2 is capable of maintaining strong absolute performance in the future. The fund is currently around 10% of its assessed capacity, with significant room to grow without damaging future returns.

Cash levels average 31% but have ranged from over 80% to as low as 2%. The manager has used cash to protect returns, with the fund producing positive returns in 68% of months since inception. K2 has not made extensive use of shorting in this strategy, with average gross short exposure of -3.2% since inception.

Risk and Return Analysis (at March 31, 2011)

Annualised return since inception (% p.a.)	12.9
One-year return (% p.a.)	10.9
Standard deviation since inception (% p.a.)	12.5
Rise in NAV since inception (%)	113.3
Monthly MVaR fund (%)	(-46.39)
Monthly MVaR benchmark (%)	(-28.16)

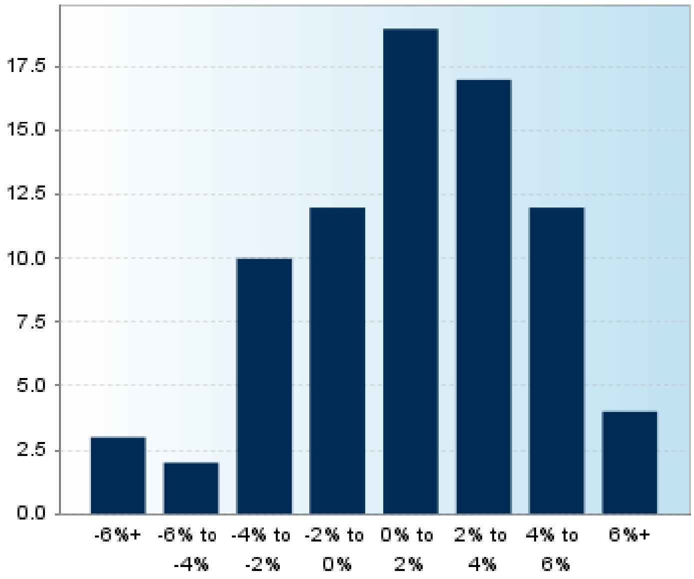
Source: K2 Asset Management Ltd.

Performance Measures (at March 31, 2011)

Best monthly return (%)	10
Worst monthly return (%)	(-9.7)
Positive months (%)	68
Maximum drawdown (%)	(-30.4)
Maximum drawdown period	16
Months to recovery	36
Skew	(-0.52)
Kurtosis	0.29

Source: K2 Asset Management Ltd.

Distribution of Monthly Returns



Source: K2 Asset Management Ltd.

Funds Under Management Table (at March 31, 2011)

Current pool size ($)	234.8 million
Total FUM in strategy ($)	234.8 million
Estimated capacity for strategy ($)	2 billion
Total FUM across all asset classes ($)	1031.5 million
Net strategy flows over past 12 months ($)	+40.9 million

Source: K2 Asset Management Ltd.

Management Group Profile

The business is an Australian Securities Exchange (ASX) listed company, with a majority ownership by entities related to the four executive directors (Mr. Newman, Mr. Neal, Mr. Hand, and Hollie Wight). There is some equity participation by other team members and a passive investor. K2 is 86% staff owned, with around 70% of the stock held by the founders. Each director has a significant proportion of their own capital invested in the K2 funds. None of the K2 directors invests in shares outside the company funds, aligning interests and ensuring efforts are focused on the business.

The business was listed in 2007. The manager believes that it will be easier to attract staff with equity and investors with transparency of valuations and a regulated reporting environment.

K2 demonstrates a compliance ethic through internal control procedures that are detailed in the K2 compliance manual. The manual outlines rules, management controls, procedures, and the responsible person for monitoring adherence to rules. K2's prime broker is Morgan Stanley in Hong Kong. The custodian is Morgan Stanley Trust National Association. The fund administrator is State Street Australia Ltd.

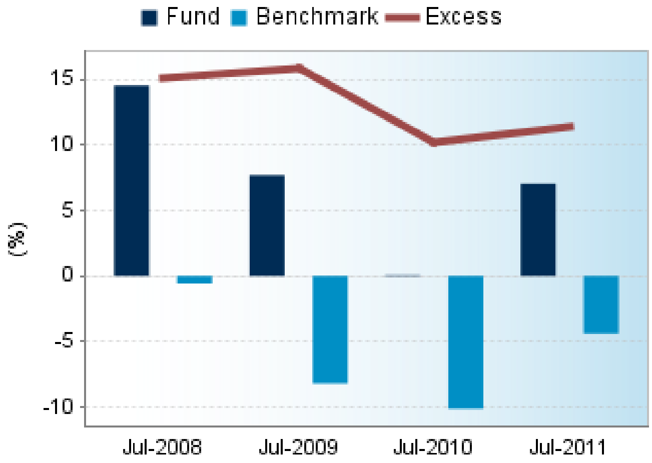
Funds Under Management

As of May 2011, K2 managed more than A$1,047 million across three strategies: Asian, Australian, and Select International. The international strategy was the most recent K2 strategy to be launched, in January 2005, and is currently at A$248.4 million. The capacity limit on this fund has been set at A$2 billion, giving it substantial room to grow. K2 remains focused on its existing products and does not currently plan any new funds.

Since 2005, K2 has diversified its investor base, steadily reducing the concentration of FUM represented by institutional clients by gaining substantial inflows from retail investors and platforms. Institutional money represented over half of K2's FUM in 2005, but now makes up 36% of the total.

Performance Analysis

3yr Rolling Returns, Over 5 Years



Source: K2 Asset Management Ltd.
Benchmark: MSCI World NR AUD.

Annualised Net Returns % (at July 31, 2011)

	1 Year	3 Years	5 Years	10 Years
Fund performance (% p.a.)	10.9	7.05	7.67	-
Income (% p.a.)	8.69	4.78	5.47	-
Growth (% p.a.)	2.21	2.27	2.2	-
Benchmark performance (% p.a.)	(-2.31)	(-4.39)	(-5.29)	-
Excess return (% p.a.)	13.21	11.44	12.96	-
Peer group return (% p.a.)	2.51	3.7	1.36	5.67
Standard deviation (%)	10.64	14.74	13.12	-
Sharpe ratio	-	0.24	0.22	-
Information ratio	-	0.17	0.17	-
Tracking error	-	14.87	13.23	-

Benchmark: MSCI World NR AUD.

S&P FUND RATING ★★★★

K2 Select International Absolute Return

STANDARD & POOR'S

Fund Rating Philosophy

A star rating is a forward looking assessment of a manager's ability to consistently generate risk-adjusted returns (net of fees) in excess of both its relevant investment objectives and its peers.

Fund Rating Process

In assigning a star rating to a fund, Standard & Poor's evaluates: the size, skill, and stability of the manager's investment team; the clarity, implementation, and risk management of the investment process; the fund's objectives, fee structure and portfolio characteristics; and the manager's business management.

Fund Rating Definitions

S&P FUND RATING ★★★★★	Standard & Poor's has very high conviction that the manager will consistently generate risk-adjusted fund returns in excess of its relevant investment objectives and relative to its peers.
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S&P FUND RATING ★★★	Standard & Poor's has conviction that the manager will generate risk-adjusted fund returns in-line with its relevant investment objectives and relative to its peers.
S&P FUND RATING ★★	Standard & Poor's has conviction that the manager will not generate risk-adjusted fund returns in-line with its relevant investment objectives and relative to its peers.
S&P FUND RATING ★	Standard & Poor's has high conviction that the manager will not generate risk-adjusted fund returns in-line with its relevant investment objectives and relative to its peers.
S&P FUND RATING ON HOLD	Issues that may affect the fund's management have emerged; and the fund rating is temporarily suspended, pending clarification.
S&P FUND RATING SELL	Significant issues exist that potentially will adversely affect the fund's performance. Investors should consider obtaining advice on switching or redeeming funds.
NEW	**Fund Rating Subscript**—here the investment process, fund manager, or the fund has a relatively short history, or the analytical team has changed significantly, but a relevant and demonstrable track record is shown on similar funds.

Glossary of Terms

Benchmark	The standard (e.g. an index) by which an investment is measured against to evaluate performance.
Excess Return	Return of an investment relative to its benchmark.
FUM	Funds Under Management - The total value of the funds managed by an asset management firm.
High Water Mark	The highest net asset value (NAV) of a fund achieved to date. If the NAV of a fund falls below this level, no performance fee will be payable to the investment manager until this level is subsequently exceeded.
Hurdle Rate	A minimum rate of return that a fund must achieve before a performance fee can be charged. This can be the benchmark or the benchmark plus an additional fixed rate.
Performance Fees	A fee payable in excess of the ongoing management fee. There is often a hurdle rate and/or high watermark that must be reached before this fee is payable.
ICR-Indirect Cost Ratio	This is a ratio of indirect costs to the total investment in a particular fund expressed as a percentage. It includes the MER, expense recoveries, performance fees and other costs associated with running the fund.
Information Ratio	Is a measure of the relative reward for the relative risk taken (excess returns of an investment (above the benchmark) divided by the tracking error). A positive information ratio would indicate efficient use of risk by the manager.
MER-Management Expense Ratio	This ratio is a calculation of investment management, marketing, trusteeship, legal, accounting and auditing costs of a managed investment fund expressed as a percentage of a fund's net asset value. It is the ongoing charges for managing a fund.
Peer Group Return	The average return of the funds in the relevant S&P peer group.
Sharpe Ratio	Is a measure of risk-adjusted performance, measuring the absolute reward for the absolute risk taken (return of the investment less the risk-free rate (e.g. bank bills) divided by the standard deviation). The higher the Sharpe ratio the greater the efficiency produced by the manager.
Standard Deviation	Measure of the variability or volatility of the monthly returns of the fund.
Tracking Error	How closely a portfolio follows or "tracks" an index to which it is benchmarked. (the standard deviation of monthly excess returns against the benchmark).
Ex Ante Tracking Error	Predicted or forecast of tracking error.
Ex Post Tracking Error	Historical or actual tracking error.