Zenith Investment Partners Pty Ltd

Highly Recommended
Recommended
Approved
Not Approved
Redeem

Product Assessment

30 Jun 2011

K2 Asian Absolute Return Fund

K2 Asset Management's (K2) Asian Absolute Return Fund is a long/short absolute return fund that offers exposure to Asian equities markets. The Fund aims to preserve capital and generate a 15% p.a. return after fees over a three to five year investment cycle. Zenith believes the Fund is well positioned to deliver attractive risk-adjusted returns in accordance with its investment objective.

K2 is a Melbourne-based boutique investment manager that is solely dedicated to managing absolute return equity funds. Founded in July 1999 by Mark Newman and Campbell Neal, the business listed on the Australian Stock Exchange in 2007. However, K2 staff members maintain a majority stake holding of 86%. The investment team is well resourced with nine members, including five staff directly involved in the Asian equities team. The primary members of the K2's investment team are co-founders Newman and Neal, as well as Robert Hand, the Head of Asian Strategy. All have extensive backgrounds in the investment industry and are well regarded by Zenith.

The Fund's investment approach is unique with investment staff afforded a high level of discretion and autonomy on stock selection based on their individual investment styles and methodology. K2's philosophy is to provide a flexible environment where team members are able to scour the entire market to identify stocks that are capable of generating an absolute return, an approach that has delivered impressive results to date. Zenith has met with key members of the investment team over a number of years and been impressed with the overall calibre of the team. We believe the team has a particular strength in Asian markets, particularly since Mark Newman, Chief Investment Officer and Robert Hand, Head of Asian Strategy, have spent considerable portions of their careers based in Asia and researching Asian stocks.

K2 employs a long/short investment approach, using a combination of top-down and bottom-up research. The portfolio is long-biased with an expected, but not targeted, net market exposure of 65% over a full market cycle. The investment process begins with top-down macro analysis led by Newman and Hand, where a range of macro-economic variables are assessed. The top-down analysis acts as a preliminary filter for the investment team, highlighting those countries, industries and companies expected to benefit from the prevailing economic environment. For bottom-up stock selection, there is no single approach; each stock picker uses their own unique approach and style. The various approaches help diversify risk within the portfolio by minimising the exposure to any single investment style, assisting K2 to deliver attractive returns through a range of market environments.

Portfolio construction involves a multi-portfolio manager approach, whereby each manager is given a proportion of the Fund's capital to manage as a sub-portfolio with required rate of return on capital established. The Fund typically consists of five sub-portfolios and key portfolio allocations may change based on prevailing market environments. After combining each of the sub-portfolios, the total number of stocks in the final portfolio is expected to range between 50-120, including long and short positions. Given K2's multi-portfolio manager approach, there is a strong connection between the output of the research process and the end stock weightings in the portfolio.

The Manager may reduce currency risk by hedging back into Australian Dollars (AUD) and although K2 does not view currency as a source of value it will actively hedge the portfolio if it believes that the AUD is rising. Conversely if K2 believes that the Australian Dollar will weaken, it has the ability to completely remove AUD hedges to benefit from the fall.

Zenith has a high degree of confidence in K2's experienced investment team and we consider the Manager's investment approach to be unique and appealing. We consequently believe that the Fund will deliver on its investment objective going forward and we therefore rate the Fund HIGHLY RECOMMENDED.

Key Features	Description
APIR Code	KAM0100AU
Asset Class	International Shares
Sub-Asset Class	Regional - ASIA EX-JAPAN
Investment Style	Long/Short
Zenith Assigned Benchmark	MSCI AC Asia x Japan A$
Recommended Investment Timeframe	5 + years
Chief Investment Officer	Mark Newman
Head of Asian Strategy	Robert Hand

Cumulative and Monthly Net Performance

Performance Analysis

Performance Statistics		5 Yrs	3 Yrs	1 Yr
Performance (% p.a.)	Fund	7.52	5.62	12.07
	Benchmark	3.64	4.09	-0.85
	Median	2.39	4.35	-0.89

The K2 Asian Absolute Return Fund aims to preserve capital over the medium term and generate a return of 15% p.a. after fees over a three to five year investment cycle. Although the Fund has not met its performance objective over the timeframe measured above, it has easily outperformed the index and the median manager over this time period. An assessment of the Fund's performance track record since inception in 1999 reveals that the Fund has considerably outperformed the index over this long time period.

Consistency Analysis

Consistency Statistics		5 Yrs	3 Yrs	1 Yr
Excess Rtn - All Mkts (% of Mths)	Fund	51.67	52.78	58.33
	Median	48.33	50.00	58.33
Excess Rtn - Rising Mkts (% of Mths)	Fund	27.03	31.82	28.57
	Median	33.78	31.82	28.57
Excess Rtn - Falling Mkts (% of Mths)	Fund	91.30	85.71	100.00
	Median	76.09	71.43	60.00

The overall consistency of monthly excess returns has been moderate over the past 5 years, however Zenith acknowledges the Fund has delivered high levels of outperformance consistency through periods of market weakness. As expected, the Fund has delivered its strongest excess returns in falling markets, where its short positions and variable market exposure provide a strong buffer.

Risk / Return Analysis

Risk / Return Statistics		5 Yrs	3 Yrs	1 Yr
Information Ratio	Fund	0.35	0.13	1.17
	Median	-0.24	0.07	0.26
Sharpe Ratio	Fund	0.13	0.05	0.73
	Median	-0.21	-0.03	-0.67
Standard Deviation (% p.a.)	Fund	14.36	16.32	9.76
	Median	14.91	14.52	8.77
Tracking Error (% p.a.)	Fund	11.14	11.43	11.08
	Median	6.33	6.41	4.37

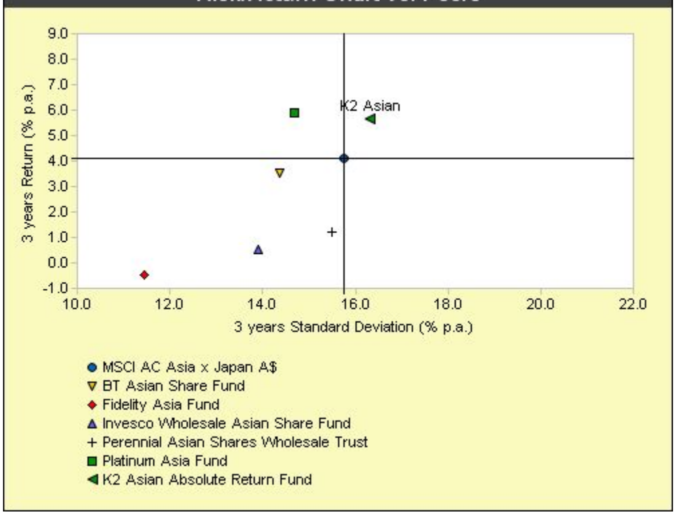
Absolute volatility may vary from that of the index over time, depending on a range of factors including the Fund's net market exposure and its level of diversification. The Fund's volatility has generally been in line with the median manager.

The Fund's lower volatility and stronger performance returns than the median manager, have resulted in the Fund delivering a stronger Sharpe ratio over the long term. This indicates the Manager has been well rewarded for risk taken.

Given the benchmark unaware approach, tracking error may be high and should only be used as guide as to how much the portfolio diverges from the benchmark. As a result, the information ratio (a relative risk adjusted measure of performance which defines risk as tracking error) is not a relevant measure of risk adjusted performance.

The chart below illustrates the Fund's strong risk/return profile in comparison to its peers and the index.

Risk/Return Chart vs. Peers



Investment Personnel

Name	Title	Tenure
Mark Newman	Chief Investment Officer	12 Yr(s)
Campbell Neal	Senior PM - Australia	12 Yr(s)
Robert Hand	Head of Asian Strategy	9 Yr(s)
Roger Watson	Senior PM - Asia	4 Yr(s)
David Poppenbeek	Head of Australia, Portfolio Manager	7 Yr(s)

Organisation

K2 is a Melbourne-based boutique investment manager that is solely dedicated to managing absolute return equity funds. Founded in July 1999 by Mark Newman and Campbell Neal, the business listed on the Australian Stock Exchange in 2007. However, K2 staff members maintain a majority stake holding of approximately 86%. Newman and Neal remain the controlling stakeholders. Importantly all members of the Firm have equity in the business and there is strong alignment of interests with unit holders with staff having invested around $15 million of personal money in the Firm's products.

Funds under management are approximately A$970 million as at 31 May 2011, and at this level the business is highly profitable.

Investment Team

K2 has a highly experienced and well resourced investment team lead by chief investment officer Mark Newman. Newman is well supported by Robert Hand, Head of Asian Strategy, and Roger Watson, Senior Portfolio Manager. The Asian investment team is rounded out by an additional two portfolio managers and the team has an average of more than 20 years of investment experience.

Mark Newman has an extensive background in the investment industry and is well regarded by Zenith. Newman, in his role as Chief Investment Officer (CIO), leads the investment team and prior to co-founding K2 in 1999 held the role of CIO Asia at the Abu Dhabi Investment Authority in the United Arab Emirates.

Newman also spent 6 years as a portfolio manager working for HSBC Asset Management based in Hong Kong and has a total of around 25 years investment experience.

Robert Hand has more than 20 years of investment experience. He is the Head of Asian Strategy at K2 which involves overseeing the asset allocation for the Asian strategy in conjunction with Newman. Hand's experience includes 15 years at National Australia Asset Management where he served as Head of Australian Equities and Senior Portfolio Manager- Asia. Hand has recently relinquished portfolio management responsibilities, preferring to concentrate on providing top down and macroeconomic analysis.

Roger Watson, who covers a broad range of stocks across Asia, joined K2 in 2007 and has around 15 years of experience. Watson's previous experience includes roles as Deputy Head of Research at Credit Suisse - Hong Kong and Deputy Head of Research at Peregrine Brokerage Ltd.

Adding further experience to the Asian investment team are Campbell Neal and David Poppenbeek, who is the Head of the Australian Strategy. Both Neal and Poppenbeek are largely focused on the Australian market and contribute Australian stock ideas as the Fund's mandate include Australian stocks.

Investment responsibilities within the Asian region are allocated along country lines; however, portfolio managers are afforded a high level of autonomy and can draw stock ideas from any sector. Newman is involved in stock selection for all countries within the region, while other stock pickers are given specific responsibility for specific countries. K2's goal is to provide a flexible environment where team members are free to scour the entire market for those investment ideas expected to deliver the most attractive returns, an approach that has delivered impressive results to date.

As discussed, portfolio management involves a multi-portfolio manager approach, where the final portfolio is formed by combining the sub-portfolios of the individual stock pickers. Portfolio weighting allocations are determined by the CIO and the Head of Asian Strategy based on a combination of their past returns on capital and on the prevailing market conditions. Importantly, K2 is careful not to create an environment where portfolio managers are reluctant to give up their capital allocation when market conditions do not favour their investment style biases. As part of guarding against this potential issue, K2 has structured remuneration on fund performance rather than the volume of funds managed by each portfolio manager.

Impressively, staff retention has been strong over the long term. Starting with an investment team of only 3 at the time of the Firm's inception in July 1999, K2 has expanded the team considerably as FUM has grown. The Manager has indicated that continued team expansion will occur where it can identify talent and cultural fit and where it requires additional specialist coverage. The high retention rate can probably be attributed to the multi-portfolio manager structure that affords individual team members considerable latitude, a remuneration structure that rewards performance, and the equity participation model. Staff remuneration consists of a base salary, a bonus that can be a multiple of base and dividends earned through equity holdings.

Zenith has met with all the key members of the K2 investment team on multiple occasions and has formally reviewed most members of the Asian team. Zenith has been impressed by the overall calibre of investment personal and is comfortable with the level of resourcing within the team. The skill sets of the various members within the team are highly complementary, with team members employing their own stock selection processes. The absence of a single in-house stock selection process and multiple portfolio manager approach reduces key person investment style risk.

Given our high regard for K2's key investment staff, we consider the firm's autonomous approach to be a comparative advantage. Zenith also believes that the Firm has a particular strength in Asian shares which is primarily driven by Newman, Hand and Watson who have spent considerable portions of their careers managing Asian portfolios.

Investment Process

K2 believes that inefficiencies exist in equities markets where stocks are often overbought or oversold relative to their underlying value, and K2 attempts to exploit these inefficiencies by using a long/short approach. The portfolio is long-biased and, over a full market cycle, the net market exposure is expected to average around 65%.

The investment approach entails a combination of top-down and bottom-up stock selection implemented by each portfolio manager. K2 does not have a pre-defined investment style, and stock pickers are given a high level of discretion to use their own methods in finding the most compelling investment opportunities.

The Fund may invest across Asia including Australia and New Zealand although it will not invest in Japan.

Security Selection

The K2 security selection process can be broken down into two broad categories:

1. Top-Down Analysis

The investment process begins with top-down macro analysis, driven by the CIO and discussed amongst the team at a monthly strategy meeting. The key macro variables include: economic growth; real interest rates; availability of credit; political cycle; currency outlook; current account; foreign exchange reserves; foreign direct investment reserves; and the domestic budget. K2 also employs an external macro-economic consultant based in Hong Kong who provides a monthly outlook for the global economy and its impact on Asia.

The CIO and the Asset Allocation Committee are responsible for setting the net market exposure guidelines for the Fund, which is a reflection of K2's ongoing view of equity market risk. In addition, the CIO's macro views will impact on the portfolio's sector and style biases by influencing the stock selection decisions of the investment team. The macro views provide insight into which particular Asian countries are likely to benefit most from the prevailing macro-economic environment, and therefore play an important role in the allocation to each sub-portfolio, as discussed in the Portfolio Construction section.

The aim of K2's top-down analysis is to identify major investment themes that are used as a guide for stock selection. The top-down analysis acts as a preliminary filter for the investment team, not necessarily screening out stocks, but highlighting those countries, industries and companies expected to benefit most from the prevailing economic environment. K2's top-down approach is qualitatively driven, based on the investment team's interpretation of various pieces of macroeconomic information, and there is less use of quantitative modelling. Despite this, Zenith believes K2's top-down analysis provides a valuable foundation for its stock selection process, helping to focus the investment team's research effort.

2. Bottom-Up Stock Selection

There is no single stock selection approach used across the team, with each stock picker utilising their own unique approach. Approaches and investment styles vary significantly between portfolio managers. Some team members make greater use of quantitative or trading tools, others invest using thematic approaches. The various stock picking methods help to diversify risk within the portfolio, minimising exposure to any single investment style and potentially enabling K2 to deliver attractive returns through a range of market environments.

Despite their broad differences, there are some fundamental consistencies in the investment approaches used by each of the portfolio managers. For example, 3 of the key factors considered by all team members are earnings, valuation and management. For its long positions, K2 seeks companies with strong earnings trends; improving debt to equity servicing ratios; that are undervalued relative to the sector and market; that are trading at a discount to net tangible assets; that are likely to witness a rising earnings multiple rating; and that are expected to benefit from a change in the macro environment. K2's investment process for its short positions is the inverse of its long positions.

Stock pickers categorise stock holdings into 4 categories: core portfolio positions; trade positions; high alpha positions; and short positions. As the name suggests, core portfolio positions require the greatest level of research and the stock picker must have a sound understanding of drivers & risks to earnings, the company's business, position of the company within its industry and strategic issues facing the company. Trading positions are held in anticipation that a short-term catalyst will lift the share price, while high alpha positions relate to positions in small volatile stocks.

Short positions are typically event driven. K2 subscribes to London-based Stock Cube, a technical analysis research provider, to provide assistance and verification for its short positions. This is one of many information sources used in the investment process.

Overall, while K2's bottom-up stock selection approach lacks the formal application and consistency of some of its competitors, Zenith acknowledges that the high level of autonomy afforded to K2's portfolio managers is likely to promote dynamic and creative thinking within the team. As long as K2 closely monitors attribution from each portfolio manager's individual approach, we are confident that this high level of autonomy will continue to benefit the performance of the Fund.

Portfolio Construction

Portfolio construction involves a multi-portfolio manager approach, where each portfolio manager is allocated a portion of the portfolio, effectively creating a series of sub-portfolios. Given that there is some cross over in stock selection responsibilities between portfolio managers, it is not unusual for a particular stock to be held in more than one sub-portfolio. The combination of stock positions effectively increases the stock's weighting in the overall portfolio. Individual weightings within the sub-portfolios vary depending on the portfolio manager's conviction, after allowing for risk constraints and liquidity.

Each portfolio manager is given capital and set a required return on the capital. After combining each of the sub-portfolios, the total number of stocks in the final portfolio is expected to range between 50 and 120, including both long and short positions. Stock turnover in the Fund in normal market conditions is expected to be high, around 400% p.a. Short positions account for some of the turnover with positions generally being held for 1-45 days.

The portfolio is long-biased and over a full market cycle the net market exposure is expected to average around 65% (not targeted), although it has reached lows of 30% at times. Gearing is not used and therefore the maximum gross market exposure is 100%.

Given K2's multi-portfolio manager approach, there is a very strong connection between the output of the research process and the end stock weightings in the portfolio. Zenith views this positively as it ensures the best ideas from the research process are given adequate representation in the portfolio.

Currency Management

The Fund actively manages currency risk by hedging back into Australian Dollar (AUD). K2 do not view currency as a source of alpha and will on average be hedged between 85-100% to AUD. However, if K2 believes that the Australian Dollar will fall, then it has the ability to completely remove AUD hedges to benefit. Newman is responsible for making the currency allocation decision based primarily on the output of K2's macro-economic analysis.

Risk Management

Portfolio Constraints	*Description*
Security Numbers	Typically 50 to 120 stocks
Maximum Gross Market Exposure (%)	max: 100%
Maximum Net Long Exposure (%)	max: 100%
Net Short Exposure (%)	min: -30%
Weight - Holding Rel. Portfolio (%)	max: 10%
Maximum High Beta Exposure Per Security (%)	max: 5%
Stop Loss Trigger	Any loss on trading positions after 30 days causes a trigger
Stop Loss Trigger (%)	cover shorts at max 20% loss
Hedging AUD (%)	0% to 100%
Portfolio Turnover (% p.a.)	Expected to be high at around 400%p.a.
Cash (%)	max: 100% i.e. Can range between 0 and 100%

Risk management for the portfolio is approached from two angles: fundamental research; and risk management constraints.

Perhaps most importantly, the investment team undertakes thorough analysis on each stock before it is included in the portfolio as part of the fundamental research process. Analysts consider a range of factors including a company's ability to service its debt and its ability to generate earnings into the future.

There are extensive risk management constraints in place, some of which are displayed in the table. These include maximum exposure limits for individual stocks for both long & short positions, and stop loss triggers. Compliance of these constraints is managed at the portfolio level by the CIO and the investment team who monitor this weekly, which ensures the aggregate exposure in the total portfolio is within specified limits. K2 utilise Stock Cube to provide assistance and verification for its short positions, while each portfolio is assessed by K2's internal proprietary software to monitor the portfolio's risk management constraints.

A key risk reduction technique utilised in theFund is a low net market exposure alongside the ability to maintain a cash position of between 0 and 100%. Net market exposure will tend to average around 65% over a full market cycle. Zenith views the Fund's flexible cash allocation as a positive aspect and in line with its absolute return focus. Despite K2's high cash allocation and low net market exposure, the Manager has been able to achieve returns in line with the fund's objectives.

Whilst K2 does not use any external quantitative risk management tools to monitor risk within its portfolio such as BARRA, the portfolio is constantly monitored by the CIO to ensure that he is aware of and comfortable with the exposures in the portfolio. Overall, we are comfortable with K2's risk management process.

Administration and Operations

Prime Broker: Morgan Stanley & Co International

Administrator: State Street Australia Limited

Custodian: Morgan Stanley & Co International.

Auditor: KPMG

Transparency: The Manager has provided full portfolios and complied with all information requests.

Risks of the Fund

With all Asian equity products, the most significant risk to the Fund is a sustained downturn in the region, which could lead to periods of negative performance for this Fund, particularly given that it is expected to be a predominately long biased investment. Investors should be aware of this market risk as Asian markets have tended to be relatively volatile. Despite the market risk, Zenith notes that the Manager has a flexible mandate where it may short sell stocks and hold significant levels of cash to protect returns in poor market environments. As a result we expect the Fund to provide strong downside protection during falling markets relative to long-only and fully invested Asian equities funds, although this is still contingent on the Manager correctly positioning the portfolio.

The risk of experiencing loss from an investment in the Fund can also be significantly reduced by investors adopting a medium to long-term (5+ years) investment time frame when investing in this Fund.

In Zenith's opinion the other major risks of the Fund are:

- As the Fund is managed in a benchmark unaware and relatively high conviction manner investors need to be mindful of the fact that its returns and volatility may vary relative to both benchmark and peers.
- Due to the Fund's relatively low net market exposure it has the potential to underperform the index and long only managers during strong bull market conditions.
- The gross exposure (total long plus total short positions) of the Fund is limited to 100%. This is important as it means that the Manager is restricted from applying leverage which can amplify gains but also losses.
- To manage capacity risk K2 has indicated it intends to limit capacity in this Fund when it reaches A$1.5 billion. K2's approach to capacity management is endorsed by Zenith and we believe that it will ultimately maximise the Manager's ability to outperform.
- Given that each portfolio manager employs their own unique stock selection process, Zenith considers key person risk to be less significant for K2 than those funds management organisations with a single investment process and single decision maker. In Zenith's view, the departure of Mark Newman (in particular), Robert Hand or Roger Watson would however be a material loss for K2, and would instigate a re-assessment of our current rating of this Fund. It should be noted that all senior staff own equity in the K2 business, creating a compelling staff retention incentive.
- Given K2's level of funds under management (FUM) of $970.4 million (as of 31 May 2011), Zenith considers the profitability of the Firm to be strong. The Firm's break-even point is $400 million.

Applications of the Fund

Compared to most other asset classes, equities offer investors the opportunity for higher capital growth over the longer term with some income. However, this higher growth is also often associated with higher volatility. Therefore, it is recommended that investors adopt a longer time frame when investing in equities. Investors should also be cognisant of the fact that the Asian equity markets are expected to be more volatile than developed markets such as Australia, the US and Europe. Furthermore, a large proportion of the countries within the Asian market are classified as emerging and subject to greater levels of sovereign risk. To lessen this risk it is highly recommended that investors diversify their investments across different regional markets and across asset classes.

One of the key attractions of funds which adopt a long/short investment approach or that can protect returns by allocating to cash, is that they have greater flexibility to add value. This is a key differentiator in comparison to long only funds.

For investors that construct global equity portfolios by combining regional products, Zenith believes this Fund is a leading option on offer to Australian investors to gain exposure to Asian equities. While Zenith prefers to utilise the skills of a highly rated global manager to make regional allocation decisions, we believe there is merit in choosing regional specialists if they demonstrate a higher propensity to outperform in their region relative to global managers. This is usually based on greater understanding of a region and a more focused approach.

Alternatively, the Fund could be used as a satellite exposure around core global equities funds for investors with a strong positive view on the Asian market, however, Zenith stresses to investors that it is difficult to time the markets and there is a danger of allocating to a region after periods of strong performance. Zenith advises against the use of the Fund as a standalone investment as it does not provide adequate diversification across regions. While we have confidence in K2's ability to enhance risk adjusted returns for investors, Zenith believes the Fund is best used as part of a blended investment portfolio based on its very different investment mandate.

Fund Characteristics

The Fund is expected to have a high level of portfolio turnover (around 400% p.a. in normal markets) based on its trading orientated style. This may result in higher capital gains implications in positive market conditions. This is particularly pertinent from an Australian perspective for those investors on a high marginal tax rate as the Fund will be less tax effective. Accordingly the Fund is likely to best suit self managed super fund investors.

K2 now has daily unit pricing which will provide unit holders with greater liquidity and a daily redemption facility which is viewed positively by Zenith.

Fees

The fees charged on this Fund are quite high with a management expense ratio (MER) of 1.72% p.a., plus a performance fee equal to 20.5% p.a. of returns above a 6% p.a. hurdle rate (net of base fee). An annual high water mark is in place which ensures that the Fund must recoup any previous underperformance of the hurdle rate before the incentive fee is applied. The high water mark is an attractive feature that is often neglected in the fee structures of other similar funds.

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