Product Assessment

Highly Recommended
Recommended
Approved
Not Approved
Redeem

K2 Select International Absolute Return Fund

30 Jun 2011

K2 Asset Management's (K2) Select International Absolute Return Fund is a long/short absolute return fund, offering exposure to global equities markets. The Fund aims to preserve capital over the medium term and generate 15% p.a. (after fees) over a three to five year investment cycle. The portfolio is long-biased and over a full market cycle the net market exposure is expected to average around 65%.

K2 is a Melbourne-based boutique investment manager that is solely dedicated to managing equities-based absolute return funds. Founded in July 1999 by Mark Newman and Campbell Neal, the business listed on the Australian Stock Exchange in 2007. K2 staff members maintain a majority holding of approximately 86%.

K2 has a highly experienced nine member investment team lead by Chief Investment Officer Mark Newman. The key investment professionals for this Fund are Newman and Nick Griffin, Head of International Strategy. Newman is involved in stock selection for all countries, while Griffin covers Europe. Nick Reddaway, a portfolio manager covering the US and Europe, has recently departed. However, the most recent addition to the team, Jeff Thomson covers Europe and the US and has previous experience managing a global long/short fund. Zenith has previously stated that we would like to see K2 add to its depth of resources in the US and Europe and this departure detracts somewhat from the manager's US expertise. However, we note that the Manager has a strong track record in these regions and has investment personnel with strong experience and high quality within its ranks. These individuals are also important to the success of this Fund in that they collectively cover Asia and Australia, regions to which this Fund has historically been biased.

K2 employs a long-short investment approach, utilising a combination of top-down and bottom-up research. The investment process begins with top-down macro analysis led by Newman, where a range of macroeconomic 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 research, there is no single stock selection approach used across the team, with each stock picker utilising their own unique approach and style. The various stock picking approaches help to diversify risk within the portfolio to minimise the exposure to any single investment style, potentially enabling K2 to deliver attractive returns through a range of market environments. 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 may consist of up to nine sub-portfolios, with higher amounts of capital allocated to high performing fund managers or those expected to do well in the prevailing market environment. After combining each of the sub-portfolios, the total number of stocks in the final portfolio is expected to range between 60 and 120, including both 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, which ensures the best ideas from the research process are given adequate representation in the portfolio.

The Manager may reduce currency risk by hedging back into Australian Dollar (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 then 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 while we believe that the team could be strengthened in the US and European regions we are comfortable that the existing team will continue to deliver impressive results for the Fund. Zenith rates the Fund RECOMMENDED.

Key Features	Description
APIR Code	ETL0046AU
Asset Class	International Shares
Sub-Asset Class	Specialist
Investment Style	Long/Short
Zenith Assigned Benchmark	MSCI World Index $A
Recommended Investment Timeframe	7 + years
Chief Investment Officer	Mark Newman
Head of Intl, Senior PM - US and Europe	Nick Griffin

Cumulative and Monthly Net Performance

Performance Analysis

Performance Statistics		5 Yrs	3 Yrs	1 Yr
Performance (% p.a.)	Fund	8.30	7.04	18.19
	Benchmark	-4.61	-2.60	4.61
	Median	1.55	4.98	6.11

The K2 Select International Absolute Return Fund aims to preserve capital over the medium term and generate a return of 15% p.a. (after fees) on a 3 to 5 year investment cycle. While the Fund has not delivered on its high absolute performance target, it has delivered strong outperformance of the index and median manager since its inception in January 2005. This is an excellent result for the strategy.

While the Fund's performance objectives are not relative to the index, we consider the MSCI World Index ($A) to be a useful reference point in assessing performance of the Fund. It is important however to note that K2 actively manages its currency position and may hedge up to 100% of the portfolio if it believes that the Australian dollar is appreciating or remove the hedges as the dollar falls.

Consistency Analysis

Consistency Statistics		5 Yrs	3 Yrs	1 Yr
Excess Rtn - All Mkts (% of Mths)	Fund	63.33	58.33	66.67
	Median	53.33	52.78	50.00
Excess Rtn - Rising Mkts (% of Mths)	Fund	46.67	44.44	57.14
	Median	40.00	45.45	37.50
Excess Rtn - Falling Mkts (% of Mths)	Fund	80.00	72.22	80.00
	Median	72.41	64.29	75.00

As displayed in the table above, the Fund has consistently outperformed the index in all market conditions, although returns have been comparatively stronger in falling markets. Delivering excess returns in over 50% of months illustrates the repeatability and consistency of the K2 process.

Although not targeted, the Fund is expected to average 65% net market exposure over a full investment cycle and consequently we believe that the Fund should provide strong downside protection relative to long only managers.

Risk / Return Analysis

Risk / Return Statistics		5 Yrs	3 Yrs	1 Yr
Information Ratio	Fund	1.08	0.72	1.21
	Median	0.33	0.36	0.73
Sharpe Ratio	Fund	0.21	0.15	1.31
	Median	-0.37	0.02	0.14
Standard Deviation (% p.a.)	Fund	12.98	14.61	10.12
	Median	12.98	14.38	8.64
Tracking Error (% p.a.)	Fund	11.95	13.31	11.26
	Median	9.14	9.55	5.61

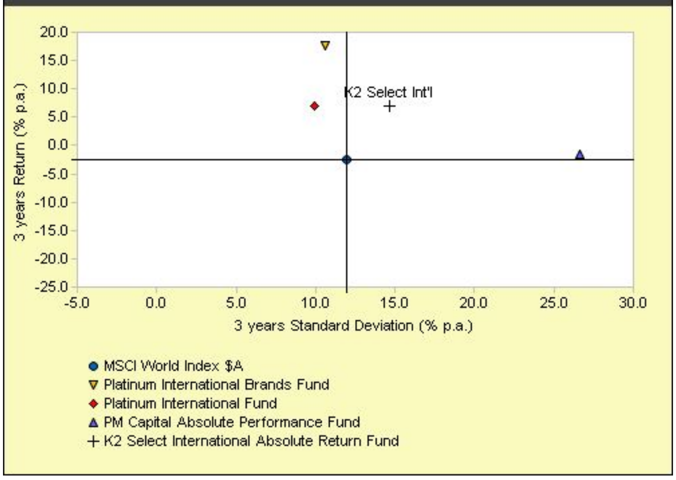
The Fund's absolute volatility may vary from that of the index over time depending on a range of factors, including the Fund's net market exposure and its degree of diversification by stock number, sectors and regions. The Fund's volatility has generally been in line with the median manager.

The Fund's lower volatility and stronger performance has resulted in a Sharpe ratio that is superior to the median manager over the long term.

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 risk/return chart below highlights the Fund's strong performance relative to its peers and to the index.

Risk/Return Chart vs. Peers



Investment Personnel

Name	Title	Tenure
Mark Newman	Chief Investment Officer	12 Yr(s)
Nick Griffin	Head of Intl, Senior PM - US and Europe	5 Yr(s)
Campbell Neal	Senior PM - Australia	12 Yr(s)
Robert Hand	Senior PM - Asia	9 Yr(s)
David Poppenbeek	Portfolio Manager - Australia, US	7 Yr(s)
Roger Watson	Head of Asia, PM - Asia	4 Yr(s)
Jeff Thomson	Portfolio Manager - US, Europe	1 Yr(s)

Organisation

K2 is a Melbourne-based boutique investment manager that is solely dedicated to managing equities-based absolute return 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. 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.

FUM stands at $970 million as at 31 May 2011 and at this level the business is highly profitable.

Investment Team

K2 has a highly experienced nine member investment team lead by Chief Investment Officer Mark Newman. The key investment professionals for this Fund are Newman and Nick Griffin (Head of International Strategy). Newman is involved in stock selection for all countries, while Griffin covers Europe and the US. Nick Reddaway, a portfolio manager for this fund has recently departed the firm. As Reddaway was responsible for the US, we feel that his departure may limit the level of expertise in this region. Zenith has previously stated that we would like to see K2 add to its depth of resources in the US and Europe. However we note that the Manager has a strong track record in these regions and we believe that the investment team has strong experience and overall quality within its ranks. Furthermore, since our last review the team has been boosted by the addition of Jeff Thomson. Thomson joined K2 after 11 years in London as a portfolio manager at Thames River Capital and Coronation Fund Managers. His impressive background includes managing European and Global long/short funds and well as specialist analyst experience across multiple sectors. Thomson will have responsibility for Europe and the US.

Portfolio management at K2 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 International Strategy based on a combination of the attractiveness of the region the portfolio manager covers, their past returns on capital and on the prevailing market conditions given that different styles perform well at different points in the cycle. 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 individual biases. To guard against this potential issue, K2 has structured remuneration on fund performance rather than the volume of funds managed by each portfolio manager. Given their focus on the world's largest markets, Zenith expects Newman and Griffin to be responsible for the majority of the portfolio weighting over time.

As described above investment responsibilities within the team are allocated along regional lines; however, portfolio managers are afforded a high level of autonomy and may draw their stock ideas from any country or sector. However, most of K2's portfolio managers focus on a single region and Newman is the only team member with coverage of all regions. Within regions K2's goal is to provide a flexible environment where team members are not bound by coverage constraints such as specific sector responsibilities and are free to scour the markets for investment ideas expected to deliver the most attractive returns. This flexible approach has delivered impressive results for the Manager to date.

As the Firm's co-founder and CIO Mark Newman has an extensive background in the investment industry and is well regarded by Zenith. Newman, in his role as 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 six years as a portfolio manager working for HSBC Asset Management based in Hong Kong and has a total of around 25 years investment experience.

Nick Griffin is the Head of International Strategy and has around 15 years of industry experience, having previously worked in London covering the global oil and gas sector on the sell-side for Deutsche Bank. Prior to this Griffin was involved in covering Australian equities at Commonwealth Financial Services, now Colonial First State. Griffin is rated highly by Zenith and we believe that he has performed well since joining the Firm to focus on the International Strategy in 2005.

Robert Hand is the Head of Asian Strategy at K2. He has around 20 years of investment experience including 15 years at National Australia Asset Management where he served as Head of Australian Equities and Senior Portfolio Manager-Asia. Other experienced investors within the team are Campbell Neal and David Poppenbeek who focus primarily on Australia. Zenith continues to believe that the Manager has a strong competitive advantage in Asia and Australia. Impressively, staff retention has been strong over the long term. Starting with an investment team of only three at the time of the Firm's inception in July 1999, K2 has expanded considerably as funds under management have grown. The Manager has indicated that continued team expansion will occur where it can identify talent and cultural fit and where it requires additional coverage. K2 will potentially look to add skill sets in Japan and Latin America if appropriate candidates are found. The strong retention 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 team. Zenith has been impressed by the overall calibre of investment personal and although we would like to see resourcing increased in the US and Europe, we are comfortable that the existing team will continue to deliver impressive results.

Investment Process

K2's investment process aims to identify market inefficiencies throughout the investment cycle where stocks do not reflect their underlying value. 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, although not targeted, is expected to average around 65%.

The investment approach can be described as a combination of top-down and bottom-up. 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.

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.

The CIO and the Asset Allocation Committee are responsible for setting the net market exposure guidelines for the Fund. 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 regions and/or 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.

The aim of K2's top-down analysis is to identify major investment themes that are then used as a foundation for stock selection. The top-down analysis acts as a preliminary filter for the investment team, not necessarily for 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 using their own unique approach. The styles and approaches vary significantly with, for example, Mark Newman using a style-indifferent and macro driven approach and Griffin using a more thematic driven approach. Some team members make greater use of quantitative or trading tools, others invest along traditional value lines. 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 stock pickers. 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; are likely to witness a rising earnings multiple rating; and are expected to benefit from a change in the macro environment. K2's investment process for its short positions is essentially the inverse of that for 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 and 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. Alongside other research tools, K2 subscribes to London-based Stock Cube, a technical analysis research provider, to provide assistance and verification for its short positions.

While K2's bottom-up stock selection approach lacks the formal application & consistency of some of its competitors, Zenith acknowledges that the high level of autonomy afforded to K2's stock pickers is likely to promote dynamic and creative thinking within the team. As long as K2 continues to closely monitor 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 uses a multi-portfolio manager approach, where each portfolio manager is allocated a portion of the portfolio to manage, 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, which serves to increase 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 60 and 120, including both long and short positions. Stock turnover in the Fund in normal market conditions is expected to be relatively high at 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 dipped as low as 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

K2 does not view currency as a source of alpha and will on average be hedged between 85-100% to AUD. The Fund actively manages currency risk by hedging back into Australian Dollar (AUD). If K2 believes that the Australian Dollar will fall, then it has the ability to completely remove the 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	60 to 120
Maximum Gross Market Exposure (%)	max: 100%
Maximum Net Long Exposure (%)	max: 100%
Net Short Exposure (%)	max: -30%
Weight - Holding Rel. Portfolio (%)	max: 10%
Maximum High Beta Exposure Per Security (%)	max: 5%
Maximum Short 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
Portfolio Turnover (% p.a.)	Expected to be high at around 400%p.a.
Hedging AUD (%)	0% to 100%
Cash (%)	0% to 100% i.e. is flexible and 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 constraints in place, some of which are displayed in the table above. 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 investment team at weekly meetings, which ensures the aggregate exposure in the total portfolio is within specified limits. Alongside other research tools, K2 utilise Stock Cube to provide assistance and verification for its short positions. 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 the Fund is a low net market exposure alongside the ability to maintain a cash position of between 0 and 100%. Net market exposure, although not targeted, 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.

Unlike the majority of its peers K2 does not have specific sector or regional constraints. This is in line with its more flexible investment approach. Given that K2 combines sub-portfolios managed by up to nine portfolio managers, we expect the portfolio to be well diversified by investment ideas and regions.

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

Operations and Service Providers

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 global equity products, the most significant risk to the Fund is a sustained downturn in equity markets which could lead to periods of negative performance, especially given that it is expected to be a predominately long biased investment. Whilst market risk is unavoidable, Zenith notes that the Manager has a flexible mandate where it may short sell stocks and hold high levels of cash to protect returns in poor market environments. As a result we expect the Fund to provide strong downside protection during bear market conditions relative to long only and fully invested global 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 (expected to average 65%) it may 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% and this is important as it means that the Manager is restricted from applying leverage which can amplify gains as well as losses.
- To manage capacity risk, K2 has indicated it intends to limit capacity in this Fund when it reaches A$2 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 however there is a reasonably high reliance on Mark Newman and Nick Griffin for this Fund and should either depart we would instigate a re-assessment of our current rating of the Fund. It should be noted that all senior staff own equity in the K2 business, creating a compelling staff retention incentive.

- Given K2's high level of funds under management 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 often associated with higher volatility. Therefore, it is recommended that investors adopt a longer time frame when in investing in equities. International equities offer Australian investors the ability to access a broader opportunity set with potential to invest in sectors not represented or not well represented in the Australian market. Given international markets are not perfectly correlated with the Australian market, this exposure also affords greater diversification benefits.

This Fund offers investors an attractive exposure to the global equities market as it is a more flexible product that is managed under a long/short and benchmark unaware approach. The Fund aims to protect investor capital and generate an absolute return of 15% p.a. through market cycles. Zenith believes K2's flexible product structure is one of the key attractions of Fund and we believe that an allocation to the Fund within an international portfolio has the potential to improve the returns of the portfolio and should also reduce portfolio risk. This is largely based on the Manager's expected low correlation with other managers driven by their unique investment style.

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 which pay a 15% tax rate.

K2 now has daily unit pricing (as opposed to previously offering monthly 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 high. There is a base fee of 1.75% p.a., plus a performance fee equal to 20.5% p.a. of any returns above zero. Unlike K2's Australian and Asian Absolute Return Funds, which have in place a hurdle rate of 6% p.a. before any performance fee is payable, there is no hurdle in place for the Fund. While the absence of a hurdle rate is not uncommon in products offered by K2's offshore hedge fund competitors, Zenith would prefer to see a hurdle rate in place to ensure that the team is not rewarded for return below the cash rate.

On a positive note, an annual high water mark ensures that the Fund must recoup any negative returns of previous years before the incentive fee is applied on current returns. The high water mark is an attractive feature that is often neglected in the fee structures of other hedge funds.

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