Product Assessment

Zenith Investment Partners Pty Ltd

Highly Recommended
Recommended
Approved
Not Approved
Redeem

# Solaris Core Australian Equity Fund

*31 Mar 2010*

**The Solaris Core Australian Equity Fund (the Fund) is managed by a boutique fund manager Solaris Investment Management Ltd (Solaris). Investing in primarily large cap Australian equities the manager employs a multi-portfolio manager approach whereby analysts are empowered as sector-specialists. Zenith is encouraged by the fact the team is a direct lift out of the ex-Suncorp Australian equity team and believes that the Solaris investment process is based on a sound investment thesis that should enable the Fund to achieve its return objectives.**

**Solaris was established by the former Australian Equities team at Suncorp Investment Management (Suncorp). Backed by Pinnacle Investment Management Ltd (Pinnacle) equity is divided between Solaris and Pinnacle in a 60/40 split with Pinnacle providing all non-investment functions as well as having provided seed capital for the funds and sufficient working capital for 3 years. Overall, Zenith believes the arrangement works well, allowing the investment team to focus on managing the Fund. The investment team consists of 10 investment professionals, including 6 analysts, 1 portfolio analyst and 2 dedicated dealers. All analysts are responsible for between 40-50 stocks with responsibilities divided by sector. Solaris believes the multi-portfolio manager approach results in better convictions, higher accountability and a naturally market neutral outcome. Zenith believes that this structure has merit, having seen it operate successfully with various other managers both domestically and internationally (albeit not typically at a sectoral level). Sitting alongside the analysts/portfolio managers is Managing Director, Denis Donohue, who oversees the investment process and all business functions.**

**The objective of the Fund is to outperform the S&P/ASX200 Accumulation Index by 3% p.a. over rolling 3 years, with an ex-ante tracking error between 2% to 4% p.a. Solaris believes the multi-portfolio manager approach in combination with the investment process that focuses on exploiting mispriced 1 year forward earnings should result in the greatest outperformance potential. The process is based on the fact that earning expectations tend to be most clustered around this time horizon leading to the greatest surprises and hence larger stock price movements.**

**The starting universe for the Fund encompasses all securities listed on the Australian Stock Exchange. After removing poor quality stocks, fundamental research is conducted on the remaining universe of over 200 stocks with a particular focus on identifying where consensus expectations are likely to be inaccurate over a 1 year horizon. The final output of the research is an Expected Total Return (ETR %) 1 year forecast for each stock. These ETRs are translated directly into portfolio positions via inputting these figures into an Expected Return Database. This database then calculates and displays a market-capitalisation weighted-average market return with stocks overweighted/underweighted according to their relative return, or excess return. Although the final portfolio is a reflection of the individual convictions it will generally contain 40-70 stocks. While cash is deliberately maintained at low levels all cash is equitised via the use of SPI futures. Portfolio construction is directly linked to the research process resulting in a portfolio that clearly represents the analysts' best ideas.**

**Risk is an essential consideration and is considered at various stages throughout the investment process. As well as formal risk constraints that are continually monitored and enforced by the Managing Director risk is examined on an ex-post basis using commercial software to ensure that the portfolio isn't displaying any unintended biases. As Solaris employs a multi-portfolio manager approach the process is highly dependent on the skill of the individual analysts. As such the loss of any of the analysts would be a material loss to the team. The fee structure includes a management fee of 0.90% with no performance fee. In addition, Zenith views the fee structure as competitive and in line with the Fund's domestic peers.**

**As the Fund has a style neutral approach it can be held as a stand-alone exposure to the Australian equities sector for investors with low investment amounts but Zenith believes the Fund should be blended with other Australian equities funds to mitigate manager specific risk. Overall, Zenith rates the Fund RECOMMENDED.**

| Key Features | Description |
|---|---|
| APIR Code | WHT0012AU |
| Asset Class | Australian Shares |
| Sub-Asset Class | Large Companies |
| Investment Style | Neutral |
| Benchmark | S&P / ASX 300 (Accum) |
| Tracking error (% p.a.) | 2 to 4 (% p.a.) |
| Recommended Investment Timeframe | 5 + years |

Cumulative and Monthly Net Performance

## Performance Analysis

| *Performance Statistics* | *1 Yr (% p.a.)* | *6 Mths (%)* | *3 Mths (%)* |
|---|---|---|---|
| Performance - Fund | 39.37 | 4.51 | 1.08 |
| Performance - Benchmark | 41.94 | 4.66 | 1.25 |
| Performance - Median Manager | 42.49 | 4.60 | 1.23 |

***For comparative purposes, the benchmark used by Zenith in the performance tables and charts of all long only Australian Share Funds is the S&P/ASX 300 Accumulation Index. It should be noted that the Manager benchmarks the performance of this Fund relative to the S&P/ASX 200 Accumulation Index.***

The objective of the Fund is to outperform the S&P/ASX200 Accumulation Index by 3% p.a. over rolling 3 years with a tracking error between 2% to 4% p.a.

As the Fund has only been established since September 2008 there is currently too little data to draw any meaningful conclusions. To date the Fund has generated a return broadly in line with the benchmark and marginally below the Median Manager. Overall, Zenith maintains confidence that the Manager can achieve the Fund's investment objective over the timeframe prescribed.

## Consistency Analysis

| *Consistency Statistics* | *1 Yr* |
|---|---|
| History of Monthly Excess Return (%) | 50.00 |
| History of Monthly Excess Return (Rising Mkts %) | 50.00 |
| History of Monthly Excess Return (Falling Mkts %) | 50.00 |

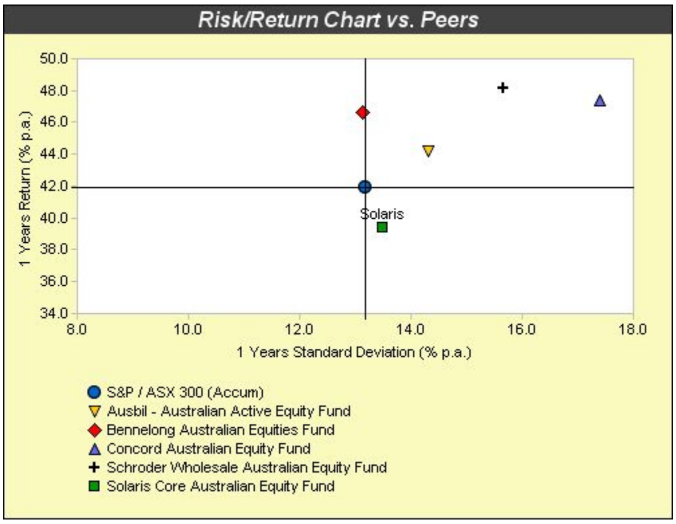
Currently the history of performance is too short for analysis of the consistency of outperformance.

Given the style neutral approach we would expect the Fund to outperform in all markets, both rising and falling, which has eventuated over the short term.

## Risk / Return Analysis

| *Risk / Return Statistics* | *1 Yr* |
|---|---|
| Information Ratio - Fund | -1.36 |
| Information Ratio - Median Manager | 0.20 |
| Sharpe Ratio - Fund | 2.65 |
| Sharpe Ratio - Median Manager | 2.90 |
| Standard Deviation (% p.a.) - Fund | 13.50 |
| Standard Deviation (% p.a.) - Median Manager | 13.48 |
| Tracking Error (% p.a.) - Fund | 1.89 |
| Tracking Error (% p.a.) - Median Manager | 2.77 |

The Fund is expected to have an ex-ante tracking error of 2%-4% p.a. Given the short length in return history, we are unable to provide a meaningful analysis of performance on a risk adjusted basis.




## Investment Personnel

| *Name* | *Title* | *Time with Manager* |
|---|---|---|
| Denis Donohue | Managing Director | 2 Yr(s) |
| Will Earnshaw | Investment Analyst | 2 Yr(s) |
| Andrew Gatenby | Investment Analyst | 2 Yr(s) |
| John Hodder | Investment Analyst | 2 Yr(s) |
| Bernard Machen | Investment Analyst | 2 Yr(s) |
| Sean Martin | Investment Analyst | 2 Yr(s) |
| Michael Bell | Investment Analyst | 2 Yr(s) |
| Damien Keune | Head of Dealing | 2 Yr(s) |
| Rob Pownall | Portfolio Analyst | 2 Yr(s) |
| Gus Roberts | Dealer | 1 Mth(s) |

### Manager Background

Solaris Investment Management Ltd (Solaris) was established in January 2008 by 9 members of the former Australian equities team at Suncorp Investment Management (Suncorp). To provide all non-investment functions, including distribution and marketing, the business partnered with Pinnacle Investment Management Ltd (Pinnacle), itself majority owned by Wilson HTM Investment Management Ltd. As well as providing these services Pinnacle provided seed capital for the underlying funds and sufficient working capital for 3 years. In return they retain a 40% stake in the Solaris business with the remaining 60.0% allocated to the Solaris Investment team. Of this, 56.5% has already been allocated to 8 members with 3.5% set aside to attract and retain future staff.

Given that the team moved en masse from their previous employer, where they were well respected, funds under management (FUM) has grown quite considerably since inception and in December 2009 was approximately AUD$3.6 billion. Based on the current level of FUM the firm is well above its breakeven level. Overall, Zenith believes the arrangement with Pinnacle works well, allowing the investment team to focus on managing the money while assuring that the business has sufficient working capital to operate effectively. We believe the fact that the investment team is essentially an entire lift out of the Suncorp team and process provides additional confidence in its ability.

**Investment Team**

While Solaris operates under a multi-portfolio manager approach whereby the analysts are empowered as sector specific portfolio managers, the business and investment process is overseen by the Managing Director, Denis Donohue. Although he has no direct stock responsibilities he reviews all trade orders prior to execution and examines active positions to ensure that the portfolio is in compliance with mandates and constraints. The team under his supervision consists of 6 analysts/portfolio managers, 1 portfolio analyst, and 2 dedicated dealers. All analysts are responsible for between 40 - 50 stocks on average with responsibilities divided by sector. Solaris believes empowering analysts as sector specific portfolio managers results in stronger convictions, higher accountability and a naturally market neutral outcome. This structure has been in place since the teams' time at Suncorp and Zenith believes that this structure has merit, having seen it operate successfully with various other managers both domestically and internationally (albeit not typically at a sectoral level).

While Donohue has oversight responsibility for trades and the portfolio, the team operates under the multi-manager approach and therefore there is no single key decision maker within the team with ultimate responsibility for portfolio performance. In his role as Managing Director Donohue contributes over 2 decades of investment experience, most recently performing the same role at Suncorp between 2004 and 2007. Prior to this he spent the majority of his career at Suncorp in the Investment Management division, performing as an analyst as well as Head of Equities.

The 6 analysts/portfolio managers have a variety of backgrounds and contribute vast experience gained from various roles. The analysts include Sean Martin, Will Earnshaw, Andrew Gatenby, John Hodder, Bernard Machen and Michael Bell. Martin and Earnshaw both sit on the Solaris Board of Directors and have just over a decade of experience having both begun their careers as Chartered Accountants. Prior to working at Suncorp, Martin worked as an equities analyst at Schroder Investment Management (Australia) Ltd for 4 years. Earnshaw gained international financial markets experience as a risk analyst with Robert Fleming & Co. and at NatWest Equities prior to commencing at Suncorp. Gatenby, Hodder, Machen and Bell all contribute varied experience with Gatenby having spent 15 years in the agriculture industry prior to joining to Suncorp in 2002. As the resources specialist Hodder contributes over 20 years of relevant experience having worked as a geologist before spending over a decade as an analyst/economist in the minerals, oil and gas sectors prior to joining Suncorp in 2006. Machen spent a decade in the Information Technology arena prior to joining the Suncorp Investment team in 1999. Bell was appointed to Analyst/Portfolio Manager from Head of Dealing in April 2010 and will provide coverage on the Industrial sector. Bell has over 15 years industry experience, 12 years spent at Suncorp and Solaris combined, where he completed a range of dealing and portfolio analytical duties. Damien Keune has been promoted to Head of Dealing given Bell's promotion. In addition, Solaris have appointed Gus Robert as Dealer who joins the team from Wilson HTM Investment Group. While performance at Solaris has been too short to draw any meaningful conclusions, at Suncorp the team achieved a top quartile result for the majority of the past decade.

Having only been established since January 2008 team stability hasn't been an issue with no team departures since this time. Over the longer term the former Suncorp team (with Donohue at the helm, 2004-2008) has only experienced 1 departure in 4 years. The generous remuneration structure that highly favours performance provides a strong retention incentive for the team. Remuneration consists of a base salary and bonus which is dependent on individual outperformance, fund outperformance and a discretionary component. No bonuses are paid if the Fund fails to exceed the benchmark regardless of whether the individual component of the bonus structure is achieved (i.e. a 60bps outperformance target for their assigned stocks). However, perhaps the most attractive retention mechanism is the fact that 8 of the investment team have meaningful equity stakes in the business. While new staff have a 3 year qualifying period for equity, all 8 members already have vested equity with a 6 year lock-in period.

Team meetings occur on a daily, monthly, quarterly and annual basis. On a daily basis the team meets to discuss trading and market issues while the monthly meeting is a peer review process that ensures that all staff are aware of fund positioning and risks. The annual meetings consist of formal performance reviews and a discussion of strategic issues.

Overall, the fact that the entire team is a lift out of ex-Suncorp equities team, the high level of equity ownership and the depth of experience of team members provides Zenith with a high level of comfort that they can achieve their objectives over the investment time frame prescribed.

## Investment Process

The objective of the Fund is to outperform the S&P/ASX200 Accumulation Index by 3% per annum over rolling 3 years.

To achieve this objective Solaris employs a multi-portfolio manager approach whereby analysts are empowered as sector-specialist portfolio managers. Solaris believes this structure results in superior performance as the sector analysts are the best placed individuals to execute portfolio decisions within their sectors. Solaris also believes that the greatest portfolio outperformance can be achieved by identifying where 1 year consensus expectations may be incorrect. This occurs as earnings expectations tend to cluster around this time horizon with any resultant earnings surprises producing large movements. This thesis is well supported by historical evidence with the multi-portfolio manager approach being employed by many domestic and international managers and Zenith believes that the structure and process should enable Solaris to achieve its return objectives.

## Security Selection

The starting universe for the Fund is very broad, encompassing all securities listed on the Australian Stock Exchange. While the Fund has a broad mandate it will predominantly invest in ordinary shares with the initial universe consisting of over 250 stocks. These stocks are passed through a risk screen to ascertain their suitability for portfolio inclusion, removing all poor quality stocks. Stocks are screened out due to:

- Liquidity issues - 120 day limit using 1/3 of volume of last 90 days;
- Financial risk - balance sheet risks, debt issues;

- Geo-political risk;
- ESG (Environmental, Social, Governance) considerations; and
- Litigation risks.

Stocks identified in this process are placed onto a "no buy" list i.e. stocks that the team is prohibited from investing in under any circumstances. This list usually consists of 8-9 names and the stocks are reviewed on a quarterly basis to ensure exclusions are still valid. The remaining universe consists of over 200 stocks resulting in each analyst being responsible for approximately 40 - 50 stocks.

Research on the remaining universe focuses on identifying where consensus expectations are likely to be inaccurate. As earnings expectations tend to be most clustered over a 1 year forecast timeframe, the process has a bias to this time horizon. However, while the 1 year horizon is the primary consideration all company earnings are forecast out a minimum of 4 years to ensure that analysts remain mindful of longer term risks. To enable analysts to identify where consensus may be inaccurate the stocks that pass through the initial risk filter are subjected to in-depth analysis that broadly concentrates on:

- Management;
- Business model;
- ESG considerations;
- Balance Sheet strength;
- Cash Flow profile; and
- Trend in Return on Equity.

As each individual analyst is motivated by and responsible for ensuring that they achieve their performance targets they are responsible for prioritising their own research. Although they have access to a standard company model and Discounted Cash Flow (DCF) valuation, they are also free to employ any analysis and valuation methodologies they find most effective. However, consistent with ensuring analysts remain mindful of the longer term risks all analysts are required to perform a DCF valuation. The final output of the research is an Expected Total Return (ETR %) 1 year forecast for each stock. This ETR includes the capital and yield returns for each stock. To ensure consistency of assumptions and to prevent the top-down overlay from affecting valuations, all analysts draw upon common assumptions, e.g. currencies, interest rates. These assumptions generally reflect consensus broker assumptions and any major updates are highlighted to all analysts overnight but can be overridden by group consensus.

Included among the stock research is an intensive company visitation program with analysts conducting approximately 500 company meetings per year. Consistent with having sole sector and stock responsibilities analysts generally conduct these visits alone although company meetings held within the Solaris head office are typically attended by multiple analysts.

All stocks have a backup analyst who is responsible for covering stocks if an individual is absent. However, the primary analyst maintains responsibility for the performance of these stocks, providing a strong incentive for each analyst to set out detailed instructions if unavailable. All backup analysts also provide a verification service whereby they review all stock positions of the lead analyst if the positions have been outperforming or underperforming for more than 3 months to ensure that any analyst bias is removed and that the position is still valid.

Overall, the process is well structured with the sector analyst/portfolio manager roles ensuring that staff remain focused on outperformance. The focus on identifying where 1 year consensus earnings expectations are inaccurate is a well documented means of achieving outperformance and the process is structured to ensure that analysts remain focused on this time horizon while remaining mindful of the longer term risks.

## Portfolio Construction

As Solaris employs a multi-portfolio manager approach stock selection and weighting remains at the discretion of the responsible sector analyst. Analysts are driven by the Fund performance target of exceeding the S&P/ASX 200 Accumulation Index by 3.0%, resulting in each analyst targeting 0.6% outperformance for their individual portfolios. A continual tally of each analyst's contribution to outperformance is maintained throughout the financial year to ensure this is tracked on an ongoing basis. Ultimately, individually and collectively, they are responsible for the performance of both stocks and sectors. Mindful of the portfolio constraints, the analyst uses the Expected Total Return (ETR %) calculated during the research process to recommend appropriate stock weightings. The analyst then initiates a buy order which must be approved by the Managing Director.

The ETR of all the analysts' stocks are fed into an Expected Return Database that calculates and displays a market-capitalisation weighted-average market return with stocks overweighted/underweighted according to their relative return, or excess return. In general, a 10% excess return dictates a 1% overweight position in the relevant stock whereas a 20% excess return would result in a 2% overweight position. The resulting sector weights are an outcome of the weights of stocks within the different sectors.

While ultimately the individual analysts are responsible for the stock and sector weights, Donohue, in consultation with the portfolio analysts, monitors all active positions to identify capitalisation and sectoral biases whilst also monitoring tracking error. He also ensures the portfolio maintains its sell discipline, enforcing that a diminishing excess return results in reduced stock weightings.

Although the final portfolio is a reflection of the individual convictions it will generally contain 40-70 stocks with stock weights limited to +/-3% and sector weights limited to +/-5%. Cash is deliberately maintained at a low level, with an expected weight during normal market conditions of 2%. However, irrespective of the levels, all cash in the fund remains 100% net exposed to equities through SPI futures.

An interesting feature of the Solaris portfolio is that the dealers are allocated a small discretionary portfolio representing 2% of the fund's capital. To ensure that no client is disproportionately disadvantaged by any underperformance, the dealer portfolio is allocated evenly among the clients. The portfolio was created to enable the dealers to capitalise on any short-term trading opportunities where they believe inefficiencies exist. To prevent conflicts of interest, all analyst trades have precedence and all orders must be approved by the Managing Director prior to execution. A portion of their remuneration is linked to the performance of this discretionary portfolio.

## Risk Management

| Portfolio Constraints | Description |
|---|---|
| Tracking error (% p.a.) | 2% p.a. to 4% p.a. |
| Weight - Sector Rel. Index (%) | -5% to 5% |
| Weight - Security Rel. Index (%) | -3% to 3% |
| Security Numbers | 40 to 70 |
| Cash (%) - Uncovered | 0% to 5% |

Risk is considered at various stages throughout the Solaris investment process and remains an essential consideration. Although the multi-portfolio manager approach affords the analysts a great deal of latitude the process is designed to ensure that they remain mindful of risk and that the final portfolio isn't exposed to any unintended biases. Overall, a remuneration structure that highly favours positive performance and ensures individual accountability serves to motivate the analysts to be aware of the risks they are assuming.

Included among the risk controls are formal risk constraints that place limits on stock and sector weights ensuring that the final portfolio doesn't assume unintended and excessive risk. While stock weightings are determined by expected total return with a +/-1% active weight position being the most likely active weight, the formal limit is a +/-3% active weight which allows for any upward drift due to appreciation. The maximum active sector weight is +/-5% which ensures that the portfolio doesn't assume excessive macro-economic tilts.

While the formal constraints act as important risk controls there are various other measures in place to mitigate and monitor risk. The stock filter acts as an initial risk measure that helps the Fund avoid potential problem stocks. Stocks that for financial, geo-political, ESG or litigation reasons are deemed non-investment grade are placed on to a "no buy" list. Analysts are strictly prohibited from investing in these stocks unless circumstances change and the stocks are upgraded with the list being reviewed on a quarterly basis. In addition to this initial filter, stock positions are reviewed every month at a team meeting attended by all analysts. The top 10 outperformers and bottom 10 underperformers are discussed and all positions that have outperformed or underperformed for in excess of 3 months are passed onto the backup analyst for review to ensure the rigour of the conviction. An additional check in the process is that all trades must be approved and passed through the Managing Director prior to execution. Automated pre and post-trade compliance checks also highlight any breaches of portfolio constraints. This ensures that trades are in line with portfolio constraints.

Risk is also measured on an ex-post basis by the Managing Director in consultation with the portfolio analyst at a monthly portfolio analytics meeting. The portfolio is passed through risk analytic software, an extension of the Goldman Sachs JBWere model that displays the portfolio characteristics and any unintended biases. This information is then conveyed back to the analysts for any action that requires attention.

## 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, which could lead to negative performance. This risk can be significantly reduced by investors adopting a medium to long-term (5+ years) investment time frame when investing in this fund.

While a style neutral approach should protect the fund from market conditions that favour value or growth methodology, the fund is still subject to market forces and investors should be aware that with a long only approach and intended low cash weighting the fund will show a strong correlation with markets. Again investors should be prepared to invest for the longer term to smooth out this volatility.

The firm's level of funds under management (FUM) has increased significantly since inception to approximately $3.6 billion (as of 31 December 2009). Solaris has stated that it has a capacity to manage 0.75% of the Australian share market capitalisation, indicating capacity constraints will not be an issue for some time. Excess levels of FUM can create issues for Australian shares fund managers, hampering their ability to efficiently enter and exit stock positions. Solaris has budgeted for strong inflows on an annual basis and these inflows will have to be managed carefully so as not affect performance.

As Solaris employs a multi-portfolio manager approach the process is highly dependent on the skill of the individual analysts. As such the loss of any of the analysts would be a material loss to the team. However, Zenith would argue the potential risk of any team members leaving is minimal given that a majority of the team retain meaningful equity stakes, they have all worked together for many years including their time with Suncorp and there has only been one departure in the past 4 years.

## Applications of the Fund

In general, 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's recommended that investors adopt a longer time frame when investing in equities. Investors should also be cognisant of the fact that the Australian equity market is fairly concentrated, with a couple of sectors dominating the market and the market only represents approximately 1% of global equity markets (in terms of market capitalisation). Therefore, to mitigate this concentration risk it is highly recommended that investors diversify their investments across asset classes and internationally.

While the Fund can be held as a stand-alone exposure to the Australian equities sector for investors with low investment amounts, Zenith believes the Fund should be blended with other Australian equities funds to mitigate manager specific risk.

The Fund can be blended with other style-neutral, value and/or growth orientated Australian equities products to achieve a more diversified exposure to the sector.

## Fees

The management fee for the Fund is 0.90% with no performance fee. This is in line with other funds in this asset class.

**Author: Andrew Cassar**
**Investment Analyst**
Email: andrew.cassar@zenithpartners.com.au
Ph: (03)9642 3320
Fax: (03)9642 3319