

# Perpetual's Wholesale Australian Fund

31 Dec 2008

The Perpetual Wholesale Australian Fund (PWAFF) is a high quality value-style Australian shares offering that is well regarded by Zenith. PWAFF is highly rated based on the experienced and well resourced investment team responsible for managing the Fund, as well as the clearly structured and robust investment process that the manager employs. In Zenith's opinion, these factors should enable the manager to deliver long term excess returns despite having high funds under management (FUM) in Australian equities.

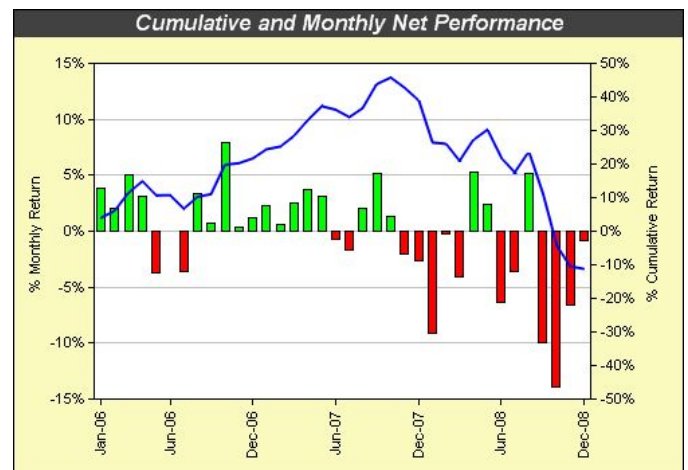
The Perpetual Australian equity investment team is one of the strongest and more stable in the Australian marketplace. The 12 member team is well led by John Sevier, Head of Australian Equities. Sevier is supported by Matt Williams, Senior Portfolio Manager, as well as the broader portfolio management team. With regards to the management of PWAFF, John Sevier and Matt Williams share equal portfolio management responsibility for the Fund. In Zenith's opinion, Perpetual's multi-manager approach (which is applied across most of the manager's Australian equities products) has helped Perpetual nurture the portfolio management skills of its analysts and assisted team stability.

Perpetual operates under a "value" orientated investment style with bottom-up fundamental analysis that targets high quality, under valued stocks. The security selection process starts by passing the entire stock universe through a quality screen whilst the second stage of the process examines the relative valuation of the stocks that pass the screen. The output from this fundamental research process is an analyst score. A portfolio matrix then sets the guidelines for portfolio construction. Each stock is divided into 1 of 3 different stock tiers based of the company's market capitalisation and is then combined with the analyst ranking of the stock. This in turn then provides the guidance for what the portfolio weights of each stock should be. Sevier and Williams are then responsible for final portfolio construction decisions and making subjective assessments with regard to the makeup of the portfolio. Zenith considers the security selection and portfolio construction processes adopted by Perpetual to be robust and applied in a disciplined, structured manner.

Investing larger pools of money than competitors presents additional challengers to Perpetual, as high FUM has the potential to hamper the managers' ability to trade efficiently. As at 30 November 2007, Perpetual managed approximately \$25.5 Billion in Australian Equities, more than double the FUM of Perpetual's nearest Australian equities competitor on the Zenith Recommended List.

In Zenith's opinion, PWAFF is a quality Australian equities product and as such it has achieved a RECOMMENDED rating. Zenith has changed its rating on this Fund (previously HIGHLY RECOMMENDED) following further consideration of the substantial challenges to trading and portfolio management that Perpetual faces given its large levels of FUM. While we consider Perpetual's investment team and process to be amongst the highest quality in the sector, Zenith's rating also reflects the challenges that Perpetual faces given its very large FUM. After contrasting Perpetual's strengths and weaknesses against those of all other funds in the sector (particularly other value-orientated managers), Zenith has decided that a RECOMMENDED rating is currently most appropriate for this Fund.

Key Features	Description
APIR Code	PER0049AU
Asset Class	Australian Shares
Sub-Asset Class	Large Companies
Investment Style	Value
Benchmark	S&P / ASX 300 (Accum)
Recommended Investment Timeframe	5 + years
Head of Equities	John Sevier
Investment Team Size	12



### Performance Analysis

Performance Statistics	5 Yrs (% p.a.)	3 Yrs (% p.a.)	1 Yr (% p.a.)
Performance - Fund	7.40	-3.95	-36.19
Performance - Benchmark	6.71	-4.04	-38.92
Performance - Median Manager	6.74	-3.97	-36.98

The Fund's performance objective is to outperform its benchmark, the S&P/ASX 300 Accumulation Index over rolling 3-year periods. To achieve this objective the Fund invests in industrial and resource stocks that the manager believes represent the best quality investment at the appropriate price.

The Fund has posted a return competitive with the benchmark (S&P / ASX 300 Accumulation Index) and the large cap median manager over a 5 year timeframe. Zenith anticipates that 'true to label' value managers will generally underperform the benchmark in prolonged bull markets where fundamentals often get overrun by positive market sentiment.

Zenith is confident that over a full market cycle PWA will achieve its investment objective based on our assessment of the quality of the investment personnel as well as the robust investment process employed at Perpetual. In addition, PWA has historically achieved strong above benchmark returns since its inception in 1986.

### Consistency Analysis

Consistency Statistics	5 Yrs	3 Yrs	1 Yr
History of Monthly Excess Return (%)	51.67	52.78	58.33
History of Monthly Excess Return (Rising Mkts %)	55.00	52.38	100.00
History of Monthly Excess Return (Falling Mkts %)	45.00	53.33	44.44

Over the long term (i.e. 5 year time period) PWA has produced modest out-performance of the market in both rising and falling markets combined (i.e. above the 50% threshold). Zenith concludes that in comparison to some of its value peers; the manager is not as deep value as managers such as Investors Mutual, which produces closer to 100% levels of excess monthly returns in falling markets over the market cycle.

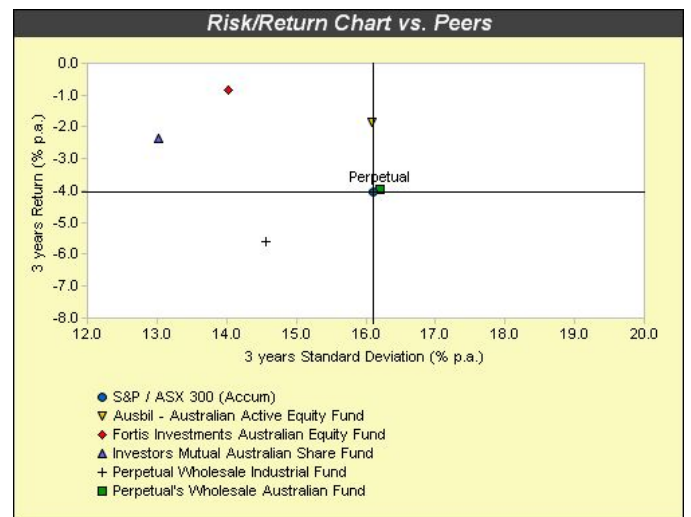
### Risk / Return Analysis

Risk / Return Statistics	5 Yrs	3 Yrs	1 Yr
Information Ratio - Fund	0.19	0.02	0.91
Information Ratio - Median Manager	0.04	0.04	0.46
Sharpe Ratio - Fund	0.07	-0.66	-2.18
Sharpe Ratio - Median Manager	0.03	-0.68	-2.40
Standard Deviation (% p.a.) - Fund	14.37	16.20	20.09
Standard Deviation (% p.a.) - Median Manager	13.68	15.72	18.87
Tracking Error (% p.a.) - Fund	3.57	4.03	3.00
Tracking Error (% p.a.) - Median Manager	3.27	4.03	4.88

PWA compares favorably from a risk/return perspective with the median manager in both the Information ratio and Sharpe ratio measures over the long term.

In summary, a positive value for these measures (i.e. a result of greater than 1.0) illustrates that the manager is generating excess returns over that of the benchmark and cash rate respectively, based on the level of risk (measured by standard deviation) of the Fund.

The risk / return chart highlights the Fund's risk adjusted performance standing relative to other managers in the universe.



## Investment Personnel

Name	Title	Time with Manager
John Sevier	Head of Equities	15 Yr(s)
Matt Williams	Senior Portfolio Manager	16 Yr(s)
Sean Cunningham	Senior Analyst / Portfolio Manager	14 Yr(s)
Amy Somes	Senior Analyst / Portfolio Manager	18 Yr(s)
Charles Lanchester	Senior Analyst / Portfolio Manager	10 Yr(s)
John Harbot	Senior Analyst / Portfolio Manager	2 Yr(s)
James Bruce	Senior Analyst / Portfolio Manager	7 Yr(s)
Max Ameodo	Senior Analyst / Global Liaison	12 Yr(s)
Vasant Khilnani	Senior Portfolio Manager	15 Yr(s)
Jack Collopy	Analyst	8 Yr(s)
Maryanne Drewe	Analyst	6 Yr(s)
Vince Pezzullo	Analyst	1 Yr(s)

The Perpetual Australian equity investment team is one of the strongest and more stable in the Australian marketplace. The team is well led by John Sevier, Head of Australian Equities, who joined the Group in 1994. Sevier is supported by Matt Williams, Senior Portfolio Manager, as well as the broader portfolio management team. Zenith, believes that Perpetual has successfully created a culture that promotes individual accountability but also spreads the portfolio management workload between the portfolio management team.

The majority of the portfolio management team (John Sevier, Matt Williams, Sean Cunningham, Amy Somes & Charles Lanchester) have worked alongside each other for over 10 years and since the departure of the previous Head of Equities in 2002 the team has remained largely in tact. This is testament to the strong succession planning and opportunities for advancement made available to investment team members.

Perpetual is one of the more progressive managers Zenith has reviewed in terms of its succession planning. In 2007 Perpetual introduced a joint portfolio manager responsibility for the PWAf where John Sevier and Matt Williams share equal responsibility for the Fund, prior to this John Sevier was the sole portfolio manager. In Zenith's opinion, Perpetual's multi-manager approach (which is applied across most of the manager's Australian equities products) has helped Perpetual nurture the portfolio management skills of its analysts, assisted team stability, diversified risk and provided a succession planning platform. Perpetual also seeks to empower its analysts by providing them with live Perpetual balance sheet money to manage in preparation for them managing client money in the future. Portfolio management and analyst remuneration pools are based on the performance of the investment team, but are also linked with the individual achievements of each team member (i.e. analyst's stock

rankings are captured internally for analyst performance analysis and incentives calculations).

The investment team consists of 12 investment professionals including; a Head of Australian Equities, 7 portfolio managers, and 4 analysts. With the exceptions of Sevier and Williams, each team member has specified stock / sector responsibilities, although the number of stocks each team member covers varies based on the individual's portfolio management responsibilities. Sevier and Williams have no set analytical responsibilities allowing them to focus their efforts on portfolio management. Despite this, both regularly attend management meetings with the analysts and seek to maintain as strong a working knowledge on the stocks in their portfolios as the investment analysts undertaking the research.

Impressively, Perpetual has managed to retain key members of the investment team over the medium term, an achievement that many competitors have been unable to accomplish. Furthermore, over this period Perpetual has added 2 senior investment professionals to the group. John Harbot joined from Paradise Investment Management in September 2006 as an analyst and portfolio manager, and Vince Pezzullo has joined from Deutsche in June 2007 to take up an analyst role.

In terms of depth and experience, Perpetual rates as highly as any domestic equity manager Zenith has reviewed. The majority of the investment team has spent between 5 and 20 years at Perpetual, with the majority of the 8 members with portfolio responsibilities having worked together for in excess of 10 years. In terms of industry experience, only 2 of the 12 members of the investment team have less than 10 years experience behind them. In addition to its qualitative capabilities, Perpetual has a dedicated 7 member quantitative team which can provide assistance in attribution analysis. The investment team is also ably supported by strong portfolio dealing and portfolio administration teams.

In Zenith's opinion, the overall quality and structure of the Perpetual Australian equities team is "first class" and as such we have a high level of comfort in their ability to generate added value.

## Investment Process

Perpetual's overall philosophy is based on 2 fundamental tenets - value and quality. The manager believes that markets are semi-efficient and that opportunities exist for adding value through the selection of quality, well priced securities. Perpetual believes investing in quality companies minimises downside risk, whilst the selection of securities trading at a discount to their inherent value will deliver out performance. Perpetual is a classic "fundamental, bottom-up, value-orientated" investor.

## Security Selection

The investment process adopted by Perpetual is robust and applied in a disciplined, structured manner. In Zenith's opinion it is this structure and discipline which has enabled the manager to deliver competitive long term performance despite its high level of funds under management (FUM) in Australian equities.

In 2006 Perpetual announced a plan to broaden its investment strategy for all of its Australian share funds by allowing opportunistic investment in offshore markets up to a maximum of 20%. The strategic allocation to offshore listed stocks is 0% and investment is only undertaken when it is deemed that the

offshore stocks are better-quality investments to a comparative Australian stock. To date PWAF has had very limited exposure to international equities and the currency exposure of all offshore positions is fully hedged back to the Australian dollar. Zenith does not consider investment into international equities to be a material divergence from Perpetual's existing investment process as Perpetual considers a number of offshore listed stocks in determining a reference point for Australian stocks in the same industry. Responsibility for international stock coverage rests with the respective sector analyst(s).

PWAF has an initial investment universe of over 450 stocks that are both listed in Australia (all stocks on S&P/ASX 300 Index) and on foreign stock exchanges. However, once stock liquidity is assessed, and stocks are fed through Perpetual's quantitative quality filters, the team is left with approximately 350 stocks to monitor. However, in reality PWAF will focus on the largest capitalisation stocks within the opportunity set.

Perpetual has advised Zenith that its Australian investment universe has continued to grow over recent years. This is based on new IPOs (initial public offerings) and more companies passing through Perpetual's quality screen. The manager believes that this is a direct result of Australian companies generally having stronger balance sheets and also a broad improvement in the quality of management personnel at companies. Zenith believes that as one of the best resourced investment teams in the market Perpetual is well qualified to adapt to covering an increased number of stocks.

The security selection process is split up into 2 stages;

The first stage starts by passing the entire universe through a quality screen. Companies must pass all 4 quality tests. These tests include:

- Sound management (a subjective call focusing on; management's track record, capital management, ability to maximise shareholder value, board of directors);
- Conservative debt (debt / equity should be less than 50%, but if not then the following are considered; interest cover must be 3.0 times or greater & debt payback period is a maximum of 5 years. For the banks the Tier 1 Capital ratio is used);
- Quality of business (a subjective call focusing on; Porter factors including barriers to entry, industry structure, competitive advantage); and
- Recurring earnings (prefer companies that have a 3 year track record of generating earnings, or a demonstrated ability to provide visible earnings in future).

Examples of stocks which fail this screen include highly geared companies. This screening process is undertaken using both internal data and broker / consensus numbers. In addition to the screening filter a formal report is prepared on the company. This report outlines how the company meets the set test criteria and also identifies any key risk indicators associated with the company that may impact on its balance sheet and / or profit and loss statement.

The second stage of the process examines the relative valuation of the stock. Perpetual adopts a flexible approach to stock valuation which tailors its method based upon the nature of the company in question. For example, cyclical stocks are valued using an assessment of potential P/E (Price to Earnings ratio) based on normalised market conditions, whilst

growth companies are valued using current price vs. future growth prospects, NPV and historic and forecast P/E. Whilst this flexibility in valuation techniques may be deemed a risk in certain cases, Zenith is confident that Perpetual has the depth and experience of personnel, as well as an appropriate level of peer debate to undertake this approach successfully.

The output from the fundamental research process is an analyst score which indicates the analyst's conviction in the stock and the expected level of out performance that the stock will provide. This rating is used as one of the primary communication tools between the analyst and portfolio manager. Each stock is ranked either 1 (strong buy - substantial out performance), 2 (buy - strong out performance), 4 (sell - under performance / relative pricing too high) or 5 (strong sell - fails filter criteria or substantially overpriced). Stocks are not allowed to be rated 3 (hold) to promote conviction of analyst's recommendations, which is a ratings structure that Zenith endorses. Ratings are then updated on an ongoing basis and are distributed to all analysts and portfolio managers.

In Zenith's view, Perpetual's investment process operates within a solid framework with all the necessary risk controls. Furthermore the process has stood the test of time and has proven to be both repeatable (out performance over multiple periods) and transferable (delivered positive returns under the guidance of different Heads of Australian Equities, John Sevier - 2002 to present and Peter Morgan - 1994 to 2002).

### Portfolio Construction

Inputs into the portfolio construction process are driven by the analyst's stock ranking scores, and the risk management constraint and guidelines that are in place for PWAF. The portfolio is usually built by giving the analyst's best ideas first priority in terms of portfolio allocation. However, this is subject to the stock's availability, liquidity and the portfolio's bias. John Sevier and Matt Williams are responsible for final portfolio construction decisions and making subjective assessments with regard to the makeup of the portfolio. Zenith is comfortable with this subjective overlay and believes that Sevier and Williams are expertly qualified to make the final portfolio construction calls.

The portfolio matrix sets the guidelines for portfolio construction and is designed to assist and provide accountability in portfolio construction decision making. However, it should be noted that these guidelines are not "hard and fast rules" and the subjective input of the portfolio managers and investment team remains a key determinant in the overall portfolio construction decision. Under the portfolio matrix each stock is divided into 1 of 3 different stock tiers based of the company's market capitalisation: large (tier A), medium (tier B) and small (tier C). The company's market capitalisation tier is then combined with the stock's analyst ranking of 1, 2, 4 or 5 which then in turn provides an approximation of the portfolio weight of each stock. For example, the guideline portfolio weight for a stock that receives an analyst ranking of 1 and sits in the Tier A market cap category is the company's index weighting plus 5% in the portfolio.

- Stock ranking 1 : tier A (+5.0%), tier B (+5.0%), tier C (Buy);
- Stock ranking 2 : tier A (+3.0%), tier B (+3.0%), tier C (Sell);

- Stock ranking 4 : tier A (-3.0%), tier B (Sell), tier C (Sell); and
- Stock ranking 5 : tier A (-5.0%), tier B (Sell), tier C (Sell).

With regards to the "Buy" and "Sell" guides for Tier C stocks this indicates that the Fund will tend to hold stocks ranked 1 and not stocks ranked 2, 4 or 5 although Sevier and Williams have discretion over the weighting relative to the index or whether to hold the stock at all.

All the above mentioned stock guidelines relative to the index are given an additional 50% allowable range to account for price changes. For example, the +5.0% constraint on tier A stocks with a ranking of 1 can move to +7.5%. Perpetual also has a strong sell discipline. Companies are sold from the portfolio if the stock fails the stock selection criteria, or if the stock's valuation reaches an excessive and unsustainable level.

Overall, Zenith is impressed by Perpetual's portfolio matrix structure and its use in conjunction with Sevier and Williams' subjective intuition. We are confident that this approach allows the analyst's views and ranking on stocks to be appropriately conveyed to the portfolio manager and that recommendations will be given the warranted consideration in the determination of the final portfolio.

### Risk Management

Portfolio Constraints	Description
Security Numbers	40 to 80 Not targeted
Weight - Security Rel. Index (%)	-5% to 5% Where price change occurs limits can be extended to +7.5% above index
Weight - Resources Sector (%)	-15% to 15% Portfolio weighting to resources relative to index
Weight - Holding Rel. Issued Capital (%)	max: 15% Perpetual may hold a max. 15% of the issued capital in a company
Weight - Overseas Listed Companies (%)	max: 20% Strategic allocation is 0%, investment offshore is only undertaken opportunistically
Cash (%)	max: 10%
Portfolio Turnover (% p.a.)	40% p.a. to 100% p.a. Not targeted

In addition to the constraints in the above table, the portfolio also has informal guidelines including; an expected tracking error range of 3%-6% p.a. (not targeted) and Perpetual also monitors for unintended & significant exposures to BARRA risk factors.

Portfolio monitoring occurs in a formal sense principally through a monthly risk management report that outlines performance and risk factors. Examples of factors considered in the report include; fund performance attribution, individual analyst performance, portfolio and ranking changes, and BARRA analysis (ex-ante tracking error, risk decomposition, factor exposures, and stock contribution to active risk).

Zenith is comfortable that Perpetual's risk management framework is strictly adhered to at all stages of the investment process. Zenith is impressed at the level of intensive due diligence undertaken on each company that is represented in the portfolio, as well as the constraints placed on the portfolio, which we consider to be adequate in controlling the portfolio's exposures without constraining the ability to add value.

### Risks of the Fund

A prolonged bull market where fundamentals get overrun by positive market sentiment poses one of the most significant risks for any value orientated manager. During these periods growth stocks tend to out perform their value peers as investors chase returns, although absolute returns provided to investors should still be positive.

Having high levels of funds under management (FUM) presents additional challengers to Perpetual, as high FUM has the potential to hamper a fund manager's ability to trade efficiently. As at 30 November 2007, Perpetual managed approximately \$25.5 Billion in Australian Equities, more than double the FUM of Perpetual's nearest Australian equities competitor on the Zenith Recommended List. There are some benefits to being large (other than the ability to financially support a large investment team and specialist equity dealers), in that the manager has greater access to lines of stock and can unwind positions by participating in block trades. Despite these potential advantages Zenith considers the difficulties of managing liquidity, as well as the inevitability of having to disclose substantial shareholdings to the market (most common in smaller companies) as outweighing the advantages of having high FUM.

In terms of key person risk, Perpetual like all fund managers is exposed. The departure of John Sevier would be regarded as a considerable loss; however, this risk is significantly mitigated by Perpetual's strong succession planning and team depth. The manager also has a solid transition track record after implementing a seamless changeover of the Head of Equities posting in 2002. In Zenith's opinion this can be largely attributed to the structured and robust nature of the underlying investment process which is readily transferable.

### Applications of the Fund

3 years Excess Correlation Table	
Fund Name	Excess Correlation
Ausbil - Australian Active Equity Fund	0.23
Fortis Investments Australian Equity Fund	-0.09
Investors Mutual Australian Share Fund	-0.01
Perpetual Wholesale Industrial Fund	0.19

As the 3 year excess correlation table highlights, the Fund blends well with its growth, style-neutral and value orientated peers.

In Zenith's opinion, Perpetual is an excellent candidate as a value orientated fund manager within the Australian marketplace. Although a number of strong candidates have been endorsed in this investment style, each possesses slightly different characteristics which may better suit different client risk profiles. Zenith considers Perpetual's investment style to be more 'moderate value' as opposed to a 'deeper value' investment approach undertaken by peers such as Investors Mutual.

Zenith believes that with regards to an investor's overall exposure to this asset class, a style neutral approach (i.e. a blend of both value and growth managers), will deliver consistent returns over the medium to long run and remove some of the volatility which would otherwise be experienced if taking on a style bent or skew.

### **Fees**

A management fee of 0.99% p.a. applies to PWAFF, which Zenith considers to be reasonable in comparison to the Fund's peers.

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