

# Zenith traditional index research methodology

Traditional index products are those products that either:

- track a market-capitalisation/value/issuer-weighted underlying index
- track an index that Zenith deems suitable/representative of a sector, region or asset class or
- have underlying traditional index exposures with a static strategic asset allocation, e.g. certain multi-asset products.

The below summarises Zenith's proprietary traditional index fund research methodology and process. We follow a structured ratings process that involves assessment of the following quantitative and qualitative factors.

\* Please note we do not disclose the weightings of factors and this should be used as a guide.

## 1. Investment process

### 1.1 Overview

Zenith offers its clients access to the investment managers we identify as the 'best of breed' through a comprehensive, multi-dimensional selection process.

Our philosophy and commitment is simple; by exploring the investment landscape in a diligent and detailed fashion, Zenith can uncover the best opportunities for our clients.

### 1.2. Screening process

An effective screening process is critically important to the overall research method. It ensures greater efficiency by directing the research team to concentrate its efforts on products with superior qualitative and quantitative parameters.

Zenith considers all Australian-registered managed traditional index products and a limited number of unregistered traditional index products. To avoid entering multiple funds for each investment manager, where appropriate, a flagship fund is used as a proxy for a particular strategy.

We generate traditional index product data surveys from our extensive database. We begin with the broadest universe to avoid any selection bias at this early stage. Data is collected directly from the investment managers. Although the collection of in-house propriety data is rare within research houses, Zenith considers this to be an important source of value add. This method has uncovered many opportunities prior to their coverage on commercial databases. The early identification of quality fund managers is one of our key competitive advantages.



### 1.3. Quantitative screen

From its database, Zenith selects a list of leading contenders that pass the initial performance screens, which include an assessment of the Product's index tracking performance **over rolling three-year and five-year periods.**

### 1.4. Qualitative screen

Whilst the first stage of the investment process tends to focus on the manager's ability to track an index based on its performance metrics, the second stage incorporates an important qualitative overlay. The initial quantitative filter may identify a strongly performing manager that subsequently fails the qualitative filter given Zenith's view on the organisation, investment resourcing, implementation or product features.

The use of a rolling three-year timeframe as the benchmark review period aims to smooth out any distortions that may lead to undesirable index-tracking metrics. If Zenith does not have prior knowledge of the credentials of investment personnel, however the manager looks attractive on the quantitative filter, we will source a view from our network of industry contacts. If negative commentary does not arise, we will undertake a preliminary meeting to determine the appropriateness of this manager's representation on our short list.

### 1.5. Detailed due diligence

After a shortlist has been constructed, detailed due diligence is undertaken with the investment manager. At this stage we thoroughly examine every aspect of the manager, from the implementation and risk management process to the people behind it. This level of due diligence is only achieved through detailed meetings, a thorough review of all documentation, including the standard questionnaire, and an in-depth look at the portfolio's implementation. Note that reviewed documentation does not include any assessment of advertising or promotional materials to any groups or individuals outside the Zenith Research team.

The meeting with the investment manager is regarded as a critical component of our investment process. Our process extends beyond meeting with the lead portfolio managers; other members of the investment team, regardless of seniority, are interviewed. This aspect of the interview process is important as it provides us with a better understanding of team dynamics, the spread of responsibility and team depth.

During the course of the review process, an assessment is undertaken on the following key attributes:

- Organisation
- Investment Resourcing
- Implementation
- Product Features

This section of the review is qualitatively driven.



## 1.6. Responsible Investment (RI) classification

Our RI classification involves an assessment of three broad indicators:

- Does an investment strategy take into account RI and if so, to what extent is this embedded in the investment process?
- Are fund managers acting as active owners of securities?
- What is the extent to which formalised policies and procedures govern the integration of RI issues for the Fund?

To generate these classifications, we rely on information derived during manager meetings as part of our due diligence process as well as the provision of formal investment documentation from managers (does not include assessment of advertising and promotional material). Classifications reflect an absolute view, not a peer-relative assessment.

Products which hold a current Zenith investment grade rating (refer to Section 3) are assigned an RI classification using our proprietary system. View more detailed information about our RI classifications [here](#).

### How can the classification be used?

The RI classification can be used as a filter on our online tool, Zenith Mosaic. This allows users to search for funds not only on aspects such as asset classes, styles and ratings, but also on which RI category a user might prefer.

## 1.6 Organisation

Key points Zenith considers include:

- Ownership structure – global alliance, overseas parent, joint venture, staff equity ownership
- Organisational structure – whether the business is solely focused on asset management or operates in broking, investment/retail banking or financial planning
- Management team structure – board composition, reporting lines (domestic, regional and/or global basis)
- Executive team analysis – CEO, CIO, Board of Directors
- Organisational history – timeline of major events (acquisitions, restructures, etc)
- Remuneration and contractual structure
- Administration – back-office capabilities, client reporting
- Funds under management (FUM) – total, split by wholesale, retail & asset class, history/trajectory of gross inflows/outflows and decomposition of mandate and client type
- Risks relating to commercial viability
- Environmental, social and governance considerations – proxy voting, incorporation in the implementation process and standing as a good corporate citizen



On the organisational front, Zenith is looking for clean reporting lines, a commitment to the domestic business, an experienced/highly credentialed executive team, effective administration and strong communication. Zenith also seeks to identify any business-related factors that may impact the ongoing operation of the product.

## 1.7 Investment resourcing

Key points Zenith considers include:

- Does the investment team have sufficient resources to execute its stated implementation process?
- What is the depth of experience of the investment team?
- How are responsibilities split (portfolio management, committee involvement, etc) within the team?
- Recent personnel changes and the reasons why?
- What is the frequency and nature of formal and informal meetings within the investment team?
- How are personnel remunerated?

On the investment resourcing front, Zenith is looking for a well-resourced, highly credentialed investment team with a solid history of index tracking performance. A spread of responsibility within the team should enhance outcomes, whilst an appropriate remuneration structure should incentivise all members of the team.

## 1.8 Implementation

Key points Zenith considers include:

- What markets/instruments are traded and how efficient are they (e.g. appropriate futures to equitise cash)?
- What return enhancements (securities lending, rebalance timing, discretionary input, etc) are used?
- How efficient is trading (trading costs, cross trading, etc)?
- Supporting research – is the majority of the research internally or externally organised?
- What replication methodology is used?
- What rebalancing rules are used to track the underlying index?
- What information sources/data feeds are used?
- At what funds under management size would the manager consider closing the portfolio due to capacity constraints?
- How is capacity managed (client concentration, legalities regarding takeovers, managing too much of an index, etc)?
- How does the manager define risk?



- How is portfolio risk managed?
- Are tracking error and tracking difference actively monitored?
- Who is responsible for risk management and what is the process?

On the implementation front, Zenith is looking for an approach that is logical and appropriate for the underlying index being tracked, with due consideration provided to key areas such as risk management.

## 1.9 Product features

Key points Zenith considers include:

- How attractive is the strategy relative to all investment options, including actively managed products?
- Does the manager use an appropriate market maker (applicable for exchange-traded products)?
- Does the underlying index design make sense?
- How tax-effective is the product?
- How competitive is the cost structure on an absolute basis and compared to peers in a similar asset class (both active and passive)?

On the product features front, Zenith is looking for an offering with attractive design features and a competitive price structure.

## 1.10 Quantitative portfolio attribution

In addition to the qualitative assessment undertaken as part of detailed due diligence, a more in-depth analysis is performed on portfolio attribution.

Whilst the quantitative data gathered from the initial filter process is re-examined in the detailed due diligence phase, it is the consistent monitoring of investment outcomes that drives this part of the process. Key information sought by Zenith to undertake this task includes tracking error and tracking difference statistics.

This data is supplied on a monthly basis and is electronically delivered to Zenith to allow for ease of data implementation into internal database systems.

The data gathered from this quantitative review is then compared with responses from the qualitative interview process with managers on implementation. During this process we are looking for consistent responses. For example, does the portfolio perform in line with expectations given its replication methodology and return enhancements?

## 1.11 Summary

We believe our key competitive advantage is that we are highly selective with which investment products we recommend for our clients. Initially we apply both qualitative and quantitative screens



to identify funds worthy of further consideration, with detailed due diligence undertaken on the resulting short list. This involves a highly comprehensive review process that encompasses an assessment of key criteria including the organisation's structure, the investment philosophy and process, the calibre of the investment personnel and an in-depth portfolio attribution analysis.

## 2. Ongoing manager evaluation

Zenith prides itself on the regularity and depth of its continual vigilance over investment managers. This extends from those managers already represented within the product and/or service to those on the 'radar screen' for possible inclusion.

Should there be a material organisational, commercial or implementation change that may impact the traditional index product, Zenith will meet immediately with the manager to evaluate the impact of the change and recommend a course of action to Zenith's Investment Committee.

Below we have detailed the specific data reviewed.

### Monthly

- Monthly performance update – all underlying managers in the database and Zenith traditional index products versus their peers
- Manager fund flow information – detailing any significant wholesale mandates lost and funds under management pool totals for each underlying manager and Zenith traditional index products
- Update database – flows through to the quantitative component of the investment process

### Quarterly

- Monthly data as above
- Quarterly questionnaire – detailing stock/security portfolio holdings and formally confirming any compliance breaches and/or investment personnel/implementation process changes
- Manager update – in person, via teleconference or via video-conference. Zenith will endeavour to speak directly with each portfolio manager to ensure an open dialogue. This update can either be general in nature or address specific issues at hand
- Adjust/amend manager asset allocation weights in the diversified funds/portfolios

### Annually

- Monthly and quarterly data as above
- Due diligence update – review existing managers and any new managers deemed worthy of addition
- Screening update – identifies any new managers worthy of further due diligence and any existing manager that now fails the initial screen
- Update database – flows through to the qualitative component of the investment process
- Review strategic asset allocations for diversified funds/portfolios



### 3. Traditional index product ratings

Zenith undertakes thorough screening of each traditional index product in our investment universe to identify quality investment opportunities.

This is followed by an extensive due diligence process, where traditional index products are assigned a rating. This rating is based on Zenith's proprietary scoring system.

Each traditional index product is assigned an overall score/rating:

<b>Rating</b>	<b>Score</b>
Index Highly Recommended	= / > 80%
Index Recommended	70 - 79%
Index Approved	55 - 69%
Index Not Rated – Screened Out	< 55%

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