



Avoca Investment Management Investment Process

Avoca Investment Management (Avoca) manages the Bennelong Avoca Emerging Leaders Fund, which primarily selects stocks for portfolio inclusion from the S&P/ASX Small Ordinaries and S&P/ASX Mid-Cap 50 Indices.

Investment philosophy

Avoca believes the intrinsic value of any security is the present value of its future free cash flows. Whilst capital markets tend to be more focused on near-term earnings and valuation rules-of-thumb in pricing equities (e.g. PEs, dividend yields), Avoca considers longer-term and maintainable cash flows as the prime driver of its calculation of intrinsic value.

The team believes the only way to estimate such future cash flows with appropriate rigour and accuracy is through in-depth, fundamental company and industry research, and subsequent robust financial modelling. Having undertaken this work and generated an intrinsic value on the stock in question using Dividend Discount Model and/or Discounted Cashflow Model techniques, comparing this intrinsic value to the market price allows Avoca to assess the prevailing value of that stock. Undertaking this process across a large group of stocks allows Avoca to assess value across that group. Accordingly, the essence of Avoca's approach to equity investment is in-depth, long-term research and financial modelling.

Investment style

In the context of smaller company investment, Avoca's investment style can be described as style neutral, high conviction within a strong risk-control framework. The team rarely invests in negative cash flow companies unless there is a clear path to profitability in the near term. Avoca rarely invests in IPOs, believing there is strong information asymmetry between the business vendors and capital markets. They have a strong preference for proven business franchises, proven management teams, and appropriately geared companies.

General investment objectives

Avoca's investment objectives are to:

- achieve or exceed the agreed risk/return objectives of clients;
- outperform the agreed client fund benchmark; and
- outperform peer managers as measured by industry surveys.

Fund objective

The **Bennelong Avoca Emerging Leaders Fund** aims to provide investors with a total return (after fees and expenses) in excess of the S&P/ASX Small Ordinaries Accumulation Index by 3-5% per annum, measured over rolling five-year periods. Whilst the fund is not managed to a tracking error objective, it is estimated that the ex-ante tracking error will be between 4-8%.

Variable	Target
Benchmark	S&P/ASX Small Ordinaries Index
Investment objective	3-5% p.a. above benchmark over rolling five-year periods
Expected ex-ante tracking error	4-8%
Stock numbers (typical)	30-50 (with maximum of 70 allowable)
Active stock limit	6% +/-
Cash limit	0-10%

Investment process

The essence of Avoca's investment process is long-term fundamental research and financial modelling. However, given the large size of the investable universe (some 500 - 600 stocks), the team utilises various quantitative screens to identify stocks considered worthy of in-depth research. That said, it is important to understand that the quantitative screens are not part of the core process, rather they are seen as a source of idea generation along with other sources such as the company meeting program and self-generated ideas.

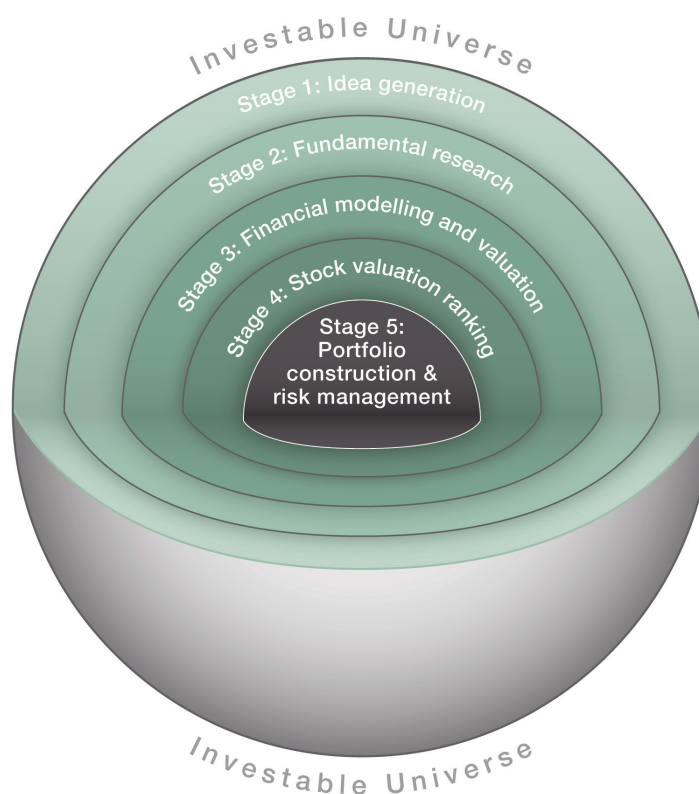
The process is best understood diagrammatically.

Investable universe

Avoca applies the following filters to its large potential investable universe:

- market capitalisation typically above \$100m and below \$3 billion; and
- reasonable liquidity in the trading of its shares.

These filters provide an investable universe of some 500-600 stocks.



Stage 1: Idea generation

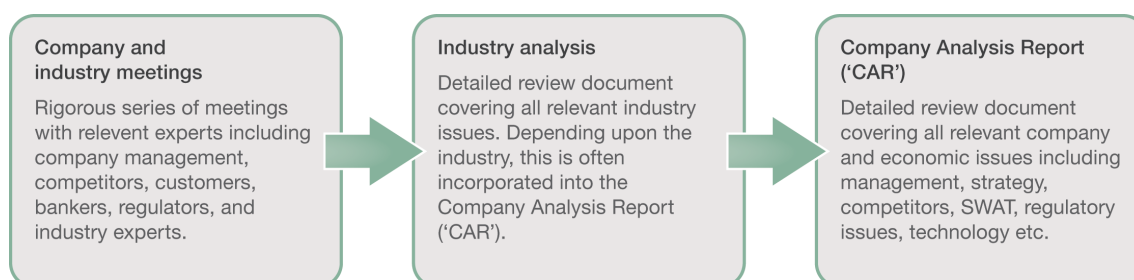
The Avoca core process (stages 2 - 5) is detailed and highly rigorous and, as such, requires a significant time commitment from the relevant analyst. Indeed over time, the team has determined that each analyst can only cover around 30-40 stocks at any one point to the required level of diligence. Accordingly, Avoca does not cover every stock in its investable universe. Given this, an intermediate stage in the process entitled 'idea generation' is required to identify a group of around 100 stocks that can be covered by the three-person team to the required level of diligence.

Avoca uses a multi-faceted approach to idea generation being:

- quantitative screens driven by consensus data and utilising simple valuation metrics (such as PEs, PEG ratios, ROEs etc.);
- company meeting program – we average around 150 one-on-one company meetings and a further 300 group meetings or conference calls per annum;
- broker economic and stock research; and
- the team's 43 years of equity research experience for self-generated ideas.

Stage 2: Fundamental research

This is the heart of Avoca's investment process. In this stage, companies that have been identified in the idea generation process (stage 1), are subject to detailed, fundamental qualitative research by one of the analysts in the team. The fundamental research process is as follows:



Avoca does not utilise sector specialisation for its analysts. Rather, the team has determined over time that better outcomes are achieved by analysts covering a wide variety of industries including industrials, financials and resources.

Stage 3: Financial modelling and valuation

Once the analyst has completed the fundamental qualitative research process and produced a 'Company Analysis Report' (CAR) as per stage 2, the team believes the analyst is then in a position of understanding that will permit robust financial modelling.

In this regard, Avoca has developed a standardised model template to facilitate work efficiencies whilst not in any way constraining analyst creativity. Accordingly, the analyst can enrich and enhance the standardised financial model to any degree of detail they see fit.

The standardised model includes:

- 3+ years historical + 6-year forecast divisional sales & EBITDA/EBIT margins;
- 3+ years historical + 6-year forecast consolidated P&L and balance sheet; and
- 3+ years historical cash flow statements.

It is important to note that year six in the financial model is deemed the 'normal' year, which means this year is mid-cycle or 'normalised' for the economic cycle. This normal year is a critical driver of the terminal value of the company and therefore a critical driver of the assessed intrinsic value of the company.

In valuing the company, the analyst has two valuation modules at their disposal:

- Dividend Discount Model (DDM) – a six-year DDM with a terminal value calculation in year six driven by the normal year; or
- Discounted Cashflow Forecast (DCF) – a free form DCF which the analyst is at liberty to extend for as many years as relevant before calculating the terminal value. For instance, if the stock in question was a 30-year toll road concession, the analyst is free to extend the DCF out to 30 years.

Stage 4: Stock valuation ranking

Valuation data for all stocks covered by Avoca is submitted to the 'Avoca Valuation System' (AVS) database. The database ranks all stocks on one core metric – assessed intrinsic value to stock price. AVS stores this data on a weekly basis. Output from the database can be displayed in tabular or graphical formats. The database can be queried for changes in relative value over time.

Stage 5: Portfolio construction and risk management

The portfolio is constructed by reference to the following elements.

1. **Avoca Valuation System (AVS)** – This primary valuation system indicates the cheapest and most expensive stocks under detailed coverage. All things being equal, it is the key driver of stock selection and weighting.
2. **Analyst confidence/conviction** – Avoca understands that any analyst's level of confidence with respect to individual stocks modelled and their resultant valuations will vary. Accordingly, it is logical that portfolio construction accounts for this varying level of confidence. Whilst there has been no attempt to quantify this factor, it is incorporated as part of the regular portfolio management process. Stocks showing the highest level of discount to intrinsic value as well as the highest level of analyst confidence would logically tend to comprise the largest active positions.
3. **Economic overlay** – Whilst the process is broadly bottom-up, it is acknowledged that during the portfolio construction stage, some consideration is given to macro-economic effects, particularly in addressing sectoral concentration. That said, Avoca believes that portfolio construction is 90% bottom-up and not more than 10% top-down.
4. **Risk management** – Avoca has portfolio risk management guidelines in place covering individual stock positions (+/- 6% active), sectoral exposures (+/- 15% active), and tracking error (4-8% ex ante). Risk reports are prepared by a third party (BNP Paribas Fund Services Australasia) and also separately monitored by Avoca's own portfolio management systems. Risk is assessed on both a pre-trade and post trade basis.

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Information is current as at June 2011.