Recommended

Product Review
Nikko AM Australian Share Concentrated Fund

ISSUE DATE 28-07-2020

ANALYST: GERALDINE GOH | APPROVED BY: SHAILESH JAIN

About this Review

ASSET CLASS REVIEWED	AUSTRALIAN EQUITIES
SECTOR REVIEWED	AUSTRALIAN LARGE CAP
SUB SECTOR REVIEWED	VALUE
TOTAL FUNDS RATED	24

About this Fund

ASIC RG240 CLASSIFIED	NO
FUND REVIEWED	NIKKO AM AUSTRALIAN SHARE CONCENTRATED FUND
APIR CODE	TYN0040AU
PDS OBJECTIVE	THE FUND AIMS TO PROVIDE LONG-TERM CAPITAL GROWTH AND INCOME BY INVESTING IN A CONCENTRATED SELECTION OF SHARES
INTERNAL OBJECTIVE	AS PER PDS OBJECTIVE BUT ALSO TO OUTPERFORM THE BENCHMARK (GROSS FEES) OVER ROLLING FIVE-YEAR PERIODS
STATED RISK OBJECTIVE	TRACKING ERROR MAXIMUM OF 9% P.A.
DISTRIBUTION FREQUENCY	QUARTERLY
FUND SIZE	$40.3M (JUNE 2020)
FUND INCEPTION	26-05-2010
MANAGEMENT COSTS	1% P.A.
RESPONSIBLE ENTITY	NIKKO ASSET MANAGEMENT AUSTRALIA LIMITED

About the Fund Manager

FUND MANAGER	NIKKO ASSET MANAGEMENT AUSTRALIA LIMITED
OWNERSHIP	100% OWNED BY NIKKO ASSET MANAGEMENT CO, LTD. (NIKKO AM EQUITY AUSTRALIA LIMITED IS 50% OWNED BY THE AUSTRALIAN EQUITY TEAM AND 50% OWNED BY NIKKO AM LIMITED)
ASSETS MANAGED IN THIS SECTOR	$10.9B (JUNE 2020)
YEARS MANAGING THIS ASSET CLASS	30

Investment Team

PORTFOLIO MANAGER	JASON KIM & TIM JOHNSTON
INVESTMENT TEAM SIZE	11
INVESTMENT TEAM TURNOVER	LOW
STRUCTURE / LOCATION	PM - ANALYST/SYDNEY

Investment process

STYLE	VALUE
BENCHMARK	S&P/ASX 200 ACCUMULATION INDEX
TYPICAL CAPITALISATION BIAS	MID-TO-LARGE
TYPICAL STOCK NUMBERS	15-25
STOCK POSITION LIMITS	8% (ABSOLUTE)
SECTOR POSITION LIMITS	20% ABSOLUTE (EX FINANCIALS EX A-REITS WHICH IS INDEX + 10%)

Fund rating history

JULY 2020	RECOMMENDED
AUGUST 2019	RECOMMENDED
NOVEMBER 2018	RECOMMENDED

What this Rating means

The **'Recommended'** rating indicates that Lonsec has strong conviction the financial product can generate risk adjusted returns in line with relevant objectives. The financial product is considered an appropriate entry point to this asset class or strategy.

Strengths

- The Manager has a disciplined and logical investment process, which is implemented by a highly experienced co-portfolio management team.
- The team has exhibited notable stability, despite progressing through generational change.
- Lonsec considers the investment culture to be cohesive and highly collegiate.

Weaknesses

- With the tendency to 'let winners run', the Manager's sell-discipline is considered to be less consistently driven by a stock's 'valuation' when compared to other 'value' style peers in the sub-sector.
- The investment objective lacks an explicit alpha target.
- The 4% grossed-up yield hurdle (applied to 90% of portfolio) for stock selection may not be tax efficient for 'high alpha' seeking investors in the accumulation stage.
- Relative performance outcomes have been disappointing over the short to medium term, furthermore, the Fund has not met its performance objective.

Fund Risk Characteristics

	LOW	MODERATE	HIGH
BUSINESS SUSTAINABILITY RISK		●	
CAPITAL VOLATILITY			●
SECURITY CONCENTRATION RISK			●
SECURITY LIQUIDITY RISK	●		

Risk categories are based on Lonsec's qualitative opinion of the risks inherent in the financial product's asset class and the risks relative to other financial products in the relevant Lonsec sector universe.

BIOmetrics

Aggregated risks

	1	2	3	4	5	6	7
STD RISK MEASURE						●	

A Standard Risk Measure score of 6 equates to a Risk Label of 'High' and an estimated number of negative annual returns over any 20 year period of 4 to less than 6. This is a measure of expected frequency (not magnitude) of capital losses, calculated in accordance with ASFA/FSC guidelines.

	LOW	MODERATE	HIGH
RISK TO INCOME		●	

Nikko AM Australian Share Concentrated Fund

Features and benefits

	LOW	MODERATE	HIGH
COMPLEXITY		●	
ESG			●

Fee profile

	LOW	MODERATE	HIGH
FEES VS. UNIVERSE			●
FEES VS. ASSET CLASS			●
FEES VS. SUB-SECTOR			●

Fee BIOmetrics are a function of expected total fee as a percentage of expected total return.

What is this Fund?

- The Nikko AM Australian Share Concentrated Fund ('the Fund') is a long-only Australian equities investment vehicle offered by Nikko Asset Management Australia Limited ('Nikko' or 'the Manager'). The Fund aims to provide long-term capital growth and income by investing in a concentrated selection of shares.
- Nikko has a long-standing 'relative value' fundamental investment approach, which aims to invest in companies below the Manager's conservative estimation of 'intrinsic value'. Companies that meet the Manager's initial screens are ranked according to total expected return, which gives an indication of which companies represent the highest relative value at any given point in the market cycle. Lonsec believes Nikko takes a more flexible approach to 'value' investing and, as a result, the Manager's style is not expected to be at the 'deep end' of the value-style spectrum relative to some peers. The Fund may more closely resemble a 'core' style at various times.
- The Fund is constructed in a 'benchmark unaware' manner, meaning portfolio positions are not weighted relative to an index. As a result there is potential for the Fund's positioning to deviate significantly from the benchmark.
- Another key feature of the Fund is that at least 90% of companies held are required to have a minimum grossed up dividend yield of 4% to be considered investable. Lonsec observes that over the past five years the Fund's dividend yield has been higher than the benchmark's, although investors should note this is not an explicit objective of the Fund.
- The dividend yield hurdle should assist in giving the Fund some defensive characteristics in falling markets. While the Strategy has typically had a beta of 0.75-0.90, the beta will be a function of where value is identified in the market. That said, the Fund is relatively concentrated, with 15-25 stocks, and individual positions up to 8% of the portfolio. The Fund is one of the most concentrated options in the peer group.
- The Manager aims to be fully invested across the market cycle. Tracking error is not targeted but monitored and can not exceed 9% p.a. The Fund has a deliberate strategy of being low turnover, expected to be in the range of 20 – 70% p.a.
- As per the Fund's PDS dated 29 November 2010, the fee disclosure for the Fund is as follows: management cost of 1.00% p.a. (including a management fee of 0.90% p.a. and administration costs & expenses of 0.10% p.a), the Fund does not charge a performance fee. Lonsec notes that the fee load is at higher end of the broader peer group, particularly given the lack of alpha target in the investment objective.
- During the financial year ended 30 June 2019, the net transaction costs for the Fund were estimated at 0.15% of the NAV of the Fund. Net transaction costs are costs incurred in managing the Fund (including explicit and implicit costs of buying and selling assets, the cost of hedging/protection strategies and/or when there are applications or redemptions of fund units by investors) that are not covered by the buy/sell spread. Buy/sell spreads are subject to change depending on market conditions. Please refer to the Manager for current buy/sell spreads and refer to the Fund's PDS for further details.
- Lonsec has coverage on four Nikko strategies as part of the Australian Equities – Large Cap review. The other three are:
  - The Nikko AM Australian Share Wholesale Fund, which is a core Australian equity strategy holding 20 – 35 stocks; and
  - The Nikko AM Australian Share Income Fund, which has a yield objective and is more diversified than the Fund, holding 40-70 stocks.
  - The Nikko AM Australian Share Value (Ex-20) Model Portfolio, which is focused on best ideas ex-20 and is the Manager's most concentrated strategy, holding just 10-15 stocks.

Using this Fund

This is General Advice only and should be read in conjunction with the Disclaimer, Disclosure and Warning on the final page.

- The Fund is subject to equity market risks and movements (both positive and negative) in the prices of the underlying securities in the portfolio. Potential investors should therefore be aware of, and comfortable with, the potential for the Fund to experience periods of negative absolute returns which may result in capital losses being incurred on their investment. Lonsec recommends that equity investments are suitable for investors with an investment time horizon of at least five years.
- The Fund is a 'long only' Australian equity product which will be predominately fully invested in the Australian equity market. As such the Fund will generally sit within the growth component of a diversified investment portfolio. As a 'relative value' style product, Lonsec considers it suitable for blending with other Australian Equity strategies including style biased funds, Small Cap, Long / Short, or Absolute Return products.
- Although the portfolio is high conviction and concentrated in nature, its beta is expected to be lower than traditional benchmark aware Australian equity products. That said, it is likely to display greater risk from stock concentration.
- Additionally, the inclusion of an income objective and a 4% yield hurdle for at least 90% of stocks held may result in inefficient tax outcomes for generally higher tax rate 'accumulation' investor who more naturally gravitate to concentrated equities options.

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Nikko AM Australian Share Concentrated Fund

Investors should consider professional tax advice when evaluating the Fund.

Suggested Lonsec risk profile suitability

SECURE	DEFENSIVE	CONSERVATIVE	BALANCED	GROWTH	HIGH GROWTH
			●	●	●

For guidance on appropriate asset allocations and risk profiles, refer to the latest Lonsec Strategic Asset Allocation Review and Risk Profile Definitions on our website.

Changes Since Previous Lonsec Review

- Vincent Li was promoted to Research Analyst in March 2020.
- In June 2020, Nikko relaxed the existing grossed-up 4% dividend yield hurdle and the hurdle now applies to only 90% of the Fund's portfolio.
- There have been no material changes to the investment team since Lonsec's previous review.

Lonsec Opinion of this Fund

People and resources

- Brad Potter assumed leadership of the investment team in June 2014 as Head of Australian Equities. Potter has over 26 years of investment experience and 18 years of tenure with Nikko. Prior to Nikko, Potter worked at Westpac as a Director – Corporate Finance and at Ord Minnett as a Senior Research Analyst. The Nikko's operating model sees all senior investors having not only portfolio management but also research responsibilities. Potter has analyst responsibilities for the Banking sector. Lonsec has met with Potter regularly for a number of years and considers him to be a capable investment professional.
- Potter is supported by Johnston as the Deputy Head. Johnston began his investment career of 22 years with Nikko and Lonsec considers him a highly experienced investor. Apart from being Deputy Head, Johnston also has analyst responsibilities for the Healthcare, Agriculture and Energy sectors. Having met Johnston on a number of occasions, Lonsec is impressed with his stock knowledge and ability to articulate the investment process. Lonsec believes he is a highly capable investor and deputy.
- Jason Kim joins Johnston as a Portfolio Manager for the Fund since he joined Nikko in 2000. Kim is a highly experienced investor with 28 years of investment experience and has been at Nikko for 19 years. Together with Johnston, Kim has been a portfolio manager on the Fund, since its inception in May 2010. Kim is also a co-portfolio manager of Nikko's flagship strategy and covers the Insurance sector. Lonsec has found Kim to be an articulate investor and considers him to be highly capable and passionate. Lonsec is mindful of Kim's competing responsibilities but notes the high degree of crossover between both strategies.
- Johnston and Kim each have sole discretion for the management of 50% of the Fund's capital and this structure is a common feature of Nikko's portfolios (although the proportions may vary). A benefit of this structure is its ability to help mitigate key person risk although given the significant proportions for which Johnston and Kim are each responsible this is to a degree moot. Despite the existence of individual responsibility, Lonsec notes that Nikko has a collegiate structure and the portfolio managers are actively encouraged to discuss portfolio activity ahead of implementing any change. Nonetheless, this can dilute accountability to investors as the relative performance of the two sub-portfolios is not disclosed.
- The investment team of 10 investors and an additional dedicated dealer is considered appropriately sized to implement the investment process. The team has historically exhibited a high degree of stability but has experienced some generational change until 2016. The investment experience levels across the team are high with an average of 21 years and an average tenure of 14 years.
- Lonsec considers communication and peer review amongst the investment team to be highly structured and robust. All team members meet multiple times throughout the week to debate and peer review stock research ideas in addition to discussing portfolio construction and broader market matters. Lonsec also considers the investment team demonstrates a high degree of collaboration relative to peers and views this favourably.
- Lonsec believes that an important factor in the stability of the team has been the opportunity for equity ownership in the franchise. Specifically, the Australian Equities business is structured as a joint venture between the investment team and Nikko. Pleasingly, Lonsec notes the high alignment of interest between the investment team and investors with all senior members of the team being equity holders. While the equity ownership structure is not unique to Nikko, the breadth of the spread of equity across the team is viewed by Lonsec to be a positive and distinguishing feature of the remuneration structure. Further, variable remuneration is based on individual performance which holds all team members accountable.

Research and portfolio construction

- Nikko seeks to identify companies that it believes exhibit fundamental intrinsic value. The philosophy gravitates towards companies that demonstrate sustainable earnings and which can capitalise these. Nikko describes their philosophy as 'value' but note that this does not necessarily mean 'cheap' value as understood from stocks trading at observable discounts (e.g. P/E or P/B) to the broader market or their history. To this end, there is an explicit cap of between four and eight years, depending on the opportunity, applying to the maximum length for which a company's franchise period will be explicitly modelled. Lonsec highlights that the characteristics sought by Nikko are generally more consistent with growth at reasonable price ('GARP') investors. Notwithstanding, elements within Nikko's process act to control factor exposures and deliver a strategy that has exhibited 'mild value' through to more 'core' outcomes over time. Additionally, the yield hurdle (discussed below) leads the portfolio to exhibit a pronounced yield bias.
- Lonsec considers the Manager's investment process and portfolio construction to be robust and logical. The initial investment universe of the S&P/ASX 200 Index is reduced to approximately 150 stocks

after a liquidity screen is applied. To prioritise the fundamental research effort, the Manager then implements an internally generated multi-factor screen to rank companies by value, quality and combined scores before conducting the bottom-up research effort.

- In contrast to other Nikko strategies, the screens for this Fund include a minimum grossed-up yield hurdle of 4% for a stock to be considered eligible for this portfolio. Lonsec understands that this is a feature retained from the Fund's earlier structure as a concentrated income strategy. However, in June 2020, Nikko relaxed the enforcement of the hurdle which now applies to 90% of the Fund's portfolio. Nikko advised that in addition to prior ongoing discussions, the implementation of this change was spurred by the advent of the novel coronavirus (COVID-19) pandemic which had hampered company dividend payouts and continues to cast doubts on future dividend sustainability of companies at the time of writing. Lonsec had previously highlighted the hurdle as somewhat unusual for concentrated strategies which are typically marketed and used by risk-tolerant investors who tend to be in an accumulation stage. Lonsec had also previously noted the hurdle precludes the Fund from investing in certain "high alpha" opportunities. While Lonsec welcomes the increased flexibility the change affords the Fund, Lonsec holds some reservation on its impact on improving Fund performance given its relative magnitude (only 10% of the portfolio will not adhere to the existing hurdle).
- While Lonsec considers this to be a reasonable feature in that context, Lonsec notes the hurdle may impede the Fund's usability by investors. In referencing the Fund's aim to deliver blended growth and income objectives over the long term, Lonsec highlights that a steady stream of yield may not be tax efficient for investors who are not zero taxpayers (e.g. accumulation investors typically attracted to concentrated strategies). Nonetheless, Nikko notes that the yield requirement has been retained as an additional measure of quality to give the portfolio added robustness. Lonsec will continue to closely monitor the impact of the change on Fund performance in future reviews.
- Analysts are accountable for their recommendations but, importantly, these are required to be peer-reviewed by the whole team. Company research includes, for instance, meeting with company management and reviewing financial disclosures. Findings are presented in a standardised report which touches on key investment factors like thesis, assumptions, risks, sensitivities, Environment, Social, and Governance (ESG) and valuation. Lonsec generally views standardised outputs as good practice helping to support consistency in an investment process.
- ESG considerations are formally incorporated into the valuation process at the stock level. This can be undertaken via a discrete estimate of the earnings impact or alternatively via a discount to the capitalisation rate. This is based on the belief that this analysis provides added insights and early signals on the 'sustainability' of returns. ESG research comes from multiple sources, including proprietary research, company information and external research providers such as MSCI. Lonsec regards this as a positive differentiating factor to other mainstream Australian equity products.
- The investment team meets on a regular basis each week to discuss the positions in each of the portfolios and to assess new investment ideas. Moreover, the meeting also includes in-depth discussions regarding the key quantitative inputs used in the stock valuation process. Lonsec believes this mechanism is a key strength of the investment process as it enhances the overall level of peer review.
- Nikko's financial analysis involves proprietary modelling of variables across the income and cash flow statements in addition to the balance sheet. Valuation analysis is based on a standardised Internal Rate of Return (IRR) model which has a three-year horizon. This can be cross-checked to a DCF analysis which is where the duration of a company's franchise period is explicitly curtailed. Lonsec considers that Nikko's valuation approach is reasonable and consistently applied.
- IRRs are ranked and the general aim is to invest in those companies with the greatest return profile. Portfolio construction is also largely consistent with the output of the CVA. Portfolio managers are, however, permitted to continue to hold names that drop in the IRR ranks (i.e. through price appreciation) and no longer rank highly. Nikko's rationale is that this is consistent with its belief of allowing 'winning stocks to run'. Moreover, Nikko highlights that it believes 'value' managers generally sell too early. Lonsec is sympathetic to Nikko's argument, however, believes that is also indicative of Nikko's flexible relative valuation methodology, potentially holding 'expensive' names, which is not wholly considered by Lonsec to be consistent with 'value' investing. Value investors are typically valuation driven and price-sensitive hence the general observation that they may sell too early.
- The portfolio managers each have sole discretion, subject to names having progressed through the investment process, to build their respective sub-portfolios. Importantly, trade ideas are typically discussed between the two and Lonsec believes that this, to a degree, supports the management of the Fund as an aggregate portfolio. Further helping in this regard, the portfolio managers also have access to a range of quantitative risk tools which are used to actively monitor factor exposures at the aggregate Fund level. Additionally, there will be some differences across the sub-portfolios however these are expected to be timing and valuation-related rather than fundamental disagreements on a company's fundamentals.
- Notably, the Fund's Active Share has been in the range of 20-70% (69.5% as at December 2019) since the last review which Lonsec views broadly positively in light of the Fund's active management philosophy. That said, it is worth noting that Nikko's flagship Australian strategy (with a few additional stocks at 20-35) exhibits a similar level of Active Share (60%-66%) as this Fund. Investors should be aware of the Fund's highly concentrated nature with aggregate holdings expected to range between 15 and 25 names.

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ESG Integration

- As a firm, Nikko has articulated a commitment to the integration of ESG within their investment processes supported by responsible investment policies (including engagement and proxy voting), some of which are publicly available. Lonsec views the strength of this commitment and disclosure of responsible investment policies to be above peers.
- As aforementioned, Lonsec also observes a notable level of ESG integration within the Nikko's research and portfolio construction process where Nikko shows a willingness to moderate position weights or stock valuations upon identifying material ESG risks it believes could adversely impact Fund performance. Nikko has also demonstrated active ownership through proxy voting and company engagement activities, however, Lonsec notes Nikko does not publicly disclose the outcomes of these activities. Overall, on a peer relative basis, Lonsec considers the degree of ESG integration within this Fund to be 'Moderately-High'.

Risk management

- The Fund's risk is managed in a relative sense versus the benchmark. Lonsec believes that the Manager has sufficient risk controls in place to effectively manage the risks within the portfolio (such as stock and sector exposures). These are overseen by a dedicated Investment Risk Manager. Given the Fund is relatively concentrated in the number of stocks it holds, Lonsec views risk management as a vital element of the investment process.
- The Manager has hard limits on both stock and sector exposures. Stock limits are managed to a maximum absolute size of 8% positions. Sector limits are managed to an absolute limit of 20% within GICS level 2 (ex-financials ex-REITs which is index +10%). The Manager will also typically not hold over 10% of a company's issued capital and will generally invest only in companies with a market capitalisation of over $300 million.
- Whilst not explicitly targeted, the Manager also aims for a portfolio beta of not much higher than the overall market, so as to manage the level of absolute risk in the portfolio.
- Risk management, to a lesser extent, is also embedded in the research process, with optimisation and 'scenario analysis' undertaken as part of portfolio construction. In addition, the Manager's ongoing portfolio review process (including daily performance monitoring) may be considered as a further form of risk management.

Funds under management (FUM)

- Nikko had approximately $9.3 billion in FUM across its Australian equities strategies as at March 2020. Nikko's most recent capacity analysis was conducted on 28 February 2019 and determined that a hard close would be appropriate at 0.75% of the S&P/ASX200 market capitalisation (currently equivalent to c. A$13 billion). Based on current FUM and market size, a soft close would occur at approximately A$12 billion.
- There are positives and negatives to low or high levels of FUM; however, on balance Lonsec believes managers with smaller FUM are better placed to add value. Larger fund managers typically have better access to key decision-makers (e.g. CEOs) and may gain better execution pricing and preferential access to IPOs and secondary offerings. Conversely, managing a large pool of money means that a manager may confront liquidity issues and is likely to be less nimble in the market as it takes longer for a position to be established or sold down.
- Lonsec notes Nikko is nearing its pre-defined capacity limit at current levels of FUM but views the Fund's mid-large market cap bias and relatively low portfolio turnover as mitigating factors to capacity constraints risk. That said, Lonsec will continue to monitor for Nikko's scale in FUM and assess the ongoing impact on Fund performance.

Performance

- The Fund's aims to outperform the S&P/ASX 200 Accumulation Index ('the Benchmark') over five-year periods by providing long-term capital growth and income from investing in a concentrated selection of shares. Lonsec notes that the Fund lacks an explicit 'alpha' target and believes that an objective of simply delivering growth and income is no longer suitable in defining an actively managed strategy as product choices have broadened for investors. All performance figures are referenced on a net of fees basis.
- Over the five-years to 30 June 2020, the Fund returned -1.2% p.a. and underperformed the Benchmark and peer group median by 4.7% p.a. and 1.9% p.a. respectively. While the Fund did not meet its capital growth objective, income contributed 7.3% p.a. to total return. Similarly, over three-years to 30 June 2020, the Fund returned -2.5% p.a. and underperformed the Benchmark and peer group median by 7.7% p.a. and 2.9% p.a. respectively. While failing to meet its capital growth objective over this period, income contributed 7.5% p.a. to total return.
- Over the shorter one-year period to June 2020, the Fund returned 16.6% and significantly underperformed the Benchmark and peer group median by 8.9% and 5.2% respectively. Over this time frame, income contributed 5.2% to total return. Lonsec notes the Fund's underperformance is partially attributed to heightened market volatility between February and April 2020 as a result of knock-on impacts from the novel coronavirus (COVID-19) pandemic. Key contributors to performance over the 12-months to 30 June 2020 include Coles, James Hardie and Nufarm. Key detractors from performance over this period include positions in Oil Search, CSL and Boral.
- Lonsec is cognisant of the Fund's disappointing relative performance in recent years and seeks to observe a sustained turnaround in performance to maintain its current conviction in the Manager.
- Given the concentrated and benchmark unaware nature of the Fund, Lonsec considers Tracking Error to be relatively low over the medium and longer terms (three, five and ten-year) but noted a high Tracking Error in the one-year to 30 June 2020 of 8.0%. Lonsec believes there is scope for the Manager to increase its level of activeness given the Fund's wide portfolio construction constraints combined with the active management fee charged. This is manifested both in the longer-term Tracking Error

and Active Share. Lonsec also notes that the Fund's volatility, as measured by standard deviation, has been above the benchmark and the peer median across all periods to June 2020.

Overall

- Lonsec has maintained the Fund's **'Recommended'** rating at its most recent review. The rating is underpinned by the Manager's experienced investment team along with its longstanding disciplined and logical investment process.
- However, Lonsec is mindful of the Manager's flexible relative valuation methodology which could challenge sell-discipline. Lonsec is also cognisant of the Fund's disappointing relative performance in recent years and seeks to observe a sustained turnaround in performance to maintain its current conviction in the Manager.

People and Resources

Corporate overview

Nikko Asset Management Australia Limited (NAML) is owned by Nikko Asset Management Co. Ltd (NAM Group), a Tokyo-based asset management group with more than US$205.2 billion in FUM (as at March 2020). NAML's Australian Equity business was responsible for $10.9 billion as at June 2020.

The Australian Equity business is structured as a joint-venture between NAML and the investment team with each group owning 50% of the operating entity (Nikko AM Australian Equities Pty Limited).

NAML is the Fund's Responsible Entity and additionally offers a range of other strategies domestically, e.g. fixed income and global equities. The Australian business is based in Sydney with overseas offices located in Edinburgh, London, New York and Singapore. NAM Group entered the Australian market via its acquisition of Tyndall Investment Management in 2011 from Suncorp Metway Ltd and subsequently re-branded the organisation.

Size and experience

NAME	POSITION	EXPERIENCE INDUSTRY / FIRM
BRAD POTTER	HEAD OF AUSTRALIAN EQUITIES	26 / 18
TIM JOHNSTON	DEPUTY HEAD OF AUSTRALIAN EQUITIES, PORTFOLIO MANAGER & SENIOR ANALYST	22 / 22
JASON KIM	PORTFOLIO MANAGER & SENIOR ANALYST	28 / 19
MALCOLM WHITTEN	PORTFOLIO MANAGER & SENIOR ANALYST	28 / 26
MICHAEL MAUGHAN	PORTFOLIO MANAGER & SENIOR ANALYST	22 / 13
CRAIG YOUNG	SENIOR RESEARCH ANALYST	24 / 24
MICHAEL WARD	SENIOR RESEARCH ANALYST	22 / 4
STEFAN HANSEN	SENIOR RESEARCH ANALYST	19 / 4
JAMES NGUYEN	PORTFOLIO MANAGER & SENIOR ANALYST	16 / 12
VINCENT LI	RESEARCH ANALYST	6 / 4
DAVID THOMS	DEALER	16 / 10
AVERAGE (N=11)	-	20 / 14

The team is led by Brad Potter, with Tim Johnston being his back-up as Deputy Head of Equities. The investment team comprises 10 equity investors and one dealer. All members of the investment team have stock research responsibilities (c. 15 to 20 stocks each) and six of the most senior members have additional portfolio management duties. The specific responsibilities are as follows for the team:

- Brad Potter – Banks;
- Tim Johnston – Healthcare, Energy;
- Jason Kim – Insurance;
- Michael Maughan – Telecommunications, Transportation/Logistics;
- Craig Young – Banks, Retail and Food & Beverage, Telecommunications;
- James Nguyen – Diversified Financials, Gaming and Utilities, Infrastructure;
- Michael Ward – Building Materials, Contractors, Metals;
- Stefan Hansen – Mining, Energy;
- Vincent Li – A-REITS, Industrials; and
- David Thoms and Malcolm Whitten – Dealing.

Remuneration / alignment of interests

The remuneration principle is to pay a market salary plus attractive short-term incentives (plus long-term incentives via shares in the Joint Venture Company). All established investment personnel in the Australian Equities team retain equity ownership. This serves the purpose of providing the investment team with access to profit sharing. Lonsec notes that equity can only be on-sold to another member of the equities team. In addition, there are financial penalties if a team member joins a competitor.

Variable remuneration is based primarily on the overall outperformance achieved by the Fund, team and

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individual. Bonuses (which are based on rolling two year performance) are adjusted positively or negatively at the analyst level to reflect individual performance contributions. To facilitate this, the Manager uses an internal analyst attribution model, which monitors performance on one and two year rolling periods.

Research Approach

Overview

INVESTMENT STYLE	INTRINSIC VALUE
NO. OF STOCKS IN UNIVERSE	200 (S&P/ASX 200 INDEX)
NO. OF STOCKS FULLY MODELED	150
UNIVERSE FILTERING	LIQUIDITY SCREEN (90-DAY MEDIAN DAILY TURNOVER) AND A 4% YIELD HURDLE
RESEARCH INPUTS	FUNDAMENTAL RESEARCH – FINANCIAL STATEMENTS, COMPANY MEETINGS ETC.
USE OF BROKER RESEARCH	CONSENSUS EARNINGS USED FOR SCREENING
VALUATION OVERVIEW	PE RELATIVE WITH DCF CROSS CHECK

Nikko seeks to identify companies that it believes exhibit fundamental intrinsic value. The philosophy gravitates towards companies that demonstrate sustainable earnings and which can capitalise these.

The Manager operates a research process referred to as Comparative Value Analysis (CVA). Those stocks remaining after the screening process (approximately 150) are then subjected to in-depth fundamental research.

The universe for idea generation comprises all names in the S&P/ASX 200 Index. Research is prioritised through the use of proprietary quantitative screens that screen/rank based on a range of criteria (liquidity, value, quality and momentum):

- Value (forecast one year);
- Price / Earnings;
- Dividend Yield (hard minimum of 4%);
- Enterprise Value multiples;
- Accounting Accruals;
- Retained Earnings / Assets; and
- EBIT / Total Assets.

Those names which screen well are candidates for further fundamental due diligence and research. This typically numbers c. 130 names. The Manager's fundamental research has a focus on EBIT drivers, profitability, cash flow and the structure of the company's balance sheet (to try and find value in non-capitalised assets).

The key inputs into the research process include broker reports; company reports; company visits; 'one on one' meetings with management; and other sources.

Research output is standardised. Additionally, the research is updated on an ongoing basis, with the Manager producing forecasts for P&L statements, Balance Sheets, Cash Flow Statements, as well as Ratio Analysis. Proprietary stock models are generally revisited bi-annually (when company results are released) and when warranted by a specific event. This includes the calculation of a three year internal rate of return (IRR) for each stock.

All research is subject to team-wide peer review before being completed. Peer review is facilitated through regular analyst meetings held three times per week. Additionally, the Manager conducts Portfolio Construction Meetings each week which provide a 'sounding board' for the Portfolio Managers which is attended by all team members.

Valuation

The formulation of a three-year IRR is a requirement for all stocks considered within Nikko's investment process. The IRR ranks are a key factor driving a stock's relative attractiveness within Nikko's process.

To enhance the consistency of the valuation output, the Manager utilises standardised inputs (such as beta, risk-free rate of return and gearing) when calculating the weighted average cost of capital for its discounted cash flow models.

Additionally, stock valuations can be cross checked against an alternative valuation model, usually a DCF, and adjusted for significant developments (such as acquisitions). Other valuation metrics considered include: earnings per share (EPS), dividends per share (DPS) and grossed up dividend yield (GUDY).

Portfolio Construction

Overview

FUND BENCHMARK	S&P/ASX 200 ACCUMULATION INDEX
RISK OBJECTIVE (INTERNAL)	TRACKING ERROR LESS THAN 9% P.A.
PORTFOLIO APPROACH	BENCHMARK UNAWARE
PORTFOLIO DECISIONS	JASON KIM & TIM JOHNSTON (50:50)
STOCK SELECTION	> 90%
TOP-DOWN INFLUENCE	< 10%
TYPICAL NUMBER OF HOLDINGS	20-25
MARKET CAPITALISATION BIAS	MID-TO-LARGE
EXPECTED PORTFOLIO TURNOVER	20-70% P.A.
OBSERVED ACTIVE SHARE	70.7% (DECEMBER 2019)
PORTFOLIO EXPOSURE IN TOP 10 HOLDINGS	55.3% (JUNE 2020)

The Manager generally aims to produce a concentrated portfolio of 15-25 stocks, tending to more greatly favour idiosyncratic/stock specific risks relative to factor risks (e.g. style). The Fund comprises of two sub-portfolios which are separately managed by two different Portfolio Managers.

The portfolio construction process is driven by a combination of qualitative and quantitative factors and the portfolio will generally be highly consistent with the stocks that rate highly in the Manager's IRR stock ranking list.

The qualitative element of the process allows the Manager to factor in market dynamics and insight gained from bottom-up analysis in constructing the portfolio. There is no general IRR which is considered particularly attractive (e.g. minimum acceptable hurdle) with the Manager noting this depends on the prevailing market opportunities.

This also encompasses the use of a potential discretionary element, which allows the Portfolio Manager to hold up to 7.5% of the portfolio in stocks that do not rank highly on IRR terms. The Manager's rationale for this component is that it allows 'winning' stocks to 'run', believing that a trap which other value managers sometimes fall into is to sell down profitable positions too early.

Additionally, this flexibility is further included in the acceptance that the three-year IRR method may miss

Nikko AM Australian Share Concentrated Fund

alpha opportunities in special circumstances (e.g. corporate targets, thematic shifts, successful acquirers, capital raisings and a quick response to changed fundamentals).

Importantly, however, Portfolio Managers must also determine milestones for the performance of these stocks and if they are not met, they are forced to reconsider the position at the Portfolio Construction meetings. In addition, such a position will also be reviewed should it start underperforming the market on a quarterly basis. So far, Lonsec understands that the Manager's usage of this discretionary element has been relatively minor to date.

BARRA is used as a quantitative tool in the portfolio construction process. The Manager believes it is particularly useful to both help assess the risks within the portfolio and for portfolio optimisation. The optimisation process is based on an efficient frontier of expected Tracking Error and expected Excess Return.

Price and earnings momentum are also considered in the portfolio construction process, with the primary objective being to optimally time stock entries and exits. Price and earnings momentum signals are also used to help identify potential 'value traps'.

The portfolio is 'stress tested' monthly through scenario analysis that allows the Manager to test the portfolio against potential market events.

Finally, the portfolio is assessed against value criteria to ensure that it is 'true to label' (e.g. idiosyncratic stock risk is driving the portfolio). The Manager relies on both BARRA output for this assessment and on its internal software.

Once implemented the portfolio is subject to ongoing review, with key 'flags' (such as a new stock entering the Top 20 IRR ranking, the stock weighting deviating more than 30% from the model portfolio target, or the stock closing in on 'fair value') used as triggers for investigation.

Risk Management

Risk limits

SEPARATE INVESTMENT RISK MONITORING	YES
EX-ANTE TRACKING ERROR TARGET	9% P.A. (MAXIMUM)
STOCK LIMIT (HARD)	8% ABSOLUTE
SECTOR LIMIT (HARD)	20% ABSOLUTE (EX FINANCIALS EX A-REITS WHICH IS INDEX + 10%)
CASH LIMIT	0-10%

The Portfolio Managers will build a concentrated portfolio of between 15-25 stocks, within specified portfolio risk guidelines outlined above.

Risk monitoring

All of the Fund's trades are monitored on a pre- and post-trade basis and its stock positions are also monitored on a daily basis. There is also a clear separation of duties between investment management and risk management, with compliance reports sent out on a daily basis to all Portfolio Managers, the dealer, the Head of Australian Equities and a separate compliance team.

Risks

An investment in the Fund carries a number of standard investment risks associated with investment markets. These include performance, liquidity, counterparty, market and tax risks. These and other risks are outlined in the PDS and should be read in full and understood by potential investors. Lonsec considers the following to be the major risks:

Concentration risk

The Fund will be generally invested in 15 to 25 different stocks and does not have any sector or country constraints. The Manager is expected to build a portfolio that may vary markedly from the benchmark (e.g. concentration risk and/or sector or industry exposures). Accordingly, investors should be mindful of the potential for sharper movements in the market price of these movements.

Equity market

Investments in equity markets are subject to numerous factors which may have an impact on the performance of an investment (both positive and negative). Unexpected changes in economic, technological, structural, regulatory or political conditions can have an impact on the returns of all investments within a particular market.

Derivatives

There is scope in the PDS to implement various derivative strategies. However, Lonsec does not expect derivatives to be a widely used given that these are not the intentions of the Manager. Derivatives are only used to managed cash flows. Derivatives are not intended to be used to speculate and the Fund does not intend to borrow.

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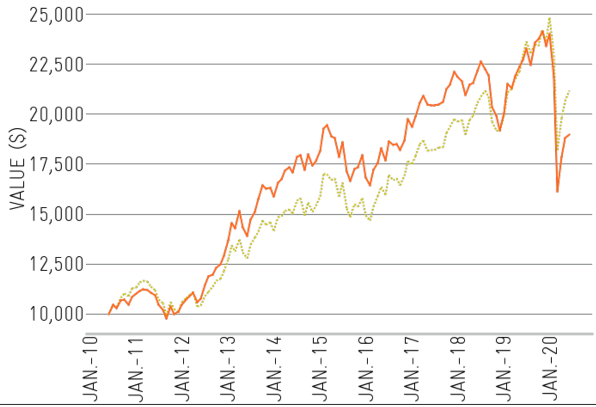
Quantitative Performance Analysis - annualised after-fee % returns (at 30-6-2020)

Performance metrics

	1 YR		3 YR		5 YR		10 YR	
	FUND	PEER MEDIAN	FUND	PEER MEDIAN	FUND	PEER MEDIAN	FUND	PEER MEDIAN
PERFORMANCE (% PA)	-16.56	-11.38	-2.46	0.33	1.23	3.09	6.62	7.23
STANDARD DEVIATION (% PA)	32.47	29.11	20.25	18.00	17.48	15.83	14.77	13.61
EXCESS RETURN (% PA)	-8.88	-3.75	-7.65	-4.69	-4.73	-2.84	-1.18	-0.66
OUTPERFORMANCE RATIO (% PA)	33.33	41.67	38.89	36.11	45.00	45.00	50.83	49.17
WORST DRAWDOWN (%)	-33.16	-29.47	-33.16	-29.60	-33.16	-29.60	-33.16	-30.06
TIME TO RECOVERY (MTHS)	NR	NR	NR	NR	NR	NR	NR	NR
SHARPE RATIO	-0.54	-0.46	-0.20	-0.09	-0.03	0.09	0.27	0.33
INFORMATION RATIO	-1.11	-0.95	-1.33	-1.09	-0.98	-0.64	-0.28	-0.24
TRACKING ERROR (% PA)	8.03	5.12	5.76	4.11	4.82	3.94	4.24	3.95

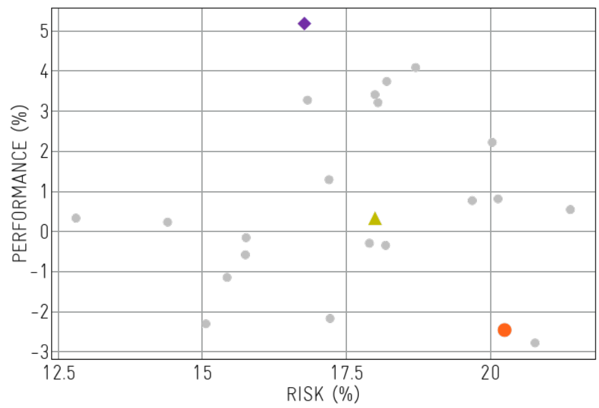
FUND: NIKKO AM AUSTRALIAN SHARE CONCENTRATED FUND
LONSEC PEER GROUP: AUSTRALIAN EQUITIES - AUSTRALIAN LARGE CAP - VALUE
BENCHMARK USED: S&P/ASX 200 TR INDEX AUD
CASH BENCHMARK: BLOOMBERG AUSBOND BANK BILL INDEX AUD
TIME TO RECOVERY: NR - NOT RECOVERED, DASH - NO DRAWDOWN DURING PERIOD

Growth of $10,000 over 10 years



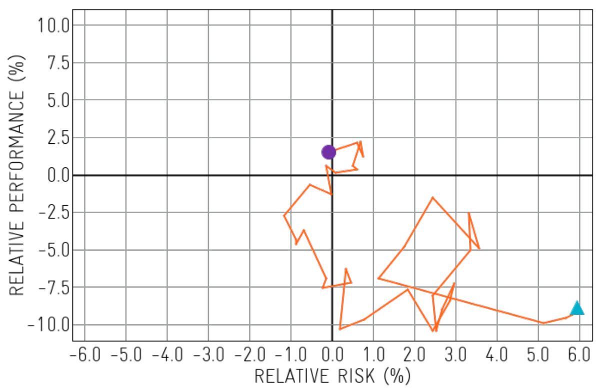
NIKKO AM AUSTRALIAN SHARE CONCENTRATED FUND
S&P/ASX 200 TR INDEX AUD

Risk-return chart over three years



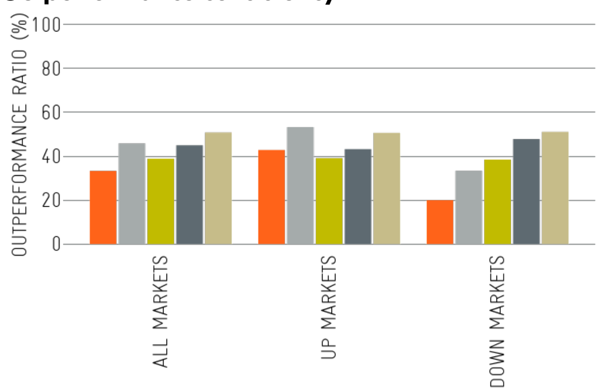
NIKKO AM AUSTRALIAN SHARE CONCENTRATED FUND
S&P/ASX 200 TR INDEX AUD
PEER MEDIAN
PEERS

Snail trail



START (06-2017) END (06-2020)

Outperformance consistency



1Y 2Y 3Y 5Y 10Y

ANALYST: GERALDINE GOH | APPROVED BY: SHAILESH JAIN

Nikko AM Australian Share Concentrated Fund

Glossary

Total return 'Top line' actual return, after fees

Excess return Return in excess of the benchmark return

Standard deviation Volatility of monthly Absolute Returns

Tracking error Volatility of monthly Excess Returns against the benchmark (the Standard Deviation of monthly Excess Returns)

Sharpe ratio Absolute reward for absolute risk taken (outperformance of the risk free return (Bank Bills) / Standard Deviation)

Information ratio Relative reward for relative risk taken (Excess Returns / Tracking Error)

Worst drawdown The worst cumulative loss ('peak to trough') experienced over the period assessed

Time to recovery The number of months taken to recover the Worst Drawdown

Snail Trail A trailing 12-month relative performance and relative risk measurement over the benchmark. The trail is generated using a 12-month rolling window over the specified period

About Lonsec

Lonsec Research Pty Ltd (Lonsec) is an investment research house with specialist areas of expertise, that was originally established in 1994 and the current entity was registered on 23 June 2011. From 1 July 2011, Lonsec became a fully owned subsidiary of Lonsec Fiscal Holdings Pty Ltd, a privately owned entity with a multi-brand strategy of providing leading financial services research and investment execution. Lonsec believes that professional financial advisers need informed opinions on the best investment strategies and financial products to provide real value for their clients. To meet this need, Lonsec has in place an experienced research team, which draws on a robust research process to undertake in-depth assessment of managed fund products.

Analyst Disclosure and Certification

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