Product Assessment

Report as at 27 Feb 2024

APPROVED

Tyndall Australian Small Companies Fund

Rating issued on 27 Feb 2024 | APIR: TYN8782AU

Investment objective

To outperform the S&P/ASX Small Ordinaries Accumulation Index by 3% p.a. to 5% p.a. (before fees) over rolling five-year periods. In addition, Tracking Error is expected to be within 6% p.a. to 10% p.a.

Manager	Tyndall Asset Management
Distributor	Yarra Capital Management Group
Sector	Australian Shares \ Small Companies
Investment Style	Value
RI Classification	Integrated
Absolute Risk	Very High
Relative Risk	Active - Benchmark Unaware
Investment Timeframe	7+ Years
Benchmark	S&P/ASX Small Ordinaries (Accum)
Min Investment Amount	$10,000
Redemption Frequency	Daily
Income Distribution	Half Yearly
Fund Size (31 Jan 2024)	$1.91M
Management Cost	0.90% p.a. Incl. GST
Performance Fee	20% of the outperformance of the S&P/ASX Small Ordinaries Index (after fees), subject to recouping underperformance
Buy / Sell Spread	0.30 % / 0.30 %
Inception Date	17 Mar 2023

Fund facts

- Expected to hold between 40 and 60 stocks
- Portfolio turnover expected to average 35% p.a. to 55% p.a. over a market cycle

Viewpoint

The Fund, managed by Tyndall Asset Management (Tyndall) and distributed by Yarra Capital Management (Yarra), offers investors exposure to a diversified portfolio of Australian smaller companies. Zenith draws confidence in the robustness of the investment process, which has successfully been applied to Australian equities over the long term, however, our conviction is moderated due to the Fund's limited track record. In addition, we highlight the relatively low asset base of the Fund, which gives rise to heightened longevity risk.

Tyndall is a 50/50 joint venture between Yarra and Tyndall's investment staff. Yarra is a Melbourne-based boutique fund manager that offers a broad range of active strategies spanning Australian equities and fixed income. In April 2021, Yarra completed an acquisition of Nikko Asset Management's (Nikko) Australian business, which included Tyndall (formerly Nikko Asset Management Australia). Nikko retained a 20% stake in Yarra. Tyndall, Yarra and Nikko share administrative support functions including capital, financial, systems and human resources, which we view positively, as it allows the investment team to focus on research and portfolio management efforts.

Tyndall's Sydney-based Australian equities team of 11 is led by Brad Potter. Zenith considers Potter to be a high-quality investor, with the requisite expertise to lead the team. In addition, we believe the investment team is highly incentivised through a profit share arrangement in the business unit.

The Fund is managed by Tim Johnston and James Nguyen, who form Tyndall's small cap team responsible for research coverage of Australian companies outside of the S&P/ASX 100 Index. Johnston and Nguyen conduct generalist coverage across all sectors. Zenith believes Johnston and Nguyen to be capable and experienced investors and holds a positive view on their long-term working relationship, which ensures alignment in investment philosophy and professional cultural cohesion. However, we note that the Fund's portfolio management structure deviates from other Tyndall strategies, which adopt a sole decision maker approach.

Tyndall believes markets are inefficient and aims to exploit these inefficiencies through the application of its proprietary relative valuation framework, which incorporates a comprehensive assessment of company financials coupled with a rigorous visitation program.

Company contact forms an important component of the research process, and includes visits to suppliers, customers and competitors. This assists in completing detailed risk assessments for companies, incorporating scenario analysis of upside and downside outcomes. The output of the research process is the production of a two-year internal rate of return (IRR) calculation for each stock. Zenith believes the stock selection process employed by the team is robust and in-depth, providing a strong input into the portfolio construction process.

In constructing the portfolio, Tyndall aims to add value predominately through stock selection, rather than taking tilts against the benchmark. Stocks are selected based on Tyndall's IRR assessment, insight, quality assessment and risk, with the largest overweight positions in the Fund being those that the team holds the strongest conviction. Zenith believes Tyndall's portfolio construction approach is well structured, positioning the Fund in the team's highest conviction ideas.

Fund analysis

Fund characteristics

Constraint	Value
Security Numbers	25 to 70
Active Stock Weight	-15% to 15%
Active Sector Weight	-20% to 20%
Cash	Max: 10%

Investment objective and philosophy

The Fund's investment objective is to outperform the S&P/ASX Small Ordinaries Accumulation Index by 3% p.a. to 5% p.a. (before fees) over rolling five-year periods. In addition, Tracking Error is expected to be within 6% p.a. to 10% p.a.

Tyndall believes markets are inefficient and aims to exploit these inefficiencies through the application of its long-standing proprietary relative valuation process. Tyndall applies a rigorous fundamental process to determine a stock's internal rate of return (IRR), with the time horizon for stock valuation being two years for small capitalisation companies.

Tyndall believes that a company's intrinsic value is best evaluated by examining its assets and normalised earnings power, while assigning value to potential growth only in exceptional cases. Through buying companies trading significantly lower than their intrinsic value and employing sound risk management techniques, Tyndall believes it can enhance the risk/return trade-off associated with traditional value investing.

Zenith cautions that the strategy has a limited performance track record. Notwithstanding this, we draw confidence in the robustness of the investment process, which has successfully been applied to Australian equities over the long term. We also note that the portfolio managers have long working histories, which Zenith believes ensures alignment in investment philosophy and professional cultural cohesion.

Portfolio applications

For investors seeking to achieve a well-blended exposure to Australian equities, Zenith suggests Australian small capitalisation funds are best used in combination with a large capitalisation Australian equities fund.

Zenith believes small capitalisation funds are most appropriate for investors with an investment time horizon of at least seven years.

Given the Fund's value bias, Zenith believes it would blend well with growth-orientated and/or style-neutral products to achieve a diversified exposure to the Australian equity sector. In addition, with limited portfolio constraints and a generous overarching risk budget, it is feasible that the Fund's risk/return characteristics materially deviate from its benchmark.

The Fund's portfolio turnover is expected to average between 35% p.a. and 55% p.a. over a market cycle, which Zenith considers to be moderate. Tyndall was not able to provide any insight on the proportion of expected turnover attributed to the resizing of existing positions and that which is due to initiating and closing positions. Given this expected level of turnover, the Fund's returns are expected to be delivered via both capital appreciation in the unit price and the realisation of capital gains in income distributions. In addition, realised capital gains are likely to be eligible for the capital gains tax discount. As such, holding all else equal, this could be beneficial for investors on higher marginal tax rates, although the Fund may be more appealing to investors who are nil/low tax rate payers or high marginal tax rate payers who invest through tax-effective vehicles such as a superannuation fund.

Fund responsible investment attributes

Key Information	Description
Zenith RI classification*	Integrated
Has Responsible Investment Policy	No
PRI Status	
PRI Signatory	No

*Zenith RI Classification scale:

- Traditional
- Aware
- Integrated
- Thematic
- Impact

Absolute performance

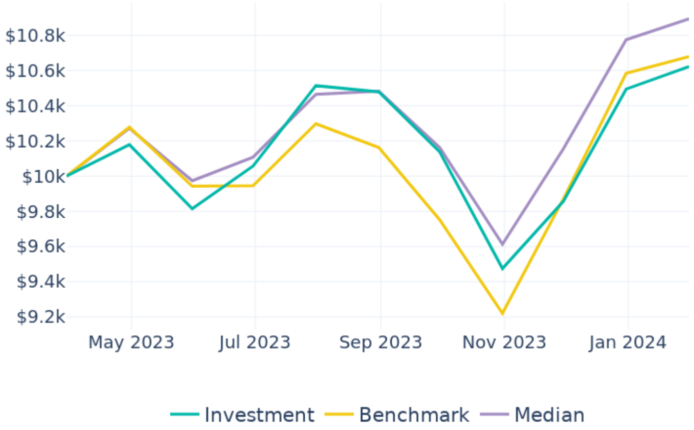
Performance as at 31 Jan 2024

Monthly performance history (%, net of fees)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	BM YTD*
2024	1.23%												1.23%	0.90%
2023				1.79%	-3.57%	2.46%	4.54%	-0.33%	-3.24%	-6.54%	4.02%	6.47%	4.94%	5.84%

**S&P/ASX Small Ordinaries (Accum)*

Growth of $10,000



Risk / return

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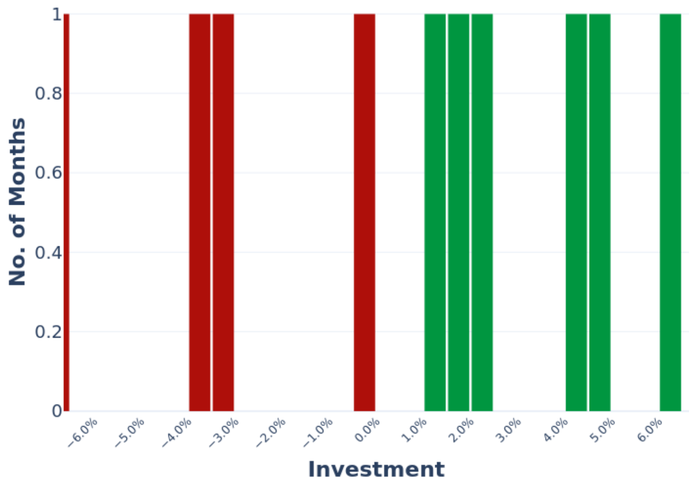
Monthly histogram



Minimum and maximum returns (% p.a.)

Absolute performance analysis

Instrument	1 Mth	3 Mths	6 Mths	Inception
Investment	**1.23%**	**12.11%**	**1.04%**	**6.23%**
Income	0.22%	0.25%	0.22%	1.06%
Growth	1.00%	11.86%	0.82%	5.17%
Benchmark	**0.90%**	**15.81%**	**3.70%**	**6.79%**
Median	**1.10%**	**13.32%**	**4.10%**	**8.93%**
Cash	**0.37%**	**1.06%**	**2.11%**	**3.42%**

Ranking within sector (p.a.)

Ranking within Sector	Inception
Fund Ranking	44 / 61
Quartile	3rd

Absolute risk

Instrument
Standard Deviation (% p.a.)
Investment
Benchmark
Median
Downside Deviation (% p.a.)
Investment
Benchmark
Median

Absolute risk/return ratios

Instrument
Sharpe Ratio (p.a.)
Investment
Benchmark
Median
Sortino Ratio (p.a.)
Investment
Benchmark
Median

All commentary below is as at 31 January 2024.

The Fund's investment objective is to outperform the S&P/ASX Small Ordinaries Accumulation Index by 3% p.a. to 5% p.a. (before fees) over rolling five-year periods. In addition, Tracking Error is expected to be within 6% p.a. to 10% p.a.

Given the Fund's recent inception in March 2023, it is too early to draw any meaningful conclusions regarding performance. However, we draw comfort from Tyndall's strong track record managing Australian equities strategies since 1995 under the same investment philosophy and process.

Investors should be aware that Tyndall does not target a specific level of income, with distributions made semi-annually where possible.

Relative performance

Excess returns

Statistic	1 Mth	3 Mths	6 Mths	Inception
Excess Return	0.33%	-3.70%	-2.66%	-0.56%
Monthly Excess (All Mkts)	100.00%	33.33%	50.00%	50.00%
Monthly Excess (Up Mkts)	100.00%	33.33%	33.33%	50.00%
Monthly Excess (Down Mkts)	0.00%	0.00%	66.67%	50.00%

Capture ratios (% p.a.)

Statistic	1 Mth	3 Mths	6 Mths	Inception
Downside Capture	0.00%	0.00%	94.24%	97.77%
Upside Capture	136.24%	77.46%	77.46%	95.86%

Tracking error (% p.a.)

Instrument
Investment
Median

Information ratio

Instrument
Investment
Median

Beta statistics

Statistic
Beta
R-Squared
Correlation

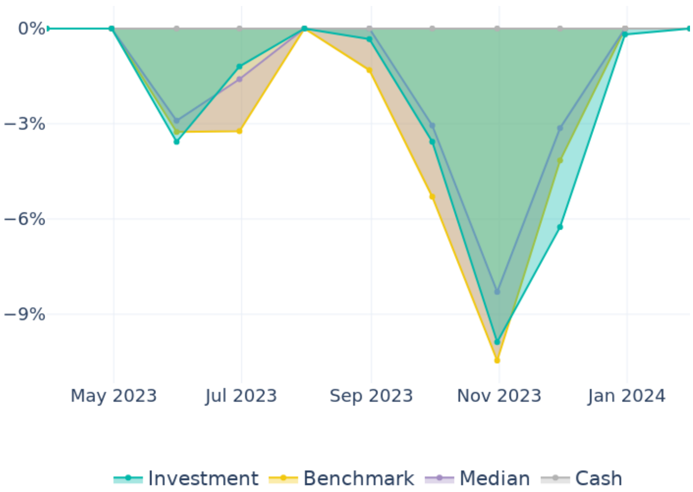
All commentary below is as at 31 January 2024.

Zenith seeks to identify strategies that can outperform in over 50% of months in all market conditions, as we believe this represents consistency of manager skill. In addition, we view a strategy's ability produce stronger upside capture ratios relative to downside capture ratios as an attractive feature.

Given the Fund's recent inception, there is insufficient performance history to conduct any meaningful analysis.

Drawdown analysis (since inception)

Drawdown analysis assesses the relative riskiness of a Fund versus the benchmark, in reference to capital preservation. The maximum Drawdown is recorded as the percentage decline in the value of a portfolio from peak to trough (before a new peak is achieved). All Drawdown analysis is calculated commencing from the inception date of the Fund in question, and Drawdown analysis for the Fund and benchmark(s) are calculated independently. That is, the largest drawdown for the Fund and benchmark(s) will not always refer to the same time period.



All commentary below is as at 31 January 2024.

Given the Fund's recent inception, there is insufficient performance history to conduct any meaningful analysis.

Fund commentary

Fund risks

Zenith has identified the following key risks of the Fund. Although Zenith believes the risks noted are all significant, we have listed them in order of importance. In addition, we have not intended to highlight all possible risks.

Key person risk: As with most fund managers, Tyndall is subject to a level of key person risk. Zenith believes there is a high degree of key person risk for the Fund, with Tim Johnston and James Nguyen integral to the investment strategy. As such, the departure of Johnston and/or Nguyen would trigger an immediate reassessment of our rating on the Fund. Mitigating this concern is their respective equity stakes in Tyndall, which Zenith believes aligns them with the ongoing success of the Fund and the business.

Longevity risk: Funds that fail to grow funds under management (FUM) to a scalable level could be wound up and terminated by the manager or Responsible Entity. The risks associated with a fund wind-up are principally that of timing, performance slippage and forcing a crystallisation of tax consequences to investors, which may be to their detriment.

As at 31 January 2024, FUM in the Fund was approximately $A 2 million. While the Fund is currently unprofitable in its own right, Zenith considers Tyndall to be financially stable and in a position to support the operation of the Fund in the short to medium term. Notwithstanding this, we will continue to monitor the level of FUM in the Fund.

Track record risk: Zenith notes that the strategy has a relatively limited track record dating back to March 2023. However, we draw comfort from Tyndall's strong track record managing Australian equities strategies since 1995 under the same investment philosophy and process.

Capacity risk: Excessive levels of FUM can inhibit a manager's ability to trade portfolio positions effectively and therefore limit outperformance potential. Tyndall has set a capacity target of $A 1.2 billion for the strategy. As at 31 January 2024, Tyndall managed approximately $A 2 million in the strategy.

Overall, Zenith does not believe the Fund is currently impacted by capacity limitations. Notwithstanding this, Zenith will continue to monitor the underlying strategy's liquidity and returns closely to ensure that increasing levels of FUM do not begin to negatively impact performance.

Security/asset selection

Tyndall applies its proprietary relative valuation process, Comparative Value Analysis (CVA), across all of its Australian equity strategies. The process seeks to identify companies with sustainable medium-term earnings that are trading at a significant discount to intrinsic value.

The initial universe includes all Australian stocks listed outside of the S&P/ASX 100 Index (primarily the S&P/ASX Small Ordinaries Accumulation Index). A liquidity screen is applied based on the 90-day median daily turnover for each stock in the universe. To be eligible, Tyndall must be able to enter/exit a position within this period, based on a notional 1% portfolio weighting, and not account for more than 30% of daily turnover. This results in a universe of less than 300 stocks.

These stocks are then subject to an additional proprietary, multi-factor stock screen that ranks stocks by value, quality and combined scores. The valuation assessment includes:

- One-year forward consensus price to earnings
- Enterprise value multiple
- Two qualitative metrics

Tyndall's quality assessment covers:

- Return on equity
- Earnings stability
- Balance sheet strength
- Durability of business model
- Management quality

After the application of the initial screens, Tyndall undertakes detailed fundamental research. This includes projections of a company's financial statements and key financial ratios. Tyndall prioritises companies with balance sheets and cash flows that can finance potential growth and returns to shareholders.

Through a fundamental research process, Tyndall derives a company's intrinsic value based on a number of standardised inputs. As part of Tyndall's discounted cashflow process, it models a 'franchise period' that is generally four to eight years and represents the period a company is expected to achieve abnormal growth. To ensure the validity of all valuations, analysts compare valuations across a range of metrics, including capitalisation of normalised earnings, discounted cash flows and, when appropriate, break-up valuations of companies.

Detailed risk assessments cover a company's earnings risk; balance sheet risk; industry and structural risk; environmental, social and governance (ESG) issues; which are subjected to detailed scenario analysis covering upside and downside outcomes.

A standard set of macroeconomic assumptions for commodity prices and currencies is employed in all models to ensure consistency throughout the process. These assumptions include currency, commodity and interest rate inputs.

The team takes a view on key macroeconomic variables and consensus forecasts based on inputs from brokers and other external sources. Unless the team has divergent views, the model defaults to the consensus. Company models are updated and/or initiated when there is new information that is likely to change estimated returns on stocks or there are new stocks that appear attractive on Tyndall's value/quality screens.

Company contact forms an important component of the research process, and includes visits to suppliers, customers and competitors. The objective is to gain a better understanding of the operations of the company and the industry in which it operates. Company visits are undertaken to validate inputs into the company models, determine the strategic value of the assets and assess management.

The output of the CVA research process is the production of a two-year internal rate of return (IRR) calculation for each stock. The stocks are then ranked based on IRR, with the highest IRR stocks generally being considered for portfolio inclusion. To ensure the consistency of assumptions, detection of errors and omissions, and validity of forecasts, all team members extensively review all research.

Overall, Zenith believes the stock selection process employed by the team is robust and in-depth, providing a strong input into the portfolio construction process.

Responsible investment approach

Tyndall has an established Responsible Investment Policy, last updated in 2020, that guides its investment decisions.

While the portfolio has no specific exclusions, Tyndall takes an active approach to ESG issues. ESG is evaluated as part of the team's fundamental analysis process and, where ESG issues are deemed to be significant, they can preclude a company as a potential investment. Zenith believes that this qualitative analysis of a company's operations is crucial on a forward basis, given that a company's performance with regard to ESG considerations is increasingly being reflected in the company's share price. Overall, Zenith is comfortable with Tyndall's approach to ESG.

Zenith has assigned the Fund a responsible investment classification of Integrated.

Portfolio construction

The Fund is constructed in a largely benchmark unaware manner that strongly leverages the output of the stock selection process.

Consensus is required between Johnston and Nguyen for a stock to be included in the Fund. In the event unanimity can not be achieved, the conservative option is taken, and either the stock is not purchased or the lower suggested weight is taken. The portfolio managers generally select stocks with high IRRs whilst selling or avoiding stocks that have low IRRs.

To construct the Fund, the portfolio managers generate a model portfolio, which is periodically optimised and assessed through the BARRA risk system. BARRA assesses the portfolio's efficiency and exposure to risk. While this optimisation process provides a guide for portfolio construction, the portfolio managers retain the flexibility to express their qualitative views in accordance with the Fund's risk constraints. The portfolio managers also consider factors such as volatility, stock concentration, sector risks and style risks.

Tyndall's buy and sell decisions are only undertaken if the portfolio managers believe that a change will improve portfolio returns after transaction costs. The portfolio is monitored on a daily basis, with a number of events triggering a review of a portfolio position. These include:

- Changes to the IRR due to stock price changes
- Abnormal stock price movements
- A stock weighting deviates more than 30% from the model portfolio target
- A stock approaches its assessed fair value
- A new stock enters the top 20 stocks ranked by IRR
- Poor price or earnings performance of a stock
- New material information becomes available
- An analyst signalling a change in forecasts or valuation
- Capital raising, initial public offerings, merger and acquisition activity

The Fund will generally hold between 40 and 60 stocks. Although the Fund is typically fully invested, it may retain up to 10% in cash. Zenith believes that actively-managed equities funds should remain fully invested and that the asset allocation decision should be left to the individual investor.

Tyndall has a formal constraint requiring the sale of a company that moves into the S&P/ASX 100 Index within 12 months. Zenith believes this sell discipline ensures the Fund remains a true Australian equity small-cap exposure.

Portfolio turnover is expected to average 35% p.a. to 55% p.a. over a market cycle, which Zenith considers to be moderate.

Overall, Zenith believes Tyndall's portfolio construction approach is well structured, positioning the Fund in the team's highest conviction ideas.

Risk management

Zenith believes that risk management is firmly ingrained in Tyndall's culture. As evident in the underlying CVA process, multiple valuation methodologies are employed when valuing stocks. To add a further layer of risk control, Zenith notes that Tyndall uses conservative inputs in its valuations. In addition, the peer-review process ensures that biases are mitigated and all positions are examined thoroughly.

While the portfolio managers utilise a number of tools to achieve an appropriate risk/return trade-off, judgement and analyst input are the primary determinants. BARRA analysis is utilised to ensure that the portfolio managers are cognisant of the risks in the portfolio, including unintended biases. Risk factors include volatility, leverage, industry, price/earnings momentum, value and size. If these exposures are deemed excessive, the portfolio may be adjusted to moderate the risk exposure. The Fund's Tracking Error is expected to range between 6% p.a. to 10% p.a.

Tyndall periodically conducts scenario analysis on the portfolio, referencing previous events that have been problematic for the market and for Tyndall. If the downside risk is too large, the portfolio is again assessed and may be adjusted with additional sector, factor or stock constraints.

Overall, Zenith believes Tyndall's risk management capabilities are appropriate. However, investors should be aware there is significant reliance on management judgement and skill.

Investment fees

	Fund	Sector Average
Total Fees and Costs (RG 97)	1.66 % p.a.	1.57 % p.a.
Management Fees and Costs	0.90 % p.a.	1.00 % p.a.
Transaction Costs	0.00 % p.a.	0.09 % p.a.
Performance fees as at 30 Jun 2023	0.76 %	0.64 %
Performance fees description	20% of the outperformance of the S&P/ASX Small Ordinaries Index (after fees), subject to recouping underperformance	
Management Cost	0.90 % p.a.	1.05 % p.a.
Buy / Sell spread	0.30 % / 0.30 %	0.27 % / 0.27 %

All fees and costs are inclusive of GST unless indicated otherwise. The Performance Fee shown is the performance fee disclosed in the PDS. It is calculated by taking the average performance fees charged over the last five financial years (or less if the investment or performance fee mechanism has not been in place for five financial years).

The sector average management cost based on the average management cost of all flagship Australian Small Companies funds surveyed by Zenith.

The performance fee is accrued daily and paid quarterly. Zenith believes there is scope for the payment period to be extended, with an annual frequency being the preferred structure. We are of the view that a longer payment frequency is better aligned with the Fund's longer-term investment objectives.

For any fund that charges a performance fee, Zenith would prefer an additional excess return hurdle (i.e. a target return greater than the index plus the management cost) and considers this best practice.

Overall, Zenith believes the Fund's fee structure is fair, relative to peers, given its stated objectives. However, there is insufficient performance data at this stage to conduct meaningful analysis on whether the fees paid are justified.

The fees mentioned above are reflective of the flagship version only, fees may differ when the product is accessed through an alternate investment vehicle such as a platform.

About the fund manager

Organisation

Nikko Asset Management Australia Limited (Nikko AM) is owned by Nikko Asset Management Co Ltd (NAM), a Tokyo-based firm that manages a range of asset classes. Established in 1959, NAM has 22 offices spread across 10 countries, servicing both retail and institutional clients. NAM provides Nikko AM with administrative support including capital, financial, systems and human resources.

NAM entered the Australian market via its acquisition of Tyndall Investment Management (Tyndall) in 2011 from Suncorp Metway Limited.

In April 2021, Yarra Capital Management (Yarra) completed an acquisition of Nikko AM, with Nikko AM taking a 20% equity stake in the combined entity. This partnership enables Nikko AM's global business to gain access to Yarra's investment products, with Yarra assuming responsibility for the distribution of Nikko AM's global suite of products in the Australian market.

The acquisition creates one of Australia's largest independently owned Australian equities and fixed income managers, with approximately $A 21 billion of funds under management as at 31 January 2024.

Tyndall is a 50/50 joint venture between Yarra and investment staff in Tyndall's Australian equities team. All investment personnel in the Australian equities team have equity ownership.

As at 31 January 2024, Tyndall had funds under management (FUM) of approximately $A 8.9 billion across its various Australian equity strategies. The Australian Small Companies strategy accounted for approximately $A 2 million in FUM, all of which was in the Fund.

Investment personnel

Name	Title	Industry Experience (yrs)	Tenure (yrs)	Location
Tim Johnston	Portfolio Manager	25	25	Sydney, Australia
James Nguyen	Portfolio Manager	20	16	Sydney, Australia

Tyndall's Australian equities team is located within its Sydney-based office. Led by Brad Potter, who has been with Tyndall since 2002, the investment team consists of 11 investment professionals with an average of 21 years' industry experience. Zenith considers Potter to be a high-quality investor with the requisite expertise to lead the team.

The Fund is managed by Tim Johnston and James Nguyen, who form Tyndall's small cap team responsible for the research coverage of Australian companies outside of the S&P/ASX 100 Index. Johnston and Nguyen conduct generalist coverage across all sectors. While Zenith believes Johnston and Nguyen to be capable and experienced investors, we note that this Fund is the first time they have managed a dedicated small cap strategy.

Johnston joined Tyndall in 1998. He has over 25 years' investment experience and was previously co-portfolio manager on the Tyndall Australian Share Concentrated strategy between 2007 and 2022.

Prior to joining Tyndall in 2008, Nguyen was a portfolio manager at DVA Capital specialising in Asian equities. Additionally, he worked at JANA Investment Advisers and Deloitte Australia. Nguyen was previously responsible for the Tyndall Australian Share ex-20 strategy between 2017 and 2023.

Zenith has been familiar with Johnston and Nguyen for an extended period, drawing comfort from their long term working relationship of over 16 years which ensures consistent application of the investment process. Furthermore, they are supported by Tyndall's highly experienced team who selectively cover stocks outside of the S&P/ASX 100 Index.

The team meets multiple times during the week to discuss research and portfolio construction matters. At the research meetings, the team discusses company news items and broader market conditions, and reviews analyst stock recommendation updates/changes. Weekly portfolio construction meetings are held to provide further peer review of all portfolio decisions and to ensure all portfolio managers are aware of any pertinent information.

The investment team has historically maintained a high level of stability, which we believe is due to the equity participation shared across the team that provides an alignment of interest with the business. In addition to equity participation, which can form a large component of remuneration, team members are paid a base salary as well as a bonus based on meeting certain performance targets.

Overall, Zenith considers Tyndall's small cap team to be sufficiently resourced. However, our conviction in the Fund is moderated by the portfolio managers' limited small cap experience. As such, we would like to see a sustained period under the current portfolio management structure before our conviction in the Fund is strengthened.

About the sector

Sector characteristics

The Zenith 'Australian Shares – Small Companies' sub-asset class consists of long-only strategies investing in Australian equities across the small capitalisation (small-cap) spectrum. Companies that fall between the S&P/ASX 100 and S&P/ASX 300 are considered small-cap companies. This is a competitive sector of the investment landscape given the growth in the number of managers and strategies available to investors. Over the long term, active management has historically demonstrated a strong ability to outperform a passive index in this sector.

Zenith benchmarks all funds in this sector against the S&P/ASX Small Ordinaries Index. However, investors should be aware that strategies in this sector can have varying allocations to the micro-cap universe, i.e. ex-S&P/ASX 300 stocks. The S&P/ASX Small Ordinaries Index is market-capitalisation weighted, resulting in those companies with the largest market capitalisations receiving the heaviest weighting.

The Australian equities asset class, as represented by the S&P/ASX 300 Index, is highly concentrated and narrow. As at 31 January 2024, the Financials and Materials sectors represented a significant portion of the S&P/ASX 300 Index, with the Financials sector accounting for approximately 29% and Materials approximately 24%. In addition, the top 10 stocks represented approximately 47% and the top 20 stocks represented approximately 62%.

The S&P/ASX Small Ordinaries Index is less concentrated than the S&P/ASX 300 Index. As at 31 January 2024, the Materials and Consumer Discretionary sectors represented 22% and 18% respectively S&P/ASX Small Ordinaries Index, with the top 10 stocks totalling 14%. Although the small-cap sector is more diversified by constituents and sectors, it comprises companies with less diversified businesses and assets. As such, a higher degree of volatility is expected of the sector relative to its large-cap counterparts.

Sector risks

Products within the 'Australian Shares – Small Companies' sub-asset class are exposed to the following broad risks:

Market risk and economic risk: A sustained downturn across the Australian equity market is a risk to the absolute performance of funds in the sector. Additionally, changes in economic, social, technological or political conditions, as well as market sentiment, could also lead to negative fund performance.

Furthermore, the small-cap sector tends to underperform the large-cap sector in market downturns due to its higher "beta" characteristic. The Materials sector represented 22% of the S&P/ASX Small Ordinaries Index (as at 31 January 2024). Resources companies are highly correlated to commodity prices, as such, a fall in commodity prices is likely to have a negative impact on performance returns.

This risk can be significantly reduced by investors adhering to a fund's prescribed investment timeframe.

Specific security risk: This is the risk associated with an individual security. The price of common shares in a company may be affected by unexpected changes in company operations such as changes in management or the loss of a significant customer.

Liquidity risk: This is the risk that a security or asset cannot be traded promptly, due to insufficient trading volumes in the Australian equity market. When trading volumes are low, buyers/sellers can significantly impact the price of a security when entering or exiting a position.

Style bias risk: Australian equity managers employ different investment styles such as Growth, Value or Neutral (a combination of Value and Growth). Each style is conducive to certain market conditions. This risk can be significantly reduced by investors adhering to a fund's prescribed investment timeframe.

Capacity/liquidity risk: High levels of funds under management (FUM) can present additional challenges to an Australian equity manager. High FUM has the potential to restrict a manager's ability to trade efficiently and/or be forced to disclose substantial shareholdings to the market (most common in smaller companies).

As a general 'rule of thumb' Zenith believes approximately 1% of the market capitalisation of the S&P/ASX Small Ordinaries Index is an appropriate capacity target for an Australian small-cap strategy, and that above this level it becomes increasingly difficult to generate excess returns. Zenith is cognisant that assessing FUM capacity as a percentage of market capitalisation is a relatively crude measure and that capacity constraints can vary depending on the underlying investment style and approach. Zenith will, therefore, assess capacity limits for each manager and strategy on an individual basis.

Regulatory risk: All investments carry the risk of being affected by changes to government policies, regulations and laws. Security prices in which funds may have exposure are also subject to certain risks arising from government intervention in the Australian equity market. Such regulation or intervention could adversely affect fund performance.

Zenith rating

Report certification

Date of issue: 27 Feb 2024

Role	Analyst	Title
Analyst	Stephen Colwell	Senior Investment Analyst
Sector Lead	Stephen Colwell	Senior Investment Analyst
Authoriser	Bronwen Moncrieff	Head of Research

Association & relationship

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Rating history

As At	Rating
27 Feb 2024	Approved
15 Dec 2023	Not Rated - Screened Out

Last 5 years only displayed. Longer histories available on request.

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