Product Assessment

Report as at 27 Feb 2024

RECOMMENDED

Pengana Emerging Companies Fund

Rating issued on 27 Feb 2024 | APIR: PER0270AU

Investment objective

To outperform the S&P/ASX Small Ordinaries Accumulation Index by 5% p.a. before fees, over rolling three-year periods. Although not targeted, the Fund's Tracking Error is expected to be within a range of 6% p.a. to 9% p.a.

Manager	Pengana Capital Group
Distributor	Pengana Capital Group
Sector	Australian Shares \ Small Companies
Investment Style	Neutral
RI Classification	Aware
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)	$718.30M
Management Cost	1.33% p.a. Incl. GST
Performance Fee	20.5% of outperformance of the S&P/ASX Small Ordinaries Accumulation Index, subject to recouping underperformance
Buy / Sell Spread	0.20 % / 0.20 %
Inception Date	01 Nov 2004

Fund facts

- Typically holds 60 stocks
- Does not invest in resource stocks, biotechnology stocks or property trusts
- Portfolio turnover expected to average between 40% p.a. and 60% p.a. over a market cycle.

Viewpoint

The Fund, managed by Pengana Capital Group Limited's (Pengana) Melbourne-based Emerging Companies team offers investors a diversified, fundamentally-driven and benchmark unaware exposure to Australian smaller companies. Zenith considers portfolio managers Steve Black and Ed Prendergast to be highly experienced and believes they have a firm understanding of Australian small companies. In addition, we view the team's robust investment approach positively, believing it is key to the Fund's strong long-term performance track record.

Pengana is a boutique Australian funds manager founded in 2003. Pengana offers a diversified range of equity-based strategies totalling $A 3.11 billion in funds under management, as at 31 January 2024. The Fund was established in November 2004 by Black and Prendergast in conjunction with Pengana.

The investment team consists of Black and Prendergast, who both have extensive investment experience. Prior to establishing the Fund, Black managed the JBWere Emerging Leaders Fund for approximately seven years, while Prendergast was a Director at Citigroup and Head of the Small Companies research team.

Black and Prendergast's investment philosophy is premised on the belief that pricing inefficiencies exist within the smaller companies universe due to a lack of research coverage. Both portfolio managers participate in an extensive management visitation program to ensure they have a well-rounded and impartial view of companies. Stocks that are deemed attractive are modelled and valued. The primary valuation tool used is the discounted cash flow (DCF) model, with measures such as price multiples used to cross-reference valuation estimates. Companies that provide an upside potential of between 30% and 50% over one to two years are targeted for inclusion in the Fund. Zenith believes the stock selection process is collaborative, quality focused and rigorous, which provides a strong foundation for portfolio construction.

Active positions within the Fund are driven by the forecasted return from the team's DCF valuations, with consensus required between Black and Prendergast for a stock to be included in the Fund. If unanimity can not be achieved, the conservative option is taken and either the stock is not purchased or the lower suggested weight is initiated. The Fund is diversified holding a mix of stocks classified as stable (approximately 80%) and cyclical (approximately 20%). Zenith believes Pengana'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	50 to 60
Active Security Weight	-7% to 7%
Company Issued Capital Weight	Max: 10%
New Zealand Exposure	Max: 15% (Historically less than 8%)
Cash	Max: 10% (Typically 2% to 3%)
Market Capitalisation	Min: $A 25 million

Investment objective and philosophy

The Fund's investment objective is to outperform the S&P/ASX Small Ordinaries Accumulation Index by 5% p.a. (before fees) over rolling three-year periods. Although not targeted, the Fund's Tracking Error is expected to be within 6% p.a. and 9% p.a.

Pengana's investment philosophy is premised on the belief that pricing inefficiencies exist within the smaller companies universe due to a lack of research coverage. Black and Prendergast adopt a conservative and valuation-focused investment style that avoids highly speculative (miners and biotechnology) or heavily-geared companies.

Portfolio applications

In general, compared to most other asset classes, equities offer investors the opportunity for higher capital growth over the longer term with some income. However, this higher growth is also often associated with higher volatility. For investors seeking to achieve a well-blended exposure to Australian equities, Zenith suggests Australian small capitalisation funds are best used in combination with large and mid-capitalisation Australian equities funds.

Due to the more volatile nature of small capitalisation funds Zenith recommends investors adopt a longer investment time horizon of at least seven years.

The Fund's style-neutral investment approach makes the Fund an attractive option for investors seeking a single fund exposure to Australian smaller companies. However, investors should note that the Fund does not hold resource stocks, biotechnology stocks or property trusts. The Fund may also hold a material allocation to companies that are outside of the S&P/ASX 300 Index. In general, micro-cap stocks tend to exhibit greater volatility than their larger-cap peers.

The Fund's portfolio turnover is expected to average approximately 40% p.a. to 60% p.a. over a market cycle, which Zenith considers to be moderate. Pengana has indicated that approximately 50% of the expected turnover is attributed to resizing existing positions and approximately 50% 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*	Aware
Has Responsible Investment Policy	Yes
Negative screens**	**Full/Partial**
Armaments	Partial
Fossil fuels	Full
Gaming	Partial
Adult Entertainment	Partial
Tobacco	Full
Nuclear Power	Partial
Human rights abuse	Partial
Animal cruelty	Partial
Other Measures	Controversial weapons (Full), Nuclear weapons (Full), Mining (Partial), Cryptocurrency (Full), Predatory lending (Partial)
PRI Status	
PRI Signatory	Yes

*Zenith RI Classification scale:

- Traditional
- Aware
- Integrated
- Thematic
- Impact

***Data has been supplied by third parties. While such information is believed to be accurate, we do not accept responsibility for any inaccuracy in such data.*

Absolute performance

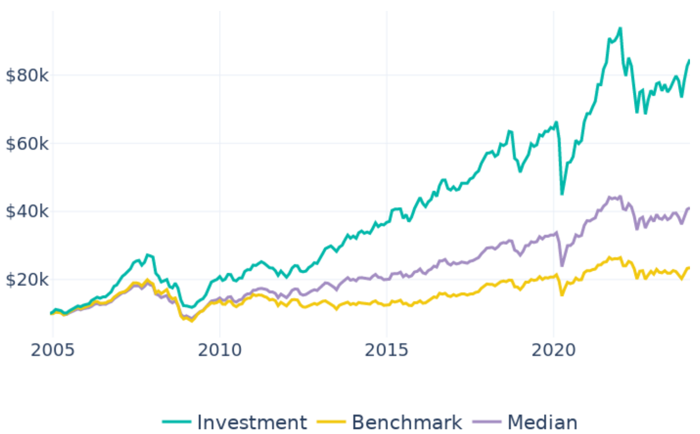
Performance as at 31 Jan 2024

Monthly performance history (%, net of fees)

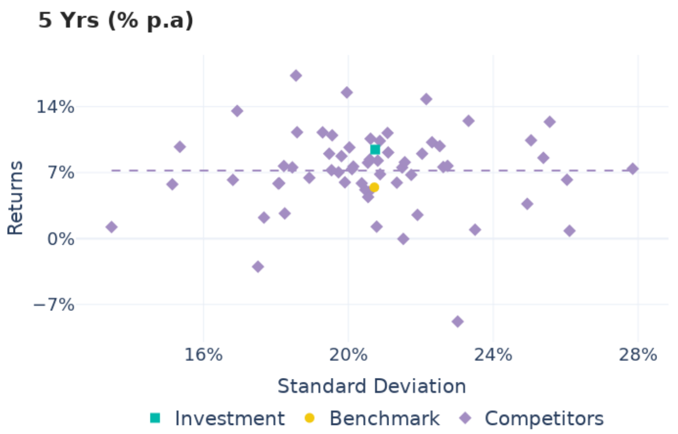
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	BM YTD*
2024	2.39%												2.39%	0.90%
2023	4.63%	0.42%	-3.13%	2.55%	-2.92%	1.54%	2.45%	2.25%	-1.88%	-6.23%	6.89%	5.30%	11.61%	7.82%
2022	-11.15%	-4.52%	6.71%	-2.82%	-7.96%	-9.65%	8.93%	0.79%	-9.28%	6.21%	3.76%	-1.95%	-21.26%	-18.40%
2021	0.01%	2.71%	2.51%	6.82%	-0.08%	5.93%	2.37%	8.52%	-1.30%	0.56%	1.51%	2.76%	36.94%	16.90%
2020	3.44%	-7.86%	-26.83%	10.00%	10.08%	0.45%	2.86%	8.70%	-1.65%	1.45%	8.95%	3.73%	6.94%	9.21%

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

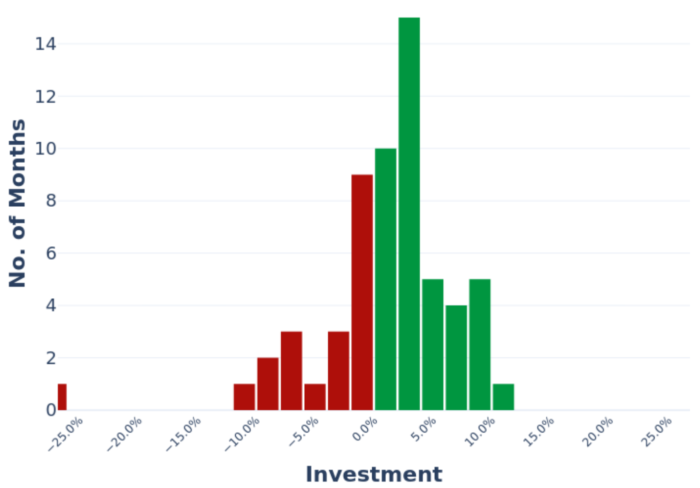
Growth of $10,000



Risk / return



Monthly histogram



Minimum and maximum returns (% p.a.)

Absolute performance analysis

Instrument	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Investment	**9.23%**	**7.20%**	**9.44%**	**10.18%**	**11.79%**
Income	7.06%	10.04%	7.93%	10.76%	7.69%
Growth	2.17%	-2.84%	1.51%	-0.58%	4.10%
Benchmark	**2.10%**	**1.33%**	**5.44%**	**6.40%**	**4.55%**
Median	**4.98%**	**3.35%**	**7.74%**	**7.66%**	**7.65%**
Cash	**3.96%**	**1.82%**	**1.43%**	**1.79%**	**3.35%**

Ranking within sector (p.a.)

Ranking within Sector	1 Yr	3 Yrs	5 Yrs	Inception
Fund Ranking	22 / 61	7 / 59	16 / 49	2 / 20
Quartile	2nd	1st	2nd	1st

Absolute risk

Instrument	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Standard Deviation (% p.a.)					
Investment	12.43%	17.59%	20.74%	17.19%	17.73%
Benchmark	13.95%	18.02%	20.72%	17.11%	18.51%
Median	12.05%	15.44%	19.22%	15.47%	16.23%
Downside Deviation (% p.a.)					
Investment	7.79%	12.40%	15.80%	12.62%	12.61%
Benchmark	8.52%	13.17%	15.00%	12.01%	13.57%
Median	7.48%	11.15%	14.02%	10.96%	11.64%

Absolute risk/return ratios

Instrument	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Sharpe Ratio (p.a.)					
Investment	0.42	0.31	0.39	0.49	0.48
Benchmark	-0.13	-0.03	0.19	0.27	0.06
Median	0.08	0.10	0.33	0.38	0.26
Sortino Ratio (p.a.)					
Investment	0.68	0.43	0.51	0.67	0.67
Benchmark	-0.22	-0.04	0.27	0.38	0.09
Median	0.14	0.14	0.45	0.54	0.37

All commentary below is as at 31 January 2024.

The objective of the Fund is to outperform the S&P/ASX Small Ordinaries Accumulation Index by 5% p.a. (before fees), over rolling three-year periods.

The Fund has achieved its outperformance objective over the most recent three-year period. Additionally, the Fund has outperformed the benchmark and median manager over all assessed period.

The Fund's risk (as measured by Standard Deviation) has been below the benchmark since inception.

The Sharpe Ratio of the Fund has been higher than that of the benchmark over all periods of assessment, which indicates that investors have been sufficiently compensated for its risk.

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

Relative performance

Excess returns

Statistic	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Excess Return	7.13%	5.87%	4.01%	3.78%	7.24%
Monthly Excess (All Mkts)	50.00%	55.56%	58.33%	54.17%	57.83%
Monthly Excess (Up Mkts)	33.33%	52.38%	54.29%	47.14%	48.15%
Monthly Excess (Down Mkts)	66.67%	60.00%	64.00%	64.00%	71.58%

Capture ratios (% p.a.)

Statistic	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Downside Capture	63.13%	88.47%	88.77%	81.43%	72.48%
Upside Capture	98.70%	112.19%	103.96%	100.26%	102.34%

Tracking error (% p.a.)

Instrument	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Investment	6.84%	6.82%	6.87%	6.58%	8.15%
Median	2.90%	3.60%	3.39%	3.45%	4.50%

Information ratio

Instrument	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Investment	1.04	0.86	0.58	0.57	0.89
Median	0.99	0.56	0.68	0.36	0.69

Beta statistics

Statistic	1 Yr	3 Yrs	5 Yrs	10 Yrs	Inception
Beta	0.78	0.90	0.95	0.93	0.86
R-Squared	0.76	0.86	0.89	0.86	0.81
Correlation	0.87	0.93	0.95	0.93	0.90

All commentary below is as at 31 January 2024.

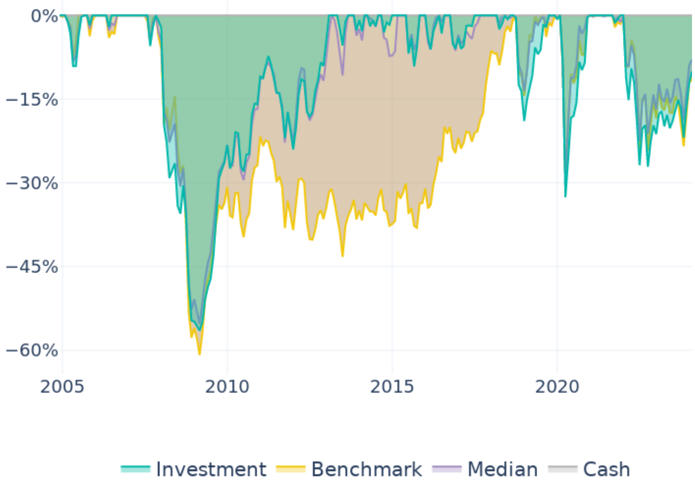
Zenith seeks to identify products that can outperform their index in greater than 50% of months in all market conditions as we believe this represents a persistence of manager skill. In addition, we view a strategy's ability to produce stronger upside capture ratios relative to downside capture ratios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

The Fund has achieved both outcomes since inception. In particular, the Fund has shown a greater level of outperformance consistency in falling market conditions, which Zenith believes is consistent with the disciplined and quality-orientated investment process employed.

Although not targeted, the Fund's Tracking Error is expected to be between 6% p.a. and 9% p.a. It has remained within this band over all assessed periods.

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.

Zenith notes that the Fund has typically demonstrated a propensity to protect investor capital during declining markets. This outcome is expected due to the Fund's quality-oriented investment process.

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 boutique fund managers, key person risk is high at Pengana. Zenith has identified Steve Black and Ed Prendergast as integral to the investment strategy, with the departure of either triggering an immediate review of our rating on the Fund. However, offsetting this risk is the significant equity ownership of both Black and Prendergast in the business, which mitigates the risk of their departures over the medium term.

Capacity risk: The Fund has a target capacity limit of approximately 0.5% of the current free float market capitalisation of the S&P/ASX Small Ordinaries Index ($A 1.23 billion as at 31 January 2024). Zenith believes this limit is highly prudent and should allow the Fund to achieve excess returns. As at 31 January 2024, funds under management (FUM) in the strategy was approximately $A 718 million, which Zenith believes does not present an issue in regards to the Fund's ability to efficiently enter and exit stock positions.

Pengana has advised that further restrictions on Fund entry may be required should the Fund experience significant net inflows. Should the Fund materially exceed its stated capacity, Pengana will engage in a capital return process, which has been implemented in the past. To manage capacity, capital returns were made in addition to regular semi-annual distributions.

Investors need to be cognisant that a return of capital reduces the cost base of their investment in the Fund, which may result in tax implications.

Benchmark risk: Black and Prendergast do not invest in resources, biotechnology or property trusts as they believe that these sectors are either too speculative or require a fundamentally different investment process than the one they employ. Zenith notes that the Fund is benchmarked against the S&P/ASX Small Ordinaries Accumulation Index, of which resource stocks comprise a material component. Therefore, Zenith believes the Fund's performance fee is not aligned with a suitable benchmark, with the S&P/ASX Small Ordinaries Industrials Accumulation Index being our preferred option.

Currency risk: Investments in international markets are exposed to changes in the value of the Australian dollar (AUD) relative to foreign currencies, which may lead to increased levels of volatility. The Fund is permitted to invest in stocks listed on the Australian and New Zealand stock exchanges.

Security/asset selection

The Fund's investment universe includes Australian stocks outside of the S&P/ASX 50 Index and equivalent-sized companies within the New Zealand Stock Exchange.

The initial filtering process screens out companies based on the following factors:

- Stocks with a market capitalisation of less than $A 25 million
- Unprofitable companies
- Resources stocks
- Biotechnology stocks
- Property trusts
- Illiquidity

Black and Prendergast do not invest in resources, biotechnology or property trusts as they believe that these sectors are either too speculative or they require a fundamentally-different investment process than that being employed. The Fund may gain resources exposure through quality mining services companies, which hold more defensive characteristics. The initial filter process generally reduces the investment universe to between 700 and 800 stocks, which are marked for further research.

Zenith notes that Black and Prendergast have the scope to include securities that do not meet the profitability criteria in select instances, where both revenue growth is present and profitability is expected in the near term. Where applicable, it is expected that such securities will comprise a relatively small proportion of the Fund.

Black and Prendergast believe management is vital to the success of a company and, as such, they spend a considerable amount of time in company-related meetings. Meetings with company management, competitors, suppliers and customers are conducted to ensure a well-rounded and impartial view of the researched company.

A large part of the research effort is directed in understanding the key profit drivers of the company. Fundamental analysis is conducted on both internal and external factors.

Internal factors include:

- The quality of company management
- Competitive advantage and sustainability
- Quality of products
- Quality of asset base
- Shareholder register
- Growth of free cash flow
- Financial strength

External factors include:

- Barriers to entry of industry
- Behaviour of competitors
- Regulation
- Outlook for the industry

Although Black and Prendergast maintain strong relationships with broker analysts, all research is developed internally. Black and Prendergast conduct all meetings together to ensure all key assessment factors are covered. The team believes this approach allows for more robust and thorough meetings, ultimately resulting in higher quality research.

Stocks that are deemed attractive from the review process are modelled and valued. Consistent with all aspects of the investment process, the modelling and valuation process is highly collaborative. Both Black and Prendergast must agree upon the model inputs and, where consensus is not reached, the more conservative option is selected. Integrated profit and loss, cash flow and balance sheet models are maintained, which allows for accurate analysis of free cash flow.

The primary valuation tool used is the discounted cash flow (DCF) model, with price multiples used to cross-reference valuation estimates. Black and Prendergast maintain simple DCF models that do not account for potential acquisitions or other speculative factors. Companies that provide an upside potential of between 30% and 50% over one to two years are targeted for inclusion in the Fund.

On occasion, the Fund may invest in stocks at the lower end of the market capitalisation spectrum. However, the required level of upside potential is scaled accordingly, with stocks expected to offer upside of up to 100% to 200%.

Overall, Zenith believes the stock selection process is collaborative, quality focused and rigorous, which provides a strong foundation for the portfolio construction process.

Responsible investment approach

Pengana has an established Responsible Investment Policy, last updated in July 2023, that guides its investment decisions.

In addition to the environmental, social and governance (ESG) constraints, the investment team 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 regards to ESG considerations is increasingly being reflected in the company's share price. Overall, Zenith is comfortable with the team's approach to ESG.

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

Portfolio construction

The Fund is constructed based on a benchmark unaware and fundamentally-driven investment approach, which strongly leverages the stock selection process. Active positions within the Fund are driven by forecasted returns from the DCF valuations, which may lead to sector tilts within the portfolio.

Consensus is needed between Black and Prendergast for a stock to be included in the Fund. If unanimity can not be achieved, the conservative option is taken and either the stock is not purchased or the lower suggested weight is initiated. Position sizes are also determined with consideration for the underlying stock's liquidity.

The Fund typically holds approximately 60 stocks. Although there are no formal sector limits, the aim is to construct a diversified portfolio, with the Fund generally containing a mix of stable stocks (approximately 80%) and cyclical stocks (approximately 20%). With consideration for market impact and information leakage, positions are usually initiated at 1% and slowly added to. A stock can be held at a maximum active weight of 7% and the Fund cannot own more than 10% of a company's issued capital.

Although the Fund may invest in listed New Zealand companies, its New Zealand positions are expected to be small over time, with exposure never having exceeded 15% of the Fund. All positions are maintained on a currency unhedged basis.

The Fund aims to be fully invested over time, with the cash exposure expected to be limited to approximately 2% to 3% at any given time. Zenith views this positively as we believe that active long-only managers should remain fully invested.

Positions can be sold for a number of reasons, including:

- *More compelling investments* - an existing holding will be replaced by a stock with better upside potential.
- *Unfavourable news/announcements* - Black and Prendergast believe when a company initially releases bad news, it is typically not the last negative announcement. Given the importance that the Fund places on capital preservation, stocks are sold promptly in the event of a negative announcement.
- *Inclusion in the S&P/ASX 50 Index* - a stock must be removed from the Fund within 12 months of its promotion into the S&P/ASX 50 Index. Zenith believes this ensures the Fund remains true to its mandate, whilst retaining the flexibility to dispose of stocks in an effective manner.

The Fund's portfolio turnover is expected to average between 40% p.a. and 60% p.a. over a market cycle, which Zenith considers to be moderate.

Zenith believes Pengana’s portfolio construction approach is well structured, positioning the Fund in the team’s highest conviction ideas.

Risk management

Black and Prendergast view risk management as a subjective task, preferring to utilise their deep knowledge and understanding of underlying stocks and the factors that affect them. As such, the Fund's risk management process is implemented at a stock-specific level that is overlaid by general portfolio constraints. The initial filtering process allows Black and Prendergast to focus their efforts on their core competencies. That is, no resources stocks, biotechnology stocks or property trusts.

Zenith is satisfied that the Fund's risk management processes are embedded throughout the entire investment process and that liquidity of holdings is adequately monitored. However, investors should be aware that there is a significant reliance on the judgement and skill of the investment team in mitigating risk in the Fund.

Investment fees

	Fund	Sector Average
Total Fees and Costs (RG 97)	2.10 % p.a.	1.57 % p.a.
Management Fees and Costs	1.33 % p.a.	1.00 % p.a.
Transaction Costs	0.08 % p.a.	0.09 % p.a.
Performance fees as at 30 Jun 2023	0.69 %	0.64 %
Performance fees description	20.5% of outperformance of the S&P/ASX Small Ordinaries Accumulation Index, subject to recouping underperformance	
Management Cost	1.33 % p.a.	1.05 % p.a.
Buy / Sell spread	0.20 % / 0.20 %	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 is based on the average management cost of all flagship Australian Small Companies funds surveyed by Zenith.

The performance fee is accrued daily and paid semi-annually. 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.

Zenith does not believe the Fund's performance fee is aligned with a suitable benchmark, with the S&P/ASX Small Ordinaries Industrials Accumulation Index being our preferred option for the Fund. In addition, 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 expensive, relative to peers, given its stated objectives. However, we believe the fees paid over the past three years (ending 30 June 2023) are attractive given the Fund's risk-adjusted performance over the same period.

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

Pengana Capital Group Limited (Pengana) is an Australian funds management boutique founded in 2003. Pengana aims to support experienced fund managers with long track records, providing staff and support whilst leaving the investment staff entirely responsible for the performance of the funds that they manage.

In June 2017, Pengana merged with Hunter Hall International Limited (ASX: HHL). As a result, HHL was renamed Pengana Capital Group Limited (ASX: PCG). The combined entity offers a diversified range of equity-based strategies totalling $A 3.11 billion in funds under management (FUM), as at 31 January 2024.

PCG is majority-owned by Pengana staff and Washington H. Soul Pattinson (ASX: SOL). SOL has a 36.18% shareholding in PCG after holding a material interest in Hunter Hall prior to the merger and subsequently purchasing NAB Asset Management's stake in Pengana in March 2017. The majority of equity ownership resides with Pengana staff and directors, which Zenith views positively.

The Fund was established in November 2004 by Steve Black and Ed Prendergast in conjunction with Pengana. Pengana equally shares in the profits generated by the business unit with Black and Prendergast each maintaining 25% exposure.

As at 31 January 2024, Pengana managed approximately $A 718 million in the strategy, all of which was invested in the Fund.

Investment personnel

Name	Title	Industry Experience (yrs)	Tenure (yrs)	Location
Steve Black	Portfolio Manager	27	19	Melbourne, Australia
Ed Prendergast	Portfolio Manager	29	19	Melbourne, Australia

Based in Melbourne, the investment team consists of co-portfolio managers, Steve Black and Ed Prendergast, who both have extensive investment experience. Prior to establishing the Fund, Black managed the JBWere Emerging Leaders Fund for approximately seven years. Prendergast was a Director at Citigroup and Head of the Small Companies research team, before leaving to establish the Fund with Black.

Having founded the strategy together in 2004, Black and Prendergast have maintained the initial co-portfolio manager structure, allowing for the team to remain extremely stable. Black and Prendergast share all responsibilities and do not allocate workload along sector or industry lines. Furthermore, there is no performance attribution between the two, ensuring ongoing and constructive management of the Fund.

Black and Prendergast have indicated that there is no intention of adding further resources to the team, preferring to maintain full control of portfolio management and research. Although Zenith would prefer to see an additional resource to mitigate the risk of incapacitation of either co-portfolio manager, we note that the existing structure has been successful and allows the co-portfolio managers to focus on managing the Fund.

Black and Prendergast each maintain a 25% exposure to the profits generated by the business unit, in addition to having significant co-investment in the Fund. Zenith believes there is an appropriate alignment of interests between the team and investors.

Overall, Zenith believes Black and Prendergast are highly experienced and have a strong understanding of the Australian small companies industry.

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.

Administration and operations

Responsible Entity	Pengana Capital Limited

Zenith rating

Report certification

Date of issue: 27 Feb 2024

Role	Analyst	Title
Analyst	Jack Hannah	Associate Investment Analyst
Sector Lead	Stephen Colwell	Senior Investment Analyst
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Association & relationship

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Rating history

As At	Rating
27 Feb 2024	Recommended
01 Mar 2023	Recommended
24 Feb 2022	Recommended
25 Feb 2021	Recommended
24 Feb 2020	Recommended
25 Feb 2019	Recommended

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

In March 2021, Zenith implemented a new ratings methodology for products classified as Traditional Index. Any rating issued from this date forward for Traditional Index products only reflect this change in methodology, with the relevant Traditional Index ratings being Index Approved, Index Recommended and Index Highly Recommended. Ratings issued for Traditional Index products prior to March 2021 are retained for historical purposes in line with our regulatory requirements and were issued in line with Zenith's Fund Research Methodology. Further information in relation to Zenith's Traditional Index Research Methodology and Traditional Index Ratings can be found on the Zenith website.

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