Lonsec

Product Review
eInvest Income Generator Fund (Managed Fund)

ISSUE DATE: 19-03-2018

About this Fund

PRODUCT REVIEWED	EINVEST INCOME GENERATOR FUND (MANAGED FUND)
ASX CODE	EIGA
FUND OBJECTIVE	TO PROVIDE INVESTORS WITH AN ATTRACTIVE LEVEL OF TAX EFFECTIVE INCOME, PAID VIA MONTHLY DISTRIBUTIONS. THE FUND AIMS TO PROVIDE A GROSS YIELD, ADJUSTED FOR APPLICABLE FRANKING CREDITS, ABOVE THAT PROVIDED BY THE S&P/ASX 300 FRANKING CREDIT ADJUSTED DAILY TOTAL RETURN INDEX (TAX EXEMPT).
EXPECTED FUND SIZE	SEEKING TO SEED THE FUND PRIOR TO TRADING ON THE ASX
DISTRIBUTION POLICY	MONTHLY DISTRIBUTIONS
IPO UNIT PRICE	$4.00
INITIAL NET ASSET VALUE	$4.00
STRUCTURE	NO OPTIONS ATTACHED TO THE UNITS
MANAGEMENT COST	0.65% P.A. (INCLUSIVE OF GST) OF NET ASSET VALUE (NAV); EXPENSE RECOVERIES CAPPED AT 0.15% OF NAV.
PERFORMANCE FEE	N/A
RESPONSIBLE ENTITY	PERENNIAL INVESTMENT MANAGEMENT LTD

About the Investment Manager

INVESTMENT MANAGER	PERENNIAL VALUE MANAGEMENT LTD
OWNERSHIP	43% PERENNIAL INVESTMENT PARTNERS / 57% INVESTMENT TEAM
ASSETS MANAGED IN THIS SECTOR	$5.1B (DEC' 2017)
YEARS MANAGING THIS ASSET CLASS	12

Investment team

PORTFOLIO MANAGER	STEPHEN BRUCE
INVESTMENT TEAM SIZE	15
INVESTMENT TEAM TURNOVER	MODERATE
STRUCTURE / LOCATION	CENTRALISED / SYDNEY

Investment process

STYLE	VALUE, INCOME FOCUSED
BENCHMARK	S&P/ASX 300 FRANKING CREDIT ADJUSTED DAILY TOTAL RETURN INDEX (TAX-EXEMPT).
RISK OBJECTIVE	INCOME PRESERVATION
TYPICAL NO. OF STOCKS	20-70, EXPECT 30-40
STOCK LIMITS	BENCHMARK + 5%
SECTOR LIMITS	BENCHMARK + 20%
MARKET CAP. BIAS	LARGE
CASH LIMIT	MAX. 20% OF NAV
DERIVATIVE EXPOSURE	LIMITED

Trust rating history

FEBRUARY 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 the relevant objectives. The financial product is considered an appropriate entry point to the asset class or strategy.

Strengths

- Large investment team capably led by seasoned 'value' investor John Murray.
- Robust and repeatable research process with a clear link between income objectives and the final portfolio construction process.
- Decade-long track record in running income capabilities.
- Well formulated market-making process.
- Investor-friendly IPO structure including the RE meeting all listing costs on behalf of investors.

Weaknesses

- As a new vehicle, the Fund does not have a track record.
- Portfolio Manager Stephen Bruce has somewhat less of a portfolio management track record versus some peers.
- Recent product innovation means the fee load is higher relative to 'smart beta' income products such as 'high yield' ETFs. However, this is an active product and the fee is competitive compared to some other active income products.
- While still having over $5b in FUM, the Manager has lost a significant level of FUM in recent times.

Scope of this Rating

- Lonsec has used its Managed Funds research process in forming a 'point-in-time' opinion on this Active ETFs ability to meet its investment objectives as outlined in the Product Disclosure Statement ('the PDS'). Lonsec considers an investment in the active ETF sector to be suitable for investors with a long-term (5+ years) investment horizon.

Fund Risk Characteristics

	LOW	MODERATE	HIGH
CORPORATE RISK		●	
CAPITAL VOLATILITY			●
SECURITY CONCENTRATION RISK		●	
SECURITY LIQUIDITY RISK	●		

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

Suggested Lonsec risk profile suitability

SECURE	DEFENSIVE	CONSERVATIVE	BALANCED	GROWTH	HIGH GROWTH
	●	●	●	●	●

eInvest Income Generator Fund (Managed Fund)

ISSUE DATE: 19-03-2018

BIOmetrics

Aggregate Risk Measure

	1	2	3	4	5	6	7
STANDARD 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 AFSA/FSC guidelines.

Features and benefits

	LOW	MODERATE	HIGH
COMPLEXITY	●		
ESG AWARENESS		●	
RISK TO INCOME	●		

Fee profile

	LOW	MODERATE	HIGH
FEES – VS LONSEC UNIVERSE			●
FEES – VS ASSET CLASS			●

What is this Fund?

- The eInvest Income Generator Fund (Managed Fund) ('EIGA' or 'the Fund') is an active and long only income focused Australian equities strategy that is seeking to be listed on the Australian Stock Exchange ('ASX') via an Initial Public Offering ('IPO'). Once quoted on the ASX, the Fund will be deemed to be an "actively managed" Exchange Traded Managed Fund or ETMF and will be listed under the ASX's AQUA Rules.
- The Fund's Responsible Entity ('RE') is Perennial Investment Management Limited ('the RE' or 'PIML'). The RE has in turn appointed Perennial Value Management Limited ('the Manager' or 'PVM') as the investment manager of the Fund. Both PIML and PVM have entered into a five-year investment management agreement. Lonsec notes that PVM is a long-standing Australian equity 'boutique' majority owned by its investment staff and has been managing income-related capabilities since 2005. PIML has also appointed ETF Investment Australia Limited ('eInvest') to provide marketing, distribution and client services for the Fund. Lonsec notes that both PVM and eInvest are related-parties of the RE.
- Lonsec notes that the Fund will be an active ETF version of the long-standing Perennial Value Shares for Income Trust ('the Trust') which has a considerable track record in delivering investors with a meaningful level of fully franked equity income. Lonsec notes that despite the different structure, both the Fund and the Trust will be run using the same investment team and process. Lonsec has a favourable investment view of the Trust.
- Lonsec notes that along with the income capability, PVM also operates three additional strategies based on the same research process and investment philosophy; these include the Value Australian Shares, Value Small / Micro Capitalisation Shares and Wealth Defender capabilities. These are also rated by Lonsec.
- PIML is the issuer of the PDS and is seeking to raise funds under the IPO to seed the Fund prior to the units trading on the ASX. Pleasingly for participants in the IPO, the RE has agreed to fund all the establishment costs of the offer, ensuring that the NAV per share upon listing will be $4.00 per unit. Lonsec notes that with many other recent professionally managed structures that have listed on the ASX, the unit price has listed at a discount to NAV as investors, through the listed vehicle, have born the costs associated with the raising.
- The Fund has the objective of generating a gross income yield in excess of that provided by the overall Australian share market, paid in monthly instalments. In doing so, the Fund will specifically aim to provide a gross yield above that provided by the S&P/ASX 300 Franking Credit Adjusted Daily Total Return Index (Tax Exempt) ('the Benchmark'). The Fund also has an internal gross income distribution target of 7% p.a. Lonsec notes that the Trust has delivered a gross distribution yield above of this aspirational target since its inception.
- PVM adopts a value-based investment style that seeks to identify and invest in 'quality' companies with sustainable business models whose share prices are trading at a discount to the Manager's assessment of intrinsic value. The foundation of its investment philosophy is the belief that equity markets are not fully efficient, as asset prices are sometimes driven by irrational influences. The Manager aims to exploit such inefficiencies to produce a consistent level of out-performance. As a value investor, the Manager aims to 'buy good businesses cheaply' with an underlying belief that good businesses are eventually recognised by the market.
- PVM employs a 'bottom-up' stock selection approach which typically results in a portfolio which has a large cap bias. Lonsec observes the Manager's value bias to be less pronounced than that of a 'deep value' investment manager. The Fund is expected to be reasonably concentrated (typically holding around 30-40 stocks) and the Manager will only invest in stocks which meet a yield hurdle of in excess of 4%. As a result, the portfolio is expected to be largely 'benchmark unaware' in its construction. While the Fund's Tracking Error is expected to be higher than most traditional Australian equity funds, the Manager's bias towards higher yielding large-cap industrial stocks may result in lower volatility of returns.
- While the Fund's PDS allows for the use derivatives, these are not expected to be used to a material extent. Lonsec expects the use of derivatives to be in the form of exchange-traded options that will be predominantly used to generate additional income. Lonsec notes that the Fund cannot have a notional derivative exposure that exceeds 10% of the NAV of the Fund. Lonsec notes that the Fund can also have a cash weighting up to 20%. However, the expectation is that the Fund will be mostly fully-invested.
- The management cost of the Fund will be 0.8% p.a. with no performance fee. The management cost consists of a management fee of 0.65% p.a. and an expense recovery capped at 0.15% p.a. The expense recovery covers expenses normally incurred in the day-to-day operation of the Fund including

ISSUE DATE: 19-03-2018

custodian, fund administration, unit registry, market-making and ASX-listing fees. Lonsec considers the fee load for the Fund to be commensurate with other active income products in the market. However, Lonsec acknowledges the recent strong product innovation that has been occurring in more index-based income products at significantly lower price points.

- Lonsec notes that the PDS has also disclosed the Fund's estimated trading costs as being 0.19% p.a. These are additional costs that are not included in the management costs. Given the Fund has not trading history, these have been based on a 'reasonable basis' using data from other PVM strategies.
- Lonsec notes that the RE will establish a distribution reinvestment plan ('DRP') for the Fund. The DRP allows investors, at their discretion, to reinvest all or part of their distributable income into the Fund subject to the terms and condition of the RE's DRP policy. The offer of a DRP will be at the RE's discretion.
- Lonsec notes that the RE will also act as the Market-Maker ('MM') for the Fund. The role of the MM is to provide liquidity in the markets for the units and to satisfy supply and demand for the units. Lonsec notes that the RE in turn has delegated its MM function to an external provider in Macquarie Securities ('MS') under a formal services agreement entered by both parties.
- Lonsec notes that the RE remains its own MM with MS being appointed as an agent of PIML. The Fund bears the risk of all MM activities undertaken which will either be a cost or a benefit of the Fund.
- Lonsec notes that MS is one of Asia Pacific's largest full-service brokers and that it has extensive experience in making markets for products such as warrants and options. However, it has only recently entered the ETMF space (in 2016) in response to growing product innovation. Lonsec considers MS to be suitably qualified and resourced to execute on its contractual obligations with the RE.
- Lonsec notes that the RE has agreed to make the Fund's indicative NAV or 'iNAV' per unit available every fifteen minutes. The iNAV will be presented on both PVM's and eInvest's web-sites as well as other financial and broker web-sites. The RE has appointed Interactive Data (Australia) Pty Ltd ('IDA') to calculate and publish the iNav. IDA is an experienced provider of such services. Under AQUA Rules, the RE will also release the Fund's portfolio holdings to the ASX on a monthly basis. Lonsec has no concerns with the Fund's iNAV and disclosure process.

Using this Product

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 returns which may result in capital losses being incurred on their investment.
- The Fund is a relatively concentrated 'long only' Australian equity product and it will generally sit within the growth component of a balanced portfolio. The Fund's explicit yield objective and the concentrated nature of the Australian equities market means that the portfolio is likely to exhibit significant sector biases. As such, the Fund is unlikely to provide a broad diversified exposure to the Australian share market alone. Lonsec considers the Fund to be suitable to be blended with broader Australian equity funds.
- The Fund's distributable income is derived from a portfolio of listed assets. Distributions can fluctuate as listed companies are not obligated to maintain/pay out a certain level of dividends on a regular basis. This is unlike what is normally associated with traditional income producing assets (for example, fixed interest). The Manager's emphasis on securing franked income and minimising stock turnover may result in better after-tax performance outcomes for investors seeking a tax-effective income streams.
- Advisors should consult the Lonsec Risk Profile Review and/or the Lonsec Risk Profile Definitions document(s) for guidance on appropriate allocations to Australian equities within a diversified portfolio. Lonsec recommends that equity investments are suitable for investors with an investment-time horizon of at least five years.

Lonsec Opinion of this Fund

People and resources — Investment Manager

- John Murray is the Managing Director of PVM and is ultimately accountable for both the performance of the Fund and management of the Manager's investment team. Murray has over 30 years of relevant industry experience. Prior to establishing PVM in 2000, he was the Investment Director, Australian Shares at Westpac Investment Management, a Senior Portfolio Manager at Maple-Brown Abbott, and the Head of Australian Equities at Perpetual Investments. Lonsec holds Murray in high regard and, as a long-term practitioner of 'value' style investing, considers him to be a very experienced investment professional.
- Stephen Bruce will be the Portfolio Manager for the Fund, having assumed sole portfolio management responsibility for PVM's income capability in October 2011. Previously Bruce was the Deputy Portfolio Manager to Murray, a position he had held since 2006. Bruce has been with PVM since April 2000 and continues to have analytical responsibility for the Banking, Healthcare, Chemicals and Agriculture sectors. Bruce also manages 25% of the Manager's 'flagship' strategy, the Perennial Value Shares Wholesale Trust. Lonsec considers Bruce to be a solid investor and acknowledges both his market experience and extensive tenure at the Manager. However, Lonsec cautions that while his formal portfolio management track record is growing, it remains shorter in duration than some longer serving portfolio managers within the peer group.

eInvest Income Generator Fund (Managed Fund)

- Bruce will be supported on risk management and derivatives trading by Dan Bosscher, who joined PVM in August 2012. Bosscher joined from UBS Investment Bank where he was responsible for derivative overlay strategies to manage the risk for a multi-strategy hedge fund. Bosscher's primary role is as the Portfolio Manager of the Perennial Value Wealth Defender strategy. Bosscher also runs a sleeve in the 'flagship' value capability and is seeding a concentrated value strategy. Lonsec considers his supporting role on this strategy to be a positive given his background in defensive portfolio management.
- The senior investors are supported by a broader investment team that comprises of 15 analysts and which exhibits an amalgam of youth and experience. While very experienced and displaying strong breadth, Lonsec notes that the team has been impacted by the recent retirements of long-standing members Tony Oesterheld (Senior Portfolio Manager) in December 2016 and more recently of Paul Durham (Senior Analyst) in October 2017. The loss of both has resulted in a reduction to the team's average tenure and industry experience respectively. That said, in Lonsec's view the transition has been handled well with both retirements having been advised to PVM well in advance, allowing for logical successors to be appointed.
- The Manager has also recently sought to recalibrate the team, with the promotion of the former co-portfolio managers of the Perennial Value Smaller Companies Trust to more senior roles. Grant Oshry has been promoted to the new role of Head of Mid Caps while Andrew Smith has been promoted to Head of Small Caps effective as of 1 November 2017. Further resources have also been brought on to accommodate the departures and allow for an uninterrupted transition of responsibilities, with Ewan Galloway joining the team as an Analyst in December 2016. Galloway covers large cap Resources and prior to commencing at PVM had held an investment role at Deutsche Bank within the Healthcare Investment Banking team. Lonsec is pleased to observe both the promotion of talented investors within the team and the willingness to re-invest in the team as required.
- While an element of key person risk ('KPR') exists in Bruce as the sole Portfolio Manager of the Fund, Lonsec still considers there to be a relatively higher level of KPR associated with Murray. Murray is the architect of PVM's investment process and remains the key Portfolio Manager within the firm as well as being a key executive for the firm. To this end, Lonsec believes that KPR is mitigated by the high level of equity participation by both Murray and Bruce. This also extends to other senior investors in the team. As it stands, nine members of the investment team hold varying levels of equity and are entitled to 60% of dividends. Equity in the business is deferred and unlocks over time, creating strong incentives for staff to remain and to perform. PVM has also sought to provide a clearer pathway to succession planning, thereby alleviating some of the KPR associated with Murray. This has been achieved via the recent internal promotions of Oshry and Smith and by Bosscher taking on additional portfolio management responsibility.
- As an overall observation, Lonsec considers PVM to exhibit many of the characteristics that define a 'boutique' investment culture such as equity ownership by the investment team, a strong alignment of interests and an investment orientated culture. Lonsec considers that such a 'boutique' culture can better guide investment behaviour to focus on the attainment of long-term investment objectives.

Research approach and portfolio construction

- The investment process for the Fund leverages off the process used by PVM for its wider core large cap value strategy and is considered by Lonsec to be logical and clearly defined. 'Bottom-up' research is conducted within a structured framework, including both an assessment of key qualitative criteria and standardised financial modelling. The company modelling performed by the Manager is considered by Lonsec to be highly detailed and a positive feature of the process. Lonsec also believes that this feature will improve the efficacy of the peer review process. Lonsec considers the Manager to have a number of qualitative advantages relative to peers including the depth of stock research undertaken (which is a function of the team size and experience) and the clarity of the portfolio construction process.
- Lonsec notes that the Fund will use the same investment process as the Manager's existing income capability ('the Trust'). In addition to the core process, Lonsec notes that PVM applies a strict quantitative screen for the Fund to filter out stocks paying gross income yields below 4%. In addition, companies are excluded if they do not satisfy size and liquidity requirements. Lonsec considers this upfront screening, which is more onerous than for the wider value capability, to be crucial in aligning the investment process with the Fund's income objectives.
- Lonsec considers the portfolio construction process to be logical and robust, with clear links between analyst recommendations and the weighting of stocks in the portfolio. The portfolio is constructed from stocks that have passed through the 'Perennial Value Screen' (PVS), a six-factor relative 'value' model that ranks stocks on price-to-earnings, price-to-free-cash flow, gross yield, price-to-book-value, net interest cover and forecast 3-year earnings per share growth.
- Lonsec notes that the 'gross yield' factor receives a 40% weight in the PVS used for the income capability which is logical given the Fund's tax-effective income objectives; the remaining factors are equal-weighted. Lonsec notes that this introduces a clear bias towards higher yielding stocks in the process. This is particularly so as the final stock weights set by the Portfolio Manager for the Fund will typically be closely linked to the PVS ranking as well as analyst conviction in a stock and its liquidity.
- Lonsec notes that analyst conviction can be tempered to a degree given the Fund's income objectives. This is due to stocks that have been assigned a 'sell' rating by the sector analyst potentially still being held in the income portfolio (albeit at a small weight) if the expected yield is attractive and sustainable. While this is a key difference to the broader value

ISSUE DATE: 19-03-2018

capability, Lonsec notes that holding these stocks has the effect of reducing the expected total return for the Fund and thus 'sell' rated stocks are not expected to ever make up a significant percentage of the portfolio.

- In recent years, the Manager has made minor enhancements to the research process. The goal has primarily been to identify and reduce exposure to companies that face significant downside risk. The genesis for this work was the performance drag the Perennial Value Shares Wholesale Trust experienced in the FY2011-FY2012 period due to exposure to some 'value trap' companies. The first stage of these enhancements was increased sensitivity analysis (i.e. identifying the 'bull', 'base', and 'bear' case scenario for a given company). This work has since been strengthened with the Manager introducing additional resources such as deeper data sets and third-party research reports with a focus on balance sheet strength. The Manager has also strengthened the portfolio risk analysis system to identify and reduce exposure to macroeconomic risk. Finally, as at 1 July 2016, PVM introduced analyst portfolios designed to increase conviction in stock recommendations and sharper pricing signals. Lonsec believes these enhancements have been prudently adopted and are a complement to the existing process.
- Lonsec notes that part of the Fund's investment objectives is to provide a 'tax effective' income stream. Given this, Lonsec is pleased to observe the role 'gross yield' plays in the PVS. Tax effectiveness is also aided by the Fund's low turnover product design; however capital gains tax and the 45-day rule are 'soft' considerations when making sell decisions.

Risk management

- The Fund will have a range of hard risk limits on stock and sector exposures. Lonsec notes that while there are relatively tighter exposure limits at an individual stock level (maximum of 'benchmark + 5%'), the limits at the sector level are comparatively broader ('benchmark + 20%'). This reflects the Fund's focus on both income yield and franking credits. Lonsec considers it likely that this will lead to a bias in the portfolio towards certain sectors of the market that return a relatively higher fully frank dividend yield such as Financials and Industrials.
- In addition, the Fund will have a hard rule that the gross dividend yield of the portfolio must be higher than the broader market. This is in-line with the investment objective of the Fund. Lonsec notes that such a rule, while understandable given the investment objectives, may lead to pressure for the Manager to stay 'long' in a stock with poorer qualitative momentum due to the risk of income dilution. This is especially so if the back-up stocks being considered have lower yields or franking levels than the incumbent stock.
- Lonsec notes that the current iteration of the risk management mandate rules were only recently introduced for the wider income capability (effective 1 October 2017). Lonsec notes that the Manager significantly altered the stock and sector limits at this time; for instance, it changed individual stock limits from an absolute limit of 10% to the current 'benchmark plus' limit stated above. The Manager also increased the portfolio's ability to allocate to cash from 10% of NAV to 20% of NAV. It also lowered the minimum market capitalisation 'floor' from $1b to $500m. All these changes are also being adopted by the Fund.
- Lonsec notes that these changes have been made to add greater flexibility to the process, aid downside protection and optimise the income generation of the Fund. Nonetheless, while Lonsec believes that these amendments have not fundamentally altered the long-standing investment strategy or portfolio characteristics of the capability, they are still new and the efficacy of the changes will need to be carefully monitored.
- Lonsec notes that the Manager has made an increasing use of the Portfolio Risk Analysis tool ('PAS') within the portfolio construction process for the wider income capability. PAS aims to quantify and highlight the levels of idiosyncratic stock, style and factor risks being taken within the portfolio. Lonsec believes this is a useful tool that should aid the Manager in identifying 'unintended bets' and achieving portfolio returns that are driven by stock specific rather than macroeconomic or sector risks.

Funds under Management

- PVM has traditionally been one of the larger managers across Lonsec's Australian equity sector in terms of funds under management ('FUM'). That said, the Manager has recently lost a significant level of FUM and as at December 2017, it managed approximately $5.0b in Australian equities. This is significantly down from $8.8bn as at 30 June 2016. The current level of FUM equates to approximately 0.35% of the market capitalisation of the S&P/ASX 300 Accumulation Index.
- The Manager has indicated to Lonsec that it will limit its total FUM to 0.75%-1.0% of the market. Therefore, at current FUM levels Lonsec does not have any capacity concerns. Nonetheless, capacity management will remain an area of focus in future reviews. Further, as corporate stability is reliant on retaining investor funds, FUM stability will also be a focus for Lonsec going forward.
- Lonsec notes there to be 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 to investors. Larger fund managers do have some competitive advantages, including increased access to key company decision makers, better execution pricing and preferential access to IPOs and secondary offerings. Conversely, managing a significant quantum of funds may result in liquidity issues when moving down the market capitalisation spectrum or reduced nimbleness when entering or exiting stock positions. Such factors, in Lonsec's opinion, can lead to alpha decay if not appropriately managed.

Performance

- The Fund, which is not yet listed, does not have an operational track record so no performance data is available. Nonetheless, the Manager has a similar strategy, the Perennial Value Shares for Income Trust ('the Trust'), that has a meaningful track record. Of

eInvest Income Generator Fund (Managed Fund)

relevance to potential investors in the Fund, Lonsec again highlights that the Trust has delivered a pre-tax distribution yield of 8.0% p.a. since its 2005 inception date.

- That said, Lonsec notes that from a total return perspective the Trust's recent performance has been underwhelming with it underperforming the S&P/ASX 300 Acc. Index by -4.5% (after fees) over the one-year period to 31 January 2018. That said, Lonsec highlights that the Manager's modest 'value' bias and focus on 'quality' has been a contributing factor to underperformance, noting that this period has been impacted by a rotation from higher-quality growth stocks to lower P/E cyclical stocks such as resources.
- Lonsec notes that over the ten-year period ended 31 January 2018, the Trust has performed much better and has returned 5.5% p.a. (after fees), outperforming the S&P/ASX 300 Acc. Index by 0.3% p.a. What also stands out over this period is the Trust's defensive characteristics, with it outperforming in close to 60% of down-market months. Lonsec consider this, along with the healthy income return, to have been a fair result for investors.

Overall

- Lonsec has assigned the Fund with an initial **'Recommended'** rating. Lonsec notes that this rating is in-line with its current rating on the Perennial Value Shares for Income Trust ('the Trust') which is run using the same investment process. This rating reflects Lonsec's relatively high regard for the senior portfolio management team, including Managing Director, John Murray and Portfolio Manager Stephen Bruce. The Fund's investment process is clearly defined and repeatable with a clear link between analyst conviction and final portfolio weights. Lonsec also notes that the Trust has a sound long-term track record.
- Nonetheless, Lonsec highlight that Stephen Bruce has less of a track record versus some more experienced portfolio managers in the wider income peer group. The Fund also does not have any track record.
- Lonsec believes the Manager bearing the cost associated with establishing the Fund to be best practice. Lonsec also considers the market-making function to be appropriately structured.

People and Resources

Corporate overview

Perennial Value Management Ltd is a boutique investment manager that was formed in 2000 by John Murray through a joint venture between senior investment professionals and IOOF. The firm is now majority owned by staff and currently has $5.1b in FUM. PVM has a number of Australian equity-related capabilities, including value, income, risk managed and small companies.

PVM acts as its own RE for over nine registered managed investment schemes. The RE is the wholly-owned entity, Perennial Investment Management Ltd ('PIML'). The Fund is the RE's first active ETF.

Size and experience

Name	Position	Experience Industry / Firm.
JOHN MURRAY	MANAGING DIRECTOR, PORTFOLIO MANAGER	31/17
STEPHEN BRUCE	PORTFOLIO MANAGER / SENIOR ANALYST	17/17
DAN BOSSCHER	PORTFOLIO MANAGER / DERIVATIVES & RISK MANAGEMENT	19/4
SCOTT STEWART	PORTFOLIO MANAGER / SENIOR DERIVATIVES TRADER	18/2
GRANT OSHRY	HEAD OF MID-CAPS	18/14
DAMIAN COTTIER	SENIOR ANALYST / RESEARCH CO-ORDINATOR	12/12
ANDREW SMITH	HEAD OF SMALL CAPS	15/8
MICHAEL POLLARD	SENIOR DERIVATIVES ANALYST	15/<1
JULIAN GUIDO	SENIOR EQUITIES ANALYST	18/<1
SAM BERRIDGE	EQUITIES ANALYST	9/4
WILLIAN WU	SENIOR INVESTMENT ANALYST	7/5
EWAN GALLOWAY	EQUITIES ANALYST	6/<1
HARAN KUMARESWARAN	EQUITIES ANALYST	10/<1
STEVE YEE	DEALER	13/7
PHILIP CORNET	DEALER	18/<1
AVERAGE		15/6

Stephen Bruce is the primary Portfolio Manager of the Fund and is supported by a team of analysts who have stock responsibilities divided along sector lines. Bruce also has direct stock responsibilities as well as managing 25% of the larger Value capability. He began his career as a Chartered Accountant with KPMG and has also held financial accounting roles with Morgan Stanley and Deutsche Bank.

Bruce is closely supported by PVM's Managing Director, John Murray. While Murray does not have direct stock research responsibilities, he is heavily involved in the overall research process.

Business management support is also provided by Anthony Patterson (PIML Executive Director). Perennial has outsourced unit registry, pricing and investment accounting to NAB.

Remuneration

PVM's remuneration is not structured in the same manner as many other managers reviewed by Lonsec. It does not conduct analyst attribution, nor reward analysts on stock recommendations; rather the team is rewarded on performance relative to the Fund's benchmark and business factors. In addition, PVM traditionally pays lower than industry base salaries but rewards its staff with equity. This directly links the remuneration of individuals to the success of the business.

PVM has an equity transfer mechanism which allows equity holders to 'cash out' up to 20% of their earned equity per annum. Typically in other firms, equity holders looking to liquidate for any reason must leave the firm to realise their equity.

eInvest Income Generator Fund (Managed Fund)

ISSUE DATE: 19-03-2018

Research Approach

Overview

RESEARCH PHILOSOPHY	VALUE / INCOME
INITIAL STOCK UNIVERSE	ASX-LISTED STOCKS
SECONDARY STOCK UNIVERSE	200+
NO. STOCKS FULLY MODELLED	200
KEY SCREENS	MIN. MARKET CAP >$500M, MIN. DIVIDEND YIELD > 4%, MIN. DAILY LIQUIDITY >$0.5M
KEY METRICS	GROSS YIELD, PE, P/FCF, P/NTA, NET INTEREST COVER, FORECAST 3-YEAR EPSG
RESEARCH INPUTS	SITE VISITS – COMPANY VISITATION PROGRAM, INDUSTRY ANALYSIS, FINANCIAL RATIOS, MANAGEMENT ASSESSMENT, OPERATIONAL TRACK RECORD ASSESSMENT
USE OF BROKER RESEARCH	IDEA GENERATION ONLY
VALUATION OVERVIEW	PVM RELATIVE RANKING SYSTEM

Research Process

Analysts focus on financial analysis and modelling on six key measures. These are used to rank stocks based on their yield, from lowest sustainable yielding to highest. Gross dividend yield is assigned a 40% weighting and the remaining five measures have an equal weighting of 12% each. The first five measures are based on forecasts looking forward one year. The sixth measure, EPS growth, is expressed as an annualised growth rate based on internal forecasts over the next three years.

In addition to a relative ranking, the analysts assign a conviction rating to each stock that is separate to the six key measures assessed. A weighted average final score is then assigned, which determines each stock's final ranking.

Portfolio Construction

Overview

FUND BENCHMARK	S&P/ASX 300 FRANKING CREDIT ADJUSTED DAILY TOTAL RETURN INDEX (TAX EXEMPT)
INTERNAL RETURN OBJECTIVE	GROSS INCOME YIELD > BENCHMARK
INTERNAL RISK OBJECTIVE	EX-ANTE TRACKING ERROR OF 3-5% P.A. (SOFT LIMIT)
PORTFOLIO DECISIONS	SINGLE PORTFOLIO MANAGER
STOCK SELECTION	BOTTOM-UP
TOP-DOWN INFLUENCE	LIMITED
TYPICAL NUMBER OF HOLDINGS	30-40
MARKET CAPITALISATION BIAS	LARGE
EXPECTED PORTFOLIO TURNOVER	LOW

Decision making

The Fund is constructed from stocks that have passed through the 'PVM High Yield Screen' and are subsequently researched and modelled. Weights are set in accordance with analyst conviction levels, which in turn are a function of total expected relative return.

A portfolio construction matrix then determines the portfolio weight range based on the analyst conviction rating and on the expected gross yield for each stock. Nevertheless, this process is not mechanical and ultimate responsibility for each active position rests with the Portfolio Manager. Lonsec notes that PVM does not afford analysts the ability to assign a 'Hold' rating on stocks, a process which is designed to drive higher analyst conviction.

The section below outlines the Fund's bias towards high-yielding stocks based on one-year forecasts. Sell rated stocks will be sold outright if there are capital preservation issues.

Portfolio construction matrix weights

Conviction rating of 1 (Buy) – expected yield > 8% translates to an active weight of 4-10%; expected yield of 4-8% translates to an active weight of 2-8%; expected yield <4% translates to ab active weight of 1-4%.

Conviction rating of 2 (Accumulate) – expected yield > 8% translates to an active weight of 2-10%; expected yield of 4-8% translates to an active weight of 1-8%; expected yield <4% translates to an active weight of 1-3%.

Conviction rating of 3 (Lighten) – expected yield > 8% translates to an active weight of 1-8%; expected yield of 4-8% translates to an active weight of 1-6%; expected yield <4% translates to an active weight of 0-2%.

Conviction rating of 4 (Sell) – expected yield > 8% translates to an active weight of 1-4%; expected yield of 4-8% translates to an active weight of 1-3%; expected yield <4% translates to an active weight of 0%.

Risk Management

Risk limits

SEPARATE RISK MONITORING	YES
STOCK CONSTRAINTS	BENCHMARK + 5%
SECTOR CONSTRAINTS	BENCHMARK + 20%
CASH RANGE	0-20%
DERIVATIVES	NOTIONAL EXPOSURE CANNOT EXCEED 10% OF NAV

Risk monitoring

PVM monitors the portfolio to ensure it complies with a range of risk limits and the portfolio construction matrix. This includes minimum/maximum number of stocks, maximum individual stock holdings, and individual sector limits amongst other constraints. On the dealing side, PVM uses pre-trade compliance through Bloomberg. Post-trade compliance is also undertaken on all trades.

The RE has established a compliance committee, with a majority of members that are external to the RE, to monitor the Fund's adherence to its compliance plan.

Important Risks

An investment in the Fund will carry a number of standard investment risks associated with domestic and international investment markets. These include economic, political, legal, tax and regulatory risks. These and other risks are outlined in the Prospectus and should be read in full and understood by investors. Lonsec considers major risks to be:

Concentration risk

The Fund will be generally invested in 30-40 different stocks and has broad sector constraints. The Manager is expected to build a portfolio that may vary markedly from the benchmark (e.g. concentration risk and/or exposure). Accordingly, investors should be mindful of

ISSUE DATE: 19-03-2018

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

Lonsec does not expect derivatives to be a widely used given that this is not the intention of the Manager. However, here is scope in the PDS to implement various derivative strategies and options strategies in particular will be used within tight mandate constraints. The Fund is authorised to utilise derivative instruments for risk management purposes, subject to the specific restriction that they cannot be used to gear portfolio exposure.

Market Maker

Macquarie Securities has been appointed by the RE to help make a liquid market for the active ETF's units once listed. The risk exists that Macquarie does not match its contractual obligations in this regard. Lonsec notes that the Fund bears the risk of all MM activities undertaken on its behalf which will either be a cost or a benefit of the Fund.

eInvest Income Generator Fund (Managed Fund)

ISSUE DATE: 19-03-2018

Glossary

Absolute Return 'Top line' actual return, after fees

Excess Return Return in excess of the benchmark return (Alpha)

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

Lonsec

eInvest Income Generator Fund (Managed Fund)

ISSUE DATE: 19-03-2018

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 and independent 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

Analyst remuneration is not linked to the research or rating outcome. Where financial products are mentioned, the Analyst(s) may hold the financial product(s) referred to in this document, but Lonsec considers such holdings not to be sufficiently material to compromise the rating or advice. Analyst holdings may change during the life of this document. The Analyst(s) certify that the views expressed in this document accurately reflect their personal, professional opinion about the matters and financial product(s) to which this document refers.

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P 10-10