

# Daintree Core Income Fund

This report has been prepared for financial advisers only



**Superior**

## INTRODUCTION

### Key Principles

The underlying principles of the assessment process are to:

- identify the long term commercial potential of the Responsible Entity/Investment Manager;
- evaluate management's capabilities, previous performance in the specific industry and the stability of the organisation;
- evaluate identified markets (domestic and international existence, stability and growth potential);
- benchmark key performance assumptions and variables against industry peers;
- weigh up the relevant risks of the Responsible Entity/Investment Manager;
- assess structure and ownership;
- determine if the Responsible Entity/Investment Manager is structured in such a way as to protect investor's interests; and
- allow an opinion to be formed regarding the investment quality of the Responsible Entity/Investment Manager.

### Assessment

SQM Research conducts a detailed site inspection of the projects/properties within the Responsible Entity's/Investment Manager's managed funds.

- The site assessment considers the following areas:
- sustainability of the site for the purpose intended;
- management skills, qualifications, capabilities and experience; and
- associated property risks and their management.

### Star Rating\*

Investment products are awarded a star rating out of a possible five stars and placed on the following websites: [www.sqmratings.com.au](http://www.sqmratings.com.au)

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### Fees charged for Report

SQM Research has received a fee from the fund manager for this report and rating.

### General Financial Product Advice

This advice will not take into account your, or your clients, objectives, financial situation or needs and will not be provided in respect of any other financial products. Accordingly, it is up to you and your clients to consider whether specific financial products are suitable for your objectives, financial situations or needs.

### Report Date: 31 January 2018

| Star Rating         | Description             | Definition  | Investment Grading           |
|---------------------|-------------------------|---|------------------------------|
| 4½ stars and above  | Outstanding             | <b>Highly suitable for inclusion on APLs</b><br><i>The fund most often outperforms its peers and benchmark. In all cases the fund is operating to its mandate and product disclosure statement (PDS). There are no corporate governance issues. Management is extremely experienced and skilled and has access to significant resources.</i>  | High Investment grade rating |
| 4 stars to 4¼ stars | Superior                | <b>Suitable for inclusion on most APLs</b><br><i>The fund outperforms (or is likely to) its peers and benchmark the majority of the time. The fund most of the time has been operating within its mandate and PDS. There are very little to no corporate governance concerns. Management is of a very high calibre.</i>   | High Investment grade rating |
| 3¾ stars            | Favourable              | <b>Consider for APL inclusion</b><br><i>The fund may outperform its peers and benchmark the majority of the time or SQM believes this is a fund that has potential to be an outperforming fund over the medium term. Management is of a quality calibre but may not yet be fully tested. There are no corporate governance concerns or they are of a minor nature.</i>  | Approved                     |
| 3½ stars            | Acceptable              | <b>Consider for APL inclusion, subject to advice restrictions</b><br><i>There is some degree of additional risk attached to the fund by way of performance. The fund may periodically underperform its peers and benchmark or it has not been fully tested. There may be some additional concentration risk. Management is generally experienced and capable. There might be corporate governance issues of a mid-level or corners over the Responsible Entities/Parent Entities financial position/ performance.</i> | Low investment grade rating  |
| 3¼ stars            | Caution required        | <b>Not suitable for most APLs</b><br><i>Performance has been significantly under-benchmark and peers. There is a greater than average risk of underperformance over the medium term. There is a risk of the fund not operating to mandate or to its PDS. There are corporate governance concerns. Management has been operating in an average manner.</i>   | Unapproved                   |
| 3 stars             | Strong Caution Required | <b>Not suitable for most APLs</b><br><i>The fund is unlikely to perform to its mandate over the near term. There might be some greater than average corporate governance concerns. SQM has a number of concerns of management.</i>  | Unapproved                   |
| Below 3 stars       | Avoid or redeem         | <b>Not suitable for most APL inclusion</b>  | Unapproved                   |

**Hold** – The rating is currently suspended until SQM Research receives further information. A rating is typically put on hold for a period of two days to four weeks.

**Withdrawn** – The rating is no longer applicable. Significant issues have arisen since the last report was issued, and investors should avoid or redeem units in the fund.

**Not rated** – The fund has not been rated by SQM.

|  |           |
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## SQM Rating



*Superior. Suitable for inclusion on most APLs*

## Fund Details

|                    |                                     |
|--------------------|-------------------------------------|
| Fund Name          | Daintree Core Income Fund           |
| APIR Code          | WPC1963AU                           |
| Manager            | Daintree Capital Management Pty Ltd |
| Responsible Entity | Perennial Investment Management Ltd |
| Custodian          | NAB                                 |

## Investment Details

|                                  |   |
|----------------------------------|---|
| Fund Inception                   | 5-Jun-17                                      |
| Fund Size                        | \$21m   |
| Fund Type                        | Fixed Income                                  |
| Return Objective (PDS)           | Total return which exceeds the benchmark      |
| Internal Return Objective        | RBA +150-200 after fees                       |
| Risk Level (PDS)                 | Low to Medium risk of short-term capital loss |
| Internal Risk Objective          | Low to Medium risk of short-term capital loss |
| Benchmark                        | RBA Cash Rate                                 |
| Number of positions in portfolio | 80  |
| Gearing (Fund)                   | None  |

## Investment Specifications Summary

|                             |  |
|-----------------------------|--|
| Minimum Application         | \$25,000                                   |
| Redemption Policy           | Daily notification window is available T+2 |
| Distribution Frequency      | Monthly                                    |
| ICR                         | 0.60%                                      |
| MER                         | 0.60%                                      |
| Performance Fee             | None                                       |
| Buy/Sell Spread             | 0.05/0.05 (%)                              |
| Currency Hedging            | All currency hedged back into AUD          |
| Time Horizon for Investment | Three years                                |

## Other

|                        |                |
|------------------------|----------------|
| Turnover               | 116.73%        |
| Top 10 Holdings Weight | Not Applicable |

## Fund Summary

### Description

The **Daintree Core Income Fund (Daintree Fund)** is an income-oriented fixed-income fund managed by industry veterans who are co-founders of the boutique fund manager Daintree Capital. The Fund aims to provide a steady stream of income and capital stability over the medium term, by investing in a diversified portfolio of credit fixed income securities and cash. The Manager can be described as an active, absolute return style, fixed income, credit investment manager. The Fund applies both top down and bottom up elements to constructing a portfolio that targets absolute returns by combining active credit management, a diversified overlay strategy and conservative risk management.

The Fund is structured as an open-ended unlisted registered managed investment scheme.

### About the Manager

Daintree Capital Management Pty Ltd is owned jointly by the Daintree executives and PVM Capital Partners Limited. PVM Capital Partners is owned by the Perennial Value Management. There have been no changes to the Daintree Capital Management structure since inception. The investment team consists of five personnel, led by Mr Mark Mitchell – Portfolio Manager and Director (Credit). Overall, the firm manages about \$20 million in FUM as of Dec-2017.

### Fund Rating

The Fund has achieved the following rating:

| Star Rating | Description | Definition                          | Investment Grading           |
|-------------|-------------|-------------------------------------|------------------------------|
| 4.00 stars  | Superior    | Suitable for inclusion on most APLs | High Investment Grade rating |

## SQM Research's Review and Key Observations

### 1. People and Resources

#### Size and Resources of the Fund Management Company

Daintree Capital is appropriately staffed with highly experienced and knowledgeable investment professionals backed by distinguished careers in fixed income and credit money management. Perennial Value Management is a strong institutional partner for the firm, providing robust support to the investment team for all matters non-investment related including operational, compliance and marketing.

### Investment Team

As a boutique, the investment team has a flat structure that maximises flexibility and speed of decision-making. All members of the team report directly to Mr Mark Mitchell, who has ultimate responsibility for investment decisions. Mr Justin Tyler, Director - Interest Rates and Currency, is Mr Mitchell's back up Portfolio Manager.

Given Mr Tyler can competently step into the management duties of Mr Mitchell in his absence, SQM Research deems key person risk to be material, but appropriately managed. The departure of either Mr Mitchell or Mr Tyler would not likely create immediate capital preservation risks for the portfolio. However, SQM Research would expect swift and determined action to "fill the gap".

### 2. Investment Process and Philosophy

#### Investable Universe

The Investment universe includes fixed-income assets, issued exclusively in developed market countries. Securities considered include bank bills, commercial paper, term deposits, corporate bonds, bank capital securities, structured credit, investment grade sovereign bonds and credit derivatives. Daintree then uses a series of indicators and filters to search the universe of securities for potential inclusion in the portfolio.

Non-Australian Dollar denominated securities are permitted. Any non-Australian Dollar currency exposure will be, as far as practical, hedged back into Australian Dollars.

#### Process / Philosophy / Style

The portfolio construction process uses both top-down and bottom-up element. The bottom-up approach focuses on individual security selection using detailed rigorous fundamental credit research. The top-down process provides a macro backdrop and key duration targets for the core portfolio. It also drives an overlay portfolio that employs largely derivatives-based strategies to reflect macro views or short-term market opportunities in order to provide modest alpha to cover management fees while, more importantly, providing an element of ongoing risk-counterbalance and diversification to the core portfolio.

The Core portfolio is the product of credit research and relative value assessment, while overlay strategies are the product of the risk-adjusted return expectations implied by government bond forecasts and the outlook for credit spreads.

In the Overlay strategy, the Fund undertakes proprietary research that leads to conclusions about risk limits: at times risk limits on some strategies will be increased or decreased relative

to others, dependent upon the macroeconomic outlook that the team expects.

### Risk Management

Risk Management for the Daintree Fund is subject to the Investment Guideline Limits. The main risks in the portfolio are defined by these guidelines and measured relative to them. All portfolio risks are monitored on an ongoing basis, and if significant deviations are detected relative to current strategy, remedial trades are undertaken.

Some of the risks that the Fund monitors and manages conservatively that are not subject to specific guidelines include the marginal contribution to portfolio risks from new trades, portfolio liquidity, proprietary yield curve exposure analytics, and analytical risk metrics such as tracking error.

All trades are subject to both pre and post-trade compliance review and monitoring by robust processes and systems

## 3. Portfolio Characteristics

### Portfolio Turnover

In the core portfolio, the Fund analyses securities on the assumption that they will be held until maturity. The typical holding period, including some modest trading, tends to be around 2-3 years. In the overlay, trades can be held for anything from less than a day up to around six months. To date, trades have tended to be held for 2-3 weeks.

### Liquidity

Daintree Capital has a strong preference for liquid securities, as evidenced by:

- actively traded markets in both the debt and the equity of the corporate entity;
- publicly listed equity (or comparable transparency if the debt is issued by an entity where the parent is not publically listed);
- recent turnover in the security concerned.

## 4. Performance & Risk

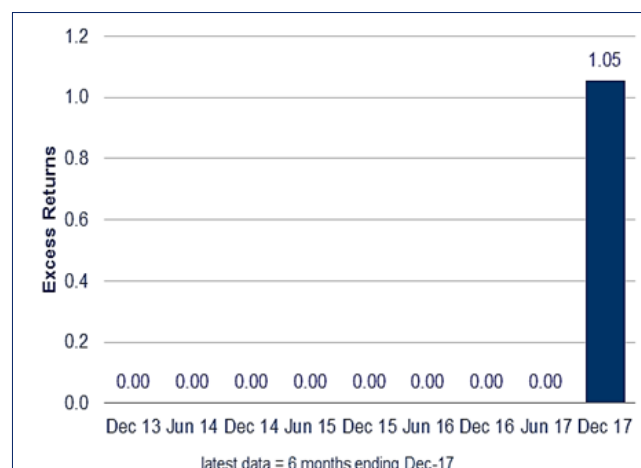
### Return Objective & Performance

The return objective officially stated in the PDS is that the Fund aims to provide "total return which exceeds the benchmark". The formal benchmark is the RBA Cash Rate.

Over the six-month period to Dec-2017, the Fund returned 1.80% (after fees) compared to 0.75% for the benchmark. This

is an outperformance of 1.05%. On an annualised basis, this meets the Fund's return objective over a very short period.

### Fund Excess Returns %: Half-yearly (net of fees)



### Length of Track Record

The Fund has a very short history of 6 months. Observations and analysis of returns will have very little statistical meaning as a result of the limited sample size of observations.

### Risk Objective

The Fund's PDS states that the risk level of the Fund is considered to be "low to medium."

The Fund's **volatility** (standard deviation of monthly returns) over **six months to Dec-2017** was 0.41% p.a. compared to a peer average of 0.54% p.a. and 0.02% p.a. for the benchmark.

## 5. Other Features

### Fees

The base management fee is 0.60% per annum of the Fund's Net Asset Value ("NAV") calculated daily and paid monthly. This compares to the peer group average of 0.57% per annum.

There is no additional expense recovery fee disclosed in the PDS. The buy/sell spread is set at a total of 0.10% (0.05% buy / 0.05% sell). This compares to the peer group average of 0.20% (0.10% buy / 0.10% sell).

### Governance

The Fund is legally offered to investors through Perennial Investment Management Limited (PIML), which is the responsible entity for the Fund.

Perennial Investment Management Limited (PIML) is the responsible entity of the Trust and is responsible for the management and administration of the Trust. PIML has appointed Daintree Capital Management Pty Ltd to manage the investment assets of the Trust.

Perennial Value is a specialist, active investment management firm. As at 31 December 2016, Perennial Value managed over \$7 billion on behalf of institutional and retail clients. Perennial Value is a related body corporate of PIML.

The Board of Directors of the Responsible Entity consists of 4 directors, none of whom are independent. SQM Research looks favourably at the inclusion of independent members on the Board of Directors – it is a meaningful way to enhance

governance and oversight. Board members have an average of 16.0 years with the firm and 28.8 years of industry experience.

The Responsible Entity's Compliance Committee is composed of 4 directors, 2 of whom are independent. The Chair is independent. SQM Research views independence in an RE oversight body such as the Compliance Committee as a strong and favourable factor in Fund governance. Compliance Committee members have an average of 6.5 years with the firm and 34.3 years of industry experience.

#### FUM (Funds under Management) / Capacity

The Fund currently has FUM of \$21 million and capacity to grow comfortably over \$1 billion, according to the Manager.

| Fund Performance to 31 December 2017 (%) |         |         |         |        |        |        | Jul-2017  |
|--|---------|---------|---------|--------|--------|--------|-----------|
| Total Return                             | 1-Month | 3-Month | 6-Month | 1-Year | 3-Year | 5-Year | Inception |
| Fund <sup>1</sup>                        | 0.71    | 1.35    | 2.64    | 8.18   | 4.48   | 5.62   | 4.87      |
| Benchmark <sup>2</sup>                   | 0.13    | 0.42    | 0.86    | 1.75   | 2.08   | 2.37   | 4.24      |
| Peer Avg                                 | 0.22    | 1.16    | 1.94    | 4.86   | 3.67   | 4.72   | 5.13      |
| Excess                                   | 0.58    | 0.93    | 1.79    | 6.43   | 2.40   | 3.25   | 0.63      |

1. Assumes dividend reinvestment. Returns for periods greater than one year are annualised. Return history starts Jul-2017

2. Benchmark is RBA Cash Rate

#### Strengths of the Fund

- Daintree Capital is appropriately staffed with highly experienced and knowledgeable investment professionals backed by distinguished careers in fixed income and credit money management.
- The technical infrastructure and quantitative investment research tools, both built by the staff and externally contracted, are institutional grade, high quality support systems that allow the Fund to carry out its strategy efficiently.
- The Fund has stringent investment processes that maximise the effectiveness of both the top-down and bottom-up elements
- The Overlay portfolio is a useful adjunct to the main Core portfolio, both in terms of generating a modest amount of alpha, but more importantly in acting as a risk counterbalance to the credit exposures in the Fund.
- The credit research process is an efficient implementation of thorough "old-school" fundamental analysis combined with some modern tools and techniques

- The Fund employs sensible, conservative, rigorous risk management practices built on the extensive market experience of Daintree's founders
- Perennial is a very strong and supportive partner for the firm, providing operational and marketing services than allow the investment team to focus on managing money

#### Weaknesses of the Fund

- The Fund carries inherent credit risk, albeit it is managed carefully and targeted at a low level. Nevertheless, investors should be aware that the Fund may display some underperformance to benchmark during instances of increased credit market volatility or stress, depending on the success or otherwise of any diversifying or overlay strategies.
- In the unusual scenario where large requests for withdrawals are made simultaneously, the Fund may face liquidity risk. This is most likely to manifest (**if at all**) as having to sell at discounted prices to generate redemption funds required. An inability to fully raise the required funds due to liquidity in a stressed market is also a possibility, although much less likely. This is a risk that most credit-related funds face,

rather than being specific to the Daintree Core Income Fund, and so is a general comment. SQM Research notes that this risk is much more modest than many other funds with more aggressive credit profiles. SQM also notes the following points that assist in keeping this risk low:

- o The Fund regularly tests the liquidity of the portfolio by asking for bids in the lines that are held and assesses the volume of holdings relative to market inventory.
- o The investment process explicitly considers an assessment of an issue's expected future liquidity before a purchase is made.
- o The team reports that the Fund could be fully liquidated in normal market conditions for a nominal cost, and this is expected to remain the case for the foreseeable future.
- o The Fund is not large relative to the market cap of the bonds in its investable universe.
- The Fund has a very short trading history, mitigated by the successful prior track records of Daintree's founders.
- Key person risk is a challenge but is being managed appropriately.

### **Other Considerations**

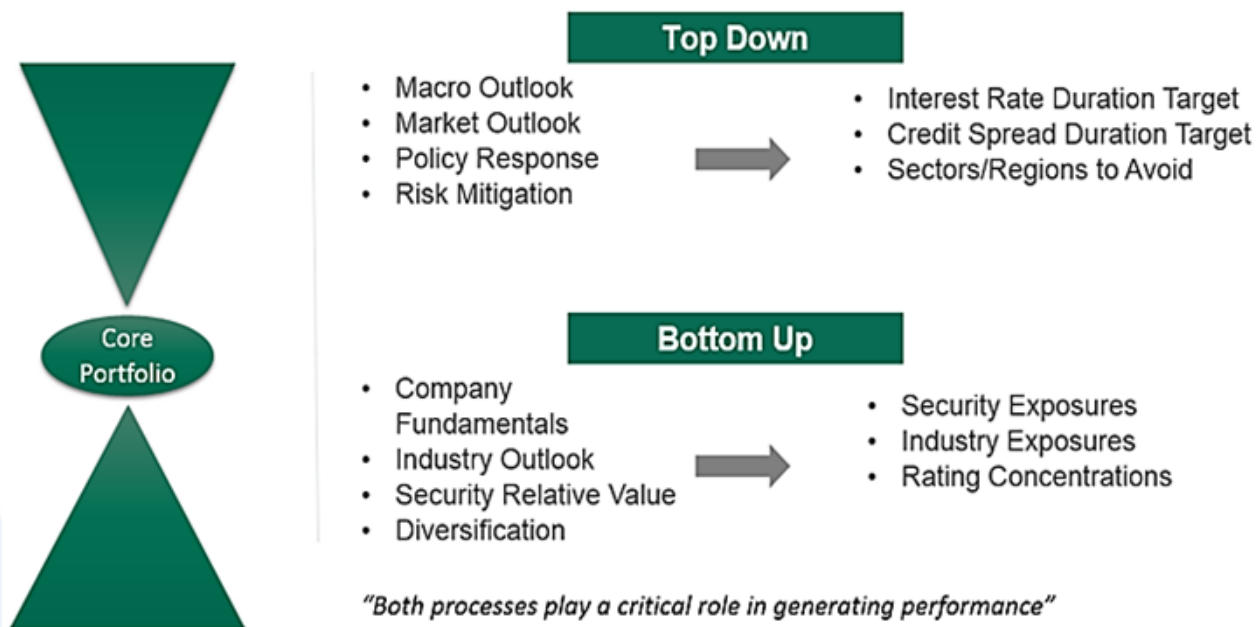
- The investment team indicate that the Daintree Core Income Trust can grow comfortably to several billion dollars in size before capacity constraints become an issue.
- The Daintree Capital distribution policy is conservative, and Daintree prioritises a steady monthly distribution.

### **Key Changes Since the Last Review**

- This is an inaugural review.



## Investment Process Diagram



## Process Description

### Universe

**Investable Universe** The Investment universe includes fixed-income assets, issued exclusively in developed market countries. Securities considered include bank bills, commercial paper, term deposits, corporate bonds, bank capital securities, structured credit, investment grade sovereign bonds and credit derivatives. Daintree then uses a series of indicators and filters to search the universe of securities for potential inclusion in the portfolio.

Non-Australian Dollar denominated securities are permitted. Any non-Australian Dollar currency exposure will be, as far as practical, hedged back into Australian Dollars.

### Investment Process

#### Top-down or Bottom-up

The portfolio construction process has two components: a top-down approach and a bottom-up approach. The bottom-up approach focuses on individual security selection. The top-down process, on the other hand, spans the core portfolio as well as overlay strategies

The portfolio construction process uses both top-down and bottom-up element. The bottom-up approach focuses on individual security selection using detailed rigorous fundamental credit research. The top-down process provides a macro backdrop and key duration targets for the core portfolio. It also drives an overlay portfolio that employs largely derivatives-based strategies to reflect macro views or short-term market opportunities in order to provide modest alpha to cover management fees while, more importantly, providing an element of ongoing risk-counterbalance and diversification to the core portfolio.

### Research Process

#### Idea Generation

The investment team prefers bonds of companies issued in developed market economies with high-quality reporting and governance standards. They also like to see companies that (where possible) are publicly listed, rated by agencies and have an active CDS (credit default swap) market. Their view (shared by SQM Research) is the more independent parties a company has to report to (rating agencies, regulators, stock exchanges, shareholders) the less likely investors are to be subject to large negative surprises or irregularities.

**Research Process**  
...continued**Initial Screen**

Daintree uses a series of indicators and filters to search the universe of securities for potential portfolio holdings. Screening factors can include:

- Publicly available agency ratings
- Liquidity considerations
- Issuers with publically listed equity
- Active credit default swap market prices
- Indicative cash bond spread pricing
- Estimated loss given default
- Third-party research

These inputs allow the portfolios managers to triangulate both risk and return elements of the security from multiple perspectives. They can then make an initial determination of the relative attractiveness of the asset and whether it warrants further research. Once a potential new asset is identified for inclusion in the portfolio (and before actual purchase), a credit analyst undertakes a review of the asset. If there is sufficient time available, a full credit review is completed. If the situation is time sensitive (for example, a well-known name doing a new issue on short notice), then a “desk review” is done by the analyst and Mr Mitchell, to be followed shortly thereafter by the full fundamental credit write-up.

**Credit Research and Security Selection**

The **Core Portfolio** is the product of credit research and relative value assessment, while overlay strategies are the product of the risk-adjusted return expectations implied by government bond forecasts and the outlook for credit spreads.

The credit research process supports the key objectives of the fund, namely capital preservation and income generation. The focus is to find securities that offer attractive risk/return characteristics with limited exposure to potential capital loss. There are two key risks the credit process looks to minimise: default risk and mark to market risk. **Default risk** is the most severe risk in a credit asset because it represents a permanent loss of capital. **Mark to market risk** is also a key concern because price down draughts in stressed markets can occur at inopportune times within the investment horizon of investors, resulting in forced losses if investors are required to withdraw capital due to personal circumstances such as retirement or unexpected expenses.

Bonds have an asymmetric payoff structure (there are certain exceptions to this characterisation in high yield and distressed bonds). This means upside potential is usually limited, while downside risk is significant. The focus in the credit research process thus rightly tends to be on downside risk mitigation. Daintree complements this with portfolio diversification and limitations on exposure sizes at the portfolio construction stage. The consistent and ongoing objective is to identify borrowers that display stable or improving credit quality with a strong focus on cash flow generation. The investment team does not participate in picking turn-around stories or distressed opportunities. The process aims to find borrowers that are highly likely to pay principal and interest back on schedule, with a minimal amount of uncertainty along the way.

Aggregate credit risk is a function of the return target. The Fund aims to have sufficient credit risk in the portfolio to generate around 75% of the return target, on average, through a market cycle.

Where the team identifies a risk period of credit spreads widening, then they will look to put in place a pre-planned hedge designed to provide some protection to the portfolio in the short-term. The hedge is determined using modelling to identify an optimal trade-off between the reliability of protection provided and its cost. Where appropriate, the Fund may also have a small long (interest rate) duration bias in the portfolio through time. This will be at times where the Managers believe duration is providing a reasonable hedge against unexpected exogenous shocks to credit.

**Research Process  
...continued**

In the **Overlay Strategy**, the team undertakes proprietary research that leads to conclusions about risk management. At times risk limits on some macro-driven derivative strategies will be increased or decreased relative to others, dependent upon the macroeconomic outlook that the team expects. For example, if a sustained period of strong risk asset performance is expected (a “risk-on” period), the relative latitude to include carry trades in the portfolio will be increased relative to other potential Overlay strategies and vice versa.

While the intent is to always have a diversified range of Overlay strategies in place, there is no requirement that Overlay strategies are expressed in the portfolio at all times. The selection and timing of strategies is the prerogative of the Portfolio Manager. Changes to overlay strategies may occur when market price levels change sufficiently relative to the team’s forecasts.

**Portfolio  
Construction  
Process****Portfolio Construction**

The portfolio is constructed so as to achieve the investment objective (150-200bp above the cash rate, after fees) with a high degree of confidence while assuming a low amount of risk. Mr Mark Mitchell has **overall** responsibility for portfolio performance and a focus on the Core portfolio. Regarding Overlay strategies, accountability rests with Mr Justin Tyler.

In the Core portfolio, position size and relative value determination is the responsibility of the analyst. Position weighting is a function of:

- desired top-down portfolio risk characteristics
- mandated limits on particular rating bands
- sector and security exposures
- individual issue relative value

Ex-ante risk modelling is used in portfolio construction, particularly in the overlay, to keep the portfolio manager aware of the likely impact on portfolio return, volatility and skew when a position is added to the portfolio. The aim is to ensure that positions are only combined in the event that the correlation between them is low enough to provide an attractive risk/return contribution. Otherwise, alternative expressions of a particular view are sought to limit the possibility of any unintended amplification of risk.

**Liquidity and Turnover**

Daintree Capital has a strong preference for liquid securities, as evidenced by:

- actively traded markets in both the debt and the equity of the corporate entity
- publicly listed equity (or comparable transparency if the debt is issued by an entity where the parent is not publically listed) and
- recent turnover in the security concerned

In the core portfolio, the Fund analyses securities on the assumption that they will be held until maturity. The typical holding period, including some modest trading, tends to be around 2-3 years. In the overlay, trades can be held for anything from less than a day up to around six months. So far trades have tended to be held for 2-3 weeks.

There are no quantified liquidity constraints, and this is not expected to change as the portfolio grows. SQM Research notes that the Fund has guidelines which state it must at all times hold a minimum of 20% in highly liquid assets. These are defined as cash, government bonds, commercial paper (CP), term deposits, negotiable certificates of deposit (NCDs) and other highly rated securities. This would assist the Fund in maintaining a workable level of liquidity in times of stressed markets. The Fund regularly tests the liquidity of the portfolio by asking for bids in the lines that are held and assesses the volume of holdings relative to market inventory.

**Portfolio  
Construction  
Process  
...continued**

Currently, the team reports that the Fund could be fully liquidated in normal market conditions for a nominal cost, and this is expected to remain the case for the foreseeable future.

The securities the Fund typically hold have more limited market liquidity compared to large-issue traditional bonds that make up the bulk of bond market activity. The Fund is not large relative to the market cap of the bonds in its investable universe. As a result, liquidity is not seen as an impediment to the efficient management of the Fund. Nevertheless, trading in these securities requires skill and the type of contacts and market knowledge that the portfolio managers have built up over their careers.

**Sell Discipline**

The most frequent situations where securities are sold occur when the relative value changes. Sell decisions can also occur where Daintree Capital believes the fundamental outlook of an issuer, industry or market has changed and there is a risk of permanent diminution of capital.

Changes to overlay strategies may occur when market price levels change sufficiently relative to the team's forecasts.

**Risk Management**

Risk Management for the Daintree Fund is subject to the Investment Guideline Limits. The main risks in the portfolio are defined by these guidelines and measured relative to them. All portfolio risks are monitored on an ongoing basis, and if significant deviations are detected relative to current strategy, remedial trades are undertaken.

Some of the risks that the Fund monitors and manages conservatively that are not subject to specific guidelines include the marginal contribution to portfolio risks from new trades, portfolio liquidity, proprietary yield curve exposure analytics, and analytical risk metrics such as tracking error.

All trades are subject to both pre and post-trade compliance review and monitoring by robust processes and systems.

The Bloomberg AIM portfolio management system provides a decomposition of ex-ante portfolio volatility, which is monitored to check that expected contributors to portfolio risk make sense given the investment strategy in the portfolio and market outlook. It is also compared to ex-post contributors to portfolio performance to check for consistency and alignment.

The aggregate level of credit risk is measured with a number of metrics including credit spread duration; VaR and CVaR. Fund guidelines are designed to prevent concentration at the rating, sector, or security level. In the bottom-up credit analysis, the team ensures that fundamental 'red flags' are identified and monitored for all holdings.

If the macro forecasting leads to concerns that credit spreads may move wider, specific planning is undertaken ahead of time for hedging positions that may be introduced to or removed from the portfolio to manage that risk. Bloomberg AIM also provides a CVaR measure along with the top contributors to this measure of tail risk. Where any particular securities on this list are of concern to credit analysts, a sell down will be prioritised.

All overlay trades are subject to tight stops. Where applicable Overlay trades are monitored during the night session and stops are placed at the Australian close to monitor any expected increase in volatility during European and US hours.

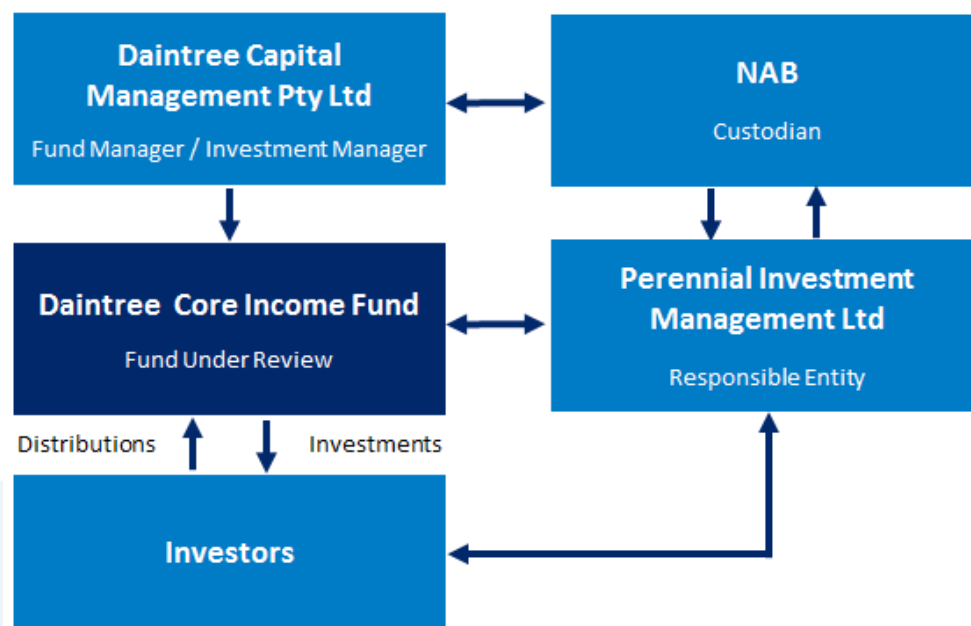
Derivatives are used as a complementary tool in the management of debt portfolios, both for investment and hedging purposes. Their impact on portfolios is measured by the characteristics of the underlying physical assets, meaning that when exposure is increased (long), there must be sufficient short-term liquid investments to back the position, and when exposure is reduced (short), there must be similar physical assets in the portfolio.

As a general rule, the use of derivatives is limited to interest rate swaps; credit default swaps (both single name and index); inflation swaps; currency forwards; and futures traded on major global exchanges including the ASX. Daintree will not enter into derivative positions where the underlying physical asset falls outside the investment guidelines or where there is no active secondary market in the instrument.

**Trading/Implementation**

|   |   |
|---|---|
| <b>Trading Resources</b>                | Trading is undertaken by all team members, with all staff having significant market experience. Specifically, the Credit Analysts have responsibility for most cash bond trading while the Director, Interest Rates and Currency is responsible for Overlay trading. All trades are reviewed by the Directors who also review end-of-day portfolio positions. Post-trade compliance reporting is run after every trading day. |
| <b>Trading Execution and Allocation</b> | Trades are automatically allocated across portfolios using the Bloomberg AIM System. Bloomberg AIM is a fully automated front-end dealing system which ensures that portfolios receive a pro-rata allocation based on the fund's size and target weighting. Daily portfolio reporting, internal communication of cash flows and internal compliance checks ensure that excess cash is not held.                               |
| <b>Currency Hedging</b>                 | Currency risk is as close to fully hedged as practicable, by way of rolling three-month currency forwards.  |

## Key Counterparties



## Parent Company

Daintree Capital Management Pty Ltd is owned jointly by the Daintree executives and PVM Capital Partners Limited. PVM Capital Partners is owned by the Perennial executives. There have been no changes to the Daintree Capital Management structure.

Daintree Capital has distribution arrangements with Perennial Value Management and as well as third party marketing arrangements.

## Investment Manager / Fund Manager

Daintree Capital Management the Fund Manager for the product under review.

## Responsible Entity

Daintree Capital's investment trusts offered to investors are legally offered by Perennial Investment Management Limited (PIML), which is the responsible entity for these trusts. In the case of investors who hold units in the schemes, investors are governed by the terms of the Trust Deeds or Constitutions.

## Management Risk

Funds management businesses rely on the operational capabilities of key counterparties. A critical element is the corporate ability of the Responsible Entity to monitor operational performance and to meet the regulatory and statutory responsibilities required. For any investment fund, there is a risk that a weak financial position or management performance deterioration of key counterparties could temporarily or permanently compromise their performance and competency. This can adversely affect financial or regulatory outcomes for the Fund or associated entities.

***Based on the materials reviewed and the high-quality service providers the firm has engaged, SQM Research believes that Daintree Capital and associated key counterparties are highly qualified to carry out their assigned responsibilities. Management risk is rated as being low.***

## Funds under Management (FUM)

The Fund is approximately \$20.8 million in size at Dec 2017, up from \$10 million in July 2017.

### Distributions

The Daintree Capital distribution policy is conservative. Distributions occur on a monthly basis, subject to the availability of distributable income.

| Distribution Date | Distribution CPU | Unit Price \$ | Distribution % |
|-------------------|------------------|---------------|----------------|
| 30-Jun-17         | 0.1800           | \$0.99930     | 0.18           |
| 15-Aug-17         | 0.2000           | \$1.00260     | 0.20           |
| 15-Sep-17         | 0.1500           | \$1.00280     | 0.15           |
| 13-Oct-17         | 0.1500           | \$1.00430     | 0.15           |
| 15-Nov-17         | 0.1500           | \$1.00610     | 0.15           |
| 15-Dec-17         | 0.1500           | \$1.00780     | 0.15           |
| 15-Jan-18         | 0.1500           | \$1.00730     | 0.15           |

### A General Note on Distributions for Managed Funds

*The Responsible Entity of a Managed Fund will generally provide for a regular schedule of distributions, such as monthly / quarterly / semi-annual or annual. This is subject to the Fund having sufficient distributable income.*

*The official total distributable income available to pay to investors is determined for the period of that Fund's financial year. By distributing the net taxable income of the Fund to investors each year, a Fund itself should not be liable for tax on its net earnings.*

*If a Fund makes distributions more frequently than once over the financial year, those distributions will be made based on estimates of the distributable income for that distribution period. The final total amount of distributable income available for passing on to investors can only be calculated after the close of the financial year, based on the Funds taxable income for that year.*

*If the total distributions a Fund pays out exceeds total tax income for that particular financial year, the excess amount may be treated as a return of capital rather than income. This will possibly have tax implications for the investor.*

*Due to the considerations outlined above, there may be periods in which no distributions are made, or a Fund may make additional distributions*

*A Fund's ability to distribute income is determined by the performance of the Fund and general market conditions. Accordingly, there is no guarantee a Fund will make a distribution in any particular distribution period.*



| Investment Staff |                             |          |                    |                     |
|------------------|-----------------------------|----------|--------------------|---------------------|
| Name             | Responsibility / Position   | Location | Years with Company | Years with Industry |
| Mark Mitchell    | Director                    | Sydney   | 1.0                | 23.0                |
| Justin Tyler     | Director                    | Sydney   | 1.0                | 19.0                |
| Simon Lee        | Senior Quantitative Analyst | Sydney   | 1.0                | 16.0                |
| Brad Dunn        | Senior Credit Analyst       | Sydney   | 1.0                | 13.0                |
| Simon Wang       | Senior Credit Analyst       | Sydney   | 1.0                | 12.0                |

## Investment Team

As a boutique, the investment team has a flat structure. All members of the team report directly to Mr Mark Mitchell, who has ultimate responsibility for the decisions the team makes. Mr Justin Tyler, Director - Interest Rates and Currency, is the backup Portfolio Manager.

Mr Mitchell is responsible for all aspects of the core portfolio, while derivative overlay trades are the responsibility of Mr Tyler. Within the credit sphere, Mr Brad Dunn covers financials, while

Mr Simon Wang covers the remainder of the corporate credit universe. Structured credit such as RMBS is covered by Mark Mitchell.

Mr Simon Lee is the quantitative analyst with responsibility for systems, database build and maintenance, portfolio reporting as well as dealing in the derivative and currency space (under the supervision of Justin Tyler).

## Meeting Schedule

The table below shows meetings that form part of the overall process.

| Meeting            | Purpose  | Frequency   | Participants                              |
|--------------------|--|-------------|---|
| Portfolio          | Review portfolios, performance, trading, risk, overlay positions, relative value: Macro View Setting, Asset Allocation, Investment Strategy, Portfolio Construction, Risk Management, Portfolio and Performance Review | Fortnightly | All staff                                 |
| Business / Project | Review projects team is working on to continue to enhance process  | Fortnightly | All staff                                 |
| Credit Committee   | Review all new credits in the portfolio to determine internal rating/recovery rating: Security and Sector Research   | Monthly     | All staff other than Senior Quant Analyst |
| Quarterly Outlook  | Review outlook for next six months to help set broad portfolio risks and overlay positioning: Macro View Setting, Asset Allocation, Investment Strategy, Portfolio Construction, Risk Management                       | Quarterly   | All staff                                 |

***SQM Research believes the practice of constant communication and the broad-based inclusion of team members in decision-making is a vital ingredient to the success of the process. Interactive peer review and collaboration across a tightly knit group of experienced investors will likely make the best use of their combined intellectual property and shared history.***



## Staffing Changes

No staff changes. This is an inaugural review.

| Average Experience (years)     | PM   | Research |
|--------------------------------|------|----------|
| Years with Company             | 1.0  | 1.0      |
| Years of Investment Experience | 21.0 | 13.7     |
| Staff Numbers                  | 2    | 3        |

*SQM Research observes that the levels of investment experience and market expertise are strong across the entire investment team.*

## Key Investment Staff

### Mark Mitchell – Managing Director, Portfolio Manager CFA, BSc (Finance)

Mark Mitchell established Daintree Capital in January 2017 and has over twenty-three years industry experience both in Australia and the USA, specialising in fixed income securities analysis and portfolio management.

Before establishing Daintree Capital, He was the Head of Credit and Portfolio Manager for over seven years at Kapstream Capital. He was primarily responsible for the development and implementation of the credit research processes and portfolio management until the time he left in October 2015. Over this time, Kapstream grew to over \$10bn in assets under management.

Before his time at Kapstream, Mr Mitchell was a Portfolio Manager/Senior Credit Analyst specialising in global credit at Colonial First State Global Asset Management between March 2001 and September 2008. Before moving to Australia, he accumulated a decade of experience in the USA across a range of sectors including high yield, bank loans, commodities, futures and listed equities.

Mr Mitchell holds a Bachelor of Science (Finance) from the DePaul University (Chicago) and is a CFA Charter holder.

### Justin Tyler - Director, Portfolio Manager - Interest Rates & Currency. CFA, BSc, BA. Grad Dip App Fin

Justin Tyler is a founding partner of Daintree Capital, responsible for interest rate and currency decisions.

Mr Tyler has over 19 years of experience in the industry. Before Daintree Capital, Justin was a Senior Investment Manager at Aberdeen where he specialised in inflation and interest rate decisions and was a member of Aberdeen's Risk Oversight

Group. He joined Aberdeen in 2009 as part of their acquisition of Credit Suisse Asset Management (Australia) Limited.

Before Aberdeen, he spent over ten years specialising in fixed income analysis and investment banking with RBC Capital Markets and Colonial First State Global Asset Management.

Mr Tyler is a CFA Charter holder and active volunteer for CFA Institute. He also holds a Graduate Diploma in Applied Finance and Investment from the Securities Institute of Australia. He graduated from the University of Sydney with Bachelor of Science and Bachelor of Arts degrees, majoring in Pure Mathematics.

### Simon Lee – Senior Quantitative Analyst B.Sc. (Hon) Physics

Simon Lee has over 16 years industry experience and joined Daintree from NAB's xVA trading desk where he was a quantitative analyst, responsible for developing and managing pricing and risk management tools.

Before that, he worked at Aberdeen Asset Management in Sydney, London and Singapore for over eight years (in separate roles) where he developed a process to improve the efficiency of interest rate risk management for Aberdeen's fixed income portfolios.

Before Aberdeen, Mr Lee has worked at Colonial First State, ING Investment Management, Morley Fund Managers (London) and Invesco Europe. He holds a B.Sc. (Hon) Physics from University College London and a Certificate in Quantitative Finance (CQF).

## Remuneration and Incentives

Base salaries are benchmarked to market.

All staff in the investment team either own equity or have the option to do so upon the clearance of specified hurdles. It is envisaged that in time, equity ownership will be a larger source of compensation than base salaries.

Performance is reviewed annually, and the award of bonuses is qualitatively determined. Business performance, the performance of the funds, and personal performance and contribution are the main drivers of bonuses. There is a substantial deferred component to all performance-based awards.

*SQM Research believes access to firm equity, and client-focused performance bonuses act as strong incentives for attracting and retaining staff. The intention (and SQM believes, the effect) is to align staff performance with client and shareholder objectives. It focuses on the customers' needs and medium-term results.*

| Entry/Exit Fees                    |       |
|------------------------------------|-------|
| Buy Spread (%)                     | 0.05% |
| Sell Spread (%)                    | 0.05% |
| Ongoing Fees                       |       |
| Management fee (% p.a.)            | 0.60% |
| Expense recoveries (% p.a.)        | Nil   |
| Cost of Fund <sup>1</sup> (% p.a.) | 0.60% |
| ICR <sup>2</sup> (% p.a.)          | 0.60% |
| Performance Fee                    | None  |

<sup>1</sup> Management fee and expected expense recoveries.

<sup>2</sup> Indirect costs ratio

## Buy/Sell Spread

A buy/sell spread is applicable and has been set at a total of 0.10% (0.05% buy / 0.05% sell). This spread represents the difference between the application price and the withdrawal price of the Fund, a reflection of transaction costs relating to the underlying assets.

## Ongoing Fees

The annual management fee of the Fund is 0.60% (+ GST & RITC) p.a. of the Fund's net assets. No additional charge is made for expense recoveries.

## Performance Fees

There is no performance fee.

## Overall Fees

If held and redeemed within 12 months, total transaction costs would amount to 0.70% of investment in the Fund. This figure includes the MER, expense recovery and the buy/sell spread. It does **not** consider rebates or negotiations or any potential **performance fee**.

*SQM Research observes that the Fund management fee (including expense reimbursement) is 0.60%, which is only three basis points higher than the peer group average of 0.57%.*

| Risk/Return Data to 31 December 2017 (%) |         |         |         |        |        |        |           |
|--|---------|---------|---------|--------|--------|--------|-----------|
| Total Return                             | 1-Month | 3-Month | 6-Month | 1-Year | 3-Year | 5-Year | Inception |
| Fund <sup>1</sup>                        | 0.30    | 0.94    | 1.80    | n/a    | n/a    | n/a    | 1.80      |
| Benchmark <sup>2</sup>                   | 0.12    | 0.37    | 0.75    | n/a    | n/a    | n/a    | 0.75      |
| Peer Avg                                 | 0.19    | 0.82    | 1.59    | n/a    | n/a    | n/a    | 1.59      |
| Excess                                   | 0.18    | 0.57    | 1.05    | n/a    | n/a    | n/a    | 1.05      |

| Metrics                                | 1-Year | 3-Year | 5-Year | Inception |
|--|--------|--------|--------|-----------|
| Tracking Error (% p.a.) – Fund         | n/a    | n/a    | n/a    | 0.41      |
| Tracking Error (% p.a.) - Peer Average | n/a    | n/a    | n/a    | 0.57      |
| Information Ratio – Fund               | n/a    | n/a    | n/a    | 2.55      |
| Information Ratio - Peer Average       | n/a    | n/a    | n/a    | 2.10      |
| Sharpe Ratio – Fund                    | n/a    | n/a    | n/a    | 4.36      |
| Sharpe Ratio - Peer Average            | n/a    | n/a    | n/a    | 4.04      |
| Volatility - Fund (% p.a.)             | n/a    | n/a    | n/a    | 0.41      |
| Volatility - Peer Average (% p.a.)     | n/a    | n/a    | n/a    | 0.57      |
| Volatility - Benchmark (% p.a.)        | n/a    | n/a    | n/a    | 0.00      |

1. Assumes dividend reinvestment. Returns for periods greater than one year are annualised. Return history starts Jul-2017
2. Benchmark is RBA Cash Rate

## Quantitative Insight<sup>1</sup>

Note: All return and risk data reported in this section are after-fees and for **periods ending Dec-2017** unless otherwise stated. Due to an insufficient period of performance, quantitative analysis charting is limited.

### Returns

Since inception in Jul-2017, the Daintree Fund has returned **1.80%** p.a. as compared to a return of **0.75%** p.a. from the RBA Cash Rate. This represents alpha of **1.05%** p.a. The peer group average over this period was **1.59%**. (Note that all Fund returns referenced in this report are net of fees).

These returns are in line with the PDS objective and are in line with SQM's expectations for the Fund relative to its fee level and volatility.

The Fund's short track record means returns and risk analysis will provide limited information.

### Risk

The Fund's **volatility** (standard deviation of monthly returns) **since inception** was **0.41%** p.a. compared to a peer average of **0.57%** p.a. and **0.00%** p.a. for the benchmark.

SQM has measured and reported tracking error in the tables above. Since the Fund's benchmark has almost no volatility, the tracking error readings add no new information to observations gained from studying volatility. The tracking error of the Fund is almost identical to its volatility (standard deviation).

The **risk outcomes** as described above regarding volatility and tracking error are in line with the PDS statements about risk and are SQM's expectations for this Fund.

1. Note: Sharpe and Information Ratios are not reliable comparison tools in periods where both the Fund and its peers/benchmark record a negative result

The table below outline limits on the Fund's asset allocation and other risk parameters:

| Fund Constraints            | Permitted Range or Limit |
|-----------------------------|--------------------------|
| Cash and Equivalents        | 0 – 100 (%)              |
| Investment Grade Securities | 0 – 100 (%)              |
| High Yield Securities       | 0 – 100 (%)              |
| Currency Hedge              | 95 – 100 (%)             |
| Interest Rate Duration      | -1 to +3                 |
| Gearing                     | None                     |

## Recent Positioning

*Comments from the Fund's fact sheet dated Dec 2017 are reproduced below as a perspective on the Manager's strategy and style.*

### Market Review / Market Commentary

The Daintree Core Income Trust (the Fund) posted a net return of 30 basis points for the month and 94 basis points for the quarter. Performance was assisted by the income from assets in the Fund, a contraction in credit spreads, and successful overlay strategies. Duration was a negative contributor for the quarter as yields rose across markets.

Fixed income markets were primarily driven by the US, where monetary policy tightening continues to put upward pressure on bond yields. This pressure has very much been focused on the short end of yield curves though, with longer-end yield moves being much more muted. Interestingly, for the calendar year, 2017 US treasury yields have ended the year roughly where they started, despite yields on the two year US treasury being around 70 basis points higher.

Locally, despite some solid data (e.g. the labour market and business surveys), the bond market rallied through October and November. If there was ever any doubt, this price action confirmed that the local market focus is now on consumption data and wages. In October there was a disappointing result for retail sales release followed by a low September quarter CPI, which together caused the market to push pricing of the first RBA hike from August 2018 into early 2019. The trend continued in November in the wake of weak wages data, and with treasury yields rising the AU/US spread moved to the narrowest levels seen since the late 1990s. The AUD also weakened.

Global drivers took over in December though, with a global bond sell-off seeing Australian ten-year bond yields rise

more than 15 basis points on the month. This coincided with a potential slowing of the US yield curve flattening trend - between the two year and 30 year points the US curve has been flattening since August, with the trend accelerating through the month of November but slowing since. Central bank communication of hiking intentions has been clear enough (and the speed of moves slow enough) to allow risk assets to continue rallying, and so once again credit spreads are tighter for the quarter. There was a moment of excitement in US high yield during late October and early November with spreads widening, but this move was subsequently retraced. In the local cash market, bank and financial spreads contracted, as did spreads on non-financial companies. Contraction was uniform across sectors and rating categories, although over the year 2017 it has been infrastructure and industrial names that have outperformed.

### Outlook

Market expectations for growth in the US and Europe remain robust, and inflation expectations are also picking up. Nothing in the economic data has seen markets meaningfully reassess the monetary policy trajectory in either market though. Thus in 2017, the Fund has seen a continued flattening in the US yield curve, and in the early part of 2018, the Fund expects more of the same. Changes to the make-up of central bank balance sheets have been well-telegraphed, and are therefore most likely priced into bond yields. This means that in the absence of changes to central bank communications, bond yield fluctuations are likely to result from changes in expectations for the conventional monetary policy trajectory. Wages and inflation data thus remain centre stage, and the Fund believes an increase in either will be required to sustainably increase volatility in markets and decisively break the curve flattening dynamic that has been evident over the last several months.

The Fund does not see inflation picking up in a meaningful way as yet. Accordingly, the Fund expects yield curves to continue flattening globally while financial market volatility remains low. Credit spreads can continue to grind tighter in this scenario, absent exogenous shocks. This does not mean credit spreads are likely to narrow in a meaningful way in the coming months though; rather it is likely that the trend continues to have a move sideways or a slow grind to narrower levels. The inflation outlook is an area of focus for the Fund, given the potential for a surprise to affect credit spreads.

The benign global conditions in play at the moment are an ideal backdrop for further gradual improvement in the Australian and New Zealand economies. Both start the year at different points in the economic cycle, with New Zealand through full employment and Australia still working through

labour market slack. A downside risk to both economies is high levels of consumer indebtedness, and fiscal policy will come into focus in both markets to tackle this: In New Zealand, the incoming government has mandated steep increases in minimum wages in an attempt to support consumption while in Australia, tax cuts have been slated. Such policies will tend to lead to short-term positive growth impulses, but the downside risk to both economies from high levels of leverage in the consumer sector will remain for some time.

That said, the Fund remains reasonably upbeat about the outlook for both economies. In Australia, the growth rotation from the mining investment boom is complete, and 2018 should see improved activity in Queensland, South Australia and Western Australia (three states that together account for nearly 40% of GDP and employment, but which have dragged national economic performance lower over the last several quarters). Consumption remains an important drag, but growth should still be positive on account of strong business investment and public sector spending on infrastructure. In New Zealand, the economic cycle is further advanced, and consumption is likely to remain a positive contributor to growth given that the economy has moved past full employment. Accordingly, the Fund expects that monetary policy should be tightened later this year amid a continued gradual pickup in core inflation. This monetary policy view is more bullish than the current consensus, where expectations are currently for a tightening cycle commencing early in 2019.

Early 2018 is likely to feature themes already evident from 2017: calm markets and low volatility is the expectation.

## Fund Composition as at Dec-2017

### Fixed Income Fund Measures

|                           |       |
|---------------------------|-------|
| Average Credit Quality    | A+    |
| Modified Duration (years) | 0.40  |
| Spread Duration (years)   | 3.64  |
| Portfolio Yield           | 3.77% |

| Fixed Income Sector | Fund % |
|---------------------|--------|
| Industrial          | 34     |
| Sub Financial       | 20     |
| Senior Financial    | 18     |
| RMBS/ABS            | 24     |
| Cash and Sovereign  | 4      |

| Ratings | Fund % |
|---------|--------|
| AAA     | 25     |
| AA      | 10     |
| A       | 35     |
| BBB     | 30     |

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