AFM Fund Review
Microequities Deep Value Microcap Fund

Australian Fund Monitors
Targeting Absolute Returns

May 2014 -0.46%

Last 12 months +28.56%

Key Points: Microequities Deep Value Microcap Fund

- The Deep Value Microcap Fund is a fundamental, research-driven Fund investing in equities with a market cap below $250m.
- The Fund was established in March 2009 to invest in this sub-sector using a value philosophy based on the view that microcaps are often under-researched and under-valued. The strategy has delivered well above index performance since inception.
- The Fund does not short, use derivatives or borrow i.e., it is long only and is concentrated; usually with 15 to 20 companies across industrial sectors. Resource stocks are avoided.
- CIO Carlos Gil has over 15 years' experience in a range asset management roles including senior management roles in Europe with

Management Company Overview

Microequities Deep Value Fund was launched in March 2009 by Carlos Gil and Sam Gutman investing in microequities, defined as companies with a market capitalization of $A250m or less. The motivation for establishing the Fund was that the Manager believed that the space has the most compelling value propositions. Gil is the CIO and has worked in range of capacities in asset management including stockbroking, funds management and investment research for over 15 years. Senior management roles have included Head of International Securities at BM Securities and at Banesto Bank, owned by Santander Group, the largest bank in the Eurozone. On return to Australia in 2005 he established Microequities to provide quality investment research on domestic microcap equities. The research company then moved to establish the Fund. Gil has Bachelor of Economics degree from the University of Sydney and a Graduate Diploma in Applied Finance from FINSIA.

Sam Gutman is Senior Adviser and a member of the Investment Team. He has a range of business experience derived from a successful career in the IT industry and has a BA with a major in Economics, and a Graduate Diploma in Applied Finance from FINSIA.

Gil is supported by Shuo Yang who has a Bachelor of Commerce and Economics from UNSW. Staff are significant investors in the Fund providing alignment of interests.

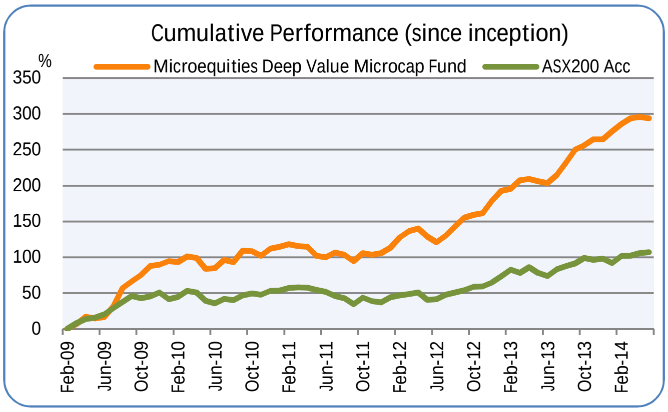
Investment Approach

The Manager's core ethos is that investments will benefit from both the market inefficiency of the sector and the underlying growth of the investment in terms of driving intrinsic value. In addition the Manager sees the Fund as a long term investor not so much as a fund manager but rather as a business partner. Within the microequities space the Fund is first and foremost a value investor. The Manager defines value as those shares that have an upside of 50 to 100% to reach intrinsic value i.e., the Fund is looking to invest in shares at a significant discount to the Manager's valuation. This emphasis on value has two advantages; firstly it reduces the potential for loss, and secondly provides the growth component to the investment as the share price moves toward intrinsic valuation over time.

micro EQUITIES Asset Management

Key Performance	Microequities Deep Value	ASX 200 Acc
May-14	-0.46	0.68
Annualised Return	29.82	14.89
Latest 3 Months	2.05	2.76
Latest 6 Months	8.06	5.43
Latest 12 Months	28.56	16.45
Latest 24 Months p.a.	31.16	21.33
Latest 36 Months p.a.	24.91	10.24
Latest 60 Months p.a.	27.97	12.39
% Positive Months	69.84	66.67
Best Month	19.68	7.98
Worst Month	-7.59	-7.51
Largest Drawdown	-10.86	-15.13
Average +ve Return	4.24	3.34
Average -ve Return	-2.22	-3.00
Annualised Standard Deviation	15.09	12.63
Downside Deviation (Since Inception)	6.20	7.78
Sharpe Ratio (Since Inception)	1.58	0.88
Sortino Ratio	3.68	1.33

*Statistics above for the ASX are adjusted to the Fund's start date



Buying stocks well below intrinsic value reduces risk, and the Manager's view is that price appreciation will be driven the underlying growth of the company.

Therefore all companies in which the Fund invests must have a growth driver that is likely to see the company's profit growth above that of the rest of the market. In general, microcaps have a more attractive growth profile which can derive from a range of factors including i) new product or service, ii) expansion into new markets,

Performance - Net of Fees (%)

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2014	2.97	2.76	2.10	0.41	-0.46	-	-	-	-	-	-	-	7.98%
2013	5.02	0.83	4.08	0.54	-0.91	-0.90	3.63	5.58	5.46	1.60	2.40	0.08	30.73%
2012	3.55	6.76	3.90	1.50	-4.67	-3.40	4.20	5.33	5.12	1.65	0.94	6.57	35.44%
2011	1.28	1.61	-1.21	-0.44	-5.93	-1.03	3.34	-1.48	-4.38	5.76	-1.03	1.08	-2.94%
2010	2.56	-0.57	4.00	-1.08	-7.59	0.45	6.47	-1.72	8.37	-0.49	-2.88	4.83	11.88%
2009	-	-	6.77	9.62	-1.99	1.51	12.67	19.68	5.98	5.44	7.19	0.82	89.62%

iii) increased market size and iv) company specific events. The second driver of upside price potential in the microcap space is the lack of research by stockbrokers, banks and research houses, mostly due to a lack of trading volume. This lack of professional coverage often creates the opportunities through significant undervaluation of companies. The Fund is specifically designed to exploit these opportunities.

Given the higher risks of investing in microcaps the Fund has three criteria for investment in any company. First, the company must have a long term growth profile to drive the intrinsic value. Second, the intrinsic value, as calculated by the Manager, must be at least 50% above the current share price. Third, the company must have little or no debt with positive cash flow from operations and 2 years of operating profit as such no research is conducted on loss-making companies. There is also a strong preference for companies with high earnings visibility and disclosure.

In terms of valuation the Manager calculates intrinsic value through the use of a 10 year discounted cash flow model with a 7.5% discount rate above the risk-free rate. The result is that a company's cash flows are discounted at rates of 11 to 17% when determining intrinsic value and this higher discount rate captures the risk of microcap companies.

Fundamental Research & Analysis

Given the Manager's emphasis on intrinsic value and growth drivers it specializes in companies with industrial products or services. Therefore the Fund does not invest in resource or property companies, as the Manager does not believe that they have expertise in these sectors. The Fund can have up to 20% in companies above $250m based on book value. This allows the Fund to benefit from the ongoing growth of companies when they exceed the $250m cap limit. For example, one investment moved from a market cap of $40m at the time of first investment to $600m when the Fund exited.

The fundamental research process requires meeting with senior management to assess both competency and ethics. Specifically, the Manager is looking for competency in terms of ability to manage the business, communicate the strategic vision and outlook, and display ethics as regards shareholders i.e., a view is formed whether the management can be trusted and their judgment. In researching a company the Manager will also contact competitors and suppliers.

All research is conducted in house as the Manager does not use broker research even where this available. Microequities prides itself on its ability to "cocoon" itself from market noise and the independence of its research views and conclusions.

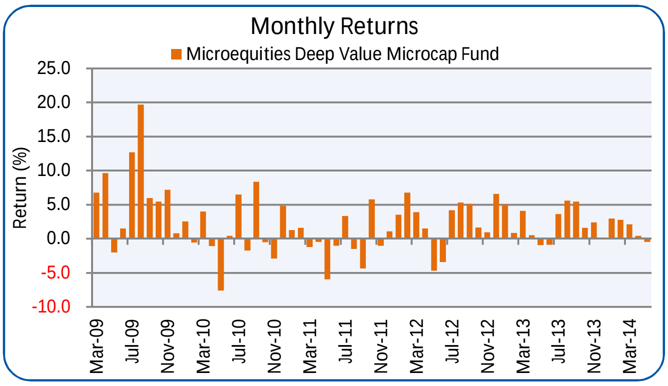
The research process also requires that the Manager build a detailed financial model with projections to value the company. Revenue forecasts towards the tail end of the DCF valuation model are typically conservatively forecast below nominal GDP growth rates.

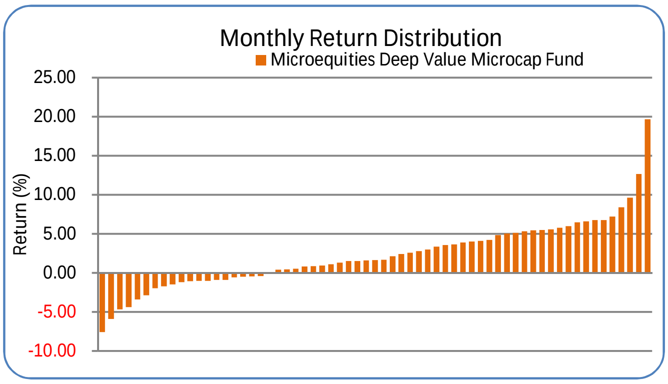
The Manager estimates they make approximately 150 company visits per year and companies not in the portfolio are monitored for any changes that may lead to further research.

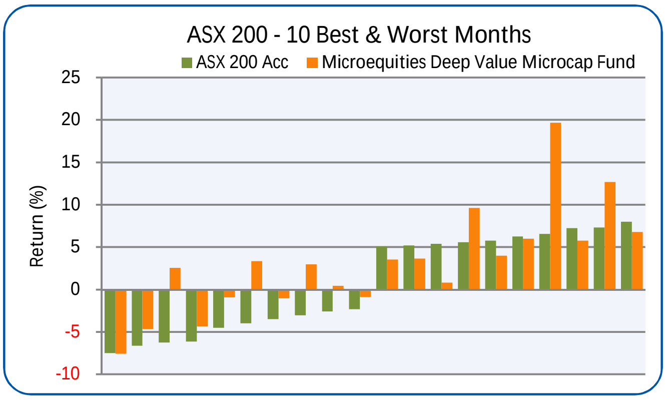
Investment Risk & Processes

The Fund will run a concentrated portfolio of around 20 stocks as the CIO has a view that professional managers should have a high conviction portfolio, backed by thorough research. There are no sector limits and the fund can have up to 20% of the Fund in a single company by market value and has a limit of 19.9% of the total equity of a single company. The Fund does not use stop losses as the Manager's view is that any selling should only occur when fundamentals of the business change,

Microequites Deep Value Fund Fund Key Terms	
Strategy	Equity Long
Geographic Mandate	Australia
Domicile/Structure	Australia
Investor Type	Wholesale only
Min. Investment	A$100,000
Additional Investment	A$20,000
Management Fee	1.8% p.a
Performance Fee	20% p.a, with high water mark
Hurdle	Yes
Min. Term	12 Months
Redemption	Monthly
Inception Date	Mar-09
Fund Size	A$44 million
Manager's Total FUM	US$75 million
Status	Open







A final factor reducing risk in terms of limiting downside is that the Fund can hold up to 80% in cash, but in most cases cash will range between 1-20%.

The Fund does not borrow, use derivatives or short stock and this reduces the risk in the portfolio. The major risk is the general illiquidity of microcaps. Across the sector some stocks will be more liquid than others however some investments will be difficult to enter and exit. The Manager notes that given the size of the Fund the illiquidity is less of an issue than the general perception and the Fund is comfortable to remain a buyer of stock for long periods of time to obtain the desired investment. In terms of selling, illiquidity is not a deterrent to exiting a stock where the fundamental case has altered and the Manager wishes to sell. The Manager accepts that some capital will be lost in the sale process due to illiquidity.

However as noted the Fund takes a business partner approach to investing and therefore has a long term approach, so turnover is low and the cost of crossing the wide bid/offer spreads in microcaps is reduced.

Performance Review

The Fund has delivered very strong performance since inception with a 29.82% annualised return compared to the ASX 200 Index Accum return of 14.89%. Volatility has been somewhat higher than the Index at 15.09% (ASX 200 Accum 12.63%) however the Sharpe ratio at 1.58 (0.88) reflects the very high incremental returns for taking on the extra volatility/risk. The Sortino ratio, which excludes the effects of upside volatility, is solid at 3.68 (Index 1.33). Up and Down capture ratios are sound at 1.18 and 0.25. The risk and return statistics indicate that the Fund's value philosophy and sound fundamental research are reflected in the stocks and portfolio and the investment outcome.

However investors need to be aware that microequities can be seriously impacted in a significant market pullback. The S&P/ASX Small Ordinaries had a maximum drawdown of 65% during the GFC with a number of small cap funds falling 50% or more.

This example is not meant to indicate the Fund will necessarily fall to this extent in a weak market but rather that the sector can be volatile.

Operational & Business Risk

The Fund has sound IT processes with all data backed up on site as well as 2 separate cloud-based storage areas.

The Fund conducts its own administration which is normally outsourced. This is unusual in the industry however management notes that they have 2 people checking and conducting entries and functions and are comfortable with the accuracy of current operations. Striking NAV is straightforward in the fund due to the absence of debt and derivatives. Fund valuations and unit prices are audited annually.

Structure , Terms & Compliance

Fees are 1.8% and 20% of the out-performance subject to a high water mark and a hurdle of a fixed 5% pa before management fees and administrative costs. Buy/sell spread is 40 bps. If investments are held for less than 12 months the Fund will levy a 2% exit fee.

All distributions are re-invested in the Fund unless the Manager elects to make a cash distribution.

Currently the Manager has FUM of $75m with $44m in the Deep Value Fund. The reminder of the FUM is in special vehicles and the High Income Microcap Fund. The Manager has a view that the Fund has capacity to $100m and will close at that point.

Service Providers

Custodian: Macquarie Bank
Prime Broker: Macquarie Bank
Administrator: In-house
Auditors: BDO
Legal: Clayton Utz

Commentary and performance data in this Fund Review is updated monthly by Australian Fund Monitors Pty Ltd. For updates email contact@fundmonitors.com

Research Analyst: Sean Webster
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Explanation of Ratios & Terms:
(see www.fundmonitors.com for a full glossary of terms)

Sharpe Ratio:

A measure of a fund's "risk-adjusted return", or the return per unit of risk. The higher the ratio, the higher the return the investment strategy has generated for each unit of risk taken. The ratio provides an indication of whether the returns were generated from manager skill or risk taking. In general a Sharpe Ratio of 1 or higher is considered as showing that an investment strategy is rewarding the investor for the risk taken.

By way of example the Sharpe Ratio for 3 year term deposit of $10,000, using average interest rates for these deposits as calculated by the RBA from January 2009 to April 2014, is 0.465. The interest rate on the term deposits is calculated by the RBA using the five largest banks.

It is calculated as follows: Excess Return / Risk where Excess Return is the annualised return since the fund's inception minus the risk free rate of return (i.e. the RBA cash rate) and Risk is the fund's annualised standard deviation (volatility) since inception.

Sortino Ratio:

The Sortino ratio is a variation of the Sharpe ratio and only takes into account downward risk on the basis that the fund should not be penalised for upside volatility. The higher the Sortino ratio, the less downside risk the investment strategy has generated.

It is calculated as follows: Excess Return / Downside Risk where Downside Risk is the fund's Annualised Downside Deviation (volatility of negative returns) since inception.

Up and Down Capture Ratio:

The Up (Down) Capture Ratio is the ratio of the Fund return in up (down) markets relative to the market's return. For example, if the market moves up 10% and the Fund by 7%, the Up Capture Ratio is 0.7. If the market moves up 5% and the Fund declines by 3% then the Up Capture Ratio is -0.6. A higher ratio is better than a lower (or negative) ratio. Similarly if the market falls 8% and the Fund falls 6% the Down Capture ratio is 0.75 i.e., the Fund only captured 0.75 of the downside. A lower ratio is better than a high ratio.

About Australian Fund Monitors

Australian Fund Monitors (AFM) is a specialist research and information provider, focusing on the Absolute Return and Hedge Fund sector. AFM holds AFS License 324476 to provide general advice to wholesale investors only.

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