

# FAIRLIGHT

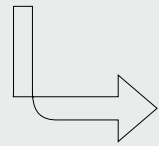
Investor  
handbook

Global Small and Mid Cap Fund

# A guide to our unique approach to concentrated global investing

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# Who we are

Fairlight Asset Management is a boutique firm investing exclusively in global equity markets. We are focused on contributing to superior investment outcomes for our clients through exceptional performance. Our team takes an ethically-aware, quality-driven approach to investing, dedicated to deep fundamental research of both the quantitative and qualitative aspects of investee companies.

Founders invest the majority of their liquid assets in the business and the fund itself in order to maximise alignment with investors. We operate in partnership with Perennial Group.

## 1.1 Our team



**Nicholas Cregan**  
Portfolio Manager & Partner

Nicholas is a founding partner of Fairlight Asset Management, serving as a portfolio manager in the investment team since the inception of the Fund in 2018. Nick has 17 years investment experience in the domestic, US and international markets. Prior to forming Fairlight Nicholas served as a Portfolio Manager at Evans and Partners, and at Schroder Investment Management where he held Senior Analyst and Portfolio Manager positions in the New York and Sydney teams respectively.

### Qualifications

Bachelor of Business



**Ian Carmichael, CFA**  
Portfolio Manager & Partner

Ian is a founding partner of Fairlight Asset Management, serving as a portfolio manager in the investment team since the inception of the Fund in 2018. Ian has 13 years experience in financial markets and a further six years as an engineer. Prior to joining Fairlight, Ian worked at Platinum Asset Management for four years as consumer team leader and managed an allocation of the highly respected International Brands Fund.

### Qualifications

Bachelor of Chemical Engineering  
Master of Biomedical Engineering  
Chartered Financial Analyst



**Will Dowd, CFA**  
Analyst & Partner

Will is a founding partner of Fairlight Asset Management, serving as an analyst in the investment team since the inception of the Fund in 2018. In addition to equity research, Will is also responsible for building the quantitative and qualitative analysis infrastructure critical to the team's investment process and risk management systems. Will has ten years investment and data analytics experience with prior roles at Evans and Partners and EY.

### Qualifications

Bachelor of Business Information Systems  
Master of Finance  
Chartered Financial Analyst



**Alvise Peggion, CFA**  
Analyst & Partner

Alvise has eight years international investing experience. He is responsible for ongoing coverage of established portfolio positions as well as investment idea generation. Prior to joining Fairlight in 2019, Alvise worked as a generalist equity analyst for Forager Funds. Alvise is proficient in Italian, English and Mandarin.

### Qualifications

Bachelor of Finance (Honours)  
Chartered Financial Analyst

## 1.2 Our guiding principles

A business defined by diligence and authenticity is critical to maximise investment returns for our clients – it’s what attracts and retains the best minds.

### Performance

Dedicated to delivering exceptional risk adjusted returns through deep fundamental research, we take responsibility and invest our money alongside our clients’. We are mindful of the capacity constraints of the product we manage and will not compromise performance for fund size.

### Integrity

We are investor-centric. The client is at the center of every decision made and comes first, always.

### Transparency

We communicate openly and honestly internally and with our clients and partners. We share our informed views respectfully, even when against popular opinion or the status quo.

### Open-mindedness

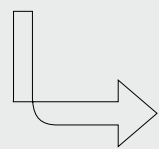
The only constant in the world is change and we embrace this in our search for the best outcomes for the portfolio. We are not always right and will alter our views congruent with new information.

## 1.3 Fund characteristics

Fairlight Small & Mid Cap Fund	Parameters
Stock numbers	30-40
Market capitalisation	US\$500m – \$20bn
Style	Long only quality
Maximum cash	20%
Estimated turnover	40%
Objective	Benchmark +3% (estimated 8-12% p.a through the cycle)
Benchmark	MSCI World SMID AUD (Net)
Responsible Entity	The Trust Company Limited part of the Perpetual Group
Administrator	Mainstream Fund Services
Auditor	Ernst & Young

Figure 1: Key fund characteristics.

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# Investment philosophy

The Fairlight Global Small & Mid Cap Fund employs a concentrated, long only strategy, investing exclusively in international markets. Our investment philosophy is grounded in fundamental research, is long term in nature and has a strong focus on quality. We aim to deliver investors a 8-12% return through the market cycle with lower volatility than the index. Our team believe a portfolio of the highest quality businesses, purchased with valuation discipline will outperform over the long term whilst protecting and preserving client capital.

## 2.1 Investments we seek to make

Investments that the fund will make can be classified into three different opportunity types, each with its own characteristics, resulting in differing return profiles through the investment cycle. We believe in the benefits of diversification, that differing investment styles such as growth and value offer returns at different points of the investment cycle, and that the market fundamentally misappraises the benefits of long-term compounding. By offering exposure through several styles of investing, we believe we can generate superior returns to targeting one investment type exclusively.

### High quality growth

When analysing growth companies, we seek two styles of investment that generate sustained excess earnings growth. The first are businesses that require little capital to operate such as internet portals, software businesses and media companies. The second are businesses that can deploy growth capital at high incremental returns such as high-quality retailers or light industrial companies.

### Stable compounders

These businesses generate modest revenue growth, unusually stable cash-flows, and often have an opportunity to expand margins. These characteristics, coupled with sensible capital allocation such as share repurchases, judicious acquisitions or dividends, often result in attractive shareholder returns. We often find these opportunities in the healthcare and consumer staple sectors.

### Low risk turnarounds & special situations

A modest percentage of our portfolio is dedicated to businesses that are facing temporary difficulties or where management have strayed or been distracted from core operations. These opportunities tend to be contrarian in nature and may take time for cyclical headwinds to abate or management to refocus on the inherent quality within the business.

Portfolio  
of 30–40  
businesses

#### High quality business

- Durable ROIC
- Cash > NPAT
- High barriers to entry
- High switching costs
- High value to cost ratio.

#### Corporate culture

- Stable, aligned management teams
- Low staff turnover, strong customer retention.

#### Sources of value

- Strategic value
- Hidden assets; tax, IP, brands, underearning operations, land.

#### Low risk

- No single point of failure or compounding risks
- Low debt
- Low EV/EBITA(x).

Figure 2: Portfolio characteristics.



Figure 3: Characterisation of investment opportunities.

## 2.2 Investments we choose to avoid

Fairlight defines quality companies as those generating high returns on invested capital (ROIC) through the market cycle while maintaining a conservative capital structure. To capture businesses of this nature, and to improve the probabilities of good investment outcomes, the following characteristics are screened out:

### Low ROIC

Property trusts, utilities, heavy industrials and banks must employ significant leverage to produce a high return on equity (ROE) from low return on assets (ROA). Fairlight screens out highly leveraged businesses from its universe.

### Macro

Mining, metals and materials businesses are highly cyclical in nature, and the performance of the business is often determined by commodity prices. The market forces that determine commodity prices are typically difficult to forecast (e.g. macroeconomic factors such as Chinese capital formation rates and credit cycles). Highly cyclical sectors also tend to be characterised as having higher volatility which can increase the probability of capital loss.

### Single point of failure

Biotech and narrow pharmaceutical companies are often highly dependent on the fortunes of one “blockbuster” drug, tightly regulated and subject to rigorous Food and Drug Administration (FDA) approval processes. These compounding risks substantially reduce the likelihood of generating a favourable result within the sector.

### ESG

ESG exclusions include tobacco, armaments, gambling, uranium mining and old growth logging (see Section 2.6 for more detail).

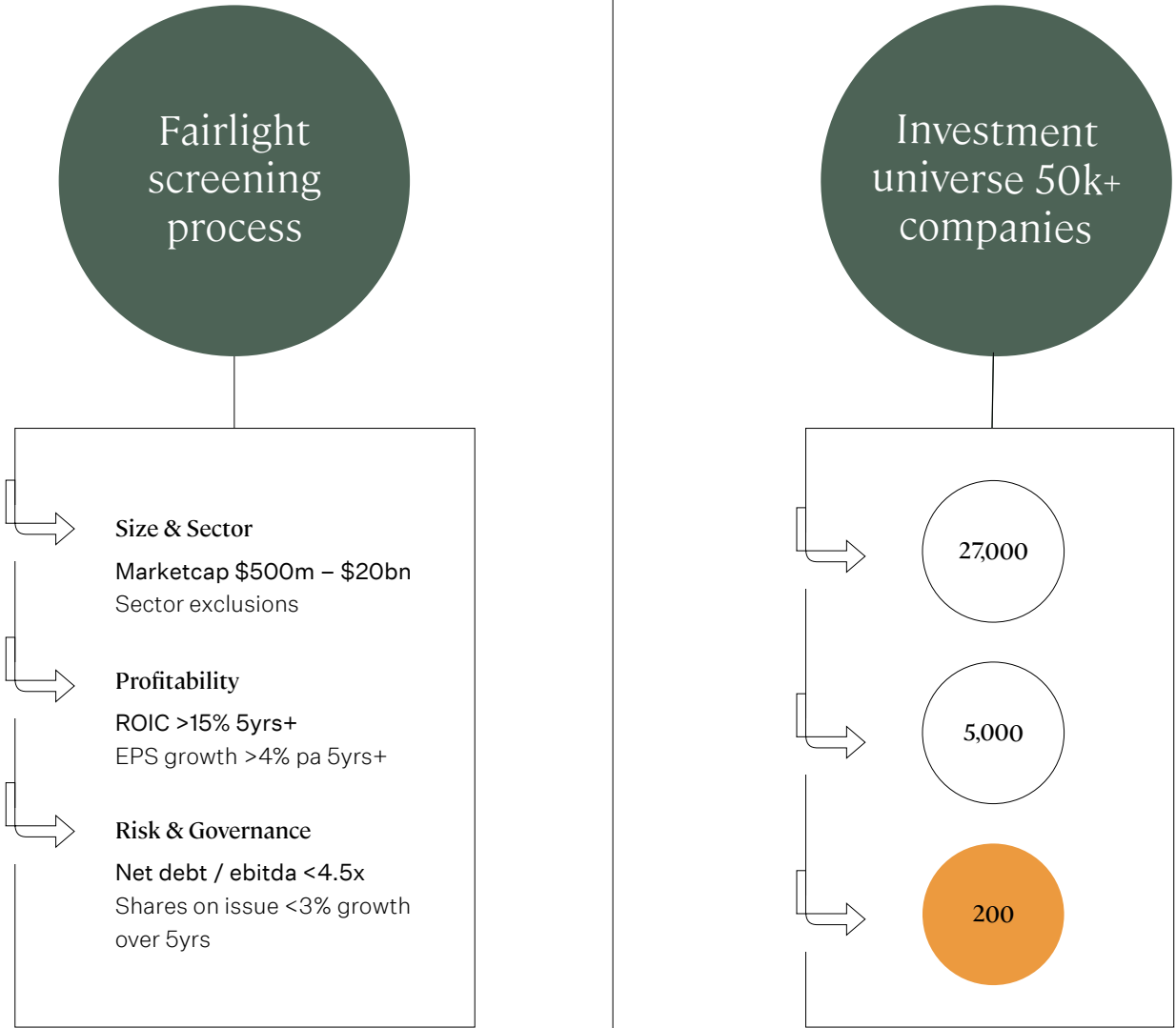
Screen Out	Low ROIC	Cyclical/Macro dependent	Value to cost ratios/ESG	Single points of failure	Fairlight Universe	Fairlight focus
	Utilities	Heavy Industrials	Tobacco	Biotech		Consumer & Media
	Property Trusts	Banks	Armaments	UnprovenTech		Light Industrials
	Infrastructure	Oil & Gas	Narrow Pharma	Single Product/Customer		Niche Technology
	Agriculture	Metals & Mining	Old Growth Logging	Binary Outcomes		Healthcare

Figure 4: Sector exclusions.

## 2.3 Refining the universe

The primary screen excludes the largest, most efficiently priced businesses from the universe (>\$20bn mkt cap), and the sectors as described above. Businesses generating less than twice the market cost of capital are screened out, as are those businesses that fail to grow earnings per share above inflation. The fund will generally not hold businesses with net debt/ebitda of above ~3.5x, however, the screen attempts to drive awareness of potential targets as they deleverage.

Also excluded by the screen are management teams with poor records of capital allocation. Namely, those that issue excessive equity to fund acquisitions, capex or management compensation.



## 2.4 Valuing investment opportunities

We employ two primary valuation techniques to assess equity value in potential investee companies; discounted net operating profit less adjusted tax (NOPLAT) and a normalised price to cash earnings ratio (PER). Discounted NOPLAT forecasts EBITA for five years and applies a terminal multiple that is allocated a premium or discount (to the US 15-year average EV/EBITA multiple) with consideration to the factors outlined in Figure 6.

Factors	Business Risk Matrix			
Revenue quality	Recurring	Capex / opex	High value to cost ratio	Pricing power
Operating leverage	Fixed cost	Variable cost	Supplier power	Restructure
Financial leverage	On balance sheet	Operating leases	Pension liability	Nuance e.g. Franchise network
Industry structure	First mover advantage	Consolidating	Scale	Growth
ESG	Principles based	Additive to returns	Customer retention	Employee retention
Management quality	Understands advantage	Clear communication	Incentives	Capital allocation

Figure 6: Qualitative valuation inputs.

We recognise that these valuation techniques approximate fair value and consider a range of other factors that may tilt the odds of a good outcome in our favour. These include the strategic value of the asset to a potential acquirer, undervalued assets such as land banks or intellectual property, or the possibility of potential divestments that may unlock value.

Liquidity is an input into the valuation process – for thinly traded securities we increase the hurdles in our assessment of fundamental risk. In other words, trading liquidity is matched with “internal liquidity”. Securities that take longer to exit require stronger balance sheets and cash flow conversion with a view that often these positions must sometimes be held for longer periods to extract returns. The team also demands a higher risk premium to compensate for possible price impact on entry and exit of the position, and cost to trade.

## 2.5 Portfolio positioning and risk

Fairlight defines risk as the probability of the permanent impairment of capital. However, we also recognise academic literature indicates that lower volatility assets outperform higher volatility assets over the long term. High volatility also presents an opportunity cost, or the inability to recycle capital during periods of market dislocation. For this reason, we prefer low volatility stocks over high volatility where the expected return is equal.

Fairlight does not believe there is any one element or ‘silver bullet’ for protecting client capital – we believe in taking a holistic view of risk, encompassing both the elements that are common to companies (e.g. debt and cash flow) along with company specific risks. The risk factors covered within our individual security analysis (valuation inputs, see Figure 6) are merged with portfolio considerations. The portfolio risk matrix shown in Figure 7 outlines the considerations that are used to guide position sizing from the perspective of portfolio risk.

Factors	Portfolio Risk Matrix			
Business risk & valuation	Business risk matrix score	Time stamped thesis	Tenure of coverage	Thesis drift/ conviction score
End market exposures	GLCS	FAM defined sub industries	Sensitivity to end market	Macro dependency
Share price correlations	Expected diversification benefit	Correlations can inform common risk factors	ETF representation	Wary of false positives
Scenario analysis/ factors	Basis for debate	Factor tilt awareness	Currency	Interest rate sensitivity
Opportunity cost/ volatility	Prefer low volatility where expected returns equal	Opportunity cost in inability to recycle capital	Trading liquidity (days to exit)	Internal liquidity (cash flow & balance sheet)

Figure 7: Portfolio risk matrix.

Fairlight does not believe there is any one element or ‘silver bullet’ for protecting client capital – we believe in taking a holistic view of risk.

Our approach to portfolio construction is highly collaborative with team debate occurring on the relative merits of the various inputs before the Portfolio Managers construct the portfolio with reference to both the aforementioned valuation and risk considerations. Where necessary, Cregan will make the ultimate decision to invest where no consensus is apparent.

The portfolio will generally hold 30 to 40 securities plus cash at any point in time (see Section 3.4 for the reasoning behind this range). Typically, 80% of the portfolio will be held in the high quality growth and stable compounders investment types with the residual of the portfolio being low risk turnarounds and cash. Figure 8 presents a stylised and indicative example of the portfolio. We address our willingness to hold high quality growth stocks at small weights through fair value within our assessment of behavioural biases in Section 2.7.

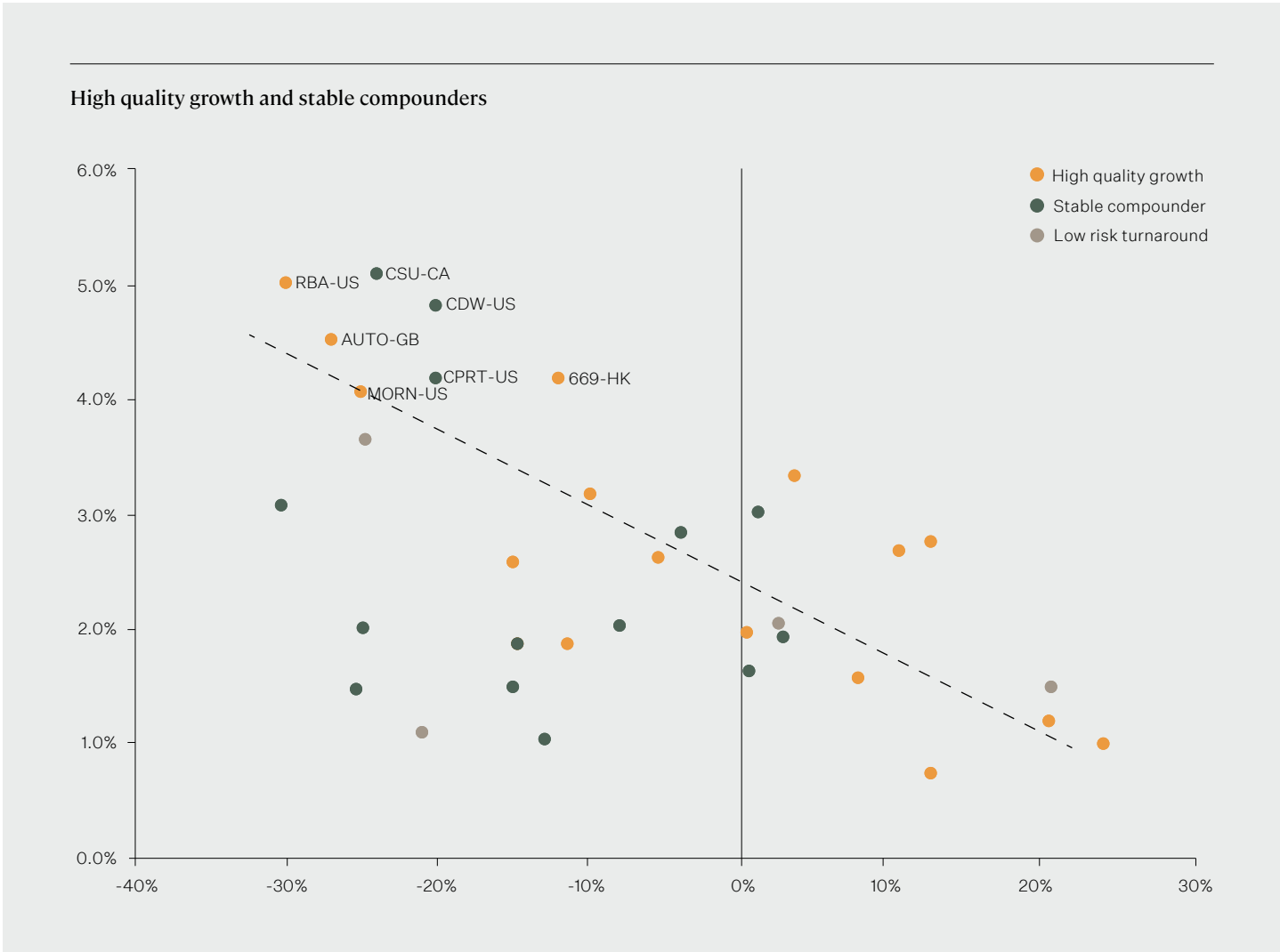


Figure 8: Portfolio positioning (representation of data related to the portfolio in this instance is indicative only and is not representative of the current portfolio holdings).



## 2.6 The role of ESG in the portfolio

Environmental, Social and Governance (ESG) assessments often lack common definitions and metrics which in turn presents a problem when trying to compare ESG practices between companies. While the impact of incorporating ESG considerations into an investment process is inconclusive and sensitive to methodology (see Section 3.8), Fairlight is of the belief that the way a company manages ESG issues is often a good indicator of overall risk levels and general management quality — which are both strong determinants of companies’ long term success. Companies with better ESG performance can increase shareholder value by better managing risks related to emerging ESG issues. Moreover, ESG issues can have a strong impact on reputation and brands, an increasingly important part of company value.

### ESG is incorporated into the Fairlight investment process in the following ways:

1. Industry exclusion screens eliminate the more obvious sources of ESG risk found in tobacco, armaments, gambling, uranium mining and old growth logging industries (see Section 2.2).
2. All researched companies are scored across a range of ESG metrics which generates a cost of capital charge that is an input into company valuation. Companies with relatively poor ESG practices incur a larger discount rate than those that are best practice.
3. Fairlight practices active ownership by engaging with companies on ESG issues (including disclosure) and voting our proxy rights.

Fairlight is a signatory to the UN Principles for Responsible Investment.

## 2.7 Mitigating behavioural biases in our investment process

Psychological biases, or heuristics, can often be obstacles to favourable investment outcomes. As humans, it is unlikely we perfectly overcome these biases, however we can often avoid those leading to the costliest mistakes by designing risk systems to act as a safety net. Here we address some of the biases Fairlight finds most damaging, and the safeguards we put in place to reduce their impact.

### The Disposition Effect

The disposition effect was first identified in 1985 and relates to the propensity of investors to lose more money when selling than they would be expected to do by chance alone. Prospect theory suggests investors are risk averse when looking at profits but tend to be risk takers when confronted with losses. Mental accounting drives investors to view each position within a portfolio as an entirely separate item and treat them in an inconsistent manner. Investors tend to bucket “winners” and “losers” separately and the chances of something being sold increases simply if they have made a profit on the investment. Consequently, it is often the case that potential winners are sold too early and poor performers are retained, particularly if the latter involves feelings of regret and loss.

Fairlight have developed selling rules as a mitigation strategy for this behavioural bias. If the primary motivation for selling a security is overvaluation (rather than say a broken thesis) then position weighting will be gradually reduced over a period of time allowing the fund to participate in trade momentum. A consequence is that at any particular time the fund will have several holdings at small weights trading at a premium to our valuation (see Figure 8).

### Anchoring

Anchoring can be a pervasive bias that is drawn from the way data is presented. During decision making, anchoring occurs when individuals use an initial piece of information to make subsequent judgments. Once an anchor is set, other judgements are made by adjusting away from that anchor. The problem arises, of course, when the anchor itself is based on false or irrelevant information.

Fairlight’s approach to information sharing is critical in overcoming this bias. By having team members approach problems from a first principles basis we can avoid the group think that is often complicit in anchoring. We also find that having team members covering competing businesses also helps to reduce the anchoring effect as analysts often attack the same data in disparate ways.

Availability bias

Recently observed or experienced events can often strongly influence decisions. Psychologists refer to this as the ‘availability bias’. To give a financial example, investors often place more weight on the information derived from the most recent quarter, even when this information has little bearing on the long-term cash flows expected to be generated from an asset.

Fairlight has developed proprietary systems that allow for rapid comparability of recent information against our original investment thesis, in doing so we can more objectively observe the degree to which this bias affects our decision making.

Investing in the familiar

Often as investors, we associate familiarity with low risk. This manifests itself in many ways, however one of the most common outcomes is a tendency to over index to home markets, also known as home bias. This bias is also often present in teams of sector specific analysts who compare investment opportunities within a very narrow range. Often minutia is triumphant over relevance and decisions are made without comparison to a wider, potentially richer, pool of assets. Taking a generalist approach can help address this problem.

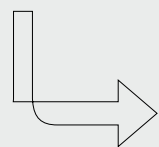
In his book, *Superforecasting – the Art and Science of Prediction*, Philip Tetlock shows that generalist superforecasters are, by a wide margin, statistically better at predicting events than experts covering a topic in depth. Tetlock also found that when these individuals were grouped into smaller teams, they became even more accurate. For example, when assessing events of geopolitical importance, a group of generalists superforecasters from a diverse range of backgrounds, with access to nothing more than Google, meaningfully outperformed a group of experienced intelligence analysts with access to classified information – reportedly by 30%.

“Our investment philosophy is grounded in fundamental research”

2.8 Currency management

Fairlight does not target currency as a source of alpha generation but rather as a risk mitigation instrument. The portfolio will typically have a significant allocation to US domiciled companies and we expect a large weighting to persist. During periods of equity market volatility over the past 20 years, the USD has acted as a reliable cushion to market drawdowns for Australian dollar-based investors (see Section 3.7). The portfolio will be managed on a primarily unhedged basis in order to benefit from this inverse correlation.

3



## Evidence in support of our philosophy

The design of the Fairlight Global Small & Mid Cap Fund has been informed by the investment teams' combined decades of experience in equity markets supplemented by empirical insights derived from the large body of available peer reviewed academic literature. Fairlight places greatest weight on academic findings that are pervasive, persistent, intuitive and able to be replicated.

### 3.1 The case for owning smaller business

Banz (1981) was the first to empirically quantify that smaller firms have had higher risk adjusted returns, on average, than larger firms using forty years of NYSE data. This insight was subsequently incorporated into the famous Fama and French (1993) three factor model which helped to popularise the concept of small company investing.

From 1927 through 2015, the return premium earned by investing in U.S. small capitalisation companies relative to U.S. large capitalisation companies has been 3.3% (Andrew Berkin, 2016). While less historic data exists for other markets, a Dimensional analysis of 15 European markets found an average return premium of 2.4% to small companies over the period 1982–2014 (Stanley Black, 2015).

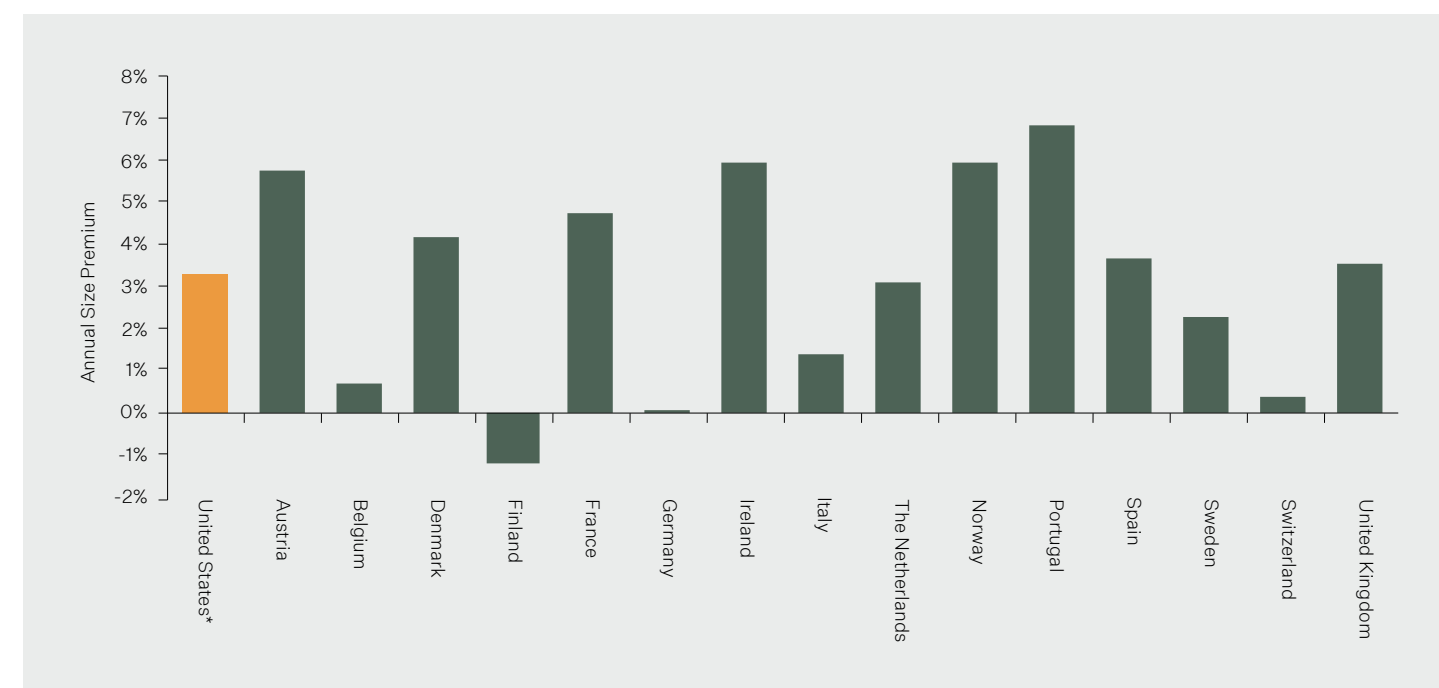


Figure 9: Size premia across various markets, U.S. 1927-2015 (Andrew Berkin, 2016), Europe 1982-2014 (Stanley Black, 2015).

There are good reasons for believing the small company return premium is real and should be expected to persist on an ex-ante basis:

- 1. The return premium is pervasive having been identified in the U.S., most European markets and to a lesser extent, emerging markets as well.
- 2. The return premium is persistent having statistical significance in the U.S. over the longest period for which data is available (1927 through to today).
- 3. The return premium is intuitive as smaller companies are able to grow faster and have a longer runway to compound growth given the more modest starting point.
- 4. The return premium is structural as smaller firms exhibit greater mispricing due to less sell-side coverage.
- 5. The return premium is compensative for lower liquidity and less diversified business models.

The reliability of the return advantage from investing in smaller companies increases with time horizon. Figure 10 is an historic analysis of the US market which shows that as an investors time horizon extends to twenty years or beyond, smaller companies have outperformed large more than 94% of the time.

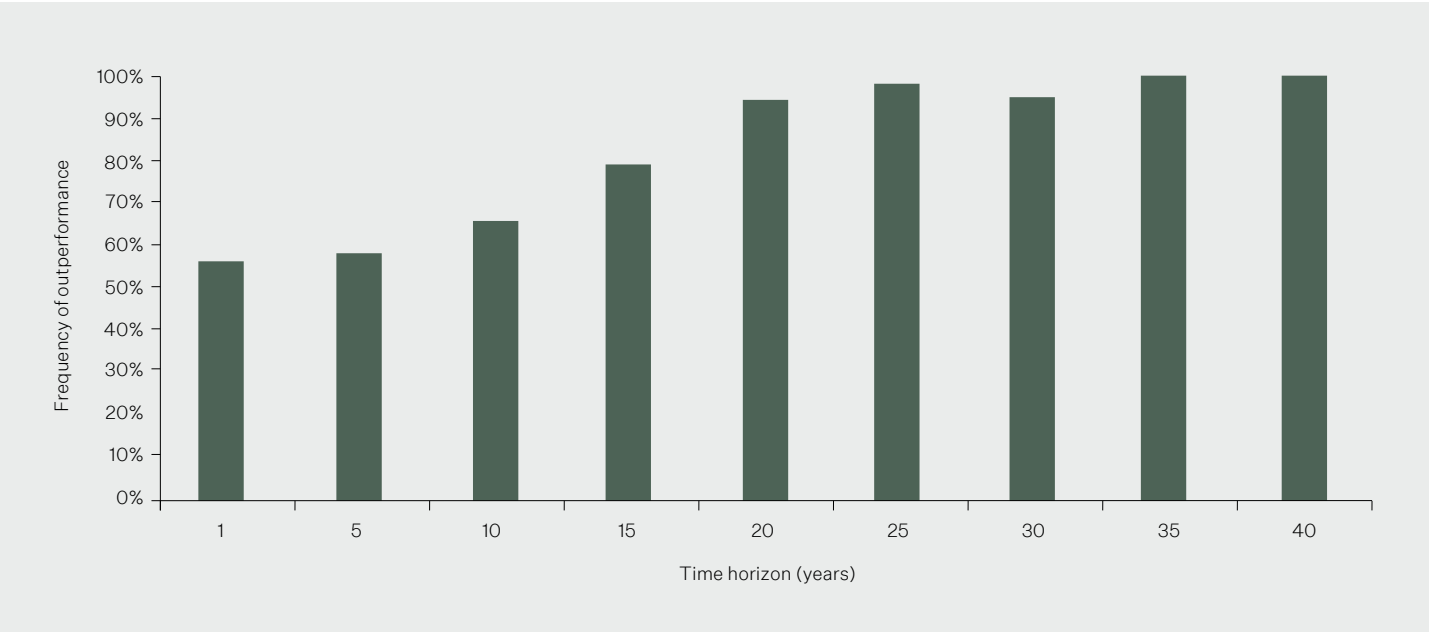


Figure 10: Percentage of time small has outperformed large in the U.S. 1926–1996 (Hanna & Chen, 1999).

### 3.2 A quality focus improves returns from smaller companies

While stock quality is an inherently subjective concept, a helpful working definition is to consider it to be any characteristic, or set of characteristics, of a security that investors should, in theory, be willing to pay a high price for, all else equal.

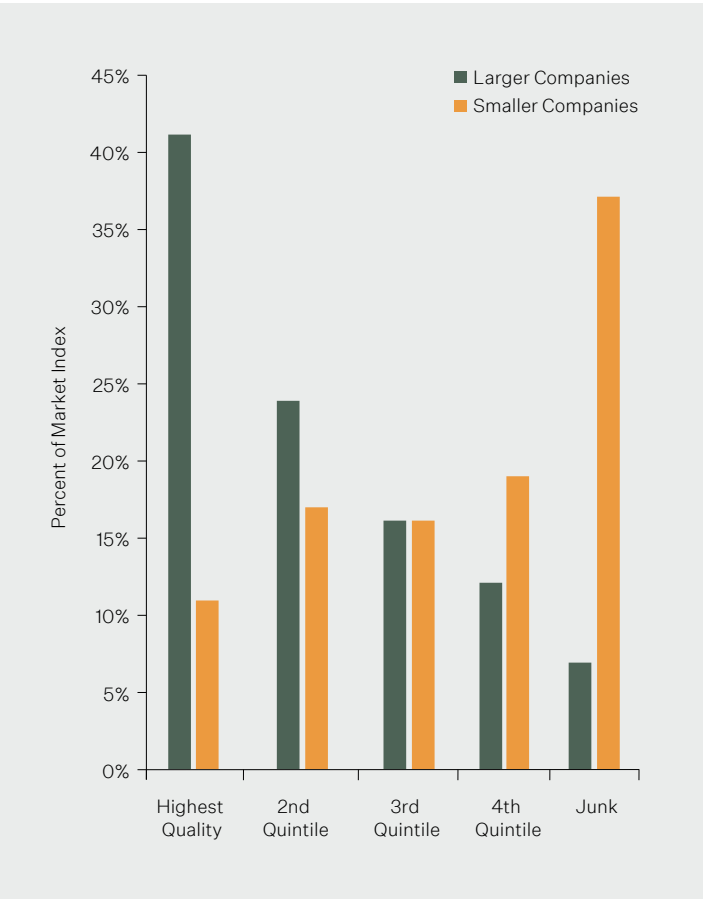


Figure 11: Smaller companies in aggregate are lower quality (Clifford Asness, 2018).

Figure 11 highlights how exposed the smaller end of the market is to “junk” and lower quality securities which are often distressed or highly speculative companies. In generating this analysis Asness (2018) scored companies on the following criteria:

- **Profitability:** Gross profits, margins, earnings, accruals and cash flows;
- **Growth:** Prior five-year growth in each of the profitability measures;
- **Safety:** either return-based measures of safety (e.g. market beta and volatility) or fundamental-based measures of safety (e.g. stocks with low leverage, low volatility of profitability, and low credit risk);
- **Payout:** Fraction of profits paid out to shareholders seen as a measure of shareholder friendliness (e.g. if free cash flow increases agency problems).

The observation that the smaller end of the market has a larger proportion of low quality companies has important implications because of the substantial academic evidence that higher quality stocks tend to outperform junk stocks. In the U.S. from 1927 through to 2015, highly profitable firms returned 3.1% per annum more than the least profitable firms (Andrew Berkin, 2016). Novy-Marx (2013) showed that the outperformance of high profitability stocks was not limited to the U.S. but rather is pervasive across all the major developed markets.

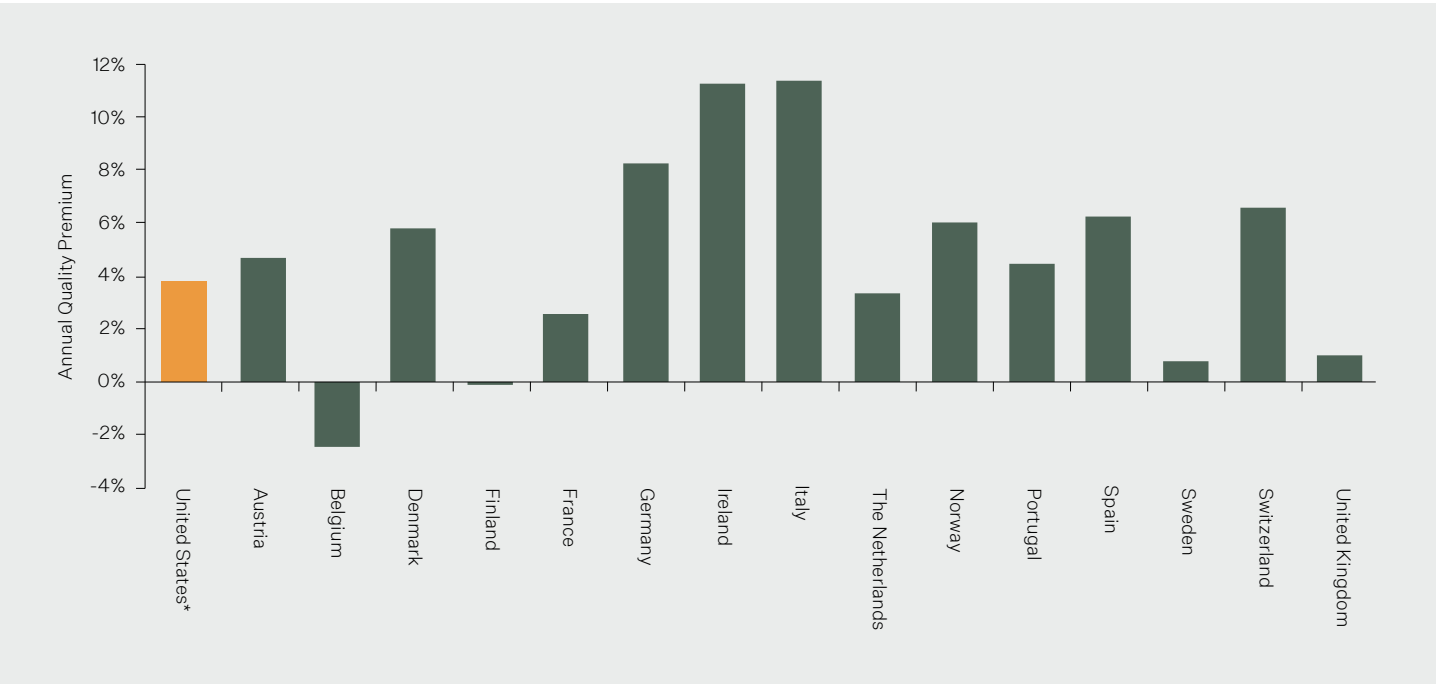


Figure 12: Quality premia across various markets, U.S. 1927-2015 (Andrew Berkin, 2016), Europe 1982-2014 (Stanley Black, 2015).

Of particular significance for investors in SMID capitalisation companies, Wang and Yu (2013) were able to demonstrate that the quality return premium is significantly larger (up to four times as much) at the smaller end of the market. While small quality stocks outperform large quality stocks, and small junk stocks outperform large junk stocks, the unfavourable exposure of the smaller company universe to more lower quality companies obscure a considerable portion of the advantage of small company investing.

The key to successful quality investing is identifying businesses that can generate high levels of ROIC in the future and patiently waiting to buy them when their market valuation implies that their ROIC will mean revert. In the classical model of capitalism, any company that is able to produce a high ROIC will have their advantages competed away with ROIC regressing back towards the mean. In

practice however, we find a not insignificant number of companies that are capable of sustaining high ROICs for an extended period of time for a variety of reasons such as innovation, brand, regulatory advantages, network effects and cost advantages.

McKinsey measured the sustainability of company ROICs by categorising the market into quintiles based on historic ROIC, and then tracking the median ROIC for each portfolio over the following fifteen years. The result (shown in Figure 13) demonstrates that while there is certainly some evidence of mean reversion, the companies with historically high performing ROICs did continue to generate higher returns than the rest of the market, even fifteen years later. Put another way, historic profitability is a reasonable predictor of future profitability and time spent researching historically successful companies isn't time wasted.

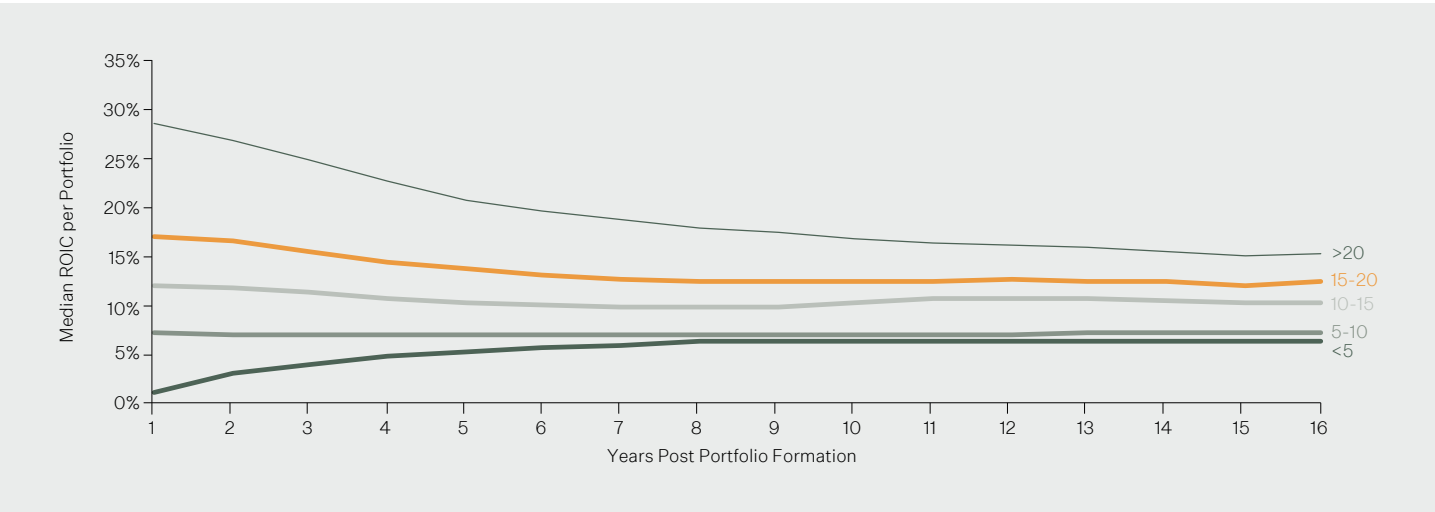


Figure 13: ROIC Decay Over Time (Koller, Goedhart, & Wessels, 2015).

Importantly for portfolio outcomes, the excess returns from investing in smaller companies and quality companies are negatively correlated. Figure 14 shows that in the past decade there has not been a single year where both factors simultaneously underperformed. This negative correlation results in a portfolio that can capture both the small company and quality company return premiums, but with reduced overall portfolio volatility.

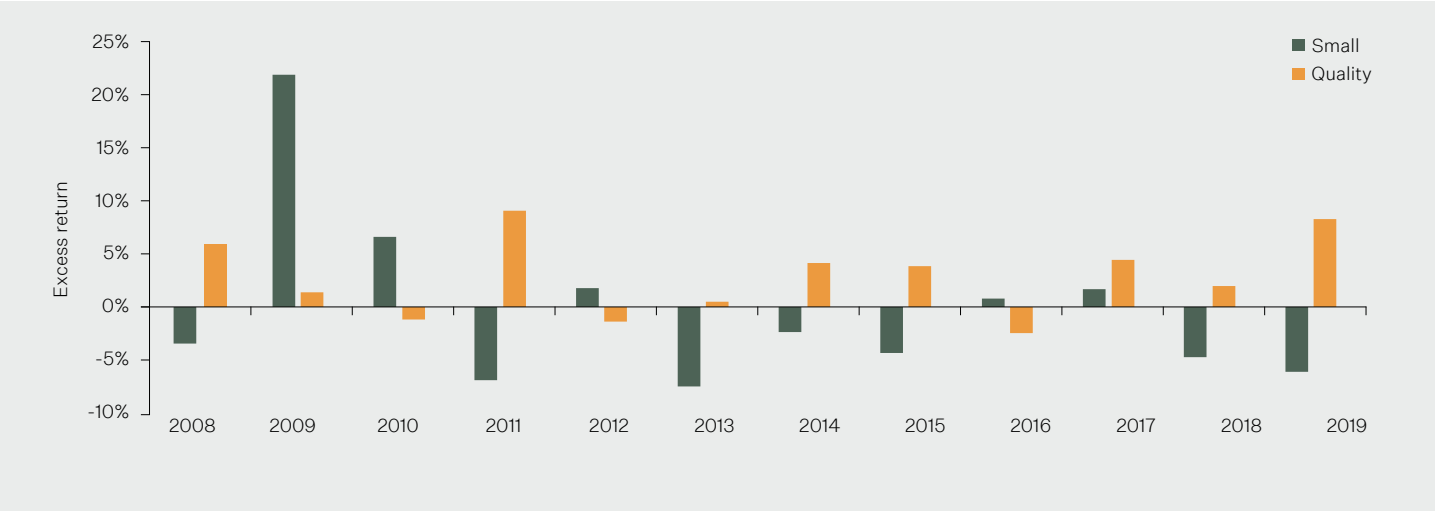


Figure 14: Excess returns from size and quality are negatively correlated.

### 3.3 The merits of offshore investing

Fairlight asserts that Australian investors are well placed to open their investment universe beyond Australian borders. We believe by doing so, investors are offered the potential to access higher quality businesses at more reasonable valuations. In applying our screens to the Australian market, there are few businesses that pass both our quantitative and qualitative requirements. The narrowness of the Australian market and the relative scarcity of high-quality companies results in valuations that are often unconvincing compared with international alternatives.

An international portfolio comprised of companies from a variety of different markets also provides a diversification benefit to the return premiums earned by both smaller and higher quality companies. There are numerous examples of individual markets where either the small company return premium (e.g. Finland) or quality company return premium (e.g. Belgium) have been absent for decades at a time.

### 3.4 Portfolio risk and concentration

It is possible to achieve most of the diversification benefits of a broad index with considerably fewer stocks. Figure 15 uses data sourced from Surz and Price (2000) which shows that while total statistical risk (standard deviation of returns) of theoretical portfolios falls quite quickly when additional stocks are added to very narrow portfolios, the benefits quickly plateau out. The active risk (tracking error) of the portfolio also declines however at a slower rate than total risk.

Number of Stocks	1	15	30	60	Entire market
Standard Deviation	45%	16.5%	15.4%	15.2%	14.5%
Diversification Benefit	0%	93%	97%	98%	100%
Tracking Error	45%	8.1%	6.2%	5.3%	0%

Figure 15: Portfolio risk as a function of concentration.

Cohen, Polk and Silli (2010) found that active managers’ best ideas (largest active weights) outperform the market, as well as the other stocks in those managers portfolios, by approximately one to four percent per quarter depending on the benchmark employed. Similar conclusions were reached by Cremers and Petajisto (2009) who found that managers who take big active positions perform better than those who take small positions. Funds with the highest aggregate active share were shown to outperform those with the lowest active share by roughly 2.5% a year. The implication for practical portfolio construction is self-evident – the expected return of a portfolio should not be compromised by the inclusion of low conviction positions for the sake of superficial diversification.

Fairlight seeks to build a portfolio that behaves differently to the market but without taking on additional risk.

While stock selection and a quality bias play an important role, so too does portfolio concentration. It is the experience of the investment team, supported by the academic work of Surz and Price (2000), that a 30-stock portfolio provides an optimal trade-off between risk and return. A 30-stock portfolio:

- Captures more than 95% of the diversification benefits of the market index (standard deviation);
- Performs appropriately differently to the market index (tracking error);
- Is sufficiently concentrated so only the investment managers best ideas are represented in the portfolio.

### 3.5 Why an active approach makes sense

Previous sections have made the case for smaller companies, a quality bias, a global perspective, and concentrated portfolios. The remaining decision for investors lies in the choice between passive and active. While quantitative tools are helpful in screening out junk companies and lottery tickets, and form an important part of the Fairlight investment process, it is the experience of the Fairlight investment team that qualitative insight properly harnessed can add additional value. This is especially true in more inefficient markets that exhibit greater degrees of security mispricing.

Fairlight believes the global SMID universe to be a market that exhibits sufficient inefficiency to warrant an active approach. One means of quantifying the level of pricing efficiency in a market is to compare the weight of resources dedicated to analysing its securities. Figure 16 shows that the current number of analysts covering the \$100b and above cohort is five times greater than that of the \$15b and below. The rate at which resources are being extracted from the SMID universe is also greater than that seen in the large capitalisation space.

# of covering analysts

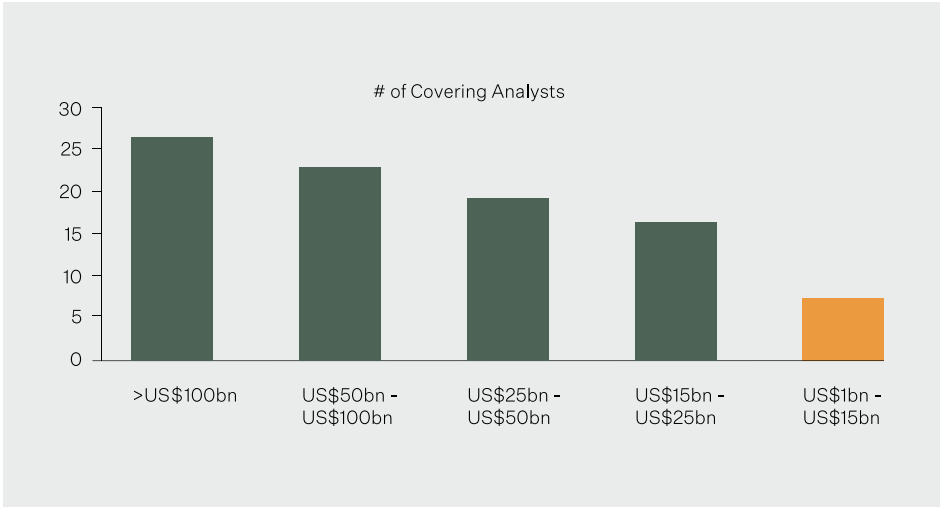


Figure 16: Analyst resources by market capitalisation (Source: Factset as at Sep 2018).

Another means of quantifying the opportunity for active managers first suggested by David Swenson of the Yale University endowment is to analyse the dispersion in asset manager returns. Figure 17 uses the difference between the 25th and 75th percentile asset manager returns in each equity asset class as a measure of dispersion. The conclusions are that dispersion (and thus active management opportunity) is higher in smaller companies than large ones, and is higher in international markets than the U.S.

Equity Asset Class	Dispersion (2010-2015)
U.S. Large Cap	2.5%
U.S. Small Cap	2.8%
Global Equity	3.1%
International Small Cap	3.5%

Figure 17: Manager return dispersion by asset class (Mauboussin, 2017).

Market inefficiency has historically been correlated with excess returns from active management. A recent empirical MSCI study (Gupta, Oberoi, & Subramanian, 2018) found that the excess return delivered by the median active manager has been consistently more attractive in global small companies and emerging markets (both relatively inefficient), compared with US and ex-US large capitalisation companies (both relatively efficient markets). Figure 18 shows the magnitude of the difference over the past decade.

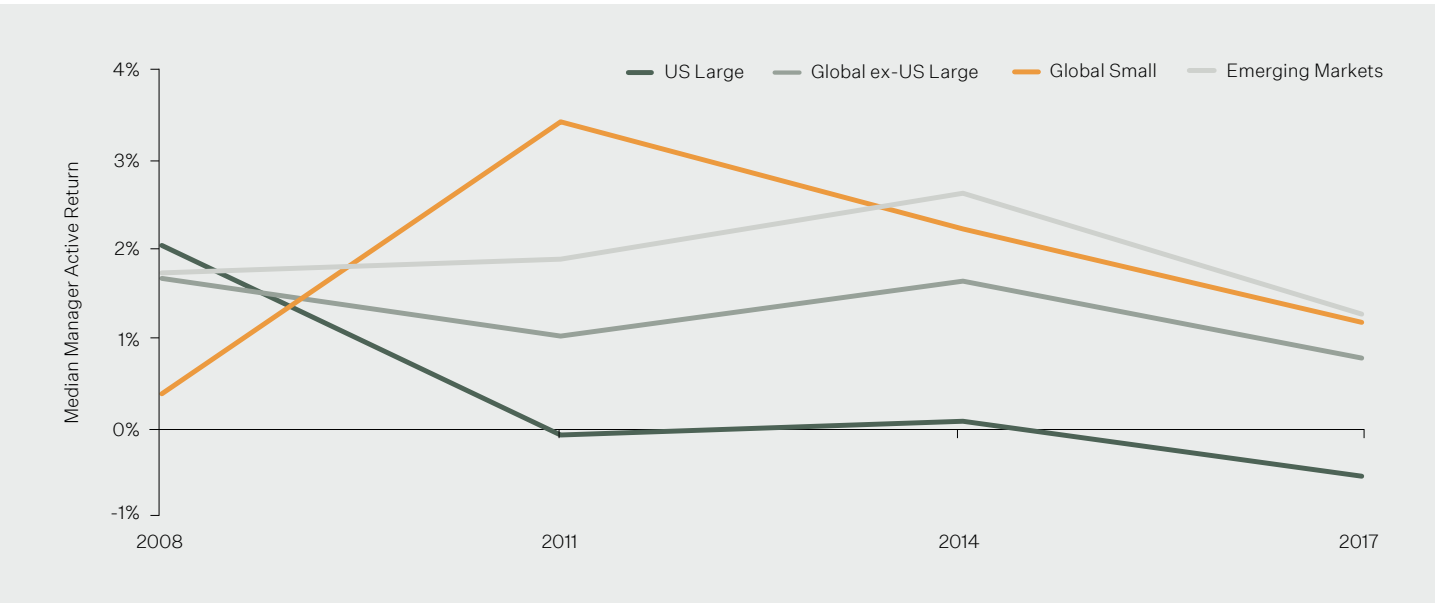


Figure 18: Active managers have performed better in inefficient markets (Gupta, Oberoi & Subramanian, 2018).



“Our approach to portfolio construction is highly collaborative”

### 3.6 Portfolio benefits from an allocation to global SMID

There is sufficient difference in the behaviour of stock prices of global small and mid capitalisation businesses compared to global large capitalisation businesses, thus an allocation to smaller global business is beneficial to total portfolio outcomes. Figure 19 shows the total return history of the MSCI Global Small and Mid Cap Index compared to the MSCI Global Large Cap Index and a blended portfolio (all unhedged).

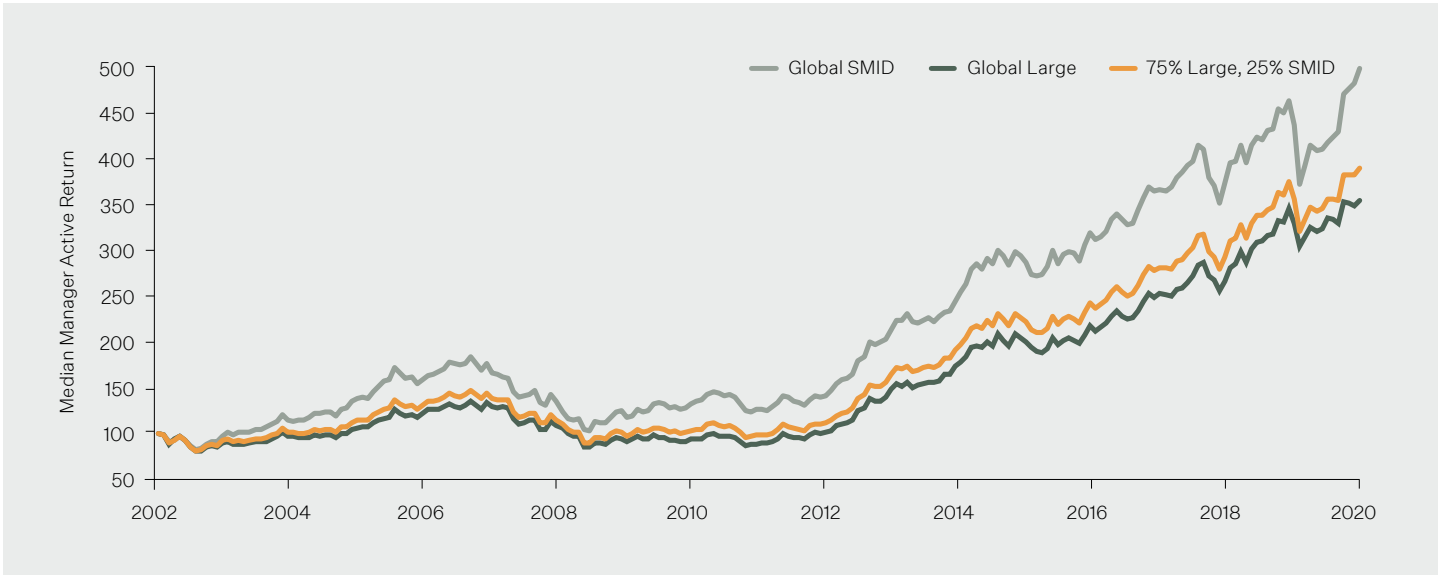


Figure 19: Total return history of global large cap vs global SMID cap (MSCI).

Over the period for which the MSCI indices are available (our data series begins in 2002) it is not surprising to see smaller capitalisation companies outperforming larger ones given what we know about the small company premium (see Section 3.1). Perhaps a less intuitive finding is that investments in smaller companies have exhibited a superior risk-return profile (excess return earned per unit of risk) as measured by the Sharpe Ratio (Figure 20).

From a portfolio perspective, making even a modest 25% allocation of the global equity budget to smaller companies has noticeably improved the risk-return characteristics of an aggregate global equity portfolio. The summary statistics in Figure 20 quantify the significantly increased annual return which has historically been achieved by a very modest increase in total risk. As a consequence, the blended global equity portfolio has delivered a superior Sharpe Ratio to investors compared with a global large cap portfolio in isolation.

	Global SMID	Global Large	Global Blend 75/25
Annual Return	8.7%	6.8%	7.3%
Standard Deviation	12.5%	11.3%	11.5%
Sharpe Ratio	0.42	0.30	0.34

Figure 20: Historic Risk and Return Statistics (MSCI AUD returns 2002–2019).



### 3.7 Unhedged portfolios have historically been more defensive

Investing offshore provides a risk mitigation benefit as a result of owning companies denominated in foreign currency. In the event of economic or financial market downturns that aren't idiosyncratic to a particular country, the Australian dollar has a tendency to depreciate relative to a basket of developed market currencies. This depreciation provides a partial hedge to a falling portfolio value at a time when it is most valuable. Figure 21 highlights the historical inverse correlation between the USD and the S&P 500 over the past twenty years.



Figure 21: 20 years to Sep 2018 of USD performance during equity declines (FactSet).

The ultimate barometer of the risk characteristics of an asset class was the realised performance during the 2008 financial crisis. During this difficult period, global SMID exhibited better risk control for unhedged Australian investors than both Australian large cap and Australian small cap equities (see Figure 22). This relative defensiveness comes from the tendency of the Australian dollar to depreciate relative to other developed world currencies in periods of economic stress, providing a buffer to unhedged AUD returns.

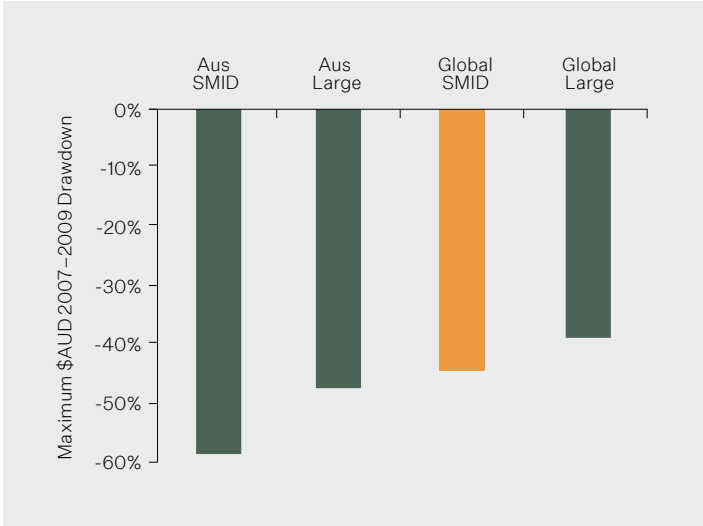


Figure 22: Global SMID outperformed domestic equities during financial crisis.

### 3.8 ESG on balance may help returns

The definition of what is socially responsible is continually evolving with significant change made since Milton Friedman (1970) advocated that the only social responsibility of business is to increase profits. In the decades since the industry has slowly converged upon a generally accepted framework for analysis generally referred to as ESG.

#### A company can be responsible in three different ways:

1. It can operate sustainably and have a minimal or positive impact on the environment.
2. It can produce products or offer services that benefit society.
3. It can adhere to prudent and proven corporate governance practices.

The central debate about incorporating ESG considerations into an investment process is whether it is additive or subtractive to investor returns. A large body of literature has investigated this empirically by comparing the historical returns of socially responsible companies (or mutual funds) with those of conventional companies (or market indexes). In the most comprehensive meta-analysis available to date, Friede (2015) identified approximately 2200 empirical studies published on the topic since research began in the early 1970s. Roughly 90% of these studies found a non-negative relationship whereby ESG investing was found to either be neutral or positive to financial performance. Significantly more than half the studies found a positive link between ESG considerations and corporate performance.

The most sophisticated studies are those that can isolate the impact of ESG from other sources of returns (e.g. market, industry). Briere (2017) decomposed the returns of almost 300 socially responsible equity funds over a ten-year period into three components: market return, asset allocation returns that are above market return, and the performance of active portfolio management. They then added a fourth component that specifically measured the effect of ESG screening. Their findings suggest that the impact of ESG screening on the variability of returns is roughly half that of the contribution made by active management and that investors in socially responsible investments can expect portfolio performance like that of conventional funds or of the benchmark, while meeting their socially responsible objectives.

Given the lack of academic consensus despite the large amount of resources that have been employed investigating the impact of ESG on investment returns, probably the most conclusive thing that can be said is that the results are highly sensitive to methodology and the time period under consideration. On balance the impact on performance appears to be modestly positive albeit not consistently nor always statistically significant. With more confidence we can conclude that at the very least there does not appear to be a cost to investing with regards to ESG considerations.

## 3.8 The boutique advantage

A study by the Affiliated Managers Group (2015) indicated that the performance of boutiques in aggregate, may be superior to that of large institutions. The analysis of institutional equity strategies from 1995 to 2014 quantified that:

- Boutiques significantly outperformed non-boutiques in institutional equity categories;
- Investing exclusively with boutiques would have created 11% greater wealth over 20 years;
- Boutiques also generated substantial net excess returns versus indices.

The group hypothesised that the results may be due to the structural advantages and alignment of the boutique model. Specifically, AMG suggested that boutiques were well placed because:

- Principals have significant direct equity ownership, ensuring alignment of interests with clients;
- Presence of a multi-generational management team fully engaged across the business;
- Entrepreneurial culture with partnership orientation attracts talented investors;
- Investment-centric organisational alignment including careful management of capacity;
- Principals are committed to building an enduring franchise embedding an appropriately long-term orientation.

De Souza and Gokcan (2003) found that hedge fund managers who invest their own capital in their funds are more likely to outperform, likely because such managers have greater conviction and are unwilling to accept uncompensated risks. The Fairlight principals invest the majority of their liquid assets in the business and the fund itself in order to maximise alignment with investors and partners.

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