



**Queen Street Partners  
Model Portfolio Report  
May 2009**

*“Capturing Emerging Manager Alpha”*

**Market Conditions**

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The market continued to rally into May, with the ASX300 finishing up 1.5%. Sentiment was driven by better economic data, such as Japanese industrial production. Domestically the federal budget release on May 8<sup>th</sup> failed to temper market enthusiasm, despite budget measures being seen as broadly negative for the superannuation industry. The financial sector remained positive for the month, with interest rates on hold and the RBA citing improving conditions in global markets. Bond prices continued to fall. The banking sector ended the month 2.2% up despite large capital raising activity. Optimism of a Chinese economic rebound pushed resource stocks higher, with a 30% jump in oil prices coupled with the falling US dollar very positive news for energy stocks. Small cap stocks did particularly well, with the Small Ordinaries returning 7.45% for the month, easily beating the 20 Leaders which returned -0.7%

**Emerging Manager Conditions**

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Industry reports of super funds' push towards greater Australian Equity indexation appeared negative for all active managers, whilst global evidence of appetite for emerging equity market products in May was very positive, with reports of good inflows at the expense of money market products. Domestically, new mandates were awarded to boutiques, and in general larger flows appear to be turning positive. Better performed incumbent managers saw cash flows as funds with underweighted equities sought to rebalance. Our recent contact with managers indicates improved confidence in the stability of emerging businesses. The only closures we are aware of affected older, emerged boutiques.

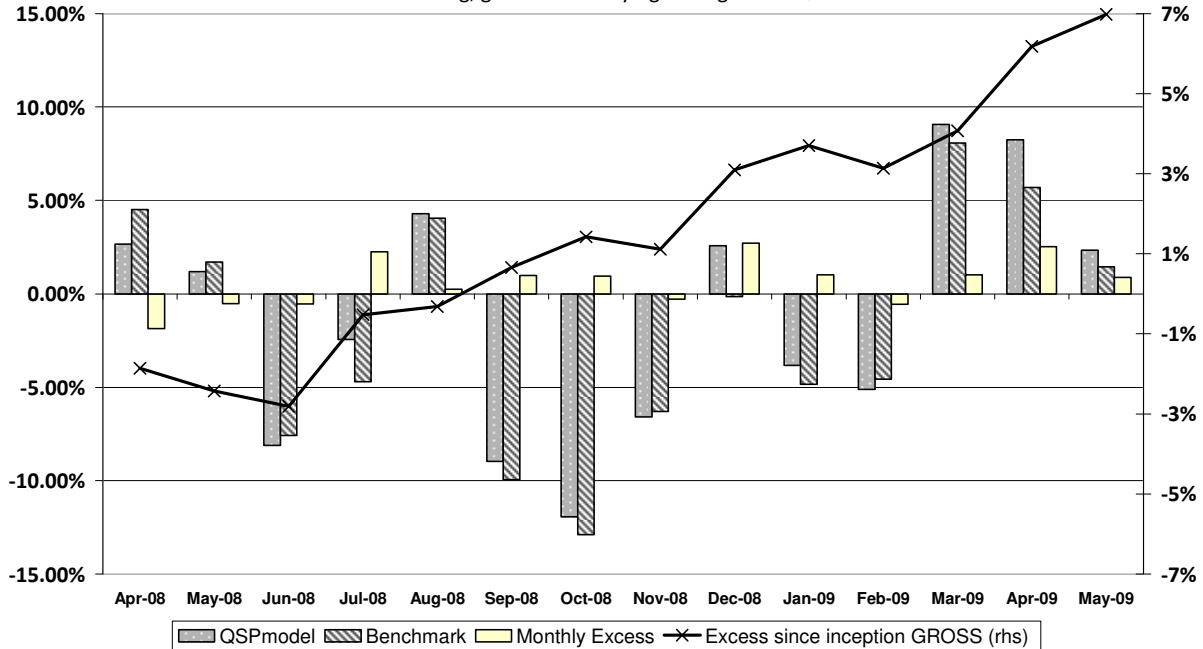
**QSP 300 Model Performance** (Inception April 2008)

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The model portfolio delivered 89 basis points of excess return gross of fees and taxes for May, in what was described by some fund managers as a tricky month in which some previously strong market trends reversed. This takes the excess performance of the model portfolio over the last 12 months to 8.3% and 6.9% since inception.

### QSP 300 Model Portfolio

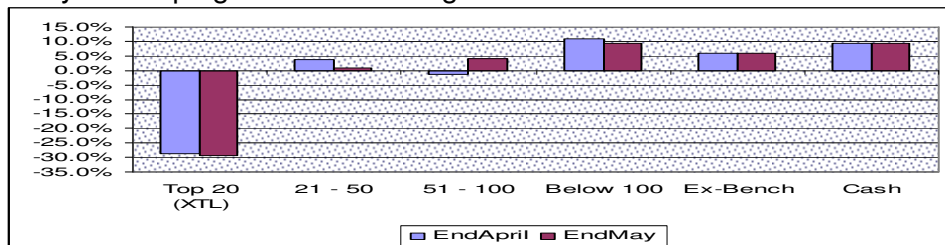
No rebalancing, gross of underlying manager and QSP fees



| gross of all fees    | 1 mth | 3 mth  | 6 mth  | 12 mth  | Inception |
|----------------------|-------|--------|--------|---------|-----------|
| QSP 300 Model        | 2.34% | 20.82% | 13.10% | -20.81% | -17.75%   |
| S&P/ASX 300 Accum    | 1.46% | 15.90% | 5.11%  | -29.19% | -24.73%   |
| Relative Performance | 0.89% | 4.92%  | 7.98%  | 8.38%   | 6.98%     |

Portfolio performance attribution was broad-based, with the bulk of excess return coming from consumer staples & discretionary, healthcare and utilities. Financials was the biggest detractor, with the large underweight in LPTs and banks. The Model's managers generally believe LPTs still represent a significant risk, with the odd exception. The bank underweight is in part a product of more cautious managers preferring to hold cash out of concerns relating to retail credit card debt exposure and the potential for future downgrades. By the end of the month, some managers had actively targeted a select few LPTs, and began slowly reducing their cash holdings, mostly in preference for more banking sector exposure. Smaller sector underweights to materials and energy also detracted, but were completely offset by the benefit of being underweight consumer staples.

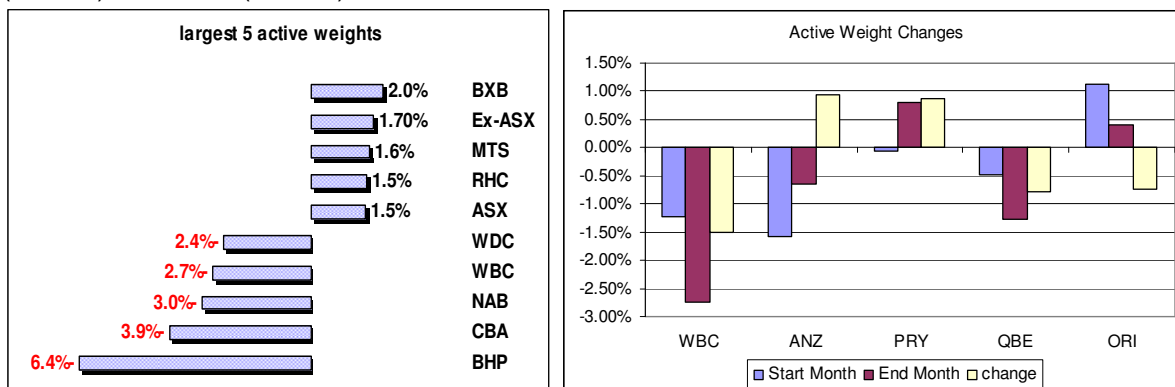
In terms of style, the portfolio started the month near style neutral on 2009 data but looking out to 2010 the portfolio begins to show a slight EPS growth tilt. The size exposure of the portfolio is more revealing, with a significant underweight to the top 20 contributing to performance. By the end of the month this underweight had slightly increased, along with a newly developing mid-50 overweight.



Change in active size exposure in the model portfolio, showing large ex-20 exposure

In terms of individual names, underweights to BHP (-6.4%), Westfield (-2.4%) and the big

banks are amongst the largest active underweight positions in the portfolio, whilst on the long side Brambles (+2.0%) is the largest overweight. Other overweights include a single non-ASX stock (+1.7%), and smaller positions in Metcash (+1.6%), Ramsay Health Care (+1.5%) and ASX (+1.5%).



Activity during the month included large changes in the active weights of Westpac and ANZ. Westpac, which announced dividend cuts and earnings at the low end of expectations in May had its underweight increased by 150bp, with about two thirds of this position being transferred to ANZ, which undertook a large capital raising during the month. Other activity included a large new position in Primary Health Care which also undertook a \$315m placement, a further reduction in QBE, and partial reduction of an overweight Orica position, which hit 6 month highs during the month.

## QSP300 Investment Outlook

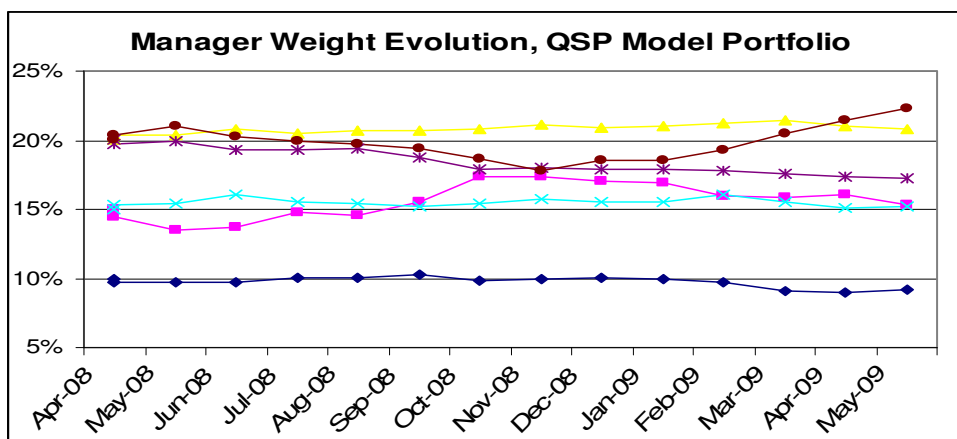
The general boutique consensus is that the market bottom has been reached, but the more macro-focussed managers express cautious optimism at continued signs of a weakening of the US downturn, but couple this with the expectation of further difficulties ahead, in short, ongoing volatility with a longer term upward trend. These influences should be felt in the portfolio through the presence of high quality defensives which retain a growth component. The rush of capital raisings has been seen as necessary in strengthening balance sheets in the face of debt rationing, but not always to the benefit of management. There is some concern that market intervention by governments has been more concerned with targeting measures of financial stability (e.g., credit spreads) rather than the economy itself. General stock-level observations are that low quality names have extended the recent market rally; our managers now hope that this will carry through to the more high quality companies in the portfolio.

## Rebalancing Decisions

The QSP Model portfolio initial manager allocations have not been rebalanced since inception in April 2008. Modelling indicates that the rebalanced performance would have not been as good, even without considering rebalancing costs. During the upheaval of the last year, individual manager returns have diverged quite significantly at times, which is both expected and a portfolio construction objective. In discussions with managers throughout, it has become apparent that most of the stocks that experience large negative returns often rebound just as strongly, which is consistent with well-known notions of mean-reversion and behavioural anomalies relating to the outperformance of past “losers” over past “winners”<sup>1</sup>. During more stable markets the timing of rebalancing is not likely to

<sup>1</sup> DeBondt, W. and Thaler, R. “Does The Stock Market Overreact?”, *The Journal of Finance*, Vol. 40, No 3 (July 1985),

be as important, but through periods of high volatility rebalancing can be both costly and counter-productive<sup>2 3</sup>. Our portfolio construction objective is to invest in a group of emerging managers who will in aggregate outperform across different market cycles, and as such the effect of poorly timed rebalancing would likely destroy the alpha generated by the diversity of the underlying managers. Certainly in the short-term we believe that emerging managers trading decisions, which are augmented by low funds under management, are capable of adding significantly to the capture of Emerging Manager Alpha. Work by Gallagher, Gardner and Swan<sup>4</sup> supports this view for Australian equity managers in general. The active evolution of our initial manager weights can be seen on the chart below. Divergences from initial weights have in general reverted towards their initial allocation.



Queen Street rebalancing decisions are generated through style/size exposure analysis and our manager rotation, evaluation and monitoring process. Rebalances may occur in response to significant manager organisational or process changes, changes in our assessment of a manager, or in response to their FUM growth and hence graduation from the class of emerging managers.

## Fee Impacts

In response to some recent queries about the impact of fees on our structure, we have reviewed the impact of underlying manager fees and our own fees, excluding tax effects, on the model portfolio performance. Queen Street's philosophy with regards to fees is that the client should expect to capture at least 65% of the gross alpha generated by the strategy. We are pleased to report that over the last 12 months the alpha capture by the client would have been approximately 75%. In practise it is likely we will be able to achieve further alpha-capture for the client through fee negotiation with underlying managers, and through transactional efficiencies achievable through the structure. Please contact us for further details.

## Queen Street Partners

pp. 793-805

<sup>2</sup> Perold, A. and Sharpe, W. F., "Dynamic Strategies for Asset Allocation", *Financial Analysts Journal*, Vol 51, No 1 (Jan/Feb 1995), pp. 149-160

<sup>3</sup> Dimson, E. and Marsh, P. "Index Rebalancing and the Technology Bubble", *Journal of Asset Management*, Vol 1, No 4 (March 2001), pp 311-320

<sup>4</sup> Gallagher, D. and Gardner, P. and Swan, P. "Excess Returns and Short-Term Institutional Trading", (2007) Working Paper, UNSW. Downloaded from <http://www.finance.unimelb.edu.au/Research/seminars/2007/Gallagher.pdf>

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We believe in combining contrasting and complimentary manager skill sets where there is a very strong alignment of interests between the ultimate client outcome and the success of the manager.

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