



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

***“Capturing Emerging Manager Alpha”***

**Market Conditions**

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Local markets roared back in July to levels not seen since brief highs in November last year, with the S&P/ASX300 price index finishing the month at 4238 points, or +7.34% on accumulation index numbers. Since March lows the market has rallied +36.6%. The Midcap 50 and Small Ords did particularly well, returning +9.75% and 9.02% respectively. Industrials led the charge with a +9.9% change, with all other sectors returning positive gains aside from Health Care, which declined by -2.2% for the month. Positive news driving local markets included building approvals numbers, a large surge in consumer confidence, a subdued rise in unemployment, positive signals from the RBA, and better than expected profit results, here and in the US.

Globally, July saw strong results in a wide range of markets. The S&P 500 was up 7.4% for the month, or 45.9% since the low on March 9<sup>th</sup> (in USD dollar terms). S&P's monthly report notes that this rally compares well with the 56.6% gain in 1933<sup>1</sup>. The FTSE All-Share rose 8.5% on better than expected earnings, and improving consumer confidence and housing prices, despite continued economic contraction. The VIX CBOE volatility index dropped to lows not seen since early September 2008, and TED spreads dropped to levels not seen since March 2007, down to slightly over 30bps. Oil prices retreated -0.63% in July, along with the US dollar, and across Asia ex-Japan markets performed well. The MSCI Asia Ex-Japan index fell early in the month before recovering strongly.

Within the broader Australian equity market result, cyclicals did very well, with the Media sector returning +17.8% after lagging the market for some time, led by West Australian News and APN, closely followed by Capital Goods (+17.2%) where Leighton Holdings had a good month, along with smaller names such as MacMahon, Emerco, GWA and Bradken. Healthcare stocks were largely down although a notable exception was Biota Holdings, which returned over 60% for the month. In terms of styles, high beta and highly volatile stocks continued to perform well in July, along with continued reversion of long-term losers and high book to market value stocks. 12-month momentum strategies performed poorly, with past 12 month losers doing very well. Size bias was in favour of small cap stocks. Quant models featuring composite and actual sales yield factors performed well, whereas growth in sales and cash yield forecast factors performed poorly.

**Emerging Manager Conditions**

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<sup>1</sup> [http://www2.standardandpoors.com/spf/pdf/index/2009\\_JULY\\_SP500.pdf](http://www2.standardandpoors.com/spf/pdf/index/2009_JULY_SP500.pdf)

Some managers decided to close shop in July. Despite good performance, the well regarded hedge fund aspirant Platypus Capital decided to wind up their fund which we believe reflects difficult hedge fund of fund markets conditions and slow uptake for single manager strategies by Australian institutions. Austock's high yield fund closed following organisational changes earlier this year, and MIR trimmed staff numbers. In what might be a sign the bottom has been reached for the hedge fund industry, John Meriwether, founding partner of Long Term Capital Management, decided to wind up his JWM Partners LLC on the back of large losses suffered since late 2007.

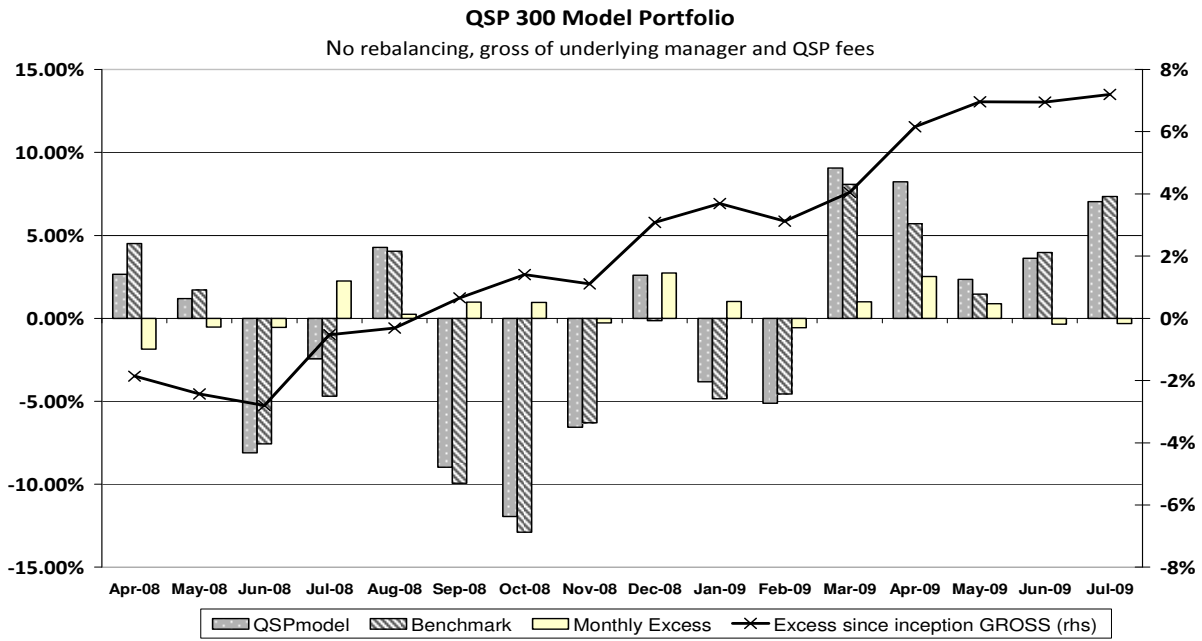
The appetite for funding new managers began to thaw in the month though broker reports suggest that while domestic institutions have been transitioning portfolios they have not been active equity buyers in the main, although they were stronger buyers in July than they have been in recent months. We did not see a lot of new Australian Equities allocations in July, but rather shifts in Bonds and International allocations. The fixed income boutique Kapstream hired a new analyst as its FUM climbed above \$600m. A few new LPT boutiques set up during the month, and Bennelong Equity Partners was added to Alpha Fund Manager's multi-manager product.

Globally, UK asset managers received record retail inflows in the June 2009 quarter, and hedge-fund flows have turned positive. New boutiques in Australia have largely weathered the storm and have generally managed to perform well, which has given investors further confidence to back them with new mandates. New staff hires have taken place with recruiters reporting a very busy month and overall an atmosphere of increased business confidence. It has also been interesting to see a few more emerging managers getting positive media exposure, following the negative sentiment about viability earlier in the year.

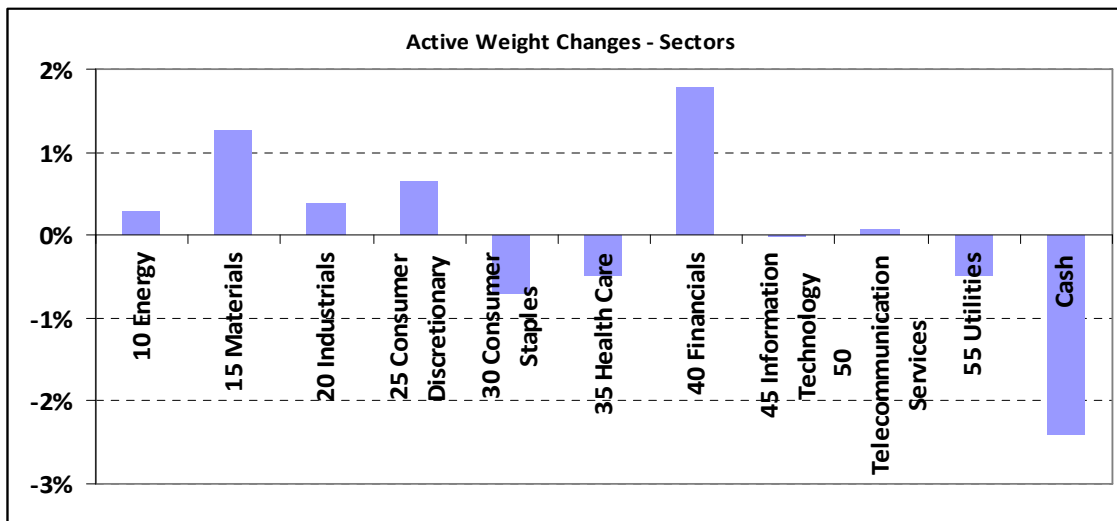
### QSP 300 Model Performance

The model portfolio gross return was +7.0% for the month versus the S&P/ASX300 accumulation return of +7.3%. Over the last 12 months the model portfolio has returned -2.0% versus -10.3% for the index, an outperformance of +8.3%, and cumulative -8.8% since inception (April 2008) versus -16.0% for the index. After all (notional) fees our 12 month outperformance is +6.6%, representing alpha capture for investors of over 80%. We are pleased that our portfolio has managed to both capture market upside and provide a degree of insulation in falling markets.

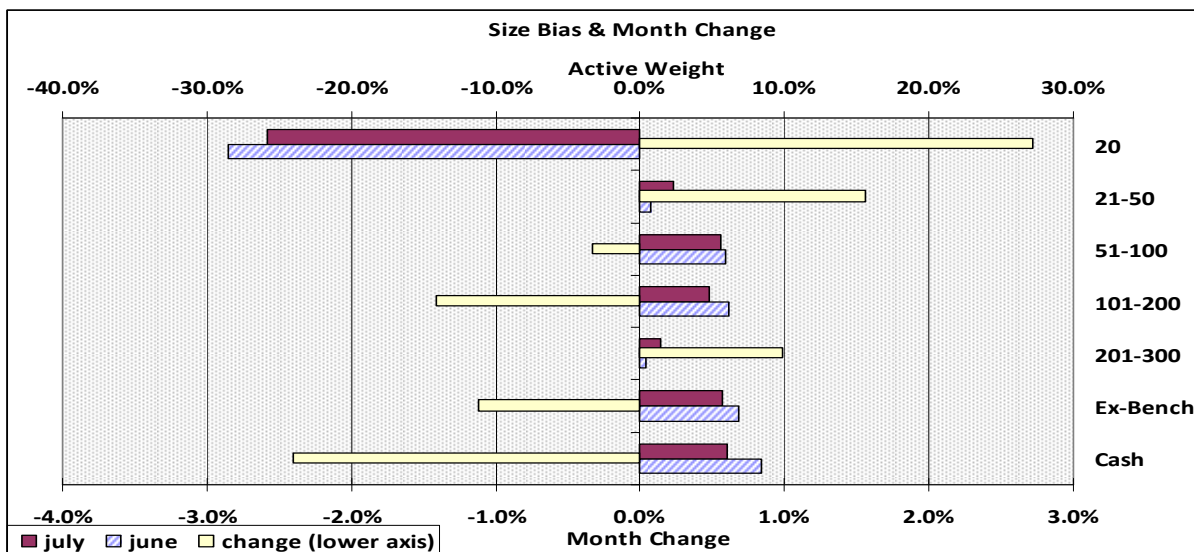
gross of all fees	1 mth	3 mth	6 mth	12 mth	Inception p/a	Inception
QSP 300 Model	7.07%	13.54%	27.16%	-2.01%	-6.64%	-8.75%
S&P/ASX 300 Accum	7.34%	13.22%	23.44%	-10.28%	-12.24%	-15.98%
Relative Performance	-0.27%	0.32%	3.73%	8.27%	5.60%	7.23%



Performance for the month came in slightly under the benchmark, returning +7.0% pre-fees. As with the previous month, the large underweight to financials is the most significant tilt in the portfolio, at -13.5%. This sector conviction across several well regarded emerging managers employing different strategies is a notable feature of the QSP 300 portfolio. This underweight reduced performance by 84bps, which was more than made up for by the contribution of overweights to Industrials and Consumer Discretionary stocks. Our -6.96% active weight in Materials stocks also detracted from performance by 26bps after the sector returned 9.5% for the month. By the end of the month the underweights to Materials and Financials had decreased, as had the cash exposure of the portfolio, down from 8.4% to 6.0% by the end of July.

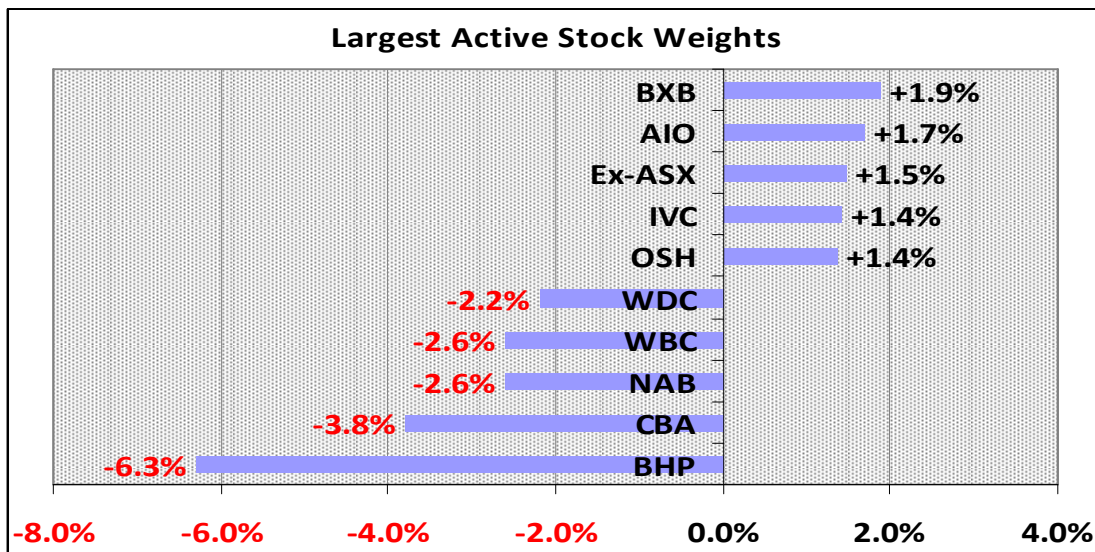


Excess performance largely came from Ex-50 stocks. Our top-20 exposures underperformed their benchmark contribution by almost 200bps. Large underweights to top-20 stocks reduced by 2.7% during the month but the portfolio remains 26% underweight the Top-20. Outperformance mostly came from the 51-200 bracket, which contributed 126bps. Boutiques continued to actively participate in capital raisings throughout July.



On value measures such as P/E and P/Book ratios the portfolio remains largely neutral, but managers are clearly expecting upward revisions of 2010 eps growth numbers. Looking out to 2011 numbers the growth tilt of the portfolio was under that of the benchmark. By the end of the month the eps growth tilt had increased but remained slightly under the benchmark. The largest shift during the month was in the cash flow per share estimates, with the fund showing a significant tilt over the benchmark which increased by almost 70% on 2010 numbers through the month, largely through resource and energy exposures. Dividend yield exposure also increased on 2010 forecasts.

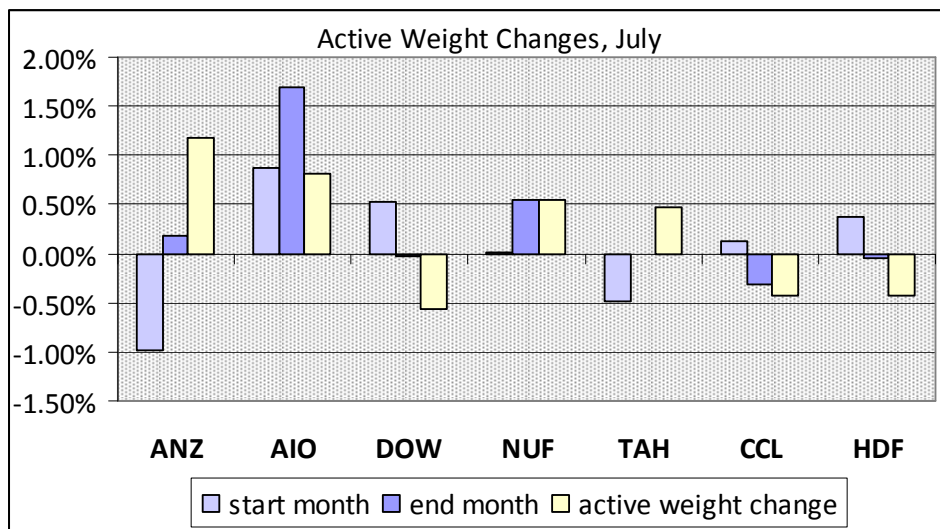
The beta of the portfolio increased from 93% to 97% by the end of July, and the ex-ante tracking error also increased, from 3.4% to 3.6%, although the majority of the higher tracking error managers in the portfolio actually saw a TE. decrease during the month. Portfolio overweights include Brambles (+1.9%), Asciano (+1.7%), Invocare (+1.4%), OilSearch (+1.4%) and a single ex-ASX stock (+1.5%). Underweights include BHP (-6.3%), CBA, NAB and Westpac (collectively -9.0%) and Westfield Group (-2.2%).



The ten largest individual active stock positions in the portfolio at end July

During the month stock activity saw the position in ANZ move from a -1% underweight to a slightly overweight position. ANZ moved to take over the Asian banking assets of RBS

during the month, raised \$2.2b AUD in a share placement, and appointed John Morschel as Chairman. The stock outperformed the other major banks for the month by over 430bps. Asciano was the next largest active weight change, almost doubling from 88 to 169bps. Popular with large institutional investors BT and emerged boutique Ausbil Dexia, Asciano's CEO sold down \$50m shares to take up his rights entitlement, which opened the door for potential takeover offers. New deals with XStrata and the successful completion of a \$2.4b capital raising reduced debt and increased the positive outlook for the company and saw the stock outperform BBI and Toll Holdings by over 870bps. An active position in Downer was largely closed out and a very small position in Nufarm increased to 55bps in a month in which Sinochem made a takeover approach, pushing the stock up almost 20%. A position in Tabcorp Holdings was sold off, and CCL's portfolio weight was reduced by 44bp to a small position in a single underlying manager. CCL's CEO hinted early in the month that the group might be interested in making a play for some of Foster's assets and Citi upgraded their target price for the stock. Fitch retention of Coke's BBB+ IDR rating was also a positive, providing good opportunity for profit taking as the price approached the Citi target later in the month. Lastly, HDF was sold off dramatically. Their institutional offering at 90c quickly saw the share price descend to that level and below. A broker upgrade from UBS and substantial buying by value manager Orbis had no effect and the stock remained depressed for the month.



### QSP300 Investment Outlook

July saw increasing confidence amongst emerging managers we surveyed. Many are expecting earnings estimates for FY10 dating from earlier this year to be revised upwards on renewed optimism and confidence in the economic fundamentals, and are hence managers are winding back some defensive positions. More defensive managers have underperformed in July, and are concerned about the earnings quality of many of the companies now leading the recovery, and have retained a cash position, albeit reduced. In particular, concerns around the strength of many financial stocks continue to linger, with the potential for increased volatility on any negative news disturbing the current bout of optimism. A raft of equity raisings at discounted prices has continued to be good ground for outperformance by managers. Some but not all are looking to the continuing good news from China, in terms of the Purchasing Managers Index (PMI), electricity generation and other indicators as signs of an increasingly positive environment. Managers are generally positive towards the Australian economy but bearish about the US and the possibility of

higher A\$ interest rates in the medium term. China sentiment remains generally strong with the commodities sector seen as a sound medium term support for the Australian market.

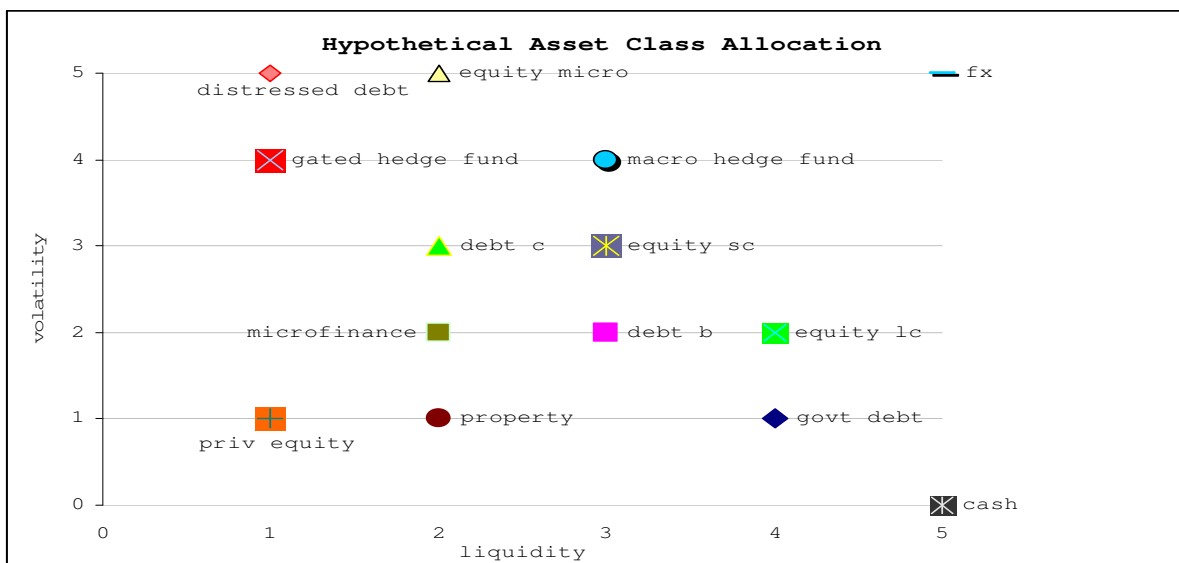
## **Diversification in Multi-Manager Portfolios**

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In this section we comment on diversification in multi manager portfolios. One of the problems typically faced in multi-manager portfolios is that of retaining the diversity of individual manager investment strategies when blending different managers at the total portfolio level. The goal of maximising the benefits of active management, whilst avoiding excessive fees and managing multiple relationships is lost if the result is simply an index-like fund. This can be best avoided by identifying and capturing diverse and reasonably uncorrelated sources of alpha, which combine to reduce individual manager and individual strategy exposure risk in an efficient and tractable structure.

For any long-term investment programme, diversification is obviously an excellent risk management tool, but the traditional partitioning of a risk budget into segments which are defined more by the market mechanism of exchange rather than the actual underlying risk exposure can muddy the waters considerably. To understand this, consider a typical partition, Australian Listed Equities and Private Equity. An equity fund which invested in listed infrastructure investments would clearly provide very little reliable diversification against the Private Equity Infrastructure component of the total portfolio. The mechanism of exchange for an investment provides considerable insight into liquidity and pricing considerations but does not give a clear indication of true diversification for the total portfolio manager, and does not provide a sensible asset allocation risk “bucket”. The same could be said about listed property and direct property and indeed, for some forms of corporate debt and ordinary equity.

Therein, however, lies the insight to a more reliable asset allocation paradigm; that of liquidity budgeting. The typical superannuation fund has great insight into the future liability and liquidity requirements for assets under management, and the allocation of assets into required liquidity partitions allows for a far cleaner matching of funds with investments. Within each partition it is then up to the risk allocator to diversify funds within investments which meet the required liquidity constraint, irrespective of the traditional classification of investments within that partition. It would also seem more intuitive to model *liquidity at risk* through modifying traditional VaR type scenarios, because when markets suffer downturns in general what is really happening is that liquidity is being removed. With the rise of investor decisions in asset allocation through choice of fund and investment switching within funds, and the need to manage potential currency hedging requirements, liquidity budgeting becomes all the more important.



If we consider a hypothetical liquidity versus volatility classification of asset classes above, we see that within each generalised liquidity band we have multiple traditional asset classes to allocate our risk budget across, allowing us to match not only future liabilities against expected returns but also required liquidity against expected future redemptions. What the chart above also demonstrates is that budgeting by liquidity requirements breaks down traditional asset classification schemes.

Within the context of portfolio construction and manager blending at Queen Street Partners, liquidity risk is a consideration in terms of both allocating to managers who invest in small and microcap stocks, and in planning manager transitions. Most of the managers we consider have low funds under management, which greatly reduces their share price impact, and their liquidity risk. Managers with significant FUM wishing to bring about large position changes in their portfolios can have significant price impacts, and in this sense, smaller more nimble boutiques can be seen to run at considerably lower liquidity risk levels. How emerging managers consider liquidity in terms of capacity management forms part of our assessment of a manager's scalability and suitability for taking up large mandates, and FUM growth concerns form a major part of our manager rotation decisions.

A common problem reported to us by super funds in 2008 was that multi-manager structures which were built with traditional diversity in mind, particularly with regard to value and growth measures, had in many cases yielded underlying investments which performed similarly and had even held very similar stock positions, not providing the diversity intended. While in many ways there was "no-where to hide" in terms of stock positions through the financial crisis, there was still a differential reaction to the crisis across sectors and liquidity bands. For example, an over reliance on small caps (e.g., liquidity and IPO driven strategies) as an alpha source, or an aversion to resources stocks (e.g., deep value bias) left those super funds with multiple portfolios holding very risky positions (notionally high "liquidity VaR"). This represented greater risk and management costs for the total fund.

The Queen Street portfolio construction process aims to reduce total portfolio risk through combining boutique managers with different investment strategies, including timing, factor exposure and stock selection decisions. Our process combines risk diversification with the appeal of concentrated high conviction strategies, which are often favoured by boutiques who don't want to build large FUM businesses, and which suit the smaller teams which typify them. Ideally, this allows us to combine different portions of market exposure into a

lower risk, more style agnostic portfolio without diluting overly the active positions which drive the outperformance. Emerging manager portfolios constructed in this way can benefit the investor who has their largest allocations with large FUM mature boutiques and institutional managers whose investment philosophy is more concerned with tracking benchmarks.

## **Emerging Manager Ratings for All**

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As mentioned last month, Queen Street Partners is building a manager ratings framework to provide a useful reference for those investors interested in familiarising themselves with our emerging manager universe. We are currently trialling a variety of formats, aiming to deliver a fresh perspective, and more than just a cut-down version of the standard fund report. We will be writing to you shortly with a brief synopsis of how one might run an emerging managers program. If you would like to register your interest in receiving QSP's Short-Form ratings please contact us directly, or sign up online on our website <http://www.queenstpartners.com/signup.htm>

## **Queen Street Partners**

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Queen Street Partners is an employee owned multi-boutique investment manager and consultant specialising in discovering, researching, constructing and monitoring Australian Equities portfolios of employee-owned emerging and boutique fund managers, which Queen Street believe capable of delivering superior performance over time. The Queen Street research and investment process incorporates qualitative and quantitative techniques, with significant focus on identifying Emerging Manager Alpha potential alongside long term business viability.

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, and welcome enquiries from organisations who share our perspective.

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