Lonsec

Recommended

Product Review
Perpetual Equity Investment Company Limited

About this Review

ASSET CLASS REVIEWED	AUSTRALIAN EQUITIES
SECTOR REVIEWED	AUSTRALIAN LARGE CAP
SUB SECTOR REVIEWED	LIC
TOTAL COMPANIES RATED	11

About this Company

LIC REVIEWED	PERPETUAL EQUITY INVESTMENT COMPANY LIMITED
ASX CODE	PIC
ASX LISTING DATE	18 DECEMBER 2014
COMPANY OBJECTIVE	GROWING INCOME STREAM AND LONG-TERM CAPITAL GROWTH ABOVE THE INDEX OVER A FIVE-YEARS.
RECENT CAPITAL MANAGEMENT	DIVIDEND RE-INVESTMENT PLAN
MANAGEMENT COSTS	1.35% P.A.

Market data

MARKET CAPITALISATION	$303M
SHARES ON ISSUE	254M
SHARE PRICE (11-7-2018)	$1.19
52 WEEK HIGH/LOW SHARE PRICE	$1.19 / $1.04
NTA (5-7-2018)	$1.16
52 WEEK HIGH/LOW NTA	$1.19 / $1.07
SHARE PRICE PREM/(DISC) TO NTA	2.59%

Board of Directors

NO. OF DIRECTORS	5
MAJORITY INDEPENDENT DIRECTORS	YES
CHAIRPERSON	NANCY FOX
AGGREGATE DIRECTORS FEES	$170,000 P.A.
COMMITTEES	NOMINATION & CORPORATE GOVERNANCE, AUDIT & RISK

About the Investment Manager

INVESTMENT MANAGER	PERPETUAL INVESTMENT MANAGEMENT LTD
OWNERSHIP	WHOLLY OWNED BY PERPETUAL LIMITED
ASSETS MANAGED IN THIS SECTOR	$20.9B (31 MARCH 2018)
YEARS MANAGING THIS ASSET CLASS	51

Investment Team

PORTFOLIO MANAGER	VINCE PEZZULLO
INVESTMENT TEAM SIZE	17
INVESTMENT TEAM TURNOVER	LOW
STRUCTURE / LOCATION	CENTRALISED / SYDNEY

Investment process

STYLE	ACTIVE – VALUE, HIGH CONVICTION
BENCHMARK	S&P/ASX 300 ACC. INDEX
MARKET CAPITALISATION BIAS	MID-CAP
STOCK POSITION LIMITS	15% OF PORTFOLIO'S NAV
GLOBAL EQUITY / CASH LIMITS	0-25% OF PORTFOLIO'S NAV EACH

Company rating history

JULY 2018	RECOMMENDED

What this Rating means

The **'Recommended'** rating indicates that Lonsec has strong conviction the financial product can generate risk adjusted returns in line with relevant objectives. The financial product is considered an appropriate entry point to this asset class or strategy.

Scope of this rating

- Lonsec has used its Managed Funds research process in forming an opinion on this Listed Investment Company's (LIC or Company) ability to meet its stated investment objectives. The extent of any 'point-in-time' divergence between PIC's share price and its underlying Net Tangible Asset Value (NTA) per share is not part of the ratings consideration.
- Lonsec does consider whether structural or management issues could potentially lead to a LIC trading at a significant discount to its NTA over an extended period of time without any recourse for shareholders. This aspect forms part of the wider qualitative and quantitative assessment that Lonsec undertakes when assessing the relative investment merits of a LIC.

Strengths

- Vince Pezzullo is an experienced Portfolio Manager with a strong track record of performance at Perpetual.
- Robust and repeatable investment process.
- Majority of directors have been designated as being 'independent' by the Company and these directors have been on the PIC Board since its inception in 2014.
- PIC has a three-year track record of growing its dividends.

Weaknesses

- PIC has had some recent turnover in the ranks of Executive Directors, including in the role of Chair. Further, Perpetual recently lost its CEO Geoff Lloyd.
- Lonsec's preference is for the role of Chair to held by an individual designated as being 'independent' by the Company.
- Pezzullo has a heavy workload given his Deputy Head of Equities responsibility and portfolio management duties.
- There is currently no clear link between the performance of global equity stocks in the PIC portfolio and the remuneration of the global equity analysts who have recommended the position. Lonsec acknowledges that the Manager is currently seeking to address this in the near future.
- Perpetual has significant assets under management across its equities business. The potential commonality of holdings between products, given the nature of the investment process, amplifies group-

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ANALYST: PETER GREEN | APPROVED BY: ADRIAN HOE

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wide capacity issues. Furthermore, the high level of FUM may constrain the ability of PMs to access the analysts' best ideas.

Company Risk Characteristics

	LOW		MODERATE		HIGH
BUSINESS SUSTAINABILITY RISK			●		
CAPITAL VOLATILITY					●
SECURITY LIQUIDITY RISK			●		
SECURITY CONCENTRATION RISK				●	

Risk categories are based on Lonsec's qualitative opinion of the risks inherent in the financial product's asset class and the risks relative to other financial products in the relevant Lonsec sector universe.

BIOmetrics

Aggregated risks

	1	2	3	4	5	6	7
STD RISK MEASURE						●	

A Standard Risk Measure score of 6 equates to a Risk Label of 'High' and an estimated number of negative annual returns over any 20 year period of 4 to less than 6. This is a measure of expected frequency (not magnitude) of capital losses, calculated in accordance with ASFA/FSC guidelines.

	LOW		MODERATE		HIGH
RISK TO INCOME		●			

Features and benefits

	LOW		MODERATE		HIGH
COMPLEXITY		●			
ESG AWARENESS			●		

Fee profile

	LOW		MODERATE		HIGH
FEES VS. UNIVERSE					●
FEES VS. ASSET CLASS					●
FEES VS. SUB-SECTOR					●

Fee BIOmetrics are a function of expected total fee as a percentage of expected total return.

What is this Company?

- Perpetual Equity Investment Company Limited (PIC or 'the LIC') is a listed investment company ('LIC') that has the dual objectives of providing investors with a growing income stream and long-term capital growth in excess of the S&P/ASX 300 Accumulation Index ('the Benchmark'). 'Long-term' is defined as being a minimum of five years. PIC first listed on the ASX in late 2014 and passed its three-year anniversary as a listed entity.
- Perpetual Investment Management Limited (Perpetual or 'the Manager') is the Investment Manager for PIC. Perpetual has a long standing 'bottom-up' investment philosophy based on identifying 'quality' companies whose securities the Manager believes to have valuation upside. It's investment approach first aims to avoid poor quality companies by assessing these against four quality criteria, being quality of business, conservative debt, sound management and recurring earnings. Companies that pass this quality filter are considered to be of investment grade. The Manager then assesses the relative attractiveness of these higher quality companies, investing in those that it believes to be trading at a discount to the Manager's assessment of inherent value.
- While PIC's investment objectives are expressed with a reference to an equity benchmark, it is run in a relatively 'benchmark unaware' manner with broad stock limits of 15% of the LIC's net asset value ('NAV') and no specific Tracking Error target. PIC also has a flexible asset allocation mandate that allows it to invest up to 50% of NAV in cash and/or global developed market equities (up to 25% in each). This internal asset allocation decision is largely valuation driven.
- PIC has a 'high conviction' approach to stock picking and will hold between 20-40 stocks. Lonsec expects the global equities allocation to be actively used. The LIC has a distinct mid-cap focus for its Australian equity allocation, although PIC will move up (and down) the market capitalisation spectrum as valuation opportunities emerge. The allocation to global equities is more opportunistic in nature and any securities purchased are not expected to exhibit any particular capitalisation bias. It is the Manager's expectation that the global securities will typically be larger and more liquid than comparable Australian-listed securities.
- Given the Manager's 'value' philosophy, Lonsec expects the LIC to underperform in the latter stages of a 'bull' market. This is a relatively common trait for managers implementing a 'value' style. Similarly, Lonsec considers the LIC's ability to vary its market exposure via its cash allocation to provide it with greater down market resilience than peers who are mandated to remain fully invested. Lonsec notes, however, that the portfolio's net equity position is not a market timing tool. Rather it is a reflection of the number of high conviction stock ideas within the investment grade universe.
- Lonsec notes that the Manager expects the portfolio to typically be unhedged despite the LIC actively being invested in offshore securities. Currency exposure may only be hedged where the Manager sees a significant risk of currency weakness. Currency hedging will never be actively employed in an attempt to add value above the Benchmark return.
- PIC has a management fee of 1.0% p.a. if the portfolio has a total NAV up to $1b, dropping to 0.85% p.a. for NAV above $1b. There is no performance fee. As the current NAV is well below $1b, the management fee is 1.0% p.a. Lonsec notes that PIC also incurs a number of fixed costs on an on-going basis. These include directors fees, audit fees, and listing costs. Combined, total 'other expenses' incurred for the 12 months ended 30 June 2017 was approximately $0.78m or 0.35% of NAV. This means that PIC's current MER is estimated by Lonsec to be 1.35% p.a.
- Lonsec notes that PIC's fees are at the upper end of the Lonsec range for its wider 'value' peer group but largely in-line with other recent LIC IPOs with similar mandates and external investment management structures. Lonsec observes that there are a number of well-established Australian equities focused LICs that have significantly lower fee structures; typically these tend to be internally-managed and demonstrating much higher absolute net assets. However, Lonsec acknowledges that PIC is much higher conviction in nature than many of these incumbents and has the ability to invest in global equities or cash.

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- Lonsec notes that the Manager has been appointed as the Investment Manager of PIC under an initial five-year term which ceases in October 2019. Lonsec notes that at this point, the agreement will automatically be extended by an additional five-year term unless there is a share-holder vote against this via an ordinary resolution or a similar vote to wind-up the LIC. The LIC may also terminate the agreement at this point by providing three-months notice. Lonsec notes that the anniversary is coming up and would reserve its right to review its rating if the Manager were to be removed from PIC.
- Lonsec notes that once the management agreement is extended into an additional term, then the Prospectus has a punitive clause which entitles the Manager to a termination payment at the termination date should it be removed. This termination payment is equal to 5% of NAV, reduced by 1/60th for each whole calendar month elapsed between the commencement of the extended term and the termination date. Lonsec notes that this payment would only be made 'in certain circumstances', which Lonsec believes would be most applicable in a hostile investment management change situation. For instance, this may occur if a third party were to seek to remove the incumbent investment manager for non-investment/ operational reasons.
- The Prospectus clearly spells out the circumstances where the Company can terminate the management agreement without triggering the termination payment clause. This includes clauses for operational issues such as insolvency or AFSL suspension of the investment manager, and pleasingly also allows for recourse if the Manager persistently fails to ensure investments are made that are 'consistent with the Company's investment strategy'. Nonetheless, the risk remains that should the agreement be terminated by the Company earlier in the extended term then investors could incur a significant compensation claim up to 5% of NAV. Lonsec notes that such clauses typically have not been included in other recent LIC IPOs that it has reviewed.
- Lonsec considers a key risk for investors in any LIC to be the possibility that these trade at a substantial discount to NAV for lengthy periods of time. Lonsec considers that trading at such a discount is a somewhat higher risk for PIC than for some other LIC peers. The main reason for this is the greater reliance on trading gains for generating accounting profits, the mid-cap investment focus, the high conviction style and the typically unhedged currency exposure. However, Lonsec notes that PIC has some relative strengths including reasonable liquidity, solid performance and a growing track record of paying a sound level of fully-franked dividends. These have contributed to the PIC share price trading in a much tighter band post the options expiry. They had traded at a substantial discount to NAV before this.
- Lonsec notes that the PIC Board of Directors (the 'Board' or 'BOD') has a growing track record of sound capital management. PIC has recently turned on its Dividend Re-investment Plan ('DRP') following the improvement in its trading. The BOD has also displayed a conservative approach to dividends including a sustainable pay-out ratio and a policy of building retained earnings.

Using this Company

This is General Advice only and should be read in conjunction with the Disclaimer, Disclosure and Warning on the final page.

- PIC is subject to equity market risks and movements (both positive and negative) in the prices of the underlying securities in the portfolio. Potential investors should therefore be aware of, and comfortable with, the potential for PIC to experience periods of negative absolute returns which may result in capital losses being incurred on their investment.
- Lonsec notes that PIC also has the objective of providing investors with a growing income stream. Lonsec notes that this income stream is an outcome of the Manager being mostly fully-invested in dividend-paying Australian and global equities. There is no guarantee that such entities will be able to continue to pay out a growing level of dividends on a yearly basis.
- Lonsec recommends advisors consult the Lonsec Risk Profile Review and/or the Lonsec Risk Profile Definitions document/(s) for guidance on appropriate asset allocations to Australian Equity within a diversified investment portfolio. Lonsec recommends that equity investments are suitable for investors with an investment time horizon of at least 5 years.
- The LIC is a 'long only' Australian equity product which will predominately be fully invested in the Australian and global developed equity markets. As such PIC will generally sit within the growth component of a diversified investment portfolio. As a 'value' style product with the ability to hold up to 25% of its NAV in cash, Lonsec considers it suitable for blending with other Australian Equity strategies including 'growth / GARP / core' style biased funds, small cap, long short, or Absolute Return products.

Suggested Lonsec risk profile suitability

SECURE	DEFENSIVE	CONSERVATIVE	BALANCED	GROWTH	HIGH GROWTH
		●	●	●	●

For guidance on appropriate asset allocations and risk profiles, refer to the latest Lonsec Strategic Asset Allocation Review and Risk Profile Definitions on our website.

Changes Since Previous Lonsec Review

- Lonsec reviewed the IPO of PIC in 2014. This is Lonsec's initial review of PIC since its IPO.

Lonsec Opinion of this Company

Board of directors

- PIC has its own separate Board of Directors ('BOD') that consists of five members, with three of these being designated as being 'independent' by the Company. The 'independent' directors are Virginia Malley, John Edstein and Christine Feldmanis. Lonsec notes that the Chair of PIC, Nancy Fox, is not designated as being 'independent' as she is also a current Non-executive Director of Perpetual Limited. While pleased with the Company having designated a majority of its Board as being 'independent' directors as per the ASX rules, Lonsec's preference is for this to be extended to the role of Chair.
- While highlighting the stability of PIC's 'independent' directors who have all been members

of the BOD since PIC's inception in 2014, Lonsec notes that there has been some instability in the ranks of the 'non-independent' directors. This includes the role of Chair, which saw Fox replace the incumbent Peter Scott upon his retirement from the role in June 2017. Lonsec notes that the resignation of Perpetual CEO Geoff Lloyd has also impacted PIC as he was a director. He has been replaced by David Lane who is also the current Group Executive of Perpetual Investments.

- The Board is very experienced and Lonsec considers that it is comprised of a mix of individuals with the requisite experience and skills in both financial services and funds management to allow PIC to meet its investment objectives. In terms of the new Chair, Lonsec notes that she is the former Managing Director of ABN Amro Australia and Ambac Assurance Corporation with her career in financial services spanning over thirty years. As well as being a current director of Perpetual, she is also a member of its Audit, Risk and Compliance Committee and its People and Remuneration Committee. Hence, Lonsec considers Fox to be a very experienced addition to the PIC BOD.
- Being ASX-listed, PIC also needs to comply with the stringent listing rules of the ASX.

People and resources - Investment manager

- The Portfolio Manager ('PM') of PIC is Vince Pezzullo who has managed this product since its inception in 2014. He has extensive PM experience at Perpetual and is also the PM for the Australian Share Fund, Geared Australian Share Fund and Direct Equity Alpha SMA. He has also been the co-PM for the Industrial Share Fund in the recent past. Lonsec notes that the Direct Equity Alpha Fund which Pezzullo has run since 2008 has a similar 'high conviction' design and mid-cap focus. Lonsec has a positive view of Pezzullo's investment experience and PM track record and believes him to be well qualified for this role.
- Lonsec cautions that Pezzullo has a heavy workload across the four funds. While noting that there is likely to be a high degree of cross holdings among the best Australian mid cap 'value' ideas, Lonsec notes some mandated difference with the Australian Share Fund having more of a large cap focus and the LIC actively investing in its global equities component. Lonsec notes that Pezzullo is also the Deputy Head of Equities in the wider business. While expecting Pezzullo to receive plenty of relevant support from the wider investment team, the risk remains that investor performance is impacted by a lack of focus on a particular capability. Having highlighted the risk, Lonsec acknowledges that Perpetual has a long-track record of portfolio managers having responsibility for multiple capabilities.
- Pezzullo reports to Perpetual's Head of Equities, Paul Skamvougeras. Lonsec holds similar conviction in Skamvougeras who has been in the critical Head of Equities role since 2015. As with Pezzullo, Lonsec considers Skamvougeras to be highly capable investor and an effective leader. Skamvougeras has 15 years of tenure at Perpetual and 22 years of industry experience all up, while Pezzullo has been at Perpetual for 10 years and has 23 years of industry experience.
- Lonsec notes that while the above investment leadership team has been in place since 2016, the team has been beset by the periodic loss of some senior investors in the medium-term such as John Sevior (2011), Charlie Lanchester (2013), Matt Williams (2014) and Nathan Parkin (2016). Each was in the Head of Equity or Deputy Head of Equity roles upon their departure as well as having portfolio management responsibilities. While concerned at the time, Lonsec is pleased to note that these roles have been stable since Parkin's departure.
- While not as close to the 'coal face', Lonsec highlights the departure of Geoff Lloyd, Perpetual Limited CEO. Lloyd had been the CEO at Perpetual for five years. Lonsec notes that Rob Adams has been appointed as Lloyd's successor and will join in late September 2018. Adams has had an extensive executive career in financial services and funds management, including the Head of Pan-Asia for Janus Henderson (current role) and the CEO of Challenger Funds Management. While acknowledging Adams credentials for this role, Lonsec cautions that there is inevitably a transition risk whenever there is a change in the CEO role for any organisation.
- In Lonsec's view, Perpetual's Australian Equities sleeve of the broader investment team remains one of the largest and more experienced in the Australian market, with a number of high quality senior personnel. The Manager has shown a commitment to growing the team in recent times, with the addition of five analysts in the last two years. The Australian equities team is 17-strong and includes six portfolio managers, one deputy portfolio manager and ten analysts. All portfolio managers report through to Skamvougeras while the analysts report to Pezzullo.
- The Manager has historically sought to appoint or promote analysts internally, based on performance merit, considering such efforts to be good for the investment culture and career progression. However, Lonsec notes that some recent appointments, including those of the last three equity analysts hired in Nicholas Vidale, James Rutledge and Rebecca O'Dwyer, have been external. In Lonsec's view, this in part reflects some of the mixed performance of the various Australian equity funds as well as the relative lack of experience within the more junior ranks of the investment team. This has led to the Manager seeking external candidates to ensure a more 'like-for-like' replacement of some of the recent senior analytical departures.
- Lonsec notes that while Pezzullo is the sole decision maker for PIC, he works closely with Perpetual's global equity analysts including the Portfolio Manager of the Global Share Fund ('GSF'), Garry Laurence. Lonsec has a high regard both for Laurence and his experienced global equities team. Laurence has been the PM for the GSF since its 2011 inception date as well as being co-PM for a Perpetual 'Asian' fund over the period 2009-2011 (with Pezzullo). Lonsec considers Pezzullo's access to this capability to be a strength given the active allocation to global equities and the high conviction taken in global stocks.

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- Lonsec considers the key person risk ('KPR') in Skamvougeras and Pezzullo to be high especially given turnover at the senior investor level over recent years. Lonsec is seeking an extended period of team stability at Perpetual. Lonsec notes that KPR is mitigated to an extent by the depth of the investment team and the ability of Perpetual to attract high calibre investors to the team.
- The investment team is largely rewarded on quantitative out-performance measures, with 90% of a PM's variable remuneration directly linked to portfolio performance and over 80% of an analyst's bonus driven by fund performance and numerical attribution. Lonsec believes this is a positive attribute in aligning the interests of the investment team with those of share-holders. In addition, Perpetual has adopted a long-term equity structure that applies to most of the senior members of the investment team. While such as structure can serve as a form of KPR mitigation by ensuring that key members of the team are 'tied' to Perpetual over the long-term, Lonsec notes that these structures have not necessarily prevented personnel departures from investment teams in the recent past.
- Lonsec notes that accountability for the global equity analysts is somewhat diminished for PIC. This is because there is no current clear link between the performance of global equity stocks in the PIC portfolio and the remuneration of the global equity analysts. Rather, global analysts are remunerated on the performance of stocks in the GSF. This is different to the Australian equity analysts whose remuneration is is more directly linked to Perpetual's range of Australian equity strategies. Lonsec would welcome clearer linkage in this area and is encouraged from discussions with the Manager that indicates that this should soon be addressed.

Research and portfolio construction

- Lonsec considers Perpetual's long-standing investment philosophy and process to be one of the key strengths of this offering. In particular, Lonsec considers it to provide the LIC with a clear and consistent focus on identifying companies that pass the Manager's comprehensive quality filters and that are trading below the Manager's assessment of intrinsic value.
- Lonsec believes there is a high level of conviction within the process, both with Pezzullo as the PM and the analysts who are not permitted to assign hold recommendations, forcing them to take a view on each company in their coverage universe. Furthermore, the Manager has recently encouraged analysts to provide even more conviction in their stock recommendations, setting a minimum amount of "one rank (strong overweight)" recommendations per year. In addition, Lonsec notes a number of structured training initiatives have been introduced since 2017, including workshops focusing on forensic accounting, behavioral finance, and interviewing and questioning techniques.
- Lonsec considers the size and scale of Perpetual to be a competitive research advantage in the local market as it permits broader coverage of the various Australian sectors and better access to company management. Lonsec believes that there is no substitute for in-depth 'ground work' and as such is pleased with the Manager's extensive company visitation program. Lonsec notes that this is not the case with the global equities market where Perpetual is a much smaller player with a smaller team versus many peers. However, the global equities team has an extensive travel budget and meets with companies of interest in off-shore markets.
- The portfolio construction process is largely intuitive in nature within the scope of the Manager's philosophy, risk controls, and mandated guidelines. While all decisions are driven by Pezzullo, there is strong link to the qualitative views and stock rankings of the various analysts. The allocation to Australian equities, global equities and cash is also driven by a 'bottom-up' assessment of valuation which again closely ties this decision into Perpetual's investment philosophy.

Risk management

- PIC has a separate Board that provides it with an additional overlay of risk management and independent scrutiny of compliance. PIC is also required to meet the stringent listing rules of the ASX.
- Lonsec notes that PIC is relatively 'benchmark unaware' with a strong focus on income and capital growth. Hence Lonsec considers the risk for it to be one of income and capital preservation. Lonsec considers Perpetual's 'quality' screen to greatly assist in ensuring that risk management is both embedded within its investment process and focused on these risks.
- Lonsec also considers capital preservation to be aided by the flexible investment mandate. In particular, the ability to diversify off-shore should allow the Manager to seek out global equity opportunities with better valuation upside or to enhance diversification by providing access to sectors such as global pharmaceuticals or IT which are not large or deep sectors on the ASX. The ability to vary the net equity exposure should also allow the Manager to build a significant cash buffer when value across equity markets is less apparent.
- Lonsec considers Perpetual's risk management processes to be in-line with industry best practices, with the Manager monitoring all relevant factor, stock, and sector exposures and contributions using BARRA risk analysis software. Perpetual also has a well established proprietary ESG framework.
- While the Manager does not employ hard sector limits, sector exposures are continuously monitored to ensure that no unintended risks are present.

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Funds under management

- Perpetual managed around $20.9 billion in Australian equities as at 31 March 2018, representing over 1.5% of the S&P/ASX 300 Accumulation Index by market capitalisation. At this level, Perpetual is the largest fund manager in terms of funds under management ('FUM') within Lonsec's peer group. While Lonsec believes this is a testament to the Manager's capability and the long-term track record, it also leads to some relative disadvantages; Lonsec believes the central issue regarding FUM size and capacity surrounds potential difficulties in terms of trading in less liquid positions.
- Lonsec believes that capacity varies between fund managers and strategies and is commonly influenced by factors such as style bias, the level of portfolio turnover and stock concentration. With regards to Perpetual, Lonsec also notes there are particular aspects to the Manager's investment process which impact on capacity. For example, all of Perpetual's PMs are permitted to select stocks only from the approved 'buy' list, which is built by a single analyst pool. While this promotes consistency across portfolios, the Manager's strategies may experience heightened transaction costs (e.g. market impact, opportunity cost of not trading) as positions are liquidated. Moreover, the Manager's risk limit of not owning more than 15% of a company across the firm may constrain the ability of PMs to access the analysts' best ideas if the allocation has been exhausted by other Perpetual funds. This particularly limits the ability of Perpetual's PMs to take positions in smaller, less liquid stocks. Lonsec believes this 'lock-step' investment process amplifies the Manager's capacity concerns.
- Lonsec notes that some steps to manage capacity have been undertaken by the Manager, including managing flows into a number of their Australian equity strategies. However, investments into most of the pooled vehicles remain open. Lonsec highlights that this does not apply to PIC, which is a 'closed-end' vehicle.
- Given the high FUM across the business, Lonsec believes more can be done to preserve capacity for existing investors before the impact on performance from higher transactions costs (both explicit and implicit) becomes significant. Lonsec would also welcome a formal and independently undertaken capacity study on the Manager.

Performance

- Lonsec notes that PIC first listed on the ASX in December 2014 and hence does not have an extensive track record. However, PIC has recently celebrated reaching its three-year anniversary and has made a good start to its corporate life. From a share price perspective, PIC has returned 8.6% p.a. over the three-year period ended 31 May 2018 and has outperformed its index, the S&P/ASX 300 Acc. Index, by 2.6%. This record is even stronger over 12-months, with PIC returning 14.3% and outperforming by 4.3%. This strong start means that PIC is well progressed in meeting one of its investment objectives which is to provide long-term capital growth.
- Lonsec notes that PIC also has the objective of providing investors with a growing income stream over a minimum of five years. Once again PIC is well progressed in meeting this, having paid a dividend per share of 2.8c in financial year 2016 ('FY16'), growing strongly to 4.7c in FY17. All dividends declared have been fully-franked ('ff'). The trend for the half-year period ended 31 December 2017 ('1H18') has been a continuation of this strength, with the dividend of 3.0c ff being a strong increase on the prior year comparison ('pcp') of 2.2c. Lonsec notes the importance of establishing a strong track record as a consistent dividend payer for any listed company and considers PIC to be well progressed in establishing such a reputation.
- Despite this growing track record, Lonsec notes that PIC has delivered a moderate 1H18 half-year result as at 31 December 2017. In particular, PIC's NPAT was $20.7m versus $22.7m in the pcp while its Earnings per Share ('EPS') also fell from 9.0c to 8.2c. The main driver of this decrease in profitability was the decrease in net gains from financial instruments which fell from $30.5m in 1H17 to $27.1m in 1H18. Lonsec notes that such trading gains and losses will be volatile from period-to-period due to market conditions in the shorter-term.
- PIC's NPAT decline has been during a year when the absolute value of its share portfolio rose to $256.3m, up from $227.2m in the pcp. Part of this return was the strong market, with PIC's benchmark also rallying strongly. However, the portfolio has grown due to inflows from the DRP and some good stock picking.
- Another noticeable feature of the PIC balance sheet has been the growth in Retained Earnings to $15.2m versus $6.5m in the pcp. In Lonsec's view, the PIC Board has adopted a sustainable dividend policy for PIC; for instance, in FY17 the DPS of 4.7c was well below the EPS of 12.6c (pay-out ratio below 40%). Building such a retained earnings buffer is important to PIC given the reliance it has on trading gains for income rather than dividends received from companies it owns. The former can be significantly impacted by market conditions which could have impact PIC's ability to pay a dividend in periods of adverse market conditions if there was not a meaningful retained earnings balance from which to pay it out from.
- PIC has been able to close out the significant discount to NTA it traded at over the period from inception to mid-2017 and now trades in a close band to NTA. Lonsec considers that one of the key reasons that PIC traded so poorly in its early years was the extensive time it took the PM to fully deploy the IPO proceeds, thereby significantly diminishing its dividend potential over this time. PIC also provided subscribers to the IPO with 'free options' and the share price traded poorly in the lead-up to option expiry. Given this back-drop, in Lonsec's view the sustained recent growth in the dividend has been critical in significantly improving the trading profile of PIC as has been the Board's conservative approach to its dividend policy.

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Overall

- Lonsec has provided PIC with a **'Recommended'** rating. Lonsec has a high regard for Perpetual's quality-focused and valuation-driven research process. Lonsec also has a favourable view of the portfolio management track record of Vince Pezzullo as well as the depth and experience of the investment team. Lonsec considers the ability of Pezzullo to alter the asset allocation to invest in global equities or cash to enhance the risk management practices of PIC.
- Lonsec has some concerns at the PIC level due to some recent turnover in the ranks of Executive Directors, including in the role of Chair. Lonsec's preference is also for an 'independent' Chair. At the Manager level, Lonsec notes that Pezzullo has a heavy workload. Perpetual also has significant assets under management across its equities business and capacity is a concern.

People and Resources

Corporate overview

Perpetual was appointed by PIC as its specialist Investment Manager ('IM') for an initial five-year term. The IM agreement will automatically extend for a further five-year term upon expiry unless terminated in accordance with the criteria specified in the Prospectus.

Perpetual is a wholly-owned subsidiary of Perpetual Limited which is listed on the Australian Stock Exchange (ASX code: PPT).

Key events

2014	IPO
2016	OPTIONS EXPIRY

Size and experience - Board of directors

NAME	POSITION	YEAR JOINED
NANCY FOX	CHAIR	2017
DAVID LANE	EXECUTIVE DIRECTOR	2017
VIRGINIA MALLEY	NON-EXECUTIVE DIRECTOR	2014
JOHN EDSTEIN	NON-EXECUTIVE DIRECTOR	2014
CHRISTINE FELDMANIS	NON-EXECUTIVE DIRECTOR	2014

PIC has its own separate Board of Directors ('the Board'), including more than 50% of 'independent' directors. However, the LIC's Chair, Nancy Fox, is also a Non-executive Director of the ASX-listed Perpetual Limited.

The Board has the responsibility for ensuring that the Company is properly managed so as to protect shareholder interests in a manner that is consistent with the LIC's obligation to all stakeholders. This includes meeting its Prospectus investment objectives.

PIC considers the following directors to be 'independent' as defined by the corporate governance policies and practices of the ASX.

Virginia Malley, Non-executive Director. Malley has over 30 year's of relevant industry experience in the investment and banking sectors. This included the role of Chief Risk Officer and membership of a variety of internal investment committees at the Macquarie Funds Management Group. Malley is a non-executive director for Perpetual Superannuation Limited and is a prominent member of a number investment-related compliance committees.

John Edstein, Non-executive Director. Edelstein had an over thirty year legal career including senior partnership roles for prominent legal practice King & Wood Mallesons. Edstein was also a recent director and chair of The Trust Company (Superannuation) Limited. He is a current director of Macquarie Investment Management Limited and Retail Employees Superannuation Pty Ltd

Christine Feldmanis, Non-executive Director. Feldmanis has over thirty years' experience in the finance industry gained in both the government and public sector. This includes senior executive roles for Deloitte, Elders Finance, Bankers Trust, NSW TCorp and Treasury Group. She is a current director of Hunter Water Corporation, Netball NSW, Uniting Financial Service and Bell Asset Management Limited as well as serving on a number of compliance and audit committees for a variety of government agencies and boutique fund managers.

The Company's Board also has two executive directors in Fox and Perpetual Investment's Group Executive, David Lane.

Board remuneration

The LIC's Constitution allows for a maximum aggregate director's fee pool of $250,000; of this maximum, $170,000 had initially been allocated for director's remuneration and has not been increased to date. This has been split relatively evenly between each of the three 'independent' directors and Fox. In particular, these directors will receive annual remuneration in the $40,000 – $50,000 range.

Lane is already remunerated by the Perpetual Group and will not receive any remuneration from PIC.

Investment manager

Perpetual is one of Australia's largest fund managers, with funds under management across all asset classes of approximately $30.2b as at 31 March 2018. Of this, approximately $20.9b was in Australian equities including PIC and $1.5b in global equities. Perpetual has been listed on the ASX since 1964 (ASX: PPT).

Perpetual Equity Investment Company Limited

Size and experience - Investment team

NAME	POSITION	EXPERIENCE INDUSTRY / FIRM
PAUL SKAMVOUGERAS	HEAD OF EQUITIES / PORTFOLIO MANAGER	22 / 15*
VINCE PEZZULLO	DEPUTY HEAD OF EQUITIES / PORTFOLIO MANAGER	23 / 10
JACK COLLOPY	PORTFOLIO MANAGER	18 / 16
ANTHONY CAY	PORTFOLIO MANAGER	21 / 21
ANTHONY ABOUD	PORTFOLIO MANAGER	19 / 6
NATHAN HUGHES	PORTFOLIO MANAGER / ANALYST	14 / 8
MARYANNE DREWE	DEPUTY PORTFOLIO MANAGER / ANALYST	33 / 14
ALEX HURRELL	ANALYST	12 / 12
JOSHUA HAIN	ANALYST	10 / 8
ALEX PATTEN	ANALYST	4 / 6
CARLY TURNER	ANALYST	12 / 5
MICHAEL CROSER	ANALYST	12 / 2
TARIQ CHOTANI	ANALYST	14 / 2
SEAN ROGER	ANALYST	6 / 5
JAMES RUTLEDGE	ANALYST	12 / 1
NICHOLAS VIDALE	ANALYST	18 / 1
AVERAGE	-	16 / 8

* Seven years experience between 1994 to 2001 and rejoined in February 2010.

The investment team of 17 is led by Skamvougeras as the Head of Equities and Pezzullo as the Deputy Head of Equities. The portfolio managers report through to Skamvougeras and the analysts to Pezzullo. Both Skamvougeras and Pezzullo report through to Group Executive for Perpetual Investments, David Lane.

Investment team remuneration

Perpetual has a strong focus on rewarding the investment team based on quantitative outperformance measures, with over 90% of a portfolio manager's bonus and 80% of an analyst's bonus driven by numerical attribution.

Bonuses can be considerable and are an important tool in aligning the interests of the investment team with those of unit and share-holders. In addition, Perpetual has in place a deferred incentive structure that applies to senior members of the investment team. The granting of deferred incentives is subject to underlying Fund or Company out-performance hurdles and/or FUM growth/revenue being delivered. Senior members of the investment team can elect for their deferred incentive to be invested in Perpetual shares or units in the products managed by the team. Deferral of incentives into investment funds and/or Perpetual shares creates further alignment with unit and share-holder interests.

Research Approach

Overview

INVESTMENT STYLE	VALUE
NO. OF STOCKS IN UNIVERSE	ALL STOCKS LISTED ON THE ASX & INTERNATIONAL STOCKS
APPROX. NO. OF STOCKS FULLY RESEARCHED	280 AUSTRALIAN AND 200 INTERNATIONAL STOCKS
COMPANY VISITS	OVER 1000 P.A.
INITIAL STOCK FILTERS	STOCKS MUST MEET ALL FOUR QUALITY CRITERIA: SOUND MANAGEMENT, CONSERVATIVE DEBT, QUALITY OF BUSINESS, RECURRING EARNINGS
TOP DOWN	0%
BOTTOM UP	100%
RESEARCH INPUTS	COMPANY VISITATION PROGRAM
USE OF BROKER RESEARCH	MARKET DATA, IDEAS, PROJECT SPECIFIC
VALUATION APPROACH PRIMARY	THE METHODOLOGY USED WILL VARY BASED ON THE NATURE OF THE COMPANY AND ITS STAGE OF THE LIFECYCLE. EXAMPLES OF METHODOLOGIES USED ARE PE, DCF AND BUSINESS BREAK UP VALUATIONS.

Perpetual's investment approach is first and foremost based on bottom-up fundamental analysis. This approach firstly selects stocks based on company specific fundamentals, and then by the relative attractiveness of their valuation. The outcome of the investment process is that the Australian equity portfolios demonstrate 'value' characteristics. The Manager buys stocks only if they have passed a rigid stock selection criteria and are deemed to be quality companies, and then only if they find them attractive on a valuation basis. The Manager searches for companies that display – quality businesses, conservative debt levels, sound management, and recurring earnings.

Analysts rank stocks based on their expected level of out-performance and conviction associated with that stock – 1 (Strong overweight), 2 (Overweight), 4 (Underweight), 5 (Sell). This ranking is the primary communication between analysts and portfolio managers.

'Quality' filters

The four 'quality' filters are defined as follows:

- Quality of business – subjective test based on a qualitative assessment of the market a company operates in, its products and social or environmental issues it may face.
- Conservative debt – where the debt to equity ratio is greater than 50%, the interest cover must be =/> 3x or the debt pay-back period must be a maximum of 5 years.
- Sound management – subjective test based on each analyst's assessment of the company's track record. In particular, the track record is gauged with reference to the historic deployment of capital, the focus on maximising shareholder value and the strength of the governance practices.
- Recurring earnings – companies must have a three-year track record of generating earnings or a demonstrated ability to provide visibility to future earnings.

Perpetual Equity Investment Company Limited

Portfolio Construction

Overview

FUND BENCHMARK	S&P/ASX 300 ACCUMULATION INDEX
RETURN OBJECTIVE	LONG-TERM CAPITAL GROWTH AND GROWING INCOME STREAM
PORTFOLIO DECISIONS	PORTFOLIO MANAGER
STOCK SELECTION	BOTTOM UP
TYPICAL NUMBER OF HOLDINGS	20-40
MARKET CAPITALISATION BIAS	MID-CAP
GLOBAL MARKETS EXPOSURE	UP TO 25% OF NAV
EXPECTED PORTFOLIO TURNOVER	LOW
% OF PORTFOLIO IN TOP 10 HOLDINGS	HIGH

Pezzullo, as Portfolio Manager, is responsible for portfolio construction and ultimately accountable for the performance of the Company. Given Perpetual's belief that investing is more of an 'art' (as opposed to a 'science'), the portfolio construction process, including the final asset allocation, is expected to be largely intuitive in nature within the scope of Perpetual's philosophy, risk controls, and fund-specific guidelines.

The final portfolio will typically consist of 20 to 40 stocks with annual portfolio turnover generally ranging between 40% to 100% p.a. Stock positions are typically established over time. Sell decisions are predominantly based on share prices reaching their price targets or deterioration in company fundamentals.

Risk Management

Risk limits

SEPARATE RISK MONITORING	YES
STOCK LIMITS	MAXIMUM 15% OF NAV
SECTOR LIMITS	NONE
CASH LIMITS	MAXIMUM 25% OF NAV
GLOBAL EQUITY LIMITS	MAXIMUM 25% OF NAV

Broad stock, global equity and cash limits and no sector limits.

Risk monitoring

Perpetual believes that the emphasis on company quality and strict screens helps to ensure that risk is adequately controlled for. On a monthly basis, Perpetual formally reviews a range of quantitative information such as the top and bottom contributing stocks, individual analyst attribution, P/E and dividend yield of the portfolio, and major absolute, overweight and underweight positions and sector weights. BARRA is used to monitor ex-ante Tracking Error, factor and risk exposures and individual stock contribution to risk.

Currency management

The exposure to off-shore markets (up to 25% of NAV) is typically unhedged from a currency perspective. Currency exposure may only be hedged where the Manager sees a significant risk of currency weakness.

Risks

An investment in the LIC carries a number of standard investment risks associated with domestic and international investment markets. These include economic, political, legal, tax and regulatory risks. These and other risks are outlined in the PDS and should be read in full and understood by investors. Lonsec considers major risks to be:

Equity market

Investments in equity markets are subject to numerous factors which may have an impact on the performance of an investment (both positive and negative). Unexpected changes in economic, technological, structural, regulatory or political conditions can have an impact on the returns of all investments within a particular market.

Derivatives

Perpetual has scope, via the PIC Prospectus, to implement various derivative strategies for the LIC. Derivatives cannot be used to lever the LIC.

Currency

The Manager has the scope, via its Prospectus, to invest up to 25% of the LIC's NAV in global developed market equities. The risk exists for potential adverse movements in exchange rates that may reduce the Australian dollar value of the LIC's global equities.

Investment

Being an LIC, its securities may trade on the ASX at a discount to its NAV for extended periods of time.

Perpetual Equity Investment Company Limited

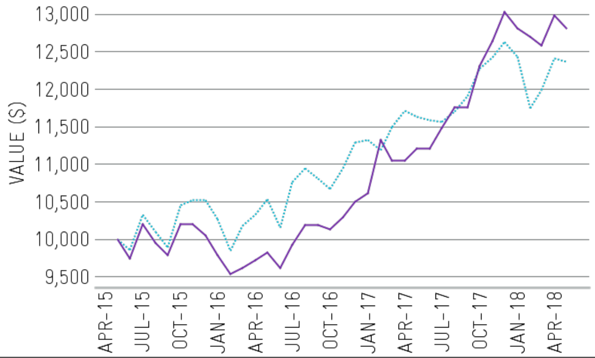
Quantitative Performance Analysis - annualised after-fee % returns (at 31-5-2018)

Performance metrics

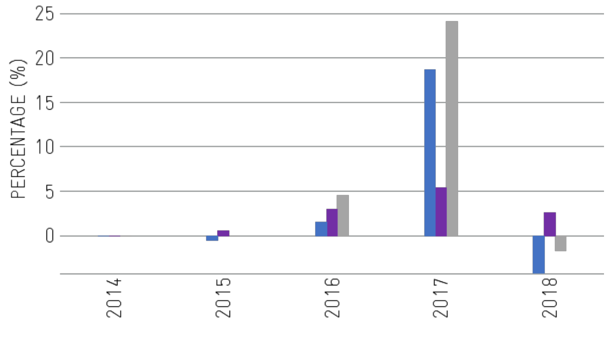
	1 YR	2 YR	3 YR	5 YR
TOTAL RETURN (% PA)	14.26	14.20	8.62	-
STANDARD DEVIATION (% PA)	7.47	7.85	8.38	-
EXCESS RETURN (% PA)	4.28	3.81	2.56	-
WORST DRAWDOWN (%)	-3.44	-3.44	-6.57	-
TIME TO RECOVERY (MTHS)	NR	NR	9	-
TRACKING ERROR (% PA)	5.52	8.50	8.84	-

FUND: PERPETUAL EQUITY INVESTMENT COMPANY LIMITED
BENCHMARK USED: S&P/ASX 300 TR INDEX AUD
TIME TO RECOVERY: NR - NOT RECOVERED, DASH - NO DRAWDOWN DURING PERIOD

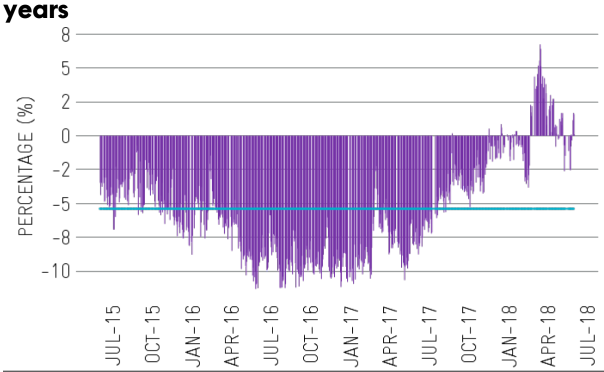
Growth of $10,000 over three years



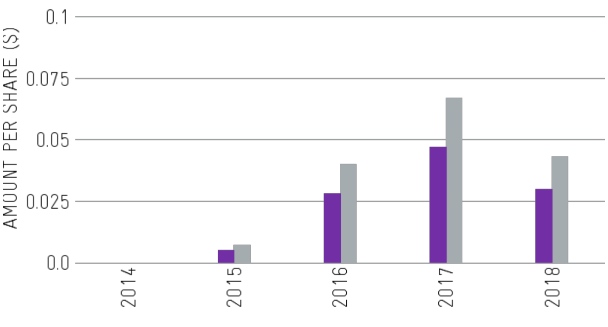
Calendar Year Returns over five years



Share Price Premium/Discount to NTA over three years



Dividend Record over five years



Lonsec

Perpetual Equity Investment Company Limited

Glossary

Click here for the glossary of terms.

About Lonsec

Lonsec Research Pty Ltd (Lonsec) is an investment research house with specialist areas of expertise, that was originally established in 1994 and the current entity was registered on 23 June 2011. From 1 July 2011, Lonsec became a fully owned subsidiary of Lonsec Fiscal Holdings Pty Ltd, a privately owned entity with a multi-brand strategy of providing leading financial services research and investment execution. Lonsec believes that professional financial advisers need informed opinions on the best investment strategies and financial products to provide real value for their clients. To meet this need, Lonsec has in place an experienced research team, which draws on a robust research process to undertake in-depth assessment of managed fund products.

Analyst Disclosure and Certification

Analyst remuneration is not linked to the research or rating outcome. Where financial products are mentioned, the Analyst(s) may hold the financial product(s) referred to in this document, but Lonsec considers such holdings not to be sufficiently material to compromise the rating or advice. Analyst holdings may change during the life of this document. The Analyst(s) certify that the views expressed in this document accurately reflect their personal, professional opinion about the matters and financial product(s) to which this document refers.