



Fund Review

Perpetual Equity Investment Company Limited

ISSUE DATE: 20-10-2014

About this Company

LIC REVIEWED	PERPETUAL EQUITY INVESTMENT COMPANY LIMITED
ASX CODE	PIC
PROSPECTUS OBJECTIVE	PROVIDE INVESTORS WITH A GROWING INCOME STREAM AND LONG-TERM CAPITAL GROWTH IN EXCESS OF ITS BENCHMARK OVER MINIMUM 5 YEAR INVESTMENT PERIODS
EXPECTED COMPANY SIZE (POST IPO)	\$150M - \$600M
BOARD OF DIRECTORS	5
INDEPENDENT DIRECTORS	VIRGINIA MALLEY, JOHN EDSTEIN, CHRISTINE FELDMANIS
IPO PRICE	\$1.00
INITIAL NET ASSET VALUE (POST IPO)	\$0.983 - \$0.984 (DEPENDENT ON LEVEL OF SUBSCRIPTIONS)
STRUCTURE	FREE LISTED OPTION ON A 1-FOR-1 BASIS (EXERCISE PRICE \$1.00, EXPIRY JUNE 2016)
FEES - ICR (P.A.)	1.0% OF THE NET ASSET VALUE (NAV) UP TO \$1B AND 0.85% OF NAV > \$1B

About the Investment Manager (IM)

INVESTMENT MANAGER	PERPETUAL INVESTMENT MANAGEMENT LIMITED (PERPETUAL)
OWNERSHIP	WHOLLY-OWNED PERPETUAL LIMITED
ASSETS MANAGED IN THIS SECTOR	\$21.7B
YEARS MANAGING THIS ASSET CLASS	48

Investment team

TEAM SIZE	18
PORTFOLIO MANAGER	VINCE PEZZULLO
NUMBER OF ANALYSTS	15
TURNOVER/TEAM RATIO (PAST 2 YEARS)	LOW-TO-MEDIUM

Investment process

STYLE	ACTIVE - VALUE
TARGETED VALUE ADD ABOVE INDEX (P.A.)	EXCEED BENCHMARK
BENCHMARK	S&P/ASX300 ACCUMULATION INDEX
TYPICAL TRACKING ERROR (P.A.)	NOT TARGETED
TYPICAL STOCK NUMBERS	20-40
TYPICAL CAPITALISATION BIAS	MID-TO-LARGE
STOCK POSITION LIMITS	=/ < 15% OF NAV
GLOBAL LISTED SECURITY LIMITS	0-25%
CASH & CASH-EQUIVALENT LIMITS	0-25%
CURRENCY HEDGING	TYPICALLY UNHEDGED

LIC rating history

OCTOBER 2014	RECOMMENDED
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What this Rating Means

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

Scope of this Rating

- Lonsec has used its Managed Funds research process in forming a 'point-in-time' opinion on this Listed Investment Company's (LIC) ability to meet its investment objectives as outlined in the Prospectus. This research process, however, does not include any assessment of the Company's ability to minimise any divergence between the share price and the Net Asset Value (NAV) per share beyond acknowledging that the Company is committed to doing so via capital management measures. Lonsec considers an investment in the LIC sector to be suitable for investors with a long-term (5+ years) investment horizon.
- The Lonsec rating will expire upon the listing of the Perpetual Equity Investment Company (PIC) on the Australian Stock Exchange (ASX).

Company risk characteristics

	LOW	MODERATE	HIGH
CORPORATE RISK		●	
CAPITAL VOLATILITY			●
CONCENTRATION RISK			●
CURRENCY RISK	●		

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

Suggested Lonsec risk profile suitability



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 5 years. Subscribers to the IPO will also be issued with a 'free' option on a 1-for-1 basis that will be listed (ASX code - PICO). These options will be exercisable at \$1.00 on or before the 10 June 2016.
- Perpetual Investment Management Limited (Perpetual or 'the Manager') has been appointed as the Investment Manager of PIC. Perpetual has a long standing 'bottom-up' investment philosophy

based on identifying 'quality' companies whose securities the Manager believes to have valuation upside. Its 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 will be 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 will also have 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 will be valuation driven.
- PIC will have a 'high conviction' approach to stock picking and thus will typically hold between 20-40 stocks. Lonsec expects the global equities sleeve to be actively used. The LIC will have a distinct mid-cap focus for its Australian equity allocation only, although PIC will move up (and down) the market capitalisation spectrum as valuation opportunities emerge. The allocation to global equities will be more opportunistic in nature and any securities purchased are not expected to exhibit any 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 market exposure via its cash allocation to provide it with greater down market resilience than peers who are mandated to remain fully invested. Lonsec does note, however, that the portfolio's net equity position is not a market timing tool; rather it will be a reflection of the number of high conviction 'value' 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 will have a management fee of 1.0% p.a. of the NAV of the portfolio up to \$1b, dropping to 0.85% p.a. of NAV above \$1b. There is no performance fee. The management fee when the NAV is below \$1b is towards the upper end of the Lonsec range for both its 'value' peer group and other recent LIC IPOs with similar mandates and external

investment management structures. However, Lonsec notes that the Manager will actively manage PIC's allocation to Australian equities, global equities and cash. Lonsec also notes that the LIC will be run in a 'high conviction' manner. Both suggest that a fee differential versus other more 'benchmark aware' or 'home biased' products is justifiable.

- Lonsec does observe that there are a number of well-established Australian equities focused LICs that have lower fee structures; typically these tend to be internally-managed and demonstrating much higher absolute net assets.

Using this LIC

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 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.
- 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.
- 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.

Changes since Previous Lonsec Review

- This is Lonsec's initial review of PIC.

Lonsec Opinion of this LIC

Board of Directors

- PIC will have its own separate Board of Directors that will consist of five members, with three of these being independent. The independent directors are Virginia Malley, John Edstein and

Christine Feldmanis. Lonsec notes that the Chairman of PIC, Peter Scott, is not independent as he is also the current Chairman of Perpetual Limited. While pleased with a majority of independent directors, Lonsec's preference is also for an independent chairmanship.

- 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.
- Being ASX-listed, PIC will also need to comply with the stringent listing rules of the ASX.

People and resources

- The Portfolio Manager (PM) for the LIC is experienced Perpetual investor, Vince Pezzullo. While noting this product to be a new entity, Pezzullo has extensive PM experience at Perpetual including being the co-PM for the Perpetual Industrial Share Fund since 2012 and the sole PM for the Perpetual Direct Equity Alpha Portfolio since 2008. The latter fund, in particular, has a similar 'high conviction' design and mid-cap focus as PIC. 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 does caution, however, that Pezzullo has a heavy workload across the three funds. While noting that there is likely to be a high degree of cross holdings amongst the best Australian mid cap 'value' ideas, Lonsec does note some mandated difference with the Industrial Share Fund having more of a large cap focus and the LIC actively investing in its global equities sleeve. Pezzullo is also taking a leading role in promoting Perpetual's 'direct investing' capabilities. While expecting Pezzullo to receive plenty of relevant support from the wider Perpetual 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 ultimately reports to Perpetual's Head of Equities, Matt Williams; he has now held this role for over three years since the departure of John Sevier in 2011. Lonsec believes that Williams has proven to be a capable replacement for Sevier. He has extensive portfolio management and analytical experience, having joined Perpetual in August 1993 as an Equities Dealer, and becoming a Portfolio Manager in 1998. Lonsec has high regard for William's investment and leadership skills and believes him to be well qualified to fulfil this role.
- In Lonsec's view, Perpetual's Australian Equities team remains one of the largest and more experienced in the Australian market, with a number of high quality senior investors and analysts. While Lonsec has been concerned by the rate of departures from the senior ranks of the investment team in recent years, the current incarnation of the portfolio management team

appears to be relatively well settled, which Lonsec views as a strong positive.

- Lonsec notes that Perpetual has recently bedded down its global equities capability; this has entailed a change of responsibilities for a number of senior analysts to support this new capability. In particular, experienced analysts Rosemary Tan and Andrew Blakely have been seconded. Lonsec notes that most of Tan and Blakely's Australian equity responsibilities have been absorbed internally by junior analysts Nathan Hughes and Nick Corkill. In Lonsec's estimation, this has somewhat lowered the overall experience levels of the Australian equity analysts.
- Lonsec notes that while Pezzullo remains the sole decision maker for this capability, he will be working closely with Perpetual's Portfolio Manager for its Global Share Fund (GSF), Garry Laurence. Laurence is an experienced global equities analyst and investor. He has been the PM for the GSF since its early 2011 inception date as well as being co-PM for a Perpetual 'Asian' fund over the period 2009-2011 with Vince Pezzullo. Prior to his career at Perpetual, Laurence had a three-year 'buy-side' analyst role at PM Capital (PMC) where he covered the financial sector both locally and globally. As well as Tan and Blakely, the global capability has been bolstered further by external global equity hires, Andrew Plummer (ex Five Oceans) and Thomas Rice (ex PMC).
- Lonsec considers the 'key person risk' (KPR) in Williams as Head of Equity to be high and Pezzullo as Portfolio Manager of the LIC to be moderate-to-high. This is especially so given Lonsec's concerns about turnover in the ranks of senior team members in the immediate past. That being said, Lonsec does acknowledge there is good depth across the senior portfolio management team.
- The investment team is largely rewarded based on quantitative out-performance measures, with over 90% of an Analyst's bonus being driven by numerical attribution. Lonsec believes this is a positive attribute in that it helps in aligning the interests of the investment team with those of end investors across the various capabilities. In addition, Perpetual has adopted a long-term equity structure that applies to most senior members of the investment team. While such a structure can serve as a form of KPR risk mitigation as it acts to ensure 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 past.

Research approach 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 is pleased to

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observe that the same 'bottom-up' and valuation-driven approach will be used for identifying global equity opportunities for the LIC.

- Lonsec believes there is a high level of accountability within the research process, both for Pezzullo as the PM of the LIC, and the individual sector Analysts who are not permitted to assign 'hold' recommendations when ranking securities; Lonsec considers this to 'force' analysts to form a clear view on each company in their coverage universe. This, in Lonsec's opinion, adds both clarity and conviction to the investment process.
- 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 programme. Lonsec does note that this is not the case with the global equities market where Perpetual is a much smaller player with a reduced team versus many peers.
- 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.

Funds Under Management

- As at 30th June 2014, Perpetual managed \$21.7 billion in Australian equities, representing over 1.5% of the S&P/ASX 300 Accumulation Index by market capitalisation. At these levels, Perpetual is one of the largest managers in terms of funds under management (FUM) within Lonsec's peer group.
- Lonsec believes, all else being equal, that it is more difficult to generate out-performance in the Australian market with higher levels of FUM versus lower levels. That said, Lonsec does not currently observe FUM to be a major impediment to the Manager's ability to consistently generate 'alpha', including for investment capabilities with a similar investment mandate to that proposed for PIC. Lonsec also notes the important and on-going role global developed market equities will play for the LIC, noting this to further alleviate capacity pressure to a degree. This is especially so as the global equities likely to be targeted are expected by the Manager to be larger and more liquid than its Australian counterparts.
- Nonetheless, Lonsec notes the concerted effort by Perpetual to grow Australian equity products that are likely to display more of a mid-cap focus. Lonsec will continue to closely observe the aggregate mid-cap exposure Perpetual has across its funds. Lonsec notes liquidity in the Australian

mid-cap space to be more constrained versus large cap stocks (both locally and globally).

- Unlike some of its peers, the Manager has not indicated a level of FUM at which it expects to soft or hard close this capability. Lonsec understands that Perpetual reviews the capacity of the business periodically; however Lonsec would welcome a clearer indication from the Manager about its expected capacity limits.

Risk management

- PIC will have a separate Board that will provide it with an additional overlay of risk management and independent scrutiny of compliance. PIC will also be required to meet the stringent listing rules of the ASX.
- Lonsec notes that PIC will be relatively 'benchmark unaware' with a strong focus on income and capital growth. Hence Lonsec considers the risk for the LIC 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 pharma or IT which are not large or deep sectors on the local bourses. 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 believes that 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.
- Whilst the Manager does not employ hard sector limits, sector exposures are continuously monitored to ensure that no unintended risks are present.
- Lonsec notes that PIC will have up to six months from its listing date to invest up to 75% of its NAV in Australian or global equities. This feature has been incorporated to ensure that PIC is not a 'forced' buyer of equities. Rather it provides Perpetual with an appropriate window to invest in stocks that have valuation upside.

Performance

- As the LIC is yet to list, there is no performance data available.
- Lonsec does note, however, that Perpetual has a long and successful track record in managing a range of Australian equities capabilities, some of which has been managed by Pezzullo. Lonsec does caution that Perpetual's global equities capability has only recently been implemented.

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Overall

- Lonsec has assigned PIC with an initial '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 investment skill and growing portfolio management track record of Vincent Pezzullo as well as the depth and experience of the wider equities investment team. Lonsec considers the ability of Pezzullo to alter the asset allocation to global equities and cash to enhance the risk management practices of PIC.
- Lonsec notes the lack of scale and track record of Perpetual's global equities capability. Lonsec also notes some concern about recent turnover amongst Perpetual's ranks of senior investors and capacity management. Finally, PIC is wholly benchmarked against the ASX 300 Accumulation Index despite being able to hold up to 50% of net assets in cash and global equities.

People and Resources

Board of Directors

PIC has its own separate Board of Directors ('the Board'), including more than 50% of independent directors. However, the LIC's Chairman, Peter Scott, is also the Chairman 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 27 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. Edstein 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 chairman 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 Delta Electricity, Netball NSW, Uniting Financial Services and Ability Capital Ltd 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 Scott and Perpetual Investment's Group Executive, Michael Gordon.

Board remuneration

The LIC's Constitution allows for a maximum aggregate director's fee pool of \$250,000; of this maximum, \$170,000 has initially been allocated for director's remuneration. This has been split relatively evenly between each of the three independent directors and Peter Scott. In particular, these directors will receive annual remuneration in the \$40,000 - \$50,000 range. Michael Gordon is already remunerated by the Perpetual Group and will not receive any remuneration from PIC.

Investment manager

Perpetual Investment Management Limited (Perpetual) has been appointed by PIC as its specialist Investment Manager (IM) for an initial 5-year term. The IM agreement will automatically extend for a further 5-year term upon expiry unless terminated in accordance with a number of set 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). PPT has a current market capitalisation of just over \$2b and runs three core financial services businesses, being Perpetual Investments (FUM of \$29b), Perpetual Private (funds under advice, or FUA, of \$13b) and the Perpetual Corporate Trust (FUA of \$484b).

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Size and experience – Perpetual Investment Team’s Equities Capability

Name/Position	Sector	Years industry/firm
AUSTRALIAN FOCUS:		
MATTHEW WILLIAMS	HEAD OF EQUITIES / PORTFOLIO MANAGER	24/21
PAUL SKAMVOUGERAS	DEPUTY HEAD OF EQUITIES / PORTFOLIO MANAGER	19/11
NATHAN PARKIN	PORTFOLIO MANAGER / EQUITIES ANALYST	20/10
JACK COLLOPY	PORTFOLIO MANAGER / EQUITIES ANALYST	14/12
VINCE PEZZULLO	PORTFOLIO MANAGER / EQUITIES ANALYST	20/7
ANDREW CORBETT	GLOBAL RESOURCES ANALYST	22/6
MARYANNE DREWE	EQUITIES ANALYST	30/11
ANTHONY CAY	EQUITIES ANALYST	17/17
ALEX HURRELL	EQUITIES ANALYST	8/8
ANTHONY ABOUD	EQUITIES ANALYST	15/2
JOSHUA HAIN	EQUITIES ANALYST	7/5
NICK CORKILL	EQUITIES ANALYST	5/3
NATHAN HUGHES	EQUITIES ANALYST	10/4
GLOBAL FOCUS:		
GARRY LAURENCE	PORTFOLIO MANAGER	11/6
ANDREW BLAKELY	GLOBAL ENERGY ANALYST	22/6
ROSEMARY TAN	EQUITIES ANALYST	10/4
THOMAS RICE	EQUITIES ANALYST	11/<1
ANDREW PLUMMER	EQUITIES ANALYST	8/<1

Remuneration / Alignment of Interests

Perpetual has a strong focus on rewarding the investment team based on quantitative outperformance measures, with over 90% 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-holders. In addition, Perpetual has in place an equity structure that applies to senior members of the investment team. The granting of equity is subject to underlying fund outperformance hurdles being achieved.

Whilst the value of this equity is a function of Perpetual’s share price, this is significantly influenced by the performance of Perpetual’s Australian equities business (which is in turn primarily linked to performance of the Perpetual’s funds).

Research Approach

Overview

INVESTMENT STYLE	VALUE
RESEARCH UNIVERSE	AUSTRALIA – ALL STOCKS LISTED ON THE ASX; GLOBAL – DEVELOPED MARKETS
STOCKS FULLY RESEARCHED	AUSTRALIAN – 280; GLOBAL – 200
COMPANY VISITS	+1000 P.A.
INITIAL STOCK FILTERS	STOCKS MUST MEET ALL FOUR ‘QUALITY’ CRITERIA: QUALITY OF BUSINESS, CONSERVATIVE DEBT, SOUND MANAGEMENT, RECURRING EARNINGS
TOP DOWN	NONE
BOTTOM UP	100%
RESEARCH INPUTS	COMPANY VISITATION PROGRAM; PROPRIETARY FUNDAMENTAL ‘BOTTOM-UP’ ANALYST RESEARCH
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.

‘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 \geq 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.

Security rankings

Each analyst is responsible for ranking their universe of securities on a scale of 1-to-5, indicating both the expected level of outperformance and the conviction associated with the security.

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Rank	Suggested Position	Return Expectation
1	STRONG OVERWEIGHT	SUBSTANTIAL OUTPERFORMANCE
2	OVERWEIGHT	STRONG OUTPERFORMANCE
4	UNDERWEIGHT	UNDERPERFORMANCE (PRICE TO HIGH)
5	SELL	FAILS THE SECURITY SELECTION CRITERIA OR IS SUBSTANTIALLY OVERPRICED

Of note is that an analyst is not permitted to rank a security as a '3' or a hold. This has been done to optimise clarity and conviction in analyst recommendations.

Portfolio Construction

Overview

Pezzullo, as Portfolio Manager, is responsible for portfolio construction and ultimately accountable for the performance of the Fund. 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 monitoring

Perpetual believes that the emphasis on company quality and strict screens helps ensure that risk is controlled. 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.

Perpetual's 'quality' screen assists in ensuring that risk management is embedded within its investment process. Whilst the Manager does not employ hard sector limits, sector exposures are continuously monitored to ensure that no unintended risks are present.

Risk Limits

NUMBER OF STOCKS IN PORTFOLIO	20 - 40 (SOFT)
STOCK CONSTRAINT	MAXIMUM ABSOLUTE STOCK WEIGHTS CANNOT BE MORE THAN 15% OF THE ISSUED CAPITAL OF THE LIC
AUSTRALIAN EQUITIES	50-100%
GLOBAL EQUITIES	0-25%
CASH	0-25%
TRACKING ERROR	NOT TARGETED
SECTOR LIMITS	DEVELOPED GLOBAL EQUITY MARKETS TARGETED
CURRENCY HEDGING	ALLOWABLE BUT RARELY EXPECTED TO BE USED
DERIVATIVES	PERMITTED UNDER THE PROSPECTUS.

Important 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.

Glossary

Absolute Return ‘Top line’ actual return, after fees

Excess Return Return in excess of the benchmark return (Alpha)

Standard Deviation Volatility of monthly Absolute Returns

Tracking Error Volatility of monthly Excess Returns against the benchmark (the Standard Deviation of monthly Excess Returns)

Sharpe Ratio Absolute reward for absolute risk taken (outperformance of the risk free return (Bank Bills) / Standard Deviation)

Information Ratio Relative reward for relative risk taken (Excess Returns / Tracking Error)

Worst Drawdown The worst cumulative loss (‘peak to trough’) experienced over the period assessed

Time to Recovery The number of months taken to recover the Worst Drawdown

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 and independent 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

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Date prepared

October 2014

Analyst

Peter Green

Release authorised by

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