

ING Extended Alpha Australian Share Fund



Highly Recommended
About this Review

Sector Reviewed	Hedge Funds – Australian Equity Long/Short
Total Funds Rated	12
Date of this Review	February 2010

About this Fund

Fund Reviewed	ING Extended Alpha Australian Share Fund
Fund Size (\$M)	12.4 (Dec 2009)
Responsible Entity	ING Investment Management Ltd
Fund Commenced	December 2009
Retail Fee (p.a.)	Not applicable
Wholesale Fee (p.a.)	0.75% + 20% of Fund return above hurdle (Index +1% (post fees))
Structure Availability	Wholesale

About the Fund Manager

Fund Manager	ING Investment Management Ltd
Ownership	ING Group NV
Assets Managed in this Sector (\$M)	440 (Oct 2009)
Years Managing this Asset Class	6

Investment Team

Team Size Dedicated to this Fund	13
Portfolio Manager	Gian Pandit
Number of Analysts	5 Large Cap, 2 Small Cap, 3 Property
Departures/Team Ratio (2 years)	33%

Investment Process

Style	Core
Targeted Value Add Above Index (p.a.)	5.0% p.a. (pre fees) over three years
Typical Tracking Error (p.a.)	< 9% p.a.
Typical Stock Numbers	45 long, 25 short
Typical Net Market Exposure	90% - 110%
Long/Short Positions Limit	140% long, 40% short
Typical Portfolio Turnover (p.a.)	300 – 400% p.a.
Typical Capitalisation Bias	Large
Franking Level (FY09)	N/A
Tax Efficiency – Income in Total Distribution (FY09)	N/A
Discount Gains as % of Total Capital Gains (FY09)	N/A
Stock Bet Limits	+8.0% (relative). Min absolute weight is -2.5% of the portfolio
Sector Bet Limits	None

Fund Rating History

February 2010	Initial Review - 'Highly Recommended'
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What this Rating Means

➤ The Highly Recommended rating indicates that Lonsec has high conviction that the fund or product can achieve its objectives and, if applicable, outperform peers over an appropriate investment timeframe. The manager or product has strong competitive advantages in people, process and product design and has no areas of material weakness. The investment is a preferred entry point to access this asset class or strategy.

Fund Risk Characteristics

	Low	Moderate	High
Capital Volatility			▲
Corporate 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.

Using this Fund

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

➤ The Fund is a 130/30 style long/short Australian equities product and as such will generally sit within the growth assets component of an investor's portfolio. The Fund is suitable for higher risk profile investors with a five year plus time horizon. Lonsec's model portfolio asset allocation (traditional assets only) is 5% within the Balanced, 6% within the Growth and 10% within the High Growth risk profiles respectively.

➤ The Fund will typically maintain a net equity exposure of close to 100% with the proceeds from short selling reinvested in the Fund's long positions. Short selling is primarily used to enhance overall fund returns and comes with increased market risk. Unlike traditional 130/30 style funds, the Fund's net equity exposure may at times be as low as 90%. Lonsec recommends that investors consider all relevant risks prior to investing.

➤ The Fund may invest in derivatives, such as futures and options, to gain exposure to investment markets and to manage risks associated with market prices and interest rates. Importantly, derivatives are not used to gear the Fund's assets.

➤ Due to the high level of portfolio turnover within the Fund, returns are expected to have a relatively low level of tax effectiveness.

Changes since Previous Lonsec Review

➤ This is Lonsec's initial review.

Recent developments at the manager include:

➤ ANZ has taken full ownership of ING Australia (insurance and retail wealth management) as at November 2009. However, ING Investment Management (INGIM) will

continue to operate as a wholly owned subsidiary of ING Group and is not part of the deal with ANZ.

- David McClatchy announced his resignation as Chief Executive Officer of ING Investment Management (INGIM), effective December 31, 2009.
- Steven Billiet (CEO ING Funds Taiwan) has been announced as his replacement.

Lonsec Opinion of this Fund

Philosophy/Style

- The Fund is a long-biased long/short Australian equity offering. Whilst the Fund displays a number of features synonymous with 'traditional' Australian equity funds (such as a relative return target and adopting a Tracking Error limit), Lonsec believes that the use of short selling results in the Fund falling within the Hedge Funds – Australian Equity Long/Short sector.
- The long/short process is based upon the manager's concentrated (Select Leaders) 'long' portfolio with additional opportunities derived from the implementation of a variety of short selling strategies. The manager attempts to profit from both rising and falling share prices by employing a variety of techniques including covered short selling, enhanced 'long' positions, pairs trades and active trading.
- The concentrated (Select Leaders) 'long' portfolio has Core/GARP style characteristics although once short selling and trading techniques are applied it is not necessarily the case that style classifications apply to the long/short fund in the same manner. The Fund targets a return of index + 5.0% pa (pre fees) over rolling three year periods (index being the S&P/ASX 200 Accumulation Index), with an ex-ante Tracking Error limit of 9% pa.
- In addition to the management fee a performance fee may be payable if the Fund's investment performance exceeds its performance hurdle (S&P/ASX 200 Accumulation Index +1.0% pa (post fees)). In general, Lonsec supports the concept of performance fees as long as they are appropriately structured. An appropriate structure is one where the performance fee is in line with industry standard (in percentage terms), where the fee is subject to an appropriate hurdle rate of return, and where the fee is subject to a prior 'high water mark'. Lonsec also considers that introducing a performance fee into the fee structure should be met by a reduction in the flat fees (not merely be added on), which Lonsec acknowledges the manager has done. With respect to the Fund's performance fee structure, Lonsec notes that the performance hurdle (index +1.0% pa (post fees)) is relatively low compared to that of a highly rated peer, but is pleasingly subject to a prior 'high water mark' without any reset periods. To this end, Lonsec would view positively any decision by the manager to adjust the performance fee to be subject to a higher performance hurdle.

People and Resources

- Material developments took place in ING Investment Management's (INGIM) Australian Equities team in June 2008, with the departures of the Co-Heads of the Australian Equities team, Paul Cuddy and Mark East, and two analysts, Michael Chun and Michael Malseed.
- Pleasingly since these departures, INGIM have appointed three new members to their large cap team (including the portfolio manager of this fund), in addition to James Wright, who has assumed the role of Head of Australian Equities and portfolio management responsibilities for the Australian Share Trust. That said, to lose key investment personnel is nonetheless disappointing and disruptive. Whilst staff turnover is a common occurrence in the funds management industry (and in some instances required), Lonsec places emphasis on team stability and would like to observe a sustained period of low staff turnover going forward.
- Despite the loss of key staff in 2008, Lonsec does not currently have any major reservations about the manager's remuneration structure and management of key person risk. INGIM offers a long term incentive program to a number of senior members of the investment team, which incorporates both equity options and a performance bonus that vests over a specified period of time. From an analyst perspective, Lonsec believes that accountability is high, given the use of 'analyst conviction ratings'. The conviction score mechanism allows the views of analysts to be tracked and measured. This forms part of the analysts' formal appraisal process, and has a strong skew towards performance based incentives.
- Subsequent to the June 2008 departures, INGIM's CIO of Asset Strategies and Alternatives, James Wright, has assumed the Head of Australian Equities position and portfolio management responsibility for the ING Australian Share Trust. Lonsec considers Wright to be a quality investment professional, having approximately 20 years of industry experience. However, Lonsec believes that being CIO, Head of Australian Equities and portfolio manager for INGIM's 'Core' strategies is a considerable undertaking. Whilst Lonsec holds reservations in Wright's onerous workload, he is not directly involved in the portfolio management of INGIM's concentrated and 130/30 Australian equities strategies. Lonsec therefore does not consider this to be a major impediment to the ING Extended Alpha Australian Share Fund.
- More specific to this product, Gian Pandit was recruited in October 2008 to manage INGIM's concentrated and 130/30 Australian equities strategies. These include the management of the ING Select Leaders Trust and the ING Extended Alpha Australian Shares Fund.
- Pandit has over 19 years experience in investment markets having worked in both the fixed income and equities sectors in various trading, research and portfolio management roles for Consolidated Press Holdings / Ellerston Capital Limited, Lodestar Capital Partners and Deutsche Bank. Prior to joining INGIM Pandit worked for Consolidated Press – Ellerston Capital Limited as an Investment Manager and Overlay Specialist implementing protection strategies for a \$3 billion fund. Lonsec has met with Pandit on several occasions since his appointment and considers him to be an exceptional hire with a proven track record in long/short investing. Pandit brings with him an

impressive skill set, particularly his demonstrable market acumen, and risk management and implementation focus, which Lonsec considers to be a key strength and attraction of this product.

- As such, Lonsec believes there is a high degree of key person risk in Pandit. A significant driver of Lonsec's conviction in this strategy is based upon Pandit being at the helm. In the event that Pandit ceased to manage this product, the rating of the Fund would most likely be downgraded. Importantly a significant portion of Pandit's variable remuneration is linked to the performance of this fund.
- An impressive feature of the investment experience is that it is diversified across the team rather than centred on a small number of individuals, with eight of the team having more than 12 years of industry experience. That said, in terms of tenure at the manager, Lonsec notes that with Gian Pandit, David Langford and Mason Willoughby-Thomas joining INGIM in 2008, the team is relatively 'new' in structure and is yet to establish a meaningful track record working together.

Research and Portfolio Construction

- Lonsec considers the manager's research process to be solid, believing that the stock scoring and ranking system promotes a strong level of consistency and transparency and importantly, a framework which intuitively lends itself to long/short investing. Whilst portfolio construction is influenced by the stock ranking system, Lonsec is pleased with the degree of qualitative overlay and the degree of accountability at the analyst level. Overall, Lonsec considers INGIM's portfolio construction process to be logical, with a strong focus on managing downside risk.
- A key positive and competitive advantage of INGIM's process is the use of in-house developed models, tools and systems, which Lonsec has observed to be continually enhanced over time. These systems assist in ensuring a strong level of consistency and transparency in the research process and allows for an effective peer review process.
- Direct contact with company management is an important component of the research process and to this end the manager undertook approximately 1000 'one-on-one' company management meetings (across both the large cap and small cap teams) over the last year. Lonsec considers this to be a reasonably solid level of coverage. Worth noting is that the size and market presence of the manager means that access to company management is typically very strong.
- Whilst the strategy has a high correlation with analyst stock views and recommendations, Lonsec believes the construction of the short side of the portfolio can be considered to be more 'art' than 'science', with Pandit having sufficient scope to impart his own conviction. To this end, the strategy is highly reliant on the skill of the portfolio manager (which Lonsec assesses to be very strong).
- Lonsec notes that INGIM conducts considerable research to determine an appropriate FUM capacity that takes into account trading market impact, market liquidity and INGIM's investment style. Overall, Lonsec is impressed with the degree of research into capacity, noting that the issue is considered of high importance within INGIM. As at October 2009, INGIM managed approximately \$440 million in

long/short equities. In terms of the Extended Alpha Australian Share Fund, the manager has signalled its intention that it will close the strategy to new investors at approximately \$1 billion. At current fund size, Lonsec does not consider there to be any capacity issues.

Risk Management

- Lonsec believes that INGIM's risk management processes are in line with industry practices. Overall Lonsec considers INGIM's portfolio management and risk management tools to be very strong, noting that portfolio maintenance is an important feature of the investment process as it constantly tests to ensure the portfolio is consistent with the investment strategy and process signals.
- Lonsec notes that the Fund may invest in derivatives, such as futures and options, to gain exposure to investment markets and to manage risks associated with market prices and interest rates. Derivatives are not used to gear the Fund's assets. Although there is a risk of loss to the Fund through the use of derivatives, Lonsec considers INGIM to have appropriate risk management guidelines in place for their use. Importantly, Pandit has extensive industry experience specialising in the implementation of protection strategies and Lonsec considers him to be well credentialed to execute such strategies.
- Within INGIM, the Risk team and the Compliance team conduct risk management, sourcing the portfolio risk reports from the quantitative team. This separation of monitoring responsibilities is important in preserving the integrity of the risk management process. The investment team also undertakes its own risk management analysis, utilising a risk management system known as NORTHFIELD (adopted during 2008). This enables the portfolio managers to monitor metrics such as Tracking Error as well as identify those stocks that are contributing the most risk to the portfolio. Lonsec notes that the manager no longer uses EXCERPT, which was previously used for risk management analysis. A tool known as 'Portfolio Analyser' is utilised to monitor sector exposures, with another called 'Style Analyser' for monitoring key style metrics at the portfolio, sector and stock level.
- Lonsec considers the manager's approach to risk management on the short side to be prudent with stocks chosen for shorting limited to a maximum absolute weight of 2.5%. Liquidity is also a key consideration, with the time to exit shorts targeted to be less than one week under typical market liquidity. Importantly, for outright short positions the manager typically implements tight stop loss limits or protects the position with an option overwriting strategy.

Performance

- Given the December 2009 inception date of the Fund, performance analysis over any meaningful time period is not yet possible. That said, the manager launched the INGIM Wholesale Extended Alpha Australian Share Fund in August 2008 which can be considered an appropriate proxy for performance.
- Short term performance of this strategy has been very encouraging, with the Fund returning 65.4% (gross) for the one year period ending December 2009. This compares favourably to the benchmark S&P/ASX 300 Accumulation Index (37.6%) and the Lonsec peer group average (33.5%).

It should be noted that Lonsec's Australian equity long/short peer group includes both absolute return style funds and beta 1 or 130/30 style products.

Overall

➤ Lonsec has assigned a 'Highly Recommended' rating at its initial review of the ING Extended Alpha Australian Share Fund. Since he joined INGIM in October 2008, Lonsec has gained significant conviction in the portfolio management capabilities of Pandit. Lonsec considers the manager to be backed by a solid investment process and impressive portfolio management and risk management tools and systems. Importantly, Lonsec believes the manager's robust and disciplined framework, coupled with the skills of Gian Pandit, intuitively lends itself to long/short investing.

➤ Lonsec considers Pandit to be an exceptional investment professional, making this an attractive fundamental offering within this sector.

People and Resources

Size and Experience

The INGIM Australian Equities team consists of 10 members including seven with specific stock analysis responsibilities (including two dedicated small cap analysts). The team has an average of 17 years industry experience, including an average of six years at INGIM.

As a result of the departures in 2008, INGIM made three new appointments to their Australian Equities team during 2008 (Gian Pandit, David Langford and Mason Willoughby-Thomas). David Langford was appointed as a Senior Equity Analyst and has responsibility for coverage of the Gambling, Media, IT, Telecommunications, Infrastructure and Utilities sectors. Langford has also recently taken on additional responsibility as Head of Equity Research. Langford has approximately 12 years of industry experience gained from broking and corporate finance at Lehman Brothers, Morgan Stanley, ABN AMRO and Telstra.

Mason Willoughby-Thomas joined INGIM as an Equity Analyst and is working closely with Vik Pitrans (Senior Equity Analyst and Global Resources Portfolio Manager) covering the metals, mining, gold and diversified resources sector. Willoughby-Thomas has eight years of industry experience from previous roles at ABN AMRO and AMP Capital Investors.

Team Structure

All members of the Australian Equities team report to Langford, who reports directly to Wright. Analysts are split down sector lines, with each analyst acting as a 'back up' analyst for one or more sectors.

Wright is supported by three other portfolio managers in the Australian Equities team. Gian Pandit runs the Concentrated and Long/Short strategies while Michael Price is responsible for the Sustainable, Imputation and Tax Effective mandates. Sinclair Currie manages INGIM's Small Companies capability and an Ex-20 strategy. Lonsec notes that in addition to his portfolio management responsibilities, Price, as Director – Investment Process, also oversees investment process development and integrity.

As well as the large cap equities team, the Fund is supported by a small cap team (two staff), property (three) and quantitative team (three dedicated to Australian equities). The equity team also employs a dedicated dealing resource (two) responsible for portfolio implementation.

Team Member	Position	Years with INGIM / Industry Experience
James Wright	CIO, Asset Strategies and Alternatives / Head of Equities	10 / 20
Michael Price	Director, Investment Process / Senior Portfolio Manager	15 / 19
Gian Pandit	Senior Portfolio Manager	1 / 19
David Langford	Head of Equity Research/Senior Equity Analyst	1 / 14
Vik Pitrans	Senior Equity Analyst / Portfolio Manager	15 / 31
Ray Gin	Senior Equity Analyst	5 / 24
Kieran Sisson	Equity Analyst	6 / 13
Mason Willoughby-Thomas	Equity Analyst	1 / 8
Sinclair Currie	Portfolio Manager – Small Caps	2 / 15
Joel Fleming	Equity Analyst – Small Caps	2 / 10

A key competitive advantage of INGIM is the extensive resources of the organisation, which allows the manager to have teams in areas such as quant, trading, and implementation, as well as allowing a significant budget for activities such as overseas travel. That said, Lonsec believes that the manager could better exploit the link with its global parent. Most other managers reviewed by Lonsec who have global links are more heavily integrated with their offshore parents. To this end, the manager has signalled its intention to promote stronger global connectivity going forward, through getting Australia integrated into the global analyst network ('Research Web') and by establishing global conference calls on a more frequent basis.

Turnover

Over the three years to June 2008, INGIM's large cap team had been one of the most stable within Lonsec's Australian equity universe, with no departures. The departures of Paul Cuddy and Mark East was a material and disappointing event. These departures followed that of the entire small cap team during 2007. Lonsec notes that in both of these instances, the departures were a result of each team pursuing another funds management opportunity.

Pleasingly since these departures in June 2008, INGIM has appointed three new members to its large cap team, in addition to James Wright, CIO.

Remuneration / Alignment of Interests

Analysts' variable remuneration is primarily linked to performance, in particular individual stock calls regardless of whether they are reflected in the portfolio. The manager operates an analyst attribution system, which allows for ongoing monitoring of analyst performance. Variable remuneration for portfolio managers is primarily linked to overall fund outperformance. Importantly, variable remuneration represents a material portion of an individual's total remuneration. Lonsec is pleased with this strong skew towards performance based incentives.

Investment Style

INGIM adopts a fundamental bottom up / top down 'Core' investment style. As a 'Core' style fund the manager is indifferent to investing in either value or growth stocks. At various stages through the market cycle the Fund may exhibit a mild value or mild growth style bias.

Via the incorporation of fundamental research and quantitative analysis the manager aims to identify and understand changes in earnings and valuations and how these may differ relative to market 'consensus'.

Research Approach

For each company assessed a Valuation score (three year intrinsic value), Earnings score (outlook over the next six months) and Conviction score (expected six month relative return) is assigned by the analyst which captures the analysts' qualitative view of the company. Stocks are then ranked based on this qualitative view and quantitative analysis to derive a final ranking. Given the dynamic nature of the ranking model, the focus is typically on whether stocks are moving up or down in ranking, rather than absolute rank.

Overview	
Investment Style	Core
No. of stocks in universe	All ASX listed stocks
No. of stocks fully modeled	125
No. of stock partially modeled	175
Key Screens	Refer Quant Analysis section below
Top Down	20%
Bottom Up	80%
Investment Process	6 key stages: Fundamental Research, Quantitative Analysis, Portfolio Construction, Risk Management, Execution, Performance Measurement
Fundamental Research	Includes an assessment of Industry strength, Business Franchise, Capital Management, Management Quality, Financial Risk, ESG factors
Quantitative Analysis	
Stocks rated on key metrics within four broad categories:	
- Value 25%	
- Quality 20%	
- Business Momentum 25%	
- Market Recognition 30%	

Inputs include:

- ING analyst estimates
- Broker consensus data
- Company specific factors

This is then all incorporated into the Multi-Factor Rating System (MFRS) that combines the fundamental research with quantitative analysis to achieve an overall rating for each stock. The MFRS weighting is based on:

- 40% quantitative analysis
- 10% qualitative assessment of the sustainability of business model (including ESG)
- 50% analyst conviction scores

Key valuation metrics, as well as the qualitative scores, 'bull' and 'bear' case points, notes from company meetings, and overall analyst conviction ratings are all encapsulated within INGIM's proprietary on-line 'Stock Rating Summary' (SRS) system. This system assists in ensuring a strong level of consistency and transparency in the research process, and allows for an effective peer review process. To this end, peer review is an important part of INGIM's process, which ensures that analysts' assumptions are continually challenged by both other analysts as well as the portfolio managers.

Valuation Approach

Primary Analysts are able to utilise the valuation method they consider most appropriate. That said standard valuation metrics assessed include NPAT, EBITDA, Net Debt, EPS, FCF, DPS, NTA, ROE, Interest Cover and NPV.

Current and three year forecasts are derived.

Secondary N/A. Internally derived valuations are compared to externally sourced data.

Portfolio Construction

Overview

Portfolio construction is the responsibility of Gian Pandit. The portfolio's long holdings exhibit a high correlation (95%) with the manager's concentrated strategy (Select Leaders) in addition to some other stocks. Pandit constructs the portfolio utilising a bottom up / top down approach. From a bottom up perspective the multi-factor model and the fundamental research undertaken (in particular the analyst's conviction rating) are the key drivers. The top down overlay involves the manager taking into account considerations such as the point in the economic cycle, what the forecasts are for key commodity prices, what point we are at in the interest rate cycle, market risk appetite, factor exposures, sector weights, diversification of return opportunities and risk management.

In constructing the portfolio, Pandit has access to a number of proprietary tools, with the primary tool being the Portfolio Construction Matrix. The Portfolio Construction Matrix essentially combines the quantitative and qualitative signals with the analyst conviction score to produce stock recommended weightings. Lonsec notes that the Portfolio Construction Matrix is purely an additional 'aid' within the overall portfolio construction framework and is largely used as a starting point. The portfolio manager is ultimately accountable for construction of the portfolio and maintains full 'flexibility' with respect to stocks selected and final weightings.

The manager's sell discipline is largely guided by the stock ranking process. Changes to a stock's qualitative and quantitative assessment will affect the total score of the company, which will in turn influence its relative ranking. Essentially, those stocks that fall below the minimum threshold will generally be sold out of the portfolio.

The portfolio typically holds up to 45 stocks (long) and 25 stocks (short). The Fund is actively traded, a factor which typically results in a high proportion of distributed income, including realised capital gains (and thus has a relatively low level of tax effectiveness).

Quantitative Performance Analysis								
Annualised after-fee % returns as at 31 December 2009								
	1 Year		2 Years		3 Years		5 Years	
	Fund	Peer Group	Fund	Peer Group	Fund	Peer Group	Fund	Peer Group
Performance (% pa)	-	33.5	-	-7.6	-	-1.3	-	7.6
Standard Deviation (% pa)	-	15.1	-	20.9	-	18.5	-	15.7
Excess Return (% pa)	-	-4.1	-	0.7	-	-0.5	-	-0.7
Outperformance Ratio (%)	-	44.2	-	51.3	-	52.5	-	51.2
Worst Drawdown (%)	-	-8.4	-	-40.5	-	-44.6	-	-42.6
Sharpe Ratio	-	1.9	-	-0.6	-	-0.3	-	0.2
Information Ratio	-	-0.2	-	0.2	-	0.2	-	0.1
Tracking Error (% pa)	-	8.0	-	9.3	-	8.4	-	8.2

Fund: ING Extended Alpha Australian Share Fund

*Benchmark: S&P/ASX 300 Accumulation Index

Peer Group: Average among Lonsec rated Australian equity long/short managers

It should be noted that Lonsec's Australian equity long/short peer group includes both absolute return style funds and beta 1 or 130/30 style products.

*Lonsec uses the S&P/ASX300 index for comparison purposes for the Australian equity long/short peer group. This index may not be the benchmark used by the individual fund manager for performance targets. For example, INGIM uses the S&P/ASX200 as its internal benchmark.

Given the December 2009 inception date of the Fund, performance analysis over any meaningful longer-term time period (three to five years) is not yet possible.

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

Analyst Disclosure & Certification

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Analysts: Brad Street
Release Authorised by: Paul Pavlidis

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