FundSource NZX

Qualitative Fund Research

Devon Trans-Tasman Fund

October 2018

About the Manager

Devon Funds Management Ltd (Devon or the Manager) has provided a comprehensive corporate profile available here. Devon was established in 2010 and has proven to be successful in growing its business in institutional and retail funds management.

Devon takes its fiduciary duty to clients very seriously. The Manager believes it has an obligation to ensure that the businesses it invests into conduct themselves in accordance with the highest governance standards. The Manager outlines its values and views on the expectations of businesses Devon invests in, viewing good corporate citizenship, stakeholder interest and sustainability as being the foundation of good business sense, available here. FundSource views corporate citizenship and governance frameworks as extremely important foundations from which a manager starts to engage with the client experiences.

Understanding clients is at the heart of any business and is critical to the longevity of an investment manager. Devon has a clearly articulated statement on Client Care here.

Devon manages a range of funds including:

- Devon Alpha Fund
- Devon Australian Fund
- Devon Dividend Yield Fund
- Devon Diversified Income Fund
- Devon Trans-Tasman Fund
- Devon Global Themes Fund; and
- Wholesale Funds

The funds above are managed by four Portfolio Managers, who, together with an additional investment analyst are also responsible for sector research. Operations consists of six people plus the Managing Director. For the number of funds being managed this is a small team of well tenured and experienced personnel. Individual bios on the team at Devon can be found here.

Using this Fund

This is General Advice only and should be read in conjunction with the Disclaimers, Disclosures and Warnings at the end of this document.

The focus of the report is the Devon Trans-Tasman (Trans-Tasman Fund or the Fund). The Fund is a ‘long only’ Trans-Tasman equity product. Although the Fund can theoretically hold high cash positions its typical cash balance is below 5%. This Fund will generally sit within the growth component of a balanced portfolio.

The Fund is relatively concentrated (typically owning 25 – 35 stocks), and has few constraints regarding stock size, sector or index composition. The Fund is suitable for higher risk profile investors with a minimum investment time frame of five years.

The Fund is subject to equity market risk and movements (both positive and negative) in the share prices of the underlying securities in the portfolio. The ability to allocate between either New Zealand or Australian equities, as well as security selection can impact performance. Accordingly, investors should therefore be aware that the Fund may experience periods of negative returns and that there is a risk of potential capital loss being incurred on their investment.

The Fund may enter into forward currency and other derivative contracts to manage its Australian Dollar currency risk.

The Fund’s investment policy allows for borrowing up to 20%. This facility, yet to be utilised, is in place for liquidity purposes and not to gear the Fund.

The Fund is a Portfolio Investment Entity (PIE). The Fund has a semi-annual distribution policy (at the Manager’s discretion).

Question	What the Manager says	What FundSource thinks
What are the Manager's assets under management - in total and in this Fund?	As at June 2018 Devon Funds Management (the Manager) had about $2.3 billion under management on behalf of a diverse range of New Zealand clients, including; the New Zealand Superannuation Fund, Community Trusts, charities, KiwiSaver schemes, corporates pension schemes and individual investors. As at 30 June 2018: Alpha Fund: $ 136.01M Australian Fund: $ 16.3M Diversified Income Fund: $ 5.7M Dividend Yield Fund: $ 185.06M Trans-Tasman Fund: $ 279.40M Global Themes Fund: $ 68.2M Mandates $1,501.65M **Manager Total FUM: $2,290.22M**	The business has significant funds under management across its six strategies. The Trans-Tasman Fund is a more diversified and constrained version of the Alpha Fund, reduced cash exposure being a key differentiator between the Trans-Tasman and Alpha funds. The Fund commenced on 30 September 1998 as the Goldman Sachs JBWere Trans-Tasman Equity Unit Trust. Devon commenced managing the Fund in 1 March 2010, renaming the Fund to the Devon Trans-Tasman Fund.
Who is accountable for managing the Fund, and how long has the investment team worked together?	Tama Willis is the Portfolio Manager. Willis has over 15 years' experience in investment markets and joined Devon in mid-2012. Primary research responsibilities are split by sector between the four Portfolio Managers and an analyst.	Willis has been a Portfolio Manager at Devon for almost five years and has certainly delivered excellent performance. While Willis is ultimately responsible, research is conducted by all the investment team. The tenure of the investment team remains strong. Since commencing operations in 2010, the Manager has added resources building out the team as required. The most recent investment team departure has been Slade Robertson who moved to the role of Managing Director in March 2017. On that basis, FundSource would view the addition of analyst resources to the investment team, over 2017, positively.
What objective is the Manager trying to achieve?	The Fund aims to generate capital growth over the long term by actively managing a portfolio of New Zealand and Australian equity investments. The Fund aims to beat its Benchmark - a 50:50 composite of the NZX 50 Gross Index and the S&P/ASX 200 Gross Index.	The Fund has been inline or above the average the FE Analytics New Zealand Managed Investment (NZMI) Australasian sector. The Manager's recent updates highlight that near term performance has dropped below the hybrid reference benchmark. The Manager reports performance on a net of fee basis, as detailed in the Funds monthly reports. FundSource notes that reference benchmarks do not typically consider fees or taxes. Further performance information can be found on the Disclose website.
What does the Manager invest your money into?	The Fund invests in a portfolio of approximately 25-35 companies which are New Zealand and Australian listed companies. While the Fund tends to be fully invested in shares, when there are few compelling investment opportunities, the Fund may hold some cash or cash equivalent securities. The investment limits are: 0-100% NZ Shares, 0-100% Australian shares, and 0-50% cash or cash equivalent securities. The Fund does not typically hedge out its Australian dollar exposure. This is consistent with its underlying benchmark.	The Fund is suitable for investors who are looking for an actively managed exposure to the New Zealand and Australian equity markets via a relatively concentrated portfolio of stocks. Notably the portfolio may include material sector bets relative to the benchmark. The Manager's default position is to leave foreign currency exposures, introducing currency risk in to the portfolio. The Manager does have discretion to vary the hedging from 0%-100%, and therefore, can reflect any specific views the Manager has with respect to currency.

		The Fund is an Australasian Equity fund, and investors in the Fund should have a minimum investment horizon of at least five years. Over shorter time periods there is the risk of a substantial loss of investment capital if the investment were to be realised.
What are the inherent risks imbedded in the Fund?	The principal risks of investing in the Fund are risks relating to: • investing in shares; • the investment objectives not being met; • the performance of a particular company they have invested in; • the concentration of the Fund in a particular region, industry, or other grouping; • Unit pricing or taxation errors; and • currency risk management between the New Zealand dollar and Australian dollar.	The Manager is aware of the broad range of risks and is mindful of them when constructing and managing the portfolio. Given the concentrated profile of the portfolio, stock specific risk is higher than more diversified equity funds. The Fund can take significant sector bets relative to the underlying indices. FundSource believes that the Fund's performance has the potential to be more volatile than a portfolio which is more diversified and benchmark aware. Stock concentration doesn't always mean investors will have will have different experience to investing in to the broader market. However, the Funds beta and volatility metrics, available from FE Analytics, indicates the Funds' performance has ranged from below to above the Funds nominated index.
Why does the Manager believe the future prices of the Fund's investments will vary?	They Manager invests in what it assesses are attractively priced companies operating in areas of the economy where there is strong growth and where the company has a sustainable competitive advantage over similar firms. The Manager also seeks out short-term opportunistic investments.	FundSource views the Fund's investment approach to be similar to many other fund managers conducting fundamental, bottom-up research, spending a lot of their time visiting companies, and utilising the research provided by external sources such as sell-side brokers, (although they rely upon their own investment models). The Manager's edge is that they invest in a relatively small number of shares and are less benchmark aware than most equity investors, including taking sector bets and investing outside the S&P/NZX 50 and S&P/ASX 200 listings. FundSource notes that at times the Manager may invest in shorter-term trading opportunities. This means the Fund can be opportunistic, which has the ability to enhance the positive and negative aspects of potential performance, volatility and trading costs associated with the Fund.
Why does the Manager believe you should give them your money rather than to someone else or to an inexpensive index fund?	The Manager clearly articulates its investment philosophy and process, which it says it has been adhering to since the inception of the Fund, and that the approach has been a success as measured by their level of outperformance of the benchmark.	The Fund's return to investors, available on the Manager's and the Disclose website, highlight the Funds' performance compared to the Funds' hybrid index, being 50:50 NZX50 Gross & ASX200 Gross Accumulation Index, highlighting the funds periods of annual outperformance and recent underperformance. FundSource believes the Funds' performance is attributable to the broader team, in this case, as Willis stepped in to the PM role in 2016, while retaining his PM responsibilities for the Australian Equity Fund. The Manager has three core statements which are publicly available through the

		Manager's values and client care statements and approach to responsible investing. These statements clearly spell out the commitment Devon undertakes to investors and how they manage funds on behalf of investors. The statements published on Devon's website do differentiate the Manager, in that few managers clearly articulate this in writing. In conjunction with a disciplined approach to investing, the Manager presents a clear rational as to why a potential investor should consider investing in this Fund.
How does the Manager decide to buy or sell investments?	The Manager filters and identifies investment opportunities through detailed industry and company analysis. Devon use research models to value each company they wish to invest in, subjecting them to rigorous analysis focusing on their earnings, capital structure, free cashflow generation and growth prospects. The investment team conducts a review of each business to assess its industry structure, management quality, governance structures, competitive position and growth plans. Peer reviews are then conducted to ensure the Fund invests in, what the Manager believes, are the best possible companies. Companies, identified in the research process, are then included in a portfolio of shares. The key factors considered in building the portfolio are the company's valuation, an assessment of the business, its risk characteristics, liquidity, the manager's views on the economy and the identification of a catalyst to boost its performance.	The Manager's focus on five key areas/characteristics of a company (business model, industry structure, financials, management, and valuation). Each characteristic is considered by the analysts which is a key input to stock selection and portfolio construction. Position sizes in the portfolio is determined by a series in inputs including: analyst views, qualitative assessments, return expectations, contribution to portfolio risk and liquidity. In addition, external factors which may be a catalyst or headwind to share price performance are considered prior to transacting. The relatively concentrated structure of the portfolio means the Manager will have to critically evaluate each position regularly, and exit companies that have reached 'fair value' in their view or where the quality of the business has declined, even if this is over a short time period. All investment ideas and portfolio changes are assessed by Devon's Investment Committee (which currently includes the entire investment team, the Managing Director and a representative from the Compliance team).
Has the CIO/ Portfolio Manager personally invested in the Fund? If so, paying the same fees as other investors?	Staff can only invest in Australasian Equities via the Manager's funds. The Portfolio Manager has invested in the Fund. He pays the same fees as other investors.	FundSource believes that the interests of investment personnel are better aligned to those of the investors, when investment personnel are significantly invested, and at the same fees. Effectively the investment team are eating their own cooking, bringing strong investor alignment.
How much latitude does the Manager have to deviate from the weightings of the Benchmark portfolio?	The Portfolio Manager has complete discretion as to which stocks are used to build the portfolio of 25-35 securities. Tracking Error: 3-6% Cash Allocation: 0% to 50% Single Stock Limit: NA Sector Limits: NA Regional Limits: NZ Equities 0%-100% Australian Equities 0%-100%	Individual stock positions can have a significant impact on the overall return of the portfolio, especially over shorter time periods, say, one year. FundSource views that the Portfolio Manager's level of discretion is expected to result in the return of the Fund differing significantly from that of the benchmark, as it has since inception. Thus, investors seeking a benchmark-like return may not be suited to the Fund. Most constraints are soft, providing further latitude for the manager to implement the process. This is reflected in the Managers

		approach to hedging, where investors should expect the Fund to be typically unhedged, but the Manager can hedge from 0-100%.
On what basis does the Manager believe the fees they charge are justified?	The Manager charges a base fee of 1% p.a. plus GST, and a performance fee of 10% of the net return of the Fund over a hurdle of 9.85% for the relevant period, subject to a high-water mark, plus GST. The Manager said it is reviewing the performance fee structure. The Devon Funds Product Disclosure Statement of 4 May 2018 states: "The high-water mark can be reset every three years at our discretion following consultation with the Trustee."	The Funds basic fee is below the average fee charged by peer funds in the FE Analytics NZMI Equity Australasia sector. FundSource notes this remains the case with the Funds administration fees added. FundSource believes that a fund manager should only charge performance fees for a long-only Australian equity fund when their base management fee is significantly below the market average fee. Notwithstanding this view, the actual performance fee calculation is not relative to the Fund's benchmark, but to an absolute percentage return. This is inappropriate. There should be a direct alignment between the manager's remuneration and the performance of the Fund relative to its benchmark.
How would you describe the quality of your organisational and investment governance processes?	The Board consists of six Directors, three of whom are independent. The Audit & Compliance Committee and Remuneration Committee are chaired by one of the Independent Directors. The Managing Director heads the Operations Team, totalling seven staff. The Trustee, Custodian, and Registrar/Administration functions are outsourced to reputable firms.	The Manager has a strong governance structure which starts with the composition of the Board and leadership of key Board Committees. In addition to the out-sourced functions, there are sufficient internal personnel in operational roles, to ensure that the four investment team members can concentrate on managing the portfolios. The integration of the environment, social and governance (ESG) in to the research process is viewed positively, however, investors should be aware that ESG and the United Nations Principles of Responsible Investing (UNPRI) are relatively loose, and is not seen as a negative screen for filtering companies. The important aspect that underpins UNPRI and ESG is the application of the principles, with active ownership being one factor Devon specifically state in their approach to responsible investing.
Is there alignment of interests through; ownership of the Manager, and remuneration of the investment team?	The Manager, Devon Funds Management Limited, is a 100% subsidiary of the Investment Services Group Limited which is wholly owned by interests associated with the staff and directors of the Manager. The business was established in March 2010 when it acquired the asset management business of Goldman Sachs JBWere NZ Limited. Staff salaries are slightly below market by design. Compensation also comes from the bonus pool and is directly tied to the performance of funds/portfolios and the business. A number of funds/portfolios have performance fees so that the firm and client incentives are aligned.	Being 100% owned by its employees and directors, there is strong buy-in from the team to work hard for the firm's long-term success - this is good news for investors. There is alignment between the bonus component of staff remuneration and the performance of the funds/portfolios, although FundSource doesn't know how bonuses are calculated and thus can't comment on the extent to which it is aligned to the interests of investors.

Conclusion and Rating

The Fund provides an investor with exposure to a concentrated Australasian equity portfolio focused on companies that exhibit a sustainable competitive advantage, strong management and governance, with a clear plan for growing shareholder wealth. The fund can invest in non-benchmark securities, which have historically been material positions in the portfolio, and deviate from benchmark sector weights significantly. Investors should expect this Fund's portfolio positioning to be materially different to that of the Fund's reference benchmark.

FundSource notes that the Funds FUM is higher than the Manager's other Funds. However, capacity is not considered an issue, due to the increased number of portfolio holdings, and therefore diversification, compared to the Managers more concentrated products.

Despite building out the operational aspects of the firm, and adding an analyst resource, portfolio management expertise has been retained.

FundSource's conviction in the Manager is underpinned by its measured approach to growing the investment team over time, methodical research process, which includes oversight from the Investment Committee, and the ability to attract staff as required.

The Manager's basic fee is below the peer average in the FE Analytics NZMI Equity Australia sector. This is aligned with FundSource's preference to see a lower than average basic management fee being applied when performance fees are being charged. However, FundSource highlights that the calculation of the Managers performance fee and the ability to reset the high-water mark after three years is not aligned with an investor's experience. The basis for calculating the performance fee is a key detractor, from a fee perspective.

FundSource recommends that investors carefully consider that the Managers focused high conviction approach to managing Australian equities, meets their investment needs and objectives.

FundSource Rating: **AA**

Fund ratings are current as at the date of publication of this report. FundSource reserve the right to review and update fund ratings from time to time.

Research Factor Weighting

Research Process Category	Model Factor Weight	Analyst Average Score
Corporate & Investment Governance	15%	4.25 / 5
Investment Philosophy & Process	20%	4.40 / 5
People	25%	4.00 / 5
Portfolio Construction & Implementation	15%	3.33 / 5
Risk Management	15%	3.40 / 5
Investment Fees	10%	2.86 / 5

Overall Average Score: **3.81 / 5**

FundSource Rating Guide

The qualitative rating of a fund is a function of the FundSource Research Factor Weighting process, which is built around the six core qualitative research process categories. The weighted scores result in an overall score, out of five, which is then matched to the following rating:

AAA: Highly Recommended

Funds that have superior average scores in all six underlying qualitative factors. This recognises aspects about the Manager and Fund in question that includes, but is not limited to, significantly experienced and stable senior personnel, a sound track record over a full market cycle, a clearly defined investment philosophy and process, and a portfolio consistent with that philosophy and process. The management company will also have established effective controls to maintain that philosophy.

AA: Recommended

Funds that have strong average scores in all six underlying qualitative factors. This recognises aspects about the Manager and Fund in question that includes, but is not limited to, experienced and stable personnel, a sound track record over a full market cycle, a clearly defined investment philosophy and process, and a portfolio consistent with that philosophy and process. The management philosophy must be coherent and consistent with existing portfolios and processes.

A: Investment Grade
Funds that have good average scores in all six underlying qualitative factors. This recognises aspects about the Manager and Fund in question that includes, but is not limited to, experienced personnel, a sound track record a defined investment philosophy and process, and a portfolio consistent with that philosophy and process.

FW: Fund Watch
There has been a material change with either the manager, this may include, but is not limited to, departures, new hires, process changes, changes to the investment philosophy. This is considered to be an interim measure, to enable further investigation, re-evaluation and an appropriate course of action to be determined.

S: Sell
This category covers previously recommended funds that are no longer recommended because of some material change. Removal from recommended status might be for a variety of reasons such as a fundamental change in the fund management company or in the manager's investment strategy, or because a fund did not meet its original expectations. The implications for ongoing service are that the fund should be reviewed on an individual client basis to ensure it still matches their original investment objective.

NR: Not Rated – Screened/ Not Rated
Funds in the Not Rated – Screened category have provided information and/or FundSource has conducted an initial analysis of the fund, but has chosen not to provide a recommendation at this stage. FOR Not Rated funds the manager may have provided information, but no review meeting has been conducted

Disclaimers, Disclosures and Warnings

FundSource Limited notes that the information in this report must be read in conjunction with the warning and disclaimer below. This report supersedes all prior reports.

Warning: Past performance is not a reliable indicator of future performance. Any information, opinions, views or recommendations in this report are for general information purposes only. To the extent that any such information, opinions, views and recommendations may constitute advice, they do not take into account any person's particular financial situation or goals and therefore do not constitute personalised financial advice under the Financial Advisers Act 2008, nor do they constitute advice of a legal, tax, accounting or other nature to any person. This report should not be relied upon as a substitute for advice from your authorised financial adviser.

Disclaimer: FundSource gives no warranty of accuracy or completeness of information in this document, which is compiled from information from public and third party sources. Opinions and ratings are reasonably held by FundSource at compilation. FundSource assumes no responsibility to update this report after publication. Except for any liability which cannot be excluded, FundSource, its directors, officers, employees and agents disclaim all liability for any error, inaccuracy or omission, or any loss suffered through relying on this report.

FundSource

FundSource is a New Zealand managed funds research house supplying independent research and data to financial advisors and fund managers since 1987.

FundSource delivers high quality quantitative and qualitative fund research to financial advisors and the broader financial services industry. FundSource works with a number of expert providers to source this data. Quantitative data is supplied by FE Australia, while qualitative research is provided by Research IP.

FundSource is a wholly-owned subsidiary of NZX, the operator of the New Zealand stock exchange. For more information about FundSource please visit www.fundsource.co.nz

NZX

NZX provides high quality information, data and tools to support business decision making. NZX builds and operates capital, risk and commodity markets, and the infrastructure required to support them.

NZX owns a suite of securities and agricultural information businesses; managed fund research house FundSource; exchange traded funds provider Smartshares; and manged funds provider SuperLife.

RESEARCH IP

FundSource's qualitative research is conducted by independent research company, Research IP Pty Ltd. Research IP was founded in 2015 as a special purpose financial services vehicle, licensing or contracting the services of specialist advisers and analysts. The rationale behind contracting, as opposed to employing staff, is to provide flexibility, and allow Research IP to leverage the skills of specialists on an as required basis, to best meet the brief and scope of the work required to be completed. Research IP is able to leverage executive, corporate, funds management, compliance, administration, operational, quantitative analytics, qualitative research, data collection, interpretation and analysis, and database technology specialists, to deliver client focused solutions.

By leveraging the skills of specialists, Research IP is able to provide innovative and tailored financial services solutions to the market place. Client focused outcomes are underpinned by the belief that the role of business model innovation and accelerating technological change opens up new possibilities, to put client interests at the centre of the financial services industry focus, based on John Hagel's work on the possibilities for "Disruption by Trusted Advisors" and John Kay's "Other People's Money: Masters of the Universe or Servants of the People".

FundSource

FundSource Limited
Level 1, NZX Centre
11 Cable Street
PO Box 2959
DX: SP23501
Wellington, New Zealand

Telephone: +64 4 495 5058
Facsimile: +64 4 496 2893
Email: fundsource+enquires@fundsource.co.nz

NZX

NZX Limited
Level 1, NZX Centre
11 Cable Street
PO Box 2959
DX: SP23501
Wellington, New Zealand

Telephone: +64 4 472 7599
Facsimile: +64 4 496 2893
Email: info@nzx.com