Zenith Investment Partners

Highly Recommended
Recommended
Approved
Not Rated
Redeem

Product Assessment

L1 Long Short Fund Limited

Rating issued on 16 Feb 2018

The Company is a newly incorporated Listed Investment Company (LIC) which intends to provide access to an established Australian equity long/short offering managed by L1 Capital (L1). L1's long/short strategy has a strong, albeit relatively short, track record dating back to September 2014, over which L1 has demonstrated material value add from short selling and market exposure adjustment. In addition, Zenith draws comfort from the impressive long-term track record L1 has built managing long-only strategies, which we expect to be the primary driver of the strategy's performance. Zenith believes the Company is well placed to meet its investment objectives over the long-term, based on Zenith's confidence in L1's investment team and the attractiveness of the underlying investment philosophy and process.

Founded in 2007 by Raphael Lamm and Mark Landau, L1 is an independent equities focused fund manager that is fully owned by the investment team. Zenith believes the investment team's ownership in the business serves as a strong staff retention tool.

The investment team, based in Melbourne, consists of four investment professionals and is led by Lamm and Landau who collectively have over 30 years investment experience. Before establishing L1, Lamm and Landau were involved in the management of Australian equities strategies for Cooper Investors and Invesco Australia, respectively. Both strategies were top performers within their peer group over five year periods prior to founding L1 in 2007. Zenith believes Lamm and Landau have established a strong working relationship which is evident in the impressive performance track record of L1's flagship Australian Equities Fund which they have co-managed since its inception in August 2007.

L1 believes that markets are inefficient in the short-term which presents opportunities for L1 to generate returns. L1 has traditionally held a bias towards stocks exhibiting quality and value attributes. Ultimately, L1 aims to build a long (short) portfolio of stocks that are high (low) quality at attractive (unattractive) valuations.

The investment process involves both a top-down and bottom-up approach. Whilst L1 expects to generate the majority of its returns through its bottom-up stock selection process, a material proportion of its overall value-add is expected to be sourced from the asset allocation/risk management decision.

For a stock to be included in the Company's portfolio, consensus is needed between Lamm and Landau. In the event unanimity is not achieved, the conservative option is taken, and either the stock is not purchased or the lower suggested weight is taken. Position weights are determined based on the level of conviction in the idea as well as the expected risk/reward trade off.

The Company is seeking to raise a minimum of $100 million under the offer, with a maximum of $600 million (including oversubscriptions). L1 will underwrite the costs of the offer so that upon listing, the shares are expected to have a Net Tangible Asset value (NTA) equal to the listing price.

L1 and the Company have agreed that, to the maximum extent permitted by law (up to a 15% position, with a maximum of 19.9%), the L1 owners will reinvest in the Company all of their after-tax proceeds from any Performance Fees via a Share purchase mechanism, the terms of which are dictated by the IMA. Zenith views this favourably in terms of alignment of interests between L1 and investors in the Company.

In Zenith's view, the Company is materially more expensive compared to broader Australian LICs. Zenith also considers the strategy expensive in comparison to Australian Long/Short managed fund strategies. Zenith also believes the performance fee for the strategy is poorly structured due to the lack of an appropriate benchmark.

FUND FACTS

- LIC targeting actively managed, long/short exposure to Australian equities
- Typically holds 40 to 60 long positions and 10 to 30 short positions
- Expected market sensitivity of between 0.2 and 0.8, gross exposure of 200% to 250%
- Portfolio turnover expected to be high at approximately 200% p.a. to 300% p.a.
- Has historically held 25% in International equities

APIR Code
ASX:LSF

Asset / Sub-Asset Class
Australian Shares
Listed Investment Companies - LICs

Investment Style
Long / Short

Investment Objective
To achieve absolute returns (net of fees) in excess of 10% p.a. and lower volatility than the market over the long-term.

Zenith Assigned Benchmark
S&P/ASX 300 (Accum)

Fees (% p.a., Incl. GST)
Management Cost: 1.44%
Performance Fee: 20.5% (Inclusive of GST net of reduced input tax credits)

ABSOLUTE RISK (SECTOR)

- VERY HIGH
- ▶ HIGH
- MODERATE
- LOW
- VERY LOW

RELATIVE RISK (FUND WITHIN SECTOR)

- Geared
- ▶ Active - Benchmark Unaware
- Active - Benchmark Aware
- Index - Enhanced/Fundamental
- Index

INCOME DISTRIBUTIONS PER

MONTH | QUARTER | **6 MONTH** | ANNUM

INVESTMENT TIMEFRAME

1-2 YRS | 3-4 YRS | 5-6 YRS | **7+ YRS**

APPLICATIONS OF INVESTMENT

SECTOR CHARACTERISTICS

Listed Investment Companies (LIC)

In assessing the performance of the LIC sector, it is vital to understand how their structure affects the final performance figures as it is materially different to unlisted funds. As listed companies, the portfolio returns generated are exposed to additional volatility from share price movements and can trade at significant premiums or discounts to Net Tangible Assets (NTA).

In addition, the impact of pre and post-tax returns needs to be considered because LICs distribute returns net of company tax, whilst benchmark index returns are quoted on a pre-tax basis. Accordingly, it is difficult to accurately compare shareholder returns to either benchmarks which do not account for tax or realised peer group LICs where the timing of company tax on realised gains differs.

As an indication however, a series of return data can be viewed on the basis of the returns generated by:

- Share price and dividends
- Change in pre-tax NTA value and dividends
- Returns generated internally by the investment portfolio

For comparison purposes, the use of the internal portfolio returns versus the benchmark gives the closest measure of the investment manager's skill in generating returns. However, these returns may not be able to be fully crystallised to shareholders given the potential for share price movements.

Caution should be used in the comparison of these figures as share price and pre-tax asset NTA are measures which take into account company tax paid on realised capital gains and unfranked income, whereas benchmark performance is a wholly untaxed measure.

At various times when assessed on a purely quantitative basis, a LIC can trade away from its NTA which may represent good buying or selling opportunities. While these instances may boost investment returns, there is no guarantee that the discount or premium will converge to NTA, therefore, gains can not be crystallised.

Australian Equities

The sector incorporates both benchmark aware and benchmark unaware strategies but the funds focus predominantly on large capitalisation stocks. The sector is one of the most competitive in the investment landscape, based on the number of managers and strategies available to investors. Despite the competitiveness of the sector, the Australian share market has historically provided many opportunities for active management, with the median active manager outperforming a passive index over the longer term.

The Australian share market, as represented by the S&P/ASX 300 Accumulation Index, is highly concentrated and narrow. Technically, a company is assigned the large cap moniker if it falls within the S&P/ASX 50, with those companies falling between the S&P/ASX 50 and S&P/ASX 100 assigned to the mid cap category. All stocks below the top 100 are considered small capitalisation stocks.

As at 31 December 2017, the Financials and Resources sectors combined represented a significant portion of the S&P/ASX 300 Accumulation Index, with the Financials sector accounting for approximately 35% of the index, and Materials approximately 18%. The split between Industrials and Resources stocks was approximately 80%/20%. The top 10 stocks represented approximately 44% of the weighting of the Index, and the top 20 stocks represented approximately 60% of the Index.

In comparison to the S&P/ASX 300 Index, the S&P/ASX Emerging Companies Accumulation Index has a much lower weighting to the Financials sector and is represented by a larger weighting to the Resources sector, which reflects the importance of resources related industries to the micro-cap sector. A significant proportion of these resource companies are classified as "exploration" companies, and in many cases are not cash flow positive, can be highly volatile and their fortune can be linked to whether (or not) a resource body is discovered.

The Small and Micro Cap sector typically have a market capitalisation of less than $500 million and the sector is comprised of approximately 1,600 listed companies with a combined total value of circa $110 billion. Over the longer-term, active management in this sector has historically demonstrated an ability to significantly outperform a passive index given it is an "under researched" segment of the market.

PORTFOLIO APPLICATIONS

In general, compared to most other asset classes, equities offer investors the opportunity for higher capital growth over the longer-term with some income, however, this higher growth is also often associated with higher volatility. As such, it is recommended that investors adopt a longer time frame when investing in equities.

Investors should also be cognisant of the fact that the Australian equity market only represents approximately 1% of global equity markets (in terms of market capitalisation). Zenith recommends that investors diversify their investments across asset classes, both domestically and globally.

The Company utilises a long/short investment strategy which provides L1 with greater flexibility to meet its investment objective and add value for investors over the long-term. The short selling capability enables the Company to profit from companies which are expected to fall in price or hedge against declines in the market and therefore, potentially offer a different return profile to most long-only Australian equity funds.

L1 maximises its ability to meet its return objectives by using a variable beta investment strategy in which the portfolio will typically maintain a net market sensitivity (beta) of between 0.2 and 0.8 over time. The strategy may also produce lower levels of volatility given the higher levels of cash typically held or the ability of the manager to reduce the net exposure through hedging the portfolio with derivatives. As the net beta exposure of the strategy will typically remain below 0.6, the strategy will generally exhibit a lower level of risk relative to the Australian market, however, this means the strategy may potentially lag long-only strategies during strong phases of a bull market rally. As such, Zenith believes the strategy is most appropriate for investors who place a greater emphasis on lower volatility and capital preservation through a full equity market cycle.

For investors seeking to achieve a well-blended exposure to Australian equities, Zenith suggests combining the strategy with other style-neutral, value and/or growth orientated Australian equities products to achieve a more diversified exposure to the asset class.

The Company is expected to invest up to 30% (typically 25%) in International equities. Although Zenith believes this feature assists in the Company achieving its objectives, investors need to be aware of this when considering the overall allocation to International equities funds.

Investors also need to be aware that as a LIC, the shares will have their own trading patterns and may trade away from their NTA which at times may impact the effectiveness of L1's investment process and/or expected risk-return profile.

RISKS OF THE INVESTMENT

SECTOR RISKS

Company's within the "Australian Equities/Listed Investment Company" sector are exposed to the following broad risks:

MARKET & ECONOMIC RISK: As is the case with all long only Australian Share funds, the biggest risk to performance is a sustained downturn across the Australian share market. In addition, changes in economic, social, technological or political conditions, as well as market sentiment could also lead to negative fund performance. This risk can be significantly reduced by investors adhering to the LIC's prescribed investment time frame.

SPECIFIC SECURITY RISK: This is the risk associated with an individual security. The price of shares in a company may be affected by unexpected changes in that company's operations such as changes in management or the loss of a significant customer.

LIQUIDITY RISK: This is the risk that a security or asset cannot be traded quickly enough, due to insufficient trading volumes in the market. When trading volumes are low, sellers can significantly impact the price of a security when attempting to quickly exit a material position.

STYLE BIAS RISK: Australian equity managers will either employ a Growth, Value or Neutral (combination of Value & Growth) styled approach to investing. Each style is conducive to certain market conditions, i.e. Growth should outperform Value in an upward trending market and vice versa in a downward trending market. As with Market Risk, investors should adhere to the LIC's investment time frame to avoid short-term market movements and style impact.

CAPACITY RISK: High levels of funds under management (FUM) can present additional challenges to an Australian equity manager, as high FUM has the potential to hamper the manager's ability to trade efficiently and/or be forced to disclose substantial shareholdings to the market (most common in smaller companies).

PREMIUM/DISCOUNT TO NET TANGIBLE ASSETS (NTA): Investors need to be aware that as a LIC, the Company's shares will have their own trading patterns and may trade away from their Net Tangible Assets (NTA) which at times may impact the effectiveness of the Company's investment process and/or expected risk-return profile.

FUND RISKS

Zenith has identified the following key risks associated with the Company; this is not intended to highlight all possible risks:

IPO / LIQUIDITY RISK: There is a risk that the IPO of the Company fails to raise sufficient capital to enable efficient market liquidity and pricing in the company shares. Should the Company fail to raise a level of capital that Zenith believes is required for the company to be priced effectively, Zenith will retain the right to revisit our issued rating.

KEY PERSON RISK: As with most fund managers, L1 is subject to a level of key person risk. Zenith views Raphael Lamm and Mark Landau as being critical and a departure of either would trigger an immediate review of our rating on the Company; however, Zenith acknowledges the material equity ownership Lamm and Landau maintain in L1 and we believe that this mitigates the risk of a departure, at least in the medium-term.

MARKET EXPOSURE RISK: One of the key risks to the Company, is a sustained downturn in the Australian equities market. However, given the underlying long/short strategy is expected to maintain a net market sensitivity (beta) of between 0.2 to 0.8, Zenith expects a return profile that is less sensitive to market movements relative to long-only peers.

CAPACITY RISK: Excessive levels of funds under management (FUM) can inhibit a manager's ability to trade portfolio positions effectively and may therefore limit outperformance potential. Zenith does not consider capacity to currently be an issue however, this is an area that we will continue to monitor closely.

LEVERAGE RISK: L1 has the ability to short sell stocks and use the proceeds to increase its long exposure. This increases an investor's exposure to L1's stock specific decisions and can magnify returns and losses. The maximum gross exposure, namely the sum of the Company's portfolio long and short exposures, is limited to 300% of the value of the Company's portfolio net assets.

DERIVATIVE RISK: L1 can use derivatives such as options and futures and these investment securities can be volatile, speculative, illiquid and leveraged. Derivatives are typically used for hedging purposes, with index/stock puts used to hedge physical stock positions and futures used to adjust the market exposure of the portfolio. Derivatives will typically not be used to leverage up the Company's portfolio.

COUNTERPARTY RISK: The Company's custody and counterparty contracts are subject to potential default risk. In particular, the Company is exposed to counterparty risk with its Prime Brokers, Credit Suisse and Morgan Stanley. Assets of the Company are required to be transferred to Credit Suisse and Morgan Stanley when borrowing stock for short selling. Assets up to the required collateral amount are held on Credit Suisse and Morgan Stanley's balance sheet and are not segregated from other Credit Suisse and Morgan Stanley assets. Should Credit Suisse and Morgan Stanley become insolvent, there is a risk that the assets posted by the Company may not be recoverable.

TRACK RECORD RISK: Zenith notes L1's long/short track record is limited, dating back to September 2014. Zenith draws comfort from the impressive long-term track record L1 has built managing long-only strategies, which Zenith expects to be the primary driver of the Fund's performance. In addition, we gain conviction in L1's strong, albeit limited, performance to date for its long/short strategy.

UNLISTED INVESTMENT RISK: The Company may gain exposures to unlisted securities which are expected to list within 12 months of purchase. While unlisted securities offer investors the potential of extraordinary returns upon listing, Zenith believes they are subject to high levels of risk. In addition, unlisted investments are also subject to the lack of transparent pricing of the underlying companies. Valuations can be based on internal estimates or on historical costs.

The L1 portfolio has a formal limit of 10% in place for unlisted securities.

TEAM FOCUS RISK: In addition to the Company, the L1 team is responsible for L1's Australian Equities Fund which has significantly more FUM. As such, there is the potential that the team's focus may be diluted away from the Company. However, Zenith is comforted by the fact that there is a high level of overlap between the strategies and that the team has a material level of personal wealth invested in its long/short strategy.

CURRENCY RISK: Given the Company's capacity to invest in internationally listed companies, it may be exposed to fluctuations in the relevant price of the currency relative to the Australian dollar. However, L1 is committed to fully hedging currency for its international positions, which significantly reduces this risk.

QUALITATIVE DUE DILIGENCE

ORGANISATION

L1 Long Short Company

The Company expects to list on the ASX in April 2018 and provide investors with exposure to Australian Equities via a long/short strategy. The Company's aim is to deliver positive, risk-adjusted returns over the long-term. Achieving a high dividend yield is not a focus, however the Company intends to pay fully franked dividends from available profits.

The Company has no employees.

The Board consists of the following individuals:

- Andrew Larke, Chairman and Independent Director
- John (JT) Macfarlane, Independent Director
- Harry Kingsley, Independent Director
- Raphael Lamm, Director
- Mark Landau, Director

Zenith is comfortable with the composition of Board. Despite the Company being the first LIC to be managed by L1, Zenith gains confidence from the presence of the independent directors and their prior experience. Given the high importance of shareholder engagement when operating LICs, Zenith believes the Board will need to ensure that these aspects are managed appropriately.

Under a five-year investment management agreement (IMA) the Company accesses the skills and capabilities of L1 Capital. L1 has managed a similar long/short strategy to that which is utilised by the Company since September 2014.

L1 Capital

Founded in 2007 by Raphael Lamm and Mark Landau, L1 Capital (L1) is an independent equities focused fund manager based in Melbourne with satellite New York and London offices. As at 31 December 2017, L1 had approximately $3 billion in funds under management.

L1 is 100% owned by the investment team with Lamm and Landau holding the vast majority of equity in L1. Lev Margolin and Joel Arber are also equity holders in the business. Zenith believes the investment team's ownership in the business serves as a strong staff retention tool. In addition, we also note that the team is co-invested in the strategies it runs, which we believe further aligns the team's interests with investors.

L1 currently offers the following strategies: L1 Capital Australian Equities Fund, L1 Capital Long Short Fund, L1 Capital Global Opportunities Fund (closed to investors) and the L1 Capital U.K. Residential Property Fund (closed ended fund), in addition to the L1 Long Short Company.

As at 31 December 2017, L1 managed $1.2 billion in the Long/Short strategy.

INVESTMENT PERSONNEL

Name	Title	Tenure
Raphael Lamm	Chief Investment Officer	10 Yr(s)
Mark Landau	Chief Investment Officer	10 Yr(s)
Lev Margolin	Portfolio Manager	9 Yr(s)

L1's investment team, based in Melbourne, consists of four investment professionals and is led by Raphael Lamm and Mark Landau who collectively have over 30 years investment experience.

Before establishing L1, Lamm and Landau were involved in the management of Australian equities strategies for Coopers Investors and Invesco Australia, respectively. Both strategies were top performers within their peer group over five year periods prior to founding L1 in 2007. Zenith believes Lamm and Landau have established a strong working relationship which is evident in the impressive performance track record of L1's flagship Australian Equities Fund which they have co-managed since its inception in August 2007.

Lamm and Landau are supported by Lev Margolin, who is the named portfolio manager of the L1's Long/Short strategy, and Martin Tavella. Although Margolin is the named portfolio manager of the strategy and is a key member of the team, Lamm and Landau are ultimately responsible for the strategy and decision making. Investment responsibilities are spread across industry lines with each team member covering multiple industries.

In addition, the team draws upon the specialised insights of a resources consultant, Chris Middleton. Zenith understands that the research that is conducted by Middleton is exclusively for L1. Although Zenith generally favours research conducted internally, our concerns are moderated by the exclusive nature of this arrangement.

Zenith also notes that L1 has a portfolio manager based in New York who manages the Global Opportunities Fund. It is our understanding that whilst L1's Long/Short strategy may hold global equities, the portfolio manager of the Global Opportunities Fund operates independently from the team.

Although the team is experienced, Zenith believes it is relatively less resourced versus peers. Given the strategy's large investment universe (S&P/ASX 300 and select global stocks), we would consider additional analytical resources to be beneficial.

There have been no departures from the investment team since inception, which Zenith believes demonstrates a strong culture within the team.

In summary, Zenith considers L1's investment team to be of a high calibre. Additionally, Zenith holds a positive view on the collegiate and tight knit nature of the team and believes it provides a conducive working environment.

INVESTMENT OBJECTIVE AND PHILOSOPHY

L1's Long/Short strategy aims to achieve positive absolute returns and lower volatility than the market over the long-term. L1 maintains an equal focus on meeting its performance objectives and capital preservation.

L1 believes that markets are inefficient in the short-term which presents opportunities for L1 to generate excess returns. L1 attempts to exploit market inefficiencies through the use of a long/short strategy that is driven primarily by fundamental analysis. L1 has traditionally held a bias towards stocks exhibiting quality and value attributes. Ultimately, the Company will aim to build a long (short) portfolio of stocks that are high (low) quality at attractive (unattractive) valuations.

The investment process involves both a top-down and bottom-up approach. Whilst L1 expects to generate the majority of its returns through its bottom-up stock selection process, a material proportion of its overall value-add is expected to be sourced from the asset allocation/risk management decision.

L1's Long/Short strategy has a strong, albeit relatively short, track record dating back to September 2014, over which L1 has demonstrated material value add from short selling and market exposure adjustment. In addition, Zenith draws comfort from the impressive long-term track record L1 has built managing long-only strategies, which we expect to be the primary driver of the strategy's performance.

SECURITY SELECTION

L1's investment universe comprises all stocks listed on the S&P/ASX 300 Index. In addition, global companies may be considered where existing Australian equities research naturally extends to the coverage of such opportunities. Given the team consider a number of globally listed stocks in determining a reference point for Australian securities within the same industry, Zenith believes that L1's ability to invest in international securities will not significantly compromise its domestic research effort.

The stock selection process begins with the identification of investment ideas, which L1 primarily sources from the following:

- Direct contact with companies
- Detailed company analysis
- Observing broader industry trends

The team focuses on making an assessment of qualitative factors and valuation for the entire investment universe. To derive inputs, assumptions and opinions with regards to these assessments, the majority of the team's time is spent conducting one-on-one visits with key company stakeholders, such as:

- Management
- Competitors
- Customers
- Suppliers
- Unions/staff
- Industry experts

The team expects to collectively conduct over 1,000 company related meetings a year. External research is used as a reference for L1 to understand how unique its views are relative to that of the broader market. L1 often seeks out brokers who have differing opinions in order to understand any concerns that the team may have overlooked. Zenith believes the emphasis placed on internal research and the manner in which external research is used adds significant rigour to the stock selection process.

There are three components that are considered in the qualitative assessment of companies:

- Management quality - companies with capable and honest management teams that have strong track records allocating capital, strategic decision making and cost management.
- Industry and company structure - companies with high barriers to entry, strong growth and a cost advantage.
- Business trends - companies with a focus on innovation, industry consolidation and supply/demand profile.

Each component is scored from 1 to 5, with 1 being "excellent" and 5 representing "poor". The scores for each stock are aggregated on an equally weighted basis to produce an overall quality score.

L1 will also produce a valuation for all companies under coverage primarily through the discounted cashflows (DCF) method. The valuation derived from the DCF method is cross checked against other valuation methods such as Price/Earnings, Enterprise Value/Earnings and Price/Sales.

The quality and valuation rankings of each stock in the universe is combined at equal weights to produce an overall ranking. The quality, value and overall rankings for each stock are retained in L1's database which in turn becomes a tool for identifying potential opportunities and monitoring existing positions. Stocks that rank in the top quartile are considered for the long portfolio whilst stocks in the bottom quartile are considered for the short portfolio.

Whilst the investment process for short selling stocks is virtually the inverse of stocks to be held long, stocks considered for short selling will also require an identifiable catalyst, which may be in the form of an earnings result. Zenith believes this requirement is intuitive and consistent with peers who are permitted to short sell stocks.

Investment in international companies in developed markets will only be considered when it is deemed that the offshore opportunity offers significantly better value relative to an Australian opportunity, and L1 holds a high degree of conviction in the investment case of the stock. Given L1 considers a number of globally listed stocks in determining a reference point for Australian securities within the same industry, Zenith believes the team's ability to invest in international securities should not materially compromise its domestic research effort.

Overall, Zenith believes L1's stock selection process is robust and transparent, providing a strong input for the portfolio construction process.

PORTFOLIO CONSTRUCTION

L1 constructs the Company's portfolio based on a benchmark unaware investment approach, which strongly draws from the output of the stock selection process. L1 aims to hold stocks which rank highly long and short stocks which rank poorly whilst aiming to ensure that no individual position or theme dominates the portfolio.

Lamm and Landau are ultimately responsible for the portfolio's decision making. For a stock to be included in the portfolio, a consensus is needed between Lamm and Landau. In the event unanimity is not achieved, the conservative option is taken, and either the stock is not purchased or the lower suggested weight is taken.

The portfolio is comprised of both long-term core positions and short-term trading positions. Long-term core positions are derived from the fundamental analysis conducted during the security selection process. As part of the security selection process, ideas for short-term trading positions are also identified. Some examples of short-term trading strategies include:

- Earnings revisions
- Mean reversion
- Arbitrages
- Corporate actions

L1's Long/Short portfolio will typically hold less than 10% of positions in short-term holdings.

Position weights are determined based on the level of conviction in the idea as well as the expected risk/reward trade off. Although positions are capped at 10%, long positions tend to average 3% and short sold positions average 2%. Short sold positions are typically ascribed a lower weighting to account for the higher risks associated with short selling. Position sizes are also a function of the underlying stock's liquidity and volatility. The Company will typically hold between 40 to 60 positions long and 10 to 30 positions short.

Short sold positions are generally standalone holdings, however, L1 will also hold short positions via a pairs trade. Pair trades involve holding a short sold position which is complementary to and offsets a long position. The pairs approach is commonly used to take advantage of a material and unjustified difference in valuations between two similar companies with similar fundamentals. The share prices of the two companies must also have exhibited a high level of correlation in the past and there must be a catalyst that will eliminate the valuation difference and generate a positive return.

Short sold positions will tend to be held for shorter durations relative to long positions. Zenith notes that this characteristic is consistent with peers who utilise short selling.

Having constructed the portfolio from a bottom-up perspective, Lamm and Landau will then seek to adjust the level of market sensitivity (beta) of the portfolio if they believe it is not suitable for the current market environment. To determine the appropriate beta of the portfolio, Lamm and Landau will consider macroeconomic research, which includes factors such as:

- Inflation
- Unemployment
- Australian and Global Gross Domestic Product
- Interest rates
- Credit spreads
- Geo-political shocks

The Company is expected to maintain a beta exposure of between 0.2 and 0.8. The beta exposure can be adjusted through the use of exchange traded funds and index derivatives contracts such as futures and options. These hedging instruments can be held on global, domestic and sector indices. As the net beta exposure will typically remain below 0.6, Zenith believes the Company's portfolio will generally exhibit a lower level of risk to the Australian market. Although L1 has limited experience managing a strategy which dynamically adjusts market exposures, Zenith believes this feature is consistent with L1's objective of preserving capital. Zenith notes that L1 has achieved this objective to date.

The Company's portfolio is expected to invest up to 30% (typically 20%) in International equities. Although Zenith believes this feature may be beneficial in the Fund achieving its objectives, we would prefer a greater exposure to Australian equities as we believe this to be L1's key competitive advantage.

Gross exposure of the Company's portfolio is expected to be approximately 200% to 250%, of which the long and short portfolios are expected to average 140% to 150%% and 80% to 90%, respectively.

Portfolio turnover is expected to be relatively high at approximately 200% p.a. to 300% p.a., Zenith notes trading positions account for the majority of the portfolio turnover.

Zenith is comfortable with L1's portfolio construction approach which ensures a strong connection between the output of their security selection process and the resultant weight of the stock in the portfolio. However, we note L1 has a limited track record short selling and dynamically adjusting market exposures. Zenith draws comfort from L1's strong, albeit limited, performance to date (the strategy was incepted in September 2014).

RISK MANAGEMENT

Portfolio Constraints	Description
Net Beta Exposure	0.2 to 0.8 Typically
Unlisted Securities (%)	max: 10% Hard limit
Security Holdings - Long	40 to 60 Typically
Security Holdings - Short	10 to 30 Typically

Portfolio Constraints	Description
Individual Stock Weights (%)	max: 10% At time of initiation (typically maximum of 6% and 4% for long and short positions, respectively)
Gross Exposure (%)	max: 300%
Net Exposure (%)	max: 150%
International Equities (%)	max: 30% Soft limit (Typically 20%)

The Company is managed within the above listed risk management constraints. Zenith believes these risk limits are broad and would prefer more prescriptive guidelines to ensure greater portfolio management accountability and provide investors with greater comfort with regards to the consideration of risk in the portfolio. However, we acknowledge that the broad constraints are consistent with the Company's absolute investment objectives.

At the individual security level, Zenith believes that risk management is well-incorporated in the detailed fundamental research process undertaken by L1.

In addition, short selling brings with it an additional set of risks to manage in the portfolio, namely that there is no limit to the maximum potential loss. Although there are no formal stop loss limits, L1 will reassess all short positions that go against the Company's portfolio, with a typical tolerance level of 10% for a less volatile stock and 20% for a more volatile stock. Zenith views these measures as prudent, given the potential unlimited losses short selling can incur.

The gross and net equity exposure of the portfolio is dependent on the asset allocation overlay employed as part of the portfolio construction process and subject to the limits noted in the table above. Zenith believes the gross and net equity exposure constraints are appropriate given L1's strategy and objective.

Zenith notes that whilst there are no industry, sector or market capitalisation exposure limits, which can potentially lead to high levels of concentration in certain sectors, this is consistent with the L1's absolute return focus.

L1 utilises Bloomberg Risk Tools and other appropriate software packages to monitor the risks in the portfolio. A weekly meeting is used as a forum to discuss the risk metrics of the portfolio.

Zenith is comfortable with L1's risk management process and in particular notes the conservative and disciplined approach undertaken by the portfolio managers. However, investors should be aware that there is a significant reliance on the judgement and skill of the portfolio managers in mitigating risk in the Company's portfolio.

Dividend Policy

The Board intends to pay fully franked dividends from available profits provided the Company has sufficient profit reserves and franking credits and it is within prudent business practices. Dividends will be made with consideration to cash flow, cash holdings and available franking credits. Given the recent inception of the Company, no dividends have been paid to date.

ADMINISTRATION AND OPERATIONS

Service Providers

L1 has appointed the following independent service providers:

Prime Broker

Credit Suisse and Morgan Stanley

Administrator

Link Fund Solution (formerly White Outsourcing)

Custodian

Credit Suisse and Morgan Stanley

Auditor

Ernst & Young

Operations

The Compliance Committee is responsible for the operational risk framework.

Pricing

The Company's underlying assets and liabilities are usually valued each NSW business day. Generally, listed securities are valued using the last available market close price quoted on the relevant exchange. Other assets are valued at their recoverable value with liabilities valued at cost.

Transparency

L1 has provided Zenith with the documentation that has been requested and we are comfortable with the level of transparency that L1 has provided.

Personal trading

L1 does not allow personal account trading. Although existing personal holdings can be exited with prior written approval from the Chief Investment Officer, Head of compliance and dealer.

INVESTMENT FEES

LICs can broadly be categorised into two groups from a management cost standpoint on the basis of whether investment operations are undertaken internally by company staff or externally under an Investment Management Agreement (IMA). Typically, internally managed LICs have lower proportional management costs as investment operations are an overhead not linked to FUM levels. Also, most internally managed LICs have large asset pools which reduces the proportional cost. Externally managed LICs tend to have management costs that are more in-line with unlisted managed funds.

Under the IMA, the Company charges management costs of 1.4% p.a. (paid monthly) exclusive of GST. There is also a performance fee of 20% p.a. (exclusive of GST) charged against the net absolute returns and is subject to a high watermark. It is calculated and accrued daily and paid semi annually in arrears. Zenith believes the performance fee for the strategy is poorly structured due to the lack of an appropriate benchmark. Given the strategy will typically exhibit equity like risk/return characteristics, an appropriate benchmark is required to ensure that any performance fees payable are justified. As it currently stands, Zenith believes that the hurdle applied to the performance fee is too low and not commensurate with the Fund's risk profile.

L1 and the Company have agreed that, to the maximum extent permitted by law, the L1 owners will reinvest in the Company all of their after-tax proceeds from any Performance Fees via a Share purchase mechanism, the terms of which are dictated by the IMA. Zenith views this favourably in terms of alignment of interests between L1 and investors in the Company.

The fees listed above translate into a management cost of 1.435% p.a. and a performance fee of 20.5% inclusive of GST and net of reduced input tax credits (RITCs) that are expected to be available.

In Zenith's view, the Company is materially more expensive compared to broader Australian LICs. Zenith also considers the strategy expensive in comparison to Australian Long/Short managed fund strategies.

Zenith notes that L1 is effectively underwriting the costs of the offer so that upon listing, the shares are expected to have a NTA equal to the listing price. While the Company will pay these costs upfront, they will be recouped over time by being offset against future fees due to L1. For the life of the IMA (five years), the Company will not pay any management fee that would otherwise have been payable to L1 until such time as all of the Company's offer costs have been recouped. Zenith sees this as a positive feature to offset the drag on portfolio returns traditionally posed by the upfront costs in newly listed vehicles.

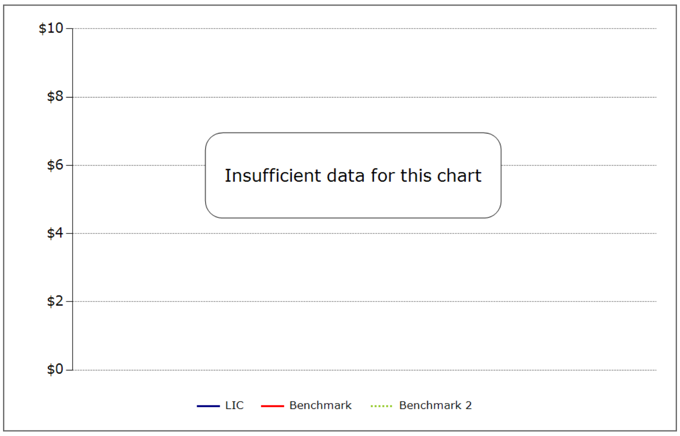
Fee Type	LIC / Peer Group	Fee %
Management Cost	L1 Long Short Fund Limited	1.44%
Sector Average - Internally managed [1]	Australian Equities LICs	0.30%
Sector Average - Externally managed	Australian Equities LICs	1.13%
Performance Fee	20.5% of the portfolio performance subject to a high watermark	

[1] *Internally Managed LICs data use published Management Cost as at 31 December 2017 and are ex-GST. All other fees are inclusive of GST, not including Reduced Input Tax Credits. Source: ASX, Zenith.*

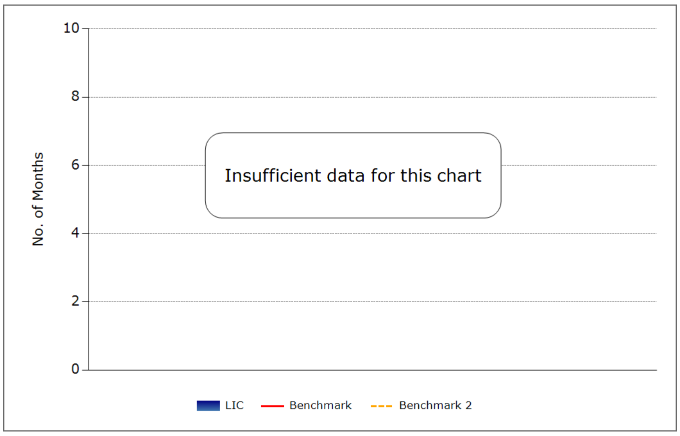
PERFORMANCE ANALYSIS

Monthly Performance History (%, net of fees)

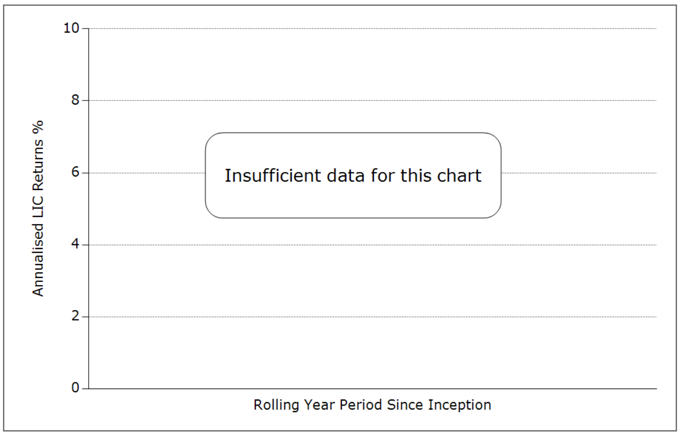
Growth of $10,000



Monthly Histogram



Minimum and Maximum Returns (% p.a.)



ABSOLUTE PERFORMANCE ANALYSIS

All commentary below is as at 31 January 2018.

The Company's Long/Short strategy aims to achieve absolute returns (net of fees) in excess of 10% p.a. and lower volatility than the market over the long-term.

The Company currently has no performance history. However, L1 has demonstrated a prior ability to generate returns from a similar Australian Long/Short strategy in line with the stated objective of this Company, providing Zenith with confidence.

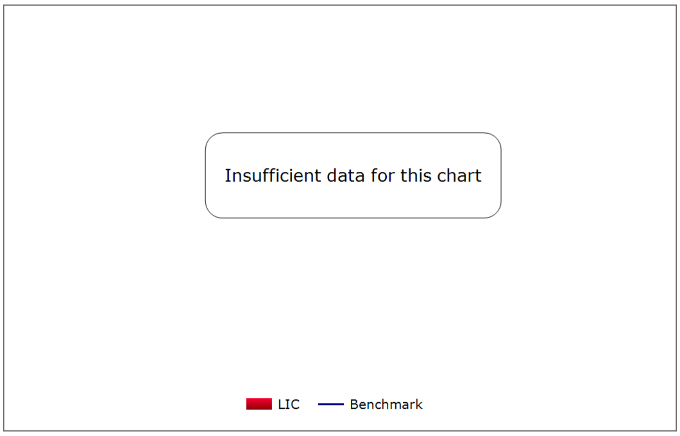
RELATIVE PERFORMANCE ANALYSIS

All commentary below is as at 31 January 2018.

The Company currently has no performance history.

DRAWDOWN ANALYSIS

Drawdown analysis assesses the relative riskiness of a Fund versus the benchmark, in reference to capital preservation. The maximum Drawdown is recorded as the percentage decline in the value of a portfolio from peak to trough (before a new peak is achieved). All Drawdown analysis is calculated commencing from the inception date of the Fund in question, and Drawdown analysis for the Fund and benchmark(s) are calculated independently. That is, the largest drawdown for the Fund and benchmark(s) will not always refer to the same time period.



All commentary below is as at 31 January 2018.

Given the Fund's inception date of December 2016, the history of performance is too short to make any definitive conclusions.

REPORT CERTIFICATION

Date of issue: 16 Feb 2018

Role	Analyst	Title
Author	Bronwen Moncrieff	Head of Research
Sector Lead	Quan Nguyen	Senior Investment Analyst
Authoriser	Andrew Yap	Head of Multi-Asset & Income Research

RATING HISTORY

As At	Rating
16 Feb 2018	Recommended

Last 5 years only displayed. Longer histories available on request.

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