

## Product Facts

<b>Investment adviser:</b>	Fortitude Capital Pty Ltd.	<b>Peer group:</b>	Alternative Strategies	<b>Fund type:</b>	Wholesale
<b>Responsible entity:</b>	N/A – Information memorandum	<b>Strategy type:</b>	Equity based	<b>Min. investment (A\$):</b>	A\$200,000
<b>APIR code:</b>	N/A	<b>Specialisation:</b>	Income	<b>Inception date:</b>	October 2009
<b>Fund status:</b>	Open	<b>Manager type:</b>	Single manager	<b>Domicile:</b>	Australia

## Standard & Poor's View

S&P has awarded this fund a three-star rating based on its conviction that the manager can generate risk-adjusted fund returns in line with relevant investment objectives and relative to peers.

The equity income fund (EIF) is a new offering from Fortitude but uses similar strategies and techniques to Fortitude's flagship absolute return trust. Although both funds are Australian equities-based, the EIF is similar in nature to a buy/write fund, but with more flexibility in its mandate. The EIF targets a high yield using a passive stock-selection strategy over names in the S&P/ASX 100 Index, with an active options overlay. This strategy should provide a good tax-effective income while protecting capital, lowering volatility, and keeping market exposure between 50% and 70%.

Through its founder, John Corr, Fortitude has deep experience trading Australian equities and their derivatives. Although for the past few years this has been from a positive gamma overlay, S&P sees no reason why it cannot be just as effective trading from the other side and being short volatility. That said, the fund has the flexibility, if needed, to use some of the premium generated to preserve capital by employing further options strategies.

The fund is high conviction and this distinguishes it from other similar products. The optimal portfolio is around 17-20 stocks and the fund may take up to 30% in net asset value (NAV) in one position over time. Turnover will be low (due to the passive stock holdings), so any income should be tax-effective. The fund size is small as it has only just started trading but S&P is confident that this strategy will complement the existing product offering. It should also help widen its investor base and increase Fortitude's profile in a different part of the market.

## Investment Style

The fund seeks to provide an income stream roughly 8% (including franking) above the dividend yield of the S&P/ASX 100, together with lower volatility and lower levels of drawdown by keeping typical net market exposure between 50% and 70%. It achieves this income by investing in a passive stock portfolio (although it may have a small value tilt) against an active options portfolio. All positions will be in constituents of the S&P/ASX 100 Index (although the main focus will be those in the S&P/ASX 20 Index). There will be a focus on large-cap stocks to allow for capital appreciation and a high, tax-effective dividend stream. The selling of options will be the main source of return for the fund.

The fund will underperform in a strong equities market, but with a yield focus and downside protection, its application is much broader. It can be used as an alternative to hybrids, or other income-generating products, while still taking on domestic equity risk.

Typical Equity Beta Range											
0	0.1	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.9	1	

Style Bias	Quant	Value	Index	Neutral
Reference S&P/ASX Index	50	100	200	300
Yield target (%) above Index	5	8	10	

Investment S&P/ASX Index	50	100	200	300
Derivative type	Exchange		OTC	
Hybrids	Yes		No	

Fund Objectives	
Target return (% p.a.)	8% (incl franking) above the dividend yield of the S&P/ASX 100 index
Target volatility (% p.a.)	6% - 8%

Fund Fees	
<b>Total cost (%) assuming objective is achieved</b>	<b>1.10</b>
Management fee (% p.a., incl. GST)	1.10
Reclaimable expenses (% p.a.)	0.00
Other fees (note, swap, fx, etc.)	0.00
Performance fee (% p.a.)	9
High water mark (Y/N)	Yes
Hurdle rate	S&P/ASX100 Accumulation Index + 8%
Buy/Sell spread (%)	0.00

Fund Characteristics	
Leverage at fund level (x)	None
Redemption period	Monthly
Notice period for redemptions	10 days
Limit on redemptions (gate)	None
Distribution frequency	Semi-annual
Currency management	N/A

## Product Features

The fund has been set up for wholesale clients and, as such, is more restrictive than peer products. Monthly liquidity is appropriate given the product structure, but all peer funds provide daily liquidity. Six-monthly distributions are longer than the quarterly norm for the peer group, so the product may be more suited to high net-worth clients who do not need monthly or quarterly income. The management fee is around average for the peer group, but it is rare to see a performance fee in products of this type. Nevertheless, with the imposition of a high hurdle rate, it will still be a competitive offering.

## Key Risks

- Key person risk: Mr. Corr is very much the focal point of the firm and the fund is very reliant on his input. With the expansion of the potential investor base, S&P is keen to see Mr. Corr not spending too much time on non-investment activities.
- Small fund size: as it is new and recently seeded, the fund currently has just under A\$3 million in assets.
- Derivatives: the fund may use derivatives as part of its strategy. These will be covered by stock or cash and exchange-traded.

## Investment Team

The team at Fortitude now consists of 8 people. Since its founding in 2004, one junior employee has been added each year, followed by three more experienced appointments in 2008 when funds under management (FUM) peaked. A further resource has been added in 2009. This results in quite an experienced team with over 13 years' average experience.

Mr. Corr is both the responsible manager and the investment manager for the fund. He has over 20 years' experience in the Australian markets, with a long background in equity derivative and proprietary trading for a number of major investment banks. His experience in managing trading desks is invaluable in operating a multi-strategy fund such as this, given the skills needed to rapidly deploy and reallocate capital among different trading styles and strategies. Mr. Corr also has significant experience in establishing, monitoring, and reviewing risk limits, another element that S&P feels is often lacking in other domestic equities-focused funds.

The other team members have particular strengths in different areas such as research, execution, or risk management, and assist Mr. Corr. There is therefore a high level of key person risk attached to Mr. Corr. The firm operates a trading desk style environment where the team all sit together and can monitor and discuss information efficiently when it becomes available. This is critical given the different styles and strategies this product uses.

Stability has been strong with one departure since inception: co-founder, Tim McGowen, who left earlier in 2009. This does place more key person risk on Mr. Corr, but has not had a major effect on the fund's operations. FUM of the firm had been declining before Mr. McGowen's departure (as fund-of-hedge-funds repatriated capital) so the decline cannot be necessarily tied to his departure. It appears that the pressure of running a boutique operation in a time zone that is not amenable to large capital allocators was a contributor. This probably influenced Mr. Corr's decision to broaden the client base away from global multi-manager funds.

The broadening of the investor base (to include those who may not understand many of the trades and strategies applied by the fund) and the lack of a dedicated business development area, will increase the competing calls on Mr. Corr's time, further adding to key person risk. S&P is keen that these tasks do not detract from his market-facing time. The appointment of Phil Cornet in 2009 will help in this regard, and a greater sharing of the marketing and business development workload by the wider team would be welcomed.

## Investment Process

The team chooses underlying stock positions from stocks in the S&P/ASX 100 Index, due to their index weighting, liquidity and the ability to pay sustainable dividends. Although the fund primarily uses buy/write strategies to generate income, it will go beyond this and incorporate other options strategies, if necessary, to deliver the target yield. In buy/write strategies a stock is purchased and a call option is sold over that stock. The distance of the strike price from the current stock price, and the duration of the option (among other aspects), helps determine how much premium, or income, the fund receives. This level of income will help cushion any loss should the stock price decline. It also caps the upside performance but, as the options will often be sold within a 60 to 90-day window, a sufficient amount of premium should be generated to offset this. Given this cushioning effect, buy/write strategies typically have a smoother return profile than the wider market.

This fund will sell options roughly 2%-3% above the current stock price, although this will change depending on the situation. At this level there is sufficient premium being generated to compensate for the likelihood of the stock dropping in that timeframe. Indeed, as volatility climbs so does the amount of income generated. Returns are also maximised by selling options in the near term rather than matching the holding profile of the underlying stock. All option positions are controlled by the capital-weighted duration of the expiries, and with reference to the average strike premium. This essentially means that the target level of income can be sustained by making sure that the price received for the time decay and market exposure is high enough to counter the potential volatility.

Stock selection will be a function of the optionality, given the passive nature of the stock portfolio. However, there will always be a focus on stocks that are high quality, with a strong sustainable dividend stream and the ability to provide high levels of tax-effective income. Additionally, the stock should possess conservative levels of gearing. Minimal fundamental work is carried out on the stocks, which initially tend to have index weighting for ease of hedging. Any research work conducted on a stock is conducted in-house and screens are run every second day. Largely due to these factors, around 70% of the fund will be invested in stocks that comprise the S&P/ASX 20. Sector and correlated stocks are not necessarily prohibited, but their ability to provide the required income from dividend and option premiums is monitored. Cash will vary but generally will be roughly 5%-10% of the portfolio; although with the premiums received from selling options, the effective exposure will be between 50% and 75%.

By definition, this strategy is likely to be short volatility and long time decay. This is the reverse of what is often traded in Fortitude's flagship fund. Therefore S&P is confident that the manager has the skill set and experience to trade these strategies.

Should the market become more volatile, the fund may use other options strategies to protect capital, rather than leave the position exposed. In this case, some of the premium generated is used to purchase insurance in the form of options or futures. This may be simple puts in the same stock, or by further extending the strike price in either duration or distance from the current price. By doing this, income is reduced but so is volatility and the fund should be able to achieve its objective of a dividend yield of around 8% (including franking) above that generated by the index.

As a good proportion of the fund could be sitting in cash, the manager also aims to maximise the amount of interest this is earning. The use of stock for collateral and margining purposes, together with other cash-flow minimisation techniques, will ensure that the maximum yield is earned (or not paid away) on the cash balances.

## Portfolio Construction

The investment universe is the S&P/ASX 100, although the majority of the portfolio is likely to be in the S&P/ASX 20 due to the liquidity and depth of the exchange-traded options in those markets. Portfolio weighting will depend on the overall liquidity of the position. The portfolio will be quite concentrated compared to peers, with a limit of 25 stocks but a more realistic 15-20 name portfolio. This allows a high-conviction approach to be taken with lower levels of turnover providing a more tax-effective exposure. This also meets the fund's objective of following a passive portfolio management approach with active options management.

The fund has been subject to back tests since 2004 and, based on those results, the manager is confident about the product profile being offered.

## Risk Management

There are some formal constraints but they are flexible enough to allow the fund to implement large positions. Initially, the position must not exceed 15% of NAV. This may be scaled up as conviction increases but must not exceed 30% of NAV at any time. The only exception is cash positioning. Market exposure will also be maintained at roughly 65% when the position is first entered, which is around average for this sector. Obviously this figure will fluctuate over time and as the position is scaled. The fund may invest up to 15% of NAV in hybrids.

The fund does not use gearing or borrowings to enhance returns. Therefore net market exposure will not exceed 100% of NAV. Any derivative positions that are implemented must be covered by either stock or cash. This is prudent as it protects against unlimited downside and reduces cash flow requirements because core stock positions may cover numerous trades.

## Systems

System-wise, Fortitude uses tools that are sufficient for their purpose such as IRESS and Risk 101. Although S&P has seen more extensive systems there is nothing lacking in the way Fortitude captures its risks. IRESS is used as an internal trading and risk management system, and enables directly dealing with the exchange. IRESS also provides risk and position-management tools, valuations, and stop-loss executions. For exposure reporting and risk reporting, Risk101 is used. This is relatively basic but gives the pertinent information in an easy to read form. The metrics included are risk numbers, market performance, strategy weightings, performance contributions, exposure summaries, and profit and loss estimates.

## Current Portfolio Holdings / Performance

As the fund commenced trading in October 2009, the current portfolio mix may not be indicative of the longer-term allocations. Also, the portfolio is not yet set to its long-term levels, and there is no track record on which to comment. However, these strategies have been used in the flagship Absolute Return Trust for almost five years. That product has a long gamma focus, whereas this product will typically be short. S&P is confident in the abilities of the manager to trade all aspects of the strategy.

## Management Group Profile

Fortitude Capital was established in 2004 by then partners, Mr. McGowen and Mr. Corr, as a firm seeking consistent absolute returns from the Australian equity market. It has evolved and now offers a range of mandates as well as two stand-alone investment products.

Fortitude, based in Sydney, now has eight staff. It is majority owned by Mr. Corr, with the remainder a passive stake owned by MFS/Alternative Assets Ltd. This has been an ongoing stake since the inception of the business.

## Assets under Management

The fund had roughly A\$2.5 million in FUM in October 2009, representing seed capital supplied by Fortitude. This is sufficient to begin trading the strategy and should not raise any implementation concerns.

*Analyst(s): Simon Scott.*

*Release authorised by: Leanne Milton.*

## S&P Fund Rating Reference Information

### Reference Material

**Sector Reports**

[www.standardandpoors.com.au/funds](http://www.standardandpoors.com.au/funds)

**Reader's Roadmap**

[www.standardandpoors.com.au/funds](http://www.standardandpoors.com.au/funds)

**Glossary**

[www.standardandpoors.com.au/funds](http://www.standardandpoors.com.au/funds)

**Guide to S&P Qualitative Fund Ratings**

[www.standardandpoors.com.au/funds](http://www.standardandpoors.com.au/funds)

**Fund Rating Team Biographies**

[www.standardandpoors.com.au/funds](http://www.standardandpoors.com.au/funds)

### Fund Rating Peer Groups by Sector

Australian Equities	International Equities	International Fixed Interest	Alternative Strategies
Large Cap Diversified	Diversified Equities	Diversified Fixed Interest	Equity Based
Large Cap Income	Emerging Markets	Diversified Fixed Interest Income	Fixed Income Based
Large Cap Indexed	Emerging Markets Asia ex Japan	Fixed Interest	FX/Futures Based
Large Cap Industrials	Emerging Markets China	Fixed Interest High Yield	Multi-Asset Based
Long Short	Emerging Markets India	Fixed Interest Income	<b>Multi-sector</b>
Small Cap	Large Cap Diversified	Mortgages	Capital Guaranteed
Specialist	Large Cap Income	Mortgages High Yield	20
<b>Australian Fixed Interest</b>	Large Cap Indexed	Mortgages Conventional	40
Cash	Large Cap Industrials	Mortgages Hybrid	60
Cash Enhanced	Long Short	<b>International Property</b>	80
Fixed Interest	Long Short Specialist	Direct Commercial	100
Fixed Interest Income	Long Short Regional	Direct Development	Equity
Mortgages	Regional Japan	Direct Diversified Direct	Other
Mortgages High Yield	Regional UK/Europe	Direct Industrial	
Mortgages Conventional	Regional US	Direct Residential	
Mortgages Hybrid	Regional Asia	Direct Retail	
<b>Australian Property</b>	Small Cap	Direct Rural	
Direct Commercial	Specialist Healthcare	Direct Specialised	
Direct Development	Specialist Information Technology	Diversified Property	
Direct Diversified Direct	Specialist Resources	Listed	
Direct Industrial			
Direct Residential			
Direct Retail			
Direct Rural			
Direct Specialised			
Diversified			
Listed			








### Fund Rating Philosophy

A star rating is a forward looking assessment of a manager's ability to consistently generate superior risk-adjusted fund returns, net of fees, relative to relevant investment objectives and peers.


### Fund Rating Process

In assigning a star rating to a fund, Standard & Poor's evaluates: the size, skill and stability of the manager's investment team; the clarity, implementation and risk management of the investment process; the fund's objectives, fee structure and portfolio characteristics; and the manager's business management.

### Fund Rating Definitions

	Standard & Poor's has very high conviction that the manager will consistently generate risk-adjusted fund returns in excess of relevant investment objectives and relative to peers.
	Standard & Poor's has high conviction that the manager will consistently generate risk-adjusted fund returns in excess of relevant investment objectives and relative to peers.
	Standard & Poor's has conviction that the manager can generate risk-adjusted fund returns in line with relevant investment objectives and relative to peers.
	Standard & Poor's has conviction that the manager will not generate risk-adjusted fund returns in line with relevant investment objectives and relative to peers.
	Standard & Poor's has high conviction that the manager will not generate risk-adjusted fund returns in line with relevant investment objectives and relative to peers.
	Issues potentially affecting the management of the fund have emerged, and the fund rating is temporarily suspended, pending clarification.
	A manager with significant issues that have the potential to adversely impact performance. Existing investors should consider obtaining advice regarding switching or redemption.

### Fund Rating Subscript

 Where the investment process, fund manager or analytical team has changed significantly, or where the fund has a relatively short history, but a relevant and demonstrable track record can be shown on similar funds.

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