STANDARD & POOR'S

Fortitude Capital Absolute Return Trust

FUND RATING ★★★★☆

Analyst(s): Simon Scott

Product Facts

Investment adviser:	Fortitude Capital Pty Ltd.	**Peer group:**	Alternative Strategies	**Fund type:**	Wholesale
Responsible entity:	N/A – Information memorandum	**Strategy type:**	Equity based	**Min. investment (A$):**	A$100,000
APIR code:	N/A	**Specialisation:**	Market Neutral	**Inception date:**	March 2005
Fund status:	Open	**Manager type:**	Single manager	**Domicile:**	Australia

Standard & Poor's View

S&P has awarded this fund a four-star rating based on its high conviction that the manager will consistently generate risk-adjusted fund returns in excess of relevant investment objectives and relative to peers.

Fortitude has a unique domestic equities offering that aims for a significant return above cash with low volatility and market exposure. This is achieved using a multiple-strategy approach with a strategic derivative overlay that takes advantage of rising volatility levels. In the almost five years since inception it has achieved these goals with less than 3% volatility and no market beta.

The fund uses five uncorrelated, complementary strategies that tend to balance themselves out over the market cycle. Historically, each has provided a near-equal contribution to attribution, although this varies over shorter time periods. Returns have been a result of a broad mandate of hedge fund strategies such as shorting, derivative usage, and up to 5x gross leverage. The team is dependent on the portfolio manager, John Corr, to achieve these objectives. He is clearly a key person risk to the fund, but as the majority shareholder with significant investment, he is aligned to the business. The wider team provides good support, but it is his experience of capital deployment across various strategies, together with the appreciation of risk management techniques, that sets this fund apart.

The major concern about the fund and the business is the large drop in assets over the past year. This was mainly due to the repatriation of capital by multi-manager funds that had their own cash-management concerns. However, the need to build assets back up and the focus on a broader less-knowledgeable investor base may be time-intensive for Mr. Corr and divert him from his market-facing activities.

Key Risks

- Key person risk – Mr. Corr is very much the focal point of the fund and it is reliant on his input. With the expansion of the potential investor base, S&P is keen not to see Mr. Corr spend too much time on non-investment activities.
- Small fund size – the fund is currently just under A$20 million in size with a narrow investor base and has reduced significantly over the past year. This should not hinder implementation.
- Leverage – the fund is able to leverage up to 500%.
- Short positions – the fund may use short positions to generate returns although it is most likely that these will be associated with an offsetting long position to maintain low market exposure. As pairs trading may occur, there is the chance for the fund to be wrong on both legs, thereby producing a greater loss.
- Derivatives – the fund may use derivatives as part of its strategy. Generally, it will be to hedge and will always be exchange traded.
- Diversification – the fund invests in Australian equities, but as it seeks mispricing opportunities and is not a stock-picking fund, it may not always be fully diversified.

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	Growth	Value	Index	**Neutral**
Reference S&P/ASX Index	50	100	**200**	300
Investment universe	**Australia**		International	

Fund Objectives

Target return (% p.a.)	5% to 10% over RBA cash rate
Target volatility (% p.a.)	Similar to fixed income

Fund Fees

Total cost (%) assuming objective is achieved	**3.50**
Management fee (% p.a., incl. GST)	1.50
Reclaimable expenses (% p.a.)	N/A
Other fees (note, swap, fx, etc.)	None
Performance fee (% p.a.)	20
High water mark (Y/N)	Yes
Hurdle rate	RBA cash rate

Fund Characteristics

Max leverage at fund level (x)	5x
Redemption period	Monthly
Notice period for redemptions	30 days
Limit on redemptions (gate)	None
Distribution frequency	Annual
Currency management	N/A
Capacity	A$500 million

Product Features

The fund fees are high for an Australian equities fund, but standard for a hedge fund of this type and must be looked at in conjunction with the fund capacity, which is relatively small. The overall objectives are more than reasonable and achievable given the mandate. Monthly liquidity is appropriate given the length of the underlying strategies, which can take up to 18 months. The low market exposure is a positive as there is a dearth of domestic market-neutral funds. The fund can use derivatives and leverage as part of its strategy and not merely to gear up the exposure.

The flexible mandate and differentiated return factors should, in S&P's view, give this fund an advantage in implementation compared to peer funds. The fund is likely to do well in more highly volatility markets and underperform in trending markets due to the low market exposure and declining volatility.

Investment Style

The fund uses a multiple-strategy approach to target absolute returns. There is an aggressive target of 5% to 10% above cash with a bias to market neutrality and low volatility. This reduction in market exposure is provided by use of a derivative overlay that takes advantage of changes in volatility. The fund will invest in Australian equity markets (or Australian companies listed overseas) and uses five complementary strategies to provide consistent returns over time. The focus is on market mispricing over a broad range of securities rather than using stock-picking fundamentals. In this way the returns, despite being in a similar market to many other funds, come from different return drivers. It is much more of a trading-orientated fund than others in the domestic-equities peer group. The use of derivatives is also an integral part of the investment process and provides both alpha generation and portfolio protection to the fund.

Investment Team

The team at Fortitude now consists of eight people. From the firm's founding in 2004, one junior employee was added each year before three more experienced hires were added in 2008, when funds under management (FUM) peaked. A further resource has been added in 2009. This results in a quite experienced team with over 13 years of average experience.

Mr. Corr is both the responsible manager and 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 multiple-strategy fund such as this, due to the skills needed to rapidly deploy and reallocate capital between different trading styles and strategies. He also has significant experience of establishing, monitoring, and reviewing risk limits which is essential given the level of leverage, shorting, and derivatives in this product.

The other team members, who have particular strengths in different areas such as research, execution, or risk management, assist Mr. Corr. He therefore represents a large level of key person risk. 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 key to the process, given the different style and strategies that this product will use.

Stability has been strong with one departure since inception. This was Tim McGowen, a co-founder who left earlier in 2009. This does place some more key person risk on Mr. Corr, but has not had a major operational effect on the fund. FUM had been declining prior to his departure, as fund-of-hedge-funds repatriated capital, so it 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 has probably influenced Mr. Corr's decision to broaden the client base away from global multi-manager funds.

As mentioned, the key person risk has increased on Mr. Corr. But in addition, with the lack of a business development area and the broadening of the investor base to those who may not understand many of the trades and strategies applied by the fund, the competing calls on Mr. Corr's time will be a challenge. S&P is keen that it does not detract from his market-facing time. The addition 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 a welcome development.

Investment Strategies

The fund makes uses of five main strategies, although there is a vast array of trading opportunities within each style. In addition, there is a strategic overlay that helps to mitigate elements of market risk in the portfolio while maintaining a profile that is generally long volatility. The five main strategies are:

- Derivatives and long gamma trading,
- Equity long/short,
- Convergence trading,
- Mergers and acquisitions,
- Yield.

Derivatives

Derivatives will be limited to exchange-traded futures and options, and any derivatives that are written will have stock protection, although this could be synthetically achieved (e.g. by purchasing an option that gives the portfolio the same economic exposure as buying the physical stock). Derivatives can be used to hedge stock-specific risk, hedge portfolio risk, enhance the return of a security, or in place of a stock.

No unprotected selling of options will occur, so in essence the portfolio will always err on the side of being long volatility. The fund also does not trade any non-exchange listed derivatives.

This strategy has performed well for the fund and is one of its core focuses. It will provide positive returns in strong markets but can also produce attractive levels of income. The use of derivatives may also help reduce portfolio volatility, which then allows some more aggressive positions to be taken in other strategies. Given the options profile, this strategy tends to be quite short dated (around 30 days) to manage the amount of premium that is lost each day due to time decay. However, the positive side of the option profile is that the probability of the option being profitable at expiry should be increasing (positive gamma) so that this time decay is not as prevalent.

Long/Short Equities

Equities are purchased with a view to short- or medium-term capital appreciation. Although Australian equities are the main focus, overseas shares may be purchased if they are involved in a merger with an Australian company. When a company has deteriorating fundamentals or is overpriced relative to peers, the manager can short these stocks to take advantage of the repricing. This can be done in isolation or with an associated position in a company in a similar sector. As with the other strategies, this can help reduce the overall market exposure of the fund and so therefore carries a good size weighting in the portfolio.

Convergence Trading

Some companies, such as BHP, have their shares listed on more than one exchange. At different times and due to the local factors in each market, the valuations may be different in each market. The fund can exploit this price arbitrage. This can be expanded to domestic markets to take advantage of pricing differences in preference shares, rights issues, options, and other forms of capital structure discrepancy. Also included in this strategy are convertible arbitrage trades.

Merger and Acquisitions

With corporate activity often comes an opportunity to profit from the perception of whether announced deals will actually occur. The difference between the price of the acquirer and acquiree relative to the bid terms indicates the probability of a merger going ahead. This spread moves over time and the fund can trade either or both sides of the trade depending on the assessment of the deal completing.

Sheriden Hure is the lead analyst in examining the terms of a deal and coming up with the probability of success, the chance of a counter-bid, and on what terms and likely prices should the deal complete or fail. Although the analysis is not as stringent as we have seen in other funds, for the purposes of the Fortitude portfolio, it is sufficient given the fund is trading the mispricing and is not a dedicated merger arbitrage fund that seeks to lever this spread. Again, Mr. Corr has deep knowledge of price action and trading patterns of many of these stocks and it is this day-to-day involvement that also helps mitigate some of our concerns.

Convertible and Yield Arbitrage

Convertible bonds have many inter-related facets that come into play at different points. One of the largest components is the yield profile compared to that of other yielding securities. The fund can take advantage of this spread and hedge out the associated equity risk by virtue of reducing the effect of the embedded option in the convertible bond.

Leverage

Leverage is used sparingly and is limited to 5x the account equity. That means the long positions plus the short positions may not exceed 5x the amount of money in the fund. This includes the effect of derivatives. Fortitude will use leverage more in falling markets due to their long gamma profile, i.e. when markets fall they will use more cash as they will be long the stock and long a put option, therefore no premiums are received to reduce the cash burn.

Investment Process

Research is often sourced externally and around 80% of trades start from information sourced externally. This may be from prime brokers, media, research companies, or other funds. In taking the idea from source to implementation, the fund first identifies that an opportunity exists before determining:

- The position has the ability to be hedged;
- There is a favourable sustainable risk/reward profile;
- There will be sufficient ongoing liquidity; and
- It will fit within the structure and parameters of the portfolio.

The fund is opportunistic in nature, so the process is not as formulated as seen in other funds. Therefore, opportunities are discussed and researched among the team with reference to the likely risk-adjusted returns of each trade. Overall concepts of capital preservation and minimal market exposure are adhered to in an effort to keep true to the fund objectives. Turnover will be relatively low as the bias is toward those stocks with equity derivatives attached. Turnover will generally be in the form of adjustments, either adjusting the delta of a position with stock purchases/sales or adjusting the risk/reward payoff with different options strategies. This may involve different maturities or strike prices and combinations of various option positions to generate a specific outcome.

Portfolio Construction

Each strategy has different trade durations, and with the fund being opportunistic and dynamic, these strategies can move in and out of favour quite quickly. For instance, some convergence trades may last a couple of days or one year. Convertible trades may also take between six and 18 months to play out. Mergers that hit regulatory hurdles may also extend their duration. Conversely long/short trades and other arbitrage opportunities may see their spreads close in a short period of time as a catalyst occurs. With all of this in mind, the portfolio construction and risk management of the fund is critical. This is where the proprietary trading experience of Mr. Corr is paramount in determining how to allocate and deploy capital to different strategies. Just as important is the trimming and closing of positions as trades move against the fund or opportunities do not appear as attractive as alternative positions.

Weightings will be adjusted according to the market cycle. For instance, mergers often increase in stronger markets and so will become overweighted during those periods. There are no formal diversification constraints preventing the fund from allocating where opportunity appears.

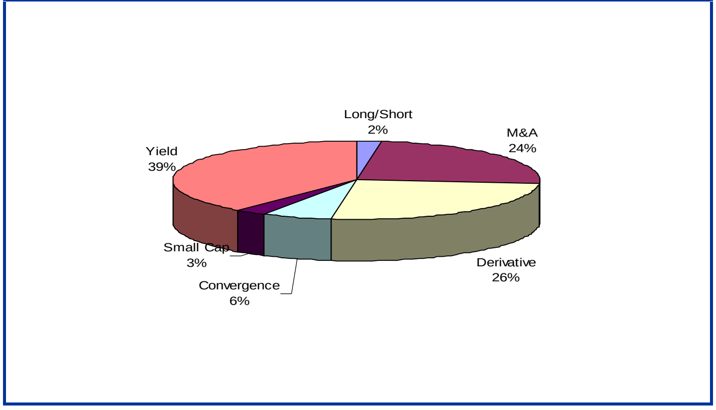
Current Portfolio Holdings

Typically, the fund will comprise around 70% listed equities, 15% equity options, 10% convertibles/hybrids, and 5% in futures. This is a fair mix and provides less non-physical equity exposure than may be at first anticipated.

At the end of August 2009, the fund exposures are as shown in the chart below. It is dominated by mergers and yield positions, which account for almost two-thirds of the portfolio. Long/shorts and convergence trades make up less than 10% of the portfolio, which is not a surprise given the stage of the cycle. These allocations do move considerably, as for instance in 2004/5 when the average positions for long/short strategies was around 14% and convergence trades accounted for 23% of the portfolio. At that time, yield strategies had a 6% allocation. This shows the benefit of an uncorrelated multiple-strategy approach to the portfolio-construction process.

On a long-term basis, it's probably fair to say that the fund is overweight yield trades, convergence, and derivatives, compared to the average levels traded by the fund since inception.

Current Portfolio Holdings (at Oct. 31, 2009)



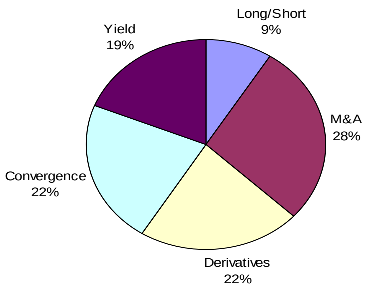
Performance

The fund now has a 56-month track record and has been extremely consistent during that time delivering on all of its objectives: a 5% - 10% over cash return, low volatility, and low levels of market exposure.

Since inception, the fund has produced an annualised return of 11.01% with a volatility of just under 3%. Each calendar year has been positive. During this period, there have been four negative months resulting in 93% of months posting positive returns. Subsequent drawdowns have been well controlled with no single one being more than 0.5%. The strategic overlay is obviously an impressive risk-management tool in times of stress and when compared to other domestic equity funds.

Attribution has been consistent between strategies since inception, although long/short is lower but with lower overall allocations. Returns do vary depending on the stage of the cycle. For example, convergence trades were strong in 2005 when American Depositary Receipts (ADR) spreads were attractive, and in 2007 there was a large amount of merger and acquisition activity providing competitive returns. This again proves the strength of the multiple-strategy process. Some strategies will have negative years, particularly in derivatives when they are used primarily for hedging or long/short depending on overall exposure levels.

Historic Portfolio Attribution (at Oct. 31, 2009)



Performance Metrics

Calendar Year Returns Since Inception	
2009 (YTD)	5.08
2008	12.29
2007	9.48
2006	16.71
2005 (Mar.-Dec.)	8.06

Risk-and-Return Analysis (at Oct. 31, 2009)	
Annualised return (% p.a.)	11.01
Standard deviation (% p.a.)	2.98
Rise in NAV since inception (%)	62.89
1-year return (% p.a.)	5.68
3-year return (% p.a.)	9.25

Performance Measures after MER (at Oct. 31, 2009)	
Average portfolio positions	70
Best monthly return (%)	3.63
Worst monthly return (%)	(0.58)
Positive months (%)	93
Maximum drawdown (%)	(0.43)
Maximum drawdown period	June 2008

Risk Management

The fund has a number of formalised constraints including maximum long positions of 10% of net asset valuation (NAV) or 20% when marked to market. After three positions at this size, the largest becomes 5% at cost. The largest short position may also be 5% at cost and no more than 10% when marked to market. No individual position may exceed 5% of the issued capital of the company being traded. There is also a limit on small-cap stocks (market capitalisation of less than A$500 million) of 10% of the NAV with no holding being larger than 5%.

The average position size is 2% with an informal limit of 5%. Naturally, each strategy has its own limits based on liquidity and the ability to effectively hedge. This results in a portfolio of around 70 positions with an average net exposure of around 4% of NAV.

All hedging is done intra-day as necessary. Short positions can be both physical and synthetic depending on the value lost in option premium compared to capital loss on the stock.

There are no formal diversification targets, but naturally opportunities across the product set help to maintain a sufficient level. Sector, industry, or capitalisation targets are not set, and at times, there may be concentration in one area.

With a market-neutral bias in the fund, the vast majority of the fund is hedged (80%+). This is conducted by equity derivatives on top of held positions or by futures trades over the portfolio as a whole. There is the chance that some positions may be unhedged. This is often where the cost of protection exceeds the reward being sought, or indeed where no protection is available (small-cap stocks). Trading another stock in the same sector in the other direction can be an effective hedge in this case. Given the hedged positions, 80% of the portfolio may be liquidated within two days.

Systems

In its systems, Fortitude uses tools that are sufficient for the 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 direct dealing with the exchange. This 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. Included metrics are risk numbers, market performance, strategy weightings, performance contributions, exposure summaries, and profit/loss estimates.

Monitoring is conducted on liquidity, and on the borrowing of stock in less liquid names in particular. This is important as costs can deplete the opportunity in longer-dated convertible arbitrage or merger arbitrage positions.

Cash is held on deposit with the prime broker (UBS) and has a slight haircut for margining. This is normal for funds of this type. The remainder will sit in bank bills rated 'AA' or higher by S&P Credit Ratings. The fund uses a local administrator, Kingsway Taitz. S&P has confidence in the administrator's ability to comprehend and price funds and strategies of this type.

Management Group Profile

Fortitude Capital was established in 2004 by original partners, Mr. McGowen and Mr. Corr, to be a firm that sought consistent absolute returns from the Australian equity market. It has evolved and now offers a range of mandates as well as stand-alone investment products. In 2009, the firm introduced a new equity income fund.

Fortitude, based in Sydney, now has eight staff members and runs two products. It is majority owned by Mr. Corr with the remainder being 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 has just under A$20 million in FUM at November 2009 and the wider strategy had A$90 million across the various accounts. This is down from a peak of A$192 million in the fourth quarter of 2008. However, the trust that this product invests into has had stable FUM with no major outflows. Fortitude's largest client (a domestic multi-manager with around 50% of FUM) has been with the fund since the start. This does provide a level of risk should this client begin to reallocate. The management of Fortitude has A$1.5 million in the fund.

Analyst(s): Simon Scott.
Release authorised by: Leanne Milton.

S&P Fund Rating Reference Information

Reference Material

Sector Reports
www.standardandpoors.com.au/funds

Reader's Roadmap
www.standardandpoors.com.au/funds

Glossary
www.standardandpoors.com.au/funds

Guide to S&P Qualitative Fund Ratings
www.standardandpoors.com.au/funds

Fund Rating Team Biographies
www.standardandpoors.com.au/funds

Fund Rating Peer Groups by Sector

Australian Equities
Large Cap Diversified
Large Cap Income
Large Cap Indexed
Large Cap Industrials
Long Short
Small Cap
Specialist
Australian Fixed Interest
Cash
Cash Enhanced
Fixed Interest
Fixed Interest Income
Mortgages
Mortgages High Yield
Mortgages Conventional
Mortgages Hybrid
Australian Property
Direct Commercial
Direct Development
Direct Diversified Direct
Direct Industrial
Direct Residential
Direct Retail
Direct Rural
Direct Specialised
Diversified
Listed

International Equities
Diversified Equities
Emerging Markets
Emerging Markets Asia ex Japan
Emerging Markets China
Emerging Markets India
Large Cap Diversified
Large Cap Income
Large Cap Indexed
Large Cap Industrials
Long Short
Long Short Specialist
Long Short Regional
Regional Japan
Regional UK/Europe
Regional US
Regional Asia
Small Cap
Specialist Healthcare
Specialist Information Technology
Specialist Resources

International Fixed Interest
Diversified Fixed Interest
Diversified Fixed Interest Income
Fixed Interest
Fixed Interest High Yield
Fixed Interest Income
Mortgages
Mortgages High Yield
Mortgages Conventional
Mortgages Hybrid
International Property
Direct Commercial
Direct Development
Direct Diversified Direct
Direct Industrial
Direct Residential
Direct Retail
Direct Rural
Direct Specialised
Diversified Property
Listed

Alternative Strategies
Equity Based
Fixed Income Based
FX/Futures Based
Multi-Asset Based
Multi-sector
Capital Guaranteed
20
40
60
80
100
Equity
Other

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

FUND RATING ★★★★★	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.
FUND RATING ★★★★☆	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.
FUND RATING ★★★☆☆	Standard & Poor's has conviction that the manager can generate risk-adjusted fund returns in line with relevant investment objectives and relative to peers.
FUND RATING ★★☆☆☆	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.
FUND RATING ★☆☆☆☆	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.
FUND RATING ON HOLD	Issues potentially affecting the management of the fund have emerged, and the fund rating is temporarily suspended, pending clarification.
FUND RATING SELL	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

— NEW —	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.