AFM Fund Review
Morphic Global Opportunities Fund

April 2014 +0.75 %

Last 12 months +25.08 %

Key Points: Morphic Asset Management's Global Fund:

- Morphic Asset Management is an early stage, boutique, Sydney-based fund manager established in 2012 with experienced CIO's, and an investment team of 6 including a dedicated risk manager.
- The Board has a majority of independent members with significant risk and investment experience.
- Morphic's Global Opportunities Fund is a global equity long/short fund with a long bias and a macro-economic overlay. The mandate allows the Fund to short sell, use derivatives and invest in assets such as commodities & currencies.
- Portfolio construction is style agnostic, biased to value-based and momentum strategies, with a vigorous risk management approach.
- Morphic's philosophy is that only funds with flexible hedging strategies will be able to deliver acceptable, steady, real, absolute returns over the investment cycle.

Management Company Overview

Morphic Asset Management (MAM) is an emerging fund manager established in June 2012 by joint CIO's Jack Lowenstein and Chad Slater. Both had previously worked together at Hunter Hall Investment Management and were heavily influenced by that experience, the lessons learnt in portfolio management during the GFC, and academic research into investment styles.

Morphic's Managing Director Jack Lowenstein, (aged 57) was educated in the UK, graduating from Oxford with a degree in Politics, Philosophy and Economics. His early career was as a journalist for 12 years, mostly covering finance. On his return to Australia he became a roving correspondent around Asia, before having a brief career in stockbroking and small company corporate finance. He was initially engaged by Hunter Hall to assist with corporate work and was then hired full time as an analyst and later portfolio manager, rising to become a Board Member and deputy CIO. Over fourteen years at Hunter Hall before leaving in November 2011 he helped oversee growth of the firm from $13m to a peak of almost $3bn in Funds Under Management.

Chad Slater, (aged 35) graduated from the University of Queensland with a B.Econ (Hons), a B.Comm and is a CFA. He initially worked as an economist at the Federal Treasury before spending five years as an analyst at Bankers Trust Australia, including a secondment to Putnam Investments in Boston. At Hunter Hall he was Head of Currency and Macroeconomics based in London for five years before leaving in April 2012 to establish Morphic with Lowenstein.

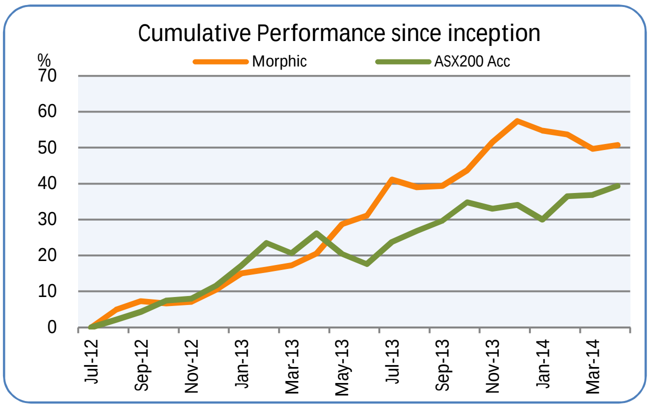
Supporting Lowenstein and Slater are a dedicated Research Manager, Tim Cheung and two investment analysts. Cheung has an MBA from Wharton Business School in the USA and an M.Comm (Hons) from UNSW. He previously worked at CFSGAM and CommSec and established a small specialised funds management business. The two investment analysts, Ronald Yu and Mike Walpole are both well qualified, with the latter having previous experience in restructuring and management consulting.

Morphic
Asset Management

Key Statistics *	Morphic Global	ASX200 Acc
Apr-14	0.75	1.77
Annualised Return	26.44	20.85
Latest 3 Months	-2.60	7.14
Latest 6 Months	4.93	3.35
Latest 12 Months	25.08	10.46
Latest 24 Months (p.a)	na	na
Latest 36 Months (p.a)	na	na
Latest 60 Months (p.a)	na	na
% Positive Months	76.19	76.19
Best Month	7.71	5.37
Worst Month	-2.63	-4.50
Largest Drawdown	-4.93	-6.72
Average +ve Return	3.08	2.98
Average -ve Return	-1.42	-2.69
Annualised Standard Deviation	9.49	9.91
Downside Deviation (Since Inception)	3.04	5.23
Sharpe Ratio (Since Inception)	2.25	1.70
Sortino Ratio	6.88	3.11

* Statistics for the ASX are adjusted to the Fund's start date

Chart 1: Cumulative returns



Morphic's appointment of Geoff Wood as dedicated Risk Manager at inception reflects the emphasis on risk control and capital preservation. Wood has Masters degrees in Computer Science and Financial Engineering and previously worked at Global Trading Strategies, a Sydney based macro fund, and in the UK Prime Broking operation of Barclays Capital.

Lowenstein and Slater are majority shareholders in Morphic as well as cornerstone investors in the Fund. The investment team are all shareholders in Morphic, and one third of the team's bonuses must be invested in the Fund for at least three years, providing a strong

Performance - Net of Fees (%)

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2014	-1.66	-0.71	-2.63	0.75	-	-	-	-	-	-	-	-	-4.21%
2013	4.17	0.90	0.99	2.80	6.77	1.84	7.71	-1.57	0.26	3.14	5.48	3.85	42.49%
	-	-	-	-	-	-	-	4.82	2.30	-0.52	0.40	3.13	10.45%

alignment of interests between management, shareholders and investors.

Morphic has a number of external shareholders who collectively own 36% of the company, many of whom are either clients or advisors of Fortnum Group, a private wealth advisor. They are shareholders in Morphic as well as being initial investors in the Fund.

In addition to Lowenstein and Slater, Morphic has three non-executive directors: Chairman Nick Minogue was a former Head of Risk at Macquarie Bank; Gerard Minack, Managing Director was Head of Developed Market Strategy at Morgan Stanley, and Scott Charlton, an accountant who represents the Fortnum Group. All non-executive directors are shareholders or represent shareholder interests. Josephine Jang has provided CFO services to Morphic since July 2013 under a service agreement between Morphic and Optimal Fund Management Fund Management where she has been CFO since 2004. This role involves managing and monitoring services provided by third parties including the fund administrator, fund auditors as well as administration and finance functions.

While not unique for an early stage or emerging fund manager the size and experience of the investment team, coupled with the appointment of a dedicated and experienced Risk Manager is significant, as is the quality and depth of experience of the three non-executive directors.

Investment Strategy & Style: The Fund is global, long/short with a long equity bias and a macro overlay.

Lowenstein and Slater had the opportunity to plan the Fund's investment philosophy and process with a clean sheet of paper, incorporating the lessons learnt from their prior experience, other institutions and academic research. The underlying philosophy is driven by the "Adaptive Market Hypothesis" which states that over the market cycle investors need to adopt various styles, as strong adherence to any one style can lead to poor performance at different times. Other academic work highlights the strong out-performance over time of a combination of value-based and momentum strategies, and these factors feature strongly in the Fund's investment process and stock screening.

The pair also adopted lessons in investment management from the best hedge funds (excellent risk management, outstanding and well incentivised personnel) and endowment investors (patient capital and medium to long-term conviction).

These lessons were incorporated into the Fund's philosophy and process is style agnostic over the investment cycle, with a longer term bias to value and momentum strategies, with risk management a primary consideration. The Fund has the ability to short sell, use derivatives and invest in asset classes such as commodities and currencies. These investments can be to hedge other investments or to generate profits.

Morphic's philosophy is summarised by the manager's view that funds with flexible hedging strategies will be able to deliver acceptable, steady, real, absolute returns for investors over the investment cycle.

In order to achieve this goal the investment team use a flexible and varying blend of investment strategies that they believe should assist investors in enhancing returns and mitigating risk, believing that no single strategy is likely to be best suited for all markets or at all times.

Investment Process

Investment ideas for stock selection can come from a number of sources including the use of analytical screens. Typically the first screen looks at criteria such as value (e.g. Price to Book), EPS growth and momentum. This screen has been back-tested with good results. The screens act to reduce the universe of over 10,000 companies to around 100 that meet the Fund's market capitalisation filter of greater than US$400m.

Morphic Global Opportunities Fund	
Fund Type	Australian Unit Trust
Strategy	Global, long/short with a long bias
Domicile	Australia
Investor Type	Retail & wholesale
Min. Investment	$10,000
Additional Investment	$5,000
Buy/Sell spread	0.30%/0.30%
Management Fee	1.35% with expense cap of 0.27%
Performance Fee	15.38% of performance over hurdle
Hurdle	MSCI All Countries Total Return $A
High Water Mark	Yes
Min. Term	No
Redemption Notice	No
Inception Date	Aug-12
Fund Size	$46m
Manager's Total FUM	$46m

Chart 2: Monthly Returns

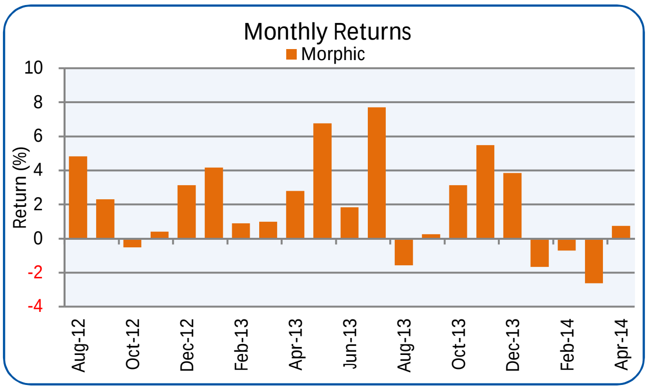


Chart 3: Distribution of monthly returns

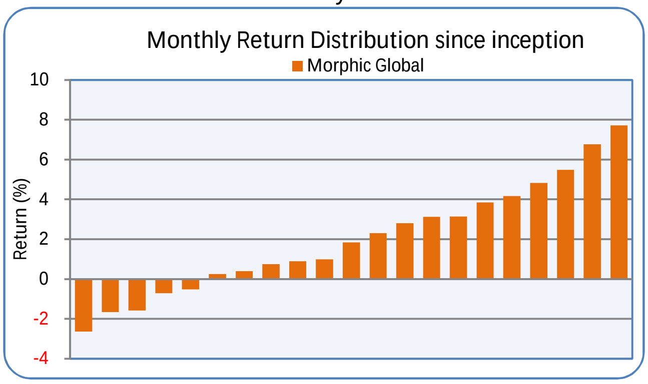
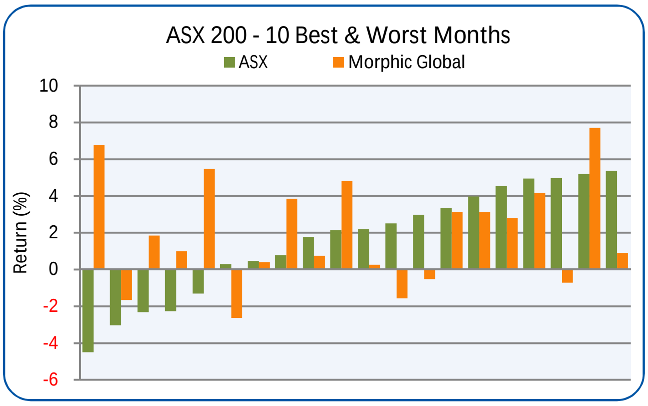


Chart 4: Correlation to ASX200's best and worst months



Investment Process (continued)

Morphic's research then seeks to identify those stocks offering value as a result of drivers that are not fully appreciated by the market. Once identified, investments are evaluated from a momentum perspective. The use of momentum filters looks to time investment at the start of stock price appreciation to ensure that the manager does not purchase "value traps".

A separate screen generates ideas for short selling by filtering over-valued stocks and stress/distress measures as well as momentum. Short positions are undertaken where the manager believes negative news or trends are not properly factored in by the market. Morphic notes that given the additional risks involved in short selling they prefer to see downward momentum confirmed prior to entering the position.

Once equity investments are justified the portfolio construction process uses two time horizons measured in "time to pay-off" to define opportunities. These are named Horizons 1 and 2.

Horizon 1 (H1) covers periods up to 3 months and Horizon 2 (H2) focuses on investments of 9 months and over. The objective is to find attractive opportunities that lie in either time frame i.e., under 3, or over 9 months. The rationale is that hedge funds/traders operate with very short/daily horizons while institutions take three to nine month investment views. By investing outside these time frames, the manager believes significant opportunities can be found as they are likely to be under-researched.

H1 positions are limited to 60% of the portfolio's total NAV and are typically of a short term trading nature. Investments are made after initial research and if the position performs then further research is conducted and the position may be increased. H2 positions are limited to 140% of the portfolio's total NAV and are only undertaken following an extensive research process. H2 investments will typically be expected to achieve their targets over periods exceeding 9 months. This horizon is expected to be the key driver of out-performance (alpha).

Stocks "migrate" from H1 to H2 if returns exceed 10% and after further research are shown to have longer term potential. The final part of the portfolio's construction is a hedge book which has two purposes; firstly to offset risk in the H1 and H2 portfolios as necessary, and secondly to undertake investments in assets classes such as commodities or currencies to generate further returns. The final portfolio therefore has 3 components; H1, H2, and the hedge book. The resulting portfolio will usually contain 35-50 stocks in addition to other investments which include ETFs that can be signficant percentage of the portfolio

As the Fund looks to generate the bulk of its out-performance from stock selections in H1 and H2 the manager will often separate these returns from those of the overall Index. For example, if the fund is significantly over-weight Japan, market risk might be reduced by shorting Topix index futures in the hedge book. This removes the market return and risk from holding stocks (beta) with the returns derived from individual stock selection (alpha) only.

The research undertaken for stock selection is also overlaid by macro-economic analysis. This ensures that stock selection is appropriate within the current economic environment. The analysis can also lead to investment ideas of a macro-economic nature, including investments in other asset classes such as commodities, currencies and ETFs to capture these ideas and these are allocated to the hedge book.

Each horizon has an individual set of risk criteria applied to limit losses, with stricter controls applied to H1 investments, given the level of research and expected holder periods. In H1 positions are a maximum initial size of 3 percent (but can move to 9 percent before being cut back) with a stop-loss limit set at 10 percent. In H2 initial positions are a maximum size of 5 percent (but can move to 9 percent before being cut back) and stop-loss limit set at 15 percent. These limits demonstrate the importance attached to the management of risk. Any investment exited as a result of a stop loss breach cannot be re-entered for at least one month.

Performance Review:

The Fund has a track record of 21 months and while not possible to draw any significant conclusions on its ability to generate alpha or the effectiveness of the risk controls, the Fund has significantly out-performed the ASX 200 Acc by 5.59% on an annualised basis but is behind (173bps) the Fund's benchmark of the MSCI All Countries Index in terms of annualised return since inception. The Fund's risk record is sound albeit in a strong market with 67% positive months and a largest monthly drawdown of -4.93%. Annualised standard deviation (or risk) is 9.49% p.a. as compared to the ASX 200 Acc standard deviation of 9.91%. The Fund also has Sharpe and Sortino Ratios well in excess of the ASX 200 Acc Index.

Portfolio and Operational Risk Management:

Risk management is an integral part of the investment process. The process is defined internally as "rules driven risk management with a focus on capital preservation." Wood is an experienced risk manager, whose primary function is to provide a systematic overview of the risks embedded in the portfolio, and to develop strategies for risk mitigation.

Risks that are evaluated include blind spots, concentration, liquidity, and portfolio correlations. Blind spots are potentially hidden risks in the portfolio. Risk rules include hard stop-loss at individual position level; liquidity, leverage and Value-at-Risk (VAR). The process also includes stress testing the portfolio for "fat tail" events and examining the potential portfolio behaviour during previous market shocks. Stress testing is undertaken using Bloomberg PORT and includes historical events such as the failure of Lehman Brothers in 2008, as well as other potential market shocks. The manager also conducts risk scenario analysis with a view to having a strategy to cover negative scenarios eventuate.

Over and above the systemic risks, portfolio limits including VaR, application of stop losses and position sizing are also independently evaluated by HFO, a risk and outsourcing business with execution and portfolio management systems as middle-office manager using the Imagine risk management system.

These are reported daily to Morphic and made available to the Fund's RE, Perpetual with any breaches noted. All positions and risk measures are evaluated and discussed in a daily morning meeting. Notably the risk manager reports to the Board as well as to the CIOs, and has trading authority and instructions to exit positions that exceed pre-set limits. Stop losses are electronically established for assets that trade in the United States.

Most trading is executed electronically through Bloomberg. All orders and portfolio details are transmitted daily to HFO, FundBPO as administrator and Merrill Lynch, providing both order verification and remote back up/remote access if required.

All data is backed-up to two storage areas. Operations can be run from two separate off-site locations with full remote access to all systems including Bloomberg. A disaster recovery plan is in place but is yet to be tested in a live situation. The plan will be reviewed and updated at least yearly by the Executive Directors.

Operational Risk and Compliance

Morphic has a designated Compliance Committee composed of Non-Executive Directors reporting to the Morphic Board. In addition, an external Compliance Review Officer has been appointed to assist in meeting compliance obligations and review the Compliance Framework and reporting. Operational Reviews are held quarterly and chaired by Perpetual, the Fund's Responsible Entity. The fully documented compliance policy covers all relevant compliance issues. External service providers provide a quarterly report validating that services are in line with Service Level Agreements.

Investor Relations and Marketing

Morphic publishes a monthly performance report with a high level of detail regarding investments and performance and risk statistics. The Fund has 3 groups of investors; Board and Management, Fortnum Group clients and advisers and the Netwealth platform, which constitute 70% of FUM.

Terms and Fees

Management Fee: 1.35% (inc GST) pa, expenses (capped) at 0.27%
Performance Fee: 15.375% of excess above the Hurdle Return with high water mark, is only payable if performance is positive. The hurdle is the MSCI All Countries Total Return Daily Index in $A.

Minimum Investment: $10,000 Liquidity: Daily

Structure and Compliance/Counterparties

The Morphic Global Opportunities Fund is an Australian based Unit Trust open to retail and wholesale investors. Morphic Asset Management Pty Limited (ABN 33 155 937 901) holds AFS License 3419916.

Prime Broker:	Merrill Lynch
Risk and Mid-Office:	HFO
Custodian:	Merrill Lynch
Administrator:	FundBPO
Auditor:	Crowe Horwath
Legal:	DLA Piper

Commentary and performance data in this Fund Review is updated monthly by Australian Fund Monitors Pty Ltd. If you do not have a current copy please contact us or visit our website:

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About Australian Fund Monitors

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