Northward Capital Pty Ltd

- Manages **Australian share**s for MLC, since 2008.
- Manages over $3 billion, across the company, as at 30 June 2011.
- Based in Sydney, Australia.
- Investment team have an equity interest.

Northward Capital is a new boutique investment manager established in November 2007 by the previous in-house Australian shares team at Insurance Australia Group (IAG).

Why has MLC chosen Northward Capital?

MLC appointed Northward Capital because of the clearly defined and differentiated investment process and experienced investment team. Northward Capital conducts fundamental bottom-up stock research to identify mis-priced stock opportunities with sustainable earnings growth, accelerating cash flows and a rising return on equity. The use of Sector Portfolio Managers ensures that investment calls are made by the analyst closest to the company research whilst the Co-lead Portfolio Managers take a holistic view to combine sector insight with an overall perspective of the risk and return opportunities across the market. Northward Capital holds approximately 30-50 stocks in a high conviction portfolio.

Simon Rutherfurd
CIO and Co-Lead PM

Philosophy on investing

Northward Capital has a disciplined, fundamental based investment approach derived from a belief that:

- Market inefficiencies provide opportunities to regularly buy mis-priced stocks;
- Fundamental research drives high conviction valuation and stock selection; and
- Stock prices ultimately reflect sustainable earnings growth, accelerating cash flows and a rising return on equity.

Fundamental bottom-up stock research is core to Northward Capital's investment philosophy. The research approach can be simplified into 4 main areas:

1. understanding the company strategy and comparative advantage, industry and competitive landscape
2. valuation of the company using a variety of different methodologies
3. assessment of company management and
4. identifying a catalyst that will unlock the value of the company.

Northward Capital believes that experienced stock analysts should have the freedom to use their talents and make investment decisions within their area of expertise unencumbered by a consensus driven environment. In this manner the analysts double up as Sector Portfolio Managers and contribute high conviction stock ideas driven by the valuation discipline. This approach minimises key person risk, allows clear accountability for investment decisions and delivers very clear signals of the analysts' highest conviction ideas.

Investment process

The key steps of Northward Capital's investment process are:

- Screen universe and focus research,
- Fundamental analysis using **BVMC** (explained below) to generate a 12 month expected return,
- Index agnostic, high conviction Sector Portfolios,
- Consolidation Portfolio.

The first step in the investment process is to screen the investment universe and focus the analyst research on a manageable number of attractive investment opportunities. The investment universe of listed Australian companies is screened for liquid stocks that have a logical extension of coverage. Fundamental analysis, which includes industry research, company visits and a comprehensive set of valuation metrics (such as Price to Earnings, Dividend Yield, Return on Equity, etc), is applied to these stocks to determine the final universe of rated stocks.

The focussed research results in approximately 125 companies that are formally rated. The analysts generate a 12 month expected return and assess each stock using a **BVMC** framework:

<u>**B**uild an Investment Case</u>: Through financial modelling, company visits and time with competitors, customers and suppliers the analyst will develop a detailed understanding of the industry, stage in the cycle, company strategy and comparative advantage.

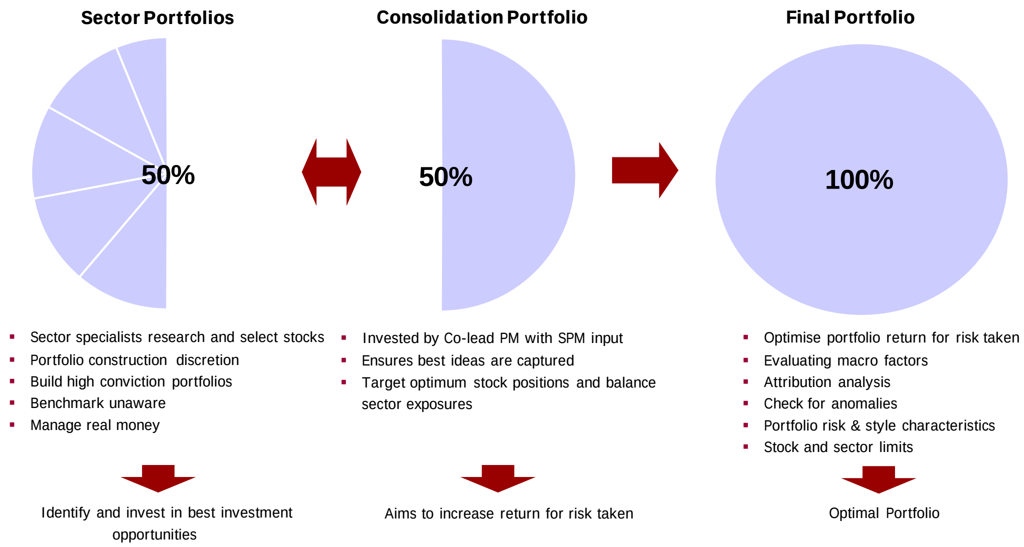
<u>**V**aluation</u>: Each company is valued and cross checked using a range of approaches at the analyst's discretion. Methods used include earnings ratios (P/E, EV/EBITDA), sum of the parts and Discounted Cash Flow.

<u>**M**anagement</u>: The management team must be of high quality with a proven track record and appropriate compensation.

<u>**C**atalyst for Re-rating</u>: The analyst must understand the stock price drivers and identify a catalyst for re-rating such as underestimated cash earnings, option value or a cyclical upturn.

The team adopts a multiple portfolio manager investment approach, which results in all team members engaging in both research and portfolio management focused on their area of expertise. Each team member is allocated primary research responsibility for stocks on a market sector basis and manages a high conviction, benchmark unaware portfolio within that sector. The individual sector portfolios hold 3 – 7 stocks, the performance of which is measured against an equal weighted benchmark of the stocks in their sector. This equal weighted benchmark ensures stock selection is based on the fundamental attractiveness of the stock rather than its market capitalisation. The sector portfolios are then combined using strategic weights resulting in a portfolio with approximately 30 stocks that accounts for 50% of the overall strategy.

The final step in the process is the Consolidation Portfolio managed by the two Co-lead portfolio managers in collaboration with the sector portfolio managers. The purpose of the Consolidation Portfolio is to increase the return for the risk taken. The Consolidation Portfolio augments the sector portfolio manager recommendations by seeking to capture the best relative BVMC opportunities while having an awareness of the relative risks and overall portfolio positioning. The consolidation portfolio also takes into account the macroeconomic environment in determining the final portfolio's sector positioning. The Consolidation Portfolio constitutes 50% of the overall strategy.



The resulting portfolio characteristics are:

- High conviction stocks based on a fundamental selection process with a strong valuation discipline;
- Portfolio 'style' driven by stock selection;
- A highly focused 30-50 stock portfolio; and
- Actively managed sector exposures, index positions and risk parameters.

Investment people

Team background and structure

Northward Capital has five investment professionals engaged in detailed company research and index agnostic sector portfolio management. There are two Co-lead Portfolio Managers who also manage a Consolidation Portfolio that constitutes 50% of the strategy. The Consolidation Portfolio ensures that the overall strategy expresses the best ideas of the analysts whilst being mindful of relative sector views and portfolio risk.

Northward Capital's team structure has a number of advantages over traditional organisation structures:

Accountability: The performance of each sector portfolio manager is known. Consequently, there is total transparency of every member's performance and total accountability for both individual and portfolio performance.

Engagement: The responsibility associated with managing a portfolio and thus ability to directly influence the final portfolio increases the engagement of team members with the investment process. This also helps in attracting and retaining experienced investment professionals.

Better knowledge translation: Analysts are sector portfolio managers and are therefore able to make their own stock choices. This avoids the problem experienced within more traditional consensus based decision models where decision makers must discard some members' opinions and experience in order to reach a portfolio decision. In the multi-portfolio manager process, all accumulated experience and knowledge is reflected in the total portfolio.

Sector specialisation: The use of sector portfolio managers rather than broad market portfolio managers means that sector specialists only have to make a call on stocks within their own research coverage. This minimises the risk that a stock view is not adequately portrayed to the rest of the team and subsequently diluted in the aggregate strategy.

Cohesive risk framework: The two co-lead portfolio managers combine the advantages of an index agnostic approach to sector portfolio management with an appropriate awareness of overall portfolio risk. Consideration of the relative valuation between sectors, overall risk parameters and portfolio constraints are captured via the Consolidation portfolio. This ensures that the aggregate strategy accurately reflects the views of the analysts without adopting unintended risks within the portfolio. Ultimately this part of the overall process aims to increase the return for the risk being taken.

Streamlined decision process: Avoidance of committee-based decision making prevents the dilution of research insights, enhances the speed of execution and captures the conviction of analysts.

Stock Responsibilities

Stock responsibilities are allocated on a market sector basis:

- Simon Rutherfurd: Transport, Materials, Packaging, Media, Services & Chemicals
- Darren Thompson: Insurance, Diversified Financials, Telcos & Gaming
- Stephen Ross: Banks, Retail, REITs, Infrastructure & Utilities
- Diane Flynn: Healthcare, Food & Beverages & Diversified Financials
- Michael Bentley: Metals & Mining, Energy & Utilities

Simon Rutherfurd

Simon is a Co-lead Portfolio Manager, Analyst and foundation member of Northward Capital's investment team (November 2007). Simon joined IAG Asset Management in October 1998 as an Equities Analyst, Australian Equities. Simon has over 20 years securities experience having previously worked for Prudential Portfolio Managers Australia as an Industrial Analyst covering Australian & New Zealand stocks. Prior to coming to Australia, Simon worked for ANZ Funds Management in NZ for three years where he was NZ Equities Manager, and at Wellington stockbroker BT Alex Brown NZ for three years where he worked as an Equities Analyst. Simon is qualified MA (English) and MBA (Finance) as well as being a qualified Chartered Accountant.

Darren Thompson

Darren is a Co-lead Portfolio Manager, Analyst and foundation member of Northward Capital's investment team (November 2007). Darren joined IAG Asset Management in May 2001 as an Industrial Analyst, Equities. Darren has over 15 years industry experience having worked for Deutsche Securities and Burdett Buckeridge Young where he was the Director of Industrial Research. Darren holds a Bachelor of Economics Degree as well as being a qualified Associate Chartered Accountant.

Stephen Ross

Stephen is a Sector Portfolio Manager, Analyst and foundation member of Northward Capital's investment team (November 2007). Stephen joined IAG Asset Management in June 2005 as a Portfolio Manager, Equities. Stephen has over 16 years investment experience in equities, having commenced his career as a Quantitative Analyst with Mercury Asset Management in 1994. Following Mercury Asset Management, Stephen moved to Commonwealth Investment Management, later Colonial First State, where he held a number of roles, including Quantitative Analyst of Indexed Equities. Stephen holds a Bachelor of Applied Science Degree, a Graduate Diploma in Investment and Finance as well as the CFA designation.

Diane Flynn

Diane is a Sector Portfolio Manager, Analyst and foundation member of Northward Capital's investment team (November 2007). Diane joined IAG Asset Management in April 2002 as an Industrial Analyst, Equities, and has over 19 years investment experience. Diane has worked for Zurich Scudder Investments as an Equities Analyst and also for AMP for seven years as a Portfolio Manager/Analyst. Diane holds a Bachelor of Business Degree and is a graduate from the Securities Institute of Australia.

Michael Bentley

Michael is a Sector Portfolio Manager, Analyst and joined Northward Capital's investment team in 2008. Michael is responsible for sector research and portfolio construction in the Resources, Energy and Chemical sectors. Michael previously worked as an Equities Analyst and Portfolio Manager with Colonial First State Global Asset Management Active Australian Prior to that Michael worked for Commonwealth Investment Management, Westfield and Chase Manhattan Global Custodial Services. Michael started his career as an Auditor with Touche Ross and Co where he completed his professional year and qualified as a Chartered Accountant.

Stock Story - Henderson Group PLC (HGG)
Current Market Price: $2.65, Target Price $3.10

Henderson Group is an independent global funds management firm, with core competencies in equities, fixed interest, property and private equity. As at December 2010, funds under management totalled $53 billion. Based in the UK, they offer a diverse range of investment products and have a creditable performance track record.

In January, Henderson Group made a friendly bid for Gartmore Funds Management, which shareholders have just voted to approve. Gartmore's exposure is concentrated in the UK retail space and nicely complements HGG's exposure. The combined group will move from the 14th to the 6th largest manager of high margin UK retail funds. Assuming 15% attrition of the Gartmore FUM, the acquisition would be approximately 15% NPAT accretive if synergy targets are met.

Henderson acquired New Star Funds Management in April 2009. New Star, another UK retail business, was under great financial pressure with a poor performance track record. Henderson achieved attrition levels and synergy savings in line with assumptions and ahead of schedule. The New Star experience bodes well for their latest acquisition, with a very similar integration plan. Gartmore is less risky given the portfolio managers responsible for 85% of FUM intend to move across and accept Henderson scrip, with plans for the rest of the FUM to be merged by August 2011, which is a more stable transition compared to the portfolio manager departures and fund outflows experienced in the lead up to the New Star acquisition.

The underlying drivers of the Henderson business are the direction of financial markets and funds flows. Obviously, with market volatility, funds flows have not returned to the steady state enjoyed pre GFC. Approximately 50% of Henderson FUM has a performance fee component, many of which depend on absolute as well as relative returns – so market levels have a meaningful impact on the likelihood of performance fees as well as the underlying management fee.

Management have proved themselves to be astute cost managers, as evidenced through the GFC downturn. The remuneration model is partly a profit share model which provides a buffer during downturns, and somewhat reduces upside leverage. However, during FY09 and FY10 the compensation ratio has been restored to about 45% of revenue, a level management believe positive leverage is possible as the top line grows.
The business will continue to be transformed from a low margin institutional business into a higher margin revenue stream through product mix and greater retail exposure. To this end, post bedding down the Gartmore acquisition, Henderson desire local expertise in the US and a number of Asian markets to better balance their UK/Europe exposure.

With regulatory approval of the acquisition pending, market forecasts are yet to incorporate the accretive Gartmore acquisition which will be a source of earnings upgrades. Incorporating Northward Capital's base case assumptions, the combined Henderson group would be trading on 11x FY12 PE vs UK and Aust peers at 11 x-12.5x PE and 12x – 16x PE respectively. Traditionally Henderson has traded at a discount to peers partly due to inferior margins (being a mix issue) and weaker inflows. These issues are being addressed. Even without a re-rating, based on EPS growth 25% and 28% for FY11 and FY12, Northward Capital has a $3.10 price target. The two dominant risks are obviously negative overall market returns and, as an Australian investor, the strength of the AUDGBP.

This stock may no longer be included in Northward Capital's portfolio as their view may have changed since this document was prepared.