

# Cadence Asset Management

September 2010

Cadence Asset Management (“Cadence”), is an Australian manager that combines fundamental research and technical trading to create above market returns. The Manager has two products available for Australian investors: a listed domestic vehicle and an open-ended trust designed for wholesale investors. The Manager is looking to reproduce the same strategy used in both products and to offer a new product in the form of a retail unit trust. All funds are run on a pari-pasu basis.

Cadence Asset Management is 100% owned by the Management; Karl Siegling and Wayne Davies and was incorporated on 3rd October 2003. The listed investment company – Cadence Capital Limited started trading and was listed on the Australian Stock Exchange (ASX) in December 2006 and the wholesale fund – Cadence Capital Fund started trading on the 1st of November of 2003.

Cadence manages a long-short Australian equity programme across all its funds. The programme has a long bias and has been more active recently in the small and midcap equity markets but its mandate is to operate across both the large and small cap equity sectors. The Manager uses a blend of technical and fundamental analysis in investing decisions. While the investment process necessarily results in a net long exposure the Manager has the ability to quickly react to market headwinds. A good example of risk reduction occurred over the period from July 2007 to July 2008 where the portfolio exposure was reduced from 110% net long to less than 20%. Similarly as markets recovered the Manager quickly moved net exposure to over 110% by May 2009. These are the characteristics that many investors would like to see from their long short investments.

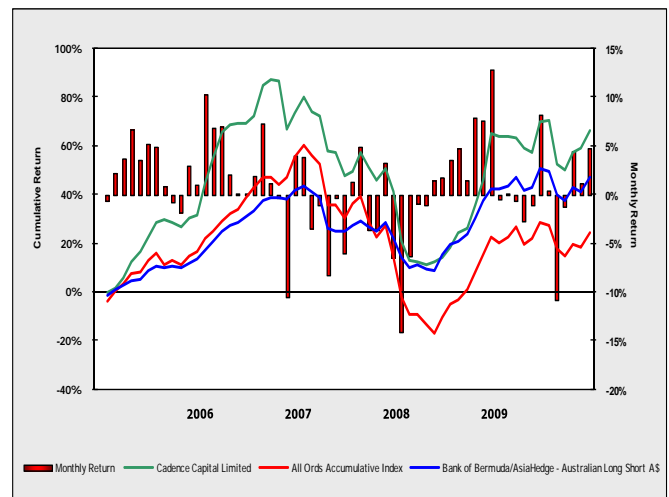
Recent market volatility and the reaction to sovereign debt issue this year is creating uncertainty and we therefore

Key Features	Description
Strategy Size	A\$37 million
Capacity	Will review at A\$250 million
Firm Size	A\$37million
Fund Inception	TBA
Domicile	Australia
Management Fee	1% excl GST
Performance Fee	20% excl GST
Hurdle rate	ASX All Ords Accumulative Index
High watermark	No
Subscription notice period	3 Sydney business days before month end
Subsequent minimum	A\$100,000
Subscription frequency	Monthly
Redemption notice	One month's notice
Redemption fee	None
Redemption gate	Manager discretion
Lock-up	None
Reference currency	A\$
Fiscal year-end	30 June
Distributions	Annual

believe that a strategy that identifies strong businesses from an analytical perspective combined with a technical overlay will add value. Accordingly, the Cadence investment programme is a candidate for consideration.

The Manager is a small team comprising of three people; Karl Siegling, Wayne Davies and Christopher Garrard are competent but of course small business risk is an issue. The listed fund has A\$30 million in assets under management; providing a steady source of income for the business. The smaller wholesale trust has sourced most of its money from high net worth individuals and fund of funds. The access to Cadence for offshore investors is through a recently relaunched Cayman Island Fund. Simultaneously Cadence is shortly to launch a new open-ended fund for the Australian retail market. While it is always difficult to predict the success of a boutique business the Manager is dealing positively in developing new sources of income. Our confidence in the long term

**Cumulative Returns**



survival of the manager is strengthened by the long-term revenue it receives from managing the listed investment company.

The backgrounds of the principals suit this style of strategy; Siegling has spent time as a research analyst and a night trader, giving him perspective of fundamental and technical approaches. Davies is seasoned in finance and operations.

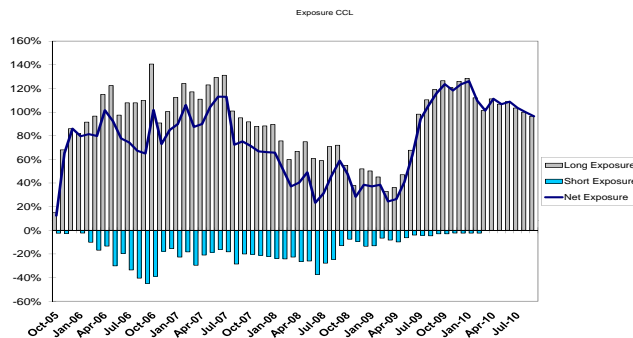
The stop loss and pyramiding into new positions are disciplines that are designed to prevent the Manager chasing a stock on its way down or to average down into new positions. We are pleased that even through difficult periods Cadence has preserved this rigorous approach.

All investment strategies work best when applied through a disciplined and methodical approach. Such qualities are clearly a significant part of the Cadence approach. We would be concerned and look to review our position if the principals and or the investment style displayed behaviours that no longer reconciled to the current practices.

The strength of this Manager is in executing a well-designed, robust investment process. The Manager uses a combination of quantitative and qualitative processes to enter and exit positions resulting in larger positions as both the market and the Manager's view strengthen.

The technical analysis provides entry and exit signals that identify long and short-term trends. Of course many trends are the result of momentum and the slow absorption of new information into the market. The result is the Manager will not buy into stocks with falling momentum, regardless of the fundamental research. We consider that this approach provides a sensible trading discipline.

The risk management of the programme is apt for a business of this size. There are fitting stops that are in place to cut positions and review positions. A disciplined approach results in decisions that fail to adhere to soft stop loss signals. There are times when the Manager has such high conviction that it may override even the hard stop loss rules. We consider that this process is structurally suitable and provided the discipline continues we will preserve our positive view of the Manager and its investment process.



## PERFORMANCE ANALYSIS

The Cadence funds all use the same investment process and trades are split based on the size of the fund. For the report on the programmes comparison we have used the listed investment companies returns.

The Manager's process is to seek out under researched stocks with positive cash flows, strong management and balance sheet. The result is the manager uncovers opportunities in large and small capitalised companies after extensive research. The least researched equities are typically small and mid capitalised stocks. While the Manager can short stocks that it believes are overvalued, the Fund has a long bias therefore we feel the ASX All Ords index is the correct benchmark.

Net Exposure of the Fund since inception has consistently been positive.

Against this index the Manager has delivered more than 7% yearly alpha. Our analysis suggests that this alpha is because of protection managed by the investment techniques and the ability of the Manager to capture significant amount of the market upside.

It is also right that a manager who may short stocks should be compared to its peers. We have used an industry index, the Bank of Bermuda/ AsiaHedge Australian Long Short A\$ Index. Again the comparison is favourable. The fund has generated positive alpha but more importantly the Fund has a higher Sharpe ratio than the index.

Monthly Performance (%) Net of Fees													
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2010	(2.68)%	(1.09)%	8.17%	0.45%	(10.81)%	(1.24)%	4.48%	1.14%	4.79%				2.02%
2009	(1.16)%	1.41%	1.70%	3.57%	4.74%	1.47%	7.82%	7.65%	12.86%	(0.51)%	0.02%	(0.61)%	45.37%
2008	(8.28)%	(0.35)%	(5.97)%	1.33%	4.92%	(3.67)%	(3.66)%	3.32%	(6.49)%	(14.16)%	(6.38)%	(0.87)%	(34.74)%
2007	2.05%	0.17%	0.02%	1.90%	7.22%	1.17%	(0.39)%	(10.59)%	4.05%	3.79%	(3.43)%	(1.04)%	3.88%
2006	6.66%	3.52%	5.14%	4.95%	0.87%	(0.75)%	(1.78)%	2.88%	1.05%	10.22%	6.86%	6.94%	56.87%
2005										(0.57)%	2.27%	3.73%	5.48%

Return	Fund	All Ords Index	Bank of Bermuda/AsiaHedge Australian Long Short \$A
Compound ROR	10.72%	4.48%	7.99%
Cumulative Return	66.37%	24.48%	46.85%
Best Month	12.86%	8.05%	5.86%
Worst Month	(14.16)%	(13.92)%	(8.92)%
% Positive Months	61.67%	61.67%	61.67%

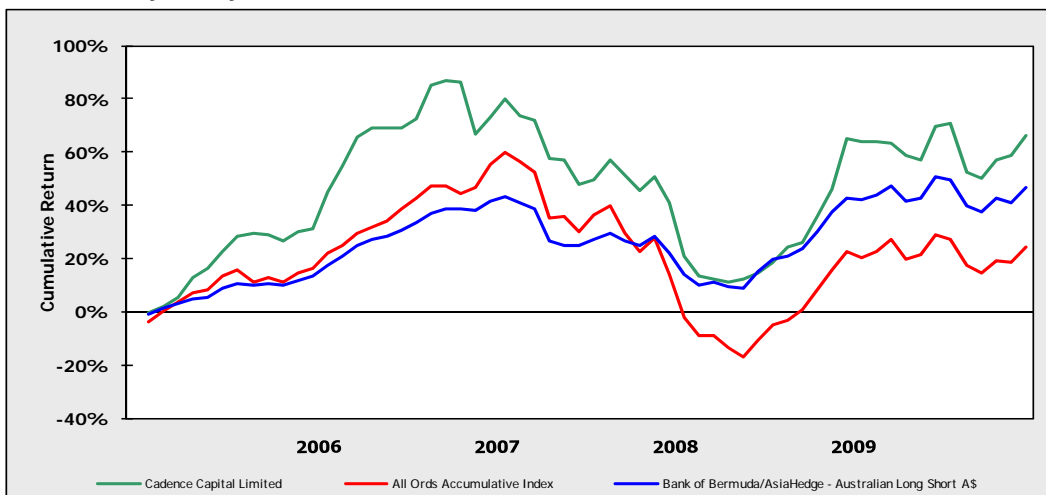
Comparison to Benchmark(s)			
Alpha		0.58%	0.01%
Annualised Alpha		7.14%	0.15%
Beta		0.84	1.41
Correlation		0.80	0.83
R-Squared		0.63	0.68

Annual Return	Fund	All Ords Index	Bank of Bermuda/AsiaHedge Australian Long Short \$A
2010	2.02%	(1.90)%	(0.31)%
2009	45.37%	39.57%	32.70%
2008	(34.37)%	(40.39)%	(19.96)%
2007	3.88%	17.96%	11.13%
2006	56.87%	24.99%	21.45%
2005	5.48%	3.45%	2.76%

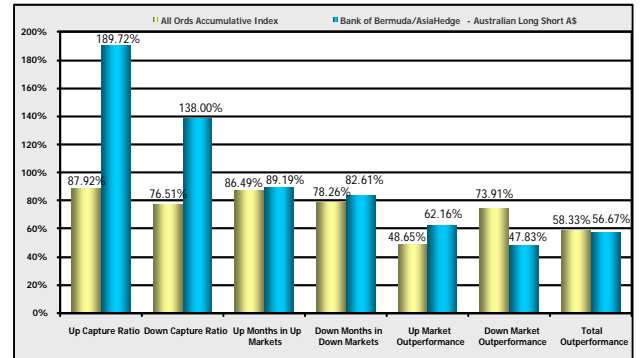
The graph below highlights that the Manager has out performed the ASX All Ords Accumulative Index on the upside and it has not lost as much when the market has fallen. We feel that while there is significant performance from stock picking it is not the only cause deciding performance. Other causes that we believe are important are the Managers focus on risk management, the sizing of positions and the accountability for each position in the portfolio.

We believe, the qualitative evidence alone suggests that this investment programme should be employed by investors interested in capturing outsized gains in

### Consistency Analysis



large and small cap stocks with an absolute return focus where cash weightings at times can be high.



While we note that the Fund has a high correlation to the All Ords Accumulative Index, the table above shows that the Manager is able to deliver significant performance in down markets. This represents the Manager's capability in risk management and being able to reduce and expand exposure.

### RISK / RETURN ANALYSIS

Risk	Fund	All Ords Accum Index	Bank of Bermuda/AsiaHedge Australian Long Short \$A
Standard Deviation	17.58%	16.74%	10.30%
Sharpe Ratio (5%)	0.39	0.05	0.33
Sortino Ratio (10%)	0.05	-0.37	-0.23
Downside Deviation (10%)	12.86%	13.88%	8.21%
Max Drawdown	(40.71)%	(48.28)%	(24.09)%
Months in Maximum Drawdown	19.00	16.00	16.00
Months to Recover	0.00	0.00	9.00

Drawdown Analysis	Fund	All Ords Accum Index	Bank of Bermuda/AsiaHedge Australian Long Short \$A
1	(40.71)%	(48.28)%	(24.09)%
2	(2.52)%	(4.34)%	(8.75)%
3	(0.57)%	(3.83)%	(3.82)%
4		(2.01)%	(1.24)%
5			(0.71)%

## STRUCTURE AND OWNERSHIP

### Organisation

Karl Siegling incorporated Cadence Asset Management Pty Ltd (the "Manager") in October 2003. In November of that year Cadence launched a wholesale investment trust – the Cadence Capital Fund.

Because of demand the Manager launched a closed end vehicle, Cadence Capital Limited which started trading in October 2005. Cadence Capital Limited was listed on the Australian Stock Exchange ("ASX") in December 2006.

For a couple of years the Manager also managed a Cayman Island Fund, designed so that offshore investors could access Cadence's investment programme. Almost all of the funds under management were withdrawn because of the GFC. The Manager has since relaunched the fund.

The Management Company is 100% owned by management.

### Investment Personnel

**Karl Siegling**, Managing Director, founder and Portfolio Manager of Cadence with 13 years relevant experience in financial markets.

Before Cadence, Karl worked as an external analyst at Wilson Asset Management where he researched stocks for the Wilson group of funds.

Before that Karl was the Managing Director of eFinancial Capital Limited (a subsidiary of Challenger Group Limited Holdings). The role had him focusing on investing for an early early stage private equity fund.

In London Karl worked on the equity trading desk at Goldman Sachs. Before that he worked at Deutsche Morgan Grenfell at first as a currency and bond trader on the night desk and then later as an equities research analyst.

Karl holds a Bachelor of Commerce and a Law degree from the University of Melbourne as well as an MBA from INSEAD in France specialising in Finance and

Entrepreneurial Endeavours. Karl has also completed the Postgraduate Diploma in Finance with the Securities Institute of Australia.

**Chris Garrard**, Senior Analyst at Cadence. He worked at IBM for 9 years as a financial analyst.

Chris is the Portfolio manager (8 years) of a family investment fund managing a portfolio of listed stocks.

Chris holds a Master of Commerce, Major in Finance from the University of Melbourne, Bachelor of Engineering with Honours and Bachelor of Commerce from the University of Melbourne.

**Wayne Davies** Chief Operating Officer joined Cadence in 2007. Wayne's first role in Australia was with Mathews Capital Partners as its Chief Operating Officer.

Before arriving in Australia Wayne was the Chief Operating Officer for Theorema Asset Management, a long short European equities fund based in London. During his time at Theorema its asset under management grew to US\$1 billion.

Before this Wayne gained experience in several industries acting as both Chief Operating Officer and Chief Financial Officer. He also gained experience with Deloitte Consulting Group as a management consultant where he specialised in operations and financial control functions.

Wayne is both a Qualified Chartered Accountant (South Africa) and an Associate member of the Chartered Institute of Managements Accounts in the United Kingdom. Wayne also holds a Bachelor of Commerce degree and a Diploma of Accounting postgraduate degree from the University of Kwazulu/ Natal.

### Investment Process

Cadence is a long short Australian equities fund, with a long bias and is typically active in the small and midcap equity market. The Manager uses a combination of technical and fundamental analysis to uncover investment ideas, and indeed uses the same dual process in exiting positions. It seeks to outperform the ASX All Ordinaries index

The programme uses a bottom-up approach for research driven long-term positions.

The underlying belief of the Manager is that markets are inefficient and so information is spread slowly through markets. This opinion is valid for the small and mid capitalised stocks listed in Australia. Many of these stocks have little or no sell side research coverage and this ensures inefficient transmission of information to the market. The Manager undertakes between 400 and 500 company visits a year. From these visits Cadence not only builds up a deep understanding of the company but also the market in which it acts.

Cadence uses both fundamental and technical trend analysis to gain core and trading investments. Core holdings require the Manager to conduct more detailed research on the company. A trading position is typically selected based on consensus information.

The Manager builds estimates for the next two years. Earnings per share growth and operating cash flows per share are required for the fundamental analysis. Cadence also looks to balance sheet strength – preferring companies with little or no debt.

Short-term (3 months and one year) share price and volume signals are part of the technical analysis. The Manager also looks at the long-term trend and weekly volumes. These indicators are not just used to prove trends but as tools for entry and exit signals.

Our discussions with Cadence revealed a fund manager that is eager to improve from past mistakes with the goal of providing better returns to investors.

#### **Security Selection**

All positions are equities on the Australian stock exchange. Most of the portfolio is liquid – but as the events of 2008 taught all investors small and midcap stocks liquidity can evaporate quickly.

#### **Portfolio Construction**

All new positions are set up by a pyramiding method. The application of this process is disciplined and applied rigorously.

The Manager has a stop loss method that allows it to hold onto stocks that it has a high conviction in. Such a system is open not only to abuse but lazy portfolio management. We would argue that as the Manager records each decision for holding on to a losing trade an audit trail is created. By continually updating its decisions the Manager more clearly displays a considered approach. We would like to see more of these accountability audit trails at other Managers.

#### **Risk Management**

The Manager has in-house risk management systems that are appropriate to the style and asset class of its investment programme. Position limits are tracked. Any loss on a position of 10% against a previous high is a soft stop and results in the need for the Portfolio Manager to review the investment thesis.

If a loss on a position is greater than 15% of the weighted average cost then a hard stop is applied. There is the flexibility for positions that reach the hard stop loss limits to remain in the portfolio but the Manager needs to clearly explain the reason for holding the position. While this allows great flexibility it does provide the investment team time to reassess their convictions and to re-establish the first investment rationale.

The programme invests across all major sectors and typically has had 20 - 40 core investments and up to 40 trading opportunities.

#### **Risks of the Fund**

The obvious risk in this programme is that it relies on balancing new ideas with applied risk management, with the investment ideas generation from Karl and Chris Garrard and the ongoing risk management and compliance from Wayne Davies. The dynamic between the two teams are one of equals and we were impressed that both had strong views that could be aired and debated. Zenith believes that at our review the team not only displayed suitable experience but also ownership of their respective responsibilities.

Cadence is a small fund manager and therefore does carry the risk associated with such a small firm. However the 7.14% a year Alpha over the comparable index, without gearing, provides an anchor for our belief that investors are being compensated for this extra risk.

The investment programme does invest in small and mid capitalisation Australian companies and liquidity of some of its positions will always be subject to market sentiment- a flight to quality will always upset interest in smaller capitalisation stocks.

#### **FEES**

The fee levels are low compared to the funds peer group, and importantly investors have been rewarded on an after fee basis.

#### **ADMINISTRATION AND OPERATIONS**

##### **Operations**

Wayne Davies actively supervises the operations. The portfolio management system allows the Manager to track performance intraday of each position in the portfolio. The operations and risk system is the backbone for the Manager and all data is kept up to date. Trades are entered and on receipt are matched to broker trader confirms. In addition all positions are reconciled to the Prime Broker position statements. The Manager acts as its own Fund Administrator for the listed vehicle. While we understand and are sympathetic to have this in-house we believe that this is not best practice for an open-ended fund. The Manager has strongly pointed out the Manager will engage an external Fund Administrator for the proposed open-ended fund.

Any errors picked up are resolved immediately by liaising with both the fund manager and the counterpart. All matched trades are then reported electronically to the prime broker from the Cadence portfolio management system. Citi Prime Brokerage matches all trades against confirms received directly from the counterparts. Any errors picked up at this stage are resolved at once by

speaking to the fund manager and/or the counterpart.

### **Service Providers**

Cadence use quality service providers, Citigroup Global Markets Australia are the Prime Broker and Custodian, Watson Mangioni as the legal advisors. Moore Stephens are the appointed Auditors. Currently the fund accounting and administration is conducted in-house by the COO. Citigroup is one of the handful of investment banks offering domestic Prime Broking services.

Watson Mangioni is a Sydney based law firm that was founded in 1994 and has been involved with several listings, including for Cadence Capital Limited.

Moore Stephens is one of Australia's leading midtier accounting firms and have been providing their services since 1935.

It is rare for a boutique Australian fund manager to undertake fund administration, it is more usual that this is outsourced. The Manager has little need to manage a large number of unit holders and the quality of the COO has reduced the cost to investors. We believe the Manager will appoint a Fund Administrator for the proposed retail fund.

### **Pricing**

The securities that are held by Cadence are quoted on the Australian Stock Exchange. The Manager does not use difficult to value over the counter derivatives therefore pricing the portfolio is transparent.

### **Transparency**

The Manager provides transparency to researchers; not only current and past positions but also the reasons for changes in the portfolio.

### **Disaster recovery**

All the IT systems are backed-up each night and the traders have the ability to work remotely in the event of a local disaster. In addition all trades and positions are recorded with the Prime Broker creating additional back up.

### **Personal trading**

The firm's documented Australian Financial Service Licensees (AFSL) compliance procedures detail employee own account dealing procedures. All employees are required to get signed trading approval from the Managing Director, Karl Siegling, before trading in any ASX listed share. A detailed record of all such trades and required authorisation is kept on file. Management believes there is no potential conflict of interest in this area as Karl Siegling has a large portion of his personal wealth invested in the Cadence funds. The employees also have investments in the Cadence funds.

### **Compliance**

The Manager has an Australian Financial Services Licence ("AFSL") that is correct for its Fund's offering.

Mike Freeman from Acomplli, a national external external compliance specialist organisation sits on the compliance specialist organisation sits on the Compliance Committee. Mr Freeman has extensive compliance experience in Australia for both listed and unlisted investment vehicles.

Wayne Davies, the COO, is responsible for day-to-day compliance and reports to the Compliance Committee.

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