



# AUSTRALIAN FUND MONITORS

## Targeting Absolute Returns

### March 2010. Herschel Absolute Return Fund added to AFM Model Equity Manager Portfolio

Herschel Asset Management's Absolute Return Fund is an Australian domiciled, long short hedge fund investing in ASX listed securities and derivatives.

The fund has a track record of over 3 years and 10 months to February 2010, during which time it provided investors with an annualised return of 16.97% at an annualised volatility of 8.78% and a Sharpe ratio since inception of 1.22.

The manager's attention to risk and downside deviation resulted in a positive return of 0.31% in 2008 and a maximum drawdown since inception of -6.02% in 2008/09. Since inception in May 2006 the fund has provided an asymmetrical risk profile: 70% of all months to date have been positive with an average return in those months of 2.51%, whilst the average return in negative months has been -1.32%. The fund's best month was +8.72% against the worst month of -3.82%.

Based on these returns and the overall risk profile, Herschel's Absolute Return Fund has been included in Australian Fund Monitors' Model Equity Manager Portfolio.

Selection in the AFM Model Equity Portfolio was based on a quantitative analysis of 81 equity based funds with at least three years' track record measured by 16 equally weighted key performance and risk indicators.

Herschel Asset Management was established in 2000 and has over A\$800m in assets under management. The Absolute Return Fund has \$35m in FUM and is open to wholesale investors and has a minimum investment of \$50,000.

Fund in Focus  
Herschel Asset Management  
Absolute Return Fund  
February 2010



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## Fund in Focus: Herschel Absolute Return Fund, Feb 2010

### Management Company Overview

Herschel Asset Management Limited is a privately owned investment management company based in Melbourne, Australia which was established by Mr. Saxon Nicholls in 2000. The firm focuses on Australian equity markets, and offers a range of products, including long only institutional mandates and managed discretionary accounts for high net worth individuals.

Herschel Asset Management is owned by Herschel Capital Partners Pty Ltd, which in turn is 91% owned by Nicholls (aged 36), with the balance of 9% owned by interests associated with Mr. John Fredersdorff. Saxon Nicholls is a director and the CEO of the company, whilst John Fredersdorff is a non executive director.

Nicholls previously worked as a fund manager at Merrill Lynch Mercury Asset Management and as a management consultant at McKinsey's. As of December 31, 2009 Herschel's total assets under management was A\$815 million, made up of approximately \$105 million in a concentrated equity fund, \$675 million in long only mandates, and approximately \$35 million in the long/short absolute return fund.

The Herschel Absolute Return Fund was launched in May 2006 and is managed by Mark Burgess, aged 48, following 22 years in the securities industry, including experience in Australia and overseas with ANZ McCaughan, JP Morgan and Ord Minnett. Burgess has full responsibility for the fund's investment strategy and implementation, and is assisted by an additional Portfolio Manager, Kristiaan Rehder.

Overall Herschel has a total investment team of 5 people, which is supported by a back office team of 5.

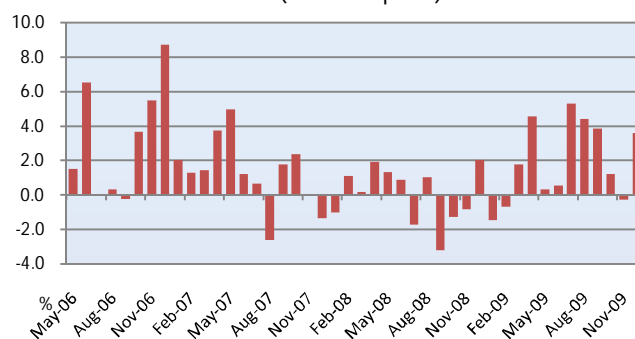


#### Key Performance Statistics to 31 December, 2009

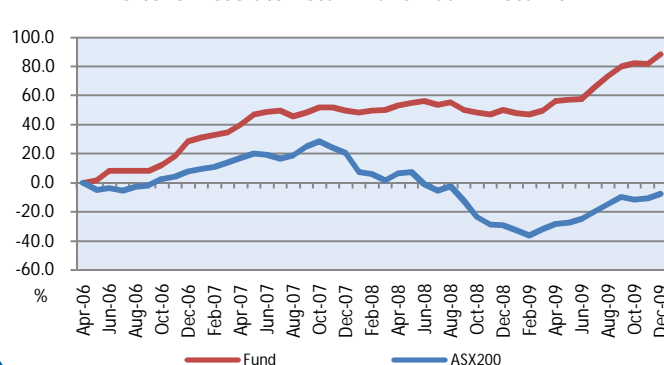
Annualised (Since May 2006)	18.85
Latest 6 Months	19.38
Latest 12 Months	25.46
Latest 24 Months	25.86
Latest 36 Months	66.42
% Positive Months	70.45
Best Month	8.72
Worst Month	-3.20
Average Positive Return	2.57
Average Negative Return	-1.13
Annualised Standard Deviation	8.54
Downside Deviation (since inception)	3.53
Sharpe Ratio (since inception) ave RBA cash rate	1.43
Sortino Ratio (since inception)	3.86

\*All performance figures in this report are net of fees unless otherwise stated.

Herschel Absolute Return Fund - Monthly Returns  
(since inception)



Herschel Absolute Return Fund - Cum. Returns



#### Key Facts as at December 2009

Strategy	Australian Equity Long / Short
Domicile	Australia
Investor Type	Wholesale only
Min. Investment	A\$50,000
Additional Investment	No minimum
Management Fee	1.5% p.a
Performance Fee	20% p.a, with high water mark
Hurdle	RBA cash rate
Min. Term	No minimum
Redemption	Monthly
Track Record	44 months
Fund Size	A\$ 35 million
Manager's Total FUM	A\$ 815 million

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## Manager Interview

AFM visited Herschel's offices in December 2009 and February 2010 to meet with portfolio managers Mark Burgess, Kristiaan Rehder and Herschel's principal shareholder Saxon Nicholls, to discuss their investment approach and assess their compliance and operations. AFM also interviewed Murray Jones of Compliance and Operational Risk Management who provides outsourced compliance services to Herschel.

## Investment Approach & Strategy Implementation

Herschel's Absolute Return Fund is an Australian domiciled equity long/short fund investing in equities listed on the ASX. There is some use of exchange traded call options and limited use of SPI futures contracts to hedge overall market risk.

Mark Burgess, the Fund's Manager, holds a BEc from Monash University, and is a Chartered Financial Analyst who has extensive experience in the Australian equity markets, commencing his career in Melbourne in 1987 in the equities team at ANZ McCaughan.

His career includes five years international experience in New York from 1993 to 1997 where he joined Ord Minnett, and three years in London with Ord Minnett and JP Morgan from 2001 to 2003, prior to returning to Melbourne in 2004.

Burgess is supported by Kristiaan Rehder, a member of the investment team who has been with Herschel since August 2005. Prior to joining Herschel Rehder spent five years with Merrill Lynch in Australia, London and Singapore in a variety of areas including Debt Capital Markets, M&A and Structured Finance. From 1998 to 2000 Rehder was employed by KPMG Corporate Finance.

*Burgess strongly believes that asset allocation and the correct macro view are keys to good performance.*

Burgess's experience, and Herschel's approach to the fund's investment strategy, combines an overall view of the macro economy and market direction, coupled with detailed knowledge of the individual stocks in the fund's universe.

Burgess is of the opinion that at times the Macro view is more important than stock picking, although believing that each of them are critical to maximizing returns.

"The macro view is the primary factor in determining the fund's total market exposure. In volatile times such as in

2008 it was the macro and overall market view that was of primary importance, whilst stock selection was secondary."

In 2008 Burgess picked the macro view (which was bearish) correctly, and as a result the fund's overall net exposure to the equity markets was reduced. From an individual stock picking point of view the portfolio was also positioned defensively as a result of the macro view.

Although not net short during the worst of 2008, the fund had close to a market neutral position, enabling Herschel to post a positive return of +0.31% for the 2008 year, with a maximum drawdown of -6.02% over three months from September to November.

## Fundamental Research & Analysis

Herschel use the services of a range of 15 brokers' research departments for both company and macroeconomic views, particularly those with global reach such as Goldman Sachs, Morgan Stanley, UBS and Macquarie.

## Information Gathering

Specific company research and analysis is conducted involving a combination of the following:

1. Broker research, including speaking with preferred analysts to ensure that there is a full understanding of specific issues surrounding a fundamental view of a company.
2. Assessment of management quality through discussions with the Company at CEO or CFO level.
3. Relevant industry analysis and comparisons as applicable and warranted.

Herschel has a small but focused investment team, and Burgess therefore uses the broker's depth of individual company research coverage to provide the core financial analysis and earnings forecasts.

Burgess places considerable emphasis on company visits and contact with CEO's and CFO's to supplement and backfill the research provided from the broking analysts. Burgess likes to "eyeball" management and he believes his experience in the Australian market allows him to keep in context what he hears and sees by comparing it with the market and financial data as a whole.

Whilst treating all corporate contact with caution, he attempts to ensure he is able to glean not only an accurate view of the company's position from these visits, but also measure the pulse of the underlying industry and the overall economy.





In this respect the connections of the overall Herschel Asset Management team, which specialises in providing asset management services to the corporate sector, proves invaluable.

### Portfolio Construction

Herschel's Absolute Return Fund consists of a concentrated long/short portfolio typically comprising 30 to 40 ASX300 listed stocks, generally with a long bias aligned to the overall market direction.

There is a slight bias to large cap stocks (ASX200) in the long side of the portfolio, although in a rising market the portfolio will tend to hold smaller caps, including resource stocks, more frequently.

On the short side, the portfolio is particularly concentrated, with stock selection limited by both liquidity and the difficulty of borrowing stock in smaller cap companies. Short stock positions are only taken when there is a high conviction view on the specific stock.

### Derivatives

The fund uses derivatives in a limited way, and only under specific circumstances, with only exchange traded call options and ASX SPI futures being used.

Exchange Traded Options are used by writing (selling) calls against long term positions with the intention of either protecting against a fall in share price, or to generate additional income. Typically income from writing calls against existing positions (no naked calls are written) is approximately 5-10 basis points per month, or up to one percent per annum.

Written calls are invariably short dated with less than 30 days to expiry, and approximately 10 to 15% out of the money. In the event the stock rallies Burgess is happy to either sell, or roll up to a higher strike price.

The fund does not trade or use put options at any time.

Share Price Index (SPI) futures on the ASX are only used to hedge the overall net position of the portfolio, rather than speculate on the market's direction. Unless he has a high conviction on individual stocks, Burgess feels this method of protecting the downside is preferable to shorting specific stocks.

### Risk Limits

The fund has specific risk limits with a hard stop loss limit of 15% on each position. In practical terms this is rarely achieved as the portfolio management system used monitors each position's P&L, and flags positions on reaching a 10% drawdown.

### Investment Risk & Processes

#### Market Implementation

Typically the portfolio may contain 20 to 45 positions at any one time, with the average of 30 and a holding period for a stock between three and a half to four months.

The Manager employs high conviction when taking a position in a stock, with a minimum entry position of 1% of the portfolio's NAV, and a maximum position size of 10%.

The fund uses the IRESS Portfolio Management System to manage exposure to individual stocks and the overall portfolio.

There are no set limits for sector exposure, with individual stock limits set at 10% of NAV.

Maximum book size is gross 150% of NAV both long and short. On average since inception the fund has averaged 50% net long.

The fund does not use any borrowing to create leverage.

All positions are monitored on a real time basis using IRESS which along with proprietary spreadsheets provide daily and monthly P&L. These are reconciled daily with UBS the prime broker, and Kingsway Taitz, the fund's administrator.

The investment team holds formal weekly investment meetings at which time overall portfolio positions are discussed and determined, along with each position's P&L contribution.

### Operations and Compliance

Daily reconciliations are undertaken of all trades against Kingsway Taitz (Administrator) and UBS (Prime Broker), in addition to full Profit and Loss reconciliation with each. There is also a full daily review of all upcoming settlements.

On a monthly basis there is a review of month end calculations and reconciliation of data and NAV calculations with Kingsway Taitz.

Herschel Asset Management has established an outsourced arrangement to monitor and control risk and compliance with Compliance and Operational Risk Management Pty Ltd. This involves overall compliance for the company, including its obligations under its AFS Licence, in addition to compliance and risk for the Absolute Return Fund.

Compliance and Operational Risk Management Pty Ltd is managed by Murray Jones, and either Mr. Jones or one of his employees makes site visits to Herschel's offices at least twice per month.

Compliance and Risk Management report directly to the Board of Herschel Asset Management, and Mr. Jones states that he frequently meets with independent director, John Fredersdorff or the CFO without Saxon Nicholls being present as CEO.

## Operational & Business Risk

### IT and Premises

Herschel Asset Management has an active IT & Disaster Recovery system in place consisting of tape, offsite web based daily back up, and PC replication, managed externally by Vital IT Pty Ltd a local IT consultancy who provide infrastructure services and support.

Additional mid and back office IT support is provided by Huw Evans Consulting Pty Ltd.

Herschel's premises in Melbourne's CBD are leased until December 2012 with an option to renew for a further five year term.

### People Risk

People Risk, including key person risk is focused on Herschel's CEO and major shareholder, Saxon Nicholls and Mark Burgess, who as the Portfolio Manager is responsible for the overall strategy direction, in addition to the majority of the fund's implementation decisions.

Burgess holds no equity in the management company, and is not under any long term employment contract, a situation about which both he and the principal shareholder, Saxon Nicholls appear to be comfortable. However, Burgess's interests are strongly aligned with those of both the Funds' investors and the company by virtue of an equitable fee sharing arrangement.

Nicholls, with over 90% of the equity in the Management Company is also strongly aligned to the business

Otherwise key person risk is typical for a boutique manager of Herschel's size. It should also be noted that the majority of fund managers, irrespective of size, carry significant key person risk in the event of the departure or unavailability of the Portfolio Manager or principal shareholder.

The culture at Herschel reflects that of both Nicholls and Burgess, who maintain a belief that pride in producing good returns is more important than either ego or short term financial reward. Burgess takes the view *"that it is all about the fund's performance and that over time the rewards will take care of themselves."*

### Investor Base & Funds under Management

As at the date of this review (February 2010) Funds under management for the Absolute Return Fund were A\$35m. Existing investors include three Australian based fund of funds, and one HNW investor who has an investment of approximately A\$10m.

Under ordinary circumstances this would make the Absolute Return Fund a marginal operation; however by being a part of Herschel Asset Management (which has total Funds under Management of over A\$800m) there are significant investment and operational synergies and efficiencies which mitigates and reduces this risk.

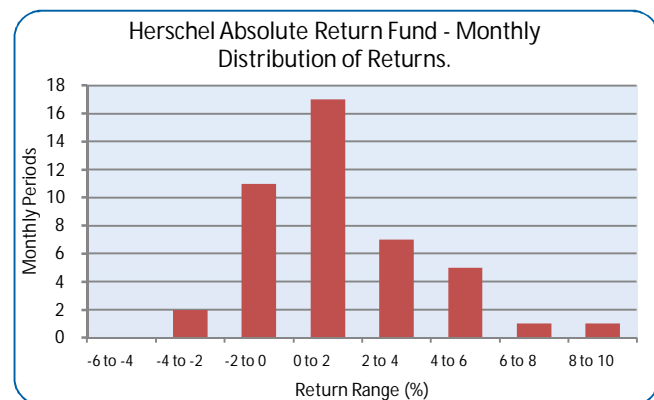
Burgess has approximately \$2m personally invested in the fund.

### Investor Communications

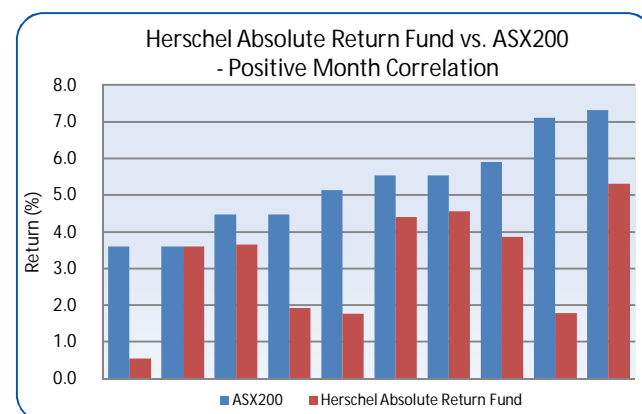
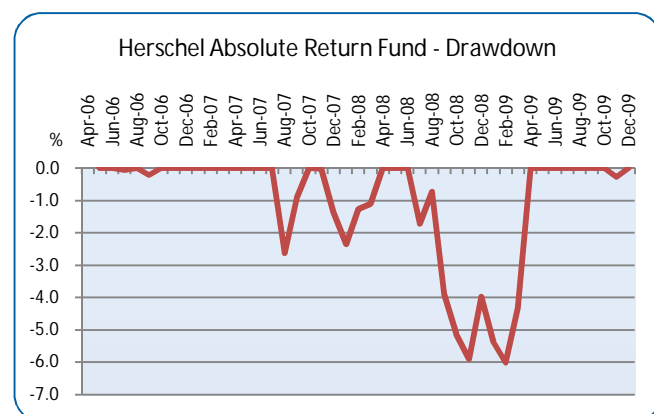
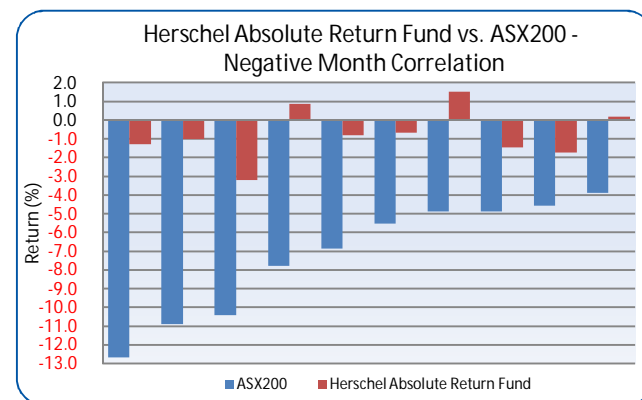
Herschel provides a one page monthly performance report distributed via email which includes a market commentary and performance attribution details where appropriate.

## Performance Analysis

### Distribution and Drawdown:



### Correlation to ASX200:



Herschel Absolute Return Fund - Performance (%)													
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2009	-1.46	-0.68	1.79	4.56	0.34	0.55	5.31	4.41	3.86	1.20	-0.28	3.59	25.46
2008	-1.00	1.11	0.17	1.93	1.33	0.87	-1.72	1.02	-3.20	-1.28	-0.81	2.04	0.31
2007	2.04	1.28	1.45	3.74	4.95	1.20	0.65	-2.62	1.76	2.36	-0.02	-1.34	16.33
2006					1.53	6.54	-0.06	0.32	-0.22	3.65	5.50	8.72	28.65

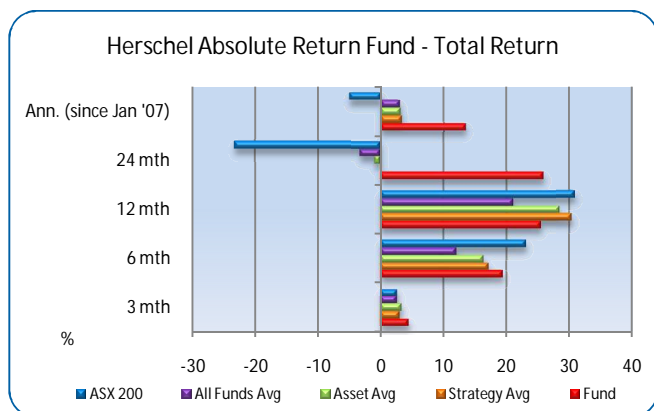
Performance Analysis			
Track Record	Company	Strategy	Asset Group
44 months	Herschel Asset Management	Equity Long/Short	Equity
Latest 6 months returns	Latest 12 months returns	Latest 24 months returns	Latest 36 months
19.38	25.46	25.86	66.42
% Positive Months	% Negative Months	Best Month	Worst Month
70.45	29.55	8.72	-3.20
Average +ve Return	Average -ve Return	Average Monthly Return	Annualised Standard Deviation
2.57	-1.13	1.48	8.54
Skew	Kurtosis	Max Drawdown	Time to Recovery
0.69	0.57	-6.02	5.00
Sharpe 1 year	Sharpe 3 years	Sharpe 5 years	Sharpe (since inception)
2.58	1.05	N/A	1.43
Downside 1 year	Downside 3 year	Downside 5 year	Downside (since inception)
2.12	3.87	N/A	3.53
Sortino 1 year	Sortino 3 year	Sortino 5 year	Sortino (since inception)
10.42	2.23	N/A	3.86

## Comparative & Industry Performance

The Herschel Absolute Return Fund outperformed others in both the Long Short category and equity based funds in general as well as the ASX200 over the longer 36, 24 and 12 month periods, particularly when looking at downside risk factors such as downside deviation, Sortino and Sharpe ratios.

### Total Return

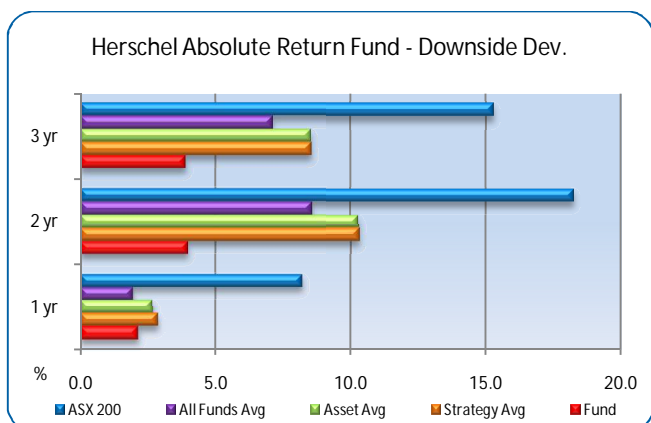
The Fund compares favourably on total return, particularly on a 24 month basis where it ranked 1/49 funds in the Equity Long Short Category. Total returns were positive across all time frames.



### Downside Deviation

Downside deviation measures the frequency and extent of negative returns and provides an excellent measure of the level of risk taken by the fund as well as the ability of the fund to protect investor's capital. The lower the downside deviation the better the fund has performed.

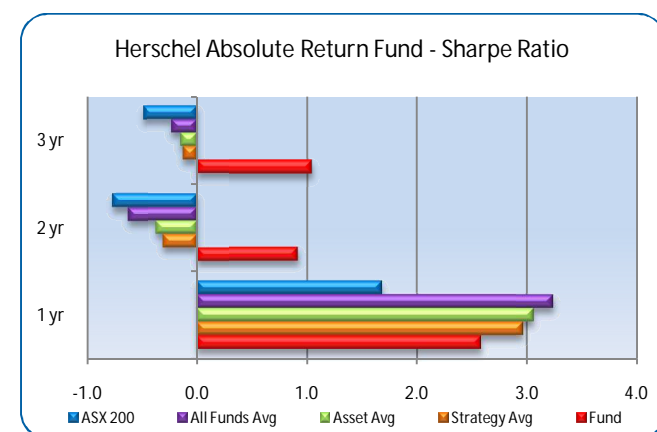
The Fund performed particularly well in this regard against peers, all funds and the ASX200 benchmark, with a low to minimal downside deviation.



### Sharpe Ratio

The Sharpe ratio provides a measure of a fund's risk-adjusted return. The ratio provides an indication of whether the returns were generated from manager skill or risk taking, using the average RBA cash rate as a risk free return benchmark. The higher the Sharpe ratio the better the fund has performed.

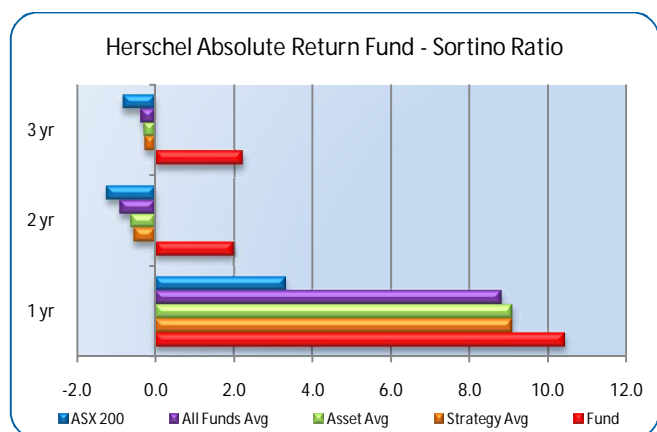
The Fund has produced positive Sharpe ratios overall, particularly over the longer period.



### Sortino Ratio

The Sortino ratio is a variation of the Sharpe ratio and only takes into account downward risk on the basis that the fund should not be penalised for upside volatility. The Sortino ratio only measures months in which the fund has produced a negative performance. The higher the Sortino ratio the better the fund has performed.

The Fund has consistently produced positive Sortino ratios and outperformed against Equity Long/Short peers, all funds and the ASX200 benchmark.





## Performance Ranking

The following charts and tables show the relative performance of The Herschel Absolute Return Fund for a series of performance periods to 31 December 2009. Only Australian based managers with a track record of at least three years are included in the analysis.

The rank table places The Fund against 48 Equity Long/Short funds (Peer) as well as against 80 Equity Based funds (Asset) and against 130 funds which have reported returns for the month of December 2009.

### Performance Analysis

The Fund ranked in the top ten percent in five categories both against other Equity Long/Short funds and also against all Equity funds in the survey period. On average across all categories The Fund ranked well, particularly over the longer term and in downside performance categories.

Herschel Absolute Return Fund	Rank versus		
Equity Long/Short	Peer	Asset	All
Group size	49	81	131
YTD	28	45	51
Latest 3 Months	12	20	26
Latest 6 Months	21	34	38
Latest 12 Months	28	45	51
Latest 24 Months	2	5	9
Annualised Return	4	7	11
Total Return	21	33	40
Average Return	4	7	14
Best Month	31	48	70
Worst Month	2	6	6
Average +ve Return	36	54	72
Average -ve Return	3	7	9

*A lower rank score indicates the fund has a better relative performance.*

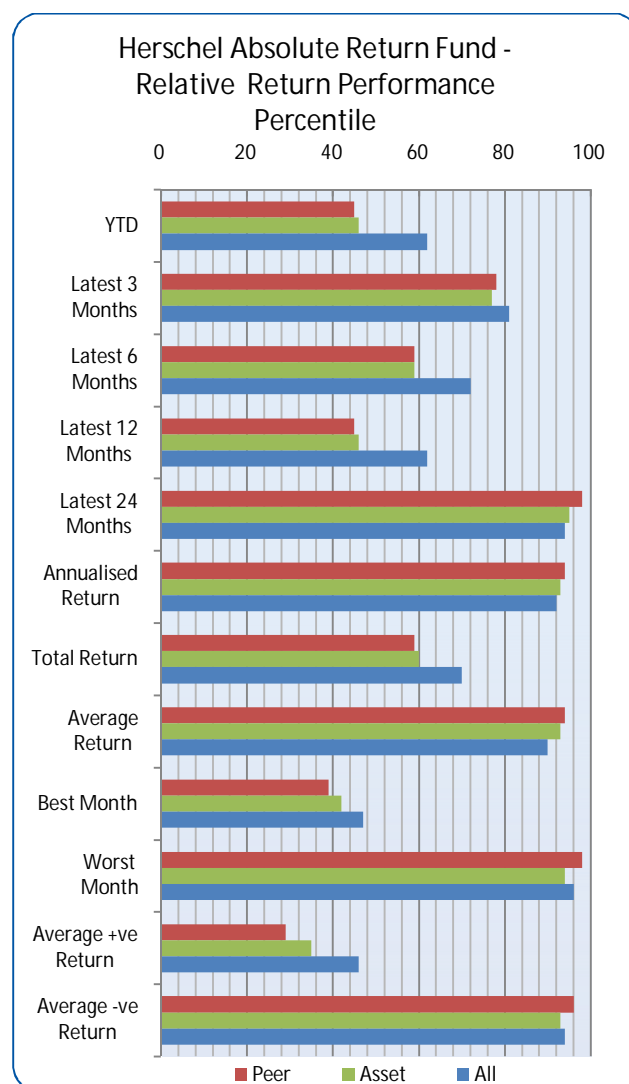
The fund's ranking and relative annualised performance, and over 24 months, indicates an ability to perform well against other funds over the longer term, particularly given the market conditions of 2008.

The fund's high ranking/scores in the category of Worst Month and Average Negative Return indicate an effective risk system and limits in volatile markets.

### Relative Return Performance Chart

The chart below indicates the relative performance of The Fund based on the same data as shown in the Rank Table.

*A higher relative return score indicates the fund has a better relative performance.*



Note: These tables and charts show returns relative to other funds, not actual returns. Past performance is not a reliable guarantee of future performance.

## Risk Ranking

The following charts and tables show the relative performance of The Herschel Absolute Return Fund for a series of Key Risk Performance Indicators to 31 December 2009. Only Australian based managers with a track record of at least three years are included in the analysis.

The Risk Ranking Table places The Fund against 48 Equity Long/Short funds (Peer) as well as against 80 Equity Based funds (Asset) and against 130 funds which have reported returns for the month of December 2009.

Herschel Absolute Return Fund Equity Long/Short Group size	Rank versus		
	Peer	Asset	All
	49	81	131
Max Drawdown	2	5	9
Annualised Standard Deviation	9	20	36
Downside All	2	9	11
Downside 1 Year	12	19	30
Sharpe 1 Year	12	18	21
Sharpe 3 Year	2	4	6
Sharpe All	2	3	3
Sortino 1 Year	13	19	22
Sortino 3 Year	2	3	6
Sortino All	2	3	4

*A lower rank score indicates the fund has lower relative risk.*

## Risk Analysis

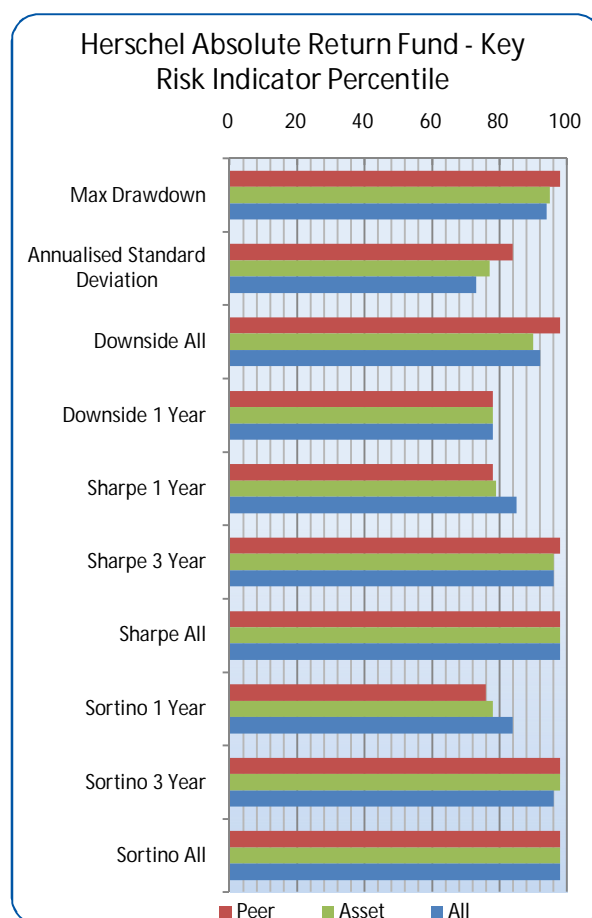
The Fund ranked in at least the top quartile in all categories against other Equity Long/Short funds and also against all funds. The fund was placed second in 6 out of 10 risk categories against peers, and in the top 5 when compared with all 81 equity based funds.

The Fund's ranking, indicates an ability to perform well against other funds over the longer term, particularly given the market conditions of 2008.

The fund's high ranking/scores in all categories indicate the fund provided excellent relative downside performance.

## Relative Risk Performance Chart

The chart below indicates the relative performance of The Fund based on the same data as shown in the Rank Table.



*A higher relative return percentile indicates the fund has lower relative risk.*

Note: These tables and charts show returns relative to other funds, not actual returns. Past performance is not a reliable guarantee of future performance.

### About Sharpe and Sortino Ratios

The Sharpe ratio provides a measure of a fund's risk-adjusted return. The ratio provides an indication of whether the returns were generated from manager skill or risk taking.

The Sortino ratio is a variation of the Sharpe ratio and only takes into account downward risk on the basis that the fund should not be penalised for upside volatility.

## Structure & Compliance

Herschel Asset Management Limited (ACN 006 968 574) (formerly Argosy Asset Management) is an Australian Public Company which was registered with ASIC on 10 May, 1988. The Company holds AFS Licence number 238721 issued on 24 November, 2003 which currently permits them to provide general financial product advice and deal in financial products to retail and wholesale clients. As of 12 March 2010 the licence is current according to ASIC's website.

Directors of the Management Company are:

- 1 Saxon Nicholls
- 2 John Fredersdorff

The managers state there are:

- No known conflicts of interest.
- No dealings or transactions with related parties.
- No beneficial conditions, liquidity or fees available to the principals.
- The Manager/shareholders' Investment in the fund is approximately A\$2m of the current FUM of A\$35m.

The Herschel Absolute Return Fund is one of a number of domestic equity funds managed by Herschel Asset Management, and is structured as an Australian based unit trust with a single class of units using series accounting.

The fund is open for investment by wholesale investors, with a minimum investment of A\$50,000.

### External Parties

The Manager has established an external Risk Committee with Compliance and Risk Services Pty Limited.

The Manager has established an external Compliance Committee with Compliance and Risk Services Pty Limited.

Custodian: UBS AG, Australian Branch

Prime Broker: UBS AG, Australian Branch

Administrator: Kingsway Taitz Pty Ltd (since July 2009)

Auditors: Ernst & Young

Legal: DLA Phillips Fox

## Fees, Terms & Conditions

The Fund pays an annual management fee of 1.5% of NAV to Herschel Asset Management, payable monthly.

The fund also pays Herschel Asset Management a performance fee of 20% achieved above a hurdle of the RBA cash rate. The performance fee is also payable monthly, and is subject to a high water mark. This ensures that no performance fee is payable by any investor while their investment is in drawdown, and unless performance has outperformed the RBA cash rate.

Redemptions are monthly with 30 days notice required in writing.

The Herschel Absolute Return Fund provides a monthly performance report with NAV pricing confirmed by the Fund's administrator, Kingsway Taitz.

## Manager Contact Details

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## AFM Fund in Focus Methodology

AFM has compiled this Fund in Focus research review using quantitative data, comparative data and extensive interviews and meetings with Herschel Asset Management at their offices in Melbourne. Wherever possible the information has been verified during these meetings and as a result of additional research and enquiries where applicable.

The Comparative Industry Performance and Ranking has been based on the returns of over 200 Absolute Return Funds which provide monthly returns and information to AFM's database, but has been filtered to only show Australian based managers with a track record of at least three years, who have provided AFM with complete data (as at the time of this report) up to and including December 2009.

Ratios and formulas included in the quantitative data and rankings are those generally available or used by the industry and use the average RBA cash rate for Sharpe ratio calculations, or zero for Sortino ratios.

## About Australian Fund Monitors

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