Q&A with Frank Villante, Portfolio Manager of the Celeste Australian Small Cap Fund.

Why should investors have a small cap allocation in their portfolio?

The top 100 stocks in the market account for $1.1 trillion or 83% of the All Ordinaries Index. The Small Ordinaries Index is around $92bn or 7% of the All Ordinaries Index. The bulk of the 200 Small Ords stocks range in market cap between $1.7bn and $100m. There are however almost 2200 stocks listed on the Australian Securities Exchange and small cap managers are not bound to just invest in the Small Ords Index. To not consider a small cap portfolio allocation would ignore 17% of the All Ords by capitalisation and 95% by number. Amongst the smaller cap stocks are good companies in industries that are growing at a rate higher than the broader economy and market. As the small cap market is less well analysed there are more opportunities to find good quality stocks trading below their intrinsic value.

How do you value small cap stocks?

We use our knowledge of the business to decide what the most appropriate valuation methodology to use is (i.e. PE, DCF, EV, etc). Choice of methodology will vary depending on the particular company and need to account for things like debt, free cash flow generation and the capital requirements of the business. There is no one valuation methodology that fits all investment possibilities when looking at small caps. We believe that the intrinsic value of any security is ultimately determined by the value of the future cash flows which the business can generate. There are times when the market price of an equity does not accurately reflect the security's intrinsic value. This may occur for many reasons, however generally:

- Investors can be swayed by emotion and market sentiment rather than acting on a careful assessment of the facts
- Not all investors possess the same understanding of securities and their industries and markets
- Investors have widely differing objectives and many have short-term investment time horizons

Constantly changing news flow, forecasts and sentiment lead to fluctuations in share prices that are often far wider than changes in the intrinsic value of a company. The true underlying worth and medium to long term profit potential of a business (2-5years) can therefore often be overlooked and mispriced. By applying our process consistently and with an even temperament we seek to capture intrinsic value anomalies.

What sort of return have small caps generated in the past ?

A 2009 study by Merrill Lynch & the University of Chicago looking back as far as 1926 has found that small cap stocks have delivered, on average, annualised returns of 10.6% pa. This is almost 2% higher than the average returns delivered from the big cap sector over the same period.

What is the Celeste competitive advantage?

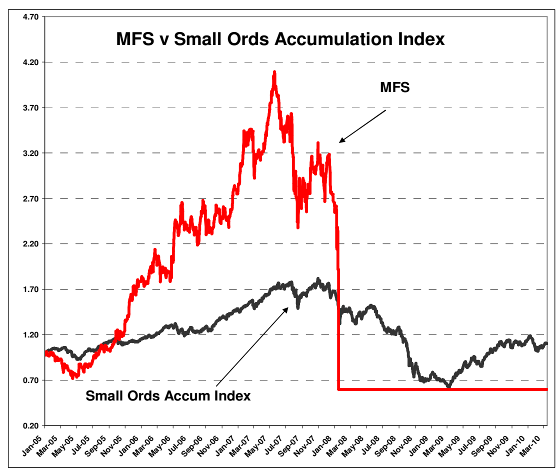
We are a well resourced highly experienced team of 4 investment professionals. We adopt a strict investment process that creates discipline in both stock selection and stock divestment. We assess all financial metrics of a company to determine accounting rigour and potential returns, both positive and negative. We utilise our experience to work as a team and stress test and cross check ideas. We conduct extensive meetings with management teams, industry contacts and relevant regulatory bodies. Through our process we seek to develop knowledge and a deep understanding of the long term profit potential of the businesses we analyse in order to determine intrinsic value. With our process we seek opportunities where share prices vary materially from our assessment of intrinsic value and are prepared to adopt a patient disposition until intrinsic value is more appropriately reflected. We believe a disciplined investment process is essential to properly manage and control investment risk and minimise scope for capital loss. Our process requires understanding of:

- The **Business Model** – how durable and robust the business is and the key reasons why this advantage is sustainable
- The **Quality of Accounting** – how conservative or aggressive in nature the accounts are stated and whether they reflect the reality of the company
- How the **Management and Board** allocate capital, manage the risks and accept responsibility
- How the company seeks to play a role in being more environmentally conscious, socially aware and rigorous in governance **(ESG)** such that **Responsible Investment** behaviour is reflected in 'triple bottom line' sensitivity allowing some measure of 'value at risk'.

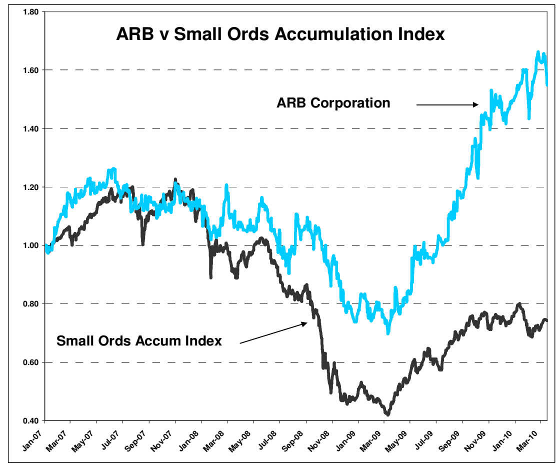
How does this work in practice?

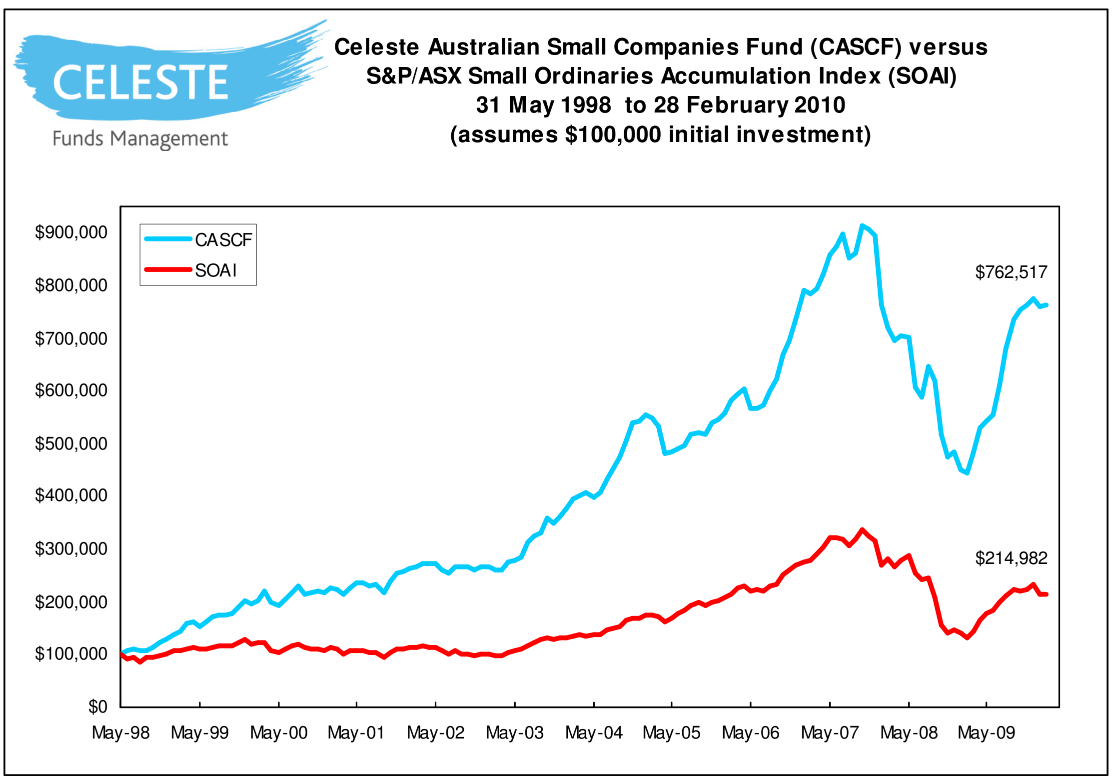
Over the course of the GFC (Global Financial Crisis) questionable business models were exposed for their lack of substance and collapsed. The Celeste process, with a focus on business model and quality of accounting served our investors well over this period.

To illustrate we did not own MFS (now Octivar). MFS did not meet our criteria of business model robustness and it accounts were considered to be aggressively stated. MFS was an asset manager and structured finance company that had a specific focus on "unlisted assets". In only 1 of the 7 years at MFS did operational cash flows exceed investments made. Cheap debt was used to fuel asset growth. We also note that did have on it former accounting partners from KPMG & PWC, the numbers told a different story. The last MFS balance sheet had $1.5b of shareholders funds, net interest bearing debt of $530m, $2.9b of assets held for resale and <30% of earnings recurrent The MFS business model was flawed. Core operations were buying and selling assets which were subject to liquidity stress. As the breadth of the MFS business was not funded by operational cash flows when asset sales dried up the company defaulted on its debt. The core existence of MFS was predicated upon gaining access to ever increasing amounts of debt, buying assets and churning them for a higher price and if markets did freeze they thought they had the capital markets as a backstop. At it's peak, the now insolvent MFS, was capitalised at $2.8b.



Alternatively we have owned ARB Corporation (ARB) for a number of years. ARB Corporation Limited provides engineered auto products and accessories to 4WD market via the auto after market and original equipment suppliers. Over the last decade sales at ARB have exhibited compound growth averaging 14% pa with Net Profit over the same period compounding at 18% pa. Over this time frame ARB has consistently generated an ROE of over 20% with minimal debt on balance sheet. Products are manufactured, sold and serviced via a network of distributors made up of both company owned and exclusive "ARB" branded franchisees. For ARB to profitably control growth in sales, management took a strategic decision to establish a production facility in Thailand in May 2006. Thai made products are distributed globally utilising ARB's locally developed research and development and intellectual property. ARB Corporation is a company with an attractive business model, a sustainable competitive position, conservatively stated accounts, and strongly aligned management and Board. In the first quarter of 2009 the extreme movement of the A$ and GFC concerns saw the stock aggressively sold down. Investor anxiety was focused on weaker short term earnings and a more challenging global sales environment. Our investment process led us to the conclusion that this apprehension was misplaced. We acquired more ARB stock as the market fell taking the view that this was a short term aberration due to overwhelming negative GFC sentiment. We continue to believe that prospects for ARB in the medium to longer term are excellent with sales fuelled by unique intellectual property, its global sales footprint and a lower manufacturing cost base.





Celeste Australian Small Companies Fund

Fund at a Glance	
Management Fee	0.95%
Performance Fee	20% of outperformance relative to ASX/S&P Small Ordinaries Accumulation Index
Benchmark	S&P/ASX Small Ords Accumulation Index
Investment objective	Benchmark +5% pa over rolling 3 years

Risk Management	
Stock number	20 to 50
Cash	0% to 15%
Stock Holding Limits	1% to 10%
Company issued Capital	Maximum 10%
Tracking Error	8% to 12%
Sector Bias	No structural sector bias

Contact Details

Celeste Funds Management
Level 14, 15 Castlereagh Street, Sydney NSW 2000
GPO Box 4266, Sydney NSW 2001

T 02 9216 1800
F 02 9216 1899
www.celestefunds.com.au

Frank Villante
Chief Investment Officer
Phone 02 9216 1820
frank@celestefunds.com.au

Scott Armstrong
Investment Analyst
Phone 02 9216 1815
scott@celestefunds.com.au

Paul Biddle
Investment Analyst
Phone 02 9216 1840
paul@celestefunds.com.au

Andreas Stephens
Investment Analyst
Phone 02 9216 1860
andreas@celestefunds.com.au

Stephen Hanich
Operations Manager
Phone 02 9216 1890
stephen@celestefunds.com.au

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