Global SMID Cap:
20/20 Alpha is Hiding in Plain Sight

Presented by:
Ned Bell, CIO
Bell Asset Management
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Global SMID Cap Equities: 20/20 Alpha is Hiding in Plain Sight

One of the unintended consequences of bucketing and labelling the various sleeves of the broader investment universe is that the most interesting opportunities can be missed for no other reason than simply not having the right bucket.

Global Small & Mid Cap equities as a collective represents 20/20 Alpha hiding in plain sight. Just because there isn't a "Global SMID Cap bucket", it doesn't mean that investors shouldn't make an allocation. The arguments in favor of a meaningful allocation are compelling yet most portfolios have little if any exposure.

The purpose of this paper is to flesh out these arguments and provide some insight into how Global SMID Cap equities should be considered for portfolios.

The Argument for Global SMID

1. <u>Strong potential growth option</u>
   - The SMID asset class provides access to many companies with excellent growth prospects.

2. <u>Avoids some of the risks of other 'growth' asset classes</u>
   - Less *valuation* risk than large cap growth, less *absolute* risk then emerging markets and less *liquidity* risk than small caps.

3. <u>Diversification</u>
   - SMID Cap exposure complements other growth sleeves in portfolios.

4. <u>Excellent fundamental performance</u>
   - Revenue and Earnings Growth for SMID cap has outstripped other asset classes.

5. <u>Sweet spot of the business cycle</u>
   - Global small and mid-cap companies are often in the 'sweet spot' of their business cycle (i.e. somewhere between 'early growth' & 'maturity')
   - Better organic growth than large cap and better profitability than small caps.

6. <u>Appealing valuation</u>
   - Global SMID Cap trades at a discount to most other growth sleeves.
   - Valuations at a very modest premium to their 10 year average.

The 20 Year Track Record

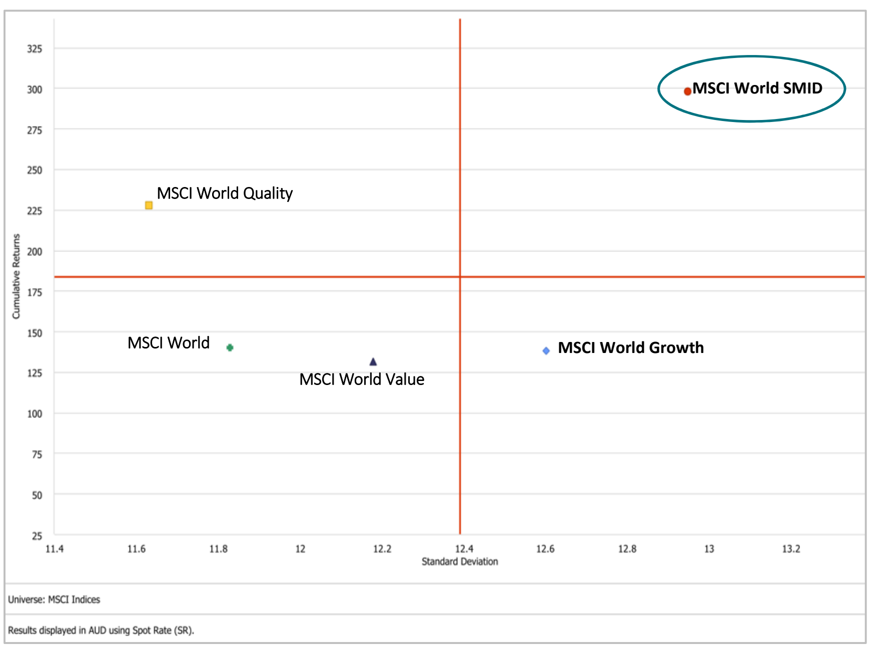
As a first step, let's consider the actual asset class performance of the Global SMID Cap asset class over 20 years vs some of the bigger style buckets - ie. Value, Growth & Quality. From our point of view, a 20 year history encapsulates several cycles and thereby offers a sound basis for referencing performance. At the end of the day, while investors such as ourselves can present the various arguments for an investment case - nothing tells the truth quite like the actual track record.

Cumulative Returns vs Standard Deviation 20 years to 30 June 2019

The chart below really says it all:

a) Global SMID Cap has comfortably outperformed all the major style buckets and MSCI World Index itself by a considerable margin over 20 years.
b) As a sub asset class that plays a Growth role in portfolios, SMID has meaningfully outperformed MSCI World Growth, albeit with a higher degree of risk, which investors have been clearly compensated for.

Chart 1:



Source: eVestment. + MSCI Indices is the median of the five Indices shown in the chart. Period is for 20 years ending June 2019, run on a monthly basis. All results are in AUD terms and measured against MSCI World-ND. Past performance is not necessarily indicative of future performance. Please refer to "Important Information" at the conclusion of this presentation.

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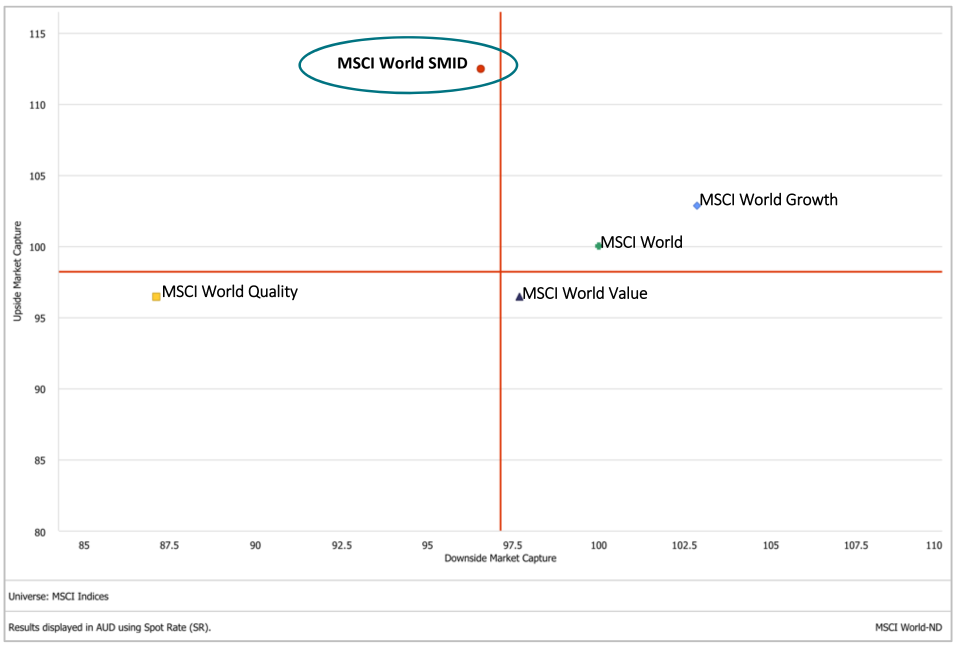
Upside and Downside Capture

a) Global SMID Upside capture has been excellent at >110%, which has outstripped all other buckets, including the broader Growth bucket.
b) The Downside capture attributes of Global SMID has also been very compelling - better than the broader benchmark and considerably better than MSCI World Growth.
c) A potential blended Quality Global SMID allocation would be optimal vis a vis downside protection.

Chart 2:



Source: eVestment. + MSCI Indices is the median of the five Indices shown in the chart. Period is for 20 years ending June 2019, run on a monthly basis. All results are in AUD terms and measured against MSCI World-ND. Past performance is not necessarily indicative of future performance. Please refer to "Important Information" at the conclusion of this presentation.

Performance in Different Market Conditions

While performance outcomes over 20 years offer an interesting perspective - so does the actual calendar year performance over a long period of time.

As such, the following analysis demonstrates the relative performance of the Global SMID Cap asset class - this time compared to the narrower but more widely accepted Growth sleeves, ie. All Cap Growth, Global Small Caps, Emerging Markets, Emerging Small Caps and Australian Small Caps.

The relevance of the analysis being that most portfolios would have meaningful exposure to the collective of these growth sleeves.

Global SMID vs other Growth Sleeves in Negative Markets

The long and short of this analysis is that Global SMID Cap performs relatively well in negative market conditions. Some investors would find this surprising in that Small & Mid Cap companies are generally considered to have riskier earnings streams that are more susceptible to negative economic conditions.

Global SMID Cap's have indeed delivered negative returns in weak markets but they haven't suffered as much as the other growth sleeves.

More specifically, Global SMID Cap equities have:

- Better downside protection than other growth sleeves.
- Outperformed the broader indices in 3 / 4 years where ACWI declined by +10%.
- Outperformed Large Cap Growth in the weaker years.
- Meaningfully outperformed EM, EM Small Caps and ASX Small Ords in the GFC

Table 1:

USD Returns	MSCI ACWI	MSCI World	MSCI World Growth	MSCI World SMID	MSCI World Small Cap	MSCI Emerging Markets	MSCI Emerging Small Cap	S&P / ASX Small Ords Accum Index
2008	-42.2%	-40.7%	-40.3%	-42.7%	-41.6%	-53.3%	-58.2%	-62.3%
2002	-18.9%	-19.5%	-19.6%	-14.9%	-15.7%	-5.9%	-3.0%	-0.4%
2001	-15.8%	-16.5%	-19.2%	-11.2%	1.3%	-2.4%	-1.6%	-6.7%
2000	-13.9%	-12.9%	-25.5%	-8.7%	-1.6%	-30.7%	-36.3%	-27.7%
2018	-9.4%	-8.7%	-8.2%	-13.2%	-13.5%	-14.6%	-18.6%	-17.7%
2011	-7.4%	-5.5%	-5.0%	-8.0%	-8.7%	-18.4%	-27.2%	-21.3%
2015	-2.4%	-0.9%	-0.3%	0.1%	0.1%	-14.9%	-6.9%	-1.7%
Average	**-15.7%**	-15.0%	-16.9%	**-14.1%**	-11.4%	**-20.0%**	**-21.7%**	**-19.7%**

Source: MSCI and S&P

Global SMID vs other Growth Sleeves in Positive Markets

The following table shows that Global SMID more than holds its own against the broader market but tends to lag the higher beta growth sleeves in very strong markets.

We would put forward the argument that the strong performance vs broader markets are reflective of the superior earnings power of SMID Cap stocks. As Global SMID Cap is a lower beta proposition, it's no surprise that higher beta growth sleeves outperform SMID's in periods of 'risk-on' markets.

More specifically, the following observations can be made about Global SMID Cap stocks in strong markets:

- Outperformed the broader indices in stronger markets.
- Quite meaningfully outperformed Large Cap growth by ~ 4.5% / year.
- Lagged the higher beta Growth sleeves.

- Outperformed ACWI in 8 / 12 calendar years.
- Outperformed MSCI World Growth in 10 / 12 calendar years.

Table 2:

USD Returns	MSCI ACWI	MSCI World	MSCI World Growth	MSCI World SMID	MSCI World Small Cap	MSCI Emerging Markets	MSCI Emerging Small Cap	S&P / ASX Small Ords Accum Index
2003	34.7%	33.8%	28.6%	43.2%	58.5%	55.5%	57.4%	77.9%
2009	34.6%	30.0%	30.8%	41.3%	44.8%	78.5%	113.8%	100.6%
2017	24.0%	22.4%	23.1%	23.6%	23.2%	37.3%	33.8%	29.9%
2013	22.8%	26.7%	27.4%	30.5%	32.9%	-2.6%	1.0%	-14.7%
2006	21.0%	20.1%	20.7%	21.0%	17.6%	32.1%	32.4%	30.2%
2012	16.1%	15.8%	16.5%	17.5%	18.1%	18.2%	22.2%	7.9%
2004	15.8%	15.3%	11.2%	22.1%	24.8%	26.0%	22.4%	31.8%
2010	12.7%	11.8%	12.3%	23.6%	26.6%	18.9%	27.2%	28.8%
2007	11.7%	9.0%	9.6%	4.7%	1.1%	39.4%	42.3%	30.1%
2005	10.8%	9.5%	10.0%	15.5%	16.1%	34.0%	29.2%	44.2%
2016	7.9%	7.5%	8.2%	10.4%	13.3%	11.2%	2.3%	12.1%
2014	4.2%	4.9%	5.5%	4.1%	2.3%	-2.2%	1.0%	-12.0%
Average	18.0%	17.2%	17.0%	**21.5%**	23.3%	28.9%	32.1%	30.6%

Source: MSCI and S&P

Recent Performance and Risk Adjusted Returns

One of the first metrics investors look to, when examining a strategic asset class allocation, is the Sharpe Ratio which measures asset class risk adjusted returns. As the following table demonstrates, while the Sharpe Ratio of Global SMID over 10 years is identical to that of the MSCI World Index - it's more than double that of the high beta growth sleeves (Emerging Markets, Emerging Small Cap & Australian Small Cap).

Table 3

Global SMID vs other Growth Sleeves – Sharpe Ratio and Recent Performance

USD Returns: June 2019	MSCI ACWI	MSCI World	MSCI World Growth	MSCI World SMID	MSCI World Small Cap	MSCI Emerging Markets	MSCI Emerging Small Cap	S&P / ASX Small Ords Accum Index
Sharpe Ratio								
10 Years	0.78	0.83	0.90	0.83	0.82	**0.37**	**0.38**	**0.40**
Recent Returns								
1 Year	5.74	**6.33**	8.43	**-0.24**	-2.73	1.21	-5.12	5.46
3 Years	11.62	11.77	14.17	10.42	10.52	10.66	5.46	10.42
5 Years	6.16	**6.60**	9.09	**5.76**	5.72	2.49	0.53	2.74
10 Years	10.15	10.72	12.21	11.74	12.15	5.81	5.86	8.45

Source: eVestment. Returns are for period 30 June 2019.

One way of interpreting this data is to assert that Global SMID Cap offers more than twice the return per unit of risk than the high beta growth sleeves that collectively represent meaningful parts of most equity portfolios (ie. MSCI World SMID @0.83 vs MSCI Emerging Markets @ 0.37). We would argue this observation strongly supports the argument for an allocation to Global SMID Cap equities.

Switching gears and looking at the recent performance of Global SMID vs peers offers some interesting insights in our view. Any tactical asset allocation decision is made with some perspective regarding recent performance vs alternatives. While Global SMID has been a great long term performer, in the last 1,3 & 5 years it has lagged the broader market and the MSCI World Growth Index. As such, investors currently considering a SMID allocation should be able to satisfy themselves that they won't be buying 'yesterday's winner', but rather a long term quality compounder that hasn't quite kept up in what has been a very strong bull market over the last 5 years.

In other words, as investors consider the various arguments for an allocation to Global SMID Cap equities – timeliness should be at the top of the list.

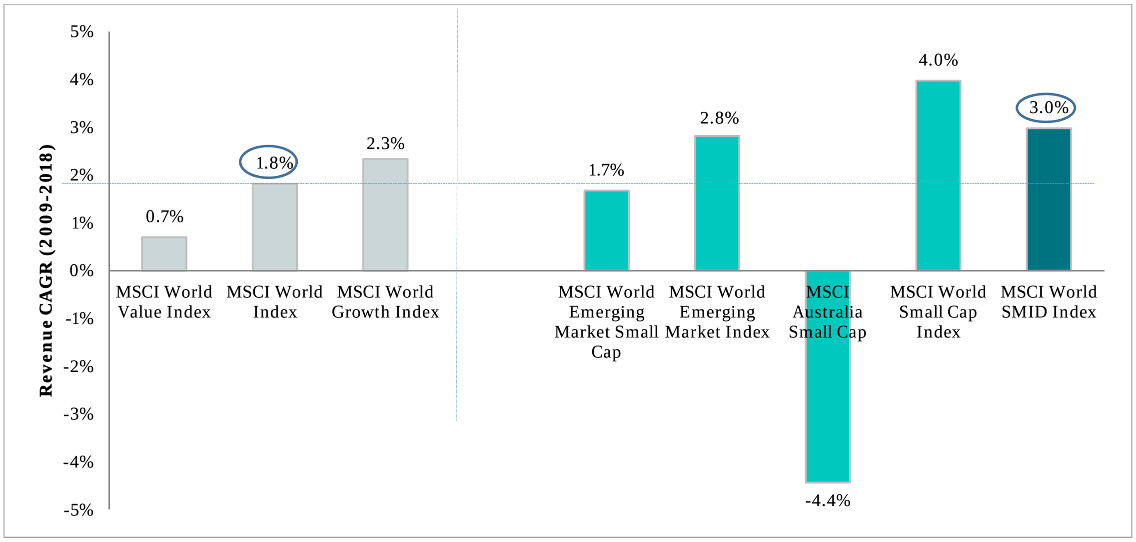
Why Global SMID Cap stocks have performed well?

It's always important for investors to dig into the 'why' part of historical asset class performance when considering asset allocation decisions. What the following charts demonstrate is that the actual fundamentals of Global SMID Cap equities have been very good. More specifically, both revenue and EPS growth have simply been better than most other subsets of the global equity investable universe.

From a revenue growth perspective, Global SMID's have outstripped all but the Small Cap universe. One could argue this is reflective of a high quality subset of businesses, when compared to EM Small Cap's (for example) which are arguably more economically sensitive and consist of a poorer subset of quality franchises.

Furthermore, we would argue that investors consider these growth sleeves for what they are – collections of companies, nothing more. Too often a thematic justification drives asset allocation decisions without enough emphasis on the quality of companies. One of the main justifications for an allocation to Emerging Markets has been that EM economies grow faster than developed economies. While this assertion has proven to be correct – the MSCI Emerging Markets Index has underperformed the MSCI World Index (developed markets) by considerable 5.31% annually over 10 years. Why? Because the fundamentals of the companies that constitute the index simply aren't particularly good.

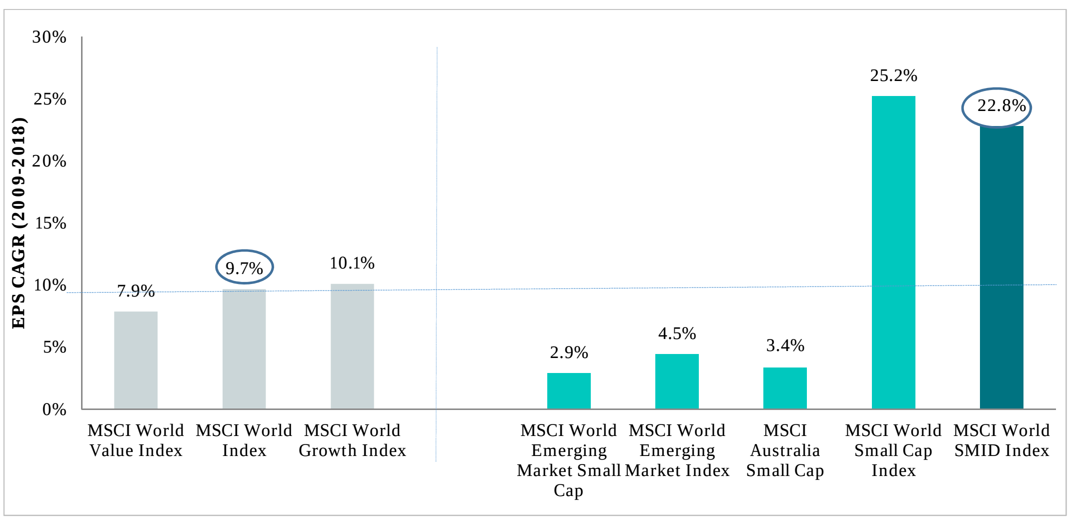
Chart 3:
Global SMID Cap Equities on the Revenue Growth Scoreboard



Source: Bloomberg

The relative earnings growth picture is starker - in that Small cap & SMID cap stocks have materially outperformed all comers. Again, this observation arguably reflects a higher quality subset of businesses that have collectively been able to deliver very strong earnings outcomes over an extended period.

Chart 4:
Global SMID Cap Equities on the EPS Growth Scoreboard



* EPS for MSCI Australia Small Cap and MSCI World Small Cap are negative in 2009. Diluted EPS from Continued Operations are used for these two asset classes.
Source: Bloomberg

Breaking down Global SMID Cap equities

It's important to for investors to build a good framework of understanding for Global SMID Cap equities - especially with respect to the size of companies and investable universe. Using the MSCI methodology as a frame of reference, Global SMID cap equities represents the bottom 28% of the MSCI Developed World Markets - as opposed to the bottom 28% of the MSCI World Index.

Chart 5:
MSCI World SMID Cap Index Breakdown

			Market Cap (USD Mn)		
	*Index Weight	Constituents	Avg	Large	Small
SMID Cap	28%	5,287	2,472	26,300	37
Mid Cap	14%	914	7,763	26,300	1,268
Small Cap	14%	4,323	1,377	10,291	37

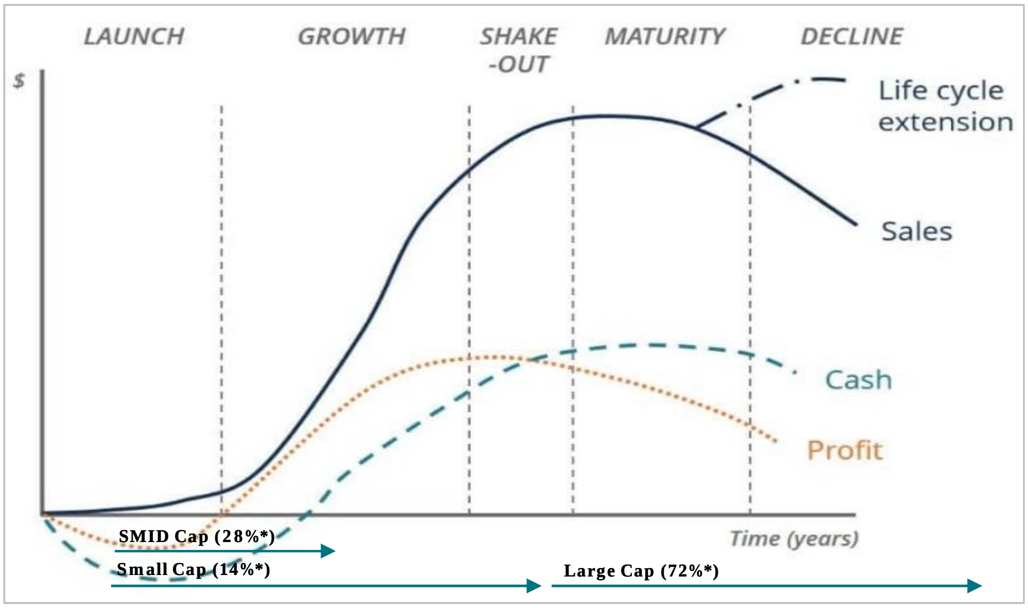
*Free-Float adjusted market capitalization in each country

While many investors are accustomed to investing in Global Small Cap stocks, Global SMID cap is less represented in portfolios. The missing link between the two is the Mid Cap area of the market. The mid cap part of the market offers an exposure to companies that are more mature and financial sound than their small cap brethren but still has a long organic growth runway in front of them.

The Global SMID investment universe provides a more diverse opportunity set of businesses. It also provides an access point to some incredibly strong global and local franchises that come with powerful earnings streams.

The chart below offers an interesting perspective as to how investors could look at their portfolio exposure. In other words, how does my portfolio look from the perspective of the corporate business cycle? Generally speaking, the more large cap exposure in a portfolio, the more exposure you will have to maturing businesses. Even the large cap technology stocks that dominate many global portfolios are now transitioning into periods of maturing growth (i.e. Apple).

Chart 6:
SMID Cap Company Lifecycle in Context



* MSCI World Index weights as at 30 June 2019
Source: Corporate Finance Institute, Bell Asset Management

20/20 Performance Drivers in Global Equities

In the world of Global equities, it's no secret that large cap growth stocks have accounted for much of the recent gains in equities. As such, many portfolios have become even more heavily skewed towards the larger cap end of the market. The implicit rising stock concentration risk has been further exacerbated by the considerable growth in passive and ETF investment vehicles at the expense of traditional active management. As the following table demonstrates, the total returns in the mega cap part of the broader index has a) been phenomenal, and b) coincided with rising ETF ownership.

While the ongoing move away from active management and the rising popularity of passive management & ETF's is generally well understood – what is arguably less understood is how these mega cap stocks will perform in negative market conditions? The market malaise in Q4 2018, offered a sneak peak of how these stock market goliaths can perform when equity flows turn negative. The first half of 2019, saw the large cap party continue as many of the well owned large names quickly put Q4 behind them and made their way to new highs.

While the large cap march may well continue, given markets are currently trading near new market highs, it is important that investors don't become too complacent and at least consider areas where mean reversion is likely.

As we look into the latter half of 2019 and 2020, the global economic and geopolitical risks staring down equity markets are seemingly heightened, while complacency amongst equity investors seems rife. This apparent disconnect seems to likely to manifest into a period of equity volatility whereby Global SMID Cap equities may well prevail.

Contrary to popular belief, we would argue there is an increasingly strong argument that Global SMID's may well outperform in a negative market environment:

a) Negative flows will weigh more on Large Cap stocks
b) Large Cap stocks as a collective carry more "Trade War Risk"
c) Emerging markets are particularly susceptible to a weaker global macroeconomic backdrop as well as the obvious trade war risks.
d) Large cap growth stocks are susceptible to valuation multiple derating.
e) Stronger fundamentals and Attractive valuations arguably underpin Global SMID Cap equities.

Table 4:

MSCI World Large Cap Index – Top 10 Constituents

(Performance and ownership trends)

			ETF Ownership*		
	Weight (%)	**5 Year Return (USD)**	**Current****	**June 2014**	**ETF's Holding Stock**
1. Microsoft	2.86	260%	18.3	11.6	270
2. Apple	2.73	132%	25.8	16.5	258
3. Amazon.com	2.31	483%	18.7	9.8	222
4. Facebook	1.35	187%	16.3	12.3	214
5. Johnson & Johnson	1.08	53%	24.2	12.7	246
6. JPMorgan Chase	1.07	121%	17.6	9.1	213
7. Alphabet C	0.99	88%	16.3	17.5	163
8. Exxon Mobil	0.95	(9%)	27.3	17.7	240
9. Alphabet A	0.95	85%	15.5	9.7	207
10. Nestle	0.93	55%	12.0	8.2	-
Average	**1.52**	**145.5%**	**19.2**	**12.5**	203

***Source:** Bloomberg
**Date: June 2019

As the chart below demonstrates, the P/E multiple expansion in Growth stocks has been very meaningful in recent years. It could be argued this valuation expansion is an outcome of the aforementioned crowding in large cap growth stocks. While the fundamental performance of the large cap growth cohort has been very impressive, the reality for investors is that they simply have to pay a higher price for those - albeit improved – earnings streams than they did several years ago.

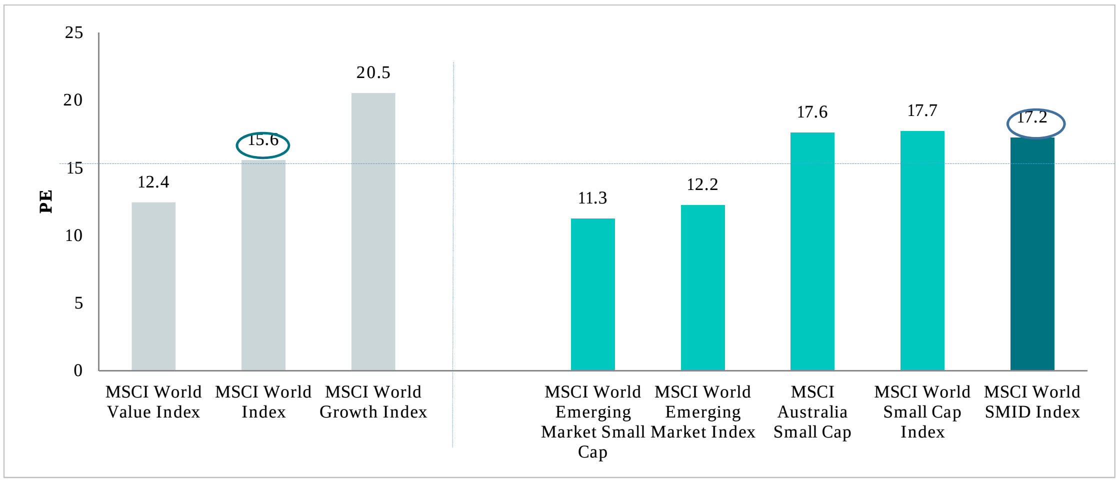
Another interesting observation in the charts below relate to the Emerging Markets asset class. While on face value, EM stocks are cheaper (ie. lower P/E) that does not mean they are undervalued. As referenced in chart 4, the actual earnings growth in Emerging Markets simply hasn't been very good when compared to other Growth sleeves like Global SMID Cap.

For Australian investors, the multiple expansion in domestic small cap equities has also been quite phenomenal – to the point where they actually trade on a modest P/E premium to Global SMID Cap stocks. Given the quality differential between the two investment subsets, this valuation differential doesn't seem to make much sense. One slightly left field argument to be made is that Australian investors reduce their domestic small cap exposure and use the proceeds to fund a Global SMID Cap allocation. In doing so, investors would arguably improve the quality of underlying companies while not paying a higher price for the upgrade.

The last and possibly most important point to be made on chart 8, is that the valuation expansion in the Global SMID Cap universe has been negligible over 10 years at 3.6%. In an environment where valuation hand wringing is prevalent as markets flirt with all-time highs – Global SMID Cap's arguably come with far less "valuation reversion risk" than other investment sleeves.

Chart 7:

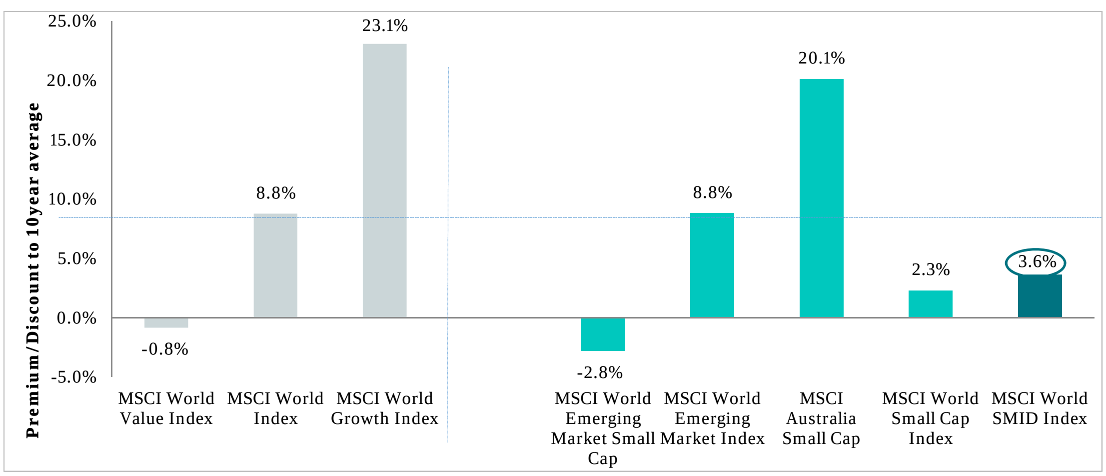
SMID Cap Equities on the <u>Value</u> Scoreboard (P/E Ratio)



* Based on 1 year Blended Forward PE as at 30 June 2019
Source: Bloomberg

Chart 8:

SMID Cap Equities on the <u>Relative Value</u> Scoreboard
(P/E vs 10 Year Average)



* Based on 1 year Blended Forward PE as at 30 June 2019
Source: Bloomberg

Global SMID Cap – Drill Down

The next part of our analysis is supposed to offer investors some perspective around the types of companies that comprise the Global SMID cohort. Simplistically, it could be said that they are less well known than the large cap brand names, but less obscure than the emerging markets companies.

The table below is simply meant to offer some perspective around the size of the companies found in the Global SMID universe. While the market cap numbers are quite self-evident, the main point to be made is that while SMID names a considerably smaller than large names – they are obviously bigger than the small cap peers. The conclusion to be drawn is that SMID as an investment universe is more scalable and therefore asset allocators should – in theory – have fewer capacity limitations with managers than would be the case with small cap managers.

Table 5:

Top 10 Holdings by MSCI Index : Company Size Perspective

MSCI World Large Cap Index

Name	Float Adj Mkt Cap (USD bn)
Microsoft Corp	976.38
Apple	933.25
Amazon.com	790.63
Facebook A	460.41
Johnson & Johnson	370.92
JPMorgan Chase & Co	366.06
Alphabet C	339.80
Exxon Mobil Corp	324.68
Alphabet A	324.15
Nestle	317.48

MSCI World Small Cap Index

Name	Float Adj Mkt Cap (USD bn)
Sarepta Therapeutics	10.29
Array Biopharma	10.11
Teledyne Technologies	9.92
Zendesk	9.73
Sage Therapeutics	9.32
West Pharmaceutical Svcs	9.28
Booz Allen Hamilton A	9.27
Fair Isaac Corp	9.13
WEX	8.97
Vici Properties	8.92

MSCI World SMID Cap Index

Name	Float Adj Mkt Cap (USD bn)
WEC Energy Group	26.30
Mercadolibre	26.27
Givaudan	26.10
Link REIT	25.92
SBA Communications A	25.28
Global Payments	25.24
Waste Connections	25.16
Lonza Group	25.16
Fleetcor Technologies	24.11
Eversource Energy	24.01

MSCI Australian Small Cap Index

Name	Float Adj Mkt Cap (USD bn)
Northern Star Resources	5.23
Evolution Mining	4.67
Magellan Financial Group	4.44
Atlas Arteria	3.76
Charter Hall Group	3.54
Iluka Resources	3.19
Cleanaway Waste Mgmt	3.17
Qube Holdings	3.08
Afterpay Touch Group	2.93
Downer EDI	2.89

The chart below is another "SMID Cap Perspective" slide – which is to say that it highlights the six largest GICS sectors (and their index weights) in the MSCI World SMID Cap Index. It also highlights the five largest constituents in each sector. While there aren't all household names – there are at least some household names.

As a collective representation of the broader Global SMID universe, they also have some quite attractive fundamental attributes – average Return on Capital of 15.9%, 5 Year Revenue CAGR of 13.1%, 5 Year Operating Income CAGR of 13.6%, Net Debt / EBITDA at 2.1x. In other words, these companies are mature enough to be generating strong returns without excessive leverage AND they have been able to deliver commendable growth at the top and bottom line.

Chart 9:

Global SMID Cap – Drill Down / Largest Index Holdings by Sector

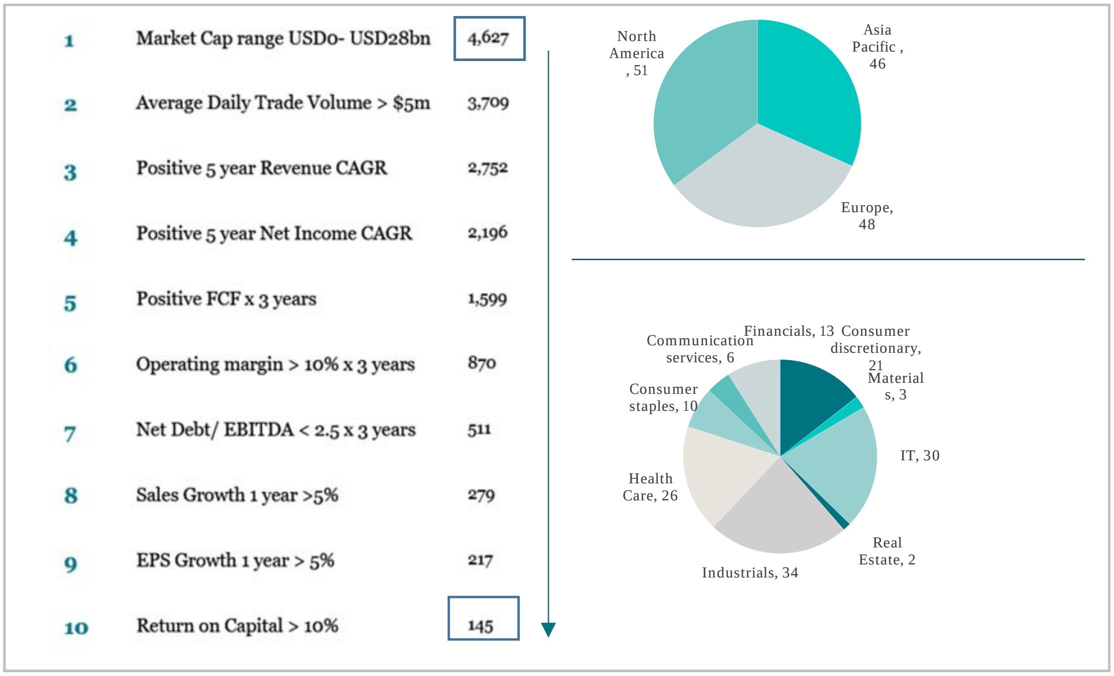
* MSCI World SMID Cap Index sector weights as at 30 June 2019
Source: MSCI

As with the previous chart, what's laid out in chart 10 is simply an illustrative example how big the investible universe is for an active manager after running the starting field over a number of quite high fundamental hurdles.

Without dwelling too much on the hurdles themselves, the point to be made is that in this case we have 145 SMID names make it to the finish line. One could argue, this is a commendable outcome given the often perceived fundamental immaturity of the Global SMID cap universe.

Another notable observation is the diversity of the 145 – they are evenly split geographically and are quite diverse by sector. Unlike the Large Cap Growth universe where Technology and Communication Services tend to dominate the line-up, SMID offers a more diverse growth exposure. One could argue that the sector differentials between the SMID opportunity set and Large Cap Growth further reinforces the argument for investors to make an allocation to Global SMID at the expense of Large Cap Growth.

Chart 10:
The Global SMID x Quality Opportunity Set



The depiction on chart 11, is the third and final “SMID Cap Perspective” slide which breaks down the aforementioned 145 SMID stars that made it over the “fundamental obstacle course”.

Of particular note is the number of these companies that have been able to achieve specific additional fundamental hurdles. For example, 100/145 names generate a Return on Capital in excess of 20%, and 103/145 names have been able to grow revenue at more than 10% CAGR over 5 years.

One of the main points to make here is that an investment in Global SMID Cap equities does not need to be at the expense of Quality.

Chart 11:
Some of the SMID Cap "Stars"

1. Return on Capital >20%	2. Operating Margins >20%	3. 5 year Sales CAGR > 10%	4. 5 Year Operating Income CAGR >15%
100/145	*109/145*	*103/145*	*91/145*
rightmove	全国保証株式会社	Broadridge	ICON
AutoTrader	Partners Group	five BELOW	HEICO
SimCorp	MarketAxess	Genmab	straumann
kakaku.com	Check Point	ULTA BEAUTY	wirecard
paycom	ARISTA	MONCLER	ROYAL UNIBREW
RATIONAL	CHR HANSEN	NEMETSCHEK GROUP	Ambu
日本M&Aセンター	align	eventim	EVERCORE

Summary

The argument for investors to make an allocation to Global SMID Cap is both compelling and timely. The challenge now for investors contemplating an allocation to Global SMID Cap equities is to determine how it will complement existing allocations in portfolios and how it will be funded.

Investors will also be well served by adopting an open minded approach to making a Global SMID Cap allocation. For example, as opposed to considering current allocations to Emerging Markets, Australian Small Caps and Global Growth as very different parts of a portfolio – an interesting perspective is to consider them on the basis that they all play "Growth Roles" in a portfolio. As such they arguably should be viewed as interchangeable for the purposes of constructing portfolios.

From the perspective of an active manager that is well grounded in the Global SMID Universe – some of the most interesting companies with the strongest franchises are found in the Global SMID Cap cohort. While their respective total addressable markets aren't as big as their mega cap brethren – the market shares and franchise quality are often stronger.

Put very simply, all investors should be building a larger Global SMID Cap allocation in their portfolios – and they should be doing so now.

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