Fund Review
iShares S&P/ASX Small Ordinaries ETF

Key Information

INVESTMENT TYPE
EXCHANGE TRADED FUNDS (ETFs) LISTED ON THE AUSTRALIAN SECURITIES EXCHANGE

ASX CODE
ISO

PDS OBJECTIVE
THE FUND AIMS TO PROVIDE INVESTORS WITH THE PERFORMANCE OF THE UNDERLYING INDEX, BEFORE FEES AND EXPENSES, COMPOSED OF SMALL CAPITALISATION AUSTRALIAN SECURITIES LISTED ON THE ASX.

FUND INCEPTION
06-12-2010

FUND SIZE
$49.4M (19 AUG 2016)

INDEX PROVIDER
STANDARD & POOR’S FINANCIAL SERVICES LLC (S&P)

UNDERLYING INDEX
S&P/ASX SMALL ORDINARIES ACCUMULATION INDEX

FUND MANAGER
BLACKROCK INVESTMENT MANAGEMENT (AUST.) LTD

RESPONSIBLE ENTITY
BLACKROCK INVESTMENT MANAGEMENT (AUST.) LTD

OWNERSHIP
AS OF 31 MARCH 2014, THE PNC FINANCIAL SERVICES GROUP, INC. (PNC) OWNED 21.8% OF BLACKROCK AND INSTITUTIONAL INVESTORS, EMPLOYEES AND THE PUBLIC HELD ECONOMIC INTEREST OF 78.2%

DISTRIBUTION FREQUENCY
SEMI-ANNUAL

DERIVATIVE USE
TYPICALLY BELOW 2% OF ASSETS, PREDOMINANTLY USED TO EQUITISE CASH RESERVES.

SECURITIES LENDING
NO

Fees

MANAGEMENT FEE
0.55% P.A.

Top 10 holdings (at 19-8-2016)

MAYNE PHARMA GROUP LTD
1.81%

EVOLUTION MINING LTD
1.71%

MACQUARIE ATLAS ROADS GROUP
1.55%

OZ MINERALS LTD
1.44%

NIB HOLDINGS LTD
1.40%

REGIS RESOURCES LTD
1.35%

INDEPENDENCE GROUP N.L.
1.29%

LINK ADMINISTRATION HLDG PTY LTD
1.27%

WORLEYPARSONS LTD
1.27%

METCASH LTD
1.23%

Portfolio Information (at 18-8-2016)

CONSUMER DISCRETIONARY
21.81%

FINANCIALS
19.07%

MATERIALS
18.65%

INDUSTRIALS
12.26%

HEALTH CARE
7.40%

What this Rating means

The ‘Investment Grade Index’ rating indicates that Lonsec has conviction the financial product can generate risk adjusted returns in line with relevant objectives. However, if applicable, Lonsec believes the financial product has fewer competitive advantages than its peers.

Strengths

• The Underlying Index is considered to offer a more ‘pure’ exposure to ‘small cap’ Australian equities relative to some ETF peers which track indices that comprise up to 34% of their holdings in the S&P/ASX100. These stocks are more widely recognised as ‘mid cap’ securities.

• The Manager employs a ‘full replication’ strategy, whereby the Fund generally invests in all securities (and in the same weights) held in the Underlying Index. This approach tends to provide a portfolio with a lower Tracking Error compared to peers who may implement an ‘optimisation’ strategy.

Weaknesses

• The Fund charges the highest management fee of the Lonsec defined peer group.

• The Fund’s Bid / Ask spread is the highest in the peer group, notwithstanding the Manager is providing more ‘pure’ small cap exposure compared to some peers.

• Over recent time periods, the Fund’s performance has shown a higher divergence from the returns of the Underlying Index.

Fund Risk Characteristics

BUSINESS SUSTAINABILITY RISK
LOW MODERATE HIGH

CAPITAL VOLATILITY

SECURITY CONCENTRATION RISK

Risk categories are based on Lonsec’s qualitative opinion of the risks inherent in the financial product’s asset class and the risks relative to other financial products in the relevant Lonsec sector universe.

BIOMetrics

Aggregate risks

A Standard Risk Measure score of 6 equates to a Risk Label of ‘High’ and an estimated number of negative annual returns over any 20 year period of 4 to less than 6. This is a measure of expected frequency (not magnitude) of capital losses, calculated in accordance with AFSA/FSC guidelines.

We strongly recommend that potential investors read the product disclosure statement or investment statement. Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL, No. 421445. This information must be read in conjunction with the warning, disclaimer and disclosure at the end of this document. This report supersedes all prior reports.
iShares S&P/ASX Small Ordinaries ETF

Features and benefits

| Complexity | Low | Moderate | High |

Fee profile

| Low | Moderate | High |

Fee VS Lonsec Universe

Fee VS Asset Class

Fee VS Sub Sector

Lonsec Opinion of this Fund

- Lonsec believes that access to transparent, straight forward information on index products, their underlying indices and how they are constructed, is crucial to investors’ understanding and ability to gauge suitability. Lonsec considers that iShares maintains very good transparency and data availability for investors. Information pertaining to the Fund’s holdings, the Underlying Index, and pricing and distribution, can be easily accessed via the Manager’s website (www.ishares.com.au).
- As would be expected from an index manager, the investment professionals employed within the equities team are generally from a quantitative background. Lonsec considers the Fund’s Portfolio Manager, Johnnie Yung, and the Asia Pacific Index team who manage the Fund to be suitably qualified and experienced. Lonsec believes the overall quality of BlackRock's investment personnel and research effort to be very high.
- The Fund did not meet its objective over the one year period to 31 July 2016, delivering (pre-fee) returns which fell short of the Underlying Index by 0.23%. However, the Fund’s performance over longer time periods has been more akin to the returns of the Underlying Index. The Tracking Error of 0.23% p.a. over 3 years was high compared to large cap ETFs, though reasonably consistent with small cap peers.
- BlackRock’s internally developed systems are sophisticated and highly integrated with implementation, compliance and risk management systems. These systems allow for trade aggregation, risk monitoring and efficient execution across BlackRock’s entire tradebook. Lonsec considers technology to be an important factor in establishing scale and minimising transaction costs needed for a successful passive index and / or ETF business.
- BlackRock seeks to match the performance of the Underlying Index via a full replication strategy, which involves the Fund holding every stock and in the same weight as per the Underlying Index. The ‘full replication’ strategy is favoured by Lonsec as it tends to support a more modest Tracking Error through time.
- The Underlying Index is known as the investable benchmark for the ‘small cap’ Australian equity market and includes robust and transparent constituent selection criteria. Implementation is provided by an experienced, independent index provider in Standard & Poor’s (S&P).
- The Fund’s MER is 0.55%p.a., and the Fund’s Bid / Ask spread averaged 0.56% for the twelve months to 30 June 2016. Relative to the Lonsec defined peer group, the Fund has the least attractive fee structure.
- Lonsec considers key person risk to be low due to the Manager’s investment strategy and robust quantitative process employed. Lonsec notes that key person risk is not typically an issue for an Index provider.
- Lonsec has assigned the Fund an ‘Investment Grade’ rating as part of the latest review. Lonsec retains the belief that the Fund represents a valid means of obtaining index-like exposure to the Australian ‘small cap’ equity market and prefers the Manager’s portfolio construction method of ‘full replication’.

What is this Fund?

- iShares, a fully owned subsidiary of BlackRock, ("The Manager") adopts a passive investment strategy in managing the iShares S&P/ASX Small Ordinaries ETF (‘ISO’ or ‘the Fund’). The Fund is designed to track the performance of the S&P/ASX Small Ordinaries Accumulation Index (or ‘the Underlying Index’) before fees and expenses. A ‘full replication’ strategy is adopted by the Manager, whereby the Fund will generally invest in all securities in the Underlying Index in the same weights that they are held in the Index.
- The Underlying Index is a market capitalisation weighted Australian equity index comprising listed Australian securities included in the S&P/ASX 300 Index but not included in the S&P/ASX 100 Index.
- As an Exchange Traded Fund (‘ETF’) strategy, ISO trades intra-day at prevailing market prices in a similar manner to other securities on the ASX. With the exception of voting arrangements, investors generally have the same ownership rights as investors in shares. All economic benefits such as dividends, bonus issues, rights issues etc. flow through to investors.

Using this Fund

This is General Advice only and should be read in conjunction with the Disclaimer, Disclosure and Warning on the final page.

- The Fund provides exposure to the performance of ‘small cap’ equities listed on the ASX. ‘Small cap’ funds invest in a market that is less liquid and more volatile than the ‘large cap’ Australian equity market. The Fund should therefore be used to complement ‘large cap’ exposure in clients’ portfolios, rather than replace it, and will generally sit within the growth component of a balanced portfolio.

Suggested Lonsec risk profile suitability

SECURE DEFENSIVE CONSERVATIVE BALANCED GROWTH HIGH GROWTH

For guidance on appropriate asset allocations and risk profiles, refer to the latest Lonsec Strategic Asset Allocation Review and Risk Profile Definitions on our website.

Changes Since Previous Lonsec Review

- There have been no significant changes to the Fund since Lonsec’s previous review in 2015.

Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL No. 421445. This information must be read in conjunction with the warning, disclaimer and disclosure at the end of this document. This report supersedes all prior reports.
Lonsec recognises that the Fund may offer investors a more ‘pure’ exposure to the Australian ‘small-cap’ sector relative to some peers. However of the peer group, the Fund charges the highest MER, and more recently has exhibited the widest average Bid / Ask spread and delivered performance that has diverged from the returns of the Underlying Index.

### People and Resources

#### Corporate overview

iShares is a fully owned subsidiary of BlackRock, a leading manager in the global ETF market. BlackRock has significant scale and resources for effectively managing and structuring ETFs both in Australia and abroad and has a proven track record of successfully running index strategies.

BlackRock Fund Advisors serves as the investment adviser to the Fund and is a subsidiary of BlackRock Institutional Trust Company, N.A., a wholly owned subsidiary of BlackRock, Inc.

BlackRock Inc. is a global asset management business with products that span active, enhanced and index strategies across markets and asset classes. BlackRock Inc. manages US$4.74 trillion as of 31 March 2016, with products offered in a variety of structures including separate accounts, mutual funds, other pooled investment vehicles and approximately 840 iShares ETFs.

#### Size and experience

<table>
<thead>
<tr>
<th>NAME</th>
<th>POSITION</th>
<th>EXPERIENCE</th>
<th>INDUSTRY / FIRM</th>
</tr>
</thead>
<tbody>
<tr>
<td>JOHNNIE YUNG</td>
<td>DIRECTOR, HEAD OF INDEX PORTFOLIO</td>
<td>18 / 6</td>
<td>JAPAN</td>
</tr>
<tr>
<td>CELIA CHAU</td>
<td>VICE PRESIDENT</td>
<td>19 / 9</td>
<td></td>
</tr>
<tr>
<td>DENNIS FOK</td>
<td>VICE PRESIDENT</td>
<td>12 / 9</td>
<td></td>
</tr>
<tr>
<td>BING FAN</td>
<td>ASSOCIATE</td>
<td>11 / 9</td>
<td></td>
</tr>
<tr>
<td>CLAIRE CREWS</td>
<td>ASSOCIATE</td>
<td>11 / 9</td>
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The strategy is implemented by BlackRock’s Asia-Pacific Index Equity team, which has over nine years of experience in managing iShares ETFs across the Asia Pacific region and is responsible for the implementation of iShares Australian and Hong Kong domiciled suite of ETF products. Johnnie Yung, Head of the Index Portfolio Management APAC ex Japan team, has overall responsibility for this team and the day-to-day management of the Funds.

BlackRock also employs a specialist Capital Markets Team, tasked with ensuring that iShares products in Australia are fully functioning across both primary and secondary markets. Their responsibilities include maintenance and development of market-maker relationships, broker dealer education and thought leadership with respect to ETF trading and analytics. This team is comprised of four Australian based resources, who form part of an integrated, eleven member team responsible for the Asia Pacific region.

### Investment Process

#### Overview

BlackRock employs a passive investment strategy designed to track the performance of the Underlying Index, before fees and expenses. The approach can be described as ‘full replication’, whereby the Fund will generally invest in all of the securities in the Underlying Index in the same weights as they are held in the index. This approach is designed to provide a portfolio with low turnover and accurate tracking.

#### Replication of the index

BlackRock receives price feeds, corporate actions adjustments, and Underlying Index constituent information from the Index Provider for the Fund on a daily basis. The Index Provider notifies BlackRock of any structural changes to the Underlying Index on a quarterly basis, and BlackRock’s proprietary portfolio construction models are used to ensure that all, or the majority of constituent securities are held by the Fund at close to their Underlying Index weights.

The Manager will also seek to utilise an internal crossing network where possible, which is derived from its large asset base and diverse client roster. This capacity may serve to reduce the level of market executed trading and avoid brokerage costs and Bid / Ask spreads.

#### Derivatives

In some circumstances the Manager may utilise derivatives to manage the exposure to certain securities and residual cash positions by purchasing index futures. This feature would primarily be used to manage exposure to the market during distribution periods, and is expected to generally constitute less than 2% of the portfolio value.

#### Underlying index

The S&P/ASX Small Ordinaries Index comprises the 200 members of the S&P/ASX 300 Index that are not included in the S&P/ASX 100 Index. Its constituents make up approximately 14% of the ASX 300, and 7% of the wider Australian equity market (by market capitalisation).

Rebalancing of the Underlying Index occurs on a semi-annual basis in March and September. As the Underlying Index is a derivative index made up of part of the S&P/ASX 200 Index and part of the S&P/ASX 300 Index, it is also subject to the rebalancing behaviour of both indices. On this basis, the Manager expects that it may also undergo rebalancing in June and December.
iShares S&P/ASX Small Ordinaries ETF

INDEX METRIC

INDEX PROVIDER / OWNER  | STANDARD & POOR'S (S&P)
MARKET COVERED          | AUSTRALIAN SMALL CAP EQUITIES SECTOR
RESPONSIBILITY FOR INDEX| S&P (INDEPENDENT OF BLACKROCK)
WEIGHTING METHODOLOGY   | FREE-FLOAT ADJUSTED MARKET-CAPITALISATION BASED
MAXIMUM MARKET-CAP      | 200 SMALLEST MEMBERS OF THE S&P/ASX 300 INDEX
CONSTITUENCY DETERMINATION | RULES BASED
CONSTITUENCY FACTORS   | LIQUIDITY, PRICE, MARKET-CAP AND FINANCIAL VIABILITY
RECONSTITUTION FREQUENCY | QUARTERLY

Transparency
Information relating to the underlying portfolio of securities in each iShares Fund is made available via the iShares website. An Estimated Intraday Net Asset Value (E.I.N) is published for each iShares ETF on the iShares website at 15 second intervals throughout the trading day. The E.I.N can also be viewed using the Bloomberg Ticker ISOIV or on IRESS using ISONAV.ETF

Liquidity
The underlying holdings of the Fund comprise securities in the S&P/ASX 300 which are not members of the S&P/ASX 100. Lonsec considers the “small cap” nature of the Fund to be more susceptible to liquidity issues in comparison to more broad-based Australian equity portfolios. However, at the current level of FUM ($49m), the Manager is unlikely to face challenges trading in and out of the underlying securities during normal market conditions.

The Fund is the second largest in terms of FUM compared to peers. All else being equal, ETFs with higher levels of FUM are generally more liquid than ETFs with lower levels of FUM.

Over the last 250 trading days to June 2016, the Fund did not trade on four of those days. The Fund’s premium / discount to NAV over the twelve months to June 2016 was the highest of the peer group at 0.36% and the Fund also exhibited the equal highest volatility to NAV at 0.46%.

Fees and Indirect Costs
Fee Comparison

<table>
<thead>
<tr>
<th>FUND NAME</th>
<th>MER (% P.A.)</th>
<th>BID/ASK SPREAD (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ISHARES S&amp;P/ASX SMALL ORDINARIES ETF (ISO)</td>
<td>0.55%</td>
<td>0.56%</td>
</tr>
<tr>
<td>VANGUARD MSCI AUSTRALIAN SMALL COMPANIES INDEX ETF (VSO)</td>
<td>0.30%</td>
<td>0.22%</td>
</tr>
<tr>
<td>VANECK VECTORS SMALL CAP DIVIDEND PAYERS (MVS)</td>
<td>0.49%</td>
<td>0.27%</td>
</tr>
<tr>
<td>SPDR S&amp;P/ASX SMALL ORDINARIES FUND (SSO)</td>
<td>0.56%</td>
<td>0.21%</td>
</tr>
</tbody>
</table>

* Source: ASX. Average daily Bid / Ask spread over the 12 months to June 2016.

ETF investors incur both direct and indirect costs / fees. Direct fees include the management expense ratio (MER) and brokerage incurred when buying and selling units. Indirect costs include Bid / Ask spreads when buying or selling units.

The Fund has the highest headline MER (0.55%p.a.) and had recorded the widest Bid / Ask spread (0.56%) in the Lonsec defined peer group.

Lonsec notes there are limitations to the use of these measures as an indication of the total cost of transacting ETFs. The Bid / Ask spread represents an average over a one year period but may not reflect the actual spread incurred. Investors can use limit price orders which allow them to nominate a price at which they can buy and sell.

Performance
The Fund under-performed by 0.23% on its benchmark minus fees objective over the twelve months to July 2016. The Fund’s three-year performance (pre-fees) to this time was within eight basis points of the returns of the Underlying Index.

The Fund recorded a 0.23%p.a. Tracking Error over the three years to July 2016. Whilst the result is higher than more broad-based equity ETFs, it indicates that the Fund has historically delivered returns within a reasonably consistent deviance from the Underlying Index. Lonsec notes that Tracking Error over the last twelve months has risen to 0.29%, reflecting a period of larger excess returns and variable performance to the Underlying Index.

12-month rolling tracking error and excess returns over five years to 31-7-2016

Risks
An investment in the Fund carries a number of standard investment risks associated with domestic and international investment markets. These include economic, political, legal, tax and regulatory risks. These and other risks are outlined in the Fund Prospectus and should be read in full and understood by investors. Lonsec considers the major risks to be:

Equity market risk
Investments in equity markets are subject to numerous factors which may have an impact on the performance of an investment (both positive and negative). Unexpected changes in economic, technological, structural, regulatory or political conditions can have
an impact on the returns of all investments within a particular market.

**Performance risk**
The value of, and returns (if any) from an investment in the Fund will depend upon the performance of the underlying investments. There is no guarantee the value of an investment in any underlying investment will increase.

**Tracking error risk**
The Fund seeks to minimize the tracking error against the Underlying Index it aims to match. There is no guarantee that this objective will be met.

**Derivative risk**
The Manager may utilise derivative instruments, including futures for hedging, to equitise cash, and risk management purposes. Derivatives will not be used to leverage the portfolio.

**Liquidity risk**
The Fund’s shares trade intra-day at prevailing market prices in a similar manner to other securities on the ASX. Listing or trading on a stock exchange does not guarantee that a liquid market exists for an ETF.

**Taxation**
Lonsec advises investors to consult a taxation specialist before making a decision to invest (or not to invest). Investors should refer to the PDS for further information.

**Further information**
Further information can be obtained by calling BlackRock on 1300 iShares (1300 4742737) or visiting: [www.ishares.com.au](http://www.ishares.com.au)
iShares S&P/ASX Small Ordinaries ETF

Quantitative Performance Analysis - annualised after-fee % returns (at 31-7-2016)

Performance metrics

<table>
<thead>
<tr>
<th></th>
<th>1 YR</th>
<th>2 YR</th>
<th>3 YR</th>
<th>5 YR</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL RETURN (% PA)</td>
<td>21.51</td>
<td>8.61</td>
<td>8.27</td>
<td>2.01</td>
</tr>
<tr>
<td>STANDARD DEVIATION (% PA)</td>
<td>15.19</td>
<td>14.90</td>
<td>13.50</td>
<td>15.86</td>
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<tr>
<td>EXCESS RETURN (% PA)</td>
<td>-0.78</td>
<td>-0.43</td>
<td>-0.45</td>
<td>-0.37</td>
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<tr>
<td>WORST DRAWDOWN (%)</td>
<td>-5.37</td>
<td>-11.27</td>
<td>-11.27</td>
<td>-20.59</td>
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<tr>
<td>TIME TO RECOVERY (MTHS)</td>
<td>1</td>
<td>7</td>
<td>7</td>
<td>35</td>
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<tr>
<td>TRACKING ERROR (% PA)</td>
<td>0.29</td>
<td>0.26</td>
<td>0.23</td>
<td>0.24</td>
</tr>
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</table>

FUND: iSHARES S&P/ASX SMALL ORDINARIES ETF
BENCHMARK USED: S&P/ASX SMALL ORDINARIES TR INDEX AUD

Growth of $10,000 over five years

Monthly excess returns over five years

Premium/discount to NAV over 250 days