LIONTRUST

CASHFLOW SOLUTION PROCESS

Long - Only

An investment process for long-only equity portfolios managed by James Inglis-Jones and Samantha Gleave

Fund name	IA Sector	Index	Fund type
Liontrust European Growth Fund	Europe (ex-UK)	MSCI Europe ex-UK	UK Unit Trust (UCITS)
Liontrust GF European Smaller Companies Fund	-	MSCI Europe Small Cap Index	Dublin OEIC (UCITS)

1. Philosophy

Our investment philosophy is based on the mistakes people make forecasting. In the equity market we believe that stock prices are frequently mis-priced, as they tend to reflect the forecasts of future profitability made by company managers which are often unreliable and, at times, completely misleading.

These understandable errors in profit forecasting seem to play a dominant role in setting investors' expectations, as investors treat these forecasts as superior and underestimate the risk that they will be wrong.

We find, in contrast, that historical analysis of company cash flows is a more reliable guide to future profitability and stock price valuation in the medium term.

Investors undervalue free cash flow, a fundamental building block of long-term growth, in favour of short-term profit forecasts. Investors' focus on profit forecasts over fundamental value provides us with a consistent opportunity to add alpha.

2. Process

We focus on the historic cash flows generated and invested by companies to support their forecast profits growth. As forecasts are often unreliable, the scale of cash invested to support forecasts is key.

In our experience, companies that generate significant free cash flow after investments prove to be rewarding stock market purchases.

Companies that invest significantly more cash than they can produce to back bold forecasts of future growth often disappoint. Therefore we pay particular attention to both the quality and sustainability of company cash flow and the valuation investors attach to it.

For long-only portfolios we want to own companies which generate significant cash flow, yet are lowly valued by investors on that measure.

They will also be run by managers that combine a realistic assessment of the risk in forecasting with a prudent approach to spending shareholders' cash. They generate significantly more cash than they need to sustain their planned growth.

This combination of low forecast risk, strong cash flow, prudent management and low investor expectations provides us with a strong margin of safety or protection against most risks the economic cycle will present us with.

Our process can best be described as focused on the forensic analysis of historic cash flows and balance sheet development as presented by companies in their annual report and accounts.

In order to identify companies' annual cash flow, balance sheet development and valuation efficiently across all equity markets we have developed a simple screen as a starting point for further qualitative analysis. The investment screen consists of two cash flow ratios that are combined equally to highlight the process characteristics that we seek.

In Europe, for instance, companies can be ranked according to their annual financial results daily, incorporating all countries and sectors with discretionary market cap cut-offs and the ability to zone in on individual markets.

This work has been completed globally and, depending on the market or universe, stocks are ranked in order of attractiveness and selection is restricted to the top 20% or quintile for long ideas. The two cashflow measures are:

- Cash flow relative to operating assets
- Cash flow relative to market value

The ratios have been developed over a number of years and contain our own proprietary definition of operating assets and cyclically adjusted, normalised cash flow (in a normal year excluding temporary or exceptional items).

2.1 Cash flow relative to operating assets

This ratio gives us a good idea of cash flow profitability and the scale of asset investment that has been undertaken. It provides us with a good sense of management prudence, financial leverage and sustainable growth potential.

2.2 Cash flow to relative market value

Our second ratio ranks companies according to how investors value a company's cash flow. It provides us with a good indication of investors' expectations regarding forecast growth and the potential stock return if those forecasts are wrong.

We combine our two cash flow measures equally to generate a list of companies.

- The top 20% of the list contains companies that are cheaper than the market (as measured by cash flow yield) with cash returns on operating assets that are better than the market
- The bottom 20% contains expensive, cash poor, overleveraged companies with profit forecasts that are vulnerable to disappointment

For long-only portfolios, our entire focus is on researching and understanding companies in the top quintile as a source of ideas for clients' portfolios. Companies that fail to rank in the best quintile of our process screen are ignored.

We cannot invest in the entire quintile, however, as we believe a concentrated, equally weighted portfolio is likely to produce the best investment returns. We therefore aim to pick the very best investments from within the top quintile by categorising stocks according to four 'secondary scores':

- **Growth:** businesses with strong momentum, high margins (indicative of economic moat) and self-funded growth
- **Cash return:** stable businesses with robust balance sheets, returning cash to shareholders through share buyback, debt pay-down and dividends
- **Recovering value:** companies we have identified as reducing capital expenditure and imposing capital controls, with management teams who are eager to return cash to shareholders
- **Contrarian:** companies that are likely to exceed expectations through pro-active management responses to prolonged tough trading conditions – including restructuring measures and asset disposals

This classification of stocks in the top quintile helps us be more efficient in focusing our research.

Once we have a list of stocks to work with, we spend considerable time sifting through the list by scrutinising their annual report and accounts.

Cash flow data and balance sheet changes are often subject to large exceptional items or reflect a particular business cycle or accounting change.

Our aim at this qualitative stage is to make sure that the cash flow ratios accurately reflect the investment opportunity we are looking for. We work carefully through all the accounts, notes and annual commentary.

We look closely for any changes in accounting policies, unusual revisions to prior year accounts, the focus of remuneration policy and the stated forecasts for growth. We want to understand the management culture of the company.

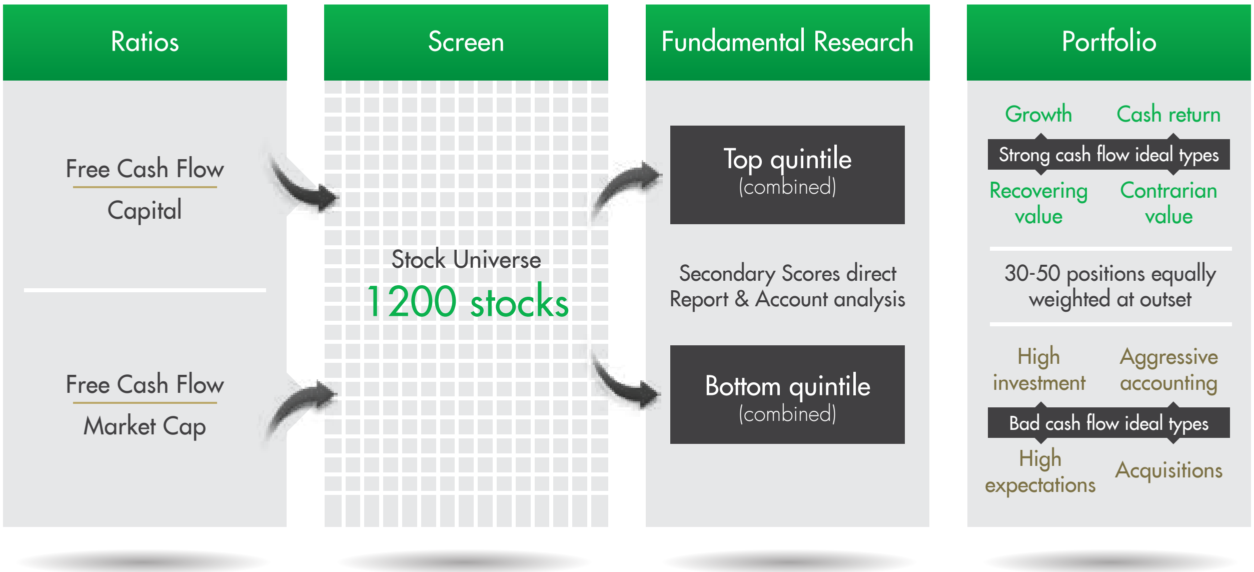
We do not attempt to understand a company's operations in enormous detail but do want a clear understanding of the importance they attach to cash flow generation and forecast risk. After we have completed this assessment stocks are selected for portfolios and are equally weighted at inception.

As a team we work together on all aspects of the analysis of the output of the screen and will discuss and agree the merits of each stock before an investment is made.

3. Portfolio construction

In Europe, approximately 80% of companies have December year-ends and therefore their annual results are worked through at the same time. The 20% of companies with year-ends outside December are ranked on our screen and analysed when they publish their accounts.

All news relating to companies selected for the portfolio is monitored carefully throughout the year, including quarterly or semi-annual results and statements regarding acquisitions, disposals, shareholding changes, etc. Any significant corporate developments that undermine our investment case will trigger changes to the portfolio.



In the absence of news-flow, stock positions are allowed to grow or contract in line with short-term performance unless individual position sizes lead to unnecessarily concentrated risk.

The limits to stock risk concentration will vary depending on the type of fund, but our aim at all times is to manage portfolio risk prudently. We allow our best performers to become more heavily weighted in our portfolios during the year whilst the weight of short-term underperformers naturally declines.

We view our portfolios as investments rather than trading positions and would expect, on average, holding periods of approximately 2 to 2½ years (annual turnover of 40-50%).

3.1 Typical portfolio characteristics and performance across the economic cycle

Our investment process does not exclude any sectors. Financials, utilities, real estate and biotechnology, for example, are all included. Sector representation in our portfolios is typically broad and well diversified.

Our aim is to run concentrated but well diversified portfolios by industry or business type. Country weights, 'top-down' or macro risks typically represent a small proportion of overall portfolio risk. Attribution analysis has demonstrated that the vast bulk of our portfolio return derives from stock specific risk which is high due to the concentrated nature of our portfolios.

None of our portfolios bear much relationship to a broad capweighted equity index. An equally weighted, 'best ideas' approach gives much greater emphasis to medium sized companies. Despite this size bias, appropriate liquidity is carefully controlled.

3.2 Performance

Corporate cash flows tend to be counter-cyclical. They peak close to the bottom of the economic cycle when pessimism is high and are typically at a trough when economic growth is strong and companies are investing heavily to capture their share of it.

At the bottom of the economic cycle our portfolios will tend to become more cyclical as it is this group of companies that are generating significant free cash flow to cushion their sensitivity to a decline in general growth.

Towards the peak of an economic cycle our portfolios can take on a more defensive hue as we favour companies that are generating stable cash flows, adopting a conservative investment strategy and paying generous dividends, whilst significant swathes of the market are leveraging up and investing heavily for further growth.

Investors will typically reward this latter group of companies with a higher equity rating as they pursue strong growth and ignore the certitude that company profits are cyclical.

For long-only portfolios we would expect more consistent returns relative to equity benchmarks. The investment process tends to position the portfolio correctly in terms of quality at each major stage of the economic cycle.

3.3 Portfolio style

In line with the counter-cyclical nature of cash flow our portfolios tend to be biased towards value at the trough of the economic cycle and move towards stable growth stocks paying attractive dividends at the peak.

Our portfolios tend to have a more consistent profile to quality with, on average, a strong bias to return on equity (ROE) and low leverage (low debt to equity).

These biases reflect the quality of the business models we seek and the prudent behaviour of their management. Overall the combination of stock specific risks relating to our cash flow process and the shifting style exposures of our portfolios across the cycle helps produce consistent excess returns.

4. Implementation

The previous three sections discuss our philosophy, process and aspects of construction. This section describes how we implement our process.

A good fund manager requires a workable investment process and the ability to implement that process in order to construct portfolios efficiently. Implementing an investment process is hard. There are two big challenges:

- First, the psychological challenge of sticking to a process when you are going through a period of underperformance
- Second, finding the right working environment which allows the job to be done (practical issues like how much time does the fund manager spend sitting in meetings rather than managing portfolios are very important).

In addition, a fund manager must have a disciplined approach to portfolio construction in order to meet realistic performance objectives with the minimum of risk. Considering each of these difficulties in turn:

4.1 Psychological

Being able to stick to an investment process at all times is hard. It requires an understanding of how the process performs in different economic environments and an appreciation of the downside when conditions are tough.

A fund manager needs an unshakeable faith in his investment process during difficult periods in order to withstand the pressure to change. Fund managers can prepare themselves for the emotional ups and downs by being realistic:

- Accepting that beating the market is hard; accepting that underperformance is inevitable at times
- Accepting that the market will be volatile at unexpected moments
- Accepting that they will feel bad when the investment process is not working
- Accepting the evidence that they have a tendency to think they are smarter than they are

This recognition is essential for long-term success. Occasional underperformance is a necessary ingredient of a 'good' investment process. A 'perfect' investment process is an illusion: if it is seen to work all the time it will eventually lose its power as too many investors will try to follow it. A 'good' investment process, however, is sustained by the fact that it will underperform from time to time and many fund managers will abandon it.

We know occasional underperformance is inevitable with any disciplined investment process focused on delivering outperformance over the longer term.

4.2 Practical

As if dealing with the emotive side of investment was not hard enough, many fund management companies present additional problems for fund managers.

Fund managers often find themselves weighed down by other company responsibilities, distracting them from running their clients' funds. Inefficient decision-making procedures, such as large investment committees, often lead to mediocre returns.

Finally, a cultural fixation on the short term is usually incompatible with the philosophy of any fund manager committed to an investment process. We believe the right working environment has many benefits, including:

- Clear responsibility for an individual fund manager.
- No bureaucracy
- The maximum time available for fund managers to spend on investment
- The consistent application of the investment process
- A focus on longer term performance

The culture at Liontrust is designed to allow fund managers to focus on what is important: the best possible execution of their investment process and the clear communication of this to their clients.

Overall, the Liontrust environment helps process-driven fund managers cope with the psychological and practical difficulties of managing portfolios. Liontrust encourages managers to apply their investment process with discipline and conviction over a realistic time horizon. This environment is necessary for us to be successful in the long term.

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