LIONTRUST

MACRO-THEMATIC PROCESS

An investment process for UK equity portfolios managed by Stephen Bailey and Jamie Clark

Fund name	IA Sector	Index	Fund type
Liontrust Macro Equity Income	UK Equity Income	FTSE All-Share Index	UK Unit Trust (UCITS)
Liontrust GF Macro Equity Income	-	FTSE All-Share Index	Dublin OEIC (UCITS)
Liontrust Macro UK Growth	UK All Companies	FTSE All-Share Index	UK Unit Trust (UCITS)

Investment process

The Liontrust Macro-Thematic process aims to identify early stage Macro-Themes and profit from the resultant investment opportunities. We define a Macro-Theme as an undiscounted, structural change in the process of realisation; and the related passage to theme-maturity, as the macro-trend. We believe that our Macro-Thematic process equips us to locate unappreciated investment ideas and capture the full, long-term potential of each portfolio holding.

Our Macro-Thematic investment methodology is iterative and scalable, consisting of four distinct and contingent stages:

1. Theme discovery
2. Identification of theme-assisted and theme-impaired companies
3. Bottom-up analysis of prospective investments
4. Portfolio construction and management

1. Theme discovery

Theme discovery is the most critical part of our four-step process. The theme serves as the premise for each portfolio holding and necessarily informs each subsequent step of the process.

A Macro-Theme is an instance of fundamental and, as yet, unappreciated change. Themes generally involve a rupture in the existing order, or an inflection in historic trends. We believe that such episodes of change require a 'top-down' starting point. A top-down vantage permits a more complete understanding of change, its drivers and the resultant investment opportunities. This objective cannot be attained with a more limited, 'bottom-up', or company specific approach.

The process is unconstrained by market-cap or sector and has the capacity to invest in markets beyond its FTSE All-Share Index benchmark. Correspondingly, we have significant latitude in sourcing new themes. Such operational freedom means that the process is not limited by any generic, or formulaic understanding of companies and markets (cyclical, defensive, value, quality etc).

Rather, we seek opportunity in instances of economic, political, social and cultural change. This approach has two clear advantages: (i) it presents long duration investment opportunities that persist beyond market cycles; and (ii) it produces limited overlap with peer group portfolios and, by default, generates periods of uncorrelated returns.

Importantly, a theme may be expressed in both positive and negative terms. A positive theme is characterised by attractive macro-trends and given realisation by a large, absolute portfolio weighting. Conversely, a negative theme should be understood in terms of its impaired thematic context and complete absence from the portfolio. This is a substantive point of difference with 'stock-picking' methodologies, which permit managers to own the best businesses in a challenged sector.

Central to theme discovery, is our belief that the unstructured reality of financial markets bears only limited correspondence to the tidy abstractions of the *Efficient Market Hypothesis*. Put simply, the idea that investors are rational in aggregate and that asset prices efficiently discount all available information comes unhinged when measured against observed human behaviour.

It is this gap between theory and practice which explains why thematic investment opportunities exist. Specifically, there are three reasons why markets and investors are bad at discounting the kind of change that defines Macro-Themes:

1. **Herding:** neuroscience and evolutionary biology inform us that humans have a collective tendency to gravitate to the apparent safety of received wisdom;

2. **Cognitive biases:** behavioural psychology teaches that cognitive biases obscure our capacity to identify and understand change *(anchoring, status quo bias, endowment effect, availability heuristic etc)*;

3. **Forecasting:** much financial analysis relies on the naïve extrapolation of historic data, with little appreciation that yesterday may exert no influence on today. This is often characterised as Hume's *Problem of Induction*.

Asymmetries of knowledge are key to our identification of Macro-Themes. To this end, we actively seek sources of data and information that are unlikely to inform the portfolios of competitors, or investors more generally. For this reason, little weight is attributed to financial media or sell side research; the latter often prone to an optimistic world view that can obscure real risks to capital.

We have a rigorous, empirical attitude to all sources of thematic information. Facts are amassed in building a thematic investment case, but must be tested against our experience of markets and concrete, real-world events. This is a check upon crudely reductive, universal theories and ensures that the process remains free from unwanted abstraction, forecasting and historical determinism.

2. Identification of theme-assisted and theme-impaired businesses

With an emerging Macro-Theme identified, the second stage of the process entails pinpointing those companies that are likely to benefit, or suffer. There is no precise, quantitative measure of correlation between a theme and a company. In fact, any numeric expression of thematic relevance would, by default, fail to capture the nuance and subtleties that inform a theme. Instead, gauging the thematic utility of a company demands a combination of legwork and judgment. This is an explicitly qualitative exercise.

Evaluating the thematic merits, or demerits of a company, requires that we pay close attention to its investor and regulatory communications. At this point in the process, we are less interested in a company's financial characteristics and pay more attention to its orientation and strategic intent: *Where does the company operate? How does it generate sales? What is the shareholder returns policy? How does it intend to grow?* To this end, we scrutinise report and accounts, earnings statements and strategy updates. Where information is limited, or further clarity needed, we will meet company management, but remain mindful of any corporate bias to optimism and overconfidence.

We are then in a position to categorise companies as either theme-assisted, or theme-impaired. Those deemed to be theme-assisted qualify for the next stage of our analysis and may ultimately feature in the portfolios. Conversely, those judged to be theme-impaired are rejected, but could well inform one of our several negative themes.

3. Bottom-up analysis of prospective investments

Now that the theme is established and prospective investments have been identified, we undertake detailed financial analysis in order to identify the most attractive opportunities and eliminate the least. We do not believe that any one financial metric can be adequate to the task of assessing all companies, under all circumstances. Certain financial measures will only ever be suited to the analysis of particular industries and there will be periods during which the value of others change, as they are granted greater, or lesser significance by investors.

Our starting point is always our fiduciary responsibility to our clients and the obligation to preserve unit holder capital. We proceed by assessing whether a company should remain solvent over the duration of the expected holding period. Assorted measures of financial stability are employed to gauge balance sheet risk and a business' capacity to service its obligations to creditors and shareholders.

From here, we assess measures of profitability and return. We want to see that a company can self-finance growth or has scope to progress dividend distributions. On this count, we prefer to view profitability in relation to measures of invested capital; companies characterised by a high return on invested capital typically offering the happy combination of low capital requirements, profit growth and dividend progression. Free cash flow metrics serve a critical, supplementary purpose.

We now review valuation multiples, to understand how investors are pricing a business' financial characteristics relative to market, peer group and history. Paying less for a thematically attractive business is preferable to paying more, but we are very careful to avoid *'value traps'*.

There is one very important caveat. The analysis of company financial statements is a backwards looking exercise. Inevitably, historic financial metrics give little guidance on a company's latent thematic potential. Consequently, we look to theme-adjust prospective investments; making allowances for companies with greater thematic potential and requiring more from those with less.

4. Portfolio construction and management

We do not use portfolio optimisation techniques as we believe many of the assumptions integral to *Modern Portfolio Theory*, or the *Capital Asset Pricing Model* to be either crudely reductive or simply wrong.

Defining risk exclusively in terms of historic volatility is not just naïve, but also dangerous to the extent that it excludes important categories of thematic risk (political, regulatory, reputational, environmental etc). Further, evidence demonstrates that there is no permanent, fixed relationship between returns and risk, as expressed in terms of historic volatility.

Instead, the weightings attributed to individual holdings and wider Macro-Themes is proportional to the degree of our conviction in each theme. This is a qualitative undertaking.

We are benchmark aware, but do not stick slavishly to market weightings in managing portfolios. Thematic investing can produce material underweights and overweights relative to market indices. This is most apparent in the idea of negative themes which can result in zero portfolio exposure to entire sectors and large underweight positions.

Although the process is multi-cap, we require liquid investments that permit scalability. Whilst small-caps are an important feature, the portfolio therefore has a natural bias to mid- and large-cap equities.

That said, we are alive to the risks of concentration and under normal circumstances, would not expect single positions to exceed 6% of a portfolio or themes to be any more than 20% of the portfolio. This discipline mitigates *stock-specific* risk, in producing well-diversified portfolios that typically consist of 50-60 individual holdings and a spread of key themes.

The structural duration of Macro-Themes instils a long-term investment focus. This approach acts as a robust check on the behavioural bias to snatch short-term, certain profit *(Prospect Theory, Disposition Effect, Hyperbolic Discounting, etc.)* and surrender potential capital appreciation.

Empirical evidence demonstrates that human beings are poor forecasters. This is explicitly the case with themes, which don't adhere to a timetable and likely develop in non-linear fashion. As such, the pace at which investors grasp and price a theme cannot be predicted. We never initiate themes and investments with a fixed, or absolute objective, or price target. Instead, we employ relative valuation targets, which offer the flexibility to accommodate changing market conditions and theme evolution.

We safeguard investor's capital in employing a thematic 'stop-loss'. This heuristic, or rule of thumb, requires that we sell any portfolio holding if the original thematic investment logic is proved false. This ensures we remain on guard against the behavioural bias to overconfidence *(Optimism Bias, Valence Effect, Positive Outcome Bias).*

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