LIONTRUST
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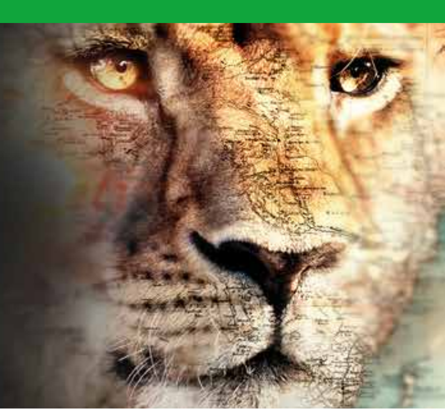


LIONTRUST INCOME FUND PROCESS

An investment process managed by Chris Field and Dan Ekstein

Introduction: A word from the fund managers

Thank you for your interest in the Liontrust Global Fundamental Income Fund.

How one chooses to invest personal wealth is one of the more consequential life decisions. We are asking you to entrust us with yours, something we consider a great privilege and responsibility. We have written this guide to help you, our partners, better understand how we manage the Fund. We want to set out plainly and clearly our approach. Your understanding and trust in our goals and strategy will enable us both to better achieve our common long-term objectives, embracing the 'ups' and occasional inevitable 'downs' with equanimity.

Our goal is to generate a consistently attractive, growing dividend stream alongside long-term returns and capital appreciation. We achieve this through investing in durable 'Quality' dividend stocks, evidenced through Competitive Powers, and balanced across two complementary investment silos: i) Dividend GARP, and ii) Repeatable Cashflow.

We are fully aligned with our investors, with a substantial portion of the Fund Manager's wealth being invested in the strategy.

We have structured this document to address some of the questions you may have and help understand our beliefs and process. We have tried to avoid unnecessary complexity and jargon. Should you wish for clarification on any points or more detail then please reach out, we're always pleased to discuss in more detail.

First principles: Not all dividends are created equal; quality dividend investing works

History shows dividends matter a great deal to overall investment outcomes. Decomposing total returns of the FTSE All-Share Index shows they have typically driven c.60% of returns, acting as a consistent source of returns over the long term, and providing attractive, reliable ballast to portfolios.

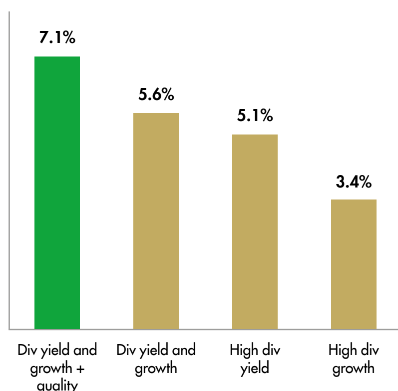
FTSE All-Share	Annualised TSR	o/w: Dividends	o/w: Price
5-Year TSR	2.89%	3.54%	-0.65%
10-Year TSR	6.51%	4.16%	2.35%
20-Year TSR	7.65%	5.04%	2.61%
50-Year TSR	7.88%	4.68%	3.20%

Source: Bloomberg; Total Shareholder Return calculations to year-end 2022.

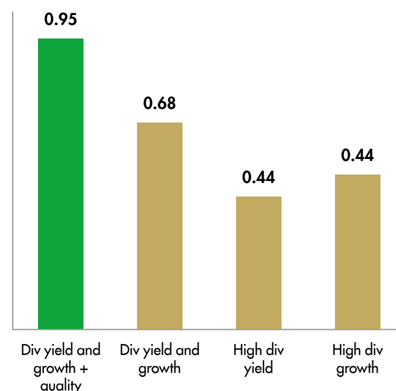
But not all dividends are created equal. Our belief is that quality dividend investing works and this principle is supported by evidence. A quantitative study we commissioned examined the performance of various dividend strategies across the past c.30 years. The data shows simply buying companies with attractive dividend yields has delivered average c.5% annualised outperformance, albeit with high volatility and unpalatable drawdowns. The reason for this is straightforward: a high dividend yield can often be more indicative of risk or poor fundamentals than it is of realisable future dividend income.

However, once filters around quality are overlain (including dividend track record, returns on capital and financial strength), not only do excess returns increase to c.7%, but volatility (as measured by Sharpe Ratio) and drawdowns are significantly reduced – what's not to like? At the intersection of yield and quality, dividend investing becomes sustainable. We have a mantra within the team that 'Return on Capital underpins Return of Capital' and the data supports this.

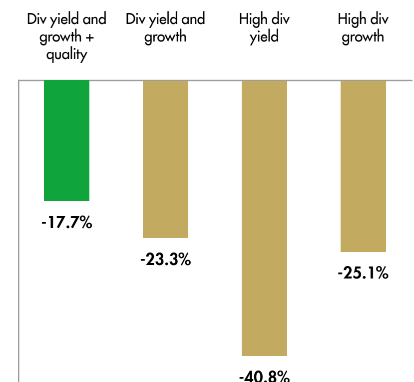
Annual returns (excess)



Sharpe ratio



Max drawdown



Source: J.P. Morgan Quantitative and Derivatives Strategy, commissioned data from December 1994 – July 2022.

Investment philosophy: Systematic framework to identify Quality dividend paying companies

For reasons that are not always obvious, certain companies just seem to have a knack of consistently achieving better than average outcomes. Progress is smoother; mishaps less frequent. These are the Quality companies we want to own. Our process is designed to pinpoint the attributes that increase likelihood of a company prospering, allowing us to build conviction in its Quality and, by implication, its intrinsic value (i.e. the sum of all future dividends). Having a systematic analytical framework allows us to take advantage of behavioural anomalies that arise in markets, when Quality companies become available at a discount. Below is the core framework we use to identify Quality.

- **Strong and/or improving returns:** Return metrics are one of the best rules of thumb for a company's competitive positioning – high returns can be a good indicator of an advantaged business. Companies with higher returns also generate more distributable cashflow per unit of earnings, creating optionality to reinvest for growth or return cash to shareholders. Hence, they trade at higher valuation multiples, all else equal. And this cashflow tends to be more reliable in the long run – a McKinsey study has shown that companies with top quintile ROICs (>25%) (return on Invested Capital) will typically sustain returns in the 'high-teens' even 15 years later, whereas average revenue growth rates are much harder to extrapolate and typically mean revert over time.
- **Clean financial models:** As dividend focussed investors, cashflow matters most. We are looking for companies with high quality earnings (ideally few adjustments), where profit converts consistently to cash. We are wary of companies 'borrowing from the future' through aggressive approaches around working capital, share-based payments or underinvestment in the business and those burdened by ongoing calls on cashflow from pension deficits or provisions. Ultimately, this should all translate to dividends which are well covered by sustainable cashflow.
- **Prudent balance sheets:** We are prepared to accept some leverage to fund growth, where the underlying business model has good predictability and debt is termed appropriately. But we dodge companies employing excessive leverage to augment otherwise unattractive returns and those which have the potentially toxic mix of high operating and financial leverage, which can quickly imperil dividends.
- **Skilled, motivated management:** Quality businesses should not generally be reliant on an individual, per-se, but the combination of strong management and a well-positioned company can be powerful. We seek out executives who manage their businesses sustainably and ethically, with focus on maximising the long-term opportunity for ALL stakeholders (customers, employees, suppliers, and shareholders). We like them to have their own 'skin in the game' too and to think like principals (i.e. owners) rather than agents.
- **Attractive underlying markets:** Industry structure, underlying growth and resilience of end-markets are critical elements of a company's potential quality and forecastability. In general shareholder value can be delivered more predictably in less competitive, faster growing markets; and, higher barriers to entry lead to more rational competitive outcomes, than vice-versa.

Competitive Powers: the underpinning of persistent quality

Some of the building blocks of Quality we have described are financial traits that can be easily identified – screening tools can filter companies with strong returns profiles, for instance. Some require more digging and judgement, such as assessing management, industry structure, quality of earnings and financial risk. Yet ultimately, the future is the only thing that matters in investing and so any useful assessment of Quality must be forward looking. Hence, the most important part of our analysis is understanding the 'secret sauce' – the combination of characteristics enabling a company to achieve strong financial outputs which, crucially, are likely to sustain over time. Here we are methodical in our approach, applying a Competitive Powers framework, which draws on the work of Hamilton Helmer, the highly regarded business strategist.

Competitive Powers are strategic traits that underpin potential for a company to generate persistently attractive returns. They go beyond operational excellence, which alone is not enough to ensure success. Powers have dual attributes – benefits to the company, manifest through pricing power or lower costs; and, barriers to competitors, who would ordinarily attempt to arbitrage away supernormal financial returns. We're yet to find a very successful company without 'Power(s)' and the companies we invest in must have at least one. Companies with Powers, particularly when allied with attractive underlying markets, see their future earnings outcomes both narrow and skew more positively compared to those without. This principle underpins a step-change in the confidence we can place in a company's future cashflows and intrinsic value, allowing us to plot future scenarios and navigate near-term uncertainty with a greater degree of clarity.

Our process is designed to pinpoint the attributes that increase likelihood of a company prospering, allowing us to build conviction in its Quality and, by implication, its intrinsic value

A brief overview of the 7 Powers is given below (we'd recommend Helmer's book to those who wish to learn more):

1. **Scale Economies:** costs decline as sales volume grows, e.g. Rentokil, Ashtead, Compass.

2. **Network Effects:** value of the service to users increase as the number of customers increases, e.g. Autotrader, London Stock Exchange, Rightmove.

3. **Counter-Positioning:** new entrants develop a business model that would cause financial damage if adopted by an incumbent, with Netflix vs. Blockbuster Video a classic case study, e.g. 3i (discount retail vs. big-box); Kitwave.

4. **Switching Costs:** occur 'when a customer values compatibility across multiple purchases from a specific firm over time' and can be bucketed into three groups: financial, procedural and relational, e.g. Experian, RELX, RS Group.

5. **Branding:** arises from historical perceptions about the seller and 'evokes positive emotions in the customers, leading to an increased willingness to pay' for essentially substitutable products, e.g. Diageo, Watches of Switzerland.

6. **Cornered Resource:** preferential access at attractive terms to a coveted asset that enhances profits. Classic examples would be a drug patent which creates monopolistic conditions, or a mine or oil field that sits at the bottom of the cost curve, e.g. AstraZeneca, Rio Tinto, Mondi.

7. **Process Power:** such companies have evolved differentiated internal processes which conveys significant benefits in terms of cost or quality and which are hard to replicate, e.g. Admiral, Spirax.

Investment process: Creating competition for capital
Our research process begins with screening and idea generation. We use screens to help monitor and narrow our investable universe, but recognise the limitations of quant models, which can't identify a great new CEO, product launch or change in industry structure. For this reason we kick tyres, turn over rocks and walk down the occasional cul-de-sac – our team meets literally hundreds of companies each year.

If an idea sparks our interest it will be followed by operational due diligence where we conduct more detailed research to understand the company, its Competitive Powers and industry position. This involves assessment of key risks and opportunities, incorporating ESG factors. Our research involves meeting with management; use of expert networks; speaking to competitors and suppliers; reviewing industry journals; attending conferences and visiting offices/facilities.

Having got to a qualitative 'yes' on a particular company we conduct our financial diligence. We use financial models for every investment. Not because we overemphasise precision, however, we find modelling helpful in understanding a company's key value drivers, its sources and uses of cash and what potential scenarios are 'priced-in' at a moment in time.

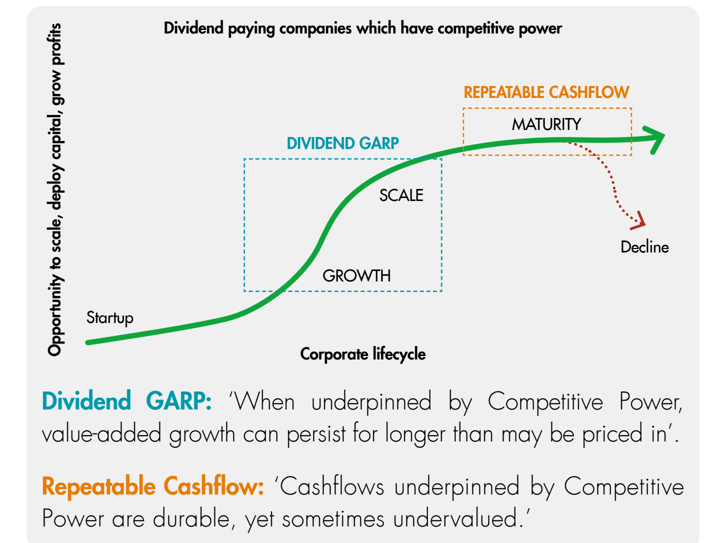
Valuation is arguably the most important, but generally the last thing we consider. If our valuation work takes place upon an uncertain competitive understanding, then any perceived margin of safety can quickly disappear. We are not dogmatic on the virtues of one valuation method over another. We find it more helpful to tackle an inherently complex, organic problem with a broad toolkit, although with preference for intrinsic rather than relative valuations, e.g. discounted cash flow (DCF), sum of the parts, yield or justified multiples-based, usually across a range of scenarios.

For our portfolios of c.30-50 stocks we will generally be looking to have a further c.50 stocks 'live' at various stages of our research process. This evolving shopping list creates competition for capital and enables us to be opportunistic should the market present opportunities, as it is wont.

Portfolio construction: Quality dividend paying companies across the Corporate Lifecycle
Our strategy seeks to provide the 'best of both worlds' – a consistently attractive dividend yield alongside superior long-term capital growth. To achieve this we construct high conviction, but balanced portfolios of stocks, broadly equally weighted, across two distinct, but complementary, investment silos – Repeatable Cashflow and Dividend GARP. The output is a distinctive, flexible style, encompassing elements of what is often termed 'Growth' investing and elements of 'Value', albeit with the common threads of Quality, underpinned by Competitive Powers. This helps mitigate style bias and produces balanced portfolios, with potential to perform across different market and economic cycles.

Repeatable Cashflow: With this silo we focus on more mature companies, which are directing more of their cashflows to dividends. A high yield (or 'cheap' valuation) is an implicit expression by 'the market' of scepticism around the sustainability and/or growth potential of that cashflow stream. Often this scepticism is appropriate; sometimes it is not, with stocks' fundamentals mispriced due to neglect, emotion, misinterpretation or myopia. Our job is to find companies trading on attractive dividend yields, with better prospects than are currently 'priced-in'. If our analysis is correct, we make money in one of two ways – either happily pocketing a sustainably high dividend or by the market coming round to our way of thinking on repeatability of cashflow and re-rating the stock to a higher valuation multiple (lower dividend yield).

Dividend GARP: with this silo we focus on businesses in the growth/scale phase of the corporate lifecycle S-Curve. Our companies will generally pay a dividend (or soon be expected to commence), though will still have plenty of runway to reinvest their cashflows and grow their businesses. As such we expect total returns to be driven less by 'yield', but rather by compound profit (and ultimately dividend) growth.



Dividend GARP: 'When underpinned by Competitive Power, value-added growth can persist for longer than may be priced in'.

Repeatable Cashflow: 'Cashflows underpinned by Competitive Power are durable, yet sometimes undervalued.'

HAMILTON HELMER'S 7 POWERS FRAMEWORK

EACH POTENTIAL HOLDING MUST HAVE AT LEAST ONE COMPETITIVE POWER

Summary thoughts: A high quality dividend strategy for attractive income today alongside future growth potential

Thank you for taking the time to learn more about how we manage the Liontrust Global Fundamental Income Fund. We believe our high quality, dividend strategy is a logical proposition for investors seeking attractive and resilient income today, with potential for above average future growth. We think our process, identifying dividend paying companies with Competitive Powers, gives us a framework to capture superior risk adjusted returns. We are passionate about what we do; substantially invested in the strategy ourselves; and would be delighted to welcome new partners into the fund.

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