

THE LIONTRUST CASHFLOW SOLUTION LONG-ONLY PORTFOLIOS

An investment process for UK and European Long-Only Equity Portfolios managed by **Gary West** and **James Inglis-Jones**



Fund Name	IMA Sector	Index
Liontrust European Growth Fund	Europe (ex UK)	FTSE All-World Developed Europe ex-UK Index
Liontrust Pan European Fund	European (incl. UK)	MSCI Pan Europe

1 Philosophy

- Our investment philosophy is based on the mistakes people make forecasting.
- People often deal with information emotionally and irrationally, making their forecasts unreliable.
- Our particular focus is on the profit forecasts made by company managers.
- Investment decisions taken by company managers to support their forecasts often create profit expectations in the stock market that are unsustainable.
- Errors in company profit forecasts are magnified in stock markets as investors adopt unreliable company forecasts to value future profits. These errors are predictable and identifiable and create our investment opportunities - particularly at key stages of a company's development.

2 Process

- The best way to exploit these investment opportunities is **to focus on company cash flow**.
- Cash flows reveal valuable information about the scale of a company's investment decisions.
- **Strong company cash flows** (after investment spending) are a good indicator of **strong growth in future** reported profits. Conversely, weak cash flows often predict a collapse in reported profits.
- We buy companies generating strong cash flows and sell those with weak cash flows.
- We create a list of companies with strong cash flows which we believe are likely to beat investors' low profit expectations and companies with weak cash flows likely to disappoint on investors' high profit expectations.
- We then use our own judgement to select the best Long and Short positions for portfolios.

3 Implementation

- It might seem that having defined and tested an investment process, its implementation would be straightforward. In fact it is very hard because of the psychological and practical difficulties that need to be overcome.
- To implement an investment process consistently a fund manager needs to believe in its merits and have a realistic understanding of its capabilities.
- Implementing any process gets harder as more people are involved. All Liontrust European equity portfolios will be managed by Gary West and James Inglis-Jones only.
- For fund managers to cope with the psychological and practical difficulties of managing portfolios, they must work in the right environment.
- Liontrust is structured so the fund managers can concentrate on the implementation of their investment process.
- We have developed some general rules of portfolio construction to help us cope with the psychological difficulties of managing portfolios and ensure a consistent application of the process for clients.

The objective of *The Liontrust Cashflow Solution* is to exploit the opportunities created by the failure of company managers to forecast profits accurately.

The aim is to buy companies **with good cash flows** which are likely to beat investors' low profit expectations and sell companies with poor cash flows and high profit expectations. To help us achieve this, two cash flow measures are used: cash flow relative to operating assets and cash flow relative to enterprise value.

Cash flow as a proportion of operating assets

We define companies with strong returns on this measure as **'good cash' companies**. 'Good cash' companies spend cautiously on operating assets and book profits prudently. They generate high returns on any cash invested and do not need to back their forecasts with substantial investments - their financial risk is low. **'Good cash' companies are likely to beat profit expectations.**

Cash flow relative to enterprise value

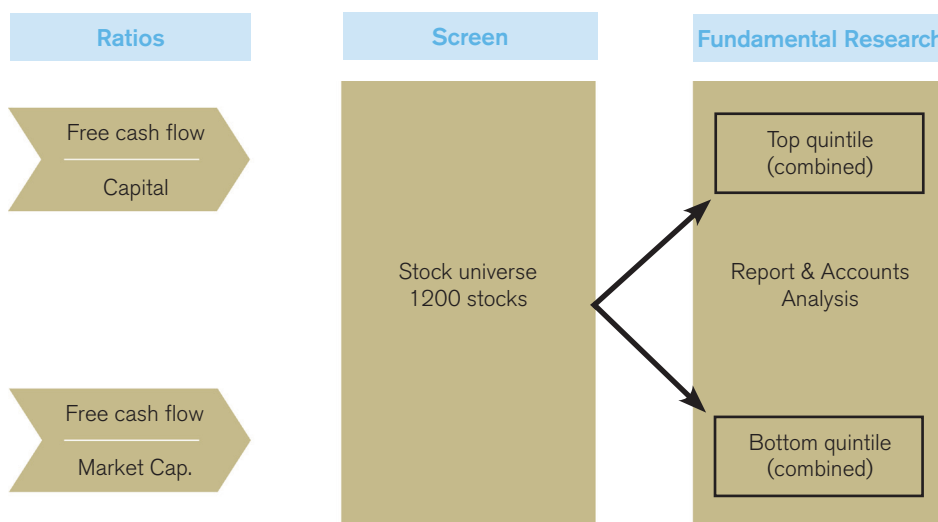
Our second ratio ranks companies according to how investors value a company's cash flow. Companies that score well on this measure (**high cash flows relative to their market value**) are **priced cheaply because investors have low expectations for profits growth**. High relative cash flows on this measure suggest that company managers have set cautious forecasts that can be realistically beaten.

Does it make sense to buy 'good cash' companies with low investor expectations and sell 'bad cash' companies with high investor expectations?

Yes, we combine our **two cash flow measures** to generate a list of companies with the best combination of our cash flow measures. By combining our cash flow ratios we generate a list of stocks **cheaper than the market** (as measured by cash flow yield) with **cash returns** on operating assets which are **better than the market**.

Stocks with this combination have **outperformed the market** in the past, as the graph shows**, and we believe they will continue to do so in the future.

**Source: Liontrust Investment Partners Limited. Study conducted using universe of all European stocks for which Worldscope have historical financial data (averaging 1,100 over the period, excluding Financials and Real Estate; the nature of companies in these sectors necessitates use of a different set of ratios). Portfolios are equally weighted, rebalanced quarterly and the returns shown are total returns.



Portfolios

We start with a list of all stocks larger than £250 million in size for each portfolio's geographical universe. We use our combined measure to identify the best 20% of stocks (our "top quintile") in each universe as our list of possible buys. Once we have created this list we set out to understand each business we invest in. In particular we look at two further aspects of our cash flow measures to refine our stock selection:

- First, we make sure that the cash flow data is indicative of the type of forecast errors we are hoping to exploit. For instance cash outflows could be due to factors beyond company managers' control like commodity price inflation rather than higher investment spending.

- Second, we make sure we understand the context of the company managers' investment decisions. We relate a company's investment decisions to its stage of development. We want to identify turning points in a company's development and determine over what time period a profit forecast is likely to be wrong.

By looking at these two aspects of our cash flow measures we generate our final selection of stocks. We believe these stocks will deliver profits significantly better than investors' expectations and generate good investment returns.

Long-only portfolios managed in accordance with *The Cashflow Solution* will typically contain a concentrated portfolio of stocks, broadly equally weighted. Portfolios can be invested to fit different geographical classifications of European investment funds.

Note: Issued by Liontrust Fund Partners LLP, authorised and regulated by the Financial Services Authority. The value of units and shares and the income generated from them can go down as well as up and are not guaranteed. Investors may not get back the amount originally subscribed. Past performance is not necessarily a guide to future performance. The issue of units in a fund may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Equity investment should always be considered as long term. There are no limits on geographical or industrial sector exposure; its geographical or industrial sector exposure will not closely mirror that of the benchmark. The income and capital value of the Fund's investments can be significantly affected by currency translation movements as a significant proportion of the Fund's assets and income are denominated in currencies other than Euros, which is the Fund's functional currency.