

THE LIONTRUST CASHFLOW SOLUTION EQUITY INCOME PORTFOLIOS

An investment process for Equity Income Portfolios managed by **Gary West** and **James Inglis-Jones**



Fund Range	Fund Name	IMA Sector	Portfolio
Income portfolios	Liontrust Income Fund	UK Equity Income	UK Stocks

Aims and objectives

1. To return more than the stock market over a five year period.
2. To yield more than index-linked gilts.
3. To provide an income stream that will grow faster than inflation over a five year period.

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 know that companies often have high dividend yields because investors have low profit growth expectations; in many cases these expectations prove to be wrong.

- Focusing on the cash flows of companies with high dividend yields enables us to identify companies that can surprise investors with their profits, without ourselves falling into the trap of trying to forecast to achieve this aim.
- We create a list of high yielding companies with strong cash flows which we believe are likely to beat investors' low profit expectations. We then use our own judgement to select the best investments 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. The Fund 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 investors.

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 high yielding companies with **good cash flows** which are likely to beat investors' low 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.**

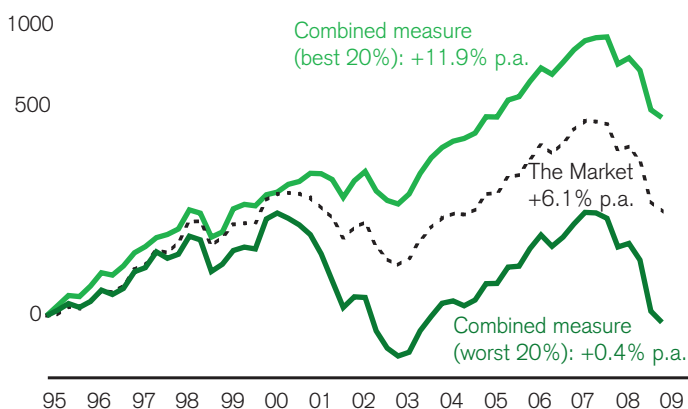
Cash flow relative to enterprise value

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?

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.

Combined cash flow measure and market return. Investment returns in Europe, 1995-2008, rebased to 100.



* Source: Liontrust European Investment Services 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.

How do we apply our process to Liontrust First Income Fund?

We use cash flow analysis to find high yielding companies that will surprise investors positively. Taking all stocks in the UK with a market capitalisation of more than £250 million, we compare companies' dividend yields with reference to the yields available on long-dated and index-linked gilts. These comparisons help us decide whether investors' profit expectations for a company are either very low, average or high. We look for:

- Stocks with yields at least 2% higher than long-dated gilts
- Stocks with yields at least 2% higher than long-dated index-linked gilts
- Stocks with yields higher than long dated index-linked gilts

Why create three lists of stocks with reference to yields on long-dated and index-linked gilts?

Comparing stock yields to government bonds is a good way to measure investor sentiment across the market. The number of stocks in each of the three pools will vary with the level of pessimism in the market. In simple terms the movement of stocks within the three lists helps define the investment opportunity within the stock market and the potential of our cash flow process to deliver a consistently superior return in different market conditions.

How do we construct the portfolio for Liontrust First Income Fund?

To each of these three lists of stocks we apply our cash flow ratios. We only look at the stocks from these groups that have the best cash flow as potential purchases and ignore the rest. To determine whether or not we should buy a stock for the portfolio we will spend time analyzing the report and accounts, ensuring the good cash flow is indicative of the forecast errors we want to exploit.

The Fund will invest in a concentrated portfolio of UK stocks, broadly equally weighted and with no sector constraints, chosen from the stocks in our three lists with strong cash flows which we believe will beat investors' low profit expectations.

Can the Fund provide an income stream that will grow faster than inflation over a five year period?

Yes. The process identifies companies with strong cash flows and prudent balance sheets. We believe it is reasonable to expect that companies with these characteristics will be able to pay a high and rising dividend. We will continue to monitor the balance between dividend growth and the Fund's underlying capital return.

* Study conducted using universe of all UK stocks with a market cap. in excess of £250m (excluding Financials and Real Estate; the nature of companies in these sectors necessitates use of a different set of ratios). The portfolio is equally weighted, rebalanced quarterly and the returns shown are total returns.

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 fall as well as rise and are not guaranteed; investors may not get back the amount originally subscribed. Past performance is not a guide to future performance. The issue of units in Liontrust Income 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. The annual management fee of the Fund is deducted either from capital or income. Deducting the fee from the Fund's capital account may result in the capital return for investors being lower than would be the case were the fee charged to income, but the potential distributions to investors may be increased (and vice versa). The Fund's Prospectus and Simplified Prospectus are available from www.liontrust.co.uk or direct from Liontrust.

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