LIONTRUST

CASHFLOW SOLUTION PROCESS

Long/Short

An investment process for long/short portfolios managed by James Inglis-Jones and Samantha Gleave

Fund name	Fund type
Liontrust GF European Strategic Equity Fund	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 to both the long and short side of our portfolio.

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 the long/short portfolio the aim of the investment process is to complement our long investments with short sales of expensive companies run by company managers, who combine over-confidence in their forecasting ability with a willingness to back their forecasts with substantial growth in operating assets such as property, equipment and stock.

They tend to generate very significant cash outflows after investments and carry significant forecast risk. If their profit forecasts prove too optimistic the toxic blend of high financial leverage as a result of significant cumulative cash outflows, falling profitability and an expensive valuation often leads to a devastating impact on share price performance.

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 and bottom 20% for short 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).

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.

Cash flow relative to 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

Our entire focus is on these two quintiles. Companies that fail to rank in the best or worst quintile of our process screen are ignored. Since we believe the best long-book returns to be generated by a concentrated, equally weighted portfolio, we further screen 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.

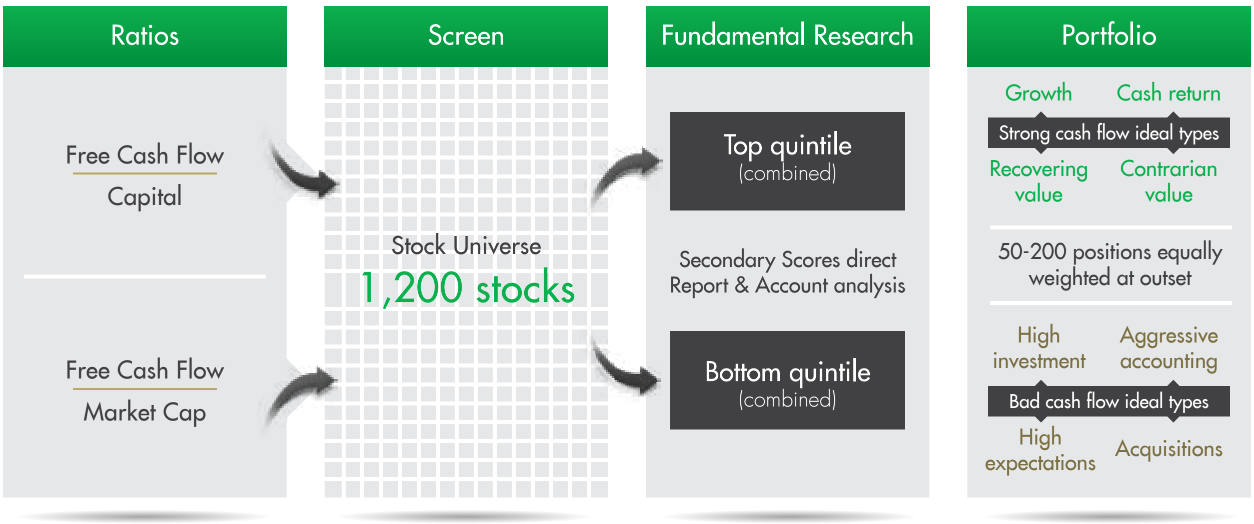
Cash flow data and balance sheet changes are often subject to large exceptional items or reflect a particular business cycle or accounting change. Our aim at this qualitative stage is to make sure that the cash flow ratios accurately reflect the investment opportunity we are looking for.

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 or short sale is made.



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