LIONTRUST
COURAGE · POWER · PRIDE

ECONOMIC ADVANTAGE PROCESS

An investment process for UK growth portfolios managed by Anthony Cross, Julian Fosh, Victoria Stevens, Matt Tonge and Alex Wedge

1. Philosophy

A fundamental principle of competitive markets is that profits regress to the mean. We believe that the secret to successful investing is to identify those few companies that have a durable Economic Advantage that allows them to defy this principle and sustain a higher than average level of profitability for longer than expected. This surprises the market, and leads to strong share price appreciation.

Economic Advantage is the collection of distinctive characteristics of a company that competitors struggle to reproduce, even if those competitors have understood the benefits arising from those characteristics. In our experience, the hardest to replicate of these particular characteristics fall into the following categories of intangible assets:

1. Intellectual property
2. Strong distribution channels
3. Significant recurring business

Other less powerful but nonetheless important intangible strengths include: franchises and licenses; good customer databases and relationships; effective procedures and formats; strong brands and company culture. It is our key belief, backed by our years of experience exploiting Economic Advantage, that only distinctive and hard to replicate intangible assets can form the basis of a sustainable competitive advantage. These assets deliver pricing power, protect margins, and thus drive sustained profitability. The market rewards excess profitability, particularly when it is higher than consensus expectations.

2. Process

Evaluation of Economic Advantage

We evaluate companies in the UK stock market for their possession of durable Economic Advantage. Companies must possess at least one of the main advantages: intellectual property, strong distribution or recurring business (at least 70% of annual turnover). We believe that investing only in these companies gives us a high chance of finding companies with the ability to deliver sustained earnings growth and long-term outperformance.

Companies with the strongest Economic Advantage from the stock market capitalisation ranges for each of our portfolios form our respective investment universes. Whilst we focus on companies that should be able to grow over the long term, economic cycles will often interrupt smooth profits and share price growth. This can create opportunities to buy growth companies that are being overlooked by the market, and therefore mispriced. If these companies can then surprise the market with their profits growth, they can deliver unusually good share price returns.

Financial Advantage

We test for evidence this theoretical Economic Advantage is converting to superior financial returns. The primary metric we use is cash flow return on capital (CFROC). A company that can earns cash flow returns that exceed its long-run cost of capital will benefit from compounding as it reinvests this excess return into the business.

Valuation

This is deliberately placed as the last step in the investment process. For FTSE 350 companies, five standard valuation metrics are used: price/earnings, enterprise value/sales, enterprise value/earnings before interest, tax, depreciation and amortisation, dividend yield and free cash flow yield. We will only invest in shares that trade at a discount to the market on at least one of these five measures.

Risk Scoring

Strict risk scoring of investee companies determines stock weightings within the Funds.

Each company is graded against eight criteria: financial risk (balance sheet and accounting risk, capital requirements and financial gearing), product dependency, customer dependency, pricing risk, regulatory change, licence dependency, acquisition risk and valuation.

These criteria are continually assessed so that stock weightings can be managed dynamically.

Employee motivation in smaller companies

Economic Advantage in smaller companies is created and maintained by talented individuals. Research demonstrates equity ownership motivates key employees, helps to secure a company's competitive edge and leads to better corporate performance.

- Equity ownership aligns the interests of employees with outside shareholders
- An 'owner-manager' culture creates a more conservative attitude towards acquisitions and gearing

Every smaller company held in the portfolios has at least 3% of its equity held by senior management and main board directors.

Changes in equity ownership are monitored. Although the requirement for high senior management and director equity ownership is confined to smaller companies (due to the lower levels of senior management and director ownership in mid and large companies), close attention is paid to changes in ownership across all companies.

Summary: We believe the process outlined can identify competitive companies most likely to deliver surprising growth in a variety of market conditions. We know that the market rewards surprising growth with long-term share price appreciation. Our experience in identifying companies with strong Economic Advantage and our measures for identifying companies able to grow their earnings in different market conditions give us confidence in delivering excellent portfolio performance.

	Economic Advantage: applies to all Funds	Market Capitalisation: key differentiator	Risk Appetite: volatility versus returns
UK EQUITIES	**Large Cap.** **(FTSE 100)**	**Liontrust UK Growth Fund /Liontrust GF UK Growth Fund** • Economic Advantage companies from throughout the FTSE All-Share Index and AIM • Approximately 90% invested in FTSE 100 and Mid 250 Indices • Overweight positions versus the FTSE All-Share of 1-2% as per company risk grades	**Liontrust Special Situations Fund/Liontrust GF Special Situations Fund** • Flexible blend of companies from throughout UK stock market indices • Minimum 3% directors' equity ownership in all smaller companies • Portfolio weightings of 1,2,3% as per company risk grades – maximum 4% • The Fund has no limits on sector exposure in comparison to the FTSE All-Share Index. Its concentrated number of holdings could mean that its sector representation does not closely mirror that of the Index
	Mid Cap. **(FTSE 250)**		
	Small Cap. **(FTSE Small Cap./ Alternative Investment Market (AIM))**	**Liontrust UK Smaller Companies Fund** • Economic Advantage companies from throughout the FTSE Small Cap, Fledgling and AIM • At least 75% of companies held will have a market capitalisation of less than £1bn • Minimum 3% senior management and directors' equity ownership • Portfolio weightings of 1,2,3% as per company risk grades – maximum of 4%	**Liontrust UK Micro Cap Fund** • Economic Advantage companies from throughout the FTSE Small Cap, Fledgling and AIM, of which at least 75% will have a market capitalisation of under £175m at purchase • Fund will look to make a managed exit from positions when market capitalisation grows above £275m • Minimum 3% senior management and directors' equity ownership • Portfolio weightings of 1,2,3% as per company risk grades – maximum of 4%
	Micro Cap. **(FTSE Fledgling / Alternative Investment Market (AIM))**		