

EUROPEAN INCOME PROCESS

An investment process for European Income Portfolios managed by Olly Russ and Oisín O’Leary



Fund name	IA Sector	Index	Fund type
Liontrust European Income Fund	IA Europe ex-UK	MSCI Europe ex-UK Index	UK Unit Trust (UCITS)
Liontrust European Enhanced Income Fund	IA Europe ex-UK	MSCI Europe ex-UK Index	UK Unit Trust (UCITS)

Investment philosophy

We believe an equity income fund should provide three things:

1. A yield on your investment that is higher than the market
2. An income stream that grows in the long run faster than inflation
3. Long-term capital growth that is at least in line with inflation

Your investment should provide a good and increasing level of income in real terms while also preserving the value of your capital over time. If a fund can consistently deliver these objectives over the long term, there is a good chance that it will be more rewarding than many other investments, and with less risk.

To achieve these aims, we look to find growing companies with low capital requirements that pay out expanding dividends. We use dividend growth as a proxy for earnings growth – we expect to see dividends rising over time as companies increase payouts to shareholders as earnings grow.

Since dividends are paid out in cash, companies with increasing payouts will need to produce high-quality cash earnings, with less scope for artificial inflation through financial manipulation or lower quality numbers. We also expect the value of companies with strong and growing dividends to increase at least in line with inflation over the long term.

We believe that if a company is targeting shareholder payouts this should help improve management focus on capital discipline, which can help to sustain higher valuations and avoid value-destroying actions. These companies are typically more stable, mature and secure businesses. Their asset base and business has been built up over many years, and is defended by a type of economic moat – an economic edge, competitive advantage or asset(s) that are hard to replicate by new entrants – such as a strong brand, niche products or a dominant market position. This economic moat is therefore usually a cash-generative asset, which is sustainable for the long-term, and the management generally believes in returning those cash flows to shareholders, to whom they rightfully belong.

As well as meeting our three objectives above, we are also aiming to achieve a total return (from income and capital) that is better than the market over the medium to long term. Just owning the types of companies listed above, however, may not produce market outperformance as the market should recognise these qualities and price them into the company’s valuation. To produce superior risk-adjusted returns, we look to find companies with the characteristics we have outlined and which are also undervalued. Generally we seek quality companies (cash-generative, well-

established businesses with hard-to-replicate assets) with a good record of dividend growth and where the market has mispriced or underestimated their future earnings potential.

Where we find mispriced assets

We look to take advantage of:

- Growth opportunities** – where the market underestimates earnings/dividend growth. We seek companies that can sustain and grow their dividends over time primarily through increased earnings. Typically, these companies are not overly capital intensive, enabling substantial sums to be paid back to shareholders without inhibiting future growth.
- Value opportunities** – where the market undervalues the expected earnings or dividend potential. In these cases, future dividend streams are being discounted too heavily by investors when arriving at the price they will pay for shares. By identifying quality companies in possession of economic moats, we believe we can be more confident in the delivery of future profits and, by extension, more secure or greater dividends.
- Special situations** – where there are opportunities for corporate change that will drive improved dividends. Sometimes companies will have opportunities to restructure their ongoing dividend profile, perhaps by paying out a large special dividend or enhancing the ongoing dividend by utilising an overly-large cash pile on the balance sheet, or other form of restructuring. Under such circumstances, a company can re-rate as well as produce additional income.

Identifying stocks

As we have detailed above, we seek to identify companies with superior dividend potential relative to the market’s expectations that are attractively valued and have unrecognised growth potential.

To narrow down our focus when selecting stocks, our starting point is to find those companies with the requisite dividend yield for inclusion in our portfolio. To ensure our portfolios are liquid, we typically use a market capitalisation cut-off point of around £500m, although we will occasionally make investments below this level where the investment case is particularly strong and the impact on the portfolio’s liquidity is minimal.

There are approximately 500 such liquid stocks in Europe excluding the UK. This list is then reduced further by identifying those companies with long-run sustainable or growing dividends, leaving around 200 companies that can potentially be included in our portfolios.

The next stage is to highlight stocks that have high or low operational or financial gearing; superior or inferior returns on invested capital; strong or weak balance sheets; consistent or inconsistent profit margins; high or low valuations and for which market estimates of future profits are being upgraded or downgraded by market analysts. These are the stocks that exhibit signs of mispricing and may fit into one of our three groups: growth opportunities, value opportunities and special situations.

Having identified interesting stocks, we undertake more in-depth analysis to ensure they meet our criteria and are being mispriced by the market.

This typically involves analysing the company on a quarterly basis along with the annual report and accounts, meeting management for less well-covered companies and comparing our thoughts on the company and valuations to those of leading sector analysts.

Each stock is assessed according to the valuation framework comprising a number of valuation ratios. This enables us to compare valuations of companies across countries and sectors to identify opportunities where the current share price of the company fails to reflect its fundamental value in absolute terms or relative to its peers. These ratios include free cash flow, dividend yield, dividend cover, price to book, price to sales and price to earnings. The most appropriate metrics depend on the sector in which the company operates, such as price to book for financials and price to sales for industrials. There is no one definitive metric for any one stock, although the ability and commitment to pay a strong dividend is obviously key, even if for certain reasons that may occasionally not be the case currently. Every position in the portfolio is usually expected to contribute to the yield within a two-year timeframe, although this does permit us to hold investments which are not currently paying a dividend but are expected to do so in the near future.

We also generally look for a high return on equity (ROE), which measures how much profit a company is able to generate relative to its shareholders' capital. Generally, high levels of profits relative to low levels of capital provided by shareholders is a desirable characteristic and normally a reflection of a well-managed company able to sustain high profit margins through a strong competitive advantage. A high ROE usually means the company can generate further growth in profits without spending significant amounts of additional money on capital expenditures. This gives the company the ability to pay generous dividends without compromising its growth prospects.

For a comprehensive list of common financial words and terms, see our glossary at: <https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms>

Companies can artificially inflate ROE, however, through the use of debt-financing relative to equity or other accounting techniques so we look to avoid those companies that have inappropriate levels of leverage. We also analyse the current point in the business cycle and overall economic environment as discussed below as well as the robustness of the business model and the unique risks for each individual stock.

Economic environment and business cycle

Companies operate in the global economic environment, which will in varying degrees affect their ability to produce earnings and pay dividends. These macroeconomic considerations play a part in investment considerations but the extent of this, as well as the importance of country of domicile when analysing companies, also largely depends on the nature of a business. Italian banks for example are closely tied to the fortunes of their local economy, whereas, a company such as Roche Pharmaceuticals is very much a global enterprise that happens to be headquartered in Switzerland. As such, Roche is far more dependent on US politics than Swiss GDP, and must be analysed accordingly.

Portfolio construction

We adopt a high conviction, concentrated approach to portfolio construction, combining the best of the growth, value and special situations investment opportunities identified. In normal market conditions, our portfolios typically contain investments in 40 to 60 companies in total. The size of each position is based on the valuation framework (cheaper stocks may have larger weightings) and also takes into account risk considerations (the risk of the identified opportunity not playing out as expected), conviction of each position's investment thesis (our opinion of the company strategy and ability to implement its strategy) and liquidity (less liquid positions may have smaller holdings).

Once an initial portfolio has been constructed as above, we will examine the portfolio as a whole to ensure the bottom-up stock selection process has not resulted in any unwanted portfolio biases, such as macro, country, currency and sector along with other portfolio factor exposures like sensitivity to oil price changes, exchange rates or interest rate moves. Although predominately a bottom-up process, focusing on the merits of the individual stocks, our portfolios aim to be as diversified as possible by sector and country. Individual position sizes are limited to a maximum of 5% of net asset value to avoid excess concentration risks in single stocks. Positions in our portfolios are sold when we believe the original investment thesis is no longer valid, better investment opportunities are identified or an investment reaches fair value and offers limited upside.

Liontrust Fund Partners LLP, 2 Savoy Court, London WC2R 0EZ

☎ Client Services: +44(0)20 7412 1777

✉ Email: clientservices@liontrust.co.uk

🌐 Website: www.liontrust.co.uk



Key Risks: Past performance is not a guide to future performance. Do remember that the value of an investment and the income generated from them can fall as well as rise and is not guaranteed, therefore, you may not get back the amount originally invested and potentially risk total loss of capital. The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term. Investment in Funds managed by the European Income team involves foreign currencies and may be subject to fluctuations in value due to movements in exchange rates. The Fund's expenses are charged to capital. This has the effect of increasing dividends while constraining capital appreciation. Investment in the Liontrust European Enhanced Income Fund writes out of the money call options to generate additional income. These call options will be "covered". Unitholders should note that potential capital growth of the Fund would be capped if these call options are exercised against the Fund and the Fund's capital returns could therefore be lower than the market in periods of rapidly rising share prices. Issued by Liontrust Fund Partners LLP (2 Savoy Court, London WC2R 0EZ), authorised and regulated in the UK by the Financial Conduct Authority (FRN 518165) to undertake regulated investment business. Always research your own investments and please consult suitability with a regulated financial adviser before investing. 2018.03. [18/191]