



RATHBONE UNIT TRUST MANAGEMENT
FUND MANAGEMENT FOR YOUR INVESTMENT NEEDS

RATHBONE BLUE CHIP INCOME AND GROWTH FUND

INVESTMENT PRINCIPLES & PROCESS

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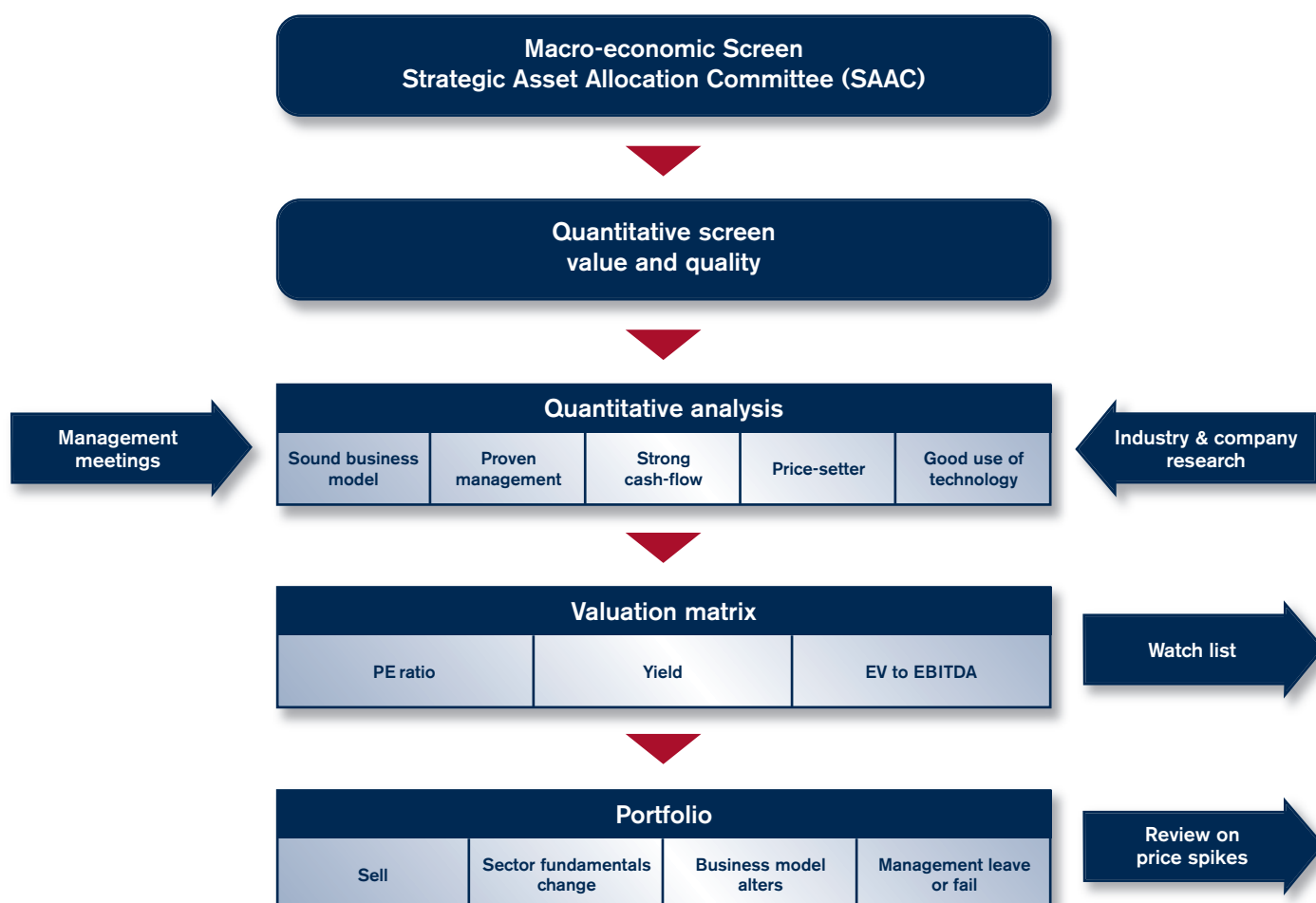
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INVESTMENT PROCESS

Overview

The Rathbone Blue Chip Income and Growth Fund is a low turnover, UK-focussed fund which will hold between 25-35 high conviction ideas. The fund will utilise Rathbone's asset allocation process to put in place a macroeconomic overlay and then draw on the manager, Julian Chillingworth's 30 years of stockpicking experience to construct a high quality portfolio which will principally be invested in FTSE 100 stocks, (70-90%), the remainder of the portfolio will be invested across the market capitalisation range. The fund is benchmark-aware but will, from time to time, have no exposure to major sectors if the manager believes they do not offer value. The fund aims to pay a dividend ahead of Consumer Prices Index (CPI), and has raised the distribution for 19 out of the last 20 years.

Process chart



INVESTMENT PHILOSOPHY

The overriding philosophy of the fund is long-term wealth creation for our investors, with a five to twenty-year view. We seek highly cash-generative businesses, which are transparent, and espouse sustainable business models and competitive positioning. We do not believe in being all things to all people, but in the credibility of a focused list of high conviction ideas. Finally, hand-in-hand with our aim is our zero tolerance towards capital erosion. This means being cognisant of current risks but also the irrational tendencies of markets, we believe that the past should not be a guide to the future but an illustration of human frailty and should be borne in mind when looking at stocks. We maintain that if there is any doubt about a business or its management, we sell.

Stage one: *Macroeconomic overview*

The first stage in the process is to formulate a macroeconomic overview which is used by the manager as a high level overview of how the economic cycle is evolving. The fund manager is an executive member of Rathbone's Asset Allocation Committee, which meets on a monthly basis, and formulates Rathbone's policy on the outlook for GDP growth, inflation and interest rates, globally. This overview informs the fund's sector weightings.

Stage two: *Quantitative screen*

An in-house proprietary screen has been developed which focuses on quality and value in order to generate a list of interesting ideas which may be included in the portfolio (see Appendix). The qualitative analysis is the over-riding determinant when constructing the portfolio.

Stage three: *Qualitative analysis*

Qualitative analysis is at the heart of the process and where the manager aims to add the most value.

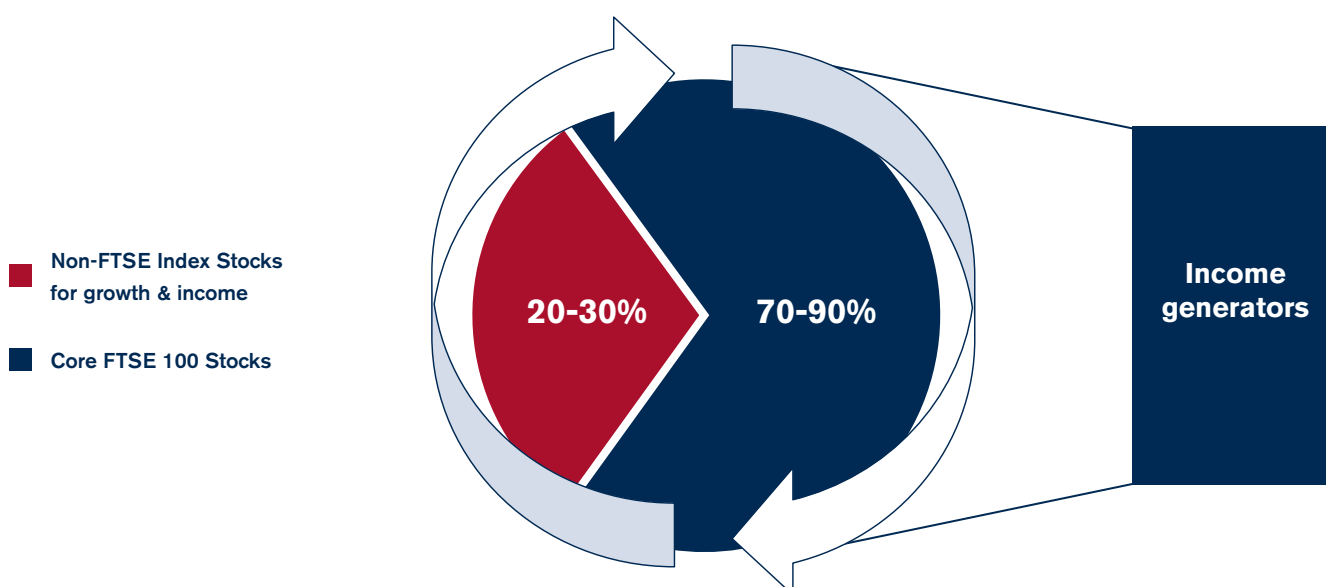
The majority of ideas are internally-generated, making use of our proprietary quantitative stock screen, and industry and company research. The fund manager also chairs Rathbone's Stock Selection Committee, and is therefore in constant discussion regarding ideas.

Firstly, the quality and credentials of the management team are assessed, and their track record reviewed. We meet all of the management teams of our stock ideas before their inclusion in the portfolio; these are reviewed at least once-a-year thereafter. The company's business model is thoroughly scrutinised to check its sustainability. Crucially, we examine what might cause the model to break down and the business to fail. The company's product or service must be a price-setter and be able to retain its competitive positioning within its sector. In an ever-evolving world, it must also demonstrate the smart use of technology to enhance its business. Experience dictates that deeply cyclical businesses do not score well on these criteria, so we do not invest in automotives or airlines.

Stage four: *Valuation screen*

The profit and loss accounts, and balance sheet are thoroughly analysed. The most important element for us is the consistent generation of cash, which can be used to grow the business and drive the dividend. The aim is to buy into an idea we like on a reasonable valuation, which reflects a combination of metrics: price/earnings, yield and EV/EBITDA (enterprise value/earnings before interest, taxes, depreciation, and amortization). Not only do the current ratings have to be attractive, but we have to see a good progression in terms of cash generation and earnings. Stocks which are viewed as expensive but where the business models are strong, they are placed on a watch list.

Portfolio construction and risk management



INVESTMENT PHILOSOPHY (CONTINUED)

In terms of market capitalisation, the fund will typically hold between 70-90% in FTSE 100 stocks, and these investments will provide the bulk of the income that the fund distributes. The remainder of the portfolio can be invested in stocks in the FTSE 250 index through to the AIM market. It is not necessary for a stock to pay a dividend to be included in the portfolio, but it must exhibit strong prospects of doing so over a reasonable time-frame.

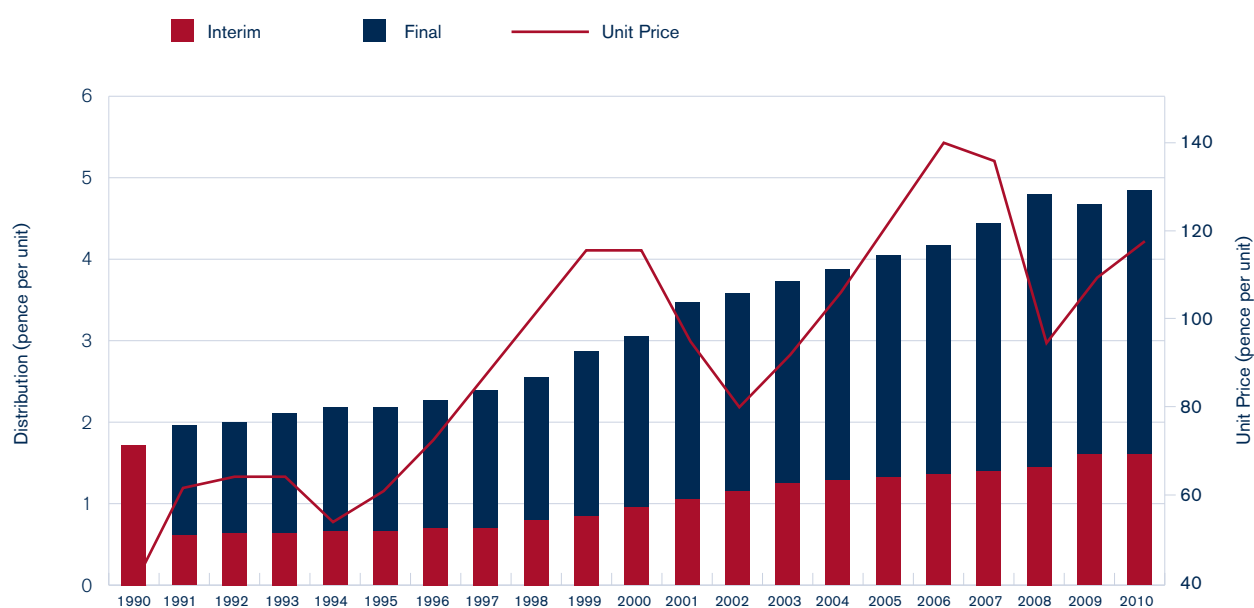
The portfolio has no explicit sector restrictions, but in constructing the portfolio, the manager is benchmark-aware and will evaluate the risk of overweighting or underweighting a major sector versus his macro view and any stock-specific valuation metrics. The pharmaceutical sector is a good example of a strong conviction view where there is zero weighting.

At any given point, the portfolio will own between 25 to 35 names, and individual stock positions will range from 3% to 5% for FTSE 100 stocks and 1% to 4% for non-core holdings.

Sell discipline

Out- and underperformance spikes are reviewed – that is 15% relative out- or underperformance against the FTSE All-Share index, although this does not lead to an automatic expulsion from the portfolio. The fund manager takes a long-term view on the investments in the portfolio; however disposals will be made if the management teams are deemed to have failed, or have meaningfully moved the business away from the original model or rationale. Equally, deterioration in fundamentals, be it at macro or micro level, will lead to an automatic review.

Dividend distribution history – 1990 to 2010



Source Rathbones, fund price based on bid prices.

The fund aims to increase the dividend distribution in excess of the CPI every year. Over the last 20 years, it has achieved an increase in its distribution for 19 calendar years out of 20.

APPENDIX

The screen

The majority of research is conducted internally, and all decisions are based on strict value-based investment principles. Although the process is more qualitative than quantitative, screens are used at a preliminary stage to help the discovery of new opportunities. They are also used extensively to monitor the relative attractions of existing investments. In particular, a proprietary Quality & Value Screen is used to rank the investment universe by two simple quantitative metrics. Earnings yield (EY) is used to measure value, where $EY =$

$$\frac{12 \text{ Month Trailing EBIT}}{\text{Enterprise Value}}$$

Earnings yield is simply the inverse of a P/E, but in order to focus on cash-flow and compare companies with different capital structures, earnings before interest and tax (EBIT) and enterprise value (market capitalisation plus net debt) are used instead of earnings per share and market price.

Earnings yield is equally weighted in the screen with our measure of quality being return on invested capital (ROIC), where $ROIC =$

$$\frac{12 \text{ Month Trailing EBIT}}{\text{Max (0, Net Working Capital) + Net Fixed Assets}}$$

And where net working capital = (current assets – cash) – (current liabilities – short-term debt), and net fixed assets = fixed assets – accumulated depreciation. Hence companies are not penalised for holding cash on their balance sheet, and short-term debt is considered to be a form of operating finance.

Short Name	ICB Sector Name	Current Marke	Div Yld	Return on	RoC R	Earnings	EY Ran	Score	Quintil	Op Mar	EV/Sal	LT Rati
2 ERGO GROUP	Mobile Telecommunications	22,661,840	0	25.2%	328	6.8%	390	718	3	-7.2	0.9	-1.25
New 2CTA SPA	Electronic & Electrical Equipmen	21,592,590	0	-222.4%	698	-18.7%	719	1417	5	-2896.9	64.8	-0.22
4IMPRINT GROUP	Media	54,652,768	6.698	16.6%	404	6.5%	404	808	4	3.6	0.3	0.96
888 HOLDINGS	Travel & Leisure	172,382,096	5.24	133.9%	99	14.8%	113	212	1	12.3	0.8	0.62
ABCAM PLC	Pharmaceuticals & Biotechnolog	557,234,880	1.062	273.8%	52	4.2%	498	550	2	34.9	8.0	2.29
ACAL PLC	Support Services	56,410,432	3.918	-2.9%	583	-1.9%	621	1204	4	0.9	0.2	2.58
ACCSYS TECHNOLI	Construction & Materials	56,866,240	0	-50.1%	663	-35.3%	732	1395	5	-131.2	3.0	-0.23
ACM SHIPPING PLC	Industrial Transportation	34,975,528	5.816	1913.2%	5	24.5%	33	38	1	39.3	1.2	0.30
ADVANCED COMPUTE	Software & Computer Services	117,110,600	0	104.0%	124	2.5%	531	655	3	13.0	5.2	3.99
ADVANCED MEDICAL	Health Care Equipment & Service	78,988,912	0	31.3%	281	6.0%	426	707	3	26.0	3.2	1.23
AEA TECHNOLOGY	Support Services	38,894,248	0	273.7%	53	16.5%	89	142	1	11.6	0.6	0.48
AEGIS GROUP	Media	1,390,642,944	2.33	242.4%	55	9.0%	295	350	1	15.0	1.2	0.80
AFC ENERGY PLC	Electronic & Electrical Equipmen	31,306,120	0	-104.0%	684	-8.1%	682	1366	5	-4740.0	575.1	-1.21
AFREN PLC	Oil & Gas Producers	854,584,832	0	9.2%	489	3.4%	520	1009	4	19.2	3.9	2.03
AFRICAN BARRICK	Mining	2,206,259,968	0.2102	9.2%	488	5.3%	452	940	4	22.5	3.4	1.53
AFRICAN CONSOLID	Mining	34,019,728	0	-348.5%	709	-4.4%	649	1358	5	No Sales	No Sales	N.A.
AFRICAN COPPER P	Industrial Metals & Mining	28,820,030	0	-15.5%	626	-23.9%	725	1351	5	-159.5	10.5	-0.66
AFRICAN DIAMONDS	Mining	26,594,670	0	-45.7%	659	-1.8%	620	1279	5	No Sales	No Sales	N.A.
AFRICAN MEDICAL	Health Care Equipment & Service	25,705,130	0	-74.8%	676	-10.7%	693	1369	5	-104.0	19.4	-1.87
AFRICAN MINERALS	Mining	1,123,106,944	0	-1.8%	577	-0.1%	575	1152	4	-1027.5	7572.1	-73.70
AGA RANGEMASTER	Household Goods & Home Const	64,389,552	0	5.3%	531	7.3%	369	900	4	2.8	0.2	0.53
AGGREKO PLC	Support Services	4,297,821,184	0.8929	34.7%	262	5.9%	433	695	3	28.3	4.4	1.54

APPENDIX (CONTINUED)

In a back-test of the screen for which historic UK data was available, the top quintile outperformed the universe by 4% per annum on a weighted average basis over 19 years. An equal-weighted portfolio of the top 30 stocks outperformed the top quintile by 2.7% per annum.

The UK screen is used in conjunction with European and global versions to place the UK stock universe in a wider context. Other ideas are initiated through broker and industry contacts. As value investors, we like assets that are marked down to low valuations. However, we also like businesses that take a little cash to produce a lot more. A preference for capital-light businesses with high ROIC (return on invested capital) tends to favour certain industries over others. Thus asset-rich, cash-poor companies (many property companies, miners, oil and gas, exploration and production companies etc.) will often screen poorly. Many financials and all utilities are actually removed from the Quality & Value screen since differences in their capital structures make their inclusion problematic for comparison purposes. This is not to say that these businesses are uninvestible; we continue to invest in financials, utilities and natural resource companies when they fit our investment criteria. For these sectors, however, earnings yield, return on equity, tangible book value, and various sector-specific measures of solvency are used as initial screens for quality and value.

Screening is the beginning of a much longer research effort during which subjective filters are applied. Once a stock idea is identified, the investment process becomes intensive and includes meeting company management and industry experts; many hours reading corporate report and accounts, and the thorough review of historic financial data. External research is used to cross reference our own work, especially for larger companies. The investment process makes a virtue of clearly understanding a company's long-term operating and corporate history. Bloomberg and Collins Stewart's Quest platform are important sources for us for this kind of company data.

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