



RATHBONE UNIT TRUST MANAGEMENT
FUND MANAGEMENT FOR YOUR INVESTMENT NEEDS

RATHBONE ETHICAL BOND FUND

INVESTMENT PRINCIPLES & PROCESS

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INVESTMENT PHILOSOPHY

This is a high conviction fund, typically with 80 to 100 holdings, with the top ten of those often making up more than 20% of the fund. The fund is managed with a blend of top-down and bottom-up approaches. We like to marry the macro research process with micro research processes. Both processes are highly influenced by a thematic investment style. Cash-flows are key as too are fundamentals within a company's balance sheet. After we have applied these techniques we look at the opportunities that exist from a valuation perspective and try to identify undervalued assets based on our views.

INVESTMENT PRINCIPLES

High Level Definition

- Quality investment – grade bonds.
- Aims for a gross interest yield of 5% to 7% (depending on market conditions, before fees and taxes).

Philosophy of investment principles

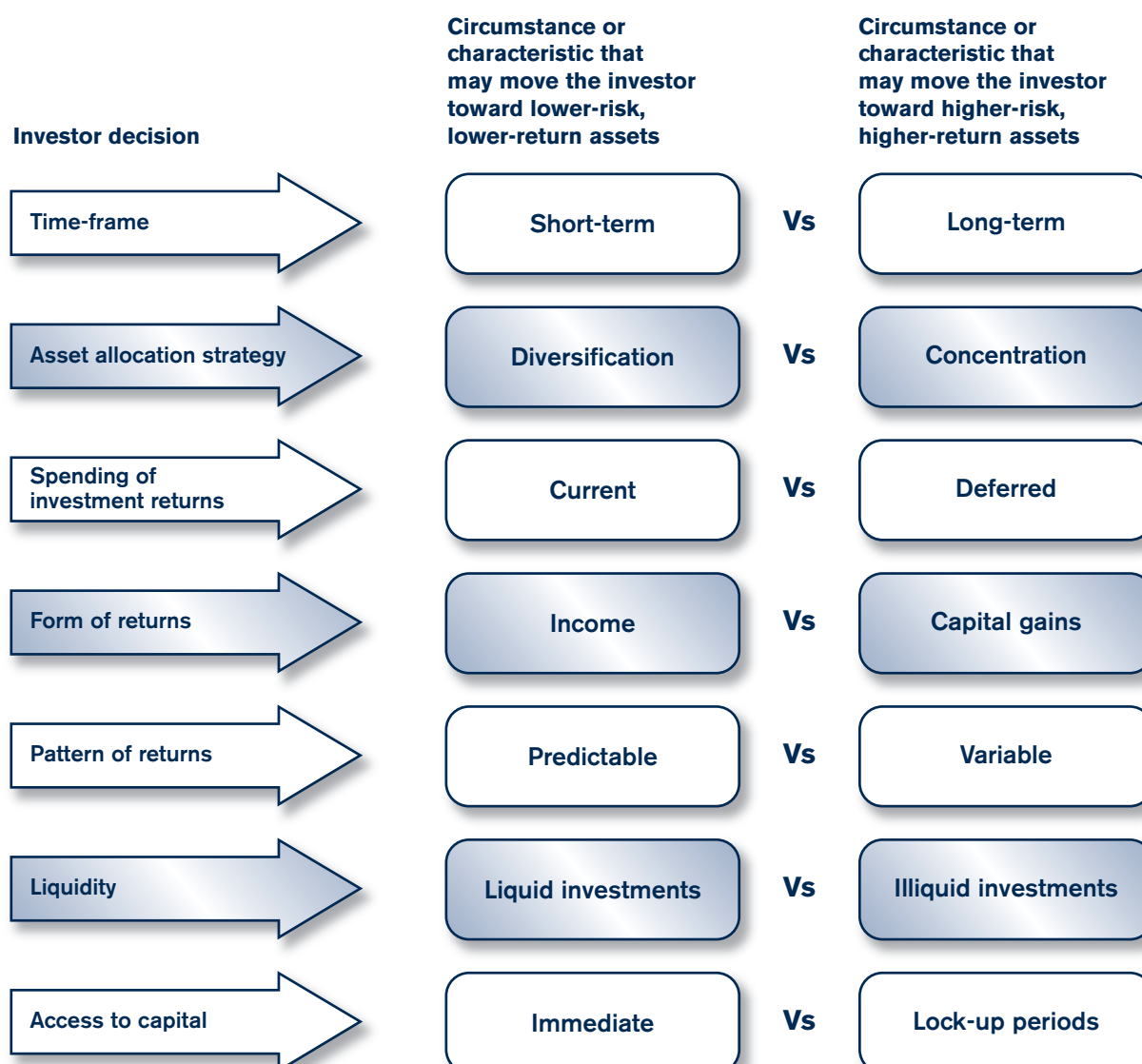
History, the present and future expectations shape the different investment trade-offs in investment decisions. There are different emotional decisions that may lead the fund to invest in one investment over another.

Asset allocation trade-offs

It is important to highlight an important part of the investment decision making process and how it affects the management style of the bonds in the fund. Often this area is not conceptualised by managers across the industry. Quite often there are characteristics and circumstances that will dictate whether we will hold a higher risk asset or a lower risk asset.

In general, lower risk assets may be held for shorter time frame, for income, as their characteristics are predictable and the liquidity means that they can be bought or sold at little cost. An example would be an AAA rated supranational that may be bought to add or reduce duration. Higher risk investments may be held for longer time frames and in greater concentration, and not purely for income but to generate a capital gain. The volatility can be higher and the characteristics of a low liquidity often require longer holding periods.

The diagram below puts this into graphical form.



INVESTMENT PRINCIPLES (CONTINUED)

The 'four Cs plus'

These decisions are primarily taken, based on the core investment principle of the 'four Cs plus' model. This is a text book way of managing fixed income assets, with the added level of investment philosophy of **Conviction**. The four Cs are:

Character – Looks at management integrity, and the likelihood of repayment of loans. Operating records of management are important.

Capacity – Looks at the availability of cash-flows and assets to repay its obligations.

Collateral – Looks specifically at assets offered as security as well as other assets managed by the company.

Covenants – This looks at the prospectus and the details within that affect the lending agreement and any restrictions on the bond.

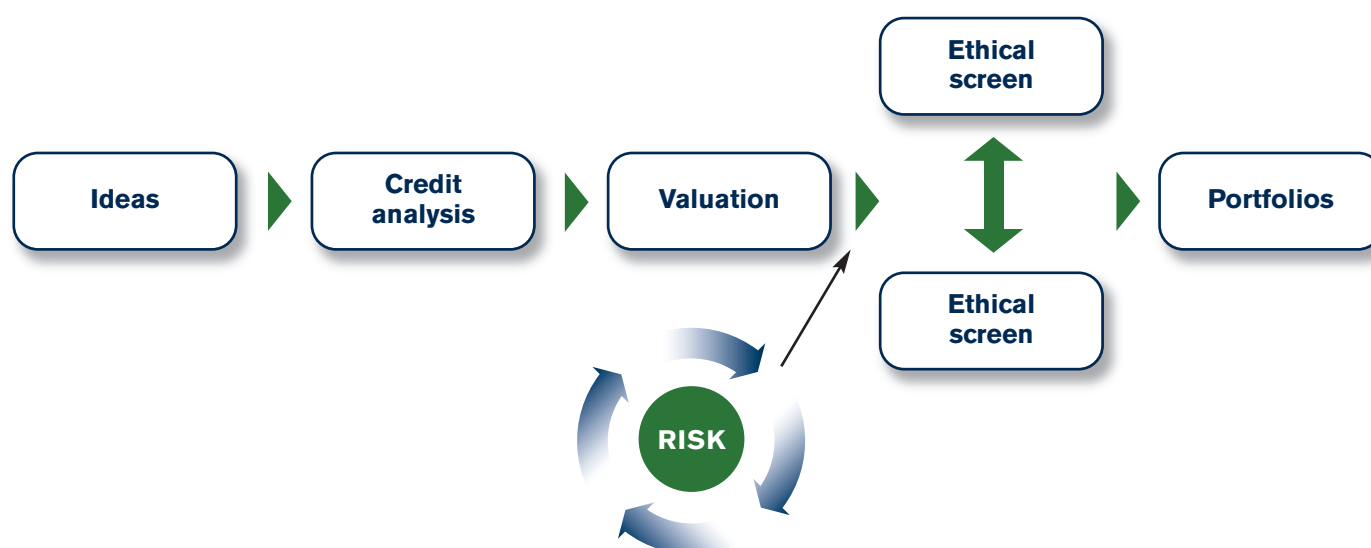
The plus is:

Conviction – To achieve long term above average performance, investors must think differently to the market. This may involve contrarian investing, a sceptical evaluation of orthodox thinking, patience and discipline, but ultimately a determined conviction.

INVESTMENT PROCESS

The process has various layers to achieve superior results:

- 1) Theme-based investment – idea generation
- 2) Credit analysis – the 'four Cs plus' model
- 3) Valuation – relative value
- 4) Evaluation of risk
- 5) Ethical screen.



INVESTMENT PROCESS (CONTINUED)

1. Theme based investment

The thematic approach is where the process starts. Individual ideas are generated from a blend of top-down and bottom-up views. It is quite often problematic to quantify specifically how the themes are developed. Themes are developed from all the opportunity sets based on our macro research and the thought processes that go into the development of those analytics. There is no distinct value of how much is assigned to short-term and how much is assigned to longer-term investments. What is important is that all investment themes are not always executed – the final weight is as a result of the current opportunities that exist.

A list of areas where themes are generated from are included below. This is not an exhaustive list, but gives a general view of how ideas are generated.

- Macro
- Sectoral
- Regional
- Supply
- Demand
- New issuance
- Regulatory issues
- Interest rate policy

2. Credit analysis

Once the themes have been developed we then carry out credit analysis to find assets that are best within the thematic framework. Here we carry out the core investment principles of the ‘four C’s plus’.

‘Kick the tyres’

Our financial analysis highlights how reported results cannot show the in-depth picture we need. Cash-flows are important. We identify and quantify existing and potential cash obligations, including those off balance sheet.

A house is only as good as its foundations

Some companies with strong operations fail to achieve a strong credit profile because of an unsound capital structure.

Character – we meet management when we can and investigate the management’s ability to react to events, we focus on strategic direction, financial philosophy, conservatism, track record, succession planning and risk control systems.

Capacity – we look at:

- Sources of liquidity – working capital, cash-flows, back-up facilities, securitisation, guarantees.
- Traditional ratios – short-term solvency, capitalisation, coverage tests.
- Cash-flow analysis – cash flow from operations, free cash-flow (FCF).

Collateral – here we look at the assets that are pledged. This impacts our view of covered bonds and Mortgage Backed Securities (MBS).

Covenants – this has become increasingly important. This can help protect us from anything from a Leveraged Buy-Out (LBO), other corporate event, asset price declines within the collateral, to something like a large increase in leverage.

There are two types of covenants:

- Affirmative Covenant – the debtor has to do certain things
- Negative Covenant – Prohibits the debtor from doing certain things.

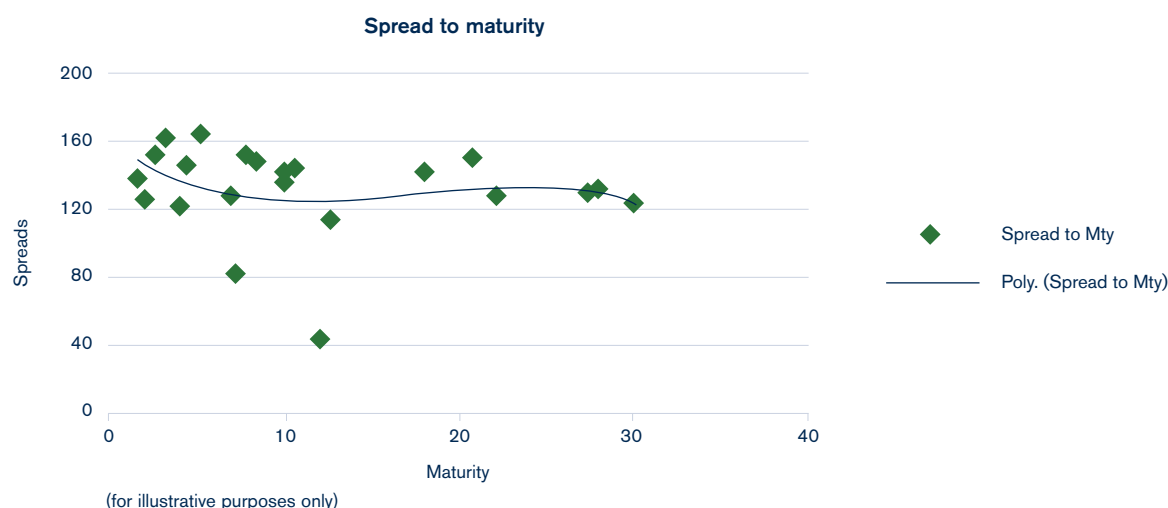
We take a view on these covenants and they provide an important extra level of analysis to extract value.

INVESTMENT PROCESS (CONTINUED)

3. Valuation

Once we have developed themes and carried out in-depth credit analysis, we then carry out valuation of bonds in the market. This looks at bonds, where they sit on credit curves, and looks at relative value trades. Below are bonds spread-to-asset-swap-maturity. Bonds that fall above are cheaper than bonds below the line, within the context of the ‘four Cs plus’ modelling.

Credit curve



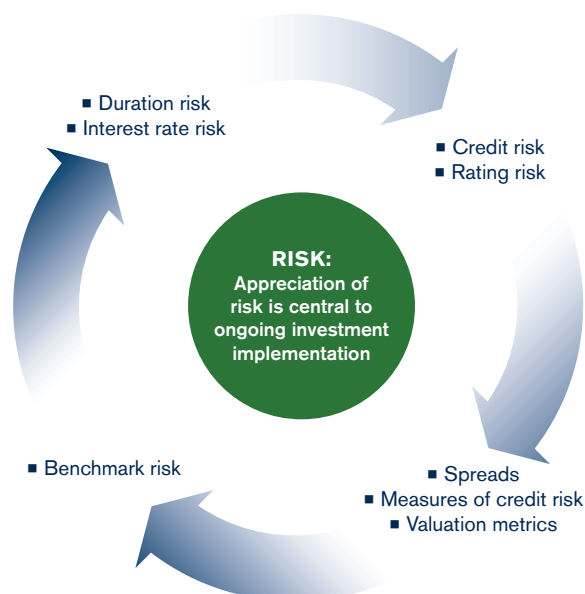
Unlike other funds, we also try to identify bonds that despite their weaker credit analysis score are technically too cheap. As per the investment principles we would look at short term strategies in this space.

New issue markets can add an extra level of alpha here.

4. Risk framework

So we have generated the investment idea from the thematic approach, carried out fundamental research and looked at valuations of bonds. However, the implementation of the investment needs to go through a risk framework before inclusion in the fund. The risk monitoring does not lead the investment management process. The previously mentioned stages lead the process. We follow a basic principle to credit risk that applies to the process and that is single issue exposures.

- AAA maximum single issue 5%
- AA maximum single issue 4%
- A maximum single issue 3%
- BBB and other maximum single 2%



INVESTMENT PROCESS (CONTINUED)

5. Ethical overlay

So after the processes have been completed above an extra level of process is applied which is the Ethical Overlay. This consists of primarily negative screening. After which if the investment passes the negative screening process, we apply a positive screening process.

Our process – overview

1. The fund manager will first identify corporate bonds that represent an attractive investment proposition.
2. Companies issuing these bonds will then be investigated by Rathbone Greenbank's ethical researchers, based in Bristol.
3. Issuing companies involved in any activities that fall into the categories outlined by negative criteria will not be considered for inclusion in the fund universe.
4. Issuing companies demonstrating well-developed policies and practices in at least one of the positive areas will be included in the fund universe, provided they are not involved in any areas of negative concern.
5. Companies identified as being suitable at this stage will then be subject to the consensus approval of at least two senior members of the Rathbone Greenbank team.
6. An annual review meeting for the Rathbone Ethical Bond Fund will be held involving the researchers, the fund managers and representatives from Rathbone Greenbank Investments and Rathbone Unit Trust Management. This meeting takes place before the annual short report is issued. The portfolio, criteria, investment process and research process are all reviewed. The criteria and portfolio content will be confirmed (or not).
7. The annual short report of the fund will contain summary details of the portfolio and an ethical report. This will include details of any proposed amendments to ethical criteria or to the screening process. Comments and feedback on any aspect of the fund are welcomed.
8. If any proposed changes attract significant comment, there is an ad-hoc meeting to review comments and determine action. Any changes are confirmed in the interim report (if appropriate).

Who are Rathbone Greenbank Investments?

The ethical research for the fund is carried out by Rathbone Greenbank Investments, the award-winning specialist ethical investment unit of Rathbone Investment Management Limited (part of Rathbone Brothers Plc). The team at Rathbone Greenbank has been at the forefront of developments in the ethical investment industry since 1992, launching one of the first bespoke ethical portfolio services.

Since 1997, when the team joined Rathbones, Rathbone Investment Management has offered a dedicated responsible investment service.

In 2004, this unit was formally rebranded as Rathbone Greenbank Investments and now works with over 500 individuals and charities, managing in excess of £350 million.

INVESTMENT CRITERIA

Exclusions

The fund shall exclude bonds issued by companies wholly or predominately involved in the following activities or whose ultimate holding company is similarly involved:

Alcohol – companies involved in the production of alcoholic beverages.

Animal testing – companies providing animal testing facilities, or those which use animals in the discovery or development of pharmaceutical or healthcare products; manufacturers or retailers not adopting a fixed cut-off date policy with regard to the testing of cosmetic or household products (and their ingredients) on animals.

Armaments – manufacturers or vendors of strategic weapon systems, ordnance or combat vehicles.

Environmentally unsustainable or high-impact activities – companies involved in mineral extraction, fossil fuel exploration and production, quarrying, agrochemical production, production of genetically modified seeds or foodstuffs; sale of hardwood products from non-sustainable sources; motor car manufacturing, or road building. Also, companies with convictions for serious or persistent pollution offences.

Gambling – companies operating betting or gaming facilities (including casinos, betting shops and internet-based services).

Nuclear power – companies involved in the construction of nuclear power plants, the generation of electricity from nuclear power, or the handling or reprocessing of radioactive waste.

Pornography – companies involved in the production or sale of pornographic material.

Tobacco – manufacturers of tobacco or tobacco products.

Positive aspects

To qualify for inclusion in the fund's universe, companies issuing bonds should demonstrate progressive or well-developed practice or policies in one of the following key areas:

Corporate community investment – companies should demonstrate long-term involvement in programmes of benefit to the community, either via cash donations or gifts in kind (e.g. staff time, use of buildings or office facilities) or membership of corporate donation benchmarking groups such as Business in the Community's PerCent Club or the London Benchmarking Group.

Employment – companies should demonstrate a commitment to workplace diversity and equal opportunities; additionally they could facilitate employee work/life balance by offering flexible working arrangements, carers' leave and/or childcare facilities.

Human rights – companies should comply with local and national standards in accordance with minimums set by the International Labour Organisation and United Nations Universal Declaration of Human Rights. Alternatively, companies may implement their own codes of conduct to ensure compliance with local laws covering child labour, working conditions and health and safety.

Management of environmental impacts – companies should have a clearly defined and published policy for managing their environmental impact. This should include monitoring and reporting on progress against key performance indicators in areas such as waste disposal and recycling, consumption of resources, emissions to air, and discharges to land and water.

Provision of beneficial products and services – companies should be involved in providing products or services that offer social or environmental benefits. Such activities might include designing or implementing cleaner or more efficient industrial processes; companies involved in enabling compliance with health and safety legislation; supplying educational products or services; providing waste recycling or acceptable forms of waste management (excluding energy-from-waste incineration); providing social housing; manufacturing, installing or operating renewable energy infrastructure; building or operating sustainable transport systems.

You should be aware that the criteria on this page may be subject to change.

The information contained in this document is for use by investment advisers only and must not be circulated to private clients or to the general public.

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