RATHBONE UNIT TRUST MANAGEMENT
FUND MANAGEMENT FOR YOUR INVESTMENT NEEDS

Rathbone Income Fund

Investment principles & process

Executive summary

An actively-managed, long-only unit trust

- Invests in large, mid, and small cap UK equities with a focus on dividend-paying stocks, trading at a large discount to fair value.
- Flexibility to invest up to 20% in other listed securities, including overseas equities.
- Securities weighted in the portfolio by total expected return rather than by benchmark weighting.

A focus on investment process to determine investment outcomes

- Risk management defined by capital protection.
- Contrarian approach, underpinned by a process that encourages conviction to step beyond benchmarks and short-term trends.
- *Long-term investment, not short-term speculation.*

High conviction strategy

- Portfolio turnover is low as the investment team 'buy and hold' for compound income and capital returns.
- Concentrated portfolio of 30 to 50 companies.

Benchmark

- Well-known indices and peer group benchmarks are used as measures of relative performance, but *never* as guides to portfolio construction.

Experienced and stable portfolio management team

- Lead manager in place since January 2000.

Fund Manager: Rathbone Unit Trust Management Limited

- Wholly owned subsidiary of Rathbone Brothers Plc, a FTSE 250 index company.

Investors frequently refer to *risk*, *quality,* and *value*, to justify their investment decisions. Few care to document what they mean by these terms and how their analysis affects their strategy. In the following pages we explain our core principles, insights and methods. The concepts of risk, quality and value are defined in a simple and straightforward way. We then describe how our understanding of these terms informs a strict investment process. Our aim, by taking time and effort to explain our process, is that clients will have clearer expectations about what the fund should achieve and the context of its returns. Better informed clients make better partners; more prepared to sit through the 'lean' times and look forward to 'fatter' days.

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Summary investment principles

Stock selection is governed by **10 core investment principles:**

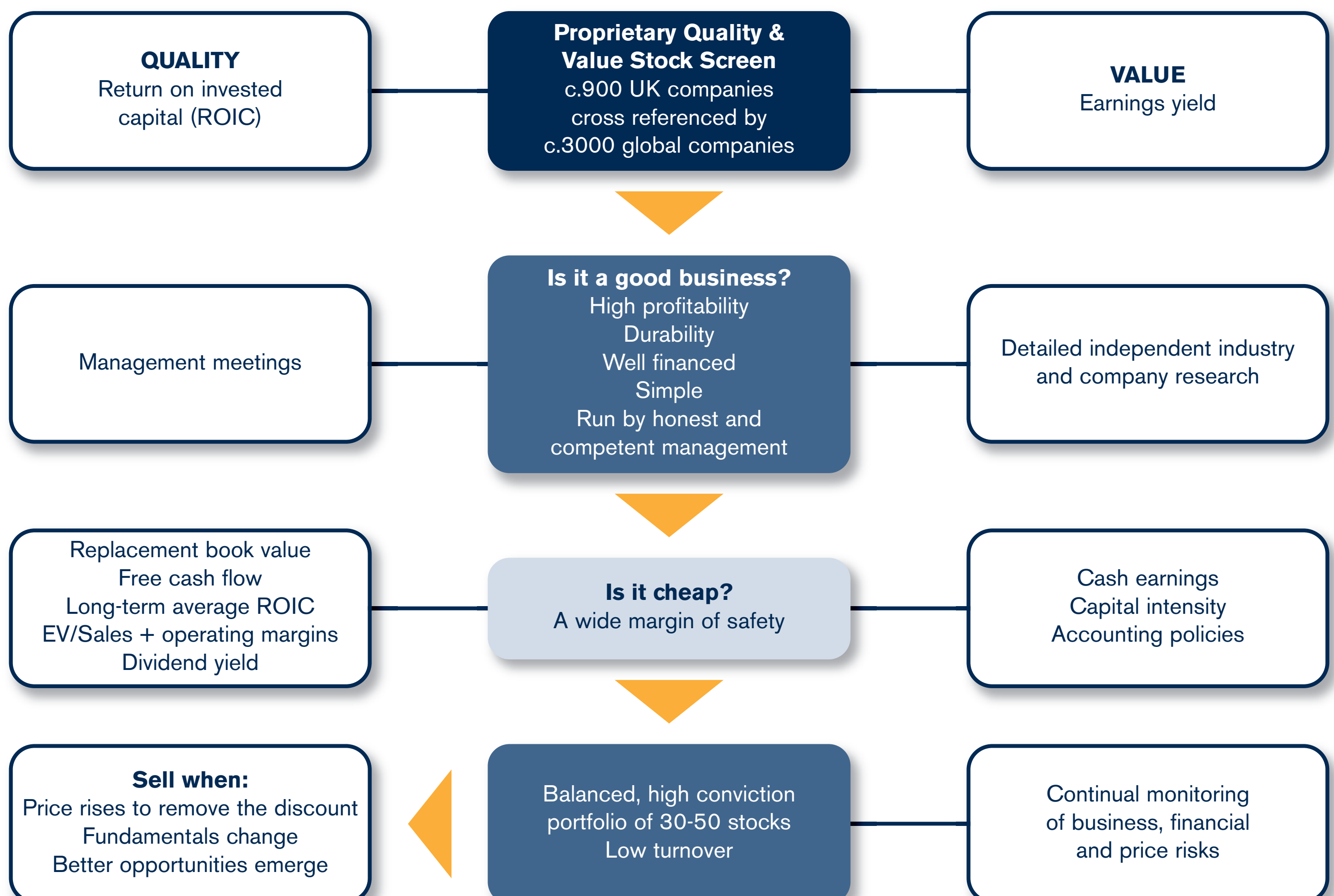
1. **Share prices will reflect underlying corporate performance over time.**
2. **Prices fluctuate more than underlying business values.**
3. **A long-term perspective is a competitive advantage.**
4. **For above-average results, investors must think and act differently to the rest of the market.**
5. **Risk is defined as a permanent loss of capital, and usually comes from overpaying, or misjudging company finances or fundamentals.**
6. **A conservative approach will include a margin of safety to minimise the risk of permanent losses, brought on by miscalculations and bad luck.**
7. **A clear, simple, and rational investment process is vital for investment success over long time periods.**
8. **By buying and holding investments that pass our strict investment criteria, investors should benefit from the compound growth in capital and dividends.**
9. **All investors (fund managers in this case) will perform poorly from time to time.**
10. **Dividend investing is important for the achievement of superior long-term results.**

Summary investment process

The investment process is formed using our 10 core investment principles, and revolves around the three areas of *risk management*, *quality* and *value*. Risk management comes first because our understanding of this concept directs our stock selection.

- **Risk Management:** A risk-based approach is aimed at minimising risk to maximise returns. Risk is defined as a permanent loss of capital and derives from three principal sources: deteriorating earnings power (business risk), too much debt (financial risk), overpaying (price risk).
- **Quality:** Business and financial risks are minimised by investment in a narrowly defined group of companies that exhibit:
  – High profitability
  – Durability
  – Low leverage
  – Simplicity
  – Honest and competent management.
- **Value:** Good investments are made when quality companies are purchased at attractive valuations, thereby minimising price risk.

Ideas are generated through a number of sources including a proprietary screen of stocks. All investments undergo intensive due diligence which gives us the confidence to make significant investments in a select group of best ideas.



Investment principles

Mainstream markets are large, well-followed, and liquid. Many heavily incentivised, educated investors scrutinise the same information, and their actions and diverse opinions quickly incorporate news into asset prices. Mispricings are rare and rough efficiency is the norm. However, discrepancies do happen in individual shares, sectors, and whole markets. Investors are not the 'rational actors' described in finance theory textbooks, who can calculate risk in terms of prospective return. We are in fact driven by powerful psychological habits that induce collective bouts of poor decision-making. Greed, fear, and envy occasionally cause us to buy what is going up and sell what is going down, the exact opposite of 'buy low, sell high'. At the extremes, asset 'bubbles' form and 'pop' under the force of mass irrationality. The existence and correction of market inefficiencies is one of the most dependable elements in investment markets. For those able to exploit them, they are the raw material for outperformance.

Investors must act differently from the rest of the market if they are to outperform. They also need to be right. Greater speed, hard work, and intelligence, are useful in making correct non-consensus decisions. However, there are plenty of investors with these attributes who still fail to add value. To run against consensus and get it right, you must have superior insights from better information, analysis, or both. You need an edge. This requires independence, scepticism, and patience. Above all, it requires a disciplined and repeatable investment process carefully designed to take advantage of market inefficiencies when they appear.

Risk management

Finance theory and much of the industry define risk as volatility (it underpins popular measures such as alpha and beta). The problem with this is that you will struggle to find investors who are worried about the possibility of their investments going up and down (unless they have very short-term objectives). What they really care about is if their investments go down, and stay there. In other words, risk should be defined in the intuitive sense as *the threat of a permanent loss of capital*.

Explaining where risk comes from and how to control it is more complicated. Share ownership represents a claim on a company's future cash-flows. Investors therefore cannot escape the fact that their fortunes are tied to the outcome of events that haven't occurred. Markets fluctuate because risk (and future return) is deceptive. Nothing is inevitable and even after the event the causes, timing and impact of any outcome are difficult to assess. The possibility for alternative outcomes reveals events and processes as the result of a bewildering set of forces and coincidence. The future cannot be predicted reliably.

Despite its elusive qualities, risk and losses are real. Some investments are undoubtedly riskier than others and they can be identified *ex ante*. There are three main sources of investment risk; loss of corporate earnings power (business risk), overleverage (financial risk), overpaying (price risk).

- **Business risk:** Capitalism ensures businesses rise and fall over time as competition between companies redistributes profitability. Many industries – typically those that sell commoditised products generated from large capital bases – are more competitive than others. This makes their future more uncertain and vulnerable to irreversible losses in earnings power.
- **Financial risk:** Debt does not increase the value of a company. It merely magnifies the gains and losses for equity owners. Highly geared companies are more risky than lowly geared ones because debt can reduce management flexibility and earnings growth. It is especially dangerous when events take an unexpected turn for the worse.
- **Price risk:** Buying company shares is no different to any other transaction. The value you get is determined by the price you pay. Pay a fancy price and you are unlikely to have a satisfactory outcome.

There are other risks that investors encounter. These include falling short of one's goals, relative underperformance, and illiquidity. Though relevant, they do not in themselves create permanent losses, these other risks are taken care of if impairments are avoided. There are, however, two more risks which complicate the problems presented by the three (business, financial, price) listed above.

- **Inflation risk:** There is a common misconception that inflation is good for equities because earnings should rise with price levels. Equities are certainly better placed than many other asset classes during inflationary periods, but inflation nevertheless 'swindles' investors by acting like a tax on corporate profitability. When inflation is high, those companies that constantly have to replenish their asset base face higher and higher cash costs just to stand still. Inflation turns business risk toxic.
- **Luck:** Being in the right place at the right time matters more than many investors care to admit. In the same way that germs do not always cause diseases, the expression of risk in actual losses is far rarer than its presence. Absence of a loss does not make a risky asset safe. Operationally weak, leveraged and richly priced companies will not necessarily lose value, at least not in the short-term.

The most effective defence against permanent losses is the ownership of the best companies available at the best prices. This combination is effectively an insurance policy in two parts:

- **Quality:** It involves the purchase of companies with above-average prospects to maintain and grow their earnings power. These are companies that exhibit the lowest business and financial risks. Their inherent strengths limit potential losses for their owners, and open up the prospect of sharing in compound earnings and dividend growth.
- **Value:** Good businesses become great investments when purchased at attractive prices, thereby reducing price risk. By finding bargains that are selling at a big discount to fair value, investors lock in a margin of safety that protects their capital from the worst effects of fluctuations in market prices, miscalculations, and bad luck.

Investment principles (continued)

A loss avoidance strategy is at odds with recent conventional market wisdom. Today many people believe that risk comes, not from owning stocks, but from not owning them... Investors must be aware that the world can change unexpectedly and sometimes dramatically; the future may be very different from the present or recent past. Investors must be prepared for any eventuality.

Seth Klarman,
Margin of Safety, 1991

Quality

Many investors fail to distinguish between a good business and a bad one. Our thinking on the subject is clear. A company is considered high quality because it has certain characteristics which reduce business and financial risks. To fulfil our definition, a company should fit the following five criteria:

1. **High profitability:** Earnings per share (EPS) is a flawed measure of profitability not only because it doesn't reflect the cash that a business generates, it also takes no account of the amount of capital required to generate returns for shareholders. A company can grow earnings by increasing debt or investing in new capacity at a high cost. Profitability is better identified by free-cash-flow (FCF) and returns on invested capital (ROIC). A focus on FCF and ROIC takes analysis beyond a company's accounting profits to focus on underlying cash-flow in relation to capital invested in the business. A business that can earn well in excess of all the costs of acquiring its assets (including the cost of finance) will have investment opportunities that generate value-enhancing growth for shareholders.
2. **Durability:** High profitability must be sustainable. To be so, a business franchise must be protected from the inroads of competitors. Stable franchises with earnings power preserved by an 'economic moat' (or competitive advantage) can earn above-average returns, raise prices without seeing demand fall, and resist losing excess profitability to rivals or regulators. Barriers to entry are usually formed by valuable assets (products, brands, location, networks, and relationships) that create entrenched competitive advantages (low costs, better pricing, greater loyalty, better service). The combination of high cash-flow ROIC, durable competitive advantages, and pricing power should also deliver inflation-protected earnings. Business risk will be lower than average.
3. **Well financed:** Too many debts can handicap even the best businesses. Cash-rich companies with few liabilities stand a better chance of surviving in hard times and thriving in the good times. They will have lower than average financial risk.
4. **Simple:** If a business is too complicated (operationally, technologically, or financially), even the company's management may not understand all of the risks involved, let alone the shareholders. Risk is reduced by insisting on transparency and sticking to what we can know and understand.
5. **Run by honest and competent management:** Sustainable and unlevered profits are no good if allowed to waste in the hands of management. Cash controlled by company executives must be allocated rationally (between investment, M&A, dividends and buy-backs) and in the interests of all shareholders.

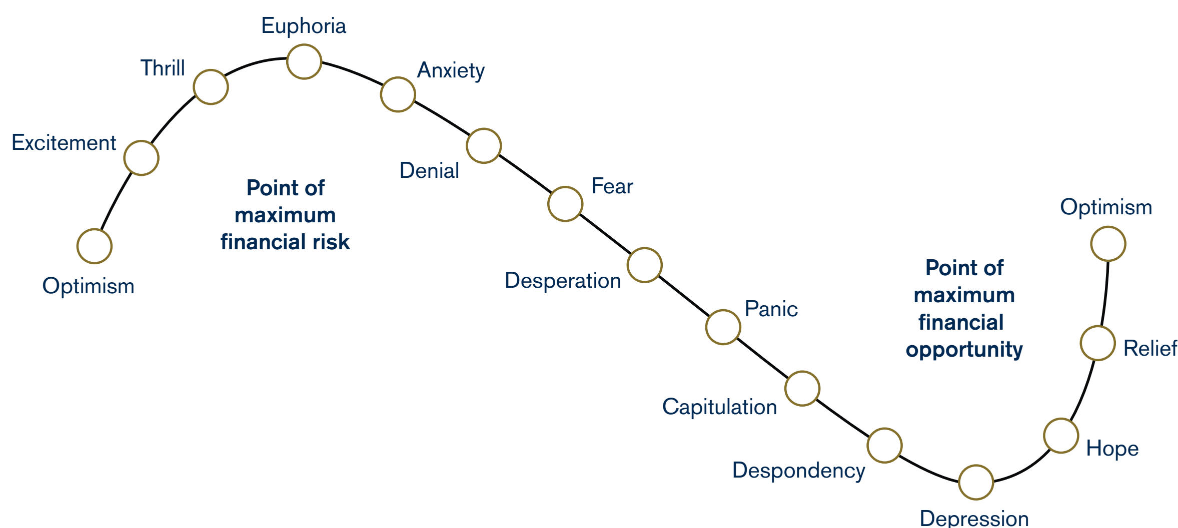
A truly great business must have an enduring 'moat' that protects excellent returns on invested capital. The dynamics of capitalism guarantee that competitors will repeatedly assault any business 'castle' that is earning high returns... Business history is filled with 'Roman Candles', companies whose moats proved illusory and were soon crossed.

Warren Buffett,
Berkshire Hathaway Letter to Shareholders, 2007

Investment principles (continued)

Value

The identification of quality businesses is one part of the investment process. The other part is concerned with finding value, since good businesses do not always make good investments. The difference is determined by price. The paradox of risk is that the reward for its incremental increase shrinks as more people take risk. High risk comes with happy buyers and high prices. When investors realise the future will not be as rosy as prices imply, the trend reverses. Pessimism is only conquered when investors begin to see room for improvement.



Source: Westcore Funds/Denver Investment Advisors LLC, 1998

Risk is lowest and prospective return is highest in the presence of low prices. We strengthen our risk protection (and prospective returns) by insisting on the highest quality companies at the best prices. Like Berkshire Hathaway's Charlie Munger, we prefer good companies at fair prices rather than fair companies at good prices. The former are best placed to survive the challenges of an uncertain future – they have lower business and finance risk. We are not buyers at any price, however. When priced for perfection, the best companies will present as much aggregate risk as a company with weak fundamentals. The rise and fall of the 'Nifty Fifty' stocks in the '60s and '70s is a salutary lesson in the dangers of overpaying for good companies. The opportunity to make significant returns from the best companies surfaces when investors are preoccupied with short-term earnings growth (EPS), rather than long-term earnings quality (ROIC). The ability to compound higher than average ROIC year after year is undervalued in the absence of an understanding of business economics and a long investment horizon.

More generally, cheap assets surface from what other investors don't want. Bargain creation begins with an element of truth (e.g. weak recent earnings record) before investor sentiment takes prices beyond what is rational. We limit our efforts to those areas where there is the greatest scope for inefficiencies, often away from the mainstream, where hard work and analytical skill have the greatest rewards. We therefore look for stocks that can be classified as:

- Poorly understood, unfashionable, dull
- Weak fundamentals in the near term
- Controversial.

Not every statistically cheap company is worthy of our time. The important thing is to find qualities in a business's economics that are underappreciated by other investors. Perception has to be much worse than reality and we must have an edge. That edge provides confidence to buy from presumably informed owners of the asset. This confidence also stems from a firmly held view of the company's true worth, its *fair value*, for which we aim to pay a big discount. Once purchased, patience and fortitude is required to await other investors to return the asset to a fairer price, at which point we sell.

Investment principles (continued)

Our edge often comes from taking a longer perspective of business prospects, looking beyond short-term headwinds to a time when underlying characteristics are re-asserted. With time, stock prices should eventually increase in conjunction with an improved outlook. Our average holding period is four to five years, giving a portfolio turnover of 20-25% per annum. This compares to an average holding period for stocks traded on many major exchanges (for example, the New York Stock Exchange is around six to nine months). Our refusal to 'churn and burn' reflects our focus on long-term fundamentals and ownership for compound growth rather than short-term noise and price movements.

In demanding a wide discount to our assessment of fair value, we are the owners of a *margin of safety*. This is both the basis of return and a tool for risk management. It acts as protection from overgrown price risk, since the purchase price should already discount a worse than likely outcome for the business. Rather than build a portfolio with faulty materials and optimistic expectations, we add assets able to withstand unexpected shocks. The price paid should more than adequately compensate us for the acceptance of business and financial risks identified in our scenario analysis. Further declines in share prices are possible, but their extent should be limited, temporary, and represent opportunities to purchase more stock at an even better price. A wide margin of safety is also crucial in providing protection from unexpected financial and business risk when our analyses prove inadequade or encounters worse than average luck.

One of your partners, named Mr Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers to buy or sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly... You may be happy to sell out to him when he quotes to you a ridiculously high price, and equally happy to buy from him when his price is low.

Benjamin Graham,
The Intelligent Investor, 1949

Investment process

Idea generation

The vast majority of research is conducted internally, and all decisions are based on the investment principles described above. Although the process is more qualitative than quantitative, screens are used at a preliminary stage to help in 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 ranks all stocks into quintiles. The top quintile contains shares with the highest returns on capital (highest quality), with the highest earnings yield (greatest value). The same screen is run for the UK, Europe, and global markets. This global framework helps to compare assets within sectors and between them.

Quality & Value Screen.xlsx - Microsoft Excel

Table Tools

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C1 Short Name

Mm	Short Name	ICB Sector Name	Current Marke	Div Yld	Return on	RoC Ra	Earnings Y	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

Index Summary UK UK FCF + Net Debt UK Stocks Held EUROPE EUROPE Stocks Held EUROPE ex UK EUROPE ex UK Stocks Held Global Risk Rater Pan-Europe

Many financials and all utilities are removed from the screen since differences in their capital structures make their inclusion problematic for comparison purposes. For these sectors, earnings yield, return on equity, tangible book value, and various sector-specific measures of solvency and profitability are used as initial screens for quality and value.

In addition to proprietary screens, other filters are used to narrow our universe of stocks. These include identifying companies with:

- Share prices at 52-week relative lows
- High dividend yields
- Low price-to-book values.

Newspaper stories and stockbroker research help us to pick up the 'scent'. Opportunities can stare contrarian investors in the face because negative headlines beget negative sentiment which is often reflected in share prices. A handful of trusted stock broker contacts who know our methods occasionally provide us with a lead. Meetings with company management teams will also provide fresh insight into competitors and companies in related industries.

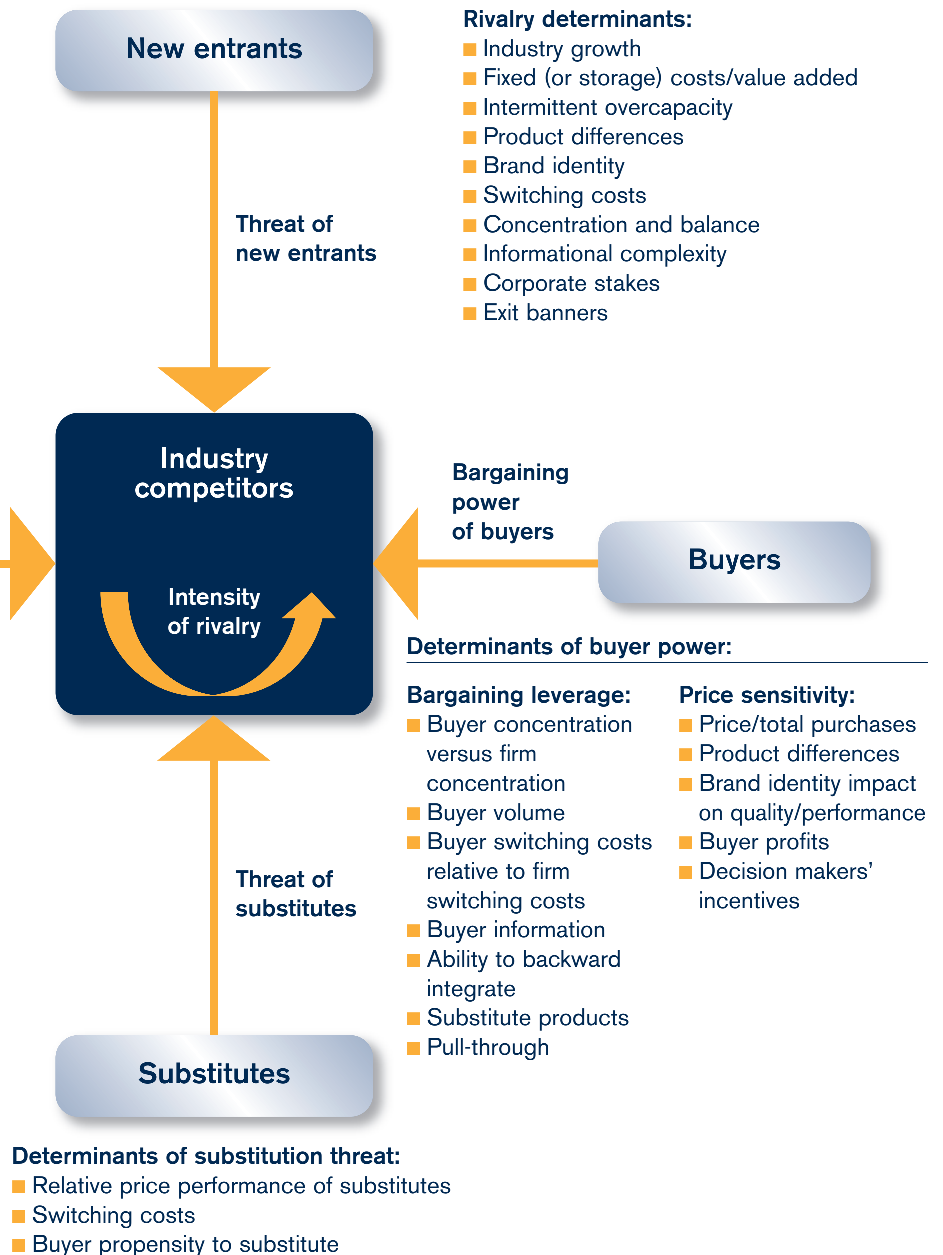
Screening is the beginning of a much longer research effort during which many subjective filters are applied. Once a stock idea is identified, the investment process becomes intensive and includes meeting company management and industry experts; hours and hours reading corporate report and accounts, 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 understanding a company's long-term operating and corporate history. Bloomberg and Collins Stewart's Quest platform are important sources for this kind of company data.

Investment process (continued)

Quality

In the same way as a pilot will use a checklist to control and navigate a plane, we have a series of checks aimed at steering analysis through an investment's potential risks and rewards. The questions we ask aim to square an investment with our five criteria of business quality:

Is it highly profitable? Are profits durable?
The management of business risk, profits and their durability will largely be determined by filtering a company through Michael Porter's framework for an understanding of its competitive advantages.



Source: Michael Porter, "Competitive Strategy", 1980.

Investment process (continued)

Is it comfortably financed?
Comfort in a company's finances partly depends on the quality and sustainability of a company's cash-flow. It is also determined by:

- The size, nature and terms of bank and corporate debt.
- Other financial liabilities (pensions, legal cases, provisions, restructuring etc.) and off-balance sheet financing (e.g. operating leases).
- The level of dividends and other discretionary payments.
- Classification of cash – i.e. whether it belongs to the company or represents customer advances – and whether the company has access to cheap and sustainable source of finance (e.g. customer deposits, negative working capital).

Is it simple to understand?
An edge might be gained by researching a complex company more thoroughly than other investors. For instance, a conglomerate with many operational divisions may deter other investors and provide an opportunity to find mispriced qualities. There are other situations however where no amount of work is going to clarify an investment proposition. We must understand the:

- Product or service
- Competitive and regulatory environment
- Accounting
- Ownership structure.

Is it run by competent and trustworthy people?
We prefer to back a great business rather than great management. In an ideal world, however, high quality people will extract the best from a wonderful company. At a minimum, we want company executives to be competent and trustworthy. They should have a strong understanding of cash allocation and the relative merits of organic investment, M&A, buybacks and dividends at different stages of the business cycle. This ultimately requires them to share our understanding of business economics and the drivers of shareholder value creation. Management that takes this attitude tends to have an ownership mentality and align their interests with shareholders by owning company shares themselves.

Value

No one company gives a perfect answer to all our questions. There is always a trade-off between quality and value; between risks and returns. It is our job to make sure discrepancies and doubts are adequately compensated by the valuation of a company. Valuation work is based on our assessment of earnings quality and business economics. If a business is a good one, time is its friend and the stock price follows underlying growth. Bad businesses deserve low valuations to reflect mediocre earnings quality.

Valuation is focussed on cash-flow as a more reliable measure of corporate profitability, and its primacy helps strip out the more questionable assumptions embedded in accounting standards. Cash-flow also spans the divide between the income statement and balance sheet by considering all the cash costs of growth (capital expenditure and working capital), and capital (interest and dividends). It is therefore a better guide to capital intensity and earnings quality.

A number of measures are used to reach an estimate of fair value. These include replacement book value, free-cash-flow yield, long-term average return on invested capital (ROIC), enterprise value-to-sales (EV/Sales) together with average operating margins, and dividend yield. No metric is used to the exclusion of others; all contribute to an understanding of fair value.

The method is more 'art than science', paying more attention to the interpretation of the past than projections for the future. This reflects our comfort in estimating normalised earnings and anticipating mean reversion than our ability to make accurate predictions. As such, we are sceptical about the use of complex valuation models – with their exact assumptions about growth, profit margins, investment returns and discount rates. The future is too complicated to be accurately modelled with a spreadsheet, and we aim to pay little or nothing for the hope of growth. Using this conservative approach, we should be roughly right or pleasantly surprised, rather than precisely wrong and sorely disappointed.

In most cases, we believe there is no such thing as bad assets, only bad prices. Our investment universe is small because we insist on quality at attractive prices, a requirement that is rarely met in markets that are efficient most of the time. There are few businesses we will never buy. These are companies where practically any price will not adequately compensate us for the outsized risk of permanent losses. They can be categorised as:

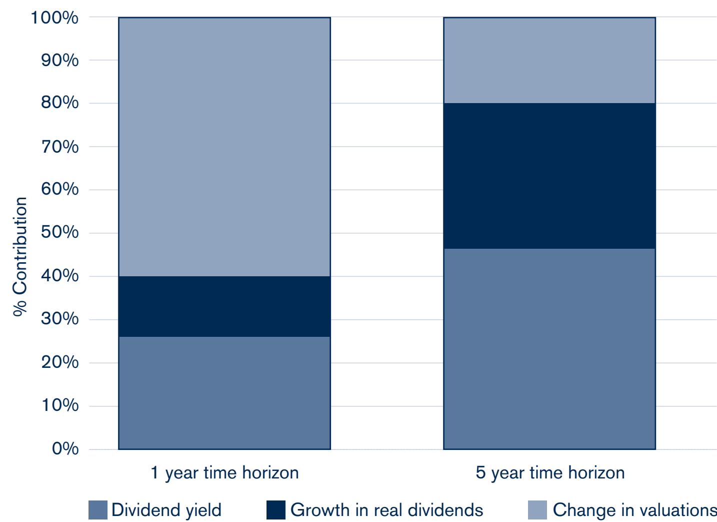
- Companies heavily exposed to technological obsolescence (e.g. newspapers in the internet age).
- Companies so indebted they have no chance of supporting their debt burden (although recapitalisation situations may make these companies investible).
- Cash sinkholes: Early stage companies, start ups, most biotechs, many 'recovery' situations.
- Companies with 'fad' products.

Investment process (continued)

Dividends

Dividends are the tangible reward for long-term ownership, and a measure of quality and value. Higher quality businesses will have the earnings power and excess capital to maintain unbroken records of growing annual distributions to shareholders. Dividend income has proved to be a substantial part of investors' historic returns.

Contribution to total real return depends on your time horizon – US data since 1871



Source: SG Equity Research

By purchasing good businesses at low prices, investors effectively own quality high-yield perpetual bonds with growing interest income and capital. The reinvestment of retained earnings at above-average rates of return offers an element of asset protection from movements in interest rates and inflation that is unavailable from lower quality, non-dividend paying businesses.

Selling

When a stock is purchased, it is our intention to own it for as long as it continues to fit our investment criteria. We never count on making a good sale. Instead we focus on making purchases so good that even a poor sale gives reasonable results. Generally speaking, a stock is sold for the following reasons:

1. The margin of safety becomes too small, either because the stock price increases to eliminate the attractive discount (rising price risk) or the fundamentals change (higher business or financing risk).

2. When better opportunities are found elsewhere.

Investment process (continued)

Portfolio construction

The constituents of a portfolio will be a function of where we see the greatest return for the smallest risk. When general prices are low, we are likely to own a greater proportion of strong business franchises with more cyclical earnings. The prices paid for these companies will reflect investor's disappointment at their recent trading rather than the quality and growth of their longer-term futures. They will have a wide margin of safety and high prospective returns.

When prices and risks are high, and bargains are few, we will be in defensive mode. Our default option in this scenario is to buy high quality companies at fair prices. During speculative phases investors tend to focus on earnings growth rather than earnings quality. The stability and returns on capital of these rare 'compounders' can be undervalued. Portfolio returns will be low in absolute terms but capital should be relatively protected. It is the 'least bad' option in a low returns environment. The cost can be relative underperformance until prices cheapen.

Risk is principally managed through the concentrated selection of the best companies at the best prices. Diversification across stocks, sectors, and company size adds a final layer of risk reduction. The number of portfolio holdings is around 40, beyond which diversification only dilutes returns for the client by introducing weaker ideas and higher trading costs. Good ideas are rare, and when they are found, we have the conviction to make them a significant proportion of fund assets. Portfolio turnover is low because a long-term approach is a major competitive advantage in identifying mispriced assets. It also ensures transaction costs are minimised, and allows access to the compound growth and dividends of superior businesses.

The fund retains a capacity to invest 20% of assets in investments other than UK equities, including cash. It will remain roughly fully invested at most times due to the fund's reliance on company dividends to grow income distributions. Cash levels will naturally rise on the margin when assets are expensive (based on long-term measures such as the cyclically adjusted price/earnings), and reduce when prices are cheaper. We believe the headwind to returns of owning cash in pricey markets will be compensated by the opportunity to use the same cash to buy bargains when they emerge. Non UK equities (principally those listed in mainland Europe) will be purchased when they offer a superior risk-adjusted return compared to UK stocks. Inclusion of non-UK stocks is restricted to sectors and areas where we have existing expertise. It is an effective way to consolidate a theme in the fund, and diversify stock-specific risks. On very rare occasions we will find investment opportunities where the senior securities in a company's capital structure are more attractive than the equity (convertibles, debt, perpetual etc). This will usually occur at the extremes of the cycle in the presence of forced sellers. Our approach to non-UK equities and senior securities is identical to the strict process and principles employed for analysis of any other opportunity.

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