



RATHBONE UNIT TRUST MANAGEMENT  
FUND MANAGEMENT FOR YOUR INVESTMENT NEEDS

# RATHBONE STRATEGIC BOND FUND

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## INVESTMENT PRINCIPLES & PROCESS

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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## CONTENTS

- 01** Executive summary
- 01** Investment philosophy
- 02** Investment team
- 04** Strategic overlay
- 05** Core strategy – normalised ranges
- 06** Asset allocation trade-offs
- 07** Direct bond selection investment process
- 09** Fund selection investment process
- 11** Buy/sell discipline of underlying fund instruments
- 12** Fund risk and governance framework

## EXECUTIVE SUMMARY

The Rathbone Strategic Bond Fund is a multi asset fixed income fund using the best investment processes that Rathbones has to offer. It uses the strong investment process used to manage bonds for Rathbone Unit Trust Management and the award-winning\* fund investment process offered by Rathbone Brothers Plc.

\*Investment Week Fund Manager of the Year Awards 2011 (Discretionary).

## INVESTMENT PHILOSOPHY

The Rathbone Strategic Bond Fund is a multi-asset fixed income fund with the ability to invest across the fixed income markets. The base portfolio will typically be invested 50% in direct bonds and 50% invested in funds. Initially, the asset allocation is driven by the output from Rathbone Strategic Asset Allocation Committee (SAAC) process.

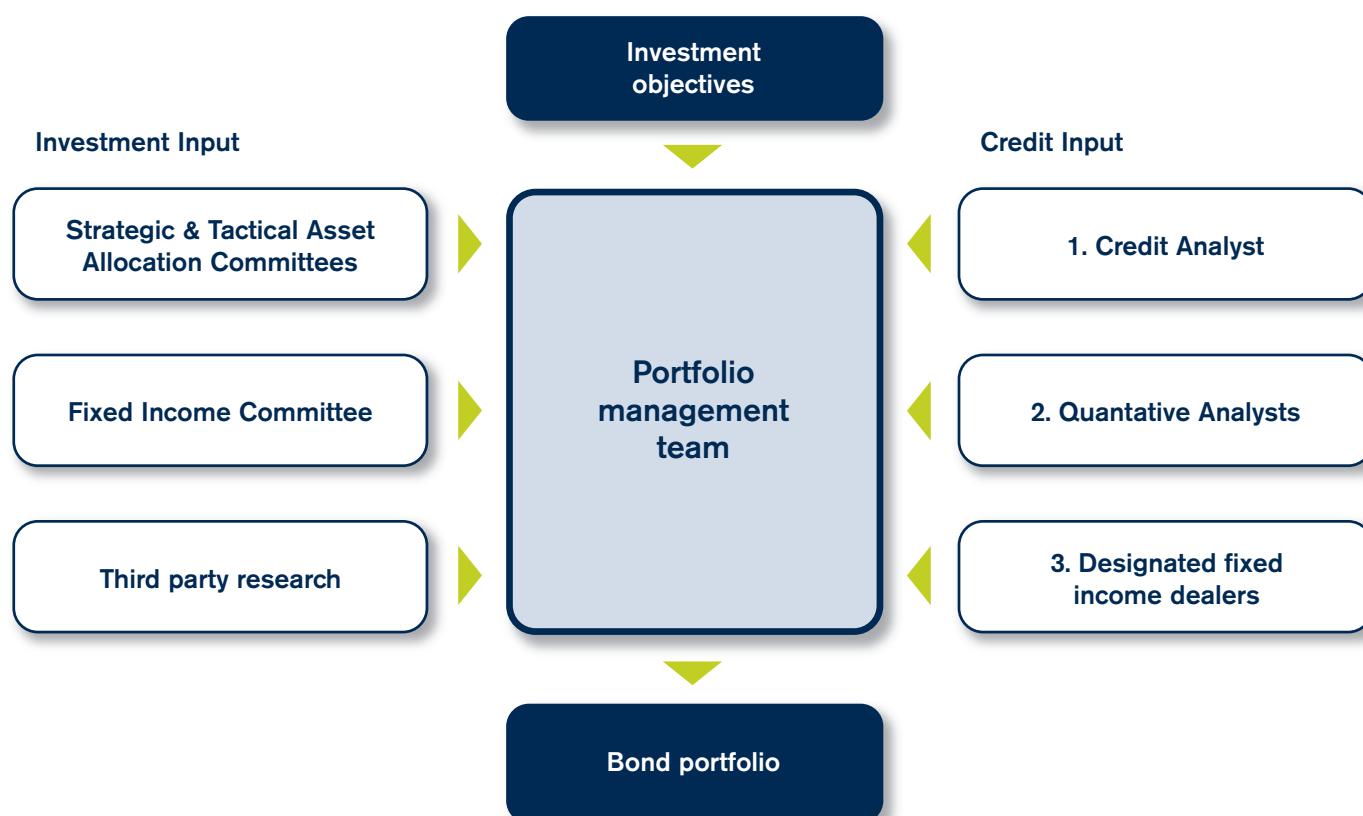
Once the investment themes have been generated through this process, the whole range of the fixed income universe is examined to find the best investment opportunities. To achieve this, 50% of the portfolio will typically be invested in predominantly Sterling-denominated government bonds and investment grade corporate debt. Depending on market conditions the fund will have the open mandate to invest all assets in government bonds. These direct securities exposures will mitigate the impact of fees levied by third party funds, reducing the fund's overall Total Expense Ratio (TER) compared to the 'fund of funds' universe. The remainder will be invested in funds focussed on specialist areas such as high yield and emerging market debt, distressed debt and credit alternatives on a best-of-breed basis.

The exposure to these funds will ensure a greater level of diversification than a single strategy investment would otherwise be able to achieve. To manage risk and volatility within the fund, up to 20% can be invested in off-benchmark assets such as qualifying alternative fixed income funds and qualifying structured products.

The processes employed for the selection of the direct-bonds and for the funds are existing proven investment processes. The third party fund selection is managed using the Rathbone Multi Asset Portfolio processes and the direct bond selection is managed using the Rathbone Unit Trust Management bond selection process. The fund, therefore, provides levels of diversification to a wide range of Fixed Income asset classes using the best investment processes that Rathbones has in place.

The fund does not target a specific nominal yield as the fund is run to maximise total return at an acceptable level of risk. As such, the yield is determined by the asset allocation and investment selections and will vary over time. In any event, even in extreme circumstances, we would not expect the fund yield to fall below that available on the FTSE Actuaries Government Securities UK Gilts sub-5 year index. Under normal circumstances investors should expect a yield well above the level of the minimum yield target set out above.

### How the philosophy is put into practice



## INVESTMENT TEAM

The lead manager of the fund is Bryn Jones, supported by a strong investment team. This team meets formally weekly. Below are the biographies of the team members.



### **Bryn Jones, Fixed Income Director and Fund Manager for Rathbone Ethical Bond Fund**

Primary role: Lead manager, asset allocation, stock selection

Bryn is a member of the Rathbone Strategic Asset Allocation Committee, Chairman of the Fixed Income Committee, and a member of the Rathbone Banking Committee. He is also an APCIMS representative for the HMT DMO's (Debt Management Office) Gilt market consultation process, and is also a co-opted Trustee for the Trust for London. Bryn joined Rathbones in November 2004. He has been a guest speaker at the Euromoney bond conference in London; at the Euromoney bank capital conference in Amsterdam, and appears regularly on CNBC and Bloomberg TV. He graduated from the University of Birmingham, with a Bachelor of Arts degree in Geography in 1995. He holds the Investment Management Certificate and sits on the IMA Fixed Income Committee. In 2008, Bryn was awarded the accolade of one of 20 of the globe's Fixed Income Rising Stars by II News. More recently, he was shortlisted for the Investment Week Fund Manager of the Year Awards 2011 (IMA Sterling Corporate Bond sector). Before joining Rathbones, he worked at Merrill Lynch, managing \$2billion of fixed income assets.



### **David Coombs, Fund Manager, Head of Multi Asset Investments.**

Primary role: Asset allocation, fund selection

David is a specialist in managing multi asset portfolios, with an emphasis on asset allocation and risk reduction. He has 21 years experience in this field, and joined Rathbones in April 2007 from Baring Asset Management. There he developed Baring's absolute return investment process in the mid-nineties. David has managed unithised and segregated funds for institutional pension funds, captive insurance companies, corporate trustees and private clients including the Baring Optimum and Extended Risk funds. David joined Barings in 1988 from Hambros Bank in Guernsey where he started his career in 1984. He now sits on Rathbones' Strategic Asset Allocation Committee and chairs the Collectives Research Committee (sitting on all of its sub-committees). In 2007, David launched, and continues to manage, our Jersey-based multi asset funds. David is an Associate of the Chartered Institute of Bankers.



### **Julian Chillingworth, Chief Investment Officer.**

Primary role: Risk management and oversight

Julian joined Rathbones in July 2001 as Deputy Chief Investment Director. He was appointed as a board director of Rathbone Unit Trust Management Limited in October 2001. Julian was appointed Chief Investment Officer of Rathbone Unit Trust Management Limited in August 2002. He has responsibility for managing the Rathbone Blue Chip Income and Growth Fund, and is also co-manager for the Rathbone Ethical Bond Fund, the Rathbone Recovery Fund, and the Rathbone Multi Asset Portfolios. As head of stock selection, he also plays a key role in the ongoing development of the investment process at Rathbones. He has nearly 30 years investment experience gained within organisations such as James Capel, Global Asset Management, Bankers Trust and Investec Asset Management.



### **Will McIntosh-Whyte**

Primary role: Fund selection

Will is an investment manager at Rathbones, having joined the charities team in April 2007. He supports the management of the Rathbone Strategic Bond Fund.

Prior to joining Rathbones, he graduated from UMIST with a BSc Hons in Management and spent a brief period working as a researcher at shipping finance firm, Theisen Securities.

Will is a CFA (Chartered Financial Analyst) Charterholder and is a member of Rathbones Fixed Income Committee and the Collectives Research Committee.

## INVESTMENT TEAM (CONTINUED)



### **Noelle Cazalis**

Primary role: Credit analyst and stock selection

Noelle joined Rathbones in July 2011 as a credit analyst. She works alongside Bryn Jones, providing in-depth credit analysis for the Rathbone Ethical Bond Fund and Rathbones Fixed Income Committee.

Noelle achieved two masters' degrees, with distinction, in 2010 from the University of Montesquieu in Bordeaux – a Magistere of International Finance, and a Masters in Banking, Finance and Financial Assets Trading. Noelle was seconded by the French Council of Economic Affairs during her time at university. She carried out a field survey of the Cambodian banking sector. The survey was sold to a French bank and Noelle was then involved in the due diligence process, and her presentation to the Board was used to acquire a Cambodian Bank. More recently, Noelle worked as a junior risk analyst at Coface.



### **Elizabeth Savage, Research Director**

Primary role: Due diligence on fund selection

Elizabeth is a Research Director and Assistant Fund Manager on the Rathbone Strategic Growth Portfolio and Rathbone Total Return Portfolio. She joined Rathbone Investment Management in March 2005 with a broad remit for fund selection and due diligence across all alternative strategies and asset classes. Elizabeth sits on the Strategic Asset Allocation and Collectives Research Committees.

She joined Progressive Alternative Investments, a fund of hedge funds in March 2002, where she worked as a hedge fund analyst with responsibility for conducting research across a range of different strategies. Elizabeth graduated from Newcastle University in 2001. She holds the Chartered Alternative Investment Analyst designation, has passed Level II of the CFA examination and is a candidate for Level III.



### **Rashpal Sohan, Asset Allocation Analyst**

Primary role: Risk management

Rashpal graduated from the London School of Economics and Political Science with a degree in Actuarial Science. He joined Rathbones in 2005 as an Asset Allocation Analyst, working as an assistant to Robin Griffiths. Rashpal assists the Rathbone Strategic Asset Allocation Committee in analysing key data and research to make asset allocation and investment decisions.

## STRATEGIC OVERLAY

The investment process starts with the output from our Strategic Asset Allocation Committee (which meets monthly) which steers the bottom-up research effort by identifying particular geographic areas, industry sectors or investment strategies that are likely to outperform in the future. This ensures that direct-bond and fund selection is forward-looking and not simply reliant on past performance.

### Asset allocation is in two parts:

- Strategic asset allocation incorporates the long-term investment themes agreed by the SAAC.
- Tactical asset allocation is undertaken to reflect short-term market movements and their effect on relative valuations.

Themes are developed from all the opportunity sets based on the 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 general list (not exhaustive) of areas where themes originate are included below:

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

There are a number of market stress measures we gauge. These include the TED spread (the difference between the US three-month Treasury bill interest rate and three-month LIBOR); the VIX Index (tracking market volatility, with high values implying pessimism and low values implying optimism); global and domestic credit spreads; default rates; global yield curves; demand for precious metals, relative value and cash levels.

We then consider economic indicators across an extremely broad range of areas such as consumption; output; the labour market; the housing market; inflation; liquidity; active fiscal policy; interest rates; political changes; money supply and currency reserves.

We are always cognisant of the regulatory, tax and liquidity requirements of our clients when sourcing investment ideas. We draw on research from the following strategists: Bank Credit Analyst, Macro Research Board, Wolfe Trahan, Capital Economics. The committee utilises distinct methodologies to arrive at the conclusions, which prevents confirmatory bias.

## CORE STRATEGY – NORMALISED RANGES

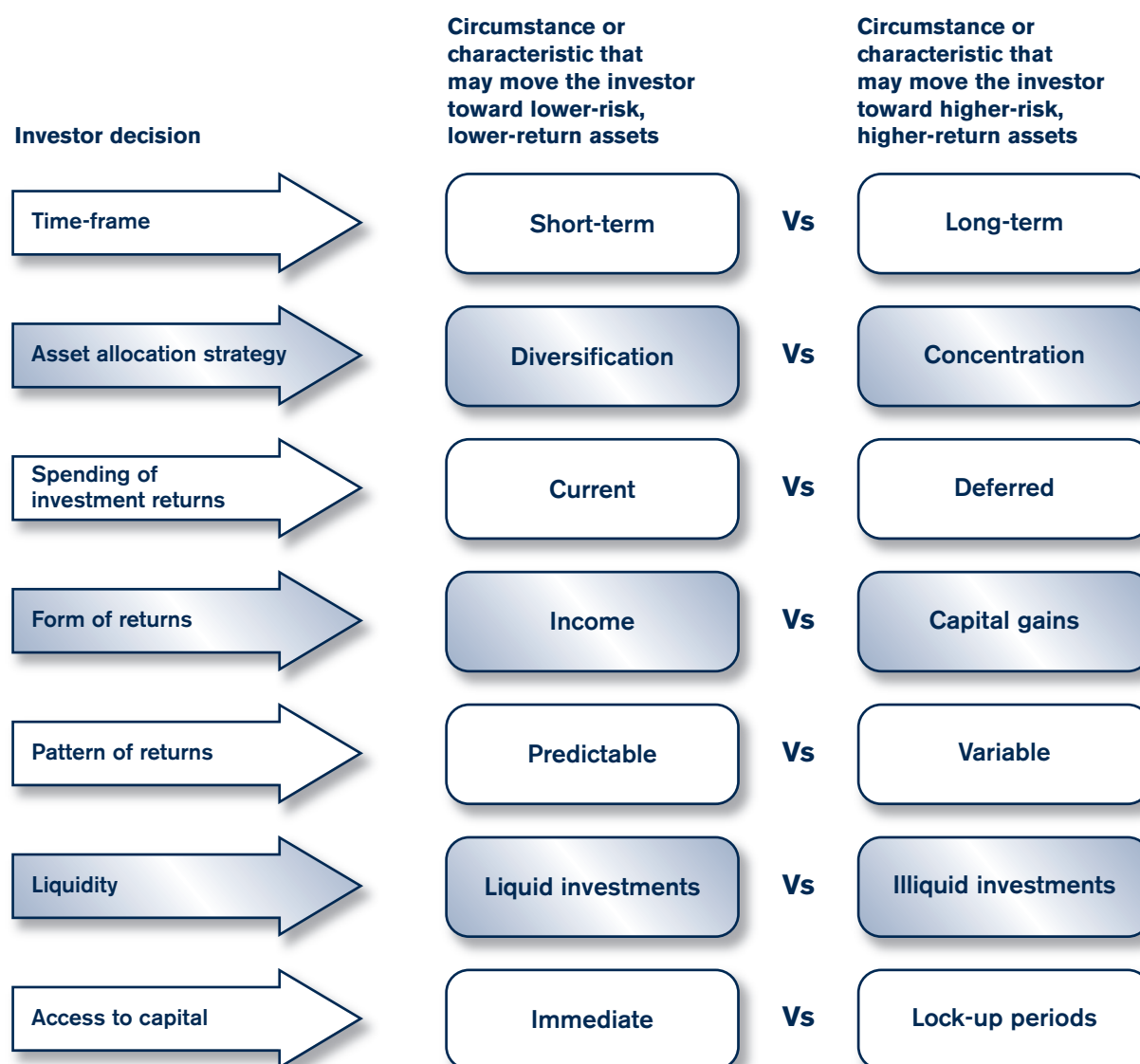
Asset Class	Index	Base portfolio %	Minimum %	Maximum %	Direct or Funds?
Government bonds		50.0			
<b>UK Gilts</b>	Actuaries All-Gilt Index TR Sterling	12.5	2.5	22.5	Direct
<b>UK Index Linked Gilts</b>	FTSE British Government Index-Linked Bonds All Maturities	12.5	2.5	22.5	Direct
<b>Global Government Bonds ex UK</b>	Citigroup WGBI World Ex-UK All Maturities TR Sterling Hedged	10.0	0.0	20.0	Funds
<b>Emerging Market Sovereign Bonds</b>	BOFA ML US Dollar Emerging Sovereign Plus TR Sterling Hedged	15.0	0.0	25.0	Funds
Investment grade corporate bonds		35.0			
<b>UK Corporate Bonds</b>	BarCap Sterling Bond Non Gilts All Maturities TR Prior to Jan 1997 & ML £ Corp. All UK Sterling (Corporate Bond Index TR Sterling Thereafter)	25.0	15.0	35.0	Direct
<b>Global Corporate Bonds</b>	BOFA ML Global Broad Corporate Bonds TR Sterling Hedged	10.0	0.0	20.0	Funds
Distressed Debt/High Yield		15.0			
<b>Global High Yield Bonds</b>	BOFA ML Global High Yield TR Sterling Hedged	15.0	5.0	25.0	Funds
<b>Distressed Debt (US)</b>	BOFA ML US High Yield Distressed Sterling TR Hedged	0.0	0.0	10.0	Funds
		100.0			

The asset allocation is decided by the investment team with decisions being made by David Coombs, Bryn Jones and Will MacIntosh-White. Bryn Jones, as lead manager, takes the ultimate responsibility for the management of the portfolio. Monthly meetings will be held to ensure the fund is managed within its investment parameters and to provide a formal and regular challenge process. Meetings will be chaired by Julian Chillingworth, CIO. The fund may move above the normalised ranges when opportunities arise in other asset classes or move below the normalised ranges where risks in assets classes are elevated. The investment process is not bound by these ranges. The fund may move outside the minimum and maximum ranges in exceptional circumstances, but only with the authority of the Julian Chillingworth.

## ASSET ALLOCATION TRADE-OFFS

With these points above in mind, it is vital to highlight an important part of the investment decision-making process, how it affects the management of the bonds and funds held within 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.



Once the asset allocation of the fund has been agreed, the implementation of the views is carried out via two investment processes. A direct bond investment process and a fund selection process. These are summarised on page 7.

## DIRECT BOND SELECTION INVESTMENT PROCESS

The process has various layers proven 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.



### 1. Credit analysis

Once investment themes have been developed through macro analysis, 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) that we invest in.

*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.

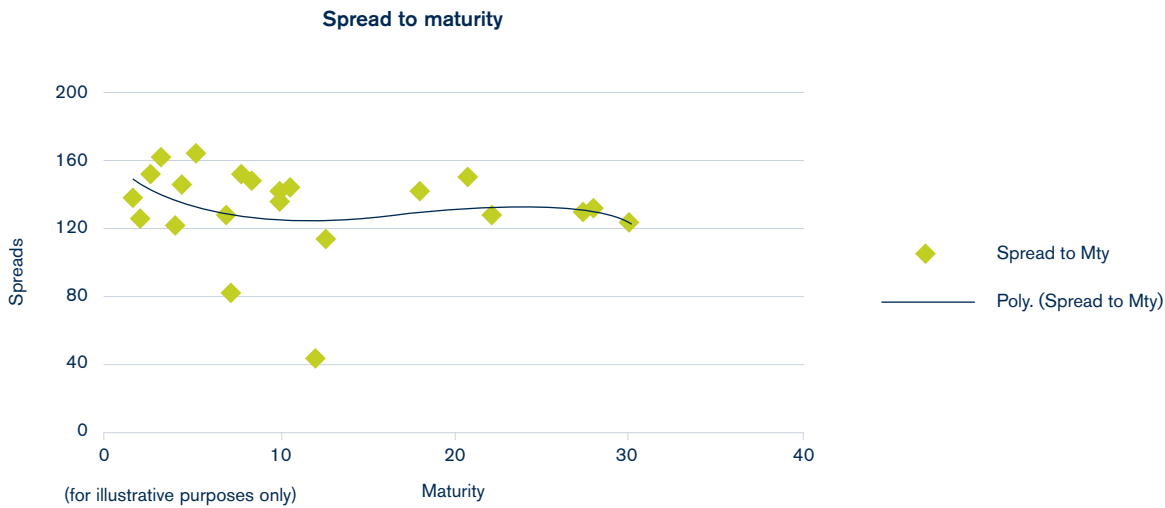
We take a view on these covenants and they provide an important extra level of analysis to extract value.

## DIRECT BOND SELECTION INVESTMENT PROCESS (CONTINUED)

### 2. 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



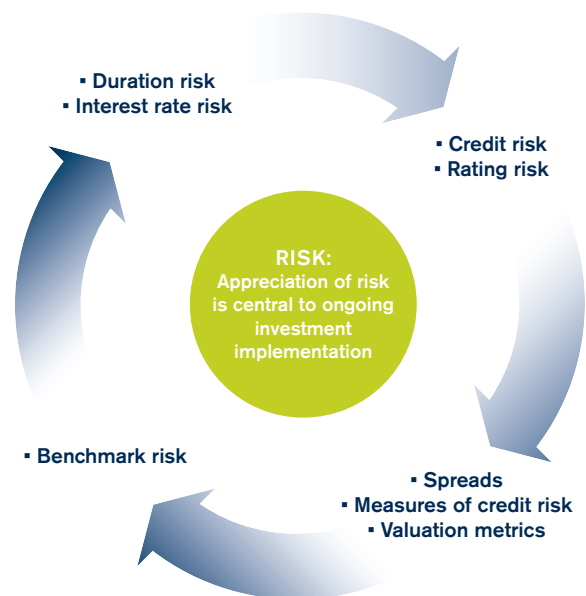
Unlike other funds, we also try to identify bonds that, despite their weaker credit analysis score, are technically too cheap. As per the investment principles, we would look at short-term strategies in this space.

Investing in new issue markets can add an extra level of alpha here.

### 3. Risk framework

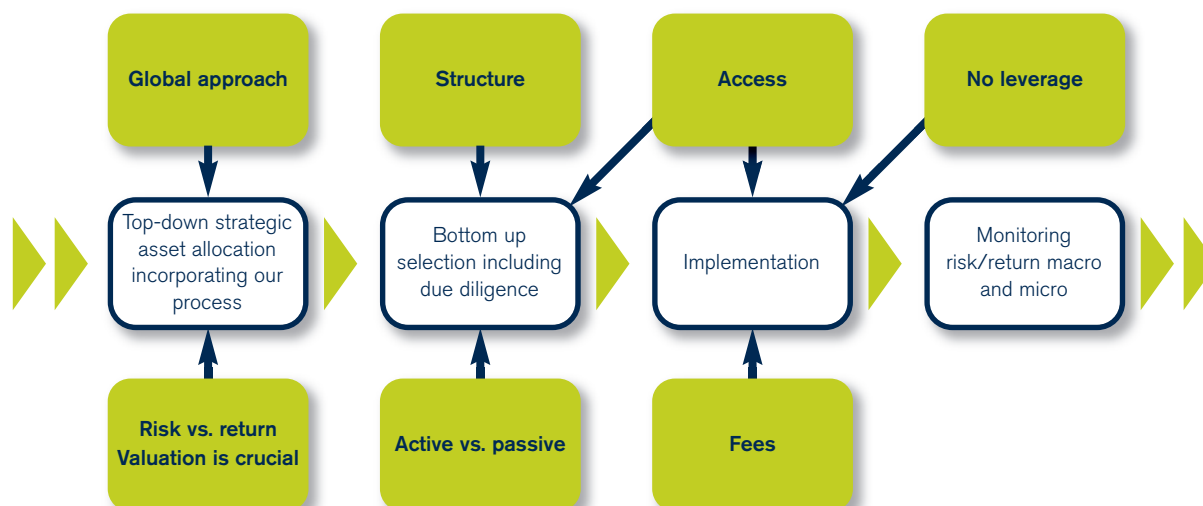
To this point, we have generated the investment idea from the thematic approach, carried out fundamental research and looked at valuations of bonds. However, the implementation of the investment needs to go through a risk framework before inclusion in the fund. The risk monitoring does not lead the investment 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%



## FUND SELECTION INVESTMENT PROCESS

The process has various inputs proven to achieve superior results.



There has been considerable change within the investment funds universe over the past few years. One example is the increasing convergence between long-only and alternative investment funds through greater use of derivatives and complex strategies via UCITS III. In light of this, we recognise the need to have a consistent approach for approving funds, conducting due diligence and monitoring performance. We also recognise that investment opportunities should not be segregated by fund structure, but by sector, geography, liquidity and the key performance drivers of such investments.

From the views generated by the Strategic Asset Allocation Committee, a recommended list is maintained by our Collectives Research Committee (CRC). Meeting quarterly, it is made up of research analysts and fund managers who specialise in particular investment areas. They come from a variety of different backgrounds, many of whom have managed client money for many years and bring a pragmatic and unbiased perspective to the decision-making. This approach allows broad coverage of available investment opportunities, twinned with rigorous, in-depth research and due diligence.

There is much interaction between the investment analysts, who possess detailed technical knowledge, and these experienced private client fund managers. This ensures that committee recommendations are always made with the objectives of the fund in mind.

Our three dedicated analysts undertake the necessary due diligence. Many houses only have this layer plus the named manager(s). David Coombs chairs the CRC and influences areas for research.

The appropriate sub-committee of the CRC here is the Fixed Income and Absolute Return Committee (which meets every six weeks), also chaired by David Coombs and consisting of 8 fixed income specialists with a total of 84 years experience.

Specific investment ideas are sourced through industry contacts, conferences and referrals. We also subscribe to third party investment and analytics software which enables us to screen the funds universe according to various risk and return metrics. Specifically, we are looking for 'best of breed' investment funds across the risk/return spectrum.

Objectives of the Collectives Research Committee and the Fixed Income and Absolute Return Committee:

- Identify the best funds with a variety of risk, return and correlation characteristics.
- Source traditional long-only funds that have consistently outperformed their benchmarks with the lowest level of risk.
- Identify alternative investments including hedge funds and structured products that have demonstrated that they can reduce the overall risk of a portfolio when combined with traditional asset classes.
- Look for fund structures that are tax and cost-efficient and have appropriate liquidity.
- Conduct thorough due diligence by identifying funds with robust risk management processes, strong corporate governance and independent, reputable counterparties.
- Monitor the performance of recommended investments on an ongoing basis.

FUND SELECTION INVESTMENT PROCESS (CONTINUED)

Best of breed selection:



A place for carefully selected and monitored alternative assets within the Fixed Income funds universe.

The majority of holdings in the alternative assets category should be liquid rather than less liquid. The purpose of holding such funds is to reduce risk in the fund. These will all be regulated UCITS funds or investment trusts and will only be selected for the fund after as much as three months or more of due diligence has been performed on the managers and processes in question. We conduct a full appraisal of all risk monitoring systems. We select funds with full transparency which spread their counterparty risk and in themselves, operate policies of separate custodians and valuations. This helps to avoid manipulation of data. In order to manage a portfolio on daily dealing, we invest in funds that also deal on a frequent basis (either daily or weekly) and are therefore, easily tradable.

## BUY/SELL DISCIPLINE OF UNDERLYING FUND INSTRUMENTS

Determining the quality throughout – there is a detailed and thorough fund buy and sell discipline:

### Buy

*We examine:*

- Manager experience and ‘edge’ over others
- Repeatable investment process
- Depth and longevity of team
- Alignment of interests, manager co-investment
- Strong and consistent risk-adjusted returns
- Long only: Consistent out-performance over twelve discrete periods covering 3 years
- Quality of risk management
- Strategy should justify fee levels
- Strong liquidity and capacity management
- Good flow of information
- Valuation integrity
- Corporate stability
- Quality of third party providers
- Fund gearing
- Use of derivatives.

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We do not try to buy ‘big-brands’ for the sake of it; to buy large funds or to blend funds together – others can and will do this. We will buy mostly regulated vehicles for added strength. The big decisions are in the asset allocation not in fund turnover.

### Sell

*We examine:*

- Changes in key personnel/corporate instability
- Style drift
- Manager lack of conviction
- Performance undershooting expectations
- Long only: under-performance for three successive quarters, unless clear catalyst for change
- Poor risk controls
- Assets under management (avoiding asset gatherers)
- Reduced transparency and changes to fund structure
- Poor administration
- Change in investment philosophy and process.

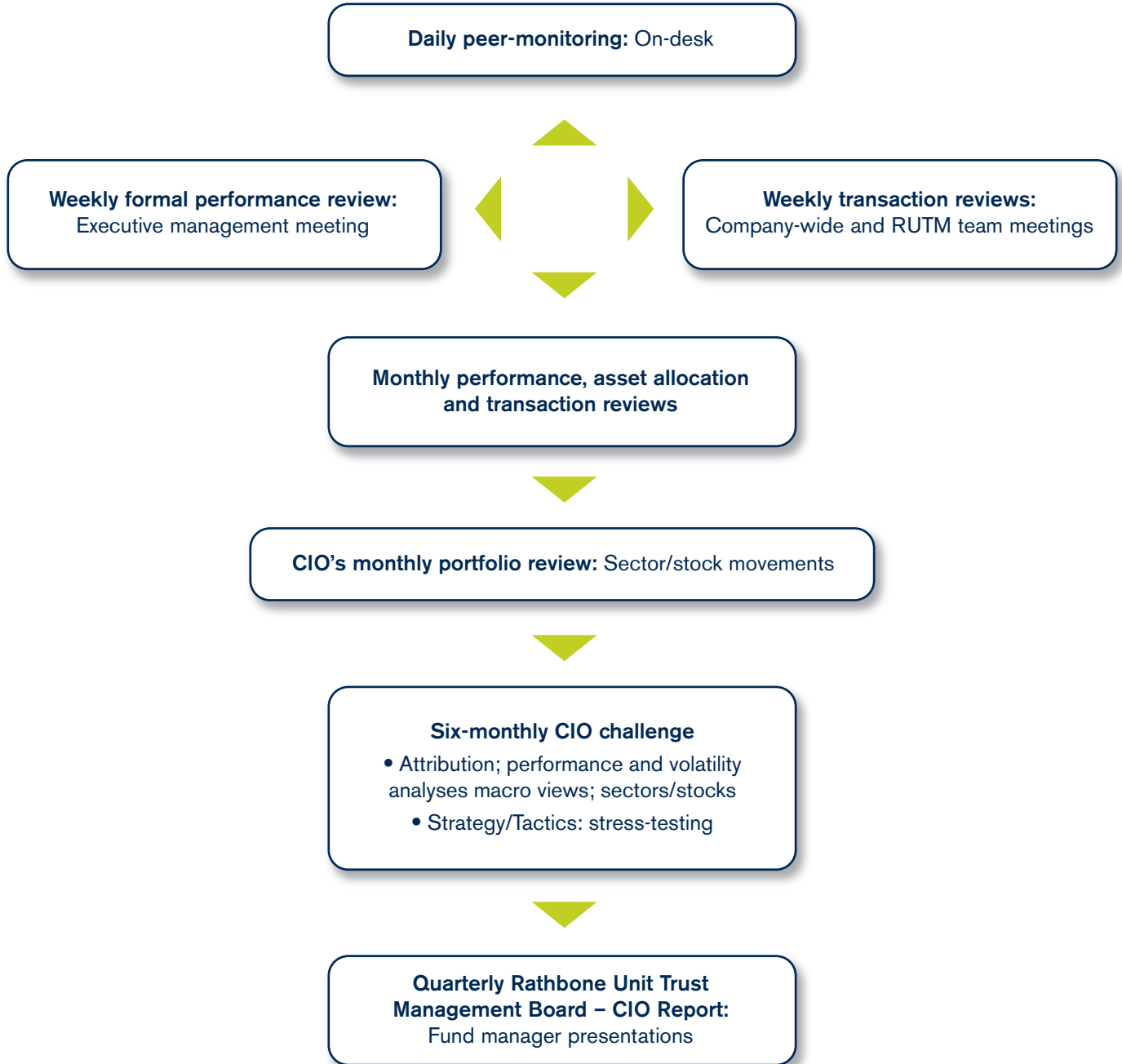
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Funds are continually monitored to ensure they are delivering to their mandate.

The fund is backed by a strong and in depth risk and performance monitoring processes.

## FUND RISK AND GOVERNANCE FRAMEWORK

### Portfolio risk and performance monitoring



## EXECUTIVE SUMMARY

The Rathbone Strategic Bond Fund is a multi asset fixed income fund using the best investment processes that Rathbones has to offer. It uses the strong investment process used to manage bonds for Rathbone Unit Trust Management and the award-winning\* fund investment process offered by Rathbone Brothers Plc.

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Established 1742