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CASHFLOW SOLUTION PROCESS

An investment process managed by James Inglis-Jones and Samantha Gleave

1. Philosophy

Our investment philosophy is based on the mistakes people make forecasting. In the equity market we believe that stock prices are frequently mis-priced, as they tend to reflect the forecasts of future profitability made by company managers which are often unreliable and, at times, completely misleading.

These understandable errors in profit forecasting seem to play a dominant role in setting investors' expectations, as investors treat these forecasts as superior and underestimate the risk that they will be wrong.

We find, in contrast, that historical analysis of company cash flows is a more reliable guide to future profitability and stock price valuation in the medium term.

Investors undervalue free cash flow, a fundamental building block of long-term growth, in favour of short-term profit forecasts. Investors' focus on profit forecasts over fundamental value provides us with a consistent opportunity to add alpha in both long-only and long/short portfolios.

2. Process

Our process can be best described as focused on the forensic analysis of historic cash flows and balance sheet development as presented by companies in their annual report and accounts.

We focus on the historic cash flows generated and invested by companies to support their forecast profits growth. As forecasts are often unreliable, the scale of cash invested to support forecasts is key. In our experience, companies that generate significant free cash flow after investments prove to be rewarding stock-market purchases.

Companies that invest significantly more cash than they can produce to back bold forecasts of future growth often disappoint. Therefore we pay particular attention to both the quality and sustainability of company cash flow and the valuation investors attach to it.

For long/short portfolios the aim of the investment process is to complement our long investments with short sales of expensive companies run by company managers who combine over-confidence in their forecasting ability with a willingness to back their forecasts with substantial growth in operating assets such as property, equipment and stock.

They tend to generate very significant cash outflows after investments and carry significant forecast risk. If their profit forecasts prove too optimistic, the toxic blend of high financial leverage as a result of significant cumulative cash outflows, falling profitability and an expensive valuation often leads to a devastating impact on share price performance.

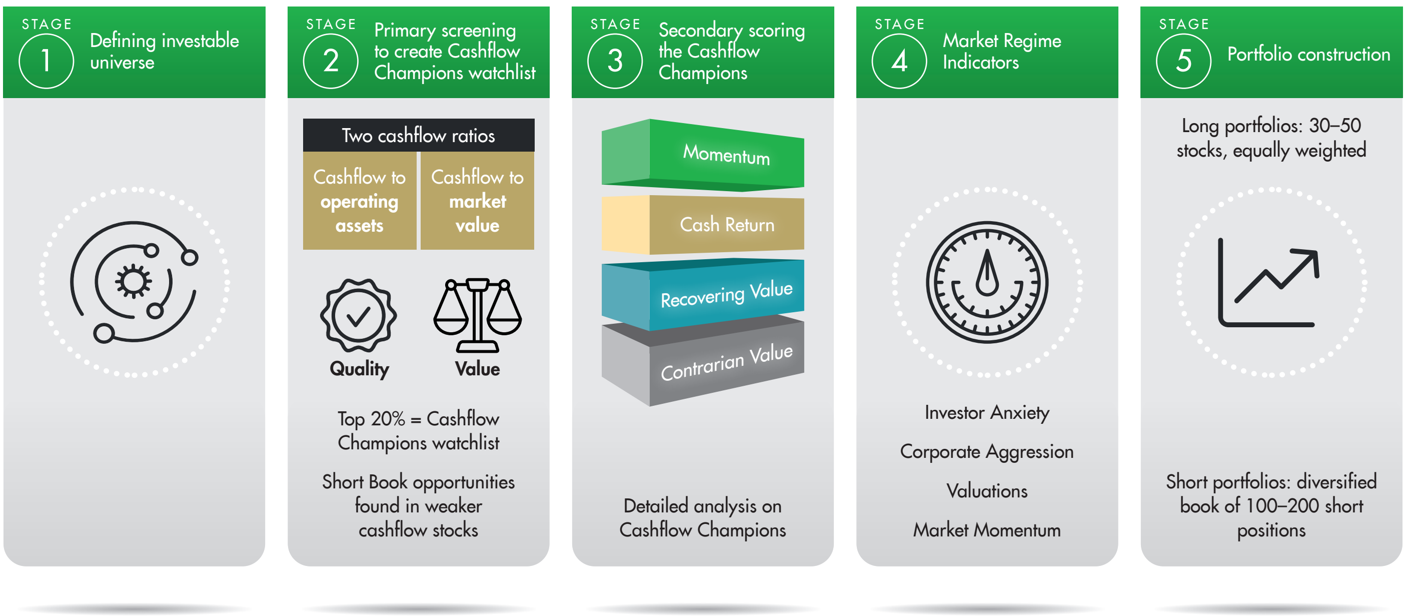
Our investment process can be broken down into several stages:

Stage 1: Defining Investable Universe

The first stage is to define the investable universe of companies with sufficient liquidity within our target geographic region.

Stage 2: Creating the Cashflow Champions watchlist

In order to identify companies' annual cash flow, balance sheet development and valuation efficiently across all equity markets, we have developed a simple screen as a starting point for further qualitative analysis.



The investment screen consists of two cash flow ratios that are combined equally to highlight the process characteristics that we seek.

The first is a quality screen (cash flow relative to operating assets) and the second is a value screen (cash flow relative to market value).

- Cash flow relative to operating assets: This ratio gives us a good idea of cash flow profitability and the scale of asset investment that has been undertaken. It provides us with a good sense of management prudence, financial leverage and sustainable growth potential.
- Cash flow relative to market value: Our second ratio ranks companies according to how investors value a company's cash flow. It provides us with a good indication of investors' expectations regarding forecast growth and the potential stock return if those forecasts are wrong

The ratios have been developed over a number of years and contain our own proprietary definition of operating assets and cyclically-adjusted, normalised cash flow (in a normal year excluding temporary or exceptional items).

Stocks are ranked in order of attractiveness across the two screens. The top 20%, or quintile, comprises the Cashflow Champions from which stock selections will be made for long-only portfolios. The bottom half of the screen provides short ideas for long/short portfolios.

- The top 20% of the list contains companies that are cheaper than the market (as measured by cash flow yield) with cash returns on operating assets that are better than the market.
- The bottom half of the list contains companies that have lower-than-average cash returns but are more expensive than the market.

Stage 3: Fundamental Research and Secondary Scoring

Our entire focus for our long-only investments is on this Cashflow Champions list.

We then conduct fundamental research on these stocks, scrutinising their annual report and accounts.

Cash flow data and balance sheet changes are often subject to large exceptional items or reflect a particular business cycle or accounting change. Our aim at this qualitative stage is to make sure that the cash flow ratios accurately reflect the investment opportunity we are looking for.

We work carefully through all the accounts, notes and annual commentary. We look closely for any changes in accounting policies, unusual revisions to prior year accounts, the focus of remuneration policy and the stated forecasts for growth.

We want to understand the management culture of the company. We do not attempt to understand a company's operations in enormous detail but do want a clear understanding of the importance they attach to cash flow generation and forecast risk.

Companies are assessed according to four 'secondary scores', refining their cash flow attributes and style factors within our screen:

Momentum: Businesses with strong momentum, high margins (indicative of economic moat) and self-funded growth.

Cash Return: Stable businesses with robust balance sheets, returning cash to shareholders through share buyback, debt pay-down and dividend (shareholder yield)

Recovering Value: Recovering businesses with management focused on reining in capital expenditure and imposing working capital control, eager to return cash to shareholders. Investors are generally sceptical, hence low conventional valuation

Contrarian Value: Companies that have experienced prolonged tough trading conditions, with management responding by restructuring and selling off assets. Investors are very sceptical.

Stage 4: Market Regime Indicators

We apply a set of key proprietary indicators which allow us to designate the prevailing market regime. This, in turn, allows us to optimise portfolio construction, targeting growth or value exposure as appropriate by emphasising different secondary scores within stock selection. For long/short portfolios, net market exposure is also dynamically adjusted according to the market regime indicators. The key indicators we analyse include valuations, investor anxiety, corporate aggression and market momentum.

Stage 5: Portfolio Construction

As a team, we work together on all aspects of the analysis and will discuss and agree the merits of each stock before an investment or short sale is made. The final stage of the process is to select stocks for portfolios. For long-only strategies, we believe the best returns are achieved through concentrated portfolios of 30 to 50 stocks that are equally weighted at inception. For long/short strategies, we maintain a highly diversified book of typically between 100 and 200 short positions.

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