

IFDS BROWN SHIPLEY STERLING BOND FUND

INVESTMENT OBJECTIVE AND PHILOSOPHY

Investment Objective

The aim of the IFDS Brown Shipley Sterling Bond Fund is to offer investors a “**Risk Conscious Route to Income**”.

The fund achieves this objective by generating a highly competitive level of income, whilst seeking to preserve capital over the medium term. In tandem, the fund aims to deliver a low volatile experience for unit holders.

Specifically, the fund is mandated to be amongst the top decile of income generators within the Investment Management Association (IMA) £ Corporate Bond sector, whilst seeking to preserve capital over the course of a complete interest rate cycle.

Investment Philosophy

Fundamental Belief

Investors should not be willing to accept additional risks without a commensurate increase in expected returns. As a corollary, investors should not expect to receive increased levels of return without incurring additional risks.

It is this **Fundamental Belief** system that ensures that the fund is neither risk seeking nor risk averse. Instead, it is **risk conscious**.

High Income

It is the fund managers' view that a “competitive” level of income must be defined in relative terms. To target an absolute level of income would result in excessive risks being taken at the top of the cycle and insufficient risks at the bottom. This goes against the fund managers' **Fundamental Belief**.

In defining competitive, it is necessary to define the competition. The fund resides in the IMA £ Corporate Bond sector and therefore the fund aims to provide a top decile level of income from the funds within this sector. The IMA criterion for the sector requires that at least 80% of the fund be invested in bonds with an “investment grade” rating from the major rating agencies.

Capital Preservation

High income is easy to achieve. The key success of the fund requires the delivery of its second objective – capital preservation over the medium term.

To clarify the position requires a definition of “medium term”. In the management of the fund, the fund manager defines medium term as the time taken to complete a full interest rate cycle. Research and experience suggests that such a cycle lasts approximately 5-6 years.

Capital preservation can never be guaranteed, however the fund has a well-defined strategy that ought to maximise the chances of achieving its aim.

**“A Risk Conscious Route
to Income”**

Fund Strategy

The “Income Generator”

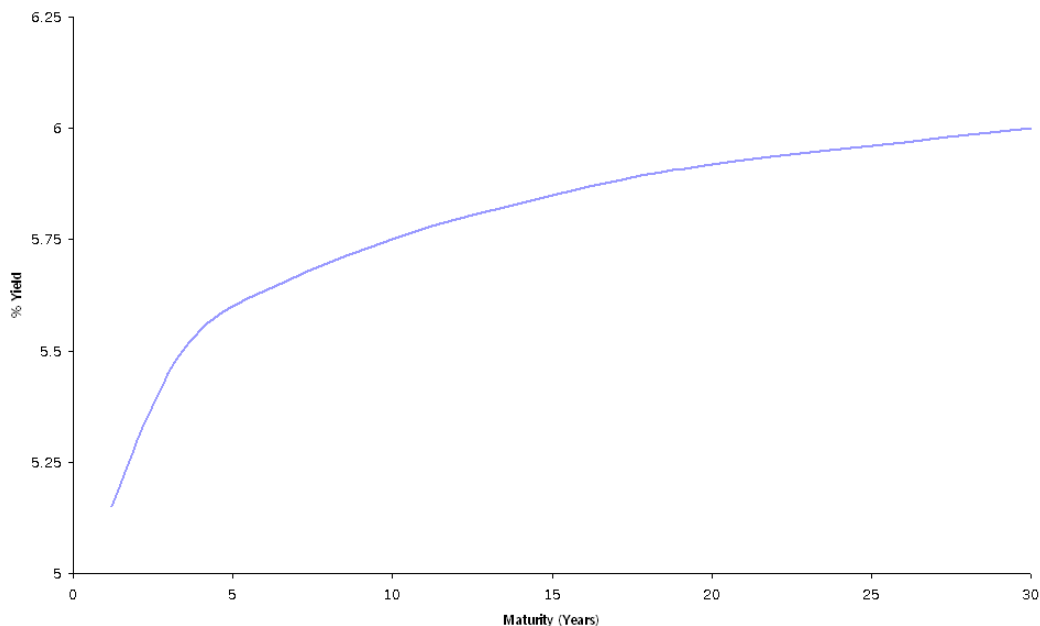
The generation of income is easy. Generating income whilst paying due attention to the impact on capital is essential as is the need to ensure that the income generated is sustainable. The **income generator** strategy addresses these issues.

The income generator strategy provides the mainstay of the fund and typically accounts for 75-80% of the fund’s assets at any one time.

The thought process behind the strategy is to select securities that work together to provide a sustainable, high level of income with the potential for some mild capital appreciation. It works as follows...

A typical “normal” yield curve has the following distribution.

Fig 1: An Example of a Typical “Normal” Yield Curve

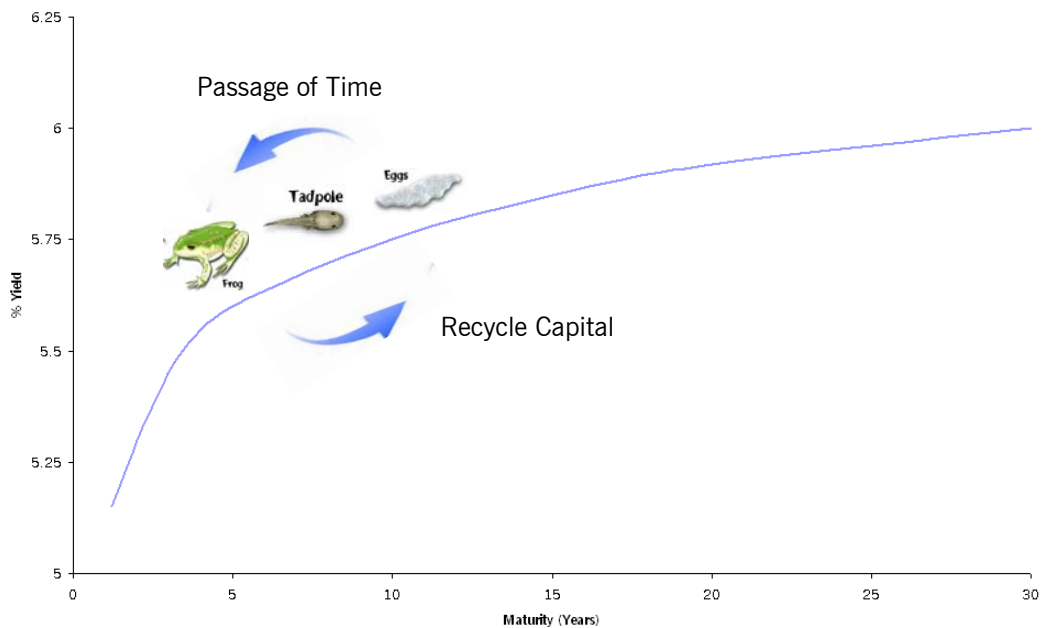


The shape of the yield curve allows the fund to purchase positions in securities with maturities in the 5-10 year range, where the curve is traditionally at its steepest.

The typical life cycle of a position within the portfolio begins with the initiation of a position with 8-10 years to maturity (spawn stage).

By holding such positions for 3-5 years, the income generated by these issues is harvested for distribution to clients (tadpole stage) during which time, the position gradually moves on to reach the end of the useful life within the fund (frog stage). The issue now has 3-5 years to maturity.

Fig 2: An Example of the “Income Generator”



Having harvested income for clients and reached the end of its useful life, we are now in a position to dispose of the issue and use the capital generated to create the next generation of bonds within the “income generator”.

The maturing process uses the inverse yield/price relationship on bonds to its advantage. Due to the steepness of the yield curve, and having held the position for close to a full rate cycle, as it “rolls” down the yield curve, it is typical that the yield on the issue is now lower than at the point of purchase. Disposing at this point - at a lower yield - means that there is often a small capital appreciation which can be realised and utilised to fund the management fee on the fund.

In creating the strategy, the fund is able to deploy a procession of issues operating at differing points within the life cycle. Whilst providing a platform for high and sustainable income generation, the strategy also allows for the fund manager to weight the components at an appropriate level for different stages of the interest rate cycle.

Managing Through the Cycle

Combining the desire to deliver a low volatile experience for investors with the fund managers' Fundamental Belief system, the fund will typically operate with a lower level of interest rate sensitivity (often referred to as duration) than the majority of its competitors.

Over the course of a rate cycle, the economic situation will change significantly, causing yields on corporate bonds to fluctuate in accordance with investor expectations of short term interest rates, inflation and the ability of companies to service their borrowings.

This provides the fund with the opportunity to manage its exposure to yield changes and corporate loans dependant upon an assessment of the current position within the rate cycle.

At the top of the rate cycle, the economic situation will likely be strong, but deteriorating. As it deteriorates, this leads to lower short term interest rate and inflation expectations; however the ability of companies to service their debts will also be deteriorating.

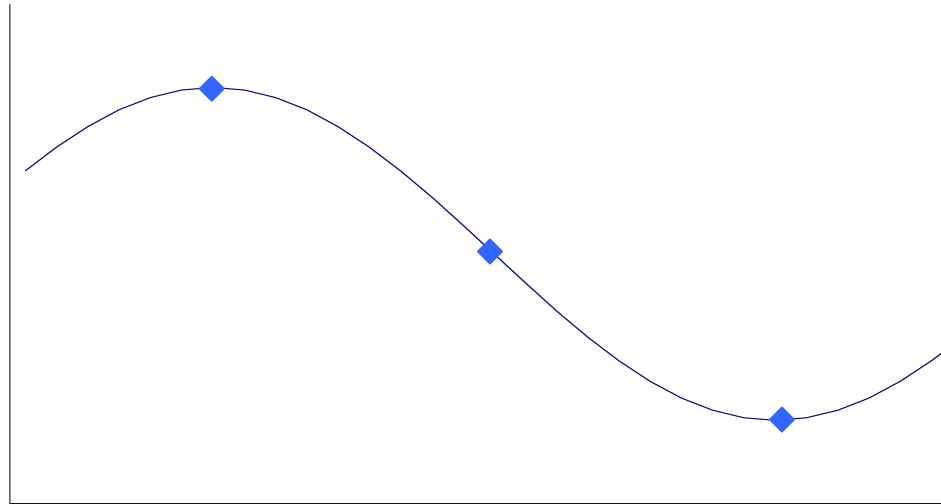
The response to such an environment ought to be an increase in the fund's sensitivity to declines in bond yields together with a reduction in exposure to lower quality corporate bonds.

Conversely, at the bottom of the rate cycle, the economic situation is likely to be poor, yet improving. In this environment, short term interest and inflation expectation would be likely to rise, whilst the ability of companies to service their debt burden improves. As such, the fund should lower its yield sensitivity whilst increasing exposure to corporate bonds.

By managing the fund with reference to the income generator strategy and the desire to position the portfolio appropriately at each point within the rate cycle, the fund manager is able to skew allocations and portfolio characteristics in a way which maximises the ability to achieve the core objectives of the fund, namely:

- Top decile income generation
- Medium term capital preservation
- Low volatile experience

Fig 3: An Example of Managing Through the Cycle



Position in Cycle	Top	Middle	Bottom
Economic Situation	Strong/Deteriorating	Average	Poor/Improving
Base Rates	High/Falling	Average	Low/Rising
Inflation	High/Declining	Average	Low/Increasing
Ability to Service Debt	Strong/Deteriorating	Average	Poor/Improving
<i>Portfolio Positioning</i>			
Duration	High	Average	Low
Exposure to Corporates	Low	Average	High
Gross Redemption vs. Running Yield	Redemption Yield > Running Yield	Redemption Yield = Running Yield	Redemption Yield < Running Yield
Income Generator Distribution			

Putting it All Together

The combination of the Fundamental Belief system, Income Generator strategy and ability to manage through the cycle creates the framework for the delivery of a well-balanced, well diversified fund with the ability to generate competitive income and maximises the potential to deliver capital preservation.

The delivery of the mandate however, requires more than a logical framework. Since the aim is to provide “A Risk Conscious Route to Income”, risk control must also be considered as must, security selection, tactical asset allocation and ultimate portfolio construction. It is only when all of these components work collaboratively that the fund can maximise the chances of meeting its aims.

Risk Control

In keeping with the fund mantra: “A Risk Conscious Route to Income”, the fund manager employs well-defined safeguards in order to provide an optimum level of capital protection.

Since income generation is easy, the key to sustainable income generation and performance is the dual goal of capital protection and the delivery of a low volatile experience.

Bond investments are relatively simple assets to value. There exists a well defined mathematical relationship between a bond's price and its yield.

UK Gilt investments are often reported to be “risk free”. Whilst this is clearly not the case, commentators express this risk-free nature on account of the near impossibility of a default by the UK Government. In the event of the Government running into cash-flow difficulties, it could ultimately resort to printing cash in order to meet bond payments.

The risks that UK Gilts do pose to investors (interest rate risk, inflation risk, re-investment risk etc) are features inherent in all fixed investments. As a result, the prime additional risk faced by investors in the corporate bond market is the risk of default. In the absence of money printing press, all corporate bodies pose this risk to investors to some extent.

To compensate investors for this additional risk, corporate bond issuers therefore must provide a yield premium over and above that on Gilt investments in order to tempt investors to take this further risk.

It follows from the Fundamental Belief system that this premium (often referred to as spread) must be sufficient magnitude to compensate for the risk of default. The role of the corporate bond fund investor is to balance the risk of default against the additional return offered by the bond.

The Role of Rating Agencies

Rating agencies are major institutions operating within debt markets whose role it is to assess the possibility of default by an issuer. By assigning a “credit rating” to a bond issuer or particular issues, these agencies provide the market with a thorough analysis of the risks inherent within corporate debt.

Credit rating agencies operate on a sliding scale rule. Using Standard & Poor’s (S&P) definitions (Moody’s and Fitch provide similar definitions); it is possible to quickly to assess the likelihood of default from a corporate issuer via reference to the assigned rating.

Fig 4: Standard & Poor’s Long-Term Credit Ratings

Rating	Description
AAA	Highest rating. The obligor’s capacity to meet its financial commitment on the obligation is extremely strong .
AA	Differs from AAA only to a small degree. The capacity to meet its commitments is very strong .
A	Somewhat more susceptible to adverse changes in circumstances than higher ratings. Capacity is still strong .
BBB	Exhibits adequate protection parameters. Adverse economic conditions are more likely to lead to a weakened capacity to meet its financial commitments.
<BBB	Obligations rated <BBB are regarded as having significant speculative characteristics.
D	An obligation rated “D” is in payment default .

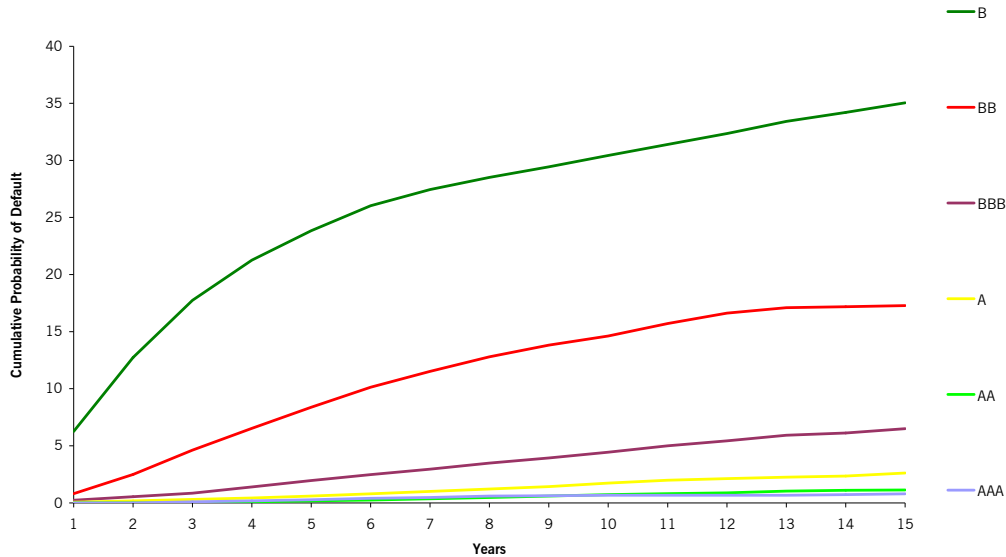
Source: S&P

The debate over the efficiency of rating agencies and their ability to respond to developments in a timely manner is likely to be discussed *ad infinitum* however the direct correlation shown between ratings and defaults **in aggregate** is incontrovertible.

Of particular note is the dramatic increase in default risk for issuers with a non-investment grade rating (<BBB). The chart below shows that a BB rated issuer is four times more likely to default in a five year period than a BBB rated issuer.

Fig 5: Average Cumulative Default Rates

S&P Cumulative Default Rates



Source: S&P

Rating the Rating Agencies

It is important to appreciate that the purpose of the agencies is merely to provide an opinion on the creditworthiness of an individual issue or issuer. Therefore, whilst the efficiency of the rating agencies on an aggregate scale cannot be denied, their ability to predict default at the individual level is no greater than another analyst's ability to proffer an opinion on the same.

This draws an important distinction in the fund's use of the output from rating agencies. At the macro level, the use of rating agency output is useful and should be utilised, however at the micro level their output should never be used as a substitute for proprietary due diligence.

Whilst professing to utilise a mixture of financial strength and operational strength when assessing the credit rating of a specific issuer, in truth, the agencies rely heavily on the use of credit metrics such as interest cover and leverage in order to determine ratings.

The consequence of this reliance on credit metrics often renders the rating process to become inherently more mechanical in nature and can often fail to take account of unusual or unique circumstances which may alter the actual probability of default at a given issuer.

Non-Rated Issues

Outside of the US, the rating process for an individual issuer is initiated by the issuer requesting an agency to undertake a review of its business, which upon completion and payment of a fee to the agency, the issuer then gains the right to use the rating and, for a further fee, will have its rating reviewed and published regularly.

The attractions of achieving a credit rating lie in the large ranks of investors who, either due to apathy or sloth, chooses to outsource their credit assessment to the rating agencies. By refusal of some investors to purchase debt instruments without a credit rating means that the purchase of a rating opens up these pools of capital to the issuer and over recent years has almost become a pre-requisite for gaining access to debt financing.

Prior to the advent of requiring a credit rating in order to access capital markets, numerous issuers, either due to the costs and time involved in the rating process or on account of their trust in the ability of institutional credit analysts to assess the risks, decided not to submit themselves to the rating procedure. This resulted in the creation of “non-rated” debt instruments.

Despite not possessing a credit rating, these instruments can be considered attractive investment options. In many cases, the covenant packages attached to these securities exceeds those on rated issues in the form of stricter credit tests or via access to better security of assets or even legal protection.

Using the Rating Agencies

The asymmetric return profile of bond investors caused by the limited liability nature of equity investments makes a default a disastrous outcome for a fixed income investor. Whilst upside on bond investors are capped to the non-discounted sum of all future cash flows (when the redemption yield equals zero), the downside potential is unlimited, with 100% of capital being put at risk.

Since capital preservation represents one of the three aims of the fund, defaults must be avoided wherever possible. In aggregate, the rating agencies have demonstrated a consistent ability to act as a good indicator of default. It is on this basis that in order to provide protection against this risk, the fund **will only ever buy investment grade issues**.

In tandem however, the fund also has the ability to buy **non-rated issues**, which in the opinion of the fund manager, **would qualify for investment grade status** in the event that the company or issue was subjected to the rating process.

In the event of a downgrade of an issuer from investment grade to non-investment grade status, the fund is not a forced seller. In such instances, the fund manager will assess the rationale for the

downgrade and determine whether the situation is likely to reverse or considers that the downgrade has been driven by overly “mechanical” factors.

Non-Credit Risks

Whilst in theory, the additional yield on a corporate bond should represent the premium required by investors to compensate them for the risk of default; in practice the premium also incorporates a liquidity risk premium together with an event risk premium.

When addressing non-credit risks in the form of liquidity, takeovers, mergers, fraud etc (collectively referred to as episodic risks). it is important to acknowledge that whilst necessary to consider such risks, they are almost impossible to analyse. Due to this “known unknown” element, it is therefore appropriate to place investment limits on exposures to issuers and sectors within the portfolio.

At this stage it is important to stress the distinction between issues and issuers. An issuer may have numerous issues available to invest in. By imposing restrictions on issue exposure would be to ignore that in general, when an issuer defaults on its debt payments, it will tend to default on all of its issues simultaneously. To account for this dynamic, the fund places limits on the exposure it will have to any single issuer to a maximum of 5% at the point of purchase.

Systemic Risks

As a special form of non-credit risk, systemic risk is equally important to take into account. Systemic risk represents the risk of having excess exposure to a particular sector of the economy such that in the event of a sector specific event such as a change in regulation, the consequences subsequently cascade throughout the sector, often with detrimental ramifications.

To aid the control of systemic risk within the portfolio, the fund limits its exposure to any particular sector to a maximum of 20% of total assets at the point of purchase.

The “Index Bums” Problem

The “index bums” problem refers to the practice used by many corporate bond fund managers in using reference benchmarks as a starting point for their asset allocation.

In fear of underperforming a particular benchmark index or peer group comparison, many fund managers resort to replicating the benchmark with a view to replicating its performance. “Active” management is deployed by deviating slightly from the benchmark according to the level of conviction held on a particular view in a form similar to the benchmark “tilting” approach adopted by many equity fund managers.

Given the inherent differences in the construction of bond benchmarks together with the different risks faced by bond and equity investors, this method of portfolio construction is nothing short of dangerous.

When discussing with fixed income investors their motivations for bond investing, common trains of thought emerge time and time again. First and foremost, fixed income investors look for high and sustainable levels of income from their portfolios – this is without doubt their overriding concern.

Once the income consideration is met, sustainability of income together with capital security comes a close second in the order of priorities followed by the desire for a lower risk and non-correlated outcome with their equity exposure.

The use of indexing within bond portfolios results in over exposure to the most heavily indebted companies, who are in turn the least able to service their debt obligations. At the same time, indexing also results in an over exposure to systemic risks. With this in mind it becomes immediately obvious that the use of these portfolio construction methods serves only to increase the risks involved. This is why the IFDS Brown Shipley Sterling Bond Fund shuns any notion of indexing and instead focuses on the attributes that our discussions with investors tell us are what they want from a corporate bond fund. High levels of income. Medium term capital preservation. A low volatile experience.

Security Selection

Typical credit selection processes examine the probability of default. Since the impact of default can be catastrophic for the bond investor, perhaps this is not surprising.

Many credit metrics and ratios exist to assist the analyst in the assessment this likelihood, however at Brown Shipley Funds we believe that such devotion to ratio analysis can blind the investor to the possible risks.

In practice, there exist three types of borrower. They can be categorised by their ability to service and repay their debts.

Spread Contractors

Some companies utilise debt markets as a means of diversifying their sources of capital or as a means of operating with a more “efficient” balance sheet, using debt capital as a method of reducing their overall costs of capital.

With a strong asset base, consistent profitability and high levels of cash generation and equity creation, when set in the context of their liabilities, the debt forms a small component of the capital structure and is easily serviced. Should they choose to do so, the company could repay their debts prior to the need to refinance.

Stable Spreaders

Further along this spectrum of borrowers, other companies rely on access to debt markets as a means of providing them with a cheaper source of capital than that available in the equity markets. This may be on account of a lower return on assets, which results in the need to lower the cost of capital in order to generate economic profits or alternatively due to a strong level of earnings visibility, making the need for equity financing lower than would otherwise be required.

Such companies typically have the ability to comfortably service their debts, but would need to undertake asset disposals in order to repay such debts prior to their refinancing date.

Default Candidates

As the debt burden is added to, some companies breach the critical point (perhaps of no return) where their capacity to service debts is such that the prospects of generating equity become almost non-existent. Regardless of the operational performance of the group, debt levels are so high that all resources of the group are devoted to the servicing of the debt obligations such that risk capital is gradually eroded. Any deterioration in operating performance will often lead to default.

Thinking as an Equity Investor

In our view the success of any corporate venture is governed by only three factors. Those factors are:

- Quality of Asset Base
- Ability of Management
- Method of Financing

Whilst it is possible to dissect such factors to almost infinite degrees of complexity, when assessed in the cold light of day, success or failure typically depends on one or more of the above.

Full details of our credit selection process are available as a separate document: **IFDS Brown Shipley Sterling Bond – Credit Selection Process**. What follows is a summary of that document.

As a starting point for our credit analysis, we begin by examining the issuer from the perspective of an equity investor. It must be remembered that management of limited liability companies have a fiduciary duty to equity investors as owners of the company. As a result, management will constantly strive to generate optimal equity value.

Most companies hold separate updates and presentations for bond and equity investors. We believe there to be good reason for this, in that at times, the desires of both parties come into direct conflict. Given the competing claims on each, we often find that management will favour the equity camp. Being ignorant of the promises made to equity investors can prove costly.

In order to maximise equity value, management are best served seeking to maximise Returns on Equity (RoE). By maximising RoE, the company has the flexibility to grow at an accelerated pace, increase its asset base without recourse to external sources of capital. Provided returns are maintained, the company will in turn be able to distribute increasing amounts of income/capital to shareholders in recompense for their initial outlay of capital.

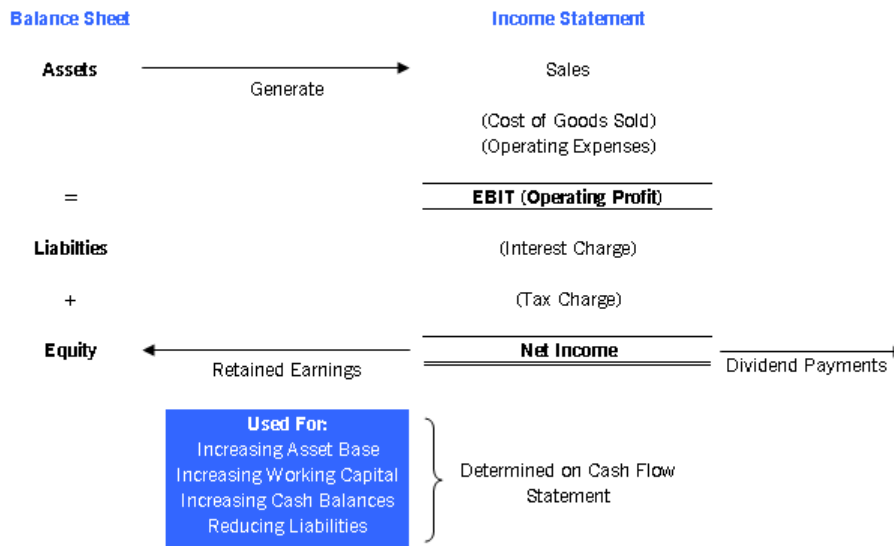
As bond investors, equity maximisation is also akin to our needs. As the risk capital of the organisation, this equity “cushion” serves to provide increased levels of protection to our fixed liability in the form of increased asset coverage, whilst if returns on assets are maintained, increases the level of interest cover.

The simple model described below depicts how assets are employed to generate operating profits and ultimately net income. Net income which is not distributed to shareholders in the form of dividends is maintained within the company as retained earnings.

It can be seen therefore that growth in equity levels are dependent on two major factors:

- Return on equity
- Earnings retention

Fig 7: Interaction of Financial Statements



Return on Equity

In analysing credit investments from the perspective of an equity investor, return on equity becomes a prime source of investigation. Understanding how such returns have been achieved, management targets and expectations of return on equity and the sustainability of such returns allow us ascertain the quality of the assets used to support our obligation together with the quality of management.

Return on equity may, however, be highly influenced by the financing decision. Whilst it is the quality of assets and the effectiveness of management in utilising these assets that governs operating profitability, these profits in accordance to the competing claims put upon them.

Since management may be easily tempted to increase returns on equity via an increased use of leverage, it is only by studying issuers from an equity perspective that it is possible to indentify those companies who are seeking to generate returns for equity investors at the expense of bondholders.

Raising Capital

Companies raise capital for a variety of reasons. During times of expansion, capital may be raised to fund a growth project or acquisition. During times of hardship, capital may be raised in order to refinance or recapitalise a balance sheet.

In the event that the issuer decides to raise capital, prior discussion with management in respect of their preferred sources becomes a critical factor. As a major source of event risk, having the perspective of an equity shareholder as well as that of a debt holder provides the opportunity to reduce exposure to this potential problem.

Price

Via an understanding of the equity creation process, management goals and promises to shareholders together with an analysis of return on equity and how this impacts the financing decision, we are able to classify issuers as either a spread contractor, stable spreader or default candidate.

It is at this stage in the process that we consider price. At all times we have been seeking to ascertain value. Once determined we are able to compare this against the prevailing market price.

In general, corporate bonds trade on a spread basis. In theory, the additional yield on a corporate bond represents the premium required by investors to compensate them for the risk of default. In the UK, this spread represents the additional yield over and above that on a similar dated gilt investment, which represents the “risk free” rate of return.

Risk of default and the associated spread required to compensate for that risk comprises of two elements:

- Probability of default
- Recovery rate in the event of default

Through our analysis of how the company “works”, its ability to service its debts and the extent of asset coverage available to us, we are able to ascertain the appropriate level of spread needed to compensate us for this risk.

Which brings us full circle to our Fundamental Belief. By ensuring that we only take risk when we believe we are being paid to do so allows us to deliver on our mandate. Not risk seeking, not risk averse, but “**A Risk Conscious Route to Income**”.

Portfolio Construction

Many investors ignore the merits of suitable portfolio construction. They do so at their peril.

Earlier we described how the income generator strategy combines with appropriate risk controls in order to maximise the ability of the fund to meet its objectives. Portfolio construction does not stop there.

Amongst credit investors there is a common misconception that diversity is delivered via a large number of positions.

As discussed in the section entitled “index bums”, the concept of index tracking within a credit portfolio is completely foreign to us. It follows then, that whilst the index may consist of a large number of issues, the preponderance of certain sectors and industries to issue debt within their capital structures leads to an excessive source of industry specific, or systemic risk.

In our experience, suitable diversification can be achieved with just 40-50 holdings. And whilst running a more concentrated portfolio can increase the exposure to episodic risks, the ability to be “on top” of all the positions in the portfolio provides much greater levels of control and conviction, thereby offering the opportunity to closely monitor their existence and take appropriate measures.

The best source of diversification in our view, is that of “chain integration” and is best described by way of example.

The era of the conglomerate is over. Though it may return some day, in the present environment the majority of organisations strive to compete via the identification of a specific niche, which they exploit via single-minded focus on what they do best. The explosion in outsourcing over recent times is testament to this.

As a consequence of this dynamic, many industry vertical chains have become disaggregated. Whilst this leads to operational efficiencies at the micro level, it exposes investors to greater levels of supply chain risk than previously when industry operated in a more integrated fashion.

To circumnavigate this problem, as investors it is possible to build a portfolio which reintegrates these supply chains. As a real example, the combination of a brewing company with a pub company would constitute “chain integration” as would combining a paper producer with a newspaper publisher.

Comprised within the income generator strategy, the portfolio operates with c.50-75 positions each constituting c.1-1.5% of the portfolio which provides a broad coverage of industries and sectors, ratings

and maturities such that investors gain access to a well diversified, risk conscious fund capable of generating high and sustainable levels of income.

The “diverse core” as we call it provides the bedrock of the fund. Sitting on top however is our “Super 7” portfolio.

The “Super 7”

As a result of our proprietary, in depth, due-diligence process, we believe we have the opportunity to identify materially mispriced assets.

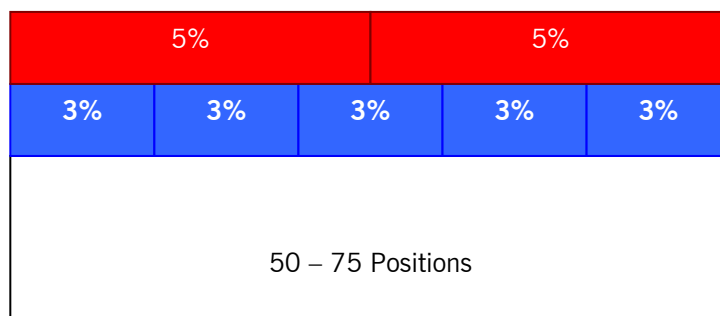
That is not to say we believe all of our positions are “cheap”. On the contrary, we believe at most points in the cycle, the vast majority of the credit markets are efficiently and appropriated priced. It is on that basis that when we uncover what we consider to be a material mispricing, we feel that our research should allow us to back such a position with clear conviction.

This is the idea behind the “Super 7” concept.

The “Super 7” represents our very best conviction issues and provides the active satellite strategy for the portfolio. Comprising of two positions representing 5% of assets and five positions representing 3%, the “Super 7” portfolio constitutes c.25% of the portfolio and provides investors with the opportunity to take advantage of those issue we consider will provide most capital appreciation as they revert back to their “fair” price.

Combined, the “Diverse Core” and the “Super 7” portfolios produce the right balance so that via the generation of highly competitive levels of income, the desire to preserve capital and deliver a low volatile experience, investors in the fund can be confident that we will always seek to produce **“A Risk Conscious Route to Income”**.

Fig 8: Portfolio Construction



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