BROWN SHIPLEY
FUNDS

IFDS BROWN SHIPLEY STERLING BOND FUND

Credit Selection Process

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.

Credit Selection

In accordance with our **Fundamental Belief**, our credit selection process hinges on the ability to gain a thorough understanding of the risks involved. It is only via examination of the risks that we may formulate an opinion on whether we are being adequately compensated for them.

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.

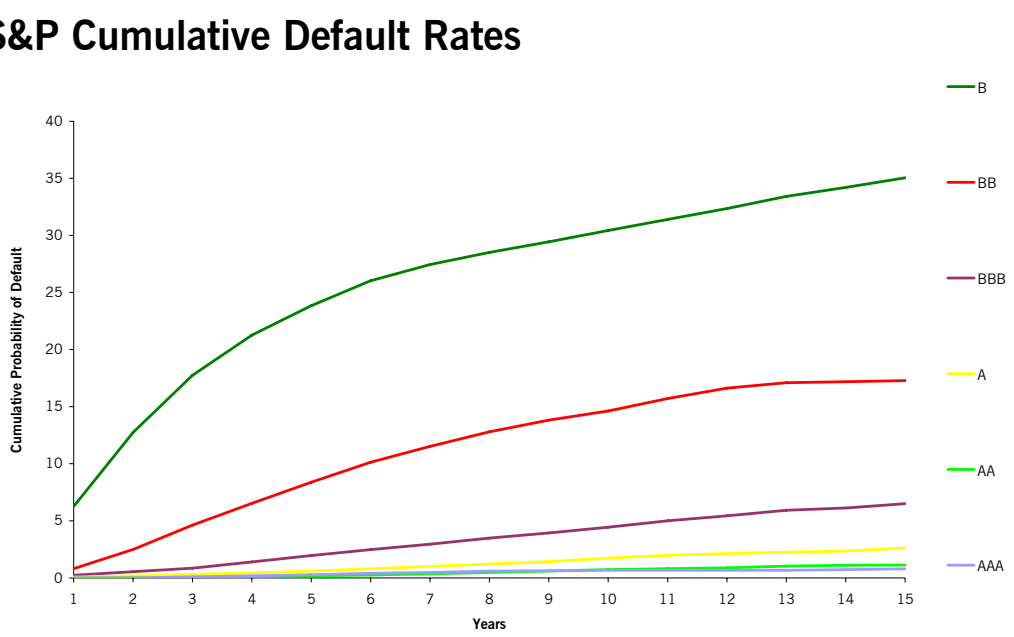
Credit Rating and the Role of Rating Agencies

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.

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 infinitim* 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 1: Average Cumulative Default Rates



Source: Standard & Poor's (S&P)

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**.

Determining Creditworthiness

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.

To draw a sporting analogy, evidence shows that even the best managers struggle to generate performance with a depleted squad or a dearth of talent. In the same sense, poorly managed teams (the asset base) are unlikely to perform to their full potential whilst a sub-standard management situation exists. The combination, however, of a talented and well-balanced squad with a knowledgeable and gifted manager often creates a potent force.

Whilst the method of financing could arguably be classed as a management decision, the difference in skills required for effective operational management and that of financial management means that each warrants separate examination. Quite often, even a strong management team can fall foul of a terminal financing decision made at some point, regardless of operational excellence.

When investing however, it is important to draw a distinction however between well managed corporate bodies and good investments. Good companies do not necessarily make sound investments; that said however, finding such bodies will increase the likelihood of achieving investment success.

Therefore, in the management of the fund we seek to go a stage further. Identification of a well-managed, strong asset base provides a sub-set of investments for further consideration. If invested in at an appropriate price, we believe this provides the recipe for solid and sustainable returns.

Asset Base

A company's asset base is of fundamental importance. It is the utilisation of the asset base that allows a company to generate sales, profits and ultimately cash flow.

The study of the asset base begins with the Balance Sheet. The "top half" of the balance sheet details the physical assets the company's management have at their disposal in order to generate sales, profits and ultimately cash flow. As highlighted in our sporting analogy, if these assets are flawed, outdated or non-competitive, generating sufficient returns will be an uphill struggle.

Fig 2: Morrison Consolidated Balance Sheet

Consolidated balance sheet

3 February 2008

	Note	2008 £m	2007 £m
Assets			
Non-current assets			
Property, plant and equipment	9	6,205	6,117
Lease prepayments	10	239	228
Investment property	11	239	241
Financial assets	12	43	19
		6,726	6,605
Current assets			
Stocks	13	442	368
Debtors	14	199	151
Financial assets	12	74	–
Cash and cash equivalents	15	191	231
		906	750
Non-current assets classified as held for sale	16	4	16
		910	766
Liabilities			
Current liabilities			
Creditors	17	(1,679)	(1,501)
Other financial liabilities	18	(77)	(254)
Current tax liabilities		(97)	(100)
		(1,853)	(1,855)
Non-current liabilities			
Other financial liabilities	18	(774)	(768)
Deferred tax liabilities	20	(424)	(478)
Net pension liabilities	21	(68)	(198)
Provisions	22	(139)	(145)
		(1,405)	(1,589)
Net assets		4,378	3,927
Shareholders' equity			
Called-up share capital	23	269	268
Share premium	23	57	41
Merger reserve	24	2,578	2,578
Retained earnings and hedging reserves	24	1,474	1,040
Total equity attributable to equity holders of the parent		4,378	3,927

Source: Morrison's Report & Accounts 2008

Company assets come in various guises. A broad distinction however, leads us to consider five types of asset.

- Long-term tangible items (plant, property, equipment etc.)
- Long-term intangible items (goodwill, patents, licences etc.)
- Current assets (inventory, raw materials etc.)
- Investments (equity stakes, long-term deposits/loans etc.)
- Cash and near cash (cash, short-term deposits, accounts receivable etc.)

The first three are considered operational assets and will be used in the companies stated operations. Study of the operational asset base is of primary concern and is the focus of our studies.

The evolution of assets classified as investments will typically be insignificant in the "greater scheme" and most likely, beyond the immediate control of management. As a result, unless the investment comprises a significant component of total asset base, such quantities warrant a lesser examination.

The ultimate goal of any management team, however, is to convert the use of all assets into the final category – cash.

Analysing the operational asset base (long-term & current asserts) provides an understanding of how a company "works" and provides a list of requirements needed to operate in a particular field. As an example of physical assets, at a basic level a retailer would require (to varying degrees) premises from which to operate, warehousing facilities, inventory and transaction facilities. In contrast, an IT consultancy would require smaller premises, negligible inventory and no discernable need for transaction facilities.

It is clear to see therefore that different industries require varying levels of asset intensity. The same vagrancies also occur within the intangible asset base. Whilst a commodity producer may maintain little intangible assets by way of brands or processes etc. a pharmaceutical company could well cease to be a viable business without the existence of intangible assets such as patents and licences.

Goodwill created upon acquisitions often represents the majority of intangible assets reported within company accounts and can pose a problem when assessing its value. Goodwill created on acquisitions theoretically represents the intangible assets a company possesses such as knowledge of processes, relationships with customers and suppliers and brands etc. To overcome this potential dilemma, we calculate returns on the asset base, with goodwill both included and subsequently excluded. Analysis of

the results often acts as a sound indicator of the need for such goodwill within the company's list of assets.

It is common practice for companies to utilise assets that they do not own. Such assets are often utilised under operating lease agreements. Where these agreements exist, it is necessary to gain knowledge of their existence and how they are utilised. The benefits of a lower depreciation change (due to non-capitalisation) from an operational lease are often negated by higher rental costs, as are the lower capital requirements of no "up-front" investment.

Generally speaking, operating leases act to the detriment of bondholders since they are effectively off-balance sheet assets supported by off-balance sheet debt and therefore increase leverage. Where possible we would seek to investigate the effects of operating leases via a process of re-capitalisation.

Re-capitalising Leases

Many companies utilise assets that they do not own. Such assets are typically secured under operating leases. The effect of an operating lease means that despite deriving economic benefits from the use of the assets, the asset is not capitalised, and hence not disclosed on the balance sheet.

This "technical" difference in ownership leads to a different method of accounting for the assets and can introduce distortions into reported returns.

A company purchasing a fixed asset (machinery) for £200m funded via a £200m debt issue would register a long-term tangible asset worth £200m on its balance sheet, coupled with a £200m debt liability.

Suppose the company depreciated the asset over a 20 year time period and the cost of debt was 5%, this would lead to an operational cost of £10m p.a. (depreciation) and an interest expense of £10m p.a. Total expense = £20m.

Alternatively, had the company entered into a 20 year lease on the machinery, with a annual rental expense of £22m, the entire expense would be accounted for as an operating cost, with no interest charge. Total expense = £22m

We have highlighted the difference in total expense purposefully in this example in order to highlight the comparison.

The total expense, when accounted for as an operating lease, can be thought of as comprising of three elements: Depreciation charge, interest expense + leesor's margin.

As we described above, the depreciation charge + interest expense would likely total £20m in our scenario, but we must also incorporate the margin that the leesor will wish to make on their investment.

In exchange for the margin, the lessor must carry the economic risks of owning the asset. In exchange for the additional payment, the company will typically have the right to exit the lease should the asset become no longer needed.

The ability to exit the lease via the incurrence of a lease exit charge, leads us to consider such leases as a form of **contingent debt**.

Our evaluation of leases as a form of contingent debt is just one area where we differ from the rating agencies. The rating agency attitude towards operating leases is to re-capitalise such leases before proceeding to calculate lease adjusted credit ratios.

Whilst we must be aware of the existence of operating leases, we believe that such "blind" ratio analysis fails to acknowledge that for functioning and profitable businesses, the need to conduct lease exits is such that the adjustment should be acknowledged only in determining operating expenses and not considered as large-scale financial liabilities.

Human Capital

Another area where our assessment differs from that of rating agencies is the consideration what is often the greatest off-balance sheet asset that companies deploy – their employee base. At a simple level, when management decide between their modes of operation, they may be able to make a choice between either physical capital (plant and equipment), or human capital (employees).

Many industries, and indeed economies, throughout history have benefited (via higher productivity) by progressively replacing human capital with physical capital on account of higher levels of efficiency and the ability to employ human capital on other tasks. There are, however many industries in which the use of human capital is of fundamental importance.

Analysis of staffing levels together with average salaries, remuneration packages and pension contributions allows us to assess the growth in the employee base, in addition to assessing the costs and efficiencies generated as a result.

Growth in Human Capital

An increase in the size of the asset base would be expected to follow through into a corresponding increase in sales and profitability. Whilst we can monitor this explicitly for physical assets, growth in the intangible asset base requires a different approach.

To assess the efficiency in which additional human capital is employed, we are able to construct some basic ratio tests.

Sales per employee, operating profit per employee and assets per employee all provide useful indicators of the efficiency in which additional human capital derives additional returns. When analysed over a period of time, such ratios also provide an indication of whether the management is seeking to change the mix of physical and human assets.

Return on Assets

Having identified the assets owned and operated by the company, we are in a position to assess their effective use by management. To do so, it is our belief that the best measure of efficiency is found via return on assets (ROA).

To arrive at an appropriate measure of return on assets, we consider the percentage returns generated by the company (measured using operating profits) as a proportion of operating assets.

ROA (Operating efficiency) = Operating Income/Operating Assets

Operating income will be measured before the effect of returns on investment but after depreciation and amortisation. To calculate this measure using EBITDA (i.e. before depreciation and amortisation) would create a bias towards companies who have deployed physical capital as opposed to human capital. Essentially, depreciation and amortisation can be thought of as the "wages" paid to tangible and intangible assets for services rendered during the period and thus need to be incorporated into the calculation.

Whilst we have attempted to remove any systematic bias within the calculation, there remains the distortion created by the human vs. physical capital decision. It is possible, in theory, for a company deploying only human capital to realise an infinite level of operating efficiency via our measure.

This illustrates the need to first gain an appreciation of the asset base via a preliminary study. "Blind" ratio analysis does not aid the investment process. The use of ratios and other measures ought only to aid the process when taken in conjunction with an understanding of the underlying operations. Failure to understand how or why such ratios may be generated leads to a system of "investment by numbers" and is, in our opinion, a significant flaw in some of the decisions taken by rating agencies and credit analysts alike.

Having analysed the composition of the asset base and the returns generated on it, we are in a position to evaluate the accuracy of the asset values as reported on the balance sheet. Discovery of an abnormally high return on assets may be an indication of an understating of the true asset values. Similarly, significantly low levels of returns are a potential indicator of overvaluation of the assets contained within report and accounts. Evidence of overvaluation of assets may act as an early warning of future asset write- downs, which would in turn reduce reported asset coverage and could ultimately lead to a ratings downgrade.

Value vs. Price

The value of any asset is equal to the sum of the cash flows generated by the asset, discounted back at the appropriate rate of return. This concept of "earnings power" allows us to assess the value of any asset irrespective of its origin, condition or state based solely on its cash generative capacity.

The price of an asset is the amount a counterparty would be willing to exchange for ownership and use of the asset. This "pricing" concept allows us to establish or estimate the proceeds any asset would realise upon sale. The key point however is that "price" and "value" may not necessarily coincide.

Over time, we believe that prices gravitate towards value. Therefore in our credit process, we seek to determine the value of the asset base, before cross-checking with a more market-orientated, price.

This combination of fundamental based valuation, complemented via a market based approach provides the best method of attempting to establish the value of the assets upon which our debt is secured. As a key determinant in evaluating the appropriate recovery rate in the event of a default on a bond, this asset study is of paramount importance.

Asset Coverage

As we highlighted earlier, companies may be able to generate higher levels of returns on the asset base via the deployment of human capital as an alternative to physical capital. Whilst re-capitalisation of human capital is possible via established methods (Lew & Schwartz model is most often applied), since slavery has been long abolished and employee claims on company assets are subordinated to those of fixed or floating charge holders, we deem it unnecessary to re-capitalise human capital.

Compensating for the potential bias created by the human vs. physical capital decision and providing a useful starting point for evaluating a crisis scenario is the concept of asset coverage.
In the event of liquidation, the order in which payments are made is fixed by statute. The order in which creditors are repaid, whilst never "cut and dry", follows a general format of preference:

- Secured creditors
- Preferential creditors
- Floating charge holders
- General creditors
- Preferential shareholders
- Ordinary shareholders

Secured creditors typically comprise of banks and other secured lenders. The Government (and other Crown departments) are considered preferential creditors, and therefore unpaid VAT, corporation tax or other taxes must be settled before floating charge holders receive payment.

Plain-vanilla corporate debt instruments usually rank as floating charge holders over company assets. By assessing the potential sale value of company assets and deducting payments required to settle secured and preferential creditors, it is possible to estimate the likelihood of capital recovery should the lender suffer distressed circumstances.

Clearly, a company that deploys human capital as opposed to physical capital therefore provides much lower levels of asset coverage. Since staff costs (wages etc.) are subordinated to debt holder's interests, the asset base of the company will ultimately "walk", leaving debt holders with little or no recourse.

The ideal combination, when assessing ratios for investment consideration, would be a company demonstrating strong operational efficiencies together with a comfortable level of asset coverage.

Operational efficiency is of paramount importance to us. Whilst asset coverage provides the comfort that, should it become necessary, asset sales may cover our position, ultimately we would prefer to be creditors of companies who are not required to adopt such drastic measures.

The efficiency in which assets are deployed directly impacts on profitability. This in turn impinges on the company's ability to generate cash and in the creation of equity.

Equity Creation

Studying the evolution of a company's balance sheet, it is the creation of equity that allows for management to be in a position to retire debt. Equity can be created in three ways:

- Issue new equity
- Retain equity via retained earnings
- Release equity via asset sales (at price in excess of book value)

All three measures have the effect of reducing leverage and would be considered bondholder friendly actions.

Taking each in turn, we can see how each method aids bondholders.

New Equity

The issue of new equity is a capital raising exercise and will result in the company receiving either cash or assets (in lieu of cash). The receipt of cash will allow management the opportunity to reduce debt levels and will also reduce the net interest bill paid by the company whilst the cash is retained in liquid form. Alternatively, if the cash raised is subsequently invested in assets or assets are received in lieu of cash, this has the effect of increasing asset coverage due to the increase in the asset base. Provided the assets generate a positive return, this will also increase the level of interest coverage. Increased asset coverage and interest coverage improves the profile of the borrower and may ultimately lead to an upgrade in the credit rating of the company.

Retained Earnings

When an entity generates profits and cash flow, management are faced with the decision of how such profits should be handled. The company has to decide whether to return profits to shareholders (via dividends or share repurchases) or alternatively re-invest such profits in order to generate organic growth. Again, as bondholders, our preference is to witness the maximum amount of re-investment within the business. Such actions swell the asset base and, as before, increase both asset and interest coverage.

Our return on assets measure also aids this process. A company generating a high return on assets is more likely to retain earnings within the company, as opposed to returning profits to shareholders. Providing such returns can be sustained, shareholders are also more willing to encourage this process at the expense of an immediate dividend payment, since the management have shown that such profits generate a better return than that available on alternative investment interests.

Asset Disposal

The final form of equity release available to companies is that of asset disposal. A company owning an asset with a book value of £100m may subsequently agree to dispose of the asset for £200m. Such a transaction would create equity of £100m and would be shown as a gain on sale of £100m in the income statement. Provided the newly formed equity is retained within the business, bondholders will benefit from the greater coverage created however may suffer lower levels of interest coverage on account of the income foregone on account of the asset sale.

Financing

We have considered our main proponents of corporate success: Asset quality and management, however, we must also asses our final determinant: financing.

Returning to our balance sheet, it is here where we can determine how the assets owned and operated by the management have been financed.

So far we have concentrated our studies on the "top half" of the balance sheet. Turning our attentions to the lower half, we are able to see the competing claims on the assets listed above.

In a similar manner by which we were able to draw broad classifications of assets, we can perform a similar task with liabilities, splitting claims into five separate components.

- Short-term operational liabilities (accounts payable, tax payable etc.)
- Short-term financial liabilities (interest payable, dividends payable etc.)
- Long-term operational liabilities (decommissioning costs, provisions etc.)
- Long-term financial liabilities (debt repayments etc.)
- Equity liabilities

Having performed such a task, we are able to analyse the nature of the liability structure in addition to gaining an understanding of when such liabilities are expected to fall due.

Armed with this information, we are now in a position to create a "net" balance sheet. The "net" sheet seeks to net assets and liabilities off until only employed capital items are left in the liability structure.

By way of an example, an oil platform subject to decommissioning costs would be reported in the formal balance sheet as both an asset (the platform) and a provision for future costs (decommissioning). Netting off the asset and liability serves to reduce the value of the underlying asset by the amount of the liability and therefore presents a clearer picture of the true position.

In a similar manner, accounts payable (liability) for services rendered or goods consumed may be netted off against accounts receivable (asset) and inventory (asset), thereby creating a net account for working capital.

Whilst the results of such a process are important themselves, allowing us to gain a clearer picture of the sources of finance. Of equal importance, is the procedure itself, which allows us to again develop a clearer understanding of how the business "works".

At all times during our credit selection process, we are mindful of two dimensions of risk.

- Is the company in a position to make timely payments to bondholders?
- Is the company's ability to make such payments being improved or impaired?

The first element requires a further study of liquidity (covered later), whilst the second is dependent more on the process of equity creation.

Whilst a common occurrence, it is possible that an investment made in a bond will not be maintained until redemption. Thus, whilst liquidity of the company is important, given our investment objectives, it ranks secondary to equity creation.

When we consider an investment, our starting point is that of an equity shareholder. Whilst this may seem unusual for selecting debt-based investments, we must remain mindful that company management have a fiduciary duty to shareholders only.

This agency problem, together with the asymmetrical risk profile of debt, caused by limited liability laws leads us to adopt this view. Management's duty to shareholders is to maximise shareholder value, and whilst the methods used to achieve this goal can often overlap with those in the best interests of debt holders, they can also lead to elements of friction between the two camps.

Return on Equity

Return on equity (RoE) is perhaps the most appropriate method of maximising shareholder value for shareholders. Although not explicitly pursued by many companies (who prefer EPS measures), maximising RoE serves to achieve this goal in the most efficient manner.

Defining Return on Equity (RoE) as:

$$\text{Return on Equity} = \text{Net Income/Shareholders Equity}$$

we can see how RoE maximisation effectively acts as a yield measure on the equity capital contributed by shareholders.

Taking this a stage further, given an earnings retention ratio, b, we are able to deduce a growth rate in the equity base of the company.

$$\text{Equity}_{1\ year} = \text{Equity}_{current} \times \text{Return on Equity} \times \text{Earnings Retention Ratio}$$

Thus,

$$\frac{\text{Equity}_{1year}}{\text{Equity}_{current}} = \text{Return on Equity} \times \text{Retention Ratio}$$

$$\text{Equity Growth Rate} = \text{Return on Equity} \times \text{Retention Ratio}$$

This is best displayed via an analogous example:

You invest £1,000 in an investment (initial equity). The return on this investment during the year is 10% (Return on Equity). This produces £100 of income, of which you spend £75 and re-invest £25. In this instance, you will have retained 0.25 (retention ratio) of the income generated within the investment.

Having completed this process, your equity stake will have now grown to £1,025 – a growth rate of 2.5%.

This growth rate can be calculated by multiplying the return on equity (10%) by the retention ratio (0.25), deriving an organic rate of equity growth of 2.5%. As highlighted earlier, the higher the anticipated return on equity, the more willing shareholders will be to leave earnings in the hands on management.

It is this process of equity creation that leads to the borrower being able to replace debt within its capital structure and ultimately enhances the credit quality of the issuer. Providing equity is created at a faster

rate than debt is added to the capital structure the amount of leverage deployed by management will reduce.

Leverage

Having produced our "net" balance sheet, the "top-half" of the balance sheet will contain the net value of all assets owned and operated by the company. Balancing these items will be the capital employed in sustaining those assets. The capital employed in the "lower half" of the balance sheet will comprise solely of borrowings (debt) and equity.

By our definition of leverage, it is the ratio of borrowings to equity that provides the most appropriate measure.

Leverage = Total Borrowings/Total Equity

Leverage is often utilised by management in order stimulate return on equity. Provided return on capital exceeds the cost of capital, leverage will serve to magnify the returns to equity holders, as the following example highlights.

A £100m investment is backed entirely by equity and generates a return of £10m on an annual basis. The return to equity holders is therefore 10% p.a.

Now suppose management decided to fund the investment using £50m equity funding and £50m in borrowings, financed at a rate of 5%. The investment again yields £10m, from which interest costs of £2.5m must be paid. The return to equity holders is reduced to £7.5m, however as a percentage of their original investment, the return has now increased to a rate of 15%.

Leverage acts as a double-edged sword however. Supposing in our above example, the return on investment fell to 4%. In this scenario the investment now yields £4m, from which interest costs of £2.5m must be paid. Return to equity holders is now reduced to £1.5m, providing a percentage return of only 3%.

The use of leverage must be watched closely. Management who resort to financial engineering of return on equity in order to placate shareholders do so at the expense of bondholders. Analysing an issuer solely from the perspective of a lender ignores the likelihood of such actions and may lead to negative surprises at some point in the future.

The Financing Decision

We can see from our earlier discussion that management are faced with numerous choices. Human vs. physical capital, ownership vs. leases and debt vs. equity financing are amongst some of the key decisions we have considered.

Amongst these however, without doubt perhaps the most important decision made is that of debt vs. equity financing, otherwise known as the financing decision.

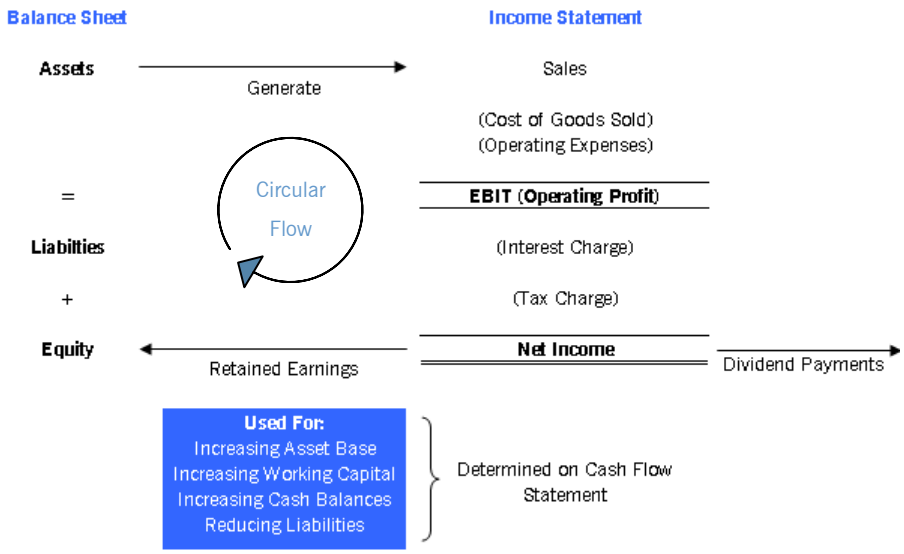
The financing decision ranks so highly on the ultimate success of an entity that we warrant it a separate examination. The financing decision not only determines the cost of capital for the company but also sets the extent of financial leverage and hence risk associated with earnings.

An increase in the risk profile of earnings is likely to manifest itself in a higher cost of equity and ultimately higher cost of debt. As the cost of capital increases, the break-even rate for return on investment becomes ever higher, until the potential for negative returns on equity is realised. At this point, as we can see from our equity growth model, rather than being created, equity is instead being destroyed.

As equity is destroyed, leverage is increased, which in turn magnifies further the negative returns. This downward spiral may ultimately lead to a company entering a distressed situation in which credit downgrades may occur or default may loom.

This circular flow of equity and cash flow forms the cornerstone of our entire process. Bringing together the core contents of the financial statements (balance sheet, income statement and cash flow statement), the model allows us to visualise how companies expand and contract over their business and life cycle.

Fig 3: Circular Flow and the Interaction of Financial Statements



Circular Flow and the Interaction of Financial Statements

Upon the creation of a corporate body, the initial capital (equity and debt) is used to purchase assets.

The operation of these assets generates sales. Removing operational expenses such as the initial cost of the goods sold, staff costs, depreciation of fixed assets and amortisation of goodwill from sales, we arrive at operating profit. This operating profit is generated via the use of operating assets and thus provides us with a "yield" on operating assets. We use this yield (Return on Assets) as a measure of the quality of the assets and the ability of management to effectively utilise these assets.

From operating profits, competing claims must be met. Providers of debt capital are rewarded in the form of interest payments, whilst the government (who effectively provide a legislative framework in which to operate) are rewarded via taxation on remaining profits. Following the payment of interest and tax, the residual net income is attributable to shareholders.

Shareholders may wish to receive immediate payment for their provision of capital via a dividend payment, or alternatively may wish to retain earnings within the corporate body. The retention of earnings leads to the creation of additional equity.

In the event of there being retained earnings available, management may chose to utilise these earnings in one of four methods: Increase the asset base, increase working capital, increase cash balances or reduce liabilities. Since all four actions are deemed bondholder friendly, it is the equity creation process within the circular flow framework we focus on.

With this model in mind, we can classify borrowers into two distinct categories, depending on their ability to replace debt with equity:

- Borrowers able to replace all debt with equity upon redemption
- Borrowers able to replace some debt with equity upon redemption
- Borrowers able to maintain current debt/equity levels
- Borrowers with increasing borrowing requirements

Borrowers falling into the first two classifications are more likely to be candidates for a credit rating upgrade at some point in the future. Such issuers are also likely to be perceived as less risky credits as time evolves, leading to an increased desire by market participants to lend capital to these entities. We term such issuers as "**spread contractors**" and as such, these would certainly be considered as suitable candidates for the fund.

Issuers will stable capital structures are unlikely to benefit from an upgrade from rating agencies; however can form valuable positions within the approved list. Offering stable income generation in, potentially, a lower risk framework these "**stable spreaders**" can be purchased and disposed of at attractive levels as market whims serve to alter the price.

Borrowers with an increased appetite for debt capital are to be avoided. These "**default candidates**" are likely to be suffering from poor returns and may be resulting to financial engineering techniques in order to satisfy shareholders requirements.

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

In general, corporate bond investments trade on a spread basis. This spread represents the additional yield required by investors to tempt them to lend capital to the corporate body rather than the local sovereign body. In the UK this spread represents the additional yield required over and above that on similar dated gilt investments by investors to compensate them for the risk of default.

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

Via our analysis of the organisation, how the company "works" 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.

This brings is 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**"

"A Risk Conscious Route to Income"

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