



IFDS BROWN SHIPLEY UK FLAGSHIP FUND

Investment Process

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The Brown Shipley Investment Policy Committee

When clients trust their money to us they will want to know that we will make decisions based on quality information, informed opinion and consistent approach. The Brown Shipley Investment Policy Committee (IPC) provides a central focus for all investment research, market analysis and investment strategies at Brown Shipley, whether for our Private Clients or for Brown Shipley Funds

The discipline and consistency this produces means that our investment directors and fund managers have access to the same recommendations on sector weighting and stock selection from which to build their portfolios. The people involved with our IPC make a significant difference to our investment strategy.

UK Equity Committee

The Equity Committee is a sub-committee of the IPC and is responsible for stock selection. A number of experienced and in some cases, very well-known individuals sit on the sub-committee. Between them they have considerable experience and expertise as fund managers or from directly advising clients.

John Smith, Fund Manager of the IFDS Brown Shipley UK Flagship Fund is able to use the thinking and output of the sub-committee in applying his strategic thinking to the fund.

IPC members bring their specialist skills gained through a variety of disciplines to the investment process. As well as the benefits of having such a broad approach, we are of the view that having this form of collegiate approach helps to avoid the behavioural problems which occur when individuals become too attached to stocks, and which is sometimes reflected when poorly performing stocks are held too long in the hope that they will eventually outperform. Similarly, it is our view that a management team, as opposed to an individual, should avoid selling better performing stocks too early.

To assist in the equity process and to provide analytical support for the equity committee, there are a number of analysts at Brown Shipley who support the process.

Investment philosophy

Our priority is to be successful portfolio managers and in the case of Brown Shipley Funds the outperformance of the chosen benchmark is paramount. This means avoiding bad stocks as well as identifying good ones or stocks with obvious potential. Our equity philosophy is based on firm principles, in particular that the total return on most equities can be linked to three sources:

Total Return comes from Dividends + Changes in Earnings + Changes in Ratings

Dividends are important over the medium to longer term, but a high yield on its own is not necessarily important. Dividend growth is the key and that requires good earnings growth and cash flow.

Changes in Earnings are key features of equity investment. Without long-term earnings growth there is unlikely to be any significant long-term growth of share prices. We start with the fundamentals, earnings forecasts and growth rates specific to each company we review to identify those that are more likely to meet our goal of long-term growth. We then consider earnings revisions and their trend. Our preference is to invest in companies where there is scope for upwards earnings revisions, whilst we tend to be cautious on companies seeing downwards revisions.

However, we recognise that a good company does not necessarily make a good investment unless it is bought at a good price. To identify what might be a good price we try and identify what is a fair value and what ratings we are comfortable with.

Changes in Ratings often have more influence on short to medium term price performance than earnings. Markets are made up of buyers and sellers – they affect ratings and matters such as sentiment can be a big influence. Valuing a company is not an exact science, but we try and identify when a company is attractively rated and when it is not.

An ideal investment will show above average growth in earnings and have the potential for a significant re-rating, whilst those companies that have poor earnings prospects and which appear vulnerable to a de-rating are likely to be those we will avoid.

Some stocks might benefit from a sizeable re-rating whilst having relatively poor long-term earnings prospects (an example might be some cyclical stocks) so we might buy and hold those for much shorter periods than stocks capable of steady long-term growth. However, even stocks that are capable of consistent earnings growth might become too highly rated and so vulnerable to a decline.

Stock-selection Methodology

Whilst we consider aspects such as strong business models, proven management, real assets, profits and cash flow amongst our stock picking criteria, we look at a number of forward-looking aspects to determine our final views. Earnings Growth forecasts and the scope for upgrades or downgrades, and valuations, both absolute and relative, are key aspects.

Broadly speaking, the IPC looks to invest in companies which have strong business model characteristics (such as niche products/technology), barriers to entry, strong market positions - for instance, where neither suppliers nor customers are too powerful - and where there is little chance of customers substituting the company's product/technology for another. In our view, these characteristics provide companies with a favourable environment in which to expand margins or pass through higher input costs (which is particularly relevant given current levels of commodity and energy inflation). We also tend to favour companies that do not have to rely solely on cyclical factors to grow the business, seeing any potential uplift to earnings from this source as more of a bonus, and would prefer those groups that are able to improve internal efficiencies or have a strong position in a market's early development.

Equity Process

There are a number of stages in our investment process before a company is recommended for inclusion within the portfolio.

Stage 1 Ideas & Themes

Individual members of the committee bring their own ideas to the rest of the committee. These are usually based on their own analysis, reading or experience.

In addition, analysts might also bring ideas to the attention of the committee. The merits of these are discussed, and particularly if they are in line with the themes we consider are relevant we then ask that further analysis and due diligence is undertaken by one of the analyst team.

Stage 2 Analysis & Due Diligence

We will make use of external broker research, as well as our own internal resources and, as part of the process, we also try and assess broker forecasts for individual companies for signs that the market is either underestimating or overestimating a company's prospects, as surprises on the upside or downside can be the cause of significant share price movements. This will be combined with an assessment of metrics (including PERs, EV/EBITDAs, PEGs) and asset-backed calculations if appropriate.

Equity investment involves risk and our due diligence seeks to understand the risks involved and whether the risk is appropriate and worth taking. Our aim is to have sufficient information to make a reasonably informed judgement on the merits of investing in a company's shares.

(Much of this stage will usually be undertaken by a member of the analyst team, who might not be a member of the equity committee).

Stage 3 Forecasts & Prospects

Having undertaken due diligence the equity committee discusses whether the company is an attractive proposition for our approved list. We consider consensus forecasts and include our own if appropriate. Our over-riding questions concern whether the prospects make it an attractive investment at current levels and whether the risks are inappropriate.

Stage 4 IPC Discussion & Decision

Having undertaken the previous stages and allowed discussion amongst members of the committee, a decision is taken on whether to introduce a stock to the approved list. The key reasons why a stock is attractive are decided; these include the setting of a price target.

Stage 5 Ongoing Analysis and Developments

Once a stock is on the approved list key developments are monitored and discussed. Those stocks that continue to have attractive prospects remain on the approved list, but if the committee is of the opinion that a stock no longer merits inclusion on the list then a switch or sale recommendation is made.

There might be a number of reasons why a stock is removed from the list, such as a change in prospects, an unattractive valuation or a better choice in the sector.

Targets

We start by considering consensus earnings per share figures for the current year and next year. We look at normalised earnings before goodwill deduction.

Having considered earnings' forecasts and identified a rating we feel comfortable with we then determine a target that we feel a stock could trade at over the coming 12 months.

A switch or sell recommendation might also be issued if there is a significant change in a stock's prospects so that it is no longer deemed as attractive or an appropriate choice for sector exposure.

A company that shows consistent EPS growth should see its target raised in line with that EPS growth.

The target that is set indicates the level at which we feel a share can reach without it being over-valued. If a share is trading above its target then it will indicate that we consider the shares to be expensively rated and that a decline is likely at some stage.

We would expect that after significant market falls quite a number of stocks to be trading well below their targets, whilst after worthwhile market rallies and particularly after a good bull phase when our overall view might be more cautious, few stocks might trade at attractive levels and some stocks will trade at or above their targets.

Stock Weightings - Each stock on the IPC Equity list is given a base portfolio weighting. This base portfolio weighting is the stock's weighting in the All Share Index, but with a minimum weighting of 0.2%. If all stocks on the IPC Equity list are held with their base portfolio weights then that will normally account for at least 50% of the portfolio and usually nearer 60%, however there will be an adjustment for sector weighting guidance and an active overlay (see below).

Sector Weightings - Since the fund is run in line with IPC industry group and sector policy the adjustments to meet appropriate IPC guidance will probably account for approximately another 20% of the portfolio. Whilst this 20% adjustment is linked to IPC sector calls, the actual choice of which particular stocks in a sector to increase weightings in is a fund manager choice.

Active overlay - Finally, there will usually be a balance of approximately 20% of the portfolio that will be actively managed. This will be dependent on market conditions and keeping in line with sector guidance, however if the market outlook is bullish, then it will likely involve increasing weightings in the 10 – 12 stocks that in the fund manager's opinion will add most value to the portfolio over the medium-term.

If the market outlook is bearish or cautious over the short-term, then a worthwhile cash balance will probably be held with increased exposure to the more defensive holdings on the IPC equity list.

Portfolio construction & Risk

The portfolio will hold all the stocks on the IPC Equity list and since the IPC Equity list is capped at 50 holdings the portfolio will be diversified across a reasonable number of stocks, although it might include some stocks with a weighting of only around 0.5%.

As a risk control an individual holding will not be higher than 2.5% above its index weighting.

Whilst the fund will hold all stocks on the IPC list, there will be no minimum size so if a company has a very large market capitalisation then an individual holding could be more than 2.5% below its base weight.

The fund's mandate allows it to hold 5% of the portfolio in collective funds. Usually these will focus on sector exposure, small cap/mid cap exposure and general market exposure.

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