



Tim Steer has steadily built his reputation at New Star since he launched his first fund back in November 2001. From launch until 31 July 2008, the New Star UK Alpha Fund rose 89.48%, beating the 38.59% rise in the FTSE All-Share Total Return Index*. The New Star UK Alpha Fund is AA-rated by Standard & Poor's†.



The careful scrutiny of accounts has been central to Tim's approach, which developed out of his previous incarnations as a chartered accountant and sell-side analyst specialising mostly in medium-sized companies. There is considerable crossover in skills between equity research and managing money so switching to managing a portfolio was straightforward.

From the beginning, Tim has stuck to his mantra that cash is king within a company's accounts. His first step in identifying attractive companies is to check whether cash flow is in line with operating profits. If not, it could signal that some of the company's profits have been engineered or are one-off benefits rather than genuinely produced by day-to-day business activities.

Less obvious movements in the accounts can also conceal tricks to boost profits such as debtors rising as the company brings forward invoices for a future accounting period to mask a downturn in revenues. Worse still, a high level of debtors may reflect greater difficulty in obtaining the actual cash from customers as still-to-be paid invoices build up. This might signal that the company's operating environment is not as strong as its revenues suggest.

Tim is critical of glossy annual reports. He says: "Unlike most people, I tend to start at the back. The first few pages of any annual report are usually little more than company spin; the real interest lies in the notes to the accounts. I have lost count of the number of companies that do not seem to understand that 'exceptional items' are supposed to be exceptional."

A proprietary tool called MERGE has been developed by Tim's colleague, Stephen Yiu, to support this analysis of accounts. This examines various groups of factors for a company: M stands for multiples and includes metrics such as price/earnings ratios; E is for essence and involves measures of the returns being generated and the health of

the balance sheet; R is for revisions to earnings; G is the growth rate of earnings, dividends and sales; and the final E is for energy – how the share price has changed over the past six months. This tool can be used to deepen conviction about a stock decision or to generate ideas.

Given the relatively concentrated nature of the UK Alpha Fund – typically around 50-60 holdings – it makes sense to sweat the assets, so Tim adopts a thematic approach to portfolio construction to bias the holdings towards areas he believes will outperform. He aims to identify sectors that are in a favourable operating environment and where newsflow is expected to be positive. To this end, the fund has been overweight in defence companies recently and Tim sees no reason to change his view on this sector. "The events in Georgia highlight the fact that the world is still unstable," he says. "Most governments do not want to take risks in ensuring their country's protection and this is especially true in the context of terrorism, which has increased the need for technology in surveillance and security, meaning defence is no longer just about traditional military hardware."

Tim is particularly attracted to the project nature of defence contracts, which provide a considerable degree of visibility to earnings. The fund holds several defence groups, including BAE Systems, Cobham, VT Group and Ultra Electronics. The sector has attracted considerable merger and acquisition activity and Detica, one of the fund's holdings, has recently received a takeover bid at a significant premium from BAE Systems, which is looking to deepen its expertise in security technology.

Another theme is the shift in global economic growth towards emerging markets and away from the developed world – a fact accentuated by the slowdown in the US and Europe. To counter the deterioration in the UK economy,

*Lipper, mid to mid, net income reinvested.

†At 31 July 2008.



NEW STAR UK ALPHA FUND

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Tim has been underweight in consumer-sensitive stocks, with the fund tilted towards overseas earners. A good example is Balfour Beatty, the infrastructure group, which is undertaking much work in the Middle East, where high oil revenues are paying for big construction projects. Balfour Beatty is involved in the construction of Dubai's Burj Mall shopping centre, the world's largest. At home, its projects tend to involve clients that are reliable, notably the government or state-owned enterprises. It is, for instance, working on the construction of the London Olympics Aquatic Centre and repainting the Forth Rail Bridge.

Tim believes his approach will continue to deliver outperformance for investors. "With companies having to turn to investors to raise capital and weak equity markets playing havoc with pension liabilities, the need to appraise a company's financial strength is as important as ever," he says. "I hope to protect investors by avoiding companies with weak balance sheets and deteriorating earnings while providing strong returns from those with attractive prospects."



Past performance is not necessarily a guide to future performance. The opinions expressed here represent the views of the fund manager at the time of writing and should not be interpreted as investment advice.