

# INVESTMENT PROCESS

## NEW STAR GLOBAL EMERGING MARKETS FUND



Brian Coffey

- Managed by Brian Coffey and experienced regional specialists that make up New Star's global emerging markets team
- Disciplined, research driven investment process
- Bottom-up stock selection blended with macroeconomic and liquidity analysis to identify growth opportunities
- Detailed stock analysis, focusing on economic not accounting profitability
- Portfolio of between 80 to 100 companies for geographical diversification

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### Fund manager profile

Brian Coffey is lead manager of the New Star Global Emerging Markets Fund and co-head of New Star's global emerging markets team. He is responsible for research and stock selection in Latin America and managing New Star's emerging markets retail and institutional portfolios. Brian has worked at New Star\* for 20 years and holds a BSc in Financial Economics from the University of London.

### Fund objective

To provide long-term capital growth principally through investments in companies in emerging markets, typically in Eastern Europe, Latin America, Asia, the Middle East and Africa.

### Investment style

The New Star global emerging markets team combines bottom-up stock selection with macroeconomic analysis to identify growth opportunities. The aim is to invest in those companies that are genuinely creating shareholder value, have growth potential and are exhibiting positive trends. Overweight positions are typically taken in markets likely to deliver superior growth as a consequence of economic reform and foreign investment.

The emerging markets team believes that to add value consistently through all phases of the market cycle it is necessary to have a process that is systematic and disciplined. The team therefore employs a research-based, process-driven investment approach. A careful consideration of liquidity and macroeconomic trends, coupled with risk controls, complement the team's stock analysis. Particular use is made of EVA® † analysis for stock selection.

The team focuses on companies with a distinct competitive advantage and the ability to generate a high or improving return on invested capital, with good earnings momentum. The portfolio typically comprises between 80 and 100 companies for geographical diversification purposes. The process is broadly style neutral although it tends to have a bias towards quality, growth stocks.

### Supporting the fund manager

Brian Coffey is lead manager of the fund and co-head of New Star's global emerging markets team. He makes the final decisions on the positioning of the fund in close co-operation with Ian Beattie, his fellow co-head of global emerging markets at New Star. Brian and Ian are able to debate stock ideas and economic trends with their experienced team of emerging market fund managers and investment professionals. The team members each specialise in certain geographical areas and meet on a regular basis to discuss over- and under-weightings, put forward stock and country ideas and review performance and strategy. The team includes Simon Ward, New Star's economist and strategist, who, with 25 years' experience of financial markets, provides invaluable input to the team.

### Investment process

There are four key elements at work at any one time when constructing the global emerging markets portfolio. These are illustrated in the chart overleaf. None of these steps should be considered in isolation, nor should they be considered as rigidly chronological. While stock analysis remains at the core of the process, all factors contribute to a final investment decision.

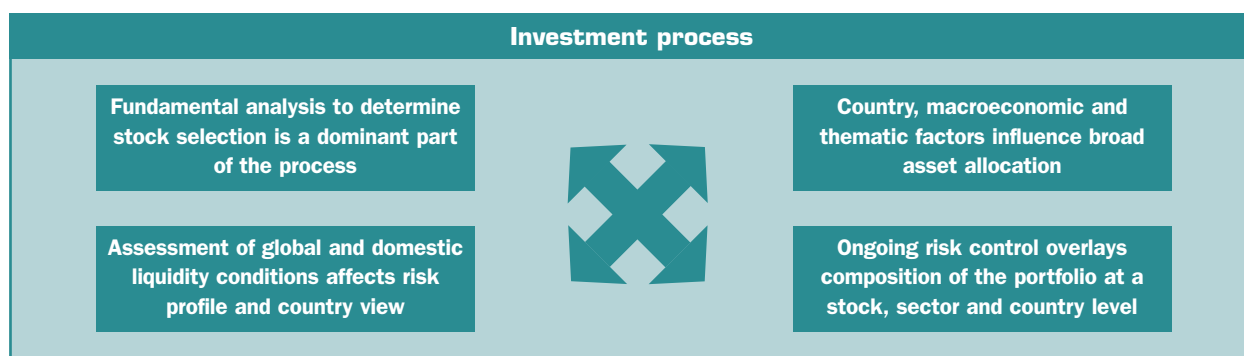
#### 1) Assessment of global and domestic liquidity conditions

Countries are researched to try to identify environments that provide a supportive backdrop to companies operating within their boundaries. This analysis is done at a number of levels.

**Global influences** – The team assesses the direction of capital flows and how these may affect financial markets in general and the various regions in which the fund invests in particular. The enthusiasm of foreign investors for, or aversion to, emerging market assets can affect valuations and may cause distortions among relative ratings as outsiders chase or avoid particular stocks. Monetary policy in developed markets can also affect emerging economies. For instance, US interest rates have tended to have a strong influence on the liquidity-sensitive markets of South East Asia.

\* Formerly WorldInvest, which was acquired by New Star on 31 December 2000.

† Economic Value Added and EVA are trademarks of Stern Stewart & Co.



**Regional and domestic influences** – The monetary policies of individual countries are considered both in isolation and in tandem with their impact on other countries. For instance, exchange rate intervention by the Bank of Japan can affect the prospects for Asian economies such as South Korea. The supply of and demand for equities is important because new issues tend to increase in certain emerging economies when investor confidence improves whilst domestic institutions’ buying of equities is on a long-term uptrend. The team considers savings rates in individual countries, changes in credit activity and sentiment among local investors. The global emerging markets team is careful, however, not to become blinded by local emotions and aims to remain loyal to more solid fundamental analysis and long-term trends.

## 2) Consideration of individual country, macroeconomic and thematic factors

Global emerging markets are diverse so the market performance of individual countries can differ significantly. The dispersion can be so wide that asset allocation can be the critical factor in delivering performance.

**Country characteristics** – There is often a higher level of political risk in emerging market countries – traditionally a result of their developing economies or relatively young political systems. While this can provide strong growth opportunities, it brings with it the risks of weak regulation, poor shareholder practices and structural economic or fiscal impediments. Countries may have a comparative advantage in certain areas. Brazil and Russia for example benefit from large natural resources and, therefore, have many commodity-related companies. South Korea and Taiwan have many specialist information technology companies and may benefit when this sector is in the ascendancy.

**Macroeconomic factors** – The global emerging markets team gauges a country’s macroeconomic policy, such as the promotion of an inflationary policy or infrastructure projects that may boost demand. Levels of regulation, taxation and shareholder protection are considered because these vary considerably between countries, distorting the ease with which valuations can be compared. The team also looks at gross domestic product (GDP) trends, since GDP growth should help support companies reliant on domestic sales. GDP trends in larger economies such as China, Japan or the US can affect other regions that have strong trade relationships. For example, Brazil’s commodity-related companies have been buoyed by strong demand from China. Conversely, Mexico tends to suffer during any economic downturn in the US.

**Themes/sectors** – Countries may be at different stages of their economic development but common opportunities can be identified at a thematic and sector level. For instance, semiconductor firms are all affected by similar conditions. If the outlook is positive for chip prices, this is likely to benefit manufacturers wherever they are located. Themes in the energy sector are also important and will affect different countries in different ways. For example, rising oil prices may affect Indian companies negatively as margins are squeezed by increased costs. Energy producers in Russia, however, will potentially benefit from increased revenue as prices rise. Alternative energy is also a theme that has developed as oil becomes increasingly expensive. Financial intermediation is another widespread theme as well as infrastructure spending and environmental plays. The New Star global emerging markets team monitors such themes and may then isolate those stocks within certain sectors that look attractive.

The team is helped in its analysis of themes and sector dynamics by the working environment at New Star. The international and regional fund managers at New Star sit within close proximity of one another. This permits the ready exchange of ideas and information.

## 3) Evaluation of individual stocks using fundamental analysis

Once the global emerging markets team members have established attractive areas, their attention turns to individual stocks. Bottom-up stock selection is a key part of the fund’s investment process, with the managers and analysts on the team spending most of their time monitoring and researching companies. Before a company is added to the portfolio, the stock is discussed by the team and its merits evaluated. Typically this will include EVA analysis and, where necessary, a restatement or reworking of the financial accounts to adjust for aggressive or unusual accounting practices.

### Economic Value Added

The team uses in-house EVA models to determine those companies that are genuinely creating shareholder value. This method restates accounts to reflect true economic profit rather than accounting profit. It prompts the team to adjust for creative accounting and provides a standard for companies across markets so it is possible to make international comparisons. This is important for a multi-country fund.

The team calculates a company's return on invested capital (ROIC) and compares this to the cost of the capital required to generate this return by calculating its weighted average cost of capital (WACC), which takes into account equity and debt financing. The comparison of the company's ROIC with its WACC then provides an EVA ratio. Broadly, if it is greater than one then the company is generating added value. This gives a measure of profitability that the emerging markets team believes is more sophisticated than return on equity. A valuation yardstick is created by dividing a company's enterprise value (EV) – its market capitalisation plus the value of its debt – by its invested capital (IC). This is the EV/IC ratio. The EVA ratio lets the team know whether the company is creating shareholder value and the EV/IC ratio lets them know what price is being paid for this return.

## **Analysis of stock fundamentals**

Other standard methods of fundamental analysis are also employed. In particular, the team makes a number of qualitative assessments, which are set out below.

**Deliverable strategy** – A portfolio constituent should have an achievable plan, with a product or service that is likely to succeed. A company's business model, the future of the market in which it operates and the level of competition are key determinants. Business prospects are cross-referenced against competitors and suppliers to determine a company's likely success.

**Quality of management** – The team meets company directors in London and travels to the various emerging markets to undertake direct company visits. Meeting corporate managers allows the team to analyse the competency of those tasked with delivering the business strategy. It is imperative that company managers have the skill, experience and drive to meet new challenges and are prepared to take difficult decisions or implement rapid change. In addition, supplier, customer and competitor companies may be cross-referenced for a more rounded view. Corporate governance is also particularly important when analysing companies in emerging markets, where shareholder and property rights can be more difficult to enforce.

**Sound finances** – A strong balance sheet ensures a solid foundation on which improved performance can be built. The team avoids companies with distressed finances unless they are convincing turnaround candidates. Careful analysis of accounts and management can reveal companies with the potential to restructure successfully.

## **Attractive stocks typically fall into two main categories**

First, the team targets companies with a positive or improving EVA that are exhibiting a rising earnings trend. These companies are proving that they can add value and if the valuation is attractive they are considered for the portfolio.

Secondly, the emerging markets team seeks out stocks that are attractively valued but require a catalyst to release that intrinsic value. In such circumstances, the team seeks to identify the catalyst likely to result in a significant increase in a company's return on invested capital that is not reflected in its valuation. This may include new management, ownership change, restructuring moves or foreign investment that might spark an improvement in the company's fortunes.

In all cases, the team is looking for positive future newsflow, so that when it arrives, the market will react and generate a rise in the share price. The team looks back approximately five years and typically tries to anticipate the next two to three. The main valuation criteria for a stock's inclusion in the portfolio include the ROIC/WACC and EV/IC ratios but a company's market capitalisation, free float and the trading volumes in its shares are also considered before a purchase is made.

## **Portfolio construction**

The portfolio is predominantly composed of large companies. It is constructed through a combination of bottom-up stock selection and country allocation. Under- and over-weight positions are taken based on a country's economic prospects and the availability of attractive stocks.

If the outlook for a country is favourable, the team will assess whether suitable securities can be identified to support the desired overweight position. If the available securities do not meet the fund's investment criteria the country allocation will be revised downwards. The fund will not invest in stocks that fail its 'quality testing' requirements regardless of a supportive macroeconomic backdrop. Equally the fund will not invest in high-quality securities if the economic environment is weak – even the best companies struggle during an economic downturn. If the process results in a significant overweight position, the team will carefully consider any issues affecting the fund's holdings and make sure that the positions are well-diversified. Cash is a residual element in the process and typically does not exceed 5%.

## **Sell discipline**

Stocks compete not only to be included in the portfolio, but also to remain there. The team continually screens the movement of all stocks owned and every two weeks carries out a review of those holdings in each region that are significantly out- or under-performing their respective country index. The process ensures that all stocks in the portfolio are there for a positive reason.

Stocks are sold for four main reasons:

- The team's country view changes to a more negative position.
- The dynamic that had propelled a sector or stock may have come to a conclusion and there is an opportunity cost in remaining invested in the company. Profits are, therefore, taken.
- The liquidity environment may prompt a reduction in a country or sector weighting and this causes a sell idea to crystallise.
- There could be a rapid deterioration in a company's earnings prospects or an external event that triggers a sale.

## Important information

Past performance is not necessarily a guide to future performance. The value of investments and any income from them may fall as well as rise and investors may not get back the amount originally invested. The value of investments may also increase or decrease as a result of changes in exchange rates between currencies. Investments made in the fund mentioned involve certain risks, as described in the prospectus. Any opinions expressed in this document may vary without prior notice and do not constitute investment advice.

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Full details of the Fund can be found in the prospectus or Offering Document, in the case of Hong Kong. Any investment decision must be made solely on the basis of the information contained in the prospectus/Offering Document, which is available on request from New Star. The simplified prospectus and most recent annual and interim reports are also available upon request. The shares referred to in this document have not been and will not be registered under any United States securities laws, and, except in a transaction that does not violate the United States securities laws, may not be directly or indirectly offered or sold in the United States of America, or any of its territories or possessions, or areas subject to its jurisdiction or to or for the benefit of a United States person.

The Fund is regulated by the Irish Financial Services Regulatory Authority (Irish Financial Regulator). The Manager, New Star Investment Funds (Ireland) Limited, is regulated by the Irish Financial Regulator. The Investment Manager, New Star Asset Management Limited, is regulated by the Financial Services Authority of the United Kingdom (the FSA). The custodian is State Street Custodial Services (Ireland) Limited.

The Fund has been registered for distribution in Denmark with the Danish Financial Supervisory Authority, in Sweden with the Swedish Financial Authority, in Finland with the Finnish Financial Supervision Authority, in Malta with the Malta Financial Services, in Spain with the Autorité des Marchés Financiers, in France with the Comision Nacional del Mercado de Valores under number 407, in the Netherlands with the Autoriteit Financiële Markten and in Italy by the Bank of Italy, Fortis Foreign Fund Services Ltd, Runnweg 57, PO. Box 8021, Zurich, has been appointed as the representative of the Fund in Switzerland. For Hong Kong: The Fund has been authorised by the Securities and Futures Commission (the SFC). Authorisation by the SFC does not in anyway imply any official approval or recommendation by the SFC. In Singapore the subfunds are recognised as Restricted Collective Investment Schemes by the Monetary Authority of Singapore.

For your protection, calls are recorded and may be monitored.

This document has not been verified or approved by any relevant supervisory authority in the jurisdictions where the Fund is registered.

Issued by: New Star Asset Management (Bermuda) Limited.

## 4) Risk control

Active risk control is an integral part of the investment process and is incorporated into every stage of portfolio construction.

**Size limits** – Size limits are followed on individual stock holdings within the portfolio and the level of issued capital held in any one company. The team will consider the liquidity in a company's shares before investing. The fund is diversified and typically comprises between 80 and 100 stocks.

**Ex-ante tracking error analysis** – Ex-ante tracking error is employed to analyse the benchmark relative risk contributed by an investment decision. The objective of risk measurement is to attempt to describe the future behaviour of a portfolio. Good risk management clearly quantifies the relative likelihood of different changes to a portfolio's future value as well as potentially unintended bets. Essentially, ex-ante tracking error allows the emerging markets team to extract better performance by allocating its risk budget to where the team members have the highest conviction rather than accepting potentially weaker returns.

**Performance and risk attribution analysis** – Regular attribution analysis allows the team to source the performance and risk of the fund as broken down by stock selection, country allocation and currency effect. This communicates more clearly the sources of performance and risk, highlighting successful or non-performing stock selection decisions so that the team can respond more accurately.

**Currency risk** – The team assesses currency expectations and considers them when determining country and stock allocation. Currencies are not hedged; interest rate differentials make using emerging market currency hedges prohibitively expensive. The fund managers may, however, hedge the currency exposure of the underlying assets back to US dollars.

New Star's internal controls, which provide an added layer of risk control for investors, are detailed below. The internal controls also ensure that fund managers fully comply with the regulatory standards.

### Independent oversight and functional segregation

#### Segregation of duties

- Separate dealing desk and back office functions for securities trading
- Separate reporting lines to senior management

#### Risk and compliance function

- Covers all aspects of the business, ensuring adequate procedures and controls are in place
- Monitors to ensure that procedures and controls are being followed

#### Use of experienced and independent third parties

- Shareholder servicing, fund accounting, custody and independent net asset value calculations

### Independent checking

#### Regular performance and attribution

- Performed by department segregated from the fund manager
- Reviewed by management

#### Regular compliance review

- Review of fund against investment restrictions and guidelines

#### Monthly investment risk review

- Identifies, quantifies and communicates investment risks, ensuring they are understood, appropriate and accepted

### Processing controls

#### Experienced back office function

- Settlement of transactions
- Review of valuations and pricing
- Reconciliation of cash and holdings

#### Weekly sign-off

- Fund manager signs off a checklist stating that the risk parameters have been met, fund objectives adhered to and any breaches reported