

INVESTMENT PROCESS

NEW STAR US OPPORTUNITIES FUND



Greg Kerr

- Diversified portfolio of North American investments
- Alpha generation through active stock-picking
- Highly disciplined, process-driven investment approach designed to exploit valuation anomalies
- Focus on return on invested capital as principal measure of corporate performance
- Strong buy and sell discipline with stocks held that trade at discount to fair value
- Freedom for manager to follow convictions and deviate from benchmark weightings

Fund manager profile

Greg Kerr has 16 years' investment experience having started his career at M&G in 1991. He holds a BSc in Physics & Philosophy from Leeds University and a PGCE from Cambridge University. After a brief spell teaching, Greg moved to M&G and has spent most of his career managing US and global funds. He was involved in the creation of M&G's specialist global team and managed the M&G Global Technology Fund from inception. This posted top decile performance under Greg's management from 1999 until 2005.

Greg joined New Star's global and US team in January 2006. He took over management of two of New Star's UK-domiciled funds during 2006 and continued his record of producing top decile performance. In January 2007, Greg became manager of the Dublin-domiciled New Star US Opportunities Fund.

Fund aim

The New Star US Opportunities Fund is a benchmark-aware rather than benchmark-constrained fund, offering a diversified portfolio of North American investments. Its aim is to generate alpha through active stock-picking, with valuation the key criterion for a stock's inclusion in the portfolio. Since the New Star US Opportunities Fund seeks total return as opposed to trying to beat a benchmark, the fund is free to avoid large stocks deemed unattractive by the manager. The fund is also able to deviate from the sector weightings of its benchmark, the MSCI USA Total Return Index. This flexibility is especially advantageous during volatile markets. In a nutshell, the fund will only own stocks that the fund manager believes are attractive investments.

Investment style

Greg describes himself as a "forward-looking investor who cares about valuations". He employs a disciplined bottom-up investment process that has a proven track record. While valuation is at the core of portfolio construction, Greg is not a 'value investor' in the classic sense. The New Star US Opportunities Fund can invest in a broad spectrum of companies across the quality range. The fund, however, generally seeks stocks of a higher quality than the rest of the market and that offer greater upside potential in spite of the fund manager's conservative assumptions about the future. What portfolio holdings have in common is that they all trade at a low valuation relative to Greg's forecasts of their future cash generation.

While economic themes have some influence on Greg's decision-making, his analysis of whether a stock is trading above or below its 'fair-value' share price determines whether it is included in the portfolio. In setting a stock's fair value, Greg assesses all aspects of a company. Sophisticated screening tools are then used to monitor the trading prices of hundreds of companies in relation to their fair values. Stocks that are trading at substantial discounts to this fair value and are fundamentally sound businesses will be considered for inclusion within the portfolio.

The fund tends not to make big thematic or sector bets. Greg believes that when investing in a market the size of the US, it should be possible to find attractive stocks in all sectors and the fund will generally invest in line with the benchmark's sector weightings in benign market conditions. While the fund retains the freedom to deviate from these weightings, this will be led by the upside potential of underlying stocks rather than top-down calls by the fund manager.

Stock selection

The fund invests in a broad portfolio of shares to provide diversification and reduce stock-specific risk. Typically the fund will hold between 60 to 100 stocks with no more than 5% of the portfolio in any one stock.

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The concept of 'fair value'

Greg seeks to identify the fair value of a stock on a relative rather than absolute basis. His process is centred on the fact that a company's share price will fluctuate to a higher degree than its fundamental circumstances warrant. The fair value of a company will typically increase over time assuming that it is being managed well. The share price, however, will generally fluctuate in a series of peaks and troughs above and below the company's fair value at any given time. The New Star US Opportunities Fund seeks to buy a quality company when its share price is in a trough and sell once the price has reached fair value (see graph alongside).

Setting a company's 'fair value'

The starting point for calculating a company's fair value is to forecast its cash generation. The actual calculation of fair value is done looking 40 years into the future but explicit forecasts are only made over a five-year period. These cashflow forecasts take into account three key measures: sound finances, business strategy and quality of management (see chart below). Greg can call on extensive internal and external resources when assessing a company based on these measures. The resulting fair value is used to gauge the potential for appreciation from a company's prevailing share price.

Sound finances. The key factor in the analysis of a company's financial strength is its return on invested capital (ROIC). Greg looks for a company's ROIC to be above its cost of capital, the difference being a measure of the degree to which the company is adding value. While Greg prefers to invest in these 'positive spread' companies, he can also invest in 'negative spread' companies if he identifies strong potential for improvement.

ROIC is used as the key measure of performance because of its effectiveness in cutting through the potential distortions of accountancy. A company can enhance its accounting profit in a variety of ways, including the use of debt, repurchasing shares or changing its depreciation schedule but this may have no benefit to the underlying economics of the business. Rather than relying on figures that may be subject to manipulation, Greg uses ROIC to build his five-year forecasts. It also ensures that the fund's fair-value prices are consistent across sectors, allowing Greg to evaluate investments in a like-for-like manner.

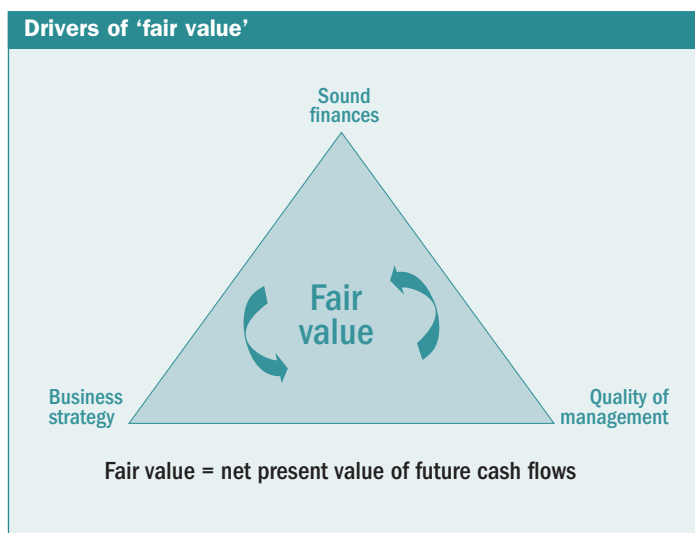
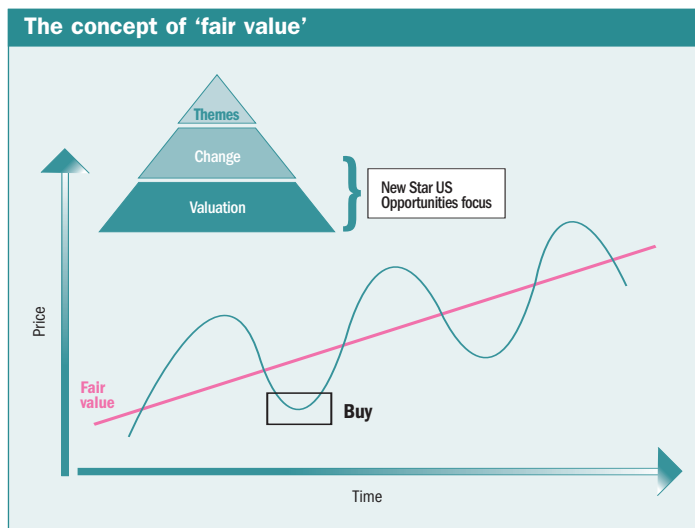
Business strategy. A company within the fund must have an identifiable strategy to increase shareholder value. This can be done in various ways depending on the financial performance of the company. In broad terms, the three main components are to grow sales, improve margins and improve asset efficiency. Each of these goals can be achieved in a variety of ways. Sales growth, for example, could be achieved by launching new products, expanding into different product categories or geographical regions, raising prices or making acquisitions. A management team's articulation of the details of its strategy helps Greg evaluate both the merits of its strategy and the likelihood of success.

Identifying and anticipating change, both within a company's business cycle and within its product offering, is important when assessing a company's growth potential. Market and economic sentiment is factored into any opinion on a stock because this will have an impact on earnings growth. Factors such as the regulatory environment, tax regime and interest rate sensitivity will also be covered at the stock level.

Quality of management. Strong management drives forward a business strategy. Greg focuses on companies with managers who have proven track records in delivering added value and where shareholder and management interests are closely aligned. To this end, he examines a company's historical financial performance and assesses whether management's behaviour has added or destroyed value over time.

It is important to understand that whether a management team's actions are adding or destroying value will depend on the financial characteristics of the company. For example, a company that is in a 'start-up phase' needs to focus on growing sales rapidly to improve profitability and return on capital. On the other hand, a company that is past its glory days may have poor profits and a bloated asset base. These 'negative spread' companies should be focused on increasing returns, not by growing but by shrinking and cutting costs.

Greg talks to the managers of the companies in which he invests so that he can gain first-hand insights into the way they are run. Such conversations help him to build a clearer picture of their business strategies. Greg cross-references what he hears from management teams with their competitors, suppliers and customers to see if the claims are supported.



Monitoring and analysis

The size of the US market makes monitoring the trading prices of hundreds of companies against their fair values a complex task. While challenging – the US stock market is twice the size of Continental European markets combined – the process can be rewarding. On average, US companies make a 10% real return on capital compared with an 8% average return from Continental European companies. Management behaviour in the US is also generally of a higher quality.

One option for covering such a vast market is to employ a large number of analysts to cover the various sectors. This brings with it bureaucracy that can ultimately compromise a fund's performance. The alternative, and the approach favoured by the New Star US Opportunities Fund, is to keep the team size small but enhance it by using software tools. By industrialising the process in this way, Greg can screen the entire US stockmarket, which contains about 3,000 stocks.

The use of screening tools ensures that the fund retains an agility and simplicity that is likely to be lacking in a fund managed by a committee. The tools and techniques used go far beyond covering simple measures such as price/earnings multiples and price-to-book ratios. The screening process cuts through accounting distortions and can be altered to incorporate Greg's changing views on themes, industries and individual companies. Information from company meetings and shared ideas with other New Star managers are also fed into the stock selection process.

A strong buy and sell discipline

Purchases and disposals are made based on valuation. The fund acts on the self-imposed restriction of generally only buying stocks that are trading 20% or more below their fair-value prices. This means that all the fund's holdings have strong growth potential.

When Greg makes an investment, it is based on his belief that the shares are materially undervalued and he is prepared to wait several years for that value to be realised. The fund invests with a long-term view but has no pre-determined holding period. Share prices are, however, typically more volatile than their underlying fundamental circumstances and often reach their fair-value price targets sooner than expected. When this target is met, the fund will sell the holding and reinvest the proceeds in more attractive investments. Greg prefers to adhere to his rule that every stock in the portfolio should trade at a discount to its fair value. This, he believes, is more likely to deliver good fund performance than owning expensive stocks in the hope that these can be sold on at higher prices.

The research process

Greg's investment experience is a useful contributor to performance success. The lessons he has learnt from his 15 years of investing in the US allow him to take a measured view of the markets. Greg has three main lines of research to assist him in his investment decision-making: internal research, external research and contact with company management.

Internal research

Greg looks to his colleagues for market analysis and generation of stock ideas. His fellow US equity specialists at New Star include Mark Beale and Tom Wicks. Greg also shares ideas with Guy de Blonay and Nick Brind, who focus on financial stocks, Hitesh Thakrar and Neil Campling, who cover technology companies, and Simon Ward, New Star's investment strategist. The close proximity of managers at New Star permits a regular exchange of ideas. The accountability for performance, however, rests with the fund manager. Greg is, therefore, the ultimate decision-maker and has the final say on all stock selection.

External research

A vast quantity of third-party research is available to Greg. He has developed close and effective relationships with stockbrokers, economists and specialist research houses over the years. This ensures he knows which people are the best to consult over specific issues. External data feeds and news systems provide up-to-the-minute information to keep Greg abreast of events.

Direct contact with company management

Greg believes it is important to meet and maintain regular contact with the managers of companies considered for the portfolio. He and his fellow New Star US equity specialists frequently see the senior executives of companies throughout the year via meetings at New Star, company visits and industry and business conferences.

Risk control

Strong risk controls are central to Greg's investment process. He implements a number of self-imposed control techniques in addition to New Star's strict internal controls. While the key driver of performance for the fund is bottom-up stock selection, there are a number of portfolio characteristics that Greg monitors. He believes these are important drivers for the portfolio and the overall market:

Size of holdings and portfolio depth

Greg's first risk control principle is to hold a broad portfolio of shares. Size limits on individual stocks ensure the risks from a fall in any one share are limited. Similarly the fund follows size limits on the level of issued capital held in any one company.

Greg holds a broad portfolio of shares, typically between 60 and 100 companies, so that the fund is not overly exposed to one stock or sector. This cushions the portfolio against problems specific to any one company. The fund does not, however, compromise its investment selection process in seeking diversity. Core holdings represent the majority of the portfolio but short-term trading positions may be taken when valuations appear compelling.

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 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.

This document is for professional advisers and other financial institutions only and should not be provided to or relied upon by private investors. This document should not be distributed to any third parties. The New Star Global Investment Funds PLC (the Fund), of which the New Star US Opportunities Fund is a sub-fund, should be viewed as an investment suitable only for investors who can fully evaluate and bear the risks involved. This document does not constitute an offer or solicitation to anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such offer or solicitation. Distribution of this document and the offering of shares in certain jurisdictions may be restricted and accordingly persons into whose possession this document comes are required to inform themselves about and to observe such restrictions. If this is the case, these funds cannot be the subject of active marketing in your jurisdiction.

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.

Investors are advised that the New Star US Opportunities sub-fund invests primarily in shares of companies that have their head offices in the United States or Canada or that exercise a preponderant part of their activity in the United States. For the purpose of clarification in Switzerland: This sub-fund invests in both the United States and Canada.

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 France with the Autorité des Marchés Financiers, in Spain with the Comición Nacional del Mercado de Valores under number 407 and in the Netherlands with the Autoriteit Financiële Markten. The Carnegie Fund Services SA, 20 rue du Conseil Général, 1205 Genève, Suisse (Postal address: Casa Postale 5656, 1211 Genève 11), Tel: +41 22 7051177, Fax: +41 22 7051179 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 sub-funds are recognised as Restricted Collective Investment Schemes by the Monetary Authority of Singapore. This document has not been verified or approved by any relevant supervisory authority in the jurisdictions where the Fund is registered.

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Quality, size and sector bias

The fund's exposure to 'high quality' versus 'low quality' companies is monitored relative to the market. The aim is to preserve a balance between companies traditionally described as value stocks and those classed as growth stocks. The fund's exposure to large, mid-cap and small-cap companies is also monitored relative to the market. In general, the fund will hold a spread of large, medium-sized and small companies.

The fund's sectoral over- and under-weightings are monitored relative to the benchmark. Greg has the freedom to position the fund plus or minus 10 percentage points compared to the benchmark and his weightings reflect where Greg finds attractive individual investment opportunities.

Valuation and information risk

Greg recognises that any investment process is fallible. He tries to compensate for this by running a sensitivity analysis on the stocks held in the portfolio. The purpose of this is to gauge how sensitive their fair value is to changes in assumptions. This helps draw a better picture of the risk/reward trade-off of a particular holding.

Greg also acknowledges that there is a limit to how much information he has about any given company – other investors may know something that he does not. This information risk is mitigated by regularly revisiting the investment thesis and listening to alternative viewpoints.

Portfolio attribution and investment risk

The fund adheres to UCITS III rules relating to size limits on individual stock holdings and the percentage of the issued capital held in any one company.

Portfolio attribution analysis, ex-ante risk and style decomposition is performed in relation to the MSCI USA Total Return Index. Performance attribution analysis allows Greg to understand the performance of the fund at a stock, sector and country level. Risk forecasting and style decomposition provide more information to assist him in ensuring that he is not taking unintended risks. They also provide senior managers and clients with assurances that Greg is adhering to the investment objective of his fund.

New Star risk framework

New Star's internal controls, which provide an added layer of risk control for investors, are detailed below. The internal controls 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
- 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

- Shareholding 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
- Automatic matching of confirmations
- Review of valuations and pricing
- Reconciliation of cash and holdings

Weekly sign-off

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