



## Investment Philosophy

Four characteristics differentiate our investment approach:

- Long-term
- Independent investment analysis
- Forecast of Profit and Loss, Balance Sheet and Cash Flow
- Calculation of the worst-case scenario

Share prices follow long-term cash earnings. The analyst's objective is to identify companies which trade at low, long-term cash-earnings multiples. We also aim to ensure earnings equal cash and the business has sufficient resources to fund organic growth, strategic targets and pay a dividend to shareholders.

We have observed no evidence of the accuracy of short-term earnings forecasts and share price returns. It is surprising that the vast majority of investors remain fixated on short-term forecasts. Saracen take a five year view, as this frequently coincides with the planning that actually takes place within a company and often covers an economic cycle. We are then forced to consider where we are in the cycle and the likely magnitude of the peaks and troughs.

Analysts' errors largely occur when estimating the impact changes in sales to profits. When economic growth is strong, this often leads to positive short-term surprises and perhaps explains why investors are frequently the most optimistic at the top of a cycle. Conversely, when demand turns down, the impact on profit and cash flow is usually severely negative.

It might seem obvious that our forecasts are independent. Stockbroker's research is frequently unduly influenced by their relationship with the companies that they are analysing. In turn this research often drives investors' actions. We try to remain healthily cynical, believing in evidence and independent views to drive our company valuation. Experience has taught us that there is more chance of finding value where few are looking and as a result, we tend to be contra cyclical.

There are many other pieces of supportive analysis. We construct a forward looking Profit & Loss, Balance Sheet and Cash Flow Statement for each investment. Many analysts just concentrate on the earnings line, but this allows us to estimate the cash generation of the business and the ability of the

business to fund replacement capital expenditure, organic growth, acquisitions and dividends. Throughout this process we analyse many ratios of financial strength and cash generation.

When forecasting, we are not only concerned about the expected returns any particular investment will achieve, but also about the potential error in our forecasts, which could occur, for example, from the impact of the economic cycle or changes to borrowing costs, new capacity etc. In addition to the process described above, our 'Central-Case', we also analyse the 'Worst-Case' scenario and use our experience to attach probabilities to them. This forms the basis of our company risk control, which is crucial when considering portfolio construction. There is danger in oversimplifying, but if the Worst-Case valuation appeared prohibitive, with a significant probability, no matter how cheap the Central Case, we would not invest in the company.

Research is a time consuming and structured process that depends on the ability and experience of our analysts to understand the business, the dynamics of the industry, the impact of the broader economy and other factors that can influence returns. It also requires one of the most prized, but vitally important attribute - patience.

**Graham H Campbell**  
**Chief Executive Officer**

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