



**LIONTRUST**

# **EUROPEAN ABSOLUTE RETURN FUND**

**INTERIM REPORT**

FOR THE PERIOD ENDED 31ST MARCH 2011



Managed by Gary West &  
James Inglis-Jones in accordance with  
**The Liontrust Cashflow Solution**

# THE LIONTRUST CASHFLOW SOLUTION

LIONTRUST EUROPEAN ABSOLUTE RETURN FUND IS MANAGED BY **GARY WEST** AND **JAMES INGLIS-JONES** IN ACCORDANCE WITH THEIR INVESTMENT PROCESS FOR EUROPEAN LONG/SHORT PORTFOLIOS, **THE LIONTRUST CASHFLOW SOLUTION.**



Cash flows provide an accurate guide to future profits growth. They reveal valuable information about a company's investment decisions and its managers' prudence in recognising reported profits. *The Liontrust Cashflow Solution* process identifies a list of companies with strong cash flows which we believe are likely to beat investors' low profit expectations and companies with weak cash flows likely to disappoint on investors' high profit expectations. From this we buy companies generating strong cash flows and sell those with weak cash flows. We take long and short positions in the portfolio using a Total Return Swap derivative (TRS).

# FUND REVIEW

## Market environment

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Over the course of the six months under review the FTSE Eurofirst Index rose by 6.0% driven by strong returns from stocks in the Electronics (+27.8%), General Industrial (+23.1%) and Oil Services (+20.4%) sectors. Food & Drug retailers (-10.5%), General Retail (-7.5%) and Banks (-4.4%) performed poorly. The Fund over the course of this period rose a more modest 1.3%, representing a strong final quarter to 2010 that unwound to some degree over the course of the first quarter of 2011. The Fund is not directly benchmarked against the market. The portfolio is constructed to be non-directional, achieved by matching investments with an equally sized portfolio of short positions. As a result we expect returns generated by the Fund to be lowly correlated with the market; however, we do expect that measured over long time periods the Fund should be capable of better returns than the market, delivered with significantly less volatility and low correlation.

Over the course of the last six months optimism regarding the momentum of global economic recovery increased as investors responded to better than expected economic data. In Europe manufacturing continued down a path of recovery as both investment and export demand remained strong. Germany, with its export-oriented economy, benefited particularly from these developments. European companies with a high proportion of overseas exposure to emerging markets have benefited from robust growth in emerging markets such as China, India and Brazil. However, companies with domestic exposure, such as general retailers, have continued to struggle with sluggish end demand.

In the first quarter of 2011 the market remained remarkably robust in the face of increased turmoil in the Middle East, the Japanese earthquake, rising oil prices and further signs of stress in peripheral Europe's sovereign debt. However, there remains a tension between the short-term tangible evidence of recovery contingent on continued emerging market growth and longer-term concerns regarding fears of a slowdown in emerging markets, particularly China; continued sovereign debt concerns in Europe (which will be only exacerbated by emerging public health and pension liabilities in forthcoming years); and, the impact of domestic government austerity measures. Furthermore, valuation measures adjusted for the economic cycle tell us that the market is expensive relative to its history, suggesting some caution is warranted.

## Analysis of portfolio return

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A powerful theme driving stock market returns in 2010 was investor preference for companies with significant exposure to emerging markets. In addition, having paid very little attention to whether or not companies were meeting their earnings expectations in 2009 and the first half of 2010, it became much more important for companies to meet their profit expectations in the second half of last year. The tendency for investors to focus more on profit delivery as the stock market recovery matures is usual and provided a more constructive backdrop for our process in the fourth quarter of last year.

## FUND REVIEW CONTINUED

The Fund responded well in such an environment and returned +4.3% in the fourth quarter of 2010 as the process did a good job during our research period earlier in the year, highlighting companies that went on to deliver strong third quarter results that exceeded analysts' expectations. However, in January this favourable environment dramatically reversed and there was a significant change of leadership, which is unusual for this stage of the stock market cycle. This was a negative development for the portfolio, causing the Fund to fall 2.8% in the first quarter of this calendar year.

There appear to have been three elements of this marked change in European stock markets: a shift out of stocks with exposure to emerging markets in favour of stocks with exposure to developed Europe; a move from stocks in the core of Europe to peripheral regions that had been roiled by sovereign debt concerns in 2010; and, a violent change of leadership with stocks that had performed well in 2010 underperforming dramatically in January, whilst underperforming stocks in 2010 increased significantly in value. What was unusual about this rotation was that price reversals of such magnitude are normally associated with market troughs or peaks or turning points in the economic cycle. Unfortunately, these developments had an adverse impact on the portfolio in the short term, unwinding a significant proportion of the returns generated in the final quarter of 2010.

Scrutinising the list of stocks that performed the best across the portfolio during the period under review one is confronted, therefore, by an eclectic mix of companies. Had the same analysis been carried out at the end of December, the stocks that had performed the best across the portfolio were, on average, long positions in companies with overseas exposure benefiting from upwards earnings revisions on the back of strong third quarter results. However, owing to the violent change in leadership that occurred at the beginning of 2011, many of the best performers across the portfolio were dominated by short positions going against us – in many cases reversing sharply downward price trends established in 2010. Some of these positions have since been closed but particularly prominent were stocks such as *Bulgari*, the Italian luxury goods manufacturer, driven higher on bid speculation or *CGG Veritas*, the French provider of seismic surveys, driven higher by the expectation of increased spending commitments by oil exploration companies.

Some of our long positions such as *Lundin Petroleum* and *IMI* that performed strongly in the final quarter of 2010 sustained these price moves into the first quarter of this year but this was unusual. More common was the tendency for the best performers in 2010 in the portfolio, such as *Andritz* and *Cargotec*, to suffer sharp price reversals despite the fact that there was no corporate news to explain this development.

That the portfolio was able to generate a positive return over the six month period had more to do with other short positions in the portfolio that performed poorly, and therefore made a positive contribution to portfolio returns. Whilst of the ten best performing stocks in the portfolio in this period only three were long positions, the opposite is true of the worst performing stocks in the portfolio. Of the ten worst performing stocks in the portfolio eight were short positions in this period. There was no particularly discernible theme uniting the successful shorts during the period under review, beyond the fact that financial companies were well represented.

## **Portfolio activity and construction**

Portfolio turnover is highly seasonal due to our focus on company annual report and accounts as the basis of our research into cash flows. As companies in the portfolio report preliminary results it is straightforward to assess, on the basis of the new cash flow information, whether or not it is likely that we will retain the investment or short position. It is usual, therefore, for the number of stocks in the portfolio to fall in the first quarter of the calendar year as we use preliminary results as an opportunity to purge the portfolio of positions that do not have the required cash flow characteristics.

As a reminder, the *Cashflow Solution* investment process that we have developed is designed to identify two types of company for long and short portfolios. We buy companies

that are prudently run, generate strong cash flows from their operating assets, and are available at a bargain price. We sell short companies that are run by managers who take significant risks with shareholders' capital, generate poor free cash flows after investments, and are highly rated by other investors. In our experience, measured over long time periods, this combination of going long strong cash flow companies and short poor cash flow companies produces consistently positive results.

Once companies begin to report full audited annual accounts – usually between March and April – we can begin our qualitative research into new ideas for the portfolio. By the middle of May we have usually completed this research, resulting in a significant rise in portfolio turnover as the portfolio is restructured to reflect the new ideas. Over the course of the period under review this pattern of turnover can be seen clearly. By the end of March this year we had closed nineteen short positions and sold seven long positions. The short positions we closed in this period were in all cases due to tangible evidence of cash flow improvements in their preliminary results. This reduction in the size of the short book was matched by sales of a shorter list of long positions in cases where preliminary results indicated that the company would no longer meet our minimum requirement: cash flow characteristics that rank in the best 20% of the universe of European stocks we address.

## FUND REVIEW CONTINUED

<b>Top 10 Equity Exposures</b>			
<b>Long Positions</b>			
<b>31st March 2011</b>	<b>% NAV</b>	<b>30th September 2010</b>	<b>% NAV</b>
Burberry	2.72	Lundin Petroleum	2.87
IMI	2.50	Burberry Group	2.50
Andritz	2.49	Cargotec	2.49
Lundin Petroleum	2.27	Ashmore Group	2.24
Umicore	2.23	Tullett Prebon	2.15
Schindler	2.20	Metso	2.15
Kongsberg Gruppen	2.13	Wacker Chemie	2.14
Petrofac	2.12	Schindler Holdings	2.12
Balfour Beatty	2.11	Petrofac	2.10
Tullett Prebon	2.09	Umicore	2.05
<b>Total</b>	<b>22.87</b>		<b>22.81</b>
<b>Short Positions</b>			
<b>31st March 2011</b>	<b>% NAV</b>	<b>30th September 2010</b>	<b>% NAV</b>
Cie Generale De Geophysique	-2.24	Hexagon	-1.64
Grifols	-2.11	Talvivaara Mining	-1.56
Acerinox	-2.01	Nokian Renkaat	-1.49
Heidelbergcement	-2.00	Mercials	-1.44
Meda	-1.98	Grifols	-1.41
SGL Carbon	-1.90	Klepierre	-1.41
NKT	-1.89	Vienna Insurance Group	-1.40
Saab	-1.88	TalkTalk Telecom Group	-1.39
Storebrand	-1.87	Fraport	-1.39
Bank Sarasin & Cie	-1.87	Ferrovial	-1.39
<b>Total</b>	<b>-19.77</b>		<b>-14.52</b>

The above table represents the top 10 underlying long and short equity positions in the Fund as can be found in the long-form accounts Non Statutory Portfolio Statement. The Top 10 Holdings table on page 9 shows the actual instruments that the Fund uses to achieve its investment objectives.

## Outlook

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In recent weeks we have concluded our analysis of company results for the long book of the portfolio and have a clear idea of the likely composition of the portfolio for the remainder of 2011. We are currently nearing completion of our analysis of potential short ideas. It seems clear that most of the opportunity has presented itself this year in the long book. Many of the signals of over optimism, excessive investment and poor cash flow are more abundant at peaks in the economic cycle. However, the short book should continue to play a valuable role this year hedging against the eventuality of a market reversal.

The process has favoured higher quality companies this year, measured by their ability to generate consistently high cash returns from their operating assets. Many of the cyclical companies that were more in vogue last year have had to reinvest in working capital as their sales have recovered. This reinvestment into working capital has acted as a drain on cash flow with the result that cyclical companies' cash flow characteristics are now less robust than they were at the bottom of the economic cycle. In 2011 we are likely to have a more concentrated long book, reflecting a greater depth of research this year. The short book, on the other hand, is likely to be more diversified reflecting less obvious opportunities.

Reflecting on the stage of the economic and market cycle our expectation would be for investors to continue to place a premium on companies that can exceed earnings expectations, whilst shunning companies that disappoint short-term profit targets. Indeed there are already signs from the movement of stocks in the portfolio that January's sharp reversal has unwound, owing to the market's subsequent reaction to final results as they were published between February and April. Against a backdrop of fragile economic recovery contingent upon a continuation of emerging market growth and evidence of an overpriced market, we believe the Fund has a valuable role to play in managing portfolio risk whilst offering the potential, in the long term, for better returns than the market at significantly lower levels of risk.

**Gary West & James Inglis-Jones**  
**Directors**  
**Liontrust European Investment Services Limited**  
May 2011

## Investment Objective and Policy

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The investment objective of Liontrust European Absolute Return Fund is to achieve a positive absolute return for investors through a portfolio of investments primarily in equities and equity-related securities (including derivatives for investment purposes) of European companies. It is expected that a positive absolute return is capable of being generated under all market conditions. The Fund will not be benchmarked against any European equity index.

Although the Fund may invest in all economic sectors in all parts of the world, it is intended that it will currently invest primarily in equities and equity-related securities (including derivatives) in companies incorporated in any European Economic Area ("EEA") Member State, together with Switzerland, which are listed on a recognised stock exchange of an EEA Member State or Switzerland. The Fund will not be restricted in choice of investment by either size or sector. The Fund may invest in transferable securities, money market instruments, warrants, cash and near cash and deposits. The Fund may invest up to 10% of its property in units or shares in collective investment schemes. The Fund is permitted to use derivatives for the purposes of efficient portfolio management and for investment purposes.

## Investment Approach

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Cash flows provide an accurate guide to future profits growth. They reveal valuable information about a company's investment decisions and its managers' prudence in recognising reported profits. The *Liontrust Cashflow Solution* process identifies a list of companies with strong cash flows which we believe are likely to beat investors' low profit expectations and companies with weak cash flows likely to disappoint on investors' high profit expectations. From this we buy companies generating strong cash flows and sell those with weak cash flows. We take long and short positions in the portfolio using a Total Return Swap derivative (TRS).

## Risk Profile

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The Fund aims to deliver a positive absolute return for investors through a portfolio of long and short investments in equities and equity-related securities (including derivatives for investment purposes) of European companies. The principal risks identified by the manager are those associated with exchange rate risk, counterparty risk and market price risk. Further details on the Fund's risks are available in the full prospectus. The Investment Adviser will receive a performance fee which is based on the appreciation in the Net Asset Value per unit, and accordingly the performance fee will increase with regard to unrealised appreciation, as well as realised gains.

# FUND PROFILE

## Total Expense Ratio

	31st March 2011	30th September 2010
Class R income units	1.96%	2.17%
Class I income units*	1.50%	–

\* launched 1st November 2010

## Fund Calendar

Ex-dividend date	1st October
Accumulation date	30th November
Accounting period ends	31st March (Interim)

# PERFORMANCE

<b>Net Asset Value pence per unit</b>			
	<b>31st March 2011</b>	<b>30th September 2010</b>	<b>% Change</b>
Class R income units	93.50	92.26	+1.34
Class I income units*	93.75	–	–

\* launched 1st November 2010

## Accumulation

The Fund accumulates income once per annum, on 30th November. The ex-dividend date is 1st October each year.

<b>Total Return% (capital and income)</b>			
	<b>6 months</b>	<b>1 year</b>	<b>Since Launch (08.07.09) to 31.03.11</b>
Liontrust European Absolute Return Fund	1.3	5.2	-2.2

<b>Discrete Years Performance%</b>					
	<b>1 year to 31.03.07</b>	<b>1 year to 31.03.08</b>	<b>1 year to 31.03.09</b>	<b>1 year to 31.03.10</b>	<b>1 year to 31.03.11</b>
Liontrust European Absolute Return Fund	–	–	–	–	5.2

Up-to-date past performance information may be obtained from the Fund's most recent fact sheet, available on our website ([www.liontrust.co.uk](http://www.liontrust.co.uk)) or by calling our Administration and Dealing team on **0844 892 1007**.

Past performance is not a guide to future performance. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally subscribed. The issue of units in the Fund may be subject to an initial charge, which is likely to have an impact on the realisable value of the investment, particularly in the short term. Equity investment should always be considered as long term.

Performance data source: Financial Express, total return, bid-to-bid basis.

# PORTFOLIO

Classification of Investments			
		% of trust value as at 31st March 2011	% of trust value as at 30th September 2010
Equities		1.91	1.78
Fixed Income		24.13	25.25
Short Term Deposits		43.93	40.40
Derivatives		0.20	1.50
		<b>70.17</b>	<b>68.93</b>
<b>Cash (including SSgA cash deposits)</b>		<b>29.83</b>	<b>31.07</b>
<b>Net assets</b>		<b>100.00</b>	<b>100.00</b>

Top 10 Holdings			
31st March 2011	%	30th September 2010	%
United Kingdom Treasury Bill 0% 03/05/2011	18.26	Close Brothers 1% Sterling Deposit	10.52
Santander 0.3% Instant Sterling Deposit	14.84	United Kingdom Treasury Bill 0% 04/10/2010	10.50
Close Brothers 0.75% Euro Deposit	13.25	SSgA Cash Management Fund	9.94
RBS 0.3% Instant Sterling Deposit	9.99	Close Brothers 0.75% Euro Deposit	9.03
SSgA Cash Management Fund	9.93	Santander 0.3% Instant Sterling Deposit	7.35
Italy Buoni Ordinari del Tesoro BOT 0% 29/04/2011	5.87	Santander 0.4% 15 Day Sterling Deposit	6.48
Close Brothers 1% Sterling Deposit	5.85	German Treasury Bill 0% 08/12/2010	6.00
Bolsas y Mercados Espanole	1.91	United Kingdom Treasury Bill 0% 15/11/2010	5.25
GBP Equity SWAP 30/06/2014	0.35	RBS 0.3% Instant Sterling Deposit	3.51
CHF Equity SWAP 30/06/2014	0.14	RBS 0.4% 30 Day Sterling Deposit	3.51
<b>Total</b>	<b>80.39</b>		<b>72.09</b>

## FURTHER INFORMATION

### Unitholder Notice: Investment & Borrowing Powers – Investment in other Collective Investment Schemes

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Paragraph 13 (e) of the Fund's Prospectus sets out the limitations for the Fund investing in other Collective Investment Schemes. We have amended the rule references in this clause of the Prospectus so that they reflect the COLL regulations of the FSA Handbook, which replaced the CIS regulations, as previously noted within this clause. Whilst this has the potential to widen the universe of available collective investment schemes available, it is not intended that this will affect the way the fund is currently invested. The investment limits have not changed.

### Liontrust Asset Management Plc

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Liontrust provides portfolio management services in UK and European equities and in fixed income securities. These are managed on a long-only, long/short and absolute return basis through unit trusts, individual savings accounts (ISAs), offshore funds, pooled pension funds and segregated institutional accounts. The Group currently manages £1.335 billion (as at 29th March 2011).

We market our investment products to professional investors, predominantly in the UK and Continental Europe. These include pension funds and other institutional investors, family offices, private banks, private client managers, multi-managers, stockbrokers and financial advisers. Some private clients, to whom no advice has been given, have chosen independently to invest with us.

### Further Information, Report & Financial Statements

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Further information on the Fund and its portfolio, the Manager's Long Final and Interim Reports & Financial Statements and the Prospectus and Simplified Prospectus are available free of charge from the Manager upon request, and from [www.liontrust.co.uk](http://www.liontrust.co.uk).

### The Manager

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Liontrust Fund Partners LLP, 2 Savoy Court, London WC2R 0EZ.

Administration & Dealing enquiries **0844 892 1007**

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Authorised and regulated by the Financial Services Authority.

# NOTES





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