



**LIONTRUST**

# EUROPEAN GROWTH FUND

**MANAGER'S SHORT INTERIM REPORT**  
FOR THE PERIOD ENDED 31ST OCTOBER 2011



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

# THE LIONTRUST CASHFLOW SOLUTION

LIONTRUST EUROPEAN GROWTH FUND IS MANAGED BY **GARY WEST** AND **JAMES INGLIS-JONES** IN ACCORDANCE WITH THEIR INVESTMENT PROCESS FOR EUROPEAN EQUITY PORTFOLIOS, **THE LIONTRUST CASHFLOW SOLUTION.**



This Fund aims to provide long-term capital growth through investment in a concentrated portfolio of mainly European companies (excluding the UK), broadly equally weighted. It invests in companies with strong cash flows which we believe are likely to beat investors' low profit expectations. 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 concentration of the portfolio could mean that the Fund will be volatile when compared with its benchmark. There are no limits on geographical or industrial sector exposures, which will not closely mirror that of the benchmark.

# FUND REVIEW

The first six months of the Fund's financial year to 31st October 2011 proved to be a difficult environment for investors. At the beginning of the calendar year the sense of optimism that had prevailed at the end of 2010 gave way to a more sober appraisal of the economic outlook as the political turmoil in the Middle East, the Japanese earthquake and further signs of stress in peripheral Europe's sovereign debt undermined the prevailing positive sentiment. Leading indicators of growth began to weaken. In August the market suffered a sharp sell-off in response to a dramatic increase in risk aversion relating to fears of an economic slowdown, compounded by renewed European sovereign debt contagion issues surrounding the potential default for Greece and a troubling sharp increase in Italian, Spanish and even French sovereign debt yields. Risks of a Japanese-style 'lost decade' or even a second Great Depression loomed large in investors' minds. Dismay over the seeming inability of Europe's politicians to grasp the severity of the situation and the need for decisive action raised the very real possibility of an unmanaged default in Greece, sending a cascade of shocks through the European banking system, resulting in widespread insolvencies.

Of further concern to markets was the troubling lack of consensus among Europe's political elite. At one end of the spectrum a growing chorus of politicians and economic observers called for the ECB to monetize sovereign debt and relieve the pressure on markets. This was countered by an understandable, predominantly German, reluctance to sanction such a development without much greater fiscal union and in particular treaty safeguards against future

member profligacy. Valuation dispersion across the market, which at the beginning of the year had been at average historic levels, widened dramatically as financial and cyclical stocks were sold aggressively.

The Fund's benchmark Index, the FTSE All-World Developed Europe ex-UK, returned -18.9% in the period under review with the bulk of the poor returns concentrated in August and September. Unsurprisingly defensive sectors dominated the list of the best performing sectors in this period with Tobacco (+9.7%), Computer Hardware & Software (+1.3%), Pharmaceuticals (+0.2%) and Food (-1.4%) withstanding the sell-off the best. Steel (-39.2%), Banks (-31.2%), and Telecoms (-30.4%) made the most significant contributions to the poor overall return.

The Fund returned -12.7% over the course of the six months under review. This was better than the IMA Europe ex-UK sector average (-15.2%) and the market (-18.9%) but a disappointing outcome for investors to see the value of their holding decline. The Fund was launched in mid-November 2006 and therefore the end of the reporting period approximated to the Fund achieving a five year record. From launch to the end of the reporting period the Fund returned +30.2% against an Index return of only +0.8% and the sector average return of +0.4%. This outperformance represents an annual average excess return of 5.3% and is good evidence pointing to the efficacy of the *Cashflow Solution* process we developed over five years ago when we arrived at Liontrust.

# FUND REVIEW CONTINUED

It is interesting to note the profile of the delivery of these returns over the past five years. It seems that in falling markets the cash flow process has been able to deliver returns that are better than the market as investors seek the safe haven of robust corporate cash flows and strong balance sheets. Yet the vast bulk of the outperformance of the market appears to occur when markets stage a sharp recovery. The best explanation for this strong performance in a recovering market may be due to the equally weighted structure of the portfolio and the tendency of the process to emphasize cyclicalities at the bottom of the economic cycle. This pattern of return delivery has obvious relevance for investors taking a longer-term constructive view of equity markets. The decision to buy equities is presumably based on their potential for superior long-term returns. Having taken this view of the potential that equities have to offer, it is clearly desirable to own a fund with the potential to perform significantly better than the market when it is going up.

## Analysis of Portfolio Return

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In our last report we referred to the significant portfolio reorganisation that occurred in May reflecting the outcome of our research into 2010 annual report and accounts. In the Fund's first half year the bulk of the return was driven by the new portfolio put in place over the course of the month of May. Looking at the performance on a stock level it is therefore more instructive to examine how the new portfolio performed from the end of May to the end of October. This analysis shows that the best performing stocks in the portfolio were *Lundin Petroleum* (+84.1%), *Paddy Power* (+12.0%) and *Bolsas y Mercados* (+1.4%).

*Lundin Petroleum* has been an outstanding performer in our portfolios that we first purchased in 2010, attracted by its cash flows and the clear commitment by the owner managers to careful investment and prudent management. *Lundin Petroleum's* main geographical sphere of operations is the North Sea and the share price benefited from an oil find last year. Since that date the company managers have increased their assessment of the size of the find on a number of occasions, pushing the share price successively higher. Indeed the find seems to be so significant that it may well prove to be the largest in the North Sea since the 1980s.

*Paddy Power* has been a consistently strong performer over the six months under review; a trend that has corresponded with a high frequency of positive revisions to analyst earnings estimates. The share price was buoyed in particular by strong first half results that were ahead of forecasts. Analysts were positively surprised in particular by the strength of their online division and UK retail.

Finally, despite generally negative broker comment regarding the competitive long-term structural threats posed by electronic dealing platforms, *Bolsas y Mercados* performed well against a falling market. *Bolsas y Mercados* has continued to confound bearish analyst expectations by reporting better than expected profits. Although first half results were in line with expectations a rise in volumes over the course of the year helped them to report third quarter results with better than expected revenues driven by Cash Equities, Settlement and Listing businesses.

Although the portfolio generated a better return than the market it was held back in this period by disappointing share price performance from *Wacker Chemie* (-52.3%), *Clariant* (-48.4%) and *SMA Solar* (-42.2%).

*Wacker Chemie* performed poorly principally as a result of deterioration in the economic environment. Interim results published in August this year were seen as slightly disappointing by investors despite the company retaining guidance for the year. A particular concern appeared to be contract risk in their polysilicon division and general downgrades to semiconductor related industries with obvious implications for *Wacker Chemie*.

*Clariant* performed poorly due to a disappointing set of first half results that were impacted heavily by the strength of the Swiss Franc. The Swiss National Bank's determination to announce unlimited intervention to hold back the value of their currency offered the stock some respite however, as a cyclical chemicals business, analysts and investors perceived risk to company profits in the deteriorating economic environment and this had an impact on the share price. The group reported third quarter results in October that revealed continued deterioration in their cash flow and as a consequence we decided to sell the investment.

Finally *SMA Solar's* performance was poor owing to a difficult environment for the solar industry that also had an impact on *Wacker*. In *SMA Solar's* case this manifested itself in a profits warning in September owing to disappointing domestic sales of rooftop systems. Third quarter results from the group met expectations.

## **Portfolio Activity and Construction**

Investor's familiar with our process will recall that the vast bulk of trading in the portfolio occurs at the beginning of summer due to the fact that most European companies have December year ends. We base our stock decisions on the evidence of cash generation presented in the audited annual accounts and this gives rise to a significant seasonality in trading activity. As we commented in our last report, by early summer we had concluded our research into those companies with December year ends. This resulted in a number of companies that had to be sold from the existing portfolio owing to weakening trends in their cash flow. However, this was offset by a number of new opportunities we had identified for inclusion in the portfolio.

We had originally held 38 stocks in the portfolio. From this group we retained 13 holdings whilst adding 13 new ideas to the portfolio. This resulted in a portfolio of 26 stocks – considerably more concentrated than in the prior year. New additions to the portfolio included *SMA Solar*, *Paddy Power*, *Jeronimo Martins*, *Red Electrica*, *Wartsila*, *Boliden*, *Valeo*, *NCC*, *Scania*, *Assa Abloy*, *Castellum*, *Diasorin* and *Bucher*. On a portfolio level the most notable development was a shift from cyclical to a more defensively biased portfolio. This was due to deterioration in the cash flows of cyclical businesses, most of whom had to reinvest in their working capital over the course of 2010 to support higher levels of turnover. The reinvestment of cash into working capital acted as a drain on cash flow with the consequence that it was only higher quality businesses, capable of generating strong cash flows over the course of the economic cycle, which managed to score highly on our cash flow

# FUND REVIEW CONTINUED

ratios in 2011. By contrast some of the weaker cyclical businesses found themselves drifting to the bottom of our cash flow screen. This development was best observed in a comparison of risk reports before and after we implemented the changes in June. This analysis showed a significant increase in the portfolios bias to high return on equity companies – a good proxy for quality – whilst the negative bias to price to book and price to sales (through the cycle measures of value that tend to favour cyclical businesses) increased markedly.

## Outlook

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What is concerning about the current investment environment is that never before in the recordable history of financial markets have so many countries had so much debt. If history is any guide to the future this debt load is very troubling for the US and other western developed economies implying a painful deleveraging episode lasting six to seven years on average. The work of Kenneth Rogoff and Carmen Reinhart has shown that the impact on economic growth can be significant for governments with public debt to GDP in excess of 90% and there are many countries that are fast approaching these levels, some that have even exceeded this threshold.

Policy makers appear to have little flexibility to respond to the weak economic outlook. Fiscal stimulus is problematic given the obvious requirement for austerity measures to restore government balance sheets. Interest rates are at record lows. One of the few remaining avenues for stimulus is quantitative easing and exchange rate depreciation. However, these policy initiatives raise the risk of a spill over into uncontrollable inflation and the prospect of a round of destructive competitive devaluations.

An unhelpful macroeconomic backdrop has opened up a valuation opportunity in European equities. European equities now appear to be fair value as measured by the cyclically adjusted price earnings ratio – a ten year smoothed earnings measure that removes the impact of the economic cycle. This stands in contrast to most other equity markets worldwide. Although it is undoubtedly the case that equities in the short term may become cheaper as the sovereign debt crisis escalates, the fact that European markets are fair value opens up the potential for investors with a long-term time horizon to access the attractive long-run real returns from equities of 5-7%, an opportunity that has rarely been available over the course of the last twenty years.

We believe that given the appropriate time horizon the cash flow process we have developed has the potential to add materially to this long-run return from equities as the last five years have demonstrated. The combination of the cash flow process applied to European markets on valuations as they stand today has the potential to offer investors in the Fund an overall attractive long-term real return with a built in inflation hedge in an environment with few comparable attractive options.

## Gary West & James Inglis-Jones

Fund Managers

December 2011

# FUND PROFILE

## Investment Objective and Policy

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The investment objective of the Fund is to provide long-term capital growth through a concentrated portfolio of investments primarily in European companies excluding the UK.

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 in companies incorporated in any European Economic Area ("EEA") Member State, together with Switzerland, but other than the UK, which are listed on a recognised stock exchange of an EEA Member State or Switzerland. The Fund may also invest in transferable securities, money market instruments, warrants, cash and near cash and deposits. The Fund may also 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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This Fund aims to provide long-term capital growth through investment in a concentrated portfolio of mainly European companies (excluding the UK), broadly equally weighted. It invests in companies with strong cash flows which we believe are likely to beat investors' low profit expectations. 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. There are no limits on geographical or industrial sector exposures, which will not closely mirror that of the benchmark.

## Risk Profile

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The Fund is invested exclusively in European securities (excluding the UK). The principal risks identified by the manager are those associated with foreign currency risk and stock market investments. The concentration of the portfolio could mean that the Fund's returns are volatile when compared with its benchmark the FTSE All-World Developed Europe ex UK Index.

## Total Expense Ratio

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	31st October 2011	30th April 2011
Class R income units	1.72%	1.69%
Class I income units*	0.98%	0.97%

\* launched 1st November 2010

# PERFORMANCE

## Net Asset Values pence per unit

	31st October 2011	30th April 2011	% Change
Class R income units	115.77	132.26	-12.47
Class I income units*	116.59	132.47	-11.99

\* launched 1st November 2010  
Based on a mid price NAV

## Distributions pence per unit

	30th April 2011	30th April 2010
Class R income units	1.48	1.24
Class I income units*	1.75	-

The Fund distributes income once per annum, on 30th June. The ex-dividend date is 1st May each year. Income can be reinvested to purchase units at no initial charge.

<b>Total Return%</b>				
	<b>6 months</b>	<b>1 year</b>	<b>3 years</b>	<b>Since Launch*</b>
Liontrust European Growth Fund	-12.7	0.7	67.4	30.2
FTSE All-World Developed Europe ex UK Index	-18.9	-9.1	30.1	0.8
Quartile Ranking	1	1	1	1

\* Launch date 15.11.06

<b>Discrete Years' Performance%</b>					
<b>To previous quarter, 12 months ending:</b>	<b>Sept '07</b>	<b>Sept '08</b>	<b>Sept '09</b>	<b>Sept '10</b>	<b>Sept '11</b>
Liontrust European Growth Fund	-	-23.3	21.5	8.8	-6.1
FTSE All-World Developed Europe ex UK Index	20.1	-19.7	16.8	1.4	-13.5

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 as at 31.10.11, total return, bid-to-bid.

# PORTFOLIO

Geographical Breakdown				
Country	FTSE All-World Developed Europe ex UK Index		Liontrust European Growth Fund	
	31st October 2011	%	31st October 2011	30th April 2011
		%	%	%
Austria	0.75		3.68	5.70
Belgium	2.08		3.32	12.45
Denmark	2.54		–	–
Finland	2.03		3.52	10.08
France	23.36		11.23	13.25
Germany	18.58		7.45	7.73
Greece	0.28		–	–
Ireland	0.60		4.53	–
Italy	6.12		2.75	–
Luxembourg	0.02		–	–
Netherlands	5.96		–	6.33
Norway	2.43		6.60	9.42
Portugal	0.67		3.82	–
Spain	8.40		6.85	2.24
Sweden	7.07		24.40	15.54
Switzerland	19.11		12.78	7.90
			<b>90.93</b>	<b>90.64</b>
<b>Cash (including SSgA* cash deposits)</b>			<b>9.07</b>	<b>9.36</b>
<b>Net assets</b>			<b>100.00</b>	<b>100.00</b>

\*State Street Global Advisors

## Top 10 Holdings

As at 31st October 2011	%	As at 30th April 2011	%
Lundin Petroleum	7.95	Lundin Petroleum	5.16
Paddy Power	4.53	Umicore	3.40
Sodexo	4.03	Kongsberg Gruppen	2.99
AstraZeneca	4.02	Wacker Chemie	2.96
Schindler	4.01	Cargotec	2.90
Jeronimo Martins	3.82	Semperit	2.87
Castellunm	3.82	CFE	2.87
Publicis Groupe	3.72	Andritz	2.83
Andritz	3.68	Schindler	2.80
Bolsas y Mercados	3.56	Clariant	2.60
<b>Total</b>	<b>43.14</b>	<b>Total</b>	<b>31.38</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.

### **Change of investment adviser**

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On 1st July 2011, Liontrust Investment Partners LLP replaced Liontrust European Investment Services Limited as investment adviser to Liontrust European Growth Fund.

### **Liontrust Asset Management PLC**

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Liontrust provides portfolio management services in UK, European, Asian and Emerging Markets 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 £1.354 billion (as at 10th November 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.

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Authorised and regulated by the Financial Services Authority.

# NOTES



# NOTES





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