



# LIONTRUST FIRST LARGE CAP. FUND

**MANAGER'S SHORT INTERIM REPORT**

For the year ended 31st December 2009

ASSET MANAGEMENT

**LIONTRUST**





## THE LIONTRUST CASHFLOW SOLUTION<sup>®</sup>

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

The Fund aims to provide long-term capital growth through investing in large capitalisation UK companies. The Fund holds a concentrated portfolio of UK companies, 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 the Fund's industrial sector exposure, which will not closely mirror that of the benchmark.

**LIONTRUST**



# INVESTMENT COMMENTARY

UK equities enjoyed a significant recovery in 2009 after the terrible year in 2008, when UK equities fell 30%. After a further significant decline in the first two months of 2009, equities rallied strongly from early March. Investor sentiment regarding the economic outlook improved significantly and equity valuations looked attractive on a cyclically-adjusted basis for the first time since 1990. The FTSE All-Share Index rose 25%, giving a total return (i.e. with income re-invested) of +30.1%. With inflation at 0.3% (as measured by the Retail Price Index) the real return was +29.8%. The average annual real rate of return for UK equities since 1899 has been just over +5%, which puts into context how volatile 2008 and 2009 have been. It was the best year for the UK equity market since 1989. Over the last decade, however, UK equities have generated extremely poor annualised returns of nominal +1.6% per annum, and have therefore not even kept pace with inflation. The picture is better over five years, where the annualised return is +6.5% per annum and better still over 20 years at +8.1%.

As in 2008, there was a significant difference in equity returns depending on market capitalisation. The FTSE 100 Index (representing the largest 100 companies in the market) reversed the relative gains it made against the FTSE All-Share Index in 2008, rising 22% whilst the FTSE All-Share Index returned +25%. As risk appetites recovered, larger companies with generally more defensive earnings were de-rated while riskier medium-sized and smaller companies, more sensitive to the economic cycle, outperformed the FTSE All-Share Index. The FTSE Mid 250 (representing the next 250 companies in terms of size) was up 46.3% and the FTSE Small Cap. Index (representing the balance of companies below the top 350 companies) was up 52.7% (*capital returns only*).

In 2009, therefore UK equities provided a reverse image of 2008. The worst performing companies in 2008 proved to be the best performing in 2009. Smaller companies outperformed large, cyclical companies outperformed defensive. To have performed well in both years, an investor would have required extreme flexibility, or rather an ability to turn investment strategy upside down, favouring companies shunned in 2008 and shunning favoured investments in 2008. This dramatic change in investor expectations is particularly clear at sector level. In the second half of 2008, commodity prices collapsed sending basic materials companies into serious decline. This year their contribution to UK equity performance has been staggering. Although the general trend in 2009 has been to favour cyclical sectors, the returns from basic materials were so large that any portfolio underweight this sector would have found it virtually impossible to outperform in 2009.

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The theme of recovery in the global economy that has dominated UK equity returns in terms of company size and sector, has also had a dominant impact on the success of investment style. During periods of sharp recovery, investors deliberately seek out companies that share a combination of characteristics that include: poor relative returns in the market decline; attractiveness on stable measures of value such as book-to-price; and high financial and operational gearing to recovery. In 2009, according to Alliance Bernstein, the worst performing companies in the UK in 2008 (the bottom 20% of the UK universe) have outperformed the best performers, the top 20%, by 62.4%. On the same basis, UK companies that were in the cheapest 20% of the UK universe at the end of 2008 based on their market value to book value have outperformed the most expensive 20% on book value by 32.4% in 2009.

Finally, companies that have been able to deliver positive earnings surprises in a severe recession have not been rewarded, whilst companies that have delivered weaker than expected earnings or profit warnings have performed extremely well as investors have looked forward to a medium-term recovery in their earnings. For these groups of companies, the spread in performance has been 33.6%, i.e. the bottom 20% of UK companies that have delivered disappointing earnings trends in 2009 have outperformed the top 20% significantly.

These dominant equity trends in 2009 have created some serious headwinds for the performance of our investment process. Our process helps identify companies that are cheap on current cash flow, have strong balance sheets and are likely to deliver positive earnings surprises. In periods of sharp market recoveries these stocks tend to fare less well; this pattern of performance was clear in 2009 and still noticeable in the final quarter.

The key theme towards the end of the year was the re-emergence of sovereign credit risk. A ratings agency downgrade of Greek sovereign debt, and the continuing saga of debt restructuring in Dubai, led to meaningful weakness in banks and other financial shares. Despite this development, UK equities made good progress in the quarter, with the FTSE All-Share Index producing a total return of +5.5%. There was a shift to larger companies in the quarter with the FTSE 100 Index up 6.2%, whilst both the mid and small cap. indices lagged, up 2.3% and down 7.7% respectively. Mining made the largest relative contribution to Index performance, continuing a trend that has dominated 2009.

Looking at the portfolio over the last three months of the year, financials made the worst contribution, with weakness from both banks and insurance. At stock level *Antofagasta* made the largest positive contribution to portfolio performance in the quarter, reflecting the broader trends in the market. The biggest negative contribution relative to the FTSE All-Share Index came from *Anglo American* and *Xstrata*, which are not held but performed strongly. Of the stocks held in the portfolio, *Drax* and *Ladbroke's* were the bottom two contributors to performance. Stock changes were modest in the quarter. We sold *Rightmove* due to concerns about their future cashflow sustainability, and *Johnson Matthey* after free cash

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generation went unexpectedly into reverse in their latest results. We added one new holding, *WS Atkins*, the multi-disciplined consultancy, after better than expected interim results delivered strong cash flow and attractive value.

The final quarter of the calendar year is always important for our process. The majority of UK companies have reported their third quarter results and provided meaningful evidence whether the cash flow signals we focus on earlier in the year are working in terms of providing durable earnings surprises. As a reminder, the aim of our investment process is to identify from company cash flows those businesses that are likely to deliver positive earnings surprises. Analysis of whether analysts upgrade or downgrade their profit forecasts through the results season is a periodic measure of how well the process is performing. By the end of Q3 we would expect process portfolios to deliver a greater than average number of earnings upgrades than the market as a whole. In 2009 the process has been very successful in this regard. 28 of the 35 holdings in your portfolio at the end of September generated positive earnings surprises in the fourth quarter. Four holdings suffered downgrades to analysts' earnings expectations and three companies' earnings were unchanged. For the UK market as a whole, the ratio of companies delivering positive earnings upgrades to downgrades peaked in November at 2.1 (according to Alliance Bernstein). For your portfolio the ratio was 7. This was considerably better than the market, yet was not reflected in fund performance in the final quarter. Why? We know that earnings surprises are far less likely to be rewarded by investors during periods, of sharp market recovery. During these periods investors are concerned more with the potential for recovery over the course of the next 18-24 months. Whilst this can be frustrating, it tends to be a short-lived phenomenon. It is clear that the process continues to do a good job identifying stocks that are cheap and surprise investors positively with their earnings. By definition this should provide investors with good returns over the medium to long-term.

## PORTFOLIO CHANGES IN 2009

Most of the portfolio changes in 2009 were made in the second and third quarters when the majority of UK companies post their annual results. We have already commented on these in the relevant quarterly reports.

In summary, significant changes have been made to your portfolio over the twelve months, reflecting the change of investment process from April. We finished the year with 34 holdings, compared to 48 at the beginning of the year. The portfolio has been constructed since April using The *Liontrust Cashflow Solution* process, with an active weighting versus the FTSE All-Share Index depending on size of company and cash flow rank, with an Index 'spine' of companies drawn from the top ten holdings in the Index to help contain the overall volatility of the portfolio versus the Index. When looking at the top ten holdings in the Index, we are actively weighted in five that score well on our process and neutral in five that score neither well nor badly on our process. None of the top ten holdings in the All-Share Index ranked in the bottom 20% of our investment process. The neutral positions

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accounted for 21% of the portfolio at year-end and include *Vodafone Group*, *British American Tobacco*, *Barclays*, *Rio Tinto* and *HSBC Holdings*. The active positive weight in the portfolio was 54.1%, compared to 26% at the beginning of the year (active positive weight is defined as the cumulative stock weights less their benchmark weight). Since March we have sold 26 holdings and bought 17 new holdings, two of which were sold in December.

## OUTLOOK

Having emerged from the quiet Christmas period, corporate news flow is due to accelerate dramatically over the course of the next three months. This is a critical period for the process. Roughly 55% of companies in the UK report December year-ends. In order for us to continue holding a company in the portfolio, or buy a new holding, it must rank in the best 20% of the market on the basis of our combined cash flow ratios derived from annual accounts. The bulk of portfolio turnover therefore occurs between March and May as we assess final results. Our expectation this year, based on the historical evidence of market recoveries, is for the market to give much more credit to companies that can surpass their profit expectations than has been the case in the recent past. Many companies became significantly more expensive over the course of last year as markets recovered and investors were prepared to look through short-term bad news in the expectation of substantial profits recovery to come. We believe it will now become important for those companies to meet investors' raised expectations. Our process is designed to identify companies that are likely to surprise investors positively. If we can continue to identify cash-generative companies on low valuations that can provide positive earnings surprises, then this year should be a much better year for our investment process.

### **GARY WEST & JAMES INGLIS-JONES**

LIONTRUST EUROPEAN INVESTMENT SERVICES LIMITED

*February 2010*

# FUND PROFILE

## INVESTMENT OBJECTIVE AND POLICY

The objective of the Fund is to provide long-term capital growth through investment in a portfolio of UK equities in companies which at the time of investment have market capitalisations which place them in the largest 350 companies ranked by market capitalisation listed on the Official List of the London Stock Exchange.

## INVESTMENT APPROACH

This unit trust aims to provide long-term capital growth through investing in large capitalisation UK companies. The Fund holds a concentrated portfolio of UK companies, 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 the Fund's industrial sector exposure, which will not closely mirror that of the benchmark.

## RISK PROFILE

The Fund is invested exclusively in UK equities. It is invested in stocks throughout the FTSE 350 Index, with no sector bias. The principal risks are those associated with stock market investments.

**TOTAL EXPENSE RATIO:** 1.65% (31st December 2008: 1.63%)

## FUND CALENDAR

Ex-dividend date	1st January
Income payment date	End of February
Accounting period end	31st December

# PERFORMANCE

## NET ASSET VALUES

	31 December 2009	31 December 2008	% Change
Income units <i>pence per unit</i>	112.18	91.19	+15.42

## DISTRIBUTIONS

The Fund distributes income once per annum, at the end of February. The ex-dividend date is 1st January each year. Income can be reinvested to purchase units at no initial charge.

At the end of February 2009, the Fund will pay a dividend distribution for the year ended 31st December 2009 of 3.10 pence per unit (31st December 2008: 2.41 pence per unit).

## TOTAL RETURN %

	1 year to 31.12.09	10 years to 31.12.09
Liontrust First Large Cap. Fund	18.5	17.5
FTSE All-Share Index	30.1	17.7
IMA UK All Companies sector average	30.1	17.1

## DISCRETE YEARS' PERFORMANCE %

	2009	2008	2007	2006	2005
Liontrust First Large Cap. Fund	18.5	-28.9	7.7	17.0	20.9
FTSE All-Share Index	30.1	-29.9	5.3	16.8	22.0
IMA UK All Companies sector average	30.1	-32.0	2.1	17.4	20.9

Up-to-date past performance information (to the last calendar quarter end) 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.*

# PORTFOLIO

## TOP 10 HOLDINGS

As at 31 December 2009	%	As at 31 December 2008	%
Royal Dutch Shell 'B' Shares	8.65	Royal Dutch Shell 'B' Shares	9.78
HSBC	8.08	BP	8.53
BP	8.07	GlaxoSmithKline	5.99
BHP Billiton	6.38	Vodafone	5.95
AstraZeneca	5.61	HSBC	5.60
GlaxoSmithKline	5.60	British American Tobacco	5.13
Vodafone	4.89	AstraZeneca	4.94
BG	3.87	BG	4.32
Rio Tinto	3.33	BHP Billiton	3.54
IMI	3.27	Imperial Tobacco	2.95
Total	57.75	Total	56.73

## SECTOR WEIGHTINGS

	FTSE All-Share Index		Liontrust First Large Cap. Fund	
	31 December 2009	%	31 December 2009	30 June 2009
		%	%	%
Basic Materials	11.92		12.51	4.13
Consumer Goods	11.93		2.58	13.63
Consumer Services	9.67		3.48	12.53
Financials	22.78		24.06	11.11
Health Care	7.90		11.21	10.93
Industrials	6.79		12.22	8.84
Oil & Gas	18.25		24.18	25.40
Technology	1.43		2.35	0.23
Telecommunications	5.83		4.89	6.78
Utilities	3.50		2.49	2.00
			99.97	95.58
Cash (including SSgA* cash deposits)			0.03	4.42
			100.00	100.00

# FURTHER INFORMATION

## LIONTRUST ASSET MANAGEMENT PLC

Liontrust Asset Management PLC is the holding company of a specialist UK and European equities fund management group, now offering world class fixed income and global equity solutions. It provides process-driven portfolio management services to a range of funds which are targeted primarily at professional investors and advisers. The Group currently manages £1.2 billion. Its management covers segregated and pooled pension fund accounts, unit trusts, offshore accounts, absolute return funds and individual savings accounts on behalf of 12,000 investors.

## FURTHER INFORMATION, REPORT & FINANCIAL STATEMENTS

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

Liontrust Investment Funds Limited, 2 Savoy Court, London WC2R 0EZ.

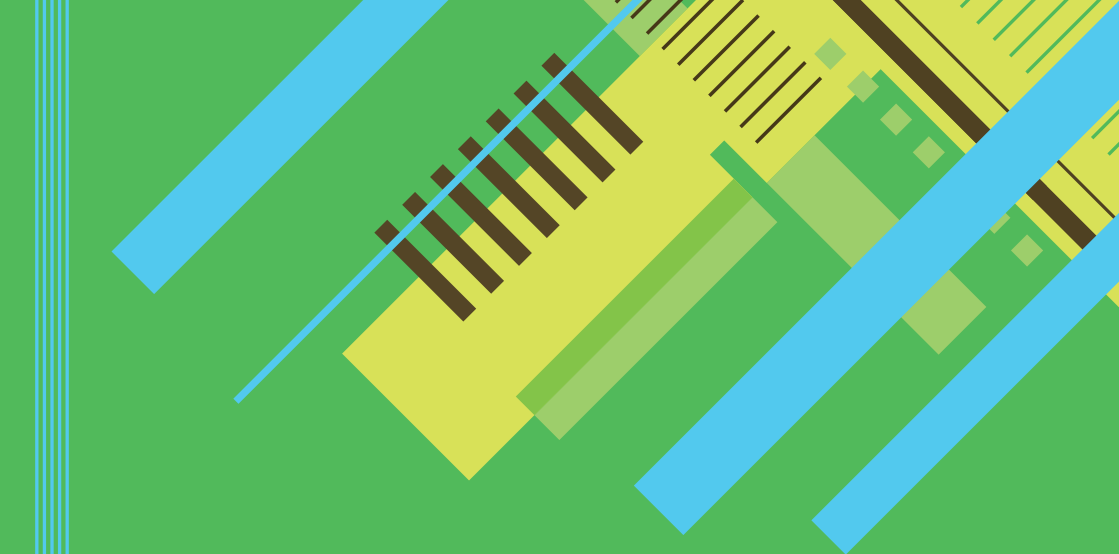
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Authorised and regulated by the Financial Services Authority.



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