



APRIL 2006

Liontrust First Growth Fund
(authorised unit trust): £187m

Liontrust First Equity Fund
(offshore fund): £13m

Liontrust First Exempt Fund
(pension fund pooling vehicle): £128m

INVESTMENT PHILOSOPHY

– *THE LANG APPROACH*

- When a company announces higher than expected profits analysts revise their forecasts. This can drive share prices upwards as the market digests and catches up with events.
- Companies that have recently surprised the market with their profits have a tendency to do so again.
- By focusing on companies that have recently surprised, *The Lang Approach* aims to identify companies whose potential to surprise the market in the future is, we believe, underestimated by stock market analysts.

THE PORTFOLIO

- The portfolio will invest in a range of companies from throughout the FTSE All-Share Index whose profits growth has recently been greater than the market's expectations.
- To reduce volatility and achieve greater consistency of performance the portfolio will be kept well diversified with no stock exceeding three times the average overweight position.

INVESTMENT COMMENTARY

A Classic Car Has So Much More Style

Bankers, bonuses and bottles of Bolly; takeovers are back. Bloomberg thinks there were European deals worth \$450bn in the first quarter of 2006, a 30% rise on the fourth quarter of 2005 and a 152% year on year increase. Takeovers usually mean fat fees for investment bankers and bigger egos for CEOs. They also usually mean poor returns for shareholders and lots of new paper floating around. Not so this time.

Some of us poor second cousins in the stock market have been watching the private equity glitterati with interest. Billions have flowed into private equity funds on the back of the staggeringly high returns of the last decade. We expected this fire hydrant of debt-powered liquidity to come gushing into the stock market. It hasn't. The recent explosion in corporate activity has not been unleashed by private equity. It has come from trade buyers – other companies. Most unexpected.

Owning a company which is taken over is fun. You wake up one morning and find the share price around 20% higher than yesterday's close. Usually it's not so fun if you own the company which is doing the takeover. Countless studies have shown acquiring companies have a strong tendency to under perform after a takeover. But a recent study by the Cass Business School in London suggests this may have changed. In 2004 companies involved in significant takeovers outperformed after acquiring. This may be a flash in the pan – there are decades of data suggesting value-destruction. However, the speculative conclusions of the aforementioned study are intriguing: for organisations operating on a global scale, it is almost impossible to grow quickly enough through organic growth alone. Mergers and acquisitions have become necessary, and evidence is mounting that recent deals have been made with due consideration to lessons of the previous, value-destroying decades.

Over the last five years we have got used to a very particular type of takeover: cheap companies, with uninspiring growth prospects being picked off by leveraged private equity funds. Over the last year this has all but disappeared. A casual flick down the league table of last year's M&A reveals a negligible number of private equity funded deals. Instead names like Nippon Sheet Glass, St. Gobain, Telefonica, Deutsche Post, and Gas Natural clutter up the list. The only private equity funded deal I could find in the UK this year is Permira and KKR's approach for Kesa, and it



isn't a done deal. But there are at least five trade deals - Linde's bid for BOC, Ferrovial's bid for BAA, L'Oreal's bid for Bodyshop, Sage's bid for Visma and Wolseley's bid for Brandon Hire – and a raft of approaches “...which may or may not lead to a formal offer for the company...”. Deals are popping up in lots of different sectors, including natural resources.

Corporate activity in the natural resource sector perfectly encapsulates what is driving M&A at the moment: a lot of companies are finding it difficult to grow, and they are petrified about value destruction. The resource sector is booming, in oil and metals. Demand is growing fast, as China and India industrialise. Supply is tight because commodity prices have been too low to encourage significant new investment for a very long time. But everyone is nervous. Companies are nervous because they have been through a long period of pain, when investments often proved disappointing, and pricing power illusory. Investors are nervous as they fret about the imminent approach of the “top of the cycle”. And this sums up the paradox of today's stock markets – investors say they want more growth, but they are scared of encouraging over investment. Investors *generally* want companies to invest for growth, but *specifically* feel uncomfortable about any individual company they own embarking on a spending spree. So M&A is the safe option. Why build new capacity when you can grow by buying someone else's? Especially if you can buy it with cash. Cash? Aren't takeovers from companies supposed to be funded by paper? Not anymore. Nearly all recent big takeovers have been funded partly, or entirely, by cash.

Cash funded takeovers, which are good news for the acquiring companies, allow companies to grow without raising the spectre of over investment. It almost sounds too good to be true, especially if you're an investment banker, or a Champagne maker. Hold on a minute, didn't some one just take over Allied Domecq...?

Fund Review

There has been a lot of change this quarter. I have been able to find a large number of new stocks which are surprising and, crucially, where the reasons for the surprises look like they can last. Also their share prices don't appear to have gone up “too much” – valuations look sensible. I have sold around ten stocks. Either they had stopped surprising, or I felt the reasons for why I first bought them no longer held true. I have bought over twenty new stocks, so the portfolio now has around 100 stocks. Each, in my opinion, has the potential to deliver surprisingly strong growth for at least the next year, many for far longer. This extraordinary explosion of new stocks has nothing to do with the economic cycle. Other changes normally drive my stock selection.

I have been saying for some months that conditions are improving for my style of investing. We have been through an unusually traumatic period. Surprising growth has been hard to come by since 2000, when the TMT bubble popped. A large number of important thematic growth drivers matured at around the same time. From 2000 to 2003 I was consistently selling more than I was buying, and a high proportion of the new purchases proved to be disappointing. It was hard for companies to grow, and so disappointments were far more common than surprises. In 2004 there was a burst of new stocks producing unexpectedly good results, but they were a very concentrated bunch (nearly all TMT) and they turned out to be very poor investments.

2004 felt very unusual. I have become used to buying newly surprising stocks, holding them for a few years, while they keep delivering surprisingly strong growth, and then profitably selling them once they become predictable again. In 2004 the opposite happened. Nearly all of my new purchases failed to keep surprising.



By the summer of 2005 they had been sold, nearly all at a loss. It was almost enough to put me off investing. Almost, but not quite.

My investment style is all about “playing the odds”. Making investment decisions on the basis of what is most likely to happen. But investment is a very unpredictable business. Frequently the less likely thing happens. Even when I have performed well I have always had an uncomfortable number of disappointing investments. Usually, they are overcome by the majority of decisions which I get right. Sometimes I get too many wrong and the whole portfolio suffers. This does not mean I have suddenly become stupid, that my investment style suddenly doesn’t work. It means that not everything is rewarding all the time – it is called risk. You cannot have reward without risk.

A hundred stocks sounds a lot. Surely there cannot be 100 great investment ideas around? Probably not. You can be pretty sure that in a year’s time quite a few of those 100 stocks will not be in the portfolio. They will have disappointed, or become predictable, and I will have moved on. I just don’t know which ones they are going to be yet. *Vedanta* or *Venture Production*, *Michael Page* or *Morgan Sindall*, *Abbot Group* or *Admiral*, *Babcock* or *Barclays*; who knows which ones will still be there?

There are some strong themes in the portfolio. The Fund owns most of the big metal mining companies – *Billiton*, *Anglo American*, *Rio*, *Xstrata*, *Kazakhmys* and *Vedanta*. They are all surprising as commodity prices stay higher, for longer than the market expects. The Fund owns a lot of oil companies - *Burren*, *JKX*, *Premier*, *Soco*, *Tullow* and *Venture*. We also own *BP* and *Shell*. Like the miners, the market seems to be underestimating how long the oil price will stay high. For the same reason we own a lot of oil service companies – *Abbot*, *Expro*, *Hunting*, *Sondex* and *Wood Group*. Building contractors and consulting engineers are well represented in the Fund, as are insurance companies. There are even a few technology stocks. But unlike 2004, companies like *Wolfson*, *Systems Union* and *Autonomy* are surprising because life is getting better, rather than stopped getting worse. Revenue is accelerating and growing faster than expected. In other words, good old fashioned growth companies. It hasn’t felt like this since 1996.

Jeremy Lang
Joint Investment Director, Liontrust Investment Services Limited.

April 2006.



1. PERFORMANCE

Liontrust First Growth Fund

Cumulative years

Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date. Figures to 31.3.06

	1 year	2 years	3 years	4 years	5 years	Since 1.4.96*
Liontrust First Growth Fund	+30.2%	+40.9%	+72.8%	+29.2%	+26.9%	+158.5%
FTSE All-Share Index	+28.0%	+47.9%	+93.8%	+36.0%	+31.7%	+122.1%
Average UK All Companies sector unit trust	+27.2%	+44.5%	+93.6%	+37.8%	+32.1%	+126.5%
Performance vs. benchmark	+2.2%	-7.0%	-21.0%	-6.8%	-4.8%	+36.4%
Sector quartile ranking	1st	3rd	4th	3rd	2nd	1st

(* Jeremy Lang assumed the management of the Fund on this date).

Discrete years

Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date.

	1 year to 31.3.02	1 year to 31.3.03	1 year to 31.3.04	1 year to 31.3.05	1 year to 31.3.06
Liontrust First Growth Fund	-1.8%	-25.2%	+22.7%	+8.1%	+30.2%
FTSE All-Share Index	-3.2%	-29.8%	+31.0%	+15.6%	+28.0%
Average UK All Companies sector unit trust	-4.1%	-28.8%	+33.9%	+13.6%	+27.2%
Performance vs. benchmark	+1.4%	+4.6%	-8.3%	-7.5%	+2.2%
Sector quartile ranking	2nd	1st	4th	4th	1st

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.



2. SECTOR ALLOCATION versus FTSE ALL-SHARE INDEX

Liontrust First Growth Fund

Sector	FTSE All-Share Index %	Liontrust First Growth Fund %	Relative Weights %
Industrials	9.2	25.5	+16.3
Oil & Gas	16.5	24.8	+8.3
Basic Materials	7.3	11.0	+3.7
Technology	1.0	3.9	+2.9
Health Care	8.2	6.8	-1.4
Utilities	4.2	1.3	-2.9
Telecoms	5.5	2.1	-3.4
Consumer Goods	8.1	2.2	-5.9
Consumer Services	11.5	4.8	-6.7
Financials	28.5	14.5	-14.0
Cash	–	3.1	–

3. MARKET CAP. WEIGHTINGS

	FTSE 100 Index (%)	FTSE Mid 250 Index (%)	FTSE Small Cap. Index (%)	Cash (%)
FTSE All-Share Index	82.9	13.7	3.4	–
Liontrust First Growth Fund	55.0	30.8	11.1	3.1

4. TOP TWENTY HOLDINGS

Liontrust First Growth Fund

	(%)		(%)
1. BP	7.9	11. Aviva	2.2
2. Royal Dutch Shell 'B' Shares	7.3	12. BAe Systems	2.0
3. GlaxoSmithKline	5.4	13. International Power	1.9
4. Barclays	5.3	14. Man Group	1.8
5. Rio Tinto	3.8	15. Wolseley	1.6
6. BHP Billiton	2.9	16. Xstrata	1.5
7. Anglo American	2.6	17. Charter	1.5
8. Vodafone	2.5	18. Rolls-Royce Group	1.4
9. BG Group	2.4	19. Reckitt Benckiser	1.3
10. Standard Chartered	2.3	20. AstraZeneca	1.3

Total 58.9% (41.1% held in a further 80 stocks and cash)



5. RISK ANALYSIS

<i>Five years to 31.3.06 bid to bid basis, net income reinvested at ex-dividend date.</i>	FTSE All-Share Index	Liontrust First Growth Fund
Total return	31.7%	27.7%
Mean annual return	6.6%	5.7%
One month low	(-11.8)%	(-8.4)%
One month high	+9.4%	+7.8%
Maximum drawdown	(-37.2)%	(-32.6)%
Percentage of positive months	61.7%	66.7%
Alpha (annual basis)	0	-0.49
Beta	1	0.83
Correlation Coefficient	1	0.95
R Squared	1	0.91
Relative Risk	1	0.87
Risk adjusted performance (annual)	0%	-0.58%
Sharpe ratio (annual)	0.16	0.11

Source: Asset Risk Consultants © 2005.

Glossary of Terms

MEAN ANNUAL RETURN : An arithmetic average (mean) of the monthly returns during the review period, multiplied by twelve.

MAXIMUM DRAWDOWN : The greatest loss that could have been experienced by an investor over the entire review period.

ALPHA : A measure of the portfolio's expected return when the benchmark produces no movement.

BETA : The amount the Fund is expected to gain or lose when the benchmark moves by one unit. It takes account of the relative risk of the Fund as well as the correlation of movements between the Fund and the benchmark.

CORRELATION : Measures the coincidence of movement that occurs between the Fund and the benchmark. Correlation coefficients can take values from +1 to -1. Correlation of +1 would indicate that the two portfolios move in perfect unison. A correlation of zero would indicate no relationship between the two. A negative correlation would indicate that they move in opposite directions.

R SQUARED : Measures the degree of explanation that can be made about movement in the Fund by a movement in the benchmark. A value of 100 equals 100% explanation. R Squared is also known as 'goodness of fit'.

RELATIVE RISK : The risk of the Fund measured in relation to the benchmark's risk which has a value of 1.00. Calculated by dividing the volatility of the Fund by that of the benchmark.

RISK ADJUSTED PERFORMANCE : The difference between the Fund and the benchmark return where the benchmark's return has been adjusted to the level of risk of the Fund. It is thought of as a measure of 'value-added' by a manager.

SHARPE RATIO : A measure of the annual excess return divided by the annualised standard deviation of returns of the benchmark. Excess returns are those in excess of the risk-free rate of return.

Bulletin Board News from Liontrust

Our New European Equity Fund Management Team

At the beginning of February we announced the appointment of two experienced European equity fund managers, **Gary West** and **James Inglis-Jones**. The team joined Liontrust on 1st March and immediately started the development of their European Equity Investment Process which, once documented, will be used to launch a number of collective investment vehicles including long/short investment funds and long-only unit trusts and offshore funds. We will also offer the Process to the institutional market who will be able to invest via long-only segregated and pooled pension funds.

Gary and James previously held senior positions at JP Morgan Fleming in the European investment division of which Gary was co-head until his departure. More recently they were with Polar Capital where they established a European Market Neutral product.

Gary has been managing funds since 1988. In 1999, after four years at Fleming Investment Management, (where he worked alongside William Pattison), he was promoted to joint head of the European equity department.

James was a senior portfolio manager within JP Morgan Fleming European equity group with responsibility for a wide range of institutional and retail portfolios.

The appointment of Gary and James is an important milestone for us. The team is a natural fit for Liontrust for two key reasons. First, a move into European equities is the logical expansion for the Company and will compliment our hugely successful UK equities operation; second, Gary and James have worked with William before at Flemings and this will help their integration into Liontrust and the development and documentation of a European Equity Investment Process. The process that Gary and James will develop also meets our key criteria of being scalable across retail and institutional marketplaces. We aim to have European equity products available for customers before the end of the year.