



OCTOBER 2006

Liontrust First Growth Fund
(authorised unit trust): £285m

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

Liontrust First Exempt Fund
(pension fund pooling vehicle): £130m

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.

I live in the stockmarket and life is good: inflation is back.

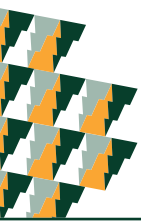
Stocks are unpredictable creatures. Surprises and disappointments, like complaining about the weather, never end. There are times when the background chatter of surprises and disappointments is an impenetrable, noisy nonsense; when there is no pattern and a surprise is just as likely to be quickly followed by a disappointment, or nothing at all. This is no good to me. I thrive on persistent surprise. Persistent surprise occurs when investors react in a predictably flawed way to change, or to something sustainably different.

There are two types of surprises. The first is uninteresting: stocks which start surprising for intrinsically erratic reasons which elicit a perfectly sensible and rational response from investors. These offer no opportunity to me. But not all surprises are like this, not all are rational. The irrational second type is where investors are missing something, where they keep getting caught out because they refuse to accept they may be wrong. I think there are quite a few of the latter type of surprises now. The number of stocks in the Fund is higher than normal as there are an unusually large number of stocks which are catching investors out for reasons I think will last for some years. The last time this happened was in the mid 1990s.

Tesco reported last week. The usual stuff – getting ever bigger by selling more of everything. Well, not quite. While the headline sales growth was as expected, there was a funny mix. Usually *Tesco* relentlessly drives unit volume growth by holding or cutting prices. This time average prices rose surprisingly fast whereas unit volume growth was a little disappointing. So it seems, for the first time in ages, inflation is back. For me, this is important.

Creeping inflation – I haven't seen it for a long time. Indeed, many of the companies I follow have struggled with deflation for over a decade. But I have noticed pockets of the economy where "good" inflation is coming back. Good inflation means pricing power. And pricing power is good for company profits, cashflow and dividend growth.





Inflation isn't universal and it isn't all good. There are many industries where pricing power is still weak. For them inflation is bad inflation, because it means rising costs, but an inability to pass these costs on, so lower profit margins.

I think the most profound change driving investor error at the moment is inflation. Inflation is creeping back into some industries and leeching away from others. Consequently I have positioned the portfolio to be exposed to the areas where I can see inflation returning and away from those where pricing power is diminishing. Where possible I have focused on the companies which can compound their strengthening pricing power with volume growth. With this in mind the Fund's holdings in mining stocks such as *Anglo American*, *BHP Billiton*, *Rio Tinto*, *Vedanta* and *Kazakhmys* should make sense. And the oil exploration and production companies such as *Tullow Oil* and *Soco International*. So too the oil service companies like *Expro* and *Wood Group*. Industrial commodity prices have been surprisingly strong for well over a year now and all of these companies are delivering surprisingly strong growth.

Commercial and government related construction markets are also surprisingly strong. A great wave of investment in infrastructure is carrying the fortunes of construction related businesses ever upwards, while the continuing evolution of the government's relationship with the private sector is helping many companies grow surprisingly fast. This is why the Fund owns *Babcock*, *Mears*, *RPS*, *Serco*, *Morgan Sindall* and *VT Group*, among others.

There are industries which have suffered many years of sluggish demand and little or no ability to raise prices which are now feeling an improvement. *Charter*, *Elementis*, *Rotork* and *Spirax Sarco* operate in such areas and are all held in the portfolio. The financial sector is also experiencing changes in relative pricing power. Lending gets ever more competitive. Insurance, on the other hand, is proving surprisingly robust. Following decades when high interest rates encouraged companies to write loss-making insurance policies (they could make back the money by investing premiums in high yielding bonds) pricing discipline has returned. Those with particularly good underwriting records like *Amlin* and *Hiscox*, or those which have been forced to focus on basics through financial stress, like *Royal Sun Alliance*, are proving to be surprisingly profitable.

I like commodity stocks because I think the elasticity of supply has changed. Historically any burst of new demand has been met by a quick pick up in supply, so prices have rarely stayed high for long. I noticed this when I first did my empirical work on earnings surprises in the UK 10 years ago. Resource stocks just didn't persistently surprise. Commodity prices moved randomly and if they were surprisingly strong for a few months, they never stayed up long enough to trigger profit surprises for resource companies for more than six months. Commodity price moves were cyclical and unpredictable. This is not the case at the moment. The demand argument for commodities is well known – industrialisation of China and India. What gets less attention is what's going on with supply. After decades of low prices very little new investment has happened. Mining companies have done the easy stuff – pulling more commodities from existing reserves and prospecting in cheap, easily accessible areas. But life is getting more difficult. Practically every company I follow is struggling to drive





unit volume growth, is complaining that costs are going up, and that new sources of supply are in difficult areas, geologically or politically. Also, in the current investment climate, where fund managers are obsessed with cash flow, many companies are reluctant to invest. They would rather buy existing capacity than develop high risk new capacity, especially when they have had decades of experience of new supply quickly dragging prices back down to painful levels. Spot commodity prices have been very weak in the last few months, but the structural dynamics have not changed. Over the next five years prices will stay higher for longer than the market expects. And the companies which control the prime reserves will generate surprisingly good profits. They will gradually loosen the purse strings and invest, but the investment cycle is likely to be gradual and long. Hence pricing power is likely to be with the producers of commodities and with the related service and equipment companies for some time. Ideal conditions for persistent surprise.

Jeremy Lang

Joint Investment Director, Liontrust Investment Services Limited.

October 2006.





1. PERFORMANCE

Liontrust First Growth Fund

Cumulative years

Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date. Figures to 30.9.06

	1 year	2 years	3 years	5 years	10 years	Since 1.4.96*
Liontrust First Growth Fund	+17.0%	+43.2%	+52.7%	+43.0%	+132.3%	+161.9%
FTSE All-Share Index	+14.7%	+43.2%	+65.7%	+53.2%	+110.2%	+126.0%
Average UK all companies sector unit trust	+14.3%	+40.7%	+59.1%	+54.8%	+111.1%	+126.8%
Performance vs. benchmark	+2.3%	0%	-13.0%	-10.2%	+22.1%	+35.9%
Sector quartile ranking	1st	2nd	4th	3rd	1st	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 30.9.02	1 year to 30.9.03	1 year to 30.9.04	1 year to 30.9.05	1 year to 30.9.06
Liontrust First Growth Fund	-16.2%	+11.7%	+6.7%	+22.3%	+17.0%
FTSE All-Share Index	-20.8%	+16.7%	+15.7%	+24.9%	+14.7%
Average UK all companies sector unit trust	-17.1%	+17.4%	+13.1%	+23.1%	+14.3%
Performance vs. benchmark	+4.6%	-5.0%	-9.0%	-2.6%	+2.3%
Sector quartile ranking	2nd	4th	4th	3rd	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	7.1	28.6	+21.5
Oil & Gas	15.3	22.6	+7.3
Basic Materials	6.7	12.1	+5.4
Technology	0.9	4.0	+3.1
Health Care	8.5	5.8	-2.7
Utilities	4.7	1.0	-3.7
Telecoms	5.3	1.0	-4.3
Consumer Goods	9.5	2.7	-6.8
Consumer Services	12.3	4.9	-7.4
Financials	29.7	15.0	-14.7
Cash	–	2.3	–

3. MARKET CAP. WEIGHTINGS

	FTSE 100 Index (%)	FTSE Mid 250 Index (%)	FTSE Small Cap. Index (%)	Cash (%)
FTSE All-Share Index	82.5	14.2	3.3	–
Liontrust First Growth Fund	50.9	34.3	12.5	2.3

4. TOP TWENTY HOLDINGS

Liontrust First Growth Fund

	(%)		(%)
1. BP	6.2	11. BAe Systems	1.5
2. Royal Dutch Shell 'B' Shares	6.1	12. Aviva	1.4
3. GlaxoSmithKline	4.8	13. Xstrata	1.4
4. Barclays	2.8	14. British Airways	1.4
5. Anglo American	2.7	15. Man Group	1.3
6. Rio Tinto	2.6	16. BPP Holdings	1.2
7. BHP Billiton	2.3	17. Rolls-Royce Group	1.2
8. BG Group	2.0	18. Robert Walters	1.2
9. Standard Chartered	1.7	19. Hunting	1.1
10. British American Tobacco	1.6	20. Reckitt Benckiser	1.1

Total 45.6% (54.4% held in a further 73 stocks and cash)





5. RISK ANALYSIS

Five years to 30.9.06 bid to bid basis, net income reinvested at ex-dividend date.	FTSE All-Share Index	Liontrust First Growth Fund
Mean annual return	7.25%	6.17%
One month low	-11.76%	-8.38%
One month high	9.37%	7.80%
Maximum drawdown	-31.18%	-28.13%
Percentage of positive months	66.67%	71.67%
Alpha (annual basis)	0	-0.63
Beta	1	0.85
Correlation Coefficient	1	0.95
R Squared	1	0.90
Relative Risk	1	0.90
Risk adjusted performance (annual)	0	-0.77
Sharpe ratio (annual)	0.22	0.16

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

Liontrust Continental Europe Fund

On 15th November we launch our first European equity growth unit trust, Liontrust Continental Europe Fund. The Fund is the first opportunity for investors to 'access' our latest investment process, known as *The Cashflow Solution*. This process has been developed by two new fund managers, Gary West and James Inglis-Jones, who joined Liontrust in March this year.

The Cashflow Solution investment process focuses on the opportunities created by the mistakes made by company managers in forecasting profits. These errors provide Gary and James with their investment opportunities, particularly at key stages in a company's development.

The Fund's portfolio will contain just thirty to fifty stocks. This concentration could mean that the Fund will be volatile when compared with a benchmark and other competitor unit trusts. There are also no limits on stock market and sector exposures and, although the Fund has representation across a number of sectors, the concentrated number and nature of its holdings could mean that its returns could be volatile, especially when compared with funds providing a more broadly based portfolio. This is an important point to remember when considering the merits of this Fund.

Further details are available from our Broker Services team on 020 7412 1766.