



JANUARY 2008

Liontrust First Growth Fund
(authorised unit trust): £467m

Liontrust First Equity Fund
(offshore fund): £19m

Liontrust First Exempt Fund
(pension fund pooling vehicle): £144m

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

Hairy and Scary

2007 was a surprising year. It was not the best of times. Commodity prices kept climbing, the consumer kept getting squeezed and the housing market started to suffer. But four in ten stocks delivered surprisingly strong profits growth. People involved in the stock market usually have a bias to optimism. Normally more stocks disappoint than surprise. In my experience around four in ten stocks surprise when the economy is behaving itself and fewer than two in ten manage to surprise when the economy is tough; even when times are very good only five in ten stocks surprise. So in a year which turned sour in June, four in ten stocks managing an earnings' surprise is pretty good going.



Jeremy Lang
Managing Liontrust
First Growth Fund since
April 1996.

In an average year for surprises, the FTSE All-Share Index was up 2% (capital return only), well below average. Behind the All-Share it was worse. The average stock fell by 10% in 2007. It is pretty unusual for the average stock to fall 10% in a year when four out of ten of them surprised. Clearly there was a lot going on underneath the surface of the All-Share Index. Two factors were at work: first, a lurch from optimism to pessimism by investors, and second, the rising importance of the global economy to UK companies.

Investors got gloomier as 2007 unfolded. This can be seen in a number of ways. When investors get nervous they begin to worry about how easy it is to sell stocks. Large stocks are easier to sell than smaller ones, so a sure sign of rising nervousness is when small stocks perform worse than large ones. In 2007 the FTSE 100 Index rose 4%, the FTSE Mid 250 Index fell 5% and the FTSE Small Cap. Index fell 12%. Another sign of rising nervousness is when the stock market gets cheaper. The All-Share Index started 2007 on a forecast price to earnings ratio ("PE") of 11.9 and a net dividend yield of 3.2%. It ended 2007 on a PE of 11.7 and a dividend yield of 3.4% (including special dividends). The All-Share Index is heavily influenced by a few large stocks. An equally-weighted index gives a clearer picture of what was happening to the average UK stock. An equally-weighted UK index started 2007 on a forecast PE of 15.0 and a dividend yield of 2.2%; it ended the year on a PE of 13.2 and a yield of 2.8%. The market did not get cheaper because gilts or index-linked gilts got cheaper, quite the contrary: 20 year gilt yields started at 4.50% and ended at 4.45%; index-linked gilts started on a running yield of 1.32%





and ended on a yield of 1.17%. The logical flipside of UK stocks getting cheaper in 2007 is that the risk premium on the UK stocks went up; more evidence of rising nerves.

Only a third of UK stocks made money last year. This was partly because the rewards for good news were pretty anaemic, but also the damage caused by bad news was nasty. The average reward for good news was only a 4% rise in stock price in 2007, while the damage from bad news was a 23% loss. This is another sign of investors seeing the glass as half empty. There is more evidence at the extremes – only four stocks in the top 500 more than doubled last year, but 52 more than halved.

The great on-rush of anxiety began in June. It came from the debt markets. Years of aggressive financial engineering and repackaging of consumer debt in the UK and US started to unravel. The banking system requires trust and confidence to work properly. Both began to evaporate and some of the new debt markets seized up. *Northern Rock* was a high profile casualty, but almost every bank which has grown its loan book quickly is vulnerable. There is a knock on to the real economy, as it will become more difficult to borrow, which may affect spending. No one really knows what will happen, because we are dealing with a new type of financial crisis. Entering the unknown is notoriously stressful.

The full force of the anxiety has not been felt by the All-Share Index because the make up of the UK stock market has changed a lot in the last few years. The Index is much less a reflection of the UK economy and much more a barometer for the health of the global economy. The global economy is much changed too. It used to be dominated by the US. Now resource-based economies like China and India are significant influences. The latter have very little financial leverage (unlike the US). Resource-based companies (mining, oil and gas, and related industries), global tobacco and beverage companies, and aerospace and defence businesses dominated the list of top performers in the UK in 2007. These are all UK-based companies, but their prospects are hardly affected by how the UK (or the US) economy does at the moment. The worst performing industries, on the other hand, were very UK-centric – property, retail, travel and banks, for example. The clincher is the relative importance of the various industries. Natural resource-based industries now represent around 27% of the All-Share Index, whereas UK banks represent only 7% (and 7% is in Far East-focused banks, *HSBC* and *Standard Chartered*). Retailers are now only 2% of the Index.

The environment for my style, as the cliché goes, was mixed. On the one hand there were plenty of surprising stocks to be found. On the other hand, the rewards on offer were not great. The significant outperformance of very large stocks also made life difficult. I tend to systematically under-own them and I am not mad about tying up large chunks of the portfolio in a few stocks. Despite all this, we had a pretty good year.

Every year I break my performance down into three key components: first, how many stocks did we get right; second, how well did those stocks perform; third, how much damage was done by the stocks which disappointed. I started 2007 with around 90 stocks. I sold 27 stocks during the year and bought 31, to end the year with a similar number. Over half of the stocks we held made money for the portfolio (54%); not bad when only 37% of stocks in the market went up. The main reason for the relatively high hit rate was that my stock selection generally did what it is supposed to do – find stocks which deliver surprisingly strong profits growth. Around 70% of our stocks surprised while we owned them and only 16% delivered disappointing news (the rest performed roughly in line with initial expectations). Recall only 40% of the market produced clear surprises and 40% were clearly disappointing. This is the core objective of my investment process – finding surprising growth stocks – and my ability to achieve this objective most of the time is why the long-term performance of the Fund is pretty good.





Finding stocks which surprise is of no use if they are not rewarding to own. Sometimes the market ignores good news. It can do this for two reasons. First, the stock is already too expensive, and so too much expected good news is already in the price. Second, the market does not believe the good news will continue. I think the latter was to blame.

Much like the average stock's experience, my stocks generally got cheaper during the year. Their average PE started around 16 and ended the year around 14. While higher than the market, an average PE in the 14-16 range is not nose-bleed inducing. But the average PE did fall, so in this sense, surprising growth was not well rewarded. In normal market conditions, when other investors' anxiety isn't shooting through the roof, successful growth stocks tend to go through a virtuous circle of good news, rising profits, and rising valuations as confidence in future growth builds. This is why growth stocks can be so rewarding when they work. This virtuous circle was taking hold in a number of our stocks in the first half of the year, but was punctured in the second half. It didn't stop high PE stocks being rewarding though; one of our best performing stocks was also one of our most expensive – *Autonomy* (PE c.32). Despite the PE on our stocks generally falling, the average reward for our surprising stocks was still 8% - better than the All-Share (+2%), a lot better than the average stock (-10%), and more rewarding than the average surprise (+4%).

I always get stocks wrong, but mercifully there weren't very many of them last year. Only around 20 stocks delivered disappointing news. Their performance was poor – on average they fell by 11%. But given that the average damage from a disappointment was more like -23%, the damage the portfolio sustained from my errors was not too bad. This is all the more comforting given, as I wrote earlier, the average PE on our stocks was quite a lot higher than average. Unlike the period 2000-2004 when a high PE was a guarantee of a tanking share price on a disappointment, our high PE stocks proved relatively robust. There were still some pretty painful investments, but more on them later.

I like to go through a few successful stock examples in my annual review, to explain how my approach works in more detail. I also write on a few of the decisions which didn't turn out too well. I write about the former to make myself feel good. I write about the latter, partly to show that I (often) get things wrong, and partly to try and convince you that when I do get stocks wrong I don't do it out of stupidity (although clearly you can reserve judgement on this).

First some of the failures. My worst decision was to own *British Airways*. Nothing went right. It disappointed, its share price performed badly and I was slow to sell it when news started to turn. I originally bought *BA* on the strength of its business class franchise and its relentless focus on costs. I also had half an eye of the switch to Terminal 5 in 2008. However, in 2007 *BA* was dogged by problems at Heathrow, security scares, the oil price, the Open Skies regulatory change and finally, worries about the US economy. I don't think any of these are structural, enduring issues, and the impact so far has been fairly limited. Forecasts began to crumble in the late summer, on the impending change in regulation on transatlantic flights, to encourage more competition. I cut our holding during the second half of the year, as the risks mounted, but I thought the forecast cuts were one-off, and speculative: some brokers had decided, in response to the Open Skies agreement, that margins would fall. The impact of the regulatory change will not hit until 2008, and it is unclear what will happen – there are capacity constraints at Heathrow and Gatwick which will not disappear quickly. I might be right, but the stock price didn't care – it ended the year down over 40%. We have sold our small residual holding this year.

Last year the worst performing stock in the Fund was *Robert Walters*, a recruitment company. They halved. This is disappointing because the company delivered nothing but good news last year, and its profits forecasts were revised up about 20%. It started the year on a PE of 18, a 50% premium to the market. It also had strong free cash flow which





it was partly using to buy back shares. *Robert Walters* ended 2007 on a PE of less than six. *Walters* has been expanding fast overseas. Over 60% of its fee income and 75% of its profits come from Europe and the Far East. It is the successful expansion into Europe and especially Asia which has driven a long period of profit surprises. However, there is clearly trouble brewing in the UK financial sector, so some of *Walters'* business in the UK will suffer. Anxiety over this has battered the stock price. I think this is harsh, as the performance of its high margin Far East operations is far more important, and here everything looks fine. I did sell our other two recruitment stocks in the second half of last year, since they were far more exposed to the difficulties in the financial sector, but I felt it was worth holding onto *Robert Walters*. I still do.

St. James's Place fell by over a third last year. Like *Robert Walters*, it appeared to do nothing wrong. Profits were strong and forecasts ended the year 20% higher. It wasn't expensive at the start of the year – a PE of 15. However, it ended the year on a PE of 7. *St. James's Place* is a wealth manager, with a skew towards life insurance products. The wealth management industry has gone through significant beneficial changes and *St. James's Place* has executed well. As a result sales and profits have persistently grown faster than expected. However, the wobbles in the stock market and a change in the tax treatment for some life insurance products has hammered *St. James's* stock price. But there is no evidence of a slowdown yet, so I remain a holder.

I had a brief flirtation with *Lookers* last year. I bought the car retailer in the early summer. I liked the changes going on in their industry – a shift of relative bargaining power from car manufacturers to dealers and a rising proportion of profits from services rather than new car sales. Unfortunately the credit crunch hit in the summer. Even though *Lookers* continued to report good sales, a close competitor issued a profits warning. I took this as a cue to sell, thinking it unlikely *Lookers* would be able to buck the rapidly weakening demand for new cars. It was sold in September, at a loss of 30%. The stock price has almost halved since.

Most of last year's other big losers were stocks like *Robert Walters* – they spent the year delivering better than expected results, but the market grew sceptical the good news would continue. Fortunately scepticism was not universal. Stocks like *Autonomy*, *Rio Tinto*, *De La Rue* and *Wood Group* kept delivering good news and were rewarded.

Autonomy, a software developer, took over its closest rival a few years ago. This transformed the business, giving *Autonomy* clear market leadership and a software support capability it was lacking. Since then demand for its niche (clever searching software) has accelerated, and sales and profit forecasts have been consistently increased. *Autonomy* has always sold on a pretty punchy PE. At the start of 2007 it was the second most expensive stock we owned (the most expensive was the oil company *SOCO International*) on a PE of 32. The stock was slightly cheaper by year end, with a PE of 31, despite having risen over 70%. A high PE is no barrier to performance if profits growth is fast and free cash flow is good.

The Fund owns all of the big multi-national, multi-metal miners. All performed well last year, but *Rio Tinto* performed the best. Strong prices for its key metals helped, but the final fillip was a takeover offer from *BHP Billiton*. I like all of the big miners because they have a great quality, long-lived asset base and most of the metals they mine have a tight supply which will not be easily loosened. Mining stocks have surprised for almost three years as metal price forecasts have consistently called for a decline when each year prices have gone up. I think there are structural reasons for strong metal prices, which have a number of years to run, so despite concern over demand weakness in the US, I remain confident of further surprises.





De La Rue's stock price rose 50% last year. Its profit forecasts rose 40% and it was one of the few stocks to end the year on a (slightly) higher PE than the start. It is a good example of a company plodding on its own different path. It is a unique company – it prints bank notes – which wandered from its core business some years ago, with disappointing results. It unravelled these unsuccessful attempts at diversification and has got back to running the basic business well. The results of this boring-sounding strategy have consistently surpassed sceptical expectations. As long as the company keeps to this conservative boring strategy the surprises are likely to continue.

The Fund has had a significant exposure to the oil service industry for a couple of years. In 2007 I added a few new stocks, all of which performed well, but the best performing stock was *Wood Group*, one of the first I bought in 2005. The boom in the industry has accelerated and the few bits of *Wood's* business which were perceived as a drag, like their gas turbine business, have been turned around. Forecasts rose by over 35%, on top of initial profits growth expectations of 30%. So a 65% price rise left the stock on a PE of 19, around the same valuation as the start of 2007. Like the mining sector, I think we are in the midst of a long boom and, as long as the companies in the oil service industry behave sensibly, there should be many more years of surprising growth.

The preceding stock examples give a glimpse of the themes currently dominating the portfolio. There are plenty of stocks involved with the mining, oil and infrastructure industries. There is very little in the consumer cyclical and banking sectors. There is the usual growth bias, and an emphasis on companies with good free cash flow and conservative accounting. Valuations do not look stretched, compared to the market PE or to other assets like cash, gilts or index-linked gilts.

In summary, 2007 was quite a good year, which was shaping up to be a lot better until anxiety exploded. As I write the build up in anxiety isn't stopping, so 2008 will probably be pretty lively. However, we are still in an environment where disappointments are punished harshly and good news is generally met with a sigh of relief. My focus on surprising growth stocks which are being tightly run and have reasonable free cash flow is likely to do okay.

Jeremy Lang
Joint Investment Director, Liontrust Investment Services Limited

January 2008





PERFORMANCE

Liontrust First Growth Fund

Cumulative years

Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date. Figures to 31.12.07

	1 year	2 years	3 years	5 years	10 years	Since 1.4.96*
Liontrust First Growth Fund	+9.2%	+34.6%	+63.7%	+100.9%	+103.7%	+214.7%
FTSE All-Share Index	+5.3%	+23.0%	+50.1%	+104.7%	+82.4%	+152.6%

(* 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.

	2003	2004	2005	2006	2007
Liontrust First Growth Fund	+16.5%	+5.3%	+21.7%	+23.2%	+9.2%
FTSE All-Share Index	+20.9%	+12.8%	+22.0%	+16.8%	+5.3%

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.

THE PORTFOLIO (31.12.07)

1. MARKET CAP. WEIGHTINGS

	FTSE 100 Index (%)	FTSE Mid 250 Index (%)	FTSE Small Cap. Index (%)	Alternative Investment Market (%)	Cash (%)
FTSE All-Share Index	84.2	12.8	3.0	–	–
Liontrust First Growth Fund	39.5	44.9	8.3	3.0	4.3





2. SECTOR ALLOCATION versus FTSE ALL-SHARE INDEX

Liontrust First Growth Fund

Sector	FTSE All-Share Index (%)	Fund (%)	Relative Weights (%)
Industrials	6.9	32.5	+25.6
Basic Materials	10.1	15.8	+5.7
Oil & Gas	17.4	21.2	+3.8
Technology	0.9	3.8	+2.9
Utilities	4.4	1.4	-3.0
Consumer Services	10.8	5.4	-5.4
Health Care	6.6	0.5	-6.1
Consumer Goods	10.2	3.9	-6.3
Telecommunications	7.1	-	-7.1
Financials	25.6	11.2	-14.4
Cash	-	4.3	

3. TOP TWENTY HOLDINGS

Liontrust First Growth Fund

	(%)		(%)
1. Royal Dutch Shell 'B' Shares	8.2	11. British American Tobacco	1.8
2. Rio Tinto	3.7	12. BAe Systems	1.5
3. Anglo American	3.2	13. Aveva Group	1.5
4. BG Group	2.8	14. Reckitt Benckiser	1.5
5. BHP Billiton	2.8	15. Rotork	1.5
6. Xstrata	2.3	16. Standard Chartered	1.5
7. Wood Group	2.0	17. Hunting	1.5
8. Expro International	1.8	18. Weir Group	1.4
9. Petrofac	1.8	19. International Power	1.4
10. Aggreko	1.8	20. IG Group	1.3

Total: 45.3% (54.7% held in a further 75 stocks and cash).





4. RISK ANALYSIS

<i>Three years to 31.12.07 bid to bid basis, net income reinvested at ex-dividend date.</i>	FTSE All-Share Index	First Growth Fund
Mean annual return	13.96%	17.23%
One month low	-4.78%	-7.22%
One month high	4.35%	7.13%
Maximum drawdown	-4.78%	-7.22%
Percentage of positive months	69.44%	75%
Alpha (annual basis)	0%	1.67%
Beta	1	1.18
Correlation Coefficient	1	0.93
R Squared	1	0.87
Relative Risk	1	1.26
Risk adjusted performance (annual)	0%	0.91%
Sharpe ratio (annual)	1.05	1.14

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 1 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 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 FIRST INCOME FUND – ANOTHER YEAR OF DIVIDEND GROWTH

Liontrust First Income Fund grew its dividend for the 11th year running in 2007. An investor who'd purchased £10,000 of units on Jeremy Lang's first day with the Fund (1.8.96) would have received a dividend of £947 in 2007, a yield of nearly 9.5%. The total amount of dividend paid out would now have reached £7,446.

LIONTRUST FIRST GROWTH FUND – CONTINUING ITS RUN OF STRONG PERFORMANCE

Liontrust First Growth Fund returned over 9% in 2007, comfortably ahead of the FTSE All-Share Index. The Fund has returned 64% over the last three years, 13% ahead of the Index. Jeremy Lang has continued to find significant numbers of stocks surprising the market with their profits growth, and those stocks have generally been rewarded with strong share price performance.

	2003	2004	2005	2006	2007
Liontrust First Growth Fund	+16.5%	+5.3%	+21.7%	+23.2%	+9.2%
Liontrust First Income Fund	+33.4%	+14.2%	+19.4%	+16.8%	-8.9%

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