VALUE Added

LIONTRUST

A PERIODIC BULLETIN FOR PORTFOLIOS MANAGED BY JEREMY LANG IN ACCORDANCE WITH *THE VALUE DYNAMIC*.

OCTOBER 2005

Liontrust First Income Fund
(authorised unit trust): £1,161m

Liontrust Dynamic Income Fund
(offshore fund): £23m

INVESTMENT PHILOSOPHY
– THE VALUE DYNAMIC

- Extreme expectations, and stock prices that have moved a lot, have a tendency to come back to the average – investors over-react to extreme events.
- The unwinding of over-reaction is remarkably consistent. Five year losers, judged on previous price falls, have a strong tendency to bounce back, and generally keep going for at least three years.
- An investor can exploit this over-reaction by concentrating on stocks with unusually high yields.
- Historically, when the number of these stocks has averaged more than twenty, the returns, even in weaker markets, have been excellent.

THE PORTFOLIO – LIONTRUST FIRST INCOME FUND

- When the number of these high yielding stocks is high, the portfolio will be more aggressively constructed, with few sector constraints.
- When the number is low, the portfolio will be matched closer to the sector distribution of the benchmark index, with stock selection focused on achieving a portfolio yield 25% higher than the FTSE All-Share Index. We also aim to grow the portfolio's dividend every year. We want good yield and income growth because both are important for total returns.

INVESTMENT COMMENTARY

This is my first quarterly review for Liontrust First Income Fund. The Fund significantly changes only once a year, so these reviews will not feature the usual "I have made the following changes in the last few months..." type of commentary. Instead I will pick out a handful of stocks each quarter and explain why they are in the Fund. As we approach the end of the year I will also write on the areas of the market which are beginning to look interesting – areas where other investors' anxiety is rising; new stocks in the annual review are most likely to come from here.

Aberdeen Asset Management first attracted my attention in 2002. The company was troubled by collapsing stock markets, a scandal in the split cap investment trust sector and its flagship technology fund was suffering from particularly sharp falls in value. The balance sheet was stretched. The dividend yield on the stock was extremely high, but the dividend was clearly unsafe. The common stock looked too risky, even for me. However, *Aberdeen* had quite a sizeable chunk of its debt in the form of a convertible bond. It was selling at 60 pence in the pound with a double digit running yield. This did look like an appealing risk-reward. The market was very worried about compensation claims concerning the appalling performance of some of *Aberdeen's* split cap investment trusts. Split cap investment trusts are publicly quoted investments, subject to standard listing requirements, and are fully regulated. Furthermore, *Aberdeen* did not offer the financial advice as to who these investments should be suitable for (this was the job of the independent financial advisers, through whom most split cap trusts were sold). So the legal case for any liability seemed tenuous. I thought the chances of the convertible not being repaid were very slim. During 2003, following the dividend cut, the yield on *Aberdeen's* stock settled at a significant premium to gilts. The stigma of split caps and TMT still loomed large in investors' minds. Taking a five year view, I thought both sources of pessimism would diminish, so I bought *Aberdeen* common stock as well as the convertibles. At the end of 2004 prospects had improved significantly; so had *Aberdeen's* stock price. The dividend yield was no longer at a significant premium to gilts. I had to decide whether dividend prospects had moved from "struggle to hold dividend on a five year view" to "likely to grow dividends". I felt the latter was likely, so I decided to keep our holding. In May *Aberdeen* raised its final dividend by around 10%.

BAe System's share price collapsed at the end of 2002. For the next eighteen months it was possible to buy *BAe* stock on a dividend yield well above gilts. Cash flow from defence projects was very poor and the commercial aerospace industry was in a slump. *BAe* is a reasonable company, but every now and then its gets itself into trouble. The defence projects it is involved in go through long development stages where cash is drained away from the company and execution risks are high. During these phases the company's profit can easily disappoint. The commercial aerospace industry is prone to long cycles, but is basically a growth business. It is highly operationally geared. In the down cycle profits are prone to disappointment. From 2002 to 2004 both activities were causing *BAe* (and its shareholders) stress. On a five year view such stress rarely persists. I was happy to buy *BAe* stock during this period, with a view that the dividend had a reasonable chance of being paid. Through 2005 I have been happy to hold with the view that its dividend was likely to grow. This year *BAe* has increased its dividend by around 8%, following two years of no growth.

British American Tobacco has been in the Fund for many years. Its dividend yield has consistently been at a significant premium to index-linked gilts and it has grown its dividend faster than inflation. *BAT* has always had a whiff of stigma around it. The

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greatest source of anxiety has been US litigation risk. Niggling away in the background have been worries over the long-term decline in demand for smoking. *BAT* has been able to grow its dividends comfortably faster than inflation despite operating in a stagnating market for two simple reasons: it has pricing power and its costs have been falling. It has been able to cut costs through more efficient manufacturing and distribution. By having plenty of pricing power, these cost savings have stayed inside the company and boosted profits and dividends. This does not look like changing anytime soon.

Outlook

Pessimism seems to be building in a few areas of the market. Investors are getting concerned about companies that are dependent on UK consumer spending, especially if it is financed by debt. They are also concerned about financial companies like banks and insurers. Companies with exposure to the North American car market are causing anxiety. Telecom companies are still deeply distrusted despite rapidly rising dividends. Big oil companies are being treated sceptically. These are all areas in which I am hunting for stocks with unusually high risk premiums for their five year dividend growth prospects.

Jeremy Lang, Joint Investment Director,
Liontrust Investment Services Limited
October 2005

1. PERFORMANCE:

Liontrust First Income Fund

Cumulative years *Source: Lipper, bid to bid basis. Figures to 30.09.05*	1 year	2 years	3 years	4 years	5 years	Since 1.8.96*
Capital Return Net income withdrawn	+15.7%	+25.0%	+50.1%	+41.5%	+45.2%	+134.9%
Total Return Net income reinvested at ex-dividend date	+20.3%	+35.2%	+70.3%	+66.4%	+76.7%	+228.7%
FTSE All-Share Index (total return)	+24.9%	+44.5%	+68.6%	+33.6%	+5.8%	+94.8%
Average UK equity income unit trust (total return)	+23.9%	+41.2%	+62.4%	+41.8%	+24.5%	+117.9%
Performance vs. benchmark (total return)	-4.6%	-9.3%	+1.7%	+32.8%	+70.9%	+133.9%
Sector quartile ranking	4th	4th	1st	1st	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-divided date.*	1 year to 30.09.01	1 year to 30.09.02	1 year to 30.09.03	1 year to 30.09.04	1 year to 30.09.05
Liontrust First Income Fund	+6.2%	-2.3%	+25.9%	+12.4%	+20.3%
FTSE All-Share Index	-20.8%	-20.8%	+16.7%	+15.7%	+24.9%
UK equity income sector average	-12.2%	-12.7%	+15.0%	+13.9%	+23.9%
Performance vs. benchmark	+27.0%	+18.5%	+9.2%	-3.3%	-4.6%
Sector quartile ranking	1st	1st	1st	4th	4th

Past performance is not a guide to the future. The value of investments, and the income from them, can fall as well as rise, and is 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.

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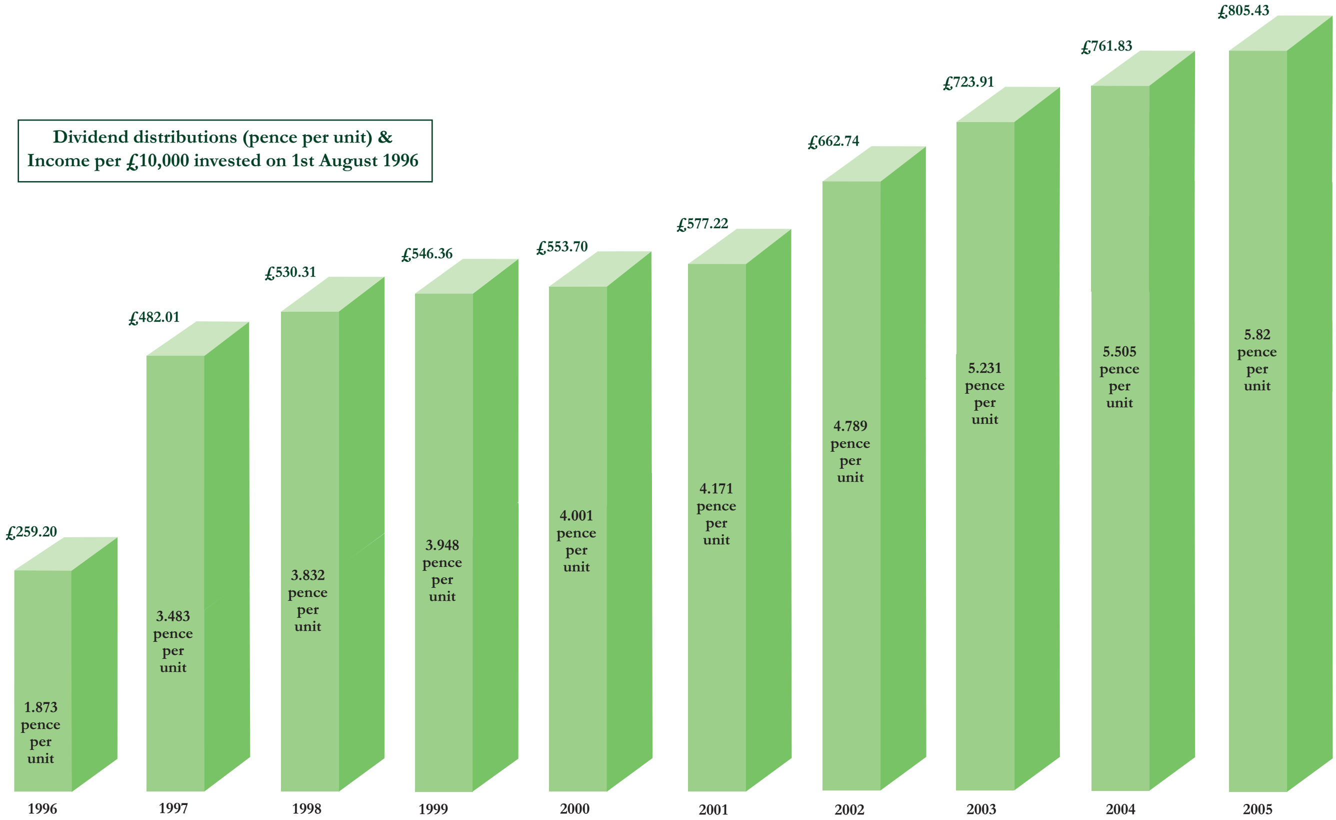
2. INCOME DISTRIBUTIONS:



Source: Liontrust Investment Funds Limited. Full offer price of the Fund on 1st August 1996, the day that Jeremy Lang assumed responsibility for the management of the Fund, was 72.26 pence. An investment of £10,000 invested on that date therefore purchased 13,838.92 units.

£10,000 invested on 1st August 1996 would have paid out a total income of £805.43 during 2005, an equivalent yield of over 8%. In addition, over this period the capital sum would have increased over the nine years under Jeremy Lang's management to £22,083. (Source: Liontrust Investment Funds Limited.)

The Fund pays out dividend distributions twice a year – an interim distribution at the end of February and a final distribution on 31st August.

The Fund's current dividend yield is 3.9%. The percentage yield will fall or rise with movements in the Fund's capital value. We aim to grow the total dividend payment in real terms (faster than inflation) each year, as well as yielding 20% more than the FTSE All-Share Index.

The annual management fee on the Fund is currently taken from capital. Whilst this may result in the capital return for investors being lower than would be the case were the fee charged to income, the potential dividend distributed to investors may be increased. The decision about whether the fee is deducted from income or capital lies solely with the Manager, and is made to ensure that dividends distributed to investors are consistent.

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3. SECTOR ALLOCATION versus FTSE ALL-SHARE INDEX:

Liontrust First Income Fund

Sector	FTSE All-Share Index (%)	Liontrust First Income Fund (%)	Relative Weighting (%)
Cyclical Services	12.7	23.7	+11.0
General Industrials	2.7	9.9	+7.2
Cyclical Consumer Goods	0.4	4.1	+3.7
Information Technology	1.0	3.4	+2.4
Financials	26.1	27.7	+1.6
Basic Industries	3.3	4.7	+1.4
Non-Cyclical Consumer Goods	16.6	16.6	–
Utilities	4.0	3.1	-0.9
Non-Cyclical Services	10.3	3.0	-7.3
Resources	22.9	2.2	-20.7
Cash	–	1.6	–

4. MARKET CAP. WEIGHTINGS:

	FTSE 100 Index (%)	FTSE Mid 250 Index (%)	FTSE Small Cap. Index (%)	Cash (%)
FTSE All-Share Index	83.8	13.0	3.2	–
Liontrust First Income Fund	49.1	32.9	16.4	1.6

5. TOP TWENTY HOLDINGS:

Liontrust First Income Fund

1	GlaxoSmithKline	(4.2%)	11	Scottish & Newcastle	(2.7%)
2	HSBC Holdings	(4.1%)	12	Bradford & Bingley	(2.7%)
3	BAe Systems	(3.7%)	13	Alliance & Leicester	(2.6%)
4	British American Tobacco	(3.3%)	14	Boots	(2.4%)
5	GKN	(3.2%)	15	Lloyds TSB Group	(2.3%)
6	Standard Chartered	(3.2%)	16	Electrocomponents	(2.3%)
7	Gallaher	(3.1%)	17	Lonmin	(2.2%)
8	Aberdeen Asset Management	(3.0%)	18	Friends Provident	(2.1%)
9	United Utilities	(3.0%)	19	Resolution	(1.9%)
10	Tesco	(2.9%)	20	Emap	(1.9%)

Total: 57.0% (remaining 43.0% held in a further 44 stocks and cash).