



COMMON SENSE

A periodic bulletin for portfolios managed by William Pattison in accordance with The Liontrust Large Cap. Process.



LIONTRUST

First Quarter 2002

Liontrust First Large Cap. Fund: £15.9m
Liontrust Winners Investment Trust PLC: £25.4m

Investment Philosophy - Liontrust Large Cap. Process

1. I want to hold stocks where prospects are improving: market expectations will be rising and news will be getting better (the 'winners'). I do not want to hold stocks where the opposite is true (the 'losers').
2. The principal quantitative characteristic that 'winners' have is positive revisions to earnings' forecasts. 'Losers' have negative revisions to earnings' forecasts and low share price momentum.
3. It is important to remember that there is an emotional bias amongst investors to sell their 'winners' too soon and hold their 'losers' for too long; this is very damaging to relative performance.
4. The aim is to achieve outperformance by running the 'winners' and selling 'losers' quickly. This will usually feel uncomfortable as the 'winners' will have gone up a lot and the 'losers' will have gone down a lot.

Liontrust First Large Cap. Fund

- > Strict risk limitations: a broadly diversified portfolio of 60-80 stocks. 'Winners' overweight by up to 3% each. 'Losers' underweight by up to 3% each.
- > Attractive ('value' driven) stocks purchased from the middle ground to achieve a sector-neutral weighting.

Liontrust Winners Investment Trust PLC

- > Aggressively managed portfolio of 15-30 'winners' only.
- > No sector or stock weighting controls.

Investment Commentary

2001 is a year most UK equity fund managers will want to forget. The FTSE All-Share Index fell 15% during the year, having fallen 8% the previous year. This is the first time the market has fallen in two consecutive years since 1974 (the Index fell 31% in 1973 followed by a further fall of 55% in 1974). These gloomy statistics hide a potentially more worrying trend: an equity market going nowhere. The chart below shows the FTSE All-Share Index since the beginning of 1998; the market has made negligible progress in the past four years.

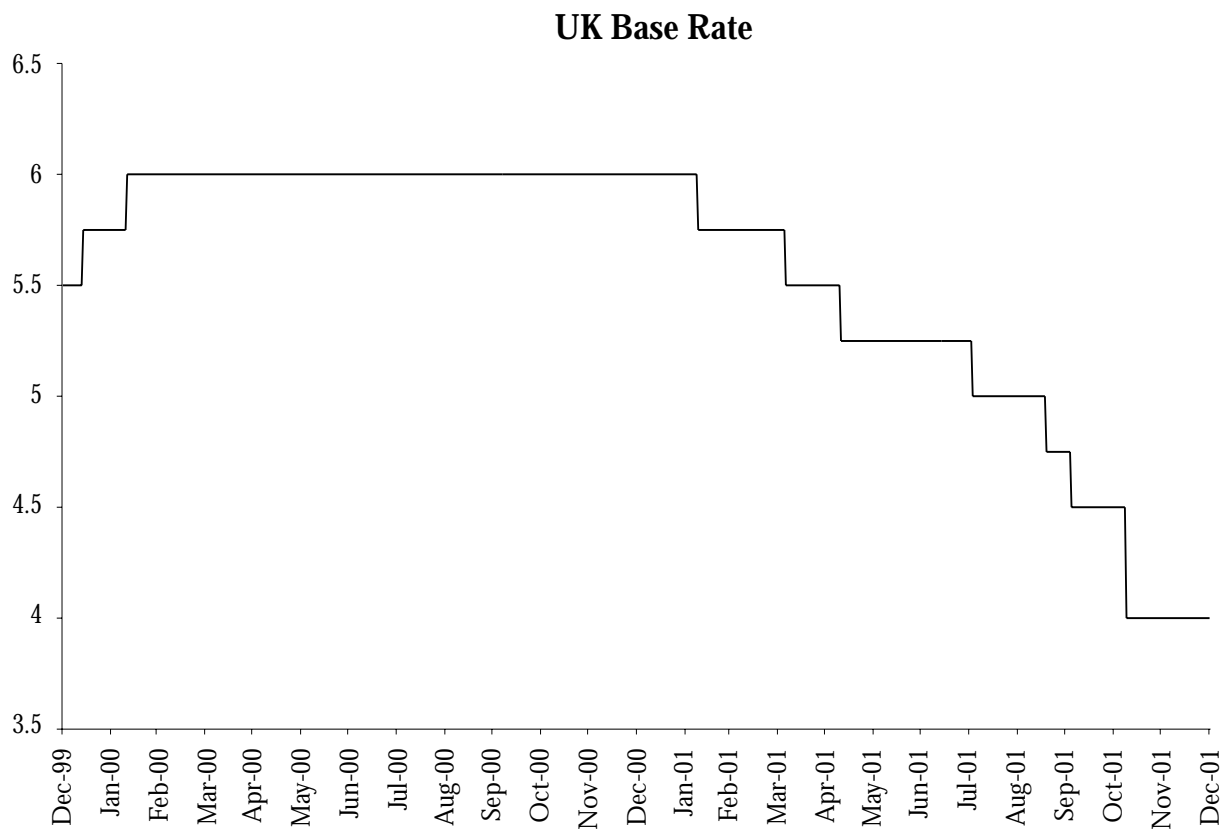
FTSE All-share Index



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Regulated by the FSA.

In the last edition of *Common Sense* (written a few days after the terrorist attack on the World Trade Centre in New York) I commented that I thought the FTSE 100 Index at 3,500 (down 50% from its peak and yielding just over 4%) would offer reasonable value. Since that time the FTSE 100 has bounced roughly 13% from 4,600 to 5,200 making my suggestion of 3,500 for the FTSE 100 look ridiculous. In my defence, I was offering only a personal view about value (and I did note that if you were investing for the long term you should remain fully invested, whatever your view of the market) and not giving a three month forecast for the equity market.

The problem for investors looking into 2002 is that some of the conventional rules of the game seem to have broken down. For a start the nature of the current economic downturn is unusual. Unlike most other business cycles this current downturn has been led by falling business investment rather than weaker domestic consumption and housebuilding. This 'investment recession' has not been caused by higher interest rates but by the unwinding of the capital spending boom in the telecommunications and information technology sectors which, in particular, fuelled US economic growth in the late 1990s. It is the behaviour of interest rates during 2001 (in both the US and UK) that has been one of the most remarkable economic features of the year (and, ironically, caused investors the most confusion). The chart below shows the change in UK base rates during the last 24 months.



The unusual stability of interest rates during 2000 contrasts with the extent and the speed of the decline during 2001. Interest rates are now at their lowest levels (both here and in the US) since the 1950s. For the equity market not to respond positively to interest rate falls of this magnitude is unusual. At a simple level the market generally likes three things: higher corporate profits, lower bond yields and lower interest rates. I commented on this back in April 2001 and noted that with little prospect of higher corporate profits or lower bond yields only lower interest rates could provide the fuel to drive the market back up. Interest rates have fallen significantly but the equity market hasn't benefited.



I make this point not because I want to draw some complicated conclusion about the historic relationship between equities and interest rates but to make the same general observation I made three months ago. The price of equities at any given time is, ultimately, a function of risk and reward and at the moment investors, in aggregate, do not appear to feel they are being sufficiently rewarded for the risks they are taking. While this feeling persists I don't think falling interest rates are sufficient to lead a sustained rally in the market. Eventually this will change, but on a one year view I can't see a catalyst (in terms of the big three: corporate profits, bond yields or interest rates) to compensate for the valuation of the equity market which still seems stretched. I would also be surprised if the FTSE 100 Index fell to my targeted level of 3,500 so I expect the most likely outcome is another dull year with equities going nowhere (albeit in a volatile manner, typical of recent years).

As I have mentioned in previous reviews we are fortunate that our investment process does not require us to have a view on the direction of the equity market (whatever our personal instincts). As regular readers of *Common Sense* will know, the stocks in the portfolio will be determined by the companies we identify where prospects are improving.

At a general level 2001 was a difficult year for the investment process because the number of stocks surprising (in terms of their earnings' revisions) has been falling dramatically (due to the effect of the economic slowdown). By the end of 2001 the number of stocks delivering persistent surprises (ie. positive earnings' revisions for two successive quarters) had fallen to levels not seen since the last recession in 1990. This made life particularly difficult in the final calendar quarter of the year.

Our investment process breaks the market down into three main categories: winners (those companies where prospects are improving), losers (those companies where prospects are getting worse) and middle ground stocks (cheap stocks which are held to help control the risk in the portfolio). Looking back at 2001 puts into context the interaction between these three groupings and helps explain why the portfolio performed as it did. The two tables below show the relevant data.

Table 1: Relative performance (%) of groupings adjusted for active stock weightings (versus the FTSE All-Share Index)

Period	Winners	Middle Ground	Losers
1Q	0.1	8.1	-7.1
2Q	4.7	8.1	-13.3
3Q	6.3	9.2	-9.6
4Q	-3.4	-7.1	19.2
5Q	5.8	2.8	-5.0

Table 2: Percentage (%) of stocks in each grouping that outperformed the FTSE All-Share Index

Period	Winners	Middle Ground	Losers
1Q	57	59	51
2Q	63	64	27
3Q	73	75	21
4Q	22	44	73
5Q	79	64	47



Each period is calculated from the date of our portfolio review to ensure consistent analysis of the data. For 2001 our “quarters” started on 5th January, 16th March, 6th June, 13th September and 6th December. (The final period “5Q” runs until the end of the year, ie. 31st December, and is included for the sake of completeness despite being only three weeks long).

The first table is more important in that it tells the story of relative performance but the second table is useful in the sense that it provides information about our “hit rate”, ie. how many of our stocks are outperforming. Usually if a grouping has outperformed significantly it will be accompanied by a high “hit rate” percentage. This will not always, however, be the case: in the first period of the year, 57% of our winners outperformed but the actual outperformance of the grouping was a negligible 0.1%. This was because of the poor performance of two individual stocks (Spirent and Matalan) with large active weights (discussed in detail at the time).

For the year as a whole there are a number of significant conclusions. First, in what was a difficult year for the investment process the cheap middle ground stocks have done well, ie. they have helped limit the downside risk. Second, despite the falling number of “positively surprising” stocks in the market our winners have done well (remember, this is typically where 60% of the portfolio is invested so the performance of the winners will drive the performance of the overall portfolio). Third, the losers have done badly over the year as a whole; this has helped relative performance since the portfolio will not hold losers (unless the sector controls force a holding for purposes of risk control). Fourth, overall hit rates have been high for both the winners and the middle ground stocks (this is relatively unusual in that the winners and cheap middle ground stocks do not usually do well at the same time). Overall it is clear that, despite the difficult environment in terms of the falling number of positively surprising stocks, the portfolio has outperformed because we have successfully identified enough stocks where prospects have kept improving; the portfolio has also benefited from holding middle ground stocks (on average 18% of the portfolio during 2001) which have outperformed. The benefit of the losers doing badly has been diluted since a large proportion of these have been the telecom stocks which the portfolio has had to hold to ensure the portfolio construction control of sector neutrality has been met.

Looking at the tables also shows, indirectly, the effect the attack on the World Trade Centre in September had in terms of the shape of the year and when the outperformance was achieved. There are a few observations to be made here. The second and third periods (2Q and 3Q) were perfect “quarters” in that our winners and middle ground stocks outperformed a lot (with correspondingly high hit rates) while the losers did very badly (for our investment process these two periods were as close as we will ever get to equity heaven). During these six months the portfolio outperformed by over 5% (a lot considering the portfolio’s tracking error of only 3%). The next period (ie. the 4Q period of 13th September to 6th December) was a nightmare; in November alone the portfolio underperformed by 3% (again a huge move given a tracking error of 3%). It is clear from the two tables why this period was so horrible: our winners underperformed (along with a very low hit rate), our middle ground stocks did badly and the losers (mostly stocks in the technology, media and telecoms sectors) went through the roof.

What happened was the market changed its focus completely during September following the attack in New York. At the start of the month investors were interested in the (depressing) fundamentals of an economic slowdown and the knock-on effect of lower corporate profits. September 11th caused temporary panic (which lasted 10 days) and then on September 21st the markets’ focus shifted to economic recovery with accelerated interest rate cuts in the US driving a liquidity based rally. In these conditions investors were interested only in companies that would benefit from an economic recovery at



some stage in the future (whatever their valuation). A huge rally in the TMT sectors occurred and most of our winners went nowhere; the portfolio in effect got squeezed at both ends (ie. losers going up and winners underperforming) and significant relative pain was the result. By the beginning of December, however, this liquidity driven rally was running out of steam and the last three weeks of the year (ie. period 5Q) was better for the portfolio with our winners and middle ground stocks again outperforming and the losers underperforming.

What this kind of analysis clearly shows (as was also the case in 2000) is the extreme sector and style rotation that has been occurring in an equity market effectively going nowhere. A major problem for fund managers today is that sound investment analysis does not always lead to a good investment decision because of poor timing. The evidence of the last few years is that poor (or just plain unlucky) timing can result in significant underperformance in the short term. This volatility highlights, in my opinion, the dangers of using tracking error as the principal measure of risk within a portfolio. Since *The Large Cap Process* was launched in October 1999 nearly a quarter of all the individual months have had monthly performance more than 2% away from the index (both good and bad). On two occasions the monthly performance has deviated from the index by more than the tracking error of the whole portfolio (which has averaged about 3.5%).

One very non-technical way of looking at months such as these (eg. November 2001) is to think of the portfolio getting a whole year's worth of volatility in just four weeks. This is not good for the stress levels of your average fund manager. Tracking error does provide a static measure of risk (which is of some use) but it struggles to cope with the sort of volatility we've experienced in the UK equity market in recent years. Tracking error also has, obviously, no way of measuring a fund manager's ability to ride out the emotional ups and downs that any distinct investment process is likely to deliver in a volatile market. This is a very different skill from stock picking and portfolio construction but it is becoming equally important in the era of a roller coaster market going nowhere.

Our quarterly review for the portfolio (carried out at the beginning of December) has resulted in a number of modest changes but nothing significant. Stocks sold completely represent about 4% of the total portfolio with the proceeds being re-invested into eight new holdings. Of these purchases, *Amey*, *Jarvis*, *Geest* and *Marks & Spencer* all have the characteristics of winners while *IMI*, *Tomkins* and *Scottish & Newcastle* have all been bought as cheap middle ground stocks. A neutral weighting in *BskyB* has been purchased for portfolio construction purposes. Of the sales, most stocks were sold either because prospects were no longer obviously improving (eg. *Safeway*, *First Group* and *Canary Wharf*) or there were more attractive alternatives in their respective sectors (eg. *Cadbury Schweppes*, *Hilton* and *Land Securities*). The only stock sold which had the characteristics of a loser (ie. negative earnings' revisions and poor share price momentum) was *British Airways*. A number of stocks have been added to (eg. *Reckitt Benckiser*, *Amersham* and *Legal & General*) and a number of stocks have had their target weightings reduced slightly, (eg. *Aggreko*, *Centrica*, *Emap*, *Rank* and *Royal Bank of Scotland*).

William Pattison

Joint Investment Director, Liontrust Investment Services Limited

4th January 2002



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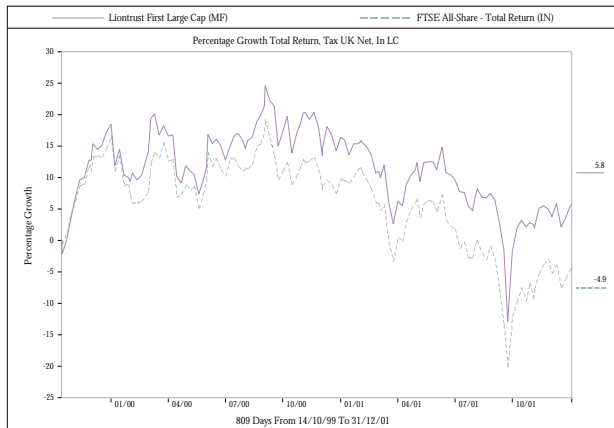
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PERFORMANCE

Liontrust First Large Cap. Fund

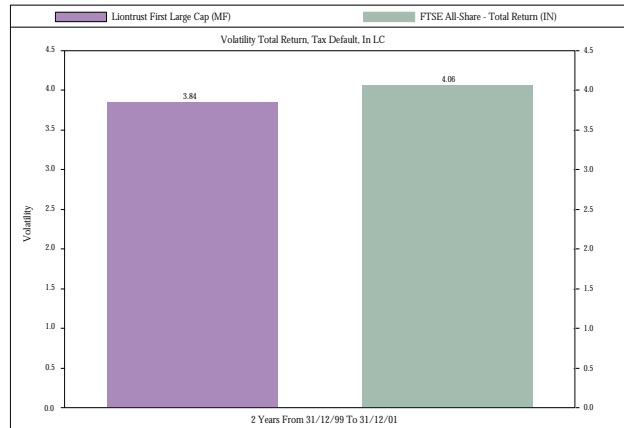
Comparative performance since launch



Produced using Hindsight ©Reuters Limited
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The value of investments can fall as well as rise. Past performance is no guarantee of future performance.

Volatility since 31/12/99



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Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date. Figures to 31.12.01

	3 months	1 year	Since launch (14.10.99)
Liontrust First Large Cap. Fund	+7.6%	-9.1%	+5.8%
FTSE All-Share Index	+8.2%	-13.3%	-4.9%
UK All Companies sector average	+10.7%	-13.6%	+1.0%
Performance vs. benchmark	-0.6%	+4.2%	+10.7%
Sector quartile ranking	4th	1st	1st

Liontrust Winners Investment Trust PLC

Source: Datastream International Limited ©
Figures to 31.12.01

Net Asset Value Performance	3 months	6 months	1 year
Liontrust Winners Investment Trust PLC	+10.5%	-2.2%	-10.5%
Share Price Performance	3 months	6 months	1 year
Liontrust Winners Investment Trust PLC	+4.1%	-11.8%	-24.1%



SECTOR ALLOCATION

Sector	FTSE All-Share Index	First Large Cap. Fund	Winners Investment Trust PLC
Resources	15.1%	13.3%	0%
Basic Industries	2.8%	3.5%	0%
General Industrials	2.4%	1.7%	0%
Cyclical Consumer Goods	0.2%	0%	0%
Non-Cyclical Consumer Goods	19.1%	20.3%	23.0%
Cyclical Services	14.2%	18.0%	27.8%
Non-Cyclical Services	13.4%	13.3%	12.2%
Utilities	3.7%	2.4%	3.3%
Information Technology	1.7%	0%	0%
Financials	27.4%	25.6%	32.2%
Cash	n/a	1.9%	1.5%

MARKET CAP. WEIGHTINGS

	FTSE 100 Index	FTSE Mid 250 Index	FTSE Small Cap Index	Cash
First Large Cap. Fund	68.6%	29.5%	0%	1.9%
Winners Investment Trust	64.4%	34.1%	0%	1.5%

TOP TWENTY HOLDINGS**Liontrust First Large Cap. Fund**

1 Vodafone Group	(9.5%)	11 Rentokil Initial	(2.5%)
2 BP	(8.6%)	12 Amersham	(2.3%)
3 GlaxoSmithKline	(6.7%)	13 Tesco	(2.2%)
4 Royal Bank of Scotland	(4.8%)	14 Smith & Nephew	(1.9%)
5 HSBC Holdings	(4.0%)	15 Northern Rock	(1.7%)
6 AstraZeneca	(3.8%)	16 Jardine Lloyd Thompson	(1.6%)
7 Shell Transport & Trading	(3.6%)	17 Legal & General	(1.6%)
8 Barclays	(3.5%)	18 Imperial Tobacco	(1.5%)
9 Lloyds TSB Group	(3.2%)	19 Bunzl	(1.5%)
10 Man Group	(2.8%)	20 JJB Sports	(1.2%)

Total: 68.5% (31.5% held in a further 45 stocks and cash)

Stocks that are highlighted are also held in the Liontrust Winners Investment Trust PLC.



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FINANCIAL CALENDAR

NB. The financial calendar of Liontrust First Large Cap. Fund has changed.

Liontrust First Large Cap. Fund (UK authorised unit trust)

Accounting dates	Interim	:	30 June	Final	:	31 December
Ex Dividend date	Final	:	1 January			
Payment date	Final	:	end February			

Liontrust Winners Investment Trust (London listed investment trust)

Accounting dates	Interim	:	30 November	Final	:	31 May
Ex Dividend date	Final	:	June			
Payment date	Final	:	September			

ANNOUNCEMENT

Liontrust First Large Cap. Fund is now available within the Liontrust PEP wrapper.

PEP Transfer forms are available on request from our Client Investment Services team on **020-7412 1766** or info@liontrust.co.uk.

BULLETIN BOARD: NEWS FROM LIONTRUST.....

- **Liontrust First Income Fund** was the best performing unit trust in the UK equity income sector in 2001, rising 14% beating the second placed Fund by 4.5%. This is compared to a fall in the FTSE All-Share Index of over 13%. Out of 88 Funds in the sector, only 14 showed a positive return. The average fund fell over 7%.*
- **Liontrust First Growth Fund** has outperformed the FTSE All-Share Index in six consecutive calendar years over an unusually diverse range of market conditions. This is something that very few funds can match.
- **The Liontrust Intellectual Capital Trust** is one of only three funds to have held its position in the first and second quartiles of the performance rankings in the UK Smaller Companies Unit Trust sector in each of the last four calendar years.
- On the strength of this performance, and despite the turbulent conditions in the market, our funds under management have grown from £1.6 billion in July to over £1.9 billion today (including funds in transition).

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

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