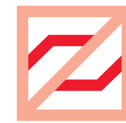
COMMON SENSE

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



LIONTRUST

Third Quarter 2001

Liontrust First Large Cap. Fund: £15.5m
Liontrust Winners Investment Trust PLC: £22.5m

Investment Philosophy

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. There are two characteristics that 'winners' have: positive revisions to earnings' forecasts and high share price momentum. '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.

Investment Commentary

Most investors are aware of the importance of dividends in contributing to the good long term real returns of equities. Most investors also know that these returns are quite poor without the magic of re-invested dividends but can't remember the exact numbers.

Returns from investing in UK equities come from two sources: capital growth and income. Without dividend income the return on equities looks unexciting. Since 1920 equities have produced an annualised return of 12.1% including dividends; without dividends this annualised return falls to only 6.9%. Income has been important. But holding equities just for income (and accepting no capital growth) also produces poor returns. With no capital gains equities have produced an annualised return of only 5.2% since 1920. Capital growth has also been important.

Below is a table showing the long term average returns for equities in each decade since 1920 along with some figures on growth and inflation.

	Equities Capital Return %	Equities Income Return %	Equities Total Return %	Inflation %	Nominal GDP %
1920-1930	3.5	6.5	10.1	-2.9	-1.7
1930-1940	1.1	5.1	6.2	0.3	2.3
1940-1950	2.2	4.5	6.7	2.8	7.7
1950-1960	11.9	5.3	17.2	4.2	6.7
1960-1970	3.5	4.7	8.2	3.6	7.0
1970-1980	4.5	6.9	11.5	13.1	15.5
1980-1990	18.0	4.8	22.8	7.0	10.0
1990-2000	10.4	3.9	14.3	3.5	5.7
Average	6.9	5.2	12.1	3.9	6.6

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From this table it is easy to see that while both income and growth are important to an investor over very long periods of time, their shorter term influence has varied considerably. There are two main observations to be made from looking at this table. First, until 1950 income was very important with returns from dividends making up the vast majority of total returns. Second, the importance of income has diminished with time and, in particular, the exceptional returns of the 1980s and 1990s have relied heavily on capital growth.

Because capital growth has been such a significant factor in driving total returns in recent years the importance of dividends has, to a large extent, been either forgotten or ignored. It is no coincidence, I think, that today many brokers don't even bother to quote dividend yields in their research on companies. Dividends are not interesting anymore. This is ironic given the outperformance of value as an investment style in the last year; income funds should have done very well during this time. To a degree the recent outperformance of income (i.e. value) funds is a result of the oversold nature of nearly all income stocks at the height of the TMT (Telecoms, Media and Technology) boom last year. However, analysis of the longer term trends in the table above shows that in periods of low inflation and low nominal economic growth (like now), overall equity returns tend to be lower than average and that income becomes relatively more important than capital growth.

This has certainly been the case in the last 15 months and is relevant to our Fund because of our focus on value in the "middle ground" (ie. all those stocks which are not identified as winners or losers). In identifying value in this middle ground area we have always looked at Price Earnings Ratios and dividend yields. The detailed rationale behind the latter part of this analysis is covered in our process document "The Value Dynamic". We aim to identify three types of stocks which offer value in terms of income (and are therefore suitable as cheap middle ground stocks). These are:

1. Poor companies which are currently viewed as being in serious trouble (these stocks will have dividend yields significantly higher than long-dated conventional gilt yields).

2. Average companies which are currently viewed as poor (these stocks will have dividend yields significantly higher than long-dated index linked gilts and will be growing their dividends at least as fast as inflation).

3. Good companies which are currently viewed as average (these stocks will have dividend yields at least as high as long-dated index linked gilts and will be growing their dividends significantly faster than inflation).

For a patient investor the returns to be had from investing in stocks with these characteristics are attractive (assuming an ability to forecast dividend growth successfully). From the perspective of the Large Cap. Process these "value" stocks are also attractive because they usually do well when our winners are struggling, as was the case in 2000. (This is an important factor when trying to get a sensible balance of risk and reward within the Fund). The number of stocks which meet these income requirements will vary over time but when there are a lot, history suggests these stocks will do well.

The number of these "income" stocks in the UK market is not as high as a year ago but still above the average of recent years. This suggests our middle ground stocks will play a vital role in terms of relative performance during 2001. The total amount of the portfolio that has been in winners and cheap middle ground stocks since the launch of the Fund in October 1999 is shown in the table to follow, with the relevant active money weights shown in brackets (the "balance" of the portfolio is held for reasons of portfolio construction).

Date	Winners %		Cheap Middle Ground %		Balance %
14.10.99	57.9	(33.8)	15.3	(5.3)	25.9
14.04.00	58.3	(33.6)	12.3	(7.1)	28.9
26.06.00	65.6	(31.4)	12.3	(6.8)	21.1
20.09.00	75.8	(35.4)	8.6	(5.1)	14.7
05.01.01	63.3	(33.1)	11.2	(8.1)	24.6
16.03.01	51.0	(28.3)	17.0	(11.5)	30.9
06.06.01	60.8	(32.7)	21.1	(10.2)	18.6

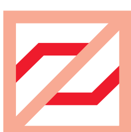
From the table it is clear that the winners are the most important part of the Fund with the active money having been fairly constant at around 33%. The amount invested in cheap middle ground stocks is significantly less but it can be seen how the weighting has drifted up with the active money doubling from about 5% to 10% since October 1999. This shift reflects the improving fortunes of higher-yielding value stocks, many of which were previously classified by us as losers (i.e. negative eps revisions and poor share price momentum). Overall, the balance between winners and cheap middle ground stocks will be determined mainly by the number of winners we are able to identify. However, if we are right in our view that income is likely to be an important driver of relative returns for the foreseeable future then a greater proportion of stocks purchased for the Fund (both winners and cheap middle ground) will have attractive income characteristics.

This has indeed been the case with the review we have just completed for the portfolio. We have purchased five winners: *Rentokil Initial, Lex Service, Garban, FKI* and *Nestor Healthcare*. All except *Nestor* have attractive income characteristics in addition to the winning characteristics we are trying to identify. We have purchased five new stocks in the middle ground: *Barratt Developments, Britannic, British Airways, EMAP* and *Stagecoach*. All these stocks have an attractive combination of dividend yield and dividend growth. A number of stocks have been sold of which the majority are either technical losers (e.g. *Arm Holdings, GWR, Pearson*) or stocks which are no longer winners (e.g. *WPP, Capita, Serco, Pace Micro Technology*). It is no coincidence that all the stocks sold have low dividend yields. As ever, buying the winners and selling the losers feels difficult because of the way these stocks have performed in the last 12 months. Comparing *Rentokil Initial* and *Arm Holdings* highlights this emotional dilemma.

RENTOKIL INITAL

ARM HOLDINGS

In addition to the stress involved when buying a winner it is difficult to then run a winner for a significant length of time (our Large Cap. process is designed specifically to help us overcome this problem). Part of the difficulty in running a winner is the fear of what might happen when the winner in question finally stops being a winner. In my experience stocks usually go (initially) from being good to average, rather than from good to bad. The fear of an eventual collapse, however, is usually enough to make investors sell their winners too soon.



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A good example of this emotional bias is the experience of *Matalan* and *Marks & Spencer* in the past 18 months. Many investors will think *Marks & Spencer* has outperformed *Matalan* during this period because of the well publicised problems at *Matalan* earlier this year. In the Common Sense I wrote at the beginning of 2000 I stated that switching *Marks & Spencer* into *Matalan* "was almost certainly the right thing to do" even though it would feel uncomfortable.

The chart below shows the relative performance of *Matalan* versus *Marks & Spencer* since that time.

MATALAN vs. MARKS & SPENCER

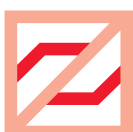
Most obvious is the roller coaster ride you have had by being a holder of *Matalan*. By December 2000 you had made a relative gain of over 150% compared to the unhappy holders of *Marks & Spencer*. By the end of January 2001 (and one profits warning later) this outperformance was rather less! However, despite this move you would have made considerably more money in *Matalan* than *Marks & Spencer* (from 01.01.00 to 16.03.01, the date we sold *Matalan*, the relative outperformance of *Matalan* over *Marks & Spencer* was 64%, the former having risen 39% and the latter having fallen 25%). This outperformance would have come at a cost, however, in terms of the stress involved in holding *Matalan*; much easier (if less profitable) to drift along with *Marks & Spencer*.

Regular readers of "Common Sense" will know that the Large Cap. Process is based on an investment philosophy which aims to take advantage of the irrational behaviour of analysts and fund managers. Occasionally a piece of research written by an analyst reminds me why these opportunities are so great. My recent favourite is from a piece of research on *BSkyB* written last month. The summary at the top of the front page reads as follows: "Having re-evaluated our long-term valuation for *BSkyB*, we have cut our price target from 959p to 700p. However, we base this on what we regard as over-optimistic long term assumptions".

It is not often an analyst admits he is being this irrational (so full marks for honesty I suppose). This kind of "jam tomorrow" analysis (i.e. being over optimistic) is very common when companies are not living up to the market's high expectations. The Fund does not hold *BSkyB*.

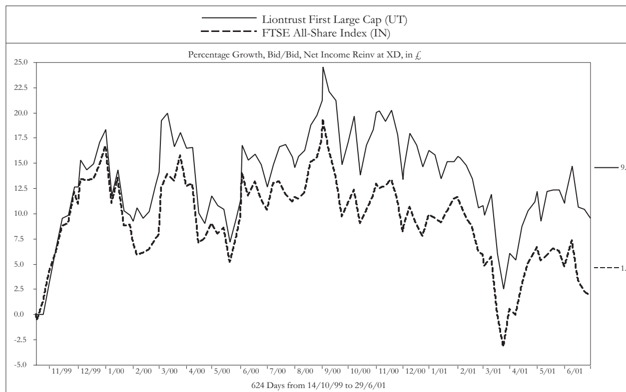
Corporate jargon is another area ripe with emotional self denial. At the time of writing this review *Regus*, the international serviced offices provider, has just issued a profits warning. Hidden within the paragraph on operational changes is a sentence which reads "these changes include a re-packaging and re-pricing of the *Regus* product range in order to improve further the value proposition for customers". Despite the positive spin this sentence could just read "we are suffering price cuts". The prospects for *Regus* do not look good, whatever the jargon.

William Pattisson, Joint Investment Director, Liontrust Investment Services Limited - July 2001



LIONTRUST FIRST LARGE CAP. FUND

Comparative performance since launch



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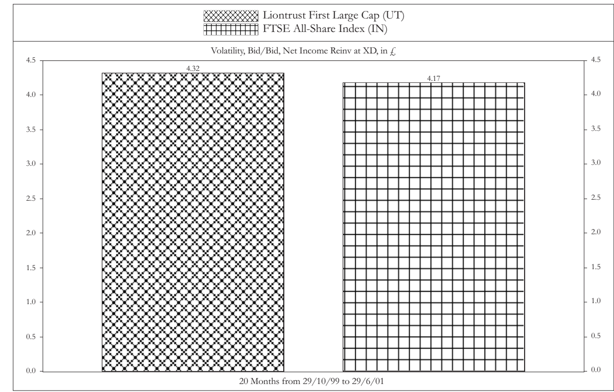
Volatility since the 29/10/99



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SECTOR PERFORMANCE (Liontrust First Large Cap. Fund)

Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date. Figures to 30.06.01	**3 months**	**6 months**	**Since launch (14.10.99)**
Liontrust First Large Cap. Fund	+3.3%	-5.8%	+9.6%
FTSE All-Share Index	+1.2%	-7.3%	+1.8%
UK All Companies sector average	+1.3%	-7.6%	+4.5%
Performance vs. benchmark	**+2.1%**	**+1.5%**	**+7.8%**
Sector quartile ranking	1st	2nd	1st

BROAD ECONOMIC SECTOR ALLOCATION versus FTSE ALL-SHARE INDEX

Sector	FTSE All-Share Index	First Large Cap. Fund
Resources	16%	15%
Basic Industries	3%	4%
General Industrials	3%	3%
Cyclical Consumer Goods	0.5%	0%
Non-Cyclical Consumer Goods	19%	20%
Cyclical Services	14%	18%
Non-Cyclical Services	12%	12%
Utilities	4%	3%
Information Technology	26.5%	0%
Financials	2%	24%
Cash	n/a	1%

MARKET CAP. WEIGHTINGS (rounded figures)

	FTSE 100 Index	FTSE Mid 250 Index	FTSE Small Cap Index	Cash
First Large Cap. Fund	67.8%	31.2%	0%	1.0%

TOP TWENTY HOLDINGS (Liontrust First Large Cap. Fund)

1. BP Amoco (9.0%)
2. GlaxoSmithKline (7.9%)
3. Vodafone Group (6.5%)
4. Royal Bank of Scotland (4.7%)
5. Shell Transport & Trading (4.6%)
6. HSBC Holdings (4.3%)
7. AstraZeneca (4.1%)
8. Barclays (3.7%)
9. Lloyds TSB Group (3.0%)
10. Smith & Nephew (2.6%)
11. Tesco (2.1%)
12. Man Group (1.7%)
13. Aggreko (1.7%)
14. Bunzl (1.7%)
15. Debenhams (1.6%)
16. Centrica (1.6%)
17. Northern Rock (1.6%)
18. Rentokil Initial (1.5%)
19. Amec (1.3%)
20. Imperial Tobacco (1.3%)

Total: 66.5% (33.5% held in a further 51 stocks and cash)

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

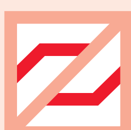
FINANCIAL CALENDAR

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

Accounting dates	Interim	: 31 Aug	Final	:	end Feb
Ex Dividend date	Final	: 1 March			
Payment date	Final	: 30 April			

Liontrust Winners Investment Trust PLC (London listed investment trust)

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



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