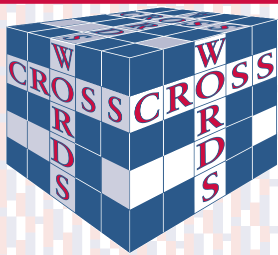
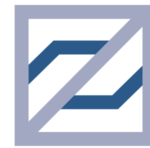


A periodic bulletin for portfolios managed by Anthony Cross in accordance with The Cross Report.



LIONTRUST

APRIL 2004

The Liontrust Intellectual Capital Trust (authorised unit trust): £110m
Liontrust First Smaller Companies Fund (offshore fund): £1m

INVESTMENT PHILOSOPHY - *THE CROSS REPORT*

- **Intellectual Capital is the intangible asset base of a company. It includes customer relationships, contracts and repeat business, distribution networks, intellectual property and organisational strengths like formats, procedures and culture. Intellectual Capital is difficult to replicate.**
- **Intellectual Capital, therefore, helps to maintain profitability in a world where deregulation, the removal of trade barriers, easy access to capital, quick distribution and shortening product life cycles have combined to increase competition.**
- **Intellectual Capital is created and exploited by motivated employees. The best method of motivating employees is through equity ownership.**

THE PORTFOLIO

- **Companies must demonstrate that their Intellectual Capital will sustain their competitive position.**
- **Directors must own at least 3% of the listed equity.**
- **A balance is maintained between sectors and each company is given a weighting based upon risk such as customer spread and financial gearing. This has helped deliver consistent performance.**

INVESTMENT COMMENTARY

Margin for Error

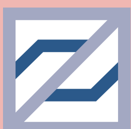
Competition is increasing. Whilst its advance has been obscured by economic cycles, the drivers for the increased competition have remained firmly in place. The removal of trade barriers and the advance of low cost regions such as the Far East have eroded the returns of many Western businesses. Abacus, a supplier of electronic components, recently summed up the problems facing a Euro-centric business: "The industry problems in our territories were characterised by reduced volume demand from customers, continued price pressure on commodity products, and the transfer of business by global customers to lower cost manufacturing regions." These problems are particularly prevalent amongst producers of low added-value goods. The manufacture of these goods has scrambled towards the lowest cost countries.

Western companies that retain some intellectual property or know-how have been able to undergo a more orderly transition. They have out-sourced parts of their business to countries that combine low cost alongside an educated workforce. Roxboro, for example, used to source components for its LEDs from countries such as Austria and Norway. Now manufacture has been moved from the US to Mexico and cheaper suppliers have been found.

Although the move to low cost countries has, up to now, helped companies remain competitive it has created a far more dangerous problem. New 'home-grown' competitors, through a mixture of reverse engineering, acquired know-how and fresh capital, have started producing similar products under their own brands. Their Western competitors are now losing business and have to spend more on marketing to support their own once dominant brands.

On top of this increased global competition, product life cycles are getting shorter. This is not only because of relentless advances in technology but also because the use of technology has made it easier to reverse engineer. Products do not remain dominant for long and research and development expenditure (like marketing expenditure), once held up to be a virtue and a catalyst for growth, has become a necessity and a rising cost.

Deregulation is breaking down old industry structures, promoting competition and price transparency. Telecoms are an obvious example. There are over 100 companies competing in the fixed line market. New entrants, coupled with an increasingly price conscious consumer, have driven down prices.



Liontrust Investment Funds Limited
2 Savoy Court, London WC2R 0EZ
Telephone: 020-7412 1766, Facsimile: 020-7412 1779

Authorised and regulated by the Financial Services Authority.

Part of the response of companies with pressure on their own prices has been to exert pressure on their suppliers. Procurement has become a hard-nosed and in many cases centralised activity. The internet is extending choice and increasing the efficiency of tendering. Old cosy supplier relationships and conventional pricing structures are being broken down. A good example of an industry in which procurement is changing is advertising. Traditionally, marketing departments of large organisations had a budget and, with the guidance of creative advertising agents, they would develop campaigns. The advertising agents used to receive a commission based on the budgeted cost of the campaign without much scrutiny of their own costs or indeed the effectiveness of the campaign. Increasingly, marketing departments want to achieve 'value for money' and are using techniques that they apply to their other suppliers. Search consultants are employed to help with the tendering process. They are introducing the concepts of open book contracts and standard book rates that are commonplace in areas such as out-sourcing and logistics. The aim is to introduce transparency into the pricing of advertising work and allow the marketing department to understand costs and allocate a reasonable level of profit. This transparency is putting pressure on prices. It can be argued that in a business where people are being paid for their creative talent, they cannot be priced like a logistics supplier. However, Morgan Stanley has estimated that the world's top seven agencies account for over 90% of global advertising billings. They suggest, "If 90% of the industry offers every marketing solution imaginable, boasts global reach, outstanding creative talent and unequalled media buying strength – commoditisation will occur."

There is a significant danger that the stock market has ignored the impact that increasing competition will have upon price and therefore future profit margins. In forecasting company profits, analysts pay too little regard to margin. The valuations of many companies assume that current depressed margins will recover to levels that were achieved in the late 1990s and in some cases nearer the peak margins of 1999/2000. Abacus, the component distributor, has seen a sharp recovery in its share price over the past year moving from 178p to 325p, a rise of 87%. Its peak margins were 9.1% on an operating profit of £18.3m. The earnings per share were 28.7p. The current multiple on peak earnings is 11.3x. The company's latest operating margin was 5.7%. A margin of 7.5% on peak sales would place the company on a multiple of 15x, similar to the overall stock market. Although the company has delivered a credible performance versus its competitors and grown its market share during the downturn, the valuation appears high and as a result I have considerably reduced the Fund's holding.

The recruitment industry provides another good example. Some recruiters add value to their clients by searching for, evaluating and enticing potential employees. They tend to focus on permanent jobs in the more highly paid executive bracket. For these recruiters, such as Longbridge, there is evidence that caps on commission rates that were imposed during the downturn are being removed and that guaranteed salaries, upon which commission is paid, are increasing.

Other recruiters focus much more on permanent employees below the executive bracket or on temporary employees whose skills tend to be assessed on the basis of a recognised skill set such as information technology, accounting or administration. The pool of such employees, where the emphasis is on qualification, rather than unique personal talent, is large. Changes have occurred for recruiters operating in this area. Employers have entered into supplier agreements with recruitment companies. Many of these rolling or fixed term agreements have been struck at lower prices than traditional rates and it is unlikely that recruiters will be able to negotiate prices back up. Nestor, for example, in healthcare personnel, has suffered from new regional NHS framework agreements that "have impacted negatively on margins."

At the time of writing (mid March), the valuations of recruitment companies, particularly temporary recruiters that entered into supplier agreements during the downturn, appear to discount a lot of recovery. If one optimistically assumes that the previous level of peak sales can be achieved but at 80 per cent of the peak margin then the current price earnings multiple for Michael Page and Robert Walters,

both involved in permanent and temporary recruitment, is between 12-14x. Spring Group (134p), predominantly temporary, has signed a number of long-term contracts, medium-term sales of £500m; a 4.0% margin would equate to a price earnings multiple of 12x. Spring returned to profit in the second half of last year with a margin of 1.7%.

The Fund does not hold temporary recruitment companies, where I believe there is too much optimism with regard to future margins. It does hold two permanent recruitment companies. A small holding was bought in Longbridge (84p) in the depths of the recruitment recession and the shares have performed strongly. The company has been refinanced and profits are seeing a strong recovery. PSD's peak margins were higher than temporary recruiters but this stems from a higher level of added value service for clients and the buoyancy of its technology markets in 1999/2000. PSD is unlikely in the medium term to get back to its peak sales but at two thirds of peak sales and fifty percent of peak margin the shares are better value than the temporary recruiters.

The Fund

The Fund's performance this quarter has been pedestrian. The performance versus the benchmark has been disappointing particularly when compared with competitor funds. The performance has not been undermined by any significant share price collapse. Indeed, the biggest faller over the quarter was Charles Stanley which, despite an absence of news, fell by 15%. Where there has been news from companies it has generally been encouraging.

Part of the reason for the poor performance is due to the way the Fund is structured. The Fund has had its fair share of risers. The average performance of companies in the Fund is a rise of about 7-8% but due to its risk averse structure the Fund rose just 5.6%. After appraising a company's Intellectual Capital and employee equity ownership, the investment process assesses risk. The larger holdings are characterised by a breadth of customer or product spread, a lack of financial stress, a tried and tested market place and a stable or improving trading environment. These 20 larger holdings represented about 45% of the Fund at the start of the year. They are all profitable companies (apart from NCipher whose market capitalisation is backed by cash). 12 out of the 20 largest holdings at the start of the year have underperformed this year. Of greater significance is that 8 out of the top 10 have underperformed. The recent outlook statements from all these 8 companies have been positive but their share price performance has ranged between -8% and +4.5%. This share price response partly reflects the fact that companies such as Clarkson (ship broking), Datamonitor (market research) and Next Fifteen (PR) performed very strongly at the end of last year. It also a symptom of a shift in investors' interest towards higher yielding, traditional value stocks and away from the growth stocks that performed so well in 2003.

Another reason for the underperformance has been an absence of resources stocks, which have performed strongly this year. I struggle to find Intellectual Capital in resources stocks. Arguably it exists in exploration businesses, which are reliant upon people skills in geological assessment and negotiation of extraction rights, but these businesses are high risk and suffer a high failure rate. The Fund has achieved a degree of exposure to rising mineral prices through owning Clarkson, the ship broker. It has benefited from the increase in shipping rates. These rates have been partly buoyed by the higher price of resources. Also, Sondex, which supplies equipment into the oil drilling market, has performed strongly since flotation in 2003.

There has been a sharp increase in the number of new issues and fund raisings. The Fund's small holdings in Campus Media (student radio and advertising), Cyberes (travel agency), Interregnum (IT venture capital) and Longbridge (recruitment) all raised new capital for strengthening their balance sheets and acquisitions. The valuations of new issues are high and they typically are high risk businesses.

The Fund has taken small holdings in Angle (Intellectual property and venture capital) and Screen FX (billboard advertising) but chosen not to invest in a number of others spanning telecoms, magazines and funerals.

As stated earlier, the valuations of a number of companies discount some fairly aggressive assumptions with regard to sales growth, price and margin. The Fund has reduced its holdings in Abacus (component distribution), Chrysalis (radio) and Mouchel (out-sourcing) and invested more in Concurrent (electronic components), NCipher (IT security) and Waterman (building consultancy) where future expectations are more reasonably priced.

In conclusion, the Fund's larger holdings, which generally performed well last year, have been more subdued this year. This, coupled with an absence of resources stocks, has impacted performance relative to the peer group. The trading news from companies owned has largely been positive but this arguably was reflected in the sharp rise in share prices last year. Signals with regard to economic recovery are mixed and as a result there has been a defensive shift into value stocks. Firmer evidence of recovery is needed for growth stocks to regain momentum. Hopefully recovery will become more apparent over the next quarter and performance will pick up.

Anthony Cross
Director, Liontrust Investment Services Limited

April 2004

PERFORMANCE

The Liontrust Intellectual Capital Trust

Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date. Figures to 31.03.04.	1 year	2 years	3 years	5 years	Since launch (8.1.98)
The Liontrust Intellectual Capital Trust	**+68.3%**	**+26.6%**	**+13.6%**	**+70.3%**	**+107.4%**
FTSE Small Cap. Total Return Index (excluding Investment Trusts)	+66.4%	+10.8%	+0.6%	+28.5%	+34.8%
UK Smaller Companies average unit trust	+64.4%	+10.9%	0.0%	+40.9%	+53.4%
Performance vs. benchmark	**+1.9%**	**+15.8%**	**+13.0%**	**+41.8%**	**+72.6%**
Position in sector	18th/69	12th/66	17th/63	13th/60	5th/54
Sector quartile ranking	**1st**	**1st**	**2nd**	**1st**	**1st**

SECTOR ALLOCATION versus FTSE SMALL CAP. INDEX

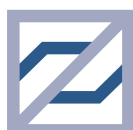
Sector	FTSE Small Cap. Index (%)	Intellectual Capital Trust (%)
Resources	3.0	1.1
Basic Industries	5.9	1.5
General Industrials	5.9	10.0
Cyclical Consumer Goods	2.1	–
Non-Cyclical Consumer Goods	7.9	7.0
Cyclical Services	27.4	39.5
Non-Cyclical Services	1.7	1.2
Utilities	0.1	–
Information Technology	8.8	20.4
Financials	37.2	11.5
Cash	–	7.8

TOP TWENTY HOLDINGS

The Liontrust Intellectual Capital Trust

1	BPP Holdings	(3.3%)	11	Lawrence	(2.1%)
2	Huntleigh Technology	(3.1%)	12	CML Microsystems	(2.1%)
3	Domnick Hunter	(2.7%)	13	Findel	(2.1%)
4	Datamonitor	(2.7%)	14	Wintrust	(2.0%)
5	Next Fifteen Communications	(2.6%)	15	Quarto Group	(2.0%)
6	NCipher	(2.5%)	16	Mears Group	(1.8%)
7	Roxboro Group	(2.4%)	17	SDL	(1.8%)
8	Numis Corporation	(2.2%)	18	Renishaw	(1.8%)
9	Clarkson	(2.2%)	19	Fuller Smith & Turner	(1.7%)
10	NSB Retail Systems	(2.1%)	20	Wilmington	(1.7%)

Total 44.9% (55.1% held in a further 54 stocks and cash)



Broker Support: 020-7412 1766
Dealers: 020-7964 4774
Facsimile: 020-7412 1779
e-mail: info@liontrust.co.uk
Website: www.liontrust.co.uk

4. RISK ANALYSIS

Source: Lipper, 74 months to 31.3.04, bid to bid basis, net income reinvested at ex-dividend date.	FTSE Small Cap. Index	The Liontrust Intellectual Capital Trust
Total return	32.87%	106.99%
Mean annual return	6.96%	14.28%
One month low	(20.18)%	(21.56)%
One month high	13.25%	17.81%
Maximum drawdown	(49.9)%	(44.8)%
Percentage of positive months	55.41%	58.11%
Alpha (annual basis)	0%	7.33%
Beta	1	0.97
Correlation Coefficient	1	0.93
R Squared	100	87
Relative Risk	1	1.04
Risk adjusted performance (annual)	0%	7.19%
Sharpe ratio (annual)	0.09	0.41

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 has continued to trade strongly throughout the financial year ending 31st March 2004. As at 25th March 2004, total **funds under management** stood at £4.95 billion with a further £181 million in transition. By contrast, on 27th March 2003, funds under management were £2.58 billion with £699.5 million of funds in transition.

- ✔ **Liontrust First Income Fund**, having risen over 33% in 2003, has continued to perform strongly in 2004, rising 4.5% in the first quarter against a rise in the FTSE All-Share Index of 0.6%, thus retaining its position as the best performing Fund in the UK Equity Income sector since Jeremy Lang took on its management in August 1996.

- ✔ After a year of underperformance in 2003 (its first since launch in October 1999), **Liontrust First Large Cap. Fund** has outperformed its benchmark, the FTSE All-Share Index, in the first quarter of 2004.

Performance data source: Lipper, bid to bid basis, net income reinvested at ex-dividend date.

Issued by Liontrust Investment Funds Limited, authorised and regulated by the Financial Services Authority. The value of units, and shares, and the income generated from them, can fall as well as rise and is not guaranteed and investors may not get back the amount originally subscribed. Past performance is not a guide to future performance. Some smaller companies may be less liquid than larger companies and the price swings in smaller company funds may therefore be greater than in larger company funds. Changes in the rate of exchange of currencies, particularly where overseas securities are held, may also affect the value of the investment. The issue of units in The Liontrust Intellectual Capital Trust 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 regarded as long-term.