

APRIL 2005

The Liontrust Intellectual Capital Trust
(authorised unit trust): £126m

Liontrust First Smaller Companies Fund
(offshore fund): £2m

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

Middle Class Crunch

I was struck by a headline in the London *Evening Standard* at the end of March. It read, “Time-bomb of our trillion pound debt”. It left me somewhat bemused as the article did not breakdown the composition of the debt, nor did it postulate as to when the “time-bomb” would detonate.

Upon investigation it appears that total UK personal debt reached £1,065 billion (£1,065,000,000,000) in January 2005. Personal debt comprised £881.9 billion of secured debt on homes and £183.6 billion of unsecured debt comprising personal loans, credit cards, store cards and overdrafts.

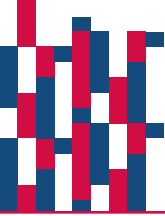
Average household debt in the UK is approximately £7,494, excluding mortgages and £43,488 including mortgages. The average owed by every man, woman and child in the UK is approximately £17,891 (including mortgages).

The appetite for increased personal debt has been strong. It rose by 12.6% during 2004. Research by Datamonitor reveals that unsecured consumer borrowing has risen by 45% since 2000. There are now 8 million more credit cards in the UK than people and the UK accounts for over 55% of the 155 million credit cards in circulation in Western Europe. Nearly half of the people who take out credit in shops had not planned to do so when they left home.

The short-term problem of personal debt looks confined to a small, albeit growing percentage of households. When the credit card companies faced a select committee of MPs in October 2004 it was estimated that over 500,000 people face crippling debts on their credit cards. The number of consumer debt problems dealt with by the Citizens Advice Bureau has risen by almost three quarters over the last seven years. The bureau dealt with almost 1.1 million debt-related issues last year. These issues included problems with housing, utilities and benefits-related debts. However, by far the biggest were consumer debt issues, which totalled 706,000 in 2003/4 compared with 405,800 in 1996/7. It is estimated that 3 million people are struggling with energy bills, 4.7 million are in debt to their water company and more than a million have had their phone cut off.

As previously stated, average household debt including mortgages is £43,488. The average house price in the UK in December 2004 was £178,906. This would imply that the free capital in the average house is approximately £135,000. This somewhat simplistic assumption obviously glosses over a myriad of differing financial situations but the financial cushion it implies does not give rise to any immediate concern. Current problems with personal debt would appear to be confined to those on low incomes, with limited capital, and who are already dependent upon the state for the provision of services. Although a serious and growing problem, it does not currently place a significant burden on the state. It will, however, be a new and growing problem over the next 30 years.





A large number of people, broadly defined as the middle classes, choose to opt out of state provision in areas such as education, pensions and healthcare. Although ultimately discretionary these are increasingly regarded as a necessity in order to escape poor state provision.

Private education for one child, starting at the age of five, will cost at least £200,000. This represents 1.5x the average free capital of £135,000 calculated above. It is a misnomer to suggest that those who embark upon private education can easily afford it. Typically a third of fees are paid for by parents for whom it is a serious financial burden. Another third is paid by parents who are more financially secure, but it still represents a significant drain on capital. The final third is paid for by grandparents.

Grandparents have been important providers of capital to the next generation, particularly as a result of having enjoyed a significant increase in the value of property over the last forty years. The future generation of grandparents, however, currently aged 30-40, may not have much free capital to pass on. Having geared up in order to buy houses, paid for the ever increasing cost of private education, topped up their pension and paid for healthcare, they are likely to die with large mortgages still intact. Indeed, the trend for increased 'pensioner debt' appears to be already underway. Research by the Consumer Credit Counselling Service and Age Concern shows that, excluding mortgages, those in their 50s owe an average of 1.69x their net annual income. The rate of growth of this debt has been 20% over the past 5 years.

The middle classes, by choosing to opt out of state provision, are, by default, saving the state a significant cost. They are in effect choosing to pay a discretionary tax. However, the combination of increasing personal debt, rising costs of private education, under funded pensions and higher healthcare costs, fuelled by longer life expectancy, will lead to a middle class crunch. The result will be that aspirations will have to be curtailed and many will have to turn back to the state for a greater proportion of services.

Pressure on the middle classes will then intensify. As a result of having to provide services to a greater number of people, the state will have to increase revenue. The easiest section of society from which to raise taxes are the middle classes. Alternatively, business could be taxed more but this would result in lower returns for investors, notably the pension funds. It would also curtail investment and damage UK competitiveness. Expenditure on non-essential services could be cut. Ironically, the middle classes have done rather well out of being employed in non-essential services. In the health service, for example, there are 19,000 quango staff with a 'central initiatives' budget of £9.4bn to cover information technology investment, staff agencies, consultancies and litigation. Meanwhile, the monitoring of dozens of health targets, according to *The Evening Standard*, requires the hiring of two officials for every nurse. There are 102 Whitehall agencies with a statutory power to inspect hospitals. In transport, £500m has been spent with consultancies in preparation for privatising the tube. Another £300m has been spent on researching the London Crossrail project. Overall last year, consultants received £1bn from the Government and £20bn was spent on computer projects.

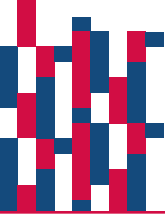
Perhaps we will all just muddle on, bailed out by a mixture of economic growth, later retirement, another surge in house prices and steadily rising wages, but such a scenario would appear to be overly optimistic. We have borrowed too much to fund today's demands (including housing, new cars, leisure and shopping).

I conclude with a recent article from *The Financial Times*. The article covered a report from Standard & Poor's, the credit ratings agency. It stated that "without further adjustment either to current fiscal stance or to social healthcare costs, the general government debt (expressed as a percentage of gross domestic product) of France, Germany and the US will surpass 200%. This will result in deficits more akin to those associated with speculative grade sovereigns."

The only comfort to be drawn from this is that the UK debt ratio is only estimated to reach 169% by 2050 compared with 42% today. Nevertheless, the article pointed out that such levels of debt will fuel downgrades in UK debt by 2035 from triple A investment grade to "speculative or junk category."

The implication is that UK government debt will become a more risky investment and higher yields will have to be offered in order to entice investors. This will drive up the cost of all debt. Increasing interest rates will be yet another problem faced by those with rising levels of personal debt.





The Fund

The Fund has had a satisfactory quarter. The prices of commodities and commodity-based shares have remained firm. Indeed at the beginning of the quarter the appetite for more speculative shares was still in full swing and, whilst it has somewhat abated, there has not as yet been a significant reversal.

The Fund, as investors know, is underweight in commodity-based stocks but has successfully used *Clarkson*, the ship broker, as a proxy for firm commodity prices. Its shares rose by 24% over the quarter.

A number of other large holdings, such as *Datamonitor* (market research), *NCipher* (Internet security) and *XN Checkout* (retail software) all rose by over 20%. They were joined by *Medical House* (healthcare), *Romag* (specialist toughened and solar glass), *Royalblue* (banking software) and *Walker Crips* (private client broking).

Poor performers, as usual, tended to be the riskier companies. These deliberately have low individual weightings. *ASOS* (on-line retailing of clothing) issued a profit warning. Whilst demand remains strong the company has experienced logistical problems running a number of warehouses. The company will move into a new larger warehouse during the summer. Due to the risks associated with high growth and in order to maintain a low weight within the Fund, profit has been continually taken on *ASOS*.

The only larger disappointment was *EPIC* (on-line training). It continues to suffer from volatility in orders from the public sector. Also too much training is completion based rather than pass rate based (the opposite of *BPP* in financial and legal training). This has meant that purchasers of training have been more focused on cost than quality.

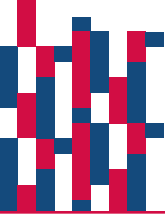
Share prices of small companies started the year strongly. By the end of March, however, share prices were under pressure. Recent weakness has been partly driven by shares being sold by private investors prior to the end of the tax year, but also because, quite simply, the rate of price increases could not be sustained. My expectation for the year is that, as long as economic conditions remain stable, share prices will rise in line with earnings growth and thus around 10% growth should be achievable.

Anthony Cross

Director, Liontrust Investment Services Limited

April 2005





1. PERFORMANCE

The Liontrust Intellectual Capital Trust

Cumulative years

Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date. Figures to 31.3.05.

	1 year	2 years	3 years	5 years	Since launch (8.1.98)
The Liontrust Intellectual Capital Trust	+18.9%	+100.6%	+50.9%	+19.3%	+147.3%
FTSE Small Cap. Total Return Index (excluding investment trusts)	+11.4%	+85.4%	+23.5%	-0.1%	+49.9%
UK Smaller Companies average unit trust	+20.1%	+97.4%	+33.2%	-3.0%	+84.5%
Performance vs. benchmark	+7.5%	+15.2%	+27.4%	+19.4%	+97.4%
Sector quartile ranking	3rd	2nd	1st	1st	1st

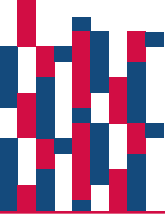
Discrete years

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

	1 year to 31.3.01	1 year to 31.3.02	1 year to 31.3.03	1 year to 31.3.04	1 year to 31.3.05
The Liontrust Intellectual Capital Trust	-12.0%	-10.2%	-24.8%	+68.7%	+18.9%
FTSE Small Cap. Total Return Index (excluding investment trusts)	-10.8%	-9.3%	-33.4%	+66.4%	+11.4%
UK Smaller Companies average unit trust	-19.2%	-9.9%	-32.5%	+64.4%	+20.1%
Performance vs. benchmark	-1.2%	-0.9%	+8.6%	+2.3%	+7.5%
Sector quartile ranking	2nd	3rd	1st	2nd	3rd

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. Some smaller companies may be less liquid than larger companies and the price swings may therefore be greater than in larger company funds. 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.





2. SECTOR ALLOCATION versus FTSE SMALL CAP. INDEX

The Liontrust Intellectual Capital Trust

Sector	FTSE Small Cap. Index %	Intellectual Capital Trust %
Resources	5.1	–
Basic Industries	7.4	1.1
General Industrials	7.4	8.8
Cyclical Consumer Goods	4.0	–
Non-Cyclical Consumer Goods	10.4	8.7
Cyclical Services	37.7	40.1
Non-Cyclical Services	2.0	–
Utilities	0.6	–
Information Technology	11.0	25.9
Financials	14.4	9.5
Cash	–	5.9

3. TOP TWENTY HOLDINGS

The Liontrust Intellectual Capital Trust

1. Datamonitor	3.5%	11. Royalblue	2.2%
2. NCipher	3.2%	12. Chrysalis	2.1%
3. Domnick Hunter	3.1%	13. Next Fifteen Communications	2.1%
4. XN Checkout	3.1%	14. Waterman	2.0%
5. Renishaw	3.0%	15. NSB Retail Systems	2.0%
6. Clarkson	2.9%	16. Fuller Smith & Turner	2.0%
7. BPP Holdings	2.7%	17. Maiden Group	2.0%
8. Numis Corporation	2.7%	18. Huntleigh Technology	2.0%
9. Wilmington	2.4%	19. Comino Group	2.0%
10. RWS Holdings	2.3%	20. Charles Stanley	2.0%

Total 49.4% (50.6% held in a further 50 stocks and cash)



4. RISK ANALYSIS

Source : Lipper, 86 months to 31.3.05, bid to bid basis, net income reinvested at ex-dividend date.

	FTSE Small Cap. Index	Intellectual Capital Trust
Total return	48.62%	145.75%
Mean annual return	7.56%	14.76%
One month low	(20.18)%	(21.56)%
One month high	13.25%	17.81%
Maximum drawdown	49.9%	44.8%
Percentage of positive months	55.81%	59.30%
Alpha (annual basis)	0%	7.30%
Beta	1	0.97
Correlation Coefficient	1	0.93
R Squared	100	87
Relative Risk	1	1.04
Risk adjusted performance (annual)	0%	7.12%
Sharpe ratio (annual)	0.13%	0.47%

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 have launched a new unit trust, **LIONTRUST DISTRIBUTION FUND**:

- Invested 65% in UK gilts, 35% in UK equities.
- Gilt portion tracks the Citigroup UK Government Bond Index. Indexation provided by State Street Global Advisors.
- Equity portion managed by Jeremy Lang in accordance with *The Value Dynamic* (UK Equity Income) investment process (as used in the management of Liontrust First Income Fund).
- Interest distributions paid quarterly at the end of March, June, September and December.
- Income and Accumulation units available.
- Minimum investment £2,500.
- Annual management fee of 1.25% deducted from capital.
- Available within the Liontrust ISA for no additional cost.

LIONTRUST DISTRIBUTION FUND – a lower risk investment, combining the ability of a gilt portfolio to provide a consistent level of income and relative security in volatile markets with the potential for capital growth and rising income of a UK equity portfolio.

To find out more, contact our Broker Services team on 020-7412 1766 or info@liontrust.co.uk.