

APRIL 2006

The Liontrust Intellectual Capital Trust
(authorised unit trust): £128m

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

Them & Us

Home is too far away for a daily commute. I therefore rent a minute flat in a large apartment block in Chelsea. I have been thinking about buying a flat in the same area but the sums do not add up. The price, I believe, I should be paying is over 30% less than the general asking price. My calculations have assumed that if I rented the flat out I would want a 5% gross yield. This target yield is probably not conservative enough given the cost of letting agent fees and service charges, so perhaps according to traditional investment parameters, general asking prices for flats in Chelsea are 40% too high.

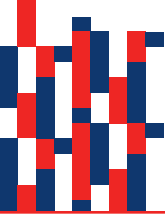
Chelsea, however, is not subject to traditional investment parameters. It is an area where people with money want to live. Some, the super rich, buy flats, in many ways like you and I would buy a luxury good. There is one important difference, however, when compared with most luxury goods. Flats in prime residential areas such as Chelsea, Knightsbridge and Mayfair are in short supply. Over the last few years this short supply has been joined by a surge in demand from the growing number of super rich.

The super rich are not the same as the rich. What the rich might agonise about and haggle over is just a percentage point or mere rounding of net worth for the super rich. Whilst there is no definition of what constitutes 'super rich', every year *The Sunday Times* lists who it believes are the wealthiest 1,000 people in the UK. The entry level for 2005 was £50m.

The rise in the number of super rich is quite startling. Citigroup estimates that the top 0.1% of US households saw their share of the country's income rise from under 2% in the early 1970s to over 7% in 2000. In the UK, meanwhile, the share of income of the top 0.5% of households had gone up from under 4% to more than 9% by the late 1990s.

A number of factors have contributed to a rise in the number of the super rich. First, as *The Sunday Telegraph* recently pointed out, from the 1950s up until the 1980s institutions dominated wealth creation. Large publicly traded companies, governments and pension funds owned an increasing proportion of the world's assets. From the 1980s, however, monolithic industries were deregulated, broken up and privatised. Entrepreneurs stepped into the breach, aided by more sophisticated debt and equity markets. Not surprisingly, entrepreneurs have proved to be more nimble than traditional institutions in exploiting change. The rewards available from risk taking have seen talent drain away from larger corporations into smaller employee equity owned businesses and venture capital. Wealth in such environments can be amassed without interference over pay and accusations of greed.





Secondly, the collapse of Soviet Communism, coupled with a commodities boom, has seen certain individuals amass extraordinary wealth. They have been joined by a growing number of Chinese and Asian multi millionaires.

Thirdly, the rise of the super rich has created an upward spiral in asset prices, particularly in property and art. This has inflated their personal balance sheets, some no doubt, have then used these balance sheets and the flood of easy credit to borrow and buy yet more assets. A lot of money has worked its way into hedge funds. Fifty per cent of Man Group's \$48bn of assets are owned by private individuals. The super rich have benefited from rising asset prices but also from financial advice and, in many cases, an advantageous tax status. Pay as You Earn (PAYE) does not seem to trouble the super rich!

Finally, specific events such as the technology boom of 2000 witnessed a transfer of wealth to entrepreneurs who cashed in and sold expensive shares to pension and insurance funds. There have also been some spectacular UK treasury blunders that have seen state wealth pass into private hands. First, the futile attempt to support the pound prior to its exit from the Exchange Rate Mechanism and, more recently, the selling of gold reserves at what, with hindsight, has turned out to be a low price.

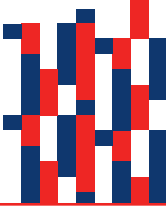
So what impact on our lives do the super rich have? The super rich are truly global. They use their yachts and planes to transport them to their houses and favoured hotels around the world. At the moment they love Britain. It has stable institutions, a relaxed tax regime and financial expertise. In particular, they are attracted to London. It is cosmopolitan and central, with regular direct flights to all parts of the globe (for those not using their own aircraft). Moscow, for example, only is three hours away. The attraction of London is demonstrated by figures from the Royal Institution of Chartered Surveyors. International buyers are taking an increasing share of the market for central London homes. The proportion of sales to overseas buyers rose from 25% in 2004 to 40% in 2005. According to Savills, a leading firm of estate agents, most are big buyers and are looking to spend between £500,000 and £15 million.

The super rich have been investing heavily in the UK. In particular, the value of unique assets such as prime residential property and agricultural estates has risen considerably. Their values are no longer dependent upon the rent they produce but rather their desirability. The result has been a rise in wealth for those lucky enough to own such assets prior to the interest of the super rich and disappointment and frustration for those who were hoping to acquire such assets at what they considered to be more reasonable prices. It is ironic that those professional Londoners who were accused of driving up rural property prices through the acquisition of weekend cottages are now suffering from the same treatment in their own back yard. Estate agents, such as Savills, have benefited from the rising value of prime property, just as the auctioneers have prospered from an active art market. Business areas such as jet chartering, private banking and other services that help run the lives of the super rich are thriving. The financial impact of the super rich has led some to argue that it has helped prop up the UK economy and offset the effects of rising oil prices and consumer fragility.

Finally, and very importantly for the UK economy, London's position as a financial centre has been reinforced. It is attracting listings of overseas companies, significant fund raisings and a growing position in currency and bond trading. When compared with America our lighter regulation is more attractive and helps underpin London as a centre of financial innovation.

There are two distinct dangers regarding the impact of the super rich. The first is to ignore traditional investment parameters when dealing in investments in which the super rich have no interest. Just because prime property prices are valued by one measure, it does not mean that other properties should be similarly valued. Of course, international buying of London property has the effect of diminishing supply, but rents would have to rise considerably to justify the prices being paid for many non-prime properties in London and elsewhere in the UK.





The second danger involves the ease with which money moves around the world and the unknown impact of leverage in the financial system. Britain may lose its attractions for the super rich. They may suffer from a growing resentment. It would be wrong to think everyone feels overjoyed to have the super rich on their doorstep. UK residents are feeling the pinch of rising taxes and fuel bills. Personal borrowings are, for some, at precarious levels. Even City professionals feel left out of the bonanza. A survey by eFinancialCareers found that 75% of City workers are looking for a new job after being disappointed with their bonuses. Despite the biggest bonus season on record, bumper payouts were limited to star performers. A mixture of increased regulation and taxes could drive the super rich away. A withdrawal of money from the UK would see asset prices fall. This fall would be exacerbated if leverage had to be unwound.

In the absence of such calamities, life trundles on for the rest of us. I have opted to carry on renting the little flat. I will continue to look after some of the financial needs of the super rich whilst others in the block, which is somewhat suitably named 'Nell Gwynn House', will no doubt look after their different needs!

The perils of overseas resource companies quoted on AIM

I have argued in previous additions of *Cross Words* that many resources companies quoted on the AIM (Alternative Investment Market) are over-valued. The fact they have become over-valued is not surprising. Against a background of rising commodity prices, coupled with a general bull market in equities, they has been investor appetite for resources based companies. In my experience AIM, with its light regulation and rapid pace of equity issuance, is the perfect mechanism for feeding investors' hunger for a particular type of risk. In order to sate their hunger investors frequently pay too much for the equity. In the short term, the feeding frenzy might drive prices higher and for the nimble profit can be made. In the longer term (usually after six to twelve months) investors' appetite wanes and, given the transient nature of stock markets, the focus moves towards another type of risk. The share prices of the previous favourites start to crumble.

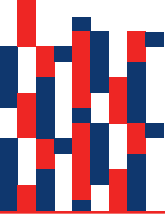
Last year AIM, with its significant overall exposure to resources companies, rose by only 4% compared with a 19% rise in the FTSE Small Cap. Index. Whilst investors' appetites for profitable resources companies across the broader stock market has remained strong, the speculative AIM companies under performed. Although AIM has perked up so far this year, in line with the surge in many small and medium sized companies, my scepticism regarding AIM resources companies has been recently reinforced.

First, without naming names, a certain hedge fund manager appears with alarming regularity to have significant holdings across many companies. It is likely that whilst there is strong demand for resources shares such a presence helps squeeze up prices. It will be an interesting spectacle too see how effective such a prop will be in supporting prices when demand starts to evaporate. My guess is that the downside might become somewhat unseemly given that the prop has used significant leverage (debt to buy shares) on the upside.

Secondly, the vultures have left the trees and are rising on the thermals of the bull market. In the last few weeks I have come across, and have exposure to, two companies that, through their industry experience, will seek to benefit from the ensuing turmoil. They will be involved with restructuring and refinancing distressed viable resources companies. Many, no doubt, will not be worth refinancing. In the words of one these company's seasoned chief executive, many AIM resources companies are an "accident waiting to happen" and over the next 12-18 months it will be a "bloodbath". No doubt such language supports their business plans but such views are, I believe, worth imparting.

I do not want to given the impression that I am anti AIM. It contains a good number of attractive companies that could quite easily be listed on the main market. AIM has been a great success for London as a global centre for raising capital. Indeed, it has been such a success that it now contains many overseas companies (on top the aforementioned resources





companies) that are attracted to London because of its financial skills and lighter regulation (particularly when compared to the United States). The internationalisation of AIM creates a dilemma for UK smaller company fund managers. Should a company that has a small market capitalisation, and is quoted on AIM, but is entirely based overseas, be the target of UK small companies funds?

I have consistently taken the view that the answer is no. Back to my earlier point, it is pretty easy for an overseas company with a half decent story to tell to raise capital when there is a demand for its type of equity but again, as I stated earlier, such demand is transient. How can a UK based fund manager, with no doubt limited language skills and a scant knowledge of a particular country's geography, law and business ethics, seriously appraise an overseas business? There have, for example, been a number of Chinese businesses that have floated on AIM. In my judgment, shares in such companies should be bought by fund managers running Asian funds who have the requisite investment experience and the likelihood of visiting the country. The same argument applies to other geographical regions.

I fear that when world markets, in response to economic woes, go through a difficult spell, the share prices of overseas companies on AIM will see significant falls. It is more important that shareholders understand a company when things are tough than when everything is rosy. It is easy to think you understand a company when its share price is rising. UK based fund managers owning small overseas companies will feel a lot less knowledgeable and confident when share prices are falling.

I do not buy smaller companies that are entirely based overseas. As a bare minimum they have got to be headquartered in the UK. This should ensure accessibility to main board directors and the reputation of the main board directors will be made or lost by them operating within UK financial markets and the UK legal system. *London Asia* is a good example.

The Fund

After a slow start in January, the Fund performed better in February and March. Smaller companies have had a very strong start to the year and have outperformed the FTSE All-Share Index. The price earnings ratio (PER) ratings of smaller companies as represented by the FTSE Small Cap., FTSE Fledgling and AIM now trade on a range of 17.8x to 21.7x December 2006 earnings. The All-Share, by comparison, trades on 13-14x.

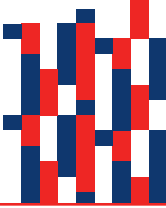
I have always argued that due to the sheer number of smaller companies it is difficult to generalise about them by ascribing an 'average' PER but the statistics above do demonstrate the re-rating that smaller companies have enjoyed over the last three years relative to larger companies.

I was somewhat bemused by my underperformance in January. Whilst *Maiden*, the financially distressed bill-board advertising company, received take over offers at a significant discount to its share price, its poor performance was made up for by *Ncipher* (Internet security) which received a bid approach. Indeed, *Maiden* was the only company in the portfolio to issue a statement that warranted a material share price fall.

I have been pleased with results and trading statements from companies within the Fund. Of note *Datamonitor* (market research) continues to beat profit expectations and companies such as *Biotrace* (testing for food hygiene), *OPD* (recruitment) and *Waterman* (engineering consultancy) produced good results and a deserved re-rating of their shares.

Others such as *ASOS* (on-line clothing retailing) and *Romag* (security glass and photovoltaic glass) continue to defy gravity, with share price rises of over 40%. In the case of *ASOS*, a fast-growing company which has experienced distribution problems, I have reduced the holding. Such share price rises, however, are symptomatic of the euphoria that has become attached to some companies. I will continue to take a rational view regarding prospects and valuation.





Out of a 62 stock portfolio, the Fund saw seven stocks up by over 30% and a further ten stocks up by over 20%. There were too many companies in the -10% to +20% range and this created a drag on relative performance. As a result, amongst this group there are a number of companies that I believe are materially undervalued relative to the smaller companies' valuations discussed earlier.

The following sixteen companies, to December 2006, trade at a PER of less than 14x (a 30% discount to the smaller companies average): *Belgravium* (IT for logistics), *Biotrace* (testing for food hygiene), *Clarkson* (ship broking), *Concurrent* (specialist computer boards), *Genetix* (cell biology instrumentation), *Huntleigh* (healthcare), *IDOX* (local government software), *OPD* (recruitment), *Maxima* (IT services), *Nextfifteen* (technology public relations), *Numis* (stock broking), *NSB* (retail software), *Polaron* (specialist measurement and lighting controls), *Quarto* (book publishing), *System C* (healthcare software and IT services) and *Wogan* (metals trading).

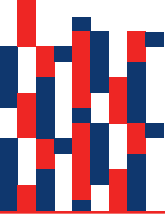
It is noticeable that thirteen out of these sixteen companies have market capitalisations of less than £50 million. Generally, smaller companies with larger market capitalisations have performed better this year. Those companies that trade on the stock exchanges SETS system are up, on average, by 3.5% more than the smallest companies that trade via market makers.

Around 25% of the Fund is in companies that trade on PERs of less than 14x. There are then a large number in the 14-18x PER range. The Fund, therefore, at the moment, has quite a 'value' feel to it and this makes me less concerned about the headline valuation of smaller companies and more optimistic that the relative performance of the Fund will pick up.

**Anthony Cross, Director,
Liontrust Investment Services Limited.**

April 2006.





1. PERFORMANCE

The Liontrust Intellectual Capital Trust

Cumulative years

Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date. Figures to 31.3.06.

	1 year	2 years	3 years	5 years	Since launch (8.1.98)
The Liontrust Intellectual Capital Trust	+19.5%	+42.1%	+139.7%	+61.8%	+195.4%
FTSE Small Cap. Total Return Index (excluding investment trusts)	+23.5%	+37.6%	+128.9%	+38.3%	+85.1%
Average UK smaller companies sector unit trust	+25.2%	+50.4%	+147.2%	+50.4%	+131.1%
Performance vs. benchmark	-4.0%	+4.5%	+10.8%	+23.5%	+110.3%
Sector quartile ranking	3rd	4th	3rd	2nd	1st

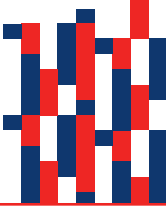
Discrete years

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

	1 year to 31.3.02	1 year to 31.3.03	1 year to 31.3.04	1 year to 31.3.05	1 year to 31.3.06
The Liontrust Intellectual Capital Trust	-10.2%	-24.8%	+68.7%	+18.9%	+19.5%
FTSE Small Cap. Total Return Index (excluding investment trusts)	-9.3%	-33.4%	+66.4%	+11.4%	+23.5%
Average UK smaller companies sector unit trust	-9.9%	-32.5%	+64.4%	+20.1%	+25.2%
Performance vs. benchmark	-0.9%	+8.6%	+2.3%	+7.5%	-4.0%
Sector quartile ranking	3rd	1st	2nd	3rd	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. 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. 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.





2. SECTOR ALLOCATION versus FTSE SMALL CAP. INDEX

The Liontrust Intellectual Capital Trust

Sector	FTSE Small Cap. Index (%)	Intellectual Capital Trust (%)	Relative Weights (%)
Technology	10.5	23.4	+12.9
Utilities	0.2	–	-0.2
Health Care	8.4	8.0	-0.4
Consumer Services	18.1	17.3	-0.8
Oil & Gas	1.1	0.2	-0.9
Financials	17.9	16.7	-1.2
Telecoms	1.8	0.3	-1.5
Basic Materials	2.3	–	-2.3
Industrials	32.6	28.3	-4.3
Consumer Goods	7.1	–	-7.1
Cash	–	5.8	–

3. TOP TWENTY HOLDINGS

The Liontrust Intellectual Capital Trust

	(%)		(%)
1. Royalblue	3.3	11. Walker Crips Weddle Beck	2.5
2. BPP Holdings	3.2	12. Biotrace International	2.3
3. Clarkson	3.0	13. Chrysalis	2.3
4. Renishaw	2.9	14. Wilmington	2.2
5. Waterman Group	2.9	15. Interregnum	2.2
6. NCipher	2.9	16. Brewin Dolphin	2.1
7. RWS Holdings	2.9	17. OPD Group	2.0
8. Next Fifteen Communications	2.7	18. NSB Retail Systems	2.0
9. Datamonitor	2.6	19. Charles Stanley	1.9
10. Huntleigh Technology	2.5	20. Sirius Financial	1.9

Total: 50.3% (49.7% held in a further 42 stocks and cash)



4. RISK ANALYSIS

<i>Five years to 31.3.06, bid to bid basis, net income reinvested at ex-dividend date.</i>	FTSE Small Cap. Index	Intellectual Capital Trust
Total return	38.3%	62.4%
Mean annual return	8.5%	11.6%
One month low	-20.2%	-21.6%
One month high	+13.3%	+11.0%
Maximum drawdown	-44.1%	-36.6%
Percentage of positive months	56.7%	60.0%
Alpha (annual basis)	0	3.44
Beta	1	0.91
Correlation Coefficient	1	0.96
R Squared	1	0.92
Relative Risk	1	0.95
Risk adjusted performance (annual)	0	3.27
Sharpe ratio (annual)	0.21	0.39

Source: Asset Risk Consultants © 2005.

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

Our New European Equity Fund Management Team

At the beginning of February we announced the appointment of two experienced European equity fund managers, **Gary West** and **James Inglis-Jones**. The team joined Liontrust on 1st March and immediately started the development of their European Equity Investment Process which, once documented, will be used to launch a number of collective investment vehicles including long/short investment funds and long-only unit trusts and offshore funds. We will also offer the Process to the institutional market who will be able to invest via long-only segregated and pooled pension funds.

Gary and James previously held senior positions at JP Morgan Fleming in the European investment division of which Gary was co-head until his departure. More recently they were with Polar Capital where they established a European Market Neutral product.

Gary has been managing funds since 1988. In 1999, after four years at Fleming Investment Management, (where he worked alongside William Pattison), he was promoted to joint head of the European equity department.

James was a senior portfolio manager within JP Morgan Fleming European equity group with responsibility for a wide range of institutional and retail portfolios.

The appointment of Gary and James is an important milestone for us. The team is a natural fit for Liontrust for two key reasons. First, a move into European equities is the logical expansion for the Company and will compliment our hugely successful UK equities operation; second, Gary and James have worked with William before at Flemings and this will help their integration into Liontrust and the development and documentation of a European Equity Investment Process. The process that Gary and James will develop also meets our key criteria of being scaleable across retail and institutional marketplaces. We aim to have European equity products available for customers before the end of the year.