CROSS WORDS CROSS WORDS

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

LIONTRUST

January 2004

The Liontrust Intellectual Capital Trust (authorised unit trust): £101.1m
Liontrust First Smaller Companies Fund (offshore fund): £0.745m

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

2003 Annual Review

It was a good year. The FTSE Small Cap. Index rose by 40.9%. The Fund was up 51.3% and ended the year in the top quartile of smaller company unit trusts. After a difficult first quarter, the ending of the war in Iraq triggered a change in sentiment. The strongest performance came from the most economically sensitive stocks as well as companies whose valuations had become severely dislocated from the underlying value of their businesses. The rally has been a classic 'value rally' but this time around the value stocks have been the fallen angels that were once labelled 'growth stocks' in 2000.

The investment process continued to be rigorously applied. First, companies have to possess Intellectual Capital and at least 3% of their equity must be owned by their directors. Intellectual Capital assets encompass customer relationships, repeat business, databases, distribution networks, intellectual property and organisational assets such as procedures, formats and culture. These intangible, often people-based assets, are frequently difficult to replicate and not easily exportable. They therefore help protect pricing power in a world where competition is remorseless. The insistence on directors owning a significant portion of equity helps to ensure that they have a strong motivation for the business to succeed. Furthermore, the 'owner manager' culture that equity ownership creates instills a greater conservatism towards acquisitions and financial gearing. Research by Liontrust has found, for example, that interest cover in geared businesses is higher when directors own over 3% of the equity.

The second part of the process focuses on risk. Some companies are more vulnerable than others. Each company is scored according to its customer and product spread, how well its market is established, future capital expenditure needs, financial risk, margin pressure and trading environment. Companies are allotted one of four weightings. The least vulnerable are given a portfolio weight of either 3% or 2%

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whereas the more vulnerable are given a weight of either 0.5% or 1%. Typically the extremes of performance are found amongst the 0.5% and 1% holdings. The five worst performers of 2003 were originally holdings of 1% or less.

The third part of the process involves monitoring the trading environment of companies and sectors. A considerable amount of time is spent reading through and diarising company statements and assessing how the trading outlook is changing. This continuous review plays a part in judging the individual stock risk described above as well as determining the desired level of overall sector exposure. By being attentive to company newsflow it is possible to reposition individual stocks and sectors before stock market sentiment changes. Broadly, a company's trading environment is deteriorating, stable or improving. A movement along the line from deteriorating to improving is positive and often results in a higher share price. The reverse is true with a movement along the line from improving to deteriorating.

The groundwork for the outperformance achieved during 2003 began back in the summer of 2002. At this time the valuations of a significant number of smaller companies, particularly in the once buoyant sectors of technology, media, financial and recruitment were at depressed levels. Companies that were profitable were rated, in many cases, at price earnings ratios that were lower than the overall stock market and unprofitable businesses were often valued at little more than the level of net cash on their balance sheets. The trading environment for companies in these sectors had been extremely difficult since mid 2000.

During the summer of 2002, company statements, particularly in the information technology and media sectors, continued to refer to challenging trading conditions but there were indications that it had stopped deteriorating. Turnover had stabilised and the benefits of cost cutting were coming through. This stability was an extremely positive development. From this time the Fund started buying additional shares in CML (microchips), Focus Solutions (financial software), Ncipher (internet security), Triad (IT Services), Datamonitor (market research) and Nextfifteen (public relations), SDL (website translation) and Workplace Solutions (staffing software). New holdings were taken in Incepta (public relations) and NSB (retail software). At the beginning of 2003 there were signs that trading had stabilised in stock broking and private client fund management. Additional shares were bought in Evolution and Numis. New holdings were taken in BWD Securities and Charles Stanley. The performance of the aforementioned companies during 2003 ranged between 60% and 430%.

The sharp increase in many share prices meant that many companies moved significantly beyond their target weight. Profit has been taken, most notably, in the financial companies but also in Datamonitor, NSB and Lawrence (animal healthcare). Incepta and Radstone Technology (defence) were sold because directors' ownership fell below 3%.

There were few significant disappointments but a number of companies underperformed the Index. BPP (accounting, financial and legal training) suffered from pricing pressure in its course materials division and poor demand in financial training. Huntleigh Technology (specialist beds and diagnostic equipment) experienced weak demand from the NHS. Hardy Underwriting, in line with other Lloyd's insurers underperformed. The Fund had benefited from an overweight position in Lloyd's during 2002 but sold

Chaucer and Beazley and scaled back Hardy at the beginning of 2003 when evidence emerged that the previous buoyant insurance rates had peaked and in some cases were declining.

The valuations of the most economically sensitive smaller companies now assume that a sustained economic recovery will occur. Evidence of an improvement is building in advertising spend, IT pipelines and recruitment but this is tempered by the occasional disappointment most notably in some of the large IT companies such as CMGLogica and Misys. Furthermore, there is a belief that margins will recover to levels that were enjoyed in the late 1990s. Given increasing competition this seems unlikely and over ambitious margin assumptions will be a pitfall that brokers forecasts will fall into over the next couple of years.

The Fund, over the last six to nine months, has undergone a gradual shift in emphasis. New and increased investments have been made in companies whose fortunes are less tied to economic growth. These include companies such as Mears (public sector out-sourcing), Quarto (book publishing), Clarkson (ship broking, benefiting from increasing world trade) and new issues such as Romag (specialist glass), RWS (patent translation) and Sondex (oil services). Despite its poor annual performance the Fund has added to Huntleigh over the last quarter. Pleasingly, the company performed strongly in December. Increased NHS spend appears to be coming through. An unrecognised attraction of Huntleigh is its growing stream of rental income. This repeat income will overtime attract a higher stock market valuation.

Going into 2004 the Fund remains underweight in consumer areas where the trading news has become more uncertain. There is good exposure to intellectual property-backed manufacturing companies such as Renishaw (measurement probes) that are experiencing improved trading. Whilst the weakness of the dollar creates a problem for exporters, those whose products are bought because of their intellectual property should not suffer from product substitution.

The Fund has a neutral weight in IT but remains overweight in media. The sector is attractive. First, there are global opportunities. Asia is seeing strong growth and is developing its own brands. Western companies are going to have to expand their marketing budgets to muscle into these markets. There is also the potential for significant growth in economies such as Brazil, China, India and Russia. According to Goldman Sachs these countries spend 0.5% of their Gross National Product on advertising and marketing compared with 2% in developed countries. Second, the Internet is creating new markets which need promoting. Third, global competition and over capacity is forcing manufacturers to spend more on marketing. Media is not immune from the pricing pressure that is afflicting other sectors so the emphasis in the Fund has been on companies where the client receives added value from the people skills or market research that is provided. This includes public relations (Nextfifteen and Creston), market research (Datamonitor), exhibitions (Mice) and direct marketing (Campus Media).

In conclusion, evidence is building that corporate recovery is underway. Valuations, however, imply that this recovery will be sustained. In the case of financial stocks further recovery may be harder to come by and the Fund will tread carefully in those sectors where margins may not return to previous levels. The Fund remains over weight in areas where newsflow is improving and underweight in consumer stocks where newsflow has deteriorated. The degree of exposure to stocks that are geared to economic recovery has been pared back. Smaller companies have significantly outperformed larger companies and since the autumn there has been a natural urge for investors to move into the larger underperforming companies. This may be beneficial over the short term but, looking at past statistics, the likelihood that smaller companies will outperform over the medium term remains compelling.

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January 2004

PERFORMANCE

The Liontrust Intellectual Capital Trust

(Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date. Figures to 31.12.03).	1 year	2 years	3 years	5 years	Since launch (8.1.98)
The Liontrust Intellectual Capital Trust	**+51.3%**	**+20.9%**	**-1.7%**	**+83.4%**	**+96.4%**
FTSE Small Cap. Total Return Index (excluding Investment Trusts)	+40.9%	+1.8%	-14.0%	+41.1%	+25.7%
UK Smaller Companies average unit trust	+38.9%	+1.2%	-18.3%	+49.7%	+40.7%
Performance vs. benchmark	**+10.4%**	**+19.1%**	**+12.3%**	**+42.3%**	**+70.7%**
Position in sector	6th/69	11th/65	15th/62	11th/58	5th/54
Sector quartile ranking	**1st**	**1st**	**1st**	**1st**	**1st**

SECTOR ALLOCATION versus FTSE SMALL CAP. INDEX

Sector	FTSE Small Cap. Index (%)	Intellectual Capital Trust (%)
Resources	3.2	1.4
Basic Industries	6.4	2.0
General Industrials	7.9	10.7
Cyclical Consumer Goods	3.7	–
Non-Cyclical Consumer Goods	10.5	7.2
Cyclical Services	37.2	42.0
Non-Cyclical Services	2.3	–
Utilities	0.8	–
Information Technology	11.1	18.0
Financials	16.9	12.0
Cash	–	6.7

TOP TWENTY HOLDINGS

The Liontrust Intellectual Capital Trust

1	Huntleigh Technology	(3.2%)	11	Charles Stanley	(2.1%)
2	BPP Holdings	(3.1%)	12	Numis Corporation	(2.1%)
3	Domnick Hunter	(3.0%)	13	Ambient	(1.9%)
4	Next Fifteen Communications	(2.9%)	14	CML Microsystems	(1.9%)
5	Datamonitor	(2.9%)	15	Ncipher	(1.8%)
6	Lawrence	(2.4%)	16	Fuller Smith & Turner	(1.8%)
7	Mice Group	(2.3%)	17	Quarto Group	(1.8%)
8	Clarkson	(2.3%)	18	SDL	(1.7%)
9	Roxboro Group	(2.2%)	19	NSB Retail Systems	(1.6%)
10	Findel	(2.2%)	20	Mears Group	(1.6%)

Total 44.8% (55.2% held in a further 51 stocks and cash)

4. RISK ANALYSIS

Source: Lipper, 68 months to 30.11.03, bid to bid basis, net income reinvested at ex-dividend date.	FTSE Small Cap. Index	The Liontrust Intellectual Capital Trust
Total return	22.79%	84.76%
Mean annual return	5.88%	13.20%
One month low	(20.18)%	(21.56)%
One month high	13.25%	17.81%
Maximum drawdown	(49.9)%	(44.8)%
Percentage of positive months	54.29%	57.14%
Alpha (annual basis)	0%	7.34%
Beta	1	0.97
Correlation Coefficient	1	0.93
R Squared	100	87
Relative Risk	1	1.04
Risk adjusted performance (annual)	0%	7.32%
Sharpe ratio (annual)	0.03	0.36

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......

✔ **The Liontrust Intellectual Capital Trust** rose over 51% in 2003, more than 10% ahead of its benchmark, the FTSE Small Cap. Index, and 30% over the FTSE All-Share Index.

✔ **Liontrust First Income Fund** rose over 33% in 2003, 13% ahead of the FTSE All-Share Index, thus retaining its position as the best performing Fund in the UK Equity Income sector since Jeremy Lang took on its management in April 1996.

✔ **Liontrust First Large Cap. Fund** and **Liontrust First Growth Fund** both underperformed the FTSE All-Share Index for the first time in 2003, bringing to an end the respective four and seven year records of consistent outperformance of their managers, William Pattisson and Jeremy Lang. Both managers have written a detailed analysis of the year and their views on the future prospects of their investment processes in their latest investment bulletins.

✔ Funds under management stood at £5.043 billion on 19th January 2004, up from £2.569 billion at the Company's last year end on 31st March 2003, an increase of 96% compared to a rise of 29% by the FTSE All-Share Index over the same period. Net unit trust inflows were £390 million, bringing the number of unitholders to 15,000 and the number of PEP & ISA investors to 8,000.

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