

## JANUARY 2007

The Liontrust Intellectual Capital Trust  
(authorised unit trust): £111m

Liontrust First Smaller Companies Fund  
(offshore fund): £1.5m

### 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

### Annual review

I will start straight away with an apology. I am sorry that the performance of the Fund when compared to the FTSE Small Cap. Index and competitor funds was poor. Those of you who know me will understand that such performance is not something that I take lightly. In this review of 2006, I will examine the poor performance and explain why I remain very confident about the investment process.

### The challenges presented by 2006

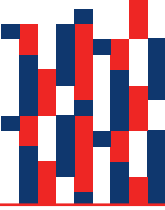
First, 2006 saw a significant disparity between the performance of the Alternative Investment Market (AIM) and the FTSE Fledgling, FTSE Small Cap. and FTSE Mid 250 Indices. This was particularly noticeable after the first quarter of 2006. For the year as a whole the AIM market rose by 1.5% compared with gains of 20% in the FTSE Fledgling, 23% in the FTSE Small Cap. and 30% in the FTSE Mid 250. The positioning of a Fund relative to the various indices was therefore an important determinant of its relative performance.

At the end of 2006 the Intellectual Capital Trust was positioned as follows: AIM 53%, FTSE Small Cap. 27%, FTSE Fledgling 13%, FTSE Mid 250 2.5% and cash of 4.5%. The Fund would have risen 10.5% if it had performed in-line with its relative exposure to the various indices. (The actual performance for the year was 10.6%.) Such analysis does show that, in hindsight, the odds were against the Fund having a good twelve months whereas other funds with an exposure to larger smaller companies (and particularly those with a significant portion in the FTSE Mid 250) were likely to perform well.

Second, the Fund has always been (for over nine years) a 'genuine' smaller companies unit trust. At the end of 2006, the average market capitalisation of each company in the Fund was £83m. The weighted average was higher at £109m. This weighted average, however, is roughly half the average £224m market capitalisation of companies in the FTSE Small Cap. Index. There was a definite feeling over the year that investors were shunning the smallest companies in preference for those with larger market capitalisations. This was reflected both through the performance of the indices as well as year end valuations. The AIM market (excluding loss makers) trades on a forward price earnings of 13.2x compared with approximately 16x from the FTSE Small Cap. and FTSE Mid 250 Indices. In previous editions of *Cross Words* in 2006 I commented on how a number of companies in the Fund remained frustratingly cheap despite perfectly reasonable profit performance. Larger companies were preferred because they were regarded as more attractive targets in a world where cheap debt was fuelling takeovers. Also, investors were prepared to pay more for companies that appeared to have a margin of safety. This desire brings me to my third point.

Third, the Fund had too many disappointments in 2006. They were nearly all smaller holdings with small market capitalisations but their combined performance created a drag. The reason that they were small holdings was that I





had identified the risks they posed. I score every company according to customer spread, product spread, financial gearing, market maturity, margin pressure and trading environment. The problem with many small companies is that they are more vulnerable to sudden changes in these risks. Notable in 2006 was how many of the disappointments were triggered by the loss of a major customer or the delay in material contracts. Examples included *CML Microsystems* (microchips), *IDOX* (local government software), *Medical House* (healthcare products), *LiDCO* (heart monitoring equipment), *Strategic Thought* (risk software) and *Workplace Systems* (software). These companies made up nearly half of the holdings that fell by over 30%. In essence, too many of my companies with a low margin of safety disappointed.

### The opportunities offered in 2007

I have applied this investment process to the management of the Fund for nine years. I have had two difficult years where I have not been in the top half of competitor funds. 2004 was the first such difficult year. Although in 2004 the Fund beat the FTSE Small Cap. Index, it suffered compared to some other funds from its lack of commodity exposure. A great deal of this commodity exposure was, ironically, gained from AIM.

I firmly believe that the investment process is effective. It does not fall into the camp of 'value' or 'momentum' but rather looks for assets in companies that create a barrier to competition and help to sustain profits growth. The assets that I regard as being critical are intangible, and are known as Intellectual Capital. These Intellectual Capital assets include customer relationships, brands, repeat business, distribution networks, intellectual property (patents, copyrights and employee know-how), databases, licences and franchises, procedures, formats and culture.

The investment process also requires the directors of each firm to own collectively at least 3% of the issued share capital. Employee equity ownership, particularly by directors, is a powerful motivator. It aligns the interests of management with shareholders and also instils a welcome degree of conservatism towards acquisitions and over gearing.

My best investments have been companies with a real depth and breadth of Intellectual Capital and, again in 2006, companies such as *Datamonitor* (market research), *Huntleigh Technology* (healthcare) and *Royalblue* (financial software) performed strongly. *Datamonitor* provides a classic example of how the investment process encapsulates a value discipline. The shares increased twenty fold from when the Fund started buying and the company's underlying strength of repeat business, market research databases and distribution was being ignored. On the other hand, companies such as *Huntleigh* and *Royalblue* have always been better appreciated. However, there have been certain buying opportunities when investors have become overly worried about their respective market conditions and again ignored their unique Intellectual Capital strengths.

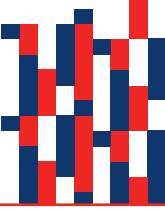
*YouGov* was the Fund's best performing company in 2006, recording a rise of 183%. Its strengths of brand, repeat business, databases and distribution were readily identifiable by the investment process at the time of its flotation.

*Bond International* provides software to recruitment companies. It has strong intellectual property and a large base of existing users that creates significant repeat business. Its shares performed well as the market slowly recognised its strengths. Likewise *Concurrent Technologies*, a manufacturer of specialist computer boards used in a variety of defence and telecom equipment, enjoyed a strong rise as the market reappraised its quality of earnings that are founded upon intellectual property and long product cycles.

The lesson of 2006 is about earnings risk, particularly through customer dependency. The sudden loss of a customer or a delay in orders can cause a significant drop in profits. This is particularly true with an operationally geared software business where the profit margin from the sale of a licence is material: *Strategic Thought* provides software that helps companies manage risk. Customers include Boeing, Rolls-Royce and NASA. Its product is highly regarded and is chosen ahead of much larger competitors. The delay in a new product launch led to a deferral of orders and triggered a significant profit fall and de-rating of the shares.

Share prices can overreact on bad news. Whilst the falls in 2006 have been dispiriting, the companies do not, in most cases, merit being disregarded. *Workplace Systems*, for example, has recently seen management changes and an increasing order





book. Its shares quickly doubled from their low point. Management equity ownership is high in all the companies in the Fund and there is therefore a strong incentive for directors to engineer a recovery.

*Focus Solutions* (financial software) provides a good example of how a reversal in earnings risk can lead to a sharp recovery in a share price. Its shares, which were in the doldrums in 2005, rose by 131% in 2006 when orders picked up.

During 2006 there were a number of sales. *D1 Oils* (bio fuels) was sold after directors' share ownership fell below 3%. Two poorly performing businesses from 2005, namely *Maiden* (billboards) and *Deal Group Media* (internet affiliate advertising) were disposed of. *Pursuit Dynamics* (specialist pumps) was sold due to concerns about the level of orders and acquisition strategy. *OPD* (recruitment) was sold after a period of good performance in order to reduce the overall level of the Fund's recruitment exposure. *Erinaceous* (property services) was sold as it had become overly acquisitive and *Numis* (broking) was sold in order to reduce exposure to brokers over reliant upon corporate transactions. There were fewer new holdings: two examples are a 1% holding in *Ten Alps* (television production) and a position in *ACP* (mezzanine finance).

I do not believe that the general shift in sentiment away from the smallest companies, particularly those on AIM, merits a change in the Fund's bias. Neglect creates opportunity and the Fund's best returns have been achieved in companies and sectors that have been overlooked. Although the larger smaller companies, particularly those in the FTSE Mid 250 Index, had a very strong year, I do not believe this means that smaller capitalised companies on lower price to earnings ratios of 10-15x (of which there are plenty in the Fund) should in the future be avoided. I have witnessed countless occasions over the last fourteen years of investing when areas of the market have been in and out of vogue. It is frequently time to invest in a neglected area when investors who have suffered a period of difficulty advocate that it should for ever more be avoided. I am reminded of 2002 when the market had all but given up with many smaller companies, only for them to achieve strong returns in the following year.

I would stress that the Fund's AIM exposure is not in high risk commodity companies or overseas-based businesses, but rather UK based companies. All bar three of the Fund's holdings are profitable and this focus on profitability has become tighter. Over the last nine years I have invested from time to time in early stage unprofitable businesses. Occasionally, they can be rewarding but, generally, they take longer than hoped to develop. From the beginning of 2006, I decided not to take on any new holdings that were not already in profit.

Although the overall performance of the Fund was poor in 2006, beneath the headline numbers I sensed a noticeable improvement in the second half. The Fund would have risen only 7.2% if it had performed in-line with its relative exposure to the various indices (as mentioned earlier) but the actual performance in the last six months was 14.6%. An absence of AIM commodity and other overseas-based business helped but, more importantly, a number of my smaller capitalised holdings at last started to perform. *Belgravium* (logistics software), *Bond International* and *Concurrent Technologies* (computer boards), *Farley* (property), *Murgitroyd* (patent attorneys), *Next Fifteen* (PR), *Maxima* (IT services) were all up by over 40%. Whilst the Fund underperformed the FTSE Small Cap. Index in the second half by 3% and the peer group by 1.5% it was a substantial improvement on the first half.

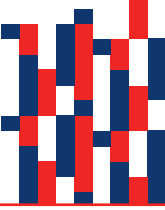
In conclusion, 2006 was tough but I am not dispirited. The Fund suffered from its bias towards the smallest companies and was hit by too many disappointments. These disappointments do not point to a problem with the investment process but rather earnings vulnerability hit a higher number of companies than would be normally expected. This is not meant as an excuse and I have become even more focussed on trying to avoid this. The Fund has well financed companies whose Intellectual Capital makes them difficult to replicate. This gives them a good chance of fending off competition and sustaining profitability. Their management are motivated to succeed regardless of the trading conditions. I look forward to my tenth year with a renewed confidence.

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

January 2007



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## 1. PERFORMANCE

### The Liontrust Intellectual Capital Trust

#### Cumulative years

Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date. Figures to 31.12.06.

	1 year	2 years	3 years	5 years	Since launch (8.1.98)
<b>The Liontrust Intellectual Capital Trust</b>	<b>10.6%</b>	<b>32.7%</b>	<b>55.5%</b>	<b>88.4%</b>	<b>206.1%</b>
FTSE Small Cap. Total Return Index (excluding investment trusts)	22.9%	46.2%	65.3%	68.2%	107.4%
Average UK smaller companies sector unit trust	23.7%	48.4%	81.1%	83.4%	155.3%
<b>Performance vs. benchmark</b>	<b>-12.3%</b>	<b>-13.5%</b>	<b>-9.8%</b>	<b>+20.2%</b>	<b>+98.7%</b>
Sector quartile ranking	4th	4th	4th	2nd	2nd

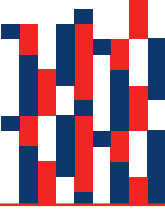
#### Discrete years

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

	2002	2003	2004	2005	2006
<b>The Liontrust Intellectual Capital Trust</b>	<b>-20.1%</b>	<b>51.6%</b>	<b>17.1%</b>	<b>20.1%</b>	<b>10.6%</b>
FTSE Small Cap. Total Return Index (excluding investment trusts)	-27.8%	40.9%	13.1%	19.0%	22.9%
Average UK smaller companies sector unit trust	-27.1%	39.0%	22.1%	19.9%	23.7%
<b>Performance vs. benchmark</b>	<b>+7.7%</b>	<b>+10.7%</b>	<b>+4.0%</b>	<b>+1.1%</b>	<b>-12.3%</b>
Sector quartile ranking	1st	1st	4th	2nd	4th

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; the price swings in smaller company funds may therefore be greater than in larger company funds.





## 2. SECTOR ALLOCATION

### The Liontrust Intellectual Capital Trust

Sector	FTSE Small Cap. Index (%)	Intellectual Capital Trust (%)	Relative Weights (%)
Technology	11.8	28.8	+17.0
Financials	19.5	19.0	-0.5
Oil & Gas	1.3	0.1	-1.2
Consumer Services	17.0	15.3	-1.7
Telecoms	1.8	–	-1.8
Basic Materials	2.3	0.5	-1.8
Health Care	8.6	6.0	-2.6
Industrials	30.9	27.5	-3.4
Consumer Goods	6.8	–	-6.8
Cash	–	2.8	–

## 3. MARKET CAP. WEIGHTINGS

### The Liontrust Intellectual Capital Trust

FTSE Mid 250 Index	2.5%	Alternative Investment Market	52.1%
FTSE Small Cap. Index	27.2%	Others	2.4%
FTSE Fledgling Index	13.0%	Cash	2.8%

## 4. TOP TWENTY HOLDINGS

### The Liontrust Intellectual Capital Trust

	(%)		(%)
1 BPP Holdings	3.9	11 Brewin Dolphin	2.7
2 Royalblue Group	3.8	12 Walker Crips Weddle Beck	2.6
3 Next Fifteen Communications	3.7	13 Charles Taylor Consulting	2.6
4 Waterman Group	3.4	14 Renishaw	2.5
5 NCipher	3.4	15 Chrysalis Group	2.5
6 RWS Holdings	3.2	16 Genetix Group	2.4
7 Maxima Holdings	3.0	17 Wilmington Group	2.3
8 Murgitroyd Group	2.9	18 Sirius Financial Solutions	2.3
9 Clarkson	2.8	19 Charles Stanley Group	2.3
10 Concurrent Technologies	2.7	20 NSB Retail Systems	2.3

Total: 57.4% (42.6% held in a further 40 stocks and cash)



## 5. RISK ANALYSIS

<i>Five years to 31.12.06, bid to bid basis, net income reinvested at ex-dividend date.</i>	FTSE Small Cap. Index	Intellectual Capital Trust
Mean annual return	11.74%	13.98%
One month low	-11.52%	-10.91%
One month high	12.36%	10.96%
Maximum drawdown	-34.65%	-26.55%
Percentage of positive months	60.00%	61.67%
Alpha (annual basis)	0	3.03
Beta	1	0.90
Correlation Coefficient	1	0.94
R Squared	1	0.88
Relative Risk	1	0.95
Risk adjusted performance (annual)	0%	2.59%
Sharpe ratio (annual)	0.46	0.63

*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 1 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

Each January Anthony Cross reviews the previous twelve months and looks ahead to the forthcoming year. This is a brief summary of his review as published in this bulletin:

### The challenges presented by 2006:

1. There was a huge disparity between the performance of the smaller and larger UK stock market indices.
2. With the disposition of its portfolio, the Fund actually performed in line with the underlying indices.
3. The Fund is a genuine smaller companies Fund and suffered from investors shunning smaller indices.
4. There were just too many disappointments, nearly all among our smaller holdings, many of which were triggered by customer losses or contract delays.
5. The lessons from 2006 were about earnings risk, especially through over-dependency on a small number of customers.

### The opportunities offered in 2007:

1. Anthony has been applying his investment process consistently for nine years. The process cannot be labelled 'value' or 'momentum' but looks for companies creating a barrier to competition to sustain profits growth.
2. Last year's best investments were in companies with a real depth and breadth of Intellectual Capital.
3. Although share prices can over-react on bad news, the companies that performed poorly in 2006 do not, for the most part, merit disposal. Indeed, neglect of these companies creates buying opportunities.
4. Our AIM exposure is confined to UK based companies who are, in almost all cases, already profitable.
5. There was an improvement in sentiment towards the smallest of companies in the second half of 2006. This is positive for the Fund.
6. Having examined the process and the portfolio in detail, Anthony is confident that they remain robust and he is enthusiastic for the outlook for 2007.