CROSS WORDS

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

LIONTRUST

First Quarter 2002

The Liontrust Intellectual Capital Trust: £56m
Liontrust Knowledge Economy Trust PLC: £15m

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.**

2001 Annual Review

The Liontrust Intellectual Capital Trust underperformed the FTSE Small Cap. Index by 3.5%, which, on top of an already grim year, is clearly disappointing. I was not alone in finding the 2001 a testing year. Despite underperforming its Benchmark the Fund was, nonetheless, ranked in the second quartile among its smaller company unit trust competitors. My aim, since I have been managing the Fund on 8th January 1998, has been to provide consistent performance. I believe I have delivered this: during the last four discrete calendar years the Fund has been in either first or second quartile. Only three other funds out of the 64 in existence over this period have achieved this.

Broadly there were three reasons for last year's underperformance. First, the investment process did not position the Fund in areas that had the strongest performance. The intangible Intellectual Capital assets the Fund looks for include contracts, customer knowledge, repeat business, distribution networks, intellectual property, format and procedural strengths, brand and culture. Companies with an abundance of these assets are difficult to imitate and they therefore have a greater chance of sustaining margin and profits growth over the long term. Intellectual Capital assets tend to be more prevalent in sectors such as electronics, distribution, information technology, support services, media, pharmaceuticals and speciality finance than in car and clothing retailing, house building, packaging, household goods and real estate. In 2001, the focus was on sectors that would benefit from higher government spending, lower interest rates and a buoyant consumer. Whilst the Fund enjoyed strong performance from *Ask Central* (restaurants), *Carpetright* (retailing), *Fullers* (brewing and pubs), *Huntleigh* (healthcare), *ICAP* (money broking), *Kier Group* (construction and house building), *Northgate* (van hire) and *Waterman* (engineering consultancy) it did not make up for being underweight in companies that were benefiting from strong consumer spend such as retailers and house builders.

Second, the Fund suffered from being overweight in Lloyd's Insurers. Until 11th September the insurers were performing well. The insurance cycle had turned and rates were improving. The scale of the potential losses arising from the terrorist attacks saw the share prices of insurers collapse.

Liontrust Investment Services Limited
2 Savoy Court, London WC2R 0EZ
Telephone: 020-7412 1700, Facsimile: 020-7412 1779
Regulated by the FSA

Third, changes to the FTSE Small Cap. Index at the end of September increased the technology component. The Fund was underweight in technology and, along with most smaller company funds, it suffered when technology shares rose significantly over the final quarter. During the fourth quarter of 2001 only 14 out of 80 funds beat the FTSE Small Cap. Index. However, over the year as a whole, these same funds were down on average by 24.5%, an underperformance versus the index of 9%.

I used the word 'reasons' for underperformance rather than 'excuses' for I could have chosen not to own high-risk insurers and increased the technology exposure more rapidly at the end of September. The Fund's second quartile ranking does, however, point towards some successful underlying trading during the year. Although the share price performance of a large number of financial, industrial, media and information technology companies ranged from poor to disastrous, there were occasions when either new holdings in such areas, or additions to existing holdings, were very profitable. Towards the end of 2000 and into 2001, the Fund reduced exposure to companies involved in component distribution, advertising, information technology and private client fund management. Companies sold completely included *Advanced Power Components* (telecoms equipment), *Trifast* (fastener distribution), *Mice Group* (exhibitions), *Incepta* (public relations), *Harvey Nash* (IT recruitment), *NSB* (software) and *Brewin Dolphin* and *BWD* (private client fund management). From mid 2001 onwards, holdings were profitably rebuilt in *Trifast*, *Mice* and *Brewin Dolphin*. Profitable additions to existing holdings made over the summer and after 11th September include *Abacus* (component distribution), *Roxboro* (electronic and industrial components), *Terence Chapman* (IT consultancy), *Scipher* (intellectual property consultancy and investment), *EPIC* (online training), *SHL* (recruitment), *Maiden* (billboards) and *OneMonday* (IT public relations).

OneMonday provides a good example of how the stock market can undervalue a people-based business. The company is one of the largest technology public relations (PR) businesses in the world. It has grown organically and maintained strong employee motivation through equity participation in the holding company and subsidiaries. Starting up a people business is far from easy. Typically, the cost of recruiting an individual equates to three months of their salary. At its trough, *OneMonday*'s market capitalisation was equivalent to three months of its total salary bill. Although technology PR is in the doldrums, anyone wishing to be in the industry over the longer-term would be better off buying *OneMonday*'s infrastructure, client list and turnover rather than attempting to build a team from scratch.

Outlook

The stock market feels like it has run out of ideas. Having been a fan of companies exposed to consumer spending, it is now jittery about them. Buoyant high street sales, rising house prices and mushrooming personal debt may have helped keep the economy afloat but their inflationary effects might have to be tamed through a rise in interest rates. On the other hand, the share prices of cyclical service and industrial companies already discount a recovery that is far from certain. Share price performance is likely to move away from sector themes and back to individual companies. This type of stock market environment suits the Fund.

Anthony Cross
Director, Liontrust Investment Services Limited

January 2002

1. PERFORMANCE

The Liontrust Intellectual Capital Trust

(Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date. Statistics to 31.12.01.)	1 year	2 years	3 years	Since launch (8.1.98)
The Liontrust Intellectual Capital Trust	**-18.7%**	**-13.9%**	**+51.8%**	**+62.5%**
FTSE Small Cap. (excluding Investment Trusts) Total Return Index	-15.5%	-18.4%	+45.2%	+37.2%
UK Smaller Companies sector average	-18.8%	-17.0%	+48.6%	+36.7%
Sector quartile ranking	**2nd**	**2nd**	**2nd**	**1st**

Liontrust Knowledge Economy Trust PLC

Net Asset Value Performance:	3 months	6 months	Since launch (2.4.01)
Liontrust Knowledge Economy Trust PLC	+14.6%	-4.8%	-9.4%

Share price performance:	3 months	6 months	Since launch (30.3.01)
Liontrust Knowledge Economy Trust PLC	+23.4%	-25.0%	-23.5%

Sources: TrustNet and Liontrust Investment Services Limited, 17th January 2002. (Since launch statistics: 2/4/01 was the date of the first NAV calculation after the cost of the issue had been accounted for; 30/3/01 was the first day of dealings on the London Stock Exchange).

2. SECTOR ALLOCATION

Sector	**FTSE Small Cap. (ex ITs) Index (%)**	**Liontrust Intellectual Capital Trust (%)**	**Liontrust Knowledge Economy Trust (%)**
Resources	2.5	2.3	2.4
Basic Industries	9.0	5.1	5.2
General Industrials	8.9	10.7	10.6
Cyclical Consumer Goods	1.3	0.5	0.4
Non-Cyclical Consumer Goods	12.3	6.7	6.3
Cyclical Services	34.3	39.4	38.3
Non-Cyclical Services	2.3	–	–
Utilities	0.7	–	–
Information Technology	11.3	11.3	10.1
Financials	17.4	18.0	17.9
Cash	–	6.0	8.8

3. TOP TEN HOLDINGS

The Liontrust Intellectual Capital Trust:

1.	Rathbone Brothers	3.84%
2.	Huntleigh Technology	3.51%
3.	Chrysalis Group	3.49%
4.	Kier Group	3.43%
5.	Waterman Group	3.40%
6.	ICAP	3.16%
7.	Carpetright	2.50%
8.	Penna Consulting	2.48%
9.	Roxboro Group	2.41%
10.	Business Post	2.28%

Total 30.5% (69.50% held in a further 57 stocks and cash)

Liontrust Knowledge Economy Trust PLC:

1.	Rathbone Brothers	3.82%
2.	Chrysalis Group	3.66%
3.	Kier Group	3.59%
4.	Waterman Group	3.54%
5.	Huntleigh Technology	3.38%
6.	ICAP	3.13%
7.	Roxboro Group	2.39%
8.	Penna Consulting	2.38%
9.	Carpetright	2.37%
10.	Abbot Group	2.36%

Total 30.62% (69.38% held in a further 57 stocks and cash)

4. RISK ANALYSIS

Source : Lipper, 44 months to 31.12.01, bid to bid basis, net income reinvested at ex-dividend date.	**FTSE Small Cap. Index**	**The Liontrust Intellectual Capital Trust**
Total return	22.26%	61.05%
Mean annual return	7.70%	16.07%
One month low	(20.18)%	(21.56)%
One month high	13.25%	17.81%
Maximum drawdown	(37.16)%	(37.53)%
Percentage of positive months	59.60%	61.70%
Alpha (annual basis)	0.00	7.53
Beta	1.00	1.03
Correlation Coefficient	1.00	0.93
R Squared	100.00	86
Relative Risk	1.00	1.11
Risk adjusted performance (annual)	0.00%	7.40%
Sharpe ratio (annual)	(0.17)	0.39

BULLETIN BOARD: NEWS FROM LIONTRUST......

The Liontrust Intellectual Capital Trust - aiming for, and achieving, consistent performance.

- If it is consistency of performance that you require, rather than the erratic, here today, gone tomorrow, returns from some smaller company funds, then the track record of The Liontrust Intellectual Capital Trust may be worth considering.
- Breaking down the last four years* into discrete periods, The Liontrust Intellectual Capital Trust has been in either the first or second quartile in each separate year:

Calendar year	1998	1999	2000	2001
The Liontrust Intellectual Capital Trust: quartile ranking	**1st**	**2nd**	**1st**	**2nd**

- What makes this performance noteworthy is that our Fund is one of only four funds, out of 64 in existence over this whole period, to have achieved this.
- Finally, consider this: last year's best performing UK smaller companies fund was in the fourth quartile for its 1999 performance. Meanwhile, of all the funds in existence over this whole period, the one with the worst performance in 2001 was the top unit trust in the whole sector during 1999!

* The figures for the year 1998 run from 8th January, the launch date of the Fund. *Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date.*

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.