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

LIONTRUST

Fourth Quarter 2002

The Liontrust Intellectual Capital Trust: £41m
Liontrust Knowledge Economy Trust PLC: £12m

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.

Reappraising shareholder value

The phrase ‘creating shareholder value’ is frequently used by companies. There are two parts to creating shareholder value, one relates to cash distributed by the company and the other to the value of the company’s shares. Normally when companies have cited that their aim is to increase shareholder value the emphasis has been on growth in the value of the company’s shares. Dividends have been regarded as little ‘thank you’ presents to be handed out to shareholders predominantly in the old economy sectors. Irregular cash handouts or share buybacks have been viewed as an admission of a lack of corporate vision and ambition.

The traditional yardstick for valuing a company’s shares is the price earnings ratio. The part of this ratio that managers can clearly influence is the earnings and usually the higher the earnings growth the higher the price earnings multiple and hence the value of the shares. There is a lot of pressure on managers to accelerate earnings per share growth beyond the natural level that GDP growth might generate. First there is the City pressure. Analysts’ forecasts are usually over optimistic but the inability to meet them is seen as a failure. Corporate financiers are always coming up with clever proposals for acquisitions and balance sheet reconstructions. Meanwhile, there is the misplaced belief (fostered by guess who) that institutional shareholders only want to invest in large companies and that the transformation from small to large is best accelerated through acquisitive growth. Bankers are also on hand to offer loans whose covenants in the good times look far from threatening. Secondly, there is the internal pressure. Many incentive schemes are linked to earnings growth and there is a natural desire to get rich quick. There is also the kudos attached to running a larger empire and the fear that pedestrian performance might lead to redundancy or takeover.

The trouble with the emphasis on earnings per share growth is that is has frequently increased business risk and hence the potential for decimation in shareholder value. Starting with acquisitions, a Business Week survey of takeovers from 1990-95 demonstrated that over 50% of acquisitions destroyed shareholder value and only 17% delivered measurable gains. Aside from mistiming economic cycles the main reasons why acquisitions fail is that the acquirer underestimates the

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difficulty of integration and control, the need to motivate employees and blend cultures, the fact that businesses which are 'for sale' frequently dress up their numbers and that an alarming number of acquired businesses turn out to have propped up their earnings through all the various accounting wheezes. Debt can be used to fund acquisitions but it can also be used to accelerate organic growth. The trouble is that most businesses are cyclical, operationally geared and increasingly devoid of physical assets. Gearing a people business, such as Harvey Nash or WS Atkins, is asking for trouble when the downturn comes or mixing conventional debt with high operational gearing and lease commitments in areas such as retailing and pub retailing can lead to a share price graph like Surrey Free Inns. Finally, the pressure on managers to deliver earnings per share growth is often at odds with business ethics. Financial engineering for the chief executive becomes more important than delivering better products and services. Acquisitions open up the possibility of provisions, stock write offs, changes in depreciation and currency gains. The introduction of exotic financing can lead to one off gains and the use of deferred earn-outs, as in the case of Incepta, delays the impact of earnings dilution.

The trouble for a shareholder who plans to own a share for five years is that a disproportionate amount of 'shareholder value' will be wrapped up in the value of the shares. The value of dividends might only equate to 10-20% of the initial stake. The remaining value will only be crystallised when sold. In the meantime the shareholder has to hope that management do not succumb to the pressures of earnings growth and resultant dangers that I have described. The shareholder also has to prey that the stock market does not reappraise downwards the multiple of earnings upon which it is going to value the company. Shareholder value is influenced by the whims of the stock market as well as management. It is not surprising that there are few really successful investments!

Maybe the experience over the last couple of years will lead to a different type of company. It is noteworthy that writers such as the late Peter Martin of *The Financial Times* have alighted upon the issue. There might be a greater focus on the dividends and cash that companies pay out to shareholders rather than share values. Perhaps the tax regime might change to encourage greater payouts and the hard stick for appraising managers would be linked to their ability to consistently put cash in shareholders hands. Companies would focus on gentle organic growth and cash generation. This is particularly true for companies operating in established markets where there is no real need for scale. In fact this would apply to many companies as scale and global reach has been over-hyped. Many companies, particularly in advertising and financial services, that accelerated their growth through acquisition are still an amalgamation of subsidiaries and brands that do not provide clients with a seamless and consistent global service. Furthermore, many large service businesses were in such a rush to buy businesses that they forgot that the main asset that they were buying was people. Some people became instantly rich and disappeared and those that remained were neglected, poorly motivated and longed for the vibrant atmosphere of a smaller organisation. It may be better to own an organically growing company that pays out cash regularly than one which gears up to make an acquisition, accelerates its earnings, enjoys a temporary re-rating and then implodes!

The Fund

Phew, what a quarter! The Fund outperformed the FTSE Small Cap. Index and was second quartile amongst its peer group. This was due to the relative robustness of its larger holdings rather than an avoidance of the rout. This again shows the importance of portfolio construction.

Areas that really suffered were media, technology and recruitment. In a number of cases newsflow has been reasonable but there has been an air of disbelief surrounding companies who are not suffering to the same extent as their competition. Mice Group (marketing services) has been resolutely upbeat yet its shares have fallen 40%. This cynicism is not surprising given the alarming trend of management to be upbeat and reaffirm expectations one minute and issue a profits warning the next. Either they are not receiving adequate management information, are crooked or, what is more likely the case, have been hanging on in the desperate belief that the third quarter would herald the start of recovery. Penna Group (recruitment and outplacement) is a case in point. Despite newsflow that indicated that profits were intact its shares had dropped 25%. It then issued a profits warning and its shares fell a further 50%.

Two areas that were popular at the start of the year have come under pressure. Retailers are suffering from the warm autumn and fears about the negative impact of operational and financial gearing if the economic downturn hits the consumer. The Fund owns no clothing retailers. Construction companies have seen their ratings dramatically cut because there is evidence of reduced private sector spend on top of worries about accounting and uncertainties about PFI. Luckily the Fund had already reduced its exposure to Kier (construction) and Waterman Partnership (engineering consultancy). The remaining portion of these holdings fell by 25% and 40% respectively. The only real glimmer of light has come from Lloyds' Insurance which was so painful this time last year. Rates are hardening and companies such as Chaucer and Hardy have raised additional capital to benefit from the firmer market.

The outlook is still extremely fragile. The summer is traditionally a quiet trading period but I fear that is has been dreadfully quiet this year. Cash in the Fund is high and it is being selectively used to buy holdings that have been undeservedly punished. Finding new holdings that are not as vulnerable to the economy as existing holdings is difficult. Richmond Foods has acquired the right to produce ice creams in the UK based upon the Nestle confectionary brands. The increase in profitability that can be achieved from higher margin brands is considerable. eBookers is an on line travel agency. It is an area of web commerce that is seeing strong growth. Sales over the quarter have included Ingenta (on line scientific publications) following its first profit warning. Helphire (car accident services) performed strongly but I am concerned that the projected margins for a business that is becoming an out-sourced service for insurers are too high. The private client brokers were sold due to the stock market fall. Ask Central was sold following director share sales and a profits warning from its competitor Pizza Express.

Anthony Cross
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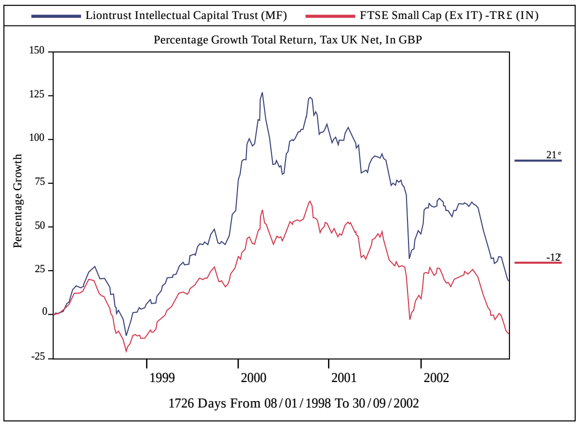
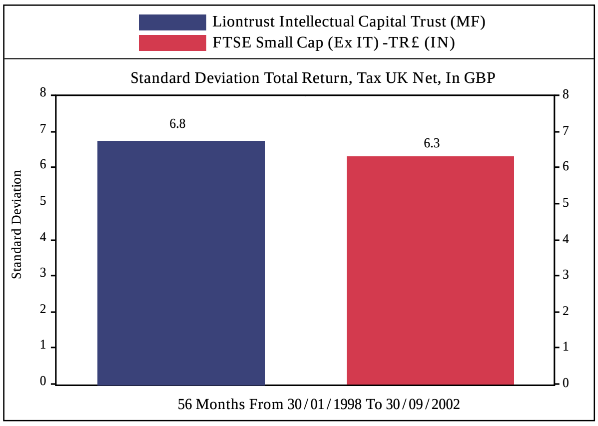
October 2002

PERFORMANCE

The Liontrust Intellectual Capital Trust





(Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date. Figures to 30.9.02.)	1 year	2 years	3 years	4 years	Since launch (8.1.98)
The Liontrust Intellectual Capital Trust	-11.1%	-44.1%	-14.0%	+24.2%	+20.9%
FTSE Small Cap. Total Return Index (excluding Investment Trusts)	-13.9%	-43.7%	-26.6%	+1.7%	-12.4%
UK Smaller Companies sector average unit trust	-14.8%	-47.3%	-19.8%	+11.2%	+0.5%
Performance vs. benchmark	+3.7%	-0.4%	+12.6%	+22.5%	+33.3%
Position in sector	25th/76	22nd/71	22nd/68	15th/65	12th/61
Sector quartile ranking	2nd	2nd	2nd	1st	1st

Liontrust Knowledge Economy Trust PLC

(Source: Datastream ©. Figures to 30.9.02)	3 months	1 year	Since launch (30.3.01)
Net Asset Value Performance:	-19.7%	-12.9%	-34.9%
Share price performance:	-21.0%	-26.9%	-51.0%
FTSE Small Cap. Total Return Index (excluding investment trusts)	-21.6%	-13.9%	-34.5%
Net Asset Value Relative to FTSE Small Cap. Total Return Index (excluding investment trusts)	+1.9%	+1.0%	-0.4%

SECTOR ALLOCATION

Sector	FTSE Small Cap. Index (%)	Intellectual Capital Trust (%)	Knowledge Economy Trust PLC (%)
Resources	3.3	-	-
Basic Industries	5.4	3.5	3.5
General Industrials	8.1	13.3	13.2
Cyclical Consumer Goods	2.9	-	-
Non-Cyclical Consumer Goods	7.1	7.3	7.2
Cyclical Services	29.5	34.4	34.3
Non-Cyclical Services	1.2	-	-
Utilities	0.9	-	-
Information Technology	7.6	15.0	14.9
Financials	34.0	17.1	17.1
Cash	n/a	9.4	9.8

TOP TEN HOLDINGS

The Liontrust Intellectual Capital Trust:

1	Hardy Underwriting	(3.3%)
2	ICAP	(3.1%)
3	Chrysalis	(3.0%)
4	Domnick Hunter	(3.0%)
5	Fuller Smith & Turner	(2.9%)
6	Business Post	(2.6%)
7	Huntleigh Technology	(2.5%)
8	BPP	(2.5%)
9	Renishaw	(2.5%)
10	WM Ransom & Son	(2.4%)
Total		27.8%

72.2% held in a further 56 stocks and cash

Liontrust Knowledge Economy Trust PLC:

1	Hardy Underwriting	(3.3%)
2	ICAP	(3.1%)
3	Chrysalis	(3.0%)
4	Domnick Hunter	(2.9%)
5	Fuller Smith & Turner	(2.8%)
6	Business Post	(2.6%)
7	Huntleigh Technology	(2.6%)
8	BPP	(2.5%)
9	Renishaw	(2.5%)
10	WM Ransom & Son	(2.4%)
Total		27.7%

72.3% held in a further 56 stocks and cash

4. RISK ANALYSIS

Source : Lipper, 56 months to 30.9.02, bid to bid basis, net income reinvested at ex-dividend date.	FTSE Small Cap. Index	The Liontrust Intellectual Capital Trust
Total return	(13.34)%	19.95%
Mean annual return	(0.72)%	6.72%
One month low	(20.18)%	(21.56)%
One month high	13.25%	17.81%
Maximum drawdown	(45.9)%	(44.4)%
Percentage of positive months	55.36%	57.14%
Alpha (annual basis)	0%	7.44%
Beta	1	1.01
Correlation Coefficient	1	0.93
R Squared	100	87
Relative Risk	1	1.09
Risk adjusted performance (annual)	0%	7.88%
Sharpe ratio (annual)	(0.29)	0.05

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 Group funds under management continue to grow, despite the difficult market conditions, rising to £1.903 billion with £890 million in transition as at 26th September 2002.* This is compared to £1.768 billion with £500 million in transition on 31st March 2002, since when the FTSE All-Share Index has fallen over 25%.†

- Liontrust First Large Cap. Fund celebrates three years of consistent outperformance of the FTSE All-Share Index since its launch in October 1999.

- William Pattisson will be giving a series of presentations around the country in October/November about the investment process he employs in the management of Liontrust First Large Cap. Fund, Liontrust Winners Investment Trust PLC and our segregated and pooled pension fund accounts. For details of the presentations, contact us on 020-7412 1766 or info@liontrust.co.uk.

Liontrust First Large Cap. Fund -15.3%, FTSE All-Share Index -31.4%, 14.10.99 (launch) to 30.9.02. Source: Liontrust Investment Funds Limited and Datastream ©, bid to bid basis, net income reinvested at ex-dividend date.
**The date of our last Stock Exchange announcement.*
† Source: Datastream ©.