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Quarterly Report No.1

On 30th May 2001 Troy Asset Management ("Troy") launched its first authorised Unit Trust, the AS Troy Fund. This investment report covers the period from the fund's inception to 31st July 2001. At launch the Fund raised £34.2m and further subscriptions in May and June raised the total amount invested to £34.945m.

The aim of the fund is to protect investors' capital and to increase the value of the fund year on year. While in the long term we intend to invest a substantial proportion of the fund's current liquidity into the U.K. and U.S. equities, we are cautious of the outlook for markets in the immediate future.

A challenging economic outlook

The global economy is slowing. The U.S., which has been the engine of growth over the last decade, is now faltering. After the longest period of expansion since the war, imbalances in the economy are now emerging. A country burdened by a combination of over-investment, booming consumption, and record private sector debt (at 7% of GDP) will not necessarily respond to the monetary and fiscal policies of cheap money and tax rebates. The rest of the world will not be immune. The fall in U.S. demand will lead to a reduction in its high balance of payments deficit and dampen growth worldwide. Countries reliant on US exports such as Taiwan and Brazil are already feeling the pain.

With this engine of growth stalled, the world economy needs Europe or Japan to pick up the baton, but the European economy is behind that of the US while Japan remains in a state of paralysis. Consequently, we face the first synchronised global slowdown since the 1970's.

Against this backdrop, the U.K. is going to struggle. To date, despite the manufacturing sector which has been in recession for a number of months, GDP growth has remained a resilient 2.1% annualised in the second quarter of 2001. This was thanks to household and government consumption. Like the US, the UK slowdown is shifting from manufacturing to services; any sustainable recovery in 2002 will rely on continued consumer spending.

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The Consumer bailout (or not)

There are a number of schools of thought with regards to the economic outlook. Many economists and strategists are looking for a "V" shape recovery next year led by a reversal of the inventory correction, which began a year ago. The alternatives are a "U" shape recovery or even an anaemic "L" shaped recovery. The "V" shape school is also relying on resilient consumer spending. This has proved the one area of strength in the U.S. economy. Until recently unemployment in the U.S. had remained at a historically low level of just over 4%. Consumers' balance sheets, while stretched with huge levels of debt, looked healthy on the asset side thanks to the bull run in common stocks and, more recently a robust housing market. Moving into the third quarter strong anecdotal evidence has emerged indicating a sharp slowdown in consumer spending. Theme park revenues are down, as are airline revenues and, notwithstanding record incentives, auto sales are weak. Initially hit by layoffs from technology related companies, the US jobs market woes are now spreading across a wide variety of industries from investment banking to automotive to airlines. In the last four weeks alone 200 corporations have announced major job cuts, and this in the relatively quiet month of August. Inundated with corporate retrenchment, the consumer is more likely to use tax rebates to pay down existing loans than take on even greater indebtedness. The "V" shape recovery is looking less plausible by the day.

A different economic cycle this time

Over the past thirty years, recessions have been caused by excess demand leading to higher inflation. By raising interest rates, governments and central banks have reined back demand, thereby keeping inflation under control. This time, if there is a recession, it will, at least in part, be due to excess supply. Excessive capital spending on technology and low yielding corporate marketing and advertising has taken place over the past few years. Companies are now making the painful adjustment to historically lower levels of nominal GDP growth. The result has been a squeeze on profit margins.

What does this mean for stocks?

Since the bursting of the "TMT" bubble last year the stockmarket has been repricing risk. Shares in these once fashionable sectors, with valuations based on revenues, or even anticipated revenues, rather than long term profitability have collapsed. However many of the Nasdaq related sectors still trade on high valuations as share prices have struggled to keep pace with earnings downgrades.

Until recently, wider market indices such as the FTSE All Share in the U.K. and the Wilshire 5000 in the U.S. have held up comparatively well as fund managers rotated portfolios into defensive sectors such as pharmaceuticals, tobacco and food retailers. Fund managers judged relative to an index, obliged to be fully invested in stocks, chose to "hide" from the Tech collapse in these sectors pushing valuations too far. Now even these sectors are coming under pressure. If they fall far enough this may present selective opportunities for the Fund in the months to come.

At present, the stock market is a dangerous place to be. Since the Fund launched world markets have been inundated with profits warnings as companies, which were geared up for further economic growth, are suddenly facing the combination of slowing demand and excess supply. The lower cost of borrowing is small comfort.

At the time of writing, the FTSE All Share index has fallen 22% from the peak it reached a year ago. However, despite this fall, equity valuations remain at historically high levels. The UK market's current price/earnings ratio is 20.4x. (Source: FT). US ratings are a more alarming 24.1x (Source: Datastream) excluding large exceptional write-offs. Given the current economic background there is an increasing risk to the earnings estimates and therefore the level of stock markets.

It is therefore too early to call the bottom.

A marathon, not a sprint

In the Fund's Key Features document we stated that:

"Following the launch of the Fund the percentage invested in equities will depend on finding suitable investment opportunities that are attractively priced"

The AS Troy fund is investing for the long term. When making investments on behalf of unitholders we are looking for returns three to five years out. With markets so volatile investors are becoming polarised into short-term speculators (hedge funds and "hot money" retail funds) judged on last quarter's or even last month's performance and longer term investors. We wish to establish a portfolio of winning stocks at the right valuations.

There is a time to invest in blue chips, small cap stocks, growth stocks and value stocks. However, there is also a time to hold high levels of liquidity - this is such a time. We will jealously guard this liquidity until such time as equity valuations reflect economic realities. This is for two reasons. Firstly to protect the capital we have and secondly it gives us the re-investment value of being able to buy equities at attractive prices after they fall.

While we carry these high levels of liquidity our policy is as follows: To invest in a variety of short-dated gilts, investment grade corporate bonds and preference shares for income at the best yields available.

Sebastian Lyon

10th September 2001

AS Troy Fund Portfolio (as at 31 July 2001)

	£m	**%**
Equities		
UK Equities	1.7	4.8
Bonds		
UK Corporate Bonds (Short dated)	1.7	4.8
UK Gilts (Short dated)	10.7	30.4
Cash		
Fixed Deposit	15.0	42.6
Other cash	5.9	16.8
Income Accrued	0.2	0.6
TOTAL	**35.2**	**100**

Performance

The AS Troy Fund is an absolute return fund. Any comparisons against equity indices are for illustrative purposes only.

Launch to 31st July, 2001

Unit Bid Price 100.6p

Fund*:	+0.6%
FTSE All Share Index (Total Return):	-5.0%
APCIMS Balanced (Total Return):	-3.2%

**bid to bid basis, net income reinvested* *Source: Lipper Hindsight*