TROY ASSET MANAGEMENT

Quarterly No.12

Our aim is to protect investors' capital and to increase its value year on year.

Trojan Fund

The Trojan Fund has now produced returns of 33.8% since its launch date (30th May 2001). This equates to an 8.4% annualised return compared to the return on cash of 4.2%. The Fund performed well over the year to 31st January 2004 and is ranked 15th out of 112 funds in the Balanced Managed sector as measured by Lipper. Given our cautious approach and the fact that we did not hold more than 60% in equities during the year, we have produced healthy risk adjusted returns. The Fund has proven itself in three different phases of a market cycle; protecting capital during the bear market years of 2001/2, capturing much of the upside in the strong rally in 2003 and holding its own in a year of average returns in 2004.

Trojan Income Fund

The Trojan Income Fund produced a return of 4.8% between 1st October 2004 and 31st January 2005. A distribution of income accrued during the four month period amounting to 1.0649p per share will be paid on 31st March. The portfolio yield is currently over 4% and the Fund is defensively positioned. We have been unwilling to move to a fully invested position given the current level of equity markets and expect opportunities to buy attractive shares on higher yields as the year progresses.

New Shares Issued

From the beginning of February, two new classes of share in both Funds became available. One class is for intermediaries and are known as ("I" shares) and the other new class of shares is exclusively for charities ("S" shares). The original shares are to be known as "O" shares. The prices for all of the Funds' shares are listed in the Financial Times.

If you are interested in the Trojan Fund or the Trojan Income Fund, please contact Francesca Davies on 020 7499 4030. Investors can choose whether to hold either income or accumulation units.

Authorised & Regulated by the Financial Services Authority
Registered office: Hill House, 1 Little New Street, London, EC4A 3TR
Registered in England No. 3930846

-

The consensus gets it right (for once)

2004 was an unusual year for markets. Almost without exception, every year, the consensus expectation of strategists is for the equity market to rise about 10%. Usually there is a small range of opinion. The less adventurous may suggest high single digit returns whilst the cheerleaders may indicate low teens percentage returns. More often than not they are wrong. Markets do not move in straight lines and, although we have argued consistently that we expect low returns from equity markets, there will inevitably be years of sharp rises and falls. The Market is an emotional beast.

In 2004, the FTSE All Share index rose by 12.8% - a truly consensus year. The last year that gave a similar return was 1998 (when the market rose 13.7%). However, 1998 was a highly volatile year. The All Share index rose 22% until July and then fell 24% until October (thanks to the demise of Long Term Capital Management) then rose sharply by 23%, ending the year up 14%. Hardly a sleep at night year! 2004 was very different. The market drifted sideways for the first eight months, with most of the return coming in the final third of the year.

We have to look back as far as 1988 to find a similar year to the one we have just experienced. In that year, the UK market rose 8.7%. In fact, over the past 20 years, 1988, 1998 and 2004 were the only three when the return was between 5% and 15% - the consensus range. In no year, during this period, was the return from equities between -5% and +5%. That leaves the remaining 17 years of the market falling by over 5% or rising by more than 15%. Conclusion: 2004 was the exception, not the rule and you are better off ignoring the consensus opinion.

With the exception of a stronger than expected oil price and a firm bond market, there were few surprises in 2004. There was no derailment of the world economy, global imbalances (which we have written about in previous quarterlies) remained unaddressed, the dollar continued to weaken and cost cutting drove better profitability and dividend growth. Markets muddled through and volatility fell to a ten year low.

The search for yield

Notwithstanding our defensive position, the portfolios managed to capture much, if not all, of the recent stock market rally. This was thanks to our bias towards income producing shares and, at long last, a strong performance from bank preference shares. In a world where investment horizons seem to be shorter than ever, our investment style is to be patient and we have waited three years for our holdings in preference shares to come good. Happily taking the dividends every year of 7% net of tax was not too painful, but we had always hoped for some capital appreciation. In 2004 the shares rose 20% including dividend income, as the yield fell to 6%. In December HBOS offered to buy back the issue of its Halifax 6.125% preference shares at a net yield of 5.7%. This offer was withdrawn once the bank realised that the offer would be declined by a number of large shareholders, ourselves included. We still believe, that compared to the equivalent bond yields of 5% gross, the shares remain good value.

-

Preference shares and higher yielding equities were not the only assets to appreciate in value during 2004. Over the past two years, investors have chased yield in commercial property, corporate bonds, and emerging market debt. Corporate bond spreads (the amount an investor receives above government bond yields for taking the increased risk) are now at their lowest for five years *(see Figure 1)*. Similarly, investment trusts and property shares trade at low discounts to their net asset values. These indicators imply a lack of risk aversion on behalf of investors and lower future returns. The valuation anomalies that were created in the bubble years have been largely exploited. We believe that large cap stocks which have performed poorly compared to small and mid caps will perform better going forward. With the exception of very reliable income producing assets such as government bonds and preference shares and the lower risk sectors such as Utilities and Consumer Goods, we believe this trend for investing for yield has, more or less, played out.

US Corporate Bond Yield Spread Less US 10 Year Treasury Yields

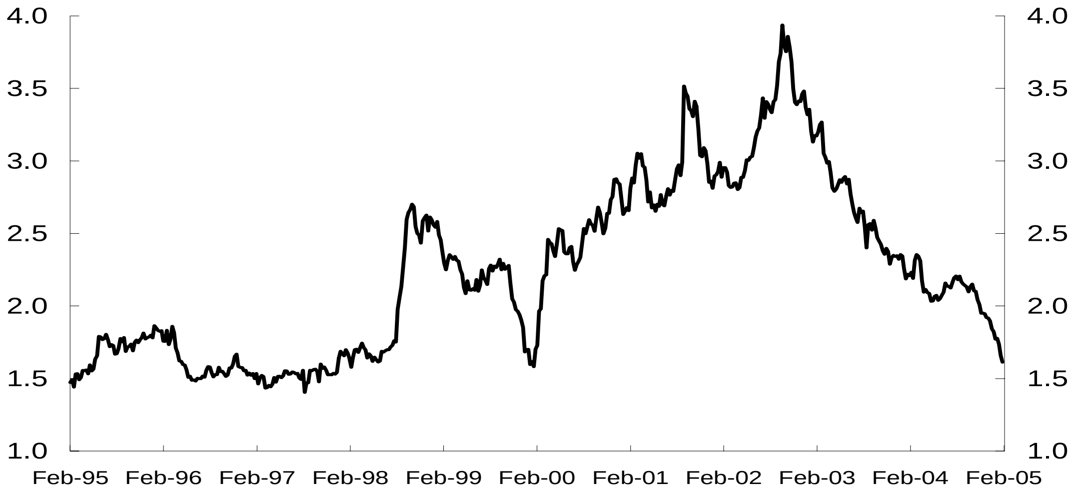

Figure 1 *Source: MAN Securities*

Value outperforms

Since 2000, the peak of the dot com bubble, yield stocks (for yield also read value) have been fantastic investments and Troy has benefited from this trend (*see Figure 2*). In those heady days when IT stocks were trading on 100 times earnings, boring businesses, such as building materials companies and food manufacturers, could be bought on yields of 6% or more and price earnings ratios of less than 10 times. The spread of valuations between the most highly valued and most lowly valued stocks had never been wider. Since then, value stocks have been the place to be. In the long run growth stocks underperform the market, but they can enjoy prolonged periods of outperformance. After such strong performance from value stocks over the past five years, there is a good case for buying growth stocks. The problem is identifying growth. With corporations deprived of pricing power, turnover growth is hard to come by in the current environment. That does not mean that we won't look for it.

In the coming months we will shift portfolios towards quality large cap stocks and away from small and mid cap stocks. In particular, we will look to avoid high levels of indebtedness. This will give the portfolios a bias away from the UK economy - something we are not uncomfortable with (see below).

-

Value versus Growth: FTSE 350 Higher Yield Index/FTSE 350 Lower Yield Index

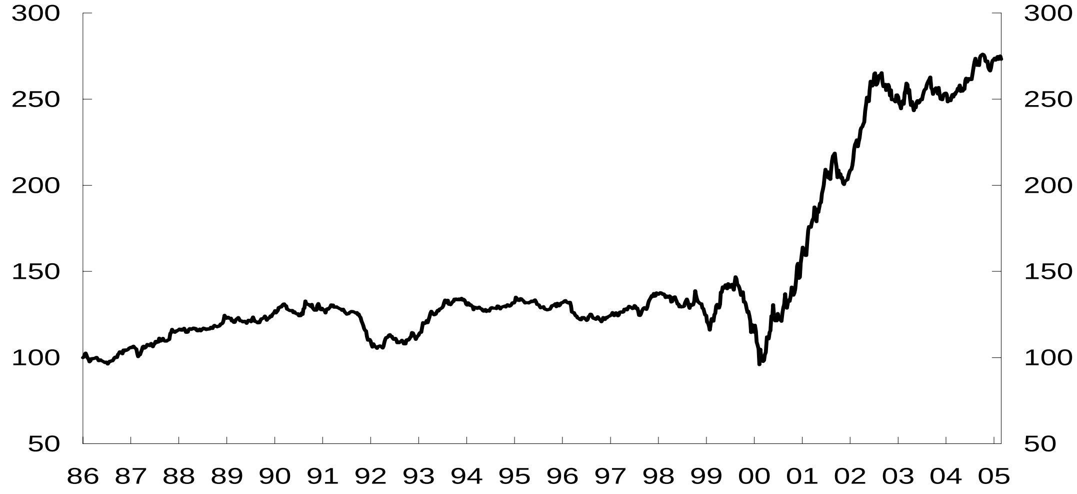

Figure 2 *Source: MAN Securities*

Another election

With the presidential election over in the US and a UK general election likely in May 2005, now is an appropriate time to look at electoral cycles. Historically, equity markets do worse in the first two years of the US cycle as any economic pain needs to be taken early. The final two years are stronger as the ground is prepared for re-election or, in the case of a president in his second term, to go out on a high. Unlike his father, President George W Bush certainly did his utmost to engineer pre-election growth with huge stimulus. The price will be paid for this in 2005 and 2006.

The US dollar has been weak due to well rehearsed reasons - a large trade deficit, weakening public finances and consumer debt at record levels - but the similarities with the UK economy are uncanny and have been ignored, hitherto. Anecdotally, sterling looks expensive. If any evidence was needed, the number of shopping trips to New York before Christmas gave a fair indication of disproportionate purchasing power. Historically, for the last twenty years, sterling has traded between \$1 and \$2. A fall in the value of the pound would have implications for inflation and may lead to the Bank of England's inability to cut interest rates in a weakening economy. If it was not for our long held concerns for the dollar, we would have reversed our dollar hedge a long time ago. We feel that a more measured stance is now in order and have reappraised the position. At \$1.90 to the £ we removed half the hedge with the intent to take the hedge off altogether if the dollar weakens further.

In the UK there is less evidence of a link between a general election and the market, whose primary influence will always be the state of the economy. Political intervention can however have a material impact on equity and bond markets – though often unwittingly. The impact of the failed UK membership of the ERM severely damaged the economic credibility of the Conservative Party but laid the anti-inflationary foundations which have sustained an unprecedented period of economic stability which continues today. This was reflected in stock market returns in the 1990s but it is clear that the underperformance of the UK equity market versus the US and Europe since 1997 can be substantially attributed to the compounding

-

effect of the abolition of the dividend tax credit by Gordon Brown. This imposed an annual tax of about £5bn per annum on pension funds and charities.

Stock markets tend to thrive in spite of governments rather than because of them and the likelihood of a third term for Labour raises the question as to whether the political reins will continue to tighten. The next Parliament may well see the first test of the independence of the Monetary Policy Committee whose admirable performance to date has not yet come into conflict with the dark force of political expediency. We believe that the rapid acceleration of public sector spending cannot be sustained without further tax increases and that the private sector is faltering under the burden of consumer debt, rising costs and increased regulation. This may well be reflected in narrower profit margins. The current glut of dividend increases and share buybacks may be an indication of the dearth of investment opportunities at present rather than a sign of optimism. We believe that there are greater risks to the UK economy than investors realise and that these will come into sharp relief after the election. A narrower Labour majority could well lead to a less favourable fiscal climate for investors and recent announcements which have impinged on the tax status of some private equity and unit trust investors may be a foretaste of things to come.

Time to get off

We have had a holding in Tate & Lyle in the portfolios for over two years. When we bought it, at just above £3 a share, the company was unloved, yielding 6% and on a price earnings ratio of less than 10 times. The management had done a good job in reducing the debt and the exposure to commodity businesses. In 2004 we got lucky. The shares rose from £3 to £5 thanks to the market's recognition of Tate's Sucralose artificial sweeteners business, branded as *Splenda*. The product, invented in the 1970s, has had a long gestation period. We can recall going to company presentations on Sucralose as long ago as the late 1980s. After a profits warning in early 2004, the shares have not looked back. The Sucralose profits have risen strongly, from a low base, while the core sugar and glucose businesses have held their own. At the time of the interim figures in November we were tempted to sell the shares when they enjoyed promotion into the FTSE 100 index after a long absence and rose to 450p. David Lang of Investec Securities, doyen of the Food Manufacturing sector, advised in his characteristic style to "*ride 'em cowboy*" and so we have.

Since then, the shares have put on a further 15%. Potential risks are no longer reflected in the price. Investors are now focusing purely on the success of Sucralose, combined with positive short-term earnings momentum, and are ignoring the other commodity businesses that remain a significant swing factor for profitability. Profits could come under pressure with the impending changes to the EU sugar regime. Sucralose is not a sure thing. The patents on the product are long in the tooth and there is a possible threat to analysts' blue sky valuations from generic producers. Value investors are out of the stock which leaves it vulnerable to the whims of investors with a shorter investment horizons and the resulting increased volatility. In addition, directors and the two largest shareholders (including competitor Archer Daniels Midland) have sold out. We have followed their lead and sold the holding at 517p.

-

Outlook

The odds of the consensus being right in 2005 are very slim. We are surprised by the implicit belief of markets that, just because the imbalances in the US and UK economies were ignored by markets in 2004, they will be ignored in 2005 and beyond. Nevertheless, the strength of corporate balance sheets is higher than it has been for many years and the recklessness of the poor allocation of capital during the tech bubble is unlikely to repeat itself. For now, cashflow is strong and is being returned to shareholders via dividends and share buy-backs. Stocks may look cheap, but it is dangerous to expect corporate margins to grow further as a per cent of GDP when they are at a 75 year high. Market forecasters are extrapolating margin growth for the next few years, but this is hard to reconcile with rising interest rates, slowing economies and minimal turnover growth. We do take some comfort that the UK market looks cheap compared to its international peers, especially the US. During 2005 we expect to shift the portfolios towards quality businesses with strong franchises and reduce exposure to mid and small cap stocks which have done so well. After a strong rally in equity markets since the lows of two years ago, significant returns are only likely to be achieved by taking excessive risk. There is little point in taking greater risk for lower returns. In fact, we would be surprised if the Trojan Fund's holding in FTSE futures is still in the portfolio by the time of the next Quarterly. For this year, we believe that our risk averse approach remains appropriate.

Sebastian Lyon Francis Brooke
March 2005

Administration

We deal weekly (at noon on Thursdays) and on the last working day of the month. If you would like to participate, application forms and a prospectus are available from Francesca Davies on 020 7499 4030, or from Capita Financial (Tel: 020 7556 8800).

TROY ASSET MANAGEMENT LIMITED13 ALBEMARLE STREET, LONDON W1S 4HJ
TEL: 020 7499 4030 - FAX: 020 7491 2445 E-MAIL: info@taml.co.uk