TROY ASSET MANAGEMENT

Quarterly No.16

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

Trojan Capital Fund

On 6th March 2006 the Trojan Capital Fund, managed by Ruth Keattch, was launched. The Fund will seek to provide capital growth over the long term and has been designed to use Ruth's talents, giving her the flexibility to capture the upside of small and mid cap stocks, allowing her to invest in larger companies and continental European stocks when appropriate. Ruth will also be able to hold up to 25% of the portfolio in cash if there is a need to protect capital.

Dilution Levy

In Quarterly No.14 we flagged an intention to introduce a dilution levy for the Trojan range of Funds. As of 1st April 2006 the manager of the Trojan Funds, Capita Financial Managers, having consulted us, will introduce a dilution levy of 0.5% which will be levied on all purchases and sales. We must emphasise that the levy is not paid to the manager but credited directly to the Funds thus ensuring that existing investors will not be disadvantaged in any way by the cost of investing new money.

'A' Day

On 6th April 2006, changes are being made to the way individuals can manage their pensions. This will provide flexibility to the amounts payable into pension funds and will increase the appeal of Self Invested Pension Plans ('SIPPs'). We believe that the Trojan Fund is an ideal long term SIPP investment. It seeks to make consistent returns with low volatility: objectives similar to with-profits funds but with full transparency, low charges and - dare we say it - without smooth-talking commission-generating advisors!

If you are interested in the Trojan Fund, Trojan Income Fund, or the Trojan Capital Fund please contact Francesca Davies on 020 7499 4030, (email address info@taml.co.uk).

2005

2005 was a remarkably benign year and the Funds made steady progress. Equity markets rose with minimal volatility, as did bonds, commodities (including gold), and property and your Funds benefited from these conditions. As our latest annual report for the Trojan Fund states:

'The reason for positive returns from all asset classes is uncertain, but is probably related to the high levels of liquidity prevalent since 2002 and 2003, when interest rates were cut to historically low levels. Although there is a feel good factor when almost everyone is making positive returns, we question how sustainable this will be. When the tide lifts all boats, it provides little confirmation that, as an investor, one has made the right decisions or whether we have just been lucky.'

The last time markets were buoyed by high levels of liquidity was over the millennium period. This distorted markets and much of the excess liquidity found its way into technology stocks. This time, the liquidity has been spread more evenly as investors are more diversified (of which more below). Nevertheless this gives little comfort, for when liquidity is less prevalent (and the Federal Reserve continues to raise interest rates…) then, maybe, all asset classes will fall. Our concern, as we said in Quarterly N°15 is that, in such circumstances, there will be fewer places to hide other than cash. This may lead us to reduce exposure further to the more risky parts of the portfolios such as mining stocks.

In seeing commodities rise strongly in 2005, one might well ask whether that has affected our long held view on inflation and the answer is no. Our view remains unchanged. The US core Consumer Price Index rose 2.1% in the year to November. Producer prices, usually a lead indicator for consumer prices, rose only 1.7% over the same period. Competitive pressures remain intense and pricing power is elusive.

Goldilocks returns

This current steady state of solid GDP growth combined with low inflation has been described once more as a 'Goldilocks' scenario; an economy not too hot and not too cold and where monetary authorities have done enough but not too much. Economists, strategists and finance ministers previously used Goldilocks to portray the world economy back in the late 1990s. The problem is, once markets have discounted a Goldilocks scenario, the economic stability leads to higher risk taking rather than risk aversion.

Yet, there are signs that markets are not in such a steady equilibrium. In the UK short-term interest rates are stable at 4.5%, while 30-year gilts yield 3.9%. This condition of a downward or inverted yield curve is unusual. In the US, short rates are at 4.5% as well, but rising while 30-year treasuries yield 4.74%. A further rate rise -(and markets are expecting the Federal Reserve to raise rates by a further 0.5%) - could cause the US yield curve to replicate the UK, if US bond yields stay where they are. The Japanese central bank is also looking to raise rates, reversing its zero rate policy which has been in place since 2001. Liquidity is being drained from the system but markets seem happy to ignore this at present. Inverted yield curves have historically warned of a slowdown and, possibly, a recession. The last time the US bond yield was inverted was in 2000, accurately predicting the downturn in 2001. For now, the bond markets are indicating that risks are rising. As before, Goldilocks may not be with us for very long.

For whom the bell tolls

In previous Quarterlies, we have been preoccupied with monitoring the health of the US consumer and the housing market. Rising property prices offset the effects of falling share prices in 2001 and 2002. Increased personal debt, via mortgage equity withdrawal, kept the American consumer spending. The combination of strength in the housing market and high government spending has been critical in keeping the US economy growing. 2005 was the first year since 1933 that Americans collectively spent more than they earned. If the US housing market were to stall, or worse fall, then the impact of lower spending and higher saving would be felt globally.

There are signs that the US housing market is cooling. Sales of existing homes have fallen for five months in a row. Toll Brothers, one of the largest US house builders operating in twenty states, warned recently that orders are down 36% year on year. The company's shares are 50% off their all time high (see Figure 2). To quote the company, "*In 2005 demand for new homes was propelled to unsustainable levels by speculative buying. We are now on the other side of that slope*".

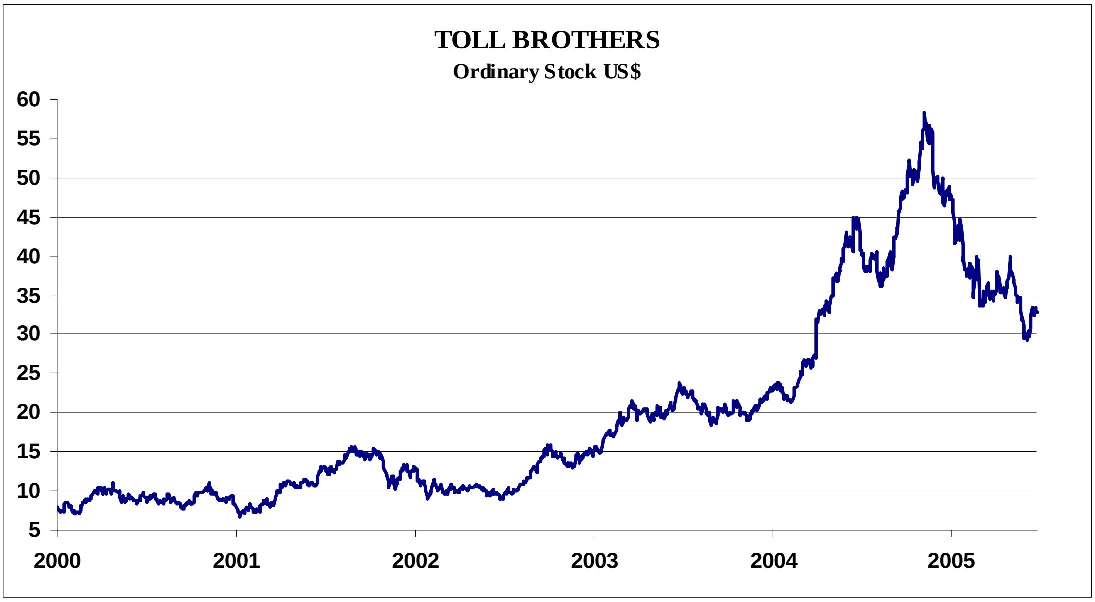

Figure. 2 *Source:Bloomberg*

If this key source of borrowing is set to diminish there is a risk of rising bad debts - with knock on effects for financial markets. Mortgage lending in the States has become far more exotic than the UK and regulators are now stepping in to tighten lending standards. The monetary conditions in the UK and Australia of soft landings (so far) for house prices, have given commentators hope that these experiences will be replicated State side and in a period of relatively low interest rates, a soft landing should be the central case. Nevertheless the fall in mortgage equity withdrawal, which has contributed up to 7% of disposable income in recent years, will lead to a drag on economic growth for a prolonged period. UK retail sales growth has fallen from 7%

in 2004 to 1% today. If this were to happen in the US, its effects would be felt outside the local economy.

Diversify or die

With the strength of equity markets in the 1980s and 1990s, diversification of risk was forgotten. Large institutional investors' portfolios increased their exposure to global equities at the cost of other asset classes that had performed less well. Private equity and commodities were backwaters. Assets such as gold were derided after an 18 year bear market. The lesson learned from the bear market of 2001-3 was that there are benefits to diversification which can improve risk adjusted returns. The trend into alternative asset classes is now well established, and added into the mix, is the growth of hedge funds. University endowments, such as Yale, remained well diversified through bull and bear markets and, as a result have enjoyed enviable long term returns. Canny private investors followed in the earlier part of this decade. Inevitably pension funds and insurance companies with the largest pool of assets are getting in on the act. There have been a number of announcements recently of trail blazing pension trustees proposing to invest in commodities, private equity and hedge funds. The amounts are relatively small so far so the trend is likely to build on itself.

At Troy, we have various long standing holdings in commodities (including gold where appropriate) and private equity via investment companies. All have performed well and have reduced volatility at times when equity markets were unstable but discounts have narrowed and opportunities in the UK are now limited. Investment is about catching long term trends early. Ruth has identified a number of opportunities in European private equity where the market is less developed than the UK or US. Some new names may be finding their way into the portfolios in the months to come. The Gadarene rush from pension funds into these alternative assets is yet to come.

Outlook

We have been surprised by investors' and companies' continuing appetite for risk. Valuations are not especially favourable, although not excessive and sentiment seems bullish. Credit spreads are at very low levels and investment trust discounts to net asset values are at multi-year lows. We are sceptical that such conditions buoyed by a wave of liquidity will last forever.

Sebastian Lyon
March 2006

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).

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