TROY ASSET MANAGEMENT

Investment Report No.18

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

A Return to Sanity

Our last report (N$^{o.}$17) published in May coincided, almost to the day, with the peak of a euphoric market run. As we said at the time, "*investors have favoured higher risk shares on lower yields and as a result markets have been less kind to us…there has been a dash for trash*". We are pleased to report that, since then, sanity has returned to markets. Investors have become more risk averse and many of the highly speculative areas we referred to have fallen sharply. The more resilient, predictable sorts of businesses we prefer to own have once again found favour. As a result the Funds have enjoyed a better time, with all three Funds close to their all time highs. By way of contrast equity markets have failed to recoup their gains from earlier in the year – a good demonstration, if any were needed, that Troy's Funds are not highly correlated with the equity market.

Boring Blue Chips

As long-term investors, it sometimes bemuses us that we are part of an industry criticised for being short term and fashion conscious.

The trend during the 1990s was for investors to buy blue chip stocks. Index tracking, as an investment style, took off and many fund managers became slaves to index weightings. 'Closet indexing' became common practice as managers found they were not permitted to stray too far away from their benchmark, irrespective of value. This became self-feeding. New issues were highly priced in the knowledge that the greater the achieved valuation, the more index funds would have to buy in the aftermarket. Over time, a huge disparity between smaller and larger capitalisation valuations opened up.

Since the peak of the market, in 2000, things have gone full circle. Valuations for FTSE 100 stocks have fallen while less liquid mid-cap stocks have moved in the opposite direction. As the table shows, (*see Figures 1&2*) the mid-cap FTSE 250 index is now yielding almost one per cent less than large capitalisation stocks. This is the widest gap since the late 1980s and is reflected in the poor performance of the FTSE 100 index, which has trailed the FTSE 250 index by 50% over the last six years. Evidently, the current fashion is to not hold the larger FTSE 100 index constituents and to take higher risks.

UK Equity valuation

FTSE 100 P/E Ratio	12.4x
FTSE 250 P/E Ratio	18.4x
FTSE 100 Dividend Yield	3.2%
FTSE 250 Dividend Yield	2.3%

All values are historic *Source: FT*

Figure 1.

FTSE 100 Total Return Relative to FTSE 250

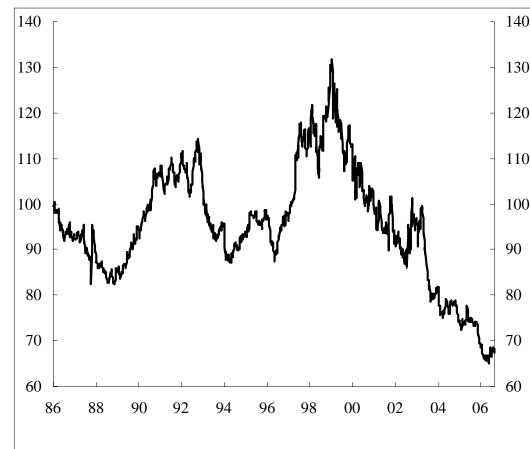

Figure 2. *Source: MAN Securities*

Over the past few months we have been shifting our portfolios towards larger stocks which is where we see the most value, the highest liquidity, and the lowest risk in the market. We acquired a number of new large cap holdings in the telecommunications, media, and technology ('TMT') sectors. Vodafone, previously the quintessential TMT stock, is now viewed with antipathy by investors and trades on a utility rating of just 10 times earnings and a yield of over 5% - this compares to 70 times earnings and a yield of 0.5% at its peak. Once the largest stock in many portfolios, it is now rare to see it as a top ten holding. Although we may be early, we see little downside risk in stocks that have fallen to earth. Having not invested in the TMT sectors for many years (except for BT, which we also view as a utility) we now find them attractive. New holdings for the funds in these sectors include Vodafone, Reed Elsevier, Daily Mail & General Trust and Sage Group. That is not to say that good money cannot be made in smaller companies, having recently received a bid for our holdings in Hardys & Hansons, but there is a greater need to be more selective.

Out of the Closet

We were intrigued to see two recent interviews with fund managers, in the *Financial Times* this summer, trumpeting their ability to own mid cap stocks and to invest away from the index (and who can blame them now, free of their shackles). Alarm bells rang. Large cap stocks are spurned in the way 'old economy' stocks once were. The current fashion is to take a high degree of stock and sector specific risk. Mining, oil exploration, building materials and property are in vogue this year – the new momentum sectors. These parts of the market are not now heavily represented in Troy portfolios; in particular our once weighty mining exposure has been sold down in recent months.

These are highly cyclical sectors and should the economy slow (which is precisely what central bankers worldwide are targeting by raising interest rates) such sectors are likely to suffer.

Hard or Soft?

The signs of a slowdown in the US are indeed emerging. The housing market, which has kept the economy moving ahead since the collapse of the equity market in 2000, is flagging. As the economy dips, all signs tend to point to a soft landing, but the risks of a hard landing are rising. The bond market is giving a clear signal that the US economy will slow next year. The equity market has, so far, viewed this as positive. Such schizophrenia is not uncommon at this stage of the economic cycle. A sure sign of this is the current unhealthy obsession with reading the tea leaves of every monthly economic statistic.

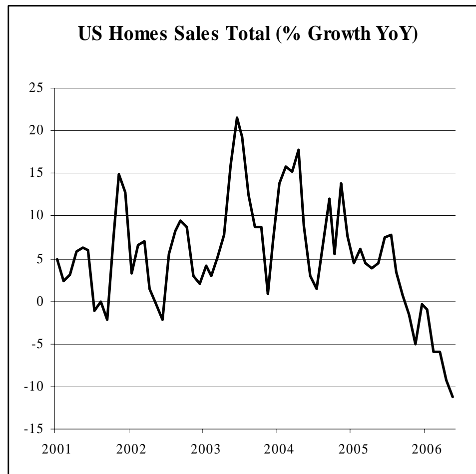

Figure 3. *Source: Bloomberg*

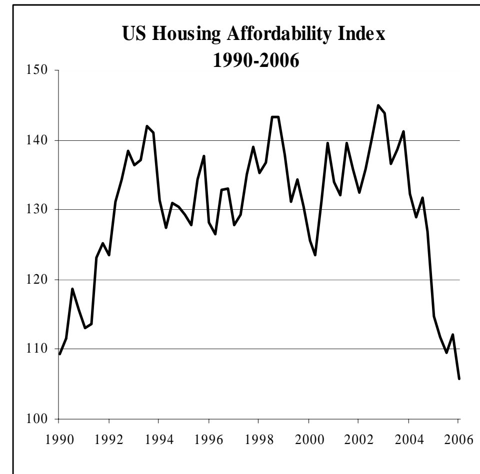

Figure 4. *Source: Bloomberg*

Markets should be worrying. Housing, unlike tech stocks, is a significant part of household wealth. The effect of a fall in house prices would be felt far more widely than was the fall in share prices. The optimists point to the soft landings experienced by Australia in 2003 and the UK in 2004. Perhaps the US will replicate them but affordability (at a 16 year low) and home sales figures do not look encouraging and, whereas previously in the 1980s and 1990s house prices fell regionally, today they are falling nationally (*see Figures 3 & 4*). Unlike equity markets that can crash, housing markets fall in slow motion. With the housing market closely linked to the financial services sector, a recession in the US is no sure thing but the risks are rising. Investors may take time to wake up to all of the wealth effects and financial implications of a decline in house prices, but the current fashionable sectors that are highly economically sensitive, may not be as chic in 2007.

Play the Odds

One thing has not changed in the last six years and that is the short-termism of investors. We live in a world where quarterly performance measurement is now considered long term. As one well known hedge fund manager recently put it, "*you have to feed the monster of monthly performance*" these days. This leaves managers investing on a very short-term basis in long duration assets. Portfolio turnover is as high as ever, as James Montier of Dresdner Kleinwort tells us, the average holding period for UK shares is just over one year. This has fallen from an average of nine years, two decades ago. Investor patience is as short as ever. Our view has always been to invest for the long run – trading amounts to a tax on investors' returns. To prove the point, Merrill Lynch recently published some research demonstrating that longer investment horizons make losses less likely. In equity

markets short-term wobbles should not distract you, for there is a 46% chance of losing money over a day and 35% over a month. Leave it a year and odds of losing reduce to 18%. In ten years the chances of a loss fall to zero. Admittedly the research is skewed by the bull market data of the 1980s and 1990s but nevertheless, the numbers tell a story - focusing on the short term does not normally benefit performance.

Stocks for the long run?

By some uncanny coincidence, I invested in a life company savings scheme ten years ago. I admit that this was a low quality, carpet-bagging exercise common back in 1996. In ten years, as a result of a combination of high front-end charges and poor performance, I have made no money on my monthly premiums – I would have been no worse off placing the cash under my mattress. We sometimes describe the Trojan Fund as a fund with similar long term objectives to with-profits life funds but without the high fees, commissions and opacity. As always, despite the cloudy macro economic picture, we will endeavour to perform over any reasonable time period but we make no promises to do so over the next month!

Sebastian Lyon September 2006

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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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