TROY ASSET MANAGEMENT

February 2007

Investment Report No.19

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

All three Funds made good progress in 2006. The Trojan Fund succeeded in making a steady advance of 11.9% on a total return basis. This is the fourth year in a row of double digit returns, thanks to a continued benign equity market backdrop. Even including the difficult early years, which were more about preserving capital amid sharply falling markets, the Fund has provided an annualised return of 10.3% since launch. This is comfortably ahead of the opportunity cost of the return on cash of 4.3%. We retained a relatively high degree of exposure to equities throughout the year, by our standards, at about 60% of the Fund.

How returns are generated is as important as the percentage number itself. Two funds making the same amount may take very different degrees of risk. Volatility (as measured by the standard deviation of returns) has averaged 1.5% per month for the Trojan Fund compared to 3.6% for the Balanced Managed sector. This implies that we have taken less than half the risk of our peers and risk-adjusted returns were superior.

Similarly the Trojan Income Fund had a pleasing year, in terms of risk-adjusted returns, performing in line with a rising UK equity market, up 16.5%, but only holding a maximum of 75% in equities during the year. Patently stock selection made a positive contribution while the risks taken were below average. The Fund benefited from bids for a number of holdings including BAA, BOC, and Gallaher. Dividend growth for the Fund in the year ended 31st January 2007 was almost 10% and Francis is confident of another year of progress. The Fund's historic dividend yield stands at 3.6%. Both the Trojan Income Fund and the Trojan Fund experienced resilient performance during the sell off in May. Amid sharp market falls, of up to 8% at one point, both funds fell less than 2%. This provided a good stress test for our approach.

Having launched the Trojan Capital Fund in March, Ruth has succeeded in producing a stellar return of over 20% in its first ten months. Ruth avoided the hotter areas of the market that fell to earth in May and June. Many of those fashionable stocks failed to recover during the rally which we have enjoyed since the summer. In her role as Head of Research, Ruth has introduced us to a number of successful UK and European opportunities including Hardys & Hansons, Ted Baker and Mecom.

We believe that the three Trojan funds are highly distinctive and we hope that they stand out from the crowd. While each one addresses the needs of particular investors they also have much in common when it comes to the types of company in which we invest - we see this as a source of strength for the future.

Market Review

2006 was a year in which it was easy to make mistakes but in the end conditions favoured our low turnover, patient approach to investment. Equity markets were volatile in the first half of the year, enjoying a speculative run and then diving sharply in May. Since the summer, stock markets have enjoyed a rally in the higher quality, cash generative stocks we tend to favour. Whilst the benefit of hindsight makes investment seem easy, the various changes in market leadership during the year made life uncomfortable at times and increased the likelihood of unforced errors. The final outcome was surprisingly benign.

A number of factors coincided to drive markets higher. Inflation conditions remained relatively stable. Wage increases were less than expected, thanks to continued immigration (particularly from EU accession countries) and just as markets began to show concern about cost-push inflation from rising commodity prices, the oil price turned tail falling by a third. Strength in financial markets becomes circular and self-reinforcing within the economy, providing strength to the more exclusive parts of the housing market. It would appear that the top end of the residential market has decoupled from the national market. This is connected to Francis's long-held view that London has become the centre of the world and, as the major beneficiary of globalisation, is replacing New York as the city of choice. Post 9/11, London is attracting high net worth individuals (think Roman Abramovich or Lakshmi Mittal) who influence both the domestic economy and its asset markets. As a result, Sterling continues to be resilient notwithstanding poor fundamentals similar to the US dollar.

The usual negatives wheeled out by the doomsters did not emerge in 2006. Geopolitical risk remains, especially in the Middle East, but investors seem tired of existing conflicts. The US dollar continued to fall but did not collapse, while the threat of systemic financial risk was confounded by a stress test: the collapse of Amaranth Advisors, a hedge fund. Instead investors focussed on the micro. Takeover activity usually boosts investors' sentiment and provides them with cash for reinvestment. Demand for UK listed companies in 2006 came from the burgeoning private equity sector and from European and Japanese companies all exploiting low funding costs which prevailed. Finally, the largest contributor to the resilience of markets has been the consistent strength of corporate profits growth. US companies, as defined by the S&P 500 index, have grown earnings at an annualised rate of more than 10% for fourteen quarters on the trot and the UK experience is no different. This has surprised even the more optimistic of commentators. In fact, since the trough of the bear market in 2003, earnings have more than kept up with share prices, leaving UK stocks on valuations that do not look excessive, compared to historic averages. Certainly, relative to other asset classes, (especially property and commodities) and despite above average returns of recent years, equities do not look overvalued. Whether they offer value on an absolute basis is another question entirely.

"*If you have to forecast, forecast often*" Edgar R Fielder, Economist

In January, we seemed to be inundated with requests as to our views for the next twelve months. This is not surprising: After almost four years of rising stock markets, it is less easy to see where the opportunities lie. In our view, there are many reasons (the continuation of those given above) why 2007 could easily be similar to 2006. We must point out, however, that markets are fluid and continuous. They know no dates and the question of 'where are we going to make good gains this year?' is not the right one. We are not soothsayers; all we can do is structure the portfolios to take into account valuation and

opportunity with consideration for a number of possible eventualities and potential downside risks. Yet our contrarian and cautious instincts tell us to be aware that such a steady rise in markets, with relatively low volatility, will not last forever.

Comfort blankets

Paradoxically many of the reasons to be positive on the outlook may also be negatives. An increasing amount of long term financing is done outside the traditional bond and equity markets. While the growth of hedge funds has increased the demand for short term returns, risk appetites have become linked to the whims of short-term momentum investors that exacerbate market movements due to the ability to borrow. Similarly, private equity investors, while looking on a three to five year view, are justifying paying higher prices by taking on greater degrees of debt.

We have been bemused by the stratospheric growth of the alternative investment world. Frightened by investment consultants, institutional investors (such as pension funds) have sold equities in recent years in favour of investing in alternatives (such as hedge funds and private equity) as well as commercial property. All are less liquid, i.e. less easily realised. Perhaps pension fund trustees have decided to take longer term investment decisions but we doubt it. They are dedicated followers of fashion and at the moment, low volatility and diversification appear to be in vogue. Having experienced the high volatility of equity markets in the latter part of the bull market at the end of the 1990s and the bear market in the earlier part of this decade, these investors prefer not to see their investments marked to market daily but monthly (in the case of hedge funds) or even semi-annually (in the case of private equity or property). They can no longer cope with the short-term vagaries of the stock market.

The huge irony of these comfort blanket investments is that much of the money realised from equities has been recycled at a higher cost (in terms of fees incurred and prices paid for reinvestment) with no guarantee of greater returns. Many hedge funds invest in equities. Private equity buyout funds have acquired a large number of companies in recent years, paying a premium to stock market investors for the privilege. Both tend to use debt (sometimes eye watering amounts) to enhance returns. Private equity and hedge funds are more opaque and are not subject to rigours of quoted company corporate governance requirements. Just because the assets are priced less frequently, it does not make them lower risk.

Another bubble?

Private investors, who do not find private equity and hedge funds as accessible for regulatory reasons, have embraced commercial property instead. Last year it was by far the most popular unit trust sector, attracting almost £4bn of new funds. This is a good contrary indicator – remember the dot com boom? Private investors are notoriously good at identifying where one should have invested in the past.

Back to reality

More than anything, cheap debt has kept these sectors bubbling. Quietly, without markets seeming to notice or care, the cost of money has risen, highlighted by the surprise move by the Bank of England raising interest rates to 5.25% in January.

The US Federal Reserve has also held rates up for longer than expected and shows no signs of cutting anytime soon: The punchbowl at the proverbial party is being removed and the guests are just starting to notice. For the first time in a while upside risk to inflation may be rising. This makes the central banks' role less easy but in the short term, at least, the pressure from commodity prices have abated. For the time being we expect interest rates to stay higher for longer – making cash more attractive.

Apocalypse now?

The three threats to the current benign scenario are higher than expected inflation (forcing higher interest rates), geopolitical risk - ignored in recent years as most people are bored with Iraq - and systemic financial risk. The reversal of the fashionable 'carry trade' (which involves borrowing a low yielding currency, such as the Japanese Yen or Swiss Franc, and buying a higher yielding one) is often cited as the threat to stability but investing on the basis of a single extreme future event can be a costly and painful business. We position portfolios carefully to take account of a range of possible outcomes, excluding rose-tinted optimism or disaster, and rely on good stock selection to maintain performance in all reasonable conditions.

We would like to thank the investors in the Funds for their support in 2006.

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