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AS Troy Fund

Quarterly Report No. 6

The aim of the Fund is to protect investors' capital and to increase the value of the Fund year on year.

Appointment of Chairman

Troy Asset Management is delighted to announce the appointment of Simon de Zoete as Chairman of the Company. Simon was formerly Deputy Chairman of CSFB (Europe), and his career has spanned over 35 years in the City at CSFB and its predecessor companies, Barclays de Zoete Wedd and de Zoete & Bevan. He is an experienced stockmarket practitioner and has advised major companies and institutional investors on market related matters for more than two decades. Simon is Chairman of the City of London Investment Trust plc.

New quarterly reporting

We have reassessed the way in which we report to unitholders and in future we will produce four quarterly reports and two six-monthly ones. The quarterlies will be used to update clients more promptly on our investment themes and give quarterly performance, while the six-monthly reports will be shorter and more formal in style. Their primary task will be to fulfil regulatory reporting requirements.

Confidence tricks

Like the law of diminishing returns, the higher stock prices rise, the lower future expected returns should be (*and they have risen a long way in the last 5 months –the FTSE 100 index is up 28% from the low*!). In March there were 62 stocks in the FTSE 100 index that yielded more than 10-year gilts. Today there are only 28. Yet, perversely, the higher the equity market climbs, the more confident investors become. This chorus of bullishness makes us nervous. Since the March lows, the stockmarket has demonstrated how schizophrenic it can be, shifting from an exceptionally anti-risk to an exceptionally pro-risk stance. Over the summer months, a warm glow of complacency has come over the market. Increasingly, we have been hearing phrases reminiscent of the bubble; "You can't afford to be out of the market", "there is a huge wall of nervous money waiting on the sidelines" and even "that stock has risen far enough for me to buy it"! Valuation techniques from that era have been dusted off by analysts, in particular comparative calculations (expensive US stocks justifying the price rises of similar businesses in the UK) and "sum of the parts" estimates when straightforward earnings valuations look stretched. The sharp falls of January and March have been long forgotten - dismissed as an aberration and put down to the loss

Regulated by the FSA
Registered office: Hill House, 1 Little New Street, London, EC4A 3TR
Registered in England No. 3930846

of investor nerves ahead of the impending conflict in the Gulf. Notwithstanding a quick military resolution to the Iraq issue (winning the peace is another matter altogether), all of the global economic imbalances remain and, if anything, have been exacerbated.

A recovery, of sorts

The US economy is showing signs of spluttering back to life. This is not surprising in light of the extraordinary amount of resources aimed at the economy's resuscitation. Tax cuts and higher government spending (including a 44% increase in defence expenditure in the second quarter), combined with the lowest short term interest rates for 50 years, were bound to have an impact, but the question is, "will it be sustainable?" As we predicted in our previous quarterly, central banks continued to cut interest rates. In early June, a concerted effort to re-inflate the global economy began. The European Central Bank cut short-term interest rates by 0.5% to 2%, the Federal Reserve followed by cutting US equivalent rates by 0.25% to 1%, and finally, in July, the Bank of England reduced base rates by 0.25% to 3.5%. No effort has been spared to revive the economy. The monetary policy cupboard is almost bare. If the US succeeds in engineering a recovery, the economy will have had the shallowest recession on record; a mere 0.6% decline in GDP between March and November 2001.

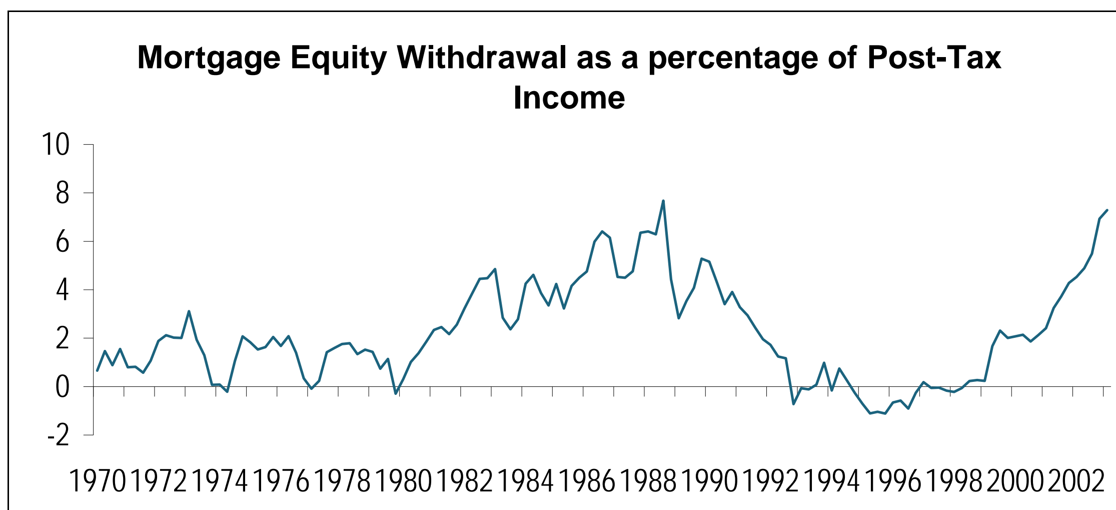
Economic downturns are never pleasant, but occasionally they are necessary. An excellent review of the global economy in The Economist (28th June 2003) summarised this issue well. *"Recessions are normally periods when excesses from previous booms are purged. The late 1990's boom created some of the worst excesses ever, yet the recession was the mildest in history, so many excesses remain".* The UK has, hitherto, succeeded in avoiding negative growth altogether. The lack of any material downturn on both sides of the Atlantic will make any recovery shallow and dull. This is the third attempt to orchestrate a recovery, and the equity market is desperate to believe in it, but a relapse is the most likely outcome. Japan has enjoyed five recoveries since the early 1990's. Over any meaningful period, the improved economic activity failed to boost an expensive stockmarket. This may be the first of many such recoveries for the US economy.

Bubble trouble

Central bankers control short-term base rates but the capital markets set long-term interest rates. Paradoxically, much of the monetary stimulus unleashed by central banks will be offset by recent rises at the long end of the yield curve. American mortgages are priced off the yield of 30-year Treasuries which has risen from 4.2%, to 5.3% in three months. This backing up of bond yields in the US since the middle of June could prove to be a restraint on the one part of the economy which has continued to grow over the past three years, namely consumption, which represents 70% of GDP. Since 2000, falling bond yields have encouraged consumers to take out larger loans against the rising value of their homes. This mortgage refinancing, which has kept the housing market and consumption going (via equity withdrawal), is now down 80% since May. At some stage households will need to save more and spend less. That time may now be at hand. This will not only restrain the economic upturn, but will also have implications for the financial sectors. Our bond exposure has not

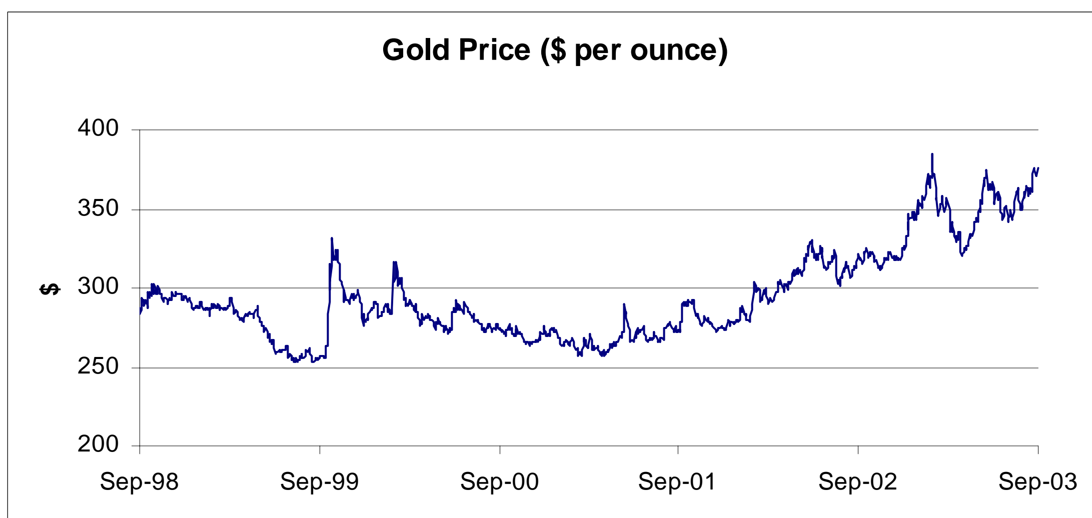
served us well in recent months as investors have wanted to play the recovery card, but we believe the recent rise in bond yields offers a buying opportunity (see our forthcoming interim report for views on the bond bubble).

It is not only the US economy that has been supported by housing equity withdrawal. In the UK, re-mortgaging is back at danger levels not witnessed since 1988 (see chart). As a result UK household debt is at an all time high. No wonder the new Governor of the Bank of England is warning of the economy's vulnerability to adverse shocks. One perceptive client recently observed that this consumer debt burden reminded him of Eurotunnel, a company that has spent most of its life refinancing, weighed down by the millstone of excessive debt. We continue to hold our longstanding negative view of the housing market (see Quarterly No.4). The number of first time buyers is flagging and sooner or later bankers will begin to worry about their mortgage books.



Bank of England, Bridgewell Securities

Does our concern over the economy and equities mean that investors cannot make money from stocks? No, but it will be more difficult. Companies with sustainable earnings will perform in the long run. This explains our bias to traditionally defensive sectors such as tobacco and utilities.



Source: Bloomberg

Given the defensive nature of the portfolio, we are pleased to see that a number of the Fund's holdings have appreciated. Mining stocks, which represent over 5% of the Fund have performed surprisingly well of late. Curiously, gold has rallied back up to over $370 an ounce, during a period of a firm stockmarket and a strengthening US dollar and we will continue to back this "insurance policy" for the portfolio.

The stocks we buy are bound to show some correlation with the equity market, but we try to invest in companies with appropriate valuations which should do well (over the medium term) irrespective of the vagaries of the market. There are three of the Fund's holdings worth highlighting. Mithras, a small investment trust with a market capitalisation of £23m, has increased by 36% over the last year. Realisations, which improved the trust's net asset value, and a subsequent tightening of the discount the shares traded on to its underlying assets (from over 40% to 25%) have been the cause. GW Pharmaceuticals shares have doubled since we bought them in August 2002. We continue to back this holding. The management has proved adept at managing investor expectations since its float two years ago. We await the ruling of the MCA, which we hope will grant the company approval to launch its cannabis based medicine, Sativex, by the year-end. Lastminute.com has performed better than we dared hope, rising 185% in the last six months. When we bought the stock last year, the company was moving from losses into profit, and by our reckoning the shares were on less than 10 times our forecast 2004 earnings. Now, having almost tripled, the market is well aware of the Lastminute story. Daytraders and momentum investors are piling in: a sell signal if ever there was one. Considering the risks, 185% is enough for us and we have banked it.

Time to jump?

The recent rally since March needs to be put into context. Our proverbial traveller emerging from a year in a tropical rainforest with no access to information would look briefly at current market levels and dismiss them with a yawn, oblivious to the agony and the ecstasy. He could have made almost the same return with his money safely in the bank. While we might be criticised for being too cautious, it now seems sensible to consider reducing our equity holdings into further strength. This bear market rally may have legs, depending on liquidity and sentiment, but we do not believe it is justified by the fundamentals. As every day goes by, staying at the party becomes more dangerous. The insiders agree; director selling on Wall Street is near all time highs.

We will continue to look for attractive investment opportunities, but in the short-term, raising liquidity might be the most prudent course.

Sebastian Lyon

Troy Asset Management Limited
8th September 2003

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