TROY ASSET MANAGEMENT LIMITED

15 ST. JAMES'S PLACE, LONDON SW1A 1NP

TEL: 020 7514 1934 - FAX: 020 7499 0357

E-MAIL: sl@taml.co.uk

TROJAN FUND

Quarterly No.8

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

Long duration assets

We remain committed to the Fund's holdings in long duration bonds and preference shares. Although we are keeping a watchful eye for any signs of inflation, shocks are more likely to come in equities (in the form of a lower than expected earnings recovery) than in bonds. If anything, inflation statistics are surprising on the downside. The Federal Reserve's favoured price index (the personal consumer expenditure deflator) rose only 0.7% in the fourth quarter of 2003, the smallest increase since 1962.

The growth in jobs - key to the US presidential election later this year - shows no sign of life and indeed, as Christopher Wood from CLSA pointed out to us recently, many Americans are now being re-employed at wage levels lower than their previous jobs. This is occurring in 48 out of 50 states and will hardly spur a consumer led recovery. Our confidence in our forecast that the Fed will not raise interest rates this year remains undiminished.

US Insider selling to buy ratio

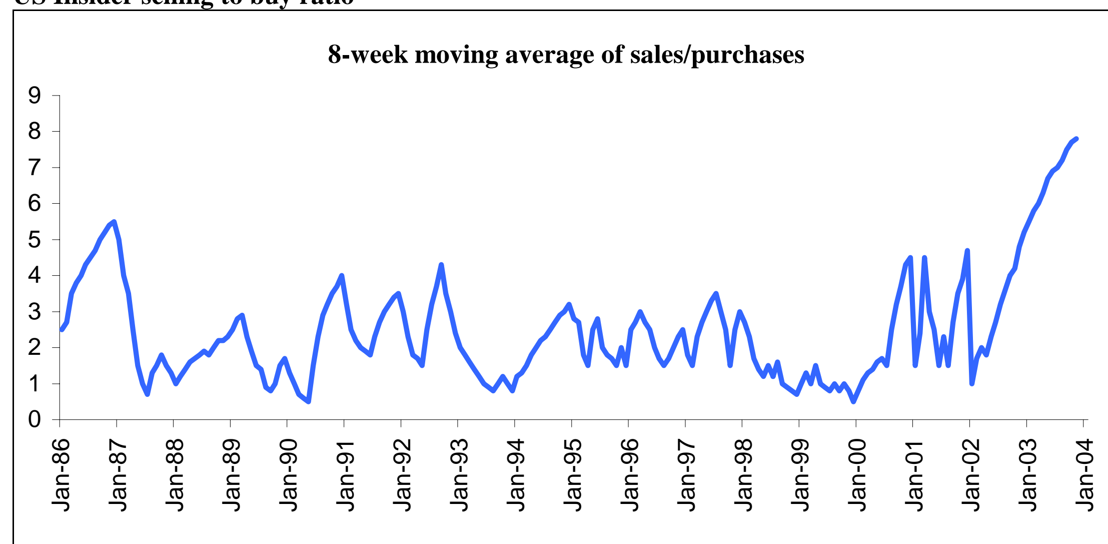

Figure 1 *Source: Independent Strategy*

Giving us the nod

Turning to equity markets, directors of US quoted companies are selling. The ratio of sales to purchases of stock is the highest it has been for 20 years, with over seven times as many sellers as buyers (*Figure 1*). UK directors agree. They sold £312.8m worth of stock in the three months to 30th November 2003. This is more than eight times the £37.6m they spent on buying shares (according to the *Financial Times).* Having missed selling out at the top of the bubble they cannot believe their luck at being given a second chance. If ever there was a strong indication of insiders' lack of belief in the sustainability of profits growth, this is it. Investors ignore such a compelling sell signal at their peril.

Nothing to buy?

The Fund had a quiet quarter. We added to our holdings in long dated German government bonds, BT and Shell Transport & Trading, which on a 4.4% yield is discounting much lower oil prices than currently prevail. Although Shell has had its difficulties with proven oil reserves, we think other oil majors may have to make similar adjustments. As contrarian investors, looking for stocks which are out of favour but have strong balance sheets – still AAA rated – and friendless, Shell fits the bill.

Following the issue of new units in recent months, and the partial sale of our holding in FTSE Futures, the Fund's liquidity is up to 17% (as at 12th March) and equity exposure has declined to below 50% for the first time in nine months. At current levels we are finding little to excite us. The daily "new low" list at the back of the *Financial Times* provides slim pickings.

S & P 500 Graham & Dodd P/E

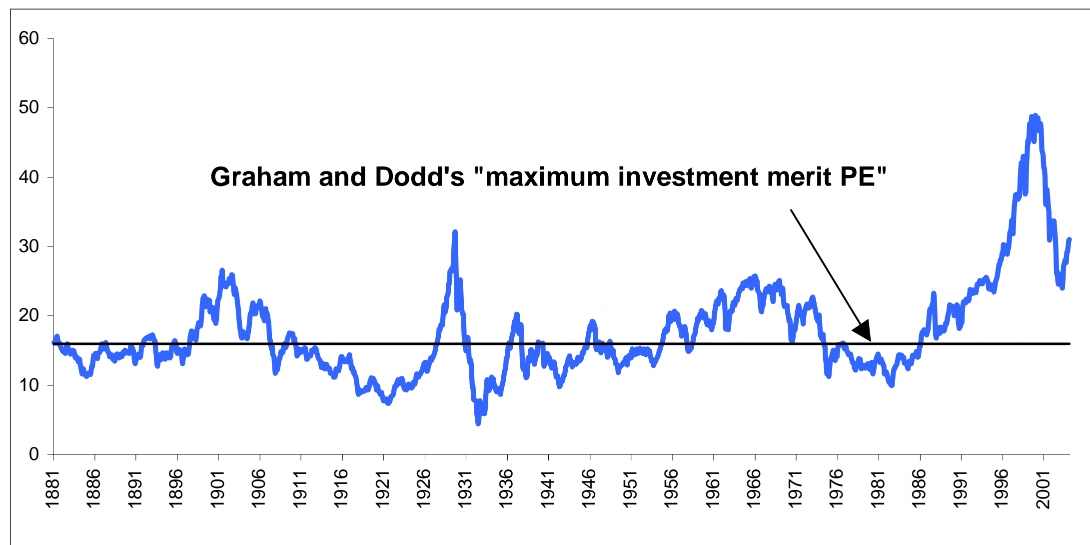

Figure 2 *Source: Dresdner Kleinwort Wasserstein*

We remain unconvinced by the equity market rally which began a year ago, and believe it will prove unsustainable. While the bullish consensus is hailing the beginning of a new bull market, we remain cautious. The belief that equity markets will rally ahead of the presidential elections has become too widely held, particularly

now that the outcome is looking less predictable. Our objective is to construct a portfolio that performs respectably in rising markets but, importantly, does not collapse when equities take a tumble. Preserving capital is more important to us than following the herd and remaining fully invested in overvalued markets, even if they do rise further in the short term.

Why are we so cautious? Shares, as an asset class, are expensive. Benjamin Graham and David Dodd in *Securities Analysis* (1934), a seminal work on investment, suggested using a 10-year rolling average of company earnings versus share prices to value the market. They declared that a price earnings multiple of about 16 times was the maximum an investor should pay for any stock *(Figure 2)*. Today, James Montier (equity strategist at Dresdner Kleinwort Wasserstein) points out that the ten-year rolling average of the US stockmarket currently stands at 31 times earnings. Using this analysis, we are nowhere near buying territory.

Furthermore the tragic events in Madrid on 11th March are a reminder that geopolitical risk has not gone away together with the additional cost it places on companies and nations. When markets are inherently expensive they tend to react negatively to such events.

Against this backdrop we will, nevertheless, continue to search for good investment opportunities on your behalf and, if markets fall (as we expect), we will reduce the Fund's liquidity.

Hedge Fund Fashion

In an environment where the most staid financial institutions are embracing hedge funds, we are often asked why Troy manages an old fashioned, long only fund rather than a hedge fund. Unitholders and potential investors correctly point out that, like us, hedge funds seek absolute returns, while virtually all other long only funds are measured relative to an index benchmark. There are a number of reasons why we do not like hedge funds, and we would not invest our own money in them. Whilst there are several excellent investors managing hedge funds who will do well for their clients, the industry has become very crowded in recent years. In particular, some traditional long only investment management companies and investment banks have entered the hedge fund arena, often in an attempt to retain their best investment professionals.

Firstly, managing a hedge fund is a different discipline to investing long only portfolios. Hedge fund managers are able to short securities with the aim of buying them back at a lower price in the future. There is no denying the profits available from shorting - fortunes have been made (as well as lost) from the collapses in Worldcom and Enron. However the unlimited liability of holding short positions (if the share price rises) differs from the long only position that has a maximum downside of 100%. Short positions are usually held for a brief period of time, more often measured in days or weeks. By holding long and short positions (and often gearing to enhance returns as well) hedge fund managers have a complicated balance sheet that needs be analysed and monitored constantly. Complex models, based on historic returns and volatility of markets, measure a hedge fund's risk. These models, however, cannot predict the future and, as risk models have become more widely

used, alarm signals tend to go off for many hedge funds at once, exacerbating market trends in both directions. In describing the collapse of Long Term Capital Management, Merton Miller, an economist and Nobel Laureate said "*In a strict sense, there wasn't any risk – if the world had behaved as it did in the past*." Although there are some hedge funds prepared to take a long-term view, many tend towards high levels of turnover in their fund's holdings. Entire portfolios may be bought and sold in a matter of days. Holdings in securities are referred to as "positions". This is a different attitude to the long-term investment approach of Troy where investments are made with a view to holding them for several years.

Secondly, hedge funds are expensive. Fees are often 1.5% to 2% per annum plus a performance related fee of between 20% and 25% on profits above a threshold which is usually the return on cash. By paying higher fees, investors are consenting to a lower starting point for investment. Investors in the Trojan Fund will be familiar with our dislike of performance related fees which, in our view, encourage managers to take incremental short-term risks.

Thirdly, hedge fund reporting systems are opaque. Unlike OEICs, unit trusts or investment trusts (which offer full disclosure of their portfolios), hedge funds often prefer to withhold up-to-date information on their investments. This makes it difficult for investors to judge how much risk is being taken. Investments are held offshore, often in places like Bermuda or the Cayman Islands, where corporate governance requirements and regulation is lighter.

Fourthly, hedge funds emphasise short-term returns while we seek to produce long-term returns. The funds often start with a small pool of assets and the ability to attract new investors depends on their monthly performance statistics. It is essential to get off to a good start. Good short-term performance leads to new money. Poor performance leads to redemptions. Hot money leaves as quickly as it arrives. The need for short-term performance inevitably leads to momentum style investing rather than making investment decisions based on fundamentals. This similarity in investment style means there is a tendency for hedge funds to have holdings in common. One experienced stockbroker told us recently of a particular stock that was held across a number of hedge funds in London. Being momentum investors they will inevitably dash for the exit at the same time.

Finally, there are a number of material tax disadvantages from investing in hedge funds for UK domiciled investors. In particular, the double hit of inheritance tax and income tax. Investors should also be aware that a large number of funds fail altogether and, consequently, the hedge fund industry's investment performance figures are flattered by the remaining survivors.

For all these reasons, Troy has no plan to run hedge funds alongside our long only funds. We like our unitholders to understand what they are invested in, and the risks we are taking on their behalf. While there are undoubtedly some excellent hedge fund managers, the growth in the number of funds over the last decade is unsustainable. There is great appeal in working for an investment boutique (we should know!) and in recent years large fund management companies have lost many talented managers to them. One sometimes feels that the launch of new hedge funds by these companies is more to do with locking in key personnel and less to do with offering clients an

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attractive investment opportunity. That such funds are now being embraced by parts of the mainstream investment management community tells us that this bubble is reaching its peak. We are sceptical of this fashion and believe that investors may be attempting to board a train that has already left the station. The law of diminishing returns is about to set in. *Caveat Emptor*.

Change of name and administrator

On the 2nd February 2004 the Fund changed its name to the Trojan Fund. On the same date it went ex-dividend by 2.824p which will be paid to unitholders on 31st March 2004. The transfer of the Fund's administration to Capita Financial has gone smoothly.

We are proud that no unitholder has paid a front-end load since launch. Troy is keen to keep our unitholders' cost of investing to a minimum. We have, therefore, removed the 5% initial charge until further notice. The Fund's single price is listed daily in the *Financial Times* Managed Funds Service under Troy Asset Management.

We now deal weekly (at noon on Thursdays) and on the last working day of the month. If you would like to participate, application forms are available from us, or from Capita Financial (Tel: 0207 556 8800).

As we said in our latest Annual report, "*Unitholders can be assured that Troy will make every effort to continue to build on the absolute returns made by the Fund to date, and remain focussed on its longer-term objectives*".

Sebastian Lyon
Troy Asset Management Limited
22nd March 2004

Trojan Fund

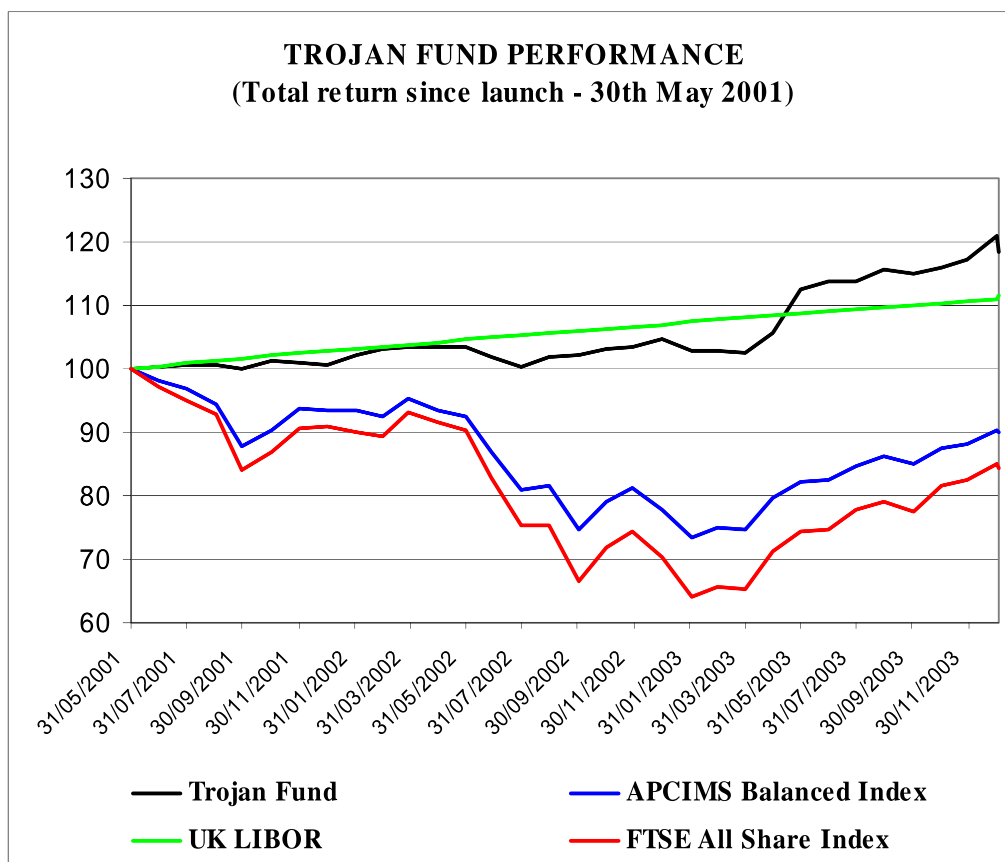
As at 31 January 2004

Unit Price **£1.13** **Fund Size** **£69.2m**

Investment Objective

The investment objective of the Fund is to achieve growth in capital and income in real terms over the longer term. The Trust's policy is to invest substantially in UK and overseas equities and fixed interest securities.

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



Performance

	Since Launch 30.05.01	1 year 31.01.03	3 months 31.10.03
Trojan Fund[1]	+18.8%	+15.5%	+2.3%
FTSE All Share Index[2]	-16.0%	+31.6%	+3.4%
APCIMS Balanced[2]	-10.4%	+22.2%	+2.7%
LIBOR	+11.4%	+3.8%	+1.0%

[1]Bid to bid, net income reinvested — Source: Lipper Hindsight
[2]Total return indices — Source: Bloomberg

Currency Exposure

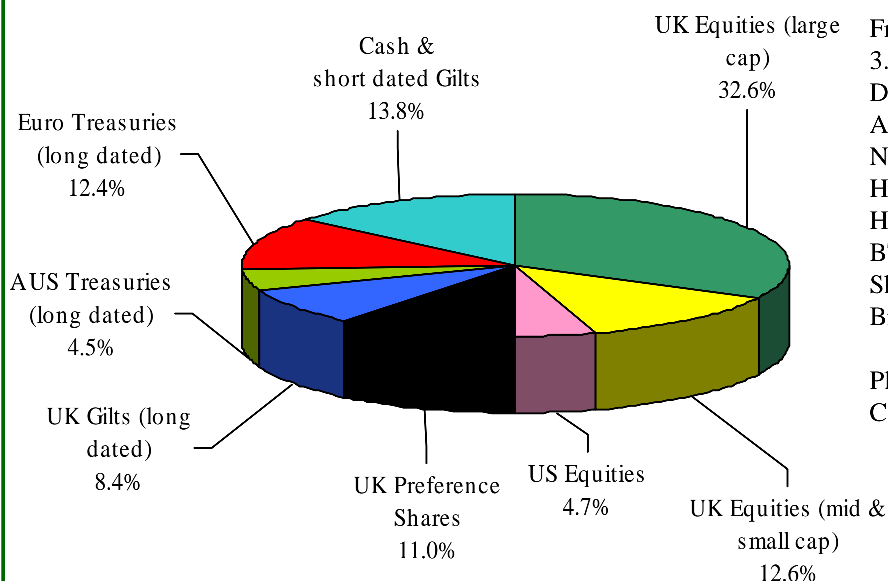
	% Fund
USD	0.6
JPY	0.0
EUR	12.4
AUD	4.5
GBP	82.5
Total	100.0

The Trojan Fund is an absolute return fund. Any comparisons against equity indices are for illustrative purposes only

Trojan Fund

As at 31 January 2004

Asset Allocation



Top 10 Holdings

	% Fund
France Gov't 5.5% 2029	6.9
3.5% War Loan	6.5
Deutsche Republic 4.75% 2028	5.5
Australia Gov't 6.25% 2015	4.5
NatWest 9% Pref	3.8
Halifax 6.125% Pref	3.7
HBOS 9.25% Pref	3.5
BT	3.2
Shell T&T	3.0
British American Tobacco	2.6
Plus 20 other holdings	43.0
Cash & Equivalent	13.8
Total	100.0

Authorised CorporateDirector (ACD)
Capita Financial Managers Ltd
4th Floor
Beaufort House
15 St Botolph Street
London EC3A 7HH

Investment Adviser
Troy Asset Management Ltd
15 St James's Place
London
SW1A 1NP
020.7514.1934

Enquiries
Capita Financial
020.7556.8800

Registrar
Capita Financial Administrators Ltd

Depository
State Street Trustees Ltd

Auditors
Ernst & Young LLP

Dealing
Weekly – Thursday at 12 noon and month end

Denominated Currency
GBP

Management Fees
Standard fee: 1%

Launch Date
30 May 2001

Dividend
Paid annually
ex date 02.02.04
Final 2.824p
payment 31.03.04

Bloomberg
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