TROY ASSET MANAGEMENT

Quarterly No.14

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

Trojan Investment Funds – proposed anti-dilution levy

At Troy, we are keen to keep investors' costs to a minimum and have made a long term commitment to have low management fees and no front end charges.

We are also conscious of the need to balance the interests of existing and new investors. This is because as the Funds grow the costs of investing new money, which include stamp duty and commissions, have until now been borne by each Fund as a whole.

When new money invested was a relatively small proportion of the Funds, this was not an issue. As the Funds have grown more rapidly over the past year we have reconsidered this and now propose to introduce an anti-dilution levy of 1% on all new investments. This will be credited directly to the Funds and ensures that existing investors will not be disadvantaged in any way by the investment of new money.

The levy will require consent from unit holders and, if approved, we plan to introduce it from the beginning of the Funds' next financial year on February 1st 2006. Until then, our existing terms will apply.

If you are interested in the Trojan Fund or the Trojan Income Fund, please contact Francesca Davies on 020 7499 4030. Investors can choose to hold either income or accumulation units.

Bulls Eye!

In an industry dominated by short term time horizons, it is always refreshing to find a commentator that places the markets within their long term perspective. Some time ago a client pointed us in the direction of John Mauldin, an investment commentator and advisor based in Arlington, Texas. His latest book, ***Bulls Eye Investing – Targeting Real Returns in a Smoke and Mirrors Market****, provided entertaining summer reading.

Mauldin puts into context the US equity market returns of the past 23 years. Much of the 18-year bull market from 1982-2000 was driven from the increase in valuations of shares and not the growth in earnings. The average price/earnings ratio in 1982 was a mere 8x and the market yielded 4%. By 2000, the market P/E had soared to 30x and the yield was just 1.1%. Over 80% of the returns came from the increase in valuation, based on falling expectations of inflation.

Mauldin reminds us that secular bull and bear market cycles have lasted between eight and twenty years as shown below in Table 1.

Table 1 – Repeating Cycles in the US Stock Market

Secular Bear Markets			**Secular Bull Markets**		
Period	Duration	Real Return	Period	Duration	Real Return
1802-1815	13	2.8%	1815-1835	20	9.6%
1835-1843	8	-1.1%	1843-1853	10	12.5%
1853-1861	8	-2.8%	1861-1881	20	11.5%
1881-1896	15	3.7%	1896-1906	10	11.5%
1906-1921	15	-1.9%	1921-1929	8	24.8%
1929-1949	20	1.2%	1949-1966	17	14.1%
1966-1982	16	-1.5%	1982-2000	18	14.8%
Overall	**95**	**0.3%**	**Overall**	**103**	**13.2%**

Source: Michael A. Alexander, John Mauldin

Since the war there have been two bull markets 1949-66 *(see Figure 1)* and 1982-2000 *(see Figure 3)* which lasted for seventeen and eighteen years respectively. In both cases, the Dow Jones Industrial Average Index rose over ten-fold – from just over 100 to 1000 in the first instance and from 1,000 to 11,000 in the second. These returns exclude dividend income. In between these two strong periods the market tracked sideways for 16 years in a broad range. Mauldin tells us that secular bear markets tend to last between eight and 17 years. His key recommendation to investors is to "*focus on absolute returns*". He says:

"The recent era of profitable buy-and-hold stock market investing, using index funds and chasing high growth large cap stocks has ended and will not come our way again for many years. Until then we need to change our investment habits and adjust with the times."

We need to remember that markets have a tendency to plunge below fair value just as they overshoot fair value on the upside. ***Bull's Eye*** is not all doom and gloom by any means. There will be plenty of ways to make money in the next few years but

**Bulls Eye Investing – Targeting Real Returns in a Smoke and Mirrors Market by John Mauldin, John Wiley & Sons Inc.*

knowing where we have come from and where we are going is essential. Understanding that the odds are stacked against you helps to ensure that you have the right approach. Since Troy was established in 2000 our central case has been that we are in a long-term disinflationary trend, which will see bond yields move lower than the market expects and force equities to be de-rated over time. Pressures will increase on corporate profitability in a low inflation/low return environment. This is likely to result in a period for stock markets similar to 1966-82. We often show the chart of the Dow during that period to prospective investors to explain our investment strategy and to indicate where we believe we are in the long run investment cycle. Of course, we may be wrong and markets could be stronger or much weaker but, like Mauldin, we think the most likely outcome is to muddle through and for valuations to fall in a glacial fashion as corporate earnings rise. This is why we believe that asset allocation will be the key to enhancing returns from stock-picking and that at times we must be prepared to reduce market exposure significantly if required. Investors will have to be patient and to have realistic expectations which focus on the need to generate consistent returns on a risk-adjusted basis. The potential for lower returns also explains why we at Troy endeavour to keep investment costs down.

Two types of bull and bear cycles

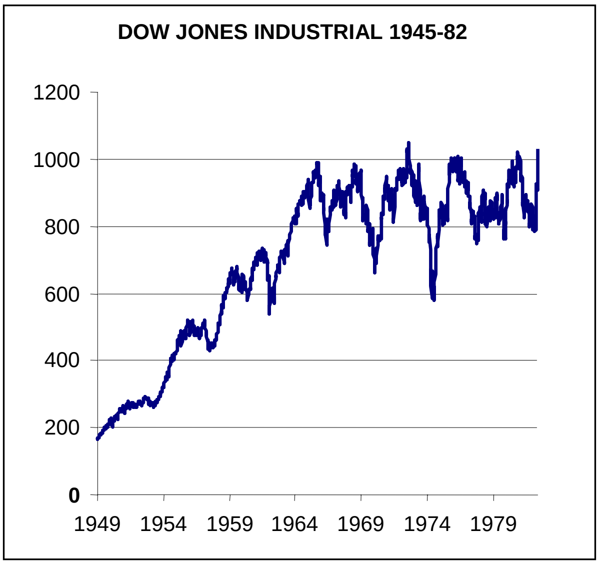

Figure. 1 *Source: Bloomberg*

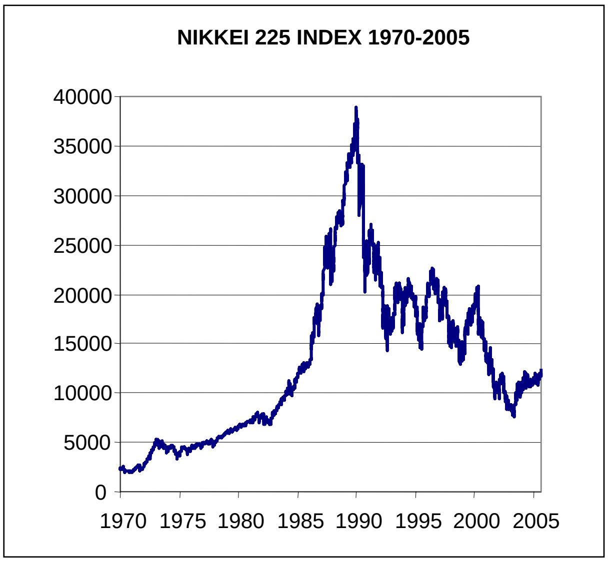

Figure. 2 *Source: Bloomberg*

Mauldin reminds us that the 1990s were the decade of financial engineering, when a Chief Executive *"could create a 10% rise in company earnings just by changing the assumptions of his company pension fund"*. Share option-linked remuneration was critical in driving earnings forward. The difference between pro forma earnings and reported earnings continued to widen as companies dismissed one-off costs that had a habit of repeating. Recent healthy changes in accounting for options and pensions have helped to redress this. Investors, who were happy to ignore the smoke and mirrors in the good times, are now rightly more sceptical after Enron and WorldCom. Options and pensions are now considered to be costs.

Some strategies will work in the investment environment that Mauldin predicts – value and income have performed well, and will continue to do so. Lower P/E stocks will do better in periods of P/E multiple compression. Momentum investing and index-tracking that did so well during the 1990s will perform poorly. The importance of returns derived from dividends must not be under-rated.

There are, of course, far more unpleasant types of bear market. The experience in Japan for the last 15 years, *(see Figure 2)* or the NASDAQ since 2000, were far more destructive - falls of 80% from peak to trough. This is not what we anticipate for the US or UK markets.

So what conclusions can we draw? We believe that we are five years into a period of adjustment for equity markets and that the US market is likely to trade in a broad range with the Dow fluctuating between about 7,500 and 11,000 (it is currently near the top end of this range). Due to the high correlation between the US and the UK markets, we would expect the UK market to behave in a similar fashion.

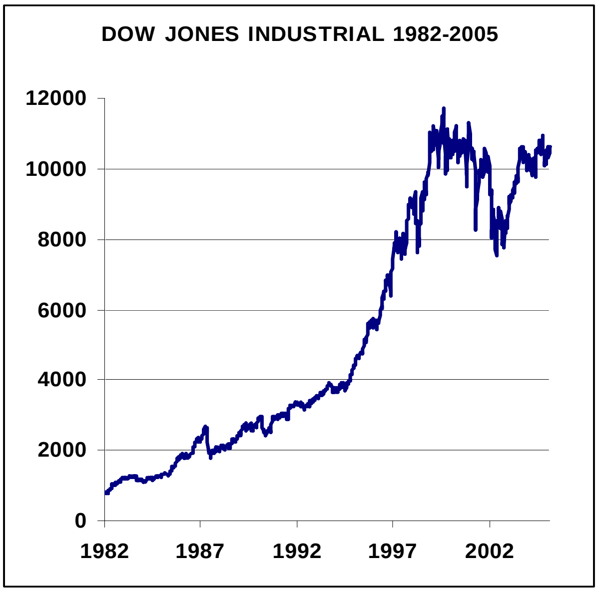

Figure. 3 *Source: Bloomberg*

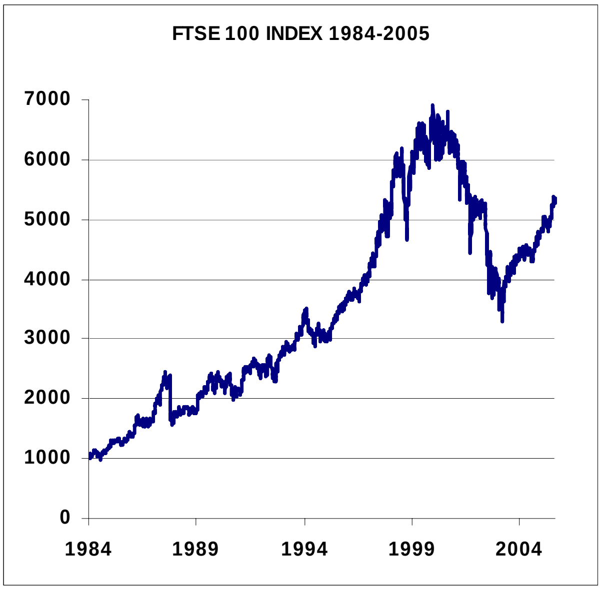

Figure. 4 *Source: Bloomberg*

Back to the Future

Market timing is notoriously difficult but it is always better to be too early than too late - however uncomfortable that might feel. Our recent experience in Tate & Lyle was a good example of this. Longstanding investors in the Trojan Fund may also recall our investments made in early 2003 into FTSE Futures contracts. These helped to raise our equity exposure ahead of the rally of 2,000 points since March 2003 when the market yielded 4% *(see Figure 4)*. Strong dividend growth since then supports nearly 40% of the rally while the remainder is accounted for by improved sentiment and investor confidence. We feel that this is enough. At the end of the quarter we sold the Fund's holdings in FTSE Futures thereby reducing the Fund's equity weighting to about 50% - its lowest for over two years. The sale realised a profit for the Fund of £2.3m.

Party on

The successful flotation of Party Gaming, an internet poker company founded only in 1997, was one of the most remarkable events of the quarter. Gaming has been one of the great internet successes and, combined with a more relaxed regulatory environment in the UK, has been reflected in strong investor demand for companies with exposure to this rapidly growing market. It can be difficult to distinguish between a secular trend and fashion but judging by the number of London cabs advertising online poker sites this is the fad of the moment.

Ironically, one of the key attractions of this issue for many investors was its sheer size, as a £4.5bn company would almost certainly move swiftly into the FTSE 100 Index and therefore automatically generate demand from index funds within months of the flotation. We find it difficult to value a business that earns its income offshore and when there are question marks over the legality of internet gaming in the US which is the company's main market. It also makes us nervous when founding shareholders take out hundreds of millions at flotation and when the three key executive directors (Chairman, Chief Executive and Finance Director) have been with the company for less than a year. Party Gaming has to replace up to 75% of their existing customers with new ones every year and is currently subject to an abnormally low tax charge which is unlikely to be sustainable. With the company now capitalised at £6.3bn the early investors have been well rewarded but the risks inherent in such a business place it outside the universe of stocks in which we are prepared to invest. Our approach, which places heavy emphasis on the assessment of downside risk, is conservative but foregoing short term returns in order to reduce the risk of permanent capital loss is a price that we are prepared to pay.

King of Beers or Boring Bud?

In contrast to Party Gaming, we wish to invest in long-established franchises that stand the test of time, preferably demonstrating large market shares and a record of strong cash generation. In July we added a new holding in Anheuser Busch, the St. Louis based brewer of Budweiser and Michelob brands. Unlike the rest of the US market, Anheuser shares were standing near a four-year low. The shares had been de-rated as earnings had progressed forwards, albeit slowly. The company had addressed market share losses and management had demonstrated robust capital discipline and prodigious cash generation by buying back 10% of the company's shares over the past three years. The valuation is at its lowest for ten years but most analysts dismiss the stock as dull.

In other words - dead money. We are prepared to wait for the catalyst so long as the risk is on the upside. This is exactly what encourages us as investors - when brokers are pounding the buy drum it is usually too late. Implicitly, there is no short term money in the shares therefore, we believe, the downside risk is limited. We do not necessarily see a catalyst in the short term but, at this price, the shares offer good long term value.

Stand clear – defibrillator in operation!

Hardened viewers of hospital dramas will be familiar with the dramatic scenes when doctors use a defibrillator to shock the patient's failing heart back into action. It is difficult not to draw a comparison with the US automobile market where Ford and GM have offered more and more attractive incentives in an increasingly desperate attempt to maintain unit sales. The extension of employee discounts to all customers on most 2005 models has been superseded by the GM announcement last month that these discounts would be extended to 2006 models. The impact of these discounted sales on profitability has prompted further downgrades by the credit agencies and Moody's have now downgraded GM to a high-risk, high yield junk rating. These incremental sales have distorted recent economic numbers in the US and to some extent disguised the continued weakening of the US consumer. We believe that this is simply deferring the inevitable slowdown, particularly given the deterioration in the savings ratio which moved into negative territory in July. The prognosis is uncertain but it seems likely that the patient's condition will deteriorate further before showing any sign of recovery.

Outlook

We are not forecasting a sharp collapse in asset prices. The more likely outcome is a long drawn out period of low growth and low returns. We have been surprised that financial markets have paid little attention to the sharp rise of the oil price. Past oil price shocks in 1973, 1979 and 1991 saw markets (and economies) run for cover. With regard to housing, the Dutch experience (mentioned in the Quarterly N°13) shows that it is not necessary to have sharp falls in house prices to slow consumption – they just need to stop rising. We believe that a similar pattern is emerging in the UK where there is evidence of falling activity in the housing market and a slowdown in the rate of mortgage equity withdrawal. In the US, housing supply is rising and transaction volumes are also slowing.

We believe that the combination of rising interest rates (in the US), higher petrol prices and a struggling housing market might finally prompt the consumer to begin to save. A resulting slowdown in 2006 may be good for bonds but less good for equities. Now is the time to keep your powder dry.

Sebastian Lyon   Francis Brooke   September 2005

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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