TROY ASSET MANAGEMENT

Quarterly No.11

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

Trojan Fund

The Trojan Fund has now produced returns of 26.8% since its launch date (May 30th 2001). The fund value is now £79m due to capital appreciation and an influx of new money in the past three months. It has achieved this return despite having the lowest monthly unit price volatility of the eighty funds in the Balanced Managed fund sector as measured by Lipper. This is a key element of our philosophy – to generate above average returns whilst taking below average levels of risk.

Trojan Income Fund

Troy launched a second Open Ended Investment Company on October 1st 2004. The Trojan Income Fund is managed by Francis Brooke. In keeping with the investment philosophy espoused by the Trojan Fund the Trojan Income Fund aims to preserve capital in real terms and to generate absolute returns without taking undue risk. By charging management fees to capital more income is available for distribution and an approximate 4% annualised yield to investors is targeted. We aim to grow the dividend year on year. The fund will be invested predominantly in UK equities but will also hold bonds, preference shares, occasional overseas equity holdings and cash when appropriate. If you are interested in the Income Fund, please contact Francesca Davies on 0207 499 4030. As with the Trojan Fund, investors can choose whether to hold either income or accumulation units.

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Breakout?

In the last Quarterly we highlighted the range-bound nature of the UK equity market over the year to mid-September. Since then the market has made a sustained upwards move, interrupted only briefly by the fallout caused by an unexpected rise in Chinese interest rates. The re-election of President Bush and his pro-business administration provided a further fillip. Bond yields have shrugged off any inflationary implications and have continued to fall back towards their March lows.

In the UK, bonds, equities and commodities have been moving in tandem in recent months in a manner which we would regard as somewhat contradictory. Strong dividend growth and free cash flow have been cited as the main supports for rising equity valuations but this is largely the product of historic cost-cutting and may not prove sustainable, particularly given the sluggish sales growth being achieved by most companies. There is little evidence to suggest that revenue growth is picking up.

The Ice Man Cometh

We recently had a meeting with Albert Edwards, strategist at Dresdner Kleinwort Wasserstein. A bear of equities and a bull of bonds since the late 1990s, Albert has espoused the contrarian view that we are in an economic ice age in which growth and inflation will remain low. Equity markets will continue to de-rate, while bond yields fall as pricing power remains subdued. According to Albert, we now live in a world of small numbers – low GDP growth, low inflation, low interest rates, low bond yields and low returns. We do not think that this is as depressing as it sounds because real returns are still achievable and may not be materially lower than long term averages.

Our view is that the late 1990s was a Pina Colada market – one could relax by the pool while the bull market did your saving for you. By contrast, we are now in the market of the polar explorer. We grind out returns. In some months we make little headway but overall we aim to make steady progress in pursuit of our objective. Welcome to the Ice Age.

US Economy – a downturn in 2005?

One of our key concerns in the United States is the overdependence on the financial sector. It now accounts for over 40% of corporate profits compared to 10% at the beginning of the 1980s. There is no better example of the extent of the consumer credit boom than the automotive sector, where Ford loses almost as much money from the sale of cars as it makes from lending money to its customers. General Motors recently announced that it is prepared to offer customers not just one car on 0% financing terms but also its replacement in three years time, as it attempts to cut a 1.2m unit inventory of unsold vehicles. Some auto finance companies can now even immobilise cars remotely if loan repayments are missed. Although this has reduced default rates substantially we think that this is a good insight into the strains present in the US consumer credit industry (see Fig. 1).

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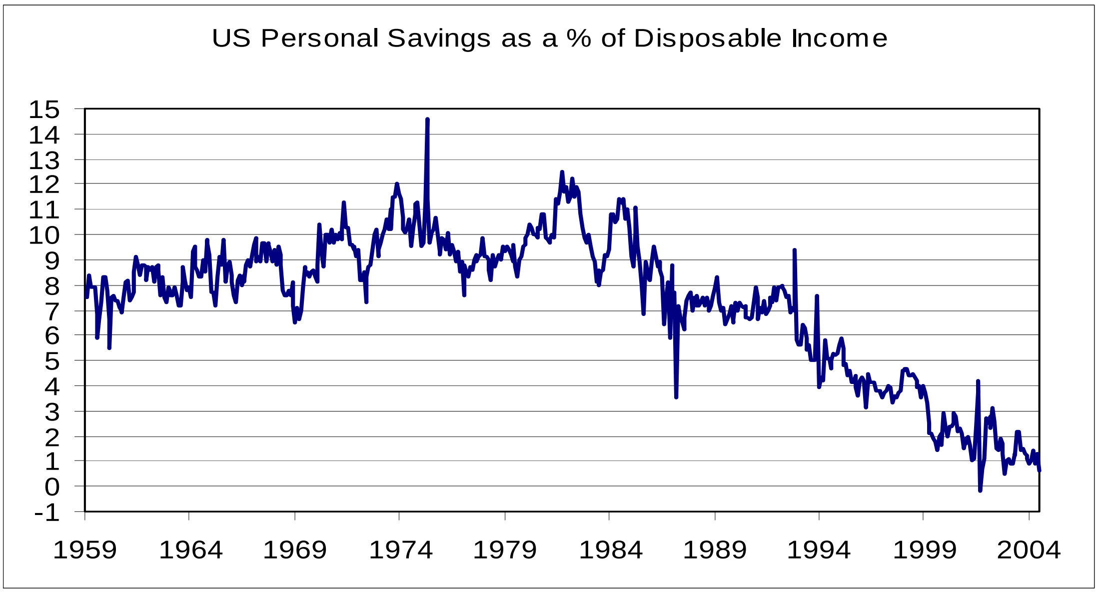

Figure 1 *Source:Bloomberg*

The chart below (see Fig. 2) shows the weakness of the recovery in bank lending in the US in the current recovery compared to 1994 when investment boomed as the economy moved out of recession. This is particularly marked given the substantial tax breaks designed to encourage investment which expire at the end of this year and without which the economy may deliver sub-trend growth in the first half of 2005.

US industrial and commercial borrowing from banks
(Now and 10 years ago, $bn – LHS 2000, RHS 1990)

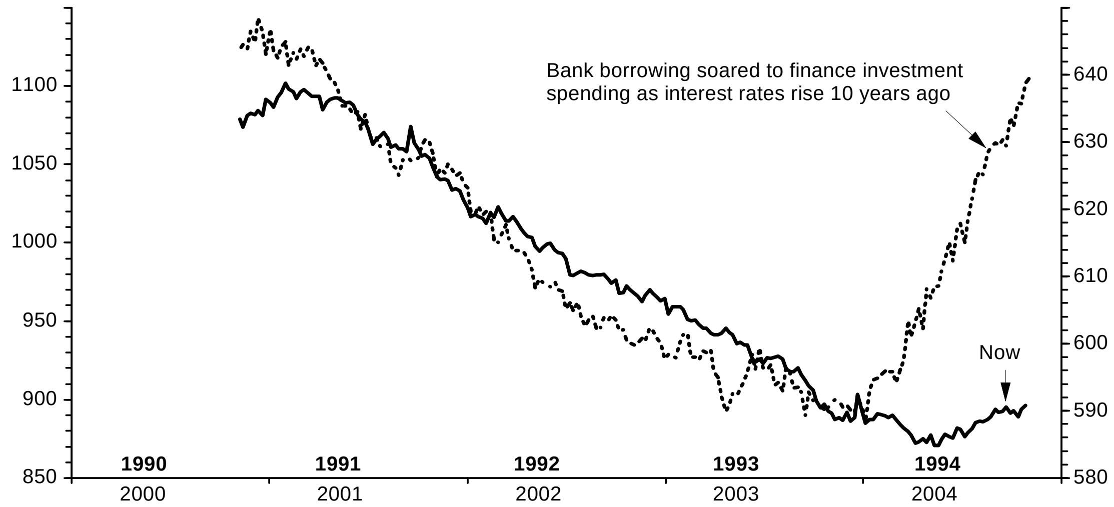

Figure 2 *Source: Thomson Financial Datastream/DKW*

New Holding

We have added a holding in Unilever to the portfolios. The shares have fallen by over 30% since mid-2002 when concerns about the lasting benefits of a major restructuring programme began to emerge. The shares now yield over 4% and stand on a significant valuation discount to other major consumer goods companies. The business generates free cash flow of approximately £1.5bn per year after dividends. This is in the context of a group capitalised at £32bn. We believe that market concerns about under-investing in advertising and promotion are overstated. Market expectations of the new chief executive are extremely low and the opportunity to surprise the market with positive news is significantly greater than the possibility of a further reduction in valuation as a result of poor trading news. Unilever also has the benefit of a balance of earnings from Euro and US dollar regions and is, therefore, less vulnerable to dollar weakness than its peers.

Dollar Hedge

All of the US equity investments in our funds are hedged back into Sterling and have been since June 2002. As a result £1.7m of gains achieved by the three US equity holdings in the Trojan Fund have been protected from the impact of the falling dollar. The Trojan Fund's US portfolio is defensive in nature, focusing on tobacco and gold and our view remains that the US market is overvalued. Ideally, we would like to hold overseas stocks and enjoy the benefit of an appreciating currency, but for the time being we expect the dollar to remain weak. For now, the hedge stays on.

Risk/Reward

In one of the meetings we had in September to market the Income Fund a potential client expressed the view that in a low return, low inflation environment investors needed to take less risk in order to achieve their primary objective of preserving the real value of their capital. This clearly resonates with our investment approach. It is particularly encouraging to note that Lipper, the performance measurement company, has calculated that not only has the Trojan Fund, within a group of eighty funds with similar objectives, produced the highest total return since launch but it has achieved this despite experiencing the lowest level of monthly volatility. (See the new risk analysis section on the Trojan Fund fact sheet).

We are also persuaded that the prevalence of short term benchmarks is continuing to amplify the swings of market sentiment – particularly after lengthy periods when the market moves out of a narrow trading range which it has occupied for some time. This makes us even more determined to pay the right price for shares even if it means that we have to hold cash at times when the market is rising. As new money comes into the funds we will, from time to time, have to accept that we will not always fully participate in short term market rises. By applying the discipline of waiting for the right moment to pay the appropriate price for individual securities we will generate the long term absolute returns that we aspire to on behalf of our investors.

Index Distortion - Can you be that sure of Shell?

Regular readers of Troy quarterlies will be well aware that we do not believe that equity portfolios constructed with close reference to a benchmark index are appropriate for private investors. This approach exposes the client to excessive market volatility and high levels of stock specific risk. Until recently the purchase of Mannesman by Vodafone in early 2000 has been the best example of institutional buying of a particular share purely on the grounds that its weighting in the index had increased as a result of a corporate transaction. In that instance most UK pension schemes ended up with over 10% of their UK equity portfolios in a single company, whose share price was to fall by over 60% in the following two years.

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The recent announcement that the Shell Transport/Royal Dutch dual structure is to be unified has thrust the issue of index concentration back to the top of the investment agenda. As a result of moving to a single listing in London the FTSE All Share Index weighting of Shell is expected to rise from 3% to over 7% next year. Despite the fact that the underlying economic interest of each shareholder will be completely unchanged, it is estimated that index and quasi-index funds will have to buy over one billion shares in order to maintain their current level of exposure. An already top-heavy index will be even more distorted with the largest five companies accounting for 35% of the total value. We believe that the stock specific risk inherent in such a benchmark is too great and it is highly unlikely that we would ever hold more than 5% of a portfolio in a single equity holding.

We hasten to add that the fundamental case to hold Shell remains intact and it continues to be our preferred integrated oil major. However, if the share price is driven up to a premium to its intrinsic value, purely by indiscriminate buying for index matching purposes, we would have no hesitation in reducing the holding.

Outlook

We remain cautious about equities given our concerns about growth prospects in 2005 – particularly in the US. The willingness of companies to return capital to shareholders, either through buybacks or higher dividends, is an implicit recognition that investment opportunities are relatively scarce in a disinflationary world.

Some strategists are now so bullish about the strength of corporate cash flow that they indulge in the hypothetical exercise of calculating how long it would take for blue chip companies to buy back all of their equity capital – apparently this would take as little as ten years in many cases. This reminds us of the overexcitement of the 1980s when an extrapolation of Nigel Lawson's budget surpluses led to speculation about the time it would take to eliminate the gilt market altogether. Within a few years, the PSBR had ballooned to record levels and gilt issuance was rampant.

It would be brave to extrapolate the current levels of dividend growth in the UK equity market on the basis of future earnings prospects and we believe that the retrenchment of earnings and dividend forecasts will be a feature of 2005. This will undermine the relief rally that has followed the re-election of President Bush. We expect this to provide a wider range of investment opportunities in 2005. We can hardly wait!

Sebastian Lyon   Francis Brooke
December 2004

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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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