TROY
ASSET MANAGEMENT

Investment Report No.22

April 2008

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

"Exit, pursued by a bear"

In December's report, titled 'Tricky Times' we said the investment environment was becoming more difficult. That has proven to be an understatement. The deterioration in the US and UK economies which we had expected, has moved to the front pages, along with sharp falls in all stock market indices. Fundamental weaknesses in the global financial system have been exposed. Not content with Northern Rock, a relatively small UK mortgage bank, the credit crisis has moved on to claim its next victim, Bear Stearns, the world's fifth largest investment bank.

The Bear Stearns collapse highlights the fragility of the system. It emerged the investment bank was thirty times geared (i.e. it had lent 30x its shareholders equity) and many of the assets on its balance sheet were illiquid mortgage backed securities that could not be valued. This sudden failure, which emerged over a matter of days, shows that, like Northern Rock, when it comes to banking, the confidence of depositors and counterparties is essential. Banking, to some extent relies on a confidence trick; if a large enough number wish to exit at once a supposedly solvent institution can still fail. Whether Northern Rock or Bear Stearns suffered a 'liquidity shortage' or were 'insolvent' is semantics. The fact is; both failed because they ran out of money. Unlike previous cycles, today the banking system is not restricted to commercial banks (like Citigroup and Royal Bank of Scotland) but to alternative providers of capital such as investment banks and hedge funds. The Federal Reserve's decision to bail out Bear Stearns shows how the game has changed.

Ben Bernanke, chairman of the Federal Reserve, has torn up the central bank rule book, not merely cutting interest rates aggressively when inflationary pressures have shown little sign of abating, but also taking on illiquid securities as collateral. To avoid Bear Stearns' collapse, the Fed extended a $29bn loan against dubious illiquid securities. Paul Volcker, erstwhile Fed chairman, said his successor had gone to 'the very edge' of his legal authority and in the process had transcended 'certain long-embedded central banking principles and practices'. We are not sure investors recognise the implications of the risks being taken by Mr Bernanke. Keeping inflation under control is clearly a low priority. Talk of the central bank keeping 'a close eye on inflation' rings as hollow as their stated 'strong dollar' policy. When interest rates are below the prevailing inflation rate and while there appears to be a readiness to print money (if perhaps not literally to drop it from helicopters) investors will only want to hold the US dollar for so long. With the Bank of England following the Fed's lead, Sterling has begun to follow the dollar's descent. The strength of the gold price, which hit an all time high of over $1,000 per troy ounce in March, has become a key indicator in the lack of confidence in central banks and the financial system they oversee.

The end of the beginning

It is hoped the rescue of Bear Stearns will mark the end of the credit squeeze that began last summer - thereby putting a floor under the stock market. There was a similar response to the resolution of Northern Rock's woes. After a sell-off of the order experienced in the first quarter, it is not at all surprising to experience a relief rally. Our concern is that the bounce is more a function of short covering (investors taking profits in stocks sold in the hope of buying back lower) than fundamental long term investment. We are sceptical and fear this is merely the end of the first chapter. The liquidity problems are one part of the problem. A long period of debt reduction lies ahead.

George Soros and the IMF have described the current turmoil as the worst financial crisis since the war. Most of the circa $350bn of bank losses announced to date have related to the now infamous US sub-prime debts. This hit compares to the recent IMF forecast for eventual losses of $1 trillion. We have seen one forecast of $1.4trn. Over the next period, as the crisis shifts from Wall Street to the real economy, losses will start appearing on prime mortgages (for residential and commercial property) and leveraged buyouts. The risk for the economy is that banks retrench and refuse to lend which will further exacerbate the problems. Stresses in the financial system remain as indicated by LIBOR, the rate banks lend to one another remains stubbornly high at 0.9% over the prevailing Bank of England rate of 5%.

The publicity surrounding the UK mortgage market is a microcosm of the issues faced by the authorities. We are now shifting from an old world where debts would never need to be repaid. The introduction of 125% mortgages in the UK and negative amortisation mortgages in the US are not just 'renting from the bank' but immediate negative equity that were predicated on ever rising property prices. Banks are reluctantly learning prudence. 125% mortgages and even 100% mortgages have disappeared. First time buyers now require a deposit and the percentage a bank is prepared of lend is falling as property prices look less certain. The result; UK mortgage lending is down 40% year on year. Two major imbalances, which have prevailed for over a decade, the vast expansion of credit and the collapse of savings in Anglo-Saxon countries are now returning to normal.

The risks of a hard landing of the kind seen in the early 1990s or possibly (with inflationary pressures rising) more like the 1970s, is rising. History may be no guide this time for over a decade consumers have spent income and what they could borrow from rising asset prices. Excessive debt levels are now unwinding and this will be a long and painful process. Investors and consumers are notoriously impatient but we feel the dash to discount a recovery is premature. In a lecture given by David Rosenberg, North American Economist at Merrill Lynch, that we attended recently he highlighted that the housing market falls in the US will evolve into a prolonged downturn in consumer spending.

Robbing Peter to pay Paul

Rights issues are back, as we forecast, with the announcement of Royal Bank of Scotland's £12bn cash call. Back in the 1980s UK banks needed to rebuild their balance sheets after incurring huge losses as Latin American countries defaulted. They went through the decade raising £3.8bn of new capital via rights issues (see Figure 1). This time it is not very different but the numbers are larger. UK Banks have been large dividend payers in recent years and if rights issues are combined with dividend cuts (as in the case of RBS) then the overall stock market dividend yield will fall. We have said in the past that dividends are vital to long term equity returns and the prospect of cuts from the highest income producing sector is not a good one. Since the launch of the Trojan Fund in 2001 the FTSE 100 Index capital return a mere 4% compared with the total return (including dividend income) of 31%. (Over the same period, the Trojan Fund capital return is 45% and a total return is 75%).

What surprised us in February was the generous dividend increases announced by banks, such as RBS and HBOS, at the time of their 2007 preliminary figures. RBS still intends to pay its final dividend for 2007, worth £2.4bn, even though it is raising £12bn. A bribe that converts capital to income.

Banks Rights Issues 1984-1991

May 84	Bank of Scotland
Aug 84	National Westminster Bank
Feb 85	Royal Bank of Scotland
Apr 85	Barclays Bank
May 85	Bank of Scotland
Jun 86	National Westminster Bank
Aug 87	Midland Bank (HSBC)
Apr 88	Barclays Bank
Oct 88	Standard Chartered
May 91	Bank of Scotland

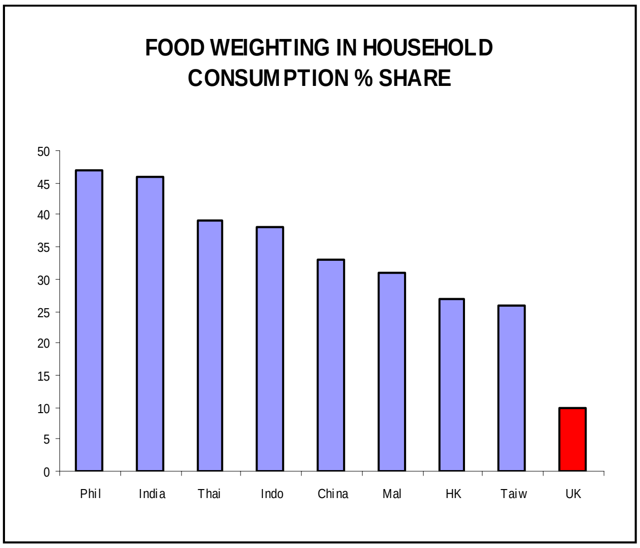
Figure 1 *Source: Company Reports and Citi Investment Research*

Plus ca change.

Coupling

The trends of rising commodity prices and falling asset prices are global not local. Those citing the odds of emerging countries decoupling need to be aware that rising commodity prices, especially food, will be more difficult to cope with there than in western economies. Inflation is rapidly accelerating in many emerging markets and is eroding real wage gains. Chinese consumers will be hit almost four times harder than their British counterparts (*See Figure 1*). Emerging market exports, particularly from China and India have provided disinflation to the OECD countries in recent years. That particular source of falling prices is fading and can only add to inflationary pressures in the West.

Figure 2 *Source: Independent Strategy*



Performance

Performance for the funds, for the year to date, has not been as we would have hoped, in absolute terms. We gain no solace from merely beating a falling stock market – investors cannot spend 'relative pounds'. It was hard to avoid paper losses in equities during the first quarter. Amid such conditions asset allocation could not be too cautious, even though we had increased liquidity levels steadily last year. While we missed the high profile disasters of 2007 in the banks, transport and property sectors, we were unable to escape the impact of the broad sell-off in January of this year. Core holdings such as BP, Royal Dutch Shell, Tesco, National Grid, GlaxoSmithKline and Sage all fell between 15% and 20% during the quarter. We are confident that all of these strong cash generative companies will be able to grow their dividends from current levels.

We have reviewed the portfolios with the aim of reducing the potential for volatility. We have also increased our own personal investments in the Funds.

Bear Necessities

Milton Friedman said that '*inflation is taxation without legislation*'. Inflation is not just bad for bonds it is also bad news for other risk assets. In the past, as investors recognised inflationary risk was rising, equity market valuations fell and dividend yields rose. The reason for the great bull market from 1982-2000 was the steady *fall* in inflation expectations. That process has been reversing since 2000. Companies able to pass on price increases, such as Johnson & Johnson, BAT and Nestle will hold their value better. This is where we will aim to concentrate the portfolios.

The outlook for markets is particularly murky. After a sharp fall in equities a relief rally was to be expected. Whether it is sustainable must be open to question. It is encouraging that investors are, for now, responding less negatively to weaker economic data and deteriorating corporate news. With so many imponderables about credit conditions, economic growth, currencies and the inflation backdrop, we believe it is too early to increase the portfolios' equity exposure aggressively. Cash drag, in the short term, is a small price to pay for greater certainty.

In contrast to the falls of 2000-2003, there are fewer places to hide for investors this time. Then bonds and value stocks offered some safety but value stocks have had a great run in recent years. Our preference for the next year will be to retain liquidity and to hold high quality large cap stocks which are not susceptible to slowing economic growth. Strong balance sheets are a must.

The temptation to bottom fish in bombed out sectors is high but there is a need for realism. We believe it is too early to start calling the turn. There are bound to be false dawns along the way. but our feeling is that we are six months into a two year journey. In a bear market, as we learned from 2001-2003, patience is rewarded.

Interestingly the UK stock market failed to surpass the all time high made seven years ago at the height of the dot com bubble. We have long suspected that the run since 2003 was a bear market rally rather than a new bull market for equities. This appears to have been confirmed in 2007 (see Figure 3). We set out our view three years ago, that we thought the stock market would trade sideways over the long term, as the US market did between 1966 and 1982 (see Figure 4). During the current phase we will need to focus on preservation of capital. On a more optimistic note, equities are not at the heady valuations of 2000. We are nearer the end of the long process of devaluation that started back then. Whisper it quietly but once we are through this difficult and volatile phase we will have reached the best time to purchase stocks since 1982. Now that is something to get excited about.

Sebastian Lyon

April 2008

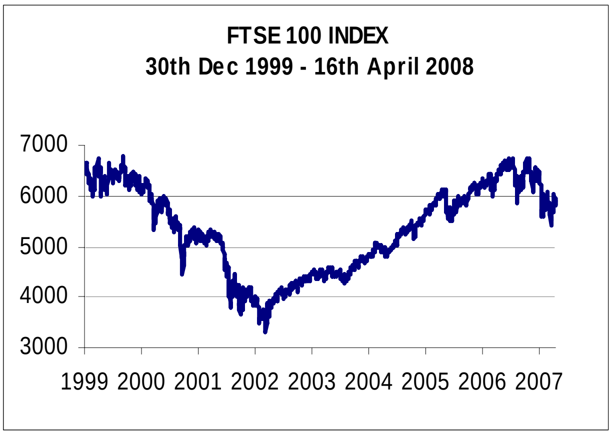


Figure 3 *Source: Bloomberg*

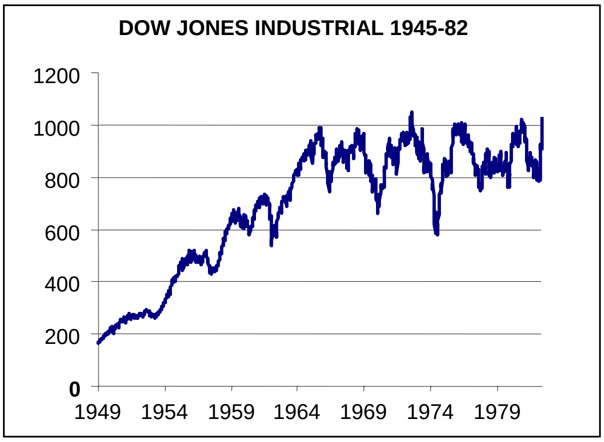


Figure 4 *Source: Bloomberg*