TROY
ASSET MANAGEMENT

Investment Report No.24

October 2008

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

Letter to investors

This report takes the form of a letter to a notional investor who has wisely kept some cash on sidelines in the last year and wishes to invest for the long term, on a three to five year view.

Dear Fellow Investor,

I have been thinking about our conversation as to when to revisit the UK stock market. Taking a market view is full of dangers but it is one of the things we are paid to do. Volatility has been unprecedented and frankly, to paraphrase Kipling, it has been hard to keep our heads when all about us have been losing theirs.

Where to start…first the good news.

Sentiment is poor

Real fear is present. In recent weeks, more people have been calling me about which bank to deposit their cash rather than whether to invest in the stock market. While it is possible these concerns could still rise, it would require a full scale run on clearing banks, a highly unlikely eventuality in our view. Post the part-nationalisation of HBOS, which was suffering from a run (although not in the public Northern Rock way) the government has implicitly guaranteed bank deposits in this country. No one has lost money in a bank or building society. Even the people who put money in Icesave accounts look like they may get their money back thanks to a mooted £3bn loan by the UK taxpayer to Iceland. We have not known private client or institutional investor confidence be this low in twenty years. This is very positive as over time fear will, once again, inevitably turn to greed.

Volatility is at an extraordinary extreme

The VIX index, which defines stock market volatility, hit a new high last week at 80 (*see Figure 1*). This is double the level the index hit at the time of the collapse of Long Term Capital Management (LTCM) in 1998, the Asian crisis in 1997 and market falls in 2002. Anyone operating in financial markets will know this from the daily gyrations we have had to deal with. Investors maps have been turned upside down and their compass is spinning. Volatility is no guide to the future but it will subside at some stage. In the meantime, it continues to indicate that fear is very high.

Vix (Volatility) Index

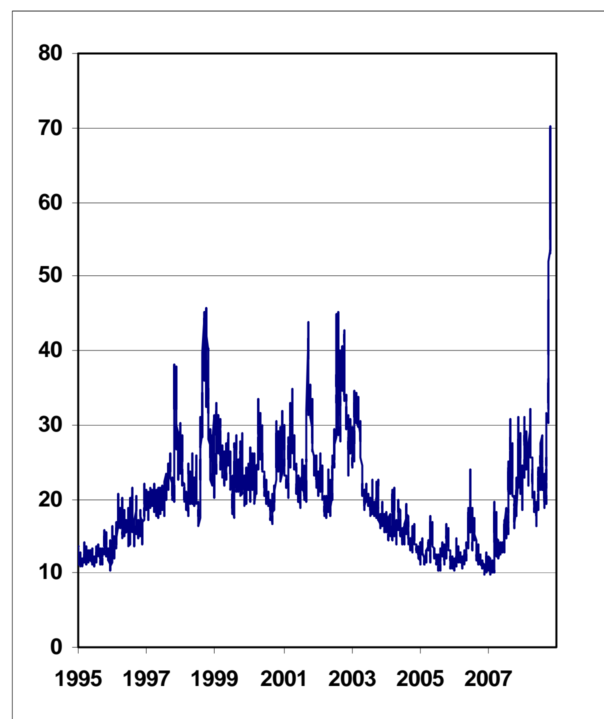

Figure 1 *Source Bloomberg*

Hedge Fund Liquidation

Hedge funds have been the major marginal buyers (and sellers) of equities in recent years.

The fall in commodities (oil, industrial and softs in particular) has blown apart the popular hedge fund trade of long commodities and short financials. The hedge fund fallout has been exacerbated by the collapse of investment banks. Bear Stearns and Lehman Brothers both provided liquidity and leverage to the industry. Hedge fund deleveraging has been savage and has led to the forced sale of assets. Mining shares are down over 70% from the highs reached in May this year. This collapse is similar to the one that ended the dot-com boom.

The demise of investment banks has effectively removed much of the borrowing capacity available to hedge funds and this leverage is not coming back any time soon. What is also emerging is that funds of hedge funds (a huge sub-sector of the industry) had been using additional leverage to enhance returns. This is not surprising. We have always said that the funds of funds' fees on top of very high hedge fund charges made returns from funds of funds unlikely to exceed cash returns in the long run. Leverage was required to enhance these pedestrian returns.

The result will be very poor performance for many hedge funds in 2008. This is likely to lead to huge redemptions as private investors and fund of funds head for the exit. Further forced selling may follow and even weaker performance. If we could short the hedge fund industry we would!

The mindless move by asset allocators to illiquid investments in recent years, such as hedge funds and private equity, all of which enhance returns through debt, is coming home to roost. Opacity, illiquidity, high charges and performance fees will become a thing of the past. In our view, this is great news for long term investor returns.

Valuation

Equity valuations are the lowest they have been for almost two decades. Yes, earnings will continue to be downgraded (see below) but even defensive earnings are cheap. The dividend yield on the UK stock market (excluding banks and assuming some other dividend cuts) is approximately 4.5%. This is traditionally a good starting point. Since Troy was founded in 2000, we always said that dividend income would provide most of the returns to investors this decade as the valuation multiple expansion of the 1980s and 1990s went into reverse. A 4.5% yield offers a good long term real return.

Now to the bad news. Major headwinds for investors remain. These are:

Economic growth forecasts are coming down

The global economy is slowing. While a financial collapse may have been averted, banks will be unable to expand lending to support economic growth. They remain undercapitalised. Earlier hopes of emerging economies, such as Russia, China, and Brazil, decoupling from western markets have been dashed in recent months.

Pain is yet to be felt in the real economy and recession is now a certainty. It is the depth and length of the slowdown that is debatable but investors would be wise to make conservative assumptions. Governments will need to increase spending and borrowing to offset falls in growth. With companies and consumers in such poor shape, tax increases are off the agenda for the time being. Over the coming years the huge shift from ever increasing levels of indebtedness towards thrift in the Anglo Saxon economies will be a further drag on economic growth.

Profit forecasts are far too high

Corporate profits are under intense pressure. We have begun to see weaker trading and some companies have warned on earnings in recent weeks. Nevertheless, the analyst community is way behind the curve. Forecasting profits growth for 2009 and 2010 when the environment during those years is likely to deteriorate looks fanciful. At some stage share prices will discount lower earnings but judging from recent reactions to profit warnings we are not there yet.

The ultimate question: Inflation or deflation?

A recession is a certainty and pretty well discounted, the question is could it be worse? Could a recession turn into a deflationary depression?

Deflation would be a disaster for equities. As asset prices fall, debt liabilities remain unchanged, leaving a diminishing value for shareholders. Inflation must be the preferred outcome in that debt is devalued by rising prices. The difference for markets is dramatic. Deflation in the 1930s (US) and 1990s (Japan) led to stock market falls of circa 70% from their peaks. Inflation is less likely to lead to such savage falls in stock markets looking at previous bear markets.

We believe the authorities in the US, led by Messrs Bernanke and Paulson, must choose inflation and reflate their economy with very low interest rates. A coordinated global approach would be preferable but the European authorities are more sceptical. International cooperation is needed if currency dislocation on a large scale is to be avoided. If the US cuts interest rates and the European Central Bank does not follow, the dollar could fall sharply. Investors may need this signal before there is a material rally for stocks. We believe it will come and have been adding to our equity holdings in recent weeks.

We may, however, be too early and there could be further downside. With risk of a policy error still high, volatility is likely to continue. This is why we are not yet moving to a fully invested position at this stage.

These are challenging and uncertain times for investors. History is only a guide and we may not have seen the bottom of this stage of the bear market that began back in 2000. Short term fallout from hedge funds' forced sales will dissipate over the next few months and may provide a great buying opportunity for long term investors. Please remember that the best time to invest is when it is the most uncomfortable. Do be aware that the Trojan Investment Funds are likely to become more volatile as we increase holdings in equities (as we have in last week or so). However, we believe it is in our investors' long term interest to begin a strategic shift within the portfolios at current market levels.

We are very grateful for your continued support.

Sebastian Lyon

October 2008

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