TROY ASSET MANAGEMENT

Quarterly No.17

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

Five years on

We are fast approaching the Trojan Fund's fifth anniversary on 30th May and in this report we discuss the changes to the investment environment over the past five years. We have also decided to update the way that we report to investors.

The first Quarterly report was written in July 2001 for investors in the Trojan Fund and in 2004 we began publishing quarterly fund fact sheets. Since then, we have launched two further Funds, the Trojan Income Fund and the Trojan Capital Fund and as each fund has somewhat different priorities and objectives, it now seems appropriate to report to investors more regularly.

From the end of May, we propose to produce monthly fact sheets for each fund including brief comments on the market background, performance and any material changes to the portfolios. This will enable each fund manager to keep the investors in their fund up to date, and moves Troy into line with its peers. We will publish a more detailed Troy investment report twice a year in February and August. This successor to the Quarterly investment report will contain our views of markets as well as information about Troy and the funds.

We very much hope that this change will keep you better informed and more up to date. We would, as always, welcome any comments from investors.

The fund fact sheets and investment reports will be sent out to our mailing list and posted on the company website. If you would prefer to receive our reports electronically then please email Francesca Davies at info@taml.co.uk.

Sebastian Lyon May 2006

Back to where we started

In February, the UK stock market reached a bit of a landmark – from our point of view at least. The FTSE 100 index, having been 5796 on 30th May 2001, when the Trojan Fund was launched, surpassed that level for the first time since June 8th 2001. For the first week following the launch the market shot up 150 points to 5950 and has only breached that level in the last few weeks (see Figure 1). Our proverbial traveller emerging from almost five years in a tropical rainforest with no access to information would look briefly at current market levels and dismiss them with a yawn, oblivious to the agony and the ecstasy experienced by others. He could have made the same return had he kept his money on deposit in the bank after dividends are included. The negligible return from UK equities compares to a capital return from the Trojan Fund of just under 40%.

Stocks have gone nowhere but in an interesting way. The reason is simple; we started at a point when valuations were high. Generally returns will be low (or negative) if you start investing when stocks are expensive. Over years markets will grow with earnings and the best returns will come from the contrarians who invest at times of distress not when risk appetites are high. The danger with high valuations is that investors pay up for future returns which may or may not materialise. It is our job to ensure that we exploit the conditions that prevail in markets and buy when future returns are undervalued rather than overvalued.

Index tracking investors in British, American, European or Japanese equities have yet to make a meaningful capital gain this decade.

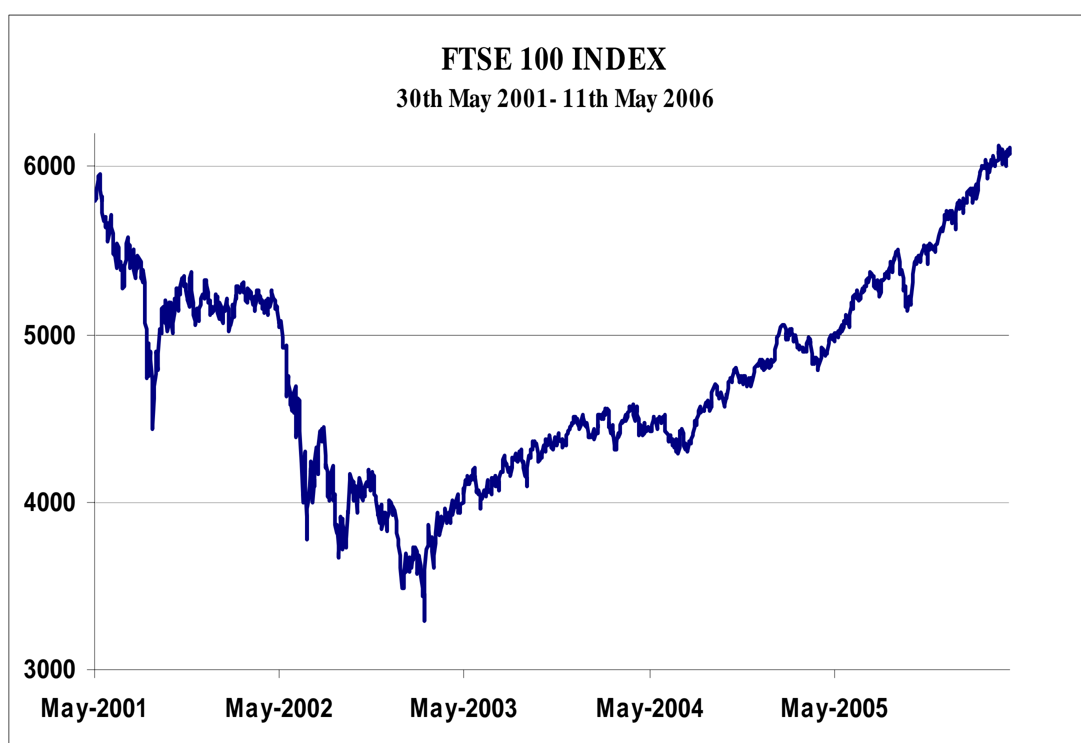

Figure 1 *Source: Bloomberg*

2001-2006

The UK equity market is, however, more attractive than it was in 2001. Then, it was on a price earnings ratio of 22 times and a dividend yield of 2.2%. Since 2001, earnings have caught up with share prices. The P/E has fallen to 14 times and the yield has risen to 2.9% - hardly a bargain by historic standards, but better value nonetheless. This explains why, for the Trojan Fund, we now have just over 50% in equities and not the 25% we started with. Nevertheless we need to bear in mind that large parts of the market's earnings are arguably at cyclical peaks. The financials and resources sectors have reported record earnings recently. A fall in profits would make overall valuations look rather less appealing. Sharp rises in earnings are usually followed by unexpected periods of below average growth; forecasts may be over optimistic, as analysts have a tendency to extrapolate these trends into the future. There are also parts of the equity market that look overstretched, especially the FTSE 250 mid-cap stocks. These shares have been buoyed by corporate activity and offer little value. A meagre dividend yield of 2.1% matches the value offered by the FTSE 100 index at its peak in December 1999.

The importance of income, revisited

It is now three years since the stock market bottomed and it seems an opportune time to reiterate our view of a low return world, which seems to be getting less fashionable by the day. The great bull markets, like 1980-2000, started from very depressed valuations. Back in 1980 the dividend yield offered by UK equities was 6.5%. It was the combination of this low starting value and earnings multiple expansion that drove high annualised returns of over 14%. In contrast, we believe that we are in the middle of a period more like 1965-1979 when much of the return from equities was derived from dividend income *(see Figure 2)*. This explains our bias towards higher yielding equities which, in our view, provide better risk adjusted returns.

Returns Composition for UK Equities

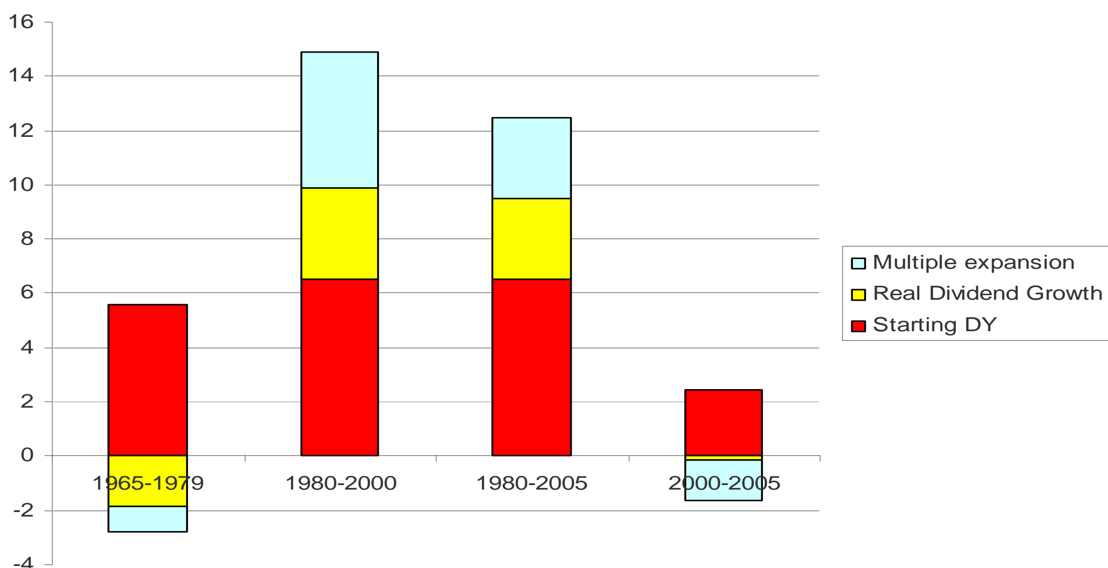

Figure 2 *Source: DKW*

Bond bear

This investment strategy does rely on a benign bond market, as higher yielding equities such as utilities tend to be priced off bond yields. Our longstanding view has been that disinflationary forces are expected to continue to affect the global economy. Over the past five years there have been two periods of doubt that this prognosis was correct; in early 2004 and today. Bond markets have been noticeably weak in recent months as there have been fears that central banks are behind the curve and that rising commodity prices will feed through to retail prices. While we would not go so far as to say deflationary forces are all pervading, if we get an inflationary scare leading to higher bond yields, the result will be deflationary as highly indebted consumers retrench. It is notable that the Trojan Fund's better periods of performance were in 2001, 2002, late 2004 and early 2005 *(see Figure 3)*. These were periods when bonds were performing well. When risk appetites were high we tended to tread water.

Excess of year on year return of world equities over bonds

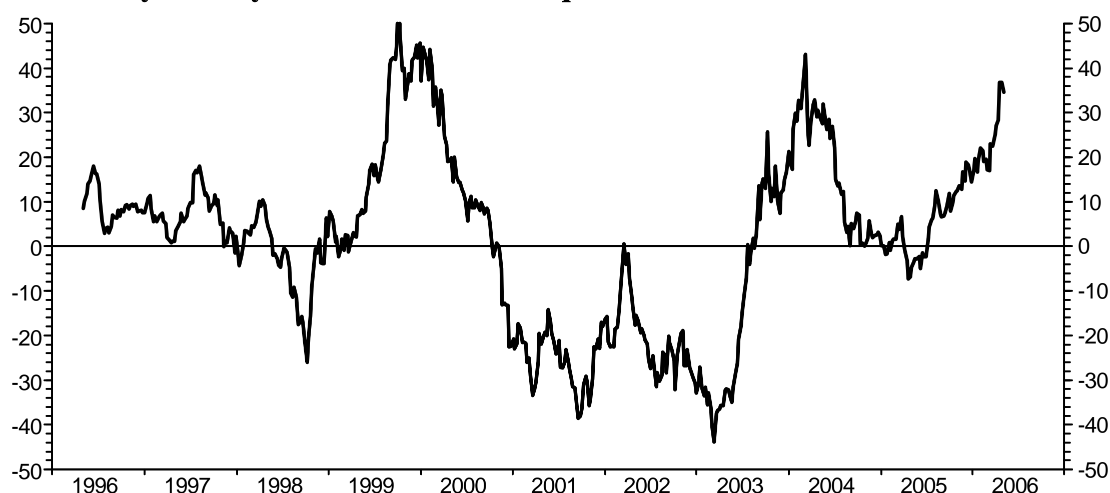

Figure 3 *Sources: Thomson Financial Datastream & DKW*

Most recently investors have favoured higher risk shares on lower yields and as a result markets have been less kind to us. Quality and value have not been popular for the last six months in fact, the lower the quality the better the performance. In the words of James Montier of Dresdner Kleinwort Wasserstein, there has been a "dash for trash". Quality now offers good value. In the last quarter we have been adding to our blue chip investments including Tesco and Daily Mail & General Trust – boring perhaps, but sound, well managed, cash generative businesses.

Why worry?

A strategist at a large US investment bank was recently quoted as saying "there is nothing to be bearish about". Comments like that, three years into an equity market rally, make us worry. We have been doing more worrying than usual on our investors' behalf lately but we look forward to the challenges of the next few years and expect them to be no less exciting than the previous five years.

Sebastian Lyon May 2006

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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