TROY
ASSET MANAGEMENT

Investment Report No.25

February 2009

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

Phew!

2008 is not a year investors will recall fondly and like many, we are not sad to see the back of it. It was a traumatic year and the word '*unprecedented*' has been used so frequently to describe events that it has begun to lose its relevance. Survival was the order of the day but we made it.

How have we done?

After such a challenging year in markets we thought that a brief summary of fund performance would be of interest.

Since 2001, each year, the Trojan Fund has produced positive annual returns for investors. In December, the fund succeeded in breaking into positive territory for 2008, producing a return of +1.1% in a year when the FTSE All Share index return was -29.9%. We admit this hardly calls for a celebration. Despite good relative performance, scraping an absolute return is no great shakes.

The Trojan Income Fund returned -12.1% in 2008. This placed the Fund at the top of its highly competitive peer group, the IMA UK Equity Income sector, over one and two years.

The Trojan Capital Fund finished 2008 strongly. After a tricky time in late 2007, the Fund has recovered its poise. The Fund return was -11.3% in 2008.

To demonstrate that we target low risk as well as respectable returns, both the Trojan Fund and the Trojan Income Fund are both the least volatile funds in their peer groups since launch. This puts paid to the fallacy that good long term returns require a high degree of risk.

Short term performance should always be viewed with scepticism. Investors should draw no conclusions from a year's numbers. In a marathon, a few hundred yards are immaterial. We always suggest performance should be measured on a three to five year rolling basis and would highlight the long term track record.

Our priority is to view our performance in isolation, and not to compare ourselves on a regular basis with our peers. The reason for this is that, in our view, managers who compare regularly with their competitors have a tendency to steer portfolios closely to their benchmark. Such an approach can only lead to (at best) average returns. However for your interest, we have given the peer group rankings for Troy's three public funds at the back of this report.

That was the year that was

The mistake investors often make is that what goes down must go back whence it came. After 2007, the consensus believed or hoped that Northern Rock marked the bottom of the banking crisis in the UK rather than being the canary in the mine. One of the reasons that we succeeded in losing less than others in 2008 was by avoiding most financial sectors, especially banks and life assurance stocks. Another area of carnage was the resources sector. While we sold down our exposure to mining far too early, the portfolios avoided the devastation wreaked by the collapse of the formerly high flying industrial commodities sector.

We made our fair share of mistakes too. We were late into diversifying into overseas currencies and gold failed to shine for a long

time in an environment of financial dislocation which should have suited it. In stocks, we held on too long to a number of holdings, the biggest sinner being BT. More often than not our patience and low turnover are a benefit, but not in this case.

One club golfers

A differentiating feature for Troy is that we are prepared to asset allocate. 2008 was a 'top down' year and pure stock pickers, who underestimated the economic forces unleashed by the credit crunch, paid a heavy price. Strategic knowledge of asset classes, markets and currencies was essential to steer through the choppy waters. We value our ability to hold cash (or other assets like bonds, index-linked and gold, where appropriate) at times when stock markets appear overvalued. This ability to make a broad selection of investments has saved investors from greater pain over the past year.

The suggested model for private clients of selecting fully invested equity funds remains the default option. This cost investors dearly in 2008. Most fund managers are obliged to be fully invested – to us, this is like managing portfolios with one hand tied behind your back.

To avoid the asset allocation issue, many marketing led fund management companies like to hide behind market timing data, citing the risks of being out of the market. By way of an example, the annualised return from the UK stock market over the past 15 years* is +7% (including dividend income). If you forego the 20 largest rising days then the return falls to +1%, but if you missed the best 40 days you would have received a lousy -3% per annum (in other words you would have lost more than a third of your money over 15 years!). These mathematics assume that the investor is a total idiot and invests at the worst possible time but let's turn the logic on its head and suppose you evade the worst 20 days over the same period. Your return rises to 13% and by avoiding the worst 40 days an investor would have achieved a mouth watering 18% per annum.

Of course both sides of this analysis are utter nonsense. No one could miss such days so exactly. Market timing may be correctly derided and we recognise that trying to pick the tops and bottoms of markets is a mug's game. Good stock market investors know there is no gain without some pain but considering the range of those returns above, a gradual exit at very high valuations and steadily buying at low valuations, as we have been doing in recent months, makes sense.

As we prepare for a more favourable environment for stocks, asset allocation may become less important to returns going forward but having the ability to asset allocate in our armoury has added material value in years like 2001, 2002 and 2008 and we will exploit it again.

* *Figures for FTSE All Share index, total returns to 30th September 2008. Source: MF Global*

Reap what you sow

Last year, once again, our industry has disappointed, providing a huge disservice to investors. The asset gathering model of investment management companies does not do clients seeking good long term performance any favours. So often new funds are heavily sold at the wrong stage in the cycle inevitably leading to disillusionment. In 2000 it was technology funds, this time around it was property, commodities and funds of hedge funds.

We would like to grow our business but never at the expense of our existing investors. Troy has gone out of its way to avoid 'hot money', always believing our simple, low charging structure would be the way forward. Instead, the industry chose to go in the opposite direction of high charges and performance fees combined with opacity and lack of liquidity. Fees matter. As John Kay of the

Financial Times points out, if Warren Buffett had charged a typical hedge fund fee of 2% and 20% on the gains on his own holding in Berkshire Hathaway, the investment management company would have received $57bn in fees, leaving a mere $5bn in gains for the Buffett Foundation. *"The cumulative effect of 'two and twenty' over 42 years is so large that the earnings of the investment manager completely overshadow the earnings of the investor".* We have always tried to align our interests with our investors and will continue to do so.

In 2008, the merits of strong balance sheets came to the fore. Although fund managers do not hold their clients' assets these days, it is important that your manager has robust finances. As you would expect from a company founded on Weinstock principles, Troy has no debt and holds enough cash to cover our annual fixed costs, exceeding all regulatory requirements comfortably. This may seem overly prudent but it means that it is a part of our business that we do not have to be concerned about, leaving us to worry about what really matters — your investments.

Cash is no longer king

UK interest rates began 2008 at 5.5% and ended the year at 2% (the Bank of England has since cut to 1.5%). Looking to the example set by the United States, the trajectory is pointing to a zero interest rate policy.

Slashing interest rates, in an increasingly desperate attempt to stimulate an economic recovery, is having a devastating impact on savers. The prudent, reliant on bank interest to supplement their income, are being punished while the reckless are bailed out and failures rewarded. Government intervention is seen as the only solution but socialism by the back door is no cure to the disease.

High debt levels are crippling and there are two paths to take. Deflation and depression or reflate the debt away via the anaesthesia of inflation. The latter road has been taken (at least here and in the US) as the least painful remedy to the economy's problems. The devaluation of currencies and the inflation that results is merely the cynical redistribution from savers to spenders. Gordon Brown's growth model is to throw money at the problem - money that he doesn't have. The world of 'sound money' has evaporated and with it the value of sterling.

The result is, for the first time in many years, cash is a less attractive asset class. Similarly, government bonds that once provided a risk-free return have become return-free risk by offering a negative real return and the potential for capital losses - should prices fall and yields rise - as we suspect they will.

Real assets, including equities, index-linked and gold have become more appealing by default, which explains our material asset allocation shift since October and November last year. While others piled into short-dated gilts in fear of bank defaults, we sold our UK bonds in favour of stocks. Our risk appetite has not changed but valuations have. We are being paid to own selective equities.

A Swedish model

There are no certainties. These are extraordinary times and the outlook is as cloudy as ever. We will continue to avoid parts of the stock market, especially banks where we fear a number are insolvent. Royal Bank of Scotland is likely to be the next bank to be taken under public ownership but the reluctance by the government to bite the bullet is holding back a potential market rally. The template for the US and UK governments should be the 'Swedish model', as advocated by Christopher Wood of CLSA.

Back in the early 1990s weak banks in Sweden were nationalised. Bad debts were recognised

quickly, thereby aligning the interests of banks and taxpayers. The deferral of the recognition of bad assets in this country will only lead to a delay in asset prices finding a floor. The consensus view is that any stock market rally will be led by industrials, retailers and financials on the simple premise that what goes down the most will go up the most. We disagree. The global economy will be dire for the next year or so. A simultaneous recession in the UK, US, Europe and Japan has never happened before.

China, with its heavy skew to exports, is proving much weaker than expected. The 'decoupling' story of 2008 is well and truly over. It is, therefore, far too early to buy for recovery. High quality, cash generative large cap stocks, with international earnings and strong balance sheets are much more likely to lead the way in our view - we favour secure income over speculation.

Time to stop being bearish

At Troy, we have been criticised in the past for being too cautious or even being '*permabears*' but we have said before that we could not wait to be more positive on stocks. Permabears have an ingrained fear and loathing of the stock market. By contrast, we are primarily equity investors and we believe in buying stocks for the long run - but only at the right price. The secular bear market that began in 2000 is nearer its end than its beginning while valuations are the lowest since the 1980s. This is why, having bided our time, we are now becoming slightly more optimistic.

We are, as always, very grateful for your continued support.

Sebastian Lyon

February 2009

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TROJAN INVESTMENT FUNDS TRACK RECORD

Trojan Fund
* IMA Balanced Managed Sector

	Rank*	Decile	Total Return (%)	FTSE All Share (%)
6 months	2/145	1	+9.1	-21.1
1 year	4/136	1	+1.1	-29.9
2 years	6/122	1	+7.3	-26.2
3 years	4/112	1	+20.1	-13.8
4 years	6/99	1	+39.1	+5.1
5 years	7/94	1	+53.4	+18.7
6 years	7/81	1	+77.1	+43.4
7 years	2/73	1	+84.3	+10.9
Since launch	2/71	1	+85.4	+0.8

Source: Lipper Hindsight

Trojan Income Fund
* IMA UK Equity Income Sector

	Rank*	Decile	Total Return (%)	FTSE All Share (%)
6 months	1/91	1	-0.9	-21.1
1 year	1/91	1	-12.1	-29.9
2 years	1/87	1	-7.8	-26.2
3 years	4/81	1	+7.7	-13.8
4 years	4/78	1	+20.3	+5.1
Since launch	8/74	2	+24.8	+12.2

Source: Lipper Hindsight

Trojan Capital Fund
* IMA Active Managed Sector

	Rank*	Decile	Total Return (%)	FTSE All Share (%)
6 months	4/118	1	-3.6	-21.1
1 year	5/110	1	-11.3	-29.9
2 years	26/95	3	-15.3	-26.2
Since launch	4/90	1	+1.8	-18.7

Source: Lipper Hindsight

Figures as at 31 December 2008