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AS Troy Fund

Quarterly Report No. 4

The aim of the Fund is to protect investors' capital and to increase the value of the Fund year on year.

Seasonality for volatility

The excitement in equity markets that followed the falls in June and July was the type most fund managers could do without. The bear market trend reasserted itself. Those seduced by August's rally (with seasonally low volumes) faced an unexpected lurch down in September as the market retested the July lows before undergoing a sharp rally in October. We do not usually analyse our monthly performance in any detail as we believe that quarterly, and even annual statistics, should be taken with a pinch of salt. Nevertheless the recent figures have interested us because they demonstrate what we are attempting to achieve.

	Aug 2002	Sept 2002	Oct 2002	Quarter
AS Troy Fund	+1.6%	+0.3%	+0.7%	+2.6%
FTSE All Share Index	+0.4%	-11.8%	+7.8%	-4.6%
APCIMS Balanced Index	+0.9%	-8.6%	+5.8%	-2.4%

(All figures are total returns – Source: Bloomberg)

While it is disappointing that the Fund did not enjoy the rally, this was due to a decline in the value of the bond content and the defensive positioning of our equities. We were nonetheless pleased to see that, in a volatile period, the Fund produced positive returns in each month. This demonstrates a lack of correlation with equity markets, but, as Troy is aiming for absolute returns, it is a pleasing result. (Unitholders should note that the portfolio might underperform in a strong equity bull market.) The Fund's longer-term returns are on the fact sheet attached.

A counter trend rally

In a bear market, while the underlying trend is downward, rallies come hard, fast and when they are least expected. Blink and you miss them. October was no exception to this rule. The FTSE 100 index fell to a closing low of 3777 on 10th October. The following day the market rose by 176 points (4.7%). This was the largest one-day increase since the day John Major was surprisingly re-elected into power in April

1992. Then the markets rallied for a tangible reason, but in mid-October there was no defining piece of corporate, economic or political news to drive markets sharply higher. In fact the fundamentals continued to deteriorate. It took a short two further trading days to rally to 4130, a rise of 9.3% from the closing low. Currently, the market is just below 4150.

For now, this rally may have further to go. A quirk of the fund management industry is its obsession with using indices as benchmarks. Defensively positioned investors, fearing that the short covering of those few days in October might lead to wholesale institutional buying, remain concerned that they might miss a further rally. With many portfolios having declined over 20% year-to-date, the last thing managers wish to risk is missing out on the chance to make up a further five or ten per cent. The recent charge into Vodafone on better than expected interims proves the point. It is hard to resist the urge to jump on the bandwagon.

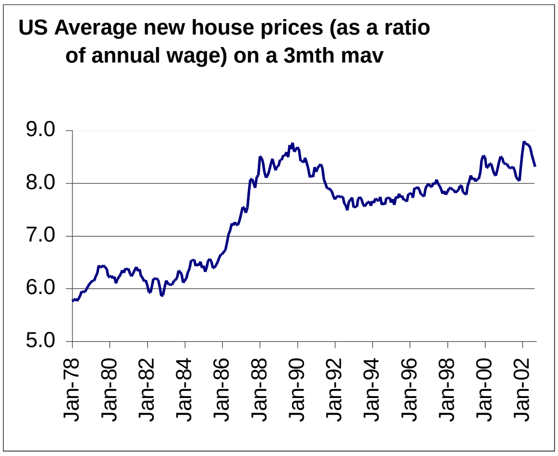
Double dip?

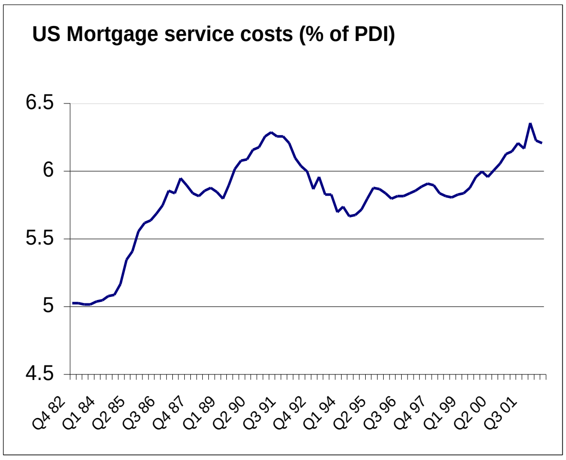
The United States economy has recorded the most muted recovery since the war. In the third quarter, US GDP rose 3.1%. Of this figure, 2.95% (95%) came from personal consumption expenditure. The consumer bailout, the key prop to the economy since the collapse of corporate investment, has lasted longer than we expected, but there is mounting evidence that this support is flagging. The latest Conference Board's Consumer Confidence figures showed a collapse from 94.7 in September to 79.4 in October, the lowest reading since 1993. There are signs US consumers have at last had enough of the anaesthetic administered to them, in the form of lower interest rates and tax cuts, to keep them spending. The savings ratio, which fell from 8.9% in 1992 to 0.3% a year ago, has now climbed to 4.8%. This will drain the economy of its largest prop. With unemployment rising, savings could increase sharply, leading to weak consumption as consumers rebuild their balance sheets.

In the UK, the economic prognosis has remained remarkably resilient. Again, like in the US, it has been the strength of consumer spending that has kept the economy from dipping into recession. On both sides of the Atlantic the detrimental effect on household wealth from the fall in share prices has been more than offset by another asset class: property.

An Englishman's home …

A common misconception is that, as Americans buy stocks, so the British buy houses. On Main Street, real estate is more important in determining a consumer's balance sheet. US residential property prices have risen strongly since 2000 and have more than compensated for the damage to wealth inflicted by stockmarket falls. Average house prices, as a percentage of the average wage (a crude P/E type measure), are back to their 1989 peak, while mortgage service debt costs as a percentage of personal disposable income have reached remarkably high levels considering interest rates are at a 40 year low (see charts).





Source: Datastream, Independent Strategy

In the UK, in the year to October 2002, house prices rose by 30.6% (Source: Halifax), which is higher than any annual return from equities for the last ten years. In addition equity withdrawal from property has climbed to 5.9% of post tax income, its highest level since 1988. Last year's interest rate cut to 4% now looks to have been misjudged, exacerbating the economic imbalances which already existed.

When it comes to borrowings, whether credit card debt or the longer-term liability of mortgages, the public are taking time to recognise that in a low inflationary environment debt levels stay stubbornly high. In the words of the Deputy Governor of the Bank of England, Mervyn King, although the servicing costs may be low "the dead weight of the debt hangs around for much longer". With no inflation to erode the liability, repayment is back-end loaded and will increasingly look daunting.

The combination of falling property prices, a reduction in mortgage equity withdrawal and rising savings ratios (and higher taxes in the UK) will remove the critical support the consumer has provided to both US and UK economies. Falling interest rates can no longer save the day.

Big cap blues

The unwinding of the excesses of the 18 year bull market continues and nowhere is this more evident than in the case of big cap stocks. While most commentators focus on the dot com bubble, this was merely the final climax.

Ideally we would prefer to have a portfolio full of high quality "blue chip" names but we have largely avoided them to date. As at 31st October, the Fund had a higher proportion invested in small and mid cap stocks (15.3%) than FTSE 100 companies (14.5%). This may be extreme by industry standards but it conveys where we see value. The large cap stocks, selected to provide the portfolio with some ballast, such as Glaxo SmithKline and B.P, have done us few favours. In general large cap stocks offer high valuations and low growth. Troy is looking for the opposite. Many large cap stocks are the product of the M&A boom of the late 1990's; Royal Bank of Scotland, Lloyds TSB, Glaxo SmithKline, AstraZeneca, and Diageo to name but a few. They are the result of mergers that were based on short-term synergy benefits.

Now those financial improvements have been made growth is limited and these huge organisations are patently less easy to manage. Consequently, the UK equity market is very top heavy. The largest five constituents of the FTSE All Share index (BP, Vodafone, Glaxo, HSBC and Royal Bank) account for 31% of the market. As few as 14 stocks represent over 50% of the market. The Fund holds four of them. Many UK investment managers own them all.

Asset allocation? It's stocks that count

Asset allocation has played a vital part in achieving the Fund's performance to date. It has been critical to get the big picture right. However, in future, as we become more optimistic about the valuations and the opportunities in the equity market, stock selection will take on a more important role in adding value. Three of the Fund's holdings have been bid for this year. During the quarter Tesco launched an agreed offer for T&S Stores. Not wishing to retain the Tesco shares offered in lieu for T&S, and with the risk of a drawn out referral to the Office of Fair Trading, we decided to sell the shares at a 27% premium to the Fund's cost price. We are pleased to be able to report that stock selection skills contributed to the Fund's performance in such a dire market.

In a disinflationary environment Troy needs to invest in companies which are profitably gaining market share. One thing is certain, discount stores, low cost airlines and internet shopping are here to stay. Unitholders may be surprised, or even shocked to hear, that we have made a small investment in Lastminute.com. At below £1 the shares were a long way shy of their issue price of 380p in March 2000. Since then, with their bountiful resources derived from the float, management have fully established the UK business and rationalised the online travel industry across Europe. Lastminute is now the clear market leader in the UK, France, Germany, and Italy. The business is a simple one. The website puts sellers of perishable services such as hotel rooms, flights, city breaks, and restaurants in touch with the mass market of their millions of registered users. With high, but stable, fixed costs of about £50m (including depreciation) and on a 12% margin, once revenues exceed £420m, profits and cash start to flow. The company is expected to make its first profit in the current financial year to September 2003. At our purchase price of 95p the shares are on sub 10 times earnings for the following year. 2% of travel bookings are made online in Europe, compared to 14% in the US. Lastminute will be one of the major beneficiaries of this trend. In 2000 the stock was priced for success. Two and a half years later with the price down by 75%, and with £50m cash on the balance sheet, the risks are lower and the rewards higher.

Rutland Trust, the Fund's second new holding, could not be a greater contrast. The company is an investment trust specialising in private equity investments at the distressed end of the market. There are currently plenty of investment opportunities for Rutland's managers but this is not priced into the shares. Following a meeting with management we were satisfied that the stated net asset value of 44p per share (of which 29p per share is in cash) was conservative. There is little downside on the Fund's purchase at 28½p.

During the quarter the Fund increased its investment in GW Pharmaceuticals - another failed new issue. GW, a biotech company, is the type of investment one would usually steer well clear of but it is interesting for the following reasons. First it is years ahead of its competition in developing a drug derived from the cannabis plant. Second, and unusually for a quoted UK biotech company, the group has recently announced successful phase three clinical trials data which demonstrated the drug to be efficacious and safe. GW now plans to launch a drug in the UK for MS patients in late 2003/early 2004. Finally, GW has the full backing of the Home Office and the Department of Health. There is little in the price for the MS treatment let alone the potential for relieving neuropathic pain and the potential to sell the company's products in overseas markets. The stock was too rich for the Fund when it came to the market in the summer of 2001 at 182p. We bought stock at 124p in February and a larger amount in a placing in August at 109p.

These three investments demonstrate the diversity and flexibility of our investment approach: ***value*** in its different guises. All three have one quality in common: no debt.

The future is not what it was

The fund has retained high levels of liquidity in cash and bonds. Valuations, in general, still look too high to warrant the start of the next bull market and earnings growth is too low. We have waited patiently for the mouth-watering investment opportunities presented by a spectacular sell off. Over the year the Fund's equity exposure has doubled to 30%. Next year the aim is to double this weighting again, but there is no rush. Heading into the New Year, news about Iraq will dominate market sentiment. Any sign that war has been averted will lead to a relief rally but will such a rally be sustained? The focus will soon return to the real enemy: deflation. Last year we posed the question - After two years of consecutive negative returns for equities, could there be a third? The answer: Conceivably. A fourth? Possibly. The stronger the year-end rally, the greater the odds of one. However, if there is a fourth, this will provide long-term investment opportunities for the Fund.

Capital preservation in bear markets is the key to long-term investment performance.

Sebastian Lyon
21st November 2002