TROY ASSET MANAGEMENT

Quarterly No.13

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

Trojan Fund – Four Years On

Since the Trojan Fund's launch four years ago (30th May 2001), the Fund has produced a total return of 39.7%. This compares to 18.0% return on cash and the total return from the FTSE All Share Index of 0.3%. The Fund performed well over the year to 31st May 2005 producing a return of 16.8% - the best return over any annual period for the Fund since launch. During the year the proportion of the Fund invested in equities never exceeded 65%. (Please note that the performance figures on the Trojan Fund fact sheet are for the period ended 29th April 2005).

The Fund is ranked 2nd out of 77 funds in the Balanced Managed sector since launch and 11th out of 113 funds over one year as measured by Lipper.

The Trojan Fund has produced these returns whilst taking much less risk than the average Fund in the Balance Managed Sector.

Both Fund Managers have added to their personal investments in the Trojan Fund and the Trojan Income Fund in the last month.

OEIC Share Listings

Following some helpful feedback from investors since our last Quarterly, only the "O" shares that are held by most of the investors in the Funds will continue to be listed in the Financial Times. In order to avoid confusion the "I" Shares for intermediaries and the "S" shares for charities will be listed in The Independent until further notice.

New Troy web site – www.taml.co.uk

The Troy web site has been updated and now includes the latest Fund fact sheets, Key Features Documents and links to other useful sites. If you are interested in the Trojan Fund or the Trojan Income Fund, please contact Francesca Davies on 020 7499 4030. Investors can choose whether to hold either income or accumulation units.

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A Central Banker Warns

No, this particular warning did not come from Alan Greenspan, nor was it from our own highly regarded Bank of England Governor, Mervyn King. In fact it came from the less well known Nout Wellink, President of the Dutch Central Bank, via the Financial Times. Mr Wellink's advice is of interest because it was originally directed at Gordon Brown and Mr King. The Dutch Governor said that he regretted the consequences of the "*artificial stimulus*" applied to the Dutch economy by the housing boom that occurred there in the late 1990s and has suggested to his fellow European central bank governors that they should learn from his experience.

The Netherlands had a strong economy, until the end of 1999. Economic growth had been driven by a falling savings ratio, mortgage equity withdrawal fuelled by rising house prices and ballooning demand for consumer credit – sound familiar? Then interest rates rose, house prices stalled and household credit growth was stopped in its tracks. By 2002 the Dutch economy was in recession. Although we have been cautious about the UK housing market for some time, a fall in house prices is not a requirement to slow the economy. When house prices cease to rise, according to Mr Wellink, credit growth slows and equity withdrawal collapses. Householders retrench and save more to recoup the costs of overspending in earlier years. We are beginning to see these signs. The housing market in the UK has stagnated for a number of months owing to higher interest rates imposed by the Monetary Policy Committee. 2003 was the peak year for two year fixed rate mortgages, many of which are now being refinanced at substantially higher rates. It is also recognised that fiscal tightening is on its way, with inevitable tax rises due at the next Budget. Gordon Brown is running short of stealth taxes and now that the General Election is over, something more obvious is on the menu. A rise in the rate of National Insurance (described by Christopher Fildes of the Spectator as "*the income tax that dare not speak its name*") was not ruled out on the hustings and looks the most likely option.

During the recent General Election campaign, a statistic that caught our eye was from the independent think tank, the Institute for Fiscal Studies. The IFS reported that, "*average household incomes after tax fell by 0.2% in real terms between 2002/3 and 2003/4. This is the first decline in any single year since the early 1990s"*. The UK may not be in recession, but the public sector is crowding out the private sector. If you think that the economy is in the rude health that the Chancellor's statistics convey, just ask a retailer. Credit card companies are no longer buying market share by offering interest free credit for account transfers. This created a magic roundabout for heavily indebted consumers (or "rate tarts" as they've become known) hopping from one card company to another. Consumer spending is falling and the Bank of England is showing no inclination to loosen monetary policy. Mr Wellink's warning may be too late.

The Great Carry Trade

Much has been made of the "carry trade" – financial institutions borrowing cheaply to invest in assets that yield a margin in excess of the financing costs. When interest rates were at record lows, this proved to be a profitable venture for investment banks in particular. As interest rates began to rise last year, investors needed to take incrementally greater risk in order to generate the same return. Towards the end of last year the carry trade shifted into the riskier assets of corporate bonds and emerging market debt. The problem with a crowded trade is that everyone rushes for the exit at the same time – usually just when they see the door slamming shut. Many investors ran for cover in April when General Motors' bonds were downgraded to junk status by the credit agencies. Corporate bond yield spreads, which were referred to in our last Quarterly N$^{o.}$12, have widened as a result. The corporate credit markets have proven to be a good leading indicator for equity markets in the past and we see no reason why it should be different this time.

The carry trade extends its tentacles into the wider economy. The trade is culturally ingrained and is not, by its nature, risk averse. Buy-to-let investors, who have all but driven first time buyers out of the property market, are playing the carry trade – buying property with borrowed money in the hope that the rent will cover their interest costs. The problem is that the margin of rental income is no longer there and new investors, arriving late to the party, are relying on capital appreciation alone. This is a good example of taking higher risk in return for lower rewards.

Carry on trading

The pressure to make short term returns is palpable and explains some of the purported pain in the hedge fund arena. Managers measured by monthly returns often feel the need to place a bet in every race, even when the odds are stacked against them. We prefer to invest only when we have a high degree of conviction, otherwise we are happy to stay on the sidelines. This does not guarantee that every investment will be successful, but it does mean that we make every effort to avoid the losers which are so costly. In such a competitive market, good quality opportunities are few and far between.

Turnover in the portfolio this quarter was characteristically low. We added a new holding of United Utilities and topped up our holding in GlaxoSmithKline. United Utilities has completed its latest regulatory review which will now be in force for the next five years. Despite the removal of regulatory uncertainty the shares were trading on a historic dividend yield of 7.4%. The board has made a commitment to hold the dividend in real terms for the next five years and in comparison to many alternatives, this seemed a good starting valuation. The GlaxoSmithKline purchase was in a similar vein as this company generates defensive earnings and dividend growth in a sector which is unloved by the market.

For reasons given at length in previous quarterlies, we do not trade actively and this allows us to spend time closely monitoring the portfolios' existing holdings. We have been heartened by robust trading and dividend increases at BT, BAT, National Grid and Reynolds American – four of our largest holdings.

Choppy Waters

The modest gains so far made by UK market indices in the year to date disguise some fairly dramatic volatility which has affected investor sentiment. The sharp rise in the FTSE Mid 250 index, which recorded a new all time high in January, has finally been checked by concerns about a slowdown in the UK economy and some well publicised setbacks in the resources sector. Smaller companies have fallen even further and the AIM index is down by 18% since mid-March. In contrast the FTSE 100 Index has performed better thanks to a rally in the dollar and the defensive attractions of utilities, consumer goods companies and integrated oil companies.

Bond markets suffered one of their periodic inflation scares in February, with the ten year gilt yield reaching 4.86% by the middle of March. Since then, increasing evidence of economic weakness has prompted a sharp fall in yields and as at today's date the ten year yield has fallen to 4.25%, a new low for the year. This strength is evident across the yield curve and even War Loan, which has been held in the Trojan Fund for over three years, now appears to be making a determined effort to reach new highs. The chart below shows how the War Loan price has moved in the fifteen years since gilt yields began falling in the early 1990s. Far from there still being a bull market in bonds, the chart also demonstrates that gilts have been range-trading since 1999.

3.5% War Loan

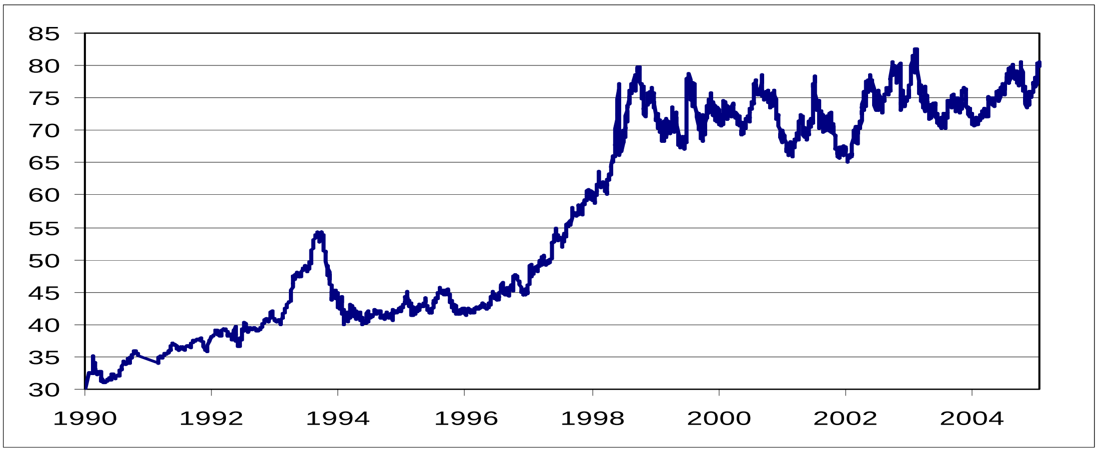

Figure 1 *Source: Bloomberg*

At a time when the Treasury is considering the issue of a fifty year bond, it is interesting to review the history of War Loan (an irredeemable gilt) whose value was effectively obliterated by inflation for most of the last century. By 1918, three separate issues had raised the size of the War Loan to £2bn and the coupon to 5%. This placed a huge strain on the nation's finances. In 1932, when the bank rate had fallen to 2%, the government made a controversial announcement to the effect that the then redeemable War Loan would be exchanged for an irredeemable 3.5% stock. If current disinflationary trends continue, it is possible to envisage this security trading at close to par for the first time in over seventy years.

A Road Map

Many commentators have noted the apparent contradiction evidenced by falling bond yields coinciding with a rally in equity markets – a condition we have not witnessed since the late 1990s. The usual conclusion is that bonds are becoming increasingly overvalued. Our view is that the valuation of bonds is more robust than that of equities and that disinflationary forces in the global economy are relentless. Pricing power will remain weak and with limited top line growth opportunities for many sectors, earnings growth is more likely to undershoot expectations.

We must emphasise that we are not forecasting a sharp collapse in asset prices. The more likely outcome is a long drawn out period of low growth and low returns. Our road map for asset classes is that bond yields move downwards while equities drift. In March 2003, the convergence of bond and equity yields proved a powerful buy signal for the equity market. If that convergence were to be repeated, we believe that this time it would be due to falling bond yields rather than weaker equity prices as in 2003. The chart below shows the Gilt/Equity Yield Ratio which, in our view, is heading back towards equality. For the reasons given above this may not, on this occasion, prove to be a strong equity buy signal. Stock picking and asset allocation will be critical to generating above average returns as it is likely that many equities may move to yields that are higher than gilts – a situation not seen since the 1950s. This explains our investment policy which is to invest in strong consumer goods franchises, utilities and long duration assets such as bonds and preference shares. We will avoid most retailers, cyclical industries and remain wary of financials. The portfolios continue to have a defensive bias.

10yr Gilt/Equity Dividend Yield Ratio

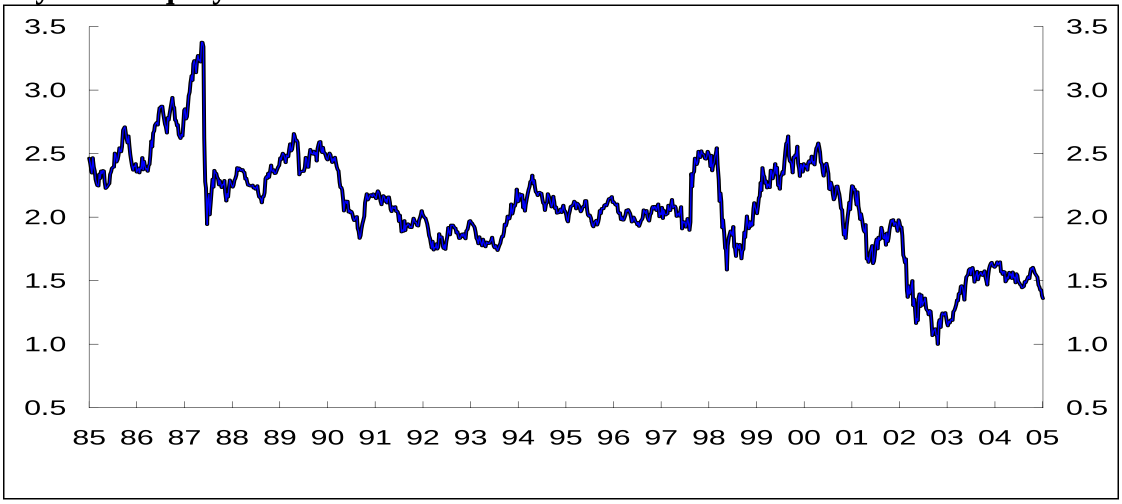

Figure 2 *Source: MAN Securities*

Lining the pockets of inflation

In contrast to the lack of pricing power elsewhere in the economy, some leading fund management houses have found it possible to *raise* investment management fees. At the risk of upsetting our peers, we do not expect this trend to catch on. We believe that in a low return environment investors will become increasingly sensitive to the proportion of investment returns being eaten up by fees and other costs. As a result our fees of 1% are below average and with no front end load or performance fees we feel that our interests are aligned closely with those of our investors. We are rewarded for the performance of our funds by the growth of funds under management in the medium to long term, rather than by virtue of geared exposure to returns in a bumper year which may prove unsustainable.

Infallible powers?

The homily addressed to the College of Cardinals by the future Pope Benedict XVI (before entering the conclave which then elected him), was based on a critique of what he described as the "*dictatorship of relativism*" in everyday life. An increased emphasis on absolutes is a philosophical view with which we have great sympathy. As regular readers of our quarterlies will be well aware, our investment decisions are always taken on an absolute basis.

Sebastian Lyon Francis Brooke June 2005

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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