TROY ASSET MANAGEMENT

Quarterly No.15

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

New Appointment

We are pleased to announce that Ruth Keattch has joined Troy as Head of Research and Investment Director.

Ruth joins from Deutsche Asset Management (2001-2005) where she was a Director with responsibility for managing UK and European mid and small cap specialist funds with a total value of over £1.5bn. Ruth was lead manager of the DWS UK Smaller Companies Fund and the DWS European Smaller Companies Fund.

Prior to that Ruth was a Director and Head of Research at Ruffer Investment Management Limited (1999-2001) and was responsible for the development of the research process and the launch and management of Ruffer's first pooled funds.

We are delighted to welcome Ruth to our investment team. She is a highly experienced investment manager with a distinguished track record. Her specialist expertise in small and mid cap equities will make a major contribution to the further development of Troy's investment process. We will be launching a new Fund in 2006 to make use of Ruth's talents.

If you are interested in the Trojan Fund or the Trojan Income Fund, please contact Francesca Davies on 020 7499 4030. Investors can choose to hold either income or accumulation units.

Pegging Along

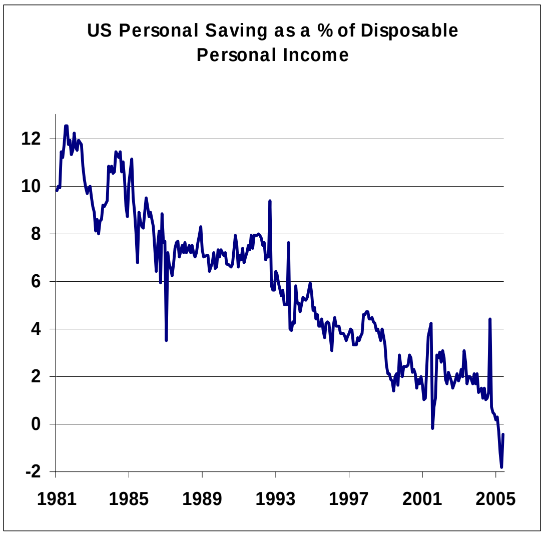
It has not been easy to write a fourth Quarterly report this year. 2005 has been a 'more of the same' year. Equity and bond markets have drifted upwards with short-lived corrections along the way. The stock market has been driven up by high levels of corporate and investor liquidity rather than value. We have increased our cash holdings gradually as we can find fewer compelling investment ideas and see more risk on the downside. Liquidity driven markets can become highly speculative, as investors cannot resist the urge to take part. Also, what worries us is that ***everything*** is going up, the funds' stocks, bonds, preference shares and even gold. While this is gratifying in the short term, there are fewer and fewer places to take cover should investors suddenly turn tail and make a dash for the exit. We always try to construct portfolios with balance - not all pointing in the same strategic direction. Yet with all asset classes having performed well of late, including property, our preference is for higher than normal liquidity levels. With less downside protection, the markets are vulnerable to unforeseen shocks.

Hospital pass

Without doubt, the most important piece of news for world markets during the past few months was the confirmation that Ben Bernanke will be Alan Greenspan's successor as Chairman of the Federal Reserve. Markets hailed the announcement with a small rally, the implication being 'business as usual'. Dr Bernanke is seen as the 'continuity candidate', a safe appointment who would continue where Greenspan left off and preserve the 'Greenspan put' - all will be well.

We beg to differ. Unlike Mr Greenspan, who has arguably played a canny hand for 18 years, Dr Bernanke is unproven. He has become renowned for his famous 'printing press' speech in November 2002, (*Deflation: Making Sure 'It' Doesn't Happen Here*) in which he suggested that the remedy for a deflationary threat was for the central bank to throw newly printed dollar bills from a helicopter. This speech was seen as successful at the time as it calmed investors' fears of a deflationary bust. Not surprisingly, since his appointment, Bernanke has been playing down the use of the printing press and stressing his inflation fighting credentials by suggesting an explicit Federal Reserve inflation target for the first time in its history. Such inconsistencies may unnerve investors.

Dr Bernanke inherits an economy riddled with imbalances including a record trade deficit and deteriorating budget deficit, a ***negative*** savings ratio (*see Figure 1*) and record levels of personal debt. These will have to be dealt with in the coming years. The key to the US economy has been the housing market that took up the slack from the strong equity market of the late 1990s. This boom has been fuelled by people borrowing against the increased value of their homes combined with spending an ever increasing proportion of their income. At some stage, as we have been saying for some time, American consumers will retrench (UK consumers are showing them the way). There is evidence that the time is drawing near - house prices are no longer rising and mortgage applications are down since the summer – the housing market is reaching a critical inflection point. Consumers' ability to spend has not been lower since the recession in the early 1990s (*see Figure 2*). This will provide a challenge for the new Fed Chairman as he attempts to keep the ball in play.



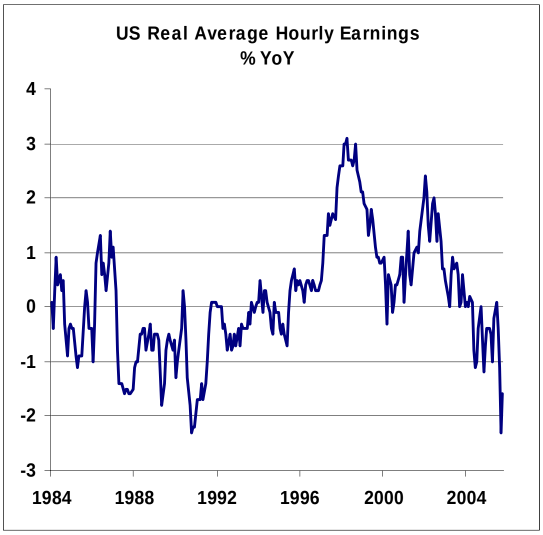


Figure. 1 *Source: Bloomberg* *Figure. 2* *Source: Bloomberg*

In the past, the handover of the reins at the Fed has hardly been without incident for the new man. Following a warm welcome, markets have a tendency of testing the new incumbent. Paul Volcker endured a bond market collapse in 1981, while Alan Greenspan faced the stock market crash of 1987 just weeks into his tenure. The implications of this new appointment should not be underestimated.

The Maestro's Swansong

Alan Greenspan recently cautioned, "Any onset of increased investor caution elevates risk premiums and, as a consequence, lowers asset values and promotes the liquidation of the debt that supported higher prices. This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums". Investors and Ben Bernanke should take note.

Is the MPC honeymoon over?

In common with the US, UK monetary policy may be less predictable than in the recent past. For the first time since 1997 we detect signs that the 'hawks and doves' may be moving further apart. In August the Governor was outvoted for the first time in MPC history when interest rates were cut by 0.25% to 4.5%. This could be seen as a mild embarrassment if set in isolation but changes to the composition of the MPC may increase the risk of further friction. The newest member of the committee, Sir John Gieve, who has spent most of his career at the Treasury, is suspected to harbour 'dovish' tendencies. Andrew Large, Sir John Gieve's predecessor, has the most hawkish record on the MPC. We suspect that this change could well upset the balance on the committee at a time when concerns are rising for the growth of public spending.

If the economy shows signs of further weakness, as is expected, the Chancellor's room for manoeuvre will be restricted by the deterioration of the public finances. The Treasury will be keen for the MPC to stimulate growth and to ease consumers' discomfort by cutting interest rates, whilst the 'hawks' will remain concerned about high asset prices and the potentially inflationary impact of sterling weakness. If Gieve adopts a more accommodative position than his predecessor, Mervyn King could find his position of authority increasingly undermined. If the Governor is outvoted again, the tensions could escalate with damaging consequences for sterling and a deteriorating relationship between the Treasury and the Bank of England. We see no merit in second guessing monetary policy but we would not be surprised to see these issues back on the front pages in 2006. International investors may conclude that sterling is not such a safe haven.

Cable

This uncertain background for monetary policy, on both sides of the Atlantic, makes currency predictions as problematic as ever. Knowing that our investors have predominantly sterling liabilities our default option has been to hedge our US dollar exposure. We did this until January, when every man and his dog were selling the dollar. At this point we took off half the hedge at a rate of over £/$1.90. Since then sterling has fallen to as low as £/$1.70 (*see Figure 3*). While we are tempted to put the full hedge back on, there are good reasons for both currencies to weaken.

In a world where no country wants a strong currency, gold (*see Figure 4*) remains the best hedge of all but it is still viewed by mainstream investors with scepticism. The recent rise in the price of the yellow metal to over $500 (a multi year high and double the level at which the Chancellor sold a significant proportion of the nation's gold reserves just four years ago) is not necessarily a sign of the fear of rising inflation. Instead the price is a reaction to concern that central bankers and politicians will be tempted to print money in order to aleviate the burden of their high budget deficits – transferring wealth from creditors to debtors. After two decades of absence, gold is making a return as a financial asset.

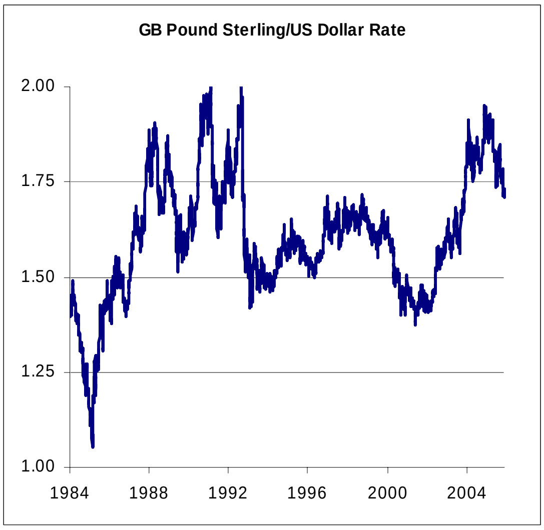


Figure. 3 *Source:Bloomberg*

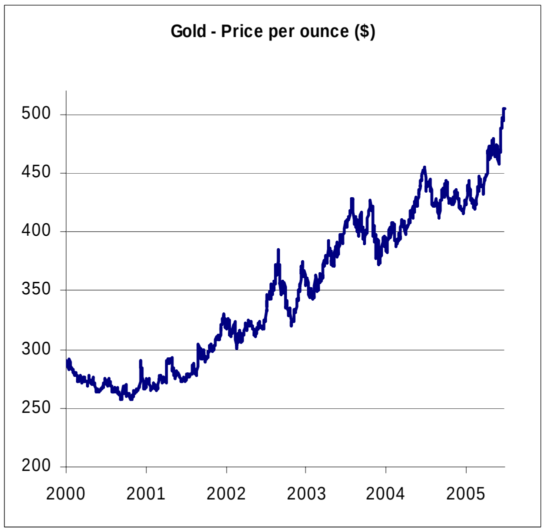


Figure.4 *Source: Bloomberg*

Portfolio activity

The three months to October were extremely volatile with equities continuing to rise strongly in August and September before falling back sharply in October as concerns about inflation and interest rates hit markets. We were reassured to see that our cautious stance resulted in a resilient performance by the funds in October. This difficult month for markets provided a good stress test for the portfolios with both Funds falling by only 1.3% in the month. The robust performance of long-dated gilts continues to support our non-consensus view that dis-inflationary forces in the global economy are still powerful enough to drive yields lower over the next twelve months. To illustrate this point, the price of War Loan, which we discussed in some detail in Quarterly N° 13, recently reached £85 - its highest price for over a generation. The sharp rise in the gold price has also been beneficial.

We have sold the majority of our holdings in the quoted Lloyds insurance vehicles in the past quarter. We had constructed a basket of shareholdings which have on balance performed well over the past eighteen months. We were surprised to see share prices hold up so well in the face of unremitting bad news from the US hurricane season. The wave of capital flooding into the insurance sector led us to the view that the beneficial impact of the increases in premiums resulting from these losses was going to be significantly diluted. A key argument in favour of these companies has been that increased capital discipline would generate higher returns through the insurance cycle and therefore justify higher valuations. With current underwriting losses threatening balance sheets, we have decided to sell down these holdings.

Outlook

Markets look set to provide another year of solid returns. As memories of the stomach lurching falls of 2001, 2002 and 2003 fade, investor emphasis and priorities have changed from capital preservation and absolute returns to beating the market. To us, the risk taken to generate returns is more important. We will not be seduced into playing the relative return game with all the implications of increasing the risk of capital losses. Our aim, to produce good risk adjusted absolute returns, remains undiminished.

Recently we met with a distinguished London based investor who is well into his fifth decade in the business and, at 70, is still going strong. Agreeing with our view that there was a scarcity of attractive investment opportunities based on fundamental valuations, we asked him what one would buy today. In expectation of being recommended something that we had overlooked the answer came back: “Wait”. We will.

Sebastian Lyon Francis Brooke December 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).

TROY ASSET MANAGEMENT LIMITED 13 ALBEMARLE STREET, LONDON W1S 4HJ
TEL: 020 7499 4030 - FAX: 020 7491 2445 E-MAIL: info@taml.co.uk WEB www.taml.co.uk