TROY ASSET MANAGEMENT LIMITED
15 ST. JAMES'S PLACE, LONDON SW1A 1NW
TEL: 020 7514 1934 - FAX: 020 7499 0357
E-MAIL: sl@taml.co.uk

Quarterly Report No. 2

The aim of the Fund is to protect investors' capital and to increase the value of the Fund year on year. While in the long term we intend to invest a substantial proportion of the Fund into U.K. and U.S. equities, we continued to retain a high level of liquidity throughout the quarter. We remain cautious of the outlook for markets in the immediate future and aim to protect the value of unitholders' funds.

"Nothing will ever be the same again"

It seems somewhat dated to have to comment on the horrendous events which occurred on 11th September 2001, the day after we published the first quarterly report. The devastating terrorist attacks in New York and Washington were a direct assault on the World's financial system. This was a concerted attempt to destroy the global economy at a vulnerable time in the economic cycle and reinforced the trends that were already well established in economies and markets. From an investor's standpoint the policy responses have been as robust as could have been expected. The news from the war is better than many could have believed. However we are reminded daily that this is not a war against the Taliban but a war against terrorism. The United States and her Allies with their combined military might are unsure where to turn next, Iraq or Sudan? With no victory in sight, we remain at the start of an extended campaign which, by the authorities' own admission, will take years not months. Set against an adversary, who attacked from within United States' borders and can hide almost anywhere, newsflow will inevitably shift from positive to negative. Equity markets dislike such uncertainty.

Except the Stockmarket

Against this background, following a sharp sell off, equity markets have rallied strongly and are currently, amazingly, above the closing levels set on the eve of September 11th. After the attacks, the UK market fell 12.7% while the US market fell 11.6%. Since then equity markets have risen by 18.2% and 18.3% respectively. The UK market is now standing 3.2% above its 10th September close and the US market is up 4.3%. These remarkable moves have surprised many investors, ourselves included. The proverbial traveller emerging from three months in a tropical rainforest with no access to information would briefly look at current market levels and dismiss them with a yawn, oblivious to

Regulated by the FSA
Registered office: Hill House, 1 Little New Street, London, EC4A 3TR
Registered in England No. 3930846

the turmoil. How can markets have effectively taken in their stride such an event as calamitous as this? Can equities really be worth more now?

The recovery in share prices has nothing to do with economic fundamentals which have deteriorated, or corporate earnings that have continued to disappoint, or even investors' longer-term attitude to risk which should be more circumspect. The answer is simple – cheap money. Central bankers, led by Alan Greenspan, have predictably rallied round to pump liquidity into the financial system. As I write, the US Federal Reserve has cut short-term interest rates to 1.75%, the lowest in forty years, and has signalled that more cuts may be necessary to pull the US economy out of recession. Investors, put off by the low short-term returns available on their cash and embarrassed by retaining liquidity in a rising market are ploughing it into stocks apparently with little regard for valuations. With their gaze firmly set on the sunlit uplands of recovery they will be disappointed if they do not look down first. Perversely, some commentators would have us believe that following the events of September 11th the US economy will recover more strongly than expected in 2002 simply on the basis that the collapse will be worse than previously expected. However it may be painted, September 11th is not good news for those in the "V" shaped recovery camp. If an economic recovery is stronger because the decline is steeper and more painful than originally expected, can such a scenario be bullish?

Central banks are running out of firepower – is there really much of a difference, to a consumer or a company, between interest rates of 2% and 1.75%? For those who are heavily indebted this will relieve some pain but lower short rates will not help companies with fixed rate debt, nor will it necessarily encourage corporates or consumers to take on even higher levels of debt. Consumer instalment debt, at 21%, is greater than previous recession highs of 16%. Corporate spreads are widening and the Fed's attempt to manage longer rates down, by announcing the end of Long Bond auctions, has backfired. Yields, which initially fell to below 5% on the day of the announcement, have since backed up to 5.6%.

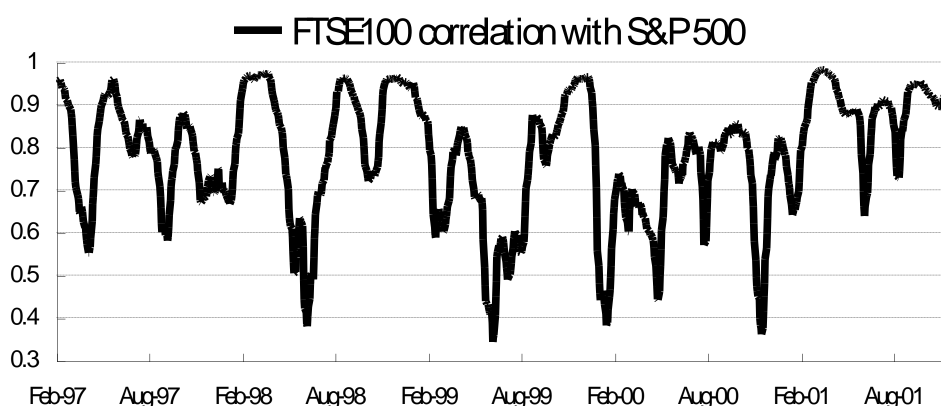
Economic headwinds remain

The initial economic news after September 11th was better than expected. Consumer confidence recovered quickly. For example, one-off zero per cent financing offers by the major car companies buoyed retail sales in October. This early resilience proved short lived. This was an economic distortion provided by an operationally geared industry desperate to avoid the downturn. By effectively selling forward to tomorrow's demand at lower prices the car industry's efforts to delay the inevitable cyclical downturn will only make it more painful and prolonged. Since October, Ford has announced an increase in bad debts from its financing arm and the loss of its chief executive. This distortion aside, economic data continues to deteriorate. The US economy is now officially in recession and shrank by 1.1% in the third quarter. US unemployment has risen to a six year high of 5.7% with the loss of almost 800,000 jobs in the last two months. This is beginning to affect confidence.

The Conference Board's index of consumer confidence has fallen for five months in a row to its lowest level in seven years. To date, the UK economy has remained remarkably resilient but signs are emerging of material imbalances which will be exposed as the economy weakens. Profits as a percentage of GDP continue to fall. This will depress the earnings outlook.

As do Stockmarket risks

It might seem a little far-sighted as a UK based investor to concentrate on the US economy and markets, but, where that market goes,we tend to follow and since September 11th, the correlation between these two markets has increased. Over 25% of quoted UK companies' profits are derived from the US and most of the sectors that dominate our market such as Pharmaceuticals, Oils and Telecoms are judged relative to their international peers. The Banks sector is the notable exception that remains predominantly domestic. Overseas investors now own over 37% of the UK equity market.



Source: Schroder Saloman Smith Barney

The UK market is now down 16.7% year to date and it looks like a second year of negative returns is upon us. Could there be a third? Conceivably. Valuations have, on balance, increased during the quarter as share prices rose unrestrained by further earnings disappointments. As one strategist put it "downgrades are bullish!". The price/earnings multiple of the market has risen from 20.4x to 21x. With record levels of volatility, risks remain high and this should be recognised through lower ratings. The siren voices of the market are luring investors to "buy beta" i.e. to invest in the riskier stocks which increase the most in a rising market, and the first port of call is the Technology sector. The Nasdaq Composite index, synonymous with the Technology sector has risen 33% from its recent low. Not surprisingly it is earnings in this sector that have been hardest hit, but valuations are sky-high. According to Morgan Stanley the sector is virtually back to the same forward earnings multiples (68x 2001earnings and 45x 2002 earnings) as it reached at the height of the bubble in 2000. In the UK, due to rarity value our ratings are even higher. The stocks that led the last bull market in the 1990's such as Arm and Vodafone, will not lead us to the next one. Warren Buffett neatly described this process in an article in Fortune recently. By buying these stocks with such little earnings

certainty and on such high valuations "*People are habitually guided by the rear view mirror and, for the most part, by the vistas immediately behind them*". The rally in technology stocks is one of the side effects of Alan Greenspan's attempt to deflate the equity bubble. This liquidity rally is reminiscent of the final quarter of 1999 when the FTSE 100 index rose by 15% to its all time high of 6930, the last time when huge amounts of liquidity were pumped into the global money supply in order to cope with the perceived concerns of Y2K. "Buying beta" into the rally is equivalent to pressing harder on the accelerator the closer we get to the cliff. This looks more like a bear market rally than the beginning of the next bull market. There will be a better time to buy equities.

Timing is everything

There are those that say market timing is a dangerous game and that long term investors should remain fully invested in equities at all times. We disagree. Any retail investor who bought an index tracker fund in the past four years will tell you that timing is everything. While over the past ten years, and even twenty years, it has been right to "buy the dips" it has not always been the case. Since 1964 annualised returns on the FTSE All Share index have been 14.2%. If you exclude the best 10 months, the return falls to 9.3%. However if you exclude the ten worst months, the returns rise to 19.8%.

Investing for income

We did invest some money in the market at the September lows (but not enough!). The Fund's allocation to bonds is for medium term tactical purposes but is exceptional. Nominal GDP growth will remain low and inflationary pressures are expected to remain subdued. The sharp rally in Technology stocks since September 21st demonstrates that the excesses of the late 1990's have yet to be purged from the system. Equity markets will inevitably shift from optimism to pessimism. We are keen to buy equities, but not yet.

Sebastian Lyon

12th December 2001

AS Troy Fund Portfolio (as at 31 October 2001)

	£m	**%**
Equities		
UK Equities	5.1	14.0
Bonds		
UK Corporate Bonds (Short dated)	1.8	4.9
UK Gilts (Short dated)	12.2	33.7
Cash		
Fixed Deposit	8.0	22.0
Other Cash	8.9	24.6
Income Accrued	0.3	0.8
TOTAL	**36.3**	**100**

Performance

The AS Troy Fund is an absolute return fund. Any comparisons against equity indices are for illustrative purposes only.

Unit Bid Price 101.2p

% Change Over Period	*30th May 2001 Since Launch*	*31st October 2001 3 Months*
Fund[1]:	+1.2%	+0.6%
FTSE All Share Index[2]:	-13.3%	-8.7%
APCIMS Balanced[2]:	-10.0%	-6.5%

[1]*bid to bid basis, net income reinvested* *Source: Lipper Hindsight*
[2]*Total return indices*

Please bear in mind:

This document is issued by Troy Asset Management Limited which is regulated by the FSA. This document is not intended as an offer or solicitation for the purchase or sale of any investment or financial instrument.

The investment approach and process described may not be suitable for all investors. The investments discussed may fluctuate in value and investors may get back less than they invested. Changes in rates of exchange may cause the value of investments to go up or down.

Although Troy considers the information in this document to be reliable no warranty is given as to its accuracy or completeness. The opinions expressed are subject to change without notice and no reliance should be placed on them. For further information please contact Troy Asset Management Limited at 15 St.James's Place, London SW1A 1NW (Tel: 020 7514 1934).