TROY ASSET MANAGEMENT

July 2007

Investment Report No.20

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

Getting Tighter

While central London house prices and buy-to-let investments are the *sujets du jour* at dinner parties these days, the dry topics of monetary policy, bond yields and inflation are, not surprisingly, off the menu. These are hardly subjects to get pulses racing. Mervyn King, when appointed as Governor of the Bank of England, said that monetary policy decisions should come as no surprise and even be "boring". He must be disappointed, now that decisions made by the Bank's monetary policy committee in setting interest rates have become the stuff of headlines. We first highlighted frictions at the MPC back in 2005 (No.15 - '*Is the MPC honeymoon over?*') when the Governor was outvoted for the first time. Since then the Bank's profile can hardly be described as low key. First, following the announcement of April's Consumer Price Index, the Governor was obliged to write a letter of apology to the Chancellor of the Exchequer for breaching the inflation target range of 1-3%. Since then, inflation appears to have dipped back but there are concerns that monetary policy will need to get tighter in order to tame prices. While an inflationary shock along the lines of the 1970s is not anticipated, prices (with the exception of labour costs) have remained stubbornly higher than expected, restricting the Bank's room for manoeuvre.

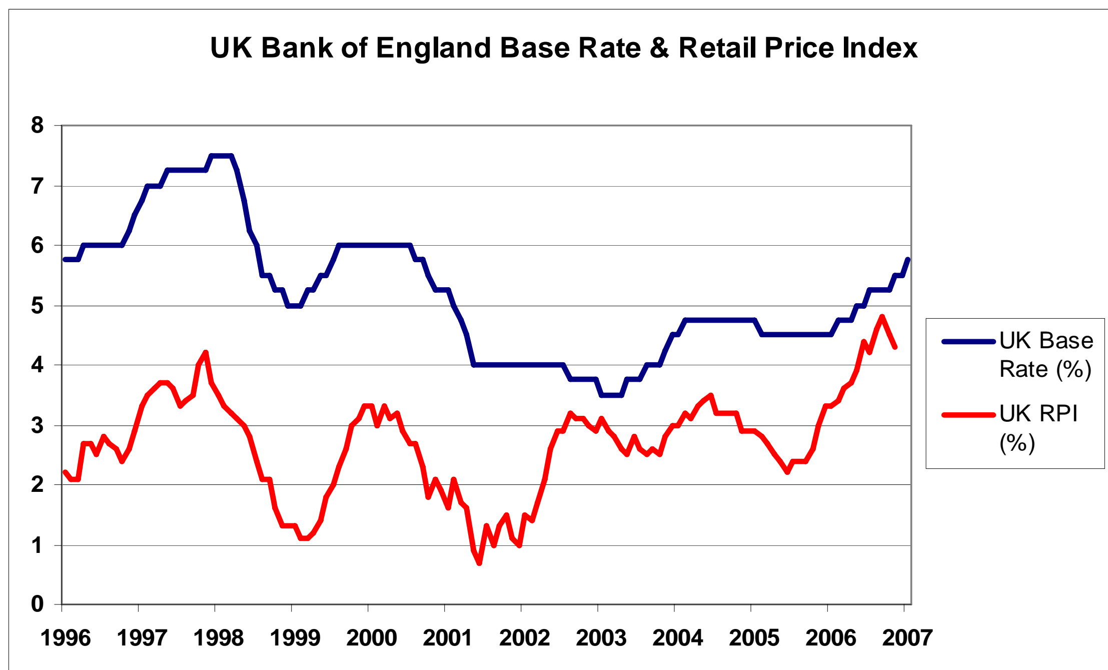

Figure 1 *Source: Bloomberg*

While we have been sanguine about the prospects for inflation for many years, we have to recognise that the evidence has become rather more ambiguous with headlines of higher utility bills and food prices giving cause to reappraise our views (*see Figure 1*). That the cost of goods leaving China is now rising, instead of falling, for the first time in years added to our disquiet. This major external fillip to disinflationary forces is no longer helping monetary authorities.

The high levels of investor confidence in the Bank of England may be misplaced. There is now a risk the MPC is behind the curve. The gentle push on the brakes of rising rates, which started last summer, has yet to slow the UK economic engine. Gradual quarter point changes seem to make little impact. The MPC needs to take more radical action to be noticed. Regrettably, interest rates may peak at well over 6%, pushing mortgage rates up over 50% from their lows - causing severe pain in some parts of the economy. Looking at the last time the RPI was this high (in late 1997/early 1998), rates may need to reach 7% or more to make an impression. The sooner rates rise the lower they will peak.

Our 'higher for longer' assumption on interest rates will have implications for asset classes, whether currencies, bonds, equities, or property. Bonds have performed poorly all year and this has not provided a good investment environment for some perceived related sectors such as utilities. The Trojan Fund's exposure to bonds (excluding short-dated gilts) has declined from its peak of over 50% four years ago to just 4% today. We retain holdings in preference shares, which offer an attractive rate of return (a gross yield of 8%) compared to alternatives. Consumer staple sectors where the portfolios have a large representation should be more resilient as should companies with robust underlying growth. Tighter liquidity conditions will remove one prop supporting equity prices - private equity buyouts. We have been careful to avoid expensive mid cap domestic companies that have been shamed into taking on ever higher levels of debt in order to avoid being taken private. This is why we sold the holding in Marstons early this year. Our preference has been for undervalued blue chip stocks and carefully selected, well financed smaller companies.

Private equity party

The door may not have shut on corporate activity but financing buyout deals, such as the purchase of Alliance Boots, will be harder in future. This may leave parts of the equity market, priced in anticipation of a takeout, exposed. Many such deals are predicated on financial engineering which would not be tolerated in the public markets. We have met recently with two senior private equity investors who expressed concern about the level of buyout valuations. In the past, the consideration paid for a business would allow for the possibility of deterioration in the trading environment. At current valuations, there is no such margin for error. Not surprisingly, after a strong run, private equity partners are looking to crystallise the value of their own businesses. The flotation of Blackstone last month, soon to be followed by KKR, are events likely to mark the peak.

An attempt to shame management into changing balance sheet structures occurred earlier this year during the battle for J Sainsbury. CVC Capital Partners planned to take

the company private, splitting off the property assets from the operating company – the so called 'opco-propco' model. This would leave a weaker retail business, paying market rents, vulnerable to higher operational and financial gearing - clearly a case of short-termism. Lord Sainsbury of Preston Candover, erstwhile chief executive of the food retailer, rightly expressed concern that while, "he did not object to the bid in principle, he would only support one that would make the business better and stronger". He said, "Sainsbury's success had been based on a strong balance sheet and a largely freehold property base. Eroding these attributes will make the company more vulnerable to competitive pressures, which is not in the best interests of the company, its customers, its staff, its shareholders, or its pensioners".

Sainsbury's rival Tesco, which has even more property than Sainsbury with 70% freehold assets, supported Lord Sainsbury's view. Sir Terry Leahy said that Tesco had no truck with the fashionable 'opco-propco' model favoured by private equity investors, pointing out that "property is an integral part of the retail business…we will retain the necessary strategic strength we see in ownership by keeping at least 70% of our assets in freehold".

No Debs' Delight

Anyone wanting to see the added value that a private equity investor has brought to UK retailers need look no further than Debenhams. Taken private back in 2003 for £1.7bn (plus £130m of debt), it was returned to the market with over £1bn of debt and hundreds of millions of pounds less of freehold property. What amazed us was how any self respecting investor would want to buy it back stripped of its assets and shorn of costs, leaving it exposed to a downturn in consumer spending. The shares re-listed on the London market 13 months ago at 195p, since then Debenhams has rewarded its new shareholders with poor trading and three profits warnings leaving the shares at 135p.

The vulnerabilities of aggressive corporate structures, euphemistically described as 'efficient balance sheets', tend to be exposed in a period of rising interest rates. Markets will begin to appreciate conservative financing. Our preference is to invest in the likes of Tesco (over Debenhams) which remains a core holding in all the funds. We have added to the investment recently, following share price weakness, in the belief that the market has underestimated the potential for a successful launch of its US convenience store business.

Cash is king, again

One positive derived from higher interest rates, is the return on sterling cash, which is at its highest for six years. We are never frightened to hold cash in the short to medium term and cash levels have risen a little in all three funds in recent months. This will provide firepower to make new investments as and when suitable opportunities appear. For the moment, we are being paid to wait. Cash offers better returns than bonds and in the short term makes equity valuations less compelling should rates surprise on the upside. The high cost of money has implications within the equity market. Investors are realising that the rising cost of debt will eat into profit expectations at a time when

trading may also deteriorate. We have a preference for well financed businesses and like to see cash on the balance sheet or, if not, comfortable levels of interest cover. We need to ensure we hold stocks that will do well irrespective of the economic environment. In recent months we have added to holdings in Glaxo SmithKline, Sage and Reed Elsevier.

As we have said in the past, diversification is no longer as helpful as it once was in protecting the downside risks for portfolios. Asset classes have become more highly correlated in recent years and cash offers greater short-term protection as a result. There is intense pressure in our industry to be fully invested at all times but our view is different. Increasing cash levels should not burn a hole when seeking to generate long term returns for investors.

Dollar takes a pounding

A further implication of higher interest rates is that sterling may remain strong for some time. Having breached $2/£ level for the first time since 1992, we have increased the hedge from 50% to 75% of our direct US dollar exposure in the funds. As interest rate differentials between the US and the UK widen further, there is a risk that the pound may overshoot on the upside. Unless we feel strongly to the contrary, our mantra is to avoid speculation on currencies and as a default we choose to hedge back foreign currency exposure into sterling.

Asian Anniversary

2007 marks the ten year anniversary of the Asian crisis. Such financial crises are never repeated exactly but they are worth learning from. Back in 1997, Asian economies ran massive current account deficits and depended on wealthy countries to finance their growth. In the past ten years this has been turned on its head. Asian countries run huge current account surpluses and have built up massive foreign exchange reserves. By contrast the US (and the UK for that matter) is now where Asia was ten years ago. Nobody, apart from those of an extremely negative persuasion, expects the US to follow the path of Asia in 1997 – the US has an excellent history in dealing with financial distress whether it be the LTCM collapse in 1998 or savings and loans in the early 1990s. Any strain is likely to be taken by further dollar weakness. As investors, we need to be aware of the potential risks of a financial crisis. Ben Graham, the legendary investor said "the chief losses to investors come from the purchase of low-quality securities at times of favourable business conditions". While we expect conditions to become more difficult going forward, we will stick to investing in high quality, well financed companies. Who knows those dinner party conversations might just have moved on from property to more interesting topics by this time next year. Blue chips anyone?

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