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AS Troy Fund

Quarterly Report No. 3

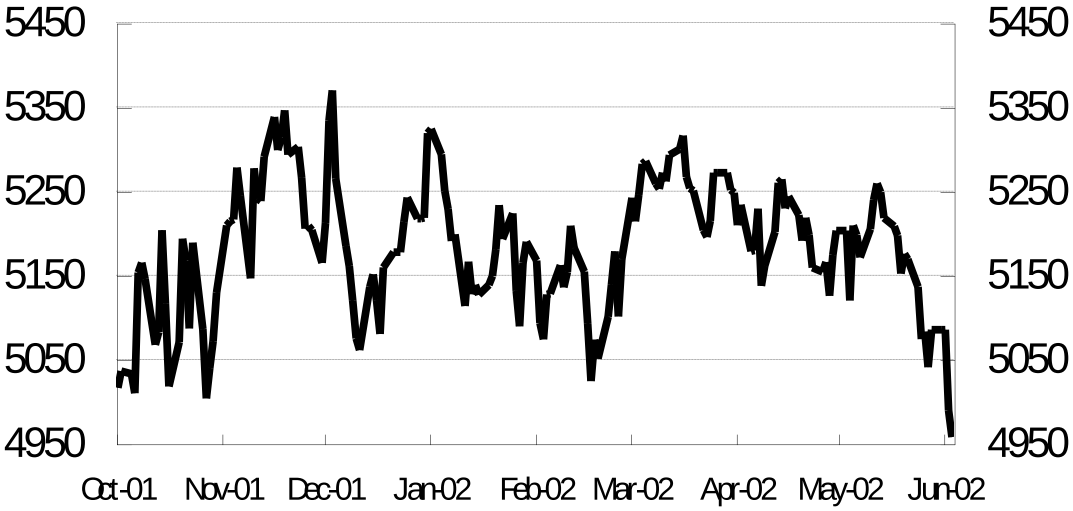
The aim of the Fund is to protect investors' capital and to increase the value of the Fund year on year.

"Flatliner"

It is not easy to report on a quarter that was only remarkable by the sheer lack of activity. Having had to endure a sustained period of stock market volatility over the past few years such a period of stability is almost alien to investors. In the quarter to 30th April the Fund rose by 1.3% on a total return basis (Source: Lipper). This compares to FTSE All Share Index equivalent return of 1.8% and the return from the APCIMS Balanced index of 0.2%.

It is not just the last quarter that was dull. Since October 4th 2001 the UK equity market has enjoyed a remarkable 34 weeks of relative stability, moving within a range of less than 8%.

FTSE 100 Index – Going Nowhere?



Source: Schroder Saloman

Investors seem to have been waiting for a catalyst to drive the market from this range bound existence. The Fund's retained high level of liquidity reflected our belief that the direction would be downward and since the end of May this has been confirmed with a break below 5000. When so many were expecting an economic cyclical upturn which would lead to better equity markets, what went wrong?

Since January GDP growth has surprised on the upside in the US. First quarter growth was 5% on an annualised basis. In contrast, the UK economy, which never collapsed in the second half of last year and therefore had no reason to rebound, did not grow at all. But all eyes were on the US which benefited from the fair winds of the lowest Fed Funds rate in 40 years and unseasonably warm weather. The second warmest winter since 1892 helped buoy retail sales, and underpinned already robust construction and housing sectors. The long awaited inventory correction also came through as expected. However, these factors will begin to unwind as we enter the second half of the year. Low interest rates may have saved the wider economy. A recovery, albeit an anaemic one, is in place but that may not save the market.

Against this background, stock markets began to focus on the dull outlook and on corporate profits, which continued to disappoint. Investors, already burnt by corporate scandal and aggressive accounting, are taking little on trust. A "show me the money" attitude on corporate earnings and cash flows is now widespread. Notwithstanding an apparently improving, or at least stable, economic environment, companies are finding it hard to produce profits growth. This is because corporate revenues are shrinking. Pricing power and volume growth are, at least for the moment, a thing of the past. While revenues are falling, company managers are trying hard to bring costs into line but this is like running up a down escalator. In the US, first quarter earnings numbers were depressing. Blue chip companies such as GE, Exxon, AT&T, Kodak and Disney reported falling revenues. In the UK (where most companies report every six months) BAT, BP, Electrocomponents, ICI and Reuters also reported declines in sales. Investors remain unconvinced by the prospect for profits growth derived from cost cutting (as we know to our cost from our investment in EMI) because there is only so much that management can squeeze out. It is a finite process. Companies' trading statements convey a cloudy outlook. At its recent interim results Daily Mail & General Trust said that trading remained very volatile and unpredictable. Moreover the company's Finance director could see "no logical reason why things should pick up too strongly". This divergence between GDP growth and corporate profits growth, referred to as the "profitless recovery", is something we alluded to in previous reports but is becoming more apparent and is alarming equity investors. For without earnings growth, equity markets look exposed.

Further to fall?

Since their peak in 1999/2000 equity markets have fallen a long way. The FTSE 100 closed at 6930 on the final trading day of the last millennium and has since then fallen by 25.5%. The S&P 500 is down almost 30% from its peak which occurred at the height of the tech bubble in March 2000. While a few of the more optimistic commentators remain in denial (mainly those with vested interests), it is now pretty uncontentious to suggest we are in a bear market. So how low can markets go? Barrons recently published a useful table to attempt to answer this. It highlights that valuations remain very high by historical standards. In comparison with the US (see below), UK valuations are lower (P/E 22.5x and a 2.8% yield), which partly explains why we hold no US equities at present. But with the two markets so highly correlated, the gravitational pull of Wall Street can only be resisted for so long.

BEAR MARKET BOTTOMS
FOR THE S&P INDUSTRIALS

Date	P/E	Dividend Yield	Price To Book	Price To Sales	Bond Yield
13/06/49	5.4	7.6%	0.89	0.43	2.4%
22/10/57	12.0	4.4%	1.43	0.75	3.7%
25/10/60	16.3	3.6%	1.64	0.93	3.9%
26/06/62	14.9	3.9%	1.54	0.85	3.9%
03/01/67	14.9	3.5%	1.85	0.93	4.4%
26/05/70	12.9	4.4%	1.45	0.66	6.9%
06/12/74	7.5	5.1%	1.07	0.38	6.8%
28/02/78	8.3	5.3%	1.14	0.40	7.6%
21/04/80	6.8	5.7%	1.08	0.34	10.8%
12/08/82	7.9	6.3%	0.97	0.33	12.2%
24/07/84	9.4	4.4%	1.36	0.44	12.8%
19/10/87	12.7	3.4%	1.92	0.58	9.6%
11/10/90	13.9	3.6%	2.24	0.60	8.9%
Average	11.0	4.7%	1.43	0.58	7.2%
Current	25-35 (est)	1.3%	6.70	1.47	4.6%

Source: Barron's 31/12/01

The mindset of a bear market has yet to set in within the investment management industry. Most fund managers still readily put clients' cash to work straight away irrespective of valuations, in fear of missing a rally. Relative returns against indices remain a priority over absolute returns. A return on clients' capital is more important than preserving clients' capital. Liquidity levels remain too low to drive the market forward. UK pension funds are more fully invested than at any time in recent years. The WM Company recently reported cash levels of 2.7%, down from over 6% in 1997, for its All Funds Universe of £340bn pension funds. Unit trusts are similarly low on cash and ISA sales are on the wane.

Smoking is back in fashion

A function of portfolio managers being fully invested is that if they sell a stock they have to buy another. Where do they to turn? With markets drifting, and earnings disappointing in many sectors, what better than the highly cash generative defensive earnings of tobacco companies. Casting fears of litigation aside, their shares have been bought aggressively. Over the last 18 months the shares in Imperial Tobacco have doubled and are now valued on a yield less than the market average, the highest valuation for the stock since its flotation in 1996. A recent broker note described Imperial as a "Growth stock you can rely on". If ever there was a bell ringing at the top that is it! We hold no tobacco stocks in the fund but we have benefited from a re-rating in defensive sectors such as food manufacturers and brewing where valuations are less excessive.

Masterful inactivity

With little changed in the world over the last quarter there has been little reason to alter our strategy. It costs us 1% in commission, market maker spreads and stamp duty to switch from one stock to another. In a low return world, turnover of the portfolio is best kept to a minimum. In fact the few transactions we did make during the quarter have added no value to date. Fortunately these were offset by the takeover bids we received for our holdings in Haslemere NV, the Netherlands listed UK property company, and Druck Holdings, the engineering group. This demonstrates that money *can* be made in bear markets; it is just easier to lose it. We will continue to look hard for similar investment opportunities on behalf of unitholders.

We are painfully aware that we are under invested in equities. The excesses of the stock market bubble of the late 1990's are grudgingly being unwound. This process is taking longer in the US than in the UK where it was never as great. We still think it is right to bide our time before investing your cash.

It is now a year since the Fund was launched. The fund is up 3.5% over that period on a total return basis (Source: Lipper). This compares to FTSE All Share Index equivalent return of –9.5% and the return from the APCIMS Balanced index of –7.5%. We consider this a satisfactory start but look forward to better years and better markets ahead!

Sebastian Lyon

14th June 2002