TROY
ASSET MANAGEMENT

Investment Report Nº31

February 2011

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

2010

In 2010, the Trojan Investment Funds performed respectably amid volatile conditions. The Trojan Fund and Trojan Income Fund both produced returns of +14.4%, a whisker behind the return of the FTSE All Share Index of +14.5%, while the Trojan Capital Fund was further ahead, returning +14.9%.

The Trojan Fund's performance trajectory, however, differed dramatically from that of the stock market, rising steadily through the year without material corrections. During the Greek chapter of the European debt crisis, in the spring, the UK market fell by as much as 17%. By contrast, Trojan Fund investors had a more comfortable ride with a maximum fall of less than 4% and the Trojan Income Fund's fall was also a relatively modest 9%. We provided market type returns with significantly less volatility. During the year the Trojan Fund's exposure to equity markets averaged approximately 50%.

Since launch, the Trojan Fund has produced an annualised return of 9.4% which compares to 4.3% for the FTSE All Share and 4.2% for cash (LIBID index).

Riding to the rescue

Up until the end of August, with the announcement of the second round of money printing, (*see Investment Report Nº30*) markets looked set for a lacklustre year. At the end of the summer, UK and US stocks had fallen 5% and 7% respectively for the year to date.

The willingness to use the monetary printing press again sent risk assets on a roll, with UK stocks lurching up 17% while US stocks rose by 19% in the following four months. Cyclical and industrial related shares performed well, leaving some of our favoured holdings behind. Our natural bias is away from more speculative small and mid cap stocks that are more likely to be subject to the vagaries of the business cycle. Long standing investors in Troy's funds will not be surprised that we lagged the market in these months. Our determination to avoid such investments can lead to periods of underperformance but has always worked out over any meaningful investment horizon.

The renewed bout of paper money debasement helped the gold price to soar, ending the year at or near all time highs in most major currencies.

Fed Chairman, Ben Bernanke, goaded investors to speculate, even openly admitting as much in an op-ed piece in the Washington Post after QEII was eventually confirmed in November. He said;

"This approach (quantitative easing) eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose … higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."

We question whether a 'manufactured' rise in the stock market will generate the desired re-leveraging of the consumer and thereby germinate a recovery in the US economy.

The rise in stock prices Mr Bernanke so dearly desires may come, but it will prove totally unsustainable, merely bringing returns forward in the same way the Fed's loose monetary policy achieved in the late 1990s and again in 2003-7. The gain will not come without subsequent pain. Puffing up asset prices through the use of loose monetary policy only provides a misplaced confidence of perpetual capital gains. As the perceptive and too often ignored economist, Ludwig von Mises, said of asset bubbles: 'In fact, all this amazing wealth is fragile, a castle built on the sands of illusion'. It is only retained gains that count in the long run.

Income rising

Equity income investing has provided its challenges over the past five years. Nevertheless in a low return world that began a decade ago, we continue to believe that much of the total return from equities will come from income and not capital growth. The credit crisis resulted in a number of dividends disappearing, especially from the banks. Others from life companies, miners and industrials were cut (or as more euphemistically described, 'rebased').

Last year BP added to the challenge by passing its dividend following the Macondo well disaster. In all, since 2007, dividend growth has been elusive. UK stock market dividend income has fallen by 29% between 2007 and 2010 (*Source: Evolution Securities*). This is the type of environment an equity income fund manager would expect to occur once in a career and most have not come through unscathed.

The Trojan Income Fund is one of a small handful of funds to have grown its dividend year on year over this period (*see Figure 2, the back page*). Francis Brooke's investment approach has been consistent since the Fund's launch over six years ago—seeking out stocks with sustainable and growing income. He has thereby avoided most of the torpedoes that have holed many equity funds below the water line. This low risk approach to equity investment works over time.

After this difficult period, we believe equity income is set for better times ahead. Corporate balance sheets are relatively strong and dividend cover is healthy. Corporate investment opportunities are not abundantly obvious and managements remain (rightly) cautious of the outlook. Rewarding shareholders with dividends looks a sensible strategy.

Softly does it

After careful consideration, we have taken the decision to 'soft close' the Trojan Fund. As a company Troy is not an asset gatherer. More often than not, less is more in investment management as there can be diseconomies of scale. The temptation for any fund manager is to take on assets for as long as possible but our concern is that the strong growth in assets may, in the long run, limit investment opportunities and compromise returns.

In our business, you get the clients and investors you deserve and we have been very fortunate. It was always critical that we attract those who understand our approach. Our priority has been to look after existing investors first and to discourage 'hot money'. This has been done, in part, by our policy to charge a dilution levy (paid to the fund—not to Troy) and our different approach which is often uncorrelated to markets.

The Trojan Fund has grown over the past two years and we are seeking, subject to FSA approval, to reduce the rate of growth by 'soft closing' the Fund to new investors from 30th April. Whilst this will not affect any existing investors who will be able to add to their holdings, should they so wish, new investors will require to have a minimum investment of £250,000 and will additionally incur an initial charge of 5%.

Anatomy of a bull and bear

The words 'investment guru' are frequently used too liberally these days but in the case of CLSA's Russell Napier the description is warranted. Russell wrote ***Anatomy of a Bear: Lessons from Wall Street's Four Great Bottoms*** (published by *CLSA*) back in 2005. The book recognises that we are in a secular bear market for stocks and indicates how the four major bottoms of the 20th century can provide investors with a guide to how the current bear market will come to end.

A lost decade

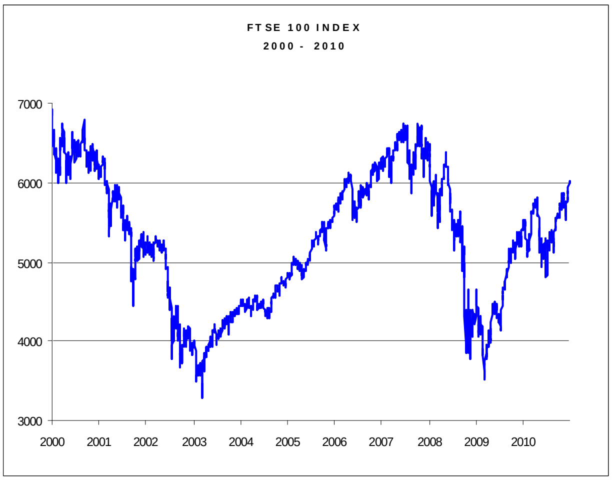

Figure 1 Source Bloomberg

In January, we enjoyed an update with Russell. His belief is that the bear market's work is not over although, on a tactical basis, he is more optimistic in the very short term. Investors, he thinks, will be hoodwinked into believing that central bankers have managed the improbable and turned the clock back to 2007. Negative interest rates, a pick-up in M&A, and a flood of new IPOs will all fool investors into thinking the monetary ills of the world are over. This will prove to be an illusion of gigantic proportions when the pressures on western governments' fiscal positions are seen in full relief in 2012. Rising bond yields will choke off the rally in stocks by raising the cost of capital. While stock markets in the west may rally to their old highs (of 1575 on the S&P 500 index or 7000 on the FTSE 100) his ultimate forecast is more sobering - for stocks to fall below their lows of 2002 and 2008. According to Russell, central bankers are endeavouring to encourage credit growth and keep negative real interest rates in place for a sustained period. Inflation will be ignored and it will, ultimately, be an inflation scare that will trigger both bond and equity markets to fall sharply.

China has, for over a decade, been a positive, disinflationary influence on the world economy but this is set to change. The biggest urban migration in human history is now over, as is its deflationary influence. Since 1994, the price of clothing in the UK has fallen 50%. Such a trend will not be repeated. We need to prepare for a high inflation period. In a recent speech in Newcastle the Governor of the Bank of England, Mervyn King, warned the British population to prepare itself for a sharp fall in the standard of living, as real wages continue to fall. The enduring patience of bond investors may be tested if the RPI creeps above 5%.

As investor confidence grows and memories of 2008 gradually dissipate, we need to consider a more volatile outlook. Investors need to be aware that momentum investing has returned, which does not suit our value-based, qualitative approach. In previous periods when there has been a paucity of attractive investment opportunities we had the comfort of turning to cash to preserve investor's capital and produce a decent positive real return. In an inflationary but zero interest rate world this safety valve has been turned off. We would therefore expect to see the volatility of the Trojan Fund slightly increase in future years. Amid our natural caution, we are continuing to find a number of undervalued blue chips, that are a refuge to invest new monies at attractive rates of return, Microsoft being a recent addition to the portfolios.

We are not alone in finding the majority of investments unappealing–one of the most talented investors of the past 20 years, Boston based Seth Klarman of Baupost, recently opted to return investors 5% of their capital citing scarce opportunities.

2020

We do not make predictions. Giving short term forecasts is a mug's game but it always amuses us, every year, when global investment banks are happy to put a target for the market for the end of the year. The standard form is to predict a positive low double-digit return to whet the appetite of their client base. A negative forecast is almost unheard of and this year is no exception.

According to the *Financial Times*, the four bulge bracket US banks (Bank of America, Citigroup, Goldman Sachs and JP Morgan) are all targeting the S&P 500 index to reach 1400–1450, an 11-15% rise.

A more useful forecast came from Robert Shiller, the Yale economics professor ,who back in 2000, wrote Irrational Exuberance (*Princeton University Press*) highlighting the unsustainable, extreme valuation of the US stock market. This prescient book included the cyclically adjusted price earnings ratio which hit an all time high in March of the same year. Shiller has bravely given a decade end target for the S&P 500 index of 1430. Shiller is assuming the US stock market valuation will revert to the long-term mean. If Russell Napier's expectations are anything to go by, Shiller and Wall Street may both be right.

Sebastian Lyon
February 2011

Trojan Income Fund dividend history since launch

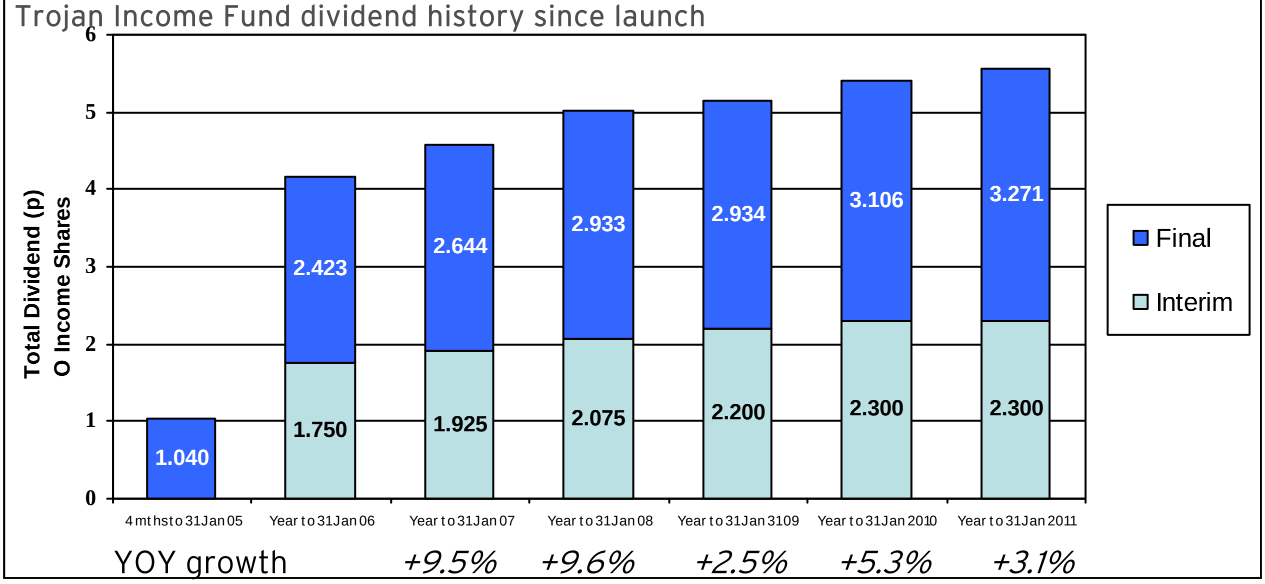

Figure 2 *Source: Capita Financial/Troy*