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AS Troy Fund

Quarterly Report No. 5

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

Don't mention the war

The war with Iraq was a monumental distraction for investors. During the quarter, they were obsessed by ongoing diplomatic manoeuvres by the US and UK governments. Hanging on every word of the UN weapons inspectors' fortnightly reports, investors found it hard to focus on anything else. Geopolitics, rather than economics dominated the stage. Earnings announcements were ignored and the equity market drifted down with continued forced selling from life assurance companies. As it became apparent that the US would invade Iraq come what may, the market sold off. Short-term capitulation occurred on 12th March. The FTSE 100 index closed at 3287, a seven-year low.

"Buy on the sound of cannons" is an old stockmarket adage, but this time the market jumped the gun, surging a week before military action had begun. The rally, as with all previous bear market rallies, was short and sharp, rising 13% in three trading days. Through the second half of March and the beginning of April, there were days of nervousness as the war did not seem to be going as planned. Pricing screens were less exciting than the minute-by-minute reports on CNN and CNBC. However, the end result was never in doubt. Once the chances of damage to Iraq's oil production receded, the oil price fell, and the equity rally continued into April.

Baghdad bounce

Traditionally in bear market rallies, it is the lower quality stocks that benefit the most and, judging by the top performers in the UK market since mid-March, the current rally is no exception. Inevitably, although we raised our equity exposure in January and at the low on 12th March, we did not participate fully in the upward move. The Fund rose 2.7% in the quarter to the end of April which compares with a total return of the FTSE All Share of +11.3% while the APCIMS Balanced index rose 8.0%. This was to be expected as the Fund is currently taking far less risk than a fully invested equity portfolio. The defensive nature of most of our equity holdings, which are biased towards the consumer staple sectors, our lack of exposure to financials and the inevitable bond market sell off which accompanied the reversal in fortune for stocks, held back the Fund's performance. Top performers in the FTSE 100 index during the rally were Granada, Reuters, Dixons and Friends Provident. It is no coincidence that

they were among the worst performing stocks during the market's fall, a simple case of the Grand Old Duke of York syndrome. These companies have consistently destroyed shareholder value in recent years and, for us, do not qualify as investment grade. Every dog has its day. While performance-hungry momentum investors may chase such stocks, we will not follow.

While the Fund was left behind in the scramble in March and April, fund managers judged relative to an index benchmark enjoyed a brief period of positive returns. However, many of them did not keep pace with the market and have been caught out by the extent of the rally. The problem with index hugging investors is that they are reactive and tend to buy too late. A strange quirk of relative investing in a bear market is that portfolio managers cannot afford to miss the rallies and thereby imprudently follow the market down, fully invested. Hedge funds, also seeking very short-term returns, create huge amounts of noise in the market. Our earplugs are in. One of the advantages Troy has is its ability to stand back, unconcerned with daily market moves and short-term trends with all the costs such activity entails. While this means the Fund will not slavishly follow the equity market's every move, it also means that the Fund will not shoot up and then spectacularly collapse.

Gordon's growth model?

In a world of international capital markets, the UK Budget has become a minor event in the economic calendar. This year was no exception, but the Chancellor's speech, fortuitously eclipsed by the toppling of Saddam Hussein, was of interest for what was omitted. What was said? The Treasury's GDP growth forecast for 2003 was cut to 2-2½ % from November's prediction of 2½ - 3%. Gordon Brown's expectations for next year remained a punchy 3-3½ % and 3% for 2005. This would be well above the UK economy's trend growth rate. In fact, the economy has not enjoyed two years of 3%+ growth since the 1980s and it is hardly likely in this low growth world. The Chancellor's growth forecasts look suspiciously convenient, making his borrowing forecasts respectable. He is clearly in denial, acting like a finance director assuring analysts and investors - "we will make our profits forecasts" and hoping that something will turn up to bail him out. With UK GDP of just 0.2% growth in the first quarter of 2003, Gordon Brown's growth predictions are already out of date. The National Insurance rises from last year's budget combined with higher Council tax and a stalled housing market will not provide the Chancellor with a Baghdad bounce.

What he omitted to mention was that taxes would have to increase again next year as government borrowing escalates, and that the UK economy, which has outperformed its competitors for the last two years, will, like its stockmarket, begin to underperform.

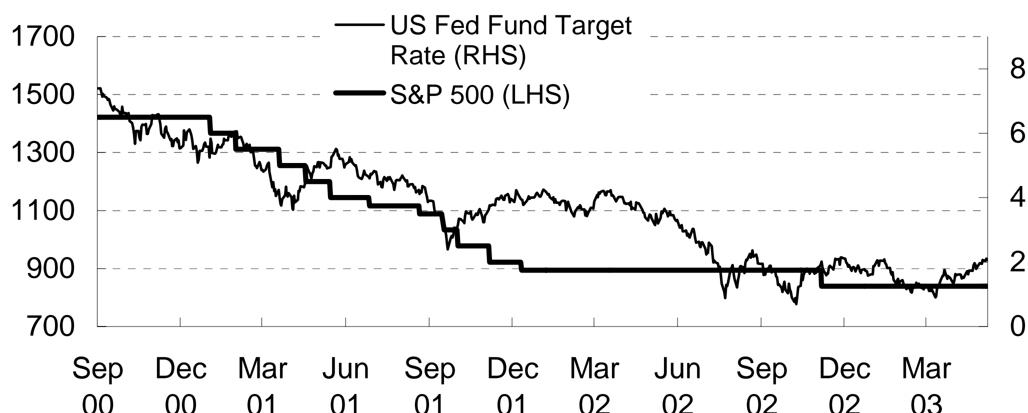
Long duration bonds

UK inflation has perked up lately, to 3% at the last count. Should we be concerned about the Fund's long bond exposure? We are not distracted by the latest statistics. The oil price is falling and when housing depreciation (a delayed function of house prices) drops out of the figures we anticipate inflation to fall to the bottom end of the Bank of England's target range of 1½-3½% over the next year. In the past quarter, US core (excluding food and energy) CPI has fallen to an annualised +0.4% - flirting

with deflation. Our confidence in holding bonds was also bolstered by a recent statement from the US Federal Reserve, which stated, "the probability of an unwelcome fall in inflation, though minor, exceeds that of a pick up in inflation from its already low level". The Fed and the Bank's next moves will be to cut rates further.

Following the recent sell off in bond markets we added to the Fund's long dated fixed interest exposure. During the quarter we invested in long-dated French government bonds and a small holding in Australian government bonds. The French bonds were offering a yield of 5%, in excess of their US equivalent, and should benefit from the continued appreciation of the Euro. At times of sustained US dollar weakness, the "mini dollar" currencies of Australia, Canada, and New Zealand tend to strengthen. Their virtues are respected central banks and balanced budgets. The Australian bonds yielded 5.3%, when purchased and have already enjoyed some currency appreciation.

Lower interest rates are not bullish for equities



Source: Citigroup Smith Barney

Ups and downs

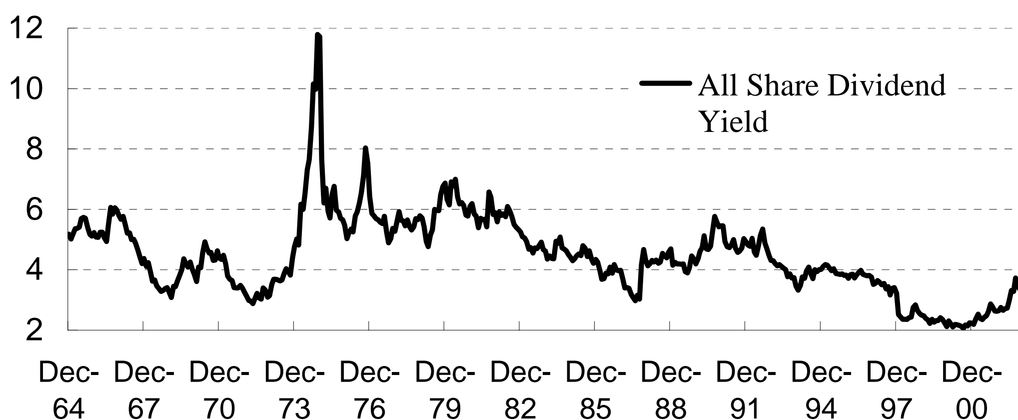
EMI was a value trap. It looked cheap and it kept getting cheaper. The company is struggling to cut costs in line with falling revenues. BMG and AOL Time Warner, both seen as industry consolidators have turned sellers of their music divisions. Piracy is taking its toll. Recurring reorganisation costs at EMI are absorbing cashflow. Debt levels at the company remain stubbornly high. This was the Fund's first equity investment in June 2001 and was sold for a loss during the quarter. The market has fallen considerably since then so it is hardly surprising that we lost money. On the positive side, the loss incurred on EMI has been more than offset by other equity holdings. GW Pharmaceuticals, in particular, has enjoyed a very strong run of late, more than doubling since we made the investment in August of last year.

Are equities cheap?

In March, Alastair Ross-Goobey attempted to ring the bell for UK equities. After a three-year bear market equities looked cheap relative to bonds and, for a day or two, equities yielded more than ten-year gilts - the first time this has happened since 1959. However, if inflation stays low, earnings growth and dividend growth, the key equity market drivers, will remain low.

With the exception of yield comparisons with the bond market, UK equities, on a P/E multiple of 17 and a dividend yield of 3.4% (source: FT), are not cheap. As the chart below shows, with the exception of the highly inflationary period in the 1970s, the time to buy stocks aggressively is when they yield over 5%. US equities remain very expensive on a P/E multiple of 19 using operating earnings or, using Standard & Poors "core" earnings figures, (which adjust for pension fund accounting, exceptionals and expense options) the P/E multiple is closer to 30. In a world seeking income, US stocks offer a paltry dividend yield of 2%. Amid the ongoing debate about the appropriate measure of corporate earnings, the price earnings ratio is of less use. As Philip Coggan of the FT recently commented," the dividend yield is a more useful measure of value".

FTSE All Share Yield (%)



Source: Citigroup Smith Barney

The Fund's present asset allocation, split evenly between bonds and equities, demonstrates that we are more optimistic about the equity market than at any time since launch, but it also indicates a firm belief that the bear market's work is not yet done.

Outlook

In this post war period, markets need to digest the US administration's new pre-emptive policy towards national security. President Bush and the neo-conservative White House are taking huge risks with the economy as a consequence of this policy change. Geopolitics, which we have been able to ignore for so long, are becoming a more important part of investment fundamentals. Whether the treatment of Iraq will lead to other rogue states changing from within is yet to be seen. Further military action, driven by renewed US confidence following a successful invasion of Iraq, should not be ruled out. The stockmarket will hate the uncertainty.

The state of the global financial system remains precarious. The US Federal Reserve has already hinted that it is prepared to look at unconventional action, including buying long-dated Treasuries, in order to reinflate the economy. This has implications for the currency markets and the prospect of further US dollar weakness. All of the factors that led to strong growth in the 1990s are in reverse. The virtuous circle of rising capital investment, leading to wealth creation (in salary and investments), leading to growth in consumption and more investment is no longer with us. Now,

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falling stockmarkets lead insurers to sell for solvency purposes and corporate pension fund liabilities to increase, which in turn leads to lower corporate profits and dividends. Finally, in the US in particular, declining share prices lead to a fall in consumer confidence. Consumers are saving more. Corporates are deleveraging and investing less - a vicious cycle. A reverse wealth effect is in train.

Troy would not want to call the short-term direction of the equity market - it would be like tossing a coin. The FTSE 100 index is up 800 points (over 24%) from the March low and a bullish consensus is becoming more audible. This could indicate the rally is running out of steam. However, we are in little doubt that in the medium term (one to two years) the trend on Wall Street remains downward. The UK market, albeit cheaper, will find it hard to resist the high correlation with its US counterpart. A strong advance in stocks from current levels would make us nervous. We would be tempted, for the first time since the Fund's launch, to reduce our equity weighting.

Two years on

It is two years since the AS Troy's launch on 30th May 2001. The Fund is up 12.8% on a total return basis. This compares with the FTSE All Share (Total Return) index return of –25.2% and the return from the APCIMS Balanced (Total Return) Index of –17.9%. In capital terms the Fund is up 6.9% (Source: Troy). A note of caution to unitholders: the Fund may not always do so well on a relative basis (the last quarter's performance demonstrates this well).

As at 31st May 2003 the Trust was ranked first out of the 103 Balanced Managed unit trusts over twelve months and first out of 92 Balanced Managed unit trusts since launch. *(Source: Lipper, bid to bid basis, net income reinvested at ex-dividend date, Sterling terms).* We look forward to the challenge of building on this track record with enthusiasm and excitement.

Sebastian Lyon

2nd June 2003

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