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# TROJAN FUND

## Quarterly No.9

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

**Three years on…**

Over the past three years, since the Fund's launch on 30th May 2001, we have achieved our aims amid difficult market conditions. The Fund has risen 19.5% on a total return basis (including net income reinvested) beating the returns available on cash (+12.9%) and the UK stockmarket which fell by 15.4%, outperforming the latter by 41.3%. The Fund succeeded both in protecting capital and protecting the value of units against inflation. On a capital only basis the Fund rose 9.9% compared to an increase in RPI (excluding mortgages) of 6.9%. Your Fund is ranked first out of 86 Balanced Managed funds since launch and is one of only four funds to have produced a positive return over the period. *(Please note the performance figures on page 6 are for the quarter ended 30th April 2004)*

As we said in the latest annual report, there will be periods when the Fund's conservative investment approach appears to be out of fashion, or perhaps simply old fashioned! In a world of "hot money" seeking returns over ever shorter periods, our style is not for the impatient. We believe, however, that we have a clear and distinctive investment policy – we stick to our knitting and are unaffected by the volatility of markets and the day to day noise. The Fund has also demonstrated that good investment returns can be achieved with low turnover. We are unafraid to hold cash when the industry is investing regardless of valuation. This is not admitting defeat or a lack of ideas, but a responsible approach to protecting capital. In the latest Berkshire Hathaway Annual Report, Warren Buffett apologised for holding high cash levels and said: "*Our capital is underutilised now, but that will happen periodically. It's a painful condition to be in – but not half as painful as doing something stupid*".

Over the past three years there are things we could have done differently. In particular we are disappointed not to have captured more of the upside in equity markets during the past year. But our aim is not simply to beat an equity market index. The past year has not been easy for those who have a more cautious view of equity markets and if there is a lesson to be learnt it is that when we do find suitable equity investments we need to invest with more conviction.

Authorised & Regulated by the Financial Services Authority
Registered office: Hill House, 1 Little New Street, London, EC4A 3TR
Registered in England No. 3930846

**Turbulent Times 2001-2004**

On 30th May 2001, the FTSE 100 index closed at 5796. It rose to 5951 on the 8th June 2001 and has never been close to that level since. The index fell to a low of 3287 on 12th March 2003, a fall of 43% from the starting point, and has since rallied to 4431 (as at 28th May 2004), a rise of 35%. Over the three years the index has fallen 24% in capital terms.

**FTSE 100 Index since launch**

*Source: Bloomberg*

What of the next three years? Predicting short term stockmarket movements is a mug's game - the annual round of FTSE 100 target predictions has made fools of many a talented investor. Forecasting over the long term is easier. We do not expect the next three years to be very different.

**Are stocks cheap?**

When we started in May 2001, UK equities looked very expensive, valued on a price earnings ratio ('P/E') of 21.7 times earnings and a dividend yield of 2.35%. To put this into perspective, the long term *average* P/E is 13 times and the average yield 4%. Three years on, following the fall in the market, it is now on a P/E of 17 times and a yield of 3.2% - hardly a bargain. The current yield level, together with forecast nominal GDP growth of 4.0% which is a good indication of corporate profits growth, gives a potential total return for the market of about 7% (not much compared to the double digit returns of the 1980s and 1990s). In fact, at the market's recent low of 3287, stocks were yielding 4%. Good value? No – simply fair value. The US equity market is even more expensive. In the words of Martin Wolf of the Financial Times, "*Since 1881, the US stockmarket valuations have been as high as they are today only twice: in 1929/1930 and then around the recent peak (in 2000).*"

Just because the market has fallen, it does not mean that stocks have become cheap. Our cautious investment policy over the past three years has served us well and we expect it to continue over the next three. The best investment returns will come from investing for income together with tactical asset allocation, keeping turnover to a minimum and making as few mistakes as possible (to buy fear and sell greed).

**Investing for income**

Dividend income is the key to long term investment returns. According to the Barclays Capital Equity Gilt study, £100 invested in UK equities in 1900 would be worth £161 in *real terms* at the end of 2003. If all the dividends had been reinvested, the £100 would be worth £17,356. Over the long run stocks appreciate in line with earnings growth, but over the past 20 years the expansion of valuations has played a more important role. In future, we expect income to be the most important contribution to returns.

Secure and preferably growing income is worth a premium in a low inflation, low return world. A company growing its dividend on a sustainable basis, at the right price, is an attractive asset. A good example is Greene King bought for the Fund in late 2001. The shares stood at 700p and yielded 4%. Since then the dividend has grown by 20% and the shares stand at 900p (a capital increase of 29%). The stock yields 3.4% today. We would dearly like to find more of these investments, but they are few and far between and it is essential that we do not overpay.

**Bond market jitters**

Our central investment case remains one of disinflation, or at least low inflation. The combination of high consumer and government debt levels (which will have to be reduced at some point), an ageing population, globalisation and additional capacity from the large emerging economies of China and India, all point to inflationary pressures remaining subdued. Very few companies have pricing power. In recent months, however, bond markets have been spooked by fears of rising inflation. The combination of a rise in the oil price together with signs of growth in employment in the US, have given investors concern regarding capacity constraints. The risk of a sharp rise in bond yields (driven by a fall in the price of bonds) has become a possibility.

Sharply rising bond yields would not be good news for equities. It was the collapse of bonds in 1987 and 1994 that led to equity market corrections.

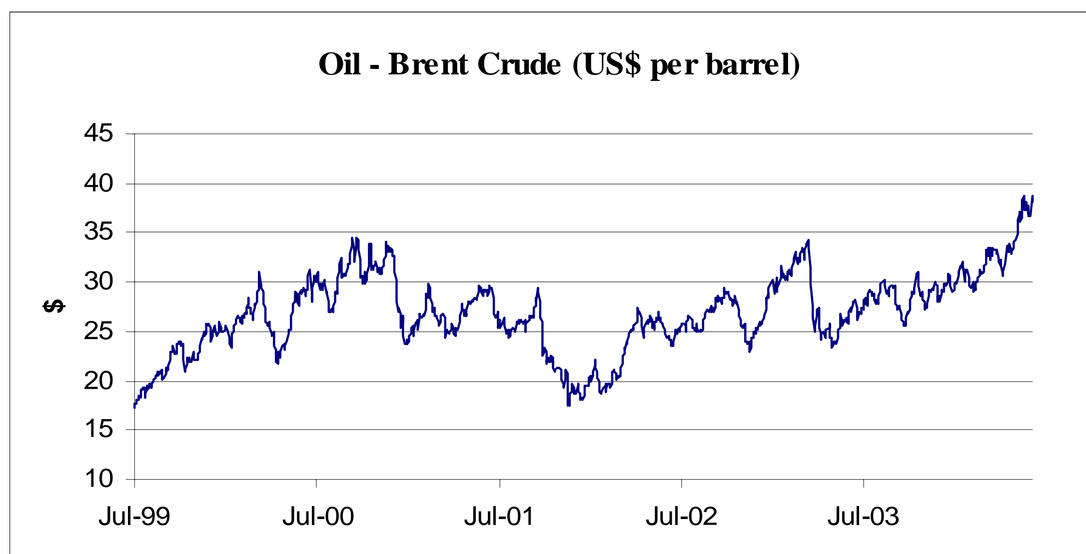
The Fund's portfolio is tilted towards a disinflationary outcome. This makes it exposed to an inflation scare. Recently the Fund's holdings in overseas bonds have provided no positive return apart from income accrued. High levels of UK interest rates also make Sterling strength a possibility, so, since the quarter end we have sold the overseas bonds for a small loss but, we believe that we have reduced the potential for greater losses. The Fund retains some UK gilt exposure and preference shares (which have less correlation with the bond market and should prove more defensive with their much higher yields of 7%). Unlike equity investments, which are for the long term, bond investments should be more tactical.

## Oil slick

The recent rise in the oil price has added to the inflationary fears, but the reasons behind it are more debatable. These include rising geopolitical risk (in Iraq and Saudi Arabia), tight capacity, record low oil reserves in the US and China, higher demand thanks to a stronger world economy and lastly, hedge fund speculation.

It is possible to argue that too much is made of the importance of the oil price. The International Energy Agency points out that oil demand has fallen from 7% of world output in 1980 (at the time of the last oil shock) to 2.5% today. Replacing government strategic reserves may underpin the price in the short term but, as the world economy slows into 2005, the price spike may dissipate.

Higher oil prices are not necessarily as inflationary as commonly perceived. Yes, the price of petrol rises and is reflected in the RPI, but increased petrol prices also act like a tax on consumers and mean they spend less elsewhere with a consequent deflationary effect on the economy. BP's gain is the retailers' loss. With the exception of the oil sector, higher oil prices also mean lower corporate profits. The recent share price falls of airline and chemical stocks are a testament to this. Having said this, a possible collapse of the Saudi regime, and the subsequent effects on the oil supply and the oil price, would invalidate the benign disinflationary prognosis. Significantly higher oil prices and a high level of uncertainty would result in the worst of all worlds for bonds and equities – stagflation – something not seen since the 1970s.




*Source: Bloomberg*

Notwithstanding the uneasy bond market nerves, at present the central case remains low inflation. Somewhat higher oil prices today result in less demand and lower oil prices in future. Although oil demand is inelastic in the short term, price will affect demand.

This variety of scenarios makes reading the investment tea leaves even more difficult than usual.

**An Insurance Policy**

During the last quarter we have bought three small holdings in the insurance sector. The underwriting companies Beazley, Brit and Chaucer sit on very low valuations in the expectation that the insurance cycle will turn down in the next year or so. We have recently met the managements of these unloved companies and are sceptical that a major downturn is on the cards. Larger companies such as Royal Sun Alliance have taken capacity out of the market and have been running their businesses for cash to rebuild reserves and cover long standing liabilities. In a low return world, insurance companies can no longer rely on investment returns to bail out underwriting losses. Balance sheet exposure to equities is at a low and many insurance companies are investing in low risk asset classes including short dated bonds. This implies an improved and more responsible pricing environment. Claims experience is also good. The improved capital discipline in the sector will lead to higher dividends.

**Outlook**

The cautious 50% equity weighting and high liquidity levels of 30% position the Fund for a more difficult environment. It may be unadventurous but an absolute return investor, seeing an absence of opportunities, should hold cash. At times this feels uncomfortable while the crowd continues to speculate, but waiting for bargains is better than piling in and overpaying.

We look forward with enthusiasm to building on our three year track record.

**Administration**

We now deal weekly (at noon on Thursdays) and on the last working day of the month. If you would like to participate, application forms are available from us, or from Capita Financial (Tel: 020 7556 8800).

Sebastian Lyon
Troy Asset Management Limited
June 2004

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Registered in England No. 3930846

# Trojan Fund

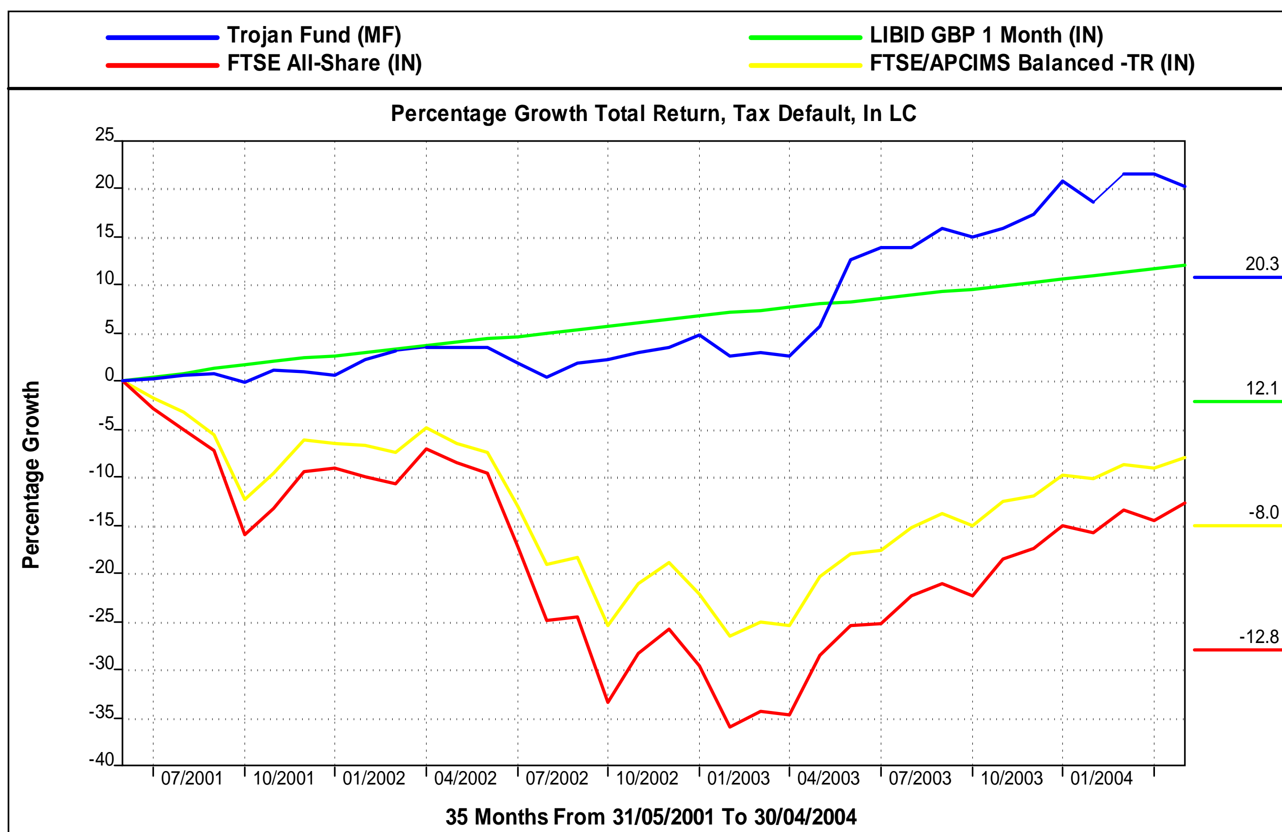
As at 30 April 2004

**Unit Price** £1.11 **Fund Size** £69.05m

## Investment Objective

The investment objective of the Fund is to achieve growth in capital and income in real terms over the longer term. The Trust's policy is to invest substantially in UK and overseas equities and fixed interest securities.

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




## Performance

| | Since Launch 30.05.01 | 1 year 30.04.03 | 3 months 31.01.04 |
|---|---|---|---|
| Trojan Fund[1] | +20.3% | +13.8% | +1.49% |
| FTSE All Share Index[2] | -12.8% | +22.2% | +3.59% |
| APCIMS Balanced[2] | -8.0% | +15.6% | +2.38% |
| LIBOR | +12.1% | +3.8% | +1.02% |

[1]Bid to bid, net income reinvested — Source: Lipper Hindsight
[2]Total return indices — Source: Bloomberg

## Currency Exposure

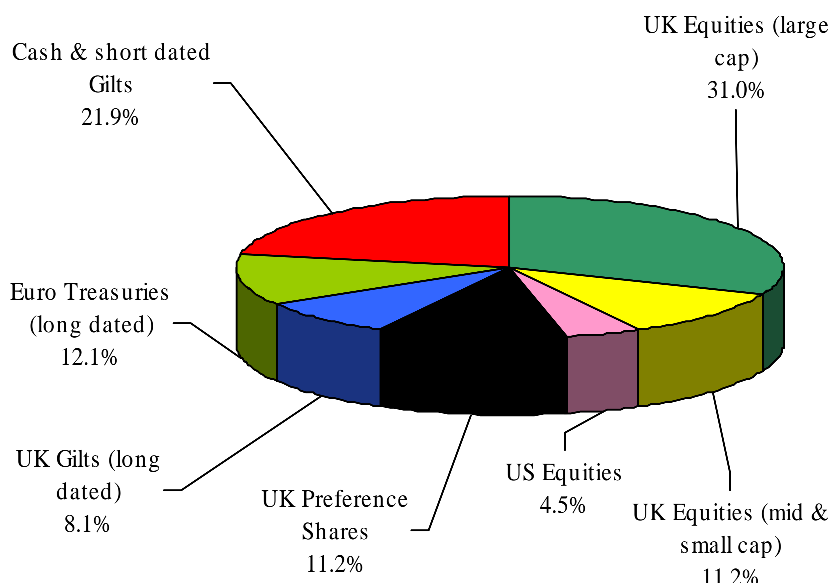
| | % Fund |
|---|---|
| USD | 4.5 |
| JPY | 0.0 |
| EUR | 12.1 |
| AUD | 0.0 |
| GBP | 83.4 |
| Total | 100.0 |

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

# Trojan Fund

**As at 30 April 2004**

## Asset Allocation




## Top 10 Holdings

| | % Fund |
|---|---|
| France Gov't 5.5% 2029 | 6.7 |
| 3.5% War Loan | 6.3 |
| Deutsche Republic 4.75% 2028 | 5.4 |
| Treasury 5% 2008 | 5.3 |
| Treasury 7.5% 2006 | 4.7 |
| NatWest 9% Pref | 4.0 |
| BT | 4.0 |
| HBOS 9.25% Pref | 3.5 |
| Shell T&T | 3.1 |
| British American Tobacco | 2.7 |
| Plus 22 other holdings | 42.4 |
| Cash & Equivalent | 11.9 |
| Total | 100.0 |

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**Registrar**
Capita Financial Administrators Ltd

**Depository**
State Street Trustees Ltd

**Auditors**
Ernst & Young LLP

**Dealing**
Weekly – Thursday at 12 noon and month end

**Denominated Currency**
GBP

**Management Fees**
Standard fee: 1%

**Launch Date**
30 May 2001

**Dividend**
Paid annually
ex date 02.02.04
Final 2.824p
payment 31.03.04

**Bloomberg**
CFTROJI_LN


**Please bear in mind:**

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**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 investments to go up or down.**

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