

# SCEPTRE

INVESTMENT MANAGEMENT  
7 Pembridge Place, London, W2 4XB

*The fund aims to achieve excellent long-term investment returns by investing in undervalued listed European equities with a specific focus on the UK.*

**Chris Broadhurst, Fund Manager**  
**Luke Howard Taylor**

**Year ended 31 December 2007**  
**Sceptre UK Fund**

*Fellow Shareholders:*

In 2007, the second full calendar year for the fund, the net asset value per share has declined by 8.5% net of all fees to £1,221.21. This follows on from a strong performance in 2006 when the fund returned 21.6% net. As a reference to general market performance over the same period the FTSE All-share index (TR) has increased by 5.3% following an increase of 16.8% last year.

We start the New Year with a portfolio of 15 companies and a 7% cash weighting. We continue to focus our attentions on acquiring stakes in businesses which have strong franchises, are run by good quality management and where we can acquire stakes at prices which are significantly below what we appraise their intrinsic value to be. Whilst many businesses offer the potential of producing excellent returns on capital, we continue to believe that in order to obtain excellent long-term investment returns at the portfolio level the most important factor remains the price which is paid for securities. We also remain focussed on the strength of balance sheets in our underlying investments and the leverage employed against the businesses with the risk it presents to our capital.

Our portfolio is heavily concentrated into a small number of securities which have little overlap with the FTSE All-share or any other index, which necessitates that we will differ in performance from any particular index from year to year sometimes for extended periods. The vicissitudes of the market will provide a varying number of undervalued opportunities to us and the first 6 months of 2007 was a period in which we found it increasingly difficult to identify quality businesses we could invest in at sufficiently low prices – as a result the fund saw its cash weighting increasing as the year progressed and peaked at 22% of assets in July.

### Performance Summary

<u>Year</u>	<u>NAV</u>	<u>Cumulative</u>	<u>FT All-Share</u>	<u>Cumulative</u>
2005*	+ 7.8 %	+ 7.8 %	+ 4.2 %	+ 4.2 %
2006	+ 21.6	+ 31.1	+ 16.8	+ 21.7
2007	- 8.5	+ 20.0	+ 5.3	+ 28.2
Annual Compounded Rate		+ 8.4		+ 11.6

\* from 30 September 2005. After all fees, bid-to-bid with dividends reinvested.

The recognition of the poor quality and illiquid nature of many recently created credit securities during the second half of the year caused a number of effects which have had relevance to our fund. Initial reactions centered on mortgage debt, housing related companies and the financial companies which provided funding for these activities. Our own direct exposure to the sector was through our 5.4% weighted position in Kensington Group, purchased towards the end of 2006, which we exited when the company was sold to Investec Group for 40% less than the price we paid. We cannot therefore congratulate ourselves on having avoided the downturn completely after making our investment in the mistaken belief that the sources of funding for these operations would not become so prohibitively expensive as quickly as they have. However, our lack of direct investments in other banks or housebuilders has certainly ensured that the fund was not exposed to two of the worst performing sectors during the year. Our experience with this investment once again reminds us that lack of detailed data on loan books (our principle reason for avoiding bank investments) and the future liquidity of funding channels are both very good reasons to continue to be extremely cautious in our investments in the financial sector.

The more significant effect of the Sub-prime crisis has been the knock-on effects on valuations of businesses with indirect exposure or perceived indirect exposure to the housing market and some of the opportunities it created in the second half of the year. The significant decline in the share price of Travis Perkins (down 39% on the year and 43% from its peak in June) has accounted for several percentage points of the decline in the NAV, however at the current price (at around 8x its earnings) we consider that a significant decline in the fundamentals of the business are discounted and we expect medium to long-term results of the business to justify a much higher valuation. The funds weighting in Travis Perkins has increased from 8.6% at the start of the year to 11.6% now and this should be taken as an indication that we consider there to be a high probability of an excellent return at the current price.

The last three months of the year saw two interlinked factors coming into play – an underperformance of the wider index and a decrease in the cash weighting of the fund. Whilst many of our smaller weighted holdings declined in price we were able to add to positions already established and saw an increasing number of our ‘potentials’ (good businesses, strong management but too expensive) fall into our buying ranges.

**Portfolio of the Sceptre UK Fund on 31 December 2007**

<b> Holding </b>	<b> % Assets </b>	<b> 31 Dec 2006 </b>	<b> Line of Business </b>
SES Global	12.7	8.9	Global operator of commercial satellites
Travis Perkins	11.6	8.6	DIY & builders merchant
ASML	11.6	-	Semiconductor manufacturing equipment
BSkyB	8.1	7.6	Satellite TV & broadband supplier
JD Wetherspoon	6.5	-	Managed pub company
RPC Group	6.5	7.9	Rigid plastic packaging manufacturer
Diploma	5.7	6.0	International parts supplier/distributor
Cambridge Silicon Radio	5.6	-	Bluetooth & wireless chip designer
British Airways	4.6	1.8	Commercial airline
Costain	4.4	-	Engineering contractor
Ideal Shopping Direct	3.7	2.9	TV shopping channel
DCC	3.4	-	Energy, healthcare and electronics distributor
Holidaybreak	3.3	-	Travel company
TT Electronics	2.8	-	Electronic equipment manufacturer
C&C Group	2.6	-	Alcoholic beverage group
<i>Cash Reserves</i>	6.7	14.1	
	100.0	43.7	

During the first half, a period in which the fund had between 15-22% cash weighting due to lack of identifiable potential investments, the performance of the fund was flat. During July the sharp falls in the market were not replicated in the fund due to our lack of exposure to the worst affected sectors of the Sub-prime crisis. This trend ended on the 14<sup>th</sup> August when world monetary authorities (starting with the US Federal Reserve) demonstrated to the market that they were willing to risk further increasing inflationary pressures by injecting large quantities of money supply into the economy and loosening credit conditions in an attempt to stabilise asset prices at the high levels which the easy credit conditions in 2001-2003 had created. The resulting rally in the market was strongest in a number of sectors which we do not invest in; emerging markets, mining and resource companies.

In line with the experience of other investment managers who focus on value criteria in selecting investments we have underperformed the market in the second half. Many of the large companies in the index which we consider too expensive or too speculative for investment continued to increase in price and ended the year as some of the best performing shares in the period. Another observation to be made is the polarisation in performance between larger and smaller companies since the middle of the year which has seen many of our smaller investments marked down during market declines but failing to take part in market rallies.

Whilst we would prefer to report an increase in the NAV, looking at the potential which has been created by these developments we believe that having deployed 15% of our cash holdings at significantly lower prices than those available to us earlier in the year and initiated new positions in strong companies which have seen their share prices savaged, the potential value in the portfolio has been much improved versus the middle of year.

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### Considerations on the size, fees and performance of the fund

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It is not sufficient to identify and invest in excellent companies at good prices to achieve the performance that we seek to deliver to shareholders. We concentrate the assets of the fund into a much smaller number of securities than the typical investment fund. We also invest in a range of different sized companies; giving very little consideration to whether we are overweight the FTSE250 or SmallCap for example, our focus is ultimately on the discount at which a specific company trades to its intrinsic value. We do not consider that a smaller company is riskier than a larger company per se; we acknowledge and build into our valuations on a case-by-case basis the drawbacks of a lower credit rating or smaller number of customers for example. Market risk (or volatility) we see more as an opportunity than a factor affecting valuation, consistent with our belief that in the short-term the stock market is not efficient and is influenced by crowd mentality. However, from a liquidity perspective we are mindful of the size of positions which we can comfortably take in smaller capitalised companies, for this reason we have limited the size of the fund, after which point we will close to new investors. This will ensure that the performance of the fund is not sacrificed for the sake of accumulating assets under management. The performance fee structure of the fund aligns our interests; our reward comes from outperforming, not simply from in-line performance with a bigger pool of assets. We also have the majority of our own capital in the fund and investors can be confident that investment decisions are made with security of capital and maximisation of return as the overriding considerations.

Our trading activities are simple and infrequent; the fund is un-leveraged and has no restrictions on the proportion of cash that it may hold, although this will only rarely be a significant portion of assets. We principally invest directly in common stock, unless there is some significant anomaly which makes another form of security preferable (such as a preference share or convertible). We seek to maintain long-term holdings in the excellent businesses that we identify and aim not to 'trade' around these positions, we increase and reduce the weighting of a particular company in the portfolio based on upside to our assessment of its intrinsic value or if there are exceptional events which present short-term uncertainties. The maximum position size we would increase an individual company to is 20% of assets, although this would have to be an exceptional opportunity.

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### Communication with shareholders

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Along with this annual summary letter to shareholders we publish monthly updates which are available electronically to all shareholders who wish to receive them. We also maintain a website, which has an archive of the monthly investor updates and a summary of the funds performance and strategy. On a monthly or quarterly basis the vicissitudes of stock market will have a much greater effect on the net asset value of the fund, but over a medium to long term horizon we expect our performance to more accurately reflect the advantages of our strategy. We calculate an estimate of the net asset value on a daily basis and publish this figure, for convenience, on the website. The official independent net asset value is agreed at the end of each month with the funds administrator and at the end of each month the fund will accept subscriptions and redemptions from investors.

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### Performance details

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The funds official inception was 2<sup>nd</sup> May 2005 with an NAV of £1,000 per share, during the period of May-September the fund held large cash balances and establishment of the portfolio caused exceptional dealing costs which do not reflect the normal level to which the fund will be exposed. The first external investors in the Fund subscribed in October 2005.