TROY
ASSET MANAGEMENT

# Investment Report No.28

April 2010

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

## A little bit of politics

*'If something is unsustainable, it will stop'*
Herb Stein – Economic Adviser to Richard Nixon

*"A democracy can only exist until the voters discover that they can vote themselves largesse from the public treasury. From that moment on, the majority always votes for the candidate promising the most benefits… with the result that a democracy always collapses over loose fiscal policy, always followed by a dictatorship"*
**Alexander Fraser Tytler,** Lord Woodhouselee 1747-1813, (possibly apocryphal)

We have not written much about politics in the past. Perhaps this was because we did not wish to offend anyone. Politics is, after all, a very personal matter and no view is identical. As Politics graduates, Francis Brooke and I have more interest than most in the subject. We realise that discussing the UK political background may not appeal to our wider investor base. More to the point, from a UK investor standpoint, politics has become less important to investors over the years as investment has become more global.

When we started in investment management, over twenty years ago, Budget day was a key date in the investment calendar. Radios were brought into the office (Parliament was not televised back then) and we hung on the Chancellor's every word. Analysts and economists pored over the detail and share prices often moved on the news. Over the twenty years, up until the credit crisis in 2008, politics became secondary to wider economic and company fundamentals. The forces of globalisation combined with the words of central bankers became increasingly critical to market participants. Markets were allowed to function with little interference. The granting of independence to the Bank of England was indicative of the trend of politicians' laissez faire approach. With each and every crisis, central bankers went into overdrive cutting interest rates ever further for longer. The failure of markets in 2008 changed all that. With central bankers running out of 'monetary easing' bullets, unconventional policies were required. Politics and economics were joined at the hip once more.

## Suspended animation

As we head towards arguably the most important general election since 1979, we find the situation hard to reconcile. Our concern, as investors, is that the electorate have gone a step too far in recognising Lord Woodhouselee's rule. Rather than accepting the UK economy is in a dire state and its debt has to be reduced, the voters may instead choose '*the candidate promising the most benefits*'. The Conservatives are resisting the need to raise taxes from their natural supporters. Labour, by contrast, resists the spending cuts which would affect its core vote. Hopes of a hung parliament are unlikely to provide a compromise – gridlock is the more probable outcome. Solving the problems of today will be painful for all. In contrast to 1979, the electorate may not yet be ready for radical change. What seems to be required is another cathartic moment for politicians and the electorate to recognise the seriousness of the problem. In the late Seventies it was the humiliation of calling in the IMF and the 'Winter of Discontent' which forced the issue. Margaret Thatcher was elected with a clear mandate for short term

pain, which would ultimately lead to long term gain. Voters today have yet to reach this conclusion because much of the danger is not visible and the huge deficit has not yet impacted their everyday lives. As with an iceberg, most of the threat is out of sight.

## Lies, damned lies

The UK is viewed as a basket case by overseas investors and who can blame them. Bill Gross of PIMCO has described UK gilts as "resting on a bed of nitroglycerine". The economy remains in intensive care. Out of all the G8 countries, the UK was the last out of the 'Great Recession'. Considering the scale of the fiscal stimulus combined with the lowest interest rates in 300 years, money printing, and a 16% devaluation of sterling, the UK could only manage growth of 0.4% in the fourth quarter of 2009.

**Back to the 1970s - the State accounts for 48% of GDP**
**Public Spending as a Percentage of GDP**

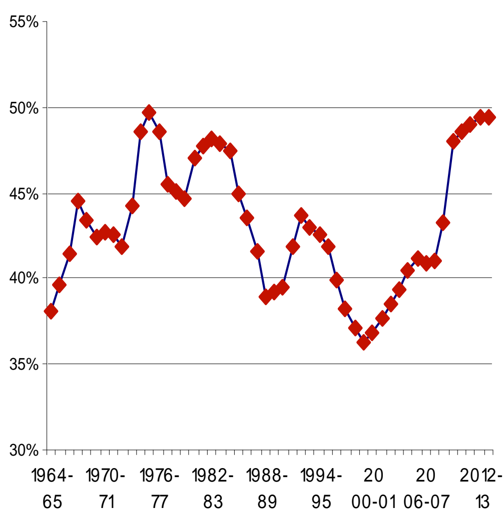


*Figure 1* *Source: HM Treasury and Arden Forecasts*

Looking forward, the UK Treasury's forecasts remain very optimistic; in expectation of a traditional post-war recovery. We would argue this is no standard recovery because the boom that preceded the bust was anything but normal. Since 2000/1, GDP performance was boosted by unsustainable fiscal spending. Government spend per head rose from £6,050 in 2001 to £10,250 in 2009 - this, in a period of benign inflation. Bank lending in the UK increased from £2.1tn in 2000 to £9tn in 2008. Ewen Stewart, a strategist at Arden Partners, estimates the combination of unsustainable fiscal stimulus and increased private indebtedness boosted GDP by over 1% per annum during the seven years to 2008. The Government spend as a percentage of GDP increased from 36% in 1999 to 48% last year (*Figure 1*).

Public sector employment has risen by almost a million in the ten years to 2009 (*Figure 2*). In 2009 alone, as the private sector was hit by 900,000 redundancies, the public sector added 300,000 jobs. The private sector is being crowded out by the public sector. In all, Mr Stewart estimates the UK government's structural overspend amounts to between £88bn and £121bn per annum. At present, politicians on both sides are talking about fiscal tightening of a tenth of these figures. In our view the UK government will struggle to retain its 'AAA' rating.

**Public Sector Employment 1999 to date (in thousands)**

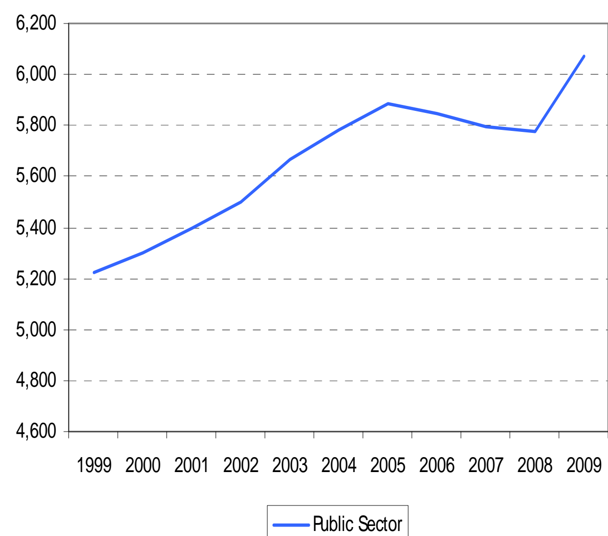


*Figure 2* *Source: ONS Labour Market Statistics*

## Sovereign risk complacency

Our core view is for low growth of 1-2% for the next three years, although we would not rule out a double-dip in 2011. This will put further pressure on the UK's finances. Higher inflation and negative real interest rates are with us for some time to come.

**Fiscal contractions required over 5yr and 10yr periods to stabilise government debt ratios at 2007 levels (% GDP p.a.)**

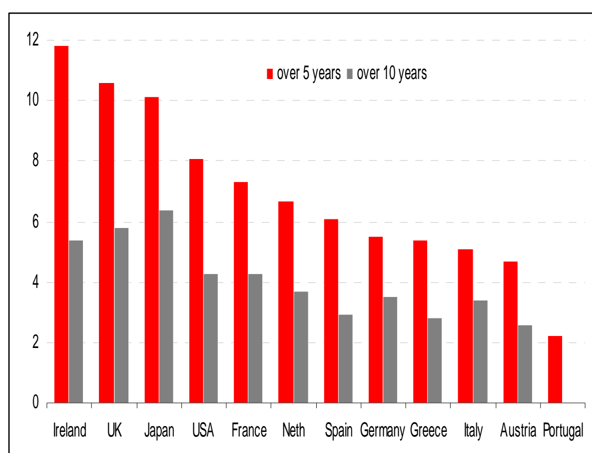


*Figure 3 Source: Cecchetti, Mohanty, Zampolli (BIS conference paper 2010), Societe Generale*

Investors seem happy to ignore these risks while all seems well. Nevertheless the UK is in a woeful state in much the same company as the weaker European states of Portugal, Ireland, Greece and Spain. Much has been written and offence taken by the fiscal recklessness of the 'PIGS'. We see recent events in Greece as the first of a number of sovereign crises to come. While Greece, to some extent, is protected by its membership of the Euro, the UK has no such protection and may be caught in a spiral of rising bond yields, currency depreciation and inflation as international investors vote with their feet. Greece is merely the dress rehearsal for further sovereign debt crises - in the UK and ultimately the United States (*Figure 3*). The US has all the same problems. While the UK will spend almost 30% more than it will receive in tax revenue in 2010, the US is spending almost 40% more than its tax take. No one in their right mind would spend 40% more than they receive in annual income year after year but politicians are unprepared to take the bad tasting medicine required because the benefits will not be seen on their watch. The virtues of prudence have been well and truly abandoned. While we may hope for the best as investors, we should prepare for a loss of faith in government bond markets, which will result in a much higher cost of capital. Government bonds, traditionally low risk assets, look anything but safe.

## An unfriendly Alliance

To some, investment looks easy. All you have to do is to buy low and sell high. In late 2008, we moved our asset allocation dramatically, in the case of the Trojan Fund from 40% to 75% in equities and in the case of the Trojan Income Fund from 80% to almost fully invested. It was an uncomfortable experience but proved correct. Equity markets have a tendency to rise steadily and fall sharply. For this reason, to preserve real wealth, we need to sell early. This is particularly tricky when the natural alternative of holding cash currently offers nothing but preservation in nominal terms. Our discipline informs us that if we do not find new investment ideas, we should not invest. As markets have risen strongly over the past year we kept our equity exposure high by historical standards (although by industry standards they would be viewed as conservative). In the past few months we have begun to reduce equity exposure in the knowledge that we cannot time the market to perfection. Memories are very short in our world and the level of complacency is remarkable considering the events of the past three years. Valuations are no longer compelling.

Back in the dark days of October and November 2008, we acquired a large holding in Alliance Trust, the generalist investment trust, on a very wide (25%) discount to its net asset value. This offered the potential upside should markets rally (as they did) but Alliance also gave the added prospect of a tightening of the discount. Our view, as held by the

Board of Personal Assets Trust for many years, is that discounts are optional. We engaged the new management at Alliance in a debate on the problem of investment trusts trading at discounts. This trust was an ideal candidate for a discount control mechanism as its shareholder base is predominantly long term private investors. With the discount worth £400m for shareholders, there is substantial value to be unlocked for the benefit of the trust's owners. Regrettably management could not be persuaded of these merits. We have therefore used the opportunity presented to us by stronger markets to take profits and sell the holding in its entirety.

## Watching paint dry

Investment is a much misunderstood discipline. It should not be a source of excitement. On the contrary, while we enjoy what we do immensely, much of our time is spent monitoring our holdings, reading results statements and meeting management. We are pleased to report that most of the companies we hold have withstood the challenging environment of the past two years extremely well - increasing long term value for shareholders. Not in terms of share prices, which may be ephemeral but in growing cash flow, dividends and book value. Performance is driven by patience. Paul Samuelson, the Nobel prizewinning economist, puts it best, "Investing should be dull, like watching paint dry or grass grow". The hyperactivity of the CNBC-watching dealing floor and 'gamma trades' (whatever they are) is not for us, our preference is for the objectiveness provided by tranquillity.

Sebastian Lyon

April 2010

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