TROY
ASSET MANAGEMENT

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Investment Report N°·39

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

Relentless

Stock markets have been on a tear this year. Weary of earning nothing on their money, savers are herding further up the risk curve in search of any sort of return. Over the past eleven months, to the end of April, the FTSE All Share has risen every single month. This is the first time that this has occurred since the Index was established back in April 1962, while this month the Index has enjoyed a period of rising 13 days in a row. A shift in investor mentality has taken place from 'buy the dips' to just ***'Buy!*** The absence of scepticism has combined powerfully with an ever-present faith in the bounty of central bankers. Nothing suppresses free thinking like free money and investors are starting to believe in a fairy-tale world of no downside, only upside. Shares have had a relentless re-rating over the past 18 months at a time when earnings growth has stagnated. Thus the S&P 500 now trades on over 18x historic earnings, up from 13x in late 2011, while the aggregate net income of S&P 500 companies declined 5% in calendar 2012 (*Source: Bloomberg*). This dislocation between markets and the economy cannot last forever.

The shift into quality companies that we highlighted in our last report indicates some are speculating by conservative means. These companies' balance sheets and perceived profit predictability may be attractive, but their valuations have become less appealing. Bulls are beginning to ditch traditional methods of equity valuation and are stretching to unfamiliar measures to justify their holdings. We have now reached the point at which few assets have the ability to protect investors from the opposing threats of deflation (leading to default risk) or inflation (which should lead to higher interest rates).

Financial memories are short. Valuations are now not dissimilar to those that prevailed at the previous stock market peak, in the summer of 2007. Jubilation can also be found elsewhere. Tiny interest rates dull the desire to separate good credits from bad: the goats are being kept with the sheep. The list of countries recently tapping international capital markets, at unprecedentedly low yields, reads like a list of Foreign Office travel advisory no-go areas. It includes Albania, Bolivia, Mongolia, and even Rwanda. Emerging market debt, like high yield corporate bonds, offers temporary liquidity. The door is wide open to eager buyers but will it be slammed shut for nervous sellers looking for a quick exit when rational analysis returns?

The Late Buyer – Investing on Margin

One of the big drivers of rising share prices in America has been the return of share buybacks which have surged just as they did prior to the stock market collapse of 2008 *(see Figure 1)*. American (and some British) companies are not known for their market timing in this regard, with a track record of buying high and selling low. Many share buybacks were suspended during the financial crisis of 2008/9 just at a time when share prices were depressed and buybacks would have significantly enhanced value for shareholders. Corporates unable to find

suitable investment opportunities in a sluggish economy are now borrowing from generous debt markets to finance buybacks at questionable valuations.

There are exceptions and as shareholders we have been beneficiaries. Over the longer term value may be generated through buybacks if companies can resist the temptation to overpay. One paragon is Colgate-Palmolive, a longstanding holding in our funds. Rather than allocating surplus capital to expensive, value-destroying acquisitions, Colgate has a track record of being price sensitive and opportunistic when buying back its stock. It was one of the few firms that actually *increased* its buyback in the dark days of 2008 when its share price fell by one third from peak to trough.

Corporates are not the only ones borrowing to buy shares. Investing on margin (with borrowed money) has returned. New York Stock Exchange member firms' debit balances in margin accounts have revisited previous highs *(see Figure. 2).* This evidence of speculation has traditionally been a contrary indicator with previous peaks in 2000 and 2007.

An Unaffordable Luxury

For those who don't remember their Economics 101, a 'Giffen good' is one that subverts the normal rules of supply and demand because it is consumed in greater quantities the more the price of it rises. Stocks can appear remarkably similar; the more they rise in price, the more investors and corporates typically want to buy them. This is paradoxical because as equities rise in price they offer less value and provide a likely lower future return. Here at Troy we do not view equities as Giffen Goods. In our asset allocating portfolios such as the Trojan Fund and Personal Assets Trust, the more stock markets rise, the less we hold in equities, while the more prices fall, the greater our allocation to stocks. Investors forget at their peril that gains made in euphoric times have a tendency to not be retained.

It is a failing of the financial industry that at times like these, too much is made of *relative* rather than *absolute* value. Only in falling markets do investors demand absolute returns whereas in a rising market they revert to relativity. As stock markets rise so expectations creep up as fear is consumed by greed. Envy is a hard emotion to resist. Many who have invested alongside us for a long time understand our approach and that in particular we are unlikely to keep up with a sharply rising market. Some newer readers may wonder why we '*fight the Fed'* by not being more fully invested. When acquiring ever-more expensive shares the market conscripts justify their purchases by claiming: 'there is no alternative' conveniently concertinaed by wags into the acronym, 'TINA'. Whether in life or investment, a poor reason to buy anything is because you can afford it.

It is an interesting coincidence that we faced the same bewilderment in 2007, when our liquidity was similar to current levels. We do not forget that we aim to preserve capital, rather than maximise upside (which leads to disproportional downside risk). We admit that we are not clever enough to know when the music stops but we are secure in the knowledge that we have long left the party before the clock with no hands strikes midnight.

We continue to advocate our belief in a secular bear market which, as in 2007, is

being ridiculed today. Bear markets end with a total lack of interest - hardly the sentiments we can observe now, but if you believe we are at the beginning of a new secular bull market that will last 18 years, then the Trojan Fund and Personal Assets Trust are probably not for you. The Trojan Income Fund, Troy Income & Growth Trust and Trojan Capital Fund are funds that have *minimum* equity allocation requirements and so they may be more suitable investments for those who fear missing out. Despite this, both Francis and Gabrielle have all eyes on the downside and continue to manage the portfolios to minimise risk and deliver positive, absolute returns over the long term. If you believe that markets have become totally divorced from economic fundamentals and as a result you would like us to tread very carefully with your savings, then our interests are aligned.

A Golden Opportunity?

Gold remains a core, if occasionally uncomfortable, holding for the Trojan Fund and Personal Assets. It is around 11%-12% of these portfolios. Gold shares add an additional 4% exposure. We have held gold since January 2005 (first acquired at $424). No one can say we are short term!

Strangely, few people ask why an asset is rising in price but more require an explanation as to why prices are falling: seemingly rising asset prices are to be expected and falling prices explained. Recent weakness in the gold price has followed investment bank sell notes that have competed to have the lowest gold price target. These banks have not been particularly accurate forecasters of the gold price (or the equity market for that matter) and we tend to ignore such prognostications as market noise. We do not deny that investment banks have the power to move markets in the short term but they are not able to mask long term fundamentals. The reasons given for reducing (and shorting) gold appear to be predicated on a fundamental improvement in the economy (of the US in particular) and a prospective change in monetary policy as a result. The belief is that the authorities have engineered a sustainable economic recovery, that QE will be reversed and that, ultimately, interest rates will begin to rise.

One of the undoubted attractions of gold has been zero interest rates and in particular negative real interest rates. We see little, if any, evidence of an economic recovery at 'escape velocity'. Normalisation of interest rates (especially positive real interest rates) remains many years away - financial repression is no quick fix. It is hard for us to envisage any reversal in QE in the UK, US or Japan in the near future. It has ceased to be a financial and economic decision and has become a political one. Perversely, monetary policy is taking further steps down the unorthodox road following the most recent announcements from the Bank of Japan. Fiat currency debasement continues unabated, which points to a higher not lower gold price. Central bankers will learn that QE is easy to start but difficult to end. Gold, to us, is money that cannot be printed or, as Alan Greenspan once put it, *"Fiat money in extremis is accepted by nobody. Gold is always accepted."*

Suffice to say, we believe the conditions remain in place for a secular bull market in bullion. This does not mean that it will always be a pleasant ride. There will be times when there will be doubts and capitulation. But we remain focussed on the long term. Holding gold is (for the present, anyway) something

we believe we need to do. We have seen falls in the past – in 2006 and 2008. During the last secular gold bull market of the 1970s and over the gloriously hot summer of 1976, the price of a troy ounce of gold melted from $187 to $105, before finally beginning its ascent to $850. The move from the 2011 peak seems to be a similar test of resolve and we accept the possibility of a further correction, but we are not traders and cannot time the tops and bottoms. We have begun to increase our holdings on weakness.

Plus Ça Change, Plus C'est la Meme Chose

These are uncomfortable times for investors with an eye on value. It is periods like these, when investment seems so easy and obvious, that are the most challenging for us. During such times our performance may suffer in relative terms. We will not however, take easy or convenient decisions with your investment and we share the sentiments of successful veteran fund manager, Jean-Marie Eveillard of First Eagle Funds, who said, *"I would rather lose half of my shareholders than half of my shareholders' money."*

Sebastian Lyon

May 2013

S&P 500 Share buybacks

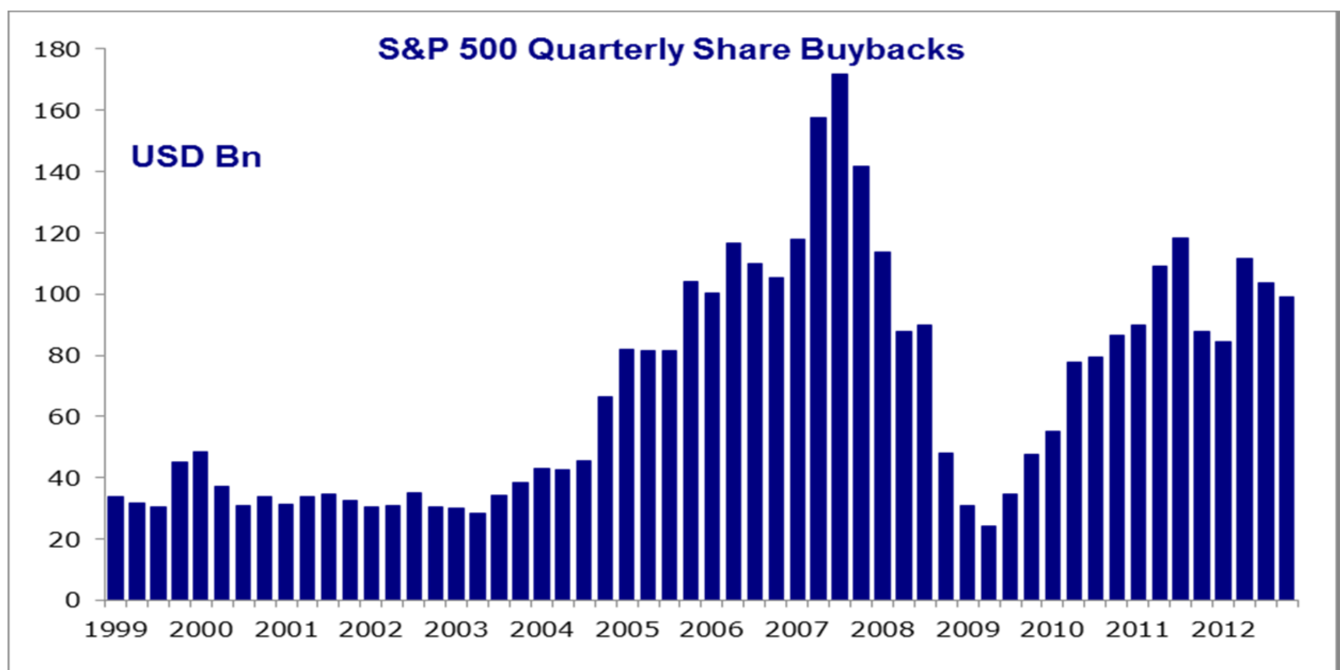

Figure 1 *Source: CLSA/Standard & Poors, May 2013*

Investing on margin – back to a high

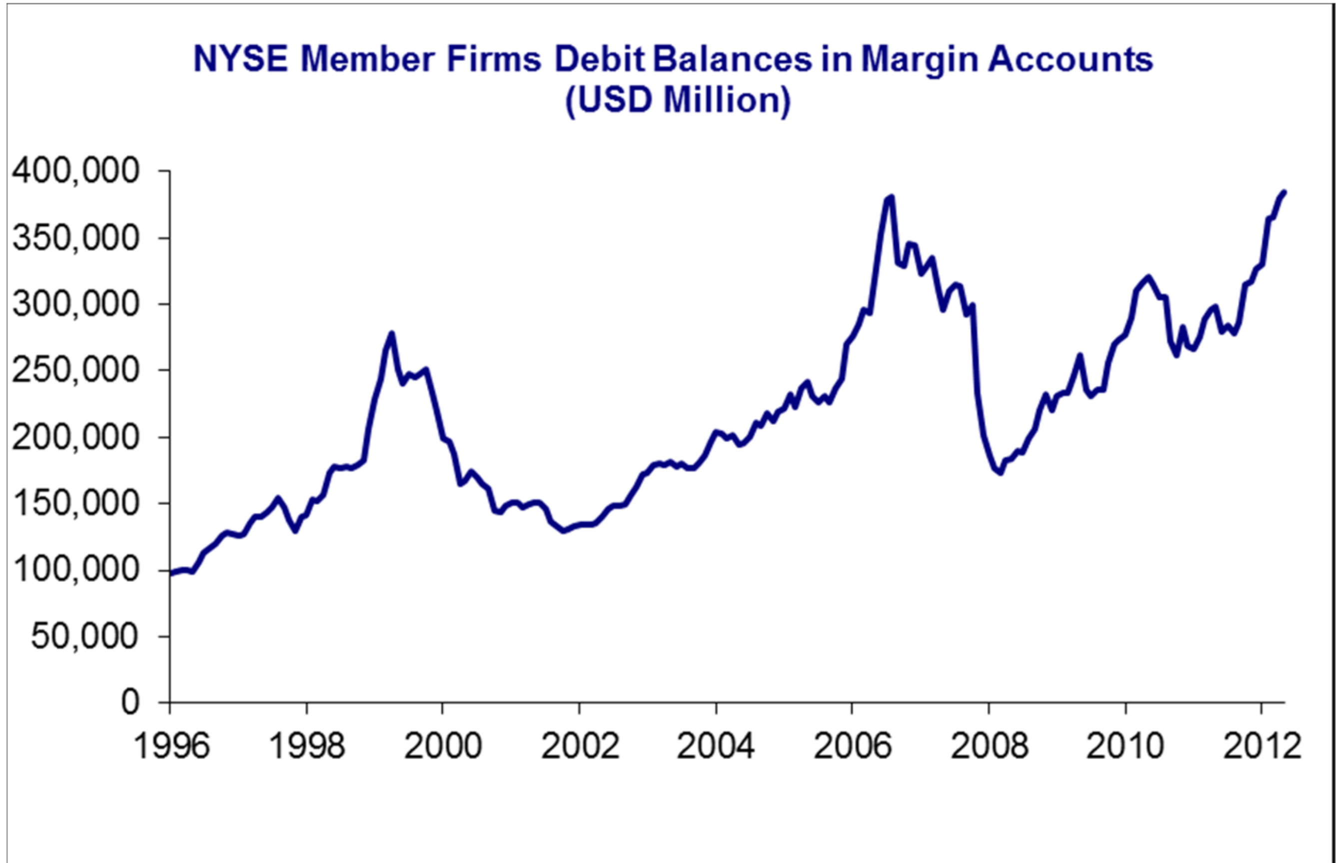

Figure 2 *Source: Bloomberg, May 2013*

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