TROY
ASSET MANAGEMENT

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Investment Report N°43

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

A Happy Anniversary

In October we celebrated the 10th Anniversary of the Trojan Income Fund. The Fund, which has been managed by Francis Brooke since its inception, has returned +141.8% over the ten years to 30th September 2014, compared to +120.2% for the FTSE All Share Index and +106.5% for the IMA UK Equity Income sector (All total returns, *Source: Lipper Hindsight*). The Fund is also the least volatile in its peer group wholly in keeping with Troy's aspirations. The statistic we are most proud of is that over the past decade the Income Fund is one of only two funds in the UK Equity Income sector which have not reduced their dividends. The Fund is also the top performing UK Equity Income fund this year to-date as at the end of October.

The past decade was a particularly testing period for equity income investors who had to cope with not only a 50% fall in the stock market from 2007 to 2009 but also major dividend cuts from large cap UK stocks – in particular, banks during the credit crisis, BP after the Macondo disaster and more recently Tesco. Francis has steered investors successfully through these extremely challenging waters. He has written a more detailed report on the past ten years.

I will keep this report shorter than usual, particularly as many of the trends I identified in August have continued into the autumn.

"It will all be over by Christmas…"

Growth and inflation numbers from Europe, Asia and Japan have continued to be very weak. According to ACM Shipping, freight rates from Asia to Europe have collapsed. Evidence is mounting, both from companies and economic data, of a global economic slowdown as we approach 2015. The US housing market, after the 'buy-to-let' driven rally of 2011-13, is now softening, notwithstanding lower bond yields which should have encouraged buyers. This is an indication of the lack of demand for credit. Loan growth is very depressed for this stage in the cycle and US bank revenues are down 2.5% in the year to June. Five years on, it remains a slow, grinding recovery with little prospect of *'escape velocity'*. The often-promised 'normalisation' of interest rates has been postponed, yet again.

It is well over four years since rises in interest rates were first mooted and as little as five months ago Mark Carney, Governor of the Bank of England, was giving strong hints of a rate rise this month. In late October, Andrew Haldane, the bank's chief economist was put into bat saying, "*Interest rates could remain lower for longer, certainly than I expected three months ago* (sic), *without endangering the inflation target.*" Now long-suffering savers will have to wait even longer to make a return on cash, possibly to the first quarter of 2016 or beyond. Speculation as to the timing of a rise has become an embarrassment. David Cameron is likely to be the first Prime Minister since Clement

Attlee in the late 1940s to have served a full parliamentary term without a single Bank of England base rate change.

We stick to our view that rates are unlikely to rise for the foreseeable future. This will no doubt continue to make equities look attractive, at least on a relative basis, even if valuations do not look particularly compelling. It also implies, in a weaker economic environment, that our more defensive stocks should perform better, as they have done, so far, in 2014. The question investors need to ask themselves is: are they sufficiently compensated for the volatility they are likely to experience in the next few years?

Laissez Faire

The unconventional use of monetary policy over the past five years looks to have become increasingly desperate. Yet in future, market intervention is likely to come from government actions even if fiscal largesse is not possible.

Our suspicion has been that 2008 marked the high water mark for laissez faire economics advocated by Margaret Thatcher and Ronald Reagan over 30 years ago, which was powerfully expressed by Reagan when he said in 1986 that the ten most terrifying words in the English language are, "*We're from the government and we are here to help*". The past couple of years have witnessed something not experienced since the 1970s – western governments directing credit. In the UK we have 'Help to Buy' and 'Funding for Lending'. Government-directed lending adds further to the existing distortions. The historical record shows that governments are poor arbiters of where credit should reach and the ultimate implications for asset prices are not positive. There was an economic reason why the Cold War ended the way it did.

Deflation First...

The largest change to world markets since the summer has been the collapse of the oil price. Brent Crude has fallen by over 30% since the middle of June. Much has been blamed on increased supply (from US shale) but the answer is less simple and is likely to be the combination of increased American supply and a fall in demand. We have long suspected that a deflationary shock was likely before higher levels of inflation take root. Policy makers will not tolerate a dose of deflation and the response, when it comes, may be disproportionate. Hope that western consumers will respond to falling prices by spending more may not be well founded. Demographic changes, especially baby boomers heading to retirement, may mean this surplus cash is saved rather than spent.

...Followed by Inflation

Total world debt (public and private), which was 160% of GDP in 2001, reached 215% in 2013 and continues to rise (*Source: Deleveraging, What deleveraging? Buttilione, Lane, Reichllin and Reinhart*). Such a debt burden inevitably lowers growth, which will ultimately lead to a default on the debt, either in the literal sense or through a hidden default facilitated by inflation. For most countries, the latter is the most politically and economically palatable option, though neither paint a pretty picture. Many investors ask us where the inflation will come from, particularly since, unlike in the 1970s, labour has little power to demand higher wages. They forget the prospect of inflation by debasement of the currency. An ordered example followed the devaluation of Sterling in 2008, which led to headline levels of inflation of 5.6% by September 2011. A more egregious illustration has recently occurred in Russia, where the Rouble has declined in value against Sterling by 25% this year. A Russian student recently interviewed on Radio 4 gave a flavour of the damaging effects of debasement, '*The most painful part is of course food … for example, for a pack* [sic] *of milk. It was around 50 roubles in mid-August and now you can go and see it for 65, 70; sometimes more than a 50% rise.*' The recent temporary upsurge in the forces of deflation is making the debt burden on the world economy ever heavier, and in the absence of strong growth, only inflation can reduce it in the long run.

A Seamless Handover

In the UK and more recently the US, QE may have been (temporarily?) suspended but we have described the race to debase currencies as a relay race. At the end of October we viewed a seamless passing of the baton from the Americans to the Japanese. The day the Federal Reserve suspended bond purchases, in what looked like a coordinated action, the Bank of Japan committed to increase its purchases aggressively. In fact, Japan's central bank is rewriting the rules of unorthodox monetary policy as we have come to know them. While the Americans' QE was typically a material percentage of their annual fiscal deficit, Japan's bond purchases will be almost twice the size of their deficit. Further monetisation, while cheered on by the stock market in the short term, may lead to a spiral of rising bond yields and downward pressure on the yen. This is the end game more familiar to those investing in Latin America rather than Japan. Once in this spiral it would be difficult to end. In the words of journalist James Grant, "*It's the way of radical monetary gimmicks that one begets another. The more they're tried, the less they succeed. The less they succeed, the more they're tried. There is no 'exit'*".

How does Mrs Watanabe protect the value of her sacred savings under her mattress?

Sebastian Lyon November 2014