



## Investment Report N°56

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

### Record Breakers

*"There is nothing riskier than the widespread perception that there is no risk."*  
Howard Marks

Investment anoraks are having a field day and, for those financial historians intrigued by market statistics, myself included, 2017 offered a wealth of record-breaking figures. The year saw the S&P 500 enjoy its fourteenth consecutive month of positive returns, a feat not witnessed before in the index's history. The length of this bull market is exceeded only by that of the 1990s, which was however interrupted by sharp corrections in both 1997 (the Asian crisis) and 1998 (Russia/Long Term Capital Management). Recent market conditions have experienced no such volatility. On the contrary, US stock markets have enjoyed almost 400 trading days without suffering from even a modest 5% correction, thereby beating records set in the 1960s and 1990s. In this remarkably benign period, the US stock market has risen for 19 out of the past 20 quarters.

According to Barron's Teresa Rivas, on 16<sup>th</sup> January, the monthly Relative Strength Index or 'RSI' (that measures market momentum - whether stocks are overbought or oversold) reached a level never exceeded in nearly a century for the S&P Composite [the S&P Composite was launched in 1923 and didn't become the S&P 500 until 1957] and the Dow Jones Industrial Average Indices. From an economic standpoint, December 2017 marked the 102<sup>nd</sup> month of expansion of the US economy. If the current expansion keeps

going until April 2018, it will match the second longest expansion from February 1961 to November 1970. If it continues to July 2019, it will break the decade-long record of March 1991 to November 2001. The concept of a recession seems anachronistic.

### Sentiment Peaking

To the trained eye the statistics above look unnerving, even freakish. Surprising but similarly uncomfortable reading to any contrarian are the data on investor sentiment. According to Investor Intelligence, sentiment measures are off the charts with bullish investors outnumbering the percentage of the bearishly inclined by the highest level since 1987 (see Figure 1) – a date which itself should be taken as a warning. Further evidence is mounting. Cash levels for mutual funds in the US are at cyclical lows, while individuals' stock exposure relative to cash is at levels not witnessed since the late 1990s (see Figure 2).

With growing confidence, financial media advice encourages private investors to cling on for the ever-upward ride, confident they will exit in time. This cheerleading, as we have said in the past, is the equivalent of pressing the foot harder down on the accelerator the closer you get to the cliff. These are not the actions of the prudent fiduciary. Arguably the risk/reward today is asymmetrical and less attractive on many measures even than in 2000 or 2008.

Why the concern when economic prospects look rosy? For the first time since 2010, the IMF is confident of synchronised global



economic growth. Perversely, it is in blue sky that markets peak. While bear markets bottom in a sea of despair, bull markets top-out amid economic optimism.

In his book, *'Investing against the tide'*, Anthony Bolton reminds us of signs to look for at market turns. He says, "The one thing I don't look at is the economic outlook as this invariably looks great at tops and horrible at bottoms." He references other, more useful markers of market peaks, namely sentiment indicators including the put/call ratio and mutual fund cash positions. Many of these are now flashing red. Over the last few years we have encountered many fully-invested bears: those who are happy to talk bearishly but are acting bullishly in their portfolios. Their actions have been vindicated to-date. Now that we are finally seeing an improvement in the fundamentals, after years of rising prices, bearish chatter is increasingly unfashionable. As Richard Russell wryly noted, it is the direction of markets that so often inform opinion.

### Stay On Course

Our investment approach, which is conservative and defensive, should not be expected to perform strongly in the current environment. The temptation at times like this is to stretch valuation parameters or to reduce quality thresholds when picking stocks. Compromising on balance sheet strength is one such investor inclination. If one needed an example of what happens when a poor business is combined with a weak balance sheet, Carillion is timely. The optical valuation of a portfolio could also be improved by shifting towards greater cyclical. However, doing so this late in the cycle is likely to end in tears. When there are few obvious opportunities, retaining cash is prudent. We

are ready to shift our asset allocation aggressively in the event that stocks de-rate. We emphasise that this is not an attempt at 'market timing'. Rather, it is a valuation-driven, counter-cyclical approach to investing which involves avoiding risk when long-term return prospects look unappealing.

### Melt up

In contrast to the conclusion suggested by Anthony Bolton's sentiment indicators, which we have sympathy with, others point to the prospect of a euphoric finale in markets, of the type we witnessed in the 1999/2000 dotcom boom. Jeremy Grantham of GMO has mooted the prospect of a 'melt up' in stocks before the next bear market. We have addressed this issue in previous investment reports and would reiterate that equity bubbles of this type, with reckless speculation and high retail investor involvement, are rare, less than once-in-a-generation events. Bull markets can just as well end with a whimper as with a bang.

Looking at long-term stock market charts, one could argue that the melt-up is already being enjoyed. Betting on such an outcome continuing at current valuations would be second-guessing the actions of other investors, relying on the 'greater fool theory' that one will be able to sell on to someone else at higher prices. For us, that is the definition of speculation, not investing.

### Mixed Messages

Despite the euphoric year for equity markets of 2017, dig a little deeper and there are mixed messages being given by the more sober and circumspect bond market. While 2-year US Treasury yields rose towards the end of 2017, from 1.3% to 1.9%, anticipating future Federal Reserve interest rate rises, the increase at the



longer end has been less dramatic. Bond markets are questioning the growth story that has boosted equities. The yield curve (the difference between the short end and the long end of the curve) ended the year at its flattest since the end of 2007. Far from predicting robust economic growth, bond investors are expecting growth to falter with the risk of a recession.

Which market is right? We have said in previous reports that the dispassionate fixed interest investors are usually more reliable than the emotionally-charged 'Mr Market'. Nevertheless, if the equity market's expectation for growth in 2018 proves correct, yields on conventional bonds are likely to rise further. This may ironically leave equities exposed to the removal of a major support for stock markets – a low discount rate applied to future corporate cash flows. Growth stocks, which have been driving markets higher, would be particularly vulnerable to a rising cost of capital. Simultaneously, central banks are tapering and unwinding their asset purchase programmes. Such a contraction in liquidity would also support a repricing of risk. This would be hard for the stock market to stomach after nine years of uninterrupted cheap money.

## Easy Does It

A number of our holdings will benefit from a tax cut tailwind in 2018. Earnings for some companies will be enhanced by 5-10%. For UK investors, denominated in sterling, this may help to offset the recent lapse in the US dollar. Our emphasis is on quality businesses that are price-makers rather than price-takers. We would therefore expect these tax benefits not to be competed away. How much of Donald Trump's corporation tax cut is discounted in share prices is subject to debate. What is clear is that this one-time boost to earnings growth

comes at a time when valuations are high and the economic recovery is long in the tooth.

Unfunded fiscal easing, otherwise known as, 'not fixing the roof when the sun is shining', may be celebrated today only to be rued later when vulnerabilities emerge. It seems strange to be easing fiscal policy at this stage in the cycle. Moody's has warned that the US tax cuts will add at least \$1.5trn to the deficit over 10 years. With total US public debt currently over 100% of GDP, the country is hardly in a position to be levering up. The President hopes that the economy follows the precedent of Ronald Reagan's 1986 tax cuts. Back then, public debt to GDP was below 50%. Moreover, given the indebtedness of many American corporates, (net debt to EBITDA for the US MSCI ex-financials index is above its 2009 peak) the capacity for increased investment is unclear.

## A Discerning List

Despite many moving parts in today's investment world, the principles within our process remains unchanged, although it constantly evolves. Our investment universe of just under 200 stocks, while stable, is certainly not static and we removed and added a number of companies during the year. The Troy investment team review and debate the list with an eye on always improving the quality. With low portfolio turnover, we spend much of our time monitoring existing holdings. By avoiding and ignoring sectors and companies that make poor and inconsistent returns, we are not distracted by the wider market noise. By keeping concentrated portfolios we are in a position to know what we own and why we own it.

Retaining this discipline is critical in a period of historical extremes, when long-term valuations



are pressing up against historical highs, sentiment is once again euphoric (think Bitcoin) and investors are parting with their capital for very little prospective return.

## Don't KID Yourself

Today there is talk of a second 'great moderation' with many trading strategies using recent historical experience to predict future outcomes. The introduction of new European regulations for investment products (MIFID II) has required the introduction of KIDs (Key Information Documents) for investment trusts. The KIDs are fact sheets to provide investors with basic facts regarding trusts including fees and risks. Specific figures for estimates of expected returns under various scenarios, 'moderate', 'favourable' and 'unfavourable', are also given. These are unreliable at best, misleading at worst, and KIDs are accordingly being viewed with mounting concern and dismay by investment managers and commentators. We would like to warn investors in Personal Assets Trust and Troy Income & Growth Trust to treat these figures with a high degree of scepticism.

The statistics given for each scenario are derived from the last five years of performance data. Extrapolating the recent past is always dangerous and, ironically, counters the industry axiom that, *'past performance is no guide to the future'*. The fact that the indicators are derived from a period of consistent stock market gains, with very low volatility, is not accounted for. Material drawdowns of 40%+ of the type experienced from 2000-2003 or 2007-2009 are ignored in these calculations.

Similarly, the focus on current economic growth is of little relevance to long-term investing and forecasts. The forecast that last year's returns are the best guide to this year's returns may prove as unhelpful as in the past. We will see.

Sebastian Lyon

February 2018



Everyone is bullish

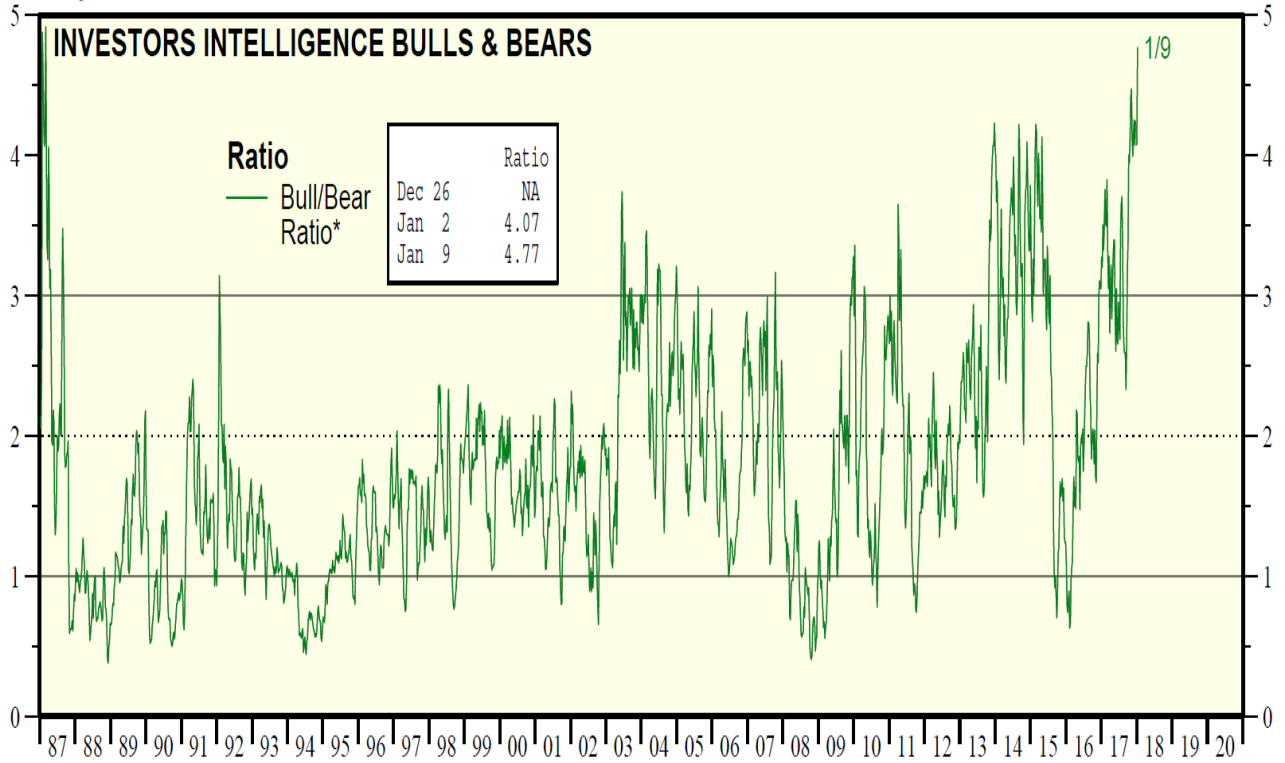


Figure 1

Source: Investors Intelligence

Individuals' stock exposure relative to cash

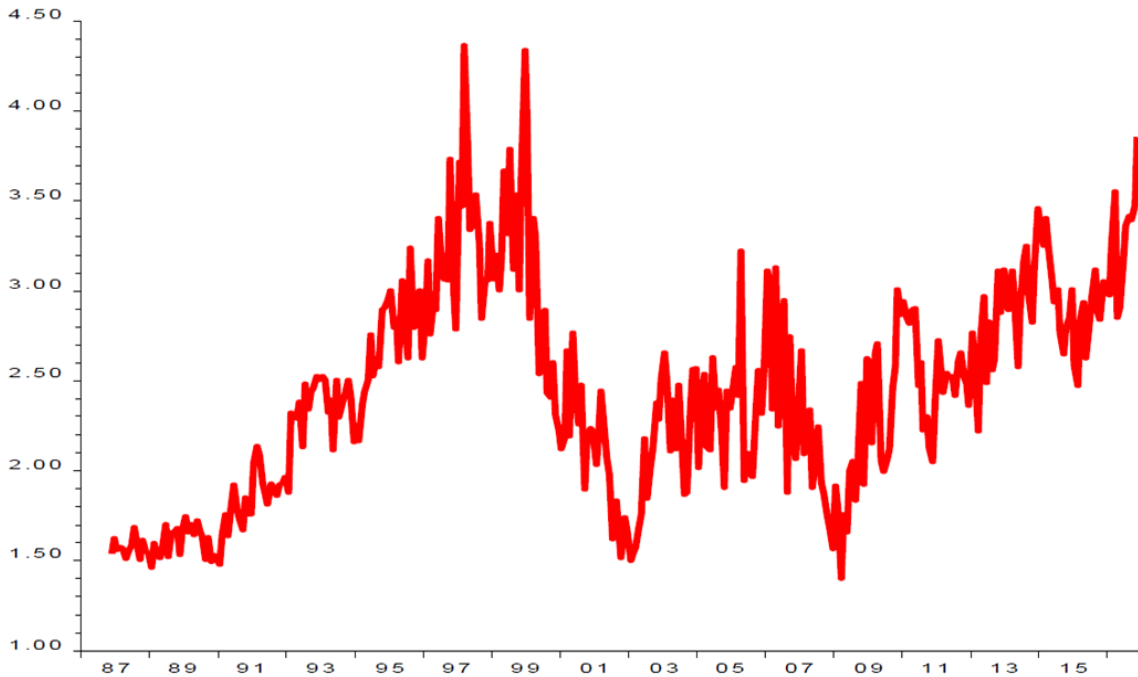


Figure 2

Source: SocGen



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