



Investment Report N°65

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

'Bad companies are destroyed by crises, good companies survive them, great companies are improved by them.'

Andy Grove former CEO, and
Chairman of Intel

The Great Divergence

The economy is currently suffering from the biggest downturn in a century, and whilst we are reminded of the axiom that stock markets and the economy are not the same thing, the current disconnect is one of the greatest we can recall. Previous stock market rallies have coincided with economic strength, especially in 1999. Not this time.

The rebound from the pandemic-induced depths in March is the result of huge monetary and fiscal stimulus, in particular the underpinning of U.S. credit markets. The Federal Reserve's promise to extend quantitative easing (QE) to the high yield bond market, their latest step into monetary unorthodoxy, steadied the ship. Zero interest rates, combined with conventional bond yields looking increasingly Japanese, have made equities the only game in town for those seeking returns *for risk* (as opposed to *return-free risk*). In some cases, stock market valuations exceed their January levels. In the U.S., equity markets would appear to have barely missed a beat despite the savage deterioration in fundamentals. Having been away for the past six months, a proverbial traveller would observe these market levels and be oblivious to the drama that had occurred in the interim.

Retail investors, bored and in lockdown, are speculating at levels not witnessed for two

decades. Is it really that easy? As is traditional, they have a preference for the most volatile of stocks, often with low (small) prices: frequently oversold cyclicals (autos, airlines and cruise companies) and equity slivers created by enormous debt burdens. Any stock that moves more than ten percent in a day is fair game – such is the divergence between sentiment and reality. We have seen this before. It never ends well.

Disconnected

There is not only a disconnection between the economy and markets, but also between markets and policies. There is the paradox of widening fiscal deficits and the strength of government bond markets, together with the chasm between state-sponsored credit markets and rising default rates.

How are such moves reconciled? One theory is that the pandemic led to the policy decision to lockdown economies. Prior to the pandemic, the world economy was growing, albeit modestly. Economic lights were switched off as a result of voluntary government action – telling many businesses to halt trading entirely. This is therefore a different recession from previous downturns which had resulted from booms and the misallocation of capital, like the dotcom bubble or the banking crisis in 2008. It therefore follows, its advocates claim, that once the self-imposed restrictions are removed the economy can return to normal.

This misses the point. Just because business has stopped it does not mean it will automatically return with renewed vigour when the restrictions are lifted. It is becoming clear



that company management teams are not allowing this crisis to go to waste. Permanent changes will result as many industries were already facing a difficult future. To retail, banking, real estate and energy we should also now add aviation and hospitality. Judging by the layoffs announced by retailers in recent weeks, this is not a temporary or conventional cyclical setback. Trends that were already in place, notably towards online rather than high street shopping, have accelerated. There are many companies whose prospects have been enhanced by this crisis, but for others the downturn could not have come at a worse time.

This helps to explain another dichotomy observed between the stock market's winners and its losers. Many weaker businesses rallied from their distressed lows in March, but soon ran out of steam once investors realised the remaining vulnerabilities in their business models. Many of them have required fresh capital and yet they remain unable to forecast what normality, post Covid-19, might look like. As time passes and the economy fails to fully recover, cash flows in these industries may not be sufficient to support the capital structures which were built for more auspicious times. By contrast, several stronger, better-capitalised businesses, seen as relatively unaffected by the downturn, have begun to make new highs. This is rational, even if the market's general optimism is not.

A Change of Habits

Trends in technology have undoubtedly accelerated as economies digitise. At the same time, many individuals will be more reluctant to make long-haul business trips and employees can be expected to work from home more often. Pubs and restaurants may be reopening gradually, but progress is slow. Central London is more like a ghost town than

the bustling metropolis with which we are all familiar. We expect the recovery to be patchy and drawn out.

Short-term economic data will also be noisy. A bounce from very depressed levels can be expected, but the question remains over the extent and durability of the recovery. Stock markets have stalled in the past month as the virus's first waves are prolonged in the U.S. and second waves emerge in Melbourne, Catalonia and elsewhere. Until a vaccine is readily available, consumer and corporate behaviour is likely to remain fragile.

No Reverse Gear

The road to hell is paved with good intentions and monetary policy seems no different. After we crossed the Rubicon into QE in 2009 there was no going back. Failed attempts at normalising policies were made in Europe in 2011 and in the U.S. in 2017/18. Raising rates and tapering QE caused markets to riot. The next downturn, when it came, was going to require more experimental policy, and quickly. That day arrived in March. There have been more than 160 interest rate cuts around the world this year and central bank balance sheets have ballooned in a matter of weeks, making the response to Lehman's collapse look slothful. Those seeking a risk-free return in cash or fixed income are offered next to nothing or even less than nothing. Gold remains a critical offset within Troy's Multi-Asset mandates, as governments are forced into ever-more imprudent policies.

Price discovery becomes much harder when central banks set the cost of capital. In 2008, equity analysts adjusting their valuation spreadsheets for lower rates saw a sharp jump in terminal values. Today, with the discount rate (30-year U.S. Treasury yields) at c.1%, anyone numerate knows that almost any



valuation can be justified with such a tiny denominator.

So what of stock-picking in this new, untethered financial world? Low rates are clearly positive for any companies demonstrating consistent, sustainable and growing earnings. James Mackintosh of *The Wall Street Journal* argues (tongue in cheek) that stocks should be even more expensive than they are today. The implied equity risk premium (ERP) – the yield differential between equities and conventional 'safe' assets – is high by historical comparisons. According to Mr Mackintosh, the ERP was at -2% in 2000, while today it is a generous +4%. Low rates imply low growth, low inflation and poor pricing power; why not value the future earnings of safer stocks, like Nestlé, more generously as stable earnings in the current environment become even more precious? Why not 50x instead of today's 25x?!

Risk-averse investors rightly get vertigo when valuations become extreme. True, certain stocks including consumer staples, software and online retailers have received lower discount rates without the downside of weaker operating results. Yet if the pandemic reminds us of anything, it is of the reality of extraneous and unpredictable risks. You should never place too high a value on earnings so far out into an unknown future.

Avoiding value traps should remain an investor's preoccupation if they wish to preserve their capital. Companies are wasting assets when their future cash flows are unforthcoming or materially worse. While they may have looked myopically attractive for many years, these high yielding stocks have succeeded in converting capital into unsustainable income. Given the widespread and lasting disruption to many industries, hiding in 'value' and being 'paid to wait'

cannot have much appeal for truly long-term investors.

Bon Appetit

The seeds of this value destruction were sown long ago. In a prescient article published in *The Wall Street Journal* in 2011, venture capitalist Marc Andreessen wrote 'Why Software Is Eating the World.' In it, he forecast that the new internet companies like Facebook, Skype and LinkedIn (the last two now owned by Microsoft) were '*...building real, high growth, high margin, highly defensible businesses*' and that '*software companies were poised to take over large swathes of the economy*'. This was no dotcom bubble but rather an ongoing evolution of innovation with profitable business models. In the past decade we have seen more industries disrupted by software. This is no longer isolated to the usual suspects of bricks and mortar retail and old media. It is spreading into financial services, healthcare and education with profound consequences.

Low capital intensity and high returns make the economics of these software and internet businesses highly attractive to stock market investors. Mr Andreessen cannily observed that this was bullish for America. The largest companies are based in the U.S. and this was no accident. The '*combination of great research universities, a pro-risk culture, deep pools of innovation-seeking equity capital and reliable business and contract law is unprecedented and unparalleled in the world*'. Many have endeavoured to dismiss the performance differentials between the U.S. and European stock markets in recent years. A value gap has opened up but this is based on the respective markets' constituents and growth. It is rational for investors to avoid those industries and companies that are being eaten. The broad U.K. stock market has



continued to lag for reasons other than Brexit and, despite the presence of a coterie of genuinely high quality companies, is dominated by a number of low growth behemoths. The fact that Troy's Multi-Asset portfolios are now down to c.10% in U.K. equities, a level we have held for a number of years, tells its own story.

Responsibility Pays

Since the establishment of our Multi-Asset mandates at Troy in 2001, which include *inter alia* the Trojan Fund and Personal Assets Trust, our focus on capital preservation has led us to spend a lot of time thinking about what could go wrong. Of the many risks over which we analyse and obsess, ESG (environmental, social and governance) factors are increasingly prominent. Consumers and regulators will punish bad actors and it is clear that companies that strive to maximise shareholder value above all else will end up with little or no value at all. This is not a fad, it is a necessity, and we have been actively engaging with company Boards going back as far as 2002. This was always done in private, eschewing a public spat that often proves counterproductive.

For long-term investors, a company's approach towards ESG issues also provides invaluable information. This relates directly to subjects that fall squarely under the ESG umbrella, such as the risk from carbon pricing or from consumers' rejection of non-recyclable packaging. Failure to take action on such issues jeopardises a company's license to operate in the future. It also provides a useful indicator of how the company is run.

Our preference for highly cash-generative companies with strong balance sheets means that our businesses tend to have the capacity to invest in their futures, over and above the bare minimum required today. Being in a

privileged financial position *and* possessing the willingness to act on matters of sustainability is a powerful combination. In January, we saw Microsoft commit to cutting carbon emissions by more than half by 2030 and to becoming carbon negative by the same year (i.e. removing more carbon than they emit). The company also pledged by 2050 to remove all the CO2 emissions for which Microsoft are directly responsible going back to when the company was founded in 1975. In the same month, another of our portfolio companies, Nestlé, committed CHF2bn to lead the shift from virgin plastics to food-grade recycled plastics. By committing to purchase recycled material at scale the company is effectively creating a market for recycled plastics which does not yet exist.

No Panacea

These are industry-leading initiatives. However, assessing the ESG credentials of any company is not a static process; it is a continuous pursuit, comprising ongoing original research and monitoring alongside regular dialogue with company management. The direction of travel and the pace of change are often just as important, if not more so, than the starting point. We are committed to constantly studying the practices of the companies in which we invest and to integrating this accumulated knowledge into our decision-making. Simple exclusions or reliance on third-party ESG research is not enough.

Company behaviour during the Covid-19 crisis has provided us with valuable insights. Again, well-capitalised, highly cash-generative businesses with a strong ethos and culture are both able and willing to behave responsibly. We have been pleased by the measures taken by our portfolio companies with several committing to making no Covid-related lay-



offs in 2020. Medtronic, the medical device manufacturer, has seen a greater short-term hit to earnings than most of our other holdings due to the postponement of elective surgeries. However, the company's financial strength and confidence in its product pipeline has led it to protect the jobs and incomes of its sales staff. Whilst these employees are underutilised in the short term, they will be crucial in selling the company's new products as surgeries return. This behaviour is not only socially sound but also commercially astute. We view companies acting responsibly towards their stakeholders as more than simply something that is 'nice-to-have'. It is a business imperative for long-term success.

What will we still not do?

Perhaps to test our resolve, we are frequently asked questions by investors to which our answer is a polite, yet firm, no. We will not invest in moon-shots. Nor will we invest in distressed turnarounds or the plethora of recovery opportunities supposedly on offer.

We will not overpay for growth, nor will we invest in highly cyclical or challenged businesses. We also have no plans to launch new investment mandates, preferring instead to concentrate on the complementary few we already have. Whilst our approach to managing the business and our appetite for risk is unchanged, we also recognise the need to adapt. Economic and investment conditions are severely dislocated and there are many forces at work which are conducive to capital losses. Vigilance will be required. Troy's investment research effort adjusts to these new circumstances whilst absorbing the consequences of rapid social and technological change. Despite a confusing and troubling backdrop, we will continue to invest in the most robust companies exhibiting strong financial productivity and sound balance sheets. We will also endeavour to protect against ongoing reckless government policies by holding gold and inflation-linked bonds. We remain focussed on value with patience and discipline, thereby avoiding the distracting swings in sentiment and the fear of missing out.

Sebastian Lyon

July 2020



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