TROY
ASSET MANAGEMENT

Investment Report No.66

www.taml.co.uk

October 2020

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

"Nothing is as permanent as a temporary government programme."
Milton Friedman, Economist

Big Government

Like it, or loathe it, big government is here. The pandemic has pulled the plug out of the global economy and governments have rushed to fill the void with emergency liquidity. This can be seen in expanding central bank balance sheets and ballooning government deficits, with the measures spanning everything from furloughing, cash transfers to consumers and lending programmes to small businesses. These programmes, as Friedman suggests, are easy to enter and hard to exit, just as quantitative easing was before them. With little room for manoeuvre, central banks have nailed interest rates firmly to the floor with forward guidance indicating a drought for savers for some time to come. Many policymakers have either considered or enacted negative nominal rates.

Negative rates have yet to succeed in Japan or Europe, and have in fact had dire implications for swathes of the economy, including the banking sector. One only has to look at UK bank shares - down almost 50% in the year to date (Source: Bloomberg, FTSE Banks index) - to see that investors fear the prospect of '*Japanification*'. While the Bank of England is careful not to rule out the adoption of negative rates, UK Gilt investors have to go out to more than five years' duration to generate a positive yield to maturity. We do not envy the task of conventional bond fund managers, who have their work cut out to generate a positive return without taking on substantial duration or credit risk.

Nothing to see here

After the agony and ecstasy of the first two quarters of 2020, the third quarter proved a relative non-event. Perhaps investors were simply exhausted by the volatility. The FTSE All Share fell -2.9%. Troy's multi-asset portfolios made small positive gains, leaving the Trojan Fund +1.9% for the quarter and +7.1% year-to-date.

Markets have moved swiftly to discount the fact that this Covid-induced recession is accelerating existing business trends, as discussed in our last report (No.65). Investors have quickly separated the long-term winners and losers of the pandemic – previously steady gains, in areas such as e-commerce, have been turbo-charged. Where next? While many debate the alphabetical shape of the economic recovery to come ('V', 'L', 'W' or even 'K') the much-promised V-shaped recovery has been put on hold for now. A second wave of the virus has left many traditionally cyclical sectors languishing near their lows for the year.

Twelve months ago we highlighted a world of 'haves' and 'have nots'. Many businesses were thriving whilst those that suffered looked myopically cheap. The latter have, however, proven to be 'value traps' in aggregate, most notably across the sectors of retail, real estate, and banks. All were vulnerable to a downturn, but some may never fully recover, even if a V-shaped recovery does materialise. Resilience, permanence, scarcity and sustainability are qualities that we look for in the equities we want to hold for the long term. If the past six months prove anything, it shows how hard it is to value the equity of a challenged business with declining cash flows, especially when it is saddled with debt. It is leverage that gives the equity sliver its fragility and leads to swan dives in share prices. The stock markets can be savage interpreters of the future economics of a business.

A ten-bagger in ten years? Almost

While the third quarter was a relatively uneventful one, there was a notable moment for the Trojan Fund. The Fund's holding in Microsoft briefly reached ten-bagger status (10x our original investment). We first bought Microsoft shares in June 2010 for $24.85 per share (equivalent to £17.22). A month ago the shares traded at $231.65 (or £173.81 – *Source: Bloomberg/Troy*). A whisker away from a ten bagger in dollar terms but a ten bagger expressed in a weaker sterling. (In total return terms, including income, the dollar return is over 10-fold).

The shares were a dull performer for the first few years, but ultimately our patience has paid off. The return comes from a combination of factors, a low starting valuation, a change in perception of the Company, the resilience of its existing business software franchise in Windows and Office, renewed growth in earnings buoyed by investment in the Cloud and recognition of a new management team creating an improved corporate culture. We are fortunate to be in a position to have held the shares for so long and allow the company to compound value for us in this way.

What lessons can be learned from this? There are many from the point of view of corporate fundamentals. Our experience with Microsoft taught us to appreciate the powerful and lucrative shifts underway in computing. It reinforces our preference for companies that retain the capacity for growth driven primarily via internal innovation, rather than acquisition. Microsoft has helped raise the bar we set for financial productivity and emphasises the big difference strong leadership can make in businesses with superior economics.

These are often intangible qualities that only emerge over time. From the perspective of portfolio management, the lesson is clearly numerical; run your winners. Resist taking profits except to reduce portfolio risk and don't tinker with holdings. Have the willingness and strength of stomach to encounter short-term volatility and, in Microsoft's case, prolonged periods of dull performance.

Baggers are a rare thing, especially in large cap stocks and are only possible for the patient. At times, investment can be like being in a proverbial sweet shop with no lack of temptations when it comes to which shares to buy. By concentrating on the businesses we own rather than short-term movements in share prices, it is easier to ignore the noise. Time is on the side of the exceptional business and, when you find such investments, it pays to be patient.

Winning by not losing

Another long-term holding made a landmark over the summer. Unilever, held since 2004 in the Trojan Fund, became the UK's biggest listed company. It is likely to occupy the largest weight in the FTSE All-Share Index once the UK plc unifies with the Dutch NV shares later this year (provided a Dutch tax dispute is favourably resolved, as we currently expect). Unilever has succeeded as other large UK listed companies have gradually fallen by the wayside. Twenty years ago, it was the 27th largest company in the UK stock market, and ten years ago it was 8th behind behemoths like BP and Vodafone. This has been a story of 'slow and steady wins the race'. Unilever's progression over those two decades has been a gradual one – more a journey of adaptation and survival. The history lesson, looking back at the constituents of the FTSE 100 Index twenty or thirty years ago, shows the UK market has arguably suffered, not only from lack of innovation and growth but also from poor capital allocation via value-destructive mergers and acquisitions.

We are supportive of Unilever's proposed unification which will provide the company with greater financial flexibility. The original unification proposal in 2018 would have moved the company to Rotterdam. Our reservations at the time centred on the Dutch withholding tax applied to dividends for UK investors, increased takeover protections and (for UK funds) UK index exclusion. The 2018 unification plan was the company's reaction to the failed bid from Kraft Heinz, a '*near death experience*', as described by the then CEO, Paul Polman. The current proposal to convert all shares to PLC shares does away with these issues whilst also making sense given the preponderance of the company's operations in the UK and the existing HQ infrastructure.

Ancient history

According to Woody Allen, '*A stock broker is someone who invests other people's money until it's all gone*'. The stories of Microsoft and Unilever are proof that stock markets evolve. But today's winners can also be tomorrow's losers. Businesses must stay relevant. We must be vigilant, even when holding companies with such historic longevity and success.

I recently came across two private client portfolio valuations from 1960 and 1968. A sucker for stock market history, I read them with interest to see what they might reveal about yesterday's winners. Some names were familiar: Shell, Marks & Spencer, Sears and ICI – yesterday's blue chips. ICI was described in the 1968 letter accordingly, "*A giant of British Industry, and an investment list without it is lacking a star.*"

Most of the shares listed are long forgotten and – a 'buy and hold' approach would have been costly. Barrow Barnsley (a coal miner), Thomas Firth & John Brown (a steel maker), Heenan Group (a Midlands-based engineer), Reliance Clifton (telephone cables) and Cape Asbestos!

Not only have the names changed, but so too has what passes as a legitimate reason to invest. The letter to the client goes on…"***Barrow Barnsley** - My Partner Mr James is now Chairman and I think it is in an upward trend in profits*".

A semblance of normality

Back in April many speculated about when things would return to a semblance of normality. A forecast of back to reality by October would have seemed prudent at the time but now looks rose-tinted.

What is normal? Video conference calls are here to stay, even once this Covid-induced storm has passed and a vaccine is developed. This will reduce carbon footprints and save on wasteful business travel. Rory Sutherland, Vice Chairman of Ogilvy in the UK, makes the point that an invitation to a Zoom link would have seemed alien in January but now they've become second nature. I have become used to paying for things with my phone, my credits cards only make it out of the wallet for special occasions and physical cash is largely redundant. Cashpoints will likely go the way of the phone box. This is not a temporary measure, born out of emergency. It is the future. Those nostalgic for a return to the way things were are likely to be disappointed.

In recent weeks, we have given a number of investor updates, via webinars, including the Personal Assets Trust Annual General Meeting. I am sure an online version of the meeting will be repeated in future years alongside a face-to-face meeting, for which there is no substitute.

One of the best questions I received during the webcast was 'Will we ever return to a *normal* interest rate environment?' Regrettably, the answer is that interest rates are unlikely to be significantly higher for years to come. The Bank of England base rate has not exceeded 1% since March 2009. It may be a generation from this starting point before the return of 'normal' rates that savers so desire. Negative real rates will remain firmly in place for the foreseeable future, as they have been for over a decade. In the ten years from December 2009, the UK retail price index rose +33.9% compared to the return on cash of +5.1%. I suspect those numbers will be even wider apart during the 2020s.

A Phoney War

From an economic perspective, it feels like we have been in a Phoney War since March. While equity markets have rallied strongly, the economy has yet to reveal the full reality of the recession, as policies such as the UK's furlough scheme have obscured the full effects of the fall in demand. We expect the recovery to be patchy and drawn out with no normality until 2022 at the earliest.

The US election is a known unknown but probably receives disproportionate attention. A post-election boom looks less probable than it did in 2016 as the effects of the virus will likely be with us well into next year. Today's markets are responding to recovery stories with some dramatic share price moves for weaker companies, but these are not investment grade businesses. We have seen many rotations into value stocks over the past decade and few were sustained. Fiscal and monetary stimulus can only help so much. We remain open-minded about the prospects for higher inflation further down the road.

All assets have risen during the last six months – fixed income, equities, and commodities. Only real estate remains challenged, as commercial real estate has suffered from falls in rents. Once reality bites, there may be few places to hide. We suspect one offset will be the US dollar. The dollar benefited from a flight to quality during the rush for liquidity in February and March. During the recent sterling strength, we increased the strategy's dollar exposure from a 7% low in March to c.28% today. This, along with our liquidity, may provide us with some protection from the market squalls that we expect in the future. Should they occur, we are well positioned to add further to our equity exposure, as we did earlier in the year.

Sebastian Lyon October 2020

Disclaimer

All information in this document is correct as at 16 October 2020 unless stated otherwise. Past performance is not a guide to future performance. The document has been provided for information purposes only. Neither the views nor the information contained within this document constitute investment advice or an offer to invest or to provide discretionary investment management services and should not be used as the basis of any investment decision. The document does not have regard to the investment objectives, financial situation or particular needs of any particular person. Although Troy Asset Management Limited considers the information included in this document to be reliable, no warranty is given as to its accuracy or completeness. The views expressed reflect the views of Troy Asset Management Limited at the date of this document; however, the views are not guarantees, should not be relied upon and may be subject to change without notice. No warranty is given as to the accuracy or completeness of the information included or provided by a third party in this document. Third party data may belong to a third party. Benchmarks are used for comparative purposes only.

Overseas investments may be affected by movements in currency exchange rates. The value of an investment and any income from it may fall as well as rise and investors may get back less than they invested. Any decision to invest should be based on information contained in the prospectus, the relevant key investor information document and the latest report and accounts. The investment policy and process of the fund(s) may not be suitable for all investors. If you are in any doubt about whether the fund(s) is/are suitable for you, please contact a professional adviser. References to specific securities are included for the purposes of illustration only and should not be construed as a recommendation to buy or sell these securities. Asset allocation and holdings within the fund may be subject to change. Investments in emerging markets are higher risk and potentially more volatile than those in developed markets.

The fund(s) is/are registered for distribution to the public in the UK and Ireland but not in any other jurisdiction. The distribution of shares of sub-funds of Trojan Investment Fund (”Shares”) in Switzerland is made exclusively to, and directed at, qualified investors (”Qualified Investors”), as defined in the Swiss Collective Investment Schemes Act of 23 June 2006, as amended, and its implementing ordinance. Qualified Investors can obtain the prospectus, the key investor information document(s) (edition for Switzerland), the instrument of incorporation, the latest annual and semi-annual report, and further information free of charge from the representative in Switzerland: Carnegie Fund Services S.A., 11, rue du Général-Dufour, CH-1204 Geneva, Switzerland, web: www.carnegie-fund-services.ch. The Swiss paying agent is: Banque Cantonale de Genève, 17, quai de l'Ile, CH-1204 Geneva, Switzerland.

In Singapore, the offer or invitation to subscribe for or purchase Shares is an exempt offer made only: (i) to ”institutional investors” pursuant to Section 304 of the Securities and Futures Act, Chapter 289 of Singapore (the ”Act”), (ii) to ”relevant persons” pursuant to Section 305(1) of the Act, (iii) to persons who meet the requirements of an offer made pursuant to Section 305(2) of the Act, or (iv) pursuant to, and in accordance with the conditions of, other applicable exemption provisions of the Act. This document may not be provided to any other person in Singapore.

Personal Assets Trust is registered for distribution to the public in the UK and Ireland but not in any other jurisdiction.

All references to indices are for comparative purposes only. All reference to FTSE indices or data used in this presentation is © FTSE International Limited (”FTSE”) 2020. 'FTSE ®' is a trade mark of the London Stock Exchange Group companies and is used by FTSE under licence.

Issued by Troy Asset Management Limited, 33 Davies Street, London W1K 4BP (registered in England & Wales No. 3930846). Registered office: Hill House, 1 Little New Street, London EC4A 3TR. Authorised and regulated by the Financial Conduct Authority (FRN: 195764).