



Trojan Global Income Fund

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"It has been raining money on fools for too long"

Elon Musk, CEO, Tesla Motors

While many will instinctively feel that people in glass houses shouldn't throw stones (Tesla – Musk's company has been the beneficiary of massive subsidies) there is more than a kernel of truth in what he says. We have reached an important juncture in global capital markets that have important and widespread implications.

Policy and inflation

For years the authorities have pursued aggressive, experimental monetary and latterly fiscal policy in an effort to support the economy via markets. Like so many quasi-governmental programs, what started out as a temporary measure to stave off the effects of the global financial crisis in 2008 became something that, once put in place, is hard to remove. The basic premise was that by supporting asset prices the authorities could encourage greater levels of activity and consumption in the real economy.

The policy could be prosecuted with abandon so long as inflation did not appear. Owing to a number of structural factors (the now familiar debt, demographics, global competition and

and technological disruption) inflation remained subdued allowing asset prices to reach ever-greater levels of valuation. The immediate effects all seemed to be good. Markets rose, economies expanded and the stock of the Central Bankers, at least in their own eyes, skyrocketed. The longer term effects, harder to see but more pernicious, were either ignored being considered unimportant or to be dealt with another day.

Thus the structural build up in debts, the resultant inequality driven between asset owners and others and the fragility of capital markets created by over-valuation were allowed to become embedded. All of this now appears to be changing.

Trouble comes in threes

There are broadly three separate influences which have taken place over different time frames but which are coming together in an unfortunate confluence of events.

First is the shocking humanitarian disaster unfolding in Ukraine. As we wrote in our factsheet in February, this is a reminder that geopolitical risk is ever-present and has a nasty habit of flaring up unexpectedly. Further, such occurrences are impossible to forecast and should not influence portfolios unduly.

That does not mean it is without consequence. The war has put upward pressure on commodity



prices, notably on oil and gas as well as food. Europe is especially effected by the rise in the price of gas on which it is dependent, whereas food prices hit the poorest counties and lower income groups hardest. Further it is further evidence that the global rules based international system under the auspices of the *Pax Americana* is fraying. The splitting of the world into two separate spheres of influence centred on the US and China has taken another step forward. In aggregate this will raise uncertainty and risk premia, create more inflation in the short term but likely make a recession more likely.

The second event is the ongoing distortions wrought by COVID and governmental policy response. Although the worst of the pandemic is hopefully now in the past we are still living with the consequences. The world economy has never been voluntarily shut down before and we are learning that turning it back on is complicated. As we are discovering consumption, rather than simply stopping, switched from services to goods and is now in the process of switching back again. This recovery in goods demand is pulling on disrupted supply chains leading to rising prices.

This matters not just because it erodes consumer purchasing power and makes real returns harder to achieve but also because of the degree to which all capital markets are on the thrall of policy. We can debate the merits of this policy approach but it is hard to think it has not had a

profound effect on capital allocation by influencing asset prices.

This dynamic reached its zenith at the March 2020 low where the authorities, terrified by unfolding pandemic, increased support (both monetary and fiscal) in a way that they probably knew was unwise – reckless even – but did not think they had any choice. The result was a speculative period in markets that was to us reminiscent of the 2000 technology boom. This is not because today's technology companies share the same bubble-like attributes of low profitability and sky high valuations, but because the Y2K problem scared the authorities into similarly reckless action driving a speculative peak. It looks awfully like February 2021 marks a similar top in markets, at least in the most speculative areas.

The combination of rising rates, a commodity price shock, a weakening fiscal impulse as well as the reversal of quantitative easing (QE) makes for a material tightening in financial conditions.

This brings us to the third overlapping event – the as yet uninterrupted credit cycle that started in 2008. In a world where support for markets is less meaningful, where cashflows may become less bountiful and where businesses find themselves over-extended having made capital allocation decisions in an environment bathed in the elixir of QE, this may become an issue.



Figure 1: Credit Cycle 2008-?

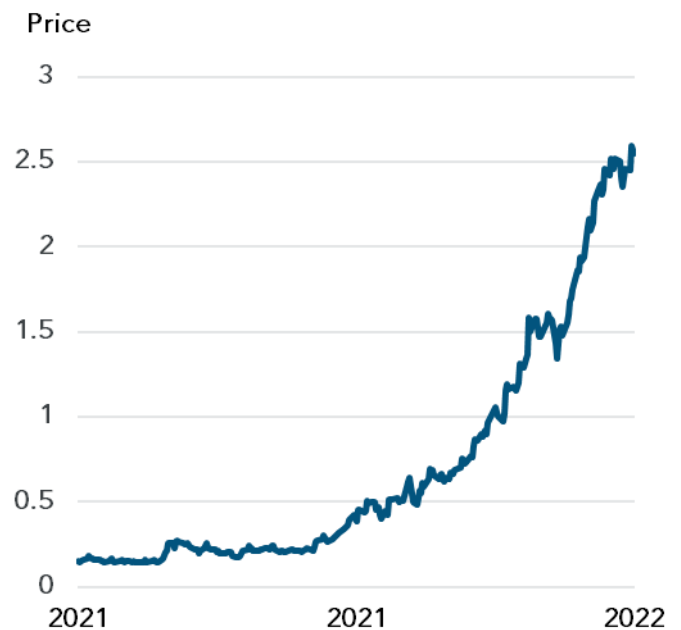


Source: Troy Asset Management Limited, 31 May 2022

Ukraine, COVID and a tightening policy environment making it more expensive for companies to raise finance therefore ushers in a more challenging time for asset markets. This confusing mix is evident in the bond market. For while the US 2 year note has sold off aggressively – moving from xx% to xx% in 3 months – longer term rates have been less flighty. As such the yield curve¹ as expressed by the difference between these rates (also called the 2-10 spread) has dramatically flattened and ultimate inverted. This suggests the rate rises anticipated by the 2 year note may well precipitate a slowdown and ultimately a recession.

The question is what do we do? The combination of elevated valuations and a tightening financial environment which may or may not precipitate a recession make the outlook quite challenging for

Figure 2: US 2 Year



Past performance is not a guide to future performance.

Source: Bloomberg, 20 April 2022

Figure 3: US 2 year, 10 year spread



Past performance is not a guide to future performance.

Source: Bloomberg, 20 April 2022

investors. Further the existential and ongoing changes relating to the clean energy transition, a febrile political environment driving debate towards the extreme, reduced cross border

¹The yield curve plots the interest rates of bonds having equal credit quality but differing maturity dates.



immigration and a renewed confidence in the efficacy of fiscal policy mean that even if cyclical inflation is peaking the longer run rate may settle at a higher level. It is possible that investors face the double blow of less supportive policy and a higher inflation hurdle rate when considering *real* capital and income growth.

It is also worth noting that while the most speculative and highly valued assets have been severely impaired, the sell-off in the wider market is still unremarkable. As such the market remains fully valued (at, or near highs relative to history) on long term valuation measures (see Figures 4 and 5).

We still fear that investors have sought perfection within an imperfect framework in the sense that the market itself remains overvalued.

Figure 4: US Market Cap/GDP



Past performance is not a guide to future performance.

Source: Bloomberg, 20 April 2022

Figure 5: Shiller PE Ratio by year



Past performance is not a guide to future performance.

Source: Multipl 20 April 2022

The result has been valuation became ignored in favour of far off but less predictable profits. This is very characteristic of the late stages of a long market ascent.

The importance of income

As we have said before although the world is changing, the need for income does not change. Even more so *real* income for those with irreplaceable capital. We must make sure that the pursuit of income does not endanger long term capital unduly, whether that be as a result of markets shocks in the short term, inflation in the medium term and obsolete business models over all time periods. As such, our unwavering aim when constructing the portfolio is to deliver income and long term capital growth without too much volatility.



Macro to micro

If the macro-economic implications of the above are profound the micro, company level, effects are equally important. Echoing Elon Musk's comments, the era of free money is over. Freely available capital has incentivised business models that prioritised growth over profitability.

Such companies, certain that capital (both equity and debt) will be both plentiful and low cost have sought to claim as much of a market as possible to steal a march on their competitors. Profitability has been deferred in favour of expanding to fill a total addressable market (think Amazon, Uber, Deliveroo). The problem with this strategy arises when conditions become less favourable both economically and in terms of the cost of capital, and these business models can be revealed to be built on sand.

Troy's approach of emphasising quality allows us to navigate these more difficult waters with confidence. Further, the discipline of the need to generate income ensures that valuation remains an important part of our process for managing the fund.

Our focus on quality ensures that our companies possess identifiable competitive advantages. This is evidenced in high and sustainable returns on capital and attractive margin structures. As a result our businesses tend to have a one-way relationship in capital markets. By this we mean that they generate sufficient cash flow to be self-financing. They can choose to use capital markets to support operations or aid capital

allocation but are not beholden to the need for continuous financing.

This matters because in more challenging times those companies that possess these qualities are more resilient both to a less favourable economic environment as well as inflation. A lack of required capital constrains the actions of others and allows the quality incumbents to shine as cheap-capital empowered competition recedes. Further the same qualities that allow for high returns on capital give companies the ability to raise prices without unduly effecting demand. We have seen this pricing power demonstrated in recent results across our portfolio.

None of the above is new but at times of speculative excess, which is descriptive of recent times, these well-established principles can easily be forgotten. Recent events suggest investors are re-learning them once again.

US trip

We continuously strive to learn more about the companies in which we are invested or which are of interest to us. To this end we have recently returned from an investment trip to the US. After 2 years of no travel it was terrific to be in New York again and to get an impression of the US investment landscape. In my view all global fund managers, if they can, should go to the US once a year at least, to gain perspective. The sheer scale of the economy, the energy of the people and the quality of the companies is a reminder of the relentless compounding of capital that a capitalist economy inevitably achieves over time.



We met with a number of portfolio companies including Coca Cola, Johnson and Johnson and Clorox as well as a number of companies that are likely to be in the portfolio in the future. Overall the tone was that the US consumer is strong but that companies are experiencing inflation at every level in their business. Equally there was an existential fear that a recession may be approaching. Management therefore talked about what they might do should these fears prove to be true. This is all consistent with the framework laid out above.

The most optimistic presentation was from Canadian National Railway (“everything is booming”). At the other end of the spectrum Jamie Dimon, the CEO of JP Morgan, suspected that we may be facing a “hurricane” and that investors should “brace themselves”. Perhaps this is not surprising given the backdrop. Railways benefit from rising commodity prices whereas a tightening monetary environment tends to be challenging for banks.

Generally we are very comfortable with our existing group of companies and excited by the prospects for some of the businesses which are in our universe but which we do not yet own.

Conclusion

Our portfolio characteristics and valuation are shown below. Following from the above, the combination of quality and value should be logical. We have businesses that should be able to operate in a robust manner in an environment when others may fall by the wayside.

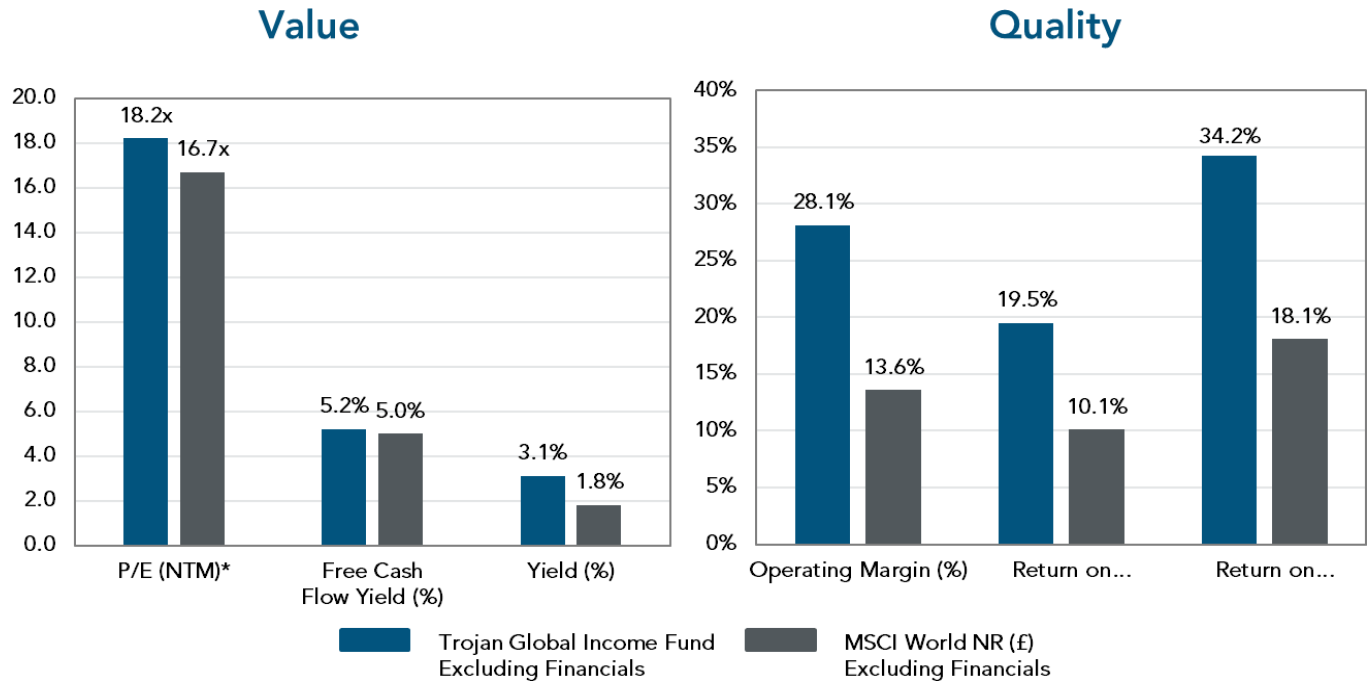
This gives us confidence in the outlook for the free cash flow the portfolio will generate. Further the value embedded in our fund should allow us to continue to produce decent returns balanced between income and capital despite the change in the backdrop that investors and companies are experiencing.

James Harries

14th June 2022



Figure 6



Past performance is not a guide to future performance.

*Price to Earnings Ratio Next 12 Months

Source: Factset, 31 May 2022. Characteristics are shown excluding financials. All references to benchmarks are for comparative purposes only. Asset Allocation is subject to change.



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