TROY
ASSET MANAGEMENT

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Trojan Global Equity Fund Newsletter

The Trojan Global Equity Fund aims to deliver capital growth over the long term without taking excessive risks. We aim to do this by investing in exceptional companies with high returns on their invested capital, run by sensible management teams and sustained by durable competitive advantages and strong balance sheets. We intend to buy them at better than fair prices.

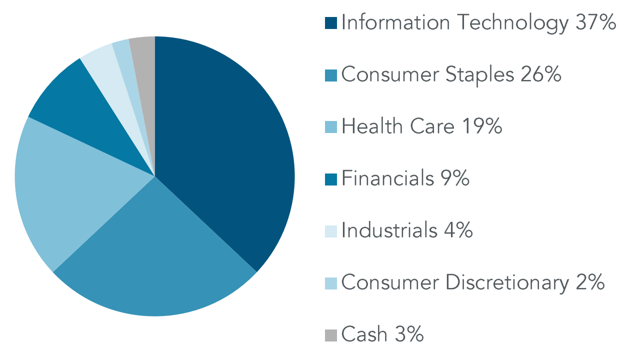
Performance Review

Over the last 12 months the Fund has returned 12.4%, and year-to-date the Fund has returned 10.0%. This compares to 12.1% and 9.1% respectively for the MSCI World Index (Net TR, £).[1]

These figures mask divergent fortunes for sectors, countries and currencies. Volatility has replaced the widespread optimism prevalent at the start of the year, amid concerns about rising inflation and tightening US monetary policy. UK investors in global equities have experienced a recovery since the lows of February and March, but returns would have been much more pedestrian without the marked contribution from the US market, particularly US tech stocks, and a tailwind from weak sterling against most trading currencies, especially the US dollar. European and Japanese stocks have made only modest gains in the year to date and emerging markets, where the Fund has no direct investments, have declined.

The Fund's own recent performance mirrors these geographic trends to some extent. In the year to date, US tech stocks (Microsoft, Alphabet, PayPal, Visa, Fiserv) and US medical technology stocks (Medtronic, Becton Dickinson) have led returns. Consumer Staples have generally lagged, and the Fund's four tobacco stocks (collectively 7.5% of the Fund) have been particularly disappointing, despite financial results that met our expectations. Holdings in Sage and eBay also detracted from returns after they both reported slightly weaker than expected operating results. The underlying operating performance of all the businesses in the Fund remains robust, and renewed stock market volatility is providing selective opportunities for reinvestment.

Sector Breakdown



Source: Troy Asset Management Limited, as at 31 August 2018.

Valuations and Returns

Our investment process remains stock-specific and does not reflect temporary views about individual industries, economies or currencies. Instead, we aim to own what we consider to be exceptional companies and keep them for as long as their prospects appear bright and their

[1] Source: Lipper

valuations reasonable. Over the last five years this valuation component has become increasingly challenging. The estimated average P/E of the Fund is now 20x, similar to where it started the year and roughly where it was 12 months ago. We are not expecting upward revaluation of the portfolio's stocks to be a major driver of returns from these levels. Returns will instead mostly depend on continued corporate operating performance. On this score we are encouraged by the progress the Fund's companies are making and their capacity to grow in a highly efficient way. The weighted-average return on equity for the Fund's holdings is 24% and their free cash flow margin is 23%, both far in advance of the market average (*see Appendix I*). Debt levels for our companies are also low at a time of rising levels of corporate leverage elsewhere in equity markets. Furthermore, the Fund's companies are growing at a healthy pace. Their average FCF per share has grown +8% p.a. over the past five years.

Going Global

In our last Newsletter we described how the portfolio had shifted towards a broad array of businesses involved in technology (enterprise software, consumer internet, payments), partly at the expense of consumer goods companies. This is perhaps the clearest demonstration that the investment process is flexible enough to incorporate new opportunities as they emerge.

There are other, less obvious changes that have also taken place which relate to the Fund's geographical diversification and our assessment of capital allocation. We think both trends have improved the overall quality of the portfolio.

The Fund always had a bias towards multi-national companies, but patchy economic growth over the last few years has partly informed an even stronger preference for geographic diversification. In recent years we have sold the Fund's holdings in Rathbone Brothers and A.G. Barr, for example; both are fine businesses in their own right with plenty of opportunities to grow, but both narrowly hitched to the fortunes of the UK economy. We have also passed on several opportunities to invest in other companies with more limited geographic scope. By contrast, companies such as Unilever, the Fund's largest consumer goods holding, sells products in about 190 countries, many of them in emerging markets. This geographic breadth provides enormous opportunity. It also provides 'capacity to suffer' should any one country experience economic difficulty. We think this should make for a more resilient investment proposition, and ultimately, higher investment returns.

Keeping it in the Family

Over time we have also become even more committed to owning businesses run by people with a very long-term vision for their companies. At a time when revenue growth has been harder to generate, we have observed many companies resort to financial engineering to satisfy investors' demands for earnings growth. This can come in several forms – aggressive cost cutting, M&A, buybacks – but each has its limitations as a lasting store of value. The longer an investor's time horizon, the more important it is to see expanding revenues do the heavy lifting, and management must be properly prepared and incentivised for this. A family or strategic owner can help anchor management's capital allocation for long-term growth. Over half of the Fund is now invested in companies that have a long-term, strategic investor or family on the shareholder register. Heineken is a good example of both geographical diversification and family ownership. 145 years after Heineken was first brewed, the company

continues to be controlled by the founder's descendants, giving its senior managers a very long perspective on running the business. Heineken's managers refuse to make detailed financial commitments to brokers and analysts. They do not make a habit of repurchasing shares and they will sacrifice profit margins in the short term if it's the right thing to do. The stock market, with a preference for instant rewards, doesn't always like this approach. Heineken's stock price recently fell over -5% on the publication of its interim financial results which revealed pressure on operating margins. Yet the leading cause of this decline is a source of optimism for investors like us. Heavy investments in countries such as Brazil, Vietnam and Ethiopia are creating a drag on profitability in the near term but they should also sustain the company's growth for many years to come. Heineken's margins therefore reflect deliberate choices about how the business is managed. The company's recent rate of organic revenue growth, at +5.6% over the last six months, is among the best across all large consumer staples businesses. And in an industry such as brewing, with high fixed costs, margins will eventually follow revenue growth. It just requires patience.

'I think one has to realise that what really changed in the margins is a profound [and] faster shift in our geographic portfolio than we originally anticipated. And it is bad news in the short term for these margins, but it's fantastic promise also for the future.'

Jean-François van Boxmeer, Heineken's CEO & Chairman of the Executive Board, July 2018

These themes – a wide geographic footprint, patient long-term investment and ownership alongside controlling shareholders – come together again in analysing L'Oréal and Facebook, the two latest purchases for the Fund.

Beauty in the Eye of the Shareholder

A holding in L'Oréal was started for the Fund in March. The company was founded in 1909 and the founder's family remain major shareholders alongside Nestlé who have owned a large stake in L'Oréal since the 1970s. L'Oréal combines a focus on beauty categories (cosmetics, skin care and hair care) with very broad diversification by brand, price point, retail channel and geography. It operates in 140 countries altogether. The company also combines the attributes of global scale with a nimble and entrepreneurial organisation. This ensures that the company is adaptive to changes in its markets, something that is necessary in dynamic categories such as cosmetics, but increasingly essential for any consumer business as shopping becomes a more digital experience.

'We have to adapt permanently, or even anticipate permanently, the consumer's demands, desires, and dreams… We are not very organised. It's intentional, because it allows us to always keep our mind open to new ideas, ready to jump on new trends and take new opportunities.'

Jean-Paul Agon, L'Oréal's Chairman & CEO, March 2017

L'Oréal's annual organic revenue growth rate has consistently been in the region of +5% over the last five years. It was +6.6% in the last six months. Current and future growth is underpinned by strong product innovation and increased consumer spending in developing countries. At 19%, operating margins are very good, but they could be higher if L'Oréal abandoned its very consistent approach to

investment. L'Oréal spends 3% of sales every year on R&D, ahead of its peers by some way, and the company is the world's biggest advertiser. It also regularly acquires small and upcoming brands that it can take internationally. E-commerce represents 10% of revenues, growing +36% in the first six months of the year, and sales in emerging markets are growing at double-digit rates. L'Oréal's shares, like its premium products, do not come at a bargain price, but adjusting for net cash on the balance sheet and the ~9% stake in French pharmaceutical company Sanofi, the Fund's shares were acquired at a modest premium to global peers.

Selfies for the Long Run

L'Oréal's growth has been accelerated in recent years by the impact of social media on beauty product consumption, a trend largely enabled by Facebook.

We acquired shares in Facebook for the Fund earlier this year. The company is not without its controversies but we firmly believe that, despite its many critics, the company is not going away anytime soon. To a large extent this is simply a matter of scale; its properties are too big and useful for users and advertisers to abandon them *en masse*. Core Facebook has over 2bn monthly active users (MAUs), Instagram has over 1bn and WhatsApp and Facebook Messenger have well in excess of 1bn each. Compare this to Twitter and Snapchat, with under 300m and 200m users respectively, both of which have stagnated. Instagram added more users in a single year than Snapchat has in total users. Facebook's audiences are also global, with just 11% of core Facebook users based in North America. This global diversity makes the company more durable by creating an enormous runway for growth from markets where even traditional advertising remains underdeveloped, let alone online advertising. Instagram is expected to represent ~20% of the group's ad revenue in the next couple of years and WhatsApp and Messenger have yet to be monetised despite their vast user bases. The overall business can continue to grow at healthy double-digit rates and it has ample resources to deal with current levels of political and regulatory scrutiny. Facebook has over $40bn in net cash on its balance sheet, naturally high operating margins and excellent cash flow characteristics. The latest fall in the company's shares was triggered by management's stated intention to invest aggressively over the next few years in areas such as safety, security, and computing power to fund growth of video and AI. Whilst these investments reduce near-term margins and earnings growth, they reinforce the value of the franchise and make it even harder for anyone else to compete against it. In Mark Zuckerberg, Facebook has a founder and controlling shareholder who is motivated to do what is right for the future health of the business.

'In light of increased investment in security, we could choose to decrease our investment in new product areas, but we're not going to because that wouldn't be the right way to serve our community and because we run this company for the long term and not the next quarter.'

Mark Zuckerberg,
Facebook's CEO & Chairman, July 2018

Facebook's shares have traded as low as 18x forward (non-GAAP) earnings this year, far below their average multiple since Facebook's IPO in 2012, and at a substantial discount to tech peers. Even before its recent controversies, Facebook elicited emotive responses among investors, journalists and consumers. Older media outlets in particular

see an opportunity to make great copy at the expense of a business model that has contributed to the gutting of the traditional newspaper industry. This febrile environment is an extreme example of something we have seen before when we first invested in other technology holdings at depressed valuation multiples. The strategy is designed to take advantage of these rare opportunities as they occur.

Our Largest Holdings

Founders and their descendants that own first-rate businesses are comfortable having a very substantial proportion of their wealth invested in one company. Troy's funds have always had concentrated portfolios on the same understanding that these great businesses are rare and they should be owned in scale once they are uncovered. Nonetheless, we believe that diversification is an important risk control which can help to mitigate the effects of unforeseen problems for any one of our funds' investments. To this end our literature for investors in the Fund has from time to time referred to a self-imposed limit, for each security, of 6% of the value of the portfolio's assets.

Given the concentration of the Fund's portfolio and the fact that the Fund is required by regulation to hold a diversified pool of assets, we have been considering the relevance of this self-imposed limit. By way of example, in recent months, two of the Fund's largest holdings have exceeded this 6% limit (see Appendix II). Given our assessment of these companies' prospects and their valuation we are not motivated to reduce the holdings. However, we remain mindful of concentrations of risk within the Fund whilst seeking to express our conviction in our best ideas in the shape of the portfolio. Therefore, with effect from Monday 22 October 2018 (a month from today), we will treat this 6% threshold as a guideline but not a limit. This will mean that, subject to the relevant regulatory requirements and the Fund's investment policy, a single holding could exceed 6% of the value of the portfolio's assets.

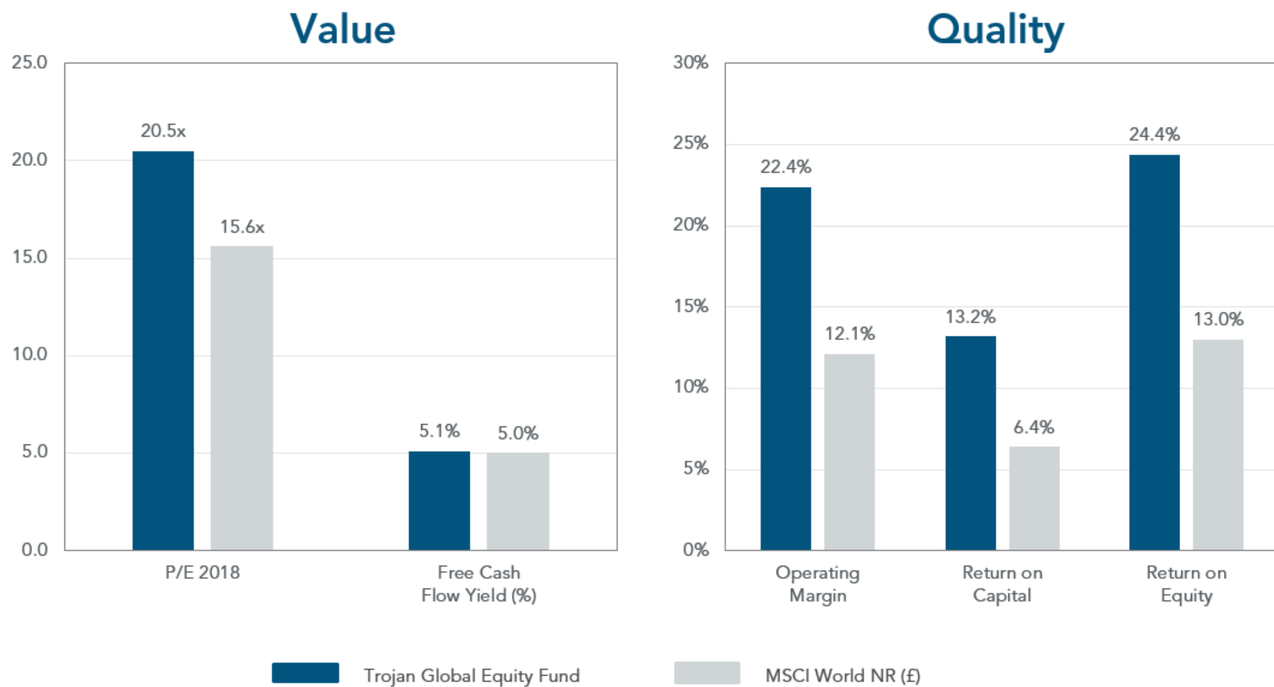
Outlook

There is always something for investors to worry about. Today it is currency depreciation, political dysfunction and trade wars, high asset values, and tightening monetary policy. Previously it was Federal deficits, Chinese economic slowdown, sovereign debt crises and plunging commodity prices. There is clearly no room for complacency and yet we are confident about the direction of the portfolio. Not because we have a firm view on macro-economic developments – we don't - but because the approach to selecting stocks embeds our cautious outlook by focusing on a tight-knit collection of world-class businesses. They are defined by their financial productivity today and their capacity to grow at above-average levels of profitability for many years to come. The valuation of their shares will fluctuate over time, but ultimately it is corporate cash flows that will determine returns for shareholders. We are encouraged by the operating performance of the Fund's companies and take comfort from the fact that they do essential things for their customers whilst generating exceptionally high returns. Any future stock market volatility will provide opportunities to add to their number at cheaper valuations.

Gabrielle Boyle and George Viney

September 2018

Appendix I



Source: Bloomberg, 31 August 2018. All references to benchmarks are for comparative purposes

Appendix II - Top 10 Holdings

Top 10 Holdings	% Fund
Microsoft	6.3
Alphabet	6.1
American Express	5.4
Medtronic	5.4
PayPal	5.3
Visa	4.8
eBay	4.6
Novartis	4.3
Becton Dickinson	4.1
Fiserv	3.9
Total Top 10	**50.2**
22 other holdings	46.6
Cash & equivalent	3.2
Total	**100.0**

Source: Troy Asset Management Limited, 31 August 2018. Asset Allocation and holdings subject to change.

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