TROY
ASSET MANAGEMENT

Investment Report No.27

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

Happy Anniversaries?

"*We will learn an enormous amount in a very short time, quite a bit in the medium term and absolutely nothing in the long term. That would be the historical precedent*"
Jeremy Grantham of GMO in *Barron's* commenting on what will be learned from the credit crisis in October 2008.

A number of anniversaries have been celebrated in recent weeks. A year on from the collapse of Lehman Brothers, central bankers, politicians and regulators were happy to comment on the debacle and air their dirty laundry in public by blaming one another. Few came out of it well. Admittedly, stock markets have recovered to within 10%-15% of that fateful day last September, which has provided them with some comfort that the world had not ended on their watch, at least not yet anyway.

The anniversary of the fall of the Berlin Wall in 1989 was also celebrated recently but for us two anniversaries still lie ahead at the end of this month that are likely to attract less in the way of press attention or docudramas; the end of the Japanese bull market in December 1989 and the peak of the UK's FTSE 100 Index ten years later. As long term investors, like Mr Grantham, we are keen to put investments in their historical context. The UK market peaked on the eve of the millennium in a wave of technological optimism. Ten years on and 25% lower, the FTSE 100 is stuck in a prolonged bear market (*see Figure 1*). Only after the falls of 2008, were investors openly prepared to acknowledge this.

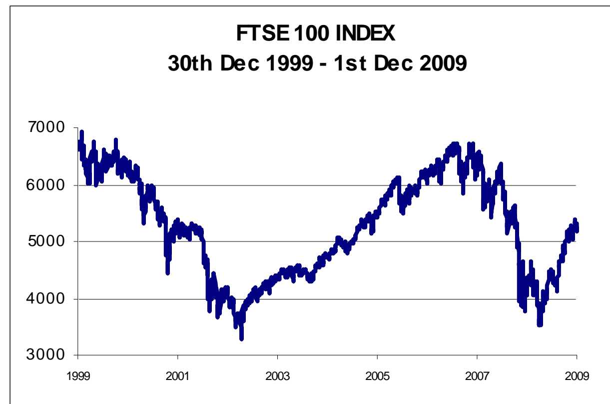

Figure 1 Source: Bloomberg

While not in the business of fortune telling, it would be helpful if we had a roadmap for markets over the next decade. Can we look forward to the end of this secular bear market sometime in the middle of the 2010s and by 2020 be well into a new secular bull market? We certainly hope so as it has been what we (and our patient investors) have been waiting for since Troy was established in 2000. Alternatively, as some commentators suggest, are we turning Japanese? A twenty year performance along the lines of the Nikkei 225 index would leave the UK stock market 75% down from its peak by 2020 (*see Figure 2*).

Figure 2 Source: Bloomberg

Turning Japanese?

The chances of the UK heading for a Japanese-style slump cannot be ruled out. Certainly the bail out of the banking system in the past year and the lack of willingness by banks to recognise bad debts are eerily familiar to the few remaining Japanese equity fund managers. There are clear differences, however, between the UK and Japan, which those drawing comparisons tend to omit. Back in the 1990s the Japanese savings ratio was 14%. Consumer balance sheets were strong and were able to fund a burgeoning fiscal deficit. Individuals were happy to buy low yielding Japanese government bonds. The Japanese economy benefitted from a healthy balance of payments surplus. These two factors underpinned the Yen, even when the fiscal deficit was ballooning out of control. In the case of the UK (and the US) we have a low savings ratio and a stubborn trade deficit. Monetary policy is very loose in contrast to Japan in the early 1990s. A policy of benign neglect and money printing is likely to lead to further falls in Sterling and imported inflation. A Japanese deflationary-style slump looks less likely – the alternative path has been taken.

Phoney world

Back in the dark days of last winter, a monetary battle was lost by the 'moral hazard' hard liners at the Bank of England, including Governor Mervyn King. The 'monetary stability' pragmatists won the day when they bailed out Royal Bank of Scotland and HBoS and began the process of what some consider to be the immoral policy of 'Quantitative Easing' – printing money. The pragmatists have been in charge ever since and will not allow a free market solution to the crisis. While there is much talk of 'exit strategies', the UK monetary authorities are reluctant to withdraw the huge stimulus provided since March. Any exit is likely to result in a second chapter in the crisis. As a result, we live in a phoney and dangerous world where the Bank buys gilts that no one would buy at prices no one would pay. Gilt yields are distorting all other asset values, as bonds, equities and property are ultimately priced off gilts. Money is being compromised, and with banks paying no interest to customers, no wonder savers cry, 'Where do I put my money?' The Bank of England Pension Fund kindly provided one answer when it published its annual report recently. Over the past two years, the trustees have increased index-linked gilts exposure from 26% of the £2.1bn fund, to a staggering 88%. It is not without irony that the Bank of England has made such a concentrated bet on inflation, when it is busy depreciating the value of sterling.

As good as gold

"In my view, people are now making the wrong decisions because they imagine the whole system can be put back together unchanged. But they are wrong."
George Soros, as quoted in David Hare's play, The Power of Yes.

Our fear is that investors and policy makers are confusing the cyclical with the structural. The problems we face are not of the traditional economic experience of the past 30 years. To give one example, the UK government deficit is on track to reach over £200bn this year - a figure that will not be reversed by tax increases on the highest paid 2% in society. Secondly, selective spending cuts will not eat into £660bn of government spending. In recent days markets have been given another reminder that all is not well. Dubai's woes added $80bn to the global debt crisis and who is holding the bill? – in part, the long suffering British taxpayer via his 84% share holding in the Royal Bank of Scotland.

The world is lurching from one crisis to the next without realising a common factor – it is not lack of money but too much debt. The 'isolated' subprime debt concerns of two years ago have now spread to sovereign borrowers. Money creation is no panacea for these problems and it will ultimately impoverish savers. How do we protect ourselves? One possibility is to follow the Bank of England pension trustees and buy index-linked gilts;

but the purest answer is gold. We started investing in gold shares in 2003 and acquired bullion for the first time in 2005 at a price of $424 per ounce. The current price is $1,140. We hear all the conventional criticisms for holding this asset '*it pays no interest*', '*it has no industrial use*', and the current favourite '*it's a bubble*'. When we first invested in gold people looked at us rather strangely and viewed us as a little unhinged. '*Why not buy a crude oil ETF instead*?' one of our smartest investors asked. They failed to see gold was not a conventional commodity play but a currency that could not be printed. Now, five years on, some of the world's smartest investors like John Paulson and David Einhorn are advocating the yellow metal's merits. Central banks, sellers of gold for over a decade, have turned buyers. In November, in a public display of abandoning paper money, the Reserve Bank of India bought 200m tonnes of IMF gold. We receive a little grudging respect now and again, having almost tripled our money and we accept this is no longer a contrarian call. Despite this, we expect the holding to provide protection from the monetary damage that we fear is yet to come.

Buying a bubble?

To tackle the common carps, it is, at times, useful to have an asset that provides capital gain instead of income, particularly when that income is likely to be taxed at ever increasing levels. Gold has little industrial use, we agree, but then how much utility does a UK gilt or a structured product have? Finally, the bubble worries. Fortunately, I can recall the dot com bubble only too well. Back in late 1999 many investors had 40% or more of their portfolios in the Technology, Media and Telecom ('TMT') sectors, while the post boy at Marconi asked me for stock tips that would benefit from the growth in fibre optics. In early 2000, I attended a conference of internet and software companies. There was standing room only in a hall that seated 400 delegates. The flaky companies presenting hardly had any revenues, let alone made any profits and were being valued on multiples of 'clicks'. No one had heard of them a few years before. Yet here they were, on the cusp of entering our blue chip, stock market index. Huddled at the back and feeling a little uneasy about the fact I could not bring myself to invest in these stocks, I came across one of my peers. "Do you own any of this rubbish?" I asked him. He glowed with pride and told me "Sebastian, if you are not in tech, you're dead!" That is my definition of a bubble.

A Golden price

Today, with the exception of gold funds (of which there are only a handful) a few investors are brave enough to hold 2% to 3% of their portfolio in gold related investments. Even fewer hold bullion itself in preference to owning more risky mining shares. Notwithstanding a long rise in the price since 2001, gold is viewed by most conventional investors with scepticism or revulsion. Most view it as risky, yet gold has made positive returns every year since 2001 (in US dollar terms). These are the characteristics of a ***bull*** market, not a bubble.

As for how to value it, we reverse the question, asking facetiously; how do you value a dollar or a pound when supply is increasing on a daily basis? To be more helpful, we have come across a number of methods of valuation. Christopher Wood, strategist at CLSA Asia Pacific Markets who highlighted gold's investment merits in 2002 suggested a target price of $3,400, based on the previous peak of $850 in 1980, adjusted for inflation since then. A further possibility comes more recently courtesy of Dylan Grice of Société Générale. To physically back the $1,700bn dollars in existence today, given the current level of US gold reserves, Grice says the price would need to rise to $6,300 (*see Figure 3*). I must emphasise we are not '*goldbugs*'. For the first 14 years of my career I never owned any exposure to gold and I look forward to the day when we can move on to more

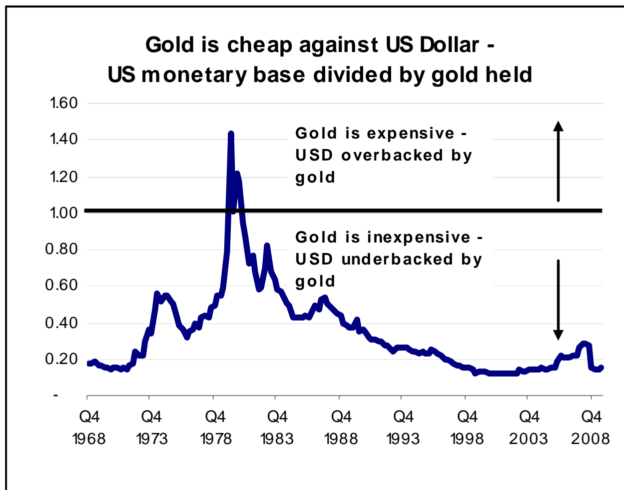

Figure 3 Source: SG Global Strategy

exciting investment opportunities but for now, it acts as a defensive alternative to cash.

Golden shares

So other than index-linked gilts and gold, what are the alternatives for the hard pressed saver looking to preserve the real value of his cash? Our last report, in the summer, highlighted our disbelief in the dash for low quality stocks. To some extent, with the benefit of hindsight, this move was rational predicated on short-covering and the threat of insolvency averted. This provided a window for weaker companies to refinance. We have not been tempted to bail out these poorly financed companies and are still surprised by their eye-watering debt burdens even following fundraisings. As Mr Soros identifies, the world will not return ex ante, where debt could just be 'rolled over' year after year. It must be repaid in the foreseeable future. Our preference is for strong balance sheets – with little or no debt. In line with our view on currencies we seek broad international earnings from companies that generate consistent profits outside the UK and the US such as Nestlé, Coca Cola and Colgate Palmolive. These businesses are underleveraged and make products in demand worldwide from an aspiring middle class. By way of an example, we recently began reducing our longstanding holding in Reynolds American in favour of Philip Morris, which is a global business that derives no profits from the United States. We believe the re-pricing of distressed equity has run its course and investors are showing signs of seeking quality. From time to time Troy is viewed as a little parochial, investing in the UK, US and in Europe. *"Why no emerging markets? No China?"* Three reasons: We have no expertise in this area, they are very high risk and we can gain access to them by buying into companies that have been in business in emerging markets for decades but are governed under a respected legal structure. Whilst these stocks are not sitting on rock bottom valuations, businesses of this strength and breadth rarely do. If we are right about the challenging environment ahead, they will give us dividend certainty, earnings predictability, and some protection from inflation.

"Events dear boy, events"

When asked by a journalist, what is most likely to blow a government off course? Harold MacMillan replied, "Events dear boy, events". The same follows for markets in 2010. This year, policy makers attempted to resuscitate the global economy by transferring the huge credit boom from the private sector to the state. The credit bubble is alive and well and can be seen clearly on the Federal Reserve's balance sheet that has ballooned by over a trillion dollars in the past year. Governments have also engaged in unprecedented borrowing to keep the show on the road. US public sector debt to GDP will rise from 40% to 80% by 2015. These policies only add to the distortions and imbalances already present before the crisis. Whether through higher tax, higher interest rates or debasement of the value of debt or a combination of these factors, the piper has to be paid! After a strong rebound this year, no one knows what events will blow markets off course but policy makers are running out of options to deal with any fallout. The answers to our problems cannot lie in ever greater debt and the debasement of money.

A year ago we were optimistic about stock markets. Today we are a little more circumspect. Confidence has returned and prices are

less distressed. Investing in the UK stock market on a ten year view from 1998 produced a negative real return and was the worst decade since 1969. Ten years on from the millennium, returns since 1999 will look no better but looking forward the outlook from 2009 for investors over the coming decade is more promising. Valuations are lower, as are expectations. Both are a good starting point. Our funds are priced daily and we report monthly. Please be aware we invest on a five year view and encourage you to measure us accordingly. Troy's approach means that we may differ materially from our peers and markets.

All of us at Troy wish all our investors a very Merry Christmas and a Happy New Year. As in previous years, we will not be sending out Christmas cards but will be donating the equivalent cost to the charity Alzheimer's Society (http://www.alzheimerssociety.com/).

We are, as always, very grateful for your continued support.

Sebastian Lyon

December 2009

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