TROY
ASSET MANAGEMENT

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Investment Report N°·55

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

Creatures of Habit

"Good judgment comes from experience, and experience - well, that comes from poor judgment."
A.A. Milne

As investors, "we are all prisoners of our own experience", or so says John Authers of the *Financial Times.* He is right. Those who started their careers in the early 1980s learnt the rewards of optimism by experiencing one of the greatest bull markets in history; it lasted 18 years to 2000. Conversely, those who started in the early 1970s were scarred for life by the near -70% drawdown of the 1973/4 savage bear market. Similarly there are differences in experience for those who started their careers after 2010, compared with those who began with the optimism of the mid-noughties, only to have it dashed by the financial crisis. While some are forever seeking out the next water-into-wine stock, others have learnt the virtues of capital preservation and look to the downside before considering the upside. Not for them the temptation of Bitcoin or other cryptocurrencies, driven by the "fear of missing out". Rather, their preference is for a margin of safety.

I started my career in 1989, following the shock of the 1987 crash. The UK economy was heading into a double-dip recession. For three years, markets tracked sideways but with materially divergent performances from their constituent parts. High return on capital, defensive businesses such as Pharmaceuticals, Brewers and Distillers made money, while cyclical, domestic businesses like banks, engineers and housebuilders were disastrous investments. Cyclicality combined with financial leverage, taken on with gusto during the boom, ended in capital losses with dividend cuts. To add insult to injury, shareholders in poor performers were tapped (via rights issues) for fresh capital to bail out their diminished equity. The virtues of good businesses were learned the hard way.

Value Trapped

What was notable during this period was that these ill-fated sectors looked myopically cheap and tempting, whether as a multiple of earnings or on account of their, ultimately unsustainable, dividend yields. Such traditional valuation metrics proved useless. In the end it was not the profits that mattered but rather the sharp deterioration of cash flows, which made a ridicule of forecasts. In recessions, as we learned again in 2008, it is balance sheets that matter. Contrarian optimists were caught repeatedly by hopeful bursts of recovery but it was only after the 'extremely difficult and turbulent day' of Black Wednesday in September 1992, when all hope was expunged, that recovery could ensue. This was thanks to a collapse in sterling and sharp falls in interest rates.

There is a view prevailing today that low valuations offer protection. This can be true in the right kind of businesses. In 2000, low valuations in 'boring, old economy' stocks offered protection and excellent medium-term investment opportunities. Today's low valuations tend to be in weaker businesses, vulnerable to economic cyclicality, transformative disruption and high levels of debt. They may be cheap for good reason. More often than not, low valuations tell you more about the quality of the business and should be a warning rather than an opportunity. Notwithstanding equity markets making all-time highs in recent months, there are large-cap stocks like J Sainsbury and Marks & Spencer trading at similar prices to those seen in the early-1990s (*see Figure 1*). For many years the shares have looked cheap, on an earnings and dividend yield basis, but it has been right to avoid them. These have been shares to "rent" and trade, not to buy and hold.

When establishing a suitable investment approach for the Trojan Fund in 2001, capital preservation was my primary concern. I had observed the share price volatility of recent crises, whether the Asian Crisis of 1997, the Russian and LTCM crises of 1998 or the dot-com bust of the previous year. During the Asian Crisis, some retail bank shares, including Barclays and Standard Chartered, fell -50% in a matter of weeks. This provided a good example of the fragility that comes with leverage. For this reason I have been wary of retail banks even when they looked like harmless, geared utilities prior to the financial crisis, not the weapons of portfolio destruction that they were to become. When it comes to stock selection, there is virtue in the boring and predictable.

Housebuilders

If there is one sector on which investors have challenged me more than any other, it is housebuilding. Whilst not a particularly large part of the UK stock market, it seems to divide opinion as much as perennial views on UK house prices. I have, over the years, been grilled in meetings as to why we don't own shares in housebuilders and have been criticised as though it were an obvious sector to hold.

Perhaps my formative years have got the better of me. Made at the right time, investments in housebuilders have delivered spectacular results and some stocks have generated strong returns over the long run. If you had invested in Barratt Developments in September 2011 you would now be sitting on a total return of over 900%. However, share price falls of -70% in the early 1990s for the likes of Taylor Woodrow or Barratt Developments were enough to turn me cold. If that did not suffice, share price collapses of -85% for Persimmon and -95% for Barratt between 2007 and 2009 should have put off all but the most stubborn and contrarian investors with stomachs of steel. Worse than in 1992, most of the major housebuilders passed their dividends during the financial crisis. If you had invested in Barratt at the wrong time, i.e. at the beginning of 2007, you would now be sitting on a total return of less than 10%, losing capital in real terms.

From an investment standpoint, these companies offer rollercoaster rides for which you may be asked to pay extra at the bottom if you want to ride back up to where you came from. While some might relish the excitement, we eschew such volatility, if we can. The worst kind of business is the kind that runs out of money. High-ticket items – you can't get more high-ticket than houses – are purchases that can be deferred or not made at all. Without sales, cash flow dries up and the hit from falling sale prices means land banks (asset values) are written down, thereby weakening balance sheets. A virtuous cycle can quickly turn into a vicious one.

Save All Your Kisses

Our preference is for the low-ticket, repeat-purchase items that offer tasty investment morsels. Repeat-purchases are frequently ignored as dull but when it comes to confectionery, compared with other food categories (like ice cream or cereal), private label products are all but absent. Brands are important. Over the past year we have started buying a holding in Hershey, voted the second most powerful brand in the United States in 2017 after Coca~Cola by the CoreBrand Index (Source: Tenet Partners/CoreBrand). Hershey is a purveyor of classic labels including the eponymous Hershey's, Reese's, Kisses and, in the US, KitKat and Cadbury. 85% of revenue is generated in the States so there remains plenty of potential for international growth.

With over 44% market share in its home market for chocolate (Mars comes second with just under 30%), Hershey has a dominant position. Despite market fluctuations, recessions or even higher internet speeds, consumer desires are unlikely to change dramatically when it comes to chocolate. The company publishes a helpful treasure trove of financial history spanning the purchase of Reese Candy Company in the 1960s to the progression of operating margins, which are currently a healthy 19%. Its share buybacks go back over two decades, with a record of consistent value creation. Since 1993 the company has acquired $5bn in shares at an average price of $33 (compared to the share price today of $107 – *see Figure 2*). Unlike many US corporations in recent years, Hershey's buybacks have been funded by free cash and not by debt. We envisage few reasons why such value creation cannot be repeated over the next twenty years.

The Next Crisis

The passing of the 10-year anniversary of the run on Northern Rock in September and of the 30-year anniversary of the 1987 stock market crash last month raises the question as to what the next crisis will look like. Market falls are often identified with crises, such as those of 2008 or 1998, but the falls due to recession are usually forgotten. These can be longer than the short, sharp reappraisal of risk induced by a crisis, and tend to be measured in years rather than months.

Research by Deutsche Bank (Long-Term Asset Return Study: The Next Financial Crisis) highlights that the post-Bretton Woods era since 1971 has made the financial system more vulnerable to crises. It has seen the removal of two important anchors: initially that of gold and, subsequently, the US dollar. Consequently, the frequency of such crises over the past forty years has increased. Liberalisation of finance since the 1980s has led to greater interdependence between the financial system and the wider economy. This 'financialisation' has become so endemic that finance now appears to drive economic activity rather than facilitating it. The result of this financial dominance is evident in the way that monetary authorities pander to capital markets; this is not a healthy relationship. The result is likely to be that asset price declines have a surprisingly negative influence on the underlying economy.

Deutsche argue that there are a number of areas of the global financial system that currently look stretched, including the valuations of many asset classes. If there were to be an asset price correction in the near future, investors could hardly claim that its arrival was unannounced.

The consensus view that prevails today, as conveyed by Martin Wolf of the FT, is that low interest rates as far as the eye can see (notwithstanding tentative tweaks in recent months) ensure that valuations can remain high indefinitely. Similar arguments were used by the economist Irving Fisher in the late 1920s who spoke of a 'permanently high plateau' of share prices. Populism is just one factor that could unsettle the delicate balance of low rates and low inflation that has prevailed, supporting record high valuations.

Those looking for another crisis may be disappointed. Market falls during the 1989 to 1992 period, the mid-1970s or from 2000 to 2002 occurred due to recessions or just extreme over-valuation, not crises. A particular problem going into the next downturn is that interest rates are likely to be extremely low and that the standard central bank playbook response of a 4-5% base rate cut will almost certainly not be available. This means that unorthodox monetary policy (QE and negative nominal rates) is likely to need to be *even* more unorthodox the next time around.

Stock market booms sow the seeds of their own destruction. In 2000 it was dot-com stocks, highly leveraged telecom companies and acquisitive media businesses (e.g. AOL and Time Warner). In 2008 it was banks, miners and housebuilders. Who is to say that next time it won't be FANGs (Facebook, Amazon, Netflix and Google) and large-cap stocks, driven by indiscriminate buying from index funds and ETFs? Over-distributing yield stocks may also suffer, as in the period 1989-92.

Patience is a Virtue

We wait for better value to emerge in the equity market. At a recent meeting we were asked what would drive us to increase our allocation to equities. The answer is simple: valuation. It is easily forgotten that valuation drives long-term investment returns. Eight years into a bull market, it is perhaps not surprising that such axioms are conveniently ignored. Today bears witness to a high degree of valuation-insensitive investment. Impatient capital has a tendency to find its way into inappropriate, low-return opportunities. Low liquidity has exacerbated the rises in equities and bonds. When investors are looking for the exits, a lack of liquidity will exacerbate losses and provide opportunities.

Sebastian Lyon November 2017

Good food costs less

J Sainsbury and Marks & Spencer – share prices 1989-2017

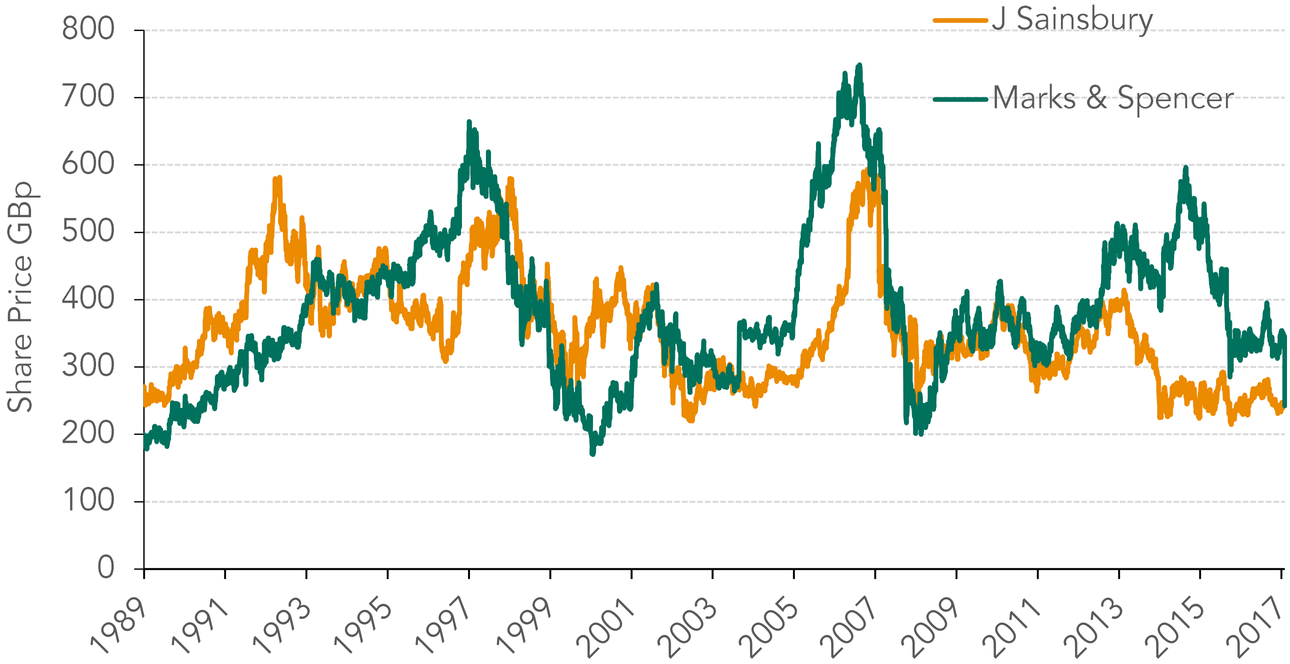

Figure 1 *Source: Bloomberg, 10 November 2017*

Chocolate tastes better

Hershey – share price 1989-2017

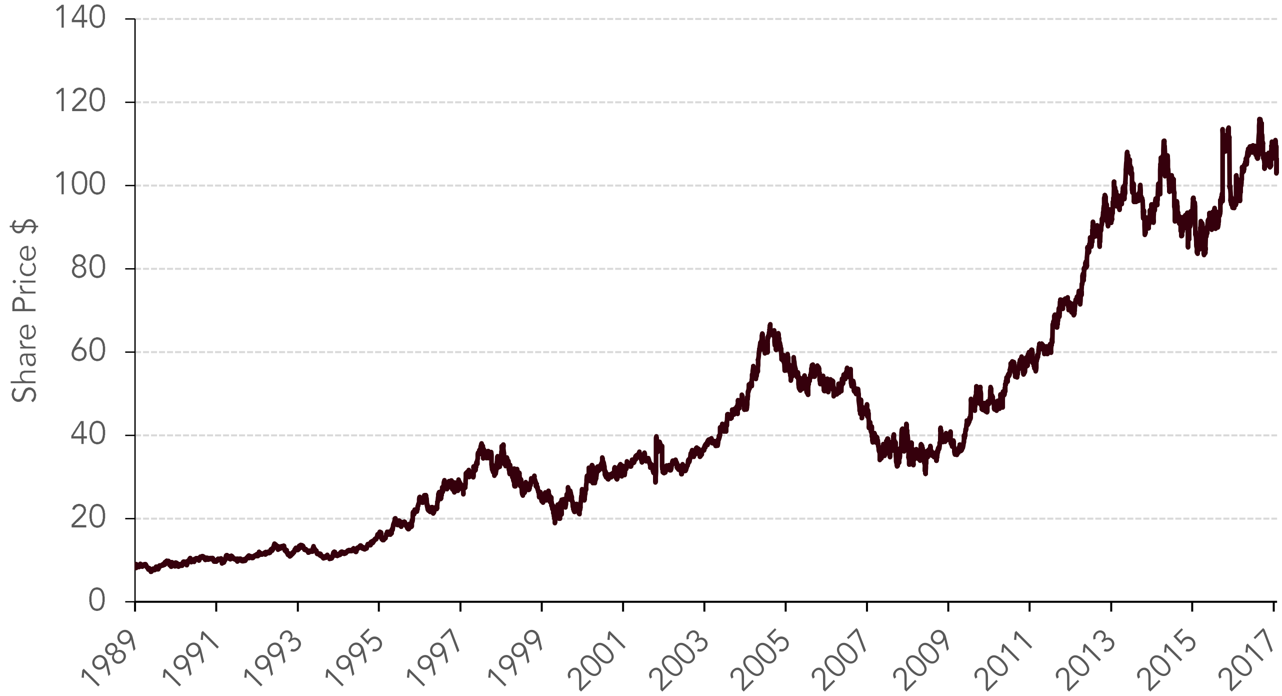

Figure 2 *Source: Bloomberg, 10 November 2017*

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