A Note from Sebastian Lyon, Founder & Chief Investment Officer

www.taml.co.uk April 2020

We hope that all our investors and their families are managing to stay safe and well in these incredibly challenging times.

This report is intended as an update on our thoughts and strategy for Troy's multi-asset mandates including, inter alia, the Trojan Fund and Personal Assets Trust. From July of this year, these reports will be written on a quarterly basis. This has not always been the case. In fact, one of my colleagues kindly informed me that, had I written religiously on a strict, quarterly basis since the launch of the Trojan Fund in 2001, this would be report Nº76, not Nº64. A few reports seem to be missing in action.

After my first report in September 2001, a fellow fund manager suggested I might be creating 'a rod for my own back' in writing about Troy's investment process so comprehensively. Nevertheless, I felt strongly, since Troy was doing something different, that our actions should be made clear to our investors. Over the years, the 'rod' has become less of a burden thanks to the support of a wonderful team of contributors and editors. Going forward, these reports will focus on Troy's multi-asset mandates, which I manage with the assistance of Charlotte Yonge.

Personal Assets Trust

As of 1st May, Troy will be appointed Investment Manager of Personal Assets Trust, after 11 years as Investment Adviser. When we were appointed Adviser in March 2009, it was described as '*evolution not revolution*'. This change to Troy's responsibilities represents a continuation in the same vein. It will not affect the way we manage the Trust's portfolio on a day-to-day basis. However, when it comes to shareholder communication, the retirement of Robin Angus at Personal Assets Trust's next AGM will see Troy assume his quarterly reporting responsibilities.

The Personal Assets Trust's quarterly reports, which began in August 1994, are an investment institution. I started to read them in the late 1990s and they have helped shape our focus on capital preservation, combined with highly selective stock picking. Robin Angus is irreplaceable, as are his quarterly letters to shareholders. On his retirement, the regular quarterlies, as written by him, will end although I know Robin will continue to write to shareholders on an ad hoc basis.

Troy's Funds

The first quarter of 2020 proved a highly challenging and volatile period for stock markets. In fact, March was the worst month for the FTSE All-Share Index (TR) (-15.1%) since we launched the Trojan Fund almost 19 years ago. For the year-to-date, the multi-asset funds' performance has been satisfactory with the Trojan Fund O Acc total return -1.7% and Personal Assets Trust (NAV) total return -2.0%. By way of comparison the FTSE All-Share Index total return was -25.1% (Source: Lipper). Elsewhere at Troy, our equity funds have also outperformed their respective benchmarks.

Investment Report N°·64

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

Coronavirus crash

After the global financial crisis ('GFC') in 2008, the word '*unprecedented*' was used an unprecedented number of times. Few words are potent enough to describe the current situation. In the weeks since February, when we wrote our last investment report, coronavirus has spread from what appeared to be an isolated incident in Wuhan, China to a global pandemic. The implications for the health of populations around the world have led policymakers to shut down vast swathes of the global economy. Epidemiology and the response of governments will ultimately determine the severity and duration of the economic downturn. Scientists are working to understand the virology so as to advise on how best to minimise the harm to human life.

We continue to focus on our responsibilities to investors, working within the limits of what we are able to know in what is a highly uncertain time for all. Troy, which is well capitalised with no debt, remains 'open for business' if not quite 'business as usual'. All employees are working from home and regular video conferences and discussions are taking place between colleagues.

Members of our investment team have held conference calls with the management teams of a number of our holdings. As we noted in Investment Report N°·63, our funds are invested in liquid assets and are therefore well placed to provide regular liquidity to investors. The shares in Personal Assets Trust have continued to trade close to net asset value (NAV) during this crisis and the discount control mechanism has worked effectively, with a combination of share buybacks and issuance.

The falls in stock markets in the first quarter of 2020 were dramatic in their speed and severity. Compounding the challenges posed by the arrival of the coronavirus pandemic, the precipitous fall in the oil price on 9th March, following the decisions made by Russia and Saudi Arabia, introduced a further significant threat to growth and stability. The FTSE 100 Index fell -23% in the seven trading days from 6th -16th March. During the 1987 market crash, stocks fell -22% in just two trading days. This time around, the total drawdown from January to mid-March has been -35%, a figure matched from October to November 1987. Crashes have happened before but the reasons for this financial dislocation are unique.

The UK stock market was ill-prepared for the sell-off. We entered the year with the consensus bullishly poised following apparent progress on Brexit and a General Election result in December that provided additional reasons for investor optimism. Yet the market, widely perceived as better 'value' than its international peers, has not proven more defensive.

The UK is particularly vulnerable on account of the index's large weightings to more cyclical sectors such as energy, mining and banks. The dividend yield provided a false signal of value. This commonly used valuation metric was inflated because pay-out ratios, especially for several major companies in the index, had become unsustainable. In a market of yield-hungry investors, many companies had sustained dividends which should have been cut long ago. These dividend payments also starved those businesses of retained earnings required for long-term investment. A number of companies were effectively bribing shareholders with their own money. Following the market sell-off, many companies have now cut or passed their dividends. Some are cutting dividends because, with no cash flow, they have to. Others, like banks, are being instructed by the UK Government to retain capital in the face of mounting bad debts, while companies receiving government subsidies are obliged to cut because of political expediency. Few remain untouched and are able to continue paying their shareholders as before. In fact, FTSE 100 dividend futures[1] point to a startling fall of almost -45% in market income in the coming year. We suspect, too, when the dust settles and dividends are reinstated, they will not return immediately to anything like their previous levels. Investors may be starved of income for some time as shortfalls become structural. Growth will re-emerge but from a lower, more sustainable base. With interest rates set to stay 'lower for longer', sustainable income will be bid up to a premium.

America, good but not great

The US stock market has held up better than the UK, helped partly for UK investors by the currency effects of a strong US dollar. We entered 2020 with selective evidence of speculation. Parabolic moves in growth stocks, such as Beyond Meat (mentioned in this report last year) or Tesla, indicated retail investor excitement. The market seemed to be priced for perfection by extrapolating the past, but past performance, as they say, is no guide to the future. The outlook for revenues and corporate profitability has changed dramatically in the past few weeks.

Corporate credit is vulnerable with 54% of investment grade credit rated as 'BBB' (one notch above 'junk' status), which reveals the frailty of many American corporations. US share buybacks, many funded by debt rather than cash flow (as with to UK dividends), have been a material support for the bull market in US equities over the past decade. Like UK dividends, these will be suspended as companies are required to conserve cash. Thus, a lever with which many companies were previously able to financially engineer earnings per share growth will disappear.

Bear market rallies

Since the last week of February, when it was confirmed that the virus had spread to Italy, stock markets have experienced record levels of volatility, matching those experienced after the bankruptcy of Lehman Brothers in October 2008. While the falls have been breath taking, if not yet stomach churning, the subsequent rallies have also been huge. This pattern is not unusual. One common misconception is that large daily rises for stock markets belong only to bull markets. On the contrary, the fastest rallies occur in bear markets. It is easy to be deceived by short covering – the repurchasing of stocks to close out short positions. This, if sustained, often leads to further buying driven by the fear of missing out. In the last week of March, the S&P 500 Index had its best three-day streak since October 1931. This hardly inspires confidence that we have entered a new bull market.

So, how does one protect investors from this extreme volatility? With government bond

[1] Derivative contracts which allow investors to take positions on future dividend payments

yields so low, a material weighting in 'conventional bonds' is unlikely to provide portfolio protection. As we have been saying for some time, the traditional 'balanced fund' has outlived its usefulness and will not come to the rescue for asset allocators.

Pre-existing conditions

After over a decade of economic expansion, and evidence of slowing growth in various parts of the economy, a recession was becoming more likely even before the advent of coronavirus. Now the pandemic has exposed inherent fragilities in our economic system. For all the market noise and Pavlovian responses to news flow, our view is that this crisis will be a prolonged and drawn out process. We consider the suspension of economic activity across the globe will result in the deepest downturn we have experienced since the 1930s, with few businesses unaffected. This is in contrast to previous financial crises where financial companies (banks in particular), were badly affected but many other companies came away relatively unscathed. Comparisons with the GFC or the recession of the early 1990s will prove unhelpful.

The epidemiological nature of this crisis empowers government intervention in a way that an 'ordinary' recession could not. With hindsight, the financial system was too brittle ahead of this crisis due to elevated debt levels and tight supply chains. Now these vulnerabilities are exposed, and risk tipping the world into a depression. The economic bicycle is desperately in need of stabilisers and new brakes. This may come in the form of greater capital buffers, tighter regulation, the requirement for stronger balance sheets or local supply chains. Corporate financial optimisation, encompassing ever-tighter working-capital practices alongside indebted ('efficient') balance sheets, is unlikely to remain the gold standard for companies.

Return to normal?

With the downturn barely begun, many are already speculating as to the shape of the recovery. Consensus expectations for a 'V'-shaped recovery look too optimistic but an 'L' is likely too pessimistic. The economy and companies will recover but a 'W'-shape or even a Nike swoosh ' ' are more likely, in our opinion. A gradual reversal of current lockdowns is not compatible with a quick return to normal. A single quarter of economic setback followed by a steady recovery may be the best-case scenario. If that occurs, perhaps we can see through the depression-type data and earnings downgrades now appearing. However, any requirement to resume the lockdown will defer the upturn. New stock market lows cannot be ruled out.

We can add little comment about the virus's epidemiology but it is worth setting out some observations on where we stand. Pandemics tend to come in waves. Shutdowns aim to 'flatten the curve' to prevent overwhelming countries' healthcare systems. The question for us, as investors, is how we all return to normal. We cannot necessarily take comfort from China's experience. Western liberal democracies cannot manage the outbreak using the same measures that the Chinese have. Emerging markets are, sadly, even less well equipped to cope. Returning to work will not be immediate. A semblance of normality may not return until the fourth quarter of this year. Full scale travel and tourism, as we were accustomed to before the pandemic, is unlikely without a vaccination or a certificate of antibodies. Both of these will take time.

Businesses will be permanently altered. For a start, we expect many of the trends in place prior to coronavirus to accelerate. Lockdowns are steering everyone towards new ways of working, shopping and playing. Zoom, Amazon and YouTube were features of many people's lives before coronavirus. Now it would be hard to imagine life without them. The digitisation of our economies, which was already occurring apace, is taking a further leap forward.

There may be other more unexpected changes to the immediate outlook. In the past, companies came roaring back after recessions, buoyed by their ability to cut costs. This time it may become socially and politically unacceptable to make sweeping redundancies. Government support can come with lasting conditions. In many sectors, shareholders may be surprised by the lack of earnings recovery compared to previous downturns.

Stimulus irreversible

With 2020 effectively an economic write-off, governments are having to build a bridge to 2021 by covering pay and alleviating other business costs. The policy response has been truly remarkable. The US government's fiscal package is $2.2tn and counting. The Federal Reserve's balance sheet has expanded by $1tn to $5.25tn. Other central banks have followed suit with the European Central Bank initiating €750bn of additional quantitative easing ("QE") and the Bank of England stepping in with £200bn. The printing presses are working hard to offset the coming slowdown. The 'doubling down' of government intervention is taking place on a new, previously inconceivable scale.

Before this current crisis, we had written about the limits of further monetary stimulus. A fiscal response will have to do the heavy lifting and, this time around, governments are more likely to sustain spending into the recovery – with no subsequent austerity. Like QE in 2009, many of these 'temporary' policies will not be reversed. In the last crisis, bonds acquired by central banks were expected to be sold in the future. Now, despite protestations, that will not happen. Populist politics had already set the wheels in motion for greater monetary and fiscal unorthodoxy. The requirement for immediate action has been brought forward in spectacular style.

At a time when so much is uncertain, one thing is clear: government spending is back on. This likely marks the start of a new chapter for the monetary backdrop. In the short term, deflationary forces are set to prevail given the hiatus in economic activity and collapse in the oil price. However, when activity resumes, the fiscal response by governments has laid the foundations for a rise in the rate of inflation. Inflation is a function of both the supply and the velocity of money. Whilst the former is accelerating, as it did with the initiation of QE in 2009, the latter, which denotes the rate at which money changes hands, remains depressed. This is because QE saw the transfer of money onto bank balance sheets, not into the real economy. Today's co-ordinated monetary and fiscal response changes this by placing the increased money supply directly into the hands of those who might spend it.

Gold is held in Troy's multi-asset portfolios as protection, both against volatile markets and against greater monetary instability. It has provided invaluable insurance in the first quarter of this year, returning +4.9% in US dollars and +12.3% in sterling terms.

This too shall pass

As in any period of heightened uncertainty, it is helpful to return to our roots and the principles upon which Troy was founded. As set out by our co-founder, Lord Weinstock in the year 2000, "Our aim is to protect investors' capital and to increase its value year on year." How do we achieve this for our multi-asset mandates such as the Trojan Fund and Personal Assets Trust?

US Treasury Inflation-Protected Securities (TIPS) and gold will protect us from real interest rates moving more negatively, i.e. when the inflation rate stands above the rate of interest. With state forces pushing money into the economy, an inflationary outcome cannot be ruled out. Cash is likely to have its value eroded if real rates go more deeply negative, and if this happens our cash weighting is likely to fall in the years to come. For now it continues to provide essential dry powder for us to deploy.

Within the stock market, we seek to hold large and well-financed companies that enjoy stable sources of demand, low levels of debt (preferably net cash) and consistently strong cash flows. As many of their smaller rivals retreat in order to conserve cash, these companies can continue to invest in their staff, products and customer relationships so that they are poised to enhance their already privileged competitive positions. It is also more important than ever to align our investments with a world that is embracing remote working and shopping at an accelerated pace. If the Dot Com bust confirmed the internet's fragile infancy, twenty years later, this crisis confirms its maturity as the dominant force driving economies in all parts of the world. A wide variety of digital services, from advertising to healthcare, are likely to provide scarce sources of sustainable growth for many years to come. Our equity investments will continue to adapt to these durable trends.

In the first quarter the Trojan Fund's equities fell -7.2%[2] which compares to -15.7% for the MSCI World Index NR (£) and -25.1% for the FTSE All Share Index. We continue to add value through stock picking and, as valuations improve, we have increased our allocation to stocks in the portfolios in the past two months. We will continue to do so in future, if and when we see further opportunities. While there remains a lack of capitulation among investors, it does not pay to become more bearish as markets fall.

We are under no illusion about the challenges that lie ahead for investors. We believe the global economy is heading towards its hardest landing of our lifetimes and experience of previous downturns can only provide a rough guide. This report has endeavoured to explore many of the prevailing uncertainties. It has also sought to indicate some likely outcomes in which our conviction has strengthened.

Our thoughts are with all those affected by this crisis.

Sebastian Lyon April 2020

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[2] Simulated gross performance is for illustrative purposes only and is not representative of how Troy would construct the portfolio. The simulation is based on the equity component of Trojan Fund. Performance has been calculated based on the equity holdings over the period representing 100% of the portfolio, however equity exposure over the period has varied significantly depending on the Manager's views at the time. As a multi-asset fund, the fund has been invested in other asset classes which contribute to the overall portfolio returns. The returns of any overseas equities are also impacted by currency movements.

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