TROY
ASSET MANAGEMENT

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# Investment Report N°41

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

## 2013 – A Down Year

In a year in which Greek government bonds rose by 50%, International Airlines Group (formerly British Airways) was the best performing stock in the FTSE 100 Index, high quality defensive equities lagged a rising market and the gold price fell by nearly 30%, it was hardly likely to be the Trojan Fund's finest hour. I am pleased, however, that our more fully invested funds, Trojan Income and Trojan Capital, had a considerably better year and captured much if not all of stock market gains without putting capital at undue risk.

Universally low yields have been a painful thorn in our side for the past two years. At the start of 2012 we wrote about how we believed that it would be harder for us to generate good returns, given that yields across most assets had significantly compressed. That warning was timely and frustratingly accurate. Our caution on equities came too early. Not holding more in equities these last 12 months was a blow on the chin, but holding alternatives that demonstrated a negative correlation to rising stocks has been more painful. At previous market peaks, in 2000 and 2007, opportunities were available for the canny to protect capital. In 2000, it was in so-called 'old economy' stocks that had been left behind in the dash for internet stocks. In 2007 bonds offered protection along with foreign currency as sterling was extremely overvalued. Today, all those escape routes are more dangerous. Furthermore, traditional safe haven assets such as gold and index-linked bonds have recently been anything but safe. Trying to act prudently has been punished.

Developed world stock markets have been driven more by the fumes of hope than the fuel of impressive earnings growth. Indeed the overwhelming majority of last year's US stock market progress came from multiple expansion (increasing valuations) rather than an improvement in corporate fundamentals. In both the UK and continental Europe, earnings in 2013 fell for a second consecutive year meaning that the advances were predicated on investors' willingness to pay more for less.

## Riding For A Fall

It is difficult to recall another time in the recent past when optimism about the stock market, profits and the UK economy was so widespread. Fear has unquestionably surrendered to greed and stock markets, to us, look more expensive and more extended than at any time since 2007. Investor faith in central bankers is at an all-time high. Many stocks are trading on, in our opinion, nose-bleed valuations, yet investors seem happy to go tripping along a high tightrope in the belief that the whole central banking fraternity stands ready with a safety net, not near the floor but only inches below the rope. This explains why stock market corrections have become both shallower and more infrequent. With interest rates already at zero this safety net may be more illusionary than real. We see risk when others seem blind to it and refuse to chase returns just because we have recently underperformed.

With the exception of a few selective opportunities, overall stock valuations look anything but mouth-watering and recent parabolic surges in social media and biotechnology stocks are reminiscent of the tech bubble in 1999. We will be consistent in our investment approach and we will not be tempted into such areas. This is a time in the cycle when careless capital will, ultimately, be lost.

## Back to the Future - Again?

As stock markets rise, so confidence in the future builds. 2013 was arguably the year in which most investors stopped being concerned about the downside and started to worry about missing any market upside. Back in the dark days of late 2008 and early 2009, investors could barely look beyond their hands. Unable to see through the fog of uncertainty, valuations as a result were compelling and the potential for double digit prospective returns were available. Stock market cycles do vary; in 2007, markets were driven more by financial leverage and less by a clamour to buy growth stocks. Today with the economy and aggregate earnings remaining relatively subdued, growth commands an ever higher premium. Rather than 2007, markets feel more like the late 1990s. As the clouds of uncertainty have parted and discount rates (bond yields) remain low, blue sky investing has returned.

Peddlers of stocks have learnt from the dotcom bust and their seducing is more sophisticated. Gone are the valuation multiples predicated on 'clicks', 'eyeballs' and 'impressions'. Today the reasons to buy the next best thing have a kernel of rationality. 'Dotcom' has been replaced with the more cerebral sounding 'Big Data', 'Mobile Computing' and 'Social Media'. These trends are real and are dramatically impacting consumers and businesses.

## Creative Destruction – The Loser's Game

In 1999 unprofitable sales from Pets.com only made a dent in its own financials and not in the sales of rival Walmart. Today online businesses are established and are having a demonstrable, negative impact upon their earthbound competitors. The internet has taken its toll on media businesses such as regional newspapers, with both advertisers and readers moving on-line. Print advertising revenues, once described by Rupert Murdoch as 'rivers of gold', ran dry. High leverage, which frequently went with the perceived reliability of these cash flows, exacerbated the business declines. Johnson Press was one such victim that has seen its market value fall by over 90% over the past decade. Those that subscribed for a rescue rights issue in 2008 are still underwater.

The trends seem clear and the corporate victims have target signs on their backs, but the ultimate beneficiaries, to our minds, remain less obvious. All the profits lost from Tesco hypermarkets are unlikely to find their way into the pockets of Ocado's shareholders. Customers, rather than shareholders, may be the real beneficiaries of disruptive technology. Many highly valued concept businesses are not creating returns for shareholders as measured by the traditional metrics of profit margins and returns on capital. Rising share prices do not necessarily indicate the creation of sustainable value. The experience of previous booms informs us that many business models or rich valuations prove ephemeral. The joy of today is soon replaced with losses tomorrow. Capitalism does not respect borders and the Internet Highway will become just as crowded as the High Street. Yet investors are increasingly being asked to put their faith in business plans rather than time-tested businesses. Myspace and Bebo will not be the last victims in the fight to control social media.

Former baseball catcher and coach, Yogi Berra, once characteristically quipped that 'It's tough to make predictions, especially about the future'. That is especially true in the field of investing. We are more concerned with avoiding big losers than picking big winners. We have no edge in speculating on the future, whether in technology or biotech. That is something we leave to others. What does concern us, however, is the damage that disruptive new businesses can do to existing businesses.

## Heavier or Lighter?

Ben Graham said "In the short run, the market is a voting machine but in the long run it is a weighing machine." In the past couple of years as earnings have failed to come through, there has been a lot of voting and not much weighing. When looking at companies to invest in one of our first questions, before assessing valuation is: Is this business going to be heavier (stronger) in five years' time or lighter (weaker)? By thinking in this way, we seek to avoid those long term value traps that may look tempting on a valuation basis. Cheap stocks can always be found but they are often cheap for a reason. The market is not necessarily efficient at pricing the secular decline of companies and hope springs eternal for the potential to turn around a business. Numerous investors have quickly celebrated purchasing cheap shares in the likes of Trinity Mirror, Yell, Marks & Spencer or WM Morrison Supermarkets only to repent at a later date. The octogenarian investor, Warren Buffett, still has a few lessons for us all and we continue to seek out opportunities in industries that enjoy a relative absence of change rather than endure a permanence of change. It should be no surprise that last year we purchased shares in Dr Pepper Snapple Group, which owns the 129 year old Dr Pepper trademark and we forewent the opportunity to participate in the IPO of 8 year old Twitter. In 2013 Dr Pepper generated $700 million of free cash flow from $6 billion of sales. Twitter consumed $80 million of cash on sales of less than $700 million. Last year, Dr Pepper actually generated more in free cash flow than Twitter did in sales (and all of the cash was returned to shareholders) but has a market capitalisation of $10 billion versus the $30 billion valuation that the internet's latest soaring bird commands. Go figure! We actually have a lot of respect and admiration for the founders and employees of Twitter. Twitter is no flash in the pan and has an astonishing 650 million active registered users, including several of my colleagues. We are more circumspect about the opportunity and the ability to monetise that vast user base.

## Growth Reinvented

One frustrating difference between this stock market cycle and the last cycle of the previous millennium is that there are fewer parts of the market being ignored. In 2000 there was a stock market valuation chasm between 'New Economy' and 'Old Economy' stocks. Investors schooled in the timeless principles of fundamental analysis and valuation could safely buy a number of solid businesses at sensible valuations knowing that time would help compound satisfactory returns. BAT was the investment, Baltimore Technologies the unfavourable bet.

Today, the bifurcation of the stock market is less clear cut. Many long-established, conservatively managed, currently profitable businesses have performed as well as the story stocks. Growth is scarce and has become highly valued. Share prices of businesses that have shown steady growth and that we could conceivably own, such as Associated British Foods and Whitbread, have performed so well that they are now sitting on top of the performance podium. The scarcity of profitable growth and the abundance of liquidity have frustratingly pushed up the prices of many companies we like to valuations we dislike. AB Foods is run by excellent long term stewards of capital. The current extreme valuation is an unfortunate consequence of the company's recent success. AB Foods is a complicated business, but the investment case has been simply reduced to the European rollout of its highly successful Primark subsidiary. Investors are being asked to forget, conveniently, the more challenged sugar and grocery businesses and are implicitly discounting a future Primark footprint wider than that which has been guided (see Figure 1). Likewise, prospective investors in Whitbread are banking on the ongoing success of its Costa Coffee business. Out-of-the-home coffee is an increasingly competitive market, yet the valuation of Whitbread points to the promise of further high growth in Costa Coffee sales. Some may argue that investors are genuinely thinking longer term, but the increasing pervasiveness of high frequency trading and passive fund management, as well as the shortening average holding period of stocks, all suggest the contrary. Instead, investors just seem to be chasing positive momentum. After a fabulous return, Francis has now sold the Income Fund's entire holding of AB Foods on a dividend yield of around just one per cent.

## A Path Less Trodden

Prudence will not always be punished. Our experience tells us that reckless behaviour is ultimately penalised by permanent capital loss. Our conservatism puts us in good stead when a sellers' market becomes a buyers' market. Judging by the number of IPO research notes arriving on our desks, private equity owners see today's benign conditions as a good time to exit while they can, which we consider a good contrary indicator. IPOs are stacked against the buyer. The seller chooses the time, the price and has an asymmetrical information advantage: they know more about the business they are selling than you know about the part ownership of the business you are acquiring. Back in April 2013, the CEO of buyout firm Apollo Global Management said "We think it's a fabulous environment to be selling. We're selling everything that's not nailed down". Twelve months on, the quality of businesses brought to market is unlikely to have improved, but the valuations demanded have increased. We are treading carefully.

Earnings need to increase sharply to provide rational justification for current valuations of most stocks and markets. If they do not, and positive market momentum continues, then equity markets are at risk of entering another bubble whilst the echoes of the last two popping are still in ear shot. Stock market bubbles are very democratic; they make all investors look foolish either before or after the peak.

Sebastian Lyon March 2014

## Buy British – Growth Re-Rated

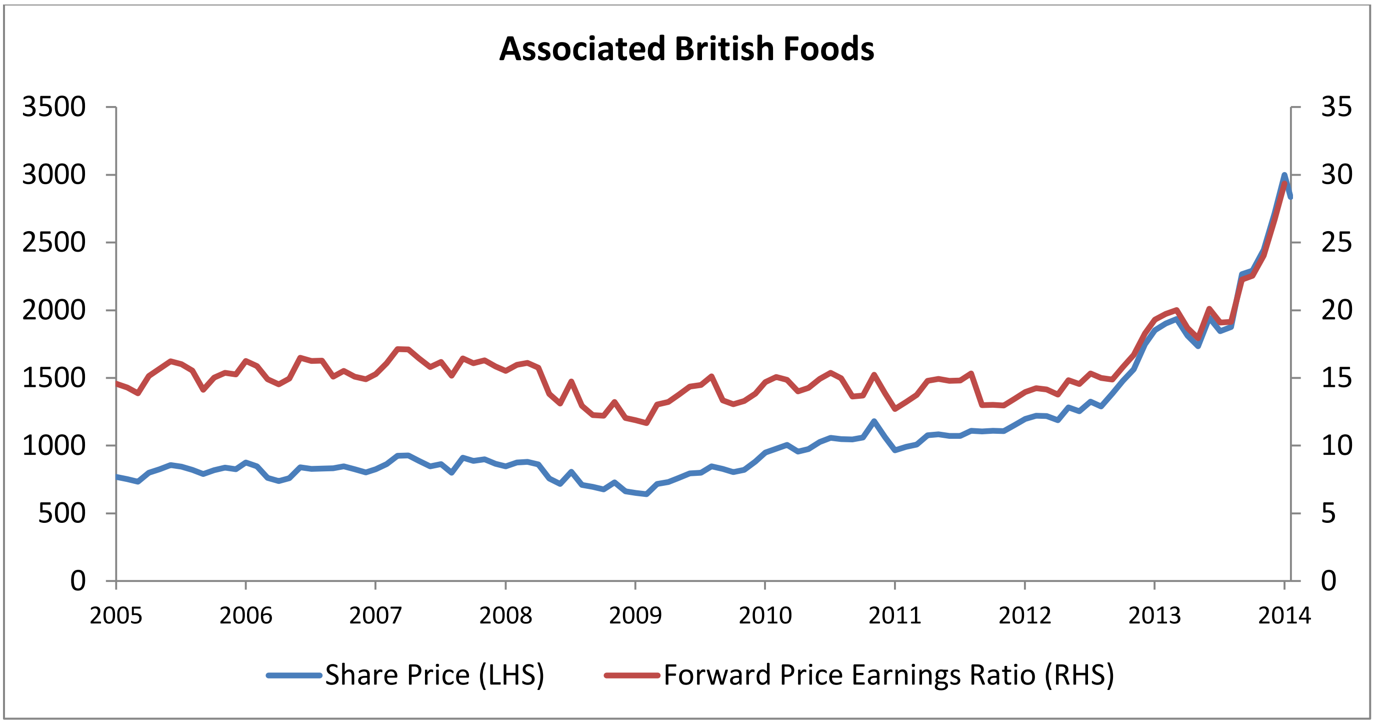


*Figure 1* *Source: Bloomberg, March 2014*