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Investment Report N°·62

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

"Those who do not remember the past are condemned to repeat it." George Santayana

Happy Anniversaries

Some anniversaries should be marked, others should be celebrated and some should be forgotten. In the past month or so we had two to celebrate at Troy. The first, on 30th September, was the 15-year anniversary of the launch of the Trojan Income Fund. Francis Brooke set out what we aimed to achieve in 2004, namely to provide an above-average return, with low volatility and a steadily growing dividend. Over the 15-year period the Trojan Income Fund has returned 256.4% (total return, with income reinvested) compared to 205.9% for the FTSE All-Share Index. The Fund is the third best performer since launch and is the least volatile fund in the IA UK Equity Income sector. Moreover, just to highlight the remarkable survivor bias in our industry, of the 80 funds in this sector at the time of the launch, only 37 remain.

The second anniversary was rather less impressive but, according to my colleagues, worthy of tea and cake rather than champagne. 2nd October was the 30-year anniversary of my career in investment management. I began my first job at Singer & Friedlander Investment Management, sadly a firm no longer in existence, back in 1989. This was shortly after Big Bang and before the fall of the Berlin Wall. Indexation only existed in embryonic form. The Bank of England Base Rate was 13.75%, while the Retail Price Index rose by 7.6% in the year to 30 September 1989. Dress-down Fridays would have been unthinkable while ashtrays were commonplace on office desks.

Investment management was seen as somewhat of a backwater in the City 30 years ago. Those who desired excitement went into investment banks enticed by roles in broking, research, market making or corporate finance. The library environment of longer-term investment appealed to me over the cut and thrust of daily share dealing. Many of the things I learned in the first few years I soon had to unlearn. 'Singers', as it was known, invested for private clients, charities and small pension funds. There was little by way of an investment process. It was not uncommon for one portfolio manager to be selling a stock for a client, while another could be buying it on the same day. Not surprisingly, client experiences of performance could differ from manager to manager, depending on their ability and style. There was a great deal of reliance on the stock broking community for investment ideas. Analysts' opinions moved share prices in large cap stocks, something increasingly rare in today's markets. Recovery opportunities and turnarounds were often favoured over substance and sustainability. Everyone loved a story and wine bars thronged with investors seeking personal stock tips. This was, after all, the era of privatisations and of 'Tell Sid'[1] - the personification of a share owning democracy.

In my Singers days, I remember looking at file upon file of client portfolios. Ten years into a bull market, private clients had made some

[1] The promotional campaign in 1986 featured TV adverts in which characters urged each other to "tell Sid" about the chance to buy shares at "affordable" prices. Many took up the option in an era of mass privatisation by the Conservative government led by Margaret Thatcher.

good returns and the lesson of compounding was not lost on me. Despite all the noise and hyperactivity of the dealers, 40% capital gains tax rate encouraged 'buy and hold'. When material stock gains were made they would be run, rather than profits taken. In my 30 years of experience, I have had the privilege to see private client portfolios where holdings in Unilever, British American Tobacco and Diageo generate an annual income higher than the original book cost.

Where are they now?

Without seeking to be self-indulgent, I thought it would be worth reflecting on some of the changes of the past 30 years and some lessons learned. For avid stock market historians, the evidence speaks for itself. The FTSE 100 index stood at 2,289 on 2nd October 1989, compared with 7,122 30 years later. This has given a total return of 6.2% per annum, although much of that came in the initial ten years. The index is barely higher than two decades ago.

Yet these dry statistics belie a remarkable change in the index's make-up, reflective of many of the changes which have occurred in the UK and elsewhere. Taking a look back over the three decades, many of the FTSE 100 index constituents have disappeared. Some like Ferranti and Plessey are long forgotten. Others such as Fisons and Blue Arrow have come and gone. Polly Peck, Railtrack and Marconi remind us that blue chips can have black holes. In fact only 24 companies have remained in the FTSE 100 throughout the entire period. The index has been a moveable feast, encompassing more than 300 companies over the past 30 years.

The FTSE 100 index total return of 6.2%, annualised, is made up of dramatically different component parts. Look closely and there are some remarkable investment tales of success and woe. In capital terms RBS, Marks & Spencer and J Sainsbury all trade below the share price level of 30 years ago, while stalwarts like Diageo, British American Tobacco and Unilever have risen over tenfold (without accounting for any dividends). What does this demonstrate? There is substantial value to be had from identifying enduring brands and holding onto such stocks. Conversely, a 'buy and hold' approach can yield strikingly different results when applied to structurally challenged businesses.

Born in the USA

Returns in the United States over the past 30 years have far exceeded the UK. The S&P 500 has returned a compound annual rate of 9.6% (10.6% in sterling terms). One of my most fruitful lessons learned early on was of the depth and breadth of the US market. I was fortunate to be placed on the US equity desk at Singers in the first two years of my career, which helped me appreciate the merits of the US stock market in relation to its international peers. It is frequently more expensive than the UK (it was in 1989), yet returns have been superior despite these higher starting valuations.

Why this outperformance? The US is shareholder friendly, has a good rule of law for matters such as intellectual property rights and is capitalist in its essence. There have been and continue to be good reasons for resilient and superior performance over alternative, large equity markets such as Europe or Japan. Intriguingly UK fund managers with a contrarian bent often dismiss the US stock market on valuation grounds. This has come with an opportunity cost. Japan, a frequent contrarian call, although admittedly hampered by the high starting valuations set in the bubble of the late 1980s, generated total return of a mere 1.3% per annum (in sterling terms) over the past 30 years. Moreover, the US tends to set the financial weather. A bearish outlook for US stocks has rarely been compatible with a bullish outlook elsewhere.

US companies have repeatedly shown their edge. Companies can reach scale in the extensive domestic market before needing to look abroad for growth. Commercial trends have a tendency to grow up there thanks to an entrepreneurial culture: think supermarkets in the 1950s, Software in the '80s, e-tailers in the '90s and Internet and Social Media companies in the 2000s. Recent value creation in these three latter sectors have been achieved, almost exclusively, in the United States stock market where trillions of dollars of equity value has been created. America boasts a disproportionate number of world class companies, a trend that has strengthened in the past 30 years. Where is the Microsoft of France or the Google of Japan? At Troy, we continue to look to the US for new trends within enterprise software, electronic payments and medical technology, which have the power to disrupt established businesses whilst also creating value for shareholders in the future.

The day the music died

It is far more profitable to learn from the errors of others rather than from your own. When we talk of the growing risks of technological disruption for businesses, this is nothing new. I was reminded by a colleague recently that my first stock pick for the Trojan Fund was one of my worst. A contrarian value play, which I had hoped was to benefit from industry consolidation.

The company no longer exists. Originally the Gramophone Company, established in the late 1890s and formerly known as Electric & Musical Industries, EMI had recently demerged from Thorn. I acquired the shares in 2001. From a glorious past, EMI benefited in the 1990s from the growth in CD sales but by the time of our purchase it had become dubbed 'Every Mistake Imaginable'. CD sales peaked in 1999 and the shares were (apparently) depressed following a series of attempted bids and mergers during the Technology, Media, and Telecoms boom of the late '90s. A £6 a share bid from Seagram, which decided to buy Polygram instead, and an aborted merger with Warner, stymied by regulators, left the company weakened. Without a suitor, EMI limped on with little protection from the onslaught of digitisation.

I acquired the shares just before the full force of digital began to take its toll on music industry revenues. Downloading music was in its infancy and the industry executives were leaden-footed in their response to file-sharing, led by Napster, which took digital piracy mainstream, teaching a generation they did not have to pay for musical content. Napster was challenged in the courts and there was a feeling 'it [the threat of file sharing] would all be over by Christmas'. It would be 2015 before global music revenues began to recover, thanks to streaming (via apps such as Spotify) and a Lazarus-like resurgence of vinyl. Nevertheless the industry today is a shadow of its former self – from a revenue peak of $38.6bn in 1999, the global recorded music business slumped to $14.3bn by 2014 (source: IFPI, note the figures in the chart in *Figure 2* are inflation-adjusted). In recognition of the deterioration in future profitability we sold the holding in 2003. Subsequent performance and ultimately the private equity buyout could not save EMI, which fell into the lap of its lenders a decade after my initial purchase. With hindsight the company's past was greater than its future.

The lessons, painfully learned, were various. Buying a stock after its first profits warning is often problematic. There may well be more to follow - almost every six months in the case of EMI. There is always more than one cockroach in the kitchen, as the saying goes. Simple valuation metrics of current earnings multiples and dividend yields are not enough. Consider instead the sustainability of the revenues and cash flows that are funding those dividends. We cannot know the future, but we can endeavour to appreciate the longer-term trends. An investor attempting to buck those trends, rather than benefit from them, will lose. Following my unfortunate investment in EMI, I have sought to resist those calls which are seductively contrarian but where the headwinds are more permanent in nature.

Get off my cloud

There are other, less unedifying lessons. The experience with Microsoft, first purchased in the summer of 2010, has been profound in shaping our thinking. We first bought the shares believing that Microsoft's headwinds for its core productivity software tools were more apparent than real. This was a contrarian call at the time and I still have the doubtful client emails to prove it! In retrospect we, like most, underestimated the potential from the company's transition to cloud computing, and its capacity for rejuvenation under new leadership.

Good things come from those companies that enjoy enduring competitive advantages and reinvest their high free cash flows back into their businesses to capture industry growth. Furthermore, Microsoft's revival led by CEO Satya Nadella highlights the immeasurable importance of good leadership and governance for long-term returns. An assessment of management has always been a component of Troy's investment process, but its integration is an increasingly prominent part of our responsibilities as shareholders. Lastly, there were occasions over the last nine years when price-sensitive investors like us became nervous about Microsoft's rising valuation. Investors interrupt compounded growth at their peril, and absent any structural deterioration in operational performance, the best thing to do in these rare situations is absolutely nothing. The investment in Microsoft has grown seven fold since it was first made, a 23.3% annualised total return, and whilst most investments won't work out nearly as well, it is essential that the investment process is flexible enough to evolve with them.

Spinning the Wheel

What conclusions do I draw after 30 years? For all of the day-to-day noise and investment industry fashions, whether they be the importance of geographical weightings, economic statistics or portfolio risk measurement driven by index construction, for me everything comes down to the primacy of return on capital employed (ROCE). By focusing on businesses with sustainable high returns, we will be rewarded.

The FTSE 100's survivors and failures remind us that time is against the weak and benefits the resilient. The failures inform us, in particular, of the damage of debt. Banks seemed attractive investments when returns on equity were high before the crisis, but this was only made possible with huge leverage that was not available to other industries. After all, no bank would lend to an industry financed like a bank.

Since the end of August there has been a resurgence in 'value' stocks, that are cyclical or facing structural challenges. These include companies that are challenged by ongoing technological change and the erosion of pricing power – modern-day EMIs. We expect global growth is likely to remain weak and monetary policy is becoming even more accommodative. There are few signs that the global economy is bottoming out. If current weakness proves temporary, this could support a more sustained period of positive performance for those weaker, more cyclical businesses.

We have experienced these bouts of stock market rotation before, most recently in late 2016 and early 2017. Stock markets had gone for a prolonged period of growth and quality outperforming, so some snap back was not surprising. Such bouts of rotation usually throw up opportunities for us in our favoured sectors.

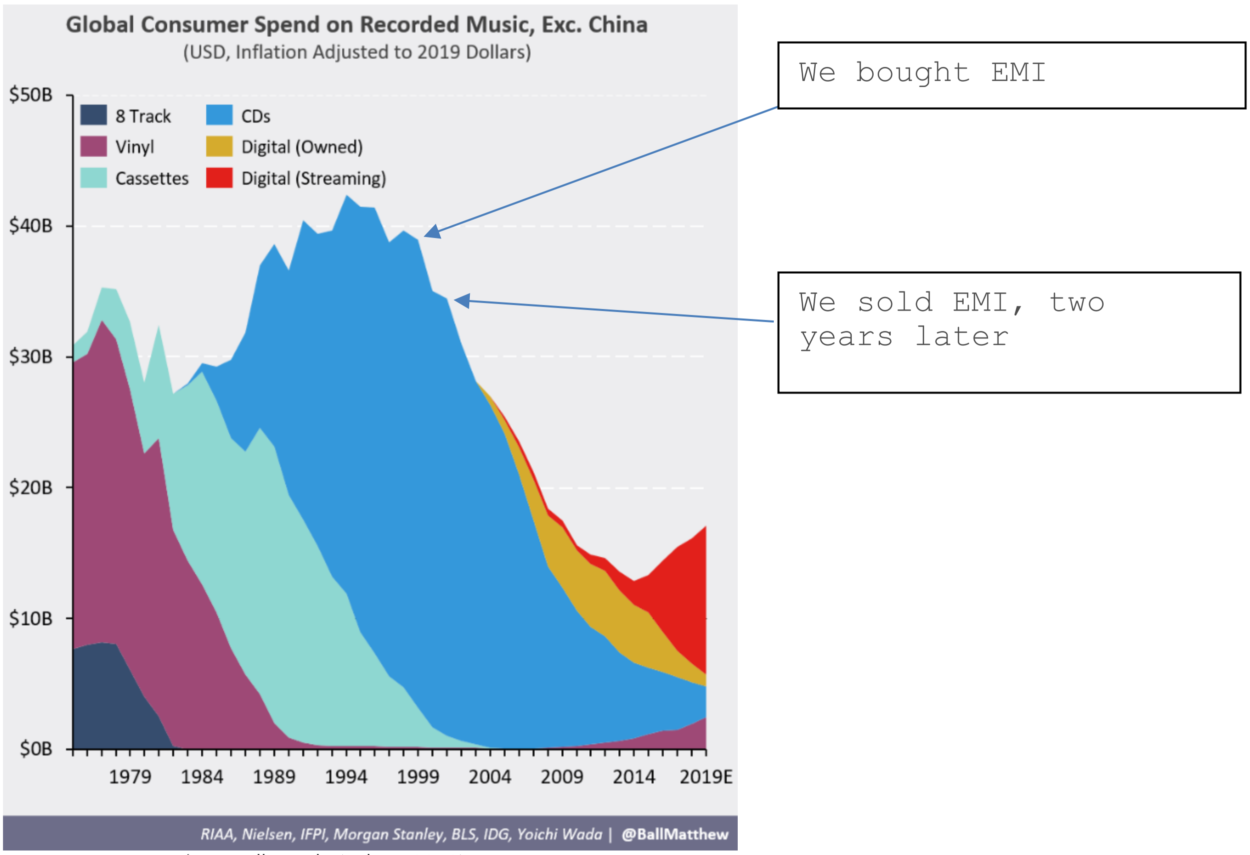
When it comes to specific political outcomes, whether they be Brexit (now twice delayed), the upcoming UK general election or the US presidential election in 2020, short-term, tactical decision-making is likely to fail. Such events are unplayable and distracting for long-term investors. We endeavour to take account of, and protect against, all substantive risks to the portfolio. This requires an appreciation and understanding of multifarious political outcomes. However, we spend a much greater part of our time identifying and analysing businesses which should be able to perform well regardless of the wider political and macroeconomic backdrop.

Sebastian Lyon November 2019

Figure 1: 30 Years of FTSE100 1989-2019

Source: Bloomberg 2019

Figure 2: The Day the Music Died – technological disruption on global music sales



Source: REDEF, Matthew Ball Article (July 5, 2019)

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