Investment Report Nº 71

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

The Rear View Mirror

"When people begin anticipating inflation, it doesn't do you any good anymore, because any benefit of inflation comes from the fact that you do better than you thought you were going to do."
Paul A. Volcker, Former Chair of US Federal Reserve

Over the calendar year 2021, the Trojan Fund returned +12.1% compared to +18.3% for our comparator index the FTSE All-Share Index (TR). The Fund's return was achieved with an average equity allocation of 42% over the period. The Fund's equity investment ended the year below 40% as we became more risk-averse into increasingly highly-valued stock markets.

Careful selection of exceptional companies continued to drive the Fund's returns, with the strongest contributions coming from our two largest holdings Alphabet (+65%) and Microsoft (+52%). Both companies delivered consistently strong revenue and profit growth. Despite these robust returns, Microsoft ended the year on a similar price to earnings valuation[1] to the start of the year while remarkably, Alphabet's price to earnings valuation fell. Perhaps more surprising was a strong performance from Diageo (+43%) despite being affected by the pandemic. Even with hospitality businesses closed for a large part of the year, the spirits company demonstrated the resilience of its brand portfolio. Long-term holdings in American Express (+38%) and Nestlé (+23%) also contributed to returns.

One of the few stocks to detract from performance was Medtronic (-9%). We expect the company to recover as it works through unexpected R&D delays and weaker surgical procedure volumes brought on by successive waves of Covid. Elsewhere in the portfolio, our choice of owning index-linked bonds over conventional bonds proved propitious. Nominal bond yields rose but this was more than offset by future inflation expectations, which increased in the year.

Gold (-3%) failed to shine in 2021. This came on the back of two strong years for the gold price, which had risen from just over $1,200 a troy ounce in January 2019 to over $2,000 by August 2020. Nevertheless, bullion's performance in 2021 surprised many, especially in the context of US real interest rates[2], which were at their most negative since the 1950s. It is likely that Bitcoin (and cryptocurrencies more generally) stole some oxygen from gold last year. We see cryptocurrencies as 'risk-on assets', whereas gold performs better during times of risk aversion. Portfolio protection was not needed in 2021 as equity markets were ebullient. Byron Wien, erstwhile Morgan Stanley strategist, now at Blackstone's Private Wealth Solutions Group, publishes an annual forecast of ten surprises. One of his ten surprises for 2022 is that gold will rally by +20% to new all-time highs. While we would never be tempted to make such precise forecasts, we are inclined to agree that gold stands to benefit as market conditions become more febrile.

[1] A means of valuing a company by calculating the share price divided by its earnings per share.
[2] The rate of interest, taking into account the effect of inflation. Where inflation is above interest rates, this is called 'negative real interest rates'.

Hail the number!

One thing that I have noticed over the past three decades is a tendency for investors to concentrate on a single data point. In the 1980s, this was balance of payments deficits. In the 1990s it was budget deficits and unemployment rates. More recently the focus has been on quantitative easing announcements and 'dot plots' that provide 'forward guidance' on future interest rate rises. Today there is little doubt that *the* number in focus is inflation – either the Consumer Price Index ('CPI') or the Retail Price Index ('RPI'). As we ended 2021 and began 2022, inflation figures made for uncomfortable reading. The UK RPI reached +7.5% (YoY) in December 2021, the highest since 1991, while the US headline CPI was +7.0% over the same period, the highest inflation print since June 1982.

It is easy to draw conclusions from the past. Some are pointing to a repeat of the 1970s, when the UK RPI rose to a peak of +26.9% in August 1975. But such comparisons are too simplistic and potentially dangerous. The current environment is different from the 1970s when unemployment was rising, not falling, and interest rates were rising sharply, not near record lows. Perhaps, as the *Wall Street Journal* suggests, 2022's inflation is more reminiscent of 1946. The end of the war released pent up demand, similar to what we are experiencing now. US inflation reached +20% in 1947, only to fall all the way back down once demand had dwindled and supply constraints reversed.

A 'Permademic' Economy

The current bout of inflation does look different from recent experiences, which have been primarily currency or commodity-driven. Those episodes were short-lived. The sharp bounce in inflation in the UK after the financial crisis could largely be put down to the weakness of sterling. It subsequently eased by 2011. Similarly, energy and other commodity price spikes in 2008 and 2017 proved fleeting. Today's inflation is more global in nature. It is also the product of some unique circumstances, many of which will not endure. Inflationary pressures may abate once economies normalise and supply chains settle back towards a more balanced equilibrium.

For several reasons, it remains unclear as to what the steady state for inflation will be once short-term factors abate. The first is that we are not yet 'post-pandemic'. Until such a time that immunity levels no longer compel governments to stop and start economies, supply-chain bottlenecks and demand gyrations will persist. Whilst the UK is close to the point of living with an endemic Covid, any open economy in this interconnected world will continue to be buffeted by global forces.

Related to this, disrupted supply chains and underinvestment in energy markets have set the stage for price rises. In the most recent CPI print in the US, these made up 1.8 percentage points of the +7% increase in the index. Over the past five years, the net contribution to inflation from energy has been around zero. Similarly, the price of goods, which in recent years have had no impact on inflation whatsoever, are now driving 2.2% of the headline rate - a function of the aforementioned cocktail of pressures from both supply and demand. The question is what happens once a sense of normality resumes?

On the demand side, the long-term outlook is currently obfuscated by the lingering effects of the Covid-dividend. Unable to spend their wages due to government restrictions, and bolstered by government handouts, the US consumer is in a position of unusual strength. Many areas of pent-up demand, such as cross-border travel, are yet to be sated. With cumulative excess savings now at nearly 20% of 2019 levels, it will take some time before households feel the pinch again. These surpluses are one substantial factor behind many people's propensity to return to work.

When to get worried?

Back in 2018, when inflation remained benign, I raised the risks of inflation re-emerging with a client. He grilled me, asking, "What factors would I look for to confirm the presence of more sustained inflation?" "Wages!" I replied. Commodity prices may rise and fall with the ebb and flow of supply and demand. Supply chain interruptions exacerbate price volatility further. But, should wages gain traction, as is looking the case for the first time in decades, then we need to be on our guard for inflation to be less 'transitory'.

The pandemic has not helped the outlook for wages, with many reconsidering their work/life balance. This has been dubbed 'the Great Resignation'. Demographics have, until recently, fostered an environment of disinflation as the retired spend less than the employed. However, a larger proportion of baby-boomers leaving the workplace to seek early retirement is now the largest contributor to labour shortages. Nervousness about contracting Covid-19, home schooling or caring for family members are some of the reasons cited for leaving the workforce. Lockdown restrictions have not helped. Many of these factors may be temporary as savings are run down and Covid concerns abate.

There is however an alternative scenario where wage inflation is sustained. Already, labour shortages are galvanising unions and bargaining power is shifting back towards the worker - the reversal of a four-decade long trend. If the slowing or reversal of globalisation causes immigration to fall substantially, even after pandemic border restrictions are lifted, labour markets could stand to remain tight. This will be balanced against the many disinflationary forces at play, not least those of automation and the ever-growing gig economy. Only time will tell, and it will take more than a few months for the dust to settle.

As we experience higher inflation in the meantime, many expect central bankers to ride to the rescue with tighter monetary policy. Their response so far might have the late, great Paul Volker turning in his grave. But we suspect there is more to the apparent inertia than meets the eye. Central bankers are, as Christopher Wood of Jefferies describes them, 'in a trap of their own making'. Interest rates have stayed so low, for so long, that debt has been allowed to balloon to over 100% of GDP in countries like the UK and the US, matching post World War II levels (*see Figure 1*). Simply put, interest rates are unable to rise above the current level of inflation without defaults and a recession. The Bank of England raised its base rate from 0.1% to 0.25% in December 2021, but current forecasts are not expecting the rate to reach 1% by the end of 2022. The Federal Reserve is expected to raise rates in March but expectations are for less than a 1% rise in the Fed Funds Rate for 2022. All of this comes at a time when the US broad money supply, as measured by M2 (a common methodology used to measure money supply), has risen by an unprecedented +40% in the past two years (*see Figure 2*). We remain firmly in an era of financial repression.

Unintended consequences

The implications of inflation for investors come in a number of forms. The first is the prospect of a rising cost of capital. This may take time to take effect as interest rates remain low, and remain negative in real terms. However, companies whose value rests upon cash flows discounted far out into the future are vulnerable to those earnings becoming less valuable as discount rates rise. Previous bouts of inflation have led to a reappraisal of the value that investors are prepared to pay for future earnings, preferring a bird in the hand over two in the bush. This may explain recent falls in the more speculative parts of the stock market during the second half of 2021 and the first weeks of 2022. Disinflation has been kind to investors for three decades or more, providing low interest rates, cheap capital and the ability to add incremental leverage, all against a background of rising valuations. Companies with pricing power may only provide partial protection to shareholders if the starting valuation is too high.

The second factor is the effect on businesses themselves and their prospects for profitability. Companies with higher gross margins (those with a lower cost of goods as a proportion of sales) should be better insulated from the vagaries of rising input costs and wages. A 5% margin business would be far more vulnerable to gas prices doubling than a 25% margin business. The former's profits are precarious, and as a result harder to manage and, by definition, harder to value.

For capital-intensive companies, there is a further disadvantage of replacing working capital at rising prices. This means that while profits may grow, cash flows fall as the cost of asset replacement increases. Profits may provide a false message as companies that run low on cash will return to their shareholders for more equity – this was very common in the 1970s and 1980s. Investors valued such companies very lowly in recognition that, when receiving dividends, they were being bribed with their own money. Lowly valued capital-intensive companies may be just as exposed to rising inflation as more highly-rated growth stocks.

There is no easy escape for investors, with risks to valuations and profitability both rising at the same time. It is perhaps not surprising that market volatility has picked up of late as market participants attempt to digest this. All are susceptible to falling into the trap of money illusion as the nominal departs from the real.

Turbulence

Nobody knows the answer to the inflation conundrum but we need to be more alert to all potential outcomes. How do we position a portfolio for these circumstances? We look carefully at equity valuations and complement our stock market allocations with index-linked bonds to partially protect us from rising inflation. Gold remains essential insurance in a world of negative real yields, and whilst cash will not protect us in real terms, it is dry powder for when opportunities present themselves. Currency volatility may re-emerge as policy diverges between Europe, the US, China and the UK. The US dollar is likely to continue to be a defensive currency in risk-averse markets.

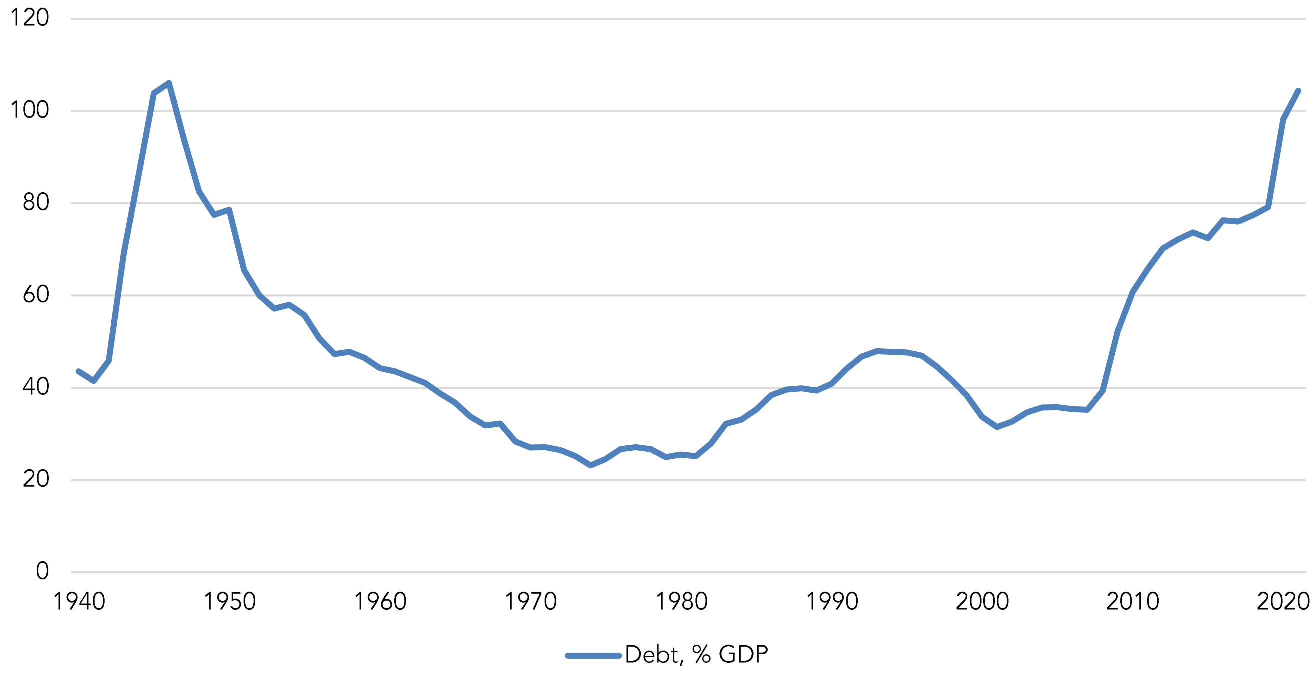
Nothing lasts forever. We have witnessed a forty-year bull market in bonds, an equity bull market flirting with 2000 valuations, record low interest rates, and a prolonged period of disinflation. Are we now entering a new regime? We suspect the money illusion (a tendency to view wealth in nominal rather than real terms) will start to mean something once again. Nominal returns, although positive, may be more volatile while real returns are likely to be harder to achieve.

Our objective is not to beat stock markets over short time periods. We seek instead to protect the real value of capital over the long term. That has just become more challenging. As we enter into 2022, we are braced for greater turbulence by being cautiously positioned, both in terms of our equity allocation and our index-linked duration. This caution, combined with our level of cash, does not guarantee positive returns over all time frames. It does however provide the flexibility to add to risk when we are paid to do so. It should also cushion any falls over shorter time horizons.

Sebastian Lyon — January 2022
Charlotte Yonge

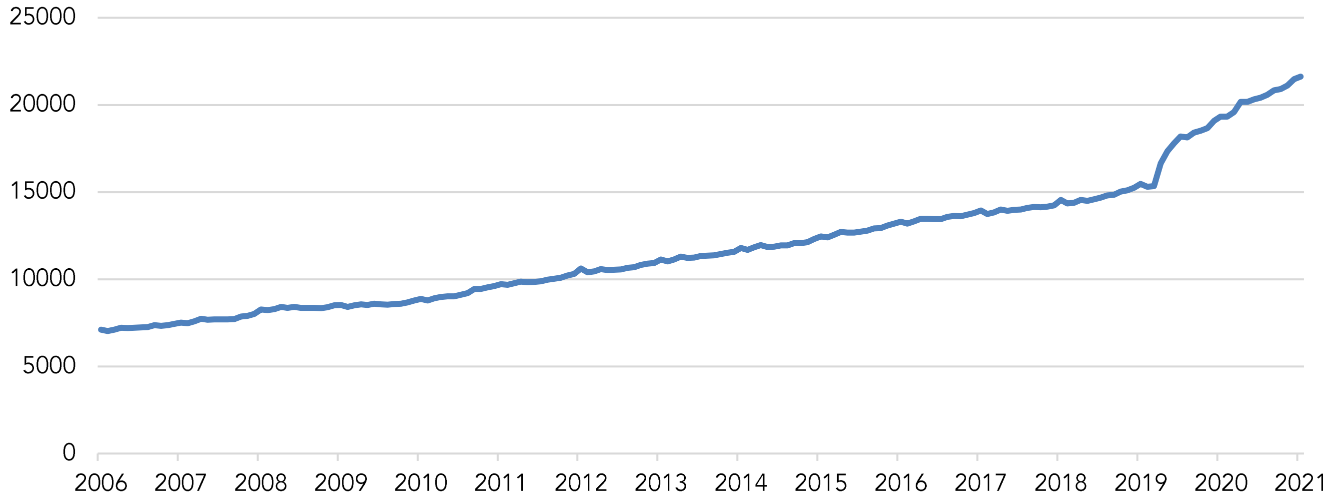
Appendix

Figure 1 – US Debt-to-GDP



Source: Federal Reserve Bank of St Louis, Congressional Budget Office, 1st December 2021.

Figure 2 – US Money Supply M2 (Billions US$)



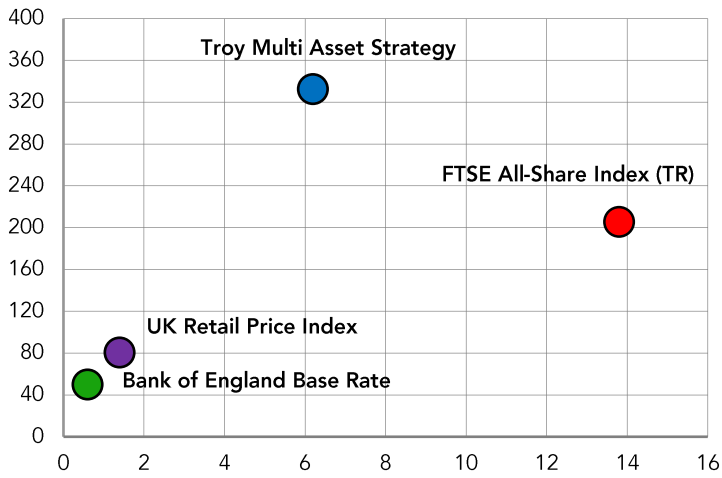
Source: Bloomberg 21 January 2022.

Past performance is not a guide to future performance

Troy Multi Asset Strategy Track Record

Total Return to 31st December 2021	*Annualised Return Since Launch	*Since Launch	15 years	10 years	5 years	3 years	1 year	6 months
Troy Multi Asset Strategy	+7.4%	+332.4%	+150.0%	+68.2%	+34.8%	+33.4%	+12.1%	+5.7%
UK Official Bank Base Rate	+2.0%	+50.0%	+17.9%	+4.4%	+2.0%	+1.1%	+0.1%	+0.1%
UK Retail Price Index	+3.0%	+82.4%	+56.7%	+32.7%	+18.9%	+11.2%	+7.5%	+4.5%
FTSE All-Share Index (TR)	+5.6%	+205.5%	+123.7%	+110.7%	+30.2%	+27.2%	+18.3%	+6.5%

**Launch date 31 May 2001*

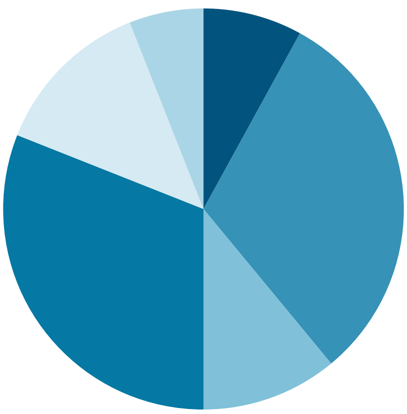


Risk analysis	Troy Multi Asset Strategy	FTSE All-Share Index (TR)
Total return	+332.4%	+205.5%
Max drawdown	-13.7%	-45.6%
Best month	+8.9%	+12.7%
Worst month	-4.7%	-15.1%
Positive months	+67.2%	+59.1%
Annualised Volatility	+6.2%	+13.8%

Source: Lipper – O Income shares total return net of fees since launch 31 May 2001 to 31 December 2021

Past performance is not a guide to future performance

Troy Multi Asset Strategy Asset Allocation



UK Equity	8%
International Equity (US 27%, Europe 1%, Switzerland 3%)	31%
Gold Related Investments	11%
US Index-Linked Bonds	31%
UK T-Bills	13%
Cash	6%

Source: Troy Asset Management Limited, 31 December 2021

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