



## Trojan Global Income Strategy

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

*"For things to stay the same around here things are going to have to change"*

*Guisepppe di Lampedusa - The Leopard*

It is with much pleasure that I write my first thoughts regarding global income investing here at Troy. With negative short and medium term interest rates in many parts of the world, yield curves flattening globally and the US Treasury market now seemingly heading the same way it seems sensible to consider just how we should go about generating some income on savings in such a yield-starved world.

Make no mistake, we are at the tail end of a mightily benign period for capital markets, stretching all the way back to 1981 when the US equity and bond markets began their great bull run. It has come as a surprise to many that, whereas the equity market bull market appears to be faltering, the bond bull market remains in full swing.

They say that knowledge of the past allows one to look forward and this is a case in point. By stretching one's time horizon back decades and understanding the structural forces that have been prevailing one can rationalise the current backdrop. The authorities have been fighting an uphill battle by arguably over-emphasising the short term as well as their own ability to control events without fully appreciating (or perhaps conveniently overlooking) the structural problems in economies. It appears that these are now becoming acute.

The recently published Annual Report\* from the Bank of International Settlements (often referred to as the Central Bank of Central Banks) was illuminating in this respect. In the

first chapter entitled somewhat gloomily "When the future becomes today" it outlines that the bank's concerns that we are facing a so-called "risky trinity" of low productivity growth, high levels of global debt and limited room for manoeuvre on the part of the authorities. Further they suggest that the current backdrop is clouded by the persistence of financial booms and busts which must be in part a function of the policy that has been implemented. This is quite a statement. It is effectively acknowledging that all the efforts of the Central Banks, most obviously via quantitative easing, may have actually been responsible for many of the problems we face via well-meaning but mistakenly short term policy. They have helped the cyclical backdrop but at the cost of damaging the underlying fabric of economies by furthering the misallocation of resources and attendant booms and busts. Greater indebtedness has been encouraged. The "risky trinity" sums this up well. Until now one could argue that the cyclical effect of increasing confidence and consumption by raising up asset prices was in some way offsetting the structural problems described; no longer. Increased prices have encouraged investment to service a level of consumption that is itself artificially stimulated; oversupply is the result.

The combination of too much debt (notably now in emerging markets and especially China), aging populations, technological disruption, globalisation and now QE-inspired oversupply are obstacles that cannot be cleared by monetary policy alone. The policy of dragging forward demand from the future has reached its limit and tomorrow has become today. Such a backdrop at a time of elevated valuations is a dangerous mix for investors.

\*<https://www.bis.org/publ/arpdf/ar2016e.htm>



So what do we do? The important thing is to recognise the foregoing and invest accordingly. Now more than ever the Troy process of buying good businesses, by which we mean those that generate high returns on capital employed, at attractive valuations and holding them for the long term is sound. Adding the requirement of an attractive dividend yield should enable us to produce good risk-adjusted returns as well as a healthy income stream. The quality of the business matters because high returns on capital employed undergird strong cash flow that in turn can sustain a progressive dividend income. The trick, of course, is to buy them when they are out of favour, which the yield itself can highlight, to also secure a decent absolute level of income without taking undue risk. It is worth remembering that in fixed income markets high yield equates to high risk but that in equities that isn't necessarily the case. It may be that we are being offered the chance to secure an attractive future income stream funded by a high quality business for any number of reasons; temporary problems that are often mistakenly seen as permanent, a high profile issue that is actually pretty immaterial, an inefficient capital structure or, and perhaps best of all, an underappreciation of the long-term attractions of a business leading to structural undervaluation. For this reason, even in a world characterised by the so-called "reach-for-yield", opportunities for income will likely be available somewhere if you have a sound investment process and a global remit.

Of course this requires patience and discipline but that is, in my view, very much what Troy is known for.

Further, by being highly selective as to what sort of businesses are bought we can concentrate effort and resources in those areas that are likely to be rewarding over the long term. At Troy the whole team is dedicated to this aim which makes for a rich but focused

environment for investment ideas and the long term deployment of capital (in this case) for income.

Much of the work has already been done. Troy has identified some 200 businesses globally that fit our criteria and that are, therefore, worthy of investment. In time this will be added to as other opportunities fit the bill. It is our job to invest in these businesses at the right time and in the right size without reference to a benchmark whilst using the avoidance of the permanent loss of capital, together with adequate diversification, as our guides. Assuming our analysis is correct, that the price paid is not too high and given enough time the returns, and income, will come.

What can go wrong? We can get it wrong in four main ways. First and foremost a company can suffer from a permanent loss of earnings power; a history of consistent income generation should be evidence that a business has been resilient for long periods but of course this can change. It is on this question that we spend the most time.

Second, we can overpay for an asset. Overpaying will reduce the return generated by an investment at least for a while. It is worth remembering however that the return from an investment over the long term will converge with the return on capital of the underlying business. Buying such a business when out of favour should make a good investment better still. It is key to realise though that time is the friend of the excellent business as its inherent qualities will prevail even if we get the timing of the purchase wrong. This is not the case for a lower quality business.

Third, we can invest in businesses with too much debt. Like economies, companies with too much debt are less flexible, more fragile and obviously more risky. Having too much debt can imperil the value for shareholders by



making a business vulnerable at points of stress. The business could then be vulnerable to bankruptcy (the most certain way of losing money), but also at risk of dilutive equity capital raisings at the wrong point in the cycle or even a takeover by another company. Although less violent than a company going bust, to the long term shareholder, the latter two are just as detrimental to returns.

Fourth, we can overtrade. By keeping frictional costs to a minimum we can allow our capital, and income derived from that capital base, to compound over time. This must be something to which we all aspire and which Troy has an excellent record of demonstrating.

We will manage a relatively concentrated portfolio of 30-50 companies that exhibit the attributes we have mentioned and that also pay income. We intend to focus on businesses in which we have sufficient confidence of their long-term attractions that we are able to commit capital in some size and for the long term. The vast majority of these companies have already been identified and analysed and we wait patiently to invest when the valuation is right.

The portfolio is likely to have four key attributes. The core of the portfolio will be very similar to the equities held across the other Troy funds. That is high quality businesses that are likely to compound capital and income over the long term.

Second, the structural backdrop suggests, and as indicated by action in the core government bond markets and in the absence of yet more extreme policy, that inflation and inflation

expectations are likely to stay extremely low. We will invest in businesses that benefit from a low rate environment and de-emphasise those that suffer.

Third, there are occasions where good businesses have had a known problem that has taken their valuation down to a level where further downside is likely to be limited.

Fourth, having experienced an almighty boom, it is likely emerging markets will continue to suffer. It is the tragedy of these economies that by suppressing their exchange rates they augment their domestic credit cycle when times are good and international flows are strong and positive. Unfortunately the opposite is also true in a downturn. As returns on capital in these economies fall and capital begins to leave, they have to tighten monetary policy at a time not of their choosing and a bust unfolds. Recent action in emerging market debt markets suggest that this dynamic is now set in train. We will therefore avoid emerging markets and related sectors, currencies and economies but prepare to reinvest on the far side of the upcoming debacle. This will be in businesses that still have inherent quality and income producing characteristics.

At a time when there is much to be concerned about we believe that the right strategy, with the right process at an investment house known for a conservative approach, with the preservation of capital at the core of the investment offering, should form a sensible part of many investors' portfolios.

James Harries

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