Trojan Global Equity Fund Newsletter

February 2018

The Trojan Global Equity Fund aims to deliver capital growth over the long term without taking excessive risks. We aim to do this by investing in exceptional companies with high returns on their invested capital, run by sensible managers and sustained by durable competitive advantages and strong balance sheets. We intend to buy them at better than fair prices.

Performance Review

The Fund returned +12.4% in the past 12 months compared to the MSCI World Index NR (£) return of +11.3%.[1]

2017 was the sixth year in a row of very strong global equity markets. The last time we had such an unbroken pattern of positive global equity returns was in the 1980s when every year of the decade was positive with one exception – 1987. The S&P 500 index went up each calendar month in 2017, a monthly pattern not seen before. An improvement in growth momentum internationally meant that the strongest returns came from emerging markets (+25.4%), Asia ex Japan (+15.0%) and Europe ex UK (+15.8%). Japan rallied in the last few months of 2017 to end the year +13.3% in sterling. The United States (+10.7%) lagged, not helped by the weaker US dollar, and the UK (+11.7%) was also a relative laggard.[1]

At a sector level technology was the stand-out performer for both the Fund and the MSCI World Index over the past year. Against the backdrop of an acceleration in global growth, the most cyclical sectors of materials, industrials and consumer discretionary were good performers. Consumer staples and healthcare lagged, particularly in the latter part of the year.

Drivers of returns for the Fund included holdings in the technology sector; PayPal, Microsoft, Alphabet, Intuit and Sage. The Fund's holdings in the payments sector, American Express and Visa, were also important contributors, as were Unilever, Heineken and British American Tobacco within consumer staples. The Fund's healthcare investments were relatively disappointing, with the exception of Becton Dickinson.

Currencies were a substantial headwind to the Fund's results last year with the pound rebounding from the depressed, post-Brexit lows to end January 2018 up around +13% against the US dollar, +6% against the Swiss franc and +9% against the Japanese yen. The majority of the Fund's US companies are multi-nationals, generating revenues all over the world, and they have battled against a rising US dollar for many years. Some respite from this has been a welcome relief for underlying profits and the Fund's investments in the United States made the single biggest

[1] Source: Lipper – O Accumulation Shares total return net of fees as at 31 January 2018
[2] Here and subsequent data comes from Bloomberg and Factset, as at 31 January 2018

contribution to geographical returns during the year.

Against a backdrop of accelerating global economic growth and rising bond yields, equity markets are showing signs of strain in 2018. The 'risk-on' trend prevails (for now) with consumer discretionary, technology and industrial shares all outperforming year-to-date in 2018, but the return of volatility in February is a stark reminder of the fragilities that exist in the financial system.

Valuations and Returns

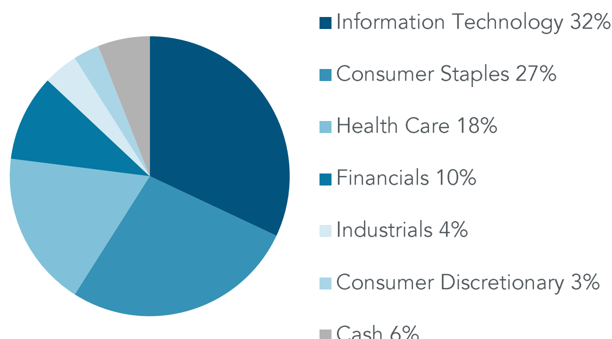
Markets have risen a long way and the MSCI World benchmark price-to-earnings (P/E) ratio for the next twelve months (NTM) stands at a 10-year high of 22.2x (See Figure 1 in the appendix). The exceptional companies we seek are hard to find at compelling valuations. The estimated average NTM P/E of the Fund is now 20.7x, below that of the broader market, but above the Fund's 18.5x multiple at the same time last year. We are more encouraged by the fact that the underlying fundamentals of the companies we own remain first class. The weighted-average return on equity for the Fund's holdings is 34% and their free cash flow margin is over 20%, both far in advance of the market average. Debt levels for our companies are also low. Revenues and profits both grew at a healthy pace in 2017, and our companies continue to generate plentiful amounts of excess cash. Whilst P/E multiples have expanded, the free cash flow yield for the Fund remains healthy at 5.4%, compared to 5.8% twelve months ago.

Asset Allocation

The Fund's turnover was minimal in 2017 with only one new company purchased for the first time for the Fund (online travel agency Priceline) and one outright sale (the small holding in the UK software business Aveva). Modest changes to the constituent parts of the Fund contrast with some important shifts in our sector allocations. The technology sector (as classified by MSCI) has grown to become the largest sector represented in the Fund. Our investments here are quite broad. They span holdings in the enterprise software companies Sage, Intuit and Microsoft, plus the payments businesses Visa, PayPal and Fiserv. Google's parent company, Alphabet, is also one of the Fund's largest holdings, but the portfolio otherwise has limited exposure to the so-called FAANGs (Facebook, Amazon, Apple, Netflix, Google).

In contrast to technology, the Fund's investments in consumer staples companies have diminished in the past couple of years to the current level of just under 27%, of which investments in tobacco companies are about a third. We have added to holdings in healthcare over the past year, taking advantage of their relatively dull share price performance, so that their presence in the Fund is stable at just under 18%. Holdings in American Express and Wells Fargo were also increased in 2017 so that financials now represent just under 10% of the Fund.

Sector Breakdown



Source: Troy Asset Management Limited, as at 31 January 2018.

In addition to these sector changes, the Fund has become more concentrated as we allocate capital to our best ideas. The top 10 holdings now stand at just under 48% of the Fund. The portfolio has 31 holdings in total.

The Fourth Industrial Revolution

The biggest challenge we have faced as global equity investors in recent years has been in navigating our way through the disruptions and opportunities presented by what has been referred to as the 'Fourth Industrial Revolution'.[2] Advances in computing power and the ongoing digitalisation of the economy are having profound implications for all the companies in our investment universe. Technology and internet companies were not always Troy's natural bed-fellows but such are the magnitude of these trends that we took the decision in 2013 to apply our investment process to these younger companies. Our approach has been to seek to understand the companies benefitting most from the growth in the digital economy, but only invest in those which enjoy the durable competitive assets to sustain their leadership (such as Alphabet, PayPal, Microsoft). Our motivation to undertake this work was also driven by valuations. Despite outstanding financial productivity and growth at some of these tech companies, their shares were very reasonably priced. We first invested in Google in 2013 when the shares were trading on a lower multiple of cash flow than many of the consumer staples in our investment universe, even though growth rates, cash flow and returns on capital are sustainably higher. eBay was bought when PayPal was still part of the group and the combination was available for just 16x earnings. The companies have subsequently grown into these valuations and seen their valuation multiples expand, but the underlying fundamentals have gone from strength to strength.

The tech platforms' dominance and impact on everyday life is altering so many rules of engagement. As important as owning some of the winners has been understanding some of the implications for everyone else. Consumer goods companies are having to adapt quickly in a world where Amazon, Google and Alibaba facilitate immediate price discovery, goods are purchased online rather than in stores, and films and TV shows are streamed via Netflix and YouTube, leaving little room for traditional advertisements. This new landscape presents particular challenges for our consumer staples companies which, as discussed earlier, have become a smaller percentage of the Fund.

[2] K. Schwab, *The Fourth Industrial Revolution*, Crown Business, 2017

Portfolio Review

Top 10 Holdings	% Fund
Alphabet Inc.	5.7
Microsoft	5.5
American Express	5.4
PayPal	5.4
eBay	5.1
Novartis	4.5
Wells Fargo	4.4
Medtronic	4.1
Becton Dickinson	4.0
Fiserv	3.4
Total Top 10	47.5
21 other holdings	46.6
Cash & equivalent	5.9
Total	100.0

Source: Troy Asset Management Limited, 31 January 2018. Asset Allocation and holdings subject to change.

'We're not trying to be like anybody else. The world doesn't need an almost as good fill-in-the-blank competitor. It needs a better eBay.'

Devin Wenig, CEO eBay, December 2017

It is a sign of the times that we are asked about Amazon in most of our meetings with investors. We do not hold shares in the company. Amazon's capital intensity, low profitability and singular corporate governance present serious difficulties for us. That doesn't mean we can ignore it. Amazon is having an impact on nearly all the businesses that we own or consider for our portfolios. It's also the case that Amazon's apparent dominance in e-commerce and cloud software is creating some attractive investment opportunities. eBay is among the best examples of this. Its revenue growth is roughly a third of Amazon's retail business, a fact that brings eBay's continued relevance into question for many investors. Under Amazon's shadow, eBay is often held to a different standard. Never mind that the absolute revenue growth of just below +10% would draw the envy of most other large companies, or that its operating margins are in the mid-20s.

When judged against most other businesses, eBay is special. It has a globally recognised brand and operates a large, two-sided marketplace that connects 170m buyers all around the world with over 20m sellers. Its website lists more than 1bn products, giving its inventory a scale and breadth that is unmatched outside of China, even at Amazon. The power and reach of its network should expand as e-commerce grows, and with less than 10% of total US retail sales taking place online today, this trend has a very long way to go before it reaches a saturation point. Global retailing is too big an industry to be cornered by a single company, and the size of the opportunity online is more important than estimating what share eBay might take of it.

Since eBay's separation from PayPal in 2015, it has made several important investments in its business. A refreshed user experience and a new branding campaign are aimed at recruiting new and lapsed customers and dispelling many popular misconceptions about the site. These initiatives are beginning to pay off in accelerating customer, volume and revenue growth, but we believe there is further progress to be made. Alongside the core marketplace business stands the second-hand ticket exchange, StubHub!, and a unique set of online classifieds in Europe and Australasia. The attention given to the Marketplace means that these other assets are often overlooked by other investors. Yet they collectively account

for just under a third of Group revenue and they generate steady revenue growth and high returns on capital.

The Fund has owned shares in eBay since 2013 and we have added to the holding throughout the last two years. eBay has also been enthusiastic buyers of its own stock. The number of shares outstanding is down by -15% since the separation from PayPal. eBay's shares were among the Fund's best performers in 2017, up +27% in US dollars (+16% in sterling). Despite this they remain attractively valued, in our view, with a FCF yield over 5%.[3] We think the company is capable of growing its earnings per share annually by low double digits, giving shareholders the potential for attractive returns from here.

'Medtronic is a medical technology company that is focussed on improving outcomes by alleviating pain, restoring health and extending life.'

Omar Ishrak, CEO Medtronic, January 2018

Medtronic has made a good contribution to the Fund's returns since it was first purchased in 2011. The company is a global leader in the manufacturing of a vast number of medical devices including coronary stents, heart valves, surgical tools and drug delivery and monitoring equipment. From its origins as the inventor of the world's first pace maker in the 1950s, Medtronic is at the forefront of developing innovative technology to treat disease. It has major business units that address diabetes, cardiovascular disease, spinal and neurological problems. Demand for these medical interventions has grown consistently as populations in developed countries get older and emerging markets modernise their healthcare provision. As rising healthcare bills come under greater scrutiny by their payers, companies such as Medtronic have a pivotal role to play in delivering better clinical outcomes at a lower cost. Medtronic is far advanced in widening the scope of its services to include data monitoring and patient care programmes to keep patients alive and out of hospitals. Its portfolio is highly diversified, by product, specialty and geography, and this diversity was further enhanced by the audacious purchase of its US rival Covidien in 2015. The deal has subsequently weighed on financial returns but the shares have remained a core holding for the Fund because the transaction gave Medtronic access to the strategically important area of minimally invasive surgery. We believe returns on invested capital are set to recover.

Medtronic offers stable levels of growth at very high levels of profitability and cash flow. Operating margins of 21% have capacity for modest improvement, and debt levels are coming down, helped by the sale of their medical supplies business to Cardinal Health. The shares trade on 16.3x NTM earnings, with a roughly 5% free cash flow yield and a 2.3% dividend yield. The annual dividend has grown every year for the last 40 years, as good an indicator as any of Medtronic's undoubted quality.

'We're entering a next growth phase with a full pipeline to sustain growth into the future, and we're transforming our productivity, culture and reputation.'

Vasant Narasimhan, CEO-elect Novartis, January 2018

Novartis has been owned in the Fund for the last six years and has produced high total returns over that period. In the last couple of

[3] Amazon's shares carry a FCF yield of just over 1%, or 149x estimated earnings.

years, however, returns have been more disappointing, giving us the opportunity to significantly increase the Fund's holding. Expectations in the near term were scaled back as certain drug launches got off to a slow start and management were forced to reinvest in Alcon, its eye care division. These issues are being addressed and management have the opportunity to realise value across the group. Novartis has a very large, diversified and highly profitable pharmaceuticals business that enjoys a relatively benign outlook for patent expiries. This breadth tends to be undervalued, leading to positive surprises from its pipeline of new drugs. Last year, for instance, Novartis released encouraging highlights of a clinical trial for a cardiovascular drug that few analysts had anticipated. Elsewhere, Novartis is asset rich. It has options to sell a 37% stake in GlaxoSmithKline's Consumer Healthcare division, a holding in Roche worth over CHF12bn, a promising position in the emerging field of biosimilars (generic copies of large-molecule drugs) and the potential to spin out a repaired Alcon to its shareholders. As a result, we believe returns on capital and returns to shareholders can improve from here.

Outlook

We enter 2018 with stronger global economic growth than we have seen for many years. A stimulus package in the US in the form of tax cuts is accompanied by the US Federal Reserve's slow retreat from its ultra-loose monetary policy. Equities have reached all-time highs, the credit cycle appears close to its peak and the prices of the most cyclical assets (commodities, industrials, emerging market equities, high yield debt) have all moved up a long way. The prospect of an end to 10 years of quantitative easing looks set to bring some serious challenges to over-extended global asset markets. Meanwhile, the disruptive forces of technology are gaining pace across all industries and segments of the economy.

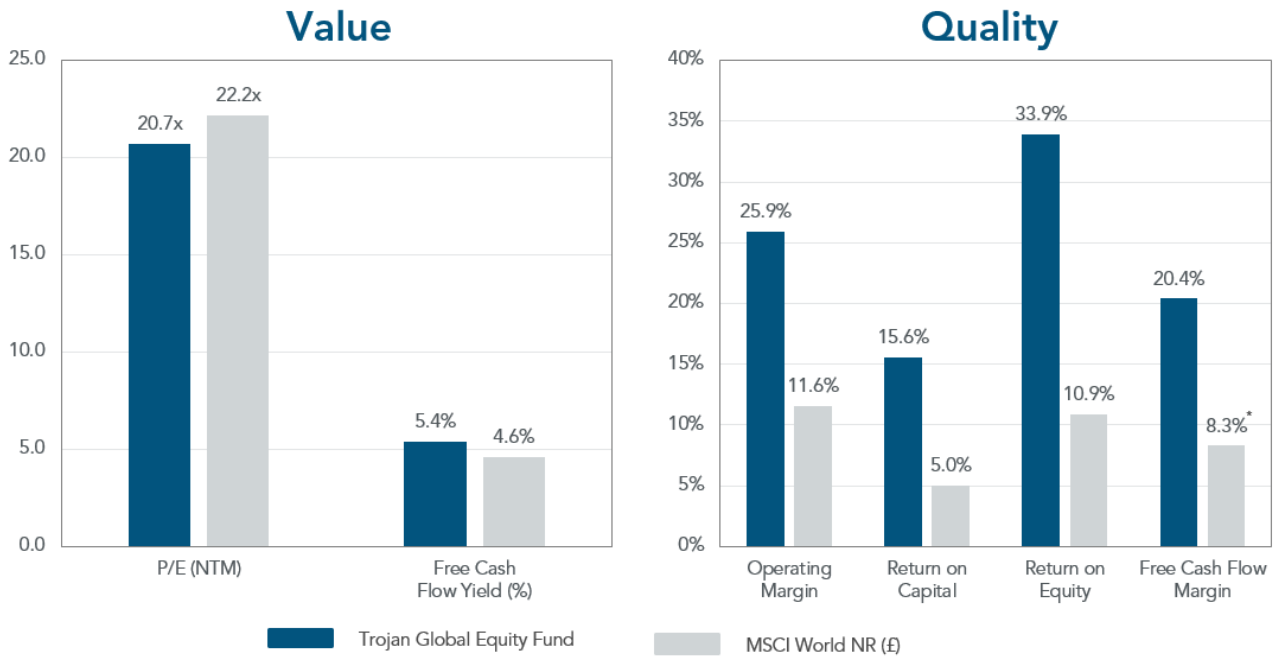
The Fund's approach to dealing with all of this uncertainty is, as ever, to invest in the healthiest companies we can find trading at reasonable stock-market valuations. We own companies at the vanguard of technological change (Alphabet, PayPal, Visa and Microsoft) and others where we believe they can navigate any future setbacks (such as Roche, Unilever and Philip Morris). At the same time we continue to avoid the most cyclical companies and sectors, and those facing structural threats to their business models.

Against the backdrop of elevated equity market valuations, we are encouraged that the weighted average valuation and financial characteristics of the Fund remain attractive. The portfolio's free cash flow yield is 5.4%, whilst our companies' average free cash flow margin stands at just over 20%. These cash flows are stable, growing and backed by robust balance sheets, leaving us confident they can be resilient to any sudden turn in the economic outlook.

Gabrielle Boyle — February 2018

Appendix

Figure 1.



Source: Bloomberg, 31 January 2018.

*Data as at 31 December 2017

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