TROY
ASSET MANAGEMENT

www.taml.co.uk January 2016

Investment Report N°48

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

2015

"The high recent valuations in the stock market have come about for no good reasons. The market level does not, as so many imagine, represent the consensus judgment of experts who have carefully weighed the long-term evidence. The market is high because of the combined effect of indifferent thinking by millions of people, very few of whom feel the need to perform careful research on the long-term investment value of the aggregate stock market, and who are motivated substantially by their own emotions, random attentions, and perceptions of conventional wisdom."
Robert Shiller

Our funds performed satisfactorily in a challenging 2015. The Trojan Global Equity Fund and the Trojan Income Fund performed particularly well, generating double digit returns of +12.3% and +10.7% respectively. UK stocks rose to an all-time high in April, surpassing the long-standing peak reached at the time of the Dotcom boom nearly 16 years earlier. There was some talk of this landmark heralding a new bull market era but deteriorating economic growth and global trade (especially in emerging markets) combined with high valuations weighed on share prices and the market ended the year not far from where it started. Over the past two years the total return on the FTSE All-Share Index has been a mere +2%.

Lacking breadth and breath

We have become concerned that the lack of breadth within markets is indicating that the rally, that began almost seven years ago, is running out of steam. In the United States, the S&P 500 returned +1.4% for the year, but this belies a wide divergence of performance. A small number of large cap technology stocks, such as Facebook, Amazon, Netflix and Alphabet (formerly called "Google" hence the acronym FANGs), led the charge and held the headline level of indices steady. This is reminiscent of the narrowing of stock markets in the late 1990s, without the absurd Dotcom frenzy that went with it.

Because of this the 'quants' and technical analysts have got excited. Their language is of market 'internals deteriorating' – looking at where marginal money is driving performance. When an ever smaller number of larger stocks are keeping market levels afloat, something inevitably gives and those last bastions of performance finally crack. Thinning markets are an admission of investor nervousness, not confidence in the direction of future market travel. The FANGs are perceived to be the secular growth lifeboats that will keep portfolios dry as more cyclical stocks plunge.

A tale of two markets

In the UK market, while high quality businesses held up well, the year's 'greatest fallers' column is littered with miners and other resource companies such as Anglo American (-73%), BHP Billiton (-37%) and the blue chip of blue chips, Royal Dutch Shell (-26%), indicating the full-on bear market in anything related to commodities. As businesses evolve and are subject to Schumpeter's 'creative destruction', investors need to discern whether yesterday's blue chips will be tomorrow's blue chips. While some will recover, others will not – as exemplified by Marconi after the Dotcom boom or RBS after the Great Financial Crisis of 2008.

A corporate financier from a highly esteemed broker once told me that his job was "to hatch, batch and dispatch [companies]" – in other words to bring new issues to the stock exchange, to benefit from the excitement of M&A (which peaked last year) and then to rescue them by refinancing with new equity. There is always something to do through the cycle.

With the spectacular falls in the mining sector we had a reminder in 2015 that equity is, in Russell Napier's words, "a sliver of hope between assets and liabilities". High borrowings and cyclical businesses are not good bedfellows and last December, when shareholders of Lonmin were invited to fund a highly dilutive 46 for 1 rights issue in order to rescue the company, nearly 30% of the issue was left with the underwriters. I suspect that investment bankers will be doing more of these deals in 2016, leaving the glamour of mergers and acquisitions behind them for a while. What of new issues? Leon Black from the private equity firm Apollo was quite right when he said, in 2013, he was "selling everything that was not nailed down". The IPO 'window' is now closed.

In contrast to this, the re-rating of high quality, cash generative businesses continued in 2015. According to Andrew Lapthorne of SocGen, the MSCI world index rose by 44% from 2011 to 2015, all of which can be accounted for by increases in valuation – corporate earnings actually fell during the period. It seems 20 times earnings is the new 15 times. While many predict that this can go on for longer, it cannot go on forever. Re-ratings rightly occur when the quality of earnings improves, but judging by the lack of growth and increased leverage the quality of earnings has deteriorated since 2011. Our view is that these re-ratings are ephemeral and, from now on, expansion in valuation multiples of our favoured holdings will be more down to luck than skill.

Investors should beware lest the 'supercycle' in commodities give way to a 'superbust' as the capital cycle comes full circle at an alarming pace. But we also need to be careful that the bull market in high quality, cash generative franchises does not become a bubble by default.

Can't pay, won't pay

Since our last report (N°.47), the yield on the UK stock market has risen to over 4%, thanks to market falls. This should be an indicator of improved value, justifying a material shift in our asset allocation. Not so fast! A trailing yield can be misleading and is not an accurate forecast of future payments. The high yield is more a health warning of further dividend cuts to come. In the UK, 25% of all dividend income is derived from oil and mining. Some pay-outs have been suspended, including Glencore and Anglo American. BHP Billiton's 12% yield is a strong indicator of investors' lack of faith in the sustainability of its dividend. The FTSE 100 pay-out ratio is presently the highest since the financial crisis (*see Figure 1*). This probably explains part of the fall in stocks since last April. Investors who have been reaching for yield in the equity market are discovering there is no certainty – some dividends are safer than others. For this cycle in particular, dividend income has been critical to returns, as companies paying shareholders have been rewarded with share price appreciation. This was not always the case. Back in 2000, managements were positively discouraged from paying out cash in preference to investing for growth. In today's income-starved world, managements are encouraged and rewarded for paying out as much as possible – some might argue, at a cost to capital investment.

It is notable that the yield on the Trojan Income Fund is now below the UK market's yield. This should reassure Trojan Income Fund investors. The same occurred in 2008 prior to a rash of dividend cuts, mainly from the banking sector. Funds with premium yields may be reaching for excess income, putting capital at risk.

Looking at potential cuts over the next few years we estimate the genuine market yield may be as much as 1% lower than the stated historical level. That still includes many companies that have increased their pay-out ratios this cycle. If we were to adjust their payments to the 10-year average ratio, the yield falls to 2.4%. Hardly a bargain.

Savers not spenders

In December, after another year of apparent indecisiveness, the Federal Reserve decided to raise US interest rates for the first time since 2006. Given deteriorating global economic fundamentals, it seems a strange time to be tightening monetary policy and, with hindsight, the Fed's decision may prove too little too late. There is little prospect of interest rate rises elsewhere in the world and we would not be surprised to see the Fed's decision reversed in 2016. Negative nominal interest rates and a fourth round of quantitative easing may be on the menu before the year ends – a policy reversal which would lead to a weaker US dollar and the potential loss of credibility for central banks.

While the past two years have been boring at the headline market level, 2016 has been anything but dull. Stock markets have had the worst start to the year for decades. Much of this shift has been blamed on the weakening Chinese economy and currency and the (not unrelated) fall in the oil price. But there is more to it than that. The fall in oil has led to tighter monetary conditions for many, pushing the US dollar higher. World trade has collapsed to near 2008 levels and corporate profitability has fallen, which is evident from the pressures on cash flows. Corporate bond yields have been rising, especially in High Yield Bonds, as financial conditions deteriorate. Valuations eventually matter.

The outlook is finely balanced. The positives include the benefit to consumers from lower oil prices and rising real household income, while the service sectors remain resilient. The surprise to many since oil prices began to fall in late 2014 is that American consumers have pocketed most of the savings made at the pumps (*see Figure 2*). This may change but, if Americans are changing their habits from spending to saving, it has profound implications.

In his book, Irrational Exuberance, published presciently in 2000, Robert Shiller rang the bell at the market top identifying the 'new economy' as a bubble. Sixteen years later, reason has only returned very slowly. The lesson learned from similar periods in history is that equities can get cheaper quickly but they get *cheap* slowly. Professor Shiller would agree.

Sebastian Lyon January 2016

UK Company pay-out ratios are heading higher - to unsustainable levels

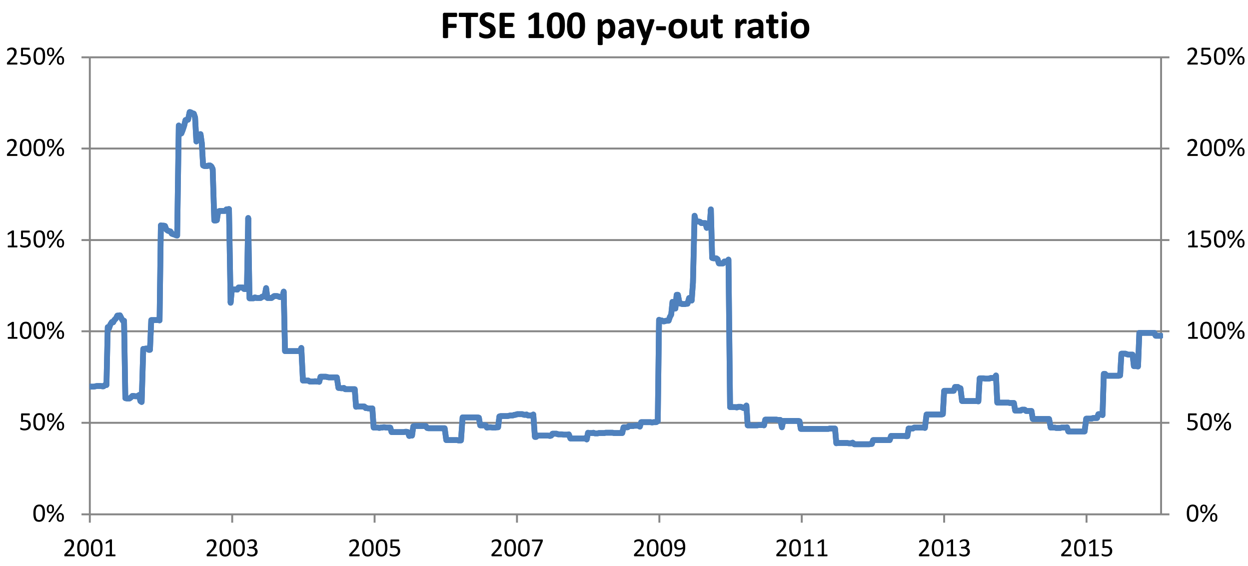

Figure 1 *Source: Bloomberg, 26 January 2016*

American Consumers are Saving More

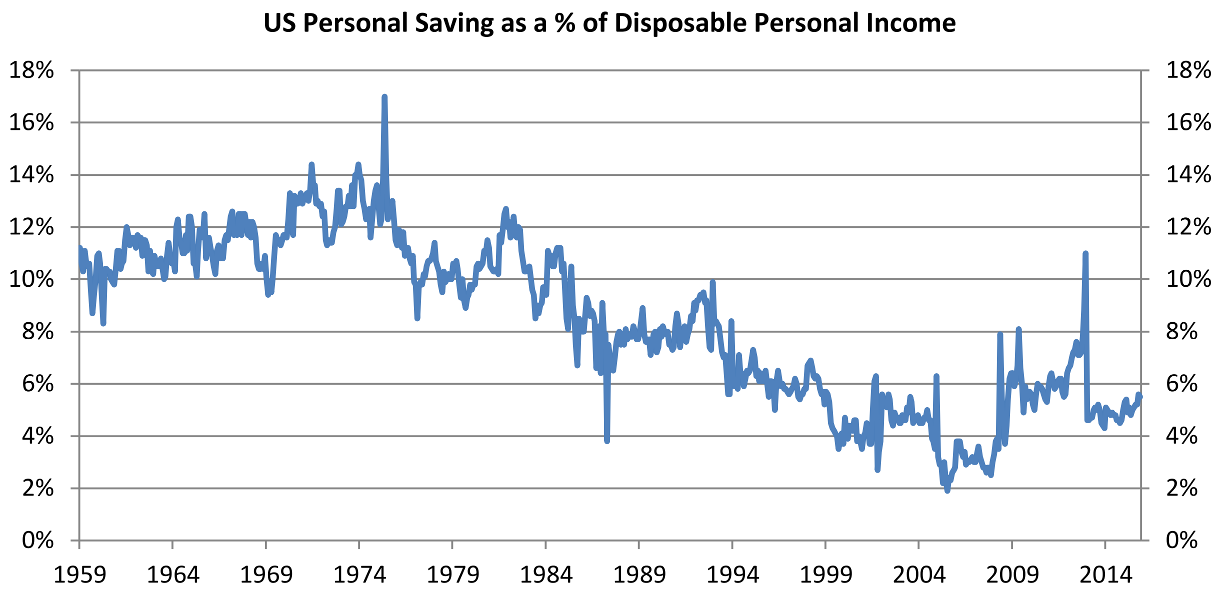

Figure 2 *Source:, Bloomberg, 26 January 2016*

TROY
ASSET MANAGEMENT