TROY
ASSET MANAGEMENT

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Investment Report N°·61

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

Deep Divisions

"Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns six percent on capital over forty years and you hold it for that forty years, you are not going to make much different than a six percent return – even if you originally buy it at a huge discount. Conversely, if a business earns eighteen percent on capital over twenty or thirty years, even if you pay an expensive looking price, you will end up with one hell of a result." Charlie Munger

A quiet, yet lively, debate has been ongoing in the world of fund management in recent months provoked by the substantial divergence of performance of one type of business relative to another. The purchase of statistically cheap 'value' stocks – lowly valued when compared to earnings, dividends or asset value – has underperformed other investment styles for a decade or more, despite many academic studies that show this approach to generate long-term excess returns. This begs the question, is this underperformance temporary or permanent? Or are we at the equivalent of a crossroads, akin to that of the 1999 tech bubble peak, which preceded a resurgence of the value style lasting seven years? During those years, so-called value stocks exhibited material outperformance, whereas others, notably 'growth' stocks, left their investors licking their wounds.

Today, the argument for the reversal of the fortunes of value investing goes like this: investors are overpaying for growth and high quality in the form of consistent, cash-generative stocks such as consumer staples and have abandoned investing in more risky, cyclical businesses like airlines, banks, housebuilders, and support service companies. Moreover, there is evidence of crowding into successful growth funds, where the managers continue to pile into the same stocks driving prices (and valuations) ever higher.

There are signs of excess in IPOs, with companies like Uber and Lyft coming to the market with loss-making business models. More recently Beyond Meat, a plant-based burger company, enjoyed its first three months as a listed company with a share price rise of c.800%, seeing the shares trade on a multiple of 80x historic sales. The rising demand for vegan/flexitarian food looks like another case of a good idea taken too far, especially when more traditional businesses like Nestlé are in on the act with their *Garden Gourmet* brand. We know which we would rather own. In a world of zero interest rates, investors are encouraged to reach for yield, while speculators are motivated to stretch for capital gain.

Shades of grey

Historically, the neat, binary categorisation of 'growth' versus 'value' has been of some use. This is particularly true of periods of excess such as the dot-com bubble where sentiment had driven valuations of many faster-growing companies to extreme heights whilst more pedestrian, but nevertheless financially productive, businesses were left languishing. However, today, this polarised view of markets is more of a hindrance than a help. Quantitative indices like MSCI Growth and

Value indices, used here in Figures 1 and 2, illustrate the shortcomings in the taxonomy. By way of example, the MSCI classifies Procter & Gamble as a value stock and Alphabet as a growth stock, yet the former is more expensive than the latter on most metrics – including Price/Earnings ratio and multiple of cash flow (EBITDA). A much more nuanced approach to stock picking is required in today's markets. At the heart of the debate is the valuation risk versus business risks. If you can be sure about the business risk, then valuation considerations become dominant. Our problem is established businesses are more at risk than ever. Competition proliferates, abetted by the disruptive forces of e-commerce and digital advertising. Companies cannot rest on their laurels, and historic consistency in volume growth, let alone pricing, is much less certain for those susceptible to disruption. Many profit pools look to be unsustainable; for an equity investor, valuing such cash flows is problematic. The challenge will be to distinguish between wasting assets and sustainable profits. Contrarianism alone is not enough.

Hope over experience

Another difference today is that we have experienced a decade of zero interest rates, providing a sustained low cost of capital. Too easy availability of capital presents grave problems for investors. It leads to periodic bouts of speculation. It also leads to malinvestment and lowers barriers to entry as new capital floods into start-ups like challenger banks or online retailers. Easy availability of capital also enables zombie companies to keep limping on. Figure 2 shows how value-style investing has underperformed growth in the zero interest rate era, as 10-year bond yields have continued to grind lower.

With hindsight, higher levels of inflation in the 1980s and 1990s gave weaker businesses the illusion of growth. The high-single-digit growth rates of food retailers against a backdrop of nominal GDP growing 5-10% belied low growth in real terms. Today these companies are struggling to grow their top lines at all. Growth even of the previous illusory kind is scarce partly because of the absence of inflation.

For now, hopes of 'normalisation' of interest rates in 2019 have gone while expectations for the return of value investing appear, at least in part, to be a bet on higher rates and higher inflation. Whilst such a day appears far off, its reappearance would still not guarantee a return to health. Many businesses whose pricing power has been eroded by competitive forces may struggle to pass on higher input costs when they materialise.

1999 and all that

The phrase, *'History doesn't repeat itself but it often rhymes'*, attributed to Mark Twain, is often repeated in our trade. Knowledge of financial history is useful, particularly for the cautionary tale it provides in avoiding the seduction of the latest hot IPOs that subsequently go on to damage their investors' wealth, whether Webvan in 1999 or Aston Martin in 2018.

Looking back at historic returns of value indices relative to growth indices, from the 2000 start-point, one might conclude that today too there should be bargains galore. Back then, to the discerning eye, it was like shooting fish in a barrel. Decent, cash-generative businesses like brewers, food manufacturers and tobacco companies offered historically low valuations with strong balance sheets. There were many such stocks available at good prices. Much as we would love it to be 2000 again, with all the expectations of future performance implied, today the picture is more nuanced. Regrettably, most of what is on sale today is not necessarily what you want to buy as a long-term investor.

To compare the current investment environment to a previous peak like 1999 is to misunderstand or ignore the dramatic changes in the corporate landscape. There are substantial differences in the fundamentals which now underpin many growth stocks. You only have to look through the recent quarterly statements of companies such as Microsoft, which we have held for almost a decade, to be impressed by the scale of revenue, profit and cash flow growth. This is not the fanciful 'white space' of the dot-com boom. The growth is real and the returns on reinvested earnings are well above the cost of capital. Many large corporates are laden with cash. Alphabet, for instance, is growing strongly, with over $100bn in net cash on its balance sheet, and has its stock valued at approximately 10x EV/EBITDA. Other attractively growing companies (think Visa or PayPal) may have greater valuation risk but they do not have the same financial (or indeed business risk) that many cheaper cyclical stocks do.

At the other end of the spectrum, we are reminded daily of once proud, blue chip companies whether it be in retail, advertising, or industrial industries that are struggling to stay relevant. In this era of winners and losers some weak businesses will not necessarily revert to the mean. Balance sheets in aggregate are weaker than they were in 1999 and much of this debt is held at the value end of the spectrum. A lack of growth has led companies to borrow cheaply to enhance and flatter earnings. This leaves behind a heavily-mortgaged equity sliver that is vulnerable to deteriorating trading, wider credit spreads or both. We must tread carefully to avoid the losers and stick, where possible, to robust businesses that can thrive in this unforgiving environment.

A different framework

The inclination to pit 'value' versus 'growth' as two polarised categories ought to be illogical to any long-term investor. Should not every investor be looking for value, i.e. companies whose long-term worth is underestimated by the current share price? We are looking for companies trading below their intrinsic value, whether fast-growing businesses or more staid, slower-growing companies on lower multiples. Both arguably represent value; multiples of today's earnings should not be viewed myopically without taking into account their sustainability or potential for growth.

Ironically it is much harder to value companies that are going backwards, with declining cash flows. In my experience many retailers fit into this category, with the problem compounded by long-term liabilities like underfunded pension funds and property leases. The contrarian investor has a tendency to be overly optimistic about future cash flows, anticipating recovery when the opposite is more likely. Such stocks are better avoided for all but the sharpest of speculators.

We also need to consider the adaptive nature of financial markets. Many cite Warren Buffett as their inspiration but interpret his teachings differently. Ben Graham's most famous acolyte moved on from investing in cigar butt stocks long ago, in favour of capital-light 'compounders' and private equity. Interestingly, looking at a portfolio of an elderly investor recently, by far the best returns generated over many years, if not decades, were holdings in companies that have grown and at relatively modest rates, with resilient business models. It was neither value nor growth that won this investment battle but rather quality, sustainability and patience.

The long game

One of the biggest threats to stock markets today is a recession. In the bear market of 2000-2003, it was cheap defensive companies which performed well. Today there are few such opportunities, as defensives have been bid up for their consistent dividend paying abilities in a market starved of income.

Thus, the more relevant issue over and above the growth/value debate is investor concentration in a select group of successful stocks – a 'nifty fifty' of today. Valuations in large-cap stocks, both those with consistently high growth rates and those with more pedestrian but defensive growth profiles, are yet to reach the extremes experienced in the 1960s, 1970s or late 1990s when the original 'one-decision' stocks were in favour. If all investors are concentrated on one side of the boat, the risk is of relative underperformance should the boat tip temporarily in the opposite direction and value and cyclicality find favour.

Where does this leave us, if value without consideration for quality is flawed but growth is too crowded? The answer: not in a good place. There are few places to hide and equity correlations can quickly go to closer to 1.0, as we witnessed in the last few weeks of 2018. There is certainly a risk of a short-term rotation back towards value but, for the reasons described here, our focus remains resolutely on long-term, absolute performance from companies that can compound their earnings far into the future. At Troy we would always rather pay a reasonable price for a good business that will continue to thrive, than bet on the mean reversion of a poor one. Today all equity is risky, with some upside and plenty of downside, at least in the short term. Businesses with sustainable growth drivers should generate good total returns over the next decade but the risk of drawdowns is substantial from today's starting point.

Gold - precious currency

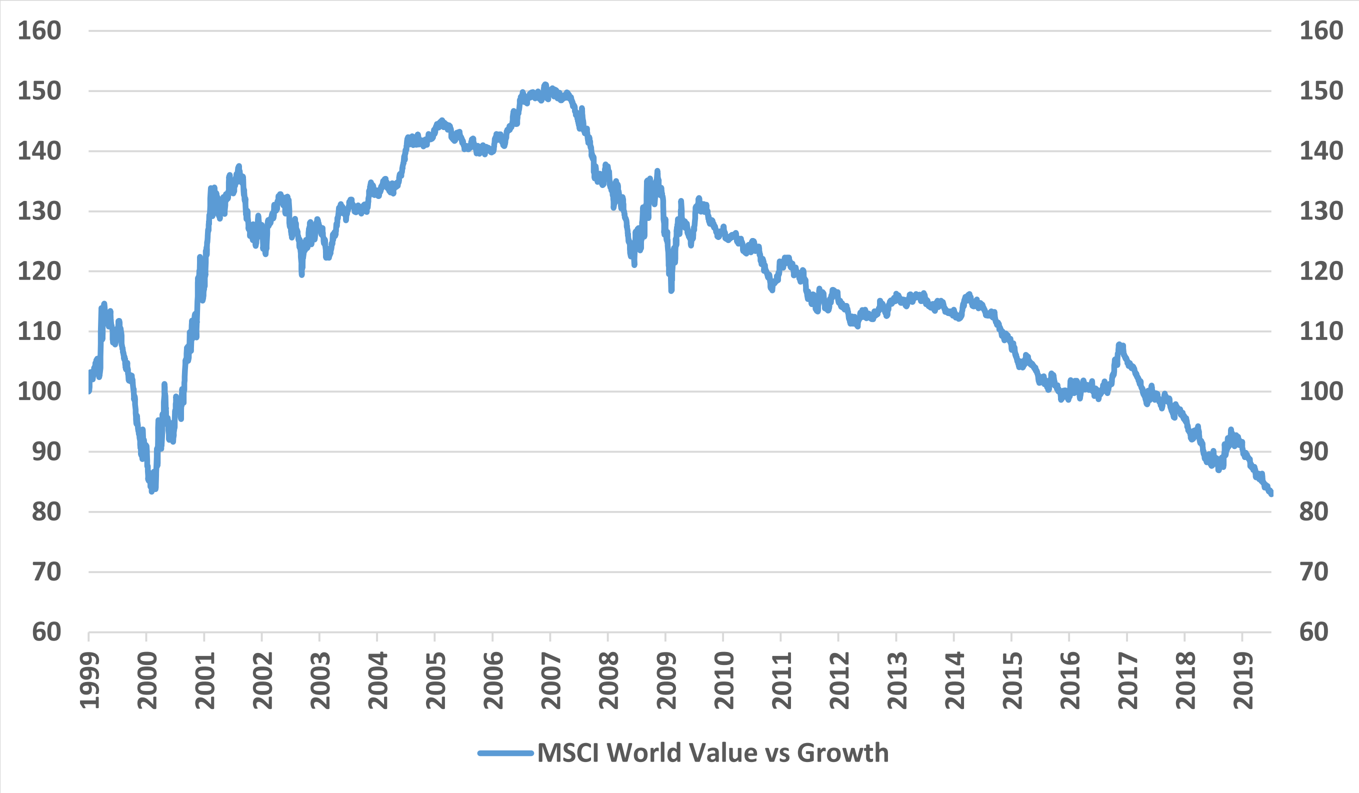
Since our last report, a five year slumber in the gold bullion price appears to be over, with the yellow metal up 19% year to date in US dollar terms.

We first acquired exposure to physical gold in 2005 at $424oz and it has been a core holding ever since. The weakness in the gold price in US dollar terms between 2012 and 2018 has belied its performance in other, weaker currencies. Recently gold has made an all-time high in sterling terms. As we do not hedge our gold holdings back into the base currency, this has benefited the Trojan Fund's performance since 2016. We believe that gold will continue to provide essential diversification from a more febrile investment environment for equity markets and fiat currencies.

For a more comprehensive review of why we view gold as an essential component of multi-asset portfolios, please see my colleague, Charlotte Yonge's Special Report No. 6, Gold - Precious Currency.

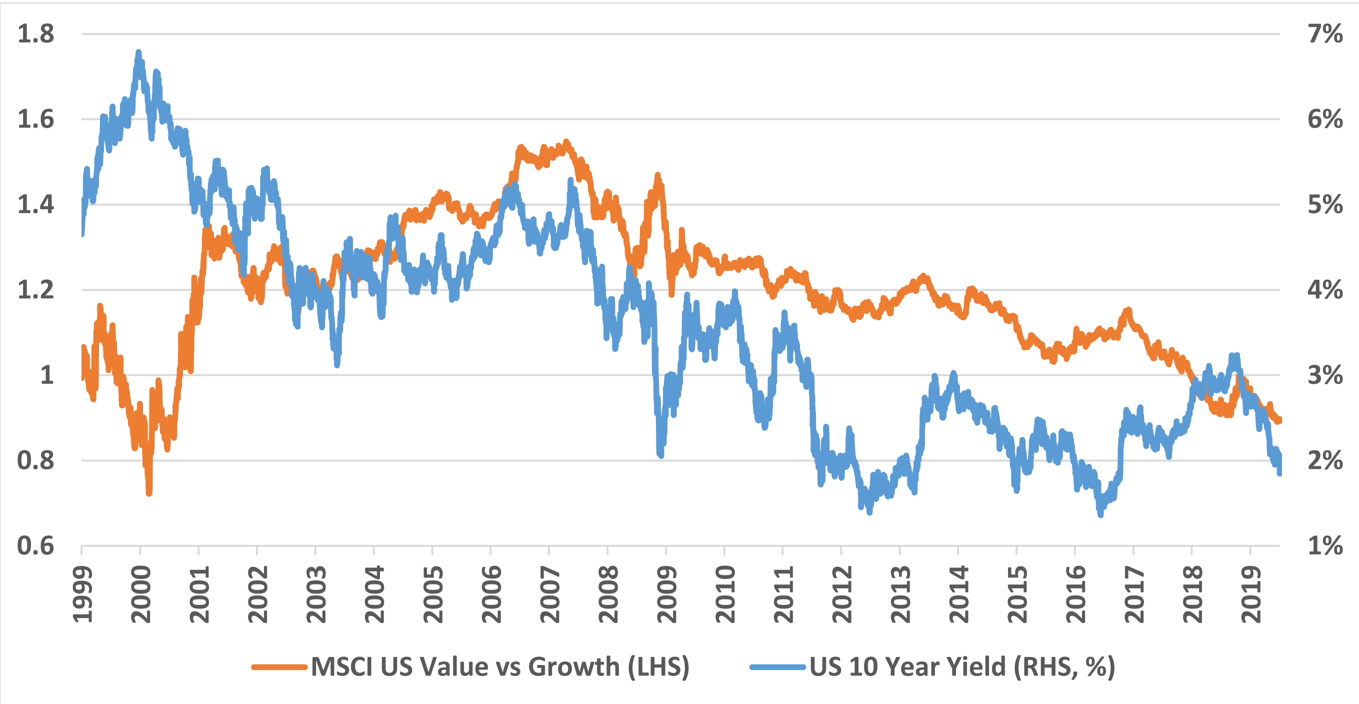
Sebastian Lyon September 2019

Figure 1: 'Value' has been underperforming 'Growth' since 2007



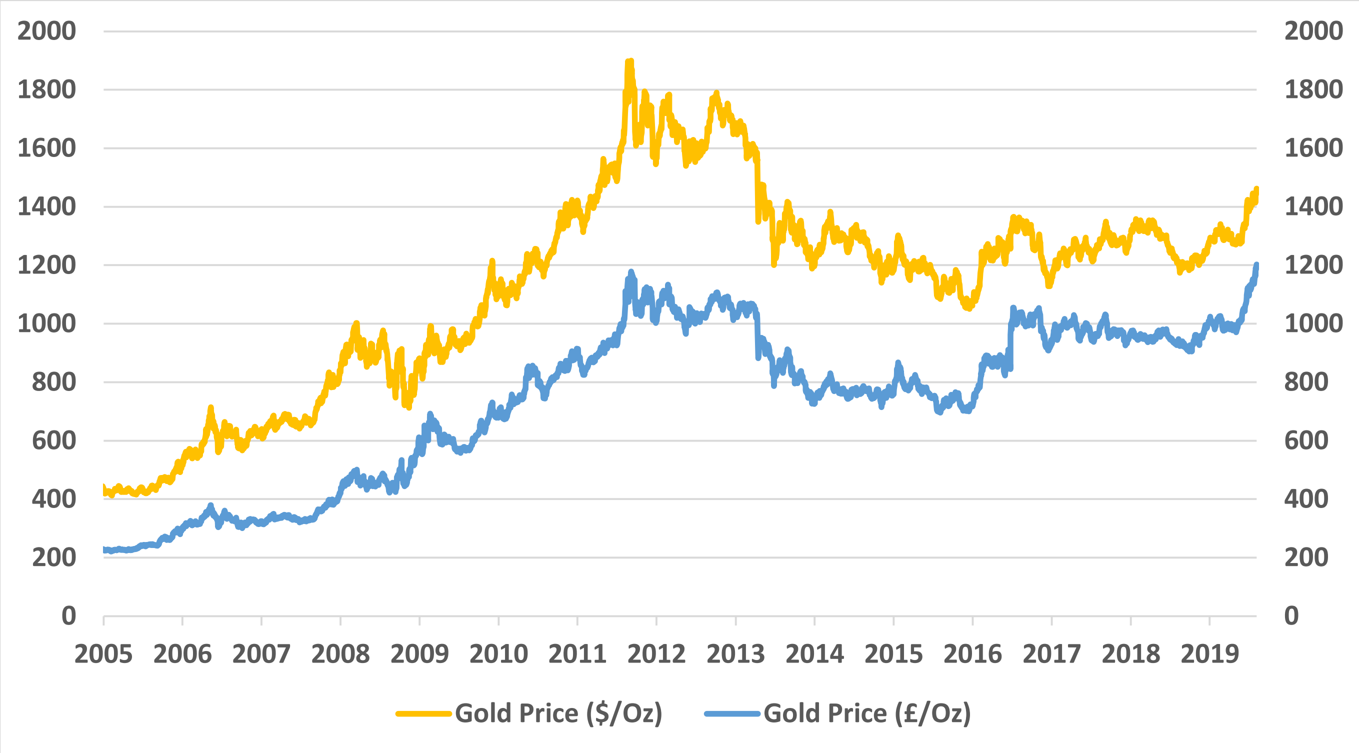
Source: Bloomberg 6 August 2019

Figure 2: A falling yield environment has not helped 'Value' investing.



Source: Bloomberg 6 August 2019

Figure 3: Gold Bullion in US Dollars & Pounds Sterling



Source: Bloomberg 6 August 2019

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