TROY
ASSET MANAGEMENT

www.taml.co.uk February 2020

Investment Report No.63

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

Complacency, Avoiding Complexity and Reasons for Realism

"Easy in but not easily out, as the lobster said in the lobster pot!" C.S. Lewis

2019 was a remarkably favourable year for asset classes, with all boats rising on a tide of liquidity. The year was the reverse of the 2018 experience in which financial markets were affected by the tighter monetary conditions, as the Federal Reserve raised interest rates. The 'Powell Pivot' last January changed everything, providing a more benign environment for asset prices. Interest rates are no longer in the ascendant and, as of September, the Fed's balance sheet has resumed its expansion. This latter move is, in practice, a continuation of quantitative easing rebranded as "Reserve Management Purchases".

If the past three years are anything to go by, stock markets appear to be driven increasingly by liquidity and much less by corporate earnings or other factors. Even geopolitical risks are frequently ignored by investors although, as I write, the coronavirus is threatening this recent complacency. According to MSCI, global corporate earnings grew by +7% in 2018 and fell by -3% in 2019. MSCI World Index TR equity indices went in the opposite direction, *falling* in 2018 by -9% and *rising* +28% in 2019 (in US$). Similarly, the UK saw the FTSE All Share Index TR fall by -9% in 2018 and rise by +19% in 2019. We doubt whether this perverse environment in which 'bad news is good news' is likely to be sustained into 2020. Following the Federal Reserve's change in direction, we expect that a significant deterioration in cash flows is required for equity markets to turn substantially negative.

The Trojan Fund returned +10.7% despite the Fund's allocation to equities remaining below 40%. With hindsight, we were too timid in our equity exposure but positive stock selection, combined with a good showing from gold-related investments and US TIPS, helped performance.

Our aim is to provide our investors with attractive, risk-adjusted returns. Over the past two years, which combines the challenging 2018 with the more ebullient 2019, our return was +7.4%. Importantly, the Fund experienced a maximum drawdown[1] of -4.8% over the two year period, which compares favourably with -15.0% for the FTSE All Share index.

Roaring 20s?

In contrast to the first decade of the century, in which UK investors suffered two c.-50% drawdowns, over the past decade they have enjoyed high returns from equities with few meaningful falls and with relatively low volatility. Certainly, since Mario Draghi pledged to do 'whatever it takes' to preserve the euro in 2012, markets have sailed serenely on, buoyed by accommodative monetary policy. Much of this can be attributed to a re-rating of stock market valuations, with last year being no exception to the rule. The Shiller (Cyclically Adjusted) Price Earnings Ratio for the US stock market ('CAPE'), which smooths earnings over a ten year cycle, has risen from

[1] Maximum drawdown measures the worst investment period

20.3x in December 2009 to 30.9x in December 2019 (*Source: Robert Shiller, Yale University*). While we accept some of the well-rehearsed arguments that a higher CAPE is partly justified by lower and stable inflation, we also note that this has been an unusually extended cycle without a recession. Therefore there is little earnings cyclicality to smooth. Valuations could only be justified if the current environment of low inflation and a benign economic backdrop remains in place. One must assume, investing today, that returns from this starting point are likely to be lower in the next decade than they have been in the last. If history is any guide, the current level of CAPE indicates that prospective annual returns, after inflation, are not likely to be higher than low single-digits. It would also not surprise us, following such a benign period, if volatility also picked up from here.

Despite the prospect for lower returns, there are reasons for selective optimism. Several robust business trends are likely to remain in place over the coming decade: the ongoing shift to cloud computing, the growth in electronic payments and the growing penetration of ecommerce to name but three. Many of the companies held in our funds should benefit from these business tailwinds. If there is one lesson to be learned by investors from the last decade, it is the tendency to underestimate the impact of these forces on incumbent business models.

Plus Ça Change

The most remarkable lack of change over the past decade has been in interest rates. From 2000-2009, the Federal Reserve changed interest rates 42 times; over the most recent decade, there were just 12 - barely one change per year. The Bank of England's moves were even less pronounced with only three changes to rates over the 2010s compared with 31 the previous decade. We began the 2010s with aggressively loose monetary policy, designed to save the world economy from a second great depression. We ended the decade with the realisation that attempts to return to a more normal era of monetary policy are doomed to failure. The result: fiscal policy is seeing resurgent support against the backdrop of growing frustration with the limitations of monetary policy. The rise of populist politicians sits well with an increase in fiscal laxity. Yet there are few signs we are about to cross the Rubicon to Modern Monetary Theory ('MMT'), to create new money to fund directly government spending. For as long as an environment of lower inflation persists, valuations may remain elevated. Ultimately, a dramatic policy shift, full-scale adoption of MMT or otherwise, would likely require a downturn in the economy, heading towards deflation.

Winning the Loser's Game

We see discerning stock selection as the best driver of compelling returns. Our commitment to investing long-term capital in excellent businesses remains. Our portfolios contain holdings, not frequently traded 'positions'. Stocks are not merely green and red numbers on a screen; they are companies in which we own a long-term share.

We were recently intrigued by a couple of pieces of research on stock markets. According to a study by Blackstar Funds, the US stock market (Russell 3000 Index) rose by nearly +900% during the long bull market from 1983-2006, yet just 25% of (c.8,000) stocks accounted for all the gains. 64% of stocks underperformed the index and 39% were down in absolute terms over those decades. 19% of stocks lost >75% of their value. Despite

a bull market, there were far more losers than winners.

Looking at Hendrick Bessembinder's paper, *Do Stocks Outperform Treasury Bills?* (Arizona State University, May 2018), the majority of stocks that have appeared in the Centre for Research in Security Prices (CRSP) database since 1926 have lifetime buy-and-hold returns ***less*** than one month Treasuries. "*When stated in terms of lifetime dollar wealth creation, the best performing 4% of listed companies explain the net gain for the entire US stock market since 1926, as other stocks collectively matched Treasury bills.*" The mantra "Stocks for the Long Run" is not enough[2]. To achieve satisfactory equity returns selectivity is everything.

Paying to Lose

There is always a temptation in financial circles to add to complexity. By contrast, we are of the late Paul Volcker's school of thought and sympathise with his view that, 'the only useful thing banks have invented in 20 years is the ATM'. Our industry has a reputation for overcomplicating and shrouding otherwise simple concepts with jargon. We have endeavoured over the years, in these reports, to keep things simple. Investment is like a sweet shop with a vast array of choices. It can be very tempting to add debt, speculate in currencies, and assume exposure to exotic markets or esoteric asset classes which are not correlated with markets. The list goes on…but we think it important to resist such temptations.

One question we are frequently asked is why we do not use such tools to manage risk or even to enhance returns.

There are a panoply of choices, whether shorting stocks directly, shorting stock market indices (via futures) or using traded options. While, in the past, we have been happy to take long futures positions to increase equity exposure, when the stock market was at extremes we chose not to 'go short'. There are many reasons for this strategy, which has been in place since the Trojan Fund was launched and which we still consider to be valid today. We are long-only investors who eschew complexity. This may at times make us look parochial and old fashioned. It does however allow us to focus on our holdings without the distractions of the various moving parts of a long-short portfolio. We manage risk through asset allocation, moderating our equity allocation according to valuation. Gold comprises an important element of our protection, as discussed in last year's special report.

As with short positions, derivatives are costly for as long as the investment case fails to play out. Time is not on the side of such investors. This contrasts with the lot of the long-term, long-only investor for whom patience is a pre-requisite.

Caught Short

We accept that shorting has a valuable purpose. We can recall many episodes in which management have been called to account by short sellers, especially in cases of fraud and accounting scandals, as was the case with the Enron scandal in 2001. Yet shorting individual securities exposes investors to the

[2] *Stocks for the Long Run* is a book on investing by Jeremy Siegel, professor of finance at Wharton School of the University of Pennsylvania.

risk of unlimited liability. This can be extremely painful, stressful and distracting. Back in early 2005, I was asked by a hedge fund manager whether I would short Google (since renamed Alphabet). The company had recently come to the market and the valuation looked rich at over 70x historic earnings. The stock, which traded at a price of $96 back then, now trades at over $1,400. Expensive stocks do not necessarily fall to earth. Many grow into their valuations over time. Remarkably Alphabet's earnings have grown from $1.25 in 2005 to $47 in 2019. So with hindsight, the shares at IPO traded on a mere 1.8x 2019 earnings (*Source: Bloomberg*). Shorting such a stock would have been a fool's errand.

Share prices may be far removed from their fair value for sustained periods of time. Sharp upward moves in stocks are not uncommon, whether in the case of Volkswagen's >+320% rise in two days in October 2008 or more recently Tesla's barnstorming >100% return year-to-date (at least until 4th February). Evidence, if any were needed, that shorting is for consenting adults only.

Apples & Pears

Much has been written about Woodford Investment Management over the past few months. Herein are found cautionary tales on the subjects of liquidity and governance.

On liquidity, our funds have always invested in listed companies and Troy has internal limits on the stakes held. Mark Carney's comments that open-ended funds are "built on a lie" may seem extreme. It is however valid in the context of illiquid asset classes being held in open-ended vehicles.

Last year we noticed that different managers use different methods to measure fund liquidity. Our method is to estimate days to liquidation for a security, assuming we trade 20% of the average volume traded over the course of the preceding 30 trading days. This is the basis for the calculation of the funds' liquidity in Figure 1. We have also seen variations on this such as 30% of the average trailing 20 days' volume or the time taken to liquidate 5% of a fund in the event of a large redemption. Market liquidity waxes and wanes, depending on prevailing conditions so these statistics will always be indicators or comparators rather than any guarantee. There is no perfect measurement and there are plenty of ways to skin this particular cat. However we consider our method the most useful measure for investors, based on the securities in which we invest. Nevertheless we believe it would be helpful to have an industry standard in order to help investors compare apples with apples and not apples with pears.

Our Board

On governance, Troy is unusual in being a private company with four non-executive directors. Back in 2000 we established the business with two strong non-executive directors. Our Board is something we have built on over the years. All four non-executive directors are shareholders in Troy so their interests are aligned with the company. As Troy has grown our governance has evolved and we have added Board sub-committees to monitor audit, risk, dealing, remuneration (with two non-executive members), product governance and charitable giving. This has aided our endeavour to achieve best practice and to incorporate many of the strengths of a public company, whilst remaining in the private domain. This last point is important in preserving our long-term focus. Also important in enabling our long-sightedness is the strength of our balance sheet; Troy has never used debt. At times this may appear quaint and excessively conservative but, most

importantly, it leaves us free to concentrate on running funds for Troy's investors.

Finally last October Troy entered its 20th year with confidence despite the obvious challenges facing our industry. We are very pleased to announce that Gabrielle Boyle, our Head of Research, has been appointed to the Board of Troy (subject to regulatory approval). Since joining Troy in 2011, Gabrielle has made a huge contribution to our business, whether in the management of the Trojan Global Equity Fund, with the broader investment team, on the Executive Committee or chairing Troy's charity committee. We are delighted to welcome her to the Board.

Sebastian Lyon February 2020

Figure 1: Fund Liquidity

Trojan Fund	% Total
AUM: £4,359m	
0-1 Day	86.9
1-5 Days	98.3
5-10 Days	99.7
10-30 Days	99.7
30-90 Days	100.0

Trojan Income Fund	% Total
AUM: £3,431m	
0-1 Day	25.4
1-5 Days	70.1
5-10 Days	81.8
10-30 Days	93.2
30-90 Days	99.3

Trojan Global Equity Fund	% Total
AUM: £301m	
0-1 Day	97.7
1-5 Days	100.0

Trojan Ethical Fund	% Total
AUM: £103m	
0-1 Day	100.0

Trojan Ethical Income Fund	% Total
AUM: £189m	
0-1 Day	80.0
1-5 Days	96.3
5-10 Days	98.7
10-30 Days	100.0

Trojan Global Income Fund	% Total
AUM: £214m	
0-1 Day	94.4
1-5 Days	100.0

Liquidity is monitored by calculating what proportion of the portfolio can be sold, assuming trading at 20% of the previous 30 days' average daily volume. Asset Allocation and holdings subject to change.

Source: Bloomberg and Troy Asset Management Limited, 31 December 2019

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