Investment Report N°·68

www.taml.co.uk April 2021

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

Good taste never goes out of style

Online advertising lacks the kitsch entertainment of traditional marketing. Today we are targeted by algorithms based on recent searches or, somewhat perversely, recent purchases. During the latest lockdown, a men's clothing company stalked me online for weeks after I had bought a couple of shirts from their website. The cinema adverts of the 1980s courted consumers in a very different way and often the corniest adverts were the most memorable. In my late teens, when travelling in India, the cinema ads were often more entertaining than the films themselves. Long after their ban in the UK, cigarette adverts were still permitted and Bollywood actors would play the equivalent of the Marlboro Man to promote brands such as *555 State Express*. One ad for a brand called *Style* sticks in my mind because it used the timeless catchphrase, '*Good taste never goes out of Style*'.

Too much may be made of investment styles. As we have discussed in several previous reports, popular categorisations of 'value', 'contrarian', 'momentum', 'quant' or 'growth' are too reductive to be helpful. Nevertheless, having an investment style of your own, in keeping with your temperament, is important. It is all too easy to be buffeted by the fashions and volatility of equity markets and many investors have a habit of being whip-sawed by the vagaries of cycles. To '*know what you own and why you own it*', to quote the great Peter Lynch, helps the investor resist the temptation to buy high and sell low. There are plenty of ways to skin the investment cat; some make great traders, others are more patient and make better long-term investors.

Companies not cohorts

At Troy, we are aware of when we are likely to do well and when we may not keep up. There will be moments when the wind is not in our sails and our emphasis on absolute returns over relative performance means our style may be out of favour for months at a time. The consequence is for us to seek to protect capital in difficult markets, but also not to make as much as others when the going is easier. This is an active choice. We will always take relative underperformance in a rising market over the risk of an absolute loss and, in so doing, must accept that our style is not for all seasons.

Our focus for the Trojan Fund is on businesses; we prefer not to think in terms of commonly cited stock market cohorts: - growth, value or anything in between. For us, the bottom line is that companies must be sustainably and highly profitable and they must be growing not shrinking. A stagnating or declining business will struggle to make the requisite investments to stay afloat. On the other hand, accumulating financial firepower affords companies the long-sightedness and dexterity to stay relevant.

If the share price of one of our holdings falls by -25%, as occurred during the pandemic, we can usually be confident that the stock is better value. The long-term earnings potential is probably undisturbed by short-term events and this knowledge girds us with the conviction to add to the holding, as we did in February and March 2020. This intrinsic underlying value is harder to discern when buying an unproven, unprofitable company; so-called story stocks often struggle to maintain the narrative when events take over.

A stock with no earnings has a valuation based on its total addressable market ('TAM') and assumptions about its future share of revenues and earnings. Its share price is founded on hope and extrapolation, not backed by hard cash flows. In less benign markets, companies with speculative valuations can fall a long way as higher discount rates penalise distant profits. An Excel spreadsheet can produce marvellous or dire predictions, depending on the analyst's mood.

For weaker businesses, it is tempting to view them on today's earnings or even 'recovery' profits but long-term history can be a more reliable guide. Low valuations are often the market's way of correctly identifying a wasting asset, not a bargain. To use my -25% share price fall analogy, a decline in the share price of a poor business may well reflect the ongoing deterioration in its economics. When the trap door of earnings downgrades threatens the balance sheet, the collapse in equity value can be savage, as witnessed last March when many companies survived only with a new dose of equity issuance. Our mission, '*preserve capital first and then grow it*', makes investing in such highly cyclical turnarounds inappropriate.

Short term versus long term

The experience of the past two decades informs us that short-term, cyclical rallies, of the type we are experiencing today, may favour broken businesses. But a rising share price does not mean the fundamentals are fixed. There are a number of FTSE 100 companies whose prices are rising today but, over 20 years, they are still below water. They may provide some excitement from time to time but they are poor stores of value.

The market seems to have extrapolated the reopening trade. Talk of 'pent-up demand' and the 'Roaring '20s' is commonplace. But there is no certainty that consumers emerging from lockdowns will spend as freely as expected. Equity markets could fall over their skis as prevailing high valuations get ahead of the recovery in earnings. Corporate news in the current quarter easily compares favourably to that from the trough of the pandemic last year. Valuations are also buoyed on a tide of liquidity as much as by improving fundamentals. This rotation has its dangers. In particular, many of the current market leaders remain challenged by technological disruption. Once the tide of this economic rebound goes out, and the semblance of cyclically-driven health gives way to secular currents, we will see who is swimming naked.

Don't generalise about tech

Some commentators have enthusiastically drawn comparisons between the recent shift to value investing and the aftermath of the dot-com boom. We believe that today's circumstances are more nuanced for a number of reasons. In 2000, the stock market was elevated by technology stocks trading at extreme valuations. Many 'dotcoms' had unproven business models, which later collapsed. Twenty years on, the technology sector represents a third of the US equity market and substantial value can be attributed to it in terms of historic earnings, current growth and cash-rich balance sheets.

This ongoing value creation must be seen in the context of a seismic wave of digitisation. The accelerating pace of technological change provides a far firmer footing for the next decade of returns than any short-lived cyclical puff. The direction of travel is no secret and pockets of excess have unsurprisingly led several to dismiss the sector out of hand. But there are also excellent opportunities hiding in plain sight. Microsoft and Alphabet have valuations not dissimilar to the overall market, despite the superiority of their financial productivity and growth. Their valuations and proven business models simply do not compare to the fragile extremes of 2000.

It is also the case today that every sector under the sun is touched by technology. And whilst the 'FAANGs[1]' is probably the most cited stock market acronym globally, it houses \$6.5trn of market capitalisation, spanning media, retail, business software, and biotech to name but four sectors. Even historically analogue industries such as healthcare are now digitising apace. Companies must either enable change, or adapt to it, to stay alive. Many of the opportunities and challenges faced by the platform companies are explored in greater detail by my colleague Marc de Vos in his recent report about cloud computing. (Please see our Special Report No.7 – Cloud Computing – Green Giants).

Unbalanced

Balanced funds have been long-term stalwarts of any private client or institutional portfolio, and yet the investment approach of 60% equity, 40% fixed income is looking decidedly dated. There are good reasons that they may fall out of fashion for the foreseeable future. Bond markets fell in the first quarter as yields rose. Many are trying to call the top of the bond bull market (or bottom in yields), following forty years in one direction for fixed income. We will only know for sure with hindsight, but there are likely to be few prizes for betting in favour of conventional bonds at such low yields – the risks are skewed to the downside. Put in the context of a 60/40 portfolio, bond yields are simply too low to provide the offset they traditionally gave when equities struggled. For a long time, bonds provided a free lunch to equity investors by reducing volatility thanks to the negative correlation between the two asset classes, while simultaneously providing valuable income. That lunch today looks overpriced and unappetising.

The past quarter saw the first -20% correction for long-dated 30-year US Treasuries in a generation. Over the past decade or so, slowly and stealthily, the risk profile of fixed income has risen. It now takes seven years to repay in coupons the capital lost from a one percentage point rise in bond yields (See *Figure 1*).

With this in mind, and recognising the threat to equities of a rising yield environment, we have eschewed conventional fixed income in our multi-asset portfolios for many years. Instead we have preferred index-linked bonds, currently United States TIPS (Treasury Inflation-Protected Securities), and gold bullion. Both have the ability to protect the portfolio from rising inflation expectations, which traditional fixed income investments will not.

There has been much debate about the return of inflation and several straws in the wind render this well-founded. We have been here before, however, following the financial crisis and in the early 2000s; inflation scares have come and gone. We remain open-minded about what happens next, especially when policymakers are clearly targeting inflation with aggressive fiscal stimulus supported by central banks. A shift to Average Inflation Targeting (AIT) at the Federal Reserve indicates a greater tolerance to move price inflation above an annual +2% increase in the consumer price index but deflationary forces are legion. One thing is certain - interest rates can only rise so far. There is simply too much debt to sustain higher yields.

[1] Facebook, Amazon, Apple, Netflix and Google

Inflation corrodes most asset values, but few more than fixed income and very high growth companies without a proven track record. Those that ignore valuation altogether may be in for a nasty surprise. Equities have tended to lag bonds in environments of considerably higher inflation (mid-single digits or above). This is what potentially makes a conventional balanced fund very wobbly. Gold, TIPS and equities with pricing power offer at least partial protection, but there are no guarantees.

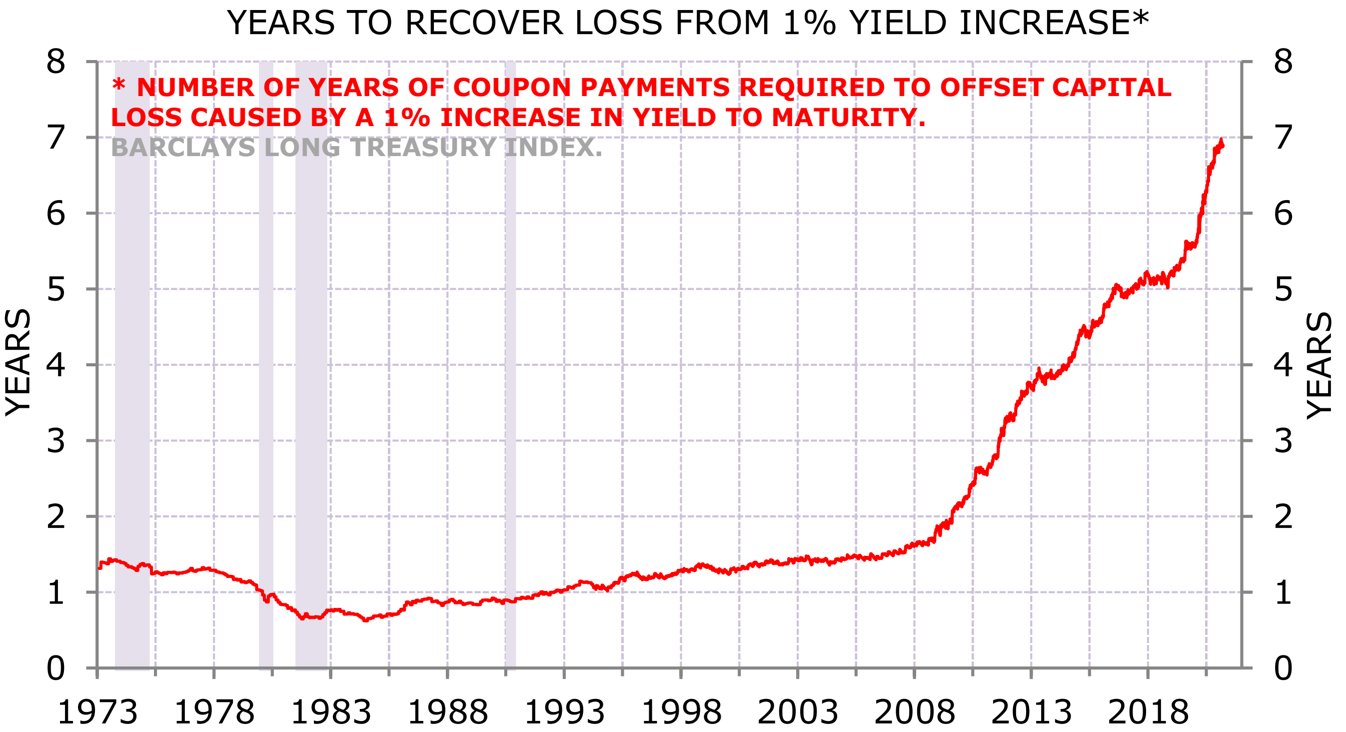
Staying the course

Amid these challenges, we are staying the course. The environment is not as riskless as may first appear. Pent-up consumer demand combined with accumulated savings will lead to an economic rebound, but much of that has been discounted. There are plenty of signs of investor excess in electric vehicles, alternative energy, new issues, and SPACs (special purpose acquisition vehicles). Speculative retail investor activity is animated by stimulus cheques, working from home and fewer opportunities to gamble on sport. This is unlikely to be sustained. Our style is to deliberately position the multi-asset portfolios cautiously and conservatively, and to endeavour to be as far away from the speculation as possible.

For those wanting to hear more about our investment style and its origins please listen to our new podcast *Far from the Finishing Post*, hosted by my colleagues Tom Yeowart and George Viney.

Sebastian Lyon April 2021

Return-free risk – bonds no longer the great diversifier?



Past performance is not a guide to future performance

Figure 1 *Source Minack Advisers*

Troy Multi Asset Strategy Track Record

Total Return to 31st March 2021	*Annualised Return Since Launch	*Since Launch	15 years	10 years	5 years	3 years	1 year	6 months
Trojan Fund O Inc	**+7.0%**	+285.3%	+143.6%	+63.0%	+28.4%	+19.2%	+9.3%	+0.2%
UK Official Bank Base Rate	**+2.1%**	+49.9%	+22.0%	+4.8%	+2.2%	+1.5%	+0.1%	+0.0%
UK Retail Price Index	**+2.7%**	+69.9%	+51.8%	+27.3%	+13.4%	+6.4%	+1.2%	+0.6%
FTSE All-Share Index (TR)	**+5.2%**	+171.6%	+114.8%	+79.0%	+35.7%	+9.9%	+26.7%	+18.5%

**Trojan Fund launch date 31 May 2001*

Source: Lipper – O Income shares total return net of fees since launch 31 May 2001 to 31 March 2021

Risk analysis	Trojan Fund O Inc	FTSE All-Share Index (TR)
Total return	+285.3%	+171.6%
Max drawdown	-13.7%	-45.6%
Best month	+8.9%	+12.7%
Worst month	-4.7%	-15.1%
Positive months	+66.4%	+58.4%
Annualised Volatility	+6.2%	+14.0%

Source: Lipper – O Income shares total return net of fees since launch 31 May 2001 to 31 March 2021

Past performance is not a guide to future performance

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ASSET MANAGEMENT

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