Special paper No.1

A bird in the hand

At Troy we favour companies that generate consistently high returns thanks to capital-light and defensibly profitable business models. Companies with steadily growing earnings streams should, by function of the mathematics of compounding, generate superior returns for shareholders over the long term. If a company has a proven track record of consistently generating attractive returns on its capital, and we judge that this should continue into the future, the stock will be a likely candidate for our investment universe. By definition, high returns on capital are not sustainable if profits are reinvested unwisely. Commitment to a regular and growing dividend is both an indicator and enforcer of profitable growth. Where management with surplus capital might otherwise be drawn to empire building through unprofitable investment, the dividend commitment encourages a focus on cash and capital efficiency.

It is no coincidence that all of the 80 UK stocks that we include in our investment universe pay a regular dividend and over 80% of them have maintained or grown their dividend every year for the last 10 years. Over this time frame, the average total return from the shares of these companies has been 377%, a compound annual growth rate of 17%[1]. This compares to a total return from the FTSE All Share of 119% or a compound annual growth rate of 8%. Not only have investors in these consistent compounders benefited from the reinvestment of dividends, which on average accounts for 33% of their total returns, but these select companies have also grown earnings at a higher rate than the FTSE All Share with an average earnings compound annual growth rate of 9.1% since 2005 versus 2.4% for the market.

Corporates might shun commitment to a progressive dividend for various reasons. There are some whose profits are too volatile, either on account of the cyclicality of their industries or the high interest payments owed to their creditors or, in many cases, both. The ability to sustain dividend growth throughout the cycle is as much an indicator of balance sheet strength as it is of earnings consistency. Of the 39 companies in the FTSE All Share that stopped paying a dividend following the financial crisis of 2008, the shopping centre developer Capital & Regional stands out as being one of the most heavily indebted. Having grown its dividend every year since 1995, the company ceased its payment for four years following the financial crisis. The cyclicality of its revenues from property was exacerbated by the debilitating effect of its debt burden, over three times its market capitalisation at the end of 2008. The share price fell from £8.42 to 7 pence and in 2009 shareholders were called upon for capital in a 2-for-1 rights issue.

[1] All figures in sterling to 1 April 2015, Source for all (unless otherwise stated): Bloomberg

Then there are companies who do not currently pay a dividend because of the superior growth opportunities perceived to be available in their markets. Amazon, whose profits have fallen 84% in the last five years, and Facebook, whose profits have risen almost twentyfold are two such examples. The profile of the future cash flows from these businesses is far from certain. Analyst estimates for Amazon's 2015 earnings range from -\$1.40 to +\$3.50. Depending on your position, the company could be on a PE of 106x or 1,000,000x. Ironically, the degree of uncertainty in returns that might be generated from reinvesting capital into a business tends to be greatest for those companies who reinvest all of their capital and pay no dividend. Benjamin Graham and David Dodd articulate the merits of the increased certainty provided by regular dividend payments. This is known as the 'bird in the hand' argument:

'It stands to reason that, if a business paid out only a small part of its earnings in dividends, the value of the stock should increase over a period of years, but it is by no means so certain that this increase will compensate the stockholders for the dividend withheld from them, particularly if interest on these amounts is compounded.'[2]

The surety of future cash flows indicated by a dividend commitment has historically provided support to share prices, reducing their volatility. The merits of the dividend should not however undermine the importance of reinvestment when effectively directed towards the most profitable opportunities. For companies generating high and stable returns on capital, not only does the allocation of cash towards dividends provide greater certainty for shareholder returns but it also tends to correspond with greater efficiency in the allocation of capital retained. We hold in high esteem those companies who, on failing to find reinvestment opportunities, are unafraid to return earnings to shareholders.

The advantages of returning cash to shareholders when reinvestment prospects are weak can be greatest for cyclical companies that are subject to more erratic growth prospects. Conversely, for cyclical companies, a substantial regular dividend commitment would deny the flexibility of reinvesting just at the moment of greatest opportunity. By definition, profitable but cyclical companies will usually generate most cash at the time when they need it least: at the top of their cycle. The temptation for such companies, in the midst of a bull market, is to forget the inevitably recurring vicissitudes of their industry and hope that 'this time is different'. Indeed, this was the case with Capital & Regional who took on an increasing amount of leverage in the years leading up to 2007 to grow their property portfolio. Shortly after, the value of their assets halved.

Cyclical companies that seek to avoid such pitfalls may earn a place in our universe. Ideally, management would refrain from reinvesting when opportunities to make money are scarce and cash is plentiful. Instead, surplus cash would be returned to shareholders through either share buybacks or special dividends, the two available means of repaying capital without commitment to a regular dividend. The former may be preferred in some

[2] Security Analysis, 1951

jurisdictions for the preferential tax treatment of capital gains over income. However, whilst this may often be the reason proffered, the effect of boosting EPS growth by buying back shares is also an incentive for management paid according to this metric. When valuations are low, buybacks offer an efficient way of distributing cash whilst increasing earnings and dividends per share through a reduction in the share count. However, the fact that cash is most often in surplus when valuations are high leads many companies to repurchase stock at less economical levels. Buybacks by S&P 500 constituent companies peaked at $600bn at the end of 2007 before the market halved over the course of the next 12 months. The 2014 value of buybacks came near to this previous high at $565bn, at a time when the S&P 500 is, on several valuation measures, as expensive as it has been since 2007. As well as removing the requirement for clever timing, special dividends, contrary to buybacks, are less ambiguous as regards management's motivation for their payment.

Companies with track records of paying special dividends demonstrate a willingness and ability to return surplus earnings to shareholders. Note that we refer only to companies distributing cash from accumulated earnings, rather than converting capital into income from the sales of assets. Over 30% of the stocks in our UK universe have paid out at least one special dividend from earnings in the last 10 years. The average total shareholder return from these companies over 10 years[3] has been 394%, which compares to 119% for the FTSE All Share. We have narrowed down this list of 27 companies to a short list of seven who pay 'specials' on a more regular basis[4]. The average 10 year total return of these stocks has been 540%, a compound annual growth rate of 20%. The ability to pay out a regular special is supported by the strength of these companies' balance sheets. The average company in the short list has net cash on its balance sheet. High returns are generated without recourse to leverage. The spare capacity demonstrated by the additional payment of a 'special' illustrates the relative security of the regular dividend. At the same time, the absence of larger regular commitment to shareholders enables such companies to deploy their spare cash at the bottom of the cycle.

The specialty insurance company Lancashire is an example of a company operating in a cyclical industry that has deployed special dividends to great effect. The company writes specialty property insurance and its profits are subject to the unpredictability inherent in these markets. Insurance premiums are currently at very low levels owing to an oversupply of capital in the market. This influx has been motivated by a search for yield by the likes of pension funds and hedge funds, consequently pushing down returns available from underwriting. In this current environment, Lancashire is choosing not to grow its insurance book but instead has been returning cash to shareholders. It has paid out two special as well as two regular dividends in the last twelve months, giving shareholders a yield of 19% based on the

[3] Or since IPO

[4] We define 'regular' as at least one special in the last five years and at least two specials in the last 10 years, yielding at least 3% on average

current share price. The company has been paying out all of its earnings at a time when returns on equity are lower than they have been in the past. Lancashire's reported return on equity was 'only' 16% last year compared to 33% in 2007 when it paid out 50% of its earnings. Since the company was listed at the end of 2005, its shares have produced a total return of 419% versus 85% for the FTSE All Share. We currently hold Lancashire in our income portfolios.

By definition, special dividends are paid subject to management discretion and are thus unpredictable. However, the result of investing in a combination of companies paying quasi-regular specials, operating in diverse sectors can be the generation of a consistent income stream in aggregate. If one has confidence in company managements' ability to understand their respective cycles and these cycles are not strongly correlated, special dividends can offer a meaningful contribution to a portfolio's income each year. The table below provides the average special yield (based on share prices as at the previous year-end) for our short list of seven regular special payers. Whilst only two of these companies are currently held in Troy portfolios, our recent research has reiterated their attractions. We continue to monitor their progress with a view to investing should valuations provide a more attractive entry point.

Charlotte Yonge
April 2015

Regular payers of special dividends in our universe

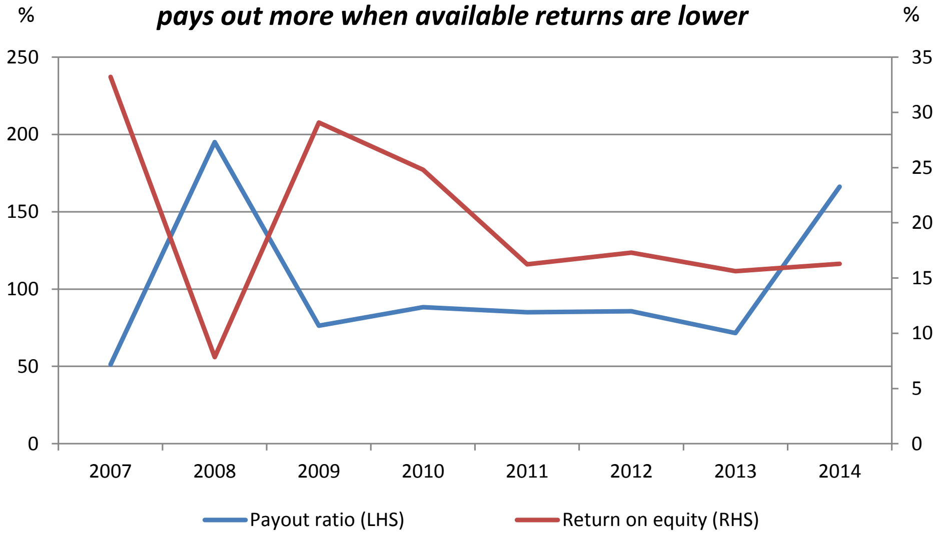
Company	Special yield (excluding the regular dividend)				
	2011	2012	2013	2014	2015
FIDESSA GROUP PLC	3.2%	3.2%	3.1%	2.0%	1.9%
HARGREAVES LANSDOWN PLC	1.1%	1.6%	1.3%	0.7%	0.0%
HISCOX LTD	0.0%	0.0%	9.8%	6.5%	7.9%
LANCASHIRE HOLDINGS LTD	34.1%	27.3%	39.7%	31.6%	14.1%
ROTORK PLC	1.3%*	0.0%	0.0%	0.0%	0.0%
SPIRAX-SARCO ENGINEERING PLC	1.4%	0.0%	4.4%	0.0%	4.2%
VICTREX PLC	3.6%	0.0%	0.0%	0.0%	2.5%
Average	6.4%	4.6%	8.3%	5.8%	4.4%

* Rotork paid two specials in 2011 in addition to special dividends in 2010, 2008 and 2007

Source: Bloomberg, April 2015

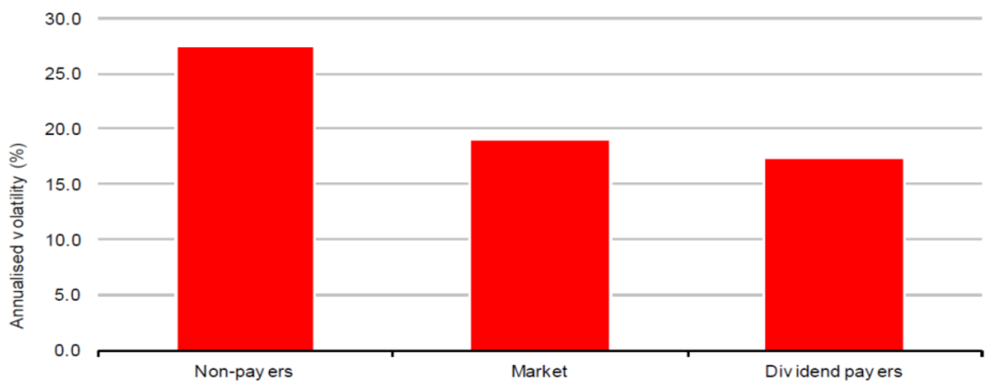
Lancashire

pays out more when available returns are lower



Source: Bloomberg, April 2015

Volatility of dividend payers and non-payers in the S&P 500 since 1995



Source: SG Cross Asset Research, January 2012