



Investment Report N°45

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

FTSE 7,000

The FTSE 100 has at last made it to a new all-time high for the first time in 15 years. Much has been made of this landmark in the financial press, but we would make two observations. Firstly, with stock markets having rallied, largely uninterrupted, for the past six years we would view this event as reason for caution rather than celebration. Secondly, for the Index to recover fully in *real* terms, it would need to reach 10,700 - 51% above its current level.

Where danger lies?

Since the last UK stock market peak in December 1999 (and especially since the financial crisis in 2008) savers have become more discerning and circumspect with regards to their own investments. The Neverland of dot com speculation, reliant on the greater fool theory, was replaced with a 'show me the money' attitude. This return to rational investing has led to the growth of fixed interest funds and greater appreciation of equity income strategies. Within the equity market, so called 'bond proxies' - companies that pay a reliable and growing dividend - have been rewarded with superior stock performance over companies offering jam tomorrow (perhaps with the notable exceptions of the biotechnology and social media sectors) or capital intensive industries which need to retain profits to sustain existing operations and so lack the ability to pay out.

As official interest rates have fallen even below zero and with fixed income markets offering so little, it is hardly surprising that utilities and consumer staple companies, such as Unilever or Nestlé, have found a consistent bid. Our concerns today are twofold: these stocks are no longer unambiguously cheap, as they were in 2008; and when interest rates or bond yields begin to rise from their present meagre levels these proxies will suffer. Cautious savers and fixed income investors who have been herded into dividend-paying stocks because of a scarcity of income from traditional risk-free assets are like bridge players now nervously trying their hand at poker. As and when cash and bonds offer reasonable returns these fair weather marginal buyers of stocks will no longer want to collect dividend cheques.

In some ways we feel sorry for the myopic and coerced buyer of high-quality, consistent dividend-paying stocks. Buying these stocks for their next dividend payment is a bit like going to the Grand National just to witness the field jump the first fence. Alternatively, going the distance with high-return compounding franchises is likely to be a rewarding journey for those investors who are prepared to commit their capital for the long term and stay the distance.

The cash flows from these businesses are not merely bond-like, but should grow in real terms. Utilities could prove the exception as they struggle with electoral promises in the UK to cap energy bills. Moreover, many utility business models are dependent on high



levels of leverage, which brings its own risks. If the cost of debt rises, the value of equity may be squeezed. In contrast, staples should be more resilient given their free market granted pricing power and typically less encumbered balance sheets.

Waiting for Godot

Consider for a minute the reason for those expected interest rate rises, for which we are still waiting ad nauseam - the last interest rate rise in the United States was in June 2006 and a year later in the UK. Higher rates and bond yields imply, not necessarily robust economic growth, but the rising threat of inflation. While there will no doubt be bumps in the road in terms of share price volatility, the cash flows from staples should grow because those companies with strong brands, high market shares and above average margins will be able to raise prices. Consumer staples with above average valuations are likely to prove volatile in a more dynamic interest rate environment, but they are more likely to grow into their rich ratings over moderate-to-long-term horizons.

Deleveraging? Not yet

Since 2008, we have experienced an inherently unanchored monetary system. Contrary to all expectations, global debt has continued to grow, reaching new highs (see *Figure 1*). While households have modestly reduced indebtedness, governments and corporations have increased leverage lured by ever decreasing interest rates. According to a recent report by McKinsey Global Institute, *Debt and (not much) deleveraging*, from 2007 to the second quarter of 2014 global debt grew by US\$57 trillion, from US\$142tn to US\$199tn. S&P 500 non-financial companies have increased debt

relative to earnings by 50% over the same period (*Source: Bloomberg*). Lower growth and the lack of inflation have made deleveraging all the more challenging. The financial system remains pro-cyclical as asset prices and leverage rise as one. The Report's authors conclude that the continuing growth of global debt "*slows the recovery, raises the risk of new crises and it limits the ability to respond to them*".

We have said that the only exits from unsustainable growth in indebtedness are, ultimately, default - perhaps Greece's choice - or inflation. But inflationary pressures have been dormant since 2011, when in the UK RPI hit 5.6%. Since 2013 the conventional wisdom has been that we were on a path heading towards normalised interest rates, but in 2015 policy has headed in the opposite direction. According to Bank of America Merrill Lynch, recent interest rate cuts from the Australian and Canadian central banks account for just two of a total of 569 interest rate reductions enacted by central banks since Lehman Brothers was declared bankrupt. Interest rates in these two far flung Commonwealth countries at least remain positive. Closer to home but worlds apart are the negative nominal rates imposed in Switzerland and Denmark. This offers the perverse option of paying someone to take out a mortgage or reward a bank to hold your cash. Radical quantitative easing is underway in Europe, including the unprecedented purchase of fixed interest securities yielding less than nothing, guaranteeing a loss on redemption. Anyone buying short to medium conventional bonds in Germany and Switzerland, where yields on maturities up to five years are now negative, is doing so on the basis of the greater fool theory. Savers looking to escape negative



interest rates may start hiding their cash under the mattress.

Central bank policy has achieved the unthinkable, having successfully inflated a bond bubble on the ashes of the dot com bust and a housing bust. With the possible exception of the United States, which is expected to begin normalising interest rates later this year, we could not be further from orthodoxy. Where will it end?

Time for Plan C?

In 2009, when QE was launched in the UK, Bank of England officials were sent out to commercial banks to explain the policy, the idea being that QE was an emergency measure that would soon be reversed. Six years on, there seems little prospect of a reversal. There is no doubt that QE, combined with zero interest rates and fiscal stimulus was extremely effective in preventing the financial system and the economy falling into a death spiral, but now markets have become worryingly addicted to extreme monetary policy. Investors have become dangerously numb to perceptions of risk.

One possible exit from the debt trap mooted by McKinsey would be for "the broader public to shift its focus onto net debt rather than gross debt", effectively wiping out central banks' holdings of government bonds. If these bonds are excluded, government debt to GDP levels in America and Britain fall from a gross 89% and 92% respectively to a net 67% and 63% - apparently much healthier levels, but (unfortunately) illusory ones. The implications of this proposed sleight of hand do not bear thinking about, but in the words of Christopher Wood of CLSA, *"if financial conjuring tricks were as simple as this, it*

would really mean there is such a thing as a free lunch which, of course, there is not."

Perhaps this Plan C will be the catalyst for investors to consider an ultimate inflationary denouement and not the deflationary one they believe in today?

Normalisation

A year ago, the Bank of England was expected to be the first major central bank to attempt to normalise rates since the ECB's failure of 2011, but concerns over disinflation and a slowdown in global growth led to an indefinite deferral of that decision. In 2015, it is the supposed turn of the Federal Reserve to be the pioneer and to conduct its first rate rise in nine years. In anticipation the US dollar has been particularly strong over the past year, advancing almost 30% against the Euro and 17% against the Yen. Currency markets have, in effect, front run the Fed in tightening economic conditions in the US.

The possibility of a repetition of what happened in the UK in 2014 cannot be ruled out. While a rise in rates is anticipated for later this year, the expected date has already drifted from April to September. We would not be surprised to see a further deferral of the decision, which would test the dollar's recent strength.

Stock picking - A Bird in the Hand

Much of our time at Troy is spent monitoring our existing holdings and seeking out new opportunities suitable for our select investment universe. We have always said that we like our holdings to pay us to own them and not vice versa. Profitable companies wishing to return cash to shareholders can either pay out dividends or



buy back shares. The special paper attached to this investment report, 'A bird in the hand', by my colleague Charlotte Yonge, looks at the merits of dividend payments and in particular special dividends. A special dividend, by virtue of its irregularity, provides a flexible means of returning cash to shareholders for more cyclical companies.

Sebastian Lyon

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There is still too much debt - no signs of deleveraging yet

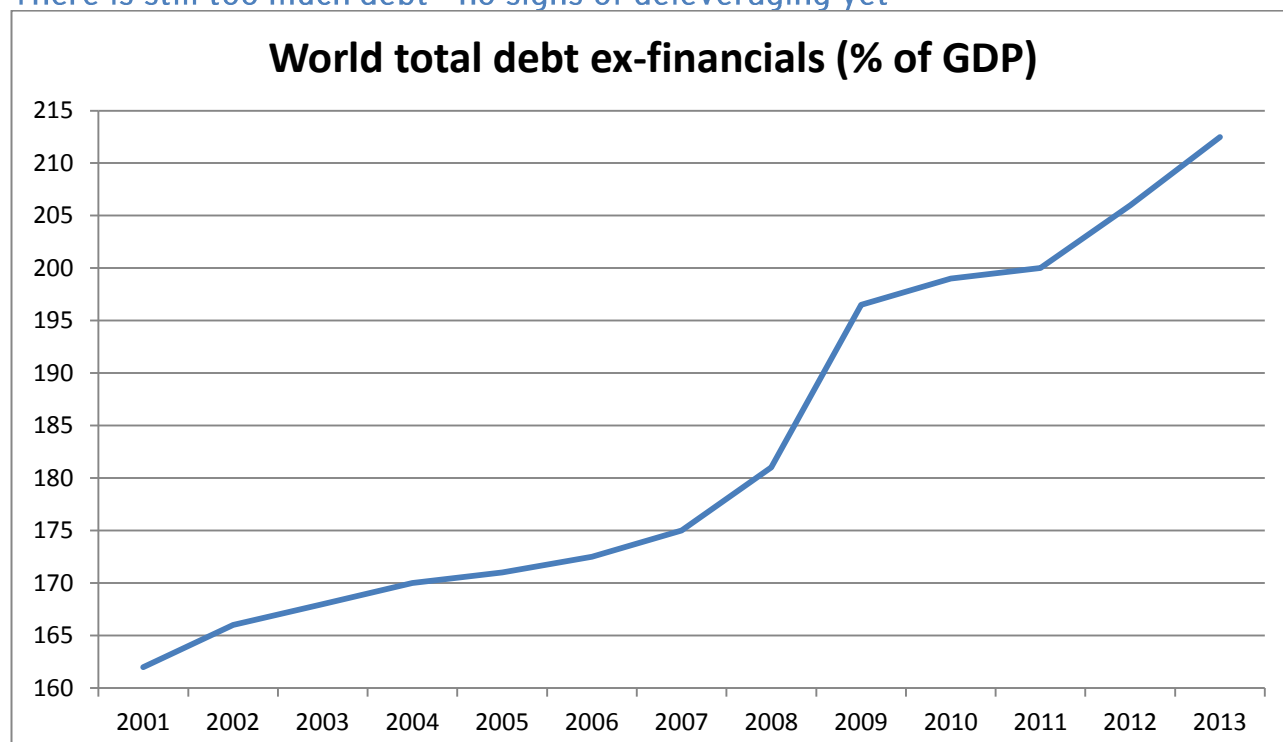


Figure 1

Source: *Deleveraging? What Deleveraging* by Buttiglione, Lane, Reichlin & Reinhart, August 2014 & The Macro Strategy Partnership

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