



Investment Report N°59

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

2018 - Messy Markets

"Buying a cyclical after several years of record earnings and when the P/E ratio has hit a low point is a proven method for losing half of your money in a short period of time."

Peter Lynch, Beating the Street

The American economist Hyman Minsky famously identified the 'Minsky Moment' at which 'stability breeds instability'. If 2017 was the year of remarkable stability, 2018 has been, in dramatic contrast, a messy year for investors. The year began with the optimism of synchronised global economic growth, combined with the benefits of President Trump's tax reform. The corporate tax cuts boosted earnings growth, providing a final sugar rush of fiscal stimulus. This blue sky outlook seduced retail investors who had taken the best part of a decade to recover their confidence from the deleterious effects of the financial crisis.

What a difference a year makes. Optimism has turned to circumspection, if not yet all-out pessimism. There is some sense of disbelief but navigating the end of this cycle was always likely to be problematic. This is partly because it has been so extended by monetary excess and the financial engineering engendered by cheap debt. Corporations themselves have sustained the bull market via share buybacks and M&A. Indeed, this economic cycle has lasted so much longer than previous experience (albeit with weaker growth) that talk of recession was, until recently, seen as heretical. We begin 2019 with the realistic

threat of a downturn but with little certainty of the outcome.

At Troy, our performance was relatively resilient as markets became more challenging. However, the final weeks of the year proved particularly difficult, leading to negative returns for all of Troy's funds in 2018, with the exception of the Trojan Global Equity Fund. We believe our performance should be viewed in the context of widespread negative returns for most asset classes in the year (Figure 1). Our continued caution over valuations and risks to growth is reflected in portfolios going into 2019.

Old Normal

Stock markets swooned twice in 2018, once in February and again in the fourth quarter. The October dip confirmed that we were entering a period of turbulence for risk assets. This cyclical bull market seems to have hit a wall of tighter monetary conditions, with the usual delayed response. Thousand-point intraday swings in the Dow Jones Industrial Average are not uncommon, while the VIX (CBOE Volatility Index) has been awakened from its slumber, having more than doubled in the past year. This is occurring as central bankers attempt to return to more 'normal' monetary policy. How this will work after almost a decade of unprecedented monetary munificence is unpredictable since it has never had to be attempted before.

To-date, this tightening has exhibited a classic pattern, the fringe being affected first but the effects slowly shifting towards the centre. This



time, it began with the collapse of Bitcoin and other cryptocurrencies in December 2017. The MSCI Emerging Markets Index topped out shortly afterwards, hindered by a resurgent US dollar, while the UK market peaked in May. The US stock market remained the 'last man standing' but the precipitous falls during the fourth quarter suggest that we may have seen the peak of this cycle.

Mourning TINA

We were always concerned by the prevailing market view of TINA – 'there is no alternative' [to equities]. Valuing stocks on the basis of zero interest rates is fatally flawed; a zero cost of capital, stretched far enough ahead, gives an infinite value. Comparing short rates to dividend or earnings yields was never likely to be a helpful long-term valuation measure for equities. In spite of its recklessness, the merits of TINA were espoused by many. With short-dated US Treasuries yielding more than equities, 2018 is, according to strategist Gerald Minack, 'the year TINA died'. Equities now face a higher cost of capital and all those discounted cash flow forecasts may require some reassessment. When the cost of capital rises and growth declines, prices adjust. Growth investing becomes less attractive. A reversion to the mean, which is resulting in a shift from growth to value investing, may already have started.

In 2018, bonds failed to offer reliable protection against equity market falls. At times, notably February, the two asset classes were positively correlated and both bond and equity investors lost. A longstanding concern of ours has been that bonds will not provide such reliable insurance against falling equity prices as they have in the past. Cash and short-duration government bonds may offer greater protection (and dry powder for future

purchases) even if they cannot provide an offset to falling stock markets. As for the future direction of interest rates, it is far from clear that the Federal Reserve will ride to the rescue. To-date Jay Powell, the new chairman, has taken recent market wobbles in his stride. This was confirmed by the interest rate rise to 2.5% at the latest Federal Open Market Committee meeting in December. In the words of my colleague, James Harries, 'Central banks need to re-establish the pricing of asset classes. Markets exist not simply for investors to make money but to ensure efficient allocation of capital in the economy. If you corrupt the pricing mechanism, you encourage poor capital allocation.' The pricing mechanism is at last reasserting itself.

Populism and the risks to globalisation

One driver of global growth for decades has been globalisation, the trajectory of which is now being challenged by populist politicians. In many economies the rise of populism, as a rejection of established political parties, is a delayed response to the financial crisis and the consequences of globalisation, which have led to greater inequality. One only has to see the daily shifts in foreign exchange markets to know that politics now rivals central banks as the main driver of markets. Forward guidance has given way to the unplayable and unreadable outcomes of political whim. In the US, the memories of the protectionist Smoot-Hawley Tariff Act are long-forgotten, in preference for rhetoric that trade wars can be won. In the wider economy, tariffs disrupt supply chains and force investment back onshore. This will ultimately affect profits and prove inflationary for import prices.

Absolute poverty has diminished worldwide and globalisation has achieved a considerable amount, releasing millions of people from



formerly communist countries into the market economy. Living standards have risen in emerging markets, while developed markets have benefited from cheaper goods. Yet wages have been constrained and inequality in the developed world has grown. The main winners are companies and wealthy individuals. According to David Roche at Independent Strategy, “two thirds of households in advanced economies saw income from work and investment stagnate or decline between 2005 and 2015.” In the US, real median incomes are unchanged over two decades whilst in Italy, GDP per capita has not grown since the introduction of the euro in 1999.

Whilst the political response has become louder of late, these problems have evolved over decades. The deregulation of financial markets in the 1980s and President Clinton’s deregulation of the mortgage market in the late 1990s led to high borrowing which fuelled asset bubbles and obscured the underlying and increasingly serious problem of falling real wages. While house prices and stock markets rose, the wealth effect offset the lack of a pay rise but that could only prove temporary. The reset came during the financial crisis when asset prices fell back to earth.

Politicians from established parties have struggled to respond to today’s challenges, paving the way for alternatives. Populism is often described as a ‘thin ideology’¹ for its provision of a framework (corrupt elite versus pure populace) without any coherent economic system. Populist politicians may align with left or right-wing economic policies but many tend to favour knee-jerk reactions over sustainable economic solutions. One such reaction, and perhaps the most far-

reaching today, is the resistance to globalisation being pursued by the Trump administration. If globalisation is reversed, global supply chains will have to be replaced by local, less efficient ones. Bringing home manufacturing, while appealing from an employment perspective, is unlikely to improve a country’s competitive position. Emergent political narratives also have a habit of conflating the multifarious issues behind the current malaise; for instance, the repercussions of automation are often falsely ascribed to globalisation. By failing to identify the root cause of today’s problems, politicians will struggle to reach an appropriate solution.

Populism in its many guises risks major unintended consequences. From the White House to the House of Commons, we are unlikely to see a straightforward transfer of power to the people. This is perhaps most evident on social media, which have played an essential role in the rise of populism. That these platforms should assume such importance is intuitive; they theoretically offer a stage for widespread debate and have the capacity to empower the voices of those who are marginalised or oppressed. However, in practice, the discourse on social media is often subject to manipulation by incumbent or centralised powers, as Niall Fergusson describes in his book *The Square and the Tower*. The interference in the US elections was one such example of this, as was the proliferation of alluring but misleading messaging during the Brexit campaign. As is almost always the case, populism risks taking hold on false pretences, creating outcomes that are inferior to the status quo.

The investment ramifications of populism are significant, particularly if the course of

¹ Cas Mudde, a political scientist at the University of Georgia coined this definition in 2004.



globalisation continues to be thwarted. Equities are likely to struggle. Corporate profits may suffer given the likely disruption to global supply chains. Lower growth is already leading to greater volatility. Whilst the short-term implications of populism may be positive for labour at the expense of capital, the consequences of capital misallocation rarely benefit anyone in the long run.

Cyclical Bull and Secular Bear

Over the longer term, markets have experienced dramatically different outcomes. The Euro Stoxx, the European equity index, has fallen by c.40% over the past 20 years and, as I write, the FTSE 100 index is now trading below the level of 19 years ago, at the peak of the dot-com boom. With capital returns absent, income has been critical. Who would have guessed that the sea of optimism which buoyed 'TMT' (Technology, Media, and Telecoms) stocks would end in almost two decades of poor returns (Figure 2)? Former constituents of the FTSE 100 have departed and survivorship bias likely flatters the headline figure. Baltimore Technologies, Bookham, Psion, Colt Telecom and Energis are distant memories and probably unknown to the current generation of investors. They have long gone to money heaven. More regrettably, successful businesses have also disappeared following takeovers. These include ARM, Allied Domecq, Cadbury Schweppes, Gallaher and Scottish & Newcastle, the last three of which were held in Troy portfolios.

Today's constituents look rather stodgy, capital intensive and cyclical. The FTSE 100 index remains dominated by banks, energy and mining companies. While many tech stocks disappeared after the boom, they were not replaced. Technology is 'missing in action'

in the UK listed market. It is part of the reason for the UK and Europe's lacklustre performance compared with the US. British successes like DeepMind were acquired by Google before UK investors had a look in. In such markets, index-trackers run the risk of capital loss even over very long time frames. The experience of the past twenty years underlines the importance of being selective.

2019

As we head into 2019, there is greater risk of recession. Whilst the outcome is far from certain, in the past three quarters of Fed tightening episodes have resulted in a downturn. Time will tell if we have moved from a 'buy the dips' bull market mentality to a 'sell the peaks' bear market mentality. Current market action provides us with a strong hint.

Peter Lynch warns investors to be careful with cyclical businesses late in the cycle, however tempting the bargains may look. This feels particularly appropriate at the moment when traditionally cyclical businesses such as airlines and housebuilders look myopically cheap. The threat of a 'hard' Brexit is clearly affecting current share prices and sterling but by how much? Many of the factors above, concerning populism and trade, are also playing a part.

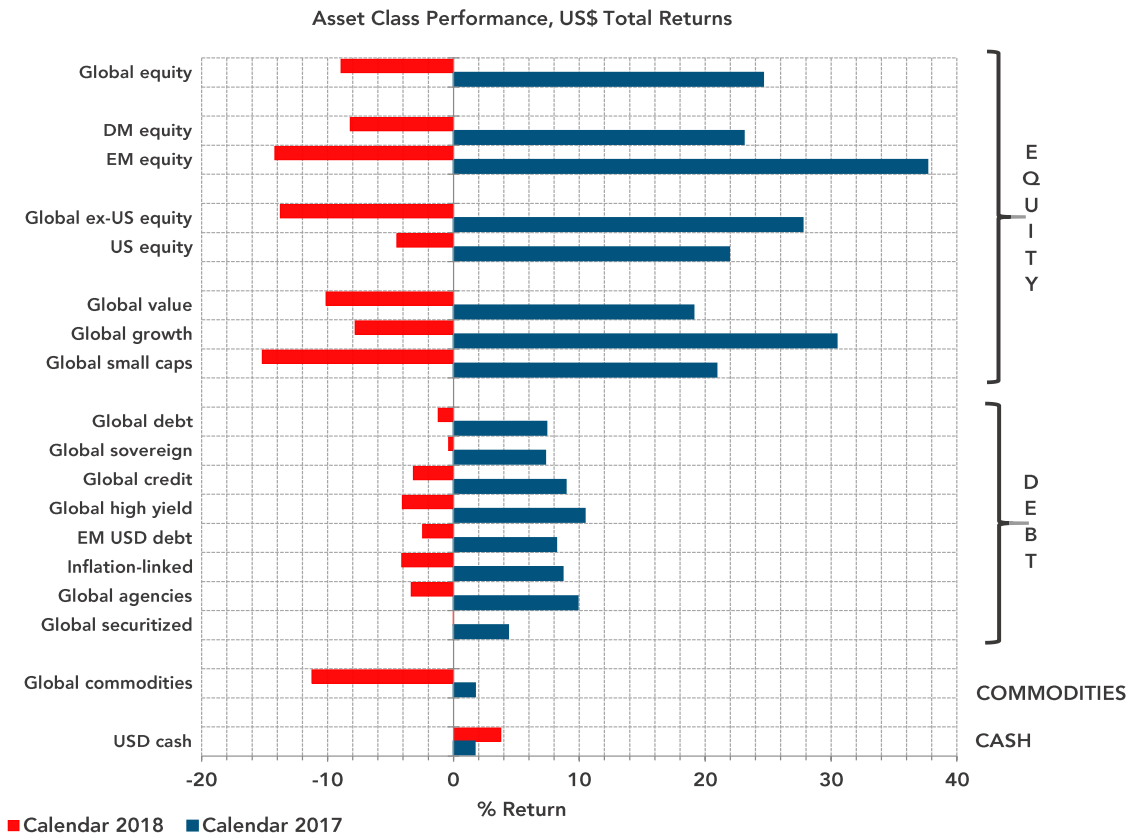
Amid the general market gloom, there is good reason for Troy to be optimistic. Our asset allocation has been cautious for some time and we are prepared to shift it more positively. 'Money is made when you buy' as the old saying goes. We head into 2019 with the most conservative positioning for a decade. Normalisation will be painful but I would expect to head into 2020 more fully invested, if value presents itself.

Sebastian Lyon

January 2019

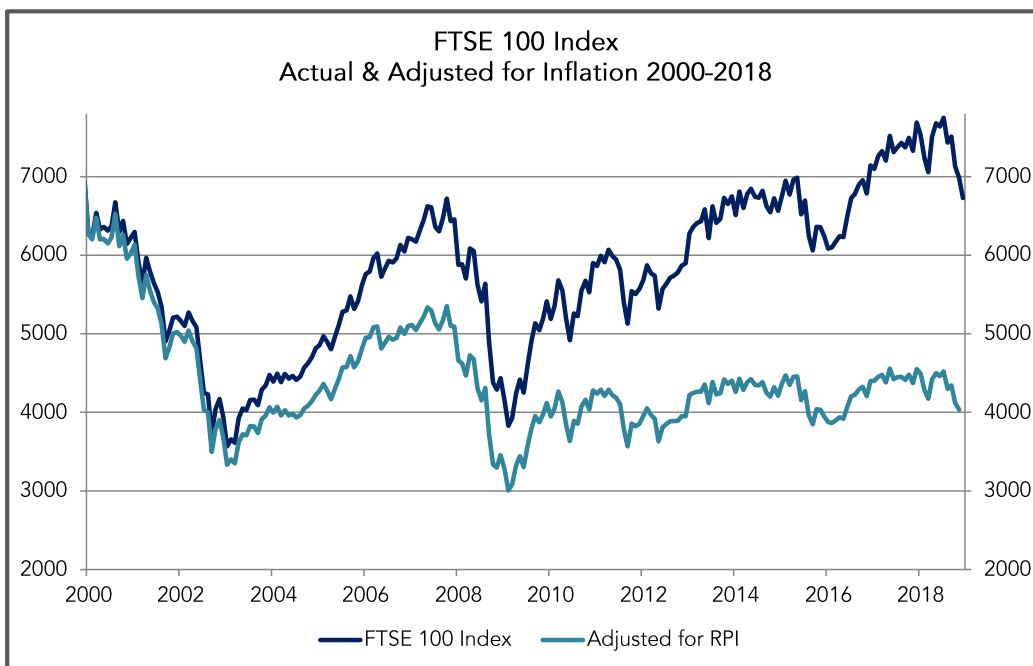


Figure 1: Asset class returns 2018 and 2017



Source: Minack Advisors, 31 December 2018. Past performance is not a guide to future performance.

Figure 2: A flat market in nominal terms and a bear market in real terms



Source: Bloomberg, 31 December 2018. Past performance is not a guide to future performance.



Disclaimer

All information in this document is correct as at 7th January 2019 unless stated otherwise. Past performance is not a guide to future performance. The document has been provided for information purposes only. Neither the views nor the information contained within this document constitute investment advice or an offer to invest or to provide discretionary investment management services and should not be used as the basis of any investment decision. The document does not have regard to the investment objectives, financial situation or particular needs of any particular person. Although Troy Asset Management Limited considers the information included in this document to be reliable, no warranty is given as to its accuracy or completeness. The views expressed reflect the views of Troy Asset Management Limited at the date of this document; however, the views are not guarantees, should not be relied upon and may be subject to change without notice. No warranty is given as to the accuracy or completeness of the information included or provided by a third party in this document. Third party data may belong to a third party.

Overseas investments may be affected by movements in currency exchange rates. The value of an investment and any income from it may fall as well as rise and investors may get back less than they invested. Any decision to invest should be based on information contained in the prospectus, the relevant key investor information document and the latest report and accounts. The investment policy and process of the fund(s) may not be suitable for all investors. If you are in any doubt about whether the fund(s) is/are suitable for you, please contact a professional adviser. References to specific securities are included for the purposes of illustration only and should not be construed as a recommendation to buy or sell these securities. Asset allocation and holdings within the fund may be subject to change. Investments in emerging markets are higher risk and potentially more volatile than those in developed markets.

The fund(s) is/are registered for distribution to the public in the UK and Ireland but not in any other jurisdiction. The distribution of shares of sub-funds of Trojan Investment Fund ("Shares") in Switzerland is made exclusively to, and directed at, qualified investors ("Qualified Investors"), as defined in the Swiss Collective Investment Schemes Act of 23 June 2006, as amended, and its implementing ordinance. Qualified Investors can obtain the prospectus, the key investor information document(s) (edition for Switzerland), the instrument of incorporation, the latest annual and semi-annual report, and further information free of charge from the representative in Switzerland: Carnegie Fund Services S.A., 11, rue du Général-Dufour, CH-1204 Geneva, Switzerland, web: www.carnegie-fund-services.ch. The Swiss paying agent is: Banque Cantonale de Genève, 17, quai de l'Île, CH-1204 Geneva, Switzerland.

In Singapore, the offer or invitation to subscribe for or purchase Shares is an exempt offer made only: (i) to "institutional investors" pursuant to Section 304 of the Securities and Futures Act, Chapter 289 of Singapore (the "Act"), (ii) to "relevant persons" pursuant to Section 305(1) of the Act, (iii) to persons who meet the requirements of an offer made pursuant to Section 305(2) of the Act, or (iv) pursuant to, and in accordance with the conditions of, other applicable exemption provisions of the Act. This document may not be provided to any other person in Singapore.

All reference to FTSE indices or data used in this presentation is © FTSE International Limited ("FTSE") 2019. 'FTSE ®' is a trade mark of the London Stock Exchange Group companies and is used by FTSE under licence.

Issued by Troy Asset Management Limited, 33 Davies Street, London W1K 4BP (registered in England & Wales No. 3930846). Registered office: Hill House, 1 Little New Street, London EC4A 3TR. Authorised and regulated by the Financial Conduct Authority (FRN: 195764).