TROY
ASSET MANAGEMENT

Investment Report N°.26

August 2009

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

From Bust to Boom?

Having been more optimistic in our February report, world stock markets have subsequently reversed the nose dive that began last summer. Over the last four months investors have enjoyed a sustained rally defying the belief that it was just another short term, counter-trend bounce.

The economic backdrop has been ignored for the time being. With cash earning so little on the street and Western governments standing behind insolvent banks, there is an understandable desire to improve on the negative real returns on offer.

Big Government

The shift back to risk assets that we saw in March was triggered by a combination of two factors; the introduction of a zero interest rate policy (ZIRP) on both sides of the Atlantic in combination with the decision by central banks to print money openly. Few economies have succeeded in 'Quantitative Easing' (as it is euphemistically described) with success. The recent instance of Zimbabwe bears witness to the failure of unlimited money creation. We only need to look further back at our own post World War II economy to understand that creating GDP growth, in nominal rather than real terms, ultimately results in inflation. The unintended consequences of this policy remain to be seen.

When the Bank of England and the US Federal Reserve are printing money how should we value UK Gilts and US Treasuries? The UK's Debt Management Office has forecast net Gilt issuance of £203bn in the current financial year (2009/10). That is fourteen times the average of the past ten years. Fourteen years' issuance crammed into one. No wonder the Bank of England is buying. What would Gilt yields be if they were not? Much higher. At some stage these Gilts must be sold to real buyers if inflation is to be controlled. The US Treasury numbers are even more eye watering. In the week beginning 22nd June alone, the US sold $104bn of Treasury bonds. Such ever increasing issuance of IOUs suggests little intention of repayment…in real terms at least. Can debt to GDP ratios in the West be stretched even further? This is clearly the intention, as ever larger budget deficits will need to be funded. The laws of supply and demand are being suspended by the authorities, and this makes the outcomes unpredictable. We are now in a totally artificial credit market.

Further credit creation will not cure our broken financial system. The authorities' attempt to wind back the clock to 2006 will not work, much as they would like to try. Things cannot return ex-ante. The demise of General Motors, the collapses of AIG Insurance and RBS all tell us that high leverage and opaque financial structures are unsustainable. The liabilities of AIG and RBS have not disappeared, but merely shifted to their respective governments' balance sheets. According to the IMF, the debt obligations of the US and UK will reach almost 100% of their GDP in a few years time. We have reached levels where debt can no longer realistically be paid back. UK sovereign default, a prospect inconceivable just a few years ago, with all its dire implications for the value of sterling, can no longer be ruled out. Hence long-dated government bonds are not the investment of choice for anyone other than short-term tactical traders.

Debt-to-GDP levels will be reduced over many years; wholesale deleveraging will not be allowed to happen. Governments will attempt to prolong the illusion of wealth so that its eventual decline happens 'with a whimper not a bang,' as expressed by CLSA's strategist, Russell Napier.

The 'Dash for Trash'

The rally in the market since early March was driven initially by *'short covering'*. Hedge funds had sold short stocks in companies with weak balance sheets in the expectation of further share price falls. Favoured targets included consumer cyclical businesses (such as retailers and pub companies) and financials, especially banks and life assurance firms. As the rally continued into April, hedge funds covered short positions and conventional investors also chased these sectors, having found they were underperforming the rally. This is why the rally has been referred to as a 'dash for trash'. Of course, cautious investors are likely to describe anything they do not own as 'trash' in a market like this! Nevertheless, investors have been falling over one another to buy in low quality, poorly financed companies in fear of suffering short term under-performance. The reason for this sudden change, from revulsion to enthusiasm, appears to be due to the new market obsession that the economy is past the worst. "Green shoot watchers" view the economic tea leaves in search for a market turnaround. It is true, the data are no longer deteriorating at as fast a rate as seen in the last two quarters. This, however, is hardly surprising. The world economy fell off a cliff after Lehman Brothers failed in September and some restocking after a collapse in inventories is inevitable.

There is a distinct difference between things getting worse at a slower rate and a full scale 'V' shaped recovery that is now hoped for and discounted by many of the more cyclical parts of the stock market. While earnings forecasts have been cut and dividends passed, many stocks' valuations have increased by over 100%. The FTSE 250 Index (synonymous with domestic mid-cap UK businesses) has increased in value from a price/earnings ratio of 9 times five months ago to over 22 times today. These companies need a huge recovery in profits to justify such valuations. The rally has been based on increased liquidity rather than an improvement in fundamentals.

Notwithstanding our more optimistic view of equities, the Funds have not kept pace with sharply rising markets. Our decision to increase our exposure to equities last autumn has added value. We went into 2008 with a low equity weighting of 40% in the Trojan Fund and a minimum 80% in the Trojan Income Fund. We came out of the bottom with weightings in the high 60s and mid 90s respectively. Our bias towards quality stocks that are well financed has, however, left us lagging behind the herd in the short term. On a more positive note, while many leading equity income funds have been cutting dividends by 20%-30% this year, Francis has grown the Trojan Income Fund's dividend by 4.5% for the six months to 31st July. The Fund has an historic yield of 5.1%.

One client asked us recently, '*When are you going to buy the rubbish*?' The answer was, '*We're not*!'. Our preference is towards more liquid 'blue chip' stocks that are able to pay sustainable and growing dividends. Their valuations have only risen a fraction since the recent rally began. With interest rates so low, stocks paying a reliable income should begin to perform. If risk aversion replaces the prevailing Panglossian 'V' shaped recovery trade, then defensive stocks will hold up much better.

The reason for our caution is that after a debt driven financial collapse in 2008, a conventional economic recovery is highly unlikely. The steady stable environment labelled the 'Great Moderation' by Ben Bernanke is over and the prospect of increased volatility in the economy as well as

the stock market is a more likely outcome. The trading environment is likely to remain challenging for the next couple of years.

While the banking system may appear to be past the worst, huge amounts of further capital will need to be raised. This will prove highly dilutive for existing shareholders. With further bad debts to come in the banking sector, from commercial property and private equity, investors would do well to remember that companies can be both profitable and insolvent.

Good money after bad

With investors keen to jump on the 'green shoots' band wagon, many of last year's losers have become this year's winners. In our December 2007 report (N°21 – *Bang to Rights*) we anticipated the return of increased equity issuance. The debt bubble of 2003-7 placed listed companies in a woeful position to survive an economic downturn of this severity. Since then we have experienced the worst of all worlds for investors; dividend cuts combined with dilutive rights issues. We have been unpleasantly surprised by the willingness to cut or even omit to pay dividends. Dividend cuts are no longer a last resort. A number of UK FTSE 100 companies have cut their payouts twice in the past ten years. New equity issues may ensure financial survival for companies, but this comes at a high price to shareholders.

One of the best performing stocks in the UK market this year is Cookson (up 85%), a cyclical business that provides products for the steel industry. This is a capital intensive firm, reliant on a sector which is exposed to the vagaries of the economic cycle. The major acquisition of Foseco, funded by debt in October 2007, only increased the company's vulnerability. When the world economy turned down in the fourth quarter of 2008, demand for Cookson's products dried up. The shares fell 80% last year. With fixed costs in place based on higher demand, cash drained from the business and the company had no choice but to approach its shareholders with a rescue rights issue - a highly dilutive 12 new shares for every 1 existing share.

This is not a first for Cookson, the firm has form when it comes to tapping its long-suffering shareholders for cash. In the past 20 years it has had no fewer than five rights issues (see below).

2009: 12 for 1, **2002:** 8 for 5, **1995:** 1 for 5, **1993:** 1 for 4, **1991:** 2 for 9

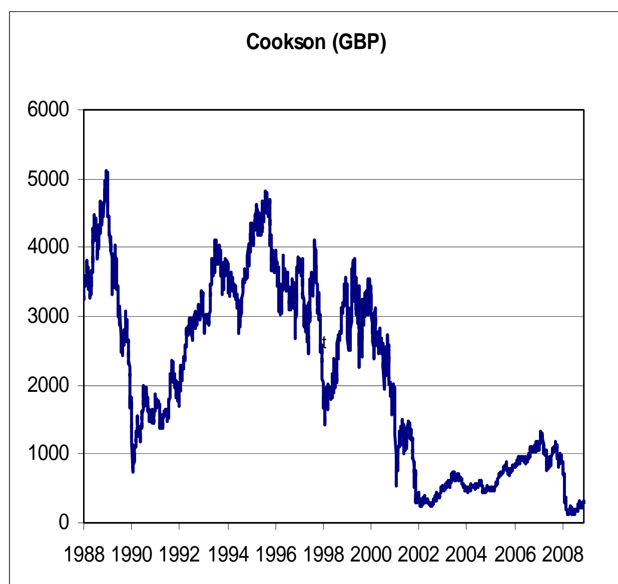

Figure 1 *Source: Bloomberg*

This would have left shareholders with 1,000 shares in 1990, who were unwilling or unable to take up their rights with the equivalent of only 16 shares today. Cookson Group's dividend has fallen from the equivalent of 121 pence per share in 1990 to 32 pence per share in 2008. The company did not pay a final divided in 2009 and is not expected to make a payment in 2010, according to the company's brokers. The capital value of Cookson shares has fallen 91% since its 1989 high (*see Figure 1*).

The sweet taste of success

The story of Cookson contrasts with a stock we have been buying in recent months; Nestlé.

Good investment ideas are few and far between. Here is a household name that many investors consider dull and predictable but that is where we prefer to look. In comparison with Cookson, Nestlé has called on its shareholders only once in twenty years for a marginally dilutive 1 for 25 rights issue in 1993. If you had bought 1000 shares in Nestle in 1990, and didn't take up the rights, you would still have the equivalent of 962 shares. In fact, this dilution has been more than offset by subsequent share buybacks since then. Whilst continuing to pay dividends, Nestlé has bought back 15bn Swiss francs of stock in the past two years which equates to just under 10% of its current market value.

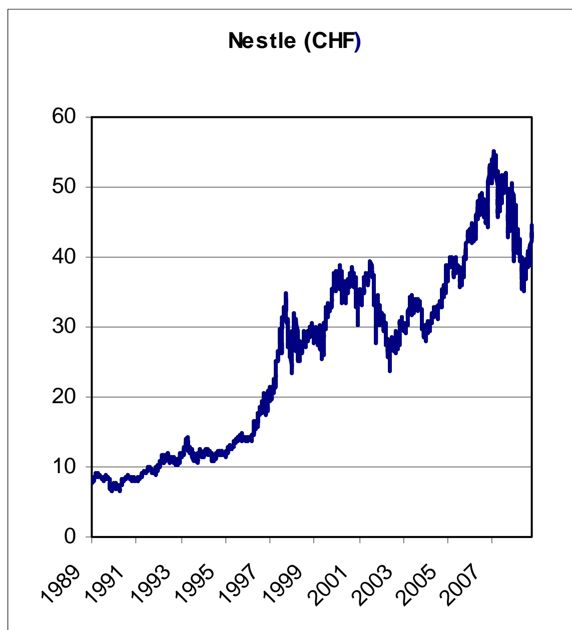

Figure 2 *Source: Bloomberg*

Since 1990 Nestlé has grown its dividend from 0.20 Swiss Francs in 1990 to 1.40 in 2009, a sevenfold rise. Over this period, the company's share price has risen from 8 Francs in 1990 to the current price of 43 Francs, a capital return of 444% (*see Figure 2*). For the patient, the combination of a strong, well diversified business and jealously guarded equity, leads to outstanding shareholder returns. Investors underrate predictable businesses in favour of excitement. This is no momentum stock or recovery story. Nestlé operates in a relatively low growth industry but with strong global brands such as KitKat, Nespresso and Perrier, the company has been able to produce consistent revenue and earnings growth well ahead of its peers. Management has a proven record of wise capital allocation, astutely selling 25% of the eye care business, Alcon at the top of the market in 2008 to Novartis for $11bn. The balance sheet is strong ('AA' rated) with minimal debt. Yet with this track record of value creation and resilience, Nestlé shares can be bought for less than 12 times 2010 earnings while Cookson's earnings are valued more highly. I wonder how many stockbrokers and analysts have recommended Cookson over the past twenty years in expectation of recovery, growth or higher dividend yield? Perhaps, for a while longer, the recovery trade will buck its long term trend but when it comes to investing irreplaceable capital, we would not bet on it.

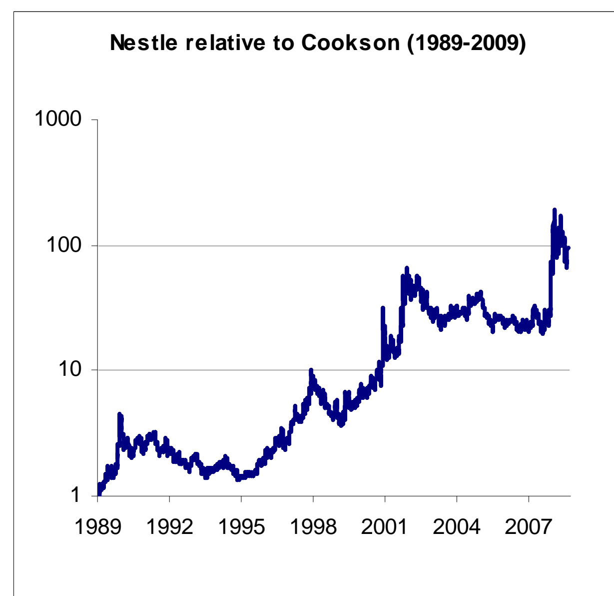

Figure 3 *Source: Bloomberg*

In summary, there remains cause for caution. We are sailing uncharted waters economically. A 'V' shaped recovery is not guaranteed but we are fortunate that quality is priced at a discount. While many temporary shareholders dip in and out for a month or so at a time, we hope to benefit from stocks like Nestlé providing steady growth for the next 20 years.

Sebastian Lyon

August 2009

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