TROY
ASSET MANAGEMENT

Investment Report N°30

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

Pity poor savers

"Spend, spend, spend!"
Mrs Viv Nicholson*, 1961 football pools winner.

At the August central bankers' symposium at Jackson Hole, Ben Bernanke deliberately lit the touch paper for markets to anticipate further monetary easing. In our July report, we had anticipated the prospect of policy makers resorting to further quantitative easing (*N°29, QE2. Not if, but when*). But Mr Bernanke was not alone in pronouncing the prospect of further stimulus. Britain is also expected to follow in the coming months. A clear policy shift has taken place from avoiding deflation to targeting higher levels of inflation.

In a television interview, Deputy Governor of the Bank of England, Charlie Bean made revealing comments, implying that the Bank would like us all to take a leaf out of Mrs Nicholson's book, telling savers to stop saving and to spend more for the sake of Britain's economy. This remarkable admission, by a senior policy maker, highlights the phoney financial world we live in and the ongoing desperate attempts to turn the clock back to 2007.

Mr Bean is wrong. No saver became wealthy by spending. Nevertheless, the interview demonstrates the unspoken conspiracy to devalue savers' hard-earned cash – '*You may as well spend it because we are debasing its value every day*'. The misconception, that borrowing our way to growth and bringing spending forward from the future, explains the persistent mistakes of economic policy over the past fifteen years or more. Consumption does not lead to wealth. Just ask Mrs Nicholson! It is well invested ***capital*** – savings and investment – that lead to sustainable growth and prosperity.

* *According to the Daily Mail, Littlewoods Pools winner, Mrs Nicholson, won £152,000 in 1961 (the equivalent to approximately £5m today) and now lives on an £87-a-week pension.*

Dave gives the green light

Quantitative easing has been given the thumbs up by David Cameron, as the only way out of the economic pickle he inherited. Having taken action to turn around the worst fiscal position in the G7, he sees the need to alleviate the pain of the squeeze on public spending with easing of monetary policy. According to Reuters, on 11th October, Mr Cameron said;

"It's monetary policy that is a better lever in terms of trying to make sure that the economy is progressing and demand is growing."

With interest rates already at 0.5% what more can be done? The BoE could follow Japan and cut rates to 0.1% but will it make much difference? No, Mr Cameron was giving the go ahead for round two of quantitative easing – we get the message – another shot fired in the race to debase. Austerity is for savers too.

When money dies

The lessons of debasing a currency are there for all to see. It is no coincidence that this summer's popular read for investment professionals was ***When Money Dies – the nightmare of the Weimar hyper-inflation*** by Adam Fergusson (*Old Street Publishing*). First published back in 1975, during a period of high

(but not hyper) inflation in the UK, the book was re-printed after a plug from Warren Buffett and the price of the original hardback soared to over $1,000 on eBay.

We were fortunate enough to have the author visit us at Troy's offices recently. As a historian, he is clearly unnerved by the actions taken by governments since the credit crisis began in 2008 and feels that the lessons of the past have not been learned (or have been conveniently forgotten) by central bankers.

As Adam Fergusson puts it…

"*Money may no longer be physically printed and distributed in the voluminous quantities of 1923. However, 'quantitative easing', that modern euphemism for surreptitious deficit financing in an electronic era, can no less become an assault on monetary discipline. Whatever the reason for a country's deficit– necessity or profligacy, unwillingness to tax or blindness to expenditure –it is beguiling to suppose that if the day of reckoning is postponed economic recovery will come in time to prevent higher unemployment or deeper recession. What if it does not? It is alarming that some respected bankers and economists today, in the US and in Britain, are still able to commend 'the printing press' as a fail safe, a last resort. A country's budget can indeed be balanced in that way, but at a cost, to whatever degree, of its citizens' savings and pensions, their confidence and trust, their morals and their morale.*"

Mr Fergusson concludes his book by providing us with the lessons from the Weimar experience. Ultimately what broke the German economy in 1923 was the constant taking of the soft political option. "*The longer the delay, the more savage the cure*".

Mouldy apples and mouldy pears

Further money printing is unlikely to narrow the gap between the economy and financial markets. Volatility will increase as investors have to navigate between increased liquidity and poor fundamentals. In the words of David Roche from Independent Strategy, "*Ironically, as QE2 reduces the **cost** of capital, it increases the **risk** to capital. A state of affairs that is absurd, momentary and bound to end in tears*". Stock markets have travelled hopefully in recent months. Any possibility of watered down or incremental easing may disappoint.

We have the unenviable task of choosing between relatively unattractive asset classes. Savers are being coerced into taking risk after a decade in which risk takers have been punished so savagely by dismal returns. Zero interest rates have distorted the price of assets that would otherwise be valued at a lower level, whether it be premium real estate, bonds, equities or commodities. The most frequently touted support for stocks, at current valuations, is their relative value compared to bonds. We are sceptical of this view.

The comparison between dividend yields and bond yields has been used *ad nauseam*, by strategists and fully invested fund mangers to validate a positive stance on equities. We believe this is a dangerous justification to support investment in stocks at current levels.

The combination of QE, low returns on cash, risk aversion and the prospect of low economic growth has driven down government and corporate bond yields to historic lows this year. They are priced for perfection and offer no appeal to us. Those purchasing Treasuries or gilts at current levels are banking on a Japan-type outcome in the West. We view this as unlikely. Ten year yields offer an unappetising return of 2.5-3.5%. The risk of capital losses should yields rise, as we suspect they will, is being

ignored.

UK Earnings yield ratio ('Fed Model')

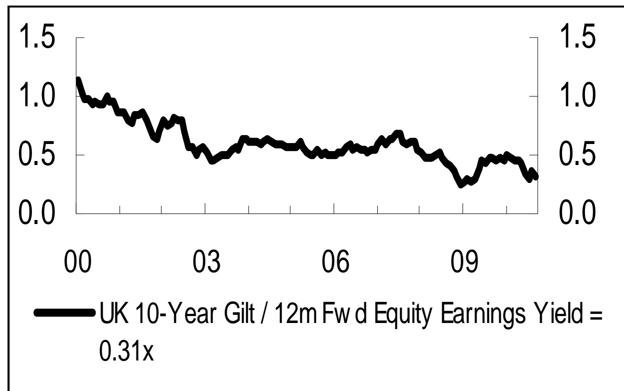

Figure 1 *Source Datastream/MF Global*

On this basis, we do not deny that equities look far more attractive when compared to bonds. Stocks not only offer a higher income but possible protection from inflation.

UK Dividend yield ratio

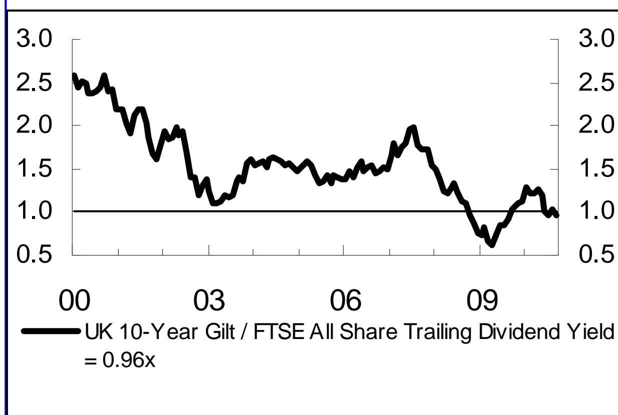

Figure 2 *Source Datastream/MF Global*

Nevertheless, the comparison is a relative point. It is rather like being asked if you prefer tapioca or blancmange when, in the past, profiteroles were on offer. As absolute investors, this relativity provides cold comfort. Whether one uses the earnings yield ratio (the discredited 'Fed model' - *see Figure 1*) or the dividend yield ratio (*see Figure 2*) the comparisons between bonds have been unhelpful for the last decade. While the comparison between bonds (nominal assets) with equities (real assets) did last from 1981–1997, over a longer time period the opposite relationship held from 1950–1968 and has been contradicted again since 2000. As bond yields have fallen, the path of equities diverged.

Falling bond yields imply a decline in growth, not an environment conducive to resilient profitability. The actions of policy makers to further depress bond yields have therefore distorted other asset prices – we are comparing mouldy apples (bonds) with mouldy pears (stocks).

No free lunch

Equities have failed to reward investors over the past decade for two reasons. First starting valuations were at extremes and second dividends have been dreadful. UK stock market dividend income has fallen by 29% in the past three years (*Source: Evolution Securities*).

The main reason given to support buying shares is that they have performed so poorly. There is little merit in this 'Buggins' turn' argument. In our view, the market is no more than fair value on an earnings basis, on a price/earnings ratio of 14.8 times, and poor value on a dividend yield of 3.1% (*Source: Financial Times*). From this starting value we anticipate unspectacular returns over the next few years. This does not rule out another Grand ol' Duke of York style run up as investors seek a home for their poor returning cash, but any such move will be unsustainable in our view.

Undervalued quality

There are thankfully exceptions to the rule. In ***absolute*** terms a number of 'Blue Chips' are attractively priced. The very same investors who make the theoretically lazy inference that equities are cheap because bonds are expensive fail to see just what is on offer. They prefer the glamour of buying expensive cyclicals that come with a seductive growth

story. We often say that investing should be as exciting as watching grass grow. The reward for this patience is the positive compounding of returns.

Our bias is to invest in those businesses that can sustain high unleveraged returns for years to come but have little requirement for continual investment. Ongoing capital investment is an impediment to compounding, particularly when it has to be done at low rates of return. Our core investments enjoy repeat revenues from goods or services that their customers buy again and again, out of necessity, unwavering loyalty, or pure habit. Unsurprisingly we favour those companies that produce life's necessities and little pleasures. These shares have historically been valued by investors at a meaningful premium.

Fortunately, this is not the case at the moment and blue chip stocks like Microsoft and Coca-Cola, that were valued at 60-70 times earnings a decade ago, are now on 10-16 times earnings. In the UK the likes of GlaxoSmithKline and British American Tobacco offer above average, sustainable and growing dividend yields. This is where we have been concentrating our portfolios. Myopic short term investors seek instant gratification and this creates a mispricing in slow burn, high quality stocks. For the patient, these solid global franchises, that are not reliant on any recovery in economic activity, should compound respectable returns in the years to come. Any deserved re-rating is a free and welcome gift.

Coca-Cola is a good example of a lightly-leveraged, high return, time-tested blue chip compounder that will still be around when I write Investment Report *Nº 100*. Like other stalwarts, the business has left its share price for dust. Since 2000, the company has enjoyed a compound annual growth rate in earnings of 14.4% and in shareholder equity of 12.4%, while the dividend has gone up at an annual rate of 10.3%. In contrast, the share price has inched up by just 0.4% per annum.

The economist J K Galbraith famously said that the only function of forecasting is to make astrology look respectable. But given how dependable Coca-Cola's operations are, some extrapolation may be illustrative. If Coke's business results in the next decade were identical to those of the last, but its share price stood still, then in 2020, on our calculations, Coca-Cola would be selling at just 1.6 times book value, and yielding nearly 8%. We sleep easy at night holding these types of investments despite all the Coke we drink!

Ten years on

It is ten years since I established Troy. The period has been a challenging one to practice investment. We have seen two 50% falls in stock markets—the hangover from the dot com bubble and the worst credit crisis since the 1930s. Troy has succeeded by avoiding errors rather than enjoying huge successes.

Ludwig von Mises, the great economist of the Austrian School, said that an entrepreneur "sees the past and the present as other people do but he judges the future in a different way." That has been Troy's strength over the past decade — both as investors and as a business. We expect the next ten years will be no less challenging than the last. I am very fortunate to be surrounded by a talented team and we all look forward to the next decade with caution and confidence.

Sebastian Lyon
October 2010

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