TROY
ASSET MANAGEMENT

www.taml.co.uk November 2011

Investment Report Nº·34

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

Another string to the bow

We are delighted to announce that Gabrielle Boyle will be joining Troy today as a Senior Fund Manager. Gabrielle is a proven investor with a strong track record and over 20 years experience. She joins us from NewSmith Capital Partners LLP where she was a Partner, responsible for Global Equity portfolios. Previously, Gabrielle was a Senior Managing Director and Portfolio Manager responsible for Global and International portfolios at Lazard Asset Management for 17 years. Her primary responsibility at Troy will be to manage the Trojan Capital Fund which Francis Brooke and I have been looking after, with the help of the rest of the team, since May 2008. The Capital Fund has a strong long-term track record, which we are confident Gabrielle will build on. She will enable us to cast our investment net wider internationally in addition to helping us with stock picking and asset allocation decisions. Gabrielle's investment performance matches our own, defending capital successfully in 2002 and 2008, while lagging stock markets in ebullient years like 2003 and 2009.

We are also pleased to report the promotion of Sean Beck and Hugo Ure to Investment Managers. Sean and Hugo joined Troy in 2009 as Investment Analysts. Hugo will assist Francis on the Equity Income portfolios including the Trojan Income Fund and Troy Income & Growth Trust, while Sean will support me on the Balanced mandates, including the Trojan Fund and Personal Assets Trust. The addition of Gabrielle, along with the recruitment of Analyst Alex Williams in the summer, takes Troy's investment team to six.

Volatility returns

"If two wrongs don't make a right, try three"
Richard Nixon

Markets will often take the occasional piece of negative news in their stride but investors can only put up with so much bad news. Europe's problems are well known. Combine them with the US fiscal problem, exacerbated by partisan politicians happy to take the Federal debt ceiling negotiations to the limit, and it was too much to keep investor confidence from sagging. The subsequent Standard & Poor's downgrade of US Federal creditworthiness from 'AAA' and mounting evidence of a weakening economy on both sides of the Atlantic acted as further bruising blows.

Volatility returned to markets in the third quarter, which made conditions more challenging than usual. Liquidity was low and much of the action was a function of index buying either via index futures or Exchange Traded Funds. Once upon a time, indices represented a market of stocks, today they represent a stock market that is bought and sold wholesale and without discernment.

In August and September the FTSE 100 index swung by more than 3% on 10 out of the 44 trading days. In the prior two months, by comparison, the index did not move once by even as much as 2% on a single trading day. This was not quite a repeat of the cardiac arrest witnessed in 2008 but it was more than a heart murmur. The volatility continued to frustrate us as only a few select

stocks presented themselves at levels that, to us, offer sufficient reward for commensurate risk.

Swiss join the race

The unmanageable government problems in Europe and the US have moved to the currency markets. The race to debase, which we have written about in the past, took a turn for the worse in September. Until then, the Swiss had been overwhelmed by huge international demand for their honest money. The Franc, a bastion of currency solidity proved too strong for the Swiss National Bank and fearing for the nation's exporters it took the drastic action of capping the Franc at 1.20 Euros – committing to buy "unlimited" amounts of foreign exchange to hold that level. This had a marked effect on the value of the currency, falling by 8% in a day against all major currencies. This dramatic move reduced the number of safe currencies by one…and there weren't many to start with. The decision adds lustre to the one currency that central bankers can't print.

Helicopter Merv

We warned in the summer of 2010 (*see Investment Report Nº 29*) that sequels of quantitative easing would be less effective than the first round in early 2009. In October, goaded on by Martin Wolf of the Financial Times ("*Time to think the unthinkable and start printing again*" September 29th), the Bank of England decided to press the print button to the tune of £75bn. They have kept their options open as to whether there will be further doses in the future.

This is an extraordinary (but unsurprising) decision in light of the current 20-year high in the retail price index at 5.6%. The inflation target of 2% has become an embarrassment. In June 2010, in his Mansion House speech, the Governor said that "No one should doubt our determination to meet the target". The evidence suggests an intentional lack of determination. Mervyn King shows remarkable confidence in his ability to forecast inflation falling, when the Bank's track record over the past two years has been dreadful. JK Galbraith once said, "*There are two types of forecasters: those who don't know and those who don't know they don't know.*"

Our concern is that the Monetary Policy Committee has embraced a new policy. Rather than using QE as a one off, defibrillator-style, shock treatment the course is set for a continuous dose of medication. We may look back in years to come and realise that this second round of QE was when the Bank began to monetise government debt. In 2009 and 2010, members of the MPC promised that the easing process would be reversed sometime in the future. This time around there was silence. At £275bn and growing, the prospect of putting the policy into reverse lacks credibility. Are we now sleepwalking towards further debasement and far greater levels of inflation - the cruellest tax of all? With no indexation or taper relief to mitigate the impact of capital gains tax, private investors are more vulnerable than ever to rising nominal prices.

Dead hand

Markets are as febrile as ever. The decision to print and the announcement that France and Germany will 'deal with' the Euro crisis has buoyed stock markets in recent weeks. Investors are under the impression that

politicians can wave a magic wand and solve the fiscal difficulties of the Euro area but these intractable problems have no easy solution. More debt is not the answer - it is a lethal injection of the same toxin. US investor John Hussman summarises the issue succinctly, "You can't get OUT by walking through yet another door marked IN". As I write, stock markets are celebrating the increase in the European Financial Stability Facility, by leveraging up the original debt further. While we bask in the warmth of another rally, this is like putting a newspaper on a damp wood fire. You get a flare up for a few seconds but the fire does not get going properly. For every bail-out, the debts remain.

With these actions, the powers that be are frustrating the abilities of rational, long term investors to allocate capital correctly. Central bankers are determined to stop asset prices (whether property, bonds or stocks) from falling to their natural level, thereby deferring the gravitational pull of valuation. This only delays the end of the bear market that we long for. Markets are no longer free but constantly subject to intervention. Adam Smith's invisible hand of the market has been replaced by the clunking fist of the state. Government intervention has brought politics front and centre. This has been most apparent in the reregulation of banks but the fingers of government intrusion are slithering into additional areas of economic activity. In this phoney world there is no longer reality in markets or the cost of money, only distortions. eBay may be the last true free market remaining. Fund managers hanker for the days when corporate earnings and valuation were their prime concern. Unfortunately the need to second guess policy action is just as important. Russell Napier of CLSA told me recently, governments have become like football referees, who when the match is not going their way, pick up the ball and change the rules to suit them. This adds to the challenge.

Our prognosis may sound gloomy but we tend to think about risk as much as we do about possible returns. Our industry is irresponsibly over optimistic often to the cost of longsuffering investors. When risk taking doesn't work, it ***really*** doesn't work and investors are reminded what risk is all about.

The word is out

According to Dylan Grice of Société Générale, "The stock market has a dirty little secret: low risk equates to high returns…thus violating one of finance's fundamental tenets that higher risk equates to higher returns" (*see Figure 1 below*). Our approach to stock selection has been consistent over the past decade. Some investors have a habit of falling in love with highly valued stocks with a danger of extrapolating growth. Moreover, those who have lost money, paradoxically, feel they need to take more risk in order to recover those losses. Meanwhile the dull plodders are so often ignored. When people criticise us for our uninspiring holdings it gives us greater confidence.

Our strong value and quality bias delivers, not month by month or even year by year but over the medium term. The need to generate short term performance breeds impatience. Investors can be seduced by the prospect of a recovery play, often with a new exciting management team - more often than not, these stocks overpromise and under deliver. This recurring phenomenon is best encapsulated by Warren Buffett, "When a management with a reputation for brilliance

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tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact". By contrast quality stocks, we argue, are systematically undervalued. One of our plodders, British American Tobacco has been a core holding in Troy portfolios for nine years and continues to keep giving. In December 2000, BAT had a market capitalisation of £11bn. Since then the company has given loyal shareholders £15.2bn back in dividends and share buybacks. A decade later the company was valued at £50bn, with only a modest increase in the valuation. Company management matters but is often overemphasised as a means of value creation. Market position and sustainability of the business franchise, on the other hand is critical. At Troy, we would always prefer to back the horse rather than the jockey!

Sebastian Lyon   November 2011

Quality* Outperforms

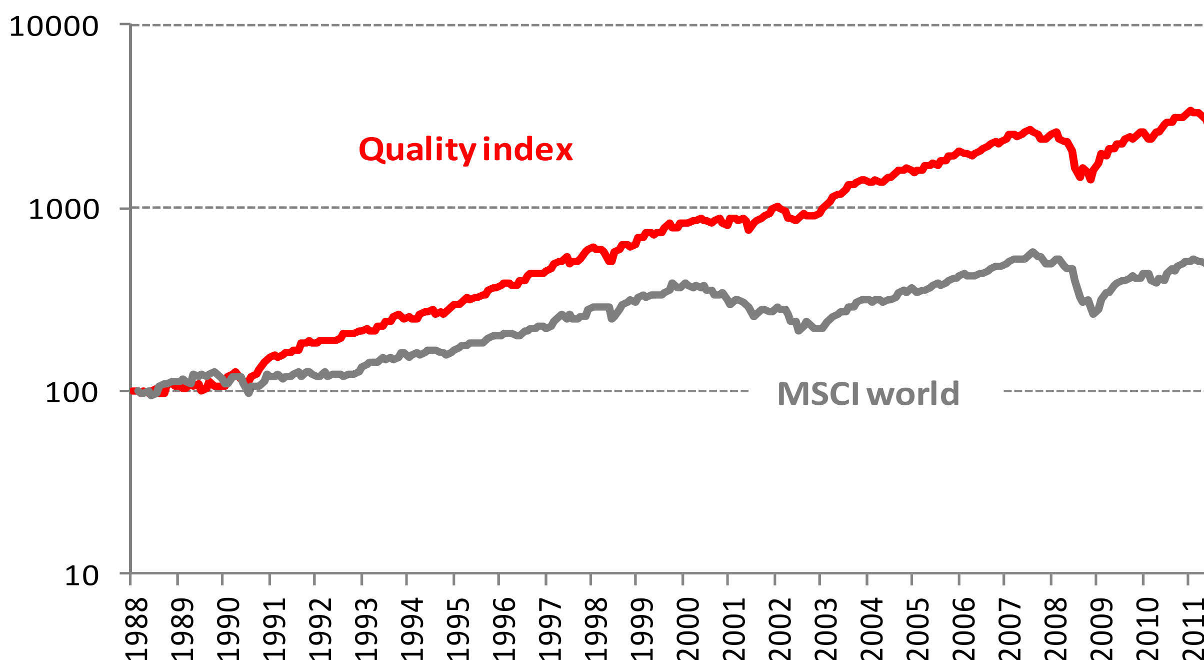

Figure 1   *Source; SG Cross Asset Research*

**As defined by FTSE All World stocks, excluding small and mid cap stocks, those performing operationally worse than their peers, those not earning their required returns on capital and those which are highly levered.*

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