TROY
ASSET MANAGEMENT

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Investment Report N°·42

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

A Solid Start

"*In science, knowledge is cumulative; in finance, knowledge is cyclical.*"
James Grant

All the Troy funds have made a solid start to 2014. As at the end of July and in total return terms for the year to date, the Trojan Fund has returned +4.4%, the Trojan Income Fund +4.7%, the Trojan Capital Fund +3.9% and the Spectrum Fund +4.2% (*Source: Lipper*). For those seeking relative comparisons, the FTSE All Share Index returned +1.3% for the same period and cash, as is now familiar, returned next to nothing.

The Trojan Fund's performance in particular will typically be out of step with the market, but it is important we stick to our established investment process. Style drift kills consistent, robust returns. We march to our own drum beat in the knowledge that there will be times when we are out of tune with the stock market. Last year I felt like a classical music lover that had turned up in error to a Metallica concert. The mood music has so far mellowed this year with a greater appreciation of many of our favoured long-term holdings. It is perhaps just as well we resisted the siren's song to change direction.

Neverland

There remains an illusion of normality in asset markets. Yet the gap between financial assets and the economy gets ever wider. Bubbly markets are not so much driven by greed (as they were in 2000 when investors sought riches from technology stocks) but are instead driven by the need for income. Prudence is judged as reckless and throwing caution to the wind conservative.

Record Breakers

In the summer of 2014, it seems barely a day goes past without some financial record being broken. In August, German government Bund yields fell to new lows, at less than 1.1%. Spanish government bonds, which only two years ago were seen as part of a peripheral basket case (alongside Portugal, Italy, Ireland and Greece) and yielded almost 7%, now yield 2.5% - allegedly their lowest since the French Revolution and currently lower than UK gilts (*Source: Financial Times, Bloomberg*). Perhaps PIIGS *can* fly. In another financial landmark, the UK Debt Management Office succeeded in issuing a long-dated (44-year) inflation-linked bond at a negative real yield for the first time, perhaps confirming our long held view that we are in a negative real yield world. The only question remaining is which negative real yield offers true value?

Like gravity, the prices of traditional low risk assets have dragged yields of higher risk investments ever lower. Bulgaria can now borrow for ten years at just over 3% and notoriously illiquid high yield bonds are a whisker away from their lowest yields ever. High risk assets are no longer priced according to risk but according to the hoped-for return. The income-hungry feel they have to lock in low returns today. They are

reluctantly speculating, unwilling or unable to wait for better opportunities tomorrow.
Holding cash, the most hated of assets, is now the big contrarian call because when almost everything is expensive in absolute terms, very little is expensive in relative terms. Cash today is even more controversial than gold. My colleague Robin Angus at Personal Assets Trust puts it plainly in his latest Quarterly Report (N°73 – see link http://www.patplc.co.uk/): "*rather than being a cowardly cop out, holding cash takes considerable courage.*" Cash and courage must be raised at the top of the market in preparation to apply both at the bottom. Although there is a need to be early, there is always a risk of being *too* early, as we have proven to be this cycle.

Over Reaching

We have lived with zero interest rates for over five years and the Credit Crunch shock has dissipated. Investors have not only progressively reached out further for yield, but have also been forced to accept decreasing levels of liquidity. The former we have written about *ad nauseam* on these pages so for now we will deal with the latter issue of liquidity.

Illiquid investments are often entered into in haste and exited with great difficulty. They are financial lobster pots, and we have seen many in our time. Today, the income-hungry are offered a smorgasbord of real estate investment trusts, catastrophe insurance bonds and green infrastructure funds. High quality and liquid equity income, occasionally viewed as a little dull, still delivers over the medium term compared to these tempting offers that are easily bought and less easily sold.

We are often asked why we do not invest in corporate bonds. The answer is simply illiquidity. Very occasionally, when a special situation crops up, such as our past purchases of BP bonds after the Macondo disaster, we might invest. This is rare. The bonds were only bought on the basis of offering equity-type returns and on the view that we would be happy to hold them to redemption.

Corporate bonds, once used as a mainstay of insurance company portfolios, are normally acquired to match known liabilities. The bonds are issued and traditionally held until redemption. Therefore, liquidity in the secondary market (in contrast to that of their blue chip equity cousins) is often extremely thin. Bid-offer spreads can be wide and prices opaque. New regulations are also hollowing out these markets. Banks are responding to rules that dictate that they must hold more capital to support merchant banking activities by predictably withdrawing capital allocated to market making. In consequence, there has been an exodus of dealers and securities held in dealer inventory have dwindled. According to the Royal Bank of Scotland trading volumes in the corporate bond market have declined by 70% since 2008. The prop desks have been abandoned.

A few years ago, I was called up by a young broker eager to do some corporate index-linked business with Troy. When I asked what the liquidity was like, he answered that investing £100,000 was easy. When I asked about investing 100 times that amount, the line went very quiet.

In the past few years, with the ongoing reach for yield, corporate bonds have found favour with retail investors who now own 37% of

credit compared with 27% in 2007 (*Source: Royal Bank of Scotland*). But these illiquid bond markets, whether plain vanilla investment grade, high-yield or emerging market, are ill-equipped to cope with a sell-off. Investors who had no trouble buying these securities, ideally manufactured for those seeking an income from their savings, will likely find it easier for a camel to go through the eye of a needle than to sell *en masse*. In a recent Bloomberg article on the topic in hand, a UK money manager complained that when he tried to sell debt securities at the end of the first half of the year, "*It was way more difficult than it should have been… extracting a bid out of anyone was very, very difficult*". Who will open the door when the second, third and following investors knock? Any fire sale is likely to burn even brighter and hotter because more of these illiquid assets have found homes in exchange traded and mutual funds that give the untested promise of instant liquidity. The latest junk bond flows indicate that a decline in value by just 1.3% was enough to set off a record weekly outflow of $7.1bn (*Source: Financial Times*). Those more used to playing bridge (private investors used to cash and blue chip equities) are forced to play poker because that is where the stakes are highest. In a rare example of pre-crisis foresight, the Federal Reserve is said to be looking at introducing exit penalties on bond funds to avert a potential run by nervous investors.

Furthermore, zero interest rates have led to an increase of correlation across most asset classes, meaning that investments in these bonds offer little, if any, diversification benefit for a portfolio should equities change their direction of travel. There is interdependency between the bond and equity markets. Corporates have been the marginal buyer of their shares, issuing bonds to fund share buybacks. In the words of David Roche from Independent Strategy, *"The rise in corporate leverage is general and worldwide. Much of it in the US was to fund share buybacks. So the equity bull market is actually (partly) a debt binge. Beware when it ends!"*

The recent past may prove no guide to the future. When radical monetary policies are inevitably reversed, or even the attempt is made to reverse them, it is likely to be very disruptive. This is no more so than in the high-yield market where the premium received over US Treasuries (*See Figure 1*) is almost the smallest it has ever been. Spreads are tighter than Rod Stewart's trousers!

The Cycle is Dead, Long Live the Cycle

The prevailing consensus appears to be that, while all assets are fully valued today, this will last for a long time to come. The argument is reminiscent of the view espoused by the economist Irving Fisher in 1929 when he said that, "*Stock prices have reached what looks like a permanently high plateau.*" Of course, these sentiments may be right, at least for a while. But it is our view that recent market returns will not be repeated as they have been simply borrowed from the future. The VIX "Fear" Index of implied US stock market volatility may be near the lows of February 2007 but it was lower before (in 2004 and 1995) from which point stock markets rose sharply. Those that endured high volatility know that it comes with the enjoyment of attractive buying prices. The same does not necessarily follow for low volatility. The benign environment can continue for some time. For those who believe they should *be paid* to take risk and *not pay* to take risk, such periods are frustrating.

A Library of Mistakes

As the quote from James Grant at the beginning of this report suggests, memories are short in finance. At the end of April, I attended the grand opening of the Library of Mistakes in Edinburgh by Lord Lamont of Lerwick who demonstrated wit and self-deprecation uncommon to most politicians. The purpose of the Library, "*changing the world one mistake at a time*", is to encourage its visitors to ask those difficult questions that many are too polite to ask. In the words of the Keeper of the Library, Russell Napier, "*the world needs a library of mistakes because smart people keep doing stupid things*". In particular, it serves as an antidote for students of finance who are (still) taught in mathematical equations rather than history. If the great financial crisis taught us one thing, it is that those black boxes of algebra failed when the chips were down. I have donated a number of treasured documents to the library including a buy note on Enron from a well-known investment bank, published just three weeks before it went bust, along with my collection of Report and Accounts of GEC and Marconi from 1996-2001. We hope to continue to learn from other people's mistakes to minimise the cost of our own. We would encourage those in Edinburgh to make a visit.

We wish our investors a happy summer.

Sebastian Lyon August 2014

Yield Spread between US high-yield corporate bonds and US Treasuries

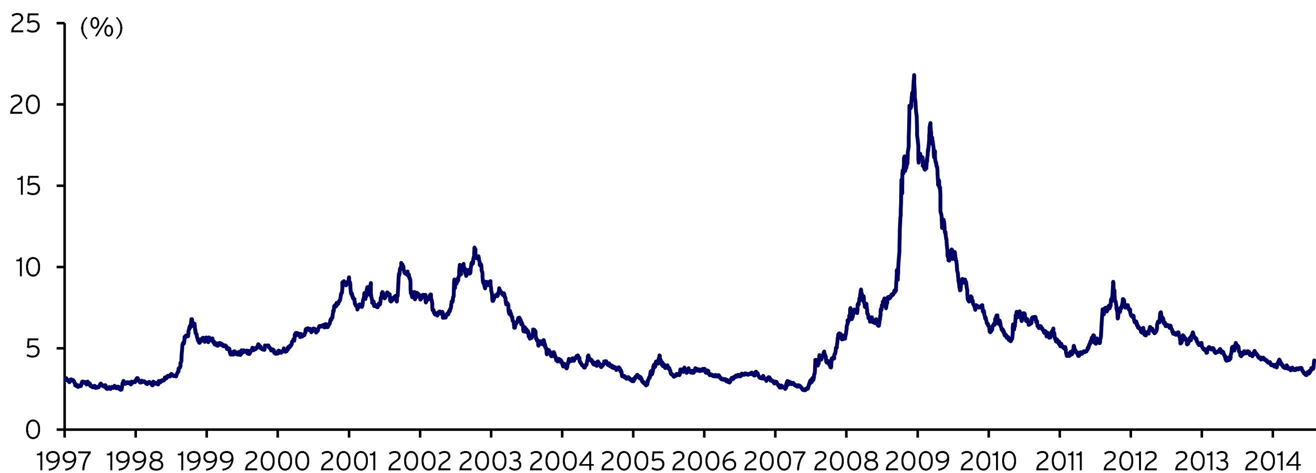

Figure 1 *Source: CLSA, August 2014*

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