TROY
ASSET MANAGEMENT

www.taml.co.uk January 2015

Investment Report No.44

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

2014 – A better year

After a challenging 2013 the Trojan Fund returned to form in 2014, producing a total return of +8.9% compared to a FTSE All Share return of +1.2%. Our multi-asset fund of funds, Spectrum, returned +7.4%. The fund is now managed by Tom Yeowart who joined us last year from Rothschild. While short term investment performance should be treated with caution, the more fully-invested equity funds did better still. The Trojan Income Fund built on its strong long-term track record, returning +10.0% to make it the second best performing fund in its highly competitive peer group, the IA UK Equity Income sector. The Trojan Capital Fund produced an even higher return of +15.0%.

Much of this success was thanks to stock picking being rewarded combined with a stronger dollar and the appeal of equity income in a yield-starved world; many of our holdings were materially rerated.

Another year of debasement

'The Bank collects all taxes, fines, loans and interest, and the price of all properties which it sells and auctions. The Bank never "goes broke". If the Bank runs out of money, the banker may issue as much as needed by writing on any ordinary paper.' Official Monopoly® Rules.

The activities of a central banker are now even less strenuous than this. No paper is required these days, just an entry through a computer. We may look back on 2014 as the year currency wars became vicious. The yen and the euro fell sharply while the rouble collapsed by 40% in sterling terms, a reminder in the case of Russia that deflation and hyperinflation are two sides of the same devalued coin. While we missed the Somalian Shilling, which appreciated by over 60% last year, the US dollar, gold (which we view unfashionably as a currency) and the Singapore dollar all performed well in sterling terms.

Former Swedish finance minister Anders Borg recently said, "*We are definitely in a period when currency turmoil is returning in a way we didn't see in the last 6 or 7 years of crisis. It was the dog that didn't bark*". In 2014 and early 2015 it has seemed once again that the preferred 'cure' for a weak economy is money printing. QE was supposed to be an emergency dose to bring the global economy back from near-death in 2009, but risks becoming long-term life support that paradoxically saps energy from markets. Not only has it failed to breathe new life into demand, but it prevents the death of excess supply, thereby providing more oxygen to the deflationary beast central bankers are attempting to slay. Six years after the Federal Reserve and the Bank of England instigated QE, the ECB has joined in. It is ironic that an Italian, Spaniard or Greek, with experience of their former currencies, would tell you that a more competitive currency is (by itself, anyway) not necessarily an advantage for an economy. The economic rationale of why the Mediterranean countries chose to join a 'strong currency union' risks being forgotten.

Faith in paper money is being tested as currency moves become ever more dramatic. An otherwise uneventful morning in January was interrupted by the Swiss franc strengthening (intraday) by as much as 30% against the pound as foreign exchange markets struggled to digest the news of the Swiss National Bank's abandonment of the franc's peg to the euro. The remarkable lack of liquidity in one of the most liquid of markets – foreign exchange – has been exposed, and currencies are not alone. Government bond markets are meant to be liquid, yet on 15th October last year that traditional rock of safety, the ten year US Treasury note, saw its yield fall from 2.20% to 1.86% in just a few hours. Asset markets are ceasing to function properly; our guess is there will be more 'unprecedented' episodes like these in the near future. Bonds, once derided as '*certificates of confiscation*' back in the early 1980s when yields reached 14%, are now considered as 'safe' on yields of 2% and below.

Down to zero and beyond

Despite periodic forecasts of interest rate rises since 2010, rates around the world continue to go in the opposite direction. The Canadians, the Swiss and even the Singaporeans cut rates in January, and outside emerging markets it is impossible to find a return on cash above +2%. The Swiss are now charging 0.75% to hold francs and bankers remain in a limbo-dancing competition to see how low they can go. We would not hold our breath for the Federal Reserve to hike rates. It may prove short-lived even if they do. A strengthening US dollar is already having a tightening effect. We suspect that the US cannot afford a very strong dollar for a sustained period.

It is not just Swiss francs that offer negative nominal returns; many bonds are locking in negative returns, around $4tn of sovereign debt at last count. This compares to around $1.3tn of gold held within official reserves, according to data sourced from the World Gold Council and assuming a gold price of $1,300 per troy ounce. Given that many criticise gold because it offers no income return, holding gold bullion as insurance in markets like these looks comparatively rational.

Fifteen years and counting

In 2014 the FTSE 100 Index again failed to match its all-time high of 15 years ago and the Index's cumulative capital return over the five years to the end of 2014, following its energetic rebound from the lows of 2009 was a mere 21% (Figure 1- back page). The majority of the 47% total return achieved from UK equity markets, over the last five years, has come from dividends and their subsequent reinvestment. Such a meagre capital return highlights the importance of investing in companies or funds that provide attractive dividends and reliable dividend growth. Yet optimism still abounds. According to *Investor's Intelligence* the annual average of the Bull/Bear ratio in 2014 was the second highest on record over the past 50 years and the virtues of index tracking are being espoused once more. 2014 saw record cash flow into US domestic equity index funds, previous peaks having been in 1999 and 2008.

Zero interest rates and low bond yields have been seen as supports to stocks in recent years but record low yields and collapsing oil & copper prices may be telling us something more worrying. Back in the early 1990s I found myself as a young graduate trainee

stuck in the lift with the Chairman of the small merchant bank, Singer & Friedlander. I recall nervously attempting to make conversation, trying to reconcile paradoxical moves between the UK gilt market and stocks. He turned to me and said, *"more often than not, it is the bond market that's right."* Today the bond and commodity markets point to a very weak global economy (Figure 2- back page).

Being selective

The oil price fall surprised many, ourselves included. Brent crude had traded steadily between $90 and $120 a barrel since 2010. Following the falls to below $50 earlier this month, many who never predicted the fall are happy to forecast that we will never see $100 again and that the price will stay low for years to come. But we have been here before. In 2008 the price fell by almost 80%, putting the recent fall – and prophecies of permanently depressed oil prices – into perspective.

A couple of years ago an investor asked how we could benefit from the fracking revolution. In our view, such capital intensive areas are unlikely to produce attractive returns and we are thankful that we ducked the fashion. US shale related stocks are drowning in a reservoir of debt and collapsing revenues. Our preference is to invest in industries where much less capital is required and returns are high. This does mean we will miss out, from time to time, on cyclical excitements.

Challenges ahead

To forecast increased volatility in 2015 is unhelpful and trite. Volatility provides opportunity as well as risk and we hope for the emergence of long term investment opportunities from a world of subterranean yields.

The pending UK General Election in May is likely to lead to further sterling weakness, as markets loathe political uncertainty. More importantly, the shifting sands of currencies and commodities will hit corporate earnings very hard in the coming year. Analysts are only just beginning to adjust for the sharp moves in rates and prices in the latter part of 2014. But even these are inconsequential concerns compared to a growing dread that financial assets have become disconnected from reality. The optimists hope that this wonder voyage will continue to be buoyed on a sea of QE-driven liquidity. The realists recognise that the economic fundamentals are not improving. The world has been muddling through since the crisis. Perhaps that will continue in 2015. The question remains can bond and stock markets continue in the same direction when they are giving such different messages?

Sebastian Lyon January 2015

Once, Twice...

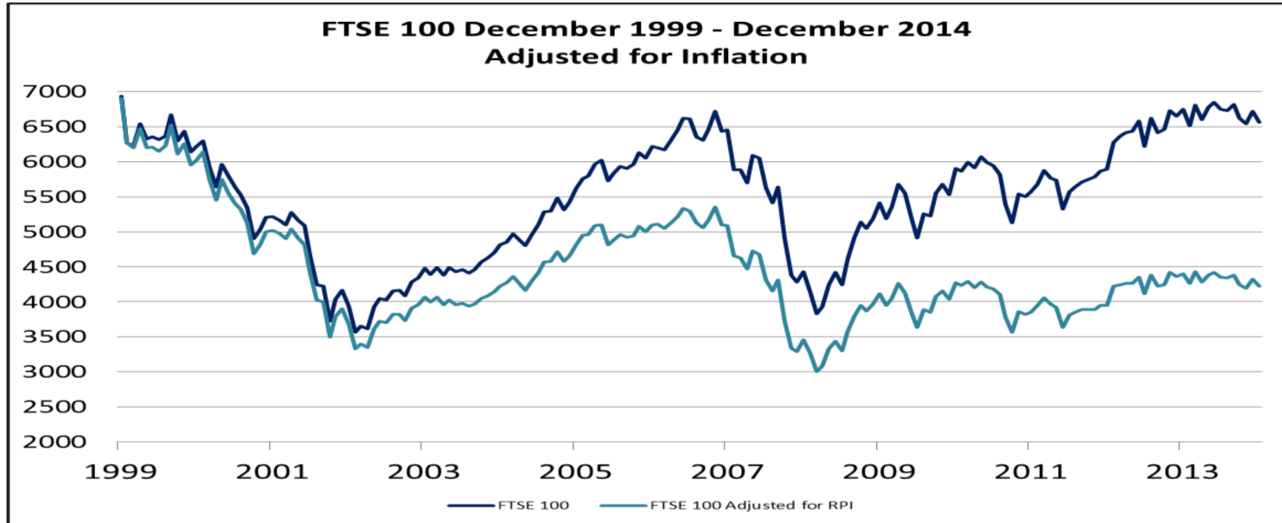

Figure 1 *Source: Bloomberg, 30 January 2015*

"I will show you fear in a handful of dust" T. S. Eliot, The Waste Land

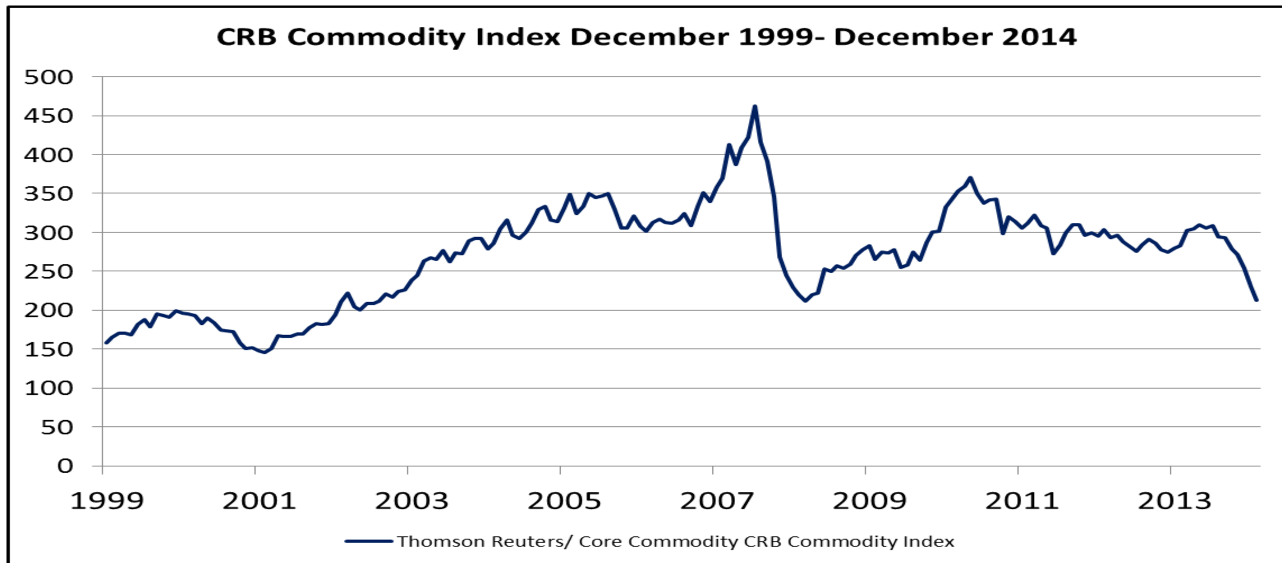

Figure 2 *Source: Bloomberg, 30 January 2015*

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