TROY
ASSET MANAGEMENT

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Investment Report N°46

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

Running hard to stand still

UK stock market progress has been lacklustre for over two years. Since March 2013, the FTSE 100 Index has failed to make a meaningful advance. There was some cheer when a new high was reached in April, 15 years after the last peak and after two 50% falls, but this was short-lived. The recent period has demonstrated the crucial contribution that dividends and their careful reinvestment has in providing satisfactory investment returns. The UK stock market remains weighed down by the unresolved Eurozone debt crisis, falling commodity prices led by oil, weaker emerging market growth and a stronger pound causing translational headwinds for multinationals reporting their results in sterling.

Today we are at a crossroads. Will stock markets continue along their elevated path or could they still tumble down the ravine of another severe drawdown? We are open-minded but concerned by the level of confidence in the consensus opinion that central bank support makes the immediate future a one-way bet. We have enjoyed an unprecedented, near four-year period devoid of any meaningful stock market correction and so it is tempting to believe that equity markets can no longer fall, or rather, will not be permitted to. As in previous cycles, caution has turned to complacency. Higher valuations are rationalised by a dearth of other opportunities and equity allocations drift higher, as if unchecked. Justification for this equity creep is that 'there is no alternative' to stocks or 'T.I.N.A.' as it is now known. When compared to the skinny yet certain returns offered by cash and low risk government bonds held until maturity, the potential promise of equities looks relatively appealing.

A fellow investment manager recently admitted to me that he would prefer to hold more cash (over bonds and stocks). However, the trivial yield of cash has compelled him to take other action. His rational dislike of conventional bonds, which offer negative asymmetric risk, meant his clients' portfolios were shifting towards an ever greater equity bias. This would be fine at or near market lows but at highs? Zero interest rates have inevitably shifted the bounds of prudence. Such is the dilemma for today's risk-averse investor, especially when contrarianism has been consistently punished.

Is it different this time? Part 1

No economic or financial cycle is exactly the same and new lessons are always learnt. However, history should not be ignored and, as James Grant of the Interest Rate Observer puts it, "*Progress is cumulative in science and engineering but cyclical in finance*". Bull markets have different causes but overvaluation has the same sorry outcome. The buoyant optimism of the dotcom-driven stock market boom of the late 1990s was markedly different from the leveraged expansion of the mid-2000s. Today, at similar market levels, the juvenile enthusiasm for markets is missing. Investors are weary and risk taking is reluctant. The US distressed debt investor, Howard Marks, suggests that investors may not be

consciously thinking bullishly but they are acting bullishly. He describes many investors as "handcuffed volunteers" and you do not face the mental anguish of going against the crowd in a chain gang.

Faith in central banks is presently very strong. Another reversal of monetary direction, perhaps a shift from a telegraphed tightening bias to the prospect of the need for more quantitative easing (QE), could unsettle sentiment and result in increased volatility. Bull markets can end, not with a bang, but with a whimper. Are the seeds being sown for a total lack of interest?

In recent weeks there has been a reminder of the dangers of credibility failure. Chinese retail investors were encouraged to believe that domestic stocks would not be permitted to fall as a bull market became a bubble under state sponsorship. The government, seeking to foster a stock market boom (to supersede an economic one) has struggled to ride to the rescue and the iron law of valuation has once again demonstrated its ubiquity. Chinese stocks are down 30% over eight weeks.

Correlation consternation

The present cycle is inevitably different in a number of subtle ways. A traditional balanced portfolio, of stocks and fixed interest, no longer offers investment return symmetry. The effect of QE and prolonged low interest rates has been to prompt a rise in both bond and stock prices. The protection that the diversification of bonds once offered is arguably no longer in place (*See Figures 1 and 2*). The charts show how the inverse relationship which had been in place for decades has broken down since 2010. What was once a clear-cut asset allocation decision is now fraught with danger as all asset classes have risen together. This breakdown in correlation highlights the attractiveness of cash after six years of a relentless and widespread bull market.

A notable feature of the dual bull market in bonds and equities has been the role of price-insensitive marginal buyers. Central banks have created trillions of dollars to buy bonds regardless of the price paid. Moreover, central banks are no longer satisfied with just manipulating credit, interest and foreign exchange markets. The Swiss National Bank is a prominent owner of many UK and US companies which fall under our own investment consideration. Its ownership results more from the bizarre spill over of desperate attempts to manage the currency than from a rational appraisal of corporate intrinsic value. CEOs incentivised by generous stock options have a personal incentive to pursue buybacks in order to shrink the denominator of the earnings per share (EPS) calculation. Passive Exchange Traded Funds are also by definition valuation agnostic and they have been the recipients of trillions of dollars of savings. These actors and others will periodically change roles to become marginal price-insensitive sellers.

Buoyed by buybacks

Arguably equities have risen because of low interest rates and not because of improving fundamentals. This has become a vicious circle. Low interest rates, along with the fact that most management compensation is linked to EPS growth, are likely to ensure that fundamentals remain weak. This is because EPS-based incentives and cheap borrowing lead management to prioritise stock repurchases over capital expenditure, with the effect of boosting EPS in the short term

at the expense of growth in the long term. Companies, not households or pension funds, have been the most consistent drivers behind the recent equity bull market. In favouring buybacks over capital investment, companies have created an uncertain outlook for their own long-term profitability. Coincidentally, the steep oil price fall over the past year has been followed by substantial capital expenditure cuts, meaning that a recovery in investment is perhaps deferred for a few more years yet. Equity valuations appear high at a time where the outlook for earnings growth is poor. The fact that corporations have been the only consistent buyers of stock suggests that traditional equity owners are considerably less bullish than the recent rise in prices would indicate.

The share buyback phenomenon is not dissimilar from the 2003-2008 cycle. In the US buybacks rose from $40bn in the first quarter of 2003 to peak at $175bn in the third quarter of 2007. Over the next two years they collapsed to $30bn and have risen ever since. No one knows when this trend will reverse but S&P 500 dividend payments and share buybacks combined for the 12 months to 31 March 2015 equated to just over 100% of S&P reported earnings. The economist, Herb Stein said, "*If something cannot go on forever, it will stop,*" but the expectation today seems to be that this trend of distributing all profits will be sustained. Is this part of the cycle very different from the last one?

That bond prices should be elevated currently is somewhat explainable given low interest rates and low inflation expectations. But the extreme depths to which yields have stooped, particularly in corporate bond markets, is at odds with the compensation lenders usually require for assuming credit risk. Given the aforementioned weakness in growth fundamentals, the capacity of corporates to service their debt is surely vulnerable, particularly if we enter a period of rising market interest rates. This argument is leant further credence by the fact that global corporate debt, as a percent of GDP, has more than doubled from 26% to 56% since 2000, according to McKinsey. These frailties are possibly beginning to just be acknowledged by way of a small widening of corporate spreads over gilt yields.

The projected rise in bank policy rates could be the trigger for a correction in equity and corporate bond markets, seeing most asset classes fall together. A decline in the gold price has already materialised, perhaps presaging the effects of higher interest rates on other asset classes.

How long for this bull market?

The current bull cycle is very long in the tooth at 75 months and counting (*see Figure 3*). This is the longest rally of its type since the 1940s, longer in duration than the bull market of the late 1990s. While financial history is being made and records broken, it is notable that the past three bull phases have been exceptionally long compared to previous cycles. Notably all three have coincided with very loose monetary policy from the Federal Reserve. The McChesney Martin adage of "*removing the punchbowl just as the party gets started*" has been forgotten. His most recent successors as Chair of the Federal Reserve have instead taken the view that it is their job to spike the bowl to keep the party going.

With an understandable look of scepticism, we are often asked, "What is the catalyst that will change market sentiment?" There are

always the Rumsfeldian "unknown unknowns" but, by definition, these cannot inform an investment decision. The principal "known unknowns" are material bond market weakness, deteriorating economic growth which would affect profits and injure buybacks, or a policy error – most likely central banks being behind the curve – which would have nasty inflationary implications. We will return to the question of "Is it different this time?" in future reports.

Insurance just got cheaper

It has been a testing time for those holding gold. Gold remains, in our view, important portfolio insurance. Currency debasement is ongoing, notably in Japan and Europe, but we believe it is only in abeyance elsewhere.

We do not forecast the gold price. Its value is likely to rise and fall inversely with confidence in fiat money. Central banks are using the might of their balance sheets to avoid deflation. Yet despite the money printing, the gold price has weakened and investors are now shunning the metal precisely because it has fallen. Investors rarely questioned its diversification merits when the price of bullion was going up, but are fearful as it falls. Momentum retains a powerful hold. As a hedge against future market instability and ongoing monetary experimentation, gold has become cheaper. To act as genuine insurance against the other risks within the Trojan Fund, the insurance coverage has to be substantial. At the moment that cover amounts to around 10% of the Fund's assets. In our opinion much less would result in meaningless protection. Much more would not represent insurance but rather a statement that governments and central banks are certain to lose control of money supply. Demand for gold has waned as confidence grows that conventional asset prices will continue to flower under the care of central bankers. The normalisation of interest rates is the key focus at present in anticipation of the Fed raising rates later this year. So far central banks have delayed interest rate normalisation after many false dawns in recent years. Debt levels have risen not fallen since 2009 so higher rates are likely to test the endurance of both global economies and financial markets.

Electric & General

Troy is delighted to have taken over the management of the Electric and General Investment Fund effective from the 1st July 2015. The Fund's investment objective is to achieve long-term growth in capital and income by investing in a portfolio of international companies. Gabrielle Boyle will manage Electric and General, which she will run alongside the Trojan Global Equity Fund.

We wish our investors a restful summer.

Sebastian Lyon August 2015

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Before & After

Stock market and bond market correlations move from negative to positive

Correlation before 2010 = -0.6

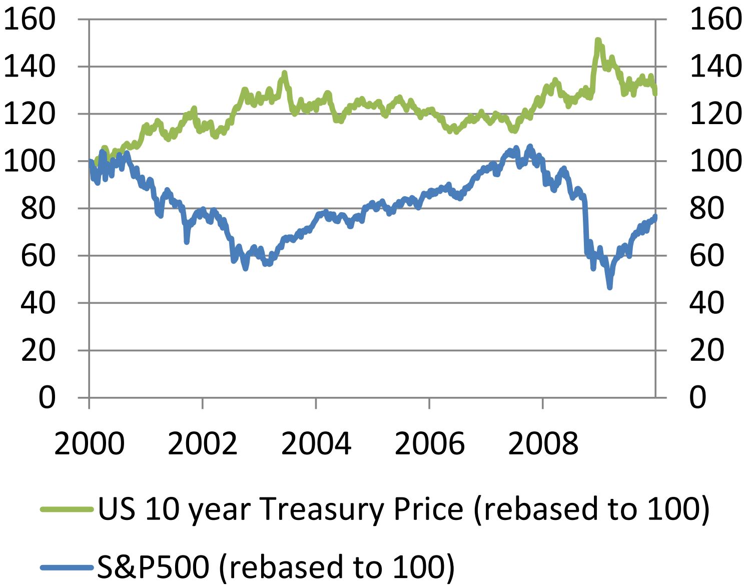

Figure 1 *Source: Bloomberg*

Correlation after 2010 = +0.3

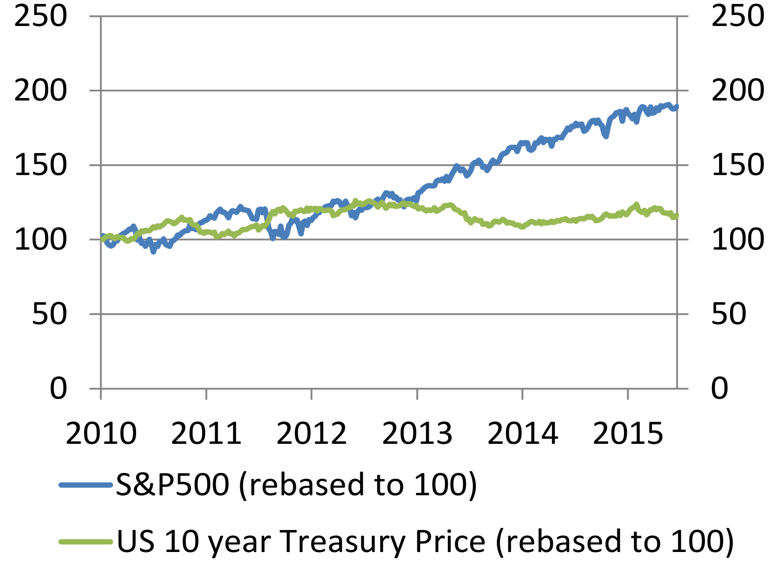

Figure 2 *Source: Bloomberg*

Long in the tooth – the current bull market is 75 months old and counting

S&P 500 – Length Of Bull Phases In Months 1943-2015

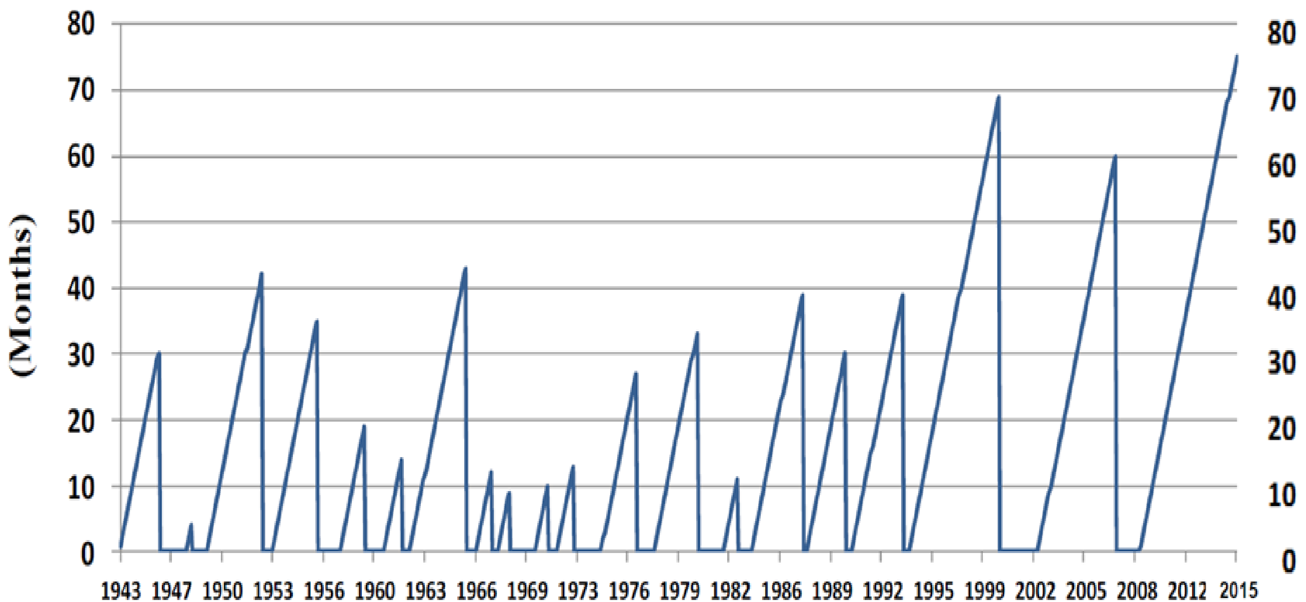

Figure 3 *Source: Societe Generale*