TROY
ASSET MANAGEMENT

www.taml.co.uk November 2015

# Investment Report N°·47

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

## The end of the beginning

*"The future ain't what it used to be"*
Yogi Berra

Stock markets were long overdue a correction, as we indicated in our August Report (N°·46). The question is whether the short, sharp shock investors experienced in the second half of August and the month of September was a temporary correction or the beginning of something more meaningful. At its worst, the FTSE 100 Index fell 17% from its peak in April, while the S&P 500 suffered a 12% retreat. Stocks have rallied since the end of September buoyed by the Federal Reserve's decision to delay normalising interest rates (again). Numerous market commentators have said quantitative easing is the monetary equivalent of heroin and markets have become dangerously addicted to the hit. Investors think and behave like relapsed patients, still looking forward to their next fix but failing to recognise that each high is less potent than the last.

As we head towards 2016, the potential for further shocks and greater volatility should not be ruled out. The market's twin props of cheap debt and stable corporate earnings look vulnerable. Corporate bond yields are decoupling from their government equivalents as (US corporate BAA) yield spreads over government bonds have increased from 2.5% to 3.3%, back to where they were in the teeth of the Euro crisis in 2011 (*see Figure 1*). The stock market rally since 2009 has been partly predicated on cheap and abundant corporate debt to fund the repurchase of stock and M&A but credit conditions appear to be coming under pressure. Even if the Fed does not raise rates, the market is doing the job for them. The invisible hand of the free market is beginning to make its presence felt after being handcuffed to non-market forces for so long.

UK and US corporate earnings are coming under pressure, not just from the deleterious effects of currency translation but also from falling levels of demand and excess supply crimping margins. Low investment hurdle rates have led to ever-decreasing returns, as zero interest rates have encouraged overcapacity. This is evident in various sectors including energy. The impact of traditional industries being disrupted by new entrants is another contributor to declines in profits. The prime example is Tesco being disrupted by Amazon. Many of these disrupters' shareholders seem happy not receiving a traditionally attractive return for their investment, thus providing capital at a very low cost; this is a luxury the shareholders of the incumbents cannot afford.

Following recent downgrades, earnings in the US are no higher than they were a year ago. In the UK, owing to the market's reliance on natural resources, earnings have been coming down for some time (*see Figure 2*). Having fallen from their peaks, are markets offering value? Alas no. Stocks are yet to be compellingly cheap. With few exceptions, quality assets remain fully valued, while what looks myopically cheap is risky. A recent spate of profits warnings from companies, including Rolls Royce, Meggitt and Wal-Mart demonstrate that deteriorating profitability is not discounted.

## QE4?

Against this deteriorating background there is much hope for renewed stimulus and even more quantitative easing. Stock markets appear to be schizophrenic, one minute wanting the reassurance of normalised interest rates and a recovered economy and the next, like Pavlov's dogs, desiring weaker growth so as to prompt further stimulus. It is unlikely that such a U-turn in U.S. policy will be forthcoming anytime soon. The Federal Reserve risks losing credibility unless such a reversal is fully justified.

As worldwide economic momentum deteriorates, could we face a global downturn in 2016, with interest rates still at all-time lows? Perhaps; this is not a central case, but it is looking possible. Whether the Fed decides to raise interest rates in the short term may be academic. As Gerard Minack of Minack Advisers states, "*the US is almost certain to enter the next recession with exceptionally low rates and little political stomach for aggressive fiscal response.*"

## Is it different this time? Part 2

Since 2007, there has been a feeling that we have been witnessing economic history. Investors have had to learn 'on the hoof' in a world of unorthodox monetary policy. We may now be entering a new chapter, where we do not see the normalisation of monetary policy (as has long been the expectation) but instead are confronted with a further step into the financial unknown.

There has been an overreliance by governments on central banks to do the economic heavy lifting but their powers are limited. They have, hitherto, failed to create consumer price inflation. Something will have to give. Raghuram Rajan, the Governor of the Reserve Bank of India hinted as much when he said in August;

*"I think it is quite legitimate for central banks to say at some point we can't carry the burden ourselves. In fact we may not have the tools to do everything that is asked of us...Don't keep asking us to do more because at some point we get into territory where the consequences may be more bad than good if we actually act."*

Policy makers have become reactive rather than pre-emptive. "Data dependency" is the ultimate wait-and-see policy, which leaves them reacting to events rather than anticipating them. The fever surrounding the Federal Reserve September meeting and the question of "will they or won't they" raise rates is evidence that the official policy of 'forward interest rate guidance' should be relabelled 'forward confusion'. At some stage, monetary policy may have reached its stock market limitations.

## The first cut is the deepest

The present cycle is different from the last in many respects but one sign of cyclical maturity is deteriorating profits, resulting in dividend cuts. This is not so surprising. With the reach for yield, company managements have been rewarded by investors for increasing dividends and stretching pay-out ratios. A fall in profits leads to a reappraisal of the sustainability of those payments. While bond coupons have to be paid if insolvency is to be avoided, dividends do not.

Capita Asset Services forecasts dividend growth in the UK of +3% in 2016 compared to +6.8% this year. This may prove to be optimistic. A cut from a large FTSE 100 company may push dividend growth into the red for the first time since 2010 (*see Figure 3*). In our analysis during the 2001-3 downturn, ten FTSE 100 companies cut or passed their dividends. These included British Airways, BT and Marconi. In the Great Recession from 2008-2010 that number rose to over thirty with some firms, like RBS, still to return to the dividend list.

Judging by the twelve dividend cuts of the UK's largest publicly-listed companies since 2014, which include three food retailers, Glencore and Standard Chartered, we may be in a third downwards cycle already. High yields, in the commodities and energy sectors in particular, indicate further cuts may be coming over the next 18 months. On a more positive note, Lloyds Bank returning to the dividend list after six years of absence offers hope of renewed sources of income for investors.

The FTSE 100 dividend cover ratio has fallen from a comfortable 2.0x in 2010 to a more exposed 1.2x today according to Bloomberg. Some companies are now paying out 100% of their free cash flow to shareholders and some have resorted to using debt to fund their payouts. Dividends are now arguably more vulnerable and less permanent than they have been for many years. There is little room for error.

Within the UK Equity Income sector, the Trojan Income Fund is one of only two funds to grow its dividend without interruption over the past decade. Francis Brooke has been careful to diversify the Fund's income stream. We do not wish to be overly reliant on the small number of megacaps that contribute a disproportionate amount to aggregate UK dividends, particularly if they have a track record of cuts (*see Figure 4*).

Dividend history can be telling in terms of indicating corporate strength and is a key indicator we look to when analysing companies. In the past 15 years, a number of companies have made a habit of reducing shareholder pay-outs. These include BT, IAG (formally British Airways), Marks & Spencer, RSA Insurance (formerly Royal & Sun Alliance), J Sainsbury and Standard Chartered. Our experience is that shares in such companies provide borrowed performance – money made in the short term is likely to have to be handed back over the longer term. In our view these are stocks to be traded, not bought and held. I have had many a meeting in which I have been harangued for not owning housebuilders. Of course, at times, house builders have proven to be great money-makers. In the mid-noughties the sector flew, as it has since 2011; but the journey has been a rollercoaster ride of extremes with share price downturns of 90% during recessions. We will leave this sort of excitement to others.

Our preference is to seek out companies with very different qualities. We favour tried and tested dividend aristocrats with proven track records of sustainably growing dividends year in, year out and that do not have a tendency to dilute existing shareholders by raising capital at the bottom of the cycle.

## Brewing up a storm?

Much has been written about the increase in the number and size of mergers and acquisitions this year and many see it as a reason for celebration and optimism, but we are censorious of such views.

Anheuser-Busch InBev, owners of the Budweiser and Stella Artois beer brands, has made a reassuringly expensive $106bn bid for SAB Miller, owner of the Castle and Peroni brands amongst many others. The deal, if it goes through, will create the world's largest brewer with over 30% of global beer production. InBev's last big deal was to acquire Anheuser Busch in June 2008 and it completed the deal in November later that year. During the interim period the S&P 500 fell almost 40%. Lightning does not strike twice and we would hardly suggest that InBev's decision to bid will coincide with material market falls but corporate activity tends to occur when management overconfidence is refreshed and inebriated by years of easily flowing money and seemingly easy stock price gains. Many may cheer such record deals, but M&A, like share buy-backs, is pro-cyclical and previous highs were in the bad vintages of 2000 and 2007.

## The beginning of the end

Should a material fall in markets occur, it is likely to call time on the end of the secular bear market that began 15 years ago, which we have written about at length in past reports. The best investments are made during apathy and despair - not ebullience and complacency. We are preparing for being far more fully invested than in the past decade or so. In 2008, many expressed reservations as we bought into a collapsing market but fundamental value was evident back then, even in great companies. Those opportunities will come again. As we head into more challenging conditions, do not be surprised if we become bullish.

Sebastian Lyon November 2015

## Not all interest rates are falling

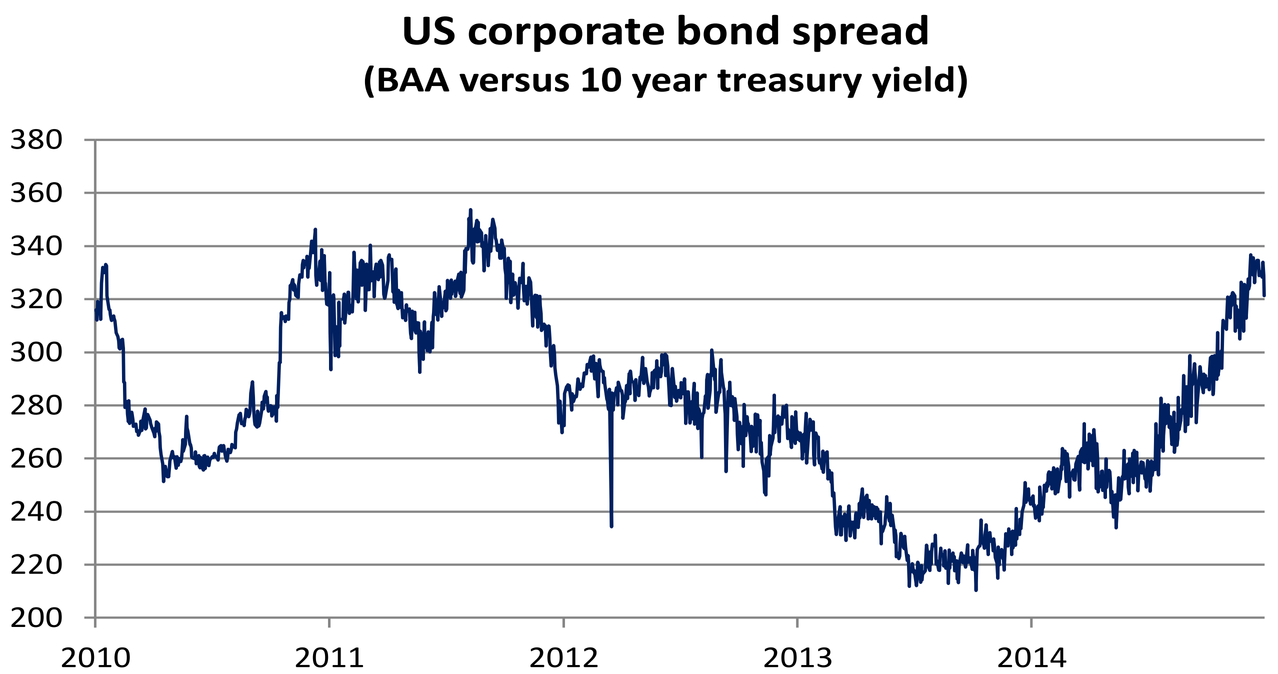


*Figure 1* *Source: Bloomberg, 30 September 2015*

## Companies struggle to grow earnings

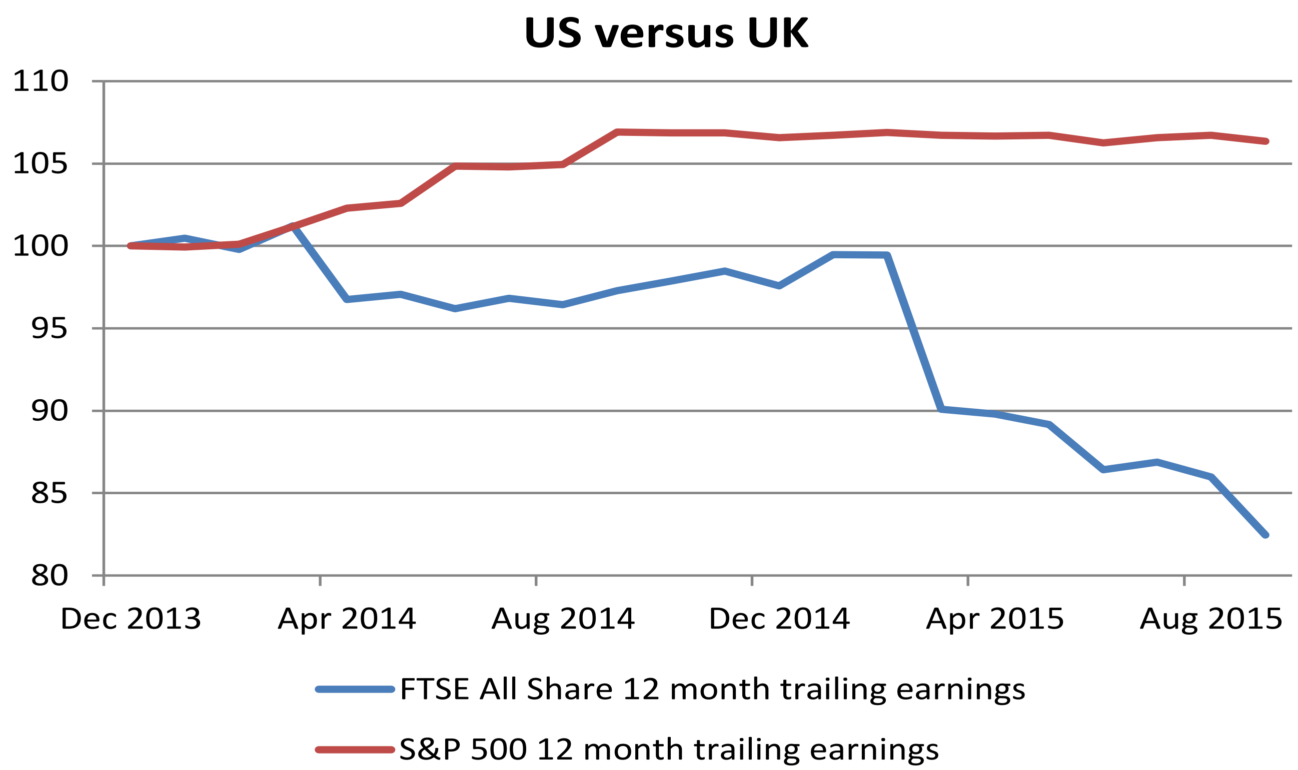


*Figure 2* *Source: SocGen, Bloomberg, 30 September 2015*

## UK Stock Market dividend income has barely recovered to 2007 highs

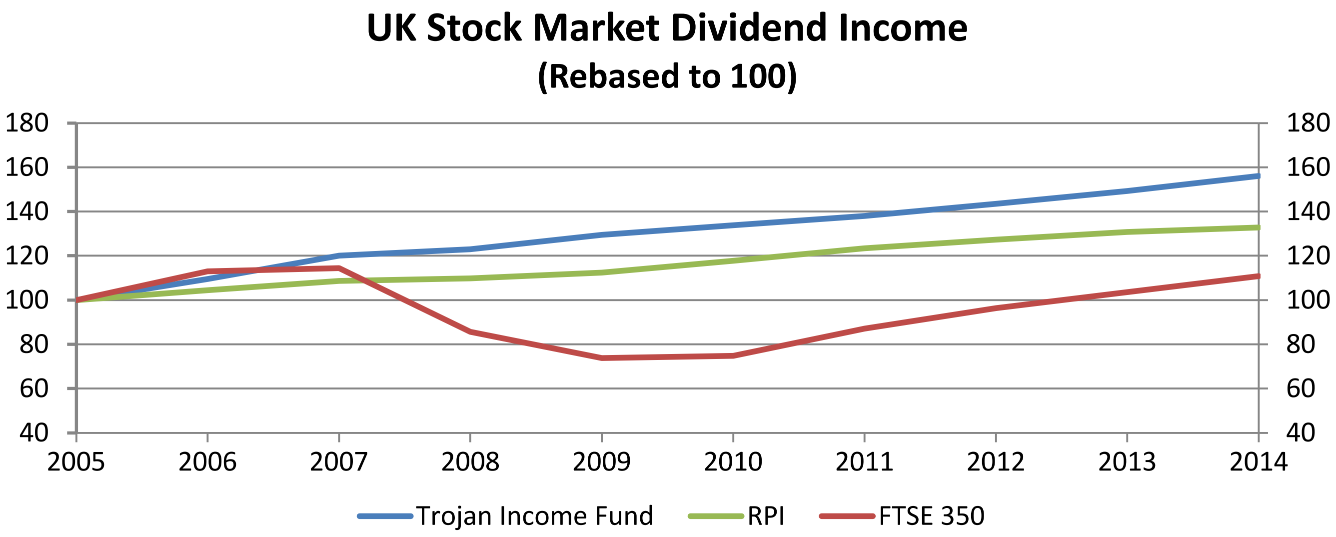


*Figure 3* *Source: HSBC/Troy Asset Management Ltd 30 September 2015*

## UK Stock Market dividend income is highly concentrated

| | FTSE 350 Index % of Income | Trojan Income Fund % of Income |
|---|---|---|
| ROYAL DUTCH SHELL | 9.8 | 4.4 |
| HSBC HOLDINGS PLC. | 7.9 | 4.4 |
| BP PLC. | 5.9 | 5.4 |
| GLAXOSMITHKLINE PLC. | 4.9 | 5.4 |
| VODAFONE GROUP PLC. | 3.7 | 3.6 |
| BRITISH AMER.TOB.PLC. | 3.5 | 2.7 |
| BHP BILLITON PLC. | 3.1 | 0.0 |
| ASTRAZENECA PLC. | 2.9 | 3.2 |
| GLENCORE PLC. | 2.7 | 0.0 |
| RIO TINTO PLC. | 2.5 | 0.0 |
| Total | 46.9 | 29.1 |

*Figure 4* *Source: SocGen, Bloomberg, 30 September 2015*