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Investment Report N°·50

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

Brexit

"There are decades when nothing happens: and there are weeks when decades happen."
Vladimir Ilyich Lenin

The recommendation by voters that the United Kingdom should leave the European Union is likely to be a watershed moment for the continent and to be followed by many weeks and months that will fundamentally transform Europe for decades to come. History teaches us that the most important economic developments tend to be unanticipated breaks from the prevailing order. It is tempting to try and predict what the vote means for markets and asset prices. Yet if there was ever an event that demonstrated the utter uselessness of crystal ball divination it was the recent referendum, given that the consensus view of bookmakers, pollsters and market pundits was for the continuation of our EU membership. Indeed, it is probably wise to heed the words of another communist revolutionary, Zhou Enlai, the first Chinese premier, who reportedly said in 1972 that it was 'too early to say' what the impact of the French Revolution was.

While the longer-term impact is unknown the political ramifications are all too visible. David Cameron, having won two referenda as prime minister, gambled for a third time and lost. The brutal rearrangement of the government has been completed in days. These are the merits of an unwritten constitution and strong historical precedents. Sterling's fall is a similar sign of flexibility which will, in the long run, help to heal the short-term economic wounds because in a world where no country wants a strong currency, the UK has just sneaked in a major devaluation. Investors in UK gilts have kept the faith and driven yields lower. The UK enjoys the political and economic flexibilities that the EU does not.

While it is far too early to draw conclusions on the longer-term economic and political effects of the vote, the shorter-term prognosis is for weaker growth in the UK. Evidence of falling housing transactions and weaker loan demand is already appearing. The UK stock market may have rallied to much cheer following the shock-induced two day sell-off but the FTSE 100 rose thanks to the translation effect of international earnings. To overseas investors the market is still off 8% in US dollar terms since the referendum. Sharp share price falls in domestic cyclicals such as 'challenger' banks (small, specialist lenders), retailers and housebuilders point to weaker domestic demand at a time when the economy was already vulnerable to a downturn. Once again, we face the paradox of healthy high quality stocks looking fully valued while cheap sectors are cheap for good reason. This warrants continued defensiveness.

Deceived by flight

The enormity of the UK's decision to end its participation in European political integration means that it is easy to be consumed by domestic affairs. But just because there is a temptation to ignore problems further afield does not mean that they have gone away. The world has been suffering from a lack of robust growth and what growth there is appears to be increasingly debt-dependent.

Growth in the value and volume of world trade has virtually stopped, suggesting that there are serious issues with the prevailing mercantilist world order. The UK may be only a minor shock away from a recession. For decades, central banks have used interest rates to tackle recessions. This is a policy option no longer available to them. The idea that central banks would directly finance fiscal deficits was once an idea derided by anyone and everyone; now "Helicopter Money" is seemingly the policy of first resort. This could be a further move on a deflationary path which ultimately ends in inflation.

Low interest rates and quantitative easing ('QE') have led to ballooning asset prices. Over $12 trillion of government bonds now offer buyers a negative nominal yield. This is not even an example of "picking up pennies in front of a steam roller". Instead, it is throwing your own pennies in front of one – courting danger with the deliberate intention of losing money. Amazingly, not a single Swiss Government bond carries a positive yield. The heights of absurdity continue to be pushed upwards. Paying to save (in nominal terms, at least) has not occurred in 5,000 years according to David Roche of Independent Strategy. Paying someone to borrow your money is, he argues, the equivalent of the "*monetary loony bin*".

Bond-like equities have also caught a bid. In a world of scarce earnings growth and greater uncertainty, investors are willing to pay huge premia for the revenue resilience and earnings dependability that many of our typical stocks possess. Recent strong returns from our equity holdings have been more a function of multiple expansion than favourable revenue and earnings growth. Bonds and bond-like equities are increasingly looking like bubbles in search of a pin. Very low (or even negative) bond yields should not necessarily lead to higher risk assets. Equities and bonds are giving mixed messages. If bond markets are right in indicating lower growth then risk should not be rewarded.

We repeat our warning that in an environment of near-universally overvalued asset markets it is likely to be easier to navigate the post-market falls than to avoid the falls themselves. This is because, with both equities and bonds looking vulnerable, traditional asset diversification may not protect to the same extent that it has in the past. We would welcome greater market dislocation as high volatility is frequently an omen of opportunity.

A glass half full

One immediate forecast following the Brexit vote was that the UK would fall into a recession. Bear in mind that forecasting recessions is not an accurate pastime, while offering exactness - a 'shallow downturn' is the consensus view - is as likely the wrong conclusion. Uncertainty and a pause while the UK renegotiates its trading position with its erstwhile European partners is bound to lead to delays in inward investment. Recent gating of open-ended property funds is an anecdote of such uncertainty. We would be sceptical of Leave campaigners' argument linking sterling weakness to the prospect of a strong economic rebound. The 1992 exit from the exchange rate mechanism was very different from today. Proponents forget that the ignominious expulsion from the ERM gave the Bank of England the freedom to cut interest rates from 15% to 6% in a matter of months. Clearly such an option is not available at a starting interest rate of 0.5%.

We do not have sufficient foresight to predict the extent of any slowdown. Our view is that the Brexit decision – barring the sort of galvanising effect on UK plc of which some Leavers dream – will only accelerate the trends, already firmly in place before the vote, of slowing global trade and weakening economic activity worldwide. Prior to the referendum, growth expectations were already in the process of being managed down. Bank shares in Europe were trading at pre-crisis lows (especially in Italy, Germany and Switzerland), an indicator of financial fragility. Concurrently the US Federal Reserve is already massaging expectations of raising interest rates this year.

It's the politics, stupid!

A further and perhaps less tangible implication of Brexit is the likelihood of greater political intervention in markets. This is a reversal of policy trends going back over 30 years. The adoption of *laissez-faire* economic policy seems to be shifting daily towards *prévenir* economics. Politicians are competing for voters on the grounds of greater intervention, whether it be Theresa May's views on Britain's company boards, Hilary Clinton on trust busting or Donald Trump on free trade. These are all reversals from the status quo. Politicians will take the economic reins back from central bankers because where monetary gallivanting has succeeded in raising asset prices it has failed the wider economy. Is it possible, with greater political intervention, that we face the prospect of weaker markets combined with a stronger economy?

To infinity…

In 2014, the value investor Seth Klarman said, "*Someday, rising stock and bond markets will no longer be government policy – maybe not today or tomorrow, but someday. Someday, QE will end and money won't be free. Someday, corporate failure will be permitted. Someday, the economy will turn down again, and someday, somewhere, somehow, investors will lose money and once again come to favor capital preservation over speculation.*"

For some time now, it has been our view that politics has become important in providing asymmetric risk to markets. Such outcomes, Brexit being just the latest example, offer greater downside risk than potential upside. Those looking at convoluted and esoteric valuation metrics such as the equity risk premium (the excess return investing in stocks offers over the risk free yield) may point to the prospect of much higher equity valuations - using a very depressed bond yield denominator will allow you to justify outrageous stock prices. Negative yields get you to infinity and beyond! Yet we remain sceptical, as unpredictable political outcomes are likely to play havoc with long term valuation metrics.

It seems today that the elastic has snapped on many bond market valuations. Back in the late 1990s the concept of reversion to the mean went into abeyance for a few years. The TMT boom led to many growth companies' ratings disconnecting from the norm. I recall a long-in-the-tooth stock broker suggesting that we needed to get used to these new valuations. He was right in suggesting that once the elastic had snapped or valuations had become untethered from both history and fundamentals, they could rise to very speculative levels and so for the following two to three years, valuations went on a tear. Vodafone, the UK stock market darling of the time, rose from a fully valued

20x earnings at the end of 1996 to 100x three years later. Notwithstanding the belief in a new paradigm, Vodafone's valuation then fell steadily to a more sober sub 10x within five years. Despite growing earnings the share price fell over 75% from the early 2000 peak. Starting valuations are the most important determinant to future returns.

Government bonds today, with $12tn offering negative nominal yields, seem to offer a similar world of valuations divorced from reality, as if we were trapped in a fairground hall of distorting mirrors. No one knows when normality will return but someday it will. This explains our unconventional view in favouring index-linked bonds.

A happy anniversary

At the end of May, the Trojan Fund reached its 15 year anniversary. In our first investment report (No.1) in the summer of 2001, we said that, "the aim of the Fund was to protect investors' capital and to grow its value year on year." The Fund has enjoyed a long period of consistent returns, combined with the lowest volatility in its sector (IA Flexible Investment). We also talked of a desire to "establish a portfolio of winning stocks at the right valuations". Our unusual and uncompromising approach to not overpaying and to staying committed to quality has at times been very unfashionable but in the very long run has proved successful. Today, not overpaying for quality is a challenge but someday that too will change.

Remarkably, at the end of May 2016 the FTSE 100 Index stood at 6230, a mere 434 points (or 7.4%) higher than it was 15 years ago. In contrast to the years prior to the dot-com boom, capital preservation rather than striving for capital growth has proven to be the more effective approach.

Since launch until the end of June 2016, the Fund has returned 7.9% per annum (net of all costs) compared to 5.0% for the FTSE All Share, 2.1% return on cash (LIBID) and our ultimate inflation enemy, the RPI, at 2.7% (Source: Lipper). Our aspiration is for our investors to sleep well at night, even if at times we do not! The Fund's volatility, since launch, has been less than half that of the UK stock market (see Figure 1).

Long-term outlook

Today most assets are expensive so we maintain a cautious approach. However, the current low return cycle must one day come to an end. We are optimistic that UK stock market returns to be enjoyed in the next 15 years will be superior to those endured in the preceding 15 years. While nominal returns may be higher, real returns may be harder to achieve.

New addition

We were delighted to welcome James Harries to the Troy investment team in June. James will be launching a global income fund in the autumn.

Sebastian Lyon July 2016

TROY
ASSET MANAGEMENT

Trojan Fund – risk v return since launch

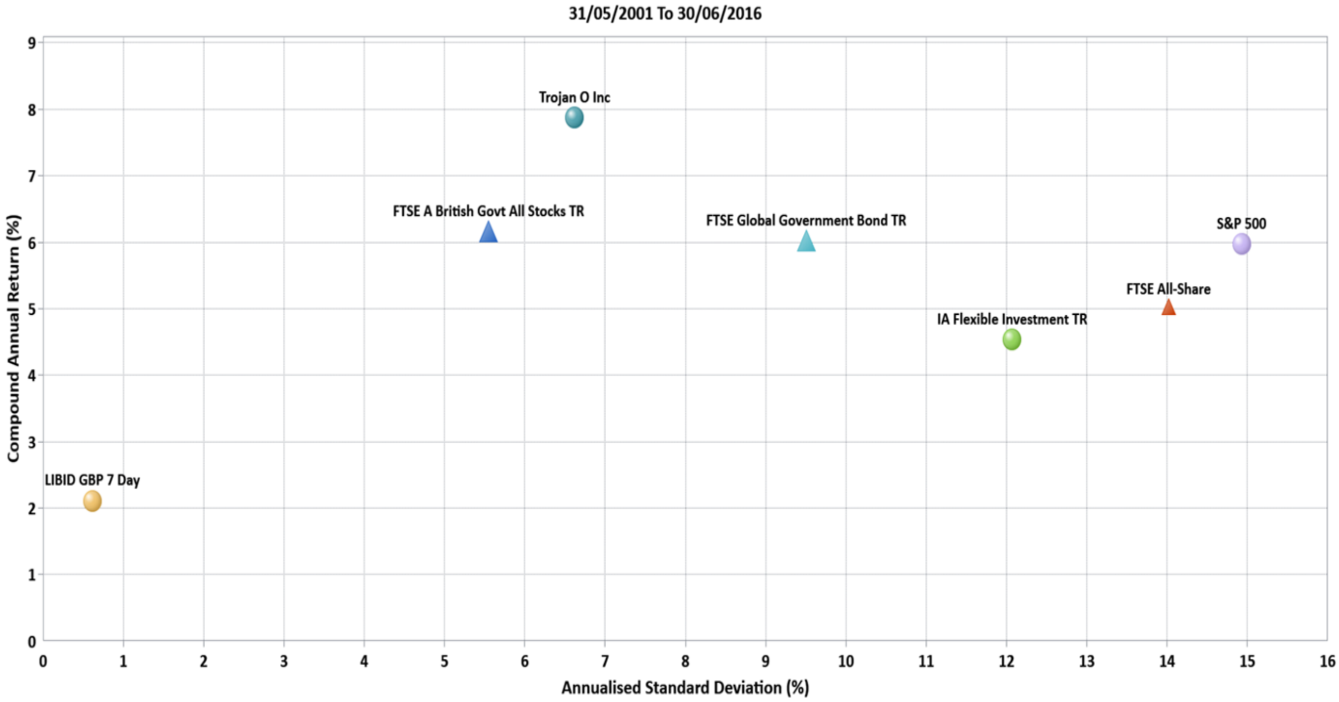

Figure 1 *Source: Lipper/Troy as at 30 June 2016*

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