



Investment Report N°53

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

Blue Skies

"I never saw the sun shining so bright. Never saw things goin' so right." Irving Berlin

Back in October 2000, at the time of establishing Troy and launching the Trojan Fund, I was certain that stock markets were expensive. Yet this was far from being consensus. The dotcom bust had played out in the middle of 2000, but some parts of the stock market remained ludicrously overvalued, especially in the technology, media and telecommunication ('TMT') sectors. Ironically dotcom share price swoons did not affect many aggregate measures of valuation as these nascent companies had no earnings to value. I was convinced that prospective returns were likely to be extremely low while share price volatility was likely to rise – not an appealing combination for risk-averse investors – and considered that there were likely to be far better entry points into equities than the one then available. Patience was required, and was duly rewarded. Within two years of October 2000, the US and UK equity markets had fallen by over 40%.

In many respects 2017 has little in common with 2000 or indeed 2007, the other market peak observed in Troy's near 17-year history. The current and prolonged bull market continues to climb the wall of worry in stark contrast to the investor euphoria that was observable in the lead up to these two stock market peaks. Elevator melodies rather than heavy metal is today's market mood music. Most investors I meet and talk to are not *thinking* bullish, but they are *acting* bullish.

The disappearance of income from traditional safe-haven assets such as cash and government bonds has led income-conscious investors to chase yield in the manner of a relay race, when, after each lap, savers and investors have to change to the outside lane and reach out further across the risk asset class spectrum to maintain incomes. American distressed debt investor, Howard Marks, thus describes investors as "handcuffed volunteers". Their investment options are cruelly limited. Given this psychological backdrop the market certainly doesn't 'feel' like a bubble, but traditional measures of valuation insist that equities, led by US indices, are expensive by historical standards. The cyclically adjusted price earnings ('CAPE') ratio of the US stock market is a well-respected long term measure of valuation. Its current reading of 29.2x (compared to its long term average of 16.8x) is only 'bettered' by the readings observed at the end of the 'Roaring Twenties' and the turn of the new millennium. Those were terrible times to be fully-invested in equities.

The US equity market valuation as measured by the CAPE multiple and the Q ratio (the difference between an asset's accorded market value and its replacement value) have been admittedly high for some years. Yet other metrics also point towards equities being expensive. US market capitalisation measured against GDP (see Figure 1), for instance, also confirms that stocks are challenging their 2000 valuation high. Similarly Goldman Sachs recently noted that the S&P 500 Index trades at its 85th valuation percentile, as measured over the past 40 years, while the median company reached the 98th percentile. The



aggregate measure is dampened by several mega cap stocks such as Apple and IBM trading at lower than median headline measures of valuation.

GMO, a respected Boston-based forecaster, estimated an excruciating annual real return (or loss of value) of -3.8% for US stocks for the next seven years in February 2017, a considerably worse figure than their canny forecast of -2.0% in the summer of 2007. For those who have followed their forecasts in the past, this is a compelling argument to be defensively positioned. Waiting for the prospect of higher returns still requires much discipline and patience. Jean-Jacques Rousseau, the eighteenth century Swiss polymath, wryly noted that, "Patience is bitter, but its fruit is sweet".

Do Bellboys Always Call the Top?

Markets, admittedly, remain bathed in sunshine and blue skies make it very difficult to consider the threats of changes to the weather. Professional investors under the age of 30 have likely never experienced the storm of a testing correction or indeed a bear market. They have enjoyed only the tailwinds blown from central bank sponsored asset inflation. The justification to bid up equities is self-evident when comparisons are made with the nearly non-existent returns available from other asset classes, including fixed income and cash. However, catalysts for past falls might occasionally have been seen by those prepared to look. In 2007 the debt edifice was ripe for collapse and the early warnings were visible in the form of Collateralised Debt Obligation ('CDO') funds liquidating and Northern Rock customers queuing for their savings back. These were signs on the road to the failure of Bear Stearns and Lehman Brothers. Previous market highs were less

obvious - rising interest rates usually called time on elevated and rising valuations. With the Federal Reserve now raising rates for the first time in over a decade the clock is ticking.

Bellboys, with their stock tips in the lift, do not always ring the bell at the top, as characterised by JK Galbraith in *The Great Crash 1929*. 1929 and 2000 were exuberant exceptions. These were once in a lifetime peaks, but they are not the only variety. In 2007 markets topped out without a high degree of retail investor activity. If and when US valuations revert to the mean they could do so with a prolonged whimper as much as with a sudden bang.

Value Insensitive

Today's marginal equity buyer is more cautious than the retail investor day trader so prominent in 1999. Private investors are less interested in share tips, having learned from the permanent capital losses they endured as the tech boom turned to bust. With much of their capital gone to money heaven, a more diversified approach to investing has been desired. Index funds and exchange traded funds ('ETFs') are increasingly selected to do the job, leaving savers to invest without concern for stock picking or even selecting managers.

As active managers, we are admittedly at risk of appearing self-serving if we discuss the merits and drawbacks of passive investing. Our central concern is unsurprisingly related to blindly allocating capital according to market capitalisation rather than by means of value. Yet we would not deny that there is a time to 'buy the market' via the purchase of an index. We have done just that at close to previous market bottoms in 2003 and 2008 by purchasing FTSE Futures. Following market bottoms it is the rump of distressed equities that bounce back the hardest. These are the



types of business we actively eschew and so the purchase of the index means our stringent approach to individual stock selection is not tainted. (In the spring of 2009, Barclays share price rose from 50 pence to 350 pence in a period of six months as disaster was averted for the banking sector. Interestingly this hope of recovery proved far too optimistic. The Barclays share price, eight years on, is 210 pence.) In short, when we buy the index we do so always as a deliberate choice, and never as a conditioned reflex.

To have some index exposure makes sense when you believe you are at the bottom of the cycle. Investors benefit from holding distressed shares that they may not wish to purchase individually, when the difference between survival and failure is binary. Today, over eight years into a cyclical bull market, we are as far away from those circumstances as it is possible to be. Our fiduciary duty tells us to reduce risk into higher prices yet passive investing ignores such rationality. Passive investors, so right for so long, have become momentum investors. One day these forced buyers may become forced sellers. Indifferent purchases can just as easily be indifferent sales. Where will the value investors with cash appear? Arguably at significantly lower levels.

Passive Aggressive

Index buying has been in a prolonged period of secular growth since the mid-1970s when Vanguard, the world's leading passive investment management company, launched its first mutual fund. Today the company receives \$2bn a day of inflows according to *The New York Times* (this is 20x the 2009 level). Index buying has a history of being in vogue at market peaks. Passive investing tends to be pro-cyclical and thereby exacerbates market moves. In 2016, US equity ETFs and index

trackers enjoyed inflows of \$563bn according to Morningstar, compared to outflows of \$326bn for active managers. In the US alone, as at the end of 2016, \$3.6tn was invested in active funds compared to \$3.1tn in passive funds. In the past three years Vanguard has attracted \$823bn of inflows. This is 8.5x the rest of the US mutual fund industry combined. If these current trends continue, 2017 is likely to be the year in which passive funds overtake active in US assets under management. Worldwide, the top two index managers BlackRock and Vanguard control over \$9tn of assets.

For now, buying begets more buying. For investors with an eye on value this can be frustrating but in the long term it is likely to present wonderful opportunities for active managers. According to JP Morgan, 37% of New York Stock Exchange traded share volumes are in the last half hour of trading as index funds rebalance their portfolio weightings (i.e. investment by conditioned reflex). This frequently leads to indices moving from negative to positive territory. What happens when the process is reversed and the machines are ordered to sell? They will be just as price and value insensitive on the way down as they were on the way up. Indexation, like all good ideas engineered on Wall Street, is likely to be taken too far.

The Art of the Deal

In the first four months of 2017 the 'reflation trade', given added impetus by the election of Donald Trump in November, faded. Ten-year Treasury yields peaked at 2.6% in March and have subsequently fallen to 2.3%. Corporate earnings have been dull and Q1 U.S. GDP data are at their lowest level for three years, growing at an annualised rate of merely 0.7%.



This is a long way from the new President's 3% aspiration.

Aspirations are one thing, reality is another. While 'soft data' (business and consumer sentiment surveys) have looked promising since the election, the 'hard data' of GDP and corporate earnings growth remain anaemic or ambiguous. "Escape velocity", a phrase used back in 2012/13 by economists to describe the hopes of breaking out from post-crisis sluggish growth, remains elusive. Frankly, it is all looking very late-cycle as companies struggle to grow their revenues. Data from the Federal Reserve suggest that bank lending may be peaking and rising inflation is proving to be a tax on consumption.

Markets rallied after the election in expectation of renewed growth and tax cuts, but President Trump's policies of making America great again and prioritising American jobs may conflict with these Wall Street expectations. If the President is to succeed in reversing the trends of globalisation, in particular the transfer of wealth from labour to capital, corporate (peak) margins will be squeezed while a newly empowered labour market could prove inflationary. Neither is likely to sustain further asset price appreciation.

Trump's book, *'The Art of the Deal'*, offers a flavour of the President's modus operandi. Legislation is merely a deal to be struck after promises have been bartered. Although the House of Representatives voted on May 4 to replace the Affordable Care Act, an initial failure in March had indicated that Congress remains difficult to handle, even with Republican majorities in both the House and Senate. Tax reform, in particular tax cuts, will be a challenge as conservative Republicans want to make fiscal stimulus revenue-neutral.

In foreign policy, isolationism advocated on the stump has been discarded, with the United States reverting to its role of 'global policeman'. However, the current unpredictability of President Trump's overseas policy is likely to increase market volatility.

Elevated stock market valuations combined with perceptible geopolitical risk importantly coincide with the Federal Reserve's attempt to raise interest rates. This makes for a particularly febrile and vulnerable backdrop. We have said for many years that the attempts of central banks to exit unconventional monetary policy, in place since the financial crisis, would be highly problematic. The Fed seems determined to continue on its chosen path of normalisation. To paraphrase Chuck Prince, the erstwhile CEO of Citigroup, others will choose to get up and dance but we prefer to remain wallflowers – defensively positioned, for more than a single outcome. The good news from the reappraisal of the Trump reflation trade, from a Troy investment perspective, is that defensive stocks have recovered some of last year's falls, which had led to a rather dull second half of 2016 for all our funds.

The Cost of Research

To support our growing internal research capabilities we buy in research selectively from third parties. The cost of this external research is currently paid for by both Troy and, as has been the industry standard, by Troy's funds through broker commissions. We have taken the decision that from January 2018 Troy will exclusively bear the full cost of research, which will have the benefit of removing a transaction cost from the funds.

Sebastian Lyon

May 2017



Market Capitalisation of S&P 500 / US GDP



Figure 1
Quarterly Data; US GDP in Nominal Dollars, Seasonally Adjusted Annual Rate

Source: Bloomberg, 31 March 2017

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