TROY
ASSET MANAGEMENT

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Investment Report N°.54

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

Dead Calm

"Any fool can carry on, but a wise man knows how to shorten sail in time."
Joseph Conrad

Back in 1983, I went on a sailing holiday to what is now Croatia. The trip was a memorable one. Just getting there on Yugoslav Airlines was an experience in itself and a reminder that state-owned enterprises are not the most efficient, nor do they offer the best food. The free market has its faults but it is an improvement on the dysfunction that collectivism is prone to serve up.

The prospect of two weeks of sailing never materialised. For twelve days, the Adriatic sea was becalmed; a mill pond without a sail in sight and we motored about from island to island eating revolting food and drinking filthy wine, served from what looked like plastic gasoline tanks. Day by day the expectation of a change in the weather dissipated until we became resigned to never hauling up our sails. Then, on the last day, the day of a regatta, the winds arrived in the shape of a force seven gale. Just over the start line, our skipper, my father and a sailing novice, lost his glasses as the boom, with a life of its own, knocked them off his face and into the sea. With a squinting, half-blind man at the helm, cautiously, we put in two reefs and eventually limped across the finish line, exhausted but safe. Heading into port, we were surprised to discover we had not come last. Two of the yachts, skippered by considerably more experienced crew and fuelled by the desire to make the most of the winds, had collided. Both were severely damaged, one totally unseaworthy with a hole in its hull. Frustration from the lack of activity had led the experienced skippers to take unnecessary risks. In investment terms, the fainter the memory of trauma the greater is the appetite for risk.

Record Lows

Markets have been becalmed for several months. Perhaps this is just a summer lull but volatility has remained remarkably subdued. Like calm waters, low volatility can beget low volatility for a time but it can create a false sense of security. As the economist Hyman Minsky warned, "Stability breeds instability."

Few financial metrics have been making all-time lows of late but The VIX Index (S&P 500 volatility index) fell to its lowest point in 30 years in June and July (*See Figure 1*). The Merrill Lynch MOVE index, which measures the implied volatility of US Treasury bonds, closed at an all-time low on 24th July (*See Figure 2*). This is extraordinary given that we are in the middle of a Federal Reserve tightening cycle and the debt ceiling issue, which unsettled markets in 2011, looms ahead yet again. Central bank attempts to unwind their balance sheets are also in prospect.

Few are seeking insurance from buying volatility, which may protect portfolios should stock markets fall sharply; in fact many are selling the VIX Index, a fashionable trade du jour. The VIX has no predictive powers; it expresses what investors *think* volatility will be not what volatility *will* be. What the wise do in the beginning, fools do at the end. Selling

volatility today is the equivalent of betting that the weather is set at fair and will never change.

Smoke in the Cockpit?

At the end of July, the US Food and Drug Administration (FDA) issued a major press release that made headlines. The prominent headline was that the US tobacco regulator wants to reduce nicotine in cigarettes to levels that are non-addictive. Needless to say, this caused some consternation amongst investors and sent tobacco share prices down sharply. The other headline was that the FDA is moving to evolve its regulatory framework so that different tobacco products can be regulated by the principle of a risk continuum. The second headline is supportive of the industry's efforts to develop and commercialise novel tobacco products that are likely to pose lower health risks to tobacco users. It is important to appreciate that the US regulator is now viewing the industry as part of the solution and not just a problem to be mitigated.

Rule-making by the FDA is a tortuous process that cannot be decided by whim or prejudice. This helps explain why it has done very little since taking over tobacco regulation in 2009. We expect the interim period to be very lengthy as the FDA gathers hundreds of thousands of pages of comment on nicotine yields. We also expect the tobacco industry to ensure the FDA follows very strict directions in any future rule-making. Even if the FDA passes rules that reduce nicotine levels in cigarettes, we would not be surprised if this took over a decade; consultation, counter-consultation and implementation would take years, judging by past experience and rule-making design.

Lower nicotine levels may help reduce smoking start rates which have already been declining for years. It is unlikely to have an overnight effect on the millions of smokers who enjoy smoking and have no desire to quit. Importantly, the EU has forced the European tobacco industry to reduce tar and nicotine levels over many years and volume decline rates have been similar to other developed markets.

The Choice of a New Generation

Critically, the industry is already moving faster than the regulator by developing and commercialising potentially safer Next Generation Products such as heat-not-burn and e-cigarettes. Between them Philip Morris International ("PMI") and British American Tobacco (both Troy holdings) have captured over 10% of the Japanese tobacco market with their respective heat-not-burn offerings. We have supported their investments in creating new commercial opportunities with potentially reduced harm profiles. It is therefore interesting to note that PMI's share price has been unmoved by the prospect of changes in regulation because the company has no exposure to the US market.

The tobacco sector has provided wonderful returns to investors for around two decades. This has come at the expense, recently, of valuation. Therefore, in recent months most of our funds have been net sellers of the sector as we maintain a focus on managing downside risks. Indeed, before the announcement, we completed one of the Trojan Fund's largest ever equity sales by disposing of most of our holding in Reynolds American before its takeover by BAT. This materially reduced our exposure to the American tobacco profit pool. We still remain holders of the sector given its well-versed attributes, namely an oligopolistic structure which enables participants to take pricing ahead of volume declines. The initial

share price reaction was probably a classic case of "sell first, ask questions later".

When Bad News is Good News

In recent weeks we have been bemused by the stock market's reaction to deteriorating corporate revenue growth. Buying the dips is nothing new but disappointing financial reports have been met with an initial sell-off frequently followed by a rally. This has occurred since Kraft Heinz's aborted approach to Unilever in February. The reason given for these strange reactions is usually high levels of corporate activity; any sign of weakness is seen as a vulnerability which could be exploited by a potential bidder or give rise to greater shareholder activism. We believe this highlights the lack of investment opportunity so often prevalent near the end of a cycle.

Looking for a Fight

Two companies which we hold in the Troy funds have been subject to activist action in recent months: Procter & Gamble ("P&G") and Nestlé. Such action usually takes the shape of an investor acquiring a stake in a company, either directly or via derivatives (the latter reducing the capital commitment required), in order to shake up corporate performance. The investor then writes openly to the Board, appealing for action, often with demands for strategic change. These activist investments can be tactical and may be to the benefit of a short-term trader. However, if successful in their aims, they can also be to the detriment of long-term investors, such as ourselves, particularly if they leave businesses with weaker balance sheets - a common trait.

In July, Trian Partners, headed by Nelson Peltz, requested to join the Board of Procter & Gamble following many years of lacklustre performance by P&G compared with its peers. This is something we also identified two years ago when we bought a holding in P&G. We have some sympathy with Mr Peltz's criticisms of the company, namely the weak organic sales and volume growth, combined with an unnecessary corporate bureaucracy. Trian does tend to be a long-only, strategic investor so if the focus remains on improving operational performance (and Mr Peltz honours his commitment in not advocating excessive leverage) our interests may be aligned. However, the definition of excessive leverage is subjective; we are more prudent than many who advocate so-called 'efficient' balance sheets. Trian holds just over 1% of the equity in P&G which should not justify the material influence afforded by Board representation.

The Milky Bars are on him

In June, Nestlé became the target of Third Point, a hedge fund managed by Daniel Loeb. We find his criticisms harder to agree with. To begin with, performance at Nestlé has been very respectable over the past decade. He compares the track record to those of companies such as Unilever, L'Oréal (in which Nestlé has a 23.2% stake) and Reckitt Benckiser that have benefited from higher growth categories like Personal Care. The comparison with Unilever looks particularly disingenuous given that prior to the Kraft Heinz approach in February, Nestlé and the Anglo-Dutch company's share price performance was nip and tuck. It also seems that Mr Loeb is comparing performance in local currencies. Of the past ten years, seven have seen sterling depreciate against the Swiss franc (and six years in the case of the US dollar). Converting the peer group share price performances into Swiss Francs gives a very different picture (see

below); Nestlé is top of the pops over a decade rather than close to the bottom as Third Point suggests.

Total Shareholder Returns (CHF)				
Company	**1Y**	**3Y**	**5Y**	**10Y**
Nestlé	17%	29%	72%	149%
Reckitt Benckiser	2%	34%	120%	96%
Anheuser-Busch InBev	(9)%	18%	90%	127%
Unilever (Amsterdam)	26%	51%	108%	106%
Unilever (London)	21%	42%	100%	94%
L'Oréal	12%	39%	109%	74%
Danone	8%	21%	45%	6%

Source: Bloomberg as at 23 June 2017.

Third Point demands that Nestlé improves its performance by (1) improving productivity, (2) returning capital to shareholders, (3) re-shaping the portfolio and, (4) monetising its L'Oréal stake. A comparison with peers points to the potential for margin improvement. The company has indicated it may dispose of US Confectionery, one its lowest margin businesses, but high margins are not always an indication of corporate health. We do not mind when margins are lower than the peer group for good reasons, for example developing businesses in emerging markets in which long-term growth opportunities look better. Alternatively the company may be investing in new products which may depress margins in the medium term. Nespresso, today a high-margin product, was in development from its patent date in 1976 and was not created into a business until a decade later. Nestlé did not fully launch the product until 2000 with 331 employees. Patience was rewarded. Today Nespresso has over 12,000 employees and sales worldwide of CHF 5bn in 2016.

We do not view Nestlé as a serial underperformer; on the contrary, it is one of our best long-term investments. Our paths diverge further over Third Point's stance on debt and the company's €23bn L'Oréal stake. L'Oréal has been a remarkable investment for Nestlé and the arrangement has been mutually beneficial for both companies since 1974. We question why a disposal of the stake now would be in the best interests of shareholders.

Finally, Third Point's suggestion to return capital to shareholders is a common cry. We do not believe that the advice for Nestlé to more than double its debt levels (from less than 1x EBITDA to 2-4x) will make it a better or stronger business. Our preference is for our investments' balance sheets to maintain a margin of safety. Nestlé's robust performance during the financial crisis was thanks to its fortress AA-rated balance sheet. It informs us where we are in the cycle if this is seen as a weakness rather than a strength. Like Third Point, we too are *'enthusiastic about Nestlé's prospects'*. Higher debt, however, is rarely the recipe for a better investment.

The Debt is in the Detail

A common theme in Troy's investment process is an aversion to high levels of indebtedness. In the real world debt brings forward demand, while in the investment world debt brings forward returns. Both lead to greater fragility. We are not debt-averse but as investors in equities, which represent the sliver of hope between assets and liabilities, our chances of survival are better with more assets and fewer liabilities. In that vein, one of our current concerns is the ballooning market for corporate credit and its illiquidity. My colleague Charlotte Yonge has written a Special paper (No.4 Μηδέν ἄγαν – *Nothing in excess*), which highlights the growing fragility of the world's largest corporate bond market.

Sebastian Lyon — August 2017

Stability Breeds Instability
VIX* Index 1990-2017

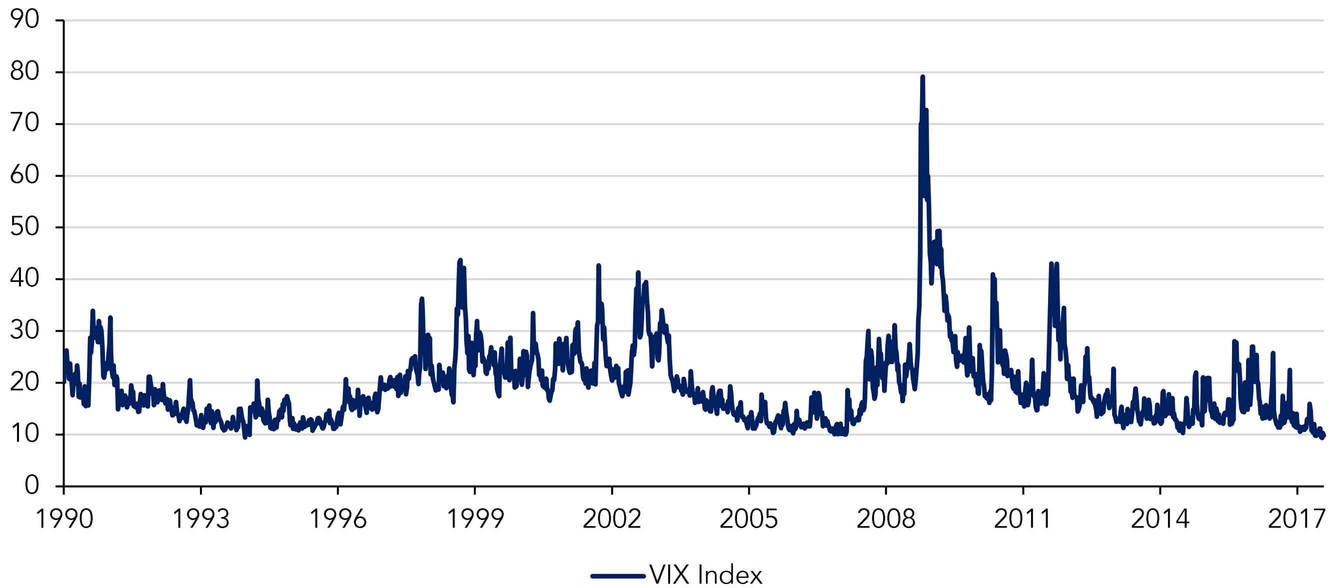

Figure 1 *Source: Bloomberg, 31 July 2017*
**The Chicago Board Options Exchange S&P 500 Volatility Index reflects a market estimate of future volatility.*

MOVE Index#

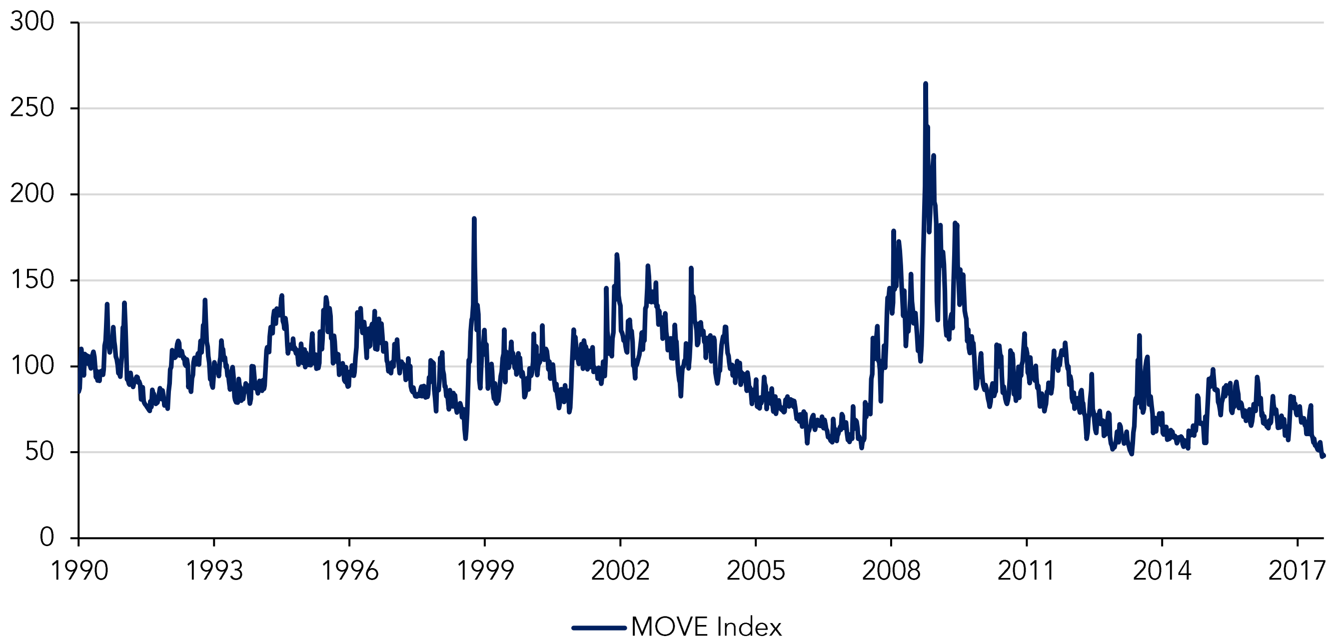

Figure 2 *Source: Bloomberg, 31 July 2017 #*
 # Merrill Lynch Option volatility Estimate Index. This is a yield curve weighted index of the normalised implied volatility on 1-month treasury options.

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