TROY
ASSET MANAGEMENT

# Trojan Global Equity Fund Newsletter Mar '15

## Name change

Effective from the 16th March 2015 the name of the Trojan Capital Fund has changed to the **Trojan Global Equity Fund.**

## Keeping it simple

The objective of the **Trojan Global Equity Fund Newsletter** is simply to give an insight into our investment approach, to explain the positioning of the Fund, how it has behaved and to comment on the outlook.

The Trojan Global Equity Fund aims to deliver capital growth over the long term without taking excessive risks. We aim to do this by investing in exceptional companies with high returns on their invested capital, sustained by durable competitive advantages and strong balance sheets and run by sensible managers. We aim to buy them at better than fair prices. The companies we invest in have staying power and have often been in business for well over a hundred years.

The Trojan Global Equity Fund can be defined as much by what we don't do as by what we choose to do. We don't invest based on themes, and we don't invest in highly cyclical companies or restructuring situations where the hope is that returns will improve from low levels. We don't like overly complicated businesses, the world is complex enough. We study the financial reports and analyse our companies over a long period, meeting with management and getting to know the industry the businesses operate in. Our team has significant combined collective investment experience and a natural bias towards investing in solid companies, avoiding paying too much, whilst remaining pragmatic.

The Fund is concentrated with investments in 32 companies. The ten largest stock positions represent over 45% of the Fund; just under half of the Fund is invested in the United States; 20% in the UK; 18% in Europe and 5% in Asia including Japan *(As at 28.02.15).* Turnover is low and was less than 20% over the past year.

## Taking the long view

After six years of extremely loose monetary policy, equities have been substantially rerated and valuations are rich relative to history, making our job of finding great companies at reasonable prices challenging. We are also very mindful that stock prices can be volatile, particularly when viewed over relatively short time periods. We are, however, investing for the ***long term*** and are confident that a collection of thriving, well managed, cash generative companies owned at fair prices will deliver excellent compound returns over time.

## The power of compounding

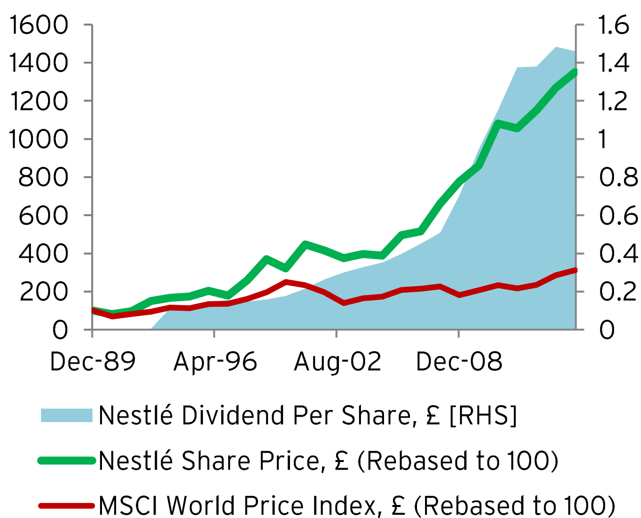
A great example of a company that embodies so many of the characteristics we seek in our investments is **Nestlé**, which has been owned in the Fund since 2009. By selling coffee, chocolate, baby food and other staples Nestlé is often considered a dull business and is frequently criticised for what some call its 'lazy' balance sheet and conservative management. At Troy we much prefer robust balance sheets, prudent management and the freedom this gives companies to be masters of their own destiny.

The bare facts are that Nestlé has grown revenues by 6% and profits by 10% compounded over ten years. Margins have expanded from 12% to around 16% and

dividends have increased steadily. The company has paid back over CHF90bn to shareholders and the number of shares in issue has fallen by 20%. Returns on capital are in the high teens and net debt is low. The sales of stakes in Alcon in 2010 for $28bn and L'Oreal in 2014 for $4.6bn highlight the riches embedded within **Nestlé's** portfolio.

A patient investor, who bought and held onto Nestlé shares from the day I started my investment career in September 1990, would have earned a 15% compound annual return (in GBP, 13% in Swiss francs) which compares with the market return, as measured by the MSCI World, of 8.6%*. With 40% of revenues generated in developing countries and a tighter focus on costs and cashflow, Nestlé's outlook is arguably stronger today than it was then and the company has every prospect of compounding great returns for decades to come.

**Nestlé vs. MSCI World (1989- 2014)**




Source: Bloomberg, 31.12.14

## 'Wonderful businesses at fair prices'

*Warren Buffett and Charlie Munger.*

Fair prices aren't so easy to find these days but over the past year four new companies were added to the Fund; Fiserv, Philip Morris International, Japan Tobacco and AVEVA. The holdings of Wells Fargo and eBay were increased and became top 10 holdings. Coach, AutoZone and Société BIC have been sold and holdings were reduced in retained investments, including Becton Dickinson, Medtronic, Johnson & Johnson, Microsoft, Intuit and Reckitt Benckiser.

| Top Ten Holdings | % |
|---|---|
| NOVARTIS | 5.8 |
| EBAY | 5.0 |
| BECTON DICKINSON | 4.9 |
| AMERICAN EXPRESS | 4.7 |
| ALTRIA GROUP | 4.6 |
| MICROSOFT | 4.5 |
| ROCHE HOLDINGS | 4.4 |
| MEDTRONIC | 4.2 |
| NESTLE | 3.8 |
| WELLS FARGO | 3.7 |
| **TOTAL TOP 10** | **45.6** |

Source: Troy Asset Management Ltd, 28.02.15

**Fiserv** is a leading provider of financial services technology in the US and was added to the Fund in February 2014. The company serves 14,500 institutions, predominantly in the US, with account processing, electronic payments and mobile banking solutions. They move over $1 trillion in payments and handle more than 20 billion digital transactions annually. Over 85% of their $5bn revenue is recurring, typically generated from 5 year

contracts, and Fiserv is a leading player in the development of online 'digital wallets'. Operating margins are high at 29% and cash flow is strong and growing. Net debt is a little high at 2.2x annual EBITDA but not a huge concern given the excellent cash generation and very good interest cover (10x). The company has retired almost 29% of its shares outstanding since 2006. The shares are valued at 20x expected 2015 earnings and carry a 6% free cash flow yield. This is a fair price for a thriving company with excellent returns on its capital and very predictable profitability.

**Philip Morris International (PMI)** is a long-term favourite within several of Troy's other portfolios and was added to the Trojan Global Equity Fund last summer. PMI has lagged its peers over the past couple of years as currency volatility and volume trends in key markets suppressed profit growth. Its valuation is fair at 19x expected 2015 earnings in light of the fact that PMI is one of the best run and most financially productive companies around. The strength of the dollar has hit PMI particularly hard as they earn all their revenues outside of the US yet report in USD which of course depresses reported profits. The shares also have a very attractive dividend yield of 4.9%.

**AVEVA** is a UK company with a global leading market share in the development and sale of specialist software which is integral in the design of large scale engineering projects. It generates 70% of its revenues from long-term contracts which create a stable and highly profitable annuity stream. Half of the business serves customers involved in the oil and gas industry and weak sentiment following a profits warning in September was compounded by a collapsing oil price. AVEVA's business is far more resilient than its share price suggests and these events gave us an opportunity to buy a holding at a historically low valuation.

**Wells Fargo (Wells)** has been held in the Fund since the end of 2013 and has been a strong contributor to returns over the year. Wells is the only 'full-service' bank owned in the Fund and it earns its place by being an exceptional franchise, with a solid balance sheet, trading on a very reasonable valuation. A number of facts mark Wells out from its international peers; it made money throughout the financial crisis and its return on asset is amongst the best in the banking world. This allows Wells to deliver mid-teens returns on equity despite having much lower leverage than other banks. Net interest margins have been impacted by very low interest rates but are still healthy. The loan to deposit ratio is just 73%, underpinned by Wells' large and growing share of deposits in the US. Wells is not dependent on other banks to fund its business. This all translates into a very profitable business, with good efficiency ratios and low levels of problematic loans. Wells is determined to increase the cash it returns to shareholders as demonstrated by the latest 17% increase in the dividend. Naturally, Wells Fargo's business is predicated on the health of the US economy. A normalisation of interest rates would be helpful but, to paraphrase Warren Buffett (Wells Fargo's largest shareholder), we think its earnings are virtually certain to be materially higher 5, 10 and 20 years from now.

**eBay** has also been an investment in the Fund since late 2013 and the investment case was predicated, less on enthusiasm for the marketplaces business, but on our assessment that the PayPal division is a unique and undervalued asset. We therefore wholeheartedly endorse eBay's decision to allow PayPal to become a separately listed

company. More than 70% of PayPal's volumes today are outside of the eBay marketplace compared to 50% five years ago. As an independent company PayPal has a wonderful opportunity to build on its base of 160 million active digital wallet customers and become a dominant force in the growing mobile payments industry. PayPal has revenues of $7.9bn, growing at around 20% per annum, and earns operating profit margins of 25%. It is likely to have a market capitalisation in the region of $35bn which is more than half of eBay's valuation today.

## Outlook

We manage the Trojan Global Equity Fund to deliver capital growth over the long term. We have written extensively of our concerns about the long-term, unintended consequences of Quantitative Easing and zero or negative interest rates. These concerns are even greater today after the substantial upward move in the stock market and the assumption, embedded in many asset prices, that such unorthodox policies are sustainable and indeed desirable. The average valuation metrics of the Fund are higher this year than last but remain reasonable, in our opinion, owing to the very high quality of the companies that we own. The weighted average forward P/E of the Fund stands at 18x, the free cash flow yield is 6% and the return on equity is 33%.[1]

We aim to be careful, discerning and patient with your capital and not to compromise on the quality of the businesses we own or the prices we pay. We are reminded today of the comments made late last year by bond investor Howard Marks that *'earning a low return is not the worst possible outcome in the investment world'*. The risk appetite of other investors will inevitably change from its current state of complacency and, as prices cheapen, opportunities will emerge to add to our collection of great companies.

Gabrielle Boyle March 2015

*MSCI World index with dividends reinvested net of withholding taxes.

[1] All data comes Bloomberg, all quoted in sterling.

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