TROY
ASSET MANAGEMENT

Trojan Global Equity Fund Newsletter
November 2015

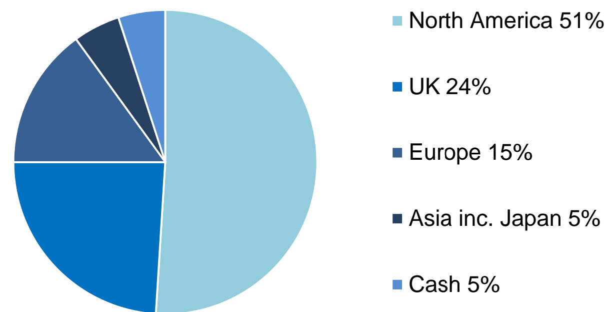
The Trojan Global Equity Fund aims to deliver capital growth over the long term without taking excessive risks. We aim to do this by investing in exceptional companies with high returns on their invested capital, run by sensible managers and sustained by durable competitive advantages and strong balance sheets. We aim to buy them at better than fair prices. The Fund has 32 holdings and the top ten stocks represent over 43% of the assets.

Review of 2015

At the time of writing 2015 is playing out as a good year for the Trojan Global Equity Fund which has returned 9% to the end of October against the market return for the MSCI World Index of 2.4%.* Performance has been broad based and driven by strong returns across a range of our stocks in the UK, US, Europe and Asia. The biggest contributors included **Altria, Microsoft** and **Fiserv** in the US. In the UK, **Sage**, **Reckitt Benckiser** and **Aveva** have been stand-out performers, as have **Heineken** in Europe and **Japan Tobacco** in Asia. Detractors include **American Express** and **Jardine Matheson** together with our pharmaceutical investments **Roche, Novartis** and **Johnson & Johnson**.

Currency has been a material factor influencing returns this year given the relative strength of the US dollar, sterling and the Swiss franc and the depreciation of the euro, the Japanese yen and emerging market currencies. The Fund has more than half its assets denominated in US dollars, 24% in sterling and over 12% in the Swiss franc. By contrast, the strength of these currencies has been a major headwind for many of our multi-national companies, impacting both their translated earnings and challenging their international competitive position. Although the comparisons will get easier from here our sense is that we will be living with a strong US dollar and sterling for some time to come.

Asset Allocation



Source: Troy Asset Management 31.10.15

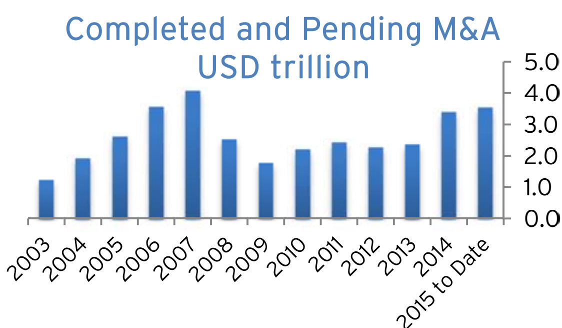
The Long Walk Down Quality Street

As discussed many times in Troy's quarterly investment reports global equities have experienced a substantial re-rating in recent years. The Trojan Global Equity Fund has undoubtedly benefited from this wave of multiple expansion. Equity valuation is never an exact science but we estimate the average forward price-to-earnings multiple for the Fund to be 18.6x and the free cash flow yield is just under 6%. Twelve months ago the average price/earnings ratio of the Fund was 17.3x and the free cash flow yield was 6.1%. Whilst the average p/e is higher than in recent years, we are encouraged by the high level of financial performance of our companies as evidenced by the Fund's average return on equity and capital of 41% and 16.7% respectively.[1] Despite macro-

economic and currency pressures, growth in earnings and cash has been robust across the portfolio. High stock prices will undoubtedly compress future returns compared to what we have grown used to since 2009, but our enthusiasm for high quality businesses is undimmed. The power to persistently reinvest earnings at high rates of return means that, with time, a portfolio of such companies can overcome richer valuations.

Animal Spirits and the Balance Sheet

A striking feature of the past two years has been the pace and magnitude of corporate activity. Global merger and acquisition volumes ranged from $2.2-2.4 trillion annually from 2010 to '13. By 2014 the total volume of completed and pending transactions increased to $3.4 trillion and so far in 2015 it is running at $3.5 trillion.[2] Zero interest rates, high levels of liquidity, a scarcity of organic growth, globalisation, tax optimisation and the disruptive impact of the internet are just some of the elements driving the latest M&A boom. Our preference is for companies to grow organically and not pay big premiums to acquire assets. Real M&A success stories are hard to find for shareholders of the acquiring company and only time and a normalisation of the cost of capital will tell if the latest round of M&A creates long term value. The frenetic pace of deals this year leaves us sceptical.



Source: Bloomberg 31.10.2015

Over the last couple of years our companies have been busy reinvesting on our behalf, including buying and selling assets. This has resulted in a slight increase in the average level of debt within the Fund and net debt to EBITDA has risen to 1x. This ratio is inflated by three holdings in particular - Becton Dickinson, SKY and Medtronic – following the completion of their recent acquisitions. In all three cases, the companies are very cash generative, have scope for asset sales and we expect their debt to be paid down quickly. Eight of the Fund's holdings have significant net cash and the remainder carry low levels of leverage. Goldman Sachs estimates that US indebtedness is at its highest level in a decade, quietly surpassing 2007 levels. The dangers of this will be rediscovered in a bear market as cash flows deteriorate and investors' focus shifts from income statements to the balance sheet. Our companies have the capacity to preserve shareholders' capital in more difficult market conditions by virtue of their resilient cash flows and strong balance sheets.

All-Weather Investing

We are in a low growth, deflationary world where the internet is challenging every established business model. Pricing power is scarce and companies need increasingly to be in the business of saving money for their customers if they are to succeed. Despite the tough backdrop, we are impressed with how many of the companies in our investment universe are facing the challenge head-on, innovating and finding ways to improve their operating performance. A great example of this is **Microsoft** which is redesigning its business model to become one of the strongest cloud computing operators in the world. Another is **Medtronic**, in medical technology, which is adapting to consistently

demonstrate better audited outcomes as healthcare slowly moves away from 'fee per service' towards a 'pay for results' system. Our aim in the Trojan Global Equity Fund is to find those exceptional companies who challenge the prevailing macro trends and can compound in any environment.

Is There Any Value Left?

We are often asked if there is any value left in the sort of companies we prefer. The answer is that there is much less than before, but that it can still be found if investors are willing to be patient. **American Express** and **Roche** are two such examples.

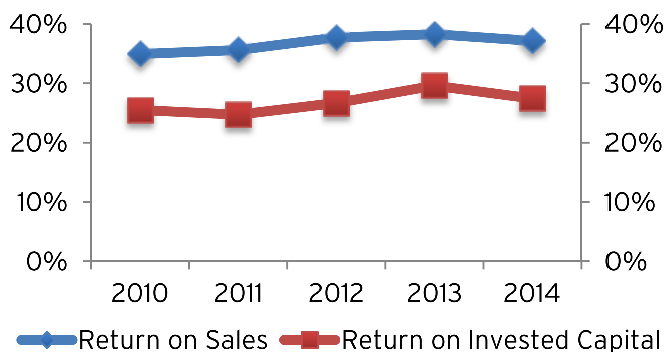
Roche's muted share price performance this year is partly explained by uncertainty over the course of earnings as the company approaches patent expiries for three of its major drug franchises. Investors' nervousness is understandable since sales from these medicines are worth about CHF 20bn combined, or over 40% of the group total, and contribute an even larger share of profits.

We don't believe we are about to see Roche follow other big pharma companies in toppling over a patent cliff. Our confidence has several layers. First, Roche can protect its existing franchises in a number of ways. Its drugs are complex, biological formulations delivered by infusion or injections and administered by specialist clinicians. The barriers to entry for any generic competitor are far greater than for simpler 'white pills' because of the technical demands of gaining regulatory approval and the significant manufacturing and sales costs necessary to convince doctors to switch very sick patients away from tried and tested brands. When competition for Roche's drugs does eventually emerge their markets are likely to remain concentrated in the hands of a few rivals, alleviating pricing pressure and allowing Roche to retain a significant portion of its economics. This also buys it time and Roche is moving fast to extend the standard of care for existing therapeutic areas. The Company is doing this by launching injectable versions of their intravenously infused drugs, thereby cutting nursing times from several hours to a few minutes and saving hospitals considerable costs.

Roche's strategy is not merely defensive. It has developed a pipeline of medicines that can be sold in combination with existing therapies to improve overall outcomes for patients. This not only expands their addressable market whilst making use of current assets, it also gives them flexibility to negotiate prices for packages of drugs once generic copies of legacy products arrive. Finally, Roche has continued to invest heavily in the discovery of novel medicines that address big, unmet needs. At its recent investor day, it was able to show impressive data for drugs due to be launched in the next few years that are designed to treat cancer, multiple sclerosis, haemophilia, severe asthma and ophthalmology. Each has the potential to generate several billion Swiss francs in peak sales so that the Company only requires a few of these to succeed in order to offset the expected losses from forthcoming patent expiries. Roche's strategy to develop innovative and life-saving medicines is also the best answer to justifiable concerns about the spiraling costs of healthcare provision.

Roche's shares have a dividend yield of 3% and the dividend has grown for over 20 years. The Company is still controlled by the Hoffmann family whose ancestors founded it almost 120 years ago. Stable ownership and incentives are necessary to succeed in an

industry with lengthy investment cycles. This conservatism has largely resisted the temptation to inflate short term results through either aggressive sales practices or expensive, debt-funded acquisitions.



Source: Bloomberg 31.10.15

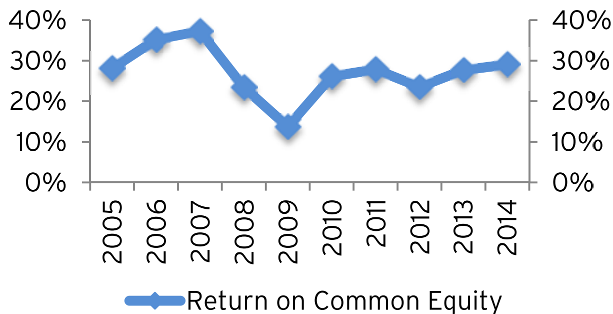
Roche's returns on both sales and invested capital can deteriorate from their high level and they would still be some of the best of any Company in the Fund's portfolio. We think a 5% free cash flow yield is a fair price for a business of this kind, especially one investing heavily to sustain its long-term growth.

A Centurion Sleeps

Shares in **American Express** have fallen 20% this year proving that the flight to good quality assets has left some behind. This has been a painful experience for us as it is one of the Fund's largest investments and we have added to our holding on the way down.

Our conviction stems from the expectation that Amex's headwinds will abate with time. The greatest of its challenges comes in the form of intense competition in the core US card issuing business and one powerfully expressed earlier this year in the announced loss of a co-branding card contract with discount retailer Costco. At 8% of global transaction volumes and 20% of total loans, this contract was far larger than we or most other analysts had appreciated and its termination next year will create a sizeable hole in Amex's earnings. To avoid this, the Company has suspended its customary guidance for 12% to 15% annual growth in adjusted earnings per share, and is investing this year and next to drive spending over its network by new and existing card members.

Competition will continue to limit Amex's rate of growth in the future as the balance sheets of other US bank card issuers are in better condition since the Financial Crisis to fight for market share. Yet Amex has several unique advantages. It has a trusted and globally recognised brand in an industry short on customers' goodwill. This is combined with a 'closed loop' (i.e. exclusive) payment processing network that not only generates strong profitability to be reinvested into rewards for its card members, but also improves customer service and lowers fraud levels because Amex enjoys control over the payments data that passes over its network. These resources position the Company to thrive in what remains a growing and dynamic industry. Card payments still account for just 50% of transaction values in the US, and less than 15% globally, and mobile and online commerce is helping accelerate the shift away from cash. Far from threatening Amex's business model, innovations such as Apple Pay, PayPal or Uber are only possible because of the ubiquity of established card payment networks. Amex can continue to adapt its business model to benefit from change as it has done successfully for the last 165 years.



Source: Bloomberg 31.10.15

Amex's share price is languishing at under 14x earnings as investors with shorter time horizons than ours fret over the shape of the recovery in earnings. This is a low price to pay for a company that, outside of 2009, consistently generates returns on equity over 20%. By contrast, the purer card network companies, Visa and MasterCard, trade on P/E multiples of over 25x.

Outlook

Equity valuations and corporate profit margins are elevated and global economic growth is anaemic. There are worryingly high levels of debt across all levels of the global economy and we face a potentially disruptive change in the direction of monetary policy in the next few months. Against this uncertain backdrop, more than ever, we are focusing our stock research efforts on challenging both our existing and potential investments for the durability of their business models. We have no special foresight into what might happen next but we can prepare for any market conditions by owning a collection of the world's finest businesses.

Gabrielle Boyle November 2015

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

[1] All data comes from Bloomberg, quoted in sterling

[2] Bloomberg

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