Trojan Global Equity Fund Newsletter

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 just under 42% of the assets.

Review of 2016

This year has had more than its fair share of surprises. From the narrow perspective of the Fund this has included posting strong absolute returns of +20.3% to the end of October, but was upstaged by an MSCI World Index NR (£) return of +25%.[1] Whilst many of our holdings have made stellar progress, relative returns have been impacted by our lack of involvement in the best performing parts of the market. Energy, materials, consumer discretionary and technology hardware have led a strong recovery after heavy losses last year. They are all sectors that we habitually avoid and their leadership has only extended into the month of November following Donald Trump's election victory. As the market mood shifts to anticipate the inflationary consequences of Mr. Trump's economic policies, financial and cyclical shares have renewed momentum, whilst consumer staples and software companies lagged.

Of course, the tumultuous political events thus far have been most powerfully felt in the currency markets. Sterling's depreciation in particular has had a defining influence on global equity returns for sterling-based investors. The MSCI World Index NR has returned just +3.3% when measured in local currencies.[2]

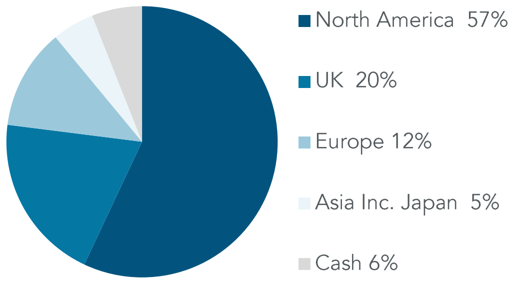
The biggest positive contributors from the Fund's performance in 2016 have predominantly been our US holdings including **Becton Dickinson, Altria, Microsoft** and **Fiserv.** Highlights outside of the US have included **Jardine Matheson** and **BAT**. At a sector level, holdings in technology were the most important contributors with **Intuit** and **PayPal** standing out.

Detractors to performance include **Sky** and our modest holdings in UK smaller companies **AG Barr** and **Aveva**. Elsewhere the Swiss pharmaceutical companies **Roche** and **Novartis** have been a drag, and consumer staples **Unilever, Heineken Holding, Reckitt Benckiser** and **Diageo** have all been relatively dull. In financials **Wells Fargo and American Express** were weak for much of the year but have subsequently rebounded following the US election.

[1] Bloomberg, MSCI as at 31 .10.16

[2] Bloomberg, MSCI as at 31 .10.16

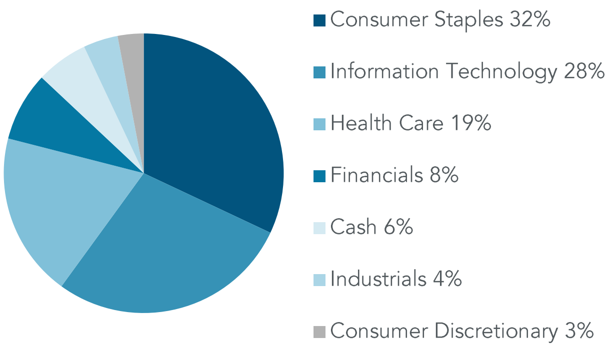
Asset Allocation



Source: Troy Asset Management as at 31.10.16

Changes to the Fund this year have included the sale of the long-standing holding in UK wealth manager **Rathbone Brothers** and an investment in the US payments company **Visa**. Following extensive work over the summer, **Alphabet** has become the second largest holding in the Fund after **Microsoft**. Investments in the technology sector (including **Visa** and **Fiserv**) now represent 28% of the Fund.

Sector Breakdown



Source: Troy Asset Management as at 31.10.16

The weighted-average financial characteristics of the Fund continue to demonstrate the excellence of the companies held. The average operating margin is 24%, the return on equity is over 30% and debt levels are low. The estimated average forward price-to-earnings multiple for the Fund is currently just under 18x with a free cash flow yield close to 6%. At the same point last year the Fund had an average price-to-earnings ratio nearly a point higher at 18.6x.[3] We continue to find compelling investment opportunities in a number of different areas including consumer staple companies, information technology, healthcare and financials which helps give balance to the Fund.

'Bond proxies' or just great businesses?

The Financial Times recently ran an article entitled 'The long-awaited bonfire of the bond proxies' highlighting the sell-off in companies that possess 'bond-like characteristics' on the expectation of increasing interest rates. Quantitative easing and zero interest rates have driven the prices of consistent, dividend-paying equities to uncomfortable levels. These distortions are just as aggressively felt when those same price-insensitive buyers seek a new home elsewhere. We see this starkly in the underperformance of so-called 'quality' stocks in recent weeks. Whilst, in the near term, these gyrations make life unsettling for long-term fundamental investors like ourselves, some respite in valuations is welcome. If this continues, items on our 'shopping list' of companies could soon move into buying territory.

The 'bond proxy' argument is also, in our opinion, flawed when applied to growing, high quality businesses. Equities, by their very nature, are not fixed income assets, carrying none of the contractual promises of a bond. Moreover,

[3] Bloomberg as at 24.11.2016

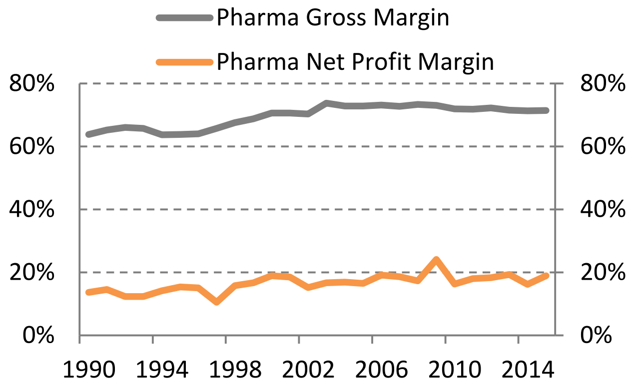
companies are not created equal and those we favour offer rare, compounding growth through reinvestment of their earnings (or 'coupons') at very high rates of return. The bond proxy term is better used, we believe, in reference to those companies that depend on debt to finance low and stable returns on their capital, with limited pricing power, and which pay out nearly all their capital to shareholders in dividends. These are typically drawn from utilities, telecoms and real estate sectors which, owing to their inferior economics, are unlikely to be a feature of the Fund.

One of the steady sectors to be drawn into the debate about bond proxies is healthcare. The sector accounts for a sizeable proportion of the portfolio (19%). Within that, an estimated 8% is invested in companies in the business of selling prescription drugs. Pharmaceutical companies have been in the line of fire this year for a host of reasons and we are often asked why we invest in them. The attached piece by my colleague George Viney, Assistant Fund Manager of the Trojan Global Equity Fund, lays out our thinking.

Big Returns from Big Pharma

The pharmaceutical industry is peculiar in many respects. Supernormal profits are granted by patent exclusivity to reward the vast expense of innovative research. Profits are then quickly lost to generic copies once patents expire. The temporary nature of product profitability has drawn comparisons with other sectors that exhibit a similar pattern of feast and famine – oil and gas companies, for example, that must constantly find new wells as older ones run dry. The comparison is fair, up to a point, and helps highlight the risk of capital misallocation that attends the search for the next blockbuster medicines. Yet the analogy can be pushed too far. The large scale manufacture and sale of prescription medicines is fundamentally a great business to be in, borne out by high and stable profit margins earned over decades.

Figure 1: Sector Profitability

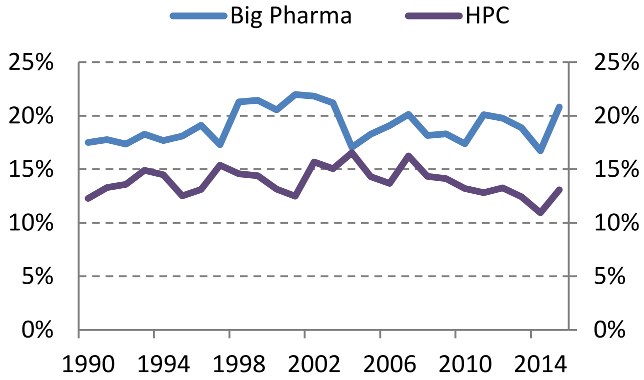


Source: Bloomberg as at 24.11.2016

The industry's stability is instructive for those who, quite reasonably, worry that political interference and healthcare reform must reduce the economics of selling drugs. The message here is that these companies are remarkably adaptive, a consistency that owes much to the resilient profile of demand. An estimated 1bn people will be over the age of 65 by 2030, up from 600m today, and 80% of older people have at least one chronic health condition (Source: L'Oréal, ncoa.org). Effective drugs are vital to containing inflating healthcare costs by reducing the amount of time patients spend in hospital. Meanwhile, expensive modern medicines are some of the last consumer categories to be adopted as economies develop. Pharmaceutical sales to emerging markets continue to grow at a robust rate even as demand for more mature consumer staples fluctuate with the economic cycle.

It might surprise some to observe that the average profitability of pharmaceuticals is better than most consumer staples companies, whilst there is little difference in the capital intensity of manufacturing. The net result is that returns on investment from Big Pharma are superior to those produced by the average, large household and personal care (HPC) company.

Figure 2: Comparing Returns on Capital



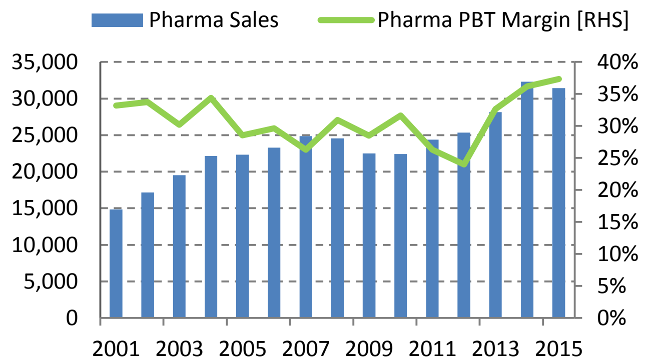
Source: Bloomberg as at 24.11.2016

The origins of Big Pharma's economics go well beyond a legal framework that grants them oligopolies for the duration of their patents. Barriers to entry also stem from brand loyalty shown by doctors and patients, stringent regulation and the vast financial resources required to bring a new drug to market. It is perhaps this final part of pharmaceuticals' business model, and all the jargon that describes it, that cause many other investors to pass them by. Try as they might, analysts' models can never properly capture the vagaries of luck, skill and good judgement involved in scientific endeavor. Investors can instead place faith in companies with long track records of investing consistently and intelligently to produce drugs that meet the unmet needs of patients.

The pharmaceutical division of Johnson & Johnson (J&J) is a good example of this. It is one of the biggest and broadest pharmaceutical businesses in the world and this diversity is important in ensuring it is never overly dependent on any one drug. Furthermore, J&J continuously reinvests its cash to create new medicines and its R&D assets are deliberately assembled to maximise its chances for success. In a presentation to investors last year, Roche showed that the industry-average success rate for R&D is just 5%. J&J deals with this high incidence of failure by employing an outsourced approach in which they work closely with small biotechs. It has struck over 300 joint ventures, alliances and partnerships over the last few years, providing lab space for another 90 independent biotechs. J&J understand that size alone cannot buy great ideas, but that economies of scale in R&D, manufacturing and sales is essential for great medicines to find their patients.

From 2008, J&J stumbled over its 'patent cliff', losing a cumulative $8.5bn in sales through the loss of exclusivity. Analysts focusing on this prospect would have fretted about whether J&J's divisional sales would ever recover. By doing so they may have missed the subsequent 25% net improvement in sales from the temporary peak in 2007.

Figure 3: J&J's Pharma Division ($m)



Source: Bloomberg as at 24.11.2016

Of course not all companies will succeed. To mitigate stock-specific risks we typically avoid small or specialist companies with narrow product portfolios. Novartis, Roche and J&J, our three pharma holdings, all invest heavily in their futures and have a wide breadth of opportunity to continue to grow. They also have other interests in healthcare beyond pharmaceutical drugs, in medical devices, diagnostics and over-the-counter medicines. Their balance sheets are strong and they continue to increase their returns to shareholders in dividends and share repurchases. Collectively our pharma holdings are valued reasonably, carrying a weighted-average free cash flow yield of 5% and a dividend yield of 3.5%.[4] Given these valuations and the demonstrated durability of the sector's economics, pharmaceutical stocks are likely to remain a distinguishing feature of the Fund for the foreseeable future.

10 year anniversary

The Trojan Global Equity Fund celebrated its 10th birthday this year. The name and shape of the Fund have changed over this period but the objective is the same: to provide capital growth over the longer term without taking excessive risks. The 10 year return to the end of October is +143.2% which exceeds that of +128.8% for the MSCI World Index Net (£) and the average fund in the IA Global Equity sector (+106.9%). We look forward to another healthy 10 years!

Gabrielle Boyle 30 November 2016

[4] Bloomberg as at 25.11.2016