TROY
ASSET MANAGEMENT

www.taml.co.uk January 2020

# Trojan Global Income Fund
# Three Year Anniversary

The Trojan Global Income Fund is 3 years old and we write to update investors on the fund, our process and progress to date.

## Our Approach

At launch we laid out our views and how we intended to manage the fund. The summary is as follows:

- That structural problems in economies, addressed by cyclical monetary policy were likely to result in declining productivity, structurally low level of inflation and interest rates at a time of elevated valuations in equity markets
- Such an environment favoured a conservatively invested, concentrated portfolio of inherently high quality businesses that would be able to dependably grow free cash flow[1] to deliver real income growth.
- We would invest without reference to a benchmark and emphasise absolute over relative returns. Risk was to be defined as the avoidance of the permanent loss of capital which we would seek to do by emphasising quality.
- Turnover would be low to allow capital and income to compound.
- Our process was likely to deliver returns with lower volatility than the wider market.
- That we would seek to enhance the quality, expected returns and free cash flow growth of the underlying portfolio as opportunities presented themselves.

## Performance – returns and income growth

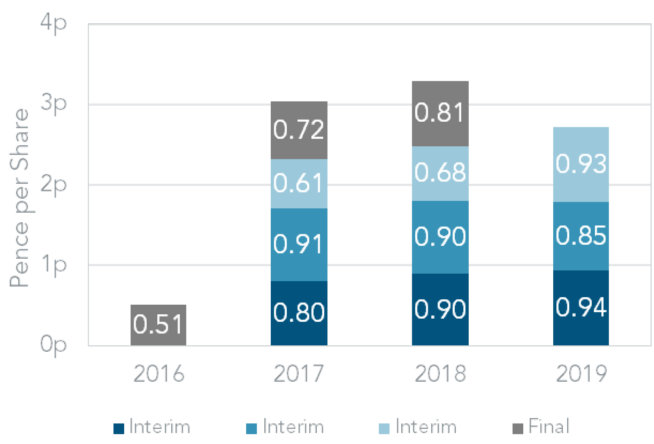
The performance since launch and over three years to the end of November is as follows:

| | Rank[1] | Quartile | Decile | Fund Total Return (%) | IA Global Equity Income (NR) (%) | MSCI World Index NR (£) (%) |
|---|---|---|---|---|---|---|
| 2019 YTD | 14/44 | 2 | 4 | +20.6 | +17.8 | +22.0 |
| 1 year | 15/43 | 2 | 4 | +12.8 | +10.9 | +13.0 |
| 3 years | 6/36 | 1 | 2 | +34.0 | +27.0 | +37.0 |
| Since launch | 6/36 | 1 | 2 | +30.6 | +24.2 | +36.5 |

**Past performance is not a guide to future performance.**

Source: Lipper – O Accumulation Shares total return net of fees since launch 01 November 2016 to 30 November 2019

The income distributed is shown below:



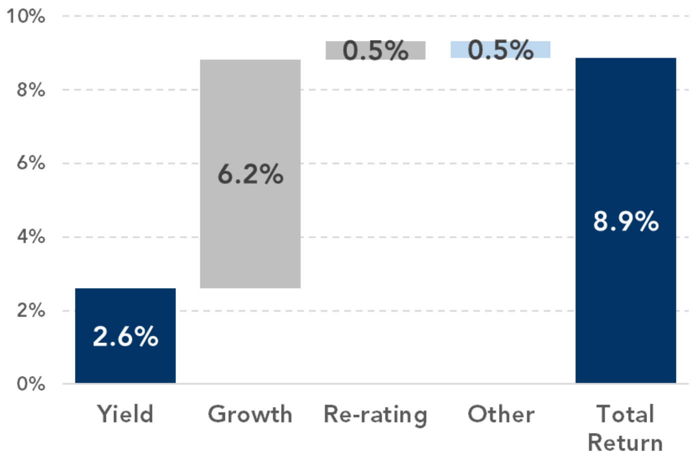

All data based on Trojan Global Income Fund O Inc share class. Income generated may fall as well as rise and past performance is not a guide to future performance. Source: Link Asset Services, 30 November 2019

[1] Free Cash Flow is a measure of how much cash a business generates after accounting for capital expenditures

## The Income Lens

One way to conceptualise the returns we have delivered is via the lens of income growth. This describes both the history of the fund so far but should also give investors an idea of what they might expect in the future. The primary driver of the Fund returns can be broken down into the current yield of the portfolio plus the dividend growth rate - itself driven by the attractive fundamentals of the underlying holdings. At launch the income yield on the fund was 2.6% which we show has grown at an annualised compound rate of 6.2%. Together these components have driven the 8.9% annualised return delivered since inception as illustrated below.

Trojan Global Income Fund Total Return Decomposition
Annualised Since Inception to 31/12/2019




Source: Factset – net of fees since launch 01 November 2016 to 31 December 2019

By taking advantage of selective opportunities over the period the current yield has risen to 2.9%, while maintaining the dividend growth rate of our underlying holdings. It is our aim to continue this process of enhancing quality while maintaining or growing the yield. Fund activity and positioning will therefore continue to balance the importance of the current yield with the prospects of future real income growth, with an emphasis on the latter.

By framing the returns this way we seek to demonstrate the core elements of our process. To be highly selective about the businesses in which we invest, to recognise the income yield we generate is in part a function of valuation but that income growth will be primarily driven by the long term performance of the underlying businesses, and that our approach is driven by absolute returns from income growth without reference to a benchmark.

Such an approach ought also to have a degree of predictability. Assuming we are right about the dependable nature of our chosen companies, the numbers shown above should represent a repeatable outcome even if the market sentiment and the valuation ascribed to our portfolio over shorter time periods is more uncertain.

## Progress to Date

Changes in sentiment were certainly apparent over the last 3 years which could be seen as having two distinct periods. Initially the election of Donald J Trump caused exuberance in capital markets. Expectations of a business-friendly administration enacting a restructuring to the US, and by extension the global economy, fuelled by both tax cuts and fiscal stimulus created the so-called "Trump bump". As such the Fund's emphasis on quality and longer term trends led it initially to lag the market. Happily, and unsurprisingly, as this sugar rush receded and heart beats returned to a resting state, the quality of our portfolio began to shine through. Performance rapidly improved from a low in the first quarter of 2018, both in relative and absolute terms notwithstanding the somewhat ill-timed start.

Since the launch of the Fund our process has remained unchanged except that the analysis of new ideas has been enhanced by the addition of Tomasz Boniek to the Global Income team as the Assistant Fund Manager. Consistent with a long term approach the number of *new* ideas remains relatively low even as *good* ideas remain as important as ever. We spend the majority of our time on the existing portfolio with new research time spent only on high quality global income ideas which we would be happy to own forever when purchased at an attractive price.

In keeping with our desire to have limited trading activity turnover in the portfolio since launch has averaged c.10.4% per annum. The main changes were well-timed additions to the healthcare and consumer staples sectors as well as a select number of idiosyncratic opportunities.

Despite the tremendous outperformance of so-called "growth" versus "value" we have not been tempted to buy areas of the market which might appear to be better value but which are low quality. This debate is important because it allows us not only to refute the suggestion that one should be "switching" from one to the other but also to help investors understand our process. Our CIO, Sebastian Lyon, has written about this in his recent Investment Report which we encourage our investors to read.

In summary it makes no sense to us to relinquish ownership of financially productive businesses in favour of cheap but inherently low quality enterprises. While we acknowledge that the performance and valuation of higher and lower quality businesses has been marked, we are not minded to heed the siren call of structurally lowering the returns on capital of the underlying portfolio in the hope of short term gain. Profits can be garnered as companies rerate from cheap to less cheap but if the operations do not create a capital surplus over the cost of financing such activities are ultimately trading rather than investing. We seek to invest in companies that can grow free cash flow and income through the investment cycle.

Further there is a structural reason why we believe this to be wrong. We are living in a world of rapidly changing technological progress. To us this makes it ever-more important to invest in businesses that are resilient to this technological upheaval. Part of this resilience comes from an ability to invest to cope with change or entrench the competitive advantages you enjoy, which in turn comes from generating plenty of free cash flow. Businesses that are not able to adequately invest owing to low returns, being over-levered or from a weakened competitive position are likely to be further structurally impaired.

At the heart of the growth/value debate is an implicit assumption of mean reversion. That businesses will recover having stumbled or will be brought low if recent fortunes have been favourable regardless of quality. Key to a long term, quality focussed process is a rejection of this idea. By investing in companies that have a *sustainably* high return on capital, that is supported by identifiable competitive advantages, and which can allocate surplus capital at high incremental returns, we should be able to sustain growth in free cash flow and income over the long term. It is at the core of what our process and ownership structure is designed to produce and is the essence of very long term, quality, income investing.

## The Investment Environment

Consistent with the above and even as equity markets have continued to make progress, and we along with them, we think it right to have more than one eye on the risks inherent in the broader investment environment while our valuations concerns persist.

We continue to view the current backdrop as highly distorted by the effects of aggressive monetary policy. To offset the oft-repeated factors of elevated levels of debt, ageing populations, global competition and technological disruption, the authorities have had to pull very hard on the policy levers to try (and usually fail) to fulfil their inflation mandate. That this mandate quietly morphed from suppressing to encouraging inflation without a significant update in thinking ensured ever-more creative measures were deployed. This has culminated in the absurdity of $11trn of government debt globally which has a negative yield.

So what, you might say? Well, not only are negative interest rates highly damaging to financial business models but they must be seen as evidence that monetary policy at least is close to exhausted. Further it demonstrates how far down the road of unconventional policy we have travelled. We fear that in order to generate a modicum of growth and inflation in the real economy, the authorities have created something that is anything but moderate in the financial economy. To us, at Troy, this urges caution and underscores the need to be highly selective in terms of the businesses in which we invest. It further makes us worry that those that ignore such concerns run the risk of seeking perfection within an imperfect framework, which could be highly damaging to returns. We seek to protect and grow investors' capital by investing in such a way that we will generate a decent growth in income and capital should markets continue to progress but provide some protection should markets become more stressed. It remains our view that we will have a better opportunity in the future to buy excellent but currently fully valued businesses; we remain patient.

## New Ideas

Future purchases are likely to arise in three main areas:

- Businesses that are high quality but have a degree of cyclicality which may offer a chance for us to invest should the current economic malaise become recessionary
- Businesses whose fortunes are geared into activity and the level of capital markets; we wish to buy them when the markets themselves are better value
- Businesses that are likely to benefit from the long term increasing economic heft of the emerging markets but who may suffer should these geographies suffer a classic capital markets driven economic cycle

The team has been spending much time getting to know these companies, conducting detailed fundamental research as well as meeting management teams to ensure we are ready to invest at the right valuation.

Although we have seen some reduction in uncertainty in the UK – for now at least – concerns relating to the slowing global economy remain as reflected in the ongoing low and falling rates seen in global sovereign bond markets. Concerns surrounding the ongoing trade dispute between the US and China, geopolitical concerns in the Middle East and the rise of populism and apparent decline of moderate political parties more broadly, not to mention the coronavirus, may well provide us with the opportunity to deploy capital in some of the areas outlined above.

## The Portfolio

Our process naturally leads us to emphasise certain sectors and businesses that exhibit the characteristics we have described. The current sector weightings are as follows:

| Sector | % of Fund |
|---|---|
| Consumer Staples | 36 |
| Health Care | 19 |
| Information Technology | 14 |
| Financials | 12 |
| Industrials | 6 |
| Consumer Discretionary | 5 |
| Utilities | 3 |
| Communication Services | 2 |
| Cash | 3 |

Source: Troy Asset Management Limited, 30 November 2019. Asset allocation and holdings subject to change.

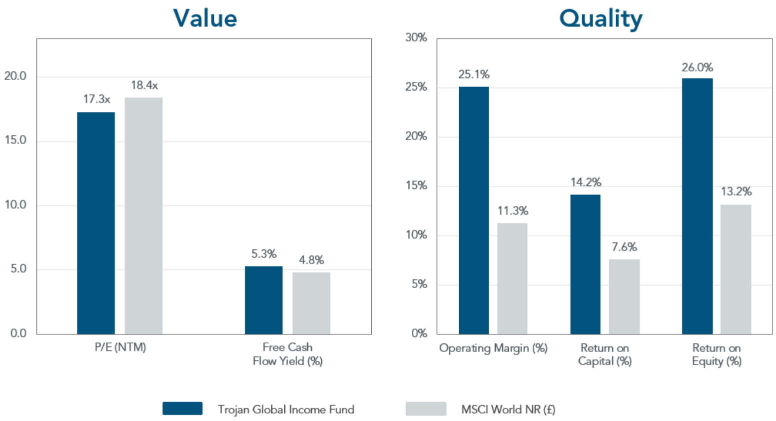
And the top 10 holdings comprise:

| Top 10 Holdings | % of Fund |
|---|---|
| Roche Holding | 4.5 |
| Novartis | 4.3 |
| British American Tobacco | 4.2 |
| Philip Morris | 4.1 |
| Reckitt Benckiser | 4.0 |
| Unilever | 4.0 |
| GlaxoSmithKline | 3.9 |
| PepsiCo | 3.7 |
| Cisco | 3.6 |
| Vonovia | 3.5 |
| Total Top 10 | 39.8 |
| 25 other holdings | 56.8 |
| Cash | 3.4 |
| Total | 100.0 |

Source: Troy Asset Management Limited, 30 November 2019. Asset allocation and holdings subject to change.

## Portfolio Characteristics

It can be seen from the below that the portfolio is currently generating a free cash flow yield[2] (excluding financials) of 5.3% which is in excess of the MSCI World Index (NR) supported by an underlying portfolio of companies that exhibit superior financial metrics relative to the wider market.




Source: Factset, 31 December 2019. Characteristics are shown excluding financials. All references to benchmarks are for comparative purposes only.

## Summary

Our style remains unchanged; we invest in a concentrated, high quality, reasonably valued portfolio that we expect to generate a resilient and growing level of free cash flow and income throughout the investment cycle. We are also excited by the number of companies we have been researching and which are of sufficient quality to be included in the portfolio in time. We believe the fund is well placed as we head into 2020 and thank investors for their support over the last 3 years.

James Harries and Tomasz Boniek

January 2020

[2] Free Cash Flow Yield is the free cash flow generated by the companies divided by their market value.

## Three current holdings:

### Roche

Roche is one of the world's great pharmaceutical and diagnostic companies and has a storied history of drug discovery and innovation that continues to this day. Augmented by the acquisition of Genentech in 2009, a rich pipeline of drugs, notably in oncology is forthcoming. Further, leading research and development productivity and an increasing focus on personal medicine complimenting the diagnostic business creates strong sustainable competitive advantages.

More than 80% of Roche's pharmaceutical sales are from biologics which are large molecules that are hard to replicate and provide protection from generic competition. Although three blockbuster cancer drugs, Avastin, Rituxan and Herceptin are subject to competition from biosimilars they are being replaced with other promising prospects such as Perjeta and Kadcyla. They are extending their franchise into newer areas such as MS and haemophilia. The diagnostics business is also strong.

Despite these strengths Roche offers a 5.7% free cash flow yield funding a 2.7% dividend yield with little debt. We view this as good value for such a high quality asset and is reflective of investors' unwillingness to take a longer term view, instead obsessing over making shorter term forecasts of likely demand for their various drugs which is hard to do and therefore of limited value over longer time periods. This is our opportunity.

### Unilever

Troy recently attended a Capital Markets Day in New York with Unilever. As an early advocate to both business and the investment community of the importance of what has become known as environmental, social and governance (ESG) considerations, Unilever's leadership in this regard has particular resonance as a gathering part of the zeitgeist.

Under the new CEO, Alan Jope, the company is grappling with some big questions – how to grow, how to use digital marketing to the best advantage, how to reduce their environmental impact - and in our judgement is doing a good job of tackling them.

Growth concerns are being addressed through portfolio change, focussing on the fastest growing geographies, driving new channels and instilling "purpose" in every brand. Digital capabilities are scaling up to connect to their massive customer base, and environmental harm is managed by being more efficient, including in the supply chain - specifically targeting a 50% reduction in the volume of plastic they produce by 2025.

The company further announced that increased investment may mean dividend growth lags earnings per share growth to reduce the payout ratio while keeping leverage capped at 1.7x net debt/EBITDA[3]. We see this as sensible. All this should help defend the excellent returns on capital for which this company is known. It thus looks reasonably valued with a 3.8% free cash flow yield funding a 3.1% dividend yield. Unilever remains a core holding.

[3] Debt/EBITDA measures a company's ability to pay off its incurred debt.

## PepsiCo

PepsiCo is a global food and beverage manufacturer with a product portfolio that includes 22 brands that generate more than $1bn each in annual sales. Its flagship brands include Pepsi-Cola, Fritos, Quaker, Tropicana, and Gatorade. Despite its name, Pepsi derives around two-thirds of profits from its snacking division which is an attractive and growing category, as more consumers replace traditional meal occasions with food on the go. The company has a commanding market share in the US, some ten times the size of its closest competitor. Internationally, Pepsi is a market leader in most geographies.

The beverages division, accounting for one-third of profits, has had its own issues in the recent past, particularly in the US, however this is improving. Recent investment in this division demonstrates a willingness to trade short-term profits for long-term growth which we view as sensible. Pepsi offers stable and predictable free cash flow growth supported by growing markets and a strong competitive position. It is a core holding.

In aggregate the above holdings, as well as the wider portfolio, we believe demonstrates our desire to concentrate the portfolio in businesses that are high quality but also decent value. This allows us also to balance the return from the portfolio between income and long term capital growth.

## Disclaimer

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