TROY
ASSET MANAGEMENT

Global Income Strategy

www.taml.co.uk

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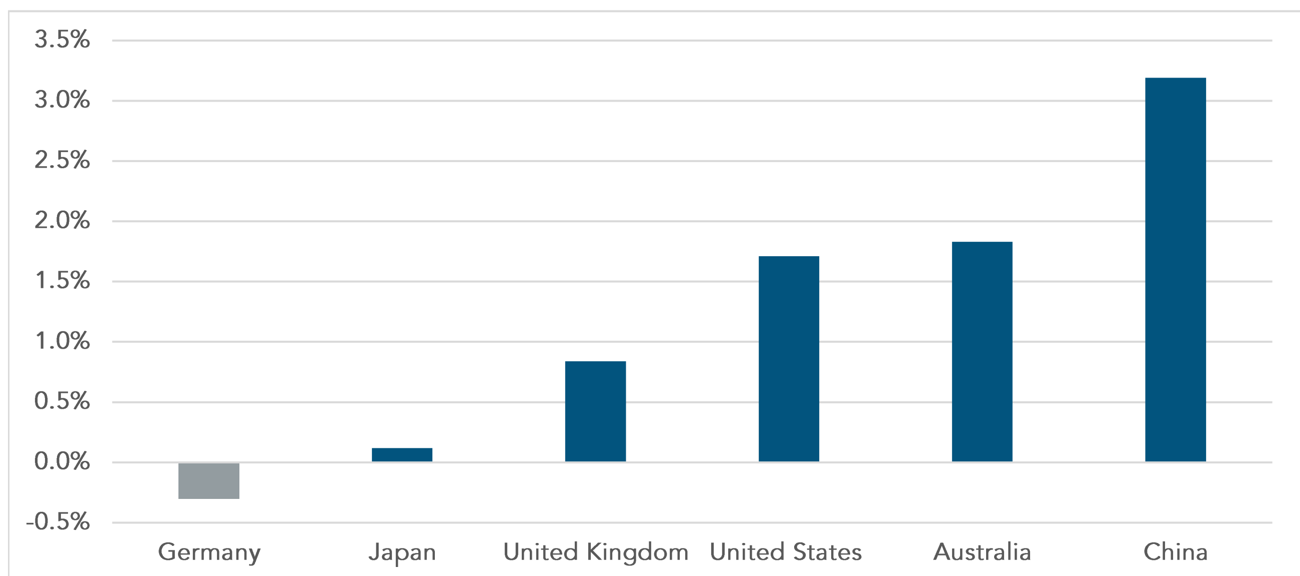
Income Matters

Why do we invest? For some to compound capital as they accumulate wealth, for others to provide a growing income on which to live. Our approach is to build a resilient global portfolio that aims to deliver above average capital and income growth with below average volatility. We believe this will serve most investors well in the coming years but especially those with irreplaceable capital and in need of income. Arguably there has never been a greater need for such an approach. Despite this, investing for income growth is currently out of favour. Spectacular returns enjoyed over the recent past make it seem rather pedestrian. Herein lies the opportunity.

The State of Play

Today a large and growing number of people are retiring at a time when markets are fully valued and income is scarce. Traditionally, assets accumulated over a lifetime would be invested in fixed income (often in the form of an annuity) to provide a sufficient and dependable income for retirement. As core government bonds no longer offer this combination of certainty and yield, other sources of income need to be sought. With inflation expectations becoming untethered it may well be that equities turn out to be less risky than government bonds while still providing an attractive and growing income over the long term, albeit with greater volatility.

Figure 1: 10 Year Government Bond Yields



Source: Bloomberg, 31 March 2021

The Importance of Income

It is an ancient investment truth that if you can fund all or part of your day-to-day expenditure from income you do not have to dip into your capital when times are tough. While this truth does not change it can be forgotten when capital returns have been strong. In our experience, the more buoyant markets are the less emphasis is placed in the importance and certainty of income. If you are compounding capital at a high rate, as has been the case for the last decade or so, then to spend a proportion of that capital each year is a comfortable prospect. Of course the opposite could also be the case. The longer one has been able to enjoy such returns the more likely it is that you are approaching a less rewarding environment.

At such times investors should be more careful to ensure that liabilities can be covered by income, so that fluctuations in the value of capital can be endured with greater equanimity.

Equity Valuations

By several long term measures, US equity markets are trading at levels seen only a few times in history. These include the size of the US equity market capitalisation as a percentage of GDP:

Figure 2: Market Cap to GDP -The Buffet Indicator, Wiltshire 5000 to GDP Ratio

Source: www.longtermtrends.net, 31 March 2021

The Shiller PE*:

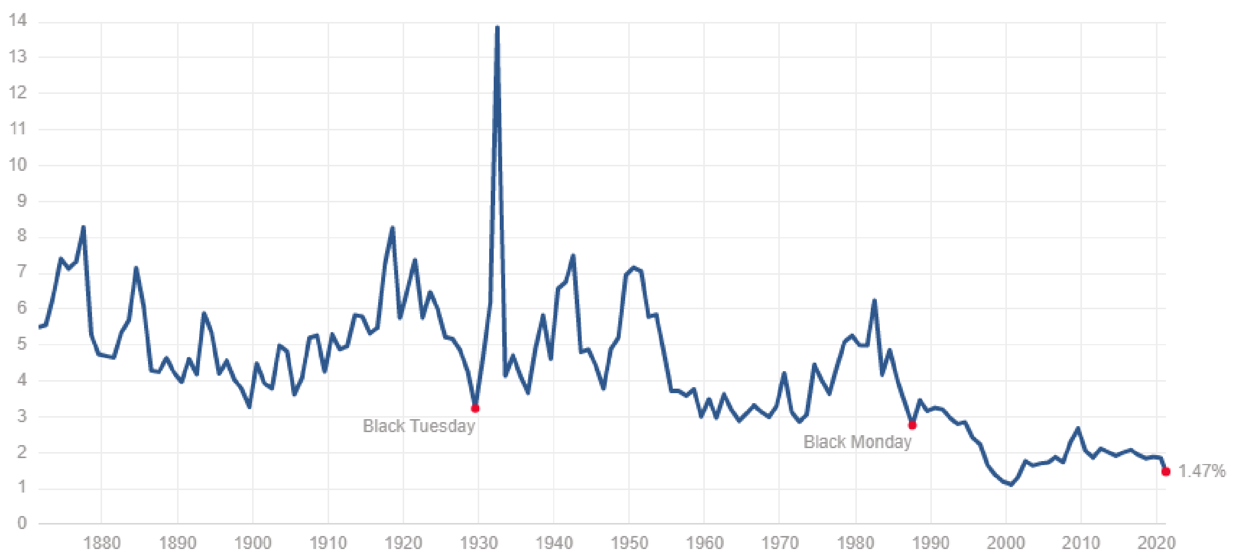
Figure 3: Shiller PE

* Shiller P/E, or P/E 10 ratio, is a valuation measure usually applied to the US S&P 500 equity market. It is defined as price divided by the average of ten years of earnings, adjusted for inflation.

Source: www.multpl.com/shiller-pe. 31 March 2021

Or simply, and of relevance, the S&P dividend yield:

Figure 4: S&P Dividend Yield



Source: www.multpl.com/s-p-500-dividend-yield. 31 March 2021

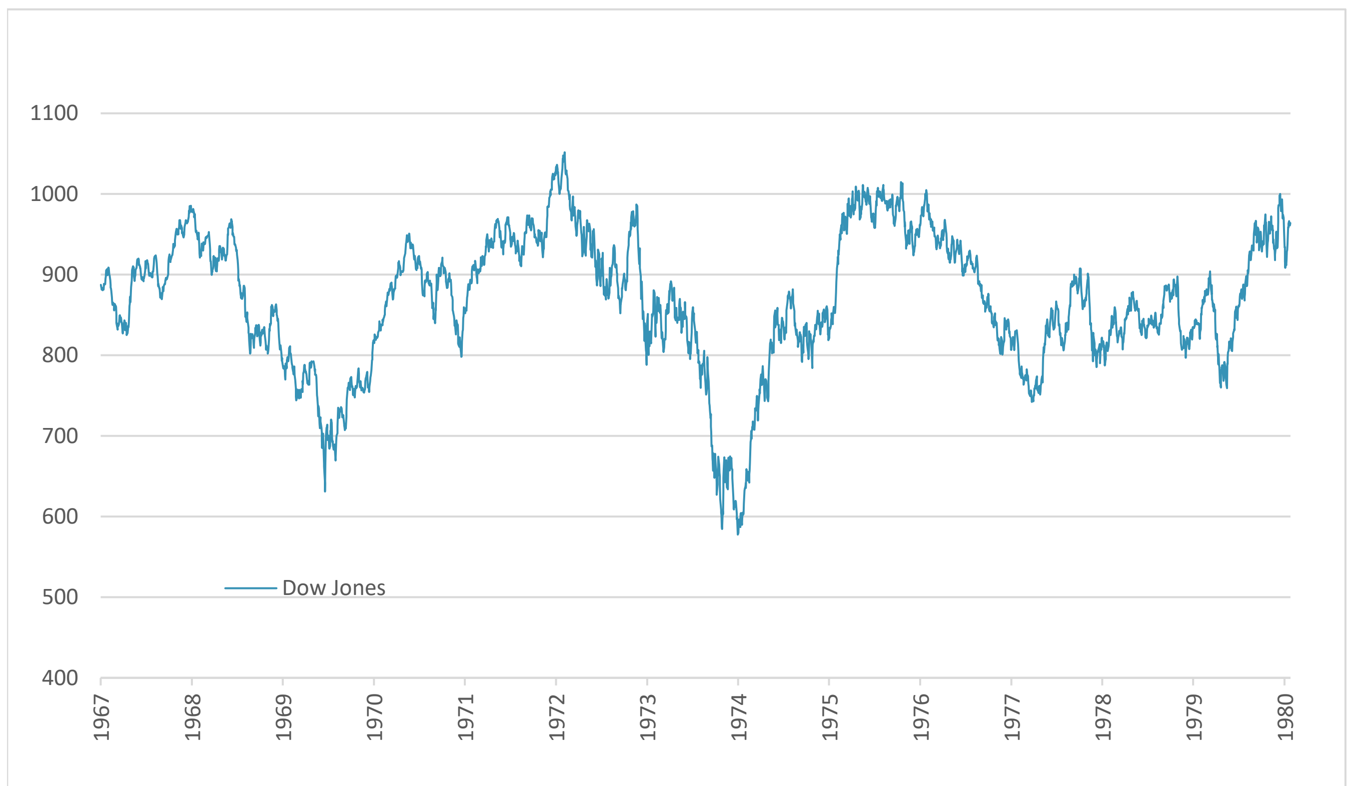
While such measures are not good when used for timing, in the sense that they tell you very little about what markets are likely to do in the short term, they do provide a pretty robust framework for expected returns. When valuations are elevated expected returns are low. The remarkable thing is when returns are likely to be at their lowest, on a forward looking basis, investors are usually at their most optimistic.

Rather like a driver pressing harder on the accelerator as the car gets closer to the cliff, the human trait of extrapolation encourages ever greater speculation as valuations rise.

Lessons from History

By way of illustration let us consider the US equity market between 1968 and 1982. I choose these dates advisedly because the market delivered almost no capital gains at all over that 14 year period.

Figure 5: US Equity Market Return 1968-1982



Past performance is not a guide to future performance

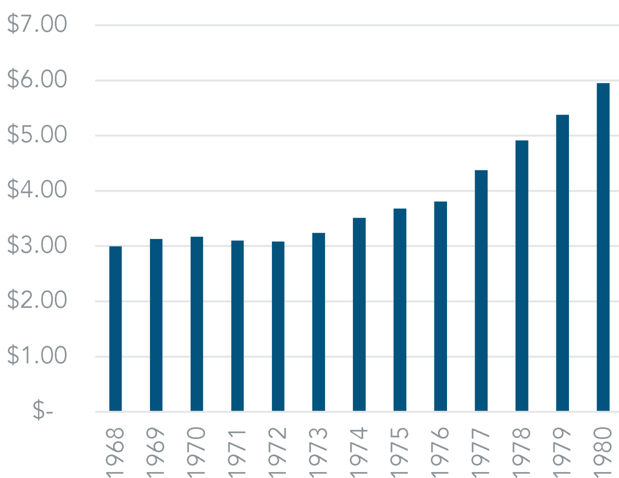
Source: Bloomberg, 31 March 2021

If one was to suffer a similar fate over the next few years a serious reduction in real purchasing power would result. It is hard to imagine this when recent gains have been so strong, but long periods of low returns are not uncommon. Current valuations make this outcome highly possible. Moreover, if you were also drawing down 3-5% of the capital each year to live on the situation would be made considerably worse.

This is if the market goes nowhere. If, as is probably more likely, there is a significant sell-off, this 3-5% capital withdrawal, in good times, can suddenly become a material proportion of your now diminished assets. Hence the danger of funding non-discretionary spending from potentially transitory capital gains rather than an even-handedness between income and capital.

While capital returns over this period were poor income continued to flow.

Figure 6: S&P 500 Annual Dividends 1968-1980



Source: https://datahub.io/core/s-and-p-500

This may be very valuable in the coming years as a reliable resource and contributor to returns.

Modern Day

Might the next decade be similar? 1982 is interesting because not only did it follow a very dull period of returns but was also, in retrospect, a very propitious time to be investing. Once again we observe the relationship between valuation and returns as low valuations implied high returns. At this time markets were like a coiled spring waiting to deliver gains. Investors could retire with a safe return of 14% by investing in a 10 year US Treasury Bond. This return was further enhanced as inflation and yields fell over a number of years. At the same time a young population, with low levels of debt, supported strong economic activity and consumption. Finally, valuations, not just in fixed income but also in equities, were very attractive, resulting in strong returns.

Figure 7: US Structural Backdrop

	December 1981	Present
US 10-Year Treasury Yield	14%	1.74%
Fed Funds Short Term Interest Rate	14.2%	0.25%
US Inflation – GDP Deflator	6.2%	1.3%[1]
US Total Public Debt/GDP	32.4%	129.8%
US Personal Savings Rate	12.2%	13.7%[2]
US Stock Market CAPE*	7.8x	35.6x
Median Age of US Baby Boomer	26 years	66 years

**Cyclically-Adjusted Price/Earnings Ratio.*
[1]31 December 2020
[2]28 February 2021
Source: Source: Bloomberg, St. Louis Fed, US Census Bureau, Robert Shiller.
All data as at 31 March 2020 unless stated otherwise.

Unfortunately, that coiled spring has now sprung. Years of policy designed to bolster asset prices, to offset economic weakness, has resulted in far less potential for returns. Moreover, a number of structural factors such as levels of debt, demographics and technological disruption have all become more impactful over time and been given a further boost by the recent pandemic. The first two can be seen as impediments to growth and consumption and the latter a highly disruptive force.

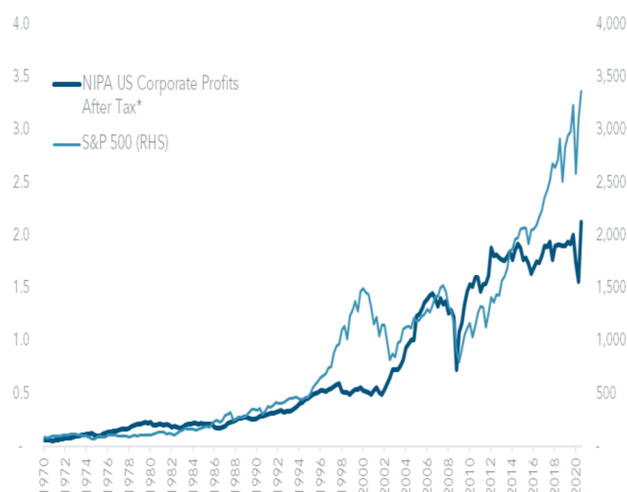
A further recent change is greater emphasis on fiscal rather than monetary policy stimulus. This matters because the primary transmission mechanism for monetary policy is capital markets themselves. Policy must therefore actively support asset prices. Conversely, fiscal policy works via the real economy. This means the authorities can be much more relaxed about gyrations in capital markets. As a result, policymakers may be a much less beholden to equity markets in the coming years.

Ultimately equity markets will converge with the underlying profitability of the constituent businesses – just as individual share prices do. At the same time, again like individual share prices, the index can diverge materially from underlying fundamentals. Figure 8 suggests we are at one of those times.

Although history never exactly repeats there are some similarities to the year 2000, the last time this divergence became so pronounced. While we are not suggesting that the current crop of technology companies is the same as then (the leading companies now are for more established, profitable and better value) there are still echoes.

There are clear signs of speculative excess observable across capital markets. These include very high levels of investor confidence, highly uniform and concentrated portfolios, elevated retail investor participation and huge share issuance in structures with questionable investor protection (SPACs)[1] at a time of heightened volatility.

Figure 8: S&P 500 relative to corporate profits



Past performance is not a guide to future performance.

**NIPA US corporate profits after tax without inventory valuation adjustment (IVA) and capital consumption adjustment (CCAdj)*

Source: Bloomberg, 25 February 2021

Incidentally we can also see that the recent COVID-driven low was still a long way from representing genuine, fundamental value.

Time to Act

The logical response, for many investors is to recognise that the elevated returns are likely to have been borrowed from the future and *use those potentially transitory capital gains to secure a reliable long term income stream.* When viewed through this lens, equity markets are offering a wonderful opportunity

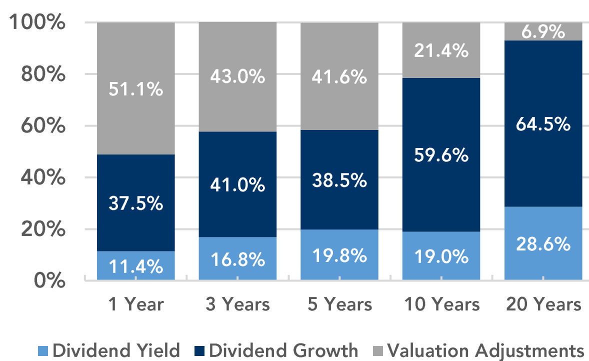
[1] Special Purpose Acquisitions Company

to convert short term capital gains into long term financial security. We would encourage investors to seriously consider taking advantage of this opportunity

Focus on Dividend Growth

Over the long term, the return from an investment is driven predominantly by the cash flow returns of an underlying business with valuations multiples being a secondary consideration. Similarly, over the long term returns are a function of dividends, and particularly growth in dividends as shown below. It is therefore only by adopting a quality-focused, long term dividend growth approach that this effect can be captured.

Figure 9: Average Absolute Return Contribution from Dividend Yield, Dividend Growth, and Valuation Adjustments for Different Holding Periods.



Past performance is not a guide to future performance

Source: MSCI Research 'Global Markets & Return Drivers', Analysis for the Ministry of Finance, Norway, February 2016. The paper examines the importance of dividend yield, dividend growth and valuation adjustments in driving global equity returns from 1994 to 2015.

To achieve this outcome we focus predominantly on sectors that lack capital intensity and cyclicality. This leads us to naturally favour particular businesses and sectors that have the attributes we seek.

Having established such a collection of businesses, turnover should be kept to a minimum to allow capital to be compounded funding an income stream that grows in real terms. Hence we will not use the dividend yield as the primary means of deciding what to buy and sell. This risks emphasising income over quality to the detriment of long term returns. Further we will not buy or sell based on a pre-determined yield or valuation, as this creates unnecessary turnover in the portfolio and is anathema to long term investing.

Once we invest in a company we aim to hold it, ideally, forever and will interrupt the compounding effect of a quality operating business reluctantly. It is our firm contention that long term returns are best derived from the holding of a settled, high quality portfolio and not in the continuous yield-driven buying and selling of shares. Unnecessary turnover and an over-emphasis on yield alone will likely lead, over time, to a dilution of quality and a greater likelihood of mistakes in business selection being made.

The Recent Rotation in Equity Markets

The current consensus narrative, inferred from recent action in equity and bond markets, is that we are to expect a rapid economic recovery, spurred by government spending as well as pent up consumer demand. This will meet supply constraints left from COVID scarring in the economy, driving up prices, which is inflation. Portfolios therefore must be rotated into a mixture of cyclical businesses regardless of capital intensity, into extractive industries again regardless of long term returns on capital and levered interest rate beneficiaries despite the dangers such leverage involves. It should be apparent from the above that this is a not a view to which we subscribe.

First, and most importantly, we do not have these sorts of businesses in our universe owing to their heavy capital intensity and

cyclicality. Such businesses typically deliver poor returns on capital over a full market cycle and are therefore by definition a "trade". Second, it seems likely to us that investors are once again getting ahead themselves. While cyclical risks to the inflation outlook have clearly increased, the more structural drivers have worsened. Debt levels, which past a certain point depress growth, have exploded, technological disruption has accelerated and the demographic backdrop has advanced by one year.

Further it seems unlikely to us that we are in the foothills of a new economic and inflation cycle with equity markets trading close to all-time highs, on some measures, and credit spreads tight. Reminding one that markets are inherently unpredictable *we wonder if COVID, rather than driving markets down to a cycle low, have created the policy environment to drive a cycle high*. As ever time will tell but it seems unlikely to us that elevated inflation expectations would withstand weak asset markets.

To us, investors will be far better served in the long run by taking advantage of the recent rotation to allocate capital to the type of high quality businesses we favour rather than chase what is currently performing – which will inevitably dilute long term returns on capital. We can point to several times in Troy's history when such rotations have occurred. It has not been necessary to capture such low-quality market moves to produce excellent long term risk adjusted results.

We do not intend to change our approach this time albeit we acknowledge that our performance relative to the market can be, and has been recently, marked over these periods. We are not trying to make money all the time, but over time with a long term, high quality, buy and hold portfolio.

A Word on Inflation

The recent upward move in bond yields may signal a secular change to a more inflationary time. We are not convinced but are open-minded to the possibility. It does not cause us to change our process. One thing of which we can be sure is that yields cannot rise beyond a certain point. Debt burdens mean we simply cannot afford it.

It may be inflation dissipates following the upcoming COVID-inspired spike – which we see as likely – and yields fall back. In such an environment a conservatively managed, quality-focused portfolio such as this should prosper.

It could be that fiscal spending does engender some inflation. In this case the authorities will have to cap short and long term interest rates. This would imply increasingly negative real interest rates. In this scenario an asset that has index-linked cash flows should be favoured. This could be an index-linked bond or a high quality equity that has competitive advantages that afford pricing power. This is a characteristic of our portfolio and gives us confidence in our positioning in either case.

Volatility

While volatility is not the same thing as risk – which should properly be thought of as permanent loss of capital – it does matter.

As an investor, whilst you are accumulating capital, volatility is your friend as it affords the opportunity to buy assets cheaply for the long term. However, when you are drawing down on capital volatility is your enemy owing to a likely shorter investing time horizon. A big fall in markets may eventually

recover but by then it may be– not to put too fine a point on it – too late (what academics call Sequencing Risk). It is not simply what return is delivered but also how.

There is a tendency to think that high risk results in high returns. Troy's long track record reminds us this need not necessarily be so. What high risk really means is a wide range of potential returns - high in terms of both rewards but also potential loss. This is especially relevant at times of elevated valuations.

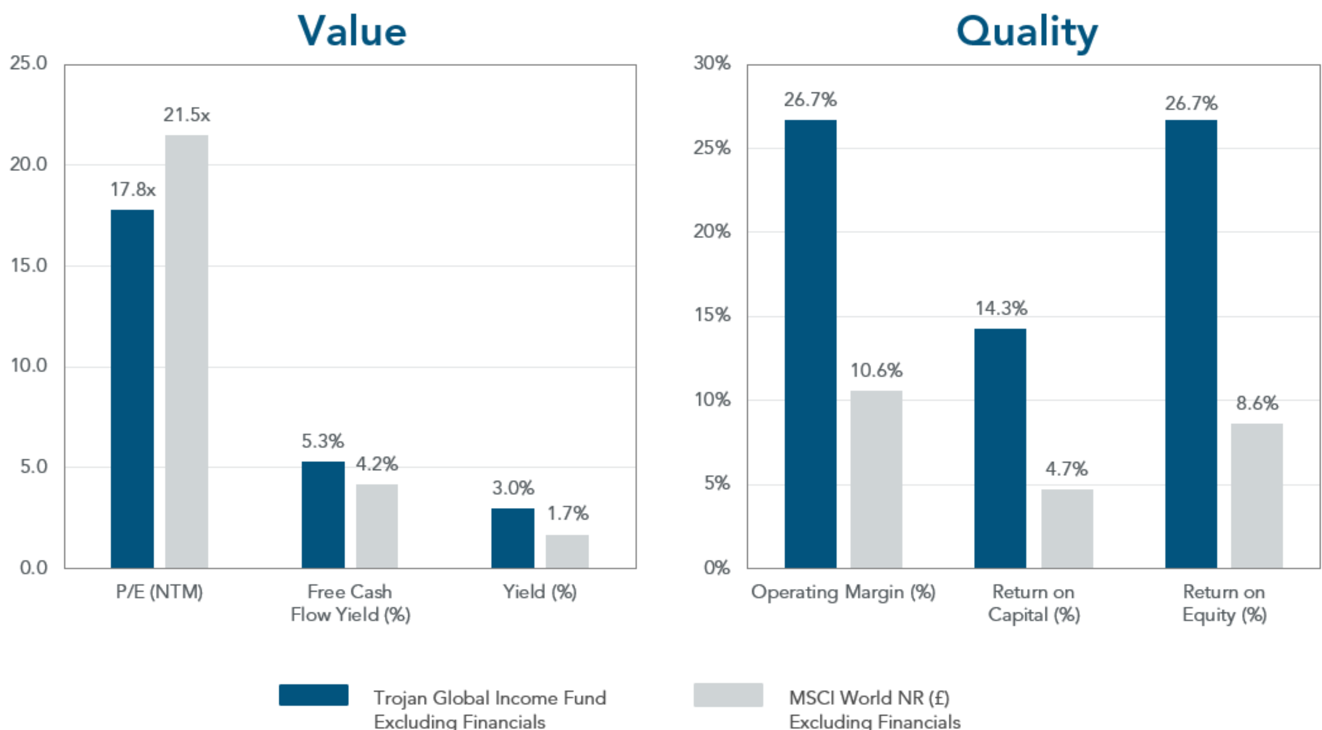
The combination of seeking an above average return, made up of both income and capital but with below average volatility is precisely what we seek to achieve over full market cycles. It underscores our conviction that avoiding large drawdowns leaves one better placed to compound capital. Please see figure 12 in appendix which demonstrates that the Fund has the lowest volatility of returns relative to its peers.

Opportunities

Overall, despite our concerns relating to the broader markets we continue to find excellent opportunities to invest in high quality global franchises trading at reasonable valuations. Our portfolio is currently generating a 5.3% free cash flow yield[2] comfortably funding a 3% dividend yield. We expect both the free cash flow and dividend to grow consistently over the long term (while acknowledging shorter time foreign exchange risks). Further, we have confidence that this portfolio will compound capital at an attractive rate on an underlying basis. This view is supported by the quality of the portfolio when compared to the broader market. Please see figure 10.

2. The FCF yield is the free cash flow generated by the company divided by its market value.

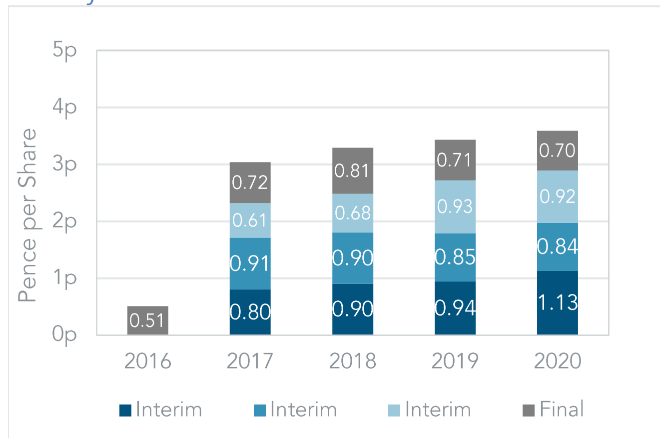
Figure 10: Value & Quality



Source: Factset, 31 March 2021 Characteristics are shown excluding financials. All references to benchmarks are for comparative purposes only. Asset Allocation is subject to change.

This resiliency of cashflows can be further demonstrated by the fact that we were able to grow the fund's dividend by 4.9% in 2020 despite the ravages of COVID which provoked widespread dividend cuts.

Figure 11: Trojan Global Income Fund Dividend History



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, 31 January 2021

Conclusion

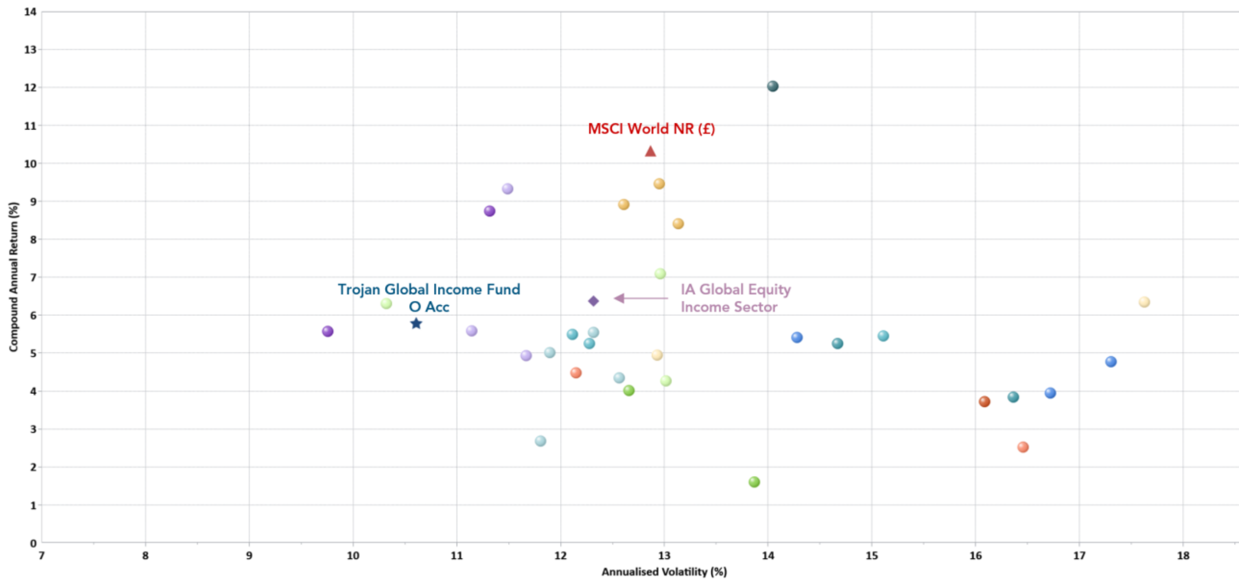
Investors today should recognise the highly unusual opportunity set with which they are faced. The combination of elevated valuations across capital markets, together with the rapid changes occurring in the global economy, makes it a risky time for those who are reliant on savings to fund their lives. At the same time the confluence of low yields in fixed income, years of capital gains in capital markets and the availability of dependable income from high quality equities is serendipitous. To have the security of income and potential for capital growth from a conservatively managed, quality-focused equity portfolio seeking to deliver above average returns with below average volatility seems like an eminently sensible way to navigate the coming decade.

James Harries

31st March 2021

Appendix

Figure 12: Volatility and Returns



Past performance is not a guide to future performance.

Source: Lipper, 01 November 2016 to 31 March 2021. All references to benchmarks are for comparative purposes only.

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