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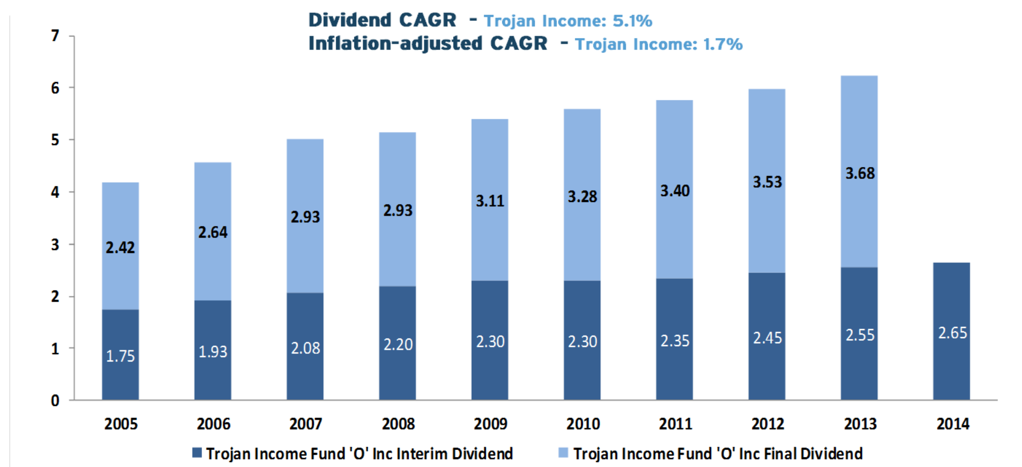
Trojan Income Fund 10th Anniversary Report

A Steady March

Marking landmark dates in the history of a fund always runs the risk of hubris but I hope that investors are prepared to indulge this opportunity to look back and take stock of the ten years since the Trojan Income Fund was launched on 30th September 2004. The headline numbers are straightforward – the total return of +141.8% exceeds that of the FTSE All Share (+120.2%) and the average fund in the IMA Equity Income sector (+106.5%) by a comfortable margin[1]. The annualised return of over 9% per annum has achieved a primary objective of the Fund – to at least maintain the real value of capital and income. The dividend has increased in every year, despite the havoc wrought by the financial crisis which made this the worst environment for UK equity dividends since the 1970's.

Fig. 1 Trojan Income Fund Dividend Track Record since 31st January 2005



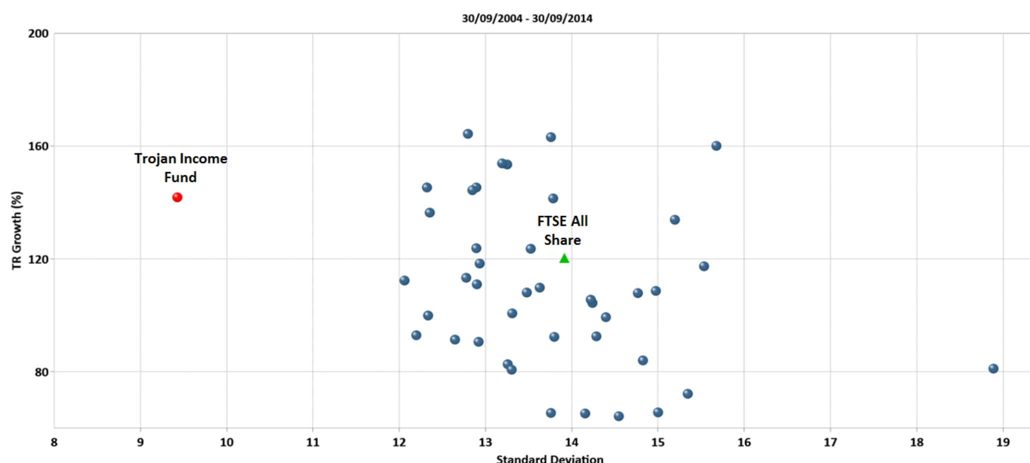
Source: Troy Asset Management 31 July 2014

When launching the Fund back in 2004 we told prospective investors that the Fund had three key objectives. These were to provide a high and regular stream of income that would grow in real terms (see Fig. 1), to minimise the risk of capital loss by emphasising absolute over relative returns and to deliver top quartile performance over reasonable periods (by which we mean at least three to five years) while exposing our investors to lower than average volatility (see Fig. 2). I am pleased to say that all these have been achieved. Since launch the dividend has grown by over 5% per annum, an increase materially above the rate of inflation, the maximum drawdown of the Fund (-25.2%) is far lower than that of the market (-45.6%) and the peer group (-46.5%), the volatility is the lowest in the sector and the Fund is in the top quartile of returns.

[1] Source: All performance figures from Lipper as at 30 September 2014

Fig. 2

Competitive Returns with Low Volatility
(Total return vs annualised volatility for all funds within the IMA UK Equity Income sector since launch)



Each fund within the IMA sector (with a track record spanning the relevant period) is represented by a point on the chart.

Source: Lipper 31 October 2014

Relative or Absolute, That is the Question

These returns should not however disguise the fact that at different times within the ten years the performance over shorter periods, of up to a year, has looked pedestrian or sometimes downright dull. These bouts of sluggishness invariably occur when markets are buoyant or even euphoric and the forces of greed outweigh those of fear. The fear of missing out when others are making money is a powerful force and even the most resolute absolute investor can be tempted to make relative performance judgments when share prices soar. We believe that this opportunity cost is in fact far easier to bear than the devastating impact of falling markets on the capital value of overpriced, fashionable equities. Our investment approach therefore condemns our investors to experience greater volatility relative to the path of the equity market but lower absolute volatility. It is the latter risk that we believe concerns investors most in the long run. As has often been said in Troy reports in the past - nobody can spend relative pounds!

Long Term Investments

Low turnover and a fairly concentrated portfolio of around forty stocks have been features of the Fund since launch and it is worth noting that six companies have been a constant presence in the portfolio since October 2004. Of these, British American Tobacco, Unilever, Pennon Group and Royal Dutch Shell have been stars, generating returns far in excess of the FTSE All Share Index over the ten year period while Centrica (slightly) and BP (more dramatically) have lagged. This ratio of winners to losers is quite acceptable in our view, particularly as even the laggards have made significant contributions to the income account. Also, unless we are convinced that the outlook for the company has changed permanently for the worse, we will buy more shares following weakness rather than be sellers at unfavourable

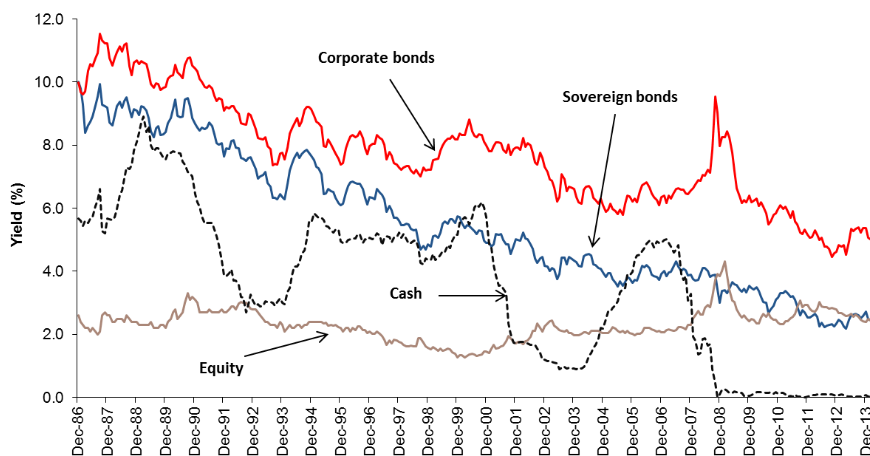
prices. This was the case with BP after the Macondo rig explosion in the Gulf of Mexico in 2010 where we added to the holding well below the current share price. Other names from the 2004 portfolio were lost to corporate activity, such as BAA and Gallaher Group. The Fund's bias towards quality companies with strong cash flow characteristics means that it has been a beneficiary of takeovers over the years, particularly when limitless leverage was available to private equity buyers before the financial crisis.

Why We Invest the Way We Do

We are often asked how we can expect to deliver above average returns when equity markets have a tendency to rise over the very long term and the Trojan Income Fund portfolio has a sensitivity to market moves, or beta, of considerably less than one (usually within a range of two thirds to three quarters of that of the market). We have always intuitively felt that a portfolio that suffers fewer destructive draw-downs was in a better position to compound returns over the long run but importantly this philosophy is robustly supported by quantitative research papers written by experts such as Malcolm P. Baker, Professor of Finance at Harvard Business School. In his 2011 paper[2] he and his co-authors analysed what they described as 'the low-volatility anomaly' and investors' 'irrational preference for high volatility'. They demonstrated that stocks that have exhibited low volatility, or low Beta, have delivered superior returns to investors and that there is every indication that the drivers of this anomaly will persist in the future. They conclude that investors should concentrate on absolute risk adjusted returns and pay less attention to benchmarking.

...And What is Yet to Come

Fig. 3 A Low Return World



Source: Societe Generale 28 February 2014

[2] Malcolm Baker, Brendan Bradley and Jeffrey Wurgler. 2011. "Benchmarks as Limits to Arbitrage: Understanding the Low-Volatility Anomaly" Financial Analysts Journal vol. 67 no. 1

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The last ten years have tested every investment strategy to the limit with extreme drawdowns, sector volatility and the greatest monetary policy experiment in the history of financial markets - quantitative easing. As yields across asset classes have fallen to extremely low levels, equities stand out as a source of income with real growth potential that actually yield more as an asset class than in the late 1980s (see Fig. 3). As long as capital flows continue to search for income then equities will be a beneficiary and valuations at present are not overly extreme. We continue to believe that a portfolio made up predominantly of UK equities and yielding approximately 4% can deliver sufficient dividend growth to at least maintain the real value of investors' income and that remains a key objective of the Fund as well as a strong foundation on which to build future returns.

Francis Brooke November 2014

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