TROY
ASSET MANAGEMENT

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Investment Report N°·33

Our aim is to protect investors' capital and to increase its value year on year.

Masterly Inactivity

"Don't just do something, stand there!"
Ronald Reagan

We remain frustrated bulls. It is our desire to be more fully invested but unless the market presents us with suitable opportunities, we will stay on the side-lines. It takes a lot of patience and discipline to '*just stand there*'. Uncertainty can lead to temptation. Some investors have a tendency to fidget – either to justify their existence or merely out of boredom. Such trades cost money, performance and distract from the overall strategy that is set. In time, you might find stocks in your portfolio that you otherwise would not have acquired and wonder why they were there.

The Funds have made respectable progress this year-to-date (with the exception of the Spectrum Fund which has been a little dull following a strong finish to 2010). The Funds remain cautiously positioned.

With the first half of the calendar year complete, the frustrating '*risk on, risk off*' dynamic has provided a challenging investment environment, notwithstanding the inconsequential outcome. One benefit for us, as Christopher Wood of CLSA puts it, is that "*investors who have the luxury of not worrying about short term performance, presumably because of a good track record, have the potential to achieve even greater outperformance precisely because they are much less likely to be whipsawed by the correlated mood swings*". It is notable that hedge funds, which are usually measured on a monthly basis, have had a particularly difficult six months. This may, of course, change in the second half if markets provide a more discernible direction. In the meantime, Troy has made very few changes to the way we are positioned.

10 years on...

The last quarter coincided with the ten year anniversary of the launch of the Trojan Fund. Since launch, until the end of May, we had generated a total return of 143.5%.

Back in 2001, we anticipated low and volatile returns from stock markets. We said at the time that the strategic use of asset allocation and growing sustainable income were likely to be the key contributors to returns. It is extraordinary that ten years on the FTSE 100 Index is almost exactly the same level today (5600) compared to the closing level on 31st May 2001 (5790). Virtually all of the 55.4% return from the UK stock market over the decade has come from dividend income. The proverbial traveller emerging after a decade in a tropical rainforest, with no access to information, would briefly look at current market levels and dismiss them with a yawn, oblivious to the turmoil of a couple of huge rallies interspersed with two 50% falls.

We are more optimistic about the next decade. The valuation of equities is considerably lower than in 2001, as earnings

have grown, but the work of the secular bear market is not complete. We expect to see single figure price earnings ratios and high dividend yields in a few years' time, through a de-rating and/or share price falls. Such valuations will offer mouth-watering returns.

Charging for performance

Our aim was, and remains, to generate absolute returns without using leverage or the ability to hedge by holding short positions.

There has been much debate and discussion of late in the financial press on the subject of charging performance fees.

Back in 2001, we recognised that returns were going to be harder to come by and that management fees (and portfolio turnover) would be critical to the potential investment outcome. This was seen as rather quaint at a time when the fashion was to establish hedge funds.

We estimate that with our 1% flat fee and by keeping portfolio turnover to a minimum, our investors have at least a 1% head-start over many funds and even greater if performance fees are charged.

The Trojan Fund's annualised return, since May 2001, is 9.3%. Had we charged performance fees on a hedge fund 'two and twenty' basis (2% annual management charge plus a performance fee of 20% on all positive returns, with a high watermark) the annualised returns would have been 2.7% per annum less. The return of 143.5% would have been a mere 89.4%.

We are delighted that the debate on fees is finally coming our way. Our aim is to make money *for* our investors and not *from* them.

I will leave the final word on the matter to Robin Angus, my colleague at Personal Assets Trust:

"*Ultimately our secret is the same as it has always been: We are managing our own money. It speaks for itself that our [PAT's] six Directors and our Investment Adviser each have well over £300,000 of their money invested in the company and that they and their families have total holdings worth £21m. If we get it wrong we do not just 'lose the game' or slip in the rankings. We ourselves suffer financially. A great deal is written about performance fees and incentives in the fund management world. We don't have those. We don't want them and we don't need them. Having one's own money on the line is the greatest incentive of all.*"

Risk free?

Little makes any sense in the untethered financial world we live in. There is no guide. Investment theory, as espoused by Ben Graham, advocates that the intrinsic value of a security is equal to its discounted future cash flows. The discount rate in turn is informed by the risk free rate. But with cash offering no meaningful return and bond yields distorted by government manipulation, where do we begin?

Those who price equities off a 10 year 'risk free' government bond recognise price but don't understand value. Does it make sense to park irreplaceable capital in US or UK 10 - year government bonds at a yield of less than 3%? We think not. In fact, there may be worse investments over the next decade but we can't immediately think of them. From these levels bonds will only perform with Japanese-style deflation and, as we have said in the past, policy is firmly inflationary. We therefore need to look at the stock market on

an absolute basis and not relative to other assets where valuations are misleading and distorted. History provides us with an indicator - a 3% dividend yield on the UK stock market rings alarm bells to us (*see Figure 1 on the back page*). Even if we strip out the partially nationalised banks that do not pay dividends – Lloyds and RBS – the figure only rises by 0.13%. Yields have been at or below 3% four times over the past four decades – 1972, 1987, 1998/9 and 2007. In the following three years the stock market fell between 38% and 70%. Clearly this is not a great starting point. For our balanced mandates many of our stocks are at or near all-time highs. While we are happy to hold them, we are neither particularly tempted nor enthusiastic to add to holdings at current levels.

Nevertheless there are exceptions to the rule. For the Income Funds, the most attractive yields in the market, with the best dividend growth forecasts, are being generated by stocks and sectors which are inherently less volatile. These include food producers such as Unilever and Nestlé, pharmaceuticals such as GlaxoSmithKline and AstraZeneca and tobacco companies like British American Tobacco and Imperial Tobacco.

By concentrating in these areas not only will investors experience less volatility but we believe that the income stream will prove more sustainable than that from the market as a whole. While the 3% starting yield is a level which historically has proved a better level at which to sell than to buy, it is possible to put together a portfolio of high quality companies that produces a yield of over 4% with real growth prospects. We continue to avoid the UK taxpayer-supported banks where more capital is likely to be required and the prospect of future dividends is uncertain.

Flatlining

On June 22nd in a rare admittance of fallibility, Federal Reserve Chairman Ben Bernanke told Congress, "We don't have a precise read on why this slower pace of growth persists". UK and US growth remains stuck below trend and the US, in particular, is struggling with job creation. Unemployment remains close to 10% on the official data, with 44.6m Americans on food stamps. On 29th July, the US announced second quarter GDP growth of 1.3% on an annualised basis and this occurred during the second round of quantitative easing. One can only speculate as to what will happen now money printing has been put on pause in America. The UK's rate of growth for the same period was only 0.7%. We need to get used to much lower levels of growth combined with higher levels of inflation.

In the minutes of the Bank of England monetary policy committee in May, there was a hint of a second round of QE in the offing. We would not be surprised to see a more measured approach by the Bank introduced in the second half of this year - more of a drip to keep the patient stable than an adrenalin shot. No Plan B is envisaged from a fiscal perspective which leaves the Bank to take up the slack.

The realisation that western economic growth will be slow for many years may, ultimately, provide us with the investment opportunities we seek.

Emerging fashions

What of the role of emerging markets? I was asked recently why Troy does not invest directly in emerging markets. Our strength is to invest in what we know and understand. Troy is no one-stop-shop. We are unusual in

suggesting investors should not invest exclusively with us. For those seeking more excitement there are plenty of frontier funds out there. We note however that one of the most successful managers in emerging markets, First State, have begun to find relative value in blue chips quoted in the UK and the US. The valuation gap has reversed over the past decade. Western companies with exposure to emerging markets are now cheaper (and arguably with better governance) than their domestically quoted equivalents. Coca Cola, Unilever and Colgate are good examples of companies that already provide us with such exposure.

Opportunity knocks

There are few opportunities to increase our equity holdings, at present, but we are very confident that opportunities (as in 2008 and 2009) will present themselves.

I shall leave the last word to Seth Klarman, founder of the Baupost group and author of the value investing classic, *Margin of Safety, Risk Averse Investment Strategies for the Thoughtful Investor:*

'Why should the immediate opportunity set be the only one considered when tomorrow's may be considerably more fertile than today's?'

Patience will be rewarded. We wish all our investors a restful summer.

Sebastian Lyon August 2011

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A 3% dividend yield is not a good starting point...

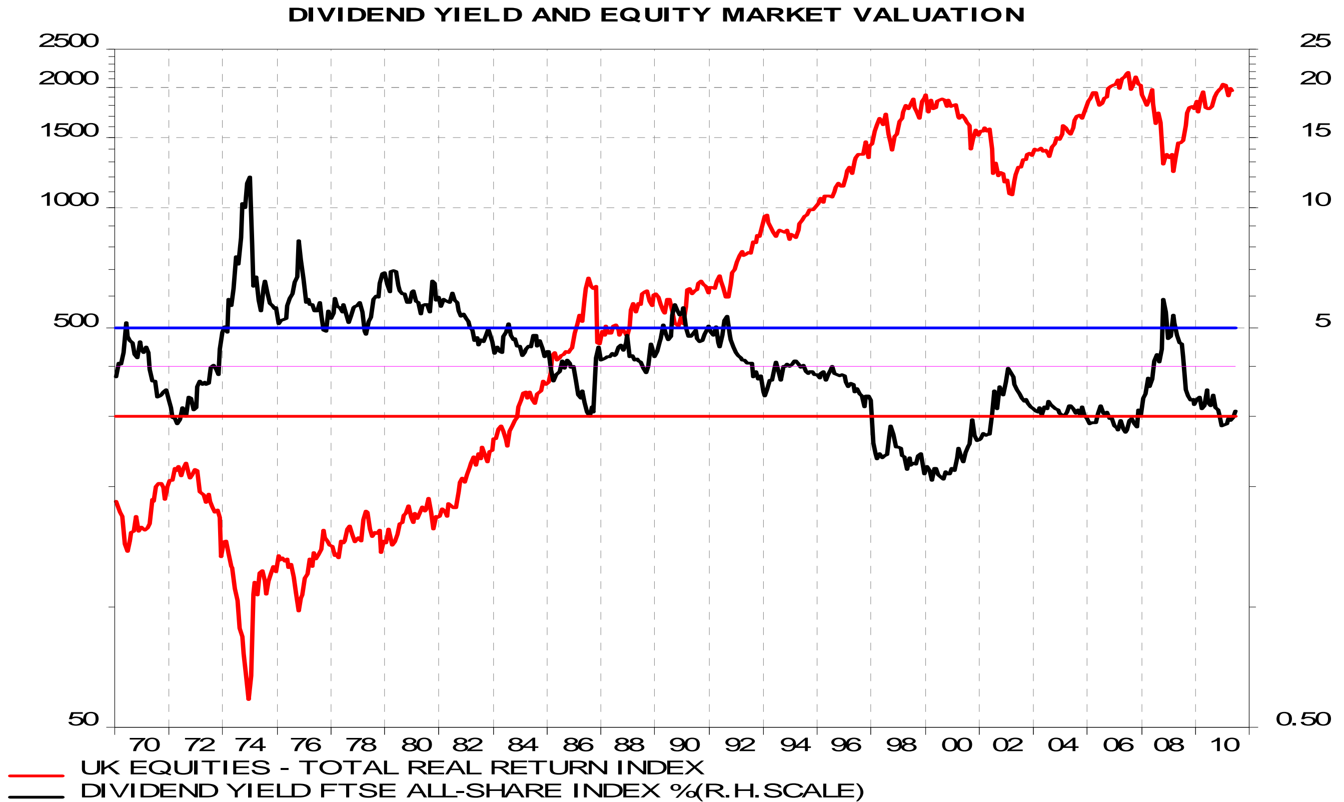

Figure 1 *Source; Datastream*

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