TROY
ASSET MANAGEMENT

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Investment Report N°·36

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

Here we go again

"…a man at my age should not have to worry about money. My father never had to worry. Consols were good enough for him. But today one can't even trust Government stocks"
Graham Greene (*England Made Me, 1935*)

At the beginning of February, we quoted Yogi Berra's idiom "*It's déjà vu all over again*" in order to convey our sense of frustration with the repeated over optimism of investors. The rally that started in October looked to us like a case of hope over experience. There was a high probability that 2012 would be a repeat of 2010 and 2011. So it does not surprise us that, once again, Eurozone difficulties are knocking markets off course, just as they did in the spring of 2010 and the summer of 2011. The remarkable complacency of the first quarter has given way to the recognition that the fiscal compact agreed last December, combined with the ECB's Damascene conversion to money printing via the Long Term Refinancing Operation, temporarily addressed the liquidity symptoms of the Euro's problems but not the solvency disease. Whatever happened to the prevalent talk of "exit strategies" two years ago? By now the global recovery was meant to be at escape velocity; instead it is at stall speed.

Investor attention is clearly focused on the European periphery today, but the United States will, at some stage, become the centre of attention once more. There is bound to be more talk of the fiscal "cliff" as we move towards the Presidential election in November.

To make matters worse, the difficulties in developed markets are now accompanied by a more pervasive slowdown in key emerging markets, notably the BRICs (a Bloody Ridiculous Investment Concept according to long-time bear Albert Edwards). The currencies of Brazil, India and Russia have been in free fall as growth hit the buffers of inflation and slowing external demand. Importantly, it appears that the Chinese are not willing to offer the world a re-run of their 2008/09 stimulus and are seeking more balanced, consumption-led growth. In some corners of China you can't see the wood for the stockpiles of coal and steel. If this lower growth trajectory is more sustainable in the long run, then we should be grateful for the temporary pain. However, others may not see it this way.

A lack of interest

Recent risk aversion has driven bond yields down to record lows. UK 10 year gilt yields dropped to 1.5% at the beginning of June while the US equivalent yield is 1.45%. In the words of Robin Angus, our colleague at Personal Assets Trust, *"…during this strange decade, the unusual became usual and the unthinkable became an everyday occurrence*." Locking in yields at this level is like picking up depreciating pennies in front of an inflationary steam roller. But what are such low yields telling us? Equity strategists argue that shares look cheap compared to bonds, but that is hardly a challenging comparison. A vast majority of the stocks in Troy's portfolios yield more than gilts but that says more about the overvaluation of bonds than the valuation of equities.

Nevertheless the negativity towards stock markets does offer encouragement and when a consultant actuary is quoted in the *Financial Times* as saying, "*There are not enough bonds in the world*", you know we are getting closer to the end of the bull market in bonds and the bear market in equities. If the world's problem is too much debt, how can there not be enough bonds? You couldn't make it up! Our preference, in fixed interest markets, remains to be firmly in the camp of Index-Linked.

Deleveraging

The phenomenon of private sector deleveraging, which began in August 2007, is going to be more persistent than many would have us believe. Consumers who were prepared to take on ever greater debt for decades are paying it back irrespective of the low rates of interest. The main purpose of refinancing a mortgage in the US is now to shorten the debt's maturity (thereby accelerating capital repayments) rather than to use the debt to fund increased consumption.

The omnipotent bond markets will not forever tolerate governments shouldering debt levels over 100% of GDP. Consumers, apart from wishing to reduce existing debt burdens, will have to compensate for a shrinking social welfare safety net by increasing their own savings. Banks are compelled by regulation to be more strongly capitalised and in the absence of sufficient retained earnings (hard to generate) or equity issuance (unpalatable to investors and highly dilutive), asset reduction remains the easiest path. Corporates will see little attraction in investing aggressively in new productive assets against the background of negligible growth. A reluctance to offer credit will meet a singular lack of demand for it, and no amount of special lending initiatives (such as those recently offered by the Bank of England) will even lead the reluctant horses to water, let alone make them drink.

Public or private?

Greggs, a long term holding at Troy, has been in the press lately thanks to the ill-conceived and now abandoned "pasty-tax". The company has delivered consistent profit growth and an unbroken 26-year track record of dividend growth. Greggs eschewed the fashion in the last decade to take on ever higher leverage (remember the opco/propco model?) advocated by private equity.

We were intrigued to see recently the different capital structure of Greggs' competitor Pret A Manger. As at the 2011 year end, Greggs managed 1571 shops and had £20m of net cash (£12,700 per shop). The bakery has not been indebted since 1994. This compares to Pret, bought by a private equity group in 2008, which has 286 stores (according to the *Financial Times*) and £457m of net debt (£1.6m of debt per shop). In some quarters, there is clearly much deleveraging still to do.

Spring Fever

It has been a long time in coming but shareholders are finally using their powers of ownership to curb executive pay that has diverged from performance. At Troy, we engage with Boards of companies where we hold a meaningful stake and have had discussions with two remuneration committees in recent months. Our intention is never to micro manage our investments. The Board committees are usually in a reasonable position to judge how to measure

performance but sometimes bonuses are paid that need explaining and targets are put in place that are too low or not clearly aligned with the interests of long term shareholders.

One of our particular bugbears is capital allocation. Much value is created or (more often) destroyed by acquisitions. We believe it is very important that management is accountable and rewarded (or not) for these business critical decisions.

Poor Sir Martin Sorrell of WPP seems to have been caught in the crossfire of this debate. We were bemused to see one fund manager criticise Sir Martin for acting *"more like an owner than a manager"*. Ironically, Sir Martin is very much an owner, with £140m of WPP stock. If every chief executive had a similar commitment then, in our view, companies would be better managed. He has also been in his role for 27 years while the average tenure of a CEO in the FTSE 100 is less than five years (according to Russell Reynolds). Regrettably, Sir Martin seems to have been seduced by the desire of US corporate executives to be paid top quartile salaries, to the cost of shareholders. Expecting and demanding top quartile pay is as self-evidently daft as the 1970s trade union leader commenting, *"It is unacceptable today that anyone should earn less than the national average wage."*

Own or Rent?

We would like to see ***more*** managers act like owners. An owner would never risk the long term health of the business in the pursuit of short-term profit maximisation. Owners are not obsessed with growth for the sake of it. They prefer less debt and more cash. Owners have patience and like us, as part owners of businesses, wait for opportunities to present themselves. Chief Executives in a hurry have a tendency to destroy rather than create wealth.

George Weston, Chief Executive at Associated British Foods, is an excellent example of an owner (ABF is a long term holding in the Trojan Income Fund). In 2011 Mr Weston was paid a base salary of £885,000 and a bonus of £438,000 which would place him firmly in the bottom quartile of remuneration (the average for a FTSE 100 CEO is £4.8m). Yet his wider family ***owns*** 54.5% of the business through Wittington Investments and his personal shareholding in ABF amounts to £40m. ABF, with successful subsidiaries such as Twinings and British Sugar is the company behind the highly successful Primark. The retailer will buy freehold stores when the terms are right and ABF has a cautious and opportunistic approach to acquisitions and disposals. Quietly, without fuss or even an investor relations team, Mr Weston gets on with running the business. By way of comparison, over the past decade, WPP shares have returned 32%, while ABF returned 140%.

Face off

Our investors will not be surprised that we gave the IPO of Facebook a miss. At 14 times turnover, we felt that much future growth was already reflected in price. The absence of a track record (the company was founded in 2004) makes forecasting future earnings that much harder. We rarely partake in IPOs. The seller decides the price and the timing. This places us, as buyers, at a huge disadvantage. That does not mean that we would never buy into internet companies. Sharp-eyed, long-standing investors will recall our foray into Lastminute.com back in 2002, which made us over 70% in a year.

The reason for the purchase was deep value. After a disastrous IPO in March 2000, right at the apex of the internet bubble, Lastminute.com shares fell by over 90% from their peak. By late 2002, the shares were a "net, net" or in other words, the company had more cash on its balance sheet, after deduction of all liabilities, than the stock market was valuing the company. The operations of the business were effectively being valued at less than nothing. It is an indication of the lack of opportunity in markets that there are few companies valued like that today. Should Facebook ever become a "net, net" we would certainly look at it. With $3bn net cash this gives a value 85% lower than today's price. We are not holding our breath.

Emerged markets

We have long advocated the merits of investing in emerging economies via holding stocks listed in developed markets. BAT, Colgate-Palmolive, Nestlé and Unilever are fine examples. Over the past decade, emerging market stocks have become more fashionable and valuations have risen as a result. The starting valuation is critical to future returns and the upside from these high valuations must now be limited. A number of our investments have listed subsidiaries and associates in Brazil, India and the Far East. Markets have a tendency to move in long cycles. From low initial valuations in 2002, following the Asian crisis in the late 1990s, shares in these subsidiaries and associates have risen in value to eye-watering levels while many of their parents' valuations have gone in the opposite direction (*see table on page 6*). We may on occasion make selective purchases in emerging markets (the Trojan Capital Fund has a holding in Indonesia's Gudang Garam) but we expect better returns over the coming decade from the less popular and considerably cheaper holding companies listed in the UK, US and Switzerland.

Never mind the quality...

Valuations of the UK stock market, at least on a myopic forward price/earnings basis, look reasonable at 9x. Dividend yields, at 3.7%, appear less compelling, thanks to the need for yield. We believe these valuations are distorted by the constituents of the Index that have changed dramatically in recent years. We are also very concerned that the quality of the market has declined in recent years with the loss of Allied Domecq, Cadbury, Gallaher, Reuters and Scottish & Newcastle. These companies have been replaced by the likes of Fresnillo, Glencore International, Eurasian Natural Resources, Evraz, Kazakhmys, Polymetal International and Vedanta, none of which pass our business quality or governance thresholds. Our instinct is that UK equities are not as cheap as they appear at first glance. The median PE, as opposed to an index weighted-average PE, explains the aberration *(see Figure 1).* The median PE of 14x, while not excessive, is hardly a bargain.

RoRo or SoSo?

Over the past two years the FTSE 100 has tracked sideways but with nauseating volatility. There has been little reward for risk. Many have been whipsawed by these so called "RoRo" – or Risk-on, Risk-off markets but perhaps a better description would be "SoSo" – or Stimulus on, Stimulus off.

The recently announced €100bn bail out of Spanish banks failed to spur stock markets up. We anticipate further efforts by

governments and central banks to stimulate the global economy and thereby distort markets. These increasingly desperate measures delay and exacerbate the final dénouement. "SoSo" may also aptly describe current investment returns.

We wish our fellow investors a restful and happy summer.

Sebastian Lyon June 2012

FTSE 100 Index
12 Month Forward P/E weighted (9x) compared to the Median P/E (14x)

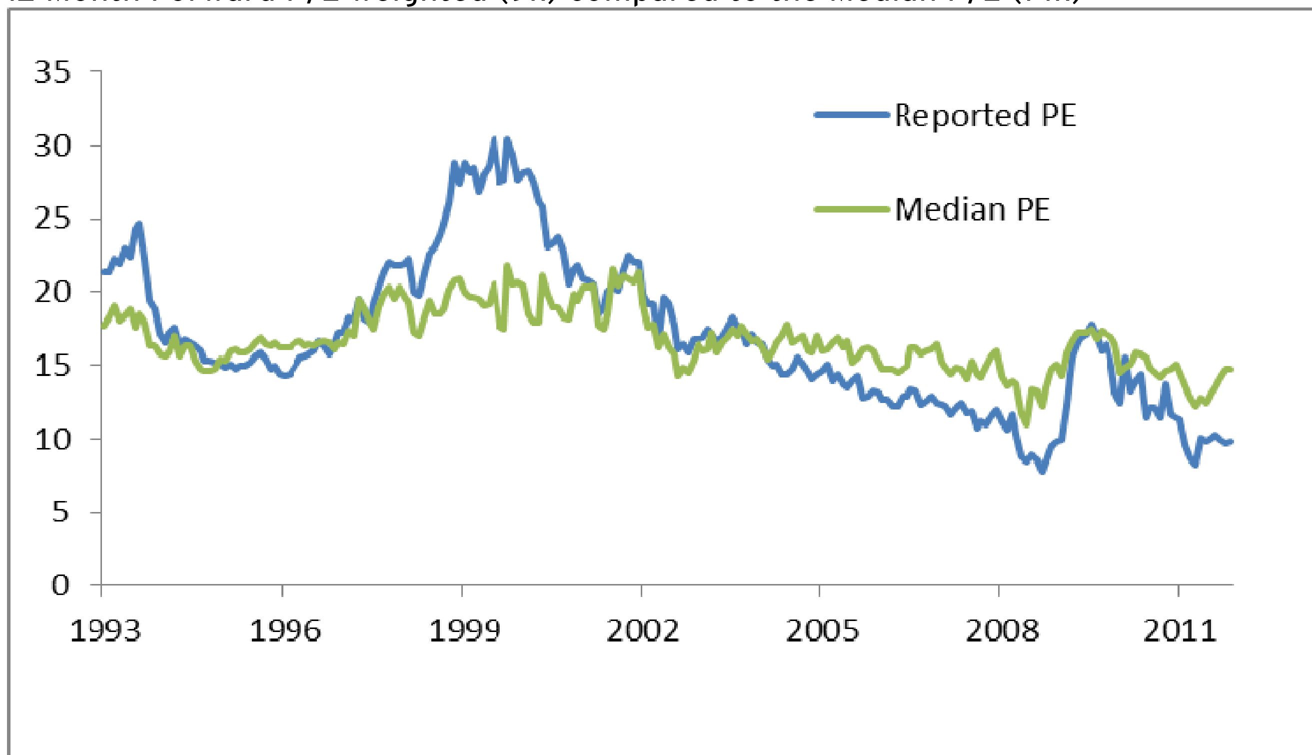

Figure 1 *Source: SocGen*

Emerging Market Valuation

Prospective Consensus Earnings Multiple

	2012	2002
British American Tobacco*	**14.3x**	**12.2x**
ITC - India (31%)	29.7x	14.0x
Souza Cruz - Brazil (75%)	23.5x	5.7x
Nestlé	**16.5x**	**15.0x**
Nestlé India (34%)	39.5x	22.5x
Nestlé Nigeria (62%)	20.0x	11.6x
Unilever	**15.9x**	**28.4x**
Unilever Nigeria (50%)	20.2x	31.0x
Hindustan Unilever (India) (37%)	30.2x	23.5x
Unilever Indonesia (85%)	34.9x	14.2x
Colgate-Palmolive	**18.3x**	**23.8x**
Colgate-Palmolive India (51%)	37.5x	27.7x
Colgate Pakistan (30%)	30.2x	5.9x

Percentage ownership of Subsidiary/Associate in brackets

*Hyperinflation valuation - BAT Zimbabwe (57%) 44,822x

Source: Bloomberg

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