TROY
ASSET MANAGEMENT

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Investment Report N$^{o.}$40

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

The penalty for prudence

"Investing today may well be harder than it has been at any time in our three decades of existence, not because these markets are falling but because they are rising...and not because there are no opportunities, but because the underpinnings of the financial system are so precarious the unabating risks of collapse dwarf all other factors."
Seth Klarman, Baupost Group

Over the past year, performance of the Trojan Fund and Personal Assets Trust has lagged behind the main equity indices. Those who have invested with us recently might well ask: "What's gone wrong?" Others, who have been with us for many years, may be less surprised in the knowledge that our returns have, in the past, diverged from stock markets. Our natural caution has proved unprofitable as we have failed to participate in sharply rising equity markets. But **short-term** missed opportunities are a price we pay for dependable and sustainable wealth protection and growth over the **long term**. The FTSE 100 looked expensive at 6,000 so it should not surprise you if we find it even less appealing at 6,700.

One investor asked us, "*How might we recapture this recent relative loss?*" The answer is that we are seeking ***absolute*** not relative returns. We acknowledge there is an opportunity cost in missing out on the recent rally but we do not intend to dramatically change course. This is hardly comforting to those investors who may desire to see some action. As Robin Angus at Personal Assets Trust puts it, "*We will stick to our guns and refuse to be deflected from pursuing our strategy by our short term under-performance.*" Our long term track record has not been generated by buying high and selling low. The more fearless others become the more prudent we feel it necessary to be. At times like these, the temptation is always to pursue returns even if these are predicated on hope rather than on realistic expectations. Activity is not in itself a virtue, however much investors may feel we ought to be "doing something". Standing apart from the crowd risks severe short-term underperformance but following the crowd makes long-term performance impossible.

A few years ago, we discussed the matter of the Trojan Fund's historic returns with trustees of a charity. One trustee enthusiastically pointed out, "you have never had a down [calendar] year." I quickly responded, "no but **we will!**" Perhaps 2013 will be one of those years - we will see - but if we do, it will not distract us from the way we invest.

Market Timing?

There are few things more embarrassing for investors than sitting it out in cash while others are making money apparently so effortlessly. Excuses are invented to join the herd. With each cycle, there is always a different reason as to why valuations will never revert to the mean. This time, the excuses are quantitative easing, zero interest rates and the unprecedented faith in the

ability of central bankers to support the market prices of many assets.

Some say you cannot time the market. We agree. But while we would never describe ourselves as 'market timers' - trading in and out on short term sentiment – we also reject the assertion that since you can't time the market, it doesn't matter when you buy the stocks you like or what price you pay for them. Instead we consider ourselves long term investors with an emphasis on valuation and when value is not apparent, we will not lock in low returns with the risk of suffering material losses. However, moderate losses must be tolerated and are all part and parcel of long-term investing.

Disconnected

The evidence suggests that those buying stocks today are paying ever more for the same level of corporate earnings. Over the past 18 months the US stock market has risen by 30% while earnings are up 6% (*see Figure 1*). This is a re-rating of almost a quarter and according to Bloomberg, the fastest rise in valuations since 1999. Either corporate earnings have to rise by a comparable percentage (which seems highly unlikely given profit margins are already at a record high), or markets will begin to reflect this lacklustre earnings environment. This does not necessarily equate to falling stock prices, but earnings need to catch up with the re-rating that has occurred. The S&P 500 Index is up 150% from its trough in early 2009. If this is another secular bear market rally (as we suspect) then it has been exceeded only once back in the early 1930s.

A flat world

Liquidity has bid up all asset classes to prices that could not be justified in a conventional interest rate environment. For asset allocators, with starting yields so low, (*see Figure 2*) not only are future returns likely to be lower but volatility will be higher. Moreover, with correlations between asset classes increasing – all boats have risen - it is much harder to diversify risk. The classic 50/50 stocks and bonds 'balanced' portfolio may, for the first time since the 1980s, not offer its traditional offsetting, 'barbell' protection. This explains our preference for high levels of liquidity.

At previous stock market peaks, in 2000 and 2007, opportunities were available for the canny to protect capital. In 2000, it was in so-called 'old economy' stocks that had been left behind in the dash for all things 'new economy' related. In 2007, bonds offered some protection along with foreign currency compared to extremely overvalued sterling. Today, defensive positioning is considerably more difficult to achieve. It is either expensive or in the case of cash, which offers no return at all, merely protects the nominal value of our capital.

Back in January 2012 we spoke about how we believed that good returns would be harder to come by. Gold and index-linked bonds had, up to then, served us well and many of our core equities had been re-rated upwards. Since then gold and index-linked bonds have slipped from the podium of popularity but the continuing rise in western equity markets begs the question as to whether our caution has been too early.

The loneliness of a long distance runner

In March I attended a dinner hosted by an American stock market strategist and Wall Street legend. The guests were a group of London-based investors, mostly hedge fund managers. One asked, "*I am not interested in how I am going to make money in the next year, what about the next few weeks?*" I began to feel a little queasy – was I the only one in the room with an investment horizon longer than three months? It got worse. Of the nine investors present eight were very optimistic about the prospect for stock markets. Perhaps, unsurprisingly, I was the only one expressing any caution. The enthusiasm was neither based on corporate earnings nor the economy but rather it was purely predicated on QE and the prospect of infinite money printing. The 'central bank put' was alive and well and thus downside risk was minimal.

The guests were asked some standard investment questions. At what level will the Dow Jones Index end the year? What are the odds of another Eurozone crisis? But the most interesting of all was, When will QE end? The average view was 2015, with a range between 2014 and 2020. No one expected it to come to an end anytime soon. So it is hardly surprising that the Fed Chairman Ben Bernanke's announcement in May, of a desire to 'taper' QE as soon as September, sent equity and bond markets into a spin. What seemed a remote prospect became suddenly imminent. Since early May ten year US government bond yields have risen by 87%, from a low of 1.6% to 3% (UK gilt yields have risen by a similar amount). This is a considerably greater percentage move in yields than the last major bond market correction in 1994 when equivalent yields rose from 5.2% to 8%.

Inflation insurance

We hold no conventional bonds but index-linked bonds have been dragged down in this bond market rout.

If in future inflation expectations drive up bond yields, then index-linked will begin to perform by decoupling from their nominal brethren as investors look to protect their capital from higher levels of inflation. This is the antithesis of today's 'reaching for income' paradigm which we wrote about in our last report. Zero interest rates have encouraged investors to focus on nominal returns ***from*** their capital, rather than a return ***of*** their capital in real terms. If we get the inflation we anticipate, we may move into a new era where chasing income will lead to a depletion of capital. The desire for capital protection in real terms will be richly valued. Investors will likely pay a premium for assets that are inflation-linked as they realise the risk lies in the future value of money. Equities that provide genuine dividend growth and do not rely on debt to fund that growth (as the interest costs will be rising) should also thrive in this environment. Anything with a fixed coupon, like conventional bonds, will be a sure way to convert capital into income. This scenario may be some way off but sadly no one knows the start time for this race to debasement. In the meantime 'linkers' may continue to be joined at the hip to conventionals and be susceptible to a further rise in real interest rates.

Will the taper be lit?

Since the Fed's announcement in May, any move in markets - whether rising bond yields, collapsing emerging market currencies, volatile stock markets or a fall in the gold price - has been blamed on the prospect of

'tapering'. Investors have rushed to discount a change in monetary policy. Will it happen? There may be a marginal $10bn to $20bn reduction in US QE (out of a current $85bn a month) to show willing but an all-out sudden reversal would cause pandemonium in global financial markets. Tapering will be more of a tiptoe than a stampede. Stock prices have been hugely subsidised over the past two years and any prospect of removal of that subsidy will have profound consequences including the re-pricing of risk.

If a strong economic recovery does take hold, as is beginning to be expected and discounted in the prices of the most cyclical of stocks, then bond yields will continue to rise (and prices fall). The rising cost of money will begin to have an impact on the real economy and that will feed back into corporate earnings and ultimately to the stock market. We cannot have it both ways forever – a weak economy with rising stimulus or a strong economy with no rise in the cost of money. A policy reversal risks a severe tightening of monetary conditions and risks a further prolonging of any meaningful economic recovery. Leaving the monetary taps turned on risks creating yet further credit bubbles and a rise in inflation. There are no easy policy choices and so the risk of policy error, given the intensity of intervention, is elevated. Our asset allocation will benefit from likely monetary mistakes. If central bankers turn the taps off too early economic and stock momentum will fade and stock-picking opportunities will remerge; if they are too late then inflation will return and our protection will prove its worth. This includes gold, which is held in anticipation of monetary instability.

Everybody knows, everybody forgets

Asked what investors would learn from the 2008 financial crisis, Jeremy Grantham, of GMO, replied: "*In the short term, a lot. In the medium term, a little. In the long term, nothing at all. That's the historical precedent.*" Five years after the demise of Lehman Brothers investors believe yet again that material falls in stock markets are an impossibility. The implicit "Greenspan put" has become an explicit "Bernanke put". Will the next Federal Reserve Chairman be so enthralled by the level of the Dow Jones Index? Our investment process has been built on fundamentals and not faith. We are excited by the prospect of much better buying opportunities ahead, just as we were back in 2007 when our conviction and liquidity levels were questioned. We do expect to be able to deliver attractive returns once again but only when valuations become more compelling. That will require patience – ours and yours.

Sebastian Lyon

September 2013

Mind the gap – the recent rally was not based on corporate earnings

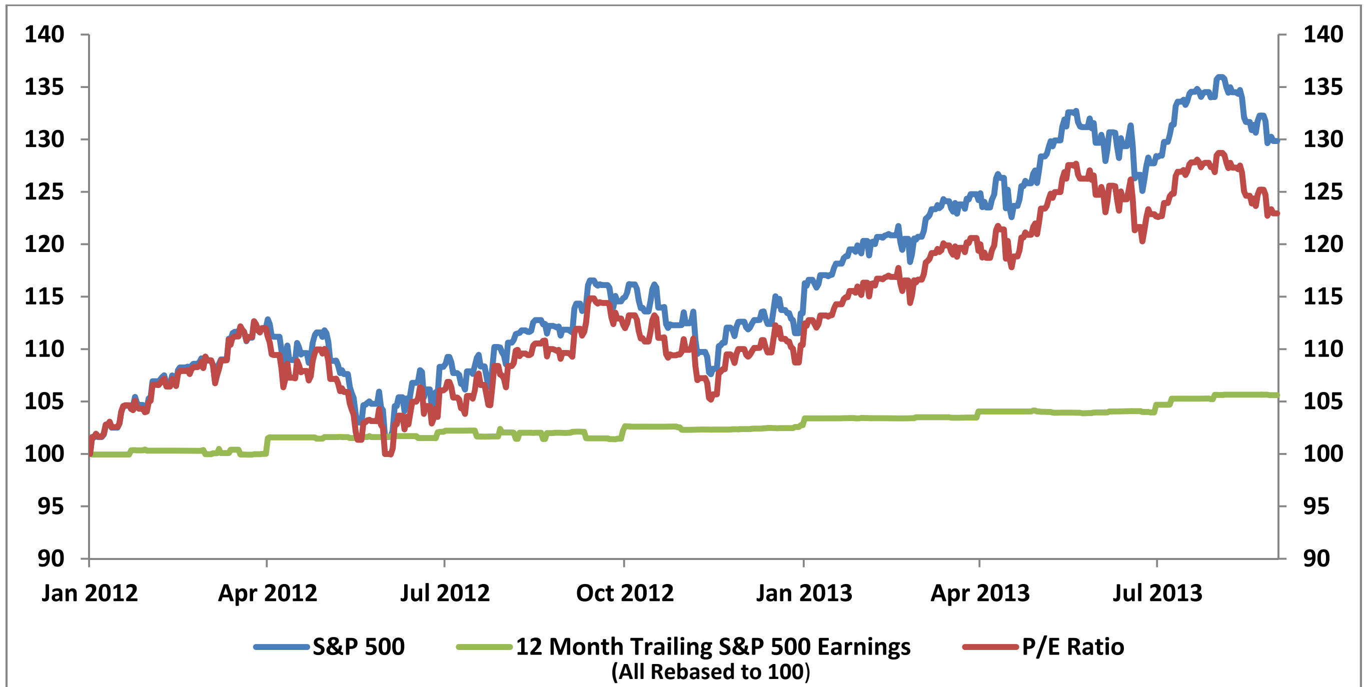

Figure 1 *Source: Bloomberg, Sept 2013*

A Low Return World – Reaching for Yield on a 'Balanced' Portfolio

(50% Equity, 40% Gov't Bonds, 5% Corporate Bonds, 5% Cash)

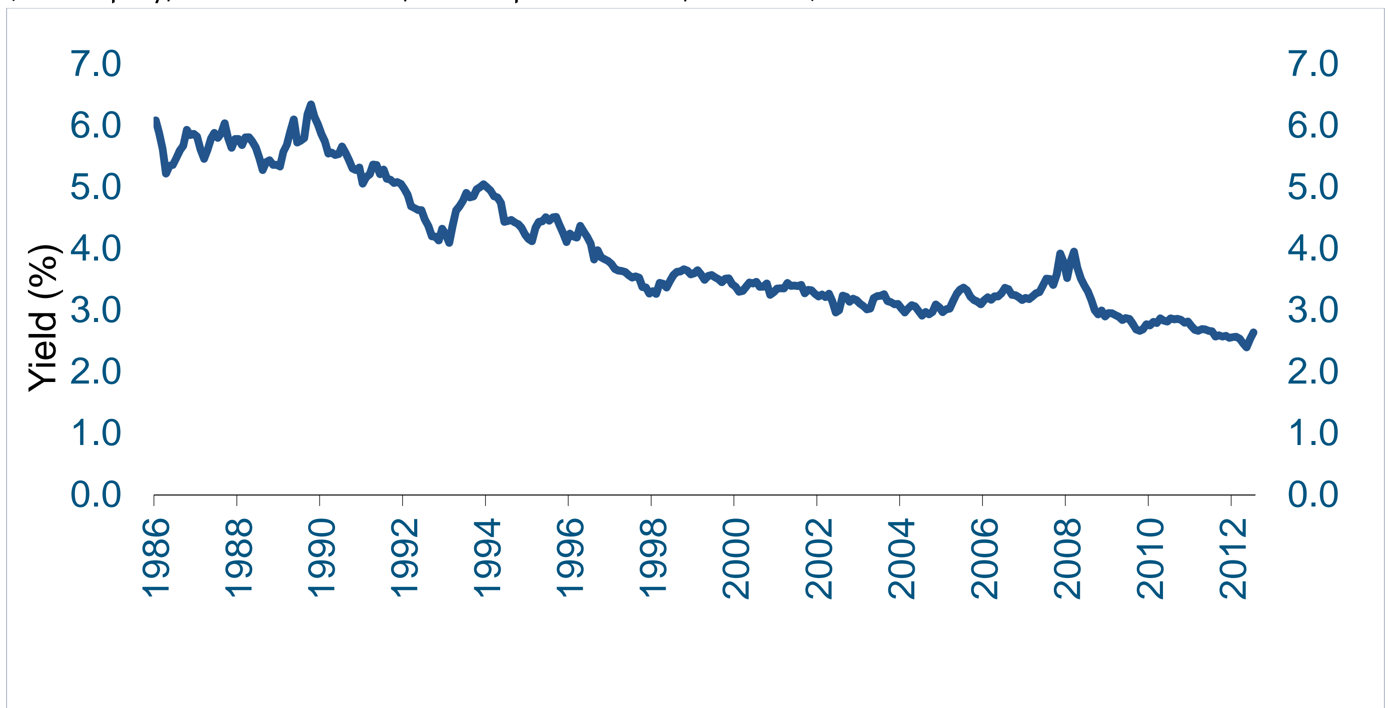

Figure 2 *Source: Société Générale, 31 December 2012*

(*Yield Indices - Sovereigns - BoA Global Gov't Bond 10 year+, Global Equity - MSCI World, Cash - US T-Bill, Corporate Bonds - BAA US Corporate Yield)

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