



Investment Report N°58

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

Investing for the future

"We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten. Don't let yourself be lulled into inaction." Bill Gates

Investing in equities requires optimism about the future. Our role, as investors, is to endeavour to discount the future cash flows of companies in which we invest. The overarching concern is to distinguish between those businesses which will survive and thrive, and those which will struggle and in time become shadows of their former selves. Looking myopically at a price multiple of today's earnings is not enough. In fact it can be positively misleading. So we need to be forecasters without being soothsayers. Just as importantly, we also need to spot where markets are over-anticipating future growth – where valuations indicate 'irrational exuberance'. This is as much an art as it is a science and, to borrow an expression, it is better to be roughly right than precisely wrong.

It is often more useful to look for clues in corporate track records than to rely on spreadsheets which project future earnings. Analysts have a tendency to obsess over the exactness of long-term forecasting, when it is hard enough to pinpoint accurately the next quarter or two. This explains our preference for more predictable businesses where there is less scope for forecasting error. While Bill Gates's words above are helpful to any long-term investor seeking to avoid traps or seize

opportunities, it is ironic that Microsoft's Excel spreadsheet has done so much both to help and to hinder the investment industry by facilitating an overreliance on exact forecasts. Given a low enough discount rate and a high enough growth trajectory, any valuation can be 'justified'.

We believe, in general, analyst training overly focuses on the figures, which are always one step removed from reality. The Chartered Financial Analyst programme, which is the industry standard, teaches asset valuation, financial reporting and portfolio management theory. All of this is essential to know, but prioritises quantitative over qualitative analysis. What of the more subjective aspects of investment? These are equally important, spanning the distinctiveness of products or services, the reasons why customers make repeat purchases, the quality of management teams and the alignment of their interests.

What's in a name?

Hard definitions of 'value' or 'growth' risk misrepresenting a more nuanced reality. For us at Troy, value investing involves the identification of excellent businesses at attractive prices. This is much more subjective than simply identifying companies on low price to earnings multiples, as per the generally accepted definition of 'value'. A very low valuation often betrays the dubious quality of a business or the weakness of its balance sheet. This is particularly true during the later stages of a bull market. More often than not, rather than the bargains they appear, these are expensive mistakes waiting to happen.



Successful turnarounds are few and far between in today's market where an increasing number of businesses are struggling to remain relevant. One only has to look at recent experiences in the outsourcing or retail sectors to see the challenges of corporate restructuring. Steady-state companies can look dull and do not offer the excitement of recovery. However, with the exhilarating hope that accompanies turnaround situations, often comes gut-wrenching disappointment and, with it, permanent financial damage.

For this reason there are many companies that we would not buy at any price, however cheap they appear. Avoiding the dross is more than half the battle when it comes to investment survival. While there may be plenty of superficially tempting opportunities in the stock market, we prefer to remain discerning. Choosing companies with attractive returns on capital, financial strength and earnings growth (usually in that order) is a more effective way to deliver steady returns than bottom-fishing across the stock market's detritus. These lessons have been learnt from painful experience.

The past few years have undoubtedly been a golden era for 'growth' investing. Performance has been driven by impressive earnings gains combined with material re-ratings. Much to the frustration of self-described 'value' investors, earnings growth during this cycle has been more narrowly concentrated in expensively priced stocks, whilst those on lower multiples of earnings have generally not benefited from any improvement in their fundamentals.

The paradox of investment styles is that the best returns are almost always had when so-called 'growth' is priced cheaply. However, chasing growth at any price can be just as

damaging to a portfolio's returns as buying businesses with weak fundamentals. Extrapolating and overpaying for recent growth, even if this proves sustainable, is often the most expensive investment mistake of all. Sometimes even the soundest and most dependable growth can be overpriced, and even the best companies can sell on too high a multiple. When valuations are excessive, investment evolves into speculation. To some extent, this is where we are today. For prudent investors, this should be a warning signal.

FAANGs for the memories

The financial industry has a predilection for complexity and jargon. Acronyms uniting disparate investment opportunities risk putting a barrier between investors and reality. A decade ago the favoured investment concept was the BRICs (Brazil, Russia, India & China) – a one-stop shop for emerging market investing. The fashion waned when correlations broke down and differential returns between the countries began to emerge.

The acronym *du jour* is FAANG (Facebook, Amazon, Apple, Netflix and Google — the parent company of which is now known as Alphabet). This is a simplistic grouping of technology stocks, the usefulness of which may have already peaked. It is certainly descriptive of the narrow leadership we have witnessed in stock markets of late. Such concentration tends to occur close to the peak of a market cycle; excluding the FAANGs, the S&P 500's first-half returns would have been negative. However, pigeon-holing markets or stocks in such a way is often unhelpful as the constituents inevitably follow different trajectories. The operations of these businesses vary considerably, as do their levels of profitability. We note that Alphabet's free cash flow margin has not fallen below 15%



since it listed on the stock market in 2004. Netflix, by contrast, has not produced positive free cash flow in any of the past six years.

The future is not what it used to be

For companies, one of the dramatic changes of the last decade has been the effect of technology. This is not just on retail, as consumers have moved their buying online, but on the changing face of advertising (see Figure 1). Back at the turn of the millennium it was easy to see the change the internet would bring to local advertising. Print advertising suffered dramatically as advertising moved online and stocks like Trinity Mirror (renamed Reach) and Johnston Press tell their own story, with share prices down 90% and 99% respectively from their peaks. Rupert Murdoch, who had previously described newspaper advertising as “rivers of gold”, commented in 2005 that “sometimes rivers dry up.” Cutting costs can only go so far when revenues are falling. Figure 1 shows that, in the US, other formats like radio and television, having initially been resilient to online challenges, are now shrinking as a percentage of the advertising pie. Who is to say that, for all the viewers of Love Island, commercial TV and radio will not follow the same trajectory as print media in a decade’s time? Ex-growth businesses can often be found in the ‘value’ category but experience informs us that stock markets do not price these assets cheaply enough. Many UK domestic stocks today are facing structural challenges and weak pricing power. This partly explains our longer-term preference for multinational diversification in all our portfolios.

Avoiding permanent capital loss from obsolescence requires engagement with the forces shaping the future, whether that be e-commerce, digital advertising, cloud

computing or artificial intelligence. Our investment process involves detailed analysis of businesses in the vanguard of technological change, even if we are not always shareholders. This greater understanding informs our investments in businesses like Microsoft but also in consumer staples companies like Colgate or Unilever. No sector is immune from the forces of disruption and we endeavour to select those companies that can adapt to succeed not only over the next two years but also over the next ten.

As investors we must construct informed opinions about the future. What can we conclude following a material re-rating of equities in recent years? Return expectations from current valuations should be low. Whilst there may be further frothy gains to be had in the short term, there is no failsafe indicator for timing the exit accurately. February’s sell-off across all asset classes was a reminder that correlations are high and diversification does not offer the protection it did in the past.

With all asset prices inflated, there are fewer places to hide than in previous cycles. It has been so long since an economic downturn that the probability of a recession is being all but ignored. Good times do not last for ever and the extrapolation of current earnings growth may be a mistake the market must re-learn. Even secular growth can be partially cyclical. For example, companies generating returns from rising asset prices, such as index providers, exchanges or retail broking platforms, will inevitably see their revenues fall in falling markets. It is often the case that structural drivers are overstated on the way up and cyclical threats are overstated on the way down.

We are frequently asked what will be the catalyst for the re-appraisal of risk.



Unfortunately this can often only be seen through a rear-view mirror. In 2007, the signs were there for those who wanted to see them, in the form of the collapse of Bear Stearns' credit hedge funds and Northern Rock. In 2000 there were no indicators other than tighter money which ultimately tipped markets over. Today, the Federal Reserve is tightening for the first time in a decade. Perhaps that is all it will take. Conservative, active fund managers tend to outperform in falling markets. Rather than panicking when markets turn down, we have the liquidity and the wherewithal to allocate to riskier assets at improving valuations. While the focus may be on relative performance today, savers will return to absolute values in the future. They always do.

Simon de Zoete

At the end of this month, Simon de Zoete will retire from the Board of Directors. Simon has been on the Board of Troy since 2003 and was Chairman for his first eight years. He has made an outstanding contribution to the company and was involved, with Lord Weinstock and myself, in formulating a plan to establish the business back in 2000. We are indebted to Simon for his unerring support to Troy over such a long period, as a director and as an investor in the funds.

We are delighted to announce that Cressida Hogg will be joining the Board of Troy later this year. Cressida is Chairman of Landsec and has spent over 20 years in the principal investment industry, first with 3i Group plc and more recently with Canada Pension Plan Investment Board. While at 3i she co-founded the infrastructure business, and ran 3i Infrastructure, a FTSE 250 investment company from 2009-2014. From 2014-2018 Cressida led CPPIB's global infrastructure investment

business, managing a portfolio of c. \$20 billion in unlisted investments. She has sat on the boards of several investee companies, including Anglian Water Group and Associated British Ports. She became a non-executive on Landsec's Board in 2014 and Chair in July 2018.

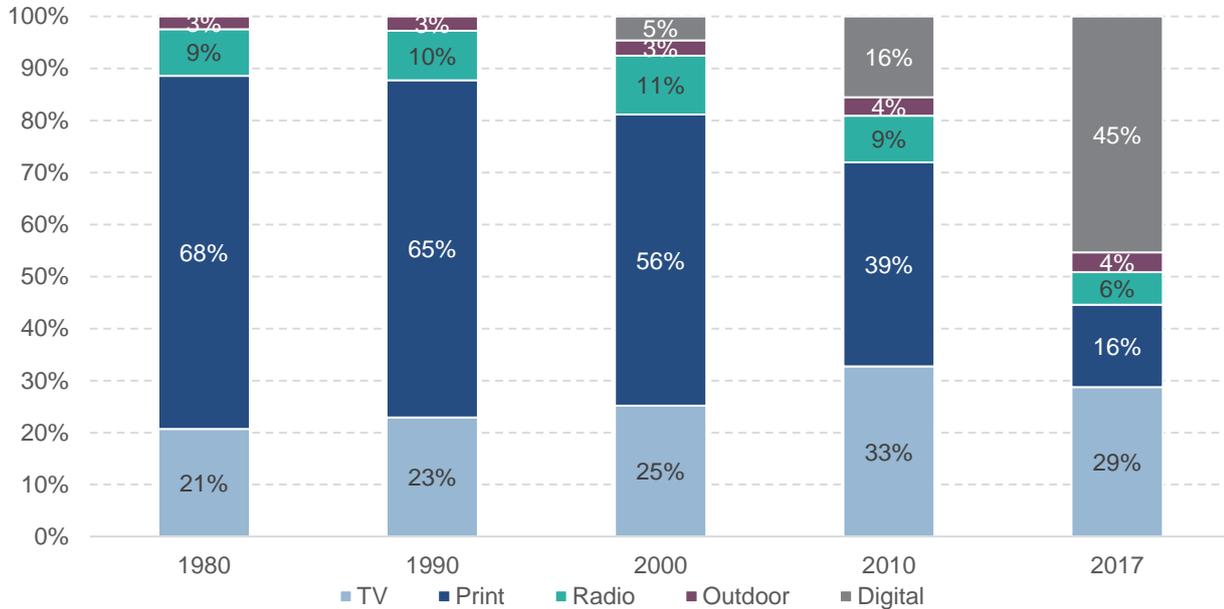
We very much look forward to welcoming Cressida to the Board.

Sebastian Lyon

August 2018



Figure 1: Rapid Changes in Advertising – US Advertising spending by media 1980-2017



Notes: All revenues exclude political and Olympic advertising; Newspapers exclude digital advertising, which is included in the digital; Radio includes satellite radio.

Source: MAGNA Global, J.P. Morgan, December 2017

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