www.taml.co.uk February 2013

Investment Report N°·38

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

2012

"Stock prices have reached what looks like a permanently high plateau."
Irving Fisher, economist, 21st October 1929

2012 was a year of slow progress for the Trojan Fund. The type of markets we experienced suited our other funds better; in particular the Income Fund, which pretty much matched the strong returns of the UK stock market but with considerably less volatility.

The planets aligned for the Trojan Fund in 2011. High quality stocks, gold bullion and index-linked bonds all performed well. The cash drag from our high level of liquidity was barely noticeable. But as sometimes happens after such a golden year, 2012 was almost its mirror image. Investors were fuelled up by central bankers to take more and yet more risk. Mario Draghi's call to arms in June, "*to do whatever it takes to preserve the Euro*", lit the fire in investors' bellies for a concerted advance in markets.

"*Risk*", according to Elroy Dimson of the London Business School, means *"more things can happen than will happen*". This sums up why markets in 2012 surprised on the upside. Things that might have gone wrong didn't. The dangers of the Euro imploding, a Chinese slowdown or the US teetering off its fiscal cliff were averted (or at least postponed). The absence of awful news diverted attention from the permanence of the same old bad news in forging investor psychology. Crisis fatigue set in and, tired of earning nothing on cash, investors embraced risk assets.

While unorthodox monetary stimuli managed to prod the financial markets awake, they have, so far, failed to revive Western economies. The Eurozone, the United Kingdom and United States all saw their economies shrink in the fourth quarter of 2012, while corporate profit growth also disappointed. According to Citigroup, UK corporate earnings were, in late 2011, forecast to grow by +9.7% in 2012. A year on, the outcome looks more like -7.1%, an implied downgrade of -15.3%, yet UK stocks ***rose*** by +12% as investors accepted higher levels of risk in a desperate gamble for returns – any returns. This disconnect between corporate profits and share prices may continue, but it cannot do so indefinitely.

Back to 2007

We are almost four years into the current cyclical bull phase for stock markets. The rally began on the solid foundations of valuation and corporate earnings growth but those supports have long since been kicked away. More risk is being taken than investors acknowledge, and complacency is a major danger.

In recent months anecdotal evidence of investor capitulation has been building. There is a whiff of panic to invest cash at any price. Investor surveys point to the highest level of bullishness since 2007. Stock market volatility, as defined by the VIX (or Fear) Index that reflects how much investors will pay to insure against volatile equity prices, is at its lowest since 2007. Sceptics of the rally have thrown in the towel and started to join in. 'High Yield' has become an oxymoron. Junk bonds are now not only yielding less than in 2007 but are also offering the lowest returns ever (*see Figure 1*). Record issuance and record low spreads (compared to equivalent government bond yields) are evidence of the next great capital misallocation. Emerging Market bonds are also an investor favourite. Bolivia can borrow for 10 years at a mere 4.75% and Indonesia at 3.3%. The credit supply conveyor belts of the City and Wall Street will run 24/7 to ensure the income-starved are fed, but we have seen recently how food can be adulterated. Who is to say that Bolivian bonds will not prove the credit markets' equivalent of horsemeat?

With bond yields having collapsed, equities are the final game in town for those scrabbling feverishly around for income. Yet bond investors make very nervous equity investors as they are not used to big losses. Since 1970, the most that global equity investors have lost in a year is 48%, while the most that bond investors have lost is 16%. In the topsy-turvy markets of today, the most cautious, with the most to lose, are taking ever more risk. We appear to have entered a bizarre phase of reluctant speculation in which tomorrow's income is being converted into today's (perhaps temporary) capital gain.

A yield bubble in equities?

Has the yield bubble shifted to equity markets? Certainly the demand for UK and global income funds has been strong in recent years. Investment Management Association data confirm that, of the £3.4bn of net UK fund sales in 2012, £2.3bn was directed into the two income sectors. The yield on the FTSE All Share Index at the time of writing is 3.3%. This yield has been lower in the past but it is near the bottom quartile of its long term range of between 5% and 3%. Another 10% rise in the stock market would diminish the yield to 3% and alarm bells would then start ringing. This level would, by coincidence, be the old high on the FTSE 100 Index of 6950 and in a world where a 3% yield looks mouth-watering (at least compared to bonds) the overvaluation could always stretch even further.

We would caution those investing in the Income Fund to be prepared to accept a higher degree of volatility. If you are unable to entertain the idea of an increased risk to your capital, then equity income may not be right for you.

Just a wee dram left?

One of our long term holdings, across the funds, has been Diageo, the distiller and marketer of alcoholic beverages, like Johnnie Walker. Many of the Company's brands have been with us for decades or even centuries *("Born 1820, Still Going Strong").* Diageo fits our investment criteria for high returns on invested capital, excellent geographic diversification (including access to emerging markets) and a robust dividend track record. But all things have their justifiable price. What about Diageo today? The shares have doubled over the past four years and the dividend yield has fallen to a miserly 2.4%, the lowest since the merger between Guinness and Grand Metropolitan that formed the company back in 1997 *(see Figure 2).* Diageo – which offers quality and growth, but now NOT at the right price - is a microcosm of the yield hungry market most investors today are foraging in. In 2002, the last time Diageo's income was valued so highly, investors lost nearly 40% of their capital, which took over four years for them to regain. It is ***retained gains*** that really matter, because it is so hard to recover losses.

Moving the goalposts

Whatever has happened to interest rates? We miss them, not least because without them we lose sight of a vital investment truth: money has its correct price. Untethered from a monetary anchor, today's optimists follow Irving Fisher by suggesting there is no downside risk. The wish being, as usual, the father to the thought, justifications are being dreamt up for ever rising prices. Some bullish on stock market prospects argue equities are cheap because cash trades at 200x earnings and ten year gilts at 50x (the inverse of the yields of 0.5% and 2% respectively). Such frameworks of valuation have lost touch with reality. While cash is no longer a nil risk asset, it remains low risk and we have decided that taking the certain ***real*** loss (after inflation) of holding cash is preferable to the uncertain risk of a material loss to capital through the purchase of overpriced equities and most bonds. High levels of cash will be a temporary shelter until fairer-priced equities can become a more permanent home.

Other recent grounds for confidence include the theory of the 'The Great Rotation' - the hope that pension funds will switch their assets from bonds into equities. We find this implausible. The cult of the equity has been replaced by a bond cult. The stock market weightings of Defined Benefit Pension Funds in the UK have been falling for 14 years from their peak of 71% in 1999 to 43% last year. Many of these funds are now closed to new members and are effectively winding down as they shift towards paying pensions to beneficiaries. For regulatory as well as liability matching reasons, such funds are unlikely to allocate greater amounts to equities in a hurry. And in a world with too much debt somebody has to own these bonds and pension funds will be asked to share this heavy burden. Pension fund trustees tell us they are still selling into rising stock markets. While in the longer term such funds may be buyers of equities again, the 'Great Rotation' will this time be at a glacial pace.

We must get used to this new period of uncertainty which has replaced the 'Great Moderation'. Financial repression in the form of negative real interest rates is likely to stay for years to come. Even if interest rates were to be increased in nominal terms, they are likely to lag rising levels of inflation as central banks choose to stay behind the curve. Remember, unexpected inflation is dreadful for financial assets - bonds ***and*** equities. Optimists overlook the inconvenient truth that bubbles do not burst on tighter monetary policy. They pop when the surety of the income is questioned.

Central bankers are guilty of style drift by shifting their stance from 'inflation targets' to 'targeting inflation'. They have, so far, failed to generate economic growth and frustration may lead them to ever more radical rigging of markets. Currency crises may not be far away as the race to debase currencies heats up. The trap of zero interest rates is harder to exit the longer they last. In his General Theory, Keynes aptly described financial repression as *'the euthanasia of the rentier'* - it is making savers buy assets they would not otherwise buy, at prices they would not otherwise wish to pay.

What to do?

There are no guarantees of an immediate reversal in the price of stocks but the margin of safety is becoming perilously thin again. Back in March 2009, in the days when cash was king, Jeremy Grantham of GMO wrote a prescient note called *'Reinvesting When Terrified'*. His message was that you can never time the market bottom, but you can time when to begin to increase your exposure to equities in a methodical way. He called the bottom within days.

Today we seem to be almost at the opposite extreme. In the same way that you will never catch the low, you will not catch the high either. Rather than reinvesting when terrified, it is also appropriate to disinvest when fearless. Markets have a tendency to climb the stairs and go down in the lift. We are not market timers but we are value investors. If and when we cannot find value, we will bide our time. This may be a long and nerve-wracking process, but at least we aim to protect your capital.

Troy

Francis Brooke and I are fortunate to work with a very stable investment team. We added one more to our group in 2012. George Viney joined us in the summer and he has fitted in even better than we could have hoped. As always, we thank you for your continued support.

Sebastian Lyon

February 2013

The views expressed in this report are not intended as an offer or solicitation for the purchase or sale of any investment or financial instrument. The information contained in this document does not constitute investment advice and should not be used as the basis of any investment decision. References to specific securities are included for the purposes of illustration only and should not be construed as a recommendation to buy or sell these securities. Although Troy uses all reasonable skill and care in compiling this report and considers the information to be reliable, no warranty is given as to its accuracy or completeness. The opinions expressed accurately reflect the views of Troy at the date of this document and, whilst the opinions stated are honestly held, they are not guarantees and should not be relied upon and may be subject to change without notice. The investments discussed may fluctuate in value and investors may get back less than they invested. Past performance is not a guide to future performance and the investment approach and process described may not be suitable for all investors. The information contained in this report is not for distribution, and does not constitute an offer to sell or the solicitation of any offer to buy any securities, in the USA to or for the benefit of US persons. Issued by Troy Asset Management Limited, Brookfield House, 44 Davies Street, London W1K 5JA (registered in England & Wales No. 3930846). Registered office: Hill House, 1 Little New Street, London EC4A 3TR. Authorised and Regulated by the Financial Services Authority (registration No: 195764).

Copyright © Troy Asset Management Limited 2013

High yield bonds or low yielding junk?

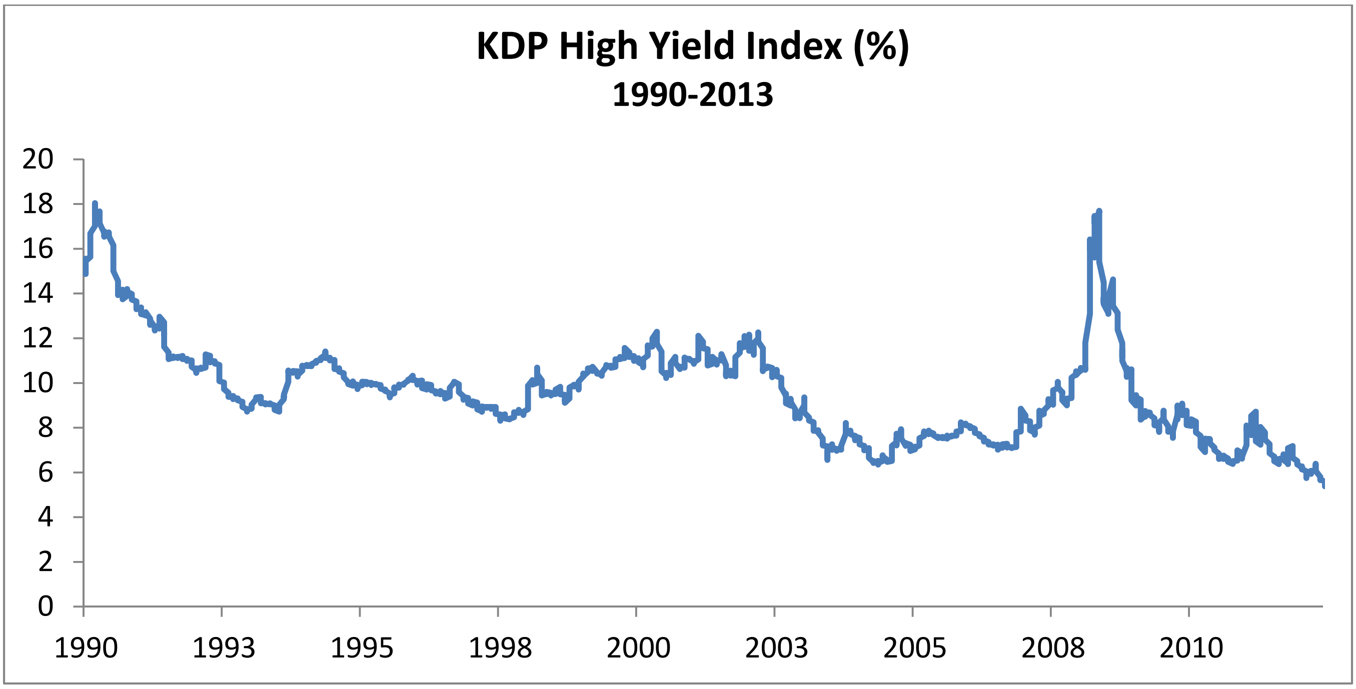

Figure 1 *Source Bloomberg*

Diageo: Just a wee dram left for shareholders?

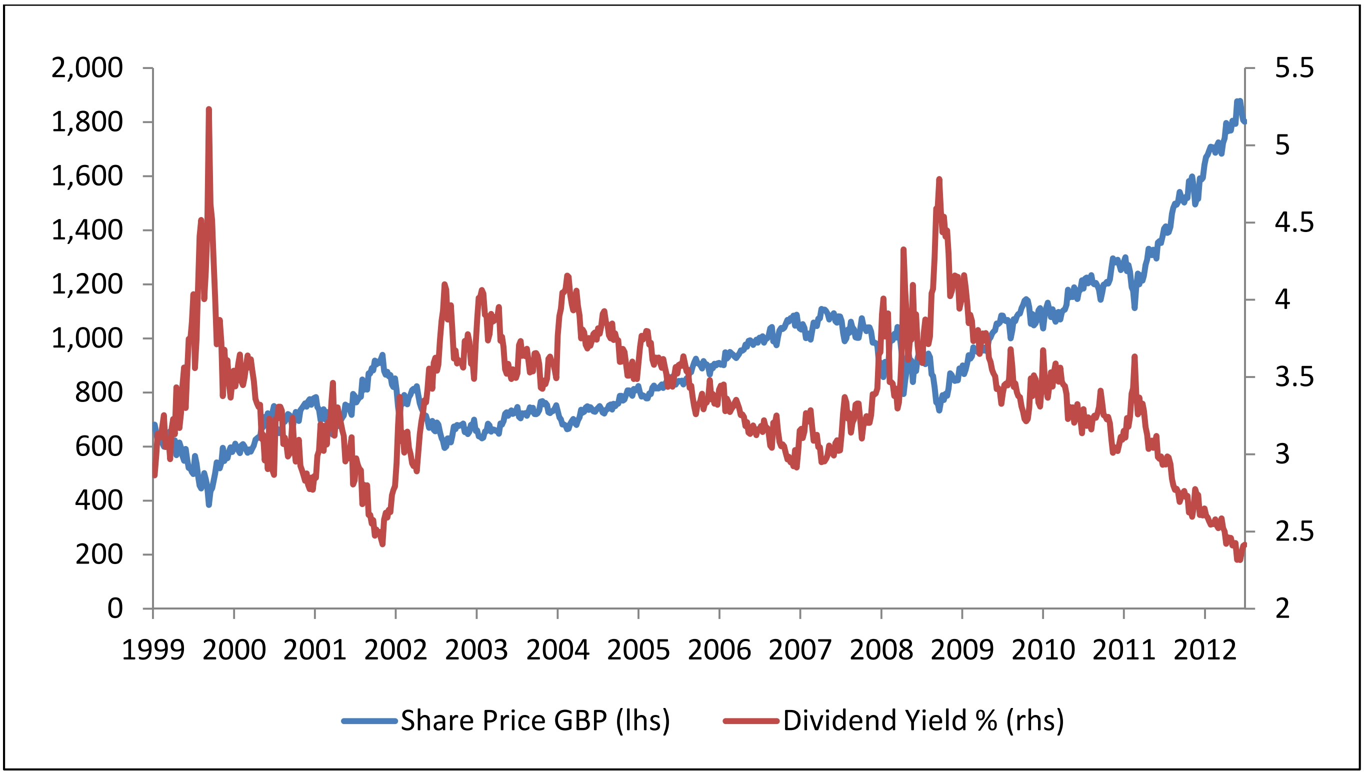

Figure 2 *Source: Bloomberg*