Evenlode Investment View

September 2018 – Lessons from a Prior Era

The secret of change is to focus all of your energy, not on fighting the old, but on building the new.

Socrates

On the surface it has been a calm, quiet year for both the FTSE All-Share and the Evenlode Income fund, with year-to-date total returns standing at +0.9% and +6.6% respectively[i]. However, there has been a considerable amount of movement underlying these aggregate returns (sector rotation, stock-by-stock volatility etc.) thanks to a political and economic climate that has remained quite fluid and uncertain, both in the UK and globally. This 'churning around' has actually been quite useful and we have looked to use it to the fund's advantage by incrementally biasing the portfolio towards the most interesting areas of value as the opportunity set shifts. The biggest change was earlier in the year when, following significant share price falls in several of the highest quality companies in the portfolio, we added meaningfully to the likes of Reckitt Benckiser, Relx, Unilever, Pepsi, Sage and Smith & Nephew. We have made several other stock specific changes over recent months and have continued to see some good opportunities in the last few weeks as share prices bounce around.

The portfolio's free cash flow yield is c5% and is steadily growing[ii]. This free cash flow comes from a wide variety of business models and sectors and is also well diversified by geography (slightly less than 20% of the portfolio's revenue comes from the UK, c.30% from North America, c.20% from Continental Europe, and a little over 30% from the rest of the world). Many of the fund's largest positions also produce very stable cash flows, with relatively repeat-purchase business models. All these factors give us confidence in both the sustainability and the growth potential of the portfolio's current 3.2% dividend yield.

The Quiet Value of a Well-Invested Franchise

During September, global insurance broker Jardine Lloyd Thompson (JTL) has received a recommended takeover approach from its US peer Marsh & McLennan. This is the third takeover approach this year in the Evenlode Income portfolio (Fidessa and UBM being the other two). JLT is a good example of a 'well-invested franchise' and has several parallels with Fidessa in terms of its significant commitment to long-term organic growth over recent years.

The higher the level of organic investment made today, the greater the burden placed on current financial results. This can make a company look optically less attractive, despite this investment actually making the company more attractive for the long-term shareholder, if sensibly deployed. Sometimes, if Mr Market fails to recognise this hidden embedded value, industry peers may do so instead - as has been the case for both Fidessa and JLT this year.

Lessons from a Prior Era

Life can only be understood backwards, but it must be lived forwards.

Kierkegaard

Wherever we can we are aiming to emphasise well-invested franchises in the portfolio. These companies tend to be friendly to the long-term shareholder, as they are well placed to adapt to a changing world whilst also capable of generating very attractive compounding free cash flows and dividends along the way.

At home, I have a 1966 copy of the Financial Times, an interesting artefact from the perspective of investment history. There is a share price listings section in the back of the paper, reassuringly similar in format to today's paper. A quick eye-cast down the columns is a journey back in time to an investment era from which more than five decades of Mr Market's gyrations now separate us. It is interesting to note both how many of the listed names have changed, but also how many have remained. Some companies inevitably petered out along the way (one wonders what became of the constituents of the 'Sisal' sector, for instance) whilst most have been subsumed by UK and global peers over the years (it is rather charming to see heritage brands such as Bovril, Rowntree and HP Sauce listed in the 1966 paper as stand-alone companies). However, there are several businesses whose lineage can be traced directly to present-day listed UK companies, some of which are significant positions in the Evenlode Income portfolio. Unilever is there, offering a not vastly different starting dividend yield to today of around 4%. As are, amongst others, Smith & Nephew, Reed Paper (now Relx) and Reckitt (then Reckitt & Colman). All would have been very rewarding investments over the following half-century (Unilever, for instance, has grown its dividend by approximately +10% per annum since then).

I find two points about these 'survivors' particularly instructive, and I think both are worth bearing in mind as we peer into the unknown future from our current vantage point.

Firstly, though these businesses have survived and prospered, they have changed a great deal over the years. Market leadership, barriers to entry and customer loyalty are key factors that we, at Evenlode, look at when identifying potential long-term investments. However, being an excellent business today - though a great starting point - is not enough. Continual change, investment, expansion and innovation are also crucial for longevity. Reed Paper was primarily a printing business in 1966, and also owned a small decorative paints division. Its descendant Relx now generates only 10% of revenues from physical print titles, with 75% of Relx's revenues digital and the paint division long-gone. Smith & Nephew remains in the business of wound care and medical devices, but the bandages and plasters that Smith & Nephew's 1966 portfolio offered would not get shareholders far in today's healthcare industry. Years of innovation, new product development and expansion has resulted in a vast change to the company's portfolio. Reckitt and Unilever were both primarily food companies with exposure to categories such as margarine, mustard, and frozen foods, and the vast majority of their sales came from the developed world. Both companies have since shifted their portfolios to take advantage of better growth opportunities and more attractive economics in other categories such as personal care, beauty and consumer healthcare. After selling its remaining food brands in 2017, Reckitt is purely a consumer health and home care business, and in 2017 less than 20% of Unilever's revenues were derived from food. Both businesses are also now truly global in scope. There is an Only Fools and Horses episode in which Trigger claims that his road-sweeping broom is twenty years old, only to add that it has had seventeen new heads and fourteen new handles over the years. The present-day reincarnations of these 1966 companies remind me a little of Trigger's broom.

Secondly, I find it fascinating to observe how these well-invested franchises have done through a period of time that has presented a vast selection of challenges, not least of which was an extraordinary period in UK political and economic history during the 1970s. This was a decade that saw, amongst other things, the three-day working week, rampant inflation and interest rates peaking at 17%.

When market-leading businesses enjoy a culture of evolution, investment and adaptation, their ability to get through even the most challenging periods in good health can startle (notwithstanding, of course, the usual share price wobbles along the way). It would be surprising if the next few decades didn't have their own fair share of challenges just as we've seen over the last fifty years. But those individuals and companies that are most willing to embrace these challenges and adapt to them (or as Socrates put it 'build the new'), will be well placed to survive and prosper.

Hugh and the Evenlode Team
27th September 2018

Please note, these views represent the opinions of Hugh Yarrow as at 26h September 2018 and do not constitute investment advice.

[i] Source: Financial Express, total return, bid-to-bid, 31st December 2017 to 25th September 2018.
[ii] Source: Evenlode Investment, Factset