Evenlode Investment View

April 2016 - Technology and Disruption

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Despite much sloshing around, the UK stockmarket is almost unchanged since the start of the year, +2.6% on a total return basis. Evenlode has returned +5.4% over the same period. Our view on valuations has changed little: the overall opportunity set is not particularly attractive and discernment is required, particularly for investors that are keen to manage risk carefully (many optically 'cheap' stocks are highly leveraged and/or cyclical). However, the volatility in January and February did provide some opportunities, and we shifted the fund towards stocks that were particular hard hit in the sell off. In my view these changes not only injected value into the portfolio, but also upgraded overall balance sheet strength and dividend growth potential.

Disruption

This month I would like to revisit 'disruptive technology', a subject I have touched on in previous investment views. The term 'disruption' has become a buzzword in investment circles over the last few years, and there is a perception that levels of disruption are increasing*. It is generally taken to mean any innovative technology that destroys the economics of a mature industry by rendering established products and services inferior, normally to the point of obsolescence.

Technology is not of course 'new', humans have always innovated - the stocking frame machines that Ned Ludd broke apart were the cutting edge technology of the late 18th century. Much of the latest technological wave has been driven by the developments in computing power and increasing levels of internet penetration. One of the clearest examples of disruption over the last decade has been the online retail sector's assault on physical retail, with Amazon leading the way. The newspaper and music industries have also seen profound change driven by digitalisation. More generally, the rise of the internet and its ability to support new, innovative business models is creating change in most areas of the economy (think Airbnb, Uber, Netflix etc.). In start-up legend Marc Andreeson's words, *software is eating the world*. Cheaper and more convenient server power, super-fast broadband, data analytics, artificial intelligence, interconnectivity and mobile device growth are all driving this trend. Other industries such as biotechnology, energy, automobiles and banking/payments are also facing interesting changes as genome sequencing, battery storage, electric cars and blockchain technologies rapidly develop.

Many of the start-up companies in these fields have gone on to list on the stock market, often trading on high valuation multiples, reflective of their future potential. But the key question for us - as dividend growth investors - is not so much whether these fashionable shares are appropriately valued. The question is how much the innovation from these new companies and industries might change the long-term economics of the more mature, stable, dividend paying businesses that we follow and invest in.

In my view the challenges are more than offset by opportunities for most of the businesses that constitute the Evenlode portfolio, for two main reasons. Firstly, many of the companies we invest in remain broadly unaffected by new technology, particularly consumer branded goods companies. Think of products such as Dove Soap, Guinness or Pampers. Society is likely to want, need and value these products in ten or twenty years time, just as it has over the last fifty years or more. I suspect it will be quite some time before soap, beer and nappies are disintermediated! ***

Secondly, many of the companies we invest in are already harnessing new technology without being 'disrupted'. They are helped by market-leading positions in niche industries with high customer loyalty. Interestingly, software franchises have always fared better at coping with disruption than hardware companies, which in my view relates to the strength of the economic moats they develop, driven as much as anything by customer embeddedness. The software franchises held in Evenlode (Sage, Microsoft,Fidessa and Aveva) are good examples, as they increasingly utilise technology in cloud and data analytics to increase the value and range of products they can offer to their customers.

Other sectors are enjoying similar dynamics. In fact, the idea of 'software' as a sector is becoming increasingly out-dated. Many of the fund's media, support services and engineering holdings are increasingly utilising software and data analytics in their business models. Engineer Spectris, for instance, sells test and measurement equipment to a broad range of industries. The demand for predictive analytics and interconnectivity (i.e. the internet of things) is increasing in this sector, as customers try to get the most out of all the data that is produced. While these changes require investment, they also provide opportunities for growth and an increase in recurring sales.

Innovation is also on the rise in the healthcare sector, particularly thanks to progress in genetics and resultant therapy areas such as immunotherapy, with many new products beginning to find their way into drug portfolios. This is transforming the landscape of areas such as cancer treatment. I believe this innovation is a positive for the sector, despite the challenges it sometimes inevitably creates for established firms****.

The More Things Change...

Clearly, there is no perfect protection from technological change. However, selling a trusted repeat-purchase brand with longevity is a good start. And more generally, businesses with a strong 'economic moat' (thanks to brands, customer embeddedness, R & D expertise, entrenched distribution etc.) should be better placed to harness rather than suffer from technology as time goes by. Also important is a culture within a business to look to the future and adapt. To use Warren Buffett's ice hockey analogy, you need to skate to where the puck is headed. Organic investment may hold earnings back a little in the shorter-term. But in periods like today, when economic growth is muted and technological change is accelerating, the best response is unlikely to be a sharp slam of the brakes on organic investment and R & D.

In short, the best insulation from what is to come is what has worked in the past. For us that means a defendable business model with a management committed to adapting to and investing in the future.

Plus ça change, plus c'est la même chose.

Hugh Yarrow
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Please note, these views represent the personal opinions of Hugh Yarrow as at 22nd April 2016 and do not constitute investment advice.

*Other commentators are less convinced by the level of innovation in today's society: see for instance Robert Gordon's *The Rise and Fall of American Growth: The U.S. Standard of Living since the Civil War.*

***Even for a very durable franchise, times do change, and business models need to keep adapting. Unilever, for instance, was mainly in the business of selling tea, soap and margarine to developed market customers 40 years ago. Since then it has evolved its portfolio into areas such as personal care while consistently investing in emerging markets. This change has been essential - margarine, for instance, is now Unilever's poorest performing category but makes up only a small portion of sales (and may well be disposed of in coming years) whilst emerging markets are now Unilever's growth engine. Likewise, consumer goods are not completely immune from the rise of the internet, with online sales a small but growing part of overall revenues. Brand strength remains strong online (and in many onlines categories brand loyalty seems to be even higher), but these businesses need to adapt. Unilever's partnership with Alibaba and JD.com in China is a good example of this adaption (Unilever's online sales in China have nearly doubled over the last year) whilst Reckitt's success with its Chinese Durex website is another great example. Reckitt are now partnering with late night pizza and beer delivery services to ensure Chinese consumers aren't short of condoms for their big nights in!

****The knowledge bases embedded in these businesses combined with entrenched distribution networks and financial strength have created high barriers to entry in the healthcare sector. Although there has been much innovation in the industry over the last 30 years, including the emergence of a whole new sub-industry in the form of biotechnology during the 1980s, the overarching economics of the industry have remained intact, and new technologies have - more or less - been assimilated into the existing industry structure. See, for instance Alfred D Chandler's *Shaping The Industrial Century.*