Evenlode Investment View

July 2016 - The Value Of Self-Funded Growth

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The UK stock market has posted a positive return so far this month, but under the surface performance trends have been quite polarised, and heavily influenced by the referendum result. Sectors such as banks, house builders, construction and property companies have generally struggled, as investors worry about the referendum's impact on the domestic economy. Conversely, UK listed multinationals have in most cases performed well as investors factor in the benefit of a significantly weakened pound.

These currency trends are helpful for Evenlode (as I discussed last month) given that the underlying portfolio is comprised predominately of globally diversified businesses. The pound's recent reversal will provide welcome relief to cash flows in sterling terms for these companies, particularly in the context of the last few years during which the pound had been quite strong against most global currencies.*

Nudging The Portfolio

We have made some incremental changes to the portfolio as a result of recent volatility. We topped up several smaller positions in the fund where share prices were impacted by the initial referendum sell-off (Fidessa, Spectris, Jardine Lloyd Thomson, WS Atkins, Paypoint, Aveva, Halfords, DMGT etc.). We have also initiated a new holding in recruitment company Page Group after shares fell sharply due to Brexit-related uncertainties. Though Page is not a repeat-purchase business (a fact we take into account in terms of both position sizing and overall portfolio construction) it has several 'Evenlode' characteristics we value highly:

1) A global market-leader with good long-term growth potential (thanks to structural growth in outsourced recruitment, a sector which has low levels of penetration in many parts of the world - from Germany to Latin America).
2) An asset-light business model, with profits routinely converted to free cash flow in good times and bad.
3) A conservative management team that runs the business to perform well through the full industry cycle (Page never runs with a net debt position and currently has more than £70m of cash on the balance sheet).
4) Its focus is on organic investment. A consistent through-cycle approach to investment has enabled Page to take market share in more difficult times.
5) It has delivered a healthy, progressive dividend stream to investors and intends to continue to through good times and bad. Dividends are very well covered by free cash flow.
6) It has a record of returning excess cash to shareholders, most recently via a special dividend in 2015.

As a result of the above, we think Page presents a good opportunity for the long-term income investor, notwithstanding the referendum-related headwinds it will face over coming months. We initiated the position on a starting dividend yield of approximately 4.5%.

Low Growth and Low Rates

Zooming out somewhat from Brexit-related volatility, the overall investment backdrop remains little changed on a global basis. The world is stuck in a post 2008 rut of anaemic growth, high levels of indebtedness and deflationary pressures.** These conditions, and central bank reactions to them, are producing strange effects in the world of interest rates and bonds. At the margin, Brexit has accentuated these trends (raising, for instance, the possibility of a rate cut and more quantitative easing from the Bank of England). Interest rates remain negative in some big parts of the global economy (the Eurozone, Japan, Sweden, Switzerland etc.), and the German 10 year government bond yield recently turned negative for the first time in its history.

Cheap (Free?) Money

Companies too are seeing their cost of debt hit record lows. Several corporate bonds from issuers such as Johnson and Johnson, General Electric and LVMH now trade at negative yields, and over the last two months several blue chip companies (Sanofi, Toyota, Unilever etc.) have been able to issue borrowings priced at very close to a 0% coupon.

'Free' money might on the face of it seem like a good thing, but in my view the current preponderance of cheap debt presents a risk to the long-term investor, particularly in a deflationary world where growth is quite scarce. It makes expensive acquisitions and share buy-backs look more attractive than they would otherwise. It also makes levels of debt look affordable that wouldn't if interest rates were at more normal levels. When the £24bn takeover of Cambridge-based ARM holdings was announced this week by Japanese technology firm Softbank, most press commentary focused on the weak pound's role in this deal. But aside from Softbank's strategic agenda, I'm sure the current low level of interest rates was by far the most important supporting factor. ***

The Value of Self-Funded Growth

We are conscious of the temptations of debt in the current environment, and have worked hard to 'lean against the wind' on this front. Of the eight positions we have added to the fund over the last year or so, seven have a net cash position on the balance sheet. This helps me sleep at night!

More generally, in the end, it all comes back to cash for us. We like businesses that tend to end up with more cash each year than they started with, even after fully investing in their futures. These businesses are self-funding their own growth. When you find a business like this, and a management team that understands the long-term power of this model (and the lowered risk profile), it can be a very enjoyable experience. Self-funding companies should also be well placed to avoid the siren call of cheap financing at times like the present.

Back To Basics

Whilst on the subject of low interest rates, it would be remiss not to mention that low rates have also contributed to an environment in which equity valuations are less attractive than when we launched Evenlode in 2009. We are very conscious of this, but remain reassured that the portfolio, based on our estimates, continues to offer attractive absolute cash-flow returns.

More generally, we think our best response to the currently challenging outlook is to stick to our guiding principle: *market leading businesses with reliable, attractive dividends and healthy balance sheets tend to be a good home for the long-term investor.* The fund's current yield is 3.4% and I continue to believe that the portfolio is well placed to deliver attractive dividend growth over time.

Hugh Yarrow
Investment Director
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Please note, these views represent the personal opinions of Hugh Yarrow as at 21st July 2016 and do not constitute investment advice.

* In my view, for companies that pay their dividends in sterling, this currency benefit to earnings and cash flow will not necessarily translate into a material pick-up in short-term dividend growth rates. Diageo is a good example. It has suffered some painful currency headwinds over recent years. It is currently growing dividends at +5% while it rebuilds dividend cover from just below 1.8x earnings to its target range of 1.8x to 2.2x. I expect it will use any short-term currency benefit to help accelerate this rebuild, rather than increase the dividend growth rate materially from +5% in the short term. Companies that pay their dividends in non-sterling currencies are a different matter, and sterling investors will see an immediate dividend uplift thanks to currency translation. Evenlode stocks that fall into this category include Unilever (announces dividends in euros), Astrazenca (announces dividends in dollars) and the fund's overseas listed companies.

**The Brexit vote can be partly understood as a symptom of this wider economic trend. Difficult economic conditions often result in a swing toward nationalism. Looking ahead, nationalism will continue to be a major theme in both this autumn's US presidential election and next year's European elections.

***ARM's Yen valuation at the point of the takeover was no lower than its the pre-referendum Yen valuation given that post-referendum share price gains offset the pound's depreciation.