

Evenlode Global Equity Investment View

September 2024 – Q3 2024 update

All market data is from FactSet and FE Analytics unless otherwise stated. Past performance is not a guide to future returns.

Evenlode Global Equity returned -1.1% in the third quarter of 2024, trailing its comparator benchmark, the MSCI World Index, which returned +0.2%. While we are disappointed with 2024 performance year-to-date, we take heart from the extraordinary and hard-to-repeat idiosyncrasy of the market this year, and from robust portfolio fundamental performance. The fund outperformed its benchmark by approximately 3.5% during each of the sharp market drawdownsⁱ at the start of both August and September. Both episodes proved short-lived, with a market recovery spanning the remainder of the month. However, as a result the fund has a materially lower volatilityⁱⁱ profile and an unusually low market beta of 0.81ⁱⁱⁱ. We view risk management as an integral part of the service that we offer our co-investors, along with growth in total returns. We remain confident that the Evenlode focus on steady, unspectacular fundamental compounding is the right formula for the patient investor.

The past quarter saw a further slowing in global equity markets. This followed a remarkably strong first half performance, dominated by the exceptional returns of a small number of mega-cap companies. This narrow performance was best exemplified by the “Alternative Seven” consisting of Alphabet, Amazon, Apple, Broadcom, Eli Lilly, Microsoft, and Nvidia. These companies alone contributed 130% of the MSCI World Index’s total return in the second quarter despite only totalling 20% of the total index by market capitalisation^{iv} (source: Bloomberg). However, in the third quarter, five of these companies posted negative total returns and the group averaged a 6% decline. Given their high concentration of the market, the MSCI World Index ending with positive returns demonstrates a considerable broadening of performance both by company and by sector. To understand this, we must consider both the top-down, macroeconomic drivers and the bottom-up factors affecting the former market leaders.

In recent years, interest rate speculation has been a key driver of wider equity prices. The post-Covid wave of inflation led to one of the sharpest rises in interest rates in recent history, which was accompanied by a surge in equity indices. As inflation cooled into the latter half of 2023, speculation over the speed and path of rate cuts has been heightened – though equity markets continued to rise into 2024.

Early in August, the publication of weak US manufacturing and employment data sparked recession fears and accelerated expectations for US rates to be lowered by the Federal Reserve. At the same time, an unexpected rate hike from the Bank of Japan reversed the yen carry trade^v. This heady combination sent equity markets down and the VIX (an index that increases with volatility) to four-year highs. While markets subsequently rallied, we began to see a sector rotation as investors shifted back towards historically defensive sectors and industries.

The US Federal Reserve finally cut rates in mid-September, opting for a 50-basis point^{vi} reduction. This had already been built into market expectations for both equity prices and US mortgage rates, so the immediate response was muted. Consensus expectations are now for a more ‘dovish’ reduction in rates, despite the Fed warning of more (but smaller) cuts to come. All this illustrates the difficulty



in predicting both the timing and effect of cuts. Our investment approach leads us towards less economically sensitive companies, somewhat shielding us from this volatility.

Outside of the US, our attention has been drawn to the Chinese economy, which has been an important motor of global activity in the century so far, particularly as an importer of capital and luxury goods and an exporter of pretty much everything else. Since 2021 however, the Chinese property market has declined in response to weak macroeconomic data and a government crackdown on Chinese property companies with excessive leverage. In 2023, it was estimated that as much as 70% of household wealth in China was invested in real estate. It is, therefore, no surprise that the Chinese consumer has had significantly less disposable income available and local equity markets also weakened. The CSI 300 index (Chinese equities) fell 45% from the 2021 peak to September 2024. In mid-September, the Chinese government lowered rates, cut bank reserve rates, and subsidised equity investment (for institutions). Chinese equity markets briefly spiked and companies with exposure to China, such as consumer goods and luxury companies, rallied. Whether these efforts will prove effective in the long term is unknown. Youth unemployment remains at a record high and wage deflation is in effect (even if the Chinese media has banned discussion of deflation). This is yet another example of the increased role governments and central banks are playing and a reminder of how the ongoing interconnectedness of markets can affect our portfolio companies.

Equally, there have been significant changes in the dynamics affecting many companies from a bottom-up perspective. An example is the current boom in capital expenditure in the large cloud service provider companies which has driven us to think further about the valuation of these companies.

Companies have four primary uses of surplus operating cashflow, having paid for maintenance capex^{vii}: growth capex, M&A, dividends, and share repurchase (for this analysis we exclude 'pile it up in the bank'). Traditional free cashflow (FCF)^{viii} valuation measures deduct growth capex but ignore the other three uses, which in our view is overly punitive to companies which focus on organic growth and overly favourable to those which grow inorganically and/or overdistribute earnings. Evenlode exclusively looks at companies with profound competitive advantages which enjoy returns on capital meaningfully above their cost of capital. The greatest of the privileges this confers is not the excess cashflow it yields every year, but the ability to reinvest some or all this cash into new assets with predictable returns well above those available in capital markets. This is the critical element for compounded share price returns.

If we compare growth capex to the other uses, it stacks up favourably in several dimensions. Dividends are arguably just as fixed a commitment as maintenance capex, and investors who do not have immediate uses for the cash are burdened with reinvestment risk, usually at returns far below those available on incremental internal investment. Share repurchases carry valuation risk. Incremental returns on repurchases are very price sensitive and our view is that share repurchases are on the whole best used in opportunistic, 'big bang' transactions to retire equity in turbulent markets, rather than as a continuous capital-return mechanism. M&A carries both valuation and due diligence risk and tends to scale badly. In conclusion, as long as there is scope for reinvestment, it is our preferred use of



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cashflow. Almost all company managements will also say this when asked, and we think it makes sense to value companies accordingly, rather than punishing them for organic reinvestment.

Our approach therefore focuses on gross cashflow, unlevered and with share option expense deducted. This means that we capitalise the returns to come from current growth capex. Given the attractive competitive advantages our companies enjoy, they usually bear less risk of returns on capex not materialising than the average company. This has served us well in the past, allowing us to 'look through' investment cycles at holdings like Broadridge and Amazon.

The size, pace, and feverish commentary around AI capex, however, has given us some pause. While there is huge demand for AI computing capacity, there are big unresolved debates ongoing about the shape and timing of this demand. This is an important difference from past episodes of technology company investment and digestion. If we look at the analogous instance of Alphabet's capex ramp in the late 2010s, it was founded on very predictable returns from a) growth into enterprise compute to catch up with Amazon and Microsoft and b) deployment of machine learning models into the search ad market, one which Alphabet had dominated for years. Currently, a large chunk of demand is for model training – the 'build it' phase – rather than inference, which is driven by end users interacting with models – the 'and they will come' phase. The signals which we can see suggest, so far, limited uptake of generative AI, particularly in revenue-generating settings. Model training is getting exponentially more expensive in a multi-player arms race, but the payoff for the winner(s) is not yet clear. It could be that generative AI yields artificial general intelligence (AGI), in which case all bets are literally off; or that it fizzles out like the metaverse and blockchain; or, most likely, it lands somewhere in between.

We believe that these concerns over the short-term profitability of AI are becoming more widespread and likely contributed to the slowing price of the "Alternative Seven", of which 6 have direct exposure to AI. Within this group Microsoft, Amazon and Google, are holdings in the Global Equity portfolio. Our view is that while their core business model in cloud remains very attractive, the spread of possible outcomes has broadened materially and the risk of future returns on capital being structurally lower cannot be dismissed out of hand. Given this situation we have been reassessing our position sizes and position risk limits for these companies.

Looking ahead

The year has been marked by a series of elections, though the most consequential remains outstanding, with the United States going to the polls in November to choose between Kamala Harris and Donald Trump. Harris, who was promoted from running-mate to candidate in July, has a narrow lead in the polls with 538 predicting that she would win in 53% of their simulations. However, such a slight advantage can easily be upset and the risk of an 'October Surprise' (an event damaging or raising either candidate's chances) is significant. Most notably, the tragic and escalating conflict in the Middle East has the potential to dramatically tilt the political calculus in an unpredictable way and has already increased volatility in the energy markets. We will not directly position the portfolio to speculate on the outcome of the election, instead relying on the long-term economics of the companies to drive value.



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We enter the Q3 reporting season in October with the expectation that the Evenlode Global Equity portfolio companies will continue their fine run of fundamental performance. Over the past four quarters, portfolio companies have averaged an organic revenue growth rate of approximately 8% and have continued to expand margins. On an apples-to-apples basis, net revenue growth has also been approximately 3 percentage points higher than that of the MSCI World Index's components. As a result, the portfolio companies have had more available capital to reinvest at sustained high attractive rates of return. We believe that, over time, this fundamental performance should enable these companies to compound cash flows and to generate attractive returns to investors.

We look forward to being in touch again soon.

Chris, James, Cristina, Gurinder, and the Evenlode Team

23 October 2024

Evenlode has developed a glossary to assist investors to better understand commonly used terms - please see <https://evenlodeinvestment.com/funds/evenlode-global-equity-fund#Documents>

Please note, these views represent the opinions of the Evenlode Team as of 23 October 2024 and do not constitute investment advice. Where opinions are expressed, they are based on current market conditions, they may differ from those of other investment professionals and are subject to change without notice. This document is not intended as a recommendation to invest in any particular asset class, security, or strategy. The information provided is for illustrative purposes only and should not be relied upon as a recommendation to buy or sell securities. For full information on fund risks and costs and charges, please refer to the Key Investor Information Documents, Annual & Interim Reports and the Prospectus, which are available on the Evenlode Investment Management website (<https://evenlodeinvestment.com>). Recent performance information is also shown on factsheets, also available on the website. Past performance is not a guide to future returns. The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Fund performance figures are shown inclusive of reinvested income and net of the ongoing charges and portfolio transaction costs unless otherwise stated. The figures do not reflect any entry charge paid by individual investors. Current forecasts provided for transparency purposes, are subject to change and are not guaranteed. Source: Evenlode Investment Management Limited, authorised and regulated by the Financial Conduct Authority, No. 767844.

ⁱMarket drawdown - A period when markets fall.

ⁱⁱVolatility - A statistical measure of the fluctuations in value over time.

ⁱⁱⁱSource: FE. Calculated over 3-year period 30 September 2021 to 30 September 2024 based on monthly returns. Beta of less than 1 suggests less volatility than the benchmark.

^{iv}Market Capitalisation - A company's Market Capitalisation is calculated by multiplying the number of shares in issue by the share price and is a reflection of the size of the company.

^vCarry trade - A type of foreign exchange trade in which you borrow money in one currency at low interest and use it to make high-interest investments in another currency. A yen carry trade involves borrowing Yen to invest in other currencies.

^{vi}Basis point - 100 basis points is equivalent to 1%, meaning 50bps is equivalent to 0.5%.

^{vii}Capex - Capital expenditure. Money invested by a company to acquire, or upgrade fixed, physical or non-consumable assets.

^{viii}Free Cash Flow (FCF) - A measure of how much cash a company can generate over and above normal operating expenses and capital expenditure. The more FCF a company has, the more it can allocate to dividend payments and growth opportunities.

