

Evenlode Income Investment View

February 2022 – Field Notes



Field Notes

After a strong 2021 for global stock markets, the first few weeks of 2022 have been a significantly more challenging period, with macro-economic and geopolitical news dominating the backdrop for financial markets. The year began with inflation and rising interest rate expectations as the major story. Over recent weeks, the Russian-Ukrainian situation has eclipsed these worries and culminated, tragically, in Russia's invasion of the Ukraine last week.

Market Movements

Global stock markets have dropped, and volatility has risen significantly. The first few weeks of the year also saw a significant sector rotation with the energy, mining, financial and defence sectors performing positively, versus a negative return for most other sectors. The US market has been a notable laggard, with technology shares (to which the US has an outsized exposure) underperforming heavily.

As I write, Evenlode Income has fallen -6.0% since the start of the year, compared to a fall of -6.4% for the IA UK All Companies sector and -2.0% for the FTSE All-Share¹. The underperformance of Evenlode Income and its peers, relative to the UK market, is mainly explained by the significant outperformance of some of the biggest oil and mining companies in the FTSE 100.

Russia

The Russia-Ukraine situation is fast-moving and exactly how the crisis unfolds over coming weeks remains to be seen. The humanitarian aspect of this crisis is appalling, and our thoughts go out to all of those impacted by it.

From an economic perspective, the severe sanctions Russia now faces will cripple its economy and financial system. Russia is not a large part of the global economy, representing approximately 2% of global GDP, but the crisis will create economic and financial ripples around the world, via several transmission mechanisms. These include the impact on the Russian financial system, heightened energy and grain prices, and dented consumer confidence globally. Having risen sharply in January, interest rate expectations have fallen back over the last two weeks, given the likelihood that central banks will be less inclined to raise rates into this uncertain environment.

From a geopolitical perspective, it seems clear that the world will be irrevocably changed by the events of the last week and the subsequent fallout. In the short-term, the world is confronted with an unpredictable and increasingly isolated Russia, and the geopolitical risk this brings. Over the medium and longer-term, the crisis will undoubtedly bring several big-picture issues into greater focus: the resilience and unity of the democratic world; global supply chain resilience (already a big topic because of Covid); national and international security; and the urgent need to transition to a more resilient and decarbonised global energy infrastructure.

Evenlode Income Investment View

February 2022 – Field Notes



Resilience, Diversification, Steady Cash Generation

As we always say at Evenlode, our aim is to insulate the portfolio and its dividend stream from a wide range of possible futures, rather than make big short-term predictions. The pandemic and now the Russia-Ukraine crisis serve as a reminder that the world can be an unpredictable place.

We find the diversified, high quality and resilient characteristics of Evenlode's fund holdings extremely reassuring at times like this. There will be some impact to multinational companies that generate an element of sales in Russia and Ukraine, but for all three Evenlode funds this exposure is low, with no holdings listed in either country, and very low underlying revenue generated from the region in aggregate. In terms of input cost inflation, no company is perfectly insulated, and even for those companies that can pass prices through to customers, there can be a lag to the process.

However, Evenlode companies have several very helpful characteristics including customer embeddedness, high gross margins, asset-light economics and high levels of cash flow generation. The portfolio's valuation also remains modest. The fund's dividend distribution is forecast to grow by approximately +18% for the full financial year to February 2022. This will bring the fund's historic dividend yield to 2.7% (based on the 28 February 2022 price), comfortably covered by a free cash flow yield of approximately 5%.

Field Notes from Results

Zooming-in to the level of individual holdings, more than three quarters of the portfolio have updated on trading since the start of the year. Operational performance is progressing well in aggregate: in the face of a complicated backdrop, it is reassuring to note that companies reporting full year results since the start of 2022 have on average grown revenue by +10% and earnings by +16%ⁱⁱ.

I will spend the remainder of this view discussing some key themes and talking points from recent results.

Supply Chains and Input Costs

Covid-related supply chain bottlenecks have been an issue for some time now, but the portfolio holdings are coping well. Global scale, digital capabilities, strong relationships with suppliers, and decades of strengthening supply chains have all helped and meant that inventory shortages have been rare. Following the pandemic, 'just in case' supply chain strategies are being favoured over 'just in time' strategies: at the margin, management teams are making sure they eliminate sole-supplier risk and have local supply options close to manufacturing facilities. The Russian situation will provide an extra impetus for this mindset shift.

Evenlode Income Investment View

February 2022 – Field Notes



In terms of input costs, mid-single digit increases have been typical for the average company over the last year, with some companies facing even higher rises. As already mentioned, no company provides perfect insulation, but Evenlode companies are well equipped to cope. Looking across the portfolio, software and digital business models are in a good position to pass prices through thanks to limited physical input costs, high gross margins and loyal subscription customers. Specialist engineers are also passing prices through successfully thanks to the mission-critical nature of their products and their relatively low-cost nature when compared to overall customer budgets. Support services companies such as Compass and Bunzl have seen a positive impact on revenue thanks to price increases, whilst also maintaining a positive outlook for margins. Meanwhile, specialist recruiters Hays and Page Group are helped by inflation: their revenues are generated from a percentage fee on the overall wage bill of the permanent and temporary staff that they place.

Consumer Branded Goods

The holdings that have faced the toughest input cost challenge over the last year reside in the consumer branded goods sector. Raw material inflation has been particularly skewed to the basket of goods that these companies buy (agricultural products, oil-derivatives etc.) and this has led to double-digit cost increases over the last year, with further increases to come in 2022. These companies also tend to take several months to pass prices through after a period of steep input cost rises, which can create an impact to margins in the short-term.

It's reassuring, in this context, that four of the fund's five main holdings in the sector (PepsiCo, P & G, Diageo and Reckitt) have reported solid results this month and expect margin growth for the coming year and beyond. PepsiCo, for instance, has grown sales by +10% and earnings by +13% over the last year, and Diageo grew sales by +20% and earnings by +22% over the last six months. Both companies expect sales to grow at a mid-single digit rate whilst increasing margins in their current financial year.

The fifth holding is Unilever, which has guided to a decline in margins for 2022. In our view the commitment Unilever is making to continue growth investments during 2022 and beyond (rather than cutting back on investment to protect short-term margins) is a sensible one for the long-term health of the company. In part, this approach reflects the feedback received from shareholders in the wake of the aborted bid for GSK's consumer healthcare business.

Data and Digitalisation

Technology shares have been out of fashion since the start of the year, but operational trends remain encouraging for the digital and data analytics business models held in the fund (RELX, Sage, Wolters Kluwer, Microsoft etc.), as does the multi-year growth opportunity. These companies benefit from highly cash generative subscription-based business models and loyal customers that are increasingly keen to invest in digital technology. The quote below from Wolters Kluwer management at recent results helps to provide some colour on this desire to invest:

Evenlode Income Investment View

February 2022 – Field Notes



‘Every day, our customers face the challenge of increasing proliferation and complexity of information and the pressure to deliver better outcomes at a lower cost. Many of our customers are looking for mobility, flexibility, intuitive interfaces, and integrated open architecture technology to support their decision-making. We aim to solve their problems and add value to their workflow with our range of digital solutions and services, which we continuously evolve to meet their changing needs’

80% of Wolters Kluwer’s revenue is recurring. The company grew earnings of +11% over the last year and the dividend was increased by +15%.ⁱⁱⁱ.

B2B Outsourcing

Another structural growth theme is business-to-business outsourcing. An increasing number of companies want to focus on their core operations and outsource ancillary services to specialists. This tends to lead to more agility, improved service levels and lower costs. Compass is a good example, with its new business pipeline for first-time food catering outsourcing running at an all-time high. Management is expecting this trend to continue over coming years. Specialist recruitment holdings Page Group and Hays are also benefiting as contract and temporary placements increase in popularity for both businesses and employees, whilst an increasing number of jobs across the world get placed through the specialist recruiters rather than in-house HR departments.

Sustainability, Transparency and Safety

The world also continues to demand better practice around the issues of sustainability, transparency, and safety. As with digitalisation and B2B outsourcing, these are also ubiquitous trends, with investment levels steadily increasing across sectors. Evenlode Income holds, for instance, two global-leading test and inspection companies, SGS and Intertek. Both enjoy strong brands and loyal customers and are well placed to capture the acceleration in demand for services such as sustainability, supply chain audits and quality control.

Summary

To sum up, it’s been a volatile start to 2022 and geopolitical risk has risen. However, the portfolio is composed of a diversified blend of resilient, highly cash generative companies offering attractive growth potential over coming years.

We look forward to keeping you in touch with our thoughts.

Hugh, Ben (A), Chris (M) and the Evenlode Team
28 February 2022

Please note, these views represent the opinions of Hugh Yarrow and the Evenlode Team as of 28 February 2022 and do not constitute investment advice.

Evenlode Income Investment View

February 2022 – Field Notes



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 in Pound Sterling, 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.

Source: Evenlode Investment Management Limited, authorised and regulated by the Financial Conduct Authority, No. 767844.

ⁱ Source: Evenlode Investment, Financial Express, total return, bid-to-bid, 31 December 2021 to 28 February 2022.

TB Evenlode Income B Inc. FTSE All-Share adjusted to midday on 28 February 2022 to match the fund's valuation point.

ⁱⁱ Source: Evenlode Investment. Averages for organic revenue and EBIT growth. Excludes Howden Joinery. Including Howden Joinery average revenue growth +12% and EBIT growth +22%.

ⁱⁱⁱ Source: Evenlode Investment. Earnings measured as organic EBIT growth.