

Evenlode Income Investment View

April 2023 – Through-cycle risk management

Pressures on the banking sector continued during April, culminating in the seizure of regional lender First Republic by regulators - the second largest banking failure in US history. Though China has been rebounding strongly from its Covid lockdowns, some cracks are also showing in both global economic data and company earnings as credit conditions tighten. Global stock markets, though, did manage to post a positive returnⁱ. There was some relief that the immediate fall-out from the banking crisis was relatively contained and that inflationary pressures continue to ease from the extremes of 2022.

For the year to date, Evenlode Income has now risen +8.4% compared to a rise of +6.5% for the FTSE All-Share and +5.2% for the IA UK All Companies Sectorⁱⁱ.

Insulation not prediction

We do not know how the coming months will unfold for either the banking sector or the global economy. When considering the short-term outlook, we sympathise with the sentiments of the economist John Kenneth Galbraith - *there are two kinds of forecasters: those who don't know, and those who don't know they don't know*. Aspiring to be of the first kind, our approach is to insulate investors from a wide range of outcomes, rather than make big predictions and bet on any specific short-term scenario. We do this by investing with a long-term time horizon, whilst managing risk carefully all the way across the market cycle. This approach involves focusing solely on market-leading business models with asset-light, high-return economics. It also involves ensuring that - at all times - the bulwark of the portfolio's cash flow stream comes from repeat-purchase business models.

Steady results for repeat-purchase businesses

On this theme of resilience, we are a good way through the first quarter results season and remain impressed with the progress and adaptability of our portfolio holdings, particularly in light of today's complex operational backcloth. Over half of the portfolio has released first quarter trading updates over the last fortnight, with average quarterly year-on-year organic revenue growth running at +8.5%.

Though not entirely immune from a weakening economy, the repeat-purchase business models in the portfolio continue to churn out solid revenue growth. There are also early signs that input cost pressures are beginning to abate - a helpful development that will allow companies to slow the pace of price increases and will also ease pressure on profit margins. Take the consumer branded goods sector, for instance. Four of the fund's five key holdings in this sector (Unilever, Reckitt, PepsiCo and Procter & Gamble) have released trading updates in the last fortnight and have upgraded guidance for the year. First quarter year-on-year revenue growth for these four holdings averaged +10%, composed of price/mix effects of +12% and a volume decline of -2%. As this revenue growth comes through and input pressures also begin to ease, there are early signs of improvement in profitability across the sector.

Another repeat-purchase example is medical devices holding Smith & Nephew. Though normally a defensive business, Covid was not a common-or-garden recession and created a more challenging trading environment for the company than normal. This was initially due to the impact of Covid lockdowns on elective surgery volumes, and then subsequently due to supply chain issues (both industry-wide bottlenecks and some self-inflicted inventory management problems). At most recent



results, though, the company posted organic revenue growth of +7%, and noted robust trends in elective surgery thanks to pent-up pandemic demand. As with consumer branded goods companies, the margin outlook is also brightening for Smith & Nephew.

A mixed picture for economically sensitive companies

In the more economically exposed portion of the portfolio, the trading picture is mixed. Recruitment companies Hays and PageGroup are perhaps the most sensitive holdings to prevailing economic conditions and they have seen a noticeable slowdown over recent weeks, reporting fee growth of +5% and -2.4% respectively for the first quarter compared to the previous year as client and candidate decision-making slows. Howden Joinery also saw a slowing of demand, reporting broadly flat sales for the period. Though the short-term outlook is muted for these companies, we find the cash generation, balance sheet strength and valuation appeal reassuring. We also continue to think that long-term through-cycle growth prospects remain very interesting.

The engineering holdings, on the other hand, continue to experience very strong demand. Covid-related supply chain bottlenecks have been an issue for some time now, and within the Evenlode portfolio it's been the engineering companies that have been most impacted, with healthy orderbooks taking time to translate into sales growth. As supply chain issues have started to ease, order book growth is now translating to revenue growth. There is also no doubt that these companies are beginning to see some early benefits from the huge investments that need to be made in reconfiguring the global industrial system over the next decade, both to meet energy security and decarbonisation requirements. Spectris and Rotork, for instance, reported organic year-on-year sales growth of +24% and +18% in the first quarter along with a positive outlook for full year margins.

Supply chain dynamics

Though supply-chain bottlenecks are now easing (for the engineers but more broadly across all sectors of the economy), it is worth noting that the last few years of trade tariffs, China lockdowns, and geopolitical tensions have exposed some pockets of vulnerabilities in most supply chains. Management teams are working on closing these gaps where, at the margin, they are identified. Supply chain changes tend to be incremental but, for instance, management teams are making sure they eliminate sole-supplier risk and looking to ensure that there are local supply options close to each manufacturing facility. Most companies also continue to run with higher-than-normal levels of inventory as a buffer against the residual impact of Covid bottlenecks and more general uncertainty. The testing and inspecting companies, including Intertek and SGS, are also noting a trend towards 'friend-shoring' for new supply chain investments. Re-shoring is relatively limited, but the events of recent years have accelerated the migration of non-complex international supply manufacturing away from China and towards Vietnam, Turkey, Mexico, Bangladesh and other South-East Asia companies.

Balance sheets a focus again

Another theme worth highlighting is the recent rapid increase in interest rates and the knock-on effects it is creating. This higher cost of capital will begin to slow takeover activity as potential acquirers (such as private equity) find it harder to generate returns at the often-frothy takeover



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valuations that have been seen over recent years. Private equity activity has by no means died out thus far; the sector has raised significant cash in recent years and continues to look for ways to deploy it. However, management teams such as Diploma and Bunzl are already beginning to mention to us that the acquisition landscape is beginning to change when they look at their pipeline of potential bolt-on acquisitions, with valuations easing off.

The strain that interest rate rises put on the financial system is also beginning to show, as illustrated most recently by the issues in the banking sector. Leveraged business models tend to be most fragile in this environment, and looking ahead it would not be a huge surprise if more pockets of vulnerability surface in financial markets, given the extent and speed of interest rate rises over recent months.

Patience and risk management

Emphasising strong balance sheets is an important element of our risk management approach – it's a factor that helps a business stay the course. The current ratio of debt-to-annual-cash-generation (or 'net debt to EBITDA' to use the jargon) is 0.8x for the Evenlode Income portfolio, compared to a ratio of 1.3x for the UK market ex financials. Approximately 40% of portfolio holdings have net cash balance sheets (14 out of 36), and what debt there is in the portfolio mostly resides on the balance sheets of the repeat-purchase holdingsⁱⁱⁱ.

More generally, a long-term compounding approach combined with careful through-cycle risk management remains our focus. This approach can seem unnecessarily austere during periods when animal spirits are running high, but history has demonstrated its ability to deliver rewarding results for the patient investor.

Hugh, Ben, Chris M and the Evenlode team

2 May 2023

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ⁱMSCI World Index, +0.1% for month ended 30 April 2023. Total return, GBP terms. Source: Financial Express.

ⁱⁱTB Evenlode Income B (Acc). 31 December 2022 to 30 April 2023. Source: Evenlode, Financial Express, total return, bid-to-bid, GBP terms.

ⁱⁱⁱSource: Evenlode, FactSet. 1 May 2023.

