

Evenlode Income Investment View

April 2024 – Pieces of good businesses

Sticky inflation and rising bond yields were at the forefront of investor minds during April. Though inflation is steadily coming down, and conditions in employment markets are gradually easing, US inflation and economic data did not cool as much as investors were expecting during the month. This led to a moderation in market expectations for interest rate cuts - six US interest rate cuts were factored in at the start of the year, but by the end of April this had reduced to only one. Geopolitical developments were also a theme, with heightened tensions between Israel and Iran keeping the oil price high. Both these factors contributed to a rise in bond yields and an easing back in global equity markets.

Rotation dynamics

The FTSE All-Share Index, in contrast to global markets, rose during April helped by its commodity and financial constituents. At the time of writing, the FTSE All-Share Index has now risen +7.1% since the start of the year. This compares to a rise of +5.1% for the IA UK All Companies Sector and -0.5% for Evenlode Income (+0.1% on a swing-price adjusted-basis)¹.

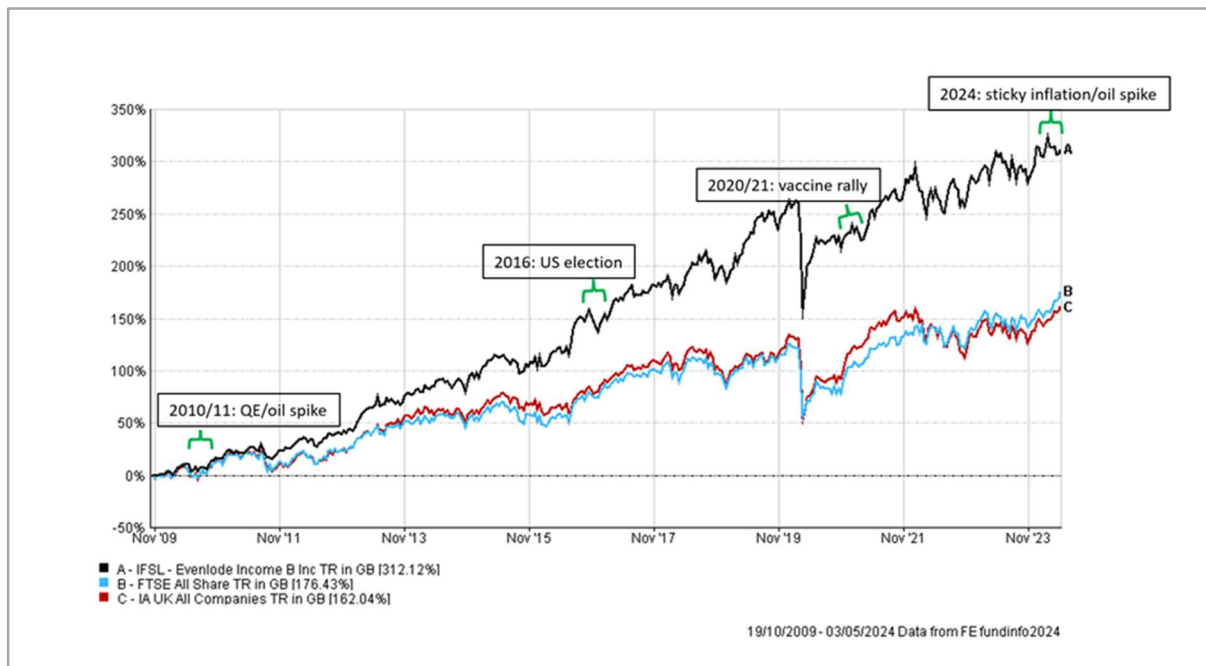
Having returned +9.3% versus +7.9% for the FTSE All-Share Index in 2023, Evenlode Income was also ahead of the UK market for the 2024 year-to-date at the end of February, so underperformance has all come in March and April. We discussed March's underperformance in last month's investment view, and similar themes continued in April. The significant, rapid rotation continued at a frenzied pace, as more cyclical and asset intensive sectors (particularly oil, mining and financial shares) have led the rally so far. Rising bond yields and rising commodity prices were proximate catalysts – the trend was also accentuated by BHP's £31bn takeover approach for UK-listed mining company Anglo American in the last week of April.

Due to Evenlode's investment approach, the fund has almost no exposure to these three sectors, but they currently make up nearly 40% of the UK index. Meanwhile, the share prices of many asset-light, high-return, cash compounding companies – the pool that Evenlode always fishes in – have been stuck in the doldrums or gone backward over recent weeks. The most negative contributors to the fund's return in April, for instance, were RELX, Diageo, Experian, Sage and LSE Group, all of which fit into this quality-compounder category and saw share price falls of between -4% and -8% during April.

A 'risk on' flavour

This recent rotation has had a similar flavour to several other 'risk on' market rallies that we have invested through over the last fourteen and a half years, as shown in the following chart.





Though these periods do not, now, look dramatic in the overall context of Evenlode Income’s life, the fund experienced similar or greater levels of relative underperformance during each period, relative to the last two months.

These deviations in return from the comparator benchmark are a side effect of our through-cycle focus on asset-light businesses that generate a high return on capital. We think this approach works well over the long-term to produce real dividend growth and strong risk-adjusted total returns, but it also means the Evenlode Income portfolio looks very different to the UK stock market. This is something we have always been keen for our clients to understand.

We can’t, of course, predict the future, but in the previous rotations mentioned above, it is worth noting that the rallies ended up broadening out and became far more inclusive.

Solid fundamental progress

Developments in the corporate world over the last two months have been less exciting than those within the stock market. Aggregate operating progress for underlying holdings has been very much in-line with start-of-year expectations. When full year results were all said and done, organic revenue growth for 2023 averaged +6%, with organic operating profit growth a little above this rate. For 2024, the forecast for the portfolio’s average organic revenue growth currently stands at 5% (in-line with where it was at the start of January), and average operating profit growth is expected to grow at a higher rate, as operating leverage begins to reassert itself in a more normal input cost environmentⁱⁱ. Free cash flow growth is also healthy, helped by the normalisation of supply chains and inventory levels. The fund’s free cash flow yield is 5.0% for this year and forecast to be 5.6% for next year, providing healthy cover for the 2.9% dividend yieldⁱⁱⁱ.



Themes from results

The majority of the portfolio holdings have now reported first quarter trading. We will discuss these results in more colour in next month's investment view but, in outline, trends are similar to those described in our March 2024 investment view (*Themes from results*). Corporate investment in technology remains a ubiquitous trend across the global economy, as companies of all shapes and sizes invest in digital tools to improve their performance, adaptability, and efficiency. Revenue and earnings growth for these software and data analytics holdings (RELX, Sage, Microsoft, Experian, LSE and Wolters Kluwer which account for just over 20% of the portfolio) continues at a very healthy rate. Consumer Staples holdings, which also make up a little more than 20% of the portfolio, are gradually beginning to see trading return to a more normal situation, as pandemic-induced demand volatility and spiking input costs begin to finally subside. We discussed both Unilever and Reckitt last month; since then, both have reported improving volume trends as input cost inflation and pricing growth slows. For the full year, they are guiding to organic sales growth of +3 to +5% and +2 to +4% respectively, with profit growing ahead of revenue as input cost inflation normalises. Procter & Gamble and PepsiCo are seeing similar trends.

Pieces of good businesses

Elsewhere, across the portfolio, we are excited about the prospects for niche, adaptable industry leaders to compound value for their owners over time. These include, among others: Informa in trade exhibitions; Compass in food catering; Spectris in test and measurement; Smiths Group, Rotork, Halma and Spirax in speciality engineering; Intertek and SGS in testing and inspection; Bunzl and Diploma in specialist distribution; Integrafin and Hargreaves Lansdown in financial technology; GSK, Smith & Nephew and Roche in health care and Games Workshop in fantasy miniatures. End markets for some holdings have been challenging for at least a year now, not least for Page and Hays in specialist global recruitment, Burberry and LVMH in luxury goods, Savills in real estate consultancy and Howden in the UK kitchen market. But we think these companies have the financial and franchise strength to weather current conditions and benefit when conditions ultimately improve.

Valuations

To finish, valuations are worth a quick discussion. We hope regular readers will forgive us for repeating our message of the last few months: within Evenlode Income's investable universe, the aggregate valuation opportunity is at the top end of the range it has been in over the last decade, other than during the Covid sell-off in 2020. This provides both a reassuring margin of safety for the long-term investor, and also potential upside (over and above dividends and per share free cash flow growth) if sentiment towards UK-listed quality compounders improves from its currently depressed level.

Part of the cause is that many cash compounders have been left behind over recent months and are offering up attractive dividend yields and total return potential. In light of the recent rise in bond yields, some of these shares are being shunned because they are considered too 'bond-like'. But, over the long-term, owning pieces of good companies is a very different proposition to the ownership of fixed coupon bonds, thanks to their ability to grow revenues and profit in real terms over time, backed



by healthy free cash flow generation. And if we face an economic downturn in the future, their defensive cash generation will be more highly valued than it is today.

Companies are eating themselves

Some of the reason for an attractive valuation environment, we think, is also due to conditions within the broader UK stock market. The river of outflows from the UK stock market has been quite consistent since at least 2016 but has accelerated more recently; flows out of UK equity funds have been negative every month for nearly three years now.

This has left the main buyer of UK shares, over the last year, as the companies themselves^{iv}. They are eating themselves: using internally generated free cash flow to buy back and cancel shares. Just over 60% of the Evenlode Income portfolio, by value, has been buying back shares over the last year.

For the long-term shareholder, without doing anything, these repurchases quietly increase the economic ownership of each share in a company. All the patient shareholder needs to do is hang onto the shares for their percentage ownership of that company to grow.

As an aside, we wrote a thought experiment in our October 2011 investment view (*A lesson from Henry Singleton*) imagining how Microsoft could use its own free cash flow stream and net cash balance sheet to buy back shares at the depressed valuation it was trading on at the time. We concluded that it could end up with only a single share outstanding by 2021 – assuming the business made the same earnings in 2021 as it did in 2011. This would have meant that the owner of that single share was entitled to \$22bn of earnings! Of course, that never happened, because Microsoft compounded its earnings at a good rate from 2011 and the valuation improved significantly.

There have been no takeovers in the Evenlode Income portfolio since 2022, but across the broader UK market acquisition activity has also increased. More than 20 UK-listed businesses are facing takeover bids this year, accounting for £100bn of market value – approximately 4% of the FTSE All-Share Index. We have, then, a dual dynamic that is leading to a shrinking pool of equity. Shares are being retired by many UK-listed companies, whilst others are in the process of being removed from the stock market entirely. Meanwhile, the supply of equity, via initial public offerings, is currently low.

These are just musings - we aren't in the game of making big predictions, and the outlook is as usual uncertain. But one does wonder what might happen if investors do ultimately decide to reallocate some capital back to the UK equity market and take advantage of the valuations on offer.

Our primary focus, though, remains on owning pieces of good companies for the long-term to benefit from the dividends and per share free cash flow growth that accrue to patient shareholders. And on that note, we remain comforted by the quality, valuation appeal and compounding potential of the aggregate portfolio. Any improvement in the valuation environment over coming years would be icing on the cake.

Hugh, Chris M., Ben P., Charlotte, Leon and the Evenlode team

3 May 2024



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ⁱ IFSL Evenlode Income B Acc (GBP). Source: Evenlode, Financial Express, total return, bid-to-bid, GBP terms. Performance from 31 December 2023 to 3 May 2024. Swing price adjusted basis compares unswung (mid) price 29 December 2023 to unswung (mid) price 5 May 2024 (published prices are swung daily to protect the fund against dilution depending on net flows).

ⁱⁱ Source: Evenlode, Visible Alpha, FactSet. Median calendar year 2024 growth forecasts of portfolio companies held at 30 April 2024. Organic revenue growth excludes FX and M&A impact.

ⁱⁱⁱ Source: Evenlode, FactSet. Free Cash Flow Yield as at 31 March 2024, based on FactSet estimates for the current year. Dividend yield is historic yield as at 3 May 2024.

^{iv} Source: Peel Hunt.

