Evenlode Investment View

February 2020 – Risk Mitigation, Time and Patience

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As discussed in my January view, investors ended 2019 in good spirits, with economically sensitive shares performing well and valuations not looking particularly attractive following a strong year for most financial assets.

This mood has changed considerably over the last month, with the spread of coronavirus and its related containment measures beginning to impact global economic activity. This effect has, so far, been experienced mainly in China (and to some extent other Asian countries), in international travel (particularly within Asia) and in global supply chains with a reliance on China (companies such as Apple and Microsoft have already noted some supply issues as a result of this disruption).

These dynamics have led to a significant correction in stock markets over the last two weeks, with falls very broad-based but particularly focused on the shares of companies with a high degree of economic sensitivity and specifically those with a high exposure to Asia and global travel. Some companies are beginning to attempt to quantify the impact of this disruption but of course the ultimate impact remains uncertain[i]. The prices of industrial metals and oil have also fallen sharply. Conversely, 'safe haven' assets such as government bonds and gold have performed well, with US Treasury yields hitting an all-time record low earlier this week.

As I write (Thursday), Evenlode Income has fallen -5.1% since the start of the year compared to a fall of -9.1% for the FTSE All-Share and -7.1% for the IA UK All Companies Sector[ii].

Risk Mitigation, Time and Patience

We aim to insulate the portfolio as best as we can from a wide range of possible futures to help manage risk over the long-term. We do this by assembling a portfolio of shares that is in aggregate high quality, well diversified, and underpinned by a bedrock of repeat-purchase cash generation. At times like these, when the unpredictable occurs and uncertainty levels rise, we are reassured by these characteristics. It is also more important than ever to maintain a patient outlook focused on long-term business fundamentals during such periods. Share prices *always* have a habit of wobbling around significantly over the short-term, normally notably more-so than business fundamentals justify. This relationship is accentuated during stock market corrections, when investor time horizons tend to become even shorter than normal. With this in mind we hold the following thought: *competitively advantaged businesses with structural long-term growth potential tend to be kind to the patient, long-term shareholder and have demonstrated a good track record of coping and adapting to a wide range of geopolitical and economic vicissitudes over the years.*

I noted last month that the overall valuation environment wasn't particularly attractive. Though this broadly remains the case at this point, it's worth noting that recent falls in stock markets have injected a substantial amount of valuation appeal back into many companies. I am reassured that the Evenlode Income fund's current dividend yield of 3.2% is well covered by its free cash flow yield of 5.5% which is in aggregate growing steadily[iii].

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Nudging the Portfolio

We have not made any dramatic changes over the last few days, but we have been investing some cash into existing holdings. The two companies we have topped up the most have been Diageo and Informa (the global business-to-business media company which has a large trade exhibitions division along with its business information and academic publishing divisions). These are both diversified, resilient, cash-generative business models with good long-term growth potential. However, the share prices of both companies have fallen more than -20% from recent highs on concerns relating to the portion of their portfolios exposed to Asia and international travel. Diageo is a good example of how, over a relatively short timeframe, a company can fall in and out of fashion with Mr Market. It was a position we significantly reduced during the first half of 2019 for valuation reasons, but as noted are now beginning to top up again.

Results Season

It's been a busy few weeks for company news and since the start of the year more than 85% of the holdings in the Evenlode Income portfolio have updated the market. For the rest of this view I'd like to briefly discuss a few holdings that have released results this month, which will hopefully give a sense of the diversity of the portfolio, and the challenges and opportunities these companies are adapting to and harnessing. Despite all being very different companies, they share several characteristics in common: an asset-light business model, strong cash generation, and opportunities to grow over the longer-term.

Spectris

I think that I would say things are sort of spotty. There are spots of concern, but equally there are spots of strong growth, and we are being as agile as we can to go and focus on those areas of growth, and maximize the opportunities.

Andrew Heath, Spectris CEO

Test and measurement business Spectris is one of the more economically sensitive businesses in the Evenlode Income portfolio, and is therefore in no way immune from an economic slowdown. However, Spectris is a market-leader in its niches and we think the company's through-cycle structural growth opportunities are very interesting, as its products and services help business customers to develop innovative products, improve the quality of existing products, run their operations more efficiently and save waste. We are impressed with management's long-term perspective and strategy of rationalising the company's portfolio and investing for the future. Meanwhile, despite the economic slowdown, the company ground out sales and profit growth during 2019 and increased the dividend by +6.7%. Spectris's highly cash generative business model also helped the company end the year with net cash on its balance sheet and announce a special dividend payment of £175m.

Bunzl

Toilet paper is not a particularly cyclical type of product

Frank van Zanten, Bunzl CEO

Bunzl is the global market-leader in the provision of not-for-resale products to its business customers and was added to the Evenlode Income portfolio in May 2019. Think loo roll, paper napkins and safety visors! It may all sound a little dull and boring, but there is nothing wrong with boring in investment, and Bunzl's latest dividend increase represented the 27th consecutive annual increase. We think it is a steady, well managed business, and 75% of revenues are generated from economically resilient sectors. Recent results were a reminder that Bunzl has some interesting structural growth opportunities. The trend towards the outsourcing of not-for-resale products is becoming more prevalent across its client base, and the need for regulation and health and safety compliance is ratcheting up across the globe. Sustainability is also a key theme. Bunzl now analyse and score the sustainability of customer procurement habits, and can then suggest changes to customers that help improve these scores. Bunzl is also trialling closed-looped recycling projects in the UK, an area which offers interesting opportunities for the company over coming years.

P & G/Reckitt Benckiser

Evenlode Income's global consumer branded goods holdings are generally grinding out reasonable growth despite the lacklustre economic environment. P & G has been performing particularly strongly recently, reporting +6% organic sales growth at recent results.

Reckitt on the other hand, has been a laggard within the sector, and this week reported organic sales growth of only +0.8% for 2019. The business has an excellent portfolio of brands, predominately in the attractive health and hygiene categories (Dettol, Durex etc.). Its emerging market position is also very good. But over the last three years a large acquisition, internal restructuring and subsequent operational issues have held the company back. This week new management committed to investing significantly back into the business to help drive growth. This will reduce margins somewhat in the short-term but we think the strategy makes sense for long-term shareholders (it is not, in fact, dissimilar to the process P & G has been through over recent years). In the meantime, the company remains highly cash generative and we think Reckitt's current valuation looks very attractive.

The whole consumer branded goods sector continues to experience a growing trend towards more digital sales. P & G, for instance, grew digital sales by approximately +30% over the year and this distribution channel now represents 10% of the company's total sales. The shift towards more natural and sustainable products (with less packaging) also remains a key trend in the sector with all Evenlode Income holdings discussing this theme at their latest results.

Microsoft/Relx/WPP

Stepping back from the quarter and reflecting more broadly on the next decade, the defining secular trend will be the increasing rate of digitization of people, places, and things.

Satya Nadella, Microsoft CEO

I view Microsoft as a good proxy for the secular trend towards a more digitalised global economy, and the company posted another strong quarter for sales and earnings growth (+14% and +40% respectively). As venture capitalist Marc Andreessen once put it 'software is eating the world', and interestingly Microsoft noted that there are now more software developers working in non-technology companies than in the technology sector itself, with technology spend as a percentage of GDP expected to double over the next decade.

Relx is also harnessing these trends, given much of the company's revenue is generated from software-based decision-analytics tools to help doctors, academics, lawyers and other professionals make better decisions in their working lives. At recent full year results, Relx reported another year of steady growth with organic sales +4%, earnings +7% and a dividend increase of +9%.
For global advertising and marketing company WPP the digitalisation trend has been more of a challenge. It has created significant change in the industry over the last few years which requires adaptation, with more than half of global media spend now from new channels. This trend (as well as a patchy global economy) has led to a tough operating environment over the last three years for WPP, and it has not been a successful investment for Evenlode Income thus far. Results this week were below analyst estimates and the company expect sales and margins to be flat over the coming year. Whilst acknowledging the challenges WPP is facing, we do think new management are taking sensible steps to invest in and strengthen the business, and growth is available over the medium-term. WPP continues to produce healthly cash generative and the balance sheet has been significantly strengthened in recent months[iv].

Howden Joinery/Moneysupermarket

Howden Joinery and Moneysupermarket are two of the most UK-orientated businesses in the Evenlode Income portfolio. We added both holdings to the portfolio in 2017 as we felt that negative Brexit sentiment was offering up an interesting opportunity in these high-quality British businesses. Though very different companies facing different end markets, both have consistently invested over the last few years to strengthen their competitive positions and harness digitalisation to drive future growth. They grew sales in 2019 by +5% and +9% respectively, whilst profits grew by +8% and +10% and dividends +12% and +6%. These results were produced during a year of uncertainty and adversity for the UK economy, and are a reminder that the strong can grow stronger even (or perhaps more accurately *particularly*) during periods of adversity.

I look forward to updating you on progress in the Evenlode Income portfolio over coming months and as always, if you have any questions or comments, please do get in touch.

Before signing off, I'd just like to mention that our latest annual Responsible Investment Report has been published on the Evenlode website this month:

(https://evenlodeinvestment.com/resources/stewardship-assets/Evenlode-Responsible-Investment-Report-2019.pdf).

This has been produced by our stewardship analyst Sawan Kumar along with the broader Evenlode investment research team. It hopefully gives our clients a flavour of the thought we put into environmental, social and governance issues at Evenlode, and the degree to which this analysis is integrated into our risk management framework.

Hugh and the Evenlode Team
27th February 2020

Please note, these views represent the opinions of Hugh Yarrow as at 27th February 2020 and do not constitute investment advice.

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[i] Diageo, for instance, released a statement this week suggesting an impact of between –1.7% to -2.5% to its organic full year sales (to June 2020) if its Asian and international travel businesses continue to be impacted through to the middle of 2020. This is in the context of previous guidance of +4% to +6% sales growth for its current fiscal year.
[ii] Source: Evenlode, Financial Express, total return, bid-to-bid, 31/12/2019 to 27/02/2020
[iii] Source: Evenlode, Factset consensus estimates, as at 27th February 2020.
[iv] WPP currently trades on a free cash flow yield of more than 10% (source: Evenlode, Factset), and ended the year on a net debt to EBITDA ratio of 0.8x (2018: 2.1x).