

# Evenlode Investment View

February 2021 – Pieces of Good Companies

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Global stock markets have resumed their climb higher in February, spurred by optimism that the worst of the Covid crisis may begin to pass over coming months. Very high government debt levels and fiscal deficits will have to be addressed at some point, but for now Covid-related government stimulus remains significant. Along with Covid-related supply constraints, this has helped catalyse a sharp rebound in oil and other commodity prices. Global bond yields have risen somewhat and within the UK market, excellent progress on the UK vaccination programme has helped the pound strengthen even more in February.

The huge, rapid sector rotation that characterised the last quarter of 2020 has continued in the first few weeks of 2021 at a similarly frenzied pace. Within the UK market, the share prices of more predictable, globally diversified companies have significantly underperformed their more economically sensitive and/or domestically focused peers.

Reflecting these trends, the UK market has risen +3.5% since the start of the year, whereas Evenlode Income has fallen -1.1% over the same period<sup>i</sup>.

## Portfolio Overview

I will discuss relative performance below, but before doing so it is worth noting that our view on the Evenlode Income portfolio's fundamentals has not changed materially over recent weeks.

More than 80% of the portfolio has released a trading update of some variety since the start of the year and we are busy analysing results and speaking with company management teams. In next month's investment view I will give a detailed run through on themes from these results including a discussion on sectors and companies. In summary though, results have been very varied by sector given the strange year that has just passed, and broadly as we would have expected.

As it stands, the companies in the portfolio saw (or are forecast to see) a weighted average revenue decline of -3% and earnings decline of -13% for 2020. So, whilst the portfolio hasn't been immune to the Covid crisis, the underlying companies have adapted well and, in the grand scheme of things, have traded robustly through it. Earnings are then forecast to see a healthy rebound in 2021 and 2022. Cumulative weighted average earnings growth for the portfolio over the 2021-22 period is forecast to be more than +20%<sup>ii</sup>.

More generally, we like the combination of market-leading positions, financial strength, and valuation appeal within the current portfolio. Our estimates of forward cash returns continue to suggest that high single digit annualised total returns are a realistic aspiration over an appropriate time horizon for investment in the fund (i.e. five years or more).

In terms of the fund's dividend, we continue to expect a fall in the full year dividend (to February 2021) of approximately -26%. This compares to a fall (for the 2020 calendar year) in the UK market's dividend stream of -38%, or -44% including special dividends (as calculated by the Link UK Dividend Monitor). Our

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current baseline forecast for Evenlode Income's February 2022 full year dividend is a rebound of +15% or more. This compares with Link's estimate of between -0.6% and +8.1% dividend growth for the UK market over the 2021 calendar year. Interestingly, these estimates would suggest a forward-looking yield for Evenlode Income of 2.9% (for the year to February 2022), compared to a forward yield of between 2.7% and 3.0% for the UK market (to December 2021). It has been several years since the Evenlode Income fund offered a comparable starting dividend yield to the UK market. We think this is of note, given the attractive economics of the companies held in the Evenlode Income portfolio and the prospects for real dividend growth over coming years<sup>iii</sup>.

## Lagging the Rally

Though your fund's long-term relative performance against the FTSE All-Share remains strong, recent performance has significantly lagged the huge market rally that picked up steam last autumn (the fund has risen +8.1% compared to +21.2% for the UK market since the end of October 2020<sup>iv</sup>).

Due to the fund's investment process (focusing only on business models with a low capital intensity that generate a high return on assets) it does not invest in energy and mining companies, and also does not invest in several big financial sub-sectors including banks and insurance companies. The fund's relative underperformance compared to the UK market since October is almost entirely explained by its sector positioning.

Specifically, the key drivers of underperformance have been<sup>v</sup>:

- The fund's zero weighting in resources companies (the FTSE All-Share Energy Minerals and Non-Energy minerals sectors have risen +51.5% and +45.6% since the end of October).
- The fund's significant underweight position in Financials (the FTSE All-Share Financials sector has risen c.+29.8%).
- The fund's overweight position in the Consumer Non-Durables sector (i.e. consumer branded goods companies), a sector which is up only +1.6% since the end of October.

More generally, the rally has been led by economically sensitive, financially leveraged and asset-intensive companies, whereas the Evenlode Income portfolio is biased towards more stable, predictable companies with strong balance sheets. The geographic diversity of the portfolio's underlying revenues (with more than 80% derived from outside the UK compared to less than 70% for the UK market) has also acted as a drag during a period in which the pound has strengthened very significantly against most global currencies (partly due to the Brexit agreement, and partly due to the UK's head-start on Covid vaccinations).

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## Polarised Performance

This polarisation of performance within the broader market has also been reflected within the Evenlode Income portfolio and investable universe. Very simplistically, the portfolio can be grouped into a top half and a bottom half during this period. Many of the larger positions are repeat-purchase, geographically diversified multinationals which have lagged the rally, or in several cases have actually declined in price (the share prices of 9 of the 39 companies held in the fund have declined since the end of October 2020). The most negative performers have been Procter & Gamble, Reckitt Benckiser, Unilever, PepsiCo and Astrazeneca.

In contrast, several of the holdings lower down the portfolio have performed very strongly. Share prices of the following holdings, for instance, have rallied by more than +25% since the beginning of October 2020, thanks to an improved outlook for the recovery from the pandemic and the economy: Hays, Compass, WPP, PageGroup, Schroders, Burberry, Savills, DMGT, Informa, IMI, Intel, Rotork, Spectris and Ashmore.

In terms of portfolio changes, the changes we make are always stock-specific. But to generalise, given the market dynamics I describe above, we are currently interested in opportunities that allow us to upgrade the quality, resilience and long-term cash compounding potential of the portfolio whilst retaining the attractiveness of the portfolio's current cash generation and dividend stream. In February, the changes we have made have been to existing holdings, but we also have an interesting watchlist of companies that could be introduced to the portfolio. We will keep you updated on any changes of note via the fund's monthly factsheets and these investment views.

## Pieces of Good Companies

*"Although it's easy to forget sometimes, a share is not a lottery ticket, it's part-ownership of a business".*

*Peter Lynch*

The pendulum of investor sentiment has swung a long way in the last 12 months. Last March, the presiding sentiment was *fear*, but in today's stock market it is *fear-of-missing-out*. Indicators of investor confidence are at quite frothy levels now, and fashionable momentum investments have been soaring. Unprofitable US technology shares, for instance, have strongly outperformed the US market so far this year, whilst owning Bitcoin and Tesla shares have been two of the most sure-fire ways to generate positive returns over recent months. On the other hand, asset-intensive and economically sensitive commodity and financial companies have also come right back into vogue as investors place their bets on a red-hot recovery.

The 'stay-the-course' income and growth approach that we deploy has been rather stuck-in-the-middle of these two extremes. However, to make a basic point, many economically attractive, market-leading

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companies with good potential for long-term growth have been left behind in this rally 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 owning pieces of good companies represents a very different thing to the ownership of fixed coupon bonds. This fact was highlighted, for instance, in the 1970s when the shares of many asset-light, market-leading companies did a good job of protecting their investors from inflation, during a decade in which fixed coupon bonds could not.

The current free cash flow yield of the Evenlode Income portfolio is more than 5%<sup>vi</sup>, and as discussed earlier our forecast for the fund's forward-looking dividend yield is approximately 2.9%, with prospects for further real long-term dividend growth from there. The short-term growth outlook has also improved for many holdings, thanks to the improving Covid situation.

In conclusion, despite recent relative underperformance, we remain confident in the current portfolio and the fund's ability to deliver its objectives over the long term.

Next month, we look forward to giving you a round-up of the current company results season. In the meantime, please do contact us if you have any questions about the fund.

## **Hugh and The Evenlode Team**

**24<sup>th</sup> February 2021**

*Please note, these views represent the opinions of Hugh Yarrow as of 24<sup>th</sup> February 2021 and do not constitute investment advice.*

*Past performance is not a reliable indicator of future results. The value of investments can go down as well as up, and investors may not get back the money they invested. Current forecasts are provided for transparency purposes, are subject to change and are not guaranteed.*

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<sup>i</sup> Source: Evenlode, Financial Express, total return, bid-to-bid, 31/12/2020 to 24/02/2021

<sup>ii</sup> Source: Evenlode, Visible Alpha, February 2021

<sup>iii</sup> Source: Evenlode forecasts, based on B Income per share amount. Though GlaxoSmithKline's lower dividend (from 2022, following the separation of its consumer healthcare business) creates a headwind in 2022, this dynamic has largely been offset in our forecasts by improved expectations for dividends from Covid-impacted payers in the portfolio

<sup>iv</sup> Source: Evenlode, Financial Express, total return, bid-to-bid, 31/10/2020 to 24/02/2021

<sup>v</sup> Source: Evenlode, Factset, 23<sup>rd</sup> February 2021.

<sup>vi</sup> Source: Evenlode, 24<sup>th</sup> February 2021. Based on free cash flow per share for the last set of full year results, compared with the current share price.