

# Evenlode Income Investment View



## February 2023 – Steady Compounding

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A risk-taking mood continued to prevail in February's stock market, with recent global economic indicators less negative than expected. Inflationary pressures are also beginning to ease back, as post-Covid supply chain issues start to be resolved. The relative resilience of recent economic data has meant that interest rate expectations remain elevated though, and this led to a rise in bond yields during February.

So far this year, Evenlode Income has risen +3.1% compared to +6.1% for the FTSE All-Share and +6.2% for the IA UK All Companies Sector.<sup>i</sup>

### Healthy Results

The fund has lagged the UK market's rally, as the share prices of more stable, repeat-purchase companies have risen less than their more economically sensitive peers. We remain very reassured though by the operational performance of underlying holdings, which have remained robust and healthy in aggregate. Holdings representing more than three quarters of the portfolio have updated on trading since the start of the year, and we are busy analysing results and talking to company management teams. For holdings reporting full year results to December 2022, organic revenue has averaged +11% and earnings have averaged +10% for the 12-month period<sup>ii</sup>. In the context of a very challenging geopolitical backdrop and extreme levels of input cost inflation, this is a solid result. Loyal customers, high gross margins, asset-light business models and strong balance sheets have all been helpful qualities as input costs and interest rates have risen.

Looking ahead, though management teams are very conscious of the current economic slowdown, most of the portfolio is relatively repeat-purchase in nature, which provides some insulation. For those holdings with more economic sensitivity, demand has thus far held up quite well in recent weeks and months. On the input cost front, if things stay as they are today, inflationary pressures will reduce this year. This is because raw material prices have already fallen back from their highs of Spring 2022, and supply chain bottlenecks are beginning to ease. Some management teams are even expecting year-on-year deflation in certain input costs for the second half of 2023, as lower prices work their way through the system. In terms of wage inflation, most global multinationals increased wages in the region of +4-5% during 2022 (this is a ballpark number at the global level – wage inflation by region and role has varied quite significantly). Most are planning for a similar rate of increase over the coming year.

### Investing for the Future

As well as resilient results and less extreme input cost inflation, we are also encouraged by the investments portfolio companies continue to make in the long-term health of their franchises. Though these investments burden the financial results of today, they lay the foundations for a steadily compounding cash flow stream – the holy grail of the long-term, fundamental investor.

Below are three examples of Evenlode companies that have been quietly investing through the recent period of uncertainty.

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## **RELX**

RELX provides information-based analytics for a customer base that includes doctors, lawyers, accountants and other business professionals. RELX's proprietary data and content, often built over many decades, has huge scale. For example, its workflow solution for lawyers, LexisNexis, hosts more than 140 billion legal and news documents and records. In recent years it has used these core data assets to develop increasingly sophisticated software and decision tools. These are mission-critical services that become embedded in day-to-day workflow, helping RELX's customers to increase productivity, reduce risk, and increase the quality of their own services and products. Ongoing organic investment has helped RELX accelerate its growth. For 2022, organic revenue grew +9%, operating profit grew +15% and the dividend was increased +10%. Management's strategy is primarily focused on organic development, which is highly beneficial for shareholders given the company's attractive economics (gross and operating margins are more than 60% and 30%, respectively). Looking forward, management expect underlying growth rates in revenue and profit to remain above historical trends in 2023.

## **Diageo**

Diageo is a global market leader in the drinks sector, with a portfolio of over 200 brands (think Johnnie Walker, Tanqueray, Guinness etc.). Growth prospects remain strong as demographic trends remain supportive - particularly in emerging markets and the US. Demand for higher quality, premium drinks also continues to increase globally, and Diageo's portfolio is well placed to benefit, with premium brands representing 60% of sales. Growth has continued over the last six months, with interim results showing organic revenue growth of +9%, profit growth of +10% and dividend growth of +5%. Management has increased organic investment in recent years, a sensible strategy given the company's attractive economics and growth opportunities. Spending on marketing, key for nurturing and building its brands, increased +17% over the last 6 months, and is +60% higher than five years ago. Meanwhile, spending on property, plant and equipment increased +14% and is more than +100% higher than five years ago, as the company builds out its distillery and brewing capacity. Despite an uncertain economic outlook, Diageo is a resilient business with strong brands and a diversified product and geographic footprint. Management target continued strength in organic sales and operating profit in 2023, which they expect to grow by +5-7% and +6-9%, respectively.

## **Spectris**

Spectris is a global leader in precision measurement equipment and software. It sells into structurally growing end-markets including pharmaceuticals, semiconductors, and machine manufacturing. Management have successfully streamlined the group in recent years, divesting non-core businesses which had less attractive competitive positions and higher capital intensity. Results for 2022 highlighted the strength of "new" Spectris, with revenue and profit increasing +14% and +17%, respectively. The dividend was increased by +5%, representing the 33rd year of continuous dividend growth. As with Diageo and RELX, organic investment has been management's primary use of capital.

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Spending on research and development increased by +24% in 2022 to more than £100m, representing nearly 8% of group revenue, a third higher than the pre-pandemic level, and driving a greater cadence of new product launches. Growth opportunities are wide-ranging for Spectris. One example is the ‘electrification of everything’ that is accompanying the energy transition. Spectris is investing in its battery and electric motor testing offerings, for instance, to capitalise on its market leading position in these areas. Opportunities to invest in life sciences products are also numerous. Spectris management expect further progress in 2023, guiding to sales growth of +6-7% and profit growth above this level.

### **Steady Compounding**

These three holdings are quality businesses whose competitive strengths and attractive growth opportunities position them well to continue delivering healthy, cash compounding growth over time. More generally, when we look across the Evenlode Income portfolio, we are encouraged by the resilience and growth opportunities that we see. Valuations also remain modest, with the fund’s dividend yield of 2.7% well covered by a free cash flow yield of 5.2%<sup>iii</sup>. Though the economic outlook is as usual uncertain, we think this combination of quality, compounding growth and valuation appeal is very reassuring for the patiently-disposed, business-perspective investor.

### **Hugh and the Evenlode Team**

**28 February 2023**

*Please note, these views represent the opinions of Hugh Yarrow and the Evenlode Team as of 28 February 2023 and do not constitute investment advice.*

*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.*

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

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<sup>i</sup> *TB Evenlode Income B Acc class. 31 December 2022 to 28 February 2023. Source: Evenlode, Financial Express, total return, bid-to-bid, GBP terms.*

<sup>ii</sup> *Source, Evenlode, company results. Unweighted average using constant currency organic revenue and EBIT growth.*

<sup>iii</sup> *Source: Evenlode. Free Cash Flow Yield based on FactSet estimates for current financial year. Dividend yield is historic yield as at 28 February 2023, based on distributions in previous 12 months.*