

Evenlode Investment View

January 2021 – Through and Beyond the Crisis



As we all turn the page on the extraordinary year that was 2020, I will as usual use this January investment view to review the year just passed and to share some thoughts on the outlook for the coming year and beyond.

After a benign start, the UK stock market began to plunge at the end of February as the global impact of coronavirus became clear. Over the following weeks fear and panic set in, and measures of volatility spiked. At its nadir, on 23rd March, the FTSE All-Share had fallen approximately -34% since the start of the year. Then, without any formal announcement, the market started to quietly recover. Initially, market sentiment was helped by the incredible monetary and fiscal stimulus that global governments and central banks unleashed to mitigate the economic aftershocks of lockdown measures. The mood also improved as investors began to realise that many large, listed companies would be able to cope with the ‘new normal’ reasonably well. From the start of November sentiment was given a further, turbo-charged boost thanks to the news of successful vaccines and a clear result from the US election. The UK market was also helped by the last-minute trade agreement between the UK and the EU, with domestically exposed constituents of the UK market performing particularly strongly in the closing weeks of the year.

Though this recovery was very significant (+37% from the 23rd March low to the end of December) it wasn't quite enough to avoid a negative return for the year as a whole, given the extent of the falls earlier in the year.

In the end, the FTSE All-Share fell -9.8% and Evenlode Income fell -7.4%. Evenlode Income's outperformance versus the UK market was very skewed towards the first half of the year as the fund's resilient qualities were appreciated during the first few months of the crisis. However, performance then lagged the breath-taking pro-cyclical fourth quarter rally.

With another calendar year added to Evenlode Income's life, below are both the fund's year-by-year and cumulative total returns versus the FTSE All-Share.

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Year	Evenlode Income (B Acc)	FTSE Allshare	Relative
2009*	+3.2%	+2.3%	+0.9%
2010	+20.1%	+14.5%	+5.6%
2011	+2.6%	-3.5%	+6.1%
2012	+12.5%	+12.3%	+0.2%
2013	+26.7%	+20.8%	+5.9%
2014	+8.2%	+1.2%	+7.0%
2015	+8.4%	+1.0%	+7.4%
2016	+17.1%	+16.8%	+0.3%
2017	+15.2%	+13.1%	+2.1%
2018	+0.4%	-9.5%	+9.9%
2019	+24.3%	+19.2%	+5.1%
2020	-7.4%	-9.8%	+2.4%
Total Cumulative	+230.5%	+104.8%	+125.7%
Total Annualised	+11.3%	+6.6%	+4.7%

* From launch (19 October 2009)

Source: Evenlode, Financial Express, total return, bid-to-bid. Past performance is not a reliable indicator of future results.

Diverse Performance

Given how challenging an operating environment 2020 proved to be, we were reassured with how well Evenlode Income's underlying companies have coped and adapted. For context, 2020 revenue for the aggregate portfolio is expected to fall by approximately -4% compared to 2019.

The diversity and volatility of stock-by-stock operating and share price performance during the year was notable. For 2020 as a whole, the fund's strongest contributors to return were Reckitt, Microsoft, Bunzl and Unilever: all repeat-purchase companies well positioned to adapt and benefit from the new stay-at-home and hygiene-conscious economy. Microsoft management noted that they had seen 'two years of digitalisation transformation in two months' during lockdown. Meanwhile, both Reckitt and Bunzl saw strong growth in sales for their hygiene products as the world acquired new habits. Reckitt and Unilever also benefited from selling low-ticket essentials, predominately through supermarket and online channels that were little impacted by the crisis. Digital channels in particular saw high levels of growth and increasing penetration. For Unilever, for instance, digital sales roughly doubled as a percentage of overall sales in the first nine months of 2020, and now represent approximately 10% of total sales.

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The most negative contributors to the fund's 2020 return were Informa, Compass, Sage and WPP. Informa and Compass are both global market-leaders that were severely impacted by lockdown restrictions in their respective industries of trade exhibitions and food catering. We reduced the position sizes of both holdings to reflect the impact of the crisis on their risk profile and dividends. In our view though, both companies are strengthening their competitive positions during the downturn and will ultimately emerge from the crisis in good shape. Both Sage and WPP are undergoing transitions. Sage enjoys a stable repeat-purchase business, with 90% of sales now recurring. These recurring revenues grew by +8.5% last year and the sector it operates in (providing enterprise software to smaller companies) has good growth potential thanks to digitalisation trends. The shares underperformed in 2020, however, as Sage management announced increased investment to help accelerate its transition to a cloud-based product ecosystem. This investment is impacting current levels of profitability but is, in our view, the right thing to do for the long-term health of the company. WPP was impacted by the post-pandemic economic downturn, as corporates reined in their expenditure on marketing, communication and advertising. WPP's industry is also in a period of structural change (and has been for several years) as it digitalises. WPP is simplifying its business and investing to accelerate this digital transition in order to drive growth through the recovery and beyond.

A thorough analysis of the balance sheets and liquidity positions of all holdings during late February and early March gave us confidence to add to many existing positions. More generally, we were active during the year in terms of 'nudging' the portfolio towards areas of attractive valuation as stock-by-stock volatility was high and trends were choppy. In general, we focused this activity on existing holdings where we saw good opportunity.

We did not exit any positions as a direct result of the crisis. However, we did exit a small position in Halfords for liquidity reasons in the summer and we also exited a position in Kone for valuation reasons in November. In terms of new holdings, we added Roche to the portfolio in early March and Hargreaves Lansdown in November. In our view both companies bring an attractive combination of competitive/financial strength, growth potential and valuation/dividend attractions to your fund.

Valuation

We are encouraged by the valuation of the current portfolio. Forward return potential has, on our estimates, improved since the start of last year and looks as attractive as it has for several years (other than a brief period in Q2 2020 when it looked even more attractive). This is both due to the 2020 fall in the fund's share price, and also our ongoing efforts during the year to bias the fund to

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better valuation opportunities. Based on our estimates of fundamental cash generation, we believe that high single digit annualised total returns are a realistic aspiration for long-term investors in the fund (i.e. on a time-horizon of five years or more). I discussed our thoughts on valuation in more detail at the end of last year in both my October and November views.

Dividends

Our view on this year's dividend distribution for Evenlode Income hasn't changed a great deal after the initial impact of the lockdown dividend cancellations announced by companies in March and April last year. We currently expect the dividend stream to fall by approximately -26% for the fund's full year to February 2021 (compared to an expected fall of approximately -40% for the UK market's dividend stream for the 2020 calendar year). The portfolio's dividends are then forecast to recover quite strongly in the forthcoming year (to February 2022), by at least +15%. The recent vaccine news gives us more confidence in the likelihood and strength of this rebound. Longer-term, we think the prospects for real dividend growth remain positive, thanks to both the competitive strength and market growth enjoyed by the underlying holdings.

Through and Beyond the Crisis – Same but Different

We're not going back to the same economy. We're recovering, but to a different economy

Jerome Powell, Chair of the Federal Reserve

The availability of multiple, effective vaccines is clearly very good news for global society, economies and the diversified companies held in your fund. We celebrate the incredible, innovative response from the global scientific and healthcare community. We're also pleased that we, as a company, were able to use an element of our charitable budget in 2020 to financially support the Oxford Jenner Institute in their work to develop a successful vaccine.

There is no doubt that stock markets are now looking through the current wave of lockdown restrictions and anticipating a return to normality over coming months thanks to the availability of these vaccines. As restrictions ease, it is almost a mathematical certainty that economic activity will show a decent year-on-year recovery in 2021, and the stimulus efforts of recent months will support this rebound. Much of life will then return to normal, but the global pandemic will have left both a long shadow on the global economy and an indelible mark on our habits. From an economic perspective, huge support from monetary and fiscal stimulus has been required to allow us all to stumble through the last year in the shape that we have. As lockdown restrictions ease, pent-up demand will return but stimulus efforts will also begin to ease, and the world (and

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particularly governments) will be left with even higher levels of indebtedness than pre-crisis. Taxation levels are likely to rise and consumers may increase their propensity to save after the psychological shock of two ‘once-in-a-generation’ financial shocks in the space of just over a decade. As discussed in my November view, both inflationary and deflationary forces will remain present within the global economy.

In terms of corporate themes, several have emerged and/or accelerated as a result of the crisis which will not go away: the acceleration of digitalisation; a much higher level of flexible and remote working; a greater appreciation of the importance of social responsibility and multi-stakeholder capitalism; more awareness of the risk posed from externalities (including most obviously climate change); a desire for supply chain, operational and financial resilience and a greater emphasis on hygiene and healthcare. These themes present risks to companies and require adaptation, but they also provide interesting avenues for growth over coming years.

Good Companies for the Long-Term

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

Peter Lynch

Before finishing, it is worth noting the degree to which market sentiment has swung from panic to optimism very sharply over the last few months. The fear that investors felt back in March has gradually morphed into a ‘fear-of-missing-out’ and various indicators of investor sentiment have surged to quite frothy levels over the last few weeks. More economically sensitive, leveraged and asset-intensive shares have roared back into fashion whilst the shares of many of their steadier peers have lagged the market or even fallen back in price.

Our focus on high quality, resilient and financially strong companies can appear overly careful during market phases such as this recent one, and the rotation over the last three months has impacted your fund’s short-term relative return figures when compared to the UK market. Episodes such as this have come and gone many times over the years, and will come and go again. It is worth stressing that our long-term investment approach isn’t changed by them. To borrow from Peter Lynch, we continue to view shares as fractional stakes in real companies rather than lottery tickets, and as we look ahead to 2021 (and the longer-term) we feel positive about the quality, resilience and valuation appeal of the underlying holdings in the fund. We are also open to evolving the portfolio where we see good reasons to do so. Given recent trends, we are particularly interested in opportunities that enhance the overall quality and long-term growth

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potential of the portfolio whilst retaining (or improving) the valuation appeal and the dividend stream.

Before signing off, I'd like to wish you all the best for the coming year and a gradual return to something resembling normality. We look forward to updating you regularly over coming months and as usual, please do get in touch if you have any questions.

Hugh and the Evenlode Team

14th January 2021

Please note, these views represent the opinions of Hugh Yarrow as of 14th January 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.