Evenlode Income Investment View

January 2024 – 2023 review and outlook for 2024

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We will, as usual, use this January investment view to discuss the year just passed, and share some thoughts on the outlook for the year ahead.

Overview - 2023

Economic and geopolitical risks were never far from the headlines in 2023, but most global stock markets ended up posting positive returns for the year, helped by a strong rally in the last two months.

Geopolitics has cast a long shadow over the post-pandemic world. In 2023, the Ukraine/Russia war rumbled on, and tensions rose in the Middle East from October. Interest rates also continued their march higher, as central banks attempted to rein-in the post-pandemic inflationary spike. The real 'shock' is not so much the new level (the UK base rate currently stands at 5.25% versus a long-term average of 4.7% since the Bank of England's formation in 1694) as the speed of the rise from the near-zero rates that prevailed in the decade or so up to the end of the pandemic. This sudden shift has inevitably created pressure in more highly leveraged areas of the global economy, not least via the banking crisis in March 2023 which started in the US with Silicon Valley Bank and then spread to Europe and Credit Suisse. More generally, inflation and higher interest rates have had a cooling effect on global economic activity.

The world, though, has managed to muddle through. Global economic growth cooled in a measured way during 2023, and company results held up reasonably well overall. Inflation is also now falling significantly. In the UK, CPI inflation fell from +10.5% in January 2023 to +3.5% in November 2023, and consensus expectations are now for the inflation rate to fall below the Bank of England's +2% target during 2024. As similar trends developed globally, central banks began hinting that we may have arrived at the top of the interest rate cycle. This change of tone led to a rally in global stock markets to finish the year.

Performance

For the year as a whole, Evenlode Income rose +9.3% compared to a rise of +7.9% for the FTSE All-Share and a rise of +7.4% for the IA UK All Companies sector.[i]

With another year on the clock, Evenlode Income (launched in October 2009) is now a little over 14 years old. During this period, the fund has a total return of +314% compared to +158% for the FTSE All-Share. This represents a compound return (after fees) of +10.5% per annum, compared to +6.9% per annum for the FTSE All-Share.

Performance drivers

The most positive contributors to Evenlode Income's return for 2023 were RELX, Sage, Microsoft, Bunzl, Howden and Spectris.

RELX provides data and software to business customers including banks, insurance companies and legal firms. The ongoing shift in business mix towards higher growth analytics and decision tools drove strong growth in 2023, and the outlook is positive as the use of data and digital tools by corporates to automate workflows and drive efficiencies continues to increase. A good example of continued product development in 2023 is a new version of their legal software, Lexis+ AI, which incorporates generative artificial intelligence technology. Trained on Lexis' proprietary data and content, it helps lawyers navigate case histories and draft letters, emails and legal summaries.

Sage is a leading provider of financial software and has successfully transitioned its portfolio to cloud-based products which now account for around 75% of group revenue. It reported strong results in 2023, with revenue and profit growing double digits, driven by increasing adoption of cloud-based software by existing and new customers.

Microsoft's strong position in cloud computing drove double digit revenue and profit growth in 2023. It is also well positioned in artificial intelligence technologies and is embedding AI across its productivity software, including Office and Teams.

Bunzl is a leading B2B distributor of essential not-for-resale products across a range of sectors, from packaging for grocery stores and restaurants, to personal protective equipment for construction projects. Bunzl is deeply embedded into its customers' operations providing custom solutions and is increasingly advising customers on more sustainable solutions, helping it deliver another year of profit and margin expansion in 2023.

Howden is the market-leader in the provision of kitchen and joinery products to trade-builders and has grown to more than 25% of the overall UK kitchen market. Despite a tough backdrop over the past year, Howden has shown a continued commitment to invest, with a steady programme of depot refurbishments and openings, new state-of-the-art manufacturing and warehousing facilities, and consistent investment in digital capabilities. Howden strengthened its competitive position in 2023 and gained market share, delivering a resilient performance despite challenging conditions, driving a strong share price performance.

Spectris is a global leader in precision measurement equipment and software, selling into structurally growing end-markets including pharmaceuticals, semiconductors and machine manufacturing. Spectris reported strong double-digit sales growth in the first 9 months of 2023 as supply chain issues eased considerably. In recent years management have streamlined the portfolio of businesses within the group, focusing on asset-light precision measurement technologies serving attractive, growing end markets. Management have also continued to invest in research and development, which as a percentage of sales, is a third higher than pre-pandemic. This is driving a strong pipeline of new product launches, and growth opportunities are wide-ranging for Spectris including interesting exposure to life sciences and the structural shift towards the 'electrification of everything".

The most significant negative contributors of note were Diageo, Unilever and Burberry.

At Diageo, sales growth began to normalise in 2023 following particularly strong demand during and after the pandemic period. In a November trading update management downgraded profit expectations due to weakness in Latin America, driven by weaker consumer demand and distributors and retailers running down inventories, with both trends at least partly linked to the increase in interest rates during 2023. This was a setback for the new management team, but we are encouraged by their continued prioritisation of reinvestment into brand building and capacity, which position it to capitalise on strong medium term growth prospects for the spirits industry, particularly high quality premium spirits, which make up the majority of Diageo's profit. We continue to view Diageo as a strong business with a portfolio of exceptional heritage brands that will drive strong pricing power and growth prospects. Following a -20% share price decline in 2023, Diageo is valued at 18x forward earnings, the cheapest it's been for 10 years, except for a few weeks in early 2020 when it became apparent that Covid-19 was spreading to Europe.

Unilever has a strong brand portfolio, with most enjoying number one or two positions in their respective categories, with a particularly strong position in emerging markets where rising per capita incomes underpin an attractive growth runway. Sales growth was good in 2023, driven by pricing, and this has started to drive a recovery in its profit margins which fell slightly in 2022 due to significant material and input cost inflation. The new management team has emphasised a renewed focus on investing behind their existing strong brands to drive competitiveness and organic growth. Unilever's shares look particularly attractive on valuation at 16x forward earnings, the lowest in more than a decade.

Burberry saw a slowdown in sales during 2023, following a period of strong growth as economies reopened from pandemic-related lockdowns. The slowdown in luxury demand has become increasingly evident during 2023, but we view Burberry as well positioned for the medium and long term. It is a strong heritage brand and has built direct distribution in key markets across Europe, the US and Asia, helping to strengthen its customer relationships and pricing power. Its net cash balance sheet is particularly helpful during this period of higher interest rates and weaker demand, allowing management to continue investing appropriately for future growth. Similar to Unilever, Burberry's valuation looks attractive, with the forward P/E multiple of 13.7x at its lowest for over a decade.

Reassuring operational performance

We have been reassured with the aggregate progress that underlying portfolio holdings have made in the last two turbulent years. Customer loyalty, attractive margin structures, self-funding business models, repeat-purchase cash generation and strong balance sheets have provided helpful insulation from a slowing economy and higher input cost inflation and interest rates.

In 2022, average growth in revenue and profit for the Evenlode Income portfolio companies was +12% and +11% respectively, helped by both pricing and robust demand. For 2023, full year results to end-December will be released over the next few weeks, and we will discuss these results in more detail in our February and March investment views. The most up-to-date results period is currently quarterly results to end-September. For portfolio companies reporting for this period, organic revenue growth averaged +6% and we would expect a similar rate for the full year, with earnings growth running at a similar level and free cash flow growth at a higher rate (as Covid-related inventories unwind). For 2024 it is still early days, but current forecasts suggest revenue growth of +5%, operating profit growth of +7% and another year of strong free cash flow growth.[ii]

Three key themes emerge from these statistics - slower but solid aggregate revenue growth, an improving margin outlook and healthy cash generation.

Evolving the portfolio

In terms of portfolio changes, we were less active than in 2022 (during which we added seven holdings and exited six). We continued, though, to evolve the portfolio as we look to optimise the combination of quality and valuation appeal.

We added one new position in the second half of the year – Spirax Sarco. Spirax is the global leader in steam and electric systems essential for the transfer of heat and energy into industrial processes. Deep knowledge of customers industrial systems drives sticky long-term relationships and a solid base of recurring revenue from maintenance and modernisation projects, with the business generating strong operating margins of 20%+ and organic growth averaging around 2x the rate of global industrial production historically. Growth prospects are strong as it helps customers meet efficiency and decarbonisation targets.

We also topped up a wide range of existing holdings including Experian, Diageo, Savills, Halma, Integrafin, Hays, Howden, Roche, Burberry, Victrex, SGS, Intertek and Smith & Nephew.

To make room for these additions, we exited Cisco, Moneysupermarket and Astrazeneca in the second quarter of the year. We also reduced a number of other holdings for valuation reasons – most notably Procter & Gamble and PepsiCo. In the last few weeks of the year, we also trimmed back the fund's holdings in Sage, Microsoft, Wolters Kluwer and RELX, as their relative valuation and dividend appeal reduced somewhat due to strong share price appreciation.

Outlook

Looking ahead, the outlook is not without complications. The geopolitical backdrop is challenging as uncertainty persists over the Russia/Ukraine conflict, tensions in the Middle East, and China's relationship with Western liberal democracies. 2024 is also the biggest election year in history, with more than 60 countries (representing half the world's population) holding elections, including the UK and the US. On the economic front, one can credibly take either a glass half-empty or glass half-full view. For the pessimists, the effects of higher interest rates continue to work their way through the system. For the optimists, inflation is cooling rapidly, and interest rates could fall quite significantly in 2024.

With these uncertainties in mind, we think that Evenlode Income's underlying holdings are in good shape to cope with the wide range of operational conditions that may prevail, as they have done over the last few volatile years.

With times tough and interest rates back at more normal levels, sensibly run market-leading companies with self-funding business models and strong balance sheets are well placed to strengthen their competitive positions. We suspect that this theme has further to run, and it applies just as much to more economically sensitive holdings as it does to the repeat-purchase bedrock positions held in the fund. Valuations are also attractive, with most high-quality UK-listed cash compounders trading on modest valuations. The fund's free cash flow yield stands at a healthy 5.5%. This resilient free cash flow stream provides a nice safety buffer for the fund's 2.7% dividend yield, and we think prospects for dividend growth are good thanks to the cash compounding potential of the aggregate portfolio over coming years.[iii]

We wish you all the best for 2024 and look forward to updating you regularly as the year progresses. Please do get in touch if you have any questions.

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

15 January 2024

Please note, these views represent the opinions of the Evenlode Team as of 15 January 2024 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 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. Current forecasts provided for transparency purposes, are subject to change and are not guaranteed. Source: Evenlode Investment Management Limited, authorised and regulated by the Financial Conduct Authority, No. 767844.

[i] *WS Evenlode Income B Acc (GBP). Source: Evenlode, Financial Express, total return, bid-to-bid, GBP terms. Performance to 31 December 2023. WS Evenlode Income launch date: 19 October 2009.*

[ii] *Source: Evenlode, Visible Alpha.*

iii Source: Evenlode. Free cash flow yield as at 31 December 2023, based on FactSet estimates for the current year. Dividend yield is historic yield as at 31 December 2023.