

Evenlode Income Investment View



June 2022 – A broadening opportunity set

We are now at the half-way mark of 2022, and it's so far been a discouraging year for investors. Input cost inflation has been the key catalyst for these downbeat conditions, initiated by Covid-related supply-chain bottlenecks in 2021 and accentuated in recent months by both Russia's invasion of Ukraine and China's Covid-related lockdowns. As a result, central banks are raising rates, the cost of borrowing is rising, consumers are feeling the pinch and economic leading indicators have deteriorated markedly. Though most companies have yet to see worsened trading conditions, the share prices of many have moved lower as valuations deflate, sentiment deteriorates, and Mr Market begins to price in a global economic slowdown and earnings downgrades.

Global stock markets have thus seen a significant correction. It has been, for instance, the worst first six months for US stock markets since 1970 (the S&P 500 fell -20% in US dollar terms). Leading the fall has been the technology-heavy Nasdaq Composite index (-29% in US dollar terms), with unprofitable and expensive companies under the most pressure as the benefit they saw from rising valuations over recent years unwinds.

In a global context the UK market has been relatively resilient, with the FTSE All-Share falling -4.6%. It has been helped by more modest starting valuations, but also by a very strong showing from the resources sector, whose members constitute some of the biggest companies in the FTSE 100. Strip the biggest stocks out though, and under the surface many UK-listed stocks have fallen more significantly. The FTSE 250 index, for instance, is down more than -20% year-to-date.

Evenlode Income has fallen -9.5% and the UK All Companies sector has fallen by -12.8%¹ in the period.

Repeat-purchase business models

In the context of the current economic backdrop, we find it reassuring that the bedrock of the Evenlode Income fund's cash generation is underpinned by repeat-purchase business models (78% of the portfolio is invested in companies that we categorise as having below average economic sensitivity). We always like this to be the case, across the cycle, to help insulate the portfolio's dividend stream from a wide range of economic outcomes. We also think the relative valuation appeal of more defensive, stable businesses has in many cases been particularly compelling over the last 18 months or so (since vaccine day), during a period in which investors have on-the-whole been preoccupied with cyclical recovery and resources stocks. The remaining 22% is invested in quality, asset-light businesses that have more economic sensitivity. With these holdings, we look for a particularly high margin of safety on their balance sheets (in aggregate, this part of the portfolio has a net cash balance sheet position). As with the 2008-9 downturn and the Covid lockdown of 2020, the quality and financial strength of these holdings gives them a greater ability to navigate through tougher economic conditions and emerge in good health, often with a strengthened competitive position.

¹ Source: Evenlode, Financial Express, total return, bid-to-bid, 31 December 2021 to 30 June 2022. All returns quoted are local currency.

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Valuation appeal

As discussed in recent investment views, the portfolio's valuation is modest, with the current free cash flow yield on the portfolio over 5% and at a more attractive level than it was five years ago². We find this interesting in the context of global markets and view long-term growth potential for this free cash flow stream as good.

A recent development in the portfolio reflecting current valuation appeal has been the announcement of takeover approaches for two smaller holdings during June. One is a recommended offer for EMIS, the healthcare software company, at a premium of about +50% to its share price. The other is an early-stage approach for Euromoney (a company discussed in last month's investment view) which may or may not lead to a recommended offer.

A broadening opportunity set

It is also worth noting that we are seeing a significant broadening out of the opportunity set, as some of the constituents of the Evenlode Income investable universe (great businesses but not held in the portfolio because they lacked relative valuation appeal) have experienced a sharp valuation de-rating. To give a sense of how quickly this dynamic has developed, several high-quality cash compounding companies that we follow have seen drawdowns of between -40% to -50% over the last few months without any change in our view on their long-term fundamentals. Given that the Evenlode Income portfolio has fallen by less than -10% year-to-date, this is creating an interesting situation in which we have a long watchlist of ideas beginning to compete for a place in the fund. We are seeing opportunities to add diversification and high-quality business models without diluting the portfolio's valuation and dividend appeal. Reflective of this trend, we are currently in the process of adding four new holdings and researching and speaking to a number of other companies whose valuations are improving. We look forward to updating you on portfolio developments over coming weeks.

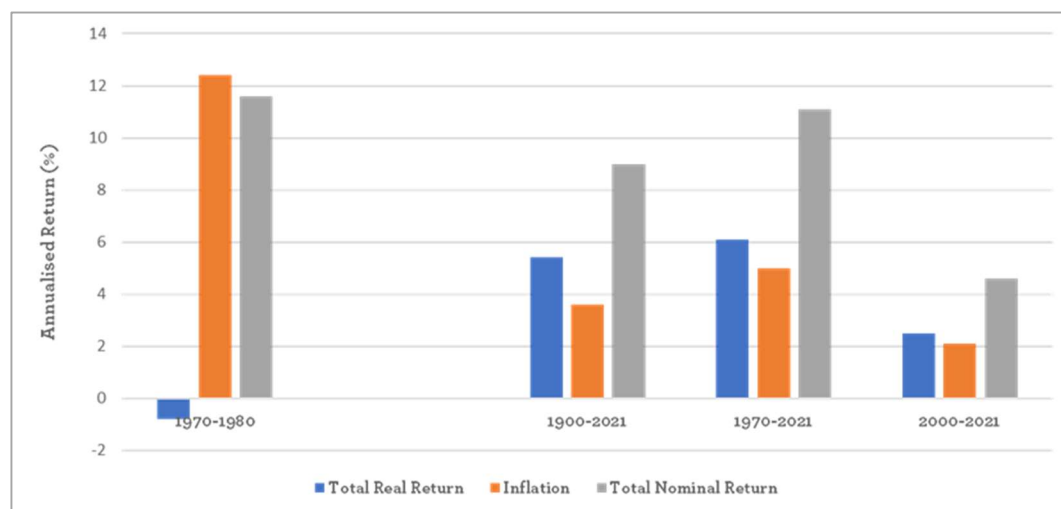
Inflation protection and long-term investing

I would like to finish by making two points that are not necessarily front-of-mind in terms of investor sentiment right now. The first is that, though there is no perfect hedge against inflation, equities are not a bad one. This will not necessarily always be the case over the short-term, as the last few months has shown with rising inflation accompanied by falling share prices. But the following chart shows how, over the long-term (whether since 1900, 1970 or 2000) the UK market has produced total nominal returns comfortably above the rate of inflation. Even in the 1970s equities nearly kept up with inflation, producing a double-digit nominal return which was only slightly negative in real terms. These 1970s returns came with a significant amount of volatility of course, but interesting to note the end-result.

² Source: Evenlode, FactSet

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Source: Dimson-Marsh-Staunton Dataset

The second point is that the types of business found in Evenlode’s portfolio and investable universe have several specifically helpful features in more inflationary times:

- Possessing loyal customers that value your products/services (and aren’t spending a huge portion of their overall expenditure on them) is helpful for pricing power.
- Attractive gross margins and operating margins are useful when input costs go up (the average gross margin, for instance, for the Evenlode Income portfolio is more than 50%).
- A low capital intensity tends to help as inflating maintenance capex requirements don’t put such a dent on free cash flow as they would for more asset-intensive companies.
- Low debt levels are desirable as they provide insulation from rising interest rates.

The economic environment is clearly tough this year, but it has been interesting to see pricing actions from portfolio companies begin to feed through to financial results. As discussed in our April investment view, average year-on-year revenue growth for the first quarter of 2022 was +15%, with a portion of this accelerated growth driven by pricing.

It has been a quiet period for company reporting over the last few weeks, but a handful of companies have released updates on more recent trading. Specialist distributor Bunzl, for instance, this week reported an acceleration in revenue growth since its last trading statement in April, with +16% growth in year-on-year revenue for the first half of the year. Guidance for full year revenue growth has also been upgraded whilst operating margin guidance has remained unchanged. As management put it, *‘our entrepreneurial teams have continued to deliver good growth through a combination of passing on substantial inflation and volume growth, supported by recovering markets and with our performance over the last two years further strengthening our competitive position’*.

To sum up, the economic and geopolitical backdrop is tough, and companies have a slowdown to deal with over coming months. There is also no perfect hedge against inflation, especially in the short-term. But equities tend to produce good real results over longer time periods and, relative to the

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average company, companies with the characteristics I mention above are particularly well-placed to deliver these long-term real returns. This is particularly true if they have the resilience and financial strength to cope with more difficult economic environments and, crucially, are held on attractive valuations.

Hugh, Ben P, Chris M, and the Evenlode Team
30 June 2022

Please note, these views represent the opinions of Hugh Yarrow and the Evenlode Team as of 30 June 2022 and do not constitute investment advice.

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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.

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