Evenlode Income Investment View

June 2023 – Two corporate themes

A gradual global economic slowdown started in the second half of last year and has continued following the US banking crisis in March. Signs of this slowdown remained evident in June. Though inflation is falling back in most regions - thanks both to this slowdown and the easing of supply chain bottlenecks - financial markets are expecting higher-for-longer interest rates. This expectation stems from the assumption that central banks will not want to drop rates too quickly and risk over-stoking inflationary pressures again.

The UK market, faced with these crosscurrents, was relatively subdued during June. At the year's half-way point, Evenlode Income has now returned +5.2% compared to +2.6% for the FTSE All-Share and +1.8% for the IA UK All Companies sector[i].

Results, resilience, economic sensitivity, and silver linings

Fundamental results from portfolio holdings have remained resilient. As discussed in last month's investment view, revenue growth has slowed relative to 2022, but remains healthy (+9.3% average for the first quarter). Meanwhile, the margin outlook has improved (most companies don't report operating profit for the first quarter, but for those that did organic revenue grew +9.8% and operating profit grew +13.8%). Recent trading updates and conversations with management have confirmed that both these trends – slowing revenue growth but improving profitability – continued into the second quarter.

We will use the rest of this investment view to give an update on two quite different themes that have come up regularly in recent conversations with company management teams. The first is generative AI, the second is supply chains.

Generative AI

To go back all the way to the post-war era and the early days of computing, it is worth noting that society has tended to use the term 'artificial intelligence' to describe whatever the latest, most sophisticated form of data analytics is at any point in time. In the 1950s it would have been the first chess computers, today it is generative AI.

As the venture capitalist Marc Andreesen puts it, software is eating the world, across all sectors of the economy. Viewed through this lens, the arrival of generative AI into the mainstream - with the launch of ChatGPT and other text-based, image-based and music-based services - is the latest development in this digitalisation trend.

As we have discussed with management teams and industry experts over recent months, companies are exploring opportunities to harness generative AI in a variety of ways, it can help them create content more easily, create better user-interfaces (both for employees and for customers), and help generate internal efficiencies, such as the production of draft code for software developers.

It also comes with challenges, which could create reputational risk if not managed well. Generative AI models can make things up ('hallucinate'), whilst questions of data quality and security also need to be thoughtfully addressed. We think the digital and data analytics companies held in the portfolio - RELX, Sage, Microsoft, Experian, LSE Group, Wolters Kluwer etc. – are well placed to manage these risks and harness the opportunities. These holdings have been investing heavily in their data analytics capabilities for many years, and benefit from close relationships with clients, high quality datasets and deep domain expertise.

One example is RELX, the providers of data analytics services to doctors, lawyers, academics and business professionals. RELX are beginning to deploy new generative AI products across their portfolio. Their new Lexis+ AI tool for lawyers, for instance, was launched and demonstrated in a recent seminar.

Another example is Sage, a provider of accounting software to small and medium sized businesses. Much of Sage's software today incorporates sophisticated data analytics technology already, such as extraction from bank feeds or outlier-detection to flag up transactions when they deviate from historical patterns. Sage is now planning to launch an accounting 'assistant', which an accounting clerk can use to both answer questions and help to perform tasks. For instance, can you provide me with a list of all overdue customers and draft a letter to chase them for payment? The AI assistant then creates a list of customers and a draft letter. The human accountant checks the list, edits the letter a little, and asks the AI assistant to send out the letters. Historically this task could take the accountant an hour or two. The new service might reduce it to a few minutes.

Sage and RELX can offer these services because they are trusted by their clients, embedded in their workflows, and have a long history of successfully deploying sophisticated data analytics within their specialist domains.

Supply chains

The second theme is supply chains, with companies seeing the return to a much a more normal situation, and input cost inflation falling as a result.

The Evenlode Income team visited test and measurement company Spectris in June. Management noted that they were struggling to source key electrical components in 2021 and 2022, with the price of some microchips, for instance, rising from £50 to £5,000 at peak due to shortages. Now, though, input cost inflation is back to much more normal levels and in some areas, including microchips, year-on-year pricing has turned negative. Supply chain easing is also evident in the company's revenue performance. For the first quarter, Spectris posted +24% organic growth, in part due to fundamental growth, but also thanks to improved orderbook conversion, as supply chains bottlenecks are cleared and finished products are shipped.

A second example is value-added industrial distribution company Diploma. Management noted to us in June that there will always be the odd issue or bottleneck in any global supply chain. The company's overall situation, though, is back to the pre-Covid 'normal', a noteworthy development and the first time we have heard this from a company.

Zooming out from these two specific themes, we continue to be impressed with the adaptability that portfolio holdings have demonstrated over the last three complex years. Not only have they coped well with challenging operating conditions, but they have also continued to invest steadily in their futures.

This combination of resilience and reinvestment forms a healthy seedbed for steady, long-term compound returns.

Hugh, Ben, Chris M and the Evenlode team

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[i] *TB Evenlode Income B Acc (GBP). 31 December 2022 to 30 June 2023. Source: Evenlode, Financial Express, total return, bid-to-bid, GBP terms.*