Evenlode Income Investment View

March 2022 – Inflation and long-term investing

The UK stock market has posted a positive return for the month, though in a somewhat volatile fashion. The ongoing conflict in Ukraine has kept geopolitical uncertainty high, though there has been some relief that the conflict hasn't escalated further. Meanwhile, lockdowns in parts of China have reminded investors that Covid-risk has not yet been consigned to the history books. Both events continue to stoke worries relating to input cost inflation, and the impact this will have on the global economy over coming months.

As I write, the Evenlode Income fund has fallen -4.7% so far this year compared to a fall of -4.9% for the IA UK All Companies sector and a rise of +0.5% for the FTSE All-Share[i]. The underperformance of Evenlode Income and its peers, relative to the UK market, is mainly explained by the significant year-to-date outperformance of some of the biggest oil and mining companies in the FTSE 100.

Russia-Ukraine

As discussed last month, the Russian economy is approximately 2% of global GDP and has quite limited integration with the global economy (other than through its commodity exports). The Evenlode Income portfolio has minimal sales exposure (less than 1%) to the Russia-Ukraine region. We have also surveyed portfolio holdings to clarify supply chain exposure to the region and, reflecting Russia's lack of economic integration, this is even less significant. The biggest impact on the global economy has, therefore, come from the extra spike in energy and other commodity costs (wheat, fertiliser, nickel etc.) that the invasion has catalysed. This input cost inflation dynamic was already a significant trend during the second half of last year due to Covid-related factors but has been given an extra bump by the events of the last month.

Results season

Results season is now complete for Evenlode Income holdings, with more than 90% of holdings updating the market over the last few weeks. In the context of the rising costs that companies were already grappling with through 2021, we have been reassured by the steady, healthy progress that the aggregate portfolio is making, and have spoken to the management teams of a wide range of business models on how they are navigating the current environment. For Evenlode Income holdings reporting full year 2021 results in recent weeks, revenue growth for 2021 averaged +9% and earnings growth averaged +17.5%[ii]. We think this is a healthy result in the context of a complex backdrop and rising input costs.

Inflation protection for the long-term investor

Input cost inflation is presenting clear headwinds for companies in the near-term, and there can be a lag in passing prices through in certain sectors (as we discussed last month, for instance, with reference to consumer branded goods companies). These challenges are particularly notable at present, with the world having shifted from a deflationary to an inflationary environment with extreme rapidity since 2020 (it's hard to believe now, but oil prices turned negative briefly less than two years ago!).

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There is no perfect way of insulating one's savings from an environment in which inflation is running high, particularly if the rise is rapid. As discussed below though, there are several fundamental qualities that we believe provide a company with some very important safety buffers. Recent results and conversations with management teams have provided tangible evidence of these factors at work.

1. High gross margin

A company's gross profit is calculated by subtracting the direct cost of producing its goods from its revenue. Its gross margin expresses this gross profit as a percentage of revenue. A high gross margin is very helpful in inflationary times. For instance, if Company A has a 50% gross margin it only needs to pass on half of its cost-of-goods inflation through price increases to maintain its gross profit in absolute terms. If Company B has a 20% gross margin, on the other hand, it needs to pass on 80% of its cost-of-goods inflation to achieve the same results.

Holdings in the Evenlode Income portfolio have an average gross margin of c.60% (compared to an average of c.25% for the FTSE All-Share)[iii].

2. Pricing power

Pricing power is extremely valuable during an inflationary episode. There are several factors that help to provide a business with pricing power. Companies with a strong competitive position are well placed, particularly when the products or services they sell represent a relatively small proportion of a customer's expenditure.

The specialist engineers held in the Evenlode Income fund (including Rotork, Smiths Group and Spectris) are good examples. Take Rotork, for example, selling high performance actuators for mission-critical applications in a range of energy, power, water and industrial end markets. These actuators are a very small cost in the context of the facilities in which they are installed, but they must work, or serious safety issues may arise. Customers are therefore reluctant to find cheaper alternatives to Rotork's quality products (and after-service support), and will tend to have bigger, less mission-critical fish to fry when looking for cost reductions. Rotork management confirmed the business model's pricing power at recent results, with 2021 input costs successfully offset, and further price rises being put through to factor in expected cost rises during 2022. Test and measurement equipment company Spectris had a similar message to convey at its recent results in the context of rising input costs: *we can and are confident of our ability to mitigate this headwind through our pricing strategies*.

These examples also highlight a broader point: loyal customers are desirable in times like these. Howden Joinery, for instance, enjoys a market-dominant position in the provision of kitchen and joinery products to trade builders. Howden's customers highly value the convenience of the local depot networks, the strong relationships with depot managers, and the quality, range, in-store availability and low cost of Howden's products. These factors have enabled Howden to raise prices as input costs have risen whilst continuing to take market share over recent months. Digital holdings (RELX, Wolters Kluwer, LSE, Sage, Microsoft, AVEVA, Euromoney etc.) and support services holdings (Bunzl, Compass, Intertek, SGS etc.) also benefit from this customer loyalty and embeddedness, enjoying repeat-purchase business models with high levels of customer renewal and pricing power as a result.

3. Asset-light business model

For asset-heavy business models, rising asset replacement requirements can eat into the spare cash available to shareholders, potentially leading to dividend cancellations and highly dilutive rights issues in periods of extreme inflation, as was seen in the 1970s (the appendix to Warren Buffett's 1983 Berkshire Hathaway letter provides an interesting perspective on these dynamics). Asset-light businesses are more favourably placed as capital expenditure and inventory-investment requirements remain low relative to cash generation, even when the price level is rising.

For inclusion within the Evenlode investable universes a company needs to demonstrate a low capital intensity. At a minimum, a company's capital investment ratio must represent less than 40% of cash flow, and the ratio is significantly lower than this for most companies in the portfolios.

4. Strong balance sheet

This characteristic helps insulate a company from the rising cost of debt if, as is likely, interest rates begin to rise, as inflation becomes entrenched.

The Evenlode Income fund's balance sheet is strong, with 14 of the 38 holdings in the portfolio sitting on a net cash position. The fund's aggregate debt to EBITDA ratio is currently 0.9x compared to a ratio of approximately 2x for the FTSE All-Share[iv].

5. Valuation appeal

Attractively valued shares offer better protection if higher inflation leads to higher interest rates and bond yields, which tend to provide a headwind to valuations. On this note, we are reassured by Evenlode Income's current free cash flow yield of approximately 5%.

Growth and resilience

Will the current spike in inflation mark the beginning of a new inflationary era? Will deflationary pressures reassert themselves? Or we will find ourselves somewhere in between: with moderate inflation running at levels more akin to the decade preceding the Great Financial Crisis than the decade that followed it? All three scenarios are credible, and only time will tell. Either way, those companies (and their shares) benefiting from the above factors should remain good friends to long-term, patient savers. They help equip a business to grind out an attractive, real free cash flow stream through a more inflationary period, whilst also providing downside protection in more challenging economic times thanks to their competitive advantages, consistent cash generation and balance sheet strength.

Hugh, Ben (A), Chris (M) and the Evenlode Team
31 March 2022

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Please note, these views represent the opinions of Hugh Yarrow and the Evenlode Team as of 31 March 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.

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.

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

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[i] *Source: Evenlode Investment, Financial Express, total return, bid-to-bid, 31 December 2021 to 31 March 2022.*

[ii] *Source: Evenlode Investment, Company Results. Aggregated average organic revenue and EBIT growth for companies reporting December-end full year results (24 of 38 holdings representing 63% of the portfolio).*

[iii] *Source: Evenlode Investment, Company Results, FactSet.*

[iv] *Source: Evenlode Investment, FactSet.*