Evenlode Investment View

May 2021 – Ship of Theseus

The UK stock market has continued to rise during May (having now risen for six of the last seven months). There are some signs that global economic leading indicators may be cooling somewhat, and some of the frothiest areas of the market have corrected a little over recent weeks. However, vaccination progress has continued at a good pace in most geographies, and the data thus far suggests that existing vaccines are effective on new variants. Company results have also been generally healthy, with the easing of lockdowns beginning to feed through to economic activity and financial results.

Since the start of the year, the Evenlode Income fund has risen +7.9% compared to a rise of +10.8% for the FTSE All-Share[i]. As discussed in previous investment views, the fund's underperformance this year occurred in February's 'risk-on' rotation, which saw the share prices of more asset-intensive, economically-sensitive and financially-leveraged businesses outperform their more stable peers. Since the end of February the fund (+10.1%) has risen roughly in-line with the UK index (+9.6%)[ii].

Results and Dividends

The first quarter results season has come and gone: in general companies have navigated through the crisis well and are now casting their eyes ahead at future opportunities. The dividend recovery is also underway. The fund's first quarter dividend distribution (for the March-May quarter) is set to increase by +15% and we would currently expect a rise in the full year distribution of a similar amount.

As we look ahead, we think the companies in the portfolio offer good potential for compounding cash flow growth as the world emerges from the pandemic.

Ship of Theseus

The Ship of Theseus is one of the oldest philosophical thought experiments. Theseus, the great mythical hero of Athens, slayed the minotaur in Crete and returned to Athens where his ship was kept in the harbour as a memorial. Over the years the planks, masts, sails etc. were gradually replaced as they decayed. Eventually, all the pieces had been replaced but the ship still stood there in the harbour. Which raises the question, is it still the same ship?

I'm often reminded of this question when considering the long-term history of listed companies. At Evenlode, we tend to invest in companies that operate in relatively stable industries where change is quite incremental from one year to the next. But even for the most-established companies, significant developments and renovations are essential over time: to their product ranges, geographical footprint and overall portfolio composition. Change is constant and companies must adapt and invest accordingly: consumer preferences shift; products that were once highly valued become commoditised; scientific innovation accelerates; the world grows increasingly digital; health, safety and compliance requirements become more rigorous; supply chains become more complex; a growing proportion of the world's population is found in emerging markets; sustainability moves up government and corporate agendas; the global economy is beginning to pivot away from its reliance on hydrocarbons. The recent pandemic has catalysed and accelerated many of these changes. It has also introduced new ones such as the increased penetration of flexible working, the demand for greater levels of hygiene, and rapid advances in biotechnology.

Companies need to embrace these trends and invest behind them to prosper and grow. This requires an adaptable mindset and a commitment to consistent, long-term investment. Fresh planks, sails and masts must be developed to renew and enhance the vessel's seaworthiness.

Invest, Adapt and Grow

Below are three examples of companies that are busy adapting to the shifting trends in their industry and investing for growth.

SGS

SGS, a new holding in Evenlode Income this year, has continually renovated and expanded its 'ship' over the years. The company was established in 1878 to offer agricultural inspection services in Europe. Since then, thanks to consistent investments and bolt-on acquisitions, SGS has become the global market-leader in the Testing, Inspection and Certification (TIC) sector, operating in a highly diversified range of industries across the global economy. Clients within the sector are attracted to market-leaders such as SGS, given their capability to offer the full range of accreditations, and their network of laboratories and inspection services across the world. The sector's growth outlook is compelling: quality and safety standards are ever-increasing. For instance, ISO (the International Organisation for Standardisation) has 23,000 standards, with approximately 1,500 revisions and new standards each year. Only 20% of the TIC market is outsourced, but this proportion is steadily increasing as the complexity of tests and regulations continues to grow.

SGS management are investing to ensure the company is well placed to take advantage of these trends. In particular, the company is aiming to diversify away from its energy end-market exposure, which represents 20% of revenue and is likely to experience lower than average growth over coming years. Priority areas of investment include nutrition (sustainable sourcing of foods, food regulation etc.) life sciences, environment and sustainability verification, and cybersecurity.

SGS management noted this month that they expect revenues to grow at a high single-digit annualised rate, and earnings growth at a double-digit rate annualised rate over the next few years. This gives a sense of the opportunity that lies ahead for SGS if they continue to invest for long-term growth.

Sage

Software is 'eating the world', with every industry adopting and investing heavily in digital information and analytics to improve their operations, and the quality of the products and services they provide to customers. This trend provides a significant growth opportunity for many companies. Sage estimate that their addressable market (i.e. the provision of enterprise software to small and medium-sized businesses) is growing at a high single-digit rate as existing customers look to spend more, whilst an increasingly number of smaller companies also look to utilise accountancy, HR and payroll software for the first time.

Sage management are focused on capturing this opportunity. The company has been investing heavily over recent years, to ensure their cloud-based products and customer service are at a level of quality that enables them to retain and grow revenue from existing customers (whilst migrating them to cloud-based solutions), and to also attract new customers to supplement this growth. This has burdened current financial results and therefore held Sage shares back over the last two years. But returning to the Ship of Theseus analogy, these investments are the fresh planks and masts to ensure the company remains well-invested over the longer term. Recent results and our conversations with management have highlighted some encouraging signs, including technological progress, improved customer service, strong customer retention and new business wins.

Relx

Fifty years ago, business-to business media company Relx (then known as Reed Paper) was a listed UK business, as it is today. But as with Theseus's ship, the company has undergone significant change over subsequent years. Back then, it was primarily a physical print and paper business (which also owned, among other things, a small decorative paints division!). Over the decades, the company has gradually transformed its portfolio of services and expanded geographically, through organic investment as well as acquisitions and disposals. Today, the company generates less than 10% of its revenue from physical print publishing, and more than 75% of revenue from digital information and analytics services. These digital products help doctors, academics, lawyers and business professionals make better decisions in order to operate more.

The company is particularly focused on incremental organic growth. As Relx's CEO Erik Engstrom put it at recent results: *I believe the most exciting general opportunity for this company is the transition that we are going through and continuing to go through of moving from electronic reference tools and databases to more sophisticated higher-value analytics and decision tools. This is where we work with a customer group or an industry group to identify and measure the results they get from using different types of analytics, and provide value through increasingly sophisticated analytics and new technologies.*

This customer-first approach and culture of incremental investment puts the company in good stead to capture the digital growth opportunity over coming years.

To sum up, companies that enjoy a strong competitive position and healthy cash generation today, tend to be friendly to the long-term shareholder. Companies that combine these characteristics with a willingness to adapt and invest, tend to be even friendlier. They are giving themselves the best chance of remaining shipshape and seaworthy for many years to come.

Hugh and the Evenlode team
28th May 2021

Please note, these views represent the opinions of Hugh Yarrow and the Evenlode Team as of 28th May 2021 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/funds/document-library). 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. Evenlode Investment Management Limited is authorised and regulated by the Financial Conduct Authority, No. 767844.

[i] Source: Evenlode, Financial Express, total return, bid-to-bid, 31/12/2020 to 28/05/2021
[ii] Source: Evenlode, Financial Express, total return, bid-to-bid, 28/02/2021 to 28/05/2021