

Evenlode Income

Investment View



May 2022 - Quietly getting on with it

After a strong year in 2021, global stock markets peaked in the last week of December and have fallen back over the first five months of 2022. The US market has led the way lower, with the S&P 500 index falling -13% and the technology-focused Nasdaq Composite index -22%ⁱ.

The UK market has bucked this trend, with the FTSE All-Share rising +1.5%. In comparison, Evenlode Income has fallen -6.3% since the start of the year, compared to a fall of -5.9% for the IA UK All Companies sectorⁱⁱ. The underperformance of Evenlode Income and its peers, relative to the UK market, is mainly explained by the significant outperformance of the big commodity producers within the FTSE 100. Due to Evenlode's asset-light investment approach, the fund has no exposure to these oil and mining companies.

The draining of animal spirits

Mr Market never likes a murky, unclear outlook and 2022 has had its fair share of dust and grime accumulate on the windscreen, economically speaking. The inflation and supply chain pressures that began in post-Covid 2021 have been accentuated in 2022 by the war in Ukraine and by recent lockdowns in China (just at the point when it looked like they might begin to ease). These dynamics, combined with a rise in interest rates, have catalysed a deterioration in economic leading indicators in recent weeks.

More generally, animal spirits rose as the world emerged from Covid in 2020-2021, fiscal stimulus was pumped into the economy, interest rates were pinned to the floor. Zero and low yielding financial assets such as cryptocurrencies and highly rated technology companies led the way higher. Now, with interest rates rising, and the returns for these once-fashionable assets turning negative, animal spirits have dissipated and worries over valuations and a clouded outlook have crept in to replace them.

Silver linings

Whilst acknowledging these significant challenges, we think some perspective is important in times like these, and there are reasons to be positive for investors willing to look further into the future than the next quarter or two.

First, the draining of animal spirits from the market is a normal, healthy part of the cycle, even if it never feels enjoyable at the time. Valuation appeal is injected, speculative excess is reduced and the potential for future annualised returns improves. Within the Evenlode Income universe, the current environment is offering the broadest opportunity set we have seen for some time (other than a brief period in March/April 2020), with attractive valuations now available for a wide range of business models across the large and mid-cap names we follow. This has led to a longer than normal watchlist - effectively more options in terms of potential holdings.

Second, for the Evenlode Income portfolio (and for most parts of the UK market) there's been very little evidence of speculative excesses over the last five years. The Evenlode Income portfolio's current 5.0% free cash flow yield, for instance, is higher than the 4.7% free cash flow yield it traded on at the start of 2017.ⁱⁱⁱ

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Third, we have been impressed by the ability of the portfolio to cope with the current environment, which is presenting an unusual and extreme set of operational problems for management teams to grapple with. We discussed these dynamics in last month's investment view.

More generally, in the sometimes-disorientating stock market and global economy of the last three years, it is worth noting that companies are quietly getting on with things, adapting to changing conditions and investing for the future. For some companies this is showing up in current results; for others current conditions and stepped-up investment levels have meant this progress is yet to find its way through fully to financial results.

We'll use the rest of this view to discuss three examples:

Spectris

Spectris is what we call a 'hidden champion'. The company is a global market leader in a niche sector: the provision of test and measurement tools to a wide range of industries including pharmaceutical, semiconductor, and energy end markets. Solutions range from detecting possible contamination in drug manufacturing to ensuring ultrapure water for critical cleaning steps in semiconductor processing (Spectris equipment can identify the equivalent contamination of just one drop of food colouring in a container the size of 20 Olympic swimming pools, for instance). The company's technical expertise and reputation for reliability drive healthy competitive advantages and attractive, cash-generative economics.

The company has not been immune to the economic volatility of the last three years but has performed resiliently. In this period, new management has invested to drive long-term growth and evolved its portfolio to focus on its strongest market positions. Looking ahead the company's growth strategy will be particularly focused on sustainability, with investments planned to develop its already strong positions in areas such as healthcare, the energy transition, environmental controls, product circularity and material reuse.

Spectris looks very modestly valued at present relative to our estimates of long-term cash flows.

Euromoney

Euromoney Institutional Investor is a business-to-business data-services company which derives about 70% of its revenues from subscriptions. These subscription services are embedded in customer's workflows, with annual renewal rates well above 90%. Most of the other 30% of revenue comes from the events Euromoney organises for its clients. Though its events activities have been impacted by the effect of social-distancing restrictions, Euromoney has weathered this downturn well and is now seeing a very strong recovery in events revenues.

Management also continued to invest heavily in developing its data analytics businesses through the Covid period, a decision that in retrospect looks very sensible. In particular, the company provides data analytics and price reporting services within its Fastmarkets division, covering daily and weekly prices for a wide range of niche commodities for which price discovery is often challenging (bio-diesel, lithium hydroxide, cobalt metal etc.). Fastmarkets price assessments are used as a benchmark across

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a commodity's supply chain to settle exchange contracts, forecast prices, and hedge exposures. These services therefore become deeply embedded in the day-to-day workflow of customers. Fastmarkets is steadily developing the pricing and forecasting services it provides, particularly for niche commodities whose usage is growing rapidly due to the role they are playing in the energy transition (for electric vehicles, battery storage etc.).

Euromoney released healthy interim results this month, with Fastmarkets growing its subscription revenues by +17%, a sign of both the pricing power that the franchise enjoys and the positive effects of the investments that Euromoney is making.

As with Spectris, the quality of Euromoney's market position and long-term cash generation look unusually undervalued to us in today's market.

Compass

Compass is the global market leader in business-to-business food catering. As with Euromoney, its financials were significantly impacted by the pandemic, but the company is now emerging in healthy shape. By the end of its latest financial quarter Compass was generating revenues at more than 100% of pre-Covid levels and expects to deliver healthy growth during this year and beyond. Its market leadership, financial strength and digital capabilities have enabled the business to strengthen its competitive position in the downturn. As well as taking market share, Compass has also seen a strong acceleration of first-time outsourcers who are increasingly seeing the benefits of handing this non-core activity to a skilled specialist. Compass can remove the hassle factor from these new customers whilst improving service quality and lowering costs. Management believes this acceleration in new business wins will add at least +1% to revenue growth over coming years (pre-Covid revenue growth typically ran at approximately +4-6% per annum). Meanwhile, Compass are dealing with cost inflation successfully and are confident that margins can tick-up gradually over coming years.

Quietly getting on with it

One of the unchanging features of the stock market is the tendency for investors to place a high degree of importance on current conditions (behavioural psychologists have a phrase for it: 'recency bias'). It is worth bearing in mind however, that the long-term value of a share is determined by the long-term stream of cash flow that the underlying company ultimately generates, not just its results over the last year or the coming quarter.

As the old investment adage goes you make your money in a bear market, you just don't realise it at the time. This is usually applied to an investor staying the course through uncertain and adverse stock market conditions, whilst keeping their eyes on the longer-term. But it can equally be applied to a company management team navigating their way through a period of economic volatility, such as the last two years. The snowballing effect of reinvestment works quietly away in the background for good businesses, and what might sometimes feel like pedestrian progress on a monthly or yearly basis can add up to very satisfactory returns as time goes by.

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Hugh, Ben P, Chris M, and the Evenlode Team
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Please note, these views represent the opinions of Hugh Yarrow and the Evenlode Team as of 31 May 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.

ⁱ Financial Express, total return in USD, 31 December 2021 to 31 May 2022.

ⁱⁱ Evenlode, Financial Express, total return in GBP, bid-to-bid, 31 December 2021 to 31 May 2022.

ⁱⁱⁱ Evenlode, FactSet. Free cash flow has grown at approximately +5% per annum over that five-year period: a pedestrian rate relative to history, but not bad we think given the operational headwinds that the pandemic has presented over this period.