

# Evenlode Investment View

November 2019 – Tenth Anniversary

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November has so far been a positive month for the UK stock market, as has 2019 as a whole.

Underneath the headline numbers, however, is a complex backdrop of crosscurrents. The global economy slowed over the summer, with particular weakness in industrial and manufacturing sectors. Recent leading indicators have shown some signs of stabilisation but US/China trade negotiations remain unresolved and tensions in Hong Kong continue. In the UK, following a nervous 'Brexit summer' investors have begun to deem a Conservative majority at December's election, followed by a withdrawal agreement with the EU, as the most likely outcome. As a result, sentiment towards both the pound and the shares of domestically orientated UK companies has recovered significantly.

## Performance

These UK-based political vicissitudes help to explain Evenlode Income's two distinct periods of performance in 2019. As I write, the fund's overall year-to date return has been +21.9% compared to +16.0% for the FTSE All-Share<sup>i</sup>. But this masks, firstly, a period up until August during which the fund strongly outperformed the market, and in which performance was driven (to generalise) by large, stable multi-national holdings (Unilever, Diageo, Relx, Smith & Nephew, Informa etc.). Following this, there has been a period over the last three months in which the fund lagged a market that continued to rise, with several performance trends reversing. To give a flavour, since the end of August, the most positive contributors to Evenlode Income's return have been Spectris, Hays, Schroders, Sage Group, Howden Joinery, Victrex, Page Group and Savills. This represents a clear theme, with most of these companies having been tarred by the 'Brexit brush' in some way or another over the last couple of years (Hays, Schroders, Howden Joinery, Page Group and Savills have, in fact, all been added to the fund since the 2016 referendum for valuation reasons following share price underperformance). On the other hand, the most negative performers over the last three months have been larger multi-national businesses (specifically Unilever, Diageo, Reckitt Benckiser, Smith & Nephew and Informa).

## Long-Term Mindset

As usual, we accept that 'share prices wobble around' in the short-term and we avoid making big predictions on political developments. Instead, we continue to focus on retaining a diversified portfolio of good, solid businesses that we think can produce steady growth in aggregate free cash flow and dividends *over the long-term, and in a wide range of economic conditions*. We are also very aware of managing valuation risk in the portfolio, particularly given that the stock market has moved higher this year. We find the portfolio's current free cash flow yield of 5.0% reassuring in this context. The free cash flow stream is growing at a good aggregate rate and provides healthy cover to the fund's 3.0% dividend yield<sup>ii</sup>.

We have continued to 'nudge' the portfolio over recent weeks in our ongoing effort to strike this balance between quality and valuation appeal. Stocks added to include Bunzl, Victrex, Ashmore, Reckitt, Relx, Unilever and Cisco.

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## **Business Fundamentals**

Back in the corporate world, it has been a very busy few weeks for results with about 90% of the portfolio updating the market since the start of October. The aggregate financial progress being made is solid, but we are also encouraged by the strategic developments and investments that many of the businesses in the portfolio are making. Below I mention three examples:

### **Howden Joinery**

As I have discussed before, we like Howden Joinery's approach to selling kitchens and other joinery products in the UK. Howden's close relationships with builders, local depot network, decentralised management culture and vertically integrated supply chain have helped it establish a market leading position (now significantly more than twice as big as its next biggest competitor). Howden released a trading statement earlier in November. The trading environment in the UK remains very tough, but the company has continued to grow (sales grew +4.9% over the most recent June-November period), generate healthy levels of cash, and increase its market leading position. The company is also investing heavily in future growth plans: opening new stores, introducing a new store format, investing in technology, increasing production capacity and expanding its French business, all of which could provide interesting opportunities for future growth.

### **Intertek**

Intertek is a leader in the global 'ATIC' sector (Assurance, Testing, Inspection and Certification) and was a new addition to the portfolio in March this year. The company provides mission-critical services to its business clients, such as testing and certifying new products ahead of their launch, and verifying supply chains. Intertek released third quarter results this week. Despite a slowdown in the global economy, organic sales grew by +3.6% in the latest quarter and management remain very positive on the long-term structural growth drivers of its business (including, among other things: an increased focus of corporations on risk management, expanding regulations, more complex sourcing and distribution operations, technological innovations, and increased consumer demand for higher quality and more sustainable products). The company has a culture of innovation and investment for the future. This has been demonstrated most recently by the announcement of two new Intertek services of note. Firstly, the 'Intertek Corporate Sustainability Certification', which provides an independent assessment of the sustainability of a company and its supply chains (a significant growth opportunity for Intertek given the desire of all companies to provide better transparency in this area). And secondly, the 'Intertek Cyber-Assured Certification', which assists companies in launching and then monitoring secure and connected products over their lifetime (again, an area seeing growing demand thanks to increasing digitalisation, the internet of things etc.)

### **Sage Group**

Small business software-provider Sage updated investors with full year results last week. These results demonstrated good progress on the company's journey to an increasingly high-quality, software-subscription business model. Recurring revenue now represents 86% of total revenue (up from 82%

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last year) with software subscription now 64% of this recurring revenue (from 55% last year). Management expect software subscription to grow to more than 90% of total revenue over the medium-term. For the year just finished, Sage's organic sales grew +5.6% thanks to more revenue from existing customers but also, encouraging, good additional growth from new customers. Profit margins were held back due to increased investment levels, but we believe this strategy is sensible from the perspective of both long-term customers and long-term investors. There are two key areas of focus for this investment: customer service and a more seamless/innovative technology platform<sup>iii</sup>. As Sage management put it, *'the prize is highly motivated colleagues, who delight our customers, who stay longer, buy more and that, in the end, leads to a significantly higher lifetime value'*.

## Tenth Anniversary

Before signing off I'd like to mention that the Evenlode Income fund was launched on 19th October 2009 and therefore had its tenth anniversary last month. Over this ten year period, the compound total return per annum after fees was +12.9% p.a. for Evenlode compared to +7.7% p.a. for the FTSE All-Share and +8.1% p.a. for the IA UK All Companies sector. The average annual dividend growth has been approximately +6.9% per annum, and the running yield on an initial investment in the fund would now be approximately 7.4%<sup>iv</sup>.

These results have been achieved by focusing only on market-leading, cash generative stocks and deploying a disciplined valuation/dividend filter, a patient mindset and ongoing management of fundamental risk. We believe this approach works well over the long-term, but it also involves the Evenlode Income portfolio looking quite different to the UK stock market. The fund's performance will often, therefore, fall in and out of fashion over shorter time periods as market trends wax and wane. This is something we have always been keen for our long-term clients to understand.

Though we are pleased with the progress so far, we are very aware that what matters most for our co-investors is not the past decade, but the coming decade, and our efforts remain focused on delivering a good starting dividend yield combined with steady prospects for real (i.e. inflation-protected) dividend growth over time.

I look forward to updating you on the portfolio's progress in the months and years ahead.

**Hugh and the Evenlode Team**  
**26th November 2019**

*Please note, these views represent the opinions of Hugh Yarrow as at 26th November 2019 and do not constitute investment advice.*

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<sup>i</sup> Source: Evenlode, Financial Express, total return, bid-to-bid, 31/12/2018 to 26/11/2019

<sup>ii</sup> Source: Evenlode, Factset. 2019 weighted FCF yield 5.0%, 2020 weighted FCF yield 5.6%.

<sup>iii</sup> Investment in technology and innovation is focused on the Sage Business Cloud (i.e. Sage's cloud-connected and cloud native solution). These cloud-enabled products now represent 42% of recurring revenue compared to 25% last year. Management's aim is to migrate the majority of Sage customers to the Sage Business Cloud over the medium-term.

<sup>iv</sup> Source: Evenlode, Financial Express, total return, bid-to-bid, 19/10/2009 to 19/10/2019. The yield on initial investment is based on the last four quarterly dividends compared to the fund's initial offer price (B Income shares).