

# Evenlode Investment View

## October 2019 - Third Quarter Review

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The UK stock market has fallen back a little in October. However, year-to-date returns remain relatively strong with the FTSE All-Share up +12.2% since the start of January and Evenlode Income +18.2% over the same period<sup>i</sup>.

It has been relatively quiet in terms of fundamental company news, with the third quarter results season due to begin in earnest over the next two weeks. Where results have been released, they have tended to confirm a sense that the global economy has seen a slowdown over the summer, particularly in those regions and sectors that have been most impacted by trade tariffs.

Over the last two weeks the pound has also strengthened significantly, reacting to increased optimism that a Brexit agreement will be reached. This has led to a reversal of some of the key trends seen for much of the rest of the year. Specifically, there has been a recovery in the share prices of small and medium sized UK companies, particularly those with more of a domestic focus. Conversely, UK-listed global businesses have generally underperformed. A corresponding change has occurred within the Evenlode Income fund. Since the start of September larger multi-nationals such as Unilever, Diageo, Smith & Nephew and Relx have seen their share prices fall whilst the share prices of several smaller companies such as Savills, Hays and Howden Joinery have risen.

As I have discussed before, strength in the pound does reduce the reported growth rate (in pound terms) of earnings and free cash flow within the Evenlode Income fund, as approximately 80% of the portfolio's underlying revenues are derived from outside the UK. However, the portfolio's current free cash flow yield is 5.1% and growing at an attractive rate<sup>ii</sup>. This provides healthy cover for the fund's 3.1% dividend yield and should bode well for dividend growth prospects, notwithstanding short-term moves in currency markets. Our approach remains to take a long-term view and insulate the portfolio's dividend stream as best we can - at all times - from a wide range of outcomes rather than make big short-term bets. This involves managing risk carefully and retaining a well diversified portfolio by both business model and geography. We have made some small changes as a result of recent performance trends and remain open to making more if (as is usually the case!) stock-by-stock volatility remains high.

### Third Quarter Review

With the remainder of this month's view I will discuss the recently completed third quarter for the Evenlode Income fund (to 30th September 2019), given an increasing desire amongst our clients for a regular quarterly commentary.

The fund rose by +1.7% during the quarter compared to +1.0% for the IA UK All Companies Sector and +1.3% for FTSE All Share Index. Investor concerns were focused on US/China trade tariffs and the impact they are having on the global economy and closer to home, on Brexit (of course). Corporate results continued to suggest that the global economy is experiencing a slowdown. The strongest positive contributors to performance were Smith & Nephew, Procter & Gamble, GlaxoSmithKline,

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Compass, Burberry, AstraZeneca and Euromoney, whose share prices all rose by over 10% during the quarter, largely thanks to the release of positive results.

Stock	Contribution to return	Stock	Contribution to return
Smith & Nephew	+0.46	Sage	-0.69
Procter & Gamble	+0.44	Spectris	-0.38
GlaxoSmithKline	+0.43	PageGroup	-0.18
Compass	+0.36	EMIS	-0.16
Astra Zeneca	+0.35	Moneysupermarket	-0.16
Burberry	+0.31	Halfords	-0.12
Euromoney	+0.30	IMI	-0.09

Smith & Nephew and Procter & Gamble are both excellent long-term franchises but for both companies the last few years have been somewhat lacklustre in terms of sales growth. However, growth has been accelerating recently. Both companies have put significant effort into streamlining their portfolio of products, re-organising their businesses to be more flexible and adaptable, and investing in digital capabilities and innovation. For Smith & Nephew, one example of these efforts is its robotic surgery platform, which is beginning to see significant sales growth as functionality develops and benefits become clearer to surgeons. For Procter & Gamble, investment in new products is leading to a more sustainable product range, such as the launch of Pampers Pure and Tampax Pure this year. These ranges offer products made from plant-based materials, with the same performance benefits as traditional offerings, and the consumer response has been very positive.

The most negative contributors were Sage Group and Spectris, with both companies releasing results during the quarter. There was some disappointment that Sage's margin progress is likely to be limited over the next year or two. We acknowledge that Sage has more work to do to keep its customer base happy and migrate them over to increasingly cloud-based products. However, we have been encouraged by the investment that new management is putting into customer service levels and innovation. Meanwhile, the structural growth in Sage's global market remains compelling as the penetration of enterprise software in the small business sector steadily ticks higher. The business model also remains resilient, with 85% of total revenue now recurring and a goal for this proportion to move above 90% over coming years. With Spectris, interim results were solid but management noted some weakness in industrial production end markets. Though Spectris is an economically sensitive business, we like the company long-term given its attractive position in test and measurement markets and a highly cash generative business model. The new management team have identified a group of core 'platform' businesses that make up the majority of revenues and enjoy excellent market positions, asset-light economics and good long term growth prospects. They will be the focus over coming years.

We remain reassured by the overall portfolio's quality and free cash flow strength but continued to make some valuation-related changes at the margin of the portfolio. There were no exits from the portfolio but several stocks were reduced including Diageo, Compass, Smith & Nephew, Cisco,

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Microsoft, AstraZeneca and Burberry. There were also no new holdings initiated during the quarter but several stocks were added to including Schroders, Reckitt Benckiser, Hays, Page Group, Victrex, WPP, Bunzl, Spectris and Sage.

**Hugh and the Evenlode Team**  
**14th October 2019**

*Please note, these views represent the opinions of Hugh Yarrow as at 14th October 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 14/10/2019

<sup>ii</sup> Source: Evenlode, Factset. 2019 weighted FCF yield 5.1%, 2020 weighted FCF yield 5.7%.