

# Evenlode Investment View

September 2021 – The Business of Investing

---



Global stock markets have weakened a little in September. The Covid situation is improving on the whole, with case rates stabilising or falling in many regions. A few clouds have gathered though, complicating the economic picture: China's slowdown and property market woes continue; global fiscal policy is tightening as furlough schemes begin to tail off; central banks are beginning to hint at tightening monetary policy over coming months; oil and gas prices have risen; and Covid-related supply chain disruptions continue.

## Sector Rotation

So far this year, Evenlode Income has risen by +10.5% compared to a rise of +13.7% for the FTSE All-Share<sup>i</sup>. Sector rotation has been a key driver of share prices within the UK market over recent weeks. The rise in the oil price, in particular, has led to very strong relative performance for energy producers at the expense of other areas of the UK market such as consumer branded goods. In fact, Evenlode Income's relative underperformance year-to-date is more than explained by two asset allocation factors: its zero exposure to energy producers and its higher weighting to consumer staples companies.

## Steady Progress

From a fundamental perspective, we are reassured by the progress the portfolio continues to make as the world emerges from the pandemic. For context, the portfolio's earnings fell by -11% during 2020 and are set to recover by +19% on a cumulative basis over the 2021-2022 period<sup>ii</sup>. Looking further ahead for Evenlode Income, the holdings in the portfolio are high quality market-leading businesses with good growth prospects.

The dividend recovery is also progressing as expected. The first and second quarter dividends for the fund were increased by +15.2% compared to the previous year and we continue to forecast a similar growth rate for the full year, which would translate to a 2.6% dividend yield<sup>iii</sup>. From there, we think prospects for real dividend growth are healthy.

## Valuation Appeal and Upgraded Quality

We find it intriguing that the portfolio has not participated in the valuation uplift that several areas of the global market have seen over the last two years.

In general, the UK market is relatively unloved, having significantly underperformed the global market over the course of the pandemic. The global stock market (and particularly certain areas of the US market which represent a large percentage of it) has been driven in part by earnings but, in the most part, by rising valuations<sup>iv</sup>.

# Evenlode Investment View

September 2021 – The Business of Investing

---



It interests us that UK companies within the portfolio are, in many cases, trading on lower valuations than their US sector peers. Furthermore, the Evenlode Income portfolio is cheaper today than it was in December 2019 on a free cash flow yield basis (today's free cash flow yield is 5.1% versus 4.8% in December 2019)<sup>v</sup>. Though not helpful from a short-term performance perspective, the lack of benefit from expanding valuations to date in the Evenlode Income portfolio is, we think, very reassuring from the perspective of long-term potential returns from the fund.

It is also worth noting that, at the margin, we have used the general rotation of the last year (i.e. the outperformance of economically sensitive shares relative to some of their more stable peers) to upgrade the cash compounding nature of the portfolio without sacrificing valuation appeal.

## **Inflation Insulation**

We have written about inflation several times over the last year, but I will return to the topic again this month, given that cost pressures from the Covid squeeze on supply chains continue to linger. To generalise, based on recent conversations with management teams, most companies are experiencing year-on-year input cost rises in the mid-single-digits (wages have ticked up at a slower rate: typically companies are seeing year-on-year wage rises running at low-to-mid-single digit levels).

Our investment approach does not involve making big predictions on the macro-economic outlook. Instead, we always aim to construct a portfolio that is reasonably well insulated from a wide range of scenarios. Whilst the inflation narrative has been in the ascendancy recently, for instance, it is perfectly possible that we may all be worrying about deflation again in six months' time once Covid bottlenecks have eased as there are also several long-term deflationary forces at play in the world today (demographics, technology, the shifting relationship between capital and labour, high global debt levels etc.).

Let's imagine, however, that inflation and economic growth do pick up somewhat over the medium-term, relative to the very low inflation environment of the last decade. We think this development would be, on balance, helpful for the companies in the portfolio (and our conversations with management over recent months confirm this). Once the current spike in input costs works through the system, a mild pick up in general inflation would help revenue growth and also help drive a little more operational leverage for many holdings.

If inflation were to pick up significantly (particularly if this coincided with low levels of economic growth: i.e. 'stagflation'), this would represent a challenging backdrop from which no business would be perfectly insulated. As a thought experiment, though, it is worth thinking about some of the characteristics that would be most helpful if one were managing a business through a prolonged period of these conditions:

# Evenlode Investment View

September 2021 – The Business of Investing

---



- 🌱 Products and services that have enduring and resilient value to customers, whatever the price level and economic situation.
- 🌱 A strong, embedded relationship with one's customers (particularly where a change to an alternative product may represent a big hassle and also result in an inferior product).
- 🌱 Products and/or services that represent a small proportion of the customer's overall expenditure (so any price increases matter less to the customer).
- 🌱 A high gross profit margin (the higher the gross profit margin, the less prices need to be put up to offset input cost inflation).
- 🌱 Asset-light economics (to avoid any price increases being absorbed by a commensurate increase in inflating capital expenditure and working capital requirements).

We find it reassuring that the asset-light companies that feature in the Evenlode portfolios tend to score very well on many or all of the above factors. However (and it's an important 'however', given no one quite knows how the economic picture will unravel over the next few years) the portfolio also has a core of repeat-purchase cash flow in the event that the inflationary picture (and the global economic recovery) doesn't turn out to be as inflationary (or 'growthy') as consensus opinion is currently expecting.

## Across the Portfolio

These are hypothetical musings. In the more immediate short-term, recent input cost price rises are feeding through the system, and companies are responding. For a few companies in the portfolio, this is limiting margin progress for 2021. I discussed this dynamic in my July investment view with respect to Reckitt and Unilever, with both noting higher-than-average input cost pressure for the particular branded goods that make up their portfolios. For this reason, as well as being deemed too boring for the current market zeitgeist, these two shares have been the main negative contributors to Evenlode Income's return during 2021 (down -9% and -7% respectively, year-to-date). Both companies have a history of managing input cost inflation well and have plans in place to offset input cost rises over coming months, but this process takes a few months. Reckitt summed up this situation at their investor day last week: *'pricing actions and productivity will offset the commodity costs inflation we've seen this year. This is a timing issue and our brands are strong and can support pricing to offset inflation. But when increases in costs are as high and as sharp as we've seen in 2021, the necessary actions will lag by one or two quarters'*. Reckitt has invested significantly over the last two years, and longer-term growth and margin prospects are good. For the patient investor, prepared to look a little further ahead than the next few weeks or months, we think both Reckitt and Unilever are offering up a very interesting combination of quality, long-term growth potential and valuation appeal at present.

# Evenlode Investment View

September 2021 – The Business of Investing

---



Elsewhere in the portfolio, a little more inflation would represent a net positive for many businesses, as conversations with several companies including Page Group, Hays, Bunzl, Spectris and Smiths Group have confirmed over recent weeks. The various digital and data analytics businesses in the portfolio also tend to be very effective at raising prices where necessary.

## The Business of Investing

To sum up, the operational environment has been complex over the last eighteen months, and share prices (at both the market and individual company level) have been volatile due to noisy short-term news flow and big swings in investor sentiment. These gyrations remind me of Jack Bogle's old saying: *'the stock market is a giant distraction from the business of investing'*.

In terms of this 'business of investing', Evenlode Income's underlying companies have coped well through the crisis and have generated strong cash flows along the way. Looking ahead, we think they continue to enjoy strong competitive positions in attractive markets, and healthy prospects for cash-generative growth.

## Hugh and the Evenlode team 28<sup>th</sup> September 2021

*Please note, these views represent the opinions of Hugh Yarrow and the Evenlode Team as of 28<sup>th</sup> September 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>). 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.*

# Evenlode Investment View

September 2021 – The Business of Investing

---



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

---

<sup>i</sup> Source: Evenlode, Financial Express, total return, bid-to-bid, 31/12/2020 to 27/09/2021. TB Evenlode Income B Inc.

<sup>ii</sup> Source: Evenlode, Visible Alpha, September 2021.

<sup>iii</sup> Source: Evenlode, based on forecasts for Evenlode Income's financial year to 28 February 2022, and current unit price (27/09/2021)

<sup>iv</sup> See, for instance, Rosenberg Research: current 2022 Consensus EPS for the US market is unchanged since January 2020 but the US market has returned c.+40%.

<sup>v</sup> Source: Evenlode, Factset. FY1 Free Cash Flow Yield.