

Evenlode Income Investment View

September 2022 – Insulation and Opportunity



During September, stock markets have remained in a disconsolate frame of mind, reaching a selling crescendo in the last week of the month. So far this year Evenlode Income has fallen -7.2% compared to a fall of -8.3% for the FTSE All-Share and -16.9% for the IA UK All Companies Sector¹.

Geopolitical risk remains elevated, energy prices and inflation are high, and central banks are rapidly increasing interest rates as they attempt to get inflation back under control. This has led to a deterioration of economic leading indicators, and investors have been busy pricing in the global economic downturn that is now underway. Closer to home, the UK's 'mini-budget' initially catalysed some further weakness in the pound, and also led to a sharp rise in mortgage rates and government bond yields (which had already been moving higher prior to the budget, along with global bond yields). The violent move in long-term UK government bonds early in the week led the Bank of England to pledge unlimited support to this particular market on Wednesday, to help stabilise the situation.

Insulation from uncertainty

Evenlode Income is not immune from the current headwinds in the UK and global economy. However, the portfolio has some reassuring characteristics to cope with more difficult times like these. We think the fund's repeat-purchase and globally diverse cash flows are particularly helpful, as discussed below. As also discussed, we are interested in the broadened opportunity set that the stock market's febrile environment has created over recent months.

Repeat-purchase cash flows

78% of the Evenlode Income portfolio is currently invested in companies that we categorise as having relatively low economic sensitivity. If you look back over the portfolio's history, this percentage has always been more than 70%. This is due to our through-cycle risk management approach: our default view is that the world is an uncertain place. If you take any decade of financial history, unpredictable things always happen and when they do it is a great comfort to have these repeat-purchase cash flows in the portfolio, particularly from the perspective of dividend sustainability.

To give a flavour of the individual companies that make up this resilient bedrock, below is a brief discussion of four key areas that most of these companies operate within:

Consumer Branded Goods (30% of portfolio)

These global businesses sell small ticket items that are considered as either necessities or little luxuries. These products generally make up a small part of their customer's disposable income and they are consumable items, which leads to repeat-purchases and loyalty over time. The fund has diversification across categories and channels within this sector, with category exposure including household and personal care, consumer healthcare, snacks and beverages (the main holdings are Unilever, Diageo, Reckitt, Procter & Gamble and PepsiCo).

Software & Data Analytics (23% of portfolio)

In this sector the main holdings are RELX, Sage, Microsoft, Wolters Kluwer and our recent addition Experian. All these companies provide software and data that is highly embedded into their business customers' workflow, and essential for ongoing operations. They typically generate a high-level of subscription revenues, which represent a low proportion of the purchaser's operating expenses. This leads to pricing power and high levels of renewals.

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Healthcare (9% of portfolio)

The fund's healthcare holdings sell essential life-changing or life-saving medicines and devices, and a significant proportion of spending in the sector is funded by governments or insurance, rather than out-of-pocket expense for individuals. Revenues therefore tend to have a low correlation with the economic cycle. The fund's main holdings in this sector are currently GSK, Smith & Nephew, AstraZeneca and Roche.

Resilient Support Services (11% of portfolio)

Several of the fund's holdings in the support services sector also have relatively low economic sensitivity. Bunzl, for instance, is a business-to-business provider of consumables essential for everyday operations (packaging for supermarkets, cleaning products for hospitals, offices, factories etc.). Another example, Compass, is the global leader in outsourced catering with revenue underpinned by long-term contracts across a range of sectors. Test and inspection companies Intertek and SGS also fall into this category. Their revenue is in large part driven by non-discretionary spend to comply with safety and regulatory standards.

The remaining 22% of the fund invested in companies with more economically sensitive business models also focuses on market-leading companies with cash generative economics and good long-term, through-cycle compounding potential. Examples of holdings include speciality engineers such as Spectris and Rotork, and other business such as Hays and Howden Joinery. For these holdings, it is worth noting that we look for a particularly high balance sheet margin of safety. In fact, on average this portion of the portfolio has no debt.

Global diversification

It's best to think of the Evenlode Income portfolio as a list of global market leaders that happen to be headquartered and listed in the UK; approximately 15% of the portfolio's underlying revenue is generated from the UK economy. As with repeat-purchase revenues, we think the global exposure is helpful from a risk management perspective, as it provides helpful diversification to the portfolio's free cash flow stream.

If currency rates stay roughly as they are today, these global cash flows will also provide a tailwind to portfolio results over coming months. Speciality engineering holding Smiths Group, for instance, announced full year results last week. Smiths is headquartered in the UK but is a global earner with roughly 95% of sales generated from outside the UK. Currency was a slight help to its most recent results (which covered the year to July 2022), adding about +1% to reported sterling sales. Looking ahead though, as management noted to us, currency would add roughly +5.5% to both sales and earnings for the company's current financial year, if currency rates stay roughly where they are today. Smiths Group, like most of the multinationals in the portfolio, has worked hard over the years to develop a 'local-to-local' production and supply chain network across the regions it operates in. This dynamic means that 'transaction risk' (the risk of products being made in one region but sold in another) is relatively limited for both Smiths Group and the Evenlode Income portfolioⁱⁱ.

A broad opportunity set

As discussed in recent investment views, we have seen a broad opportunity set emerge in the market weakness of 2022, which is continuing to develop. As an illustration of this dynamic, the Evenlode Income fund is down around -7% year-to-date, whereas for the average stock in the fund's investable universe, the median share price fall has been more than -20%. FTSE 250 companies have seen particularly high selling pressure which has accelerated in recent weeks. This has created an interesting situation. Whilst absolute valuations were, overall, more attractive in the depths of the 2020 Covid-related stock market sell-off, the

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broadness of the opportunity set is currently as good as we've seen for perhaps a decade. This means that many high-quality companies are competing for a place in the fund on valuation grounds. It's provided an opportunity to add some interestingly diverse business models and cash flows to the fund over the summer (Experian, LVMH, Diploma, Games Workshop, Integrafina) and we have also topped up a variety of existing positions. On the sell-side we have exited EMIS and AVEVA following takeover approaches and have reduced the fund's holding in Euromoney (also subject to a recommended takeover offer). We continue to monitor an interesting watchlist of potential holdings and remain open to evolving the portfolio further in this fast-changing market.

Steadily onwards

In summary, the outlook remains difficult and uncertain, but we are reassured by the quality, resilience and global diversification of portfolio holdings. The portfolio's free cash flow yield stands at 5.2%, which is attractive and provides healthy cover for the fund's 3.0% dividend yieldⁱⁱⁱ. From here, we think the long-term growth prospects for per share free cash flow and dividend growth are good thanks to the resilience, pricing power, growth opportunities and cash-compounding economics of the fund's underlying holdings^{iv}.

Hugh, Ben P, Chris M, and the Evenlode Team

30 September 2022

Please note, these views represent the opinions of Hugh Yarrow and the Evenlode Team as of 30 September 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 TB Evenlode Income B Inc class. Source: Evenlode, Financial Express, total return, bid-to-bid, GBP terms. Year to date figures are for the period 31 December 2021 to 29 September 2022.

ⁱⁱ Though currency transaction is relatively limited at the portfolio level, there are some examples of holdings where this dynamic is worth noting. Victrex and Games Workshop, for instance, will see a positive impact in the event of weak sterling: they make the majority of their products in the UK and sell them globally (albeit some of the input costs for these products are sourced internationally). Howden Joinery, on the other hand, will be negatively impacted by currency transaction dynamics. Though Howden manufactures much of its product range in Yorkshire and Cheshire, the company

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sources many of its raw materials and components internationally and sells the vast majority of its kitchen and joinery products within the UK. Notwithstanding these headwinds, Howden is an excellent business with a strong net cash balance sheet, and therefore well equipped to withstand the likely operational headwinds it will face in coming months and emerge in good shape. Recent share price weakness has left the company's valuation looking particularly interesting for the patient investor.

ⁱⁱⁱ *Source: Evenlode, FactSet. Free cash flow yield based on 2022 estimates. Dividend yield of 3.0% based on TB Evenlode Income B Inc class 29 September 2022 share price and current forecast dividend for fund's distribution for 12 months ending February 2023. The historic dividend yield based on the previous 12 month's distributions is currently 2.9%.*

^{iv} *For Evenlode Income holdings reporting six-month results to June 2022, average revenue and operating profit growth was +14% and +11% respectively. The ability of companies to take price in a high input inflation environment was a key driver of these double-digit growth rates.*