

Evenlode Income Investment View

September 2023 – ‘Old normal’ vibes

In a quiet month for company news, it was the bigger economic picture that occupied investors in September. The global economy has been cooling in a measured way, as has global inflation, as supply chain issues begin to resolve and employment markets ease from the very tight conditions of last year.

With these developments front of mind, central banks in the US, Europe and UK held interest rates in September, and hinted that they might be at or very close to their peaks. Mr Market though, chose to focus on the length of time that interest rates may need to stay at these levels, to bring inflation firmly back into line. September's rise in the oil price helped bolster this 'higher-for-longer' narrative. Bond yields thus continued their nearly three-and-a-half-year upward march from 2020 lows, creating a headwind for stock markets. US and global markets posted a negative return, and though the UK market posted a slightly positive return, a strong showing from the oil sector masked weakness for most other stocks.

Year-to-date Evenlode Income has now returned +2.5% compared to a return of +0.7% for the IA UK All Companies and +2.4% for the FTSE All-Shareⁱ.

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An 18th century gentleman or lady wouldn't miss a beat if presented with an interest rate of 5.25%. From the Bank of England's formation in 1694, interest rates have averaged 4.7%ⁱⁱ During periods in the modern era when rates have stood at this sort of level, inflation has often also ticked along at a reasonable clip. But shares of companies have generally posted real returns over sensible holding periods. Since 1900 and 1970 respectively, for instance, here are the numbers.ⁱⁱⁱ

	1900 – 2023 (%)	1970 – 2023 (%)
UK base rate average	5.0	6.4
UK stock market total return (annualised)	9.0	11.1
UK inflation (annualised)	3.6	5.0

The real 'news' in terms of the current interest rate environment is the rapidity of the rise. Last January, UK base rates were only 0.25%. This rapid change is not British exceptionalism, but part of a global trend. Rates in the US, for instance, have been on a very similar trajectory, with the federal funds rate now standing at 5.25% - 5.50%.

This dynamic has created some speed bumps for financial markets and the economy. We will spend the rest of this view briefly discussing some implications of higher rates.

Less frothy

When interest rates are low, history has shown that pockets of financial markets can get frothy. As the economist and journalist Walter Bagehot noted in 1852, the archetypal Englishman John Bull '*can stand a great deal, but he cannot stand two per cent*'. When interest rates fall to such a low level, there is a danger that investors respond by taking greater risks. As Bagehot went on, '*people won't take 2 per cent; they won't bear a loss of income. Instead of that dreadful event, they invest their careful savings*



in something impossible – a canal to Kamchatka, a railway to Watchet, a plan for animating the Dead Sea, a corporation for shipping skates to the Torrid Zone. A century or two ago, the Dutch burgomasters, of all people in the world, invented the most imaginative occupation. They speculated in impossible tulips’.

There was no tulip bubble in the 2010s, but as rates have normalised over the last couple of years some glitches in the financial ‘matrix’ have emerged. Issues with cryptocurrencies, FTX, NFTs, Silicon Valley Bank and Credit Suisse can all be loosely collected in this category. More generally, highly leveraged structures are significantly riskier when interest rates stand at 5.25% rather than 0.25%.

One can advance an argument that the removal of excess froth from the financial system has a cathartic, healthy dynamic. In the fullness of time, it should benefit sensibly run companies with sensible capital structures.

Modest valuations a comfort

More mundanely, the rise in interest rates has provided another option for savers, which has presented a headwind for equity valuations over recent months. There is now an alternative in the form of interest from cash or bond yields. Within the UK stock market though, we are reassured by how modest valuations appear when viewed from the perspective of longer-term history. Not unrelated presumably, to how downbeat sentiment is towards the UK stock market (and has been, really, for the last few years).

Taking a specific example, consumer health and hygiene company Reckitt Benckiser has returned a cumulative +678% over the last twenty years, compared to +277% for the FTSE All-Share. Its current year Price/Earnings (PE) multiple is 17x compared to a PE multiple of 18x twenty years ago (and an average PE of 20x for the period as a whole).

And here’s another. Test and measurement company Spectris has returned +1,235% over the last twenty years, also compared to +277% for the FTSE All-Share. But its current year PE multiple is 17x compared to a PE multiple of 20x twenty years ago (and an average PE of 17x for the period as a whole).^{iv}

Neither company is of course perfect (there is no such thing), but they both expect compound growth to continue over coming years. As Spectris management recently put it, ‘*we expect to deliver organic growth consistent with our medium-term objectives of +6-7%, alongside strong progress on expanding margins, as we drive forward with our ambitions to be a leading sustainable business’.*

Though these are nice examples, there are many holdings in the fund for which valuation has either subtracted from, or not meaningfully added, to the attractive long-term compound returns generated by fundamental growth and dividends alone. The use of patience and fortitude in the act of capturing these long-run fundamental returns sums up the ‘get rich slowly’ approach.

The opportunity set has broadened out

The last eighteen months has enabled us to upgrade the quality of the portfolio without diluting its valuation and dividend appeal, as a wider list of high-quality UK cash compounders within the



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investable universe came back into range for us from a valuation and dividend perspective. Additions of Experian, Games Workshop, Diploma, Integrafina, Halma and Spirax-Sarco were all part of this process. Looking ahead, we continue to curate an interesting watchlist of names.

Self-funded growth and economic resilience

More generally, we are encouraged by the excellent combination of quality, valuation and dividend appeal in the portfolio. The aggregate portfolio has ground out reassuring results over recent months, given the context of a slowing economy. In 2022, average growth in revenue and profit for Evenlode Income companies was +12% and +11% respectively. This year, organic revenue growth for the first half averaged a bit over +7%. The current forecast for full year organic revenue growth is about +6%, with margin expansion driving profit growth at a slightly higher rate.^v This theme, of slowing revenue growth combined with the silver lining of lower input cost inflation, is one that we have heard from a wide range of companies. As the CEO of a UK-listed multinational put it to us last week, in relation to global supply chains, *‘you still get the odd one-off, but the big scary stuff post-Covid has mostly normalised’*.

Staying the course

No one quite knows how the next few weeks or months will pan out. Perhaps interest rates and inflation will stay higher for longer, and we will be back to the old normal with the 2009-2020 period looking like an aberration. Or perhaps inflation and interest rates are close to a peak, and they will now march steadily, or even rapidly lower (the Bank of England, in its August Monetary Policy report, forecast that UK CPI inflation will be back to +2.8% by the end of next summer).

Either way, we think the aggregate portfolio has good potential to compound free cash flow over coming years thanks to the strong competitive positions and attractive microeconomics of underlying holdings. Meanwhile, the bedrock of repeat-purchase cash generation and balance sheet strength provide insulation from a wide range of economic conditions.

As the investor Peter Lynch once put it, *‘often, there is no correlation between the success of a company's operations and the success of its stock over a few months or even a few years. In the long term, there is a 100 percent correlation between the success of the company and the success of its stock. This disparity is the key to making money; it pays to be patient, and to own successful companies’*.

Hugh, Chris M., Ben P. and the Evenlode team

3 October 2023

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ⁱSource: Evenlode, Financial Express. Evenlode Income B Acc (GBP), 31 December 2022 to 3 October 2023, total return, bid-to-bid, GBP terms.

ⁱⁱSource: Bank of England, Evenlode.

ⁱⁱⁱSource: Dimson, Marsh, Staunton database 2022, Evenlode.

^{iv}Source: FE for total returns (20-year returns taken from 31 December 2003 to 30 September 2023). FactSet, Evenlode for PE Multiples.

^vSource: Evenlode, Company Results for FY 2022 and H1 FY 2023. Visible Alpha data for FY 2023 forecast results.

