

Evenlode Investment View

August 2016 - Three Themes From Results



Bond bulls or bears, we are living in historic times. Savour the zaniness.

James Grant, *Interest Rate Observer*

The UK stock market has risen quite sharply over the last few weeks, helped in no small part by the pound's weakness, and the knock-on benefit this has to the earnings of multi-nationals, which dominate the index. Sentiment globally has been helped by somewhat better leading economic indicators (particularly in the US), while there has also been no let off in experimentations from the central banking community. In the UK, the Bank of England decided to reduce interest rates last week from 0.5% to 0.25% and commit to a further £70bn of money printing (quantitative easing) with the aim of softening Brexit's impact on the UK economy. This is the first move in UK base rates for more than seven years, and sets another all-time low, not seen since the Bank of England was created in 1694. In sympathy, yields on UK government bonds also hit an all time low, with 10 year gilt yields falling to less than 0.6% this week. Strange times indeed and as I discussed last month, these low rates come with widespread effects.

Results Season

Back in the slightly more humdrum world of company results, it has been a very busy month, with approximately three quarters of the Evenlode portfolio updating investors since mid-July. This month I'd like to briefly highlight three significant themes from these updates.

1. Efficiency, Productivity and Digitalisation

This is a topic I have discussed before, but it remains more relevant than ever. In a lower growth world, corporations are becoming increasingly focused on efficiency. At the same time software, data analytics and outsourced services are providing many of the companies in which the fund invests with effective solutions to deliver this desired outcome.

It is a trend that's particularly noticeable in the software, media, support services and engineering sectors, which in total make up nearly half of the portfolio.

A highlight on this front, we felt, were Fidessa's recent results. The customers for Fidessa's software solutions are predominately investment banks, who have faced tough markets for several years. Whilst their initial response was to put off investment decisions, they are now starting to think about 'smarter' investments. Fidessa is a key supplier in this respect, and this is how they currently see it:

We believe that across all asset classes, the market is moving towards the increased use of service-based solutions and that few vendors have both the depth of applications and the scale of infrastructure needed to deliver these solutions. We are committed to playing an increasingly important role in the markets as customers focus on efficiency, transparency, compliance and performance, and expect that this will provide us with significant opportunities for further growth.

We saw many other signs of customers looking to get 'smarter' in recent results. Test and measurement company Spectris, for instance, noted an interesting dynamic amongst its Asian customers over recent months:

We made good progress in Asia, and in China in particular. This is very much focused on high end products relating to innovation, research and development and automation, rather than the expansion of capacity in process industries. We think this represents the beginnings of a transition in the Chinese

economy.

If so, it would be a welcome trend. As I noted back in my June 2010 investment view, *China's economic growth seems to embody at a country level what we are trying to avoid at the company level. As the years have gone on China's growth story has needed more and more capital to generate each marginal unit of GDP growth. A shift to smarter growth would clearly help on this front.*

2. Strength in Adversity

Several of the companies held in Evenlode are enduring tough industry conditions, particularly some of the more recent additions to the portfolio. This is not unusual: the Evenlode quality/value approach will often lead us to initiate stakes in companies that - despite being fundamentally high quality - are currently unfashionable, and therefore provide an attractive dividend yield and valuation for the fund at purchase.

We like it when businesses can continue to perform resiliently in a downturn: investing for the future, quietly strengthening their competitive position, retaining a strong balance sheet, generating strong cash flows and paying healthy dividends. The newest positions in the Evenlode fund: Pagegroup, Aveva, Euromoney and Victrex (all initiated in 2016) are good case studies, and have continued to generate strong cash flow over recent months.

This statement from Pagegroup's management team is very much aligned with our preference for resilience and long-termism:

When we invest in a new business, be it a new country, a new office or a new discipline, we do so for the long term. Downturns in the general economy of a country or in specific industries will inevitably have a knock-on effect on the recruitment market. However, it has been our practice in the past, and remains our intention, to maintain our presence in our chosen markets through these downturns, while closely controlling our cost base. In this way, we are able to retain our highly capable management teams in whom we have invested and, normally, we find that we gain market share during downturns, which positions our business for market-leading rates of growth when the economy improves.... a strong balance sheet is essential to support the business at these times.

Page increased its interim dividend by a little over +4% this week, and was also able to announce a special dividend thanks to surplus cash on its balance sheet. The other three companies mentioned above also offer the possibility of surplus cash returns, given their lack of debt and cash generative business models. It is so much nicer to own a business that is more likely to surprise by giving you extra cash (thanks to a clean balance sheet), than one more likely to surprise by asking you for extra cash (to shore up a troubled balance sheet).

3. Brexit and Currency Implications

The impact of the UK referendum result and pound weakness was limited in recent results as the event occurred right at the end of the half year, but Brexit and currency was a key discussion point.

Most businesses have not seen a significant change in trading patterns so far, but acknowledge the extra uncertainty. On the currency front, sterling's weakness provides a challenge for UK-facing businesses, as input costs from abroad rise in price. Some of these rising costs will be passed on to customers, which will have an impact on the UK inflation rate over coming months. Our sense, however, is that these costs will not be wholly passed on, given the overall deflationary environment

and the uncertain outlook for demand. Evenlode has relatively few business models for which these rising cost dynamics will be of any significance, but PZ Cussons and Halfords are examples.

The majority of Evenlode holdings are UK-based global businesses. The management teams of these companies are beginning to indicate the positive impact on earnings if currency rates remained at recent levels: most are set to benefit by between +5-10% for the full year. In some cases, the increase will be higher. Glaxosmithkline is a good example, given its significant UK research and development facilities but global revenue exposure (not least to the US dollar). Glaxo expect currency to increase underlying earnings by +19% in 2016 if rates remain at current levels. Other UK exporters in the Evenlode universe include companies such as Rotork, Victrex, Spirax-Sarco and Renishaw. While the impact on competitiveness for this group of companies is incrementally positive, it is in many cases not huge. Most have worked hard over the years on developing supply chains and production footprints that help offset global revenues with a global cost base.

I would like to finish by thanking our co-investors for their ongoing support and trust this year. We continue to work hard on researching new opportunities and look forward to updating you over coming months on the Evenlode fund. In the meantime, enjoy the last few weeks of summer!

Hugh Yarrow
Investment Director
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Please note, these views represent the personal opinions of Hugh Yarrow as at 12th August 2016 and do not constitute investment advice.