Evenlode Investment View

December 2016 - Inflation and Real Long-Term Growth

In recent weeks investor expectations for inflation and interest rates have risen quite rapidly. This has partly been due to the prospect of post-election fiscal stimulus in the US (both from infrastructure spend and tax cuts) and partly due to a recovery in commodity and energy prices. As a result bond yields have moved higher – from a very low level earlier in the year – and there has been a rotation in the stock market towards financial and commodity stocks. At the same time, the share prices of many predictable dividend payers have fallen back due to their perceived similarities to fixed coupon bonds.

The Evenlode approach (focusing solely on asset-light, high return businesses) results in a portfolio that is quite different to the UK market and will at times - such as the last few weeks - be out of step with market trends (particularly given the fund does not invest in some large sectors of the market such as banks and oil/mining producers). However, the approach works well over the long-term, and consistently investing in this way is a central part of our investment philosophy.

In this month's view I'd like to briefly highlight three reasons why we think the Evenlode portfolio would, in fact, be well equipped to deal with an environment of rising inflation and interest rates *if* this scenario were to transpire over coming years.

1) Real Growth

Something that the equity of competitively advantaged companies has in its favour (and something that fixed coupon bonds don't enjoy) is the potential for real growth in capital and dividends over time. Here are some examples, for instance, of the wide variety of sources Evenlode's cash flow stream derives from:

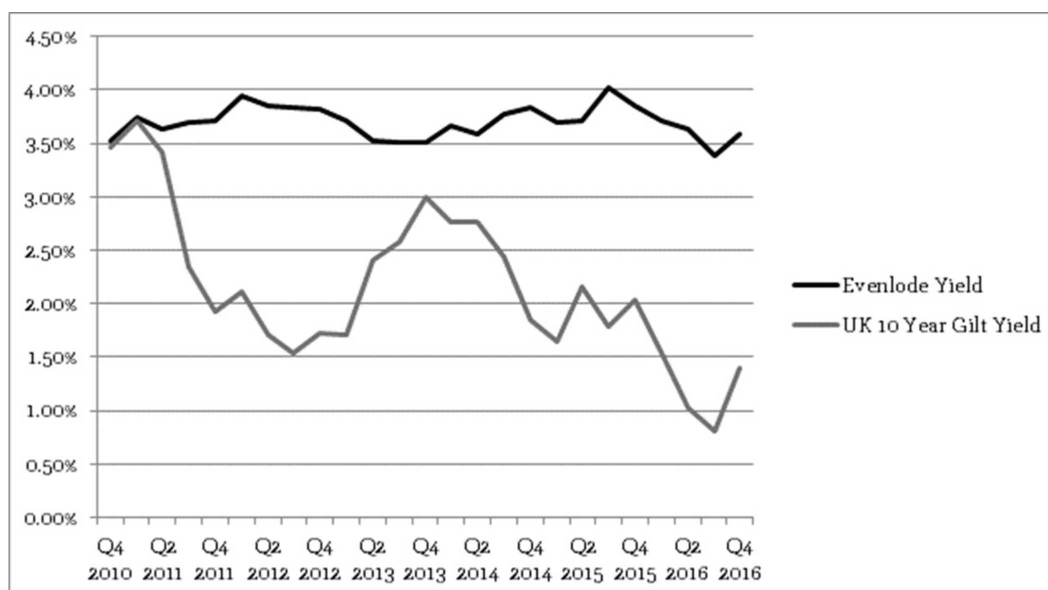
- Vaccines, healthcare therapies, medical devices
- Shampoo, ice cream, nappies, soft drinks, crisps, beer
- Financial, engineering and healthcare software, decision-making analytics, academic journals
- Mission-critical engineering products and monitoring systems

These goods and services should remain in demand over time and often have strong customer loyalty, helping them retain their pricing power (in both deflationary and inflationary conditions). Inflation in the modern world of paper money has in fact been quite persistent since the pound decimalised in 1971. £1's purchasing power has declined by more than 90% in the intervening 40 plus years. So companies have been dealing with inflationary pressure for decades - the last few years of low inflation are something of an outlier.*

Over and above inflation-proofing, cash generative equities can also consistently invest in innovation, product range expansion and geographical diversification, something I have often discussed in these views. This provides the potential for compounding real growth over time.

2) Attractive Dividends

The chart below shows the evolution of Evenlode's dividend yield over time versus the UK ten-year government bond:



It is a reminder of what a strange few years it has been for the bond market. While the equity market has seen some yield compression, it has been by no means as extreme, and a combination of dividend growth and valuation management has meant that Evenlode's yield has remained fairly stable over the last few years**.

Taking a longer-term perspective, it's worth remembering that there have been plenty of periods in the past when bond yields traded at or above equity dividend yields - the large yield premium that equities have exhibited in the last few years is by no means the 'normal' state of affairs. And in many ways that makes sense, given the real potential for dividend growth that equities are able to offer investors.

3) Balance Sheet Strength

Ultra-low bond yields combined with low economic growth have led UK businesses in aggregate to take on more debt. As regular readers will know, managing the balance sheet strength of the overall Evenlode portfolio and biasing the portfolio towards self-funding businesses has been a particular focus for us over the last couple of years. Low levels of debt in the portfolio help insulate it from the risk of rising borrowing costs if and when interest rates rise.***

Protection from Uncertainty

Clearly there is no perfect hedge against inflation. But, to conclude, a collection of asset-light, competitively advantaged companies are not simply a 'deflation bet', but should cope well with rising inflation too.

Though the higher inflation/interest rate narrative is becoming consensual again (as it has several times over the last few years), it's worth holding the thought that there is a very credible scenario in which deflationary pressures retain their grip on the global economy for some time. Various structural factors are unlikely to dissipate in the medium term including a high stock of global debt (for which even a small rise in rates will create problems), demographic trends and innovation. In my view, therefore, *protection from uncertainty* via a collection of good, diversified businesses is more important than a big binary bet on either the inflation or deflation narrative.

In next month's view I will take stock of the year in full and look ahead to 2017. In the meantime I'd like to thank all Evenlode's investors for their interest and support this year, and wish you an enjoyable, peaceful Christmas.

Hugh Yarrow
Fund Manager
15th December 2016

Please note, these views represent the personal opinions of Hugh Yarrow as at 15th December 2016 and do not constitute investment advice.

**It is particularly interesting how effective asset-light companies were at coping during the inflationary 1970s. Buffett wrote a good piece on this in the appendix to his 1983 Berkshire Hathaway essay, which I discussed in my November 2009 Investment View: An Eye On Inflation (http://evenlode.wiseinvestment.co.uk/news/evenlode-investment-view-november-2009)*
***In terms of valuation management we were seeing the best opportunities in mid-caps earlier in the year (both in terms of new and existing holdings). In the last few weeks, however, we have begun to bias new capital towards some of the fund's larger company holdings again. Unilever, for instance, is now offering a 3.7% starting dividend yield and dividend growth of 6% per annum. As highlighted at the company's recent investor day, medium-term dividend growth should be comfortably backed by free cash flow growth thanks to reasonable sales growth, increasing margins, high cash conversion and high compounding returns on invested capital.*
****The aggregate net debt to EBITDA ratio for the Evenlode portfolio is currently less than 0.5x, compared to a ratio of 2x for the UK market. This market ratio has doubled from 1x over the last five years (source: Factset, Evenlode).*