Evenlode Investment View

October 2016 - Seven Years On

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Investors, and particularly UK based investors, have had plenty to think about over the last few weeks. On the global front, the build up to the US presidential election is gaining momentum and is inevitably creating some uncertainty. Also of note has been a significant rebound in the oil price, helped by a surprise production cut from OPEC*, the first agreed since 2008.

Closer to home, worries over Brexit have resurfaced, with recent noises from both European and UK leaders raising concerns of a 'hard Brexit' involving the UK's departure from Europe's single market. In sympathy, sterling has fallen against the dollar to levels not seen since the mid-1980s. Whilst a weaker pound has a negative impact on UK companies with significant overseas input costs (such as retailers - Tesco's spat with Unilever this week being a good example), it is a significant positive for companies with overseas earnings. This dynamic has helped the stock market move higher.

The Evenlode portfolio is also benefitting from this currency trend given the global exposure of its underlying holdings, and geographic diversification continues to be a characteristic we like. For the long-term investor it lowers the risks that political and economic events can produce at the national level, whilst also providing a runway for good growth over coming decades via expansion within newer markets.

However, we are open to the opportunties that negative sentiment towards the UK may unearth. New post-referendum positions in Page Group and EMIS are examples, and there is list of other high quality businesses in Evenlode's investable universe which are exposed to the UK economy but not currently held in the fund. If sentiment towards the UK continues to deteriorate then some of these names are likely to become more interesting to us on valuation grounds.

Debt and Valuations

Zooming out from referendum-related bumps in the road, I would like to return to the two key risks that I believe currently confront us all: *debt* and *valuations*. Ben and I have talked about both of these risks in recent investment views. The low interest rate/low inflation environment makes growth hard to come by, but also makes debt cheap. Using debt to juice up earnings growth is therefore tempting, and leverage levels across the market are creeping up. At the same time persistently low interest rates and bond yields have led to a valuation environment that is less attractive than it was six or seven years ago.

Balancing Quality and Value

There is no miracle cure for either of these issues. However, we believe the best response is our usual one: *to maintain an appropriate balance between quality and value at all times*. As income investors, this means combining good potential for future dividend growth with attractive current dividend yields.

Below are three examples of relatively new stocks in the portfolio that in my view demonstrate this balance, and have released reassuring trading updates in the last few weeks:

Page Group

As I discussed in July, we initiated a new holding in recruitment company Page Group on an initial yield of 4.5% when the share price fell sharply following the referendum result. Third quarter results this week demonstrated the group's global diversity (only 22% of the group's profits come from the UK and of that only 4% is from financial services) and structural growth opportunities. Page's results were also a reminder of how patchy the growth environment is around the world - both by geography and industry. The UK, Hong Kong, Brazil and the global financial services sector are tough for Page currently, but in contrast Continental Europe, Latin America, Australasia and the global technology and procurement sectors are strong! Meanwhile, cash continues to pile up on the balance sheet, a favourite characteristic of mine. Page's dividend is growing at +5% and the company also recently announced a supplementary special dividend.

Victrex

Victrex is a global leader in the niche market of high performance polymers. Polymers have several advantages over metal in applications such as planes, cars and medical implants - they are light, strong, more easily processed, water resistant etc. By switching from metals to polymers, customers can therefore save money, reduce production time and improve the performance and energy efficiency of their products. Victrex's differentiated products and high levels of customer embeddedness also create effective barriers to entry. The company generates strong cash flow and has no debt, allowing averaged dividend growth of +15% per annum over the last decade. Long-term growth prospects are good, but end markets have been mixed recently, and we added Victrex to Evenlode at a yield of 3.5% in the January sell-off. As with Page Group, the cash position on its balance sheet is quietly ticking up.

Pepsi

We introduced Pepsi to the portfolio last month to replace Evenlode's holding in SABMiller (recently acquired by AB Inbev) on a dividend yield of nearly 3%. Pepsi is one of the great global franchise businesses with a market leading position in both savoury snacks (Walkers, Doritos, Lays etc.) and soft drinks (Pepsi, 7Up etc.) Pepsi has some debt but a strong balance sheet in the context of its repeat-purchase business model, and has a habit of consistently converting earnings to cash flow. The company has increased its dividend for forty four consecutive years, testament to the business model's resilience through good times and bad, and has increased its dividend by +7% this year. We think future dividend growth potential is excellent, particularly in the context of the company's growth runway in newer markets.

Seven Years On

Evenlode will pass its seventh anniversary next week. The fund was born on 19th October 2009 as the global economy emerged from the ashes of the Great Financial Crisis of 2008 and 2009. At the time, Ben and I stated publicly that we saw Evenlode as a very long-term investment project (i.e. twenty years plus), and this aspiration remains unchanged. In the last two years we have also welcomed Chris and Steph to the barn as investment analysts - they are already proving to be great additions to the Evenlode team. The other three members of the Evenlode team - Nicole, David and Callum - provide us with first-class operations and dealing support.

Over this seven year period our approach has remained unchanged, focusing only on quality (i.e. high return, asset-light) stocks, with a disciplined valuation and dividend filter. This approach works well for long-term dividend growth investing, but it also involves us doing things very differently to the UK market and running a relatively focused portfolio (currently 38 positions - and not always in stocks that are bathing in the glow of positive market sentiment!). The fund's performance will, therefore, fall in and out of fashion over shorter time periods - this is something we are keen for our co-investors to appreciate.

I have been known to compare long-term fundamental investing with a pastime of mine, long-distance swimming. Both disciplines require a combination of psychological resolve and good technique. As with swimming, the calmer you stay and the more you ignore the 'chop' and stick to your rhythm, the more effectively you'll move though investment waters. But most importantly, both require endurance and the ability to cope with boredom, pain, uncertainty and discomfort!

Though we are pleased with the progress to date**, we are acutely aware that what matters most for our investors is not the past but the future, and our efforts remain focused on retaining an attractive combination of quality, value and dividend yield within the portfolio to drive future returns and dividend growth.

Hugh Yarrow
Fund Manager
13th October 2016

Please note, these views represent the personal opinions of Hugh Yarrow as at 13th October 2016 and do not constitute investment advice.

* The Organisation of the Petroleum Exporting Countries
**Since launch, Evenlode's average annual dividend growth has been a little over +8% per annum (and the yield on an initial investment in the fund would now be approximately 6.5%). On an annualised total return basis (19/10/2009 to 30/09/2016), Evenlode has returned +14.2% compared to +8.5% p.a. for the UK market.