

Evenlode Investment View

October 2018 – Ninth Anniversary



The stock market is a giant distraction from the business of investing

Jack Bogle

The UK stock market has fallen by more than -6% so far in October, with daily volatility at a higher level compared to recent months. This leaves the FTSE All-Share down -5.8% since the start of the year, compared to a rise of +1.3% for the Evenlode Income fundⁱ. Commentators have attributed various causes to the recent correction including the impact rising US interest rates may have on the global economy, escalating US trade tariffs, volatility in emerging market economies; political developments in Italy and, for UK investors, continuing uncertainty surrounding Brexit negotiations.

There are undoubtedly risks to the economic outlook and as always, it is impossible to predict the exact trajectory of the stock market over the short-term. However, as long-term investors, we note recent share price falls have injected a non-trivial amount of valuation appeal into many good businesses and some share prices have fallen more than others, providing opportunity. We continue to 'nudge' the portfolio in response to this stock-by-stock volatility, with our long-term aim of managing fundamental and valuation risk always in mind. This month we have also exited the fund's position in Jardine Lloyd Thompson following its takeover approach in September. This has provided the portfolio with cash to redeploy into other quality companies on attractive valuations.

We continue to plough our usual through-cycle furrow, and remain reassured by the overall balance of quality and value in the portfolio, which benefits from several helpful characteristics for the patient shareholder:

- 1) A collection of market-leading businesses with diversification by geography, sector and business model.
- 2) A large portion of the portfolio invested in relatively repeat-purchase, stable businesses which provide insulation from the vagaries of the economic cycle. This is particularly the case after the changes we made to the fund earlier in the year when several of these holdings underperformed considerably versus more economically sensitive businesses (Unilever, Relx, Reckitt, Compass, Sage, Smith & Nephew, Pepsi etc.).
- 3) A current dividend yield of 3.4% more than 1.5x covered by free cash flow generation and with, in our view, good prospects for steady dividend and free cash flow growth over timeⁱⁱ.
- 4) A strong balance sheet, with net debt to EBITDA at 0.9x for the overall portfolio. 44% of the portfolio's holdings (17 of the 39 holdings) have no debt at all (and many of the more economically sensitive businesses fall into this 'no debt' category, which we also find reassuring)ⁱⁱⁱ.

All the above characteristics are important metrics that we monitor carefully over time.

Unilever

I mentioned last month that from the perspective of Evenlode Income investors I would prefer Unilever to remain as a UK-listed business rather than 'go Dutch' as management had proposed, given

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its important place in the portfolio. I therefore welcomed the company's decision to withdraw this proposal earlier in October following feedback from UK shareholders.

At the operational level Unilever released very reassuring third quarter results this month and noted a pick up in the rate of growth in its markets. Overall organic sales grew +3.8% during the quarter, driven by emerging market sales +5.6% and online sales +50% year-to-date. These results are a reminder of how well a business with a collection of strong brands, a diversified global franchise, and a culture of investing consistently in the future, can cope with ups and downs such as geopolitical uncertainty, currency volatility and inflationary/deflationary trends (the company has faced both of these scenarios in different parts of the world over the last few years). Unilever's investment in product development and its more flexible organisational structure is also beginning to bear fruit with ten new brands launched so far this year and seventeen since the start of 2017.

Company Updates

More generally, slightly more than half of the portfolio has updated the market over the last few weeks. We have been pleased overall in terms of the steady progress most businesses are making with positive updates from companies as varied as Unilever, Relx, Diageo, Page Group, Hays, Pepsi, Procter and Gamble, Moneysupermarket, Aveva, Microsoft and Novartis. Growth opportunities remain notably good in certain structurally attractive areas such as digital analytics/software, business-to-business outsourcing (e.g. specialist recruitment) and the sale of consumer branded goods to emerging market consumers. Though emerging market exposure is not fashionable at the moment, it is interesting to note the growth that many businesses in the portfolio are delivering from these regions (see Unilever as mentioned above or Pepsi, whose emerging market business grew by +10% in the quarter). We continue to view the Evenlode Income fund's exposure to these parts of the world (from which a little more than 30% of the portfolio's revenues are generated) as very attractive on a long-term view.

As usual some companies have disappointed the market, most notably WPP after releasing third quarter sales and profits that were below expectations. We acknowledge the operational pressures that WPP is currently facing and expect these headwinds to continue in the near-term. We reflect these risks via a small position size. However, free cash flow generation remains healthy, the valuation is attractive and we think the company can grow over the longer-term. We're also reassured by new management's strategy of simplifying the portfolio and prioritising a strong balance sheet.

Ninth Anniversary

Before signing off I'd like to mention that the Evenlode Income fund was launched on 19th October 2009 and therefore had its ninth anniversary this month (only one more year left until the end of the decade!). Since launch, the compound total return per annum after fees has been +12.5% p.a. for Evenlode compared to +7.8% p.a. for the FTSE All-Share and +8.1% p.a. for the IA UK All Companies sector. The average annual dividend growth has been approximately +6.9% per annum, and the running yield on an initial investment in the fund would now be approximately 7.1%.^{iv}

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These results have been achieved by focusing only on market-leading, cash generative stocks and deploying a disciplined valuation/dividend filter, a patient mindset and ongoing management of fundamental risk. Though we are pleased with the progress so far, we are very aware that what matters most for our co-investors is not the past but the future, and our efforts remain focused on retaining an attractive combination of quality and value within the portfolio to deliver a good starting dividend yield combined with steady prospects for real (i.e. inflation-protected) dividend growth in the future.

I look forward to updating you on the portfolio's progress in the months and years ahead.

Hugh and the Evenlode Team
30th October 2018

Please note, these views represent the opinions of Hugh Yarrow as at 30th October 2018 and do not constitute investment advice.

ⁱ Source: Financial Express, total return, bid-to-bid, 31st December 2017 to 29th October 2018.

ⁱⁱ Source: Evenlode Investment, Factset. The portfolio's 2018 free cash flow yield is estimated at 5.1%, and 2019 free cash flow yield at 5.8%. On the subject of dividend growth prospects, it is worth noting that AB Inbev reduced its dividend payment this month. We were aware of this possibility and support the move given recent emerging market currency weakness in the context of an indebted balance sheet. Given the company's small position size, the reduction does not have a material impact on our overall expectations for dividend growth in the portfolio. We continue to view AB's long-term prospects for free cash flow growth as attractive.

ⁱⁱⁱ Source: Evenlode Investment, Factset. EBITDA = Earnings Before Interest, Tax, Depreciation and Amortisation.

^{iv} Source: Evenlode, Financial Express, total return, bid-to-bid, 19/10/2009 to 19/10/2018. Dividend growth based on B Income units. 7 years from first full year of dividends (to March 2011). Running yield based on last 4 quarterly dividend payments versus initial offer price.