

Evenlode Global Investment View

September 2022 – Currency, Economy, Company



The commentary below applies to both the Evenlode Global Dividend and Evenlode Global Income portfolios. Market data is from Factset and FE Analytics.

Currency

The year so far has been remarkable in many ways. As sterling-based investors it feels particularly so, as the pound has tumbled in recent days following the new Chancellor's 'fiscal statement' on 23 September. The announcement encouraged financial markets from bonds to currencies to equities to make a statement in return which was not entirely complimentary. It now costs 26% more pounds to buy a dollar than it did a year agoⁱ. Whatever one's view on the UK's current fiscal situation however, the UK is certainly not alone when it comes to fighting a losing battle with the strength of the US currency; it now costs 21% more euros to buy a dollar than a year ago too.

We're not usually given to concerning ourselves too much with currency moves; we are equity investors, and it is our view that in the long run it is the performance of the companies that we invest in on behalf of our clients that will drive total returns. Currency will have an effect of course but it will likely make up a relatively small positive or negative depending on whether one's base currency appreciates or depreciates (for sterling, the long-term depreciation record is unfortunately clear). This doesn't mean we should completely ignore what's going on in markets outside of our home ground of shares though. The magnitude of the dollar's move translates to real effects for companies. Those that buy inputs or pay staff in dollars but generate international revenues in other currencies face a headwind.

The rapid dollar appreciation has been a headwind to the performance of Evenlode Global Income relative to our benchmark, the MSCI World index. By country of listing, the fund has lower US exposure than the index and appears to under-index to the dollar significantly. The US makes up 70% of the benchmark on a listing basisⁱⁱ, versus 36% for the fund's portfolioⁱⁱⁱ. This however overstates the currency-related difference, as multinationals generate a large proportion of revenues in non-domestic currencies. The underlying revenues of the companies that make up the index that come from the North America is approximately 52%^{iv}, and for the fund 43%. The US economy makes up around 26% of global GDP^v, showing the dollar bias of listed equities generally.

So compared to the fund's benchmark there is an under-indexation to the dollar, which has been a negative for relative performance. We estimate that over the last year currencies have accounted for about a five percentage point headwind to performance compared to the MSCI World^{vi} – quite significant. Over that time the MSCI World Index has returned 0.3% in sterling, and the Evenlode Global Income fund -0.4%^{vii}. In dollars, the index has returned -21.1%, and the fund -21.7%^{viii}. The fund has more or less kept pace with the index despite the headwind, albeit in a downward direction in dollar terms.

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In hindsight it is tempting to think that we should have held more US listed companies, but there is a reason why we didn't – valuation. Whilst there are some good valuation opportunities in the US market, and those are reflected in the portfolio (the largest position currently is in software giant Microsoft), in our estimation there has been better value to be found elsewhere. Managing valuation risk has been something of a theme of our portfolio activity since the start of the pandemic and the commensurately strong market. This trend is starting to reverse as equity markets come off the boil.

Economy

If there is need of a catalyst for equity markets to head downwards, look no further than the economy. Inflation is at the top of the news agenda and running at multi-decade highs. It is one of the reasons that the dollar has been so strong, as the Federal Reserve has raised interest rates from record lows ahead of other central banks, making the dollar more attractive. That's the policy response, but one of the reasons for the high inflation is disruption to global supply chains following the coronavirus pandemic and its associated lockdowns, which are still ongoing in China. Securing supply of some components has come at increased cost, and transportation prices have increased markedly as a rebound in demand has hit limited carrying capacity.

War in Ukraine has driven up energy and commodity prices too. Energy price increases are greatest for European economies, with the US being a net exporter of energy. It is perhaps why the Fed has raised rates more aggressively, as this action might have more of an effect on demand-driven inflation, and less impact on energy use which is at the core of European inflation.

The US is taking other policy actions as well, some of which point to geopolitical developments. The cryptically-named Inflation Reduction Act addresses myriad issues, including drug pricing, and includes a huge package of measures designed to stimulate the green economy. Amongst these is a subsidy for electric car purchases, but only where a significant proportion of the battery components are sourced from the US^{ix}. There is a similar provision for use of domestically-sourced steel in wind projects^x. There are many environmental reasons to support localised production of heavy input materials that would otherwise have to be transported over long distances. That 85% of rare earth metal processing occurs in China hints that geopolitics and security of supply is a factor in these provisions too.

All of this, and more, forms the complex monetary, fiscal and economic backdrop that companies must navigate at the current time.

Company

So what are companies doing? Near term supply chain challenges are being met by the businesses within the portfolio by using some of their cash flow to secure supply of inputs, thereby increasing inventories. In some cases, such as consumer goods giant Nestlé, companies are building capacity to

Evenlode Global Investment View

September 2022 – Currency, Economy, Company



ensure that demand can be met. Others are having to wait a bit longer to be paid, such as IT consultancy Capgemini. They are able to weather this because they are, as a whole and individually, inherently cash-generative businesses that have strong balance sheets. Free cash flow declined during the first half of the year, by about a fifth overall for the portfolio - not desirable but by no means terminal. Most businesses are expecting the situation to reverse somewhat through the second half of 2022, and some are already reporting easing in supply chain constraints.

The increase in input costs impacts profitability and businesses in the portfolio have been taking actions to mitigate this. Raw materials, packaging, transportation and labour costs have all increased, and have been a catalyst to find efficiencies in operations. Cost cutting can only go so far though; reducing critical investments that benefit the long-term health of a company, such as research and development, should be avoided. In the long term, increased costs need to be passed on to the end customer to maintain margins, and we have seen this happening in practice. Most businesses, and particularly those in the consumer goods sector, are reporting that they have been able to raise prices, but that passing on the full impact of input cost inflation will take time and will be done in stages. Ultimately businesses can only do this if they create goods and services that their customers value beyond the cost of production, and it helps if those goods represent a relatively small cost compared to their budget. This is something we actively look for in the companies that make it into the portfolio. Looking at the equity markets, companies have fallen in value in dollar terms this year. Some have fallen in sterling terms. The fall in price reflects many of the current economic worries and challenges, and also the expensive valuations that were a feature in parts of the market as we started the current year. Whilst we don't know how this will play out (and as the recent reaction to the UK Chancellor's announcement shows there is always the risk of the unexpected), the portfolio's businesses are proving to be resilient. As a measure of valuation, the current free cash flow yield is 5.1%, about the average for the portfolio since it was launched nearly five years ago.

Resilient, diversified businesses trading at decent valuations is what we aim for, and this is what we have in the current portfolio. Such companies have proven to be good investments in less inflationary times but looking longer term, real assets like companies also have the potential to protect from the worst impacts of inflation as they can adjust to the changing economic conditions.

Ben, Chris, Bethan, Rob and the Evenlode team

September 28th 2022

Please note, these views represent the opinions of the Evenlode Team as of September 28th 2022 and do not constitute investment advice.

Where opinions are expressed they are based on current market conditions, they may differ from those of other investment professionals and are subject to change without notice. This document is not

Evenlode Global Investment View

September 2022 – Currency, Economy, Company



intended as a recommendation to invest in any particular asset class, security or strategy. The information provided is for illustrative purposes only and should not be relied upon as a recommendation to buy or sell securities.

For full information on fund risks and costs and charges, please refer to the Key Investor Information Documents, Annual & Interim Reports and the Prospectus, which are available on the Evenlode Investment Management website (<https://evenlodeinvestment.com>). Recent performance information is also shown on factsheets, also available on the website.

Past performance is not a guide to future returns. The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Fund performance figures are shown inclusive of reinvested income and net of the ongoing charges and portfolio transaction costs unless otherwise stated. The figures do not reflect any entry charge paid by individual investors.

Current forecasts provided for transparency purposes, are subject to change and are not guaranteed. Source: Evenlode Investment Management Limited. Evenlode Investment Management Limited is authorised and regulated by the Financial Conduct Authority, No. 767844.

ⁱ Source: Factset, year to 28th September 2022

ⁱⁱ Source: MSCI - 31 August 2022

ⁱⁱⁱ Source: Evenlode Investment – 31 August 2022

^{iv} Source: Factset Georev. North America (USA and Canada).

^v Source: Factset – data as at June 2022

^{vi} Source: Factset, Evenlode, based on a comparison of local currency returns to returns in the fund's base currency.

^{vii} B Acc units. The Evenlode Global Dividend fund I Acc units returned -0.2%. Year to 27 September 2022.

^{viii} The Evenlode Global Dividend fund returned -21.5%. Year to 27 September 2022

^{ix} <https://www.supplychainedive.com/news/biden-signs-inflation-reduction-act-in-boost-to-us-electric-vehicle-product/629854/>

^x <https://www.whitehouse.gov/briefing-room/statements-releases/2022/08/19/fact-sheet-the-inflation-reduction-act-supports-workers-and-families/>