Evenlode Global Income Investment View

August 2024 – A tale of two markets

EVENLODE
GLOBAL INCOME FUND

Market data is from Bloomberg, FactSet and FE Analytics.

Last month we noted the increase in volatility that had been seen on some trading days in the broad equity market, which stood in contrast to its relatively calm ascent stretching back for over a year. We wondered whether this was just a short pause in proceedings, or whether it marked a return to levels of volatility[i] more historically typical of equities. In the intervening couple of weeks, the answer has been… 'Neither of these scenarios'. We were instead treated to one of the more dramatic periods of volatility in recent memory, with the Japanese stock market (now infamously) dropping by a double-digit percentage in one day and the US market experiencing a drop of over -6% in dollars over a couple of trading days[ii] with large intraday swings. Market prices have recovered somewhat since, but the episode is another reminder that the path to returns does not move in a straight line. That's for the market, but for the Evenlode Global Income portfolio there was a much more limited effect, the fund drawing down by -2%[iii] before recovering half of that.

There has of course been speculation as to the cause of this volatility, with a hedge fund technique called the 'carry trade'[iv], and experienced traders going on holiday being prime amongst the cited reasons. At Evenlode, the investment and trading teams remain more than adequately manned even in August, but we do see a drop off in trading volumes in the height of the summer holiday season. All other things being equal, the lower the volume of shares traded in a stock or index, the greater the volatility usually is. Whatever the reasons for the market fall, the divergent performance of the fund and the market indicates that this has not been a case of just *anything* being sold in a panic. That was more the experience at the onset of the coronavirus pandemic in March 2020 by way of comparison with another volatile period. In the more recent episode, the portfolio's holdings in the Health Care and Consumer sectors performed solidly in absolute terms. The market downturn was led by the Information Technology sector although the fund's holdings in this sector performed relatively well; they did decline, but it was a lot less compared to the market. The sector has been the standout driver of the market's rise in recent times and its downward move has not eliminated those gains. But it has narrowed the gap between the fund's performance and that of the comparator benchmark, the MSCI World Index.

We can't say for sure, but the solidity of portfolio companies' operational performance may have helped their market performance. The real-world backdrop to the market drama has been described in the first half corporate reports that have now largely been collated for the fund's holdings. The picture in terms of reported numbers has been solid, with the median organic revenue growth figure coming in at +5%, profit margins expanding, and cash flow growing. We have been watching out for the latter two points in particular, as margins and cash flow were affected by inflation and supply chain disruptions in 2022-23. It is good to see businesses in the portfolio getting back to more 'normal' operations, but as ever there is a lot of interesting detail that we'll draw out here.

Consumer normalisation

It seems that companies and consumers have now digested the ripple effects of the Covid pandemic, with normalisation of consumer trends continuing in Q2. In Consumer Staples, those products that we buy on a daily basis, companies such as Unilever and Nestlé reported more muted price and volume increases, but more aligned with our expectations for mid-single-digit longer-term revenue growth. This sector was one of the most affected by input cost inflation and margins have now recovered strongly after the challenges of the past few years, enabling continued reinvestment in their brands through marketing. There has been much focus on the health of the US consumer recently, and while discretionary spending appears like it could be under some pressure, the core of peoples' wallets seems robust. Procter and Gamble's CEO Jon Moeller noted in their Q2 earnings call:

"We generally don't see the dynamic that some are describing… private label shares as an example, which typically would be increasing during a time of significant consumer pressure, that's not what we're seeing… Is unit growth declining? [That's], again, not what we're generally seeing."

At the more discretionary end of the spectrum the deceleration has been more apparent but the highest quality brands are taking share. After an extraordinary period of growth over the past few years, LVMH's business has been robust at 2% organic growth. Though behind peer Hermès, who cater to the very richest in society (who are generally unaffected by economic cycles), LVMH's performance vs the rest of the luxury goods industry is reassuring. The company noted weakness in Champagne, which could be a barometer for happiness levels. Their CFO Jean-Jacques Guiony said:

"Champagne is quite linked with celebration, happiness, et cetera. Maybe the current global situation, be it geopolitical or macroeconomic, doesn't lead people to cheer up and to open bottles of champagne."

Sobering stuff. Snap-on, who sell professional-grade tools to US mechanics, continued to see customers being cautious on spending on larger items in the face of economic and political uncertainty. We reflect this cyclical risk in our smaller max position size and long-term valuation framework, but long-term the company enjoys a deserved reputation for quality and service, and a close connection with their customers. This gives CEO Nik Pinchuk, always good for a one-liner summary of the prevailing conditions, some insight behind his statement that:

"While the [technicians] are busy and have cash… fear is the outlook killer."

Business services

We are also seeing a similar discretionary vs staple spending split in business spending. Overall, businesses are continuing to invest, but core processes are being prioritised. Companies in the testing, inspection and certification (TIC) sector like SGS, Bureau Veritas and Intertek all continued to grow revenues in the high-single digit range, spread broadly across end markets. This included a return to the development of new consumer products. The TIC companies' services are critical components of their customers value chains; new products must be certified, and infrastructure must be inspected. Wolters Kluwer, RELX and Experian, providers of mission-critical corporate software and information, saw their revenue growth trajectories unchanged, at mid to high single digit rates. Their solutions form a central part to customer operations and most of revenues are generally considered recurring.

Higher interest rates, political uncertainty and some unknowns are causing companies to pause before kicking off certain projects, particularly those in more cyclical industries. Much of Accenture and Capgemini's business is critical to customer operations, but some is based on more forward-looking, discretionary work. Capgemini are now expecting flat revenue growth for the year. Their CEO Aiman Ezzat said:

"We do not count on any return in discretionary spend at all this year… the aerospace [industry] has abruptly turned from an investing towards a tightening phase, driven notably by many supply chain issues. And the anticipated slowdown in the auto sector is becoming more abrupt and happening faster than we anticipated. Second, the recovery in Financial Services is there, but at a slower pace than initially anticipated… we have taken a cautious view on France… because of the political environment."

Artificial Intelligence (AI)

No results roundup can pass without mention of the hot topic *du jour*. From the results we've seen AI remains firmly in the early adoption phase. Microsoft, like all the big tech companies, are investing heavily in datacentre capacity to serve demand, backed by extremely strong cash flows from their enviable business model. AI accounted for eight percentage points of Microsoft's cloud platform Azure's thirty percent growth in Q2. However, much of this will be from AI model development and training, from the likes of OpenAI and other AI 'start-ups.' Microsoft are also investing in their own silicon chips to reduce costs of running the associated computations, a notable issue for large models.

The systems integrators like Accenture and Capgemini are the ones who actually implement large corporate technology projects and are yet to see AI-related revenues come through significantly. The bread-and-butter, good old-fashioned IT projects from before the days of ChatGPT are still a priority for companies. Often, they are highly complex but add lots of value, including the potential to use their data in the application of new technologies, including AI. Capgemini's CEO again:

"The hype is coming down because people don't see the benefit as fast… if you really want to get value out of Gen AI [it] is going to be use case by use case… the hype around the silver bullet is gone. And now we are really getting in a disciplined approach…"

And Accenture's CEO Julie Sweet:

"It is important to remember that while there's a near universal recognition now of the importance of AI… the ability to use Gen AI at scale varies widely with clients on a continuum… most clients are coming to the realization of the investments needed to truly implement AI across the enterprise, starting with a strong digital core from migrating applications and data to the cloud, building a new cognitive layer, implementing modern [enterprise resource planning] and applications across the enterprise to a strong security layer. And nearly all clients are finding it difficult to scale GenAI projects because the AI technology is a small part of what is needed."

There have been some good use cases. Microsoft noted that adoption of AI-driven assistants for software developers has led to material productivity gains. Marketers are using AI to increase the efficiency of the creative process by automating some processes, such as early storyboarding or ad personalisation. Wolters Kluwer sell business workflow software in various sectors. CEO Nancy

McKinstry has overseen their tremendously successful transition from print to digital media and information, and summarised the corporate AI attitude well:

"I'm pleased to say all five [of our] divisions now have Gen AI-enabled features in the market. We're focusing our efforts on use cases in several areas, including summarization, enhanced and voice-activated Q&A and AI assistance…We clearly see that people are excited about this. On the other hand, they're also a little bit cautious in terms of widespread adoption. They really need to see these solutions prove out…I do believe that on the monetization front, some activities… for example, summarization, I believe [these] will be table stakes… building in that capability will support retention, support price increases, but unlikely to lead to brand new revenue streams. However, other things will lead to customers [being] willing to pay more as they see productivity benefits improve substantially… So again, early days, but we are optimistic…"

It remains to be seen whether these use cases will be incremental or transformative, and whether the economics work for customers enough to justify the level of capital investment being deployed by the large technology companies. We will be watching with interest.

Ben P, Chris E, Rob, Ben A, Phoebe and the Evenlode team

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Evenlode has developed a glossary to assist investors to better understand commonly used terms – please see https://evenlodeinvestment.com/funds/evenlode-global-income-fund#Documents

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[i] *Volatility - A statistical measure of the fluctuations of a value over time, expressed as a percentage. For funds or indices, higher volatility is an indication of higher risk.*

[ii] *31 July to 6 August.*

[iii] *31 July to 6 August 2024, B Acc GBP units in sterling.*

[iv] *Carry Trade - This is when someone borrows money at a low interest rate and then uses it to invest in an asset that will give them a higher return.*