Evenlode Global Income Investment View

February 2024 – Steady as she goes

EVENLODE
GLOBAL INCOME FUND

Market data is from FactSet and FE Analytics.

In last month's Global Income investment view, we indulged a bit of poetic license concerning the weather and the stock market. Would the stormy conditions that had broken out in the UK portend anything for the trading of company shares we wondered. In the out-turn, if the market did take anything from the increased wind speeds it was in the form of an updraft, famously led by large technology companies. Some of the growth figures are very impressive and the promise of artificial intelligence is becoming tangible with real life productivity tools such as Microsoft's Copilot being made widely available. Much capital is being invested into the effort to develop new tools and services, evidenced by chipmaker NVIDIA's meteoric revenue growth. How this capital is translated into new revenue streams and business models is one of the investment questions of the time, and how those tools affect society at large will likely shape the coming couple of decades. Much as in the early days of the internet the promise is great but the exact shape, benefits, and pitfalls alike, will only be known in the fullness of time.

In a global income portfolio, a non-yielder like NVIDIA is unlikely to feature. That said we do own a few relatively low yielding companies, like Microsoft, that have exposure to AI technology; either delivering tools for those that are building products or are incorporating these capabilities into products themselves. In the most recent corporate reporting season, the technology-driven portfolio companies demonstrated attractive revenue growth. While this growth was not at the explosive rate of the aforementioned chipmaker, the growth rates of these established technology companies have a good likelihood of persistence into the future. If revenue growth can be consistently delivered by a business achieving an attractive return on capital, whether in a technology and data-driven organisation like Wolters Kluwer or in different industries like LVMH in luxury goods, or SGS in testing, the virtuous circle of cash generation and re-investment can compound through time and deliver a steadily growing income stream, one of our core aims over the medium term.

Examining the most recent stock-take on corporate performance, with just over half of the portfolio having reported results for 2023, revenue growth is averaging 6%[i], margins are moving upward following a more challenged 2022, and dividend growth is around 7% so far. The dividend is backed by growing free cash flow after 2022 when companies battled supply chain issues and associated inflation. The sector most affected in the portfolio was consumer goods so it was good to see Nestlé's free cash flow increase by 57% and L'Oréal's by 24%. As ever there are exceptions and idiosyncrasies – LVMH's free cash flow declined as it invested in its hyper-prime retail real estate portfolio, probably a good long-term move given the nature of its luxury products. Relatively new portfolio holding Diageo reported half year results that showed the impact of a slowdown in the Latin America and Caribbean region, but a better-than-expected performance in its largest market of the US and an improving trend.

Elsewhere there was steady progress in revenues from health care firms like Sanofi and GSK in pharmaceuticals and EssilorLuxottica in eyewear. There is a small subset of companies that experienced a Covid-related boost to revenue that is now wearing off, most obviously those in medical testing. Quest Diagnostics and Sonic Healthcare have seen Covid testing revenues decline significantly, something that we all hoped would be a temporary situation. Their underlying 'base' testing businesses are growing at high single digit rates driven by population growth, changing demographics and an expanding awareness of the value of medical testing in clinical decision-making. Quest's Covid testing revenues fell -80% and now accounts for less than 2% of their sales. Perhaps a less obvious Covid 'winner' was bicycle components maker Shimano, which saw a spike in demand during Covid which is now returning to pre-pandemic growth rates. The company is very well resourced and is using its ample cash reserves to invest in future capacity, but we are keeping an eye on its margins in the shorter term. Event ticketing company CTS Eventim was certainly a Covid 'loser' in that ticket sales more or less halted for a couple of years. However, thanks to its strong balance sheet and some governmental assistance programmes it made it through in fine shape and is reaping the benefits now as people flock back to live events. The company has also just won an agreement to deliver the ticketing programme to the Los Angeles Olympics in 2028, outside of its traditional core European market.

So business is rarely 'business as usual', but these results have progressed more or less as we expected they would. Reported results look backward of course, but we do get a small glimpse of the future as part of deal, and Rob will now take us through some of his observations from results as they relate to the broader economy.

Emerging economic themes – Rob Strachan

While we do not make investment decisions reliant on macroeconomic forecasts, company results give on-the-ground insights into the global operating environment from their perspective. When aggregated, themes emerge that can inform us on the macro picture. In short, the picture is a bit fuzzy.

One recurrent theme from the results season has been signs of weakening economic confidence. This is not surprising, given the after-effects of the Covid pandemic, including 'proper' inflation and interest rate increases. These things tend to move through the economy with a lag. CH Robinson, a US trucking freight broker, has seen declining volumes and freight rates due to an excess capacity of truckers relative to goods demand and supply chains generally easing of late. Snap-on sells professional-grade tools to auto mechanics in the US. In Q4, sales to these mechanics declined -6% and shifted the mix to quicker pay-back items (though this helped profit margin), attributed to mechanics being confidence-poor even while cash-rich. Schindler, an elevator and escalator company in our investable universe but not currently in the portfolio, saw new installations decline globally due to rising building costs and the impact of higher rates on financing and demand. Despite these indicators, for the long-term we remain confident in the strength of their competitive advantages, cash generation and industry trajectory. We account for cyclical risks in our risk factor, max position frameworks and portfolio construction.

On the other hand, some signals from companies point to strength in the real economy. The consumer goods companies such as Unilever, Procter & Gamble and Nestlé, are starting to see volumes grow after a period of digestion of price increases in response to cost inflation. This is a positive indicator of their pricing power, and the value consumers see in their favoured brands. Inflation is easing, which helps reduce companies' costs such as transportation as already mentioned and raw commodities. We are pleased to see this benefit being healthily reinvested in brand and marketing investments, as reflected in the results of the marketing conglomerate, Publicis. For the full year, the food and beverage industry spent +19% more on Publicis' suite of marketing offerings. Microsoft is a behemoth and bellwether of corporate IT spending and continued to growth at a strong clip. This quarter was also the first when substantial AI revenue emerged. The cloud platform Azure grew +28% in the quarter, a fifth of which was from AI services. Even for Snap-on, while individual mechanics were feeling less confident (about a third of Snap-on's revenue), garage managers and business customers in other industries continued to buy more systems, diagnostics instruments and tools. These mixed signals from a narrow view of the vast macroeconomic picture indicate that it is difficult to make reliable predictions on where the wind will blow next for the global economy. We choose to manage this risk by focusing on the analysis of companies, choosing ones that can adapt in changing conditions while emerging stronger over time, and putting them together in a portfolio that is well insulated from gusts one way or another. For the portfolio those might come from changes in the operating environment, or from the market price reaction.

The market reaction

So, we have looked at some of the detail on corporate performance in the portfolio last year and implications for current and near-future trading. Bringing it back to the top, how has the action been in the market? Within the portfolio there has been a clear correlation between the revenue growth reported and recent share price moves. Those with slower or negative growth have seen muted or negative share price moves whereas the opposite is true for those posting stronger numbers. As noted above, we do expect all the businesses in the portfolio to grow their cash flows through time, even if there has been a near term reversal in revenue growth because of the fallout from Covid or some other reason. Thus, whilst the overall return of the fund has been positive through the year so far (albeit behind the global market), there is continued valuation appeal and thus a margin of safety to allow shareholder returns to compound through time. Some of the economic straws in the wind may just blow away, but if not that margin of safety may prove quite helpful.

Ben P, Ben A, Bethan, Chris, Rob and the Evenlode team

28 February 2024

[i] 55% of the portfolio by number and 54% by weight, median organic revenue growth.