

Market data is from Bloomberg, FactSet and FE Analytics.

We continue to watch the high wire spectacle of the US stock market with great interest and, as with all good live spectacles, it provides a mixture of wonder and jeopardy. There have been hints that the acrobatic feats of a certain AI-related chipmaker might be starting to wobble. As equity and income investors, we watch these market exploits through the cracks in our fingers as there are no safety nets in equity investing. Whilst the recent volatility is fascinating, we leave others to predict the outcome. Instead, we will focus on the performance of companies that we do or might own in the Evenlode Global Income portfolio.

Last month we discussed the rather grounded matter of dividend growth from the portfolio which, to recap, has settled into a high single digit rate year on year. This month we will take a closer look at the real-world drivers that support that dividend growth – revenues and cash flow.

Back to basics

Dividends can only be paid sustainably when a company generates sufficient excess cash flow after investing in the assets that will drive future profitability. That statement is universal, regardless of industry, and this ‘free cash flow’ⁱ is fundamental to our investment approach. That a large and publicly listed company might not generate excess cash from its operations might be surprising. But firms that generate a lot of revenue can be lossmaking, and even firms that are profitable can be so without generating free cash flow. Such companies may do work without getting paid for it – consistently running with a large balance of debtors who owe them for work already delivered. Alternatively, these companies may need to constantly refresh existing assets, like plant and machinery, or even develop digital assets like software without generating new revenue opportunities. These activities don’t reduce profit, as that stuff ends up on the company’s balance sheet, but they do suck up cash that might otherwise be used to pay a dividend.

Some reinvestment may be highly profitable in future, but all investments come with the risk of sacrificing earnings today for the promise of future returns. The companies we look for are in a sweet spot. They have the quality of product or service that keeps customers coming back for more, consistently generating revenues, and they use some of that to invest in the assets of the business – think of Louis Vuitton’s stock of handbags, Microsoft’s cloud operating software or OpenAI investment, or Nestlé’s research into the next generation of pet foods. Whether tangible or intangible, these investments are vital to the long-term attractiveness of a business’s offering to customers, and thus the long run viability of the franchise. Steadily investing, generating a return on that investment, and repeating year in year out provides the compounding effect we are seeking, with the dividend being a tangible output of this process.

We’re taking a little time to go back to the basics because their importance can sometimes seem lost in a time of much market noise, especially during phases of elevated stock market valuations and financial excitement. Now is one of those phases, with the imagination of the markets running hot. By contrast, steady compounding is continuing quietly within the Evenlode Global Income portfolio. There has been some volatility in the free cash generated by the portfolio in recent times because of



the supply chain challenges through and post Covid – Nestlé invested in its inventories to secure supply for example. However, none of this is particularly headline-grabbing and the types of businesses we seek have shown relative resilience to their cash flows.

To put some numbers on it, over the last five years free cash flow for the portfolio has grown at +5% per annum on a compound basisⁱⁱ. As this includes some persistent effects from the Covid crisis and the following inflation, we think that the sustainable growth rate of free cash flow should be above this figure going forward. How much higher is naturally unknown and will depend on the operating and economic environment. Looking at forecasts produced by analysts at research houses, the simple average free cash flow growth expected for the portfolio in 2024 is 9%, with the median being 10%ⁱⁱⁱ. Analyst's fortune-telling capabilities can sometimes be off, but this sort of rate does seem reasonable to us given what we hear from companies and is about the same as expected in aggregate for the MSCI World Index^{iv}. Being in line with the index for free cash flow growth might not sound like something to shout about, but given our assessment of low economic sensitivity for the portfolio, the risk to that figure for the fund is lessened.

There is also the question of how much one is paying for that cash flow. The free cash flow yield^v of the Evenlode Global Income portfolio is currently 4.8%, compared to 3.7% for the MSCI World Index^{vi}, so we are getting more cash flow for our buck than the broader market. In the fulness of time we expect compounding cash flows and dividends to drive capital returns. Starting from an undemanding price gives plenty of chance for the companies within the portfolio to deliver without having to justify a lofty valuation.

Global bargains

The fund currently has quite a different geographic balance to our comparator benchmark, and we are often asked about the importance of the listing country versus the geographies where companies generate their underlying revenues and cash flow. We believe the latter is of greater importance. A third of the portfolio is made up of US listed businesses, a large 'underweight' compared to the MSCI World Index for example. However, 47% of its underlying revenue comes from North America^{vii}, only a little lower than the figure for the benchmark. On this side of the Atlantic, 62% of the portfolio is listed in Europe including the UK, and this is where we see a majority of the valuation opportunity in our investable universe of businesses that meet our investment criteria.

Looking at the US listed businesses in the portfolio, they generate a majority of their revenues in the country – 69% of their revenues in fact, compared to 59% for the MSCI US Index^{viii}. We see relative value in domestically focused firms in what appears quite an expensive US equity market. These include business software and services company Paychex, medical testing laboratory operator Quest Diagnostics and tool maker Snap-on. These businesses are expected to grow cash flows but are reporting a mixed picture for the US domestic economy and business confidence. Some uncertainties can lead to attractive equity market valuations, as seems to have happened for this small group of companies. Other companies are multinational and whilst the North American market is big for them,



they sell a lot elsewhere – this includes the likes of Microsoft, Cisco and P&G. The prospect for free cash flow growth from US listed businesses in the portfolio is +10% this year.

European listed companies within the portfolio have more geographic balance to their underlying revenues, with about a third coming from each of North America and Europe, a fifth from the Asia Pacific region and the balance from Latin America, the Middle East and Africa. The average free cash flow growth expectation for companies listed in Europe including the UK is +9% this year.

So, the prospects for companies listed either side of the Atlantic within the portfolio is pretty similar, at least, where near term free cash flow growth is concerned. However, the same cannot be said for the relative valuation opportunities. Having the balance of that weighting toward European listings is what drives the portfolio's attractive valuation. For some reason companies listed in Europe are trading cheaper, and one reason might be the differing overall picture for corporate performance. The European market as measured by the MSCI Europe Index is not expected to grow its free cash flow this year, whilst the MSCI US Index indicates +12% growth^{ix}. Economic growth as measured by gross domestic product (GDP)^x was +0.5% in Europe in 2023, and +2.5% in the US. It's possible that all companies are being tarred with the same brush despite differing prospects and underlying businesses within the European equity market.

Another reason for a differing valuation landscape could be geopolitical. With snap elections in France and an increasingly vocal Eurosceptic voice to add to the ongoing war in Ukraine, the Old Continent is presenting some challenges. Combined with slower economic growth it's easy to be gloomy, but superior GDP growth, a corporate sector generating profit and cash flow growth and a buoyant stock market are no guarantees of voter satisfaction. Surveys in the US suggest a great deal of scepticism on American politics and federalism^{xi}. The presidential showdown, Biden vs Trump II, may keep us entertained for the remainder of 2024, although after the recent televised debate the odds on a change of White House occupant have significantly narrowed.

The combination of stock market, economic and geopolitical movements is enough to make one's head swim. That's a very good reason to bring things back to basics. The fund's portfolio of companies is generating the cash flow needed to sustain investment and grow dividend distributions. That growth is as good as the broader stock market and the portfolio is trading at a superior valuation. For us, that provides plenty of entertainment and the prospect of an attractive long-term outcome. We will leave the acrobatics to others and continue to watch with a cautious eye upwards.

Ben P, Chris E, Rob, Ben A 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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ⁱFree Cash Flow (FCF) - A measure of how much cash a company can generate over and above normal operating expenses and capital expenditure. The more FCF a company has, the more it can allocate to dividend payments and growth opportunities.

ⁱⁱ Source: Evenlode, company statements. Compound basis means that growth occurs on the original amount and previous growth. For example, £100 growing at 5% per year on a compound basis would turn into £127.63 at the end of 5 years ($£100 * 1.05 * 1.05 * 1.05 * 1.05 * 1.05$).

ⁱⁱⁱ Source: Visible Alpha, Evenlode. Simple average (or mean) is calculated by adding all the numbers in a data set together and dividing by the number of values. The median is the middle value when a data set is ordered from smallest to largest.

^{iv} Source: FactSet

^v The Free Cash Flow Yield is the total free cash flow generated by a portfolio or index, divided by the market value of the companies in the portfolio or index.

^{vi} Source: FactSet, Evenlode.

^{vii} Source: FactSet, Evenlode.

^{viii} Source: FactSet.

^{ix} Source: FactSet.

^x Gross Domestic Product (GDP) is a measure of the value added created through the production of goods and services in a country during a certain period. GDP is used to measure the economic health of a country.

^{xi} See for example: <https://www.pewresearch.org/politics/2023/09/19/views-of-the-u-s-political-system-the-federal-government-and-federal-state-relations/>

