

The commentary below applies to the TB Evenlode Global Income portfolio. Market data is from FactSet and FE Analytics.

When we penned our review of 2022, we noted that much of the significant market action had been in sectors that we don't have direct exposure to. The energy sector was the clear standout performer of the year, benefiting from high prices following Russia's invasion of Ukraine. The finance sector also rose as interest rates increased from nothing to something. The absence of these sectors from the portfolio that we select on behalf of our clients is a deliberate choice. The Evenlode approach requires certain business characteristics, most notably high returns on capital and consistent free cash generation. Energy firms and banks are each, in their own way, capital intensive businesses and do not naturally fit with our investment style.

Financial events now make the front-page headlines and while the fund has no direct exposure to banks, that doesn't make the news around Silicon Valley Bank, Credit Suisse, central bank intervention and interest rate decisions irrelevant. If economic demand falls as a result of a contraction in credit, then we should expect a knock-on effect on revenues across many sectors. This could amplify the demand softening that was already an emerging theme from corporate updates. That said, we don't select businesses according to how we think they or the global economy is going to fare this year, but over many years, and invest when market prices look sensible.

Consumer goods is a core sector where we find attractive returns on capital and a steady long-term outlook, despite some interesting (and surprisingly volatile) dynamics through the pandemic years. Here we'll take a closer look at the 'fast-moving' consumer goods (FMCG) segment of the portfolio, companies that produce the day-to-day items that we all buy as a matter of routine. At the time of writing these make up 28% of the portfolio, so is an important part of our investment landscape.

The fast-moving consumer goods business – a brief recent history

Many of the companies in the portfolio might be household names in their own right – Nestlé, L'Oréal, Unilever and Procter & Gamble – and they create products under brand names that are certainly well known to billions of people. These span a full range of sub-sectors and categories such as food, health, hygiene, home care and personal care, and include a range of both essentials and 'little luxury' products, such as Head & Shoulders (from P&G), Magnum (Unilever), Strepsils (Reckitt), Doritos (PepsiCo) and Burt's Bees (Clorox).

The last decade for the sector has been one of deconsolidation. Having been built up both organically (i.e. growing the brands they already own) and by acquiring other brands ('inorganic' activity in the lingo), most of the multinational FMCG conglomerates have been taking stock and re-focusing their businesses. Back in 2015, Procter & Gamble announced that they were disposing of a long tail of brands in their beauty portfolio to focus on their ten core categories from the 16 they previously addressed, and from 170 brands down to 65. In 2017 Unilever decided to divest its slow-growing spreads business that sold margarine and the like, and in 2022 completed the disposal of its tea business, which was subsequently rebranded Ekaterina. Some of the disposals have been of businesses



that don't have obvious supermarket positioning – in 2015 Reckitt spun off Indivior which makes Suboxone, an opioid dependence treatment.

Each company has its own reasons for evolving the portfolio of brands but there are common themes. Coalescing around brands in a category has benefits of scale, particularly when it comes to getting products onto the shelves (including the virtual sort), and marketing expertise. There are benefits to procurement and manufacturing, although manufacture tends to be localised within geographies. Geographic focus helps to bring local knowledge to the product offering; consumers are similar but different all around the world. Nestlé produces a matcha flavoured Kit Kat for the Japanese market, a very popular taste locally but one that seems to be like Unilever's Marmite to Western audiences. That's perhaps a simplistic example but the combination of different tastes, preferred shopping channels, variant structures of distribution networks and consolidation or otherwise of retailers makes regional and local knowledge helpful.

FMCG companies have above all been focusing around their categories and brands that are growing. This leads to better economics in the long run, but disposing of lower growth areas is a drag on overall revenue growth in the short term. 'Shrinking to grow' has been experienced by most of the multinational FMCG companies at some point in their recent history and will in all likelihood recur periodically in the future. This form of corporate reinvention is nothing new; no business that has stood the test of many decades, even centuries, is doing exactly the same thing that it did 20, 50 or 100 years ago. Those that refused to change no longer exist – all companies must roll with the times. Therefore, we're not averse to such corporate activity, as long as the companies in question continue to invest behind their brands in the form of marketing and product innovation. Nestlé is a prime example of where this can go right. It used its resources as the world's largest food producer to invest in new areas and now has the growth engines of pet food and coffee, developed over many years but now bearing fruit. The scale and diversification of global FMCG firms affords the years of development necessary to develop products and categories.

Of course, even well-run businesses experience challenges, and this brings us on to another important point – competition. Nestlé and Unilever are competing multinationals but must also fend off smaller regional players in their respective categories. The multinational's heft in marketing and distribution of products is a big help, but not a guarantee of success. The value proposition to customers must stack up, and that means product quality must be upheld across price points. New innovations in the market must be addressed and subsumed into the firm's products and business model. For example, the cosmetics colossus L'Oréal is seeing growth in its 'active cosmetics' business, essentially new skincare products where the health benefits are as important as the beauty element. It is additionally growing through ecommerce-based sales channels which continue to rise in importance to consumers.

Consumer goods – the equity opportunity

Bringing the story right up to date, the FMCG industry has, like all businesses and individuals, been absorbing the impact of inflation. Without dwelling on the causes of inflation, it has been an



incontrovertible fact of life over the last eighteen months. Consumer products companies have seen costs rise in many of their key inputs, particularly raw materials, energy, packaging and transportation. This has meant that profit margins have been in focus, and indeed these declined in 2022. Some of the cash generated by the sector was used to secure the supply and price of inputs, and the free cash flow for the FMCG companies in the portfolio fell by -9% on average in the yearⁱ.

Given the significant increase in costs for these businesses in percentage terms this represents a resilient performance. The result was helped by the high margins that the FMCG companies command and their ability to pass the impact through to their customers. The average revenue growth for our cohort of FMCG firms was +9.8% in 2022, which was mainly driven by price increases, helping to mitigate the impact on margins. We don't know whether inflation will continue at a high level or not, but companies are reporting an easing of the input cost and supply pressures of last year which is encouraging. If inflation does persist, companies will have to raise prices to consumers over time but probably at a lower rate if demand does fall as noted above.

Over time, we believe that resilient operational performance should translate into positive shareholder returns. Indeed, this has been the case and interestingly the consumer staples sector is the only sector that has delivered positive returns for the portfolio in every calendar year since its launch in 2017ⁱⁱ.

Of course, a calendar year is a somewhat arbitrary time period and there is no clear reason why outperformance should fit this steady pattern. We are also aware of the risk that this outperformance could leave the market valuations of these companies inflated. However, there are a couple of indicators which suggest the valuation of these businesses still stacks up and continue to warrant the largest sector allocation in the portfolio. Despite being the only sector to post consistent positive performance for the funds, the fund's holdings in the sector have underperformed the wider market (as measured by the constituents of the MSCI World Index) in three of the past five calendar years, materially so in 2021. So, from a backward looking perspective relative to the market, this indicates that valuations for our holdings in the sector might still look reasonable.

What matters though is not what's happened in the past, but what might occur in the future. On a forward-looking basis we value all companies in our investable universe. Whilst not an exact science, the exercise indicates the relative valuation appeal of a business compared to other options and gives us a sense of the overall valuation environment. The FMCG companies in the portfolio are all trading within the 'fair value' range or better, and at more attractive valuations than our overall investable universe average. This makes no guarantees about the future but does at least indicate that current market levels more than adequately reflect the risks and opportunities that our portfolio of FMCG companies face.

The companies are backing themselves. The average dividend increase from our cohort was 9.1% year on year. That appears quite a statement in the face of 2022's overall cash flow declines, but it is one that is backed up by their demonstrated resilience in the recent and not-so-recent past. Cash flows



Evenlode Global Income Investment View

March 2023 – Consumer goods (or, some of the notes we do play)



should naturally recover, in the absence of an unlikely event that requires further material investment in inventories.

‘Steady performance driven by resilience to risks available at sensible valuations’ is a short summary of how we see the fast-moving consumer goods sector. In our opinion, that’s worthy of retaining the sector as a core part of our clients’ portfolio.

Ben, Chris E., Bethan, Rob and the Evenlode team

29 March 2023

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Source: Evenlode Investment Management Limited. Evenlode Investment Management Limited is authorised and regulated by the Financial Conduct Authority, No. 767844.

ⁱSource: Company results, Evenlode Investment. FMCG companies that reported full year results for 2022 were Henkel, L’Oréal, Nestlé, PepsiCo, Reckitt and Unilever.

ⁱⁱSource: FactSet.

