Evenlode Global Income Investment View

March 2024 – Dinner conversations

Market data is from FactSet and FE Analytics.

At an investment conference dinner last week, I was chatting to my neighbours on the table and the conversation inevitably turned to the state of the global stock market, the tone of the discussion being set by the market's make up and its recent performance. The global market is increasingly a US-centric one, with 71% of the benchmark MSCI World Index being made up of companies listed in the States in dollar terms at the end of February. Within this, technology companies dominate, with Microsoft at the top of the chart making up 4.6% of the index at a market capitalisation of $2.9 trillion. In close second is Apple at $2.8 trillion, and third spot is held by artificial intelligence chipmaker NVIDIA at $1.9 trillion.

To underscore the heft of those at the top of the market capitalisation charts, in less than a month since MSCI inked their February factsheet, NVIDIA has added about $400 billon of market value, so now stands at $2.3 trillion in market capitalisation. Setting that value in context, there are around 1,500 companies in the MSCI World Index, of which only sixteen are worth more than $400 billion. This move, amongst others, has helped the market to quite a run, the MSCI World Index is up by +27% in sterling and +34% in dollars since the end of 2022 at the time of writing. The question around the dinner table was, of course, can this strong run continue?

As an active fund manager managing a global portfolio, to me this question is naturally not just idle chit chat over a nice meal. Although at Evenlode we manage portfolios that are not benchmarked to an index in terms of the companies that we can choose to invest in on our clients' behalf, the performance of the portfolios that we run is set in the context that was being discussed over dinner. Over the period since the end of 2022 the Evenlode Global Income fund has returned +12% in sterling, positive and steady performance but rather more modest than the broad market. So, I along with the Evenlode team using our investment process, need to consider what this means for future returns, both on the upside and managing downside risks.

Some of the greatest downside risks in equity investing come from investing during periods of mania where the value of shares becomes vastly overblown and detached from the earning power of the company in question. The history of the stock market has seen such episodes and, given the nature of the companies driving the market at the current time, the late 1990s 'dotcom' bubble has been mentioned on more than one occasion in the press as a comparator. However, the mere fact that some companies in a certain sector have gone up a lot in value, or happen to be very big, does not necessarily mean that we are in a bubble scenario. We have a position in Microsoft, a company that has enjoyed handsome returns of late and has a vast market value. At 4.3% of the Evenlode Global Income portfolio at the time of writing, this is a marginal 'underweight' to the company's position in the MSCI World Index, but a large position nonetheless. In our estimation the valuation of the company is acceptable given its prospects, but less of an opportunity than it was following the company's share price decline in 2022 which is why we have reduced the position from about 6% of the portfolio at its peak. So, a less attractive valuation than it has been, but in a bubble? Not in our estimation.

We have had other strong performers in the world of information technology, data and communications within the portfolio. Much as with Microsoft, the valuations of companies like RELX, Wolters Kluwer and Publicis still look fine but now present less opportunity and so we have been reducing those positions as well. This is part of our risk management framework, which looks at both corporate fundamentals such as the returns on capital and market positions that a company possesses, and the valuations at which those companies trade on the stock market.

We value companies based on a long-term projection of the cash flows they might generate and use that as the basis of our decision making. However, a simple way of looking at the picture is to examine how the price/earnings (P/E) multiple that a company is trading at has evolved over time. All other things equal, a higher P/E multiple means a more expensive company. The five companies that saw their P/E multiple increase the most over the year to end-February enjoyed an expansion of 6 'turns'. Whilst these are great businesses in our view, their earnings potential has not expanded that much, hence our reduction in their position sizes.

We also hold companies that have not enjoyed the same positivity from the market. Each company has its own story to tell, but the five most negative P/E contractions averaged a fall of 2 P/E 'turns'. There has been generally muted performance from consumer goods and healthcare firms in the market, despite being expected to grow revenue and profitability as they did generally last year, explaining the contraction in the P/E multiple.

That's not to say there are no negatives to consider. Consumer goods and healthcare company Reckitt is a case in point, in March suffering from a severe sell off as fears around US litigation involving its infant nutrition business Mead Johnson gathered pace. We are happy to discuss the details with interested readers, but in sum we think the lost market value far outweighs the likely value to settle the cases. Such situations are very much the exception rather than the rule in the portfolio though; as we noted last month revenue, profit, cash flow and dividend growth has progressed as expected as companies reported their results for 2023 and laid out their expectations for 2024. Bringing it back to generalities there are areas of the portfolio where valuations are looking more attractive despite the general rise in the market.

Putting it another way, there are some areas of the Evenlode Global Income portfolio that have performed well in the market, and that performance mirrors some of the broader upward market momentum. Those companies remain in the portfolio because the valuations remain acceptable in absolute terms, but at smaller position sizes reflecting the lessened valuation appeal. Should they move significantly further upward, the risks would start to outweigh the potential returns on offer and more meaningful reductions in position sizes would result.

We cannot speak for the whole market as we have not analysed every company in the same level of detail as those that make it into the Evenlode portfolios. But it's probably fair to say that the statement above applies at a broader level – in our view the market is not in a bubble and valuations are not crazy, but we should be mindful of further moves upward. Any such move could come from those areas of the market that look better value, like those that we see in the Evenlode Global Income portfolio. In that case the broad set of market valuations may remain acceptable in risk/reward terms. If the returns come from piling more value on those companies that have already seen their valuations increase significantly then the balance may tip the other way at the market headline level.

Considering again the MSCI World Index return of +27% since the end of 2022 (sterling terms), the context for that was a weak market seen during the calendar year of 2022. The market is now at all-time highs but has had to make up some lost ground before getting there. There is always detail behind the market headlines, and whatever the further moves from here, they are likely to keep us discussing those details over dinner and elsewhere for some time to come.

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

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