

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

At Evenlode, we view equity investments as fractional stakes in real businesses and believe it is the long-term fundamentals of these businesses that drives the fund performance. Often these businesses churn out decent results, sometimes a bit better, sometimes a bit worse, but their internal fundamental characteristics rarely change too quickly. They continue to invest sensibly, produce products that make a difference for their customers and operate with efficiency. However, sometimes the external environment in which they operate can change, and this can be rapid. Economies can descend into recession, supply chains can lock up, and market specific shocks can cause management unimagined headaches. Equally, sometimes these effects can be positive! Just as no man is an island, no business can operate without careful consideration of its environment.

Having spent our last few investment views looking at company-specifics, here we'll zoom out a bit first and discuss what the 'investment environment' means. It's a big topic, one that will mean different things to different people. Are we talking about the operating environment for companies? The situation with interest rates? Banking collapses? Inflation? Equity market prices? Bond yield curves? Where are the borders of the investment environment? Can we divide a global economy up into geographic segments when trade is interconnected?

The almost abstract nature of some of these questions is immediately intimidating and we are first to admit that we are not macro sages. Recognising this, we don't make investments dependent on explicit macro predictions. However, by selecting a company we are making at least an implicit prediction that we think this company is going to prosper in the long term. If a company's revenue, profit or cash flow deteriorates in a year, is that ok, or is it a sign that a company no longer fits our criteria?

Should this happen, we need to consider the corporate and economic backdrop to assess the company's performance and reassess its prospects. This continued reassessment through time is very important and requires a solid set of business fundamentals as the basis on which to make the assessment. We examine these fundamentals by grading several risk factors for each company, and also reflect them in the valuation model we use for the business which represents the other key part of our investment approach. In the process we don't want to be dissuaded from investing in a good business by any old small piece of negative news, but equally we want to be alive to changes that happen through time and act accordingly. We're aiming to strike a balance.

Reflecting new information – some examples

An example or two might help illustrate this balance from the Evenlode Global Income portfolio. Here are two recent transactions from the portfolio - first is a situation where we owned the company and then sold it, and the second where we did not own the company and subsequently bought it.

We disposed of online marketplace eBay early in 2023. Overall, we achieved positive total returns during our period of ownership. We initially purchased the company in November 2019 after its share price had declined somewhat, and the stock subsequently performed well as online ecommerce platforms benefitted from enforced at-home purchasing of goods thanks to the covid-19 pandemic.



That initial market enthusiasm eventually waned though, as vaccination programmes were rolled out globally and brick and mortar stores reopened. Our valuation discipline led us to reduce the position size as the share price increased, protecting us from some of the ensuing decline. Ultimately though, we sold the small holding we retained as we had carried out a fundamental review of the ecommerce market and eBay's position within it.

The previous paragraph is a summary of the portfolio activity and outcomes from one company that was analysed over a long period of time. There is a lot in there. Where our assessment of eBay is concerned the investment environment consisted of, amongst other things:

- The onset of a global pandemic changing its user base's behaviour due to lockdown restrictions.
- Fiscal and monetary response to the pandemic, changing its user base's purchasing power.
- The development of a covid-19 vaccine changing these responses.
- Its own corporate activity, selling business units and developing new ones, eg in payments.
- The development of competitor businesses and business strategies, including niche trading platforms.
- The market price reaction to all of this.

Each of these elements is simply stated, but complex under the bonnet. We distilled them into our risk factors. For example, did the move to online retail forced by lockdown restrictions change eBay's competitive advantage? This is a question relevant to our 'Moat Strength' risk score, and our judgement was that while lockdowns presented a benefit to eBay's revenue, it didn't fundamentally alter its competitive position within online retail. However, a reassessment of the online retail market as a whole did make us change the Moat Strength risk score, which looked through temporary changes to consumer behaviour and asked more fundamental questions about where people might go to shop if they wanted cheap prices or something specific like trainers or handmade goods.

Before that reassessment, the valuation part of our process meant we reacted to eBay's climbing share price in the pandemic, selling the holding down materially (albeit not fully). In terms of the investment environment, our assessment of the valuation of a business interacts most frequently with the market value of the business. The market value is, needless to say, prone to change and sometimes quite rapidly. Our own valuation model changes relatively infrequently, but we may alter it if our assessment of the risks and opportunities presented to the company changes.

The second example, where we did not own the company and purchased it, is the addition of US banking software company Jack Henry to the portfolio in March. The company sells core banking systems to a large number of banking-related institutions in the US. The collapse of Silicon Valley Bank and others earlier this year led, understandably, to market concerns around the demand that there might be for Jack Henry's products. If the longer-term demand is dented, then maybe the market price decline is warranted, if not it's just got cheaper. To help assess the balance of probability to one end or the other of this spectrum of outcomes we spoke to experts in the industry, including the ex-CEO. The conclusion was that the difficulties in the banking sector are unlikely to lead to a change in the long-term demand profile driven by digitisation of banking and need for additional capabilities to manage risk. Balance sheet risk management could be higher up the agenda for banks given the



financial difficulties experienced by some institutions. Mitigation of potential revenue risk for Jack Henry includes a very variable cost base. On the other hand, the company focuses solely on one geography, the US, something reflected in the ‘Diversification’ risk score and therefore the company’s maximum portfolio position size.

So, for Jack Henry, the investment environment is specific to one geography, and one industry, indirectly linked to macroeconomic factors such as interest rates, and a general trend towards digitisation of operations and services, amongst other things.

The current investment environment

The examples of eBay and Jack Henry show that the considerations needed for each business around the investment environment backdrop can vary widely. Even if we are not making forecasts, it is important that we understand the relevant backdrop as far as necessary to make these balanced judgments and reflect ever-present uncertainties and opportunities in our risk scoring and position sizing.

We can learn much from companies themselves and draw some themes on the investment environment as well as digesting and cross-checking broader news flow and our company-specific questions such as those we asked in the above examples. Some of these themes include:

- Supply chain challenges easing, and in some cases starting to feed through to improved cash flow. An improving cost environment is being hinted at.
- Consumer demand proving more robust than expected.
- Continued investment in digital products and services.
- Healthcare spending normalising post-covid, particularly in testing.

We can use these observations and more to assess coming company results, and those will in turn set the context for the next. Linking company-specifics with the broader investment environment to separate out what is structural and what might be temporary is what we’re aiming to do. For example, last year the free cash flow generated by the portfolio dropped a little as supply chain challenges were grappled with; our assessment was that this was challenging but not permanent for the portfolio, and most importantly manageable due to the financial and competitive qualities of the businesses in question. We are looking particularly for signs of these effects on things like pricing of products, working capital cycles and balance sheet strength. We remain open to assimilating new information as we receive it into our assessment of risk and opportunity for individual companies and evolving our own view accordingly through time.

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

24 May 2023



Evenlode Global Income Investment View

May 2023 – The investment environment



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