Evenlode Global Income Investment View

May 2024 –Zooming out

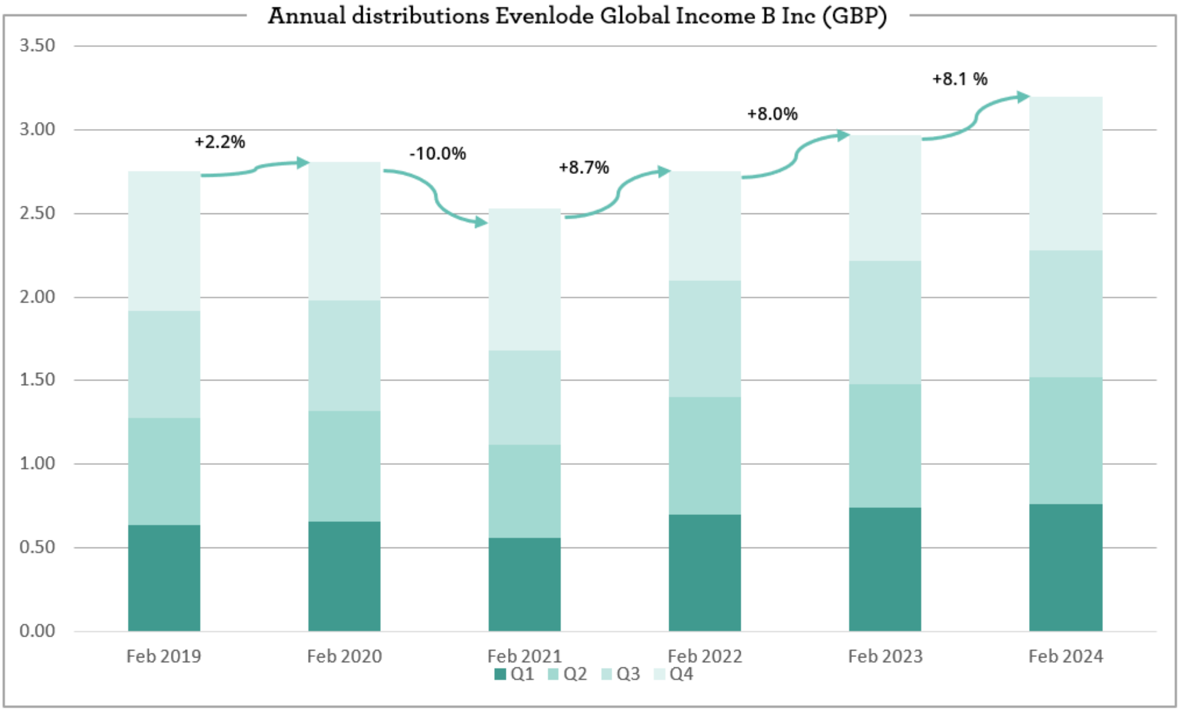
Market data is from Bloomberg, FactSet and FE Analytics.

The Evenlode Global Income fund unit price reached an all-time high in sterling terms over the last month, a fact that should come around reasonably regularly as we look to deliver positive returns from the equities in which we invest our clients' capital. The returns have been steady - at that recent high point the fund had returned 73.3%[i] including reinvested dividends since its inception in November 2017.

Being invested in equities does of course come with the risk of market volatility, so it's not certain in advance when those highs will come, and indeed when the inevitable lows will arise too. Whilst we fully expect positive returns in the fulness of time, we always have an eye on the downside as well. We also compare our results to other benchmarks and in the context of the global stock market the fund's recent performance has lagged. The comparator benchmark MSCI World Index has very nearly doubled in sterling terms over the same time period, with the fund and benchmark performance diverging particularly over the course of the last year. Technology and financial companies have been particularly strong in the market, as well as some businesses at the more discretionary end of the consumer landscape such as certain auto manufacturers and retailers. Whilst the fund's performance has benefitted from some of that strength from software and data-related companies in particular, it has not enjoyed its full force. Partly that is because, on the flip side, Consumer Staples and Health Care companies in the fund have been relatively soft in their market performance. Generally speaking, we expect that our approach to equity investing will see relatively better performance (i.e. compared to the benchmark index) in more challenged markets and see less relative upside in strong market conditions. This is what we have experienced over longer time periods, and this 'low beta'[ii] characteristic has been particularly marked with the strong upward momentum in the market over the last year.

Performance comparison like this is helpful to understand why performance differs from a benchmark, but as we manage a portfolio that does not need to look like the benchmark it's also helpful to take a step back, zoom out, and consider what it is we are trying to achieve with the fund. For all of the portfolios we manage at Evenlode Investment the idea is that companies that can grow their cash flows through time can reinvest in themselves to generate further returns. They can also use that cash flow to pay a growing dividend distribution to shareholders, particularly important for our Income strategies (the Evenlode Global Equity strategy does not mind dividends but has a greater proportion of lower-yielding companies). It is the steady nature of cash generation that we seek that leads us to think that the strategy will have the performance profile noted above.

The following chart shows how the dividend outcome has progressed for the Evenlode Global Income fund over time in sterling terms. We had just got going with year-on-year comparisons when the coronavirus pandemic hit. There was a reduction in dividends temporarily, although in the out-turn this was more like a phasing of distributions whilst companies dealt with the uncertainties of the time and since then things have progressed as we would expect. We think that the sorts of companies we seek should be able to grow their free cash flows[iii] in the mid-to-high single digits annually in percentage terms. If done sustainably that will feed through to similar dividend growth providing there is enough cash flow cover to cope with any operational challenges that come along. We have seen this in the last couple of years with supply chain disruptions and input cost inflation; despite these challenges the growth in dividend flows to the fund has settled into a high single digit pace. We currently expect similar growth this year and barring some very challenging event like another pandemic coming along we think this is the sort of growth that can be achieved over longer time periods.



As an indicator of resilience, the free cash flow being generated by portfolio companies is more than double the underlying 2.1% historic yield[iv] and 2.4% 'running' yield (i.e. the yield based on announced and expected dividend increases this financial year). That cash flow provides a cushion if economic challenges return, but also scope for faster dividend growth if conditions are more benign. Our assessment that the portfolio is less sensitive to the economic cycle than the overall market provides some further solidity.

With no change in the valuation environment, total returns will tend toward the dividend growth plus the yield clipped each year. The valuation environment has, however, changed for the market. With the global stock market moving up as it has been, driven by the US, multiples have expanded, dividend yields overall commensurately declined, and the 'dividend growth plus yield' equation has had a tailwind – in October the MSCI World Index yielded 2.1%, and it currently stands at 1.7%[v]. Earnings and dividends have been growing in the overall market, but market prices have been growing faster. The same cannot be said overall for the Evenlode Global Income portfolio – the yield has not moved materially since October leaving returns to be driven by the fundamentals of dividend growth rather than a valuation uplift.

There are lots of exciting things to talk about in the market like artificial intelligence (AI), and weighty challenges like the energy transition, geopolitical rivalries and global peace. Certainly, some companies are growing very fast thanks to a capital expenditure boom from deep-pocketed technology companies looking to gain a strategic foothold in AI. Valuation shifts matter in the short term and over the last year this effect has been layered on top of the rapid earnings growth for semiconductor companies in particular. In the longer run a more sober equation driven by sustainable growth drives returns, maybe less exciting but ultimately as, if not more, powerful than near term market forces. We don't mind valuation uplifts when they are driven by fundamentals, or when they take companies that are trading cheaply more toward their true value. Our valuation discipline looks to capture some of that positive effect should it occur, and we have arguably seen this happening for some companies. But it is also about managing the downside risks of the opposite happening, where growth is insufficient to justify valuations. If we can manage both the opportunity and the risk presented by the market, the fundamentals of cash flow and dividend growth can ultimately do their work.

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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i IFSL Evenlode Global Income B Acc shares – 20 November 2017 to 23 May 2024. High point reached on 15 May 2024.

ii Beta is a measure of how much a portfolio moves relative to its benchmark over time. A portfolio with a beta of 1 moves with the market on average over time. A portfolio with a beta of less than one will experience less movement in either direction when the market moves and a portfolio with a beta of more than one will experience more movement. The beta of the Evenlode Global Income fund is currently about 0.6 (source: Bloomberg, Evenlode, based on last 3 years).

iii Free 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.

iv Historic yield - A measure of how much income a fund has historically paid out to investors and calculated as total dividends paid out over the last 12 months, expressed as a percentage of the latest share price.

v Source: FactSet.