Evenlode Global Income Investment View

September 2024 – Olympic legacy

Market data is from S&P Capital IQ and FE Analytics.

For the intro to this month's investment view, we could have more or less cut and paste from August's missive as a scene-setter describing recent stock market action. The beginning of the month saw another downward move, albeit less severe than the early-August drama. This was, as last month, followed by a recovery and at the time of writing the US stock market has reached another all-time high in dollar terms. The US market has not reached those levels when measured in other currencies though as the dollar has weakened further in the run up to the much-anticipated interest rate cut from the Federal Reserve. Less anticipated was a stimulatory package announced by the People's Bank of China (PBOC) intended to revive the economy, where consumer confidence is low and the stock market has, in stark contrast to the US, been languishing. The stimulus included 'innovations' including funding for Chinese companies to buy back their own shares. Western companies with exposure to the Chinese consumer such as luxury goods leader LVMH saw their stock prices rise following the announcement, but it will take time to see whether any permanent improvement in the economic situation results. Much hinges on the property sector in the country which was directly a beneficiary of the package of measures and provides a big part of the wealth effect that helps consumer spending along. There is some exposure directly to the Chinese consumer story in the Evenlode Global Income portfolio through LVMH and L'Oréal for example, and despite a rise on the news from the PBOC, their share prices remain subdued. For those with patience, including us, this represents a longer-term opportunity to own these enviable franchises at attractive valuations, and we have been adding to the positions through this year.

The fund's performance continues to run counter to Mr Market's fickle short-term changes of mood; once more in the most recent period of weakness the fund held up well and was quiescent as the market got back to the races. The fact that the fund's performance is different to the broader equity market is unsurprising – it's make-up is quite different by design. However, the degree to which the portfolio's market performance is different to the market itself is unusually high, measurable through terms such as the portfolio's 'beta'[i]. This is more an observation than some deep insight, but it is reflective of the fact that we position the portfolio in more attractively valued areas of our investable universe. Those seem largely to be parts of the market that are not so excitable at the moment, as we have noted in recent missives[ii], with the odd exception such as LVMH. If things are operationally progressing ok at those businesses (as they seem to be on the whole), and the valuations make sense (which they do), then we have no trouble with limited market drama.

At any business there is always something to talk about though, and companies and the markets they operate in always evolve through time. A sector that we have been analysing exemplifies this – sporting goods. Ben Armitage has been taking inspiration from the Olympics and Paralympics to distil our thoughts from our work on an area of consumer goods that has had to balance on the narrow bar between performance and fashion.

Sports – Where performance, fashion, technology and marketing collaborate and compete

Despite a sprinkling of controversy (has Macron had his dip in the Seine yet?) the Olympic and Paralympic games were, as ever, a great success and a true spectacle of human endeavour. It's hard to overstate the elite level at which Olympic athletes operate, and all too easy to become a temporary expert in sports on which we have no right to judge. Criticising a gymnast for an errant foot after landing a double backflip with half twist is easy work from the comfort of the couch.

In our day jobs here at Evenlode we do need to judge the performance of companies, and sometimes we can see their activities near the centre of the action. Many of our portfolio companies were involved in sponsorship or partnership with the Olympics/Paralympics including P&G, Sanofi, Cisco and LVMH; Louis Vuitton was on show in every medal presentation. The cost and benefit of these sponsorships may be revealed to us in financial statements over the coming months and years, although the causality between any one piece of promotion by a company and its subsequent sales success (or otherwise) is difficult to isolate. Still more companies were more or less visible at the Olympics via manufacturing the high-performance clothing worn by some of the athletes such as Nike and Adidas, or in the case of portfolio company Shimano, by manufacturing high quality components used by Olympic cyclists.

Adidas and Nike both have strong intangible assets in the form of world-famous brands. Until the 2010's, when it came to fitting out both professional and aspiring athletes, they were the only real runners in a two-horse race. However, they have had a tumultuous time in performance terms in more recent years. Although the specific reasons in each case are not the same, we can take lessons to keep in mind when considering any consumer discretionary companies in the future. Excluding a few pockets of positivity, the consumer discretionary sector, including luxury goods, has been trending downwards recently as global demand has been suppressed owing to consumer concerns over tightening disposable income. Added into that mix, as noted above, China has been weak thanks to general low confidence of the consumer amplified by President Xi's regime being notoriously cautious over western influence, including that of strong brands. Simultaneously, the Chinese economy has been limping, a situation kickstarted by the Evergrande property company saga and fuelled by persistent real estate woes ever since. China represents 15% of revenue for both Nike and Adidas and was until recently seen as a strong growth driver for both.

We initiated a position in Adidas in early 2022, after which a trifecta of bad news in quick succession led to considerable stock volatility[iii]. In addition to the emerging issues in China, supply chain challenges hit the sector and for Adidas a lucrative collaboration with Kanye West was quickly jettisoned as he made a series of controversial public statements. Changes in management and strategy promptly followed. We engaged with the company several times as the saga unfolded and this helped us to stay with the stock through the most difficult time. Once relative stability had resumed and the share price recovered, we exited the position having had limited impact on the portfolio but also having learned a lot.

Nike, on the other hand, has not featured in the portfolio. They were, however, in our investable universe and, on valuation grounds, on our watchlist as potential new entrants to the portfolio throughout 2024. The share price began a steady descent in early 2023. A particularly pronounced decline on the release of their disappointing annual results in mid-2024 led us to dig a little deeper before making an investment decision. Nike have experienced the same consumer caution and supply chain issues as their peers. However, they also made some missteps which have, in our estimation, weakened their position at the top of the sportswear podium.

Since the inception of the brand in 1971, Nike have thrived on being the big name in sportswear, built from a base of running expertise and innovation in sports footwear, where most of their revenue is generated. Over time, that was strengthened by athlete sponsorship and savvy marketing, as well as expansion into the world of 'athleisure' and fashion. This latter element of the business ticked up to a point where today we estimate that 50% of revenue generated by the company comes from people buying the brand for fashion rather than for sport. Simultaneously, innovation for the everyday runner seemed to falter. Whilst many top athletes still wear Nike footwear, the shoes they wear tend to retail in excess of £200. For the casual, the entry level c.£70 Nike Pegasus running shoe has barely changed over seven years. Meanwhile, challenger brands like On and Hoka in running, and Crocs and Birkenstock in leisure, have filled the gap with innovative and/or more comfortable alternatives and made material gains in market share, particularly among younger demographics.

Distribution of products is critical to a global sportswear company, getting to the end touch point with customers and is an area where Nike perhaps over-innovated. The last five years saw Nike reduce focus on wholesale distribution, favouring direct-to-consumer digital channels. On the face of it, that makes sense since Nike can then capture a greater share of the economics of selling their own products, built on the fact that they are the biggest sportswear brand out there. However, they did it by cutting what they term 'non-differentiated retail', which in plain English means smaller speciality sports stores. The issue is that those are the places where running enthusiasts go for advice, gait analysis and to try on new products. Nike left a space where challenger brands were happy to land and expand, meaning that now, according to some estimates, Nike have essentially zero share in speciality running. For us, the challenge from being both a scale fashion brand and an innovative sports company seem to have led to a misfiring on both sides of the business. They may well be surmountable, but on the balance of probability we removed them from our watchlist until such time as we can see a demonstrable stabilisation in sportswear performance.

Despite the challenges, sports are a potentially attractive growth market globally. Our final sporting case study comes in the form of portfolio company Shimano. They manufacture cycling components which make up the lion's share of their revenue (80%) with a sideline in fishing tackle making up the remainder. Angling was an Olympic event at the 1900 Games for the only time, but it is still a popular pastime globally. On the other hand, cycling has become incredibly popular at the Olympics. At the Paris Olympics 2024, there were 22 cycling events featuring 512 athletes, and it's fair to assume that many of the bikes belonging to them will have been equipped with Shimano components. For context, Shimano equips 15 of the 18 World Tour men's cycling teams and 7 of the 15 women's teams. The rest are equipped mainly by Shimano's nearest rival, the US-based, privately owned SRAM in what is effectively another two-horse race.

We entered a position in Shimano in early 2023, with it having been in our investable universe since 2018. The pandemic was turbulent for Shimano and had some knock-on effects. Initially, lockdowns saw a pullback in consumer activity in cycling, which was quickly followed by unprecedented demand. The pandemic demand caused bicycle manufacturers to rapidly increase production and led to excess inventories across the industry, which are only now starting to unwind. On a recent call with the company, we learned that inventories are expected to be back to more normal levels by the end of the current year.

The inventory backlog caused a drop-off in the stellar performance seen through the pandemic, and the share price fell in line with that. We took the opportunity to take a position at an attractive valuation, albeit with a conservative position size to reflect cyclical risks (pun intended) and the fact that it operates essentially in one niche. In 2024 the share price of Shimano has been positive and in contrast to the other sporting names discussed here, a catalyst for that performance has derived from better-than-expected sales in China.

Despite falling consumer confidence, China has seen a surge in the popularity of cycling generally and in road-bikes specifically. Drivers of that demand include government incentives, formation of cycling clubs across the country and by Tik-Tok, where consumers can watch a bike advert and click directly through to purchase the bike there and then. Crucially, whilst some low-end component manufacturers do exist in China, the quality and brand strength of Shimano is winning the day. According to the company, Chinese consumer preferences mirror their western counterparts in the desire to own brand-named bikes with Shimano components and trade up as their hobby develops.

We are more marathon runners than sprinters in our investment approach, and in that context, we generally like to let our runners run and our riders ride within the confines of our investment philosophy and valuation framework. However, we are constantly keeping an eye on the scoreboard, as the business world is as dynamic as any competitive sporting event. One or two adverse occurrences do not always necessitate direct action. Let's not forget that in 2016 Usain Bolt broke the 100m world record with his laces untied (the shoes were Puma, for reference). However, a collection of events gives us cause to investigate and act where we judge it to be necessary.

Ben P, Chris E, Rob, Ben A, Phoebe 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] *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 0.68 (source: Bloomberg, Evenlode, based on the last five years), a low figure compared to the fund's history.*

[ii] *https://evenlodeinvestment.com/news/markets-move*

[iii] *Volatility - A statistical measure of the fluctuations of a value over time, expressed as a percentage. Generally, higher volatility is an indication of higher risk.*