Evenlode Global Investment View

February 2023 – Investment Through Thick and Thin

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

Last month we indulged in the annual ritual of looking forward to the year ahead and making a few (hopefully!) educated predictions. Since then, nearly half of the portfolio has given us an update and the overall picture is slightly more positive than we had expected. However, management teams have still struck a cautious tone. Actions, as they say, speak louder than words, so it's been interesting to hear where businesses are putting their investment focus. Corporate experience of the global economic situation, particularly with regard to inflation, has elements of the 'observer effect', where behaviour changes as a result of observation. Popularised by quantum physicist Erwin Schrodinger's famous thought experiment with an unfortunate cat[1], the observer effect is visible in many other fields including the social sciences and finance. The companies we are hearing from and talking to are obviously affected by the global economy, but in their various ways are the global economy, at least in part, and the actions of one affect those of others.

On inflation, and pets

Inflation has been the number one financial concern for many individuals, companies and central banks over the last year. There are physical causes of the inflation, including disrupted supply chains and concerns about energy supply stability due to the war in Ukraine. With this there are also political, operational and humanitarian angles to the inflationary picture too.

The Swiss food giant, **Nestlé**, reported broad based inflation in its input costs, including raw commodities, packaging, freight and energy. The impact to the company's operating margins was relatively limited though, due to price increases and cost controls, driven by unusual dynamics. The fastest growing part of the business is the Purina pet food franchise, so much so in fact that the company had to dial back on its marketing spend to ensure that it could invest more to expand production capacity meet future demand. Lower marketing spend helps margins, although if that is a permanent state for a consumer goods company then its brand power would diminish over time. Management was keen to point out that the reduction in spend was temporary, and in fact increased during the second half of the year. The wider effects that stem from the demand and supply dynamic for pet food are just a small example of the underlying complexities of the economy which contribute to a number such as inflation.

Similarly, other dynamics within individual businesses contribute to wider economic trends. To ensure supply of the inventories used to make products, companies have been buying extra, using up some cash and no doubt impacting the price of the commodities and other inputs. For individual companies this is manageable; we select strongly cash-generative companies in part as it enables them to deal with such operational volatility. For the collective, it has likely exacerbated the price increase of the things that are being bought. Consumer goods companies **PepsiCo** and **Unilever**, along with Nestlé, have seen the biggest impacts overall. Conversely, other consumer firms are enjoying a better experience - **L'Oréal** (cosmetics) and **LVMH** (luxury goods) for example. As a result, we've seen only a small decline in the free cash flow generated by the portfolio as a whole. Also impacting cash flow in some cases is an increase in the time it takes to get paid, as with business services firm **SGS**, a direct example of the actions of one company affecting another. This is a

[1] *In the (thankfully!) hypothetical experiment, a cat locked in a box with a 50% chance of being killed by a vial of poison, if unobserved, may be considered both alive and dead. Only on opening the box can one determine if the cat is alive or not.*

temporary situation caused by covid disruptions, and there aren't any signs that this might lead to our companies not being paid in the fullness of time.

Looking ahead, companies are reporting that they expect cost pressures to ease as we go through the year. Whilst their crystal ball is no better than ours, most businesses do buy ahead of time and so have some visibility on these things. There are other signs from the 'spot' market for purchasing goods and services now. Transportation brokerage **C H Robinson** reported that ocean freight rates are back to the levels seen before the pandemic in some regions, and the rate for transporting a truckload of goods in the US is down 21% from its highs. Demand for transport is declining, and pricing with it.

On investing, and patience

Nestlé's investments in the future of the business are just one example in the portfolio.

Information, data and analytics company **RELX** has increased its investments into new products, spurred on by strong demand for its software and services that help businesses manage risk. LVMH is investing in new champagne production. Businesses around the world are continuing to invest in the promotion of their products, using the services of advertising agencies **Publicis** and **Omnicom** to get their messages out there. The agencies have benefitted from investing in themselves in recent years, developing their offerings in digital advertising and commerce which are now required by virtually all businesses in one form or another.

Investing through less certain times such as these lays the path for the future success of the businesses we have invested in on your behalf. There are no certainties that these investments will bear fruit, but RELX, Publicis and Omnicom have all transformed their businesses for the better by doing just this over many years. Patience has sometimes been required, as has a willingness at companies to evolve with the times – responding to what is observed in the market as well as guessing what might happen next.

On this, **Microsoft** is providing an interesting case study. It has made a large investment in OpenAI, the creators of ChatGPT, the AI-powered text generation service that has been rarely out of the news in recent weeks. For fun we asked Chat-GPT to write a closing paragraph in the style of Evenlode Investment, but instead received this rap explaining that the service is not currently available:

Most new technologies go through a "hype-cycle", where excitement over new possibilities initially outstrips the immediate and useful application of that technology. However, this is usually followed by a waning in enthusiasm as reality bites, often referred to as the "trough of disillusionment". When Chat-GPT resumes, we'll be sure to test how good this technology is at impersonating us. To avoid any doubt however, we'll be sure to clearly signpost if it is not a human producing these words. We have no intention of using it as a matter of course for our own communications however (regular readers might think our writing would be improved by a bit of artificial intelligence – please let us know if so!).

ChatGPT may be an interesting novelty in the short-term, but it also feels like it may have some far-reaching applications in the long-term (beyond writing dismal lyrics about its own lack of current capacity). For Microsoft it represents an investment with an uncertain outcome, but one that is very affordable given the success of its previous investments in cloud computing platform Azure and the financial resources that it is generating. We would rather companies tried to innovate than not, and most innovations are not as high profile as ChatGPT has been. High profile or not, it's encouraging to see continuous re-investment within the portfolio as we believe this is key to a growing stream of cash flows.

Ben, Chris, Bethan, Rob and the Evenlode team
22 February 2023

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