

Evenlode Global Dividend Investment View

April 2024 – Following the value

Market data is from FactSet and FE Analytics.

At over a quarter of the way through 2024 the overall equity market trend remains strong. Energy and finance companies have found favour and the driving force of performance from technology and data-related companies has continued, albeit checked slightly in the latter part of April. Within the Evenlode Global Dividend fund, French advertising and marketing conglomerate Publicis has benefitted from this trend, with its digital consultancy Sapien and data business Epsilon playing into the artificial intelligence theme. The rest of the portfolio's top five performers year-to-date are a motley crew outside of the AI enthusiasm: CTS Eventim (European event ticketing), Bureau Veritas and Intertek (testing, inspection and certification) and Shimano (bicycle parts). While we appreciate positive share price performance, short-term upward moves increase the risk that a company's valuation becomes disconnected from the business fundamentals. With these examples the valuations remain acceptable in absolute terms, although we have nudged the positions downward a little to reflect the change in valuation appeal.

Valuation is one of many risks that we manage, the others being based around the qualities of the businesses themselves. Our valuation model is an inherently long-term framework that is intended to see through near-term performance to capture the long run economics of a business. When companies' share prices outperform materially in the short-term without reflecting any meaningful change in the business, this increases valuation risk. We have over the last year reduced other positions more materially where their share prices have appreciated significantly, including Microsoft, Wolters Kluwer and RELX. As with the more recent strong performers, the valuations look reasonable in absolute terms and so they remain positions, but at position sizes that reflect the different opportunity compared to when the share prices were lower.

As fully invested equity investors the capital from reducing positions needs to go somewhere. Regular readers will know that we have been, to generalise, moving toward companies in the Consumer Goods and Health Care sectors where the valuations look compelling. However, one can have too much of a good thing and we want to ensure that we manage the diversification of the portfolio as well as its valuation. Recently this has led us to add initial positions in Deutsche Börse and CME Group to the portfolio. Both are asset light, highly cash generative businesses with formidable competitive advantages, paying healthily growing dividends. Both are also relatively good value in our estimation.

CME Group is one the largest derivatives exchanges in the world. Their key products are derivatives based on underlying assets like US interest rates, the S&P family of equity indices, WTI crude oil pricing, as well as derivatives for key metals and agricultural commodities. In each they are the dominant provider, taking a tiny fee (fractions of a basis point) on each trade. Their competitive advantage is built on cost benefits that come with scale, helped by the fact that there is generally no alternative venue for trading derivatives in a particular underlying asset. Derivatives are typically not fungible (readily interchangeable) like cash or stocks and shares, meaning liquidity is lower and the implicit costs from bid-ask spreads are larger. Additionally, due to higher counterparty risk with derivatives, traders are required to post collateral against potential losses, known as 'margin', which comes with costs. These costs dramatically reduce with scale; liquidity improves which reduces the costs from bid-ask spreads¹, and the margin requirements decrease because the exchange can net off overall long and short exposures of participants. This means it



is uneconomical to try and move to a different provider. Additionally, unlike cash equity trading (the buying and selling of 'regular' shares), clearing must be done via the exchange's associated clearing house and the contracts are the intellectual property of the exchange.

Trading volatility is offset by diversification by asset class and volume-related pricing (CME's pricing increases when trading volumes decline). While there is a certain amount of derivatives trading that is related to cyclical speculative activities, this is offset by the fact that much of the trading is carried out by participants managing their operational risks, for example a food producer hedging against the cost of wheat changing.

Deutsche Börse owns the main European derivatives exchange Eurex, which accounts for about a quarter of revenues. It also contains Clearstream, an investment management solutions business and a fund administration service. The derivatives business is mainly for STOXX and related European equity indices and European interest rates, benefitting from the same competitive advantages as CME. Clearstream is one of four international central securities depositories, managing custody for bonds issued internationally. This is more effectively done when there are more connections to local custodians, hence there are good returns to scale. The investment management solutions business contains Simcorp, one of the three big providers of systems for large asset managers, ISS, the proxy advisory service and other portfolio analytics products. The fund administration service offers mid and back-office services to European funds, including accounting and distribution.

For all of CME and Deutsche Börse's businesses, the price customers pay is small relative to their overall costs and the value they provide. They both offer mission-critical services that are used regularly, with significant switching costs. The result is exactly the asset-light, cash generative, high return on capital economics that we look for at Evenlode. In the current environment, many companies that steadily churn out these economics over many years do appear to be trading at a discount to other parts of the market. The two exchanges thus offer the opportunity to diversify the cash generating streams of the portfolio at a price that makes sense over the long run.

Returning to the broader market, we have arrived at the first quarter corporate reporting season. For the big technology companies that are dominating the market some of the benefits and costs of moving into the new world of cloud computing and artificial intelligence are starting to become clearer. Microsoft is seeing stellar growth in its Azure cloud operating system, some of which is driven by delivering AI tools, and is increasing its capital expenditure on data centres and AI training so that it can make the most of the opportunity. Elsewhere things are also progressing, albeit at a steadier rate. The testing, inspection and certification companies SGS and Bureau Veritas (noted above) are seeing revenues grow in the high single digits, and it is perhaps this solid growth alongside valuations that seem cheap that has led to them being amongst the fund's better performers. Still, elsewhere there are continuing signs of the post-pandemic normalisation in certain industries and niches. Shimano's revenues and profits are making a sharp return downward to pre-pandemic trend levels, but the company indicated that they expect profitability this year to be better than previously indicated and bike manufacturers are reporting improving demand trends. Shimano's positive share price performance in recent times perhaps reflects some of this light at the end of the tunnel, and a weak Japanese yen likely plays a part as well. Consumer



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Goods companies are seeing a return to volume growth following the price increases of the recent inflationary period, having seen margins return to more normal levels.

Steady corporate and consumer spending outside of the artificial intelligence theme is probably indicative of the 'real world' economic situation, particularly in the West. Most companies are maintaining their outlook for steady progress throughout the remainder of the year, and we remain happy with that as long as the valuations continue to make sense.

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

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ⁱThe bid-ask or bid-offer spread is the difference between the highest price being presented to buy an asset and the lowest price being offered to sell it at any given time.

