Evenlode Global Dividend Investment View

December 2024 – A metaphor for 2024

EVENLODE
GLOBAL DIVIDEND FUND

The melt-up

In April of this year, I was in a meeting with a client discussing the Evenlode Global Dividend portfolio and the global equity market. At that time, we had just opined in an investment view[i] that whilst there had been quite a significant rally in the global stock market driven by the artificial intelligence (AI) boom, some of the emergent chatter about a market bubble was overdone. Toward the end of the meeting, I was asked a question along the lines of 'what keeps you awake at night'. It's a good question to ask; a clarifying one. When it comes to the Evenlode fund portfolios through time, we make sure that we have controlled the two things that we can – the type of business in the portfolio, and the valuations at which they trade in the market. That's my job after all; as a portfolio manager if something were out of line with the criteria we have set out, then we should do something about it, and we do. We can't control everything, and so if there are things that I do worry about, they tend to be outside of our control. From political risk to macroeconomic exposures, we look to insulate the portfolio through business and valuation risk management, but we have limited ability to affect the things like the outcome of elections or the path of interest rates.

At the time my response regarding any causes of insomnia was this: *A 'melt-up' in the equity market*. Whilst market valuations were not extremely high in the spring, they had crept up and further increases would start to look stretched. History shows that the more stretched valuations get on the way up, the bigger the ultimate resulting move in the opposite direction. Fast forward to the time of writing and since the time of our March investment view the MSCI World Index is up by +12.1% in US dollars[ii], driven by the US market which is up by over +15%. Valuations have thus indeed got more stretched, which was part of my concern, but I also had the suspicion that if the market upswing continued then the fund would lag. In the event the fund's unit price has barely budged over the same time period, leaving quite a gap between its performance and that of its benchmark.

Welcome to the machine

This leaves me with a feeling akin to tapping an old-school instrument control panel on a machine whilst wondering out loud '*is this thing on??*'. If market prices are the ultimate signal on our metaphorical machine, the inner workings are the companies in the portfolio. Our investment process is like taking the machine apart, checking the components are actually working, and satisfying ourselves that at some point the signals from inside will reach the dials at the front. The opportunity, but also the challenge of managing an active equity strategy is not only that signals of corporate performance vary in the time they take to get to be reflected in the 'control panel' signal of market price, but that short term performance is often reflected quickly, and the long term more slowly. Add in the possibility of overoptimism and undue pessimism skewing things depending on the situation, and the machine can sometimes feel like a chaotic engine, and at other times appear to have broken down.

Additionally, there are plenty of other 'machines' that one can look at for signals. Taking the US, the dominant engine in the global stock market, the dials have been up in the red for some time. In terms of return, who doesn't want the dial turned up to maximum? Earnings growth, one of the fuels of return, is very strong for a certain subset of companies. But there are other indicators that show signs of stress

in the workings – earnings growth has been accompanied by expansion in valuation ratios, implying that the growth must keep going to justify the price signal. There are the things that affect that earnings growth, the 'externalities' of the macro economy, impact of geopolitics and evolving challenges such as the impact of climate change (coffee prices are at an all-time high following a drought in Brazil, to take one signal). Then there is the human construct of the investment cycle, with artificial intelligence the current focus for discussions about capital investment. Whilst the new tools being made available by this nascent technology are amazing, they will need to justify the enormous sums being poured into developing them, principally through significantly enhanced productivity for users and the economy as a whole. Whilst there are many activities that could be aided by these tools, much of our existence is still very much grounded in the physical world, and indeed the physical meets the virtual in terms of the energy demands of data processing for AI, which adds operating cost to capital expenditure. Productivity gains are not guaranteed and may be limited in size[iii]. The economic cycle affects far more prosaic industries than AI though. Capital goods, discretionary consumer purchases like cars, and financial services are cyclical in nature. There are very few businesses that aren't in some way affected by economic ups and downs, but some are more sensitive than others.

In other words, the dials on the machine of the global economy have always fluctuated positively and negatively, and the current time is no different. In terms of the workings of the Evenlode Global Dividend portfolio, we've highlighted earnings and cash flow progress through the year, and some of the variant performance of companies within it. Most recently[iv] consumer franchises have seen revenue growth slow, but overall growth has remained resilient. We have pulled on the lever marked 'valuation' as some market prices declined reflecting short-term performance, and others increased reflecting optimism around AI, but this is perhaps where the metaphor of a portfolio as a machine starts to fray. Unlike in a high-precision engine (maybe maintained with tools from Snap-on and oiled with Fuchs' speciality lubricants?), the uncertainties of corporate and market performance do not neatly intermesh into a performance-driven train. Investment is often talked about in mechanistic terms, and my metaphor here is guilty of that. Analysts ask questions about a company's 'growth algorithm', and portfolio return and standard deviation has an 'efficient frontier'. But the reality is that optimisation in a pure mathematical sense is not possible, only risk management, consistent decision making, and applied patience. This brings me back to my comment on portfolio management above; we have a couple of levers that we can actually control, designed to take valuation opportunities when they become available and introduce resilience into the mechanics of the portfolio. With these balanced as best they can be our engine should continue to trundle along nicely, and it is my belief this will translate into more than satisfactory readings on the control panel in the fulness of time. But racier models than ours are, for now at least, in the lead.

The time machine

A time machine would be pretty helpful in tuning up the performance engine, and in the absence of a flux capacitor we do have one of sorts. That is the willingness to wait for the signals of market performance to emerge, even if those around are swinging about. As I say, this is part of the challenge but is what the mechanics of our process are set up to do at Evenlode.

Stepping out of the metaphorical, we appreciate that performance ultimately matters for our clients, and we also appreciate your understanding as we apply our investment process on your behalf with your (or your own clients') savings. In these investment views we try to reveal the inner workings of the machinery of your portfolio as much as possible so that it is clear what we are doing with your capital and why we are doing it. We do not take your patience for granted, and if there is any way that we can aid your understanding further, then I encourage you to get in touch.

Wishing you a merry festive break and a prosperous 2025.

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

19 December 2024

Evenlode has developed a Glossary to assist investors to better understand commonly used terms.

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Market data is from S&P CapIQ, Bloomberg and FE Analytics unless otherwise stated.

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[i] *Dinner conversations, March 2024*

[ii] *Source: FE Analytics. 28 March 2024 to 17 December 2024, total return terms.*

[iii] *See for example https://news.mit.edu/2024/what-do-we-know-about-economics-ai-1206*

[iv] *Most recently after the third quarter reporting season: The consumer economy, October 2024*