

Evenlode Global Investment View

January 2023 – Scene Setting



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

January is the traditional time to look ahead to the coming year and muse about what might be in store. Equity investors might hope for something a bit more sedate from the coming twelve months, especially after two years of covid disruption and financial volatility. The global equity market downturn of last year was driven by real-world concerns around the effects of inflation, economic growth and the sustainability of some business models, but also by the high starting valuations achieved by many companies in the era of ultra-loose monetary policy. These economic factors are not static and deserve careful consideration.

Looking to the bright side, as we start the year some of the inflationary pressures are reducing with oil and gas prices moderating, helped by the relatively warm winter weather in Europe leading to lower gas demand, and expectations of lower economic output in the coming year. Supply chains are also normalising after the dislocations of covid, which should help with some other elements of inflation driven by scarce supply. The fact that equity prices are generally lower also means that there is more margin of safety overall in the market compared to this time last year.

There are additional bright spots that have been reflected in positive share price performances over the last few months. Companies at the discretionary end of consumer spending such as the luxury goods firm LVMH, the cosmetics giant L'Oréal and the sportswear brand adidas, are likely to benefit from China's belated relaxation of covid restrictions, and their stock is up commensurately. In the case of adidas this is off the back of a very weak 2022 overall, during which it seemed anything that could go wrong, did go wrong. New boss Bjorn Gulden will certainly be hoping for a more positive 2023. We join him in this desire, but as important are the long-term prospects for the company. We believe that the company's difficulties are surmountable, and Bjorn comes with good pedigree having worked across the road at Puma.

But we certainly shouldn't ignore the ongoing challenges facing businesses from the current global economic situation. Software giant Microsoft has been in the news this week for announcing 10,000 redundancies, joining the recent high-profile rounds of job cutting in the information technology sector. IT-enabled communications were touted as keeping us productive and sane during covid lockdowns and technology companies hired rapidly to meet the expected surge in demand. However, a normalisation in demand is now happening instead. This has been in part caused by the office-dwelling world drifting away from home and back to sitting alongside colleagues once more. But it is also due to the worsening overall economic situation; Microsoft's CEO Satya Nadella cited corporate clients exercising caution on spending as part of the rationale for the reduction in headcount. This caution has been reflected by the market, with Microsoft's shares down -32% in dollars since their peak in late-December 2021¹.

Such cyclical dynamics are nothing new of course. Buoyant conditions often lead to share price appreciation as Mr Market looks toward bright futures and discounts risk, and slower conditions see share prices sag as some of those risks come to bear and put themselves firmly back on the agenda. Something that was unusual through the worst of the covid years was that share prices appreciated significantly despite the severe, indeed unprecedented, disruption to global trade. Part of the reason for this was the success of information technology businesses, which have grown to be the largest part

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of the global market thanks to the digitisation of everything and the significant benefits of scale in many business models. As IT businesses were pandemic ‘winners’ (if there can be any winners from such an event) the market move was not as counterintuitive as it seemed, but nonetheless other factors such as low interest rates and fiscal stimulus played their part in inflating asset values.

As we sit here at the start of 2023 the situation for Technology sector valuations is somewhat reversed from the pandemic highs. Optimism has given way to pessimism, and this has led to interesting valuation opportunities in our view. Microsoft is one example in the portfolio; it was a holding at the end of 2021 but at a lower position size, and as the share price has weakened, we have built the position to be, at the time of writing, the largest in the portfolio.

There are plenty of examples in other sectors in the form of new additions to the portfolio last year. The credit reference agency, Experian, the aforementioned L’Oréal, and business service companies SGS and Intertek were all initiated as new positions following periods of share price weakness based on various concerns about the global economic outlook.

We don’t doubt that the outlook is uncertain in the near term, but looking beyond, over the next five to ten years we can ask some fundamentally simple questions to help us apply our investment process and invest with confidence. Will businesses need more help inspecting and assuring their supply chains in the future? Will people want to buy more cosmetics? Will there be more demand for robust information to drive lending decisions? Will there be more demand for cloud computing services? And will all of these things be valued by the people doing the purchasing? For SGS, Intertek, L’Oréal, Experian and Microsoft we think the answers are ‘yes’ to their respective demand drivers, and as global market leaders they have the ability to invest to ensure that their products and services genuinely add value to their customers’ lives. Sitting high tech cloud services alongside foundation and mascara might seem a little odd, but both products deliver experiences of value to their consumers in their own ways.

We expect that when company results are reported for 2022, the portfolio metrics will bear some temporary scars from the disruption that companies have experienced. Free cash flow is likely to have fallen a little overall as companies invested to ensure supply of key inputs, but the levels are still very manageable in the context of the cash generative nature of the business models that we select. The narrative around input costs will be interesting as some of the pressures seem to have abated of late. We expect dividend growth to continue as distributions recover from the pandemic, but the outlook of boards and management teams will be key to what sort of level we might see this year. However, we firmly believe that the medium to long-term prospects for dividend growth remain very positive, backed by consistent, and ultimately growing, cash generation.

If the last few years have taught us anything it’s to expect the unexpected, in the economy, in geopolitics, and in the market. But they have also taught us that we are robust, that we can see through significant challenges, and that opportunities can arise almost no matter what the situation. We’re sure that both of these sentences will hold true in 2023.

Ben, Chris, Bethan, Rob and the Evenlode team

19 January 2023

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Please note, these views represent the opinions of the Evenlode Team as of 19 January 2023 and do not constitute investment advice.

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¹Source: FactSet. 27 December 2021 - 19 January 2023.