Evenlode Global Investment View

September 2021 – Values - Redux

The commentary below applies to both the Evenlode Global Dividend and TB Evenlode Global Income portfolios. Market data is from Factset and FE Analytics, corporate valuation analysis from ourselves at Evenlode.

Back in May[i] we wrote about the valuation environment in global equities, with markets having risen significantly from pre-pandemic levels. As we sit four months on the MSCI World index has risen further by 8.4% in sterling terms, and 4.6% in dollar terms[ii], the pound having weakened a little over that time.

So the question of equity valuations has not gone away, and the shape of the question is similar. Information technology companies continue to be in the driving seat, with the MSCI World IT index up 18.4% over the same period. Conversely the MSCI World Consumer Staples index is up by only 3.7%. The IT and consumer goods sectors are key ones for the Evenlode Global Income/ Evenlode Global Dividend portfolio, and their divergent fortunes hint at some of the ongoing activity that we have undertaken.

Prices and pricing

The consumer goods sector was already looking like one of the better value areas of the market, and its relative underperformance has made that all the more so. The market's bearish sentiment toward the sector should not be ignored – there is usually some logic behind the narrative. In the case of consumer goods there is a clear factor that is causing concern – cost inflation. The price of raw commodities, packaging and transportation costs have all increased, by double-digit percentage rates in certain areas. The effect on profit margin has been dramatic in some cases. Clorox, the US household consumer goods company in which we initiated a position this year, saw its gross profit margin reduce by 10 percentage points in the three months to the end of June. While such a large margin decline is rare, other consumer goods companies are also feeling the squeeze from rising costs and this is reflected in investor sentiment.

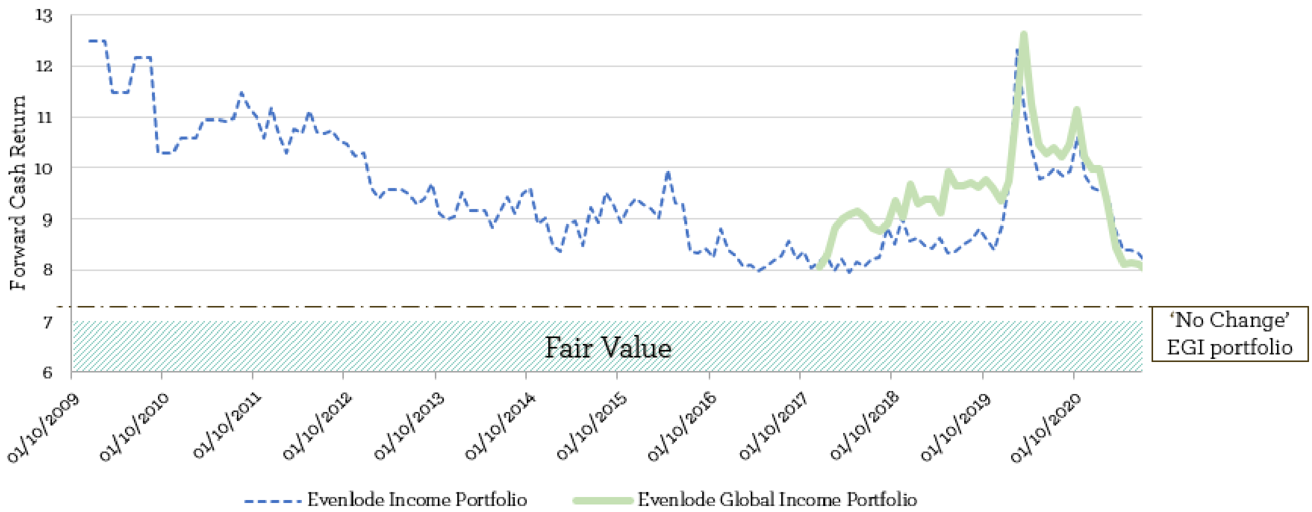
Our search for companies fitting with the Evenlode investment process involves assessing whether those firms have pricing power. Pricing power is a term banded around and means slightly different things depending on who you ask. Broadly speaking companies that possess pricing power should be able to pass increases in cost on to their customers in the form of higher prices for their goods and services. Putting it another way, they should be able to increase their own prices without affecting the volumes that customers demand too much. Consumer goods companies like Procter & Gamble, Clorox and Unilever have shown historically that this is possible for them, although there is a lag. Intuitively people are more willing and able to bear price increases if they are more gradual, and there is of course a limit to how far any business can push prices in one hit. There are also business reasons why there is a lag as consumer companies have contracts with retailers that are renewed periodically, particularly in Europe. Nonetheless, if prices can be increased at an appropriate pace then a patient company should be able to catch up with inflation over time. Past performance is no guarantee of the future of course, but history at least is on the side of these companies when it comes to pricing power. A business will only find itself in the enviable position of having pricing power if it delivers something that customers perceive to be of value. In the consumer goods space, brands are very relevant to the relationship that a customer has with a product; product quality is clearly important, and (like it or not) the business's marketing abilities are crucial to customer perception and engagement. In the case of Clorox, a continued commitment to investment in research and development of products, and in digital marketing capabilities (where the company has historically been strong) are encouraging. Whilst there may be a temptation to scrimp when costs are increasing elsewhere, these are core enablers of future success and continued investment is essential to the long-term health of the firm.

Value and activity

Short-term concerns often offer valuation opportunities for investors with a long-term time horizon. We believe this to be the case for the consumer goods industry and have been increasing the fund's exposure to the sector. Most recently we initiated a position in luxury goods giant LVMH, most famed for the Luis Vuitton brand and indeed it generates most of its profits from fashion and leather goods. We bought a small position after the share price declined on the back of worries about demand from China following comments from the government that were perceived to indicate increased taxes for the very wealthy. Those concerns look a little overdone to us, especially as a large amount of Chinese luxury consumption comes from the middle-class rather than the super-rich, and encouraging and enabling the middle class cohort is one of the stated aims of the Chinese government. Looking at the long term, the brand heritage of its portfolio is virtually impossible to replicate, creating a very attractive moat around the firm's ability to price and its customers' willingness to spend. The nature of the LVMH business and consumer are a very different to, say, Clorox, who's name is that associated with bleach and other cleaning products, meaning that initiating a position in LVMH has the added benefit of diversifying the portfolio even within the consumer goods sector.

On the flip side we recently sold the fund's position in ticketing company CTS Eventim, having been nudging the holding down as its share price rose following the announcements of successful vaccine trials last year. The disposal is notable as we only purchased the holding in the Spring of 2020. We remain very satisfied with the company's market leading position in European event ticketing, but the share price has recovered to sit at pre-pandemic levels and the firm has less cash after dealing with the hiatus in events. With no dividend in prospect in the near term and other consumer-related options available, we have been able to maintain a suitable balance in the portfolio, but remain very open to re-investing in Eventim should the price make sense in the future.

Within holdings already in the fund we have increased Nestle and P&G, and have reduced eyewear business EssilorLuxottica and technology company Hexagon, amongst other changes made in the effort to manage valuation opportunity and risk alongside maintaining the fundamental quality of the portfolio. What has been the effect on the portfolio?



The chart above may look familiar from our May investment view. It shows our proprietary 'forward cash return' measure[iii], which is an estimate of valuation based on a long-term valuation model for each of the companies in the portfolio. All other things being equal, the higher the forward cash return, the more attractive the valuation. We calculated what the portfolio valuation would have looked like if we'd made no changes to manage valuations within it over the last year, depicted with the horizontal dashed line. Whilst the portfolio would still look like it is better than fair value, it would be lower than we've ever experienced in the fund, or in our longer experienced with the UK-focussed Evenlode Income fund.

So the activity has maintained valuation appeal, but we have also been sure to manage the fundamental characteristics of the portfolio. There is still a broad spread of sectors, sub-sectors, business models and geographies within the portfolio. The underlying debt levels have not increased, and the returns on capital generated by the companies is impressive. And all of the business have, in our judgement, pricing power amongst other attractive qualitative characteristics like structural growth opportunities in their respective markets.

Whilst we look to the long term, the short term happens day by day. As local and global economies deal with the continued effects of the coronavirus pandemic, companies will continue to experience a broad range of conditions driven by (as yet) unimaginable supply and demand volatility. We require that the companies within our portfolio are sufficiently cash generative to withstand a broad range of scenarios. By combining this quality discipline with maintaining an attractive portfolio valuation, we aim to add an extra margin of safety to the fund's risk profile, whilst looking optimistically at the future.

Ben Peters, Chris Elliott, Bethan Rose and the Evenlode team
30th September 2021

Please note, these views represent the opinions of the Evenlode Team as of 30th September 2021 and do not constitute investment advice.

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For full information on fund risks and costs and charges, please refer to the Key Investor Information Documents, Annual & Interim Reports and the Prospectus, which are available on the Evenlode Investment Management website (https://evenlodeinvestment.com). Recent performance information is also shown on factsheets, also available on the website.

Past performance is not a guide to future returns. The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Fund performance figures are shown inclusive of reinvested income and net of the ongoing charges and portfolio transaction costs unless otherwise stated. The figures do not reflect any entry charge paid by individual investors.

Current forecasts provided for transparency purposes, are subject to change and are not guaranteed.

Source: Evenlode Investment Management Limited. Evenlode Investment Management Limited is authorised and regulated by the Financial Conduct Authority, No. 767844.

[i] https://evenlodeinvestment.com/news/values
[ii] Source: FE Analytics, 28/05/2021-24/09/2021. Total Return Terms.
[iii] Source: Evenlode Investment proprietary analysis