Evenlode Global Investment View

October 2019

EVENLODE
GLOBAL INCOME FUND

Fourth Quartered

No sooner had the fourth quarter of 2019 become a reality did global stock markets take a turn for the worse. The short term news flow has been about economic activity, or lack thereof, but comes on the back of a drip-fed diet of tariff spats, industrial slowdowns in specific sectors like autos and semiconductors and, of course, Brexit (thought I'd get that topic out of the way early on).

The fourth quarter of 2018 was notable for the apparent end to the near-decade-long global equity bull market, based on ostensibly similar sentiment to the current time, before the market said otherwise in the new year and rallied by over 20% as measured by the MSCI World index[i]. Last year markets had also been strong mid-year, but only time will tell whether 2019 proves to be a carbon copy.

Short term moves are interesting, but of more interest to us than whether the market has been going up or down is what corporate valuations are available at the current time, and whether those compensate for the risks involved in equity investing. This is illustrated by some of our portfolio actions over the last year, but first a recap on a couple of aspects of the Evenlode investment approach to set the scene.

Opportunities and risks

The type of business we look for on behalf of our clients is one that delivers value to its customers that few can match in their chosen field. Whether it's because I need confidence in accessing the latest high quality academic research (Wiley, Wolters Kluwer, Relx), need a critical piece of IT infrastructure that can't fail (Microsoft, Oracle, Accenture), or want a taste or smell that delivers every time (PepsiCo, P&G, Unilever), the return I receive as a customer is worth more to me than the purchase price. If a company finds itself in such an incumbent position it can take the resources generated from its customers to improve its goods and services in a virtuous circle. That's the opportunity presented by a high-quality business.

However, no business operates without risks, be it from competition, technological disruption, governmental interference, weak finances or just bad luck. We try to assess as many of those risks as possible when selecting companies for investment. Selecting robust companies is our first risk management tool.

Second comes valuation. We make some basic assumptions in order to value the companies that pass our quality test, reflecting our analysis of the opportunities and the risks. In the uncertain world of business, our view is that the valuation of a company represents a risk rather than a fact, and it is our second risk management tool. Thanks to the volatility of the equity market it is the factor that changes most often. At any time we are attempting to balance the opportunities with the quality and valuation risks present within the Evenlode Global Income portfolio.

Fundamental shifts

We update our view of companies on an ongoing basis, through business analysis, monitoring news flow, interactions with companies and our regular set of investment and portfolio management meetings. Despite this effort, it is rare that there is a sudden, fundamental shift in our assessment of a company's quality. Sometimes our view is modified through time as new information becomes available, and occasionally we can just decide we have got something wrong in our earlier analysis. This hasn't happened in the Evenlode Global Income portfolio so far, although we did reduce the fund's position in IT giant IBM in response to the increased debt taken on to fund the acquisition of Red Hat.

Valuation rules

What has happened is that market prices have moved, which means that all portfolio changes have been reflecting of the different valuation risks and opportunities on offer.

Some of the stable, high quality consumer franchises in the portfolio like Nestle, P&G, PepsiCo and Diageo have risen in price quite considerably. P&G delivered a 63% total return in the year to end-September 2019[ii], remarkable for what is underneath it all a pretty stable and steady company selling the basics helping to keep us and our babies clean and fresh.

With any return number it's important to ask: 'where did we start from, and where did we end up'? In P&G's case the valuation a year ago looked to more than compensate for the risks, trading at better than fair value in our estimation. By the end of September 2019 it had moved into fair value territory[iii].

Fair value is ok, but if there are other high-quality businesses that offer better value then we can reduce valuation risk by moving from one to the other. And this is what we did. By reducing some consumer companies where the valuations look less appealing, we made room for others, including a new holding in Reckitt Benckiser, and building into the fund's position in German consumer and industrial conglomerate Henkel. Nestle, P&G, PepsiCo and Diageo remain holdings, but at a lower level reflecting the changing valuation environment.

Other reductions have included Cisco in the technology space and Wolters Kluwer in media, while we also exited Thomson Reuters, also from the media sector. On the additions side we built positions in another media firm Relx, and medical devices maker Medtronic, and added new holdings in travel IT service business Sabre, and in speciality chemicals manufacturer Fuchs Petrolub.

The shape of things to come

It's difficult to impose a clear theme or to artificially construct a narrative behind these changes. Instead, the changes are reflective of our bottom-up approach to selecting good companies and managing risk at a portfolio level. This includes one of the most basic considerations, diversification,

so whilst we start from a bottom up perspective we do monitor the overall shape of the portfolio across a range of measures to ensure that we're not drifting towards over-concentration, or other undesirable factors like excessive overall leverage.

At a high level, all of the changes noted above did not really alter the shape of the Evenlode Global Income fund. A little under a third of the portfolio is invested in consumer goods companies, a fifth in healthcare, slightly less in media and a similar sum in information technology firms, and the balance made up of selected service and industrial companies.

Over 85% is invested in companies that we deem to be less economically sensitive than average, and the leverage in the portfolio is below the market average. These two facts are particularly important in combination when thinking about risk management, meaning that the portfolio of companies is well set to face any difficulties that may come along.

The valuation of the portfolio still looks better than fair, and the underlying geographic spread of revenues is diverse. All of these measures are similar to what they were a year ago.

Under the surface

The last year or so has been a time of reasonably significant portfolio activity for the Evenlode Global Income fund. The lack of shift in the headline statistics belies the portfolio management that has been going on under the surface.

Ultimately all of our analysis and activity is targeted at the fund's basic aim of delivering an income to our co-investors today, and a growing income stream into the future. We believe that managing risk is very important in delivering this basic aim and it is what we will continue to do, no matter how the rest of 2019 and beyond shapes up.

Ben Peters and Chris Elliott
Fund Managers

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[i] Source: FE Analytics, 21.6% from 1st January 2019 to 30th September 2019, total return in sterling.
[ii] Source: Factset.
[iii] The forward cash return is our proprietary valuation measure based on the discount rate derived from a discounted cash flow model. A year ago this stood at 8.6% for P&G. At end-September 2019 it had reduced to 6.2%. We are happy to bore anyone to tears on how this works, please get in touch if you are interested in the details.