

Evenlode Global Investment View

September 2018 – Taking stock



The Evenlode Global Income fund has now passed its official financial half year point, to the end of August 2018. It's a natural time to have a look at how things have unfolded since launch last November. As fundamental, long term business investors we're naturally most interested in what is going on for the companies that we entrust with our clients' savings, but external factors like currency movements can't be ignored. That's particularly true for sterling-based investors at the current time.

Looking at price progress over the last ten months, by sector the fund's holdings in the information technology sector contributed the most to performance. Microsoft tops the list, backed by rapid take-up of its Azure cloud computing platform and good performances across all of its other divisions. Networking company Cisco, Apple and chipmaker Intel also provided positive returns. The media sector gained, with Dutch publisher, software and data company Wolters Kluwer seeing strong performance both fundamentally and in share price terms. The consumer goods sector was positive in absolute terms, although it lagged the MSCI World index average and so was a negative when comparing with the benchmark. The only sector to negatively contribute was consumer durables, with off road vehicle manufacturer Polaris falling as fears over America's trade tariff strategy came into focus. Of the businesses within the portfolio, Polaris and Apple are the most exposed to cross-border supply chains, and we're keeping a watching brief on how tariffs progress and how the companies respond. Strong cash flow and market positions go some way to cushioning the negative effects of increasing duties, with the bigger risk being to consumer demand than from the levies themselves.

Tackling currencies, for the sterling investor the overall weakening of the pound versus the US dollar by 2% was a tailwind to performanceⁱ, albeit with significant swings. The effect of euro exposure was more limited, with a 1% sterling depreciation and less volatility, and the pound also fell against the Swiss franc. Overall currency fluctuations added approximately 1.4 percentage points to the price performance of the fund (i.e. ignoring the effect on income), compared to a total return of 9.9% in aggregate to end-Augustⁱⁱ. This tallies with longer term research that we have conducted, indicating that the great British pound's decline over past years has added roughly one percentage point to annual returns on average, although this clearly fluctuates over shorter time periods.

Back to business

At Evenlode we have a natural bias towards businesses in some sectors, and away from others where we don't find many or any companies that fit our investment process (see our other investment views if you'd like more detail on our approach to investing). Here we'll take a look at some of the biggest industries within the Global Income portfolio.

Consumer goods is the largest sector, consisting of stable businesses selling products ranging from Doritos corn chips (PepsiCo), to Ray Ban sunglasses (Luxottica), to San Pellegrino sparkling beverages (Nestle). The sector as a whole fell in price over the winter period, but staged a rebound as spring and summer progressed. The fundamental performances have seen low to mid-single digit revenue growth driven primarily by increasing volumes, and generally expanding margins as companies find efficiencies in their operations. Cash flow is growing as a result, and we are comfortable with the strong brand positions of these companies

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as we transition into a world of digital marketing and online distribution models. Marketing spend is in focus, with firms looking to get better returns on the marketing investments being made. New holding Henkel, a German industrial and consumer conglomerate, is active in using digital methods to target advertising. Distribution is shifting with the internet, and firms must keep up. Brands that are number one or two in their category fair well, as (surprisingly, at least to me) people search around less online than in the store. Novel models are being deployed. The current archetype of a disruptive model is subscription-based shaving company Dollar Shave Club, purchased by Unilever and challenging both the price point and convenience of the incumbents (P&G's Gillette brand had to respond to the new world order, and was a little slow in doing so).

The **healthcare sector** performed well in fundamental and share price terms, with pharmaceutical companies making progress in bringing new therapies to market. Roche has for example been seeing positive results from its Impower series of immuno-oncology drug trials, and also enjoyed the successful launch of MS therapy Ocrevus. In medical devices, Medtronic is the global market leader, seeing accelerating growth driven by products such as the MiniMed 670G insulin pump, described as the closest thing to an artificial pancreas yet devised. We believe that the sector looks good value in aggregate, and there is an attractive long term future, providing companies invest in novel science to develop remedies for unmet needs or improve on current standards of care. Firms are helping healthcare systems to understand where the value is being added (and only paying when it is), with innovative 'outcomes based' pricing being trialed. Companies are also using new technologies to help with their research efforts, with GlaxoSmithKline partnering with consumer genetics company 23andme as an example.

The **technology sector** consists of both hardware and software companies. We like software that becomes highly embedded in customer workflows, exemplified by Microsoft in operating systems, Oracle in databases, and Sage in accountancy software. These businesses have been performing well, particularly in moving towards cloud based services such as Microsoft's Azure cloud platform, which is a significant expansion of the business model from its Windows desktop operating system. The transition has not been fast enough at Sage for some people's liking, and despite seeing revenue growth in the mid-to-high single digits, former-CEO Stephen Kelly stepped down in late-August. The board are looking for a replacement to drive the business towards a cloud based software-as-a-service (SaaS) business model. Firms like Sage that have an entrenched user base and recurring revenues are well placed to evolve over time and we look forward to an appointment being made in due course. In hardware we tend to be more circumspect, as history is littered with examples of products becoming commoditized (think of Nokia handsets in the 00s and hard disk drives in the 90s). However, where we see a strong incumbent position of products that are hard to replace, we can become comfortable with the business model. Cisco is a good example, being by far the dominant player in providing the routers and switches that are the 'plumbing' of the internet. The product set has to evolve to cope with the ever-increasing demands of networking clients; the latest switch, the Catalyst 9000, is sold with a subscription to keep the software elements up to date. Cisco are also building services on top of the hardware, particularly around security which is an ever increasing worry for global organisations. This makes sense for Cisco as they can see network traffic as it travels through the hardware provided by them.

The **media sector** is one with many of the characteristics that we look for, particularly where data and analytics can add significant value to customers and become part of their day-to-day lives. Companies like Wolters Kluwer, Relx and Thomson Reuters are key holdings in the portfolio and demonstrate those traits. These businesses are continuing to develop into data, software and analytics companies, delivering services that help professionals to make decisions and manage their businesses. Thomson Reuters released legal

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product Westlaw Edge, which uses artificial intelligence to help lawyers to build cases and highlight where case law might be contradicted. Wolters Kluwer provides the UpToDate service to healthcare professionals, allowing them to make clinical decisions using the latest scientific knowledge. The company recently bought Emmi, a service that helps patients to stay on top of their treatments, and has subsequently integrated UpToDate data into the service. These developments illustrate how new technologies can be harnessed by data owners to provide value-adding services to their customers, creating a good runway for profitable reinvestment and growth into the future.

Portfolio changes

Our overall approach is long term in nature, but we do make changes to the portfolio, usually where we see valuation opportunities. There has also been some M&A activity within the fund.

Since the fund's launch and investment of the initial portfolio, we have added positions in advertising agency Publicis, software companies Sage & Oracle, and industrial and consumer goods firm Henkel. In all of these cases we invested after price declines brought the businesses into positions where we were comfortable with their valuations in both absolute terms and relative to other opportunities in our investable universe.

We divested two businesses, healthcare firm Novartis and payroll and HR outsourcer Paychex. In both cases price rises meant there were better value opportunities elsewhere in the Global investable universe, and both were small positions. However, both are excellent companies and we look forward to re-investing in the future should valuations permit.

Two businesses were taken over. Dr Pepper Snapple, a largely North-American purveyor of soft beverages, was combined with private equity-owned Keurig Green Mountain, a coffee company. As above, exhibitions business UBM was acquired by diversified media company Informa. We know Informa well and it fits well with the media themes noted above, and so we have retained the equity in the combined company in the portfolio.

Looking ahead

Overall we have observed solid corporate performances, perhaps not at the same growth rates as before the financial crisis of the late-00s but very acceptable for patient, long-term oriented investors. There is the macroeconomic and geopolitical backdrop to consider, and currently global trade tensions and negotiations for Britain's exit from the EU top the list of investor, political and media worries. We think about these matters but do not let them cloud our decision making; we believe that companies that deliver goods and services that their customers want, need, desire or value will be able to cope with most economic outcomes, providing they are appropriately resourced and not financially stretched. Nonetheless, we are vigilant to changing conditions in underlying markets and should we believe there has been a fundamental change to a business' long term prospects then we will take action.

Shorter term, macro or company-specific factors can drive share prices up or down, and we look to make the most of these valuation opportunities provided by these movements if it makes sense in a long term context whilst taking into account risk management in the portfolio (allowing for sufficient diversification for

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example). The valuation environment for global equities is providing opportunities for investing in a broad range of sectors. We caution that the double-digit annual total returns from equities that have been enjoyed in the decade since the global financial crisis are unlikely to be repeated (at least without seeing valuations that are not justified by corporate fundamentals, or a material upturn in long term prospects). However, in our estimation there continues to be enough value to invest in businesses with stable and growing cash flows, at sensible prices that compensate for fundamental business risk and the volatility that is inevitably seen in share prices.

Thank you to all of our co-investors for your interest and support in the early days of the Evenlode Global Income fund, and we look forward to keeping you updated with progress, thoughts and ideas in the coming months and years.

Ben, Chris and the Evenlode Investment team.

ⁱ Source: Factset

ⁱⁱ B Income GBP Shares. Source: T Bailey, Financial Express