Evenlode Investment View

June 2016 - Brexit

This morning, the UK voted to leave the European Union. This is a major event in the political history of the UK and will create both political and economic uncertainty in the short and medium term. It will also have knock-on effects on Europe and the wider world. The pound has hit levels it has not seen for 30 years this morning, and the UK stock market, having all but priced in a 'remain' vote in the last few days has fallen (with more economically sensitive, domestically exposed companies particularly hard hit). Thoughts will now turn to changes in leadership for the UK government, Britain's negotiations with Europe, and the political future of the United Kingdom (given that Scotland and Northern Ireland voted firmly in favour of 'remain').

Evenlode is an equity fund, and consists primarily of UK listed shares. In this sense, it is not immune from today's events. However, it is worth reiterating that it is always our aim to insulate the Evenlode portfolio from uncertainty (rather than predict it). This through-cycle risk management may sometimes appear overly cautious, but days like this are a reminder that investment is a marathon not a sprint, and controlling risk is very important for the long-term investor.

As a result of our cautious approach, the Evenlode portfolio has several reassuring characteristics that give us confidence in the portfolio's ability to continue generating healthy cash flows and dividends, notwithstanding the events of the last 24 hours:

Global Diversification

While more than 80% of the companies in the Evenlode fund are listed on the UK stock market, the cash flow generated by portfolio holdings are global in nature (approximately 80% of cash flows are generated from outside the UK). From the perspective of UK-based dividend investors, it is worth noting that the sharp fall in the pound today represents a significant positive tailwind to reported cash flows (and therefore the ability of these UK multinationals to pay and grow dividends in sterling). In some cases sterling weakness may improve competitiveness against global peers.

Our process and preference for global cash flows also means we have little or no exposure to some of the sectors that may be most impacted by today's result. The fund, for instance, has no exposure to banks, insurers, property companies or housebuilders.

Stable and Healthy Cash Flows

We always like the bedrock of the portfolio to reside in businesses for whom cash flows are relatively predictable. A large portion of the portfolio comprises repeat-purchase business models where companies sell items with limited economic sensitivity (such as low ticket branded goods and healthcare products) and/or companies that are backed by subscription based business models or long-term contracts. These companies also tend to have relatively low capital requirements and healthy free cash flow, helping to provide a safety buffer for dividends in more difficult times.

Balance Sheet Strength

We are always conscious of managing balance sheet risk in the portfolio – weak balance sheets are often one of the key causes of dividend cuts. Our focus on business models which can achieve attractive returns on equity without utilising leverage is a reassuring starting point. These 'high return' business models tend to be inherently less indebted than the average company, and the leverage employed by the companies in the Evenlode portfolio is, on aggregate, significantly less than that employed by the average company*. We are paying even more attention to balance sheets than usual in the current environment. With bond yields low, debt is cheap and makes expensive acquisitions and share buy-backs look more attractive than they would otherwise, thus providing a temptation to 'juice up' earnings in a low growth world. It is not a coincidence that five of the last six new holdings introduced to the portfolio have no debt.

In summary, we remain reassured by the high quality, globally diversified portfolio that provides the cash flow stream to pay Evenlode's dividends. As normal, we remain open to using stock-by-stock price volatility to gradually shift the fund towards the best valuation opportunities in our investable universe as share prices move around.

We, the Evenlode team, think it is particularly important in times like this to keep communicating with our co-investors. We will release further updates on our website in coming days and weeks via videos, factsheets and investment commentaries. As always, please do get in touch if you have any queries.

Hugh Yarrow
Investment Director
June 2016

Please note, these views represent the personal opinions of Hugh Yarrow as at 24th June 2016 and do not constitute investment advice.

*Average net debt to EBITDA is 0.5x for the Evenlode portfolio versus 1.5x for the market (ex financials). Total leverage (total assets to equity) is 3.6x for the Evenlode portfolio versus 6.9x for the UK market. *Source: Evenlode Investment, Factset, Canaccord.*