Evenlode Investment View

October 2017 - Eighth Anniversary

Financial markets have been quite sanguine during October, with both the UK market and the Evenlode fund posting positive returns. Globally sentiment has been helped by an acceptable start to the third quarter reporting season and the continuation of reasonable economic data. Year-to date, the UK market has risen +9.0% and Evenlode has returned +12.4%.

Consumer Branded Goods

Though a positive month overall, one area of the Evenlode portfolio that has had a weaker October is the consumer branded goods sector. Evenlode's exposure to the sector has reduced over the last few years as we have seen opportunities elsewhere, but it still represents a little over 25% of the portfolio. Recent weakness follows a strong period of performance and can partly be attributed to sector rotation. However, third quarter results from several of these companies were a reminder of three key structural trends the sector continues to face:

1) Increased private label penetration, particularly in developed markets.
2) Steady growth in sales through e-commerce channels.
3) Changing consumer preferences (e.g. towards fresher, more healthy produce in food categories).

We continue to see attractive free cash flow characteristics for Evenlode's holdings in this sector and very good potential for long-term growth in both cash flow and dividends. Though the consumer staples industry is a relatively slow-changing sector, it has faced many challenges and emergent trends over the decades which it has adapted to, just as it needs to today. In terms of our preferences within the sector, we have several:

1) A willingness to be flexible, adapt and invest consistently in the future.
2) A portfolio of very strong brands (this is particularly helpful for digital channels - c85% of Unilever's portfolio, for instance, is comprised of brands that are number 1 or 2 in their category)
3) Exposure to categories where private label is less entrenched (consumer health, beauty, personal care, alcoholic beverages etc.).
4) A well entrenched position in emerging markets.

On this last point, recent results demonstrated a notable contrast between low growth conditions in developed markets (particularly the US) and the growth outlook in emerging markets. Emerging market economies have, on the whole, been through a difficult few years but structural trends for the consumer branded goods industry remain healthy. Per capita spend on these categories are still very low relative to developed markets (a fifth or less) whilst affordability and consumption trends remain positive. The potential from this long-term growth runway for companies such as Unilever, Diageo, Pepsi and PZ Cussons is substantial.

Business to Business

Elsewhere in the portfolio, recent newsflow from many of the business-to-business franchises in the portfolio reiterates the opportunities many of these 'hidden champions' are finding to help their customers become more efficient, make better decisions, and improve the quality of the products and services they offer their own customers (not least through the harnessing of software and data analytics). Examples include Fidessa, Relx, Microsoft and Aveva, all of which have reported positive trading updates over the last week or two.

As financial software firm Fidessa put it recently *we are committed to playing an increasingly important role in the markets as customers focus on efficiency, transparency, compliance and performance, and expect this this will provide us with significant opportunities for further growth.*

Free Cash Flow and Balance Sheet Strength

Meanwhile, our ongoing efforts to ensure a good combination in the fund of healthy free cash flow generation and strong balance sheets continue. This year we have focused fresh capital where these characteristics look particularly attractive, whilst reducing exposure to certain holdings such as pharmacuetical stocks Astrazeneca and Glaxosmithkline (where long-term prospects remain good in our view but recent free cash flow generation has been muted). We have also brought new positions into the fund that we feel add to overall quality, valuation and dividend growth appeal. I mentioned new holdings in Howden Joinery and Cisco last month, both of which enjoy strong competitive positions, high free cash flow cover on dividends and net cash balance sheets. This month we have added another new position: in Moneysupermarket, the UK's market leading price comparison website. This asset-light business model has barriers to entry that have grown increasingly strong over the years thanks to a two-sided network effect. Moneysupermarket is highly cash generative, providing good cover for the ordinary dividend and the potential for excess shareholder returns as cash builds up on the balance sheet.

Eighth Anniversary

The Evenlode Income fund was launched on 19th October 2009 and therefore had its eighth anniversary this month (this decade seems to be ticking past rather quickly!). Since launch, the compound total return per annum after fees has been +13.5% per annum for Evenlode compared to +9.8% p.a. for the UK Market and +9.7% p.a. for the IA UK All Companies sector. The average annual dividend growth, from a starting yield of 4.3%, has been approximately +7.5% per annum (the yield on an initial investment in the fund would now be approximately 6.8%) and the delivery of real dividend growth to investors over time remains a key aim of the fund.

These results have been achieved by focusing only on asset-light, cash generative stocks, with a disciplined valuation/dividend filter, a patient mindset and the ongoing management of fundamental risk. We believe this approach works consistently well over the long-term, but it also involves the Evenlode portfolio looking quite different to the UK stock market. The fund's performance will, therefore, fall in and out of fashion over shorter time periods as market trends wax and wane. This is something we have always been keen for our long-term clients to understand.

Though we are pleased with the progress to date, we are acutely aware that what matters most for our co-investors is not the past but the future, and our efforts remain focused on retaining an attractive combination of quality and value within the portfolio to drive future returns and dividend growth.

Evenlode Global Income

Before signing off, I'd like to mention the launch of the Evenlode Global Income fund, which we announced last month and will be managed by my colleagues Ben Peters and Chris Elliott. The Evenlode team has been steadily building out a global investable universe over the last few years and the new fund, launching in November, represents the same Evenlode investment approach applied to a broader opportunity set. As with the Evenlode Income fund, a key objective of Evenlode Global Income will be to deliver attractive real dividend growth to investors over the long-run, from a diversified portfolio of high quality businesses. I'd recommend taking a look! For more information please see *http://evenlode.wiseinvestment.co.uk/news/the-evenlode-global-income-fund.*

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Please note, these views represent the personal opinions of Hugh Yarrow as at 26th October 2017 and do not constitute investment advice.