Evenlode Investment View

December 2017 - Treading Carefully

'Those who live by a crystal ball are destined to eat glass'

Ray Dalio, *Principles*

2017 has offered up plenty for investors to think about: a surprising UK election, Brexit negotiations, North Korea, Trump, interest rate rises and very mixed corporate news-flow. However, reasonable economic progress and low financial asset volatility have been dominant themes for the year overall, and following a wobble in November stock markets have resumed their upward trajectory this month.

Principles Rather Than Predictions

As we head into 2018, regular readers will not be surprised that I'll refrain from making any big, bold forecasts on the global economy or the stock market's trajectory.

On the subject of forecasting, I have just read Ray Dalio's new book *Principles*. I found the first part of the book particularly interesting, in which he reflects on his experiences building his company Bridgewater Associates from a start-up during the 1970s into the largest hedge fund in the world. Dalio describes investing through some very difficult market environments in the early part of his career, including the highly challenging 1970s and early 1980s when volatility in interest rates, inflation, commodities, bonds and stocks were at extreme highs. Dalio emerged from this period with a great respect for the inherent uncertainty always present in financial markets and economies and the problems that overconfidence can get you into (at one point he noted 'being so wrong — and especially so publicly wrong — was incredibly humbling and cost me just about everything. I saw that I had been an arrogant jerk who was totally confident in a totally incorrect view'). In response to these experiences, he built an investment process based on time-tested principles that aimed to manage risk carefully, diligently observe and respond to the facts, and avoid 'betting the farm' on one particular macro-economic outcome. He in no small part attributed Bridgewater's ultimate prosperity to his early experiences and challenges.

When hearing the story of successful long-term investors - regardless of how different their styles appear ostensibly - I'm always interested in how much commonality there tends to be. It's rarely (never?) easy, there tends to be plenty of self-doubt along the way, and the whole process often resembles a ceaseless endurance sport! But a pattern emerges: *distill some basic timeless principles that are useful in managing both fundamental and valuation risk in a wide range of environments. Then apply and improve these principles consistently and diligently over the long-term, through a wide range of market conditions.*

Balancing Quality and Value

Returning to the outlook for 2018, at Evenlode we remain focused on shepherding a diverse portfolio of quality companies that provide sustainable dividends and potential for good total returns thanks to attractive free cash flow valuations.

This harmony between quality and value is always a tricky balance to strike, not least in the current valuation environment which remains relatively unappealing following several years of rising markets. However, we have been reassured by the strategic and financial progress that holdings have been making, particularly in terms of free cash flow. The average free cash flow yield for portfolio holdings remains comfortably above 5%, providing a reassuring safety buffer for the dividend stream*. As I have discussed before, free cash flow yield is a most interesting metric in the sense that it is simultaneously a measure of both quality (it tells you whether a business is converting its earnings to cash) but also value (it tells you how many pence of spare cash you're receiving for every pound you spend on a share).

Meanwhile, we've been encouraged by opportunities over the last two years to introduce new positions to

the portfolio that have helped maintain the quality/valuation balance whilst increasing diversification. The last three additions to the portfolio – Cisco, Howden Joinery and Moneysupermarket are good examples: all highly cash generative companies with strong competitive positions and net cash balance sheets, but operating in very different niches (both to each other and to the rest of the Evenlode Income portfolio).

I would also note that good valuation opportunities can be found (as always) in companies that, though high quality and consistently cash generative, have been struggling for growth over recent years due to difficult end markets or other operational headwinds. In my view Smiths Group falls into this category. The company enjoys some very attractive market positions in the medical and engineering sectors and continues to throw off cash in a reassuring way, but challenging conditions in certain sectors have held back performance in recent years. Underinvestment has been a problem too, but new management are now investing meaningfully in innovation to drive long-term organic growth. As management put it at the company's recent investor day 'building an R & D culture, a culture of invention, takes a lot of patience and consistency over years not months. The rewards are certainly not immediate, and not short-term, but they are truly sustainable'. Smiths Group offers a starting yield of more than 3% very well covered by free cash flow. I mentioned several other companies in last month's investment view that in my view fall into a similar category, including media companies Informa, UBM, DMGT and Euromoney.

Finally, it is worth reiterating our focus on balance sheet management. Interest rates remain low, and even high debt levels are therefore quite manageable. However, dividend cuts tend to come when poor free cash flow generation coincides with a weak balance sheet. Managing balance sheet risk – at both the individual stock and the aggregate portfolio level – is therefore an important ongoing exercise. A strong balance sheet equips a business well in a wide range of macro-economic environments. In deflationary periods low debt levels provide a safety cushion when nominal revenues and cash flows reduce. But as investment research house Bernstein recently noted, stocks with unleveraged balance sheets have also tended to perform relatively well during periods of rising interest rates, given higher interest costs have a proportionately smaller impact on such companies relative to their leveraged peers**.

So we tread carefully into 2018, remembering the old motto 'prepare for the worst, hope for the best'. I look forward to updating you on the fund's progress during 2018. In the meantime I'd like to thank all co-investors for their interest and support this year and wish you an enjoyable, peaceful Christmas.

Hugh Yarrow
Fund Manager
19th December 2017

Please note, these views represent the opinions of Hugh Yarrow as at 19th December 2017 and do not constitute investment advice.

*Source: Canaccord, Evenlode Investment, 19th December 2017.
**Source: Bernstein, *'Quant, Beyond The Value Trade'*