Evenlode Investment View

April 2018 - The Pendulum Swings

The UK stock market has managed to claw back most of its year-to-date losses over the last few weeks, helped in part by a reasonable first quarter corporate reporting season (as I write, the FTSE Allshare has returned -1.0% year-to-date compared to a return of +0.1% for Evenlode Income*). However, global stock market volatility has remained high, with investors continuing to digest the prospect of rising interest rates, particularly in the US, as expectations for inflation have increased. A recent uptick in oil and other commodity prices has added to this more inflationary mood music.

The Pendulum Swings

I find the current market environment an interesting juxtaposition to that of two years ago. Back then, we were seeing the most interesting opportunities to deploy fresh capital into companies exposed to end markets such as energy and industrial production, which were quite unfashionable at the time. Meanwhile, 'dull' and 'boring' was in fashion and we were finding ourselves reducing exposure to several more stable companies for valuation reasons.

The pendulum of sentiment has swung a long way since then. Energy and industrial production stocks are now enjoying a significantly more favourable industry backdrop and have been driving recent performance at both the market level and within the Evenlode Income fund (stock examples include Rotork, Aveva, Victrex, Spectris and Smiths Group - with both Rotork and Aveva releasing very positive updates over the last couple of weeks as their end markets begin to show signs of recovery). Though we remain very happy with these holdings, at the margin we are beginning to see the opportunitiy set shift. In particular, several of the more stable franchises within the portfolio have found themselves on improved starting dividend yields and valuations, a trend that we welcome given their resilient characteristics. I mentioned several stocks that we have been adding to last month including Relx, Smith & Nephew, Sage and Reckitt**. We have continued to drip cash into these holdings during April, along with others such as Unilever and Pepsi. All these stocks have undergone non-trivial share price corrections over the last few months, ranging from around -15% for Smith & Nephew to more than -30% in the case of Sage and Reckitt.

Consumer Brand Goods

Three of the companies mentioned above (Unilever, Pepsi and Reckitt) reside in the consumer branded goods sector which has become notably unpopular with investors recently. Whilst I believe it is partly because investors have simply become interested in other more 'exciting' areas of the market, it is also because the sector is currently learning to adapt to several challenges. These can be loosely grouped into three broad trends:

1) Difficult retailer and consumer dynamics in the developed world (pressure from private label, retail consolidation etc.)
2) The growth in e-commerce as a distribution channel.
3) The rising demand for more natural, healthy and authentic products – driven particularly by the millennial consumer.

Our view remains that, whilst these challenges should by no means be dismissed and are having some impact on current sales growth, companies possessing the following key characteristics are well placed to cope with these changes....

1) A willingness to be flexible, adapt and invest consistently in the future
2) A portfolio of category-leading brands (particularly helpful for digital channels).
3) Exposure to categories with more attractive economics and long-term structural trends (consumer health, beauty, personal care, food-on-the-go, nutrition, beverages etc.).
4) A healthy exposure to emerging market geographies.

.....and in fact not just cope with these current challenges but also harness the opportunities they present.

In my view Unilever, Reckitt and Pepsi offer a particularly good combination of the characteristics listed above, along with attractive dividend yields (3.3%, 3.0% and 3.5% respectively, all nicely underpinned by cash generation) combined with good potential for dividend growth over coming years (their most recent dividend increases have been +8%, +7% and +15% respectively***). It has been particularly encouraging to see good progress being made for these companies in emerging markets over recent months, following a cyclically tough period. The long-term growth opportunity in these regions remains very compelling with spending on most consumer branded goods category less than one fifth of the equivalent in developed markets.

To summarise, we have seen some interesting opportunities to broaden out the portfolio over the last two years. In fact we have added 15 new positions to the fund since the end of 2016, which is quite active for us (8 have left the portfolio over the same period, partly due to takeover activity, and partly due to valuation and fundamental considerations). Presently, however, we are seeing the most interesting opportunities within the existing portfolio. The goal remains to strike a healthy balance between quality and valuation appeal. On this note, I remain reassured by the portfolio's 3.3% dividend yield, which is provided by a collection of resilient businesses with good prospects for steady dividend growth over time.

Hugh Yarrow
Fund Manager
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Please note, these views represent the opinions of Hugh Yarrow as at 27th April 2018 and do not constitute investment advice.

*Source: Financial Express to 27th April 2018.

**A few words on Sage might be worthwhile here given that the company did not have a great quarter relative to expectations. It is very possible that the business doesn't deliver the medium-term organic growth guidance laid out at the recent capital markets day (i.e. sustainable +10% organic growth which is an ambitious and arguably unnecessarily high bar for management to set). However, a starting free cash flow yield of 6% combined with prospects for reasonable (even if single digit) organic growth and gentle margin expansion remains attractive in my view. Free cash flow is underpinned by the fact that 78% of Sage's revenue is recurring, a percentage that is likely to continue to increase over coming years – towards the 85-90% level - as cloud adoption continues amongst their customer base. And the long-term growth opportunity remains, notwithstanding the latest quarter - both in terms of migrating existing users to higher-value products/ subscriptions and signing up new customers.

***Source: Canaccord Quest, 2018 dividend yield.