Evenlode Investment View

May 2018 - Staying The Course

EVENLODE
INVESTMENTS FOR LIFE

Investing should be like watching paint dry or grass grow

Paul Samuelson

Having been down -8.9% in late March, the UK stock market has subsequently posted a very significant rally over the last two months, reaching an all time high this week. At the time of writing the FTSE All-Share has now risen +3.1% year-to-date and Evenlode Income +4.7%[1].

Despite these gyrations, the overall flavour of the market has been distinctly 'risk-on' and inflationary, with cyclical stocks such as industrials and resource producers in the most part favoured. This general mood has been helped by a reasonably benign economic backdrop, with the last few months - though still very patchy - representing perhaps the closest we have come for some time to a 'synchronised global recovery'. In parallel the oil price has surged, helped by global demand growth, falling inventories and Iranian tensions. These trends have been echoed at the micro-economic level. Many companies have been reporting improved trading conditions, particularly those with end market exposure to sectors such as industrial production, energy and emerging markets (areas that even two years ago were quite depressed). In the Evenlode Income portfolio over recent weeks for instance, Rotork reported order intake up +27% whilst Victrex and Aveva both reported organic sales growth well above +10%.

Another theme that has been building over the last few months has been an increasing level of debt-financed merger and acquisition (M & A) activity, something we've observed at both the market and the fund level[2]. With interest costs remaining low and sentiment improving, this is perhaps inevitable. It is also noticeable to see a greater number of leveraged buyouts from the private equity sector, most recently highlighted within the Evenlode Income portfolio by an offer for DMGT's associate company Zoopla.

In short, despite some volatility, *animal spirits remain high and seem to be rising*. And the 'hot money' is returning to investment markets.

Staying The Course

When "conditions" are good, the forward looking investor buys. But when "conditions" are good, stocks are high. Then without anyone having the courtesy to ring a bell, "conditions" get bad.

Fred Schwed, *Where Are The Customer's Yachts?*

Our through-cycle approach to risk management may seem a little humdrum during such periods of investor enthusiasm. But it is often the case that the more buoyant an investment environment feels over the short-term, the more caution the long-term investor should exercise in order to 'stay the course'.

With stock markets hitting all time highs, M & A activity picking up, corporate debt levels rising, and interest rates heading higher, here are four factors we are monitoring particularly closely:

1. Valuation

The overall valuation environment remains relatively unattractive in our view, with future return potential looking lower over the next few years than it was in the first few years after 2008-9. As always, we look to bias towards higher return opportunities, though always with an eye on risk management. On this front, and notwithstanding the overall market's rise, we have welcomed the pick-up in stock-by-stock volatility. In February's view I mentioned that some of the more 'boring', stable franchises in the portfolio have undergone significant corrections in recent months, and we have shifted the portfolio accordingly (towards stocks such as Reckitt, Relx and Pepsi). There have also been other stock-specific examples where share prices have moved lower on newsflow that did not in our view materially change the long-term investment case. Examples over recent months have included Smiths Group, DMGT, Moneysupermarket, Compass and Smith & Nephew following results. Such share price wobbles can help us manage valuation risk over time.

2. Balance Sheet Strength

With the increase in M & A activity, more debt has found its way onto corporate balance sheets. Borrowing might juice up shareholder returns in the good times , but it works both ways. A leveraged company's ability to both invest and pay a progressive dividend is compromised when conditions deteriorate (particularly if interest rates are rising). Interestingly, investment research firm Bernstein pointed out this month that balance sheet resilience doesn't seem to be a charactersitic particularly valued by global markets at the moment (i.e. the factor is relatively cheap)[3]. This is perhaps a reflection of both the current risk-seeking zeitgeist and the low interest rate environment. More anecdotally, but in a similar vein, we have seen some good opportunities to add businesses with net cash balance sheets to the portfolio over the last couple of years on attractive dividend and free cash flow yields. In fact, 15 of the 40 companies in the current Evenlode Income portfolio fall into this category.

3. Diversification

We continue to think carefully about portfolio diversification. Whilst the Evenlode Income fund is a focused portfolio, we like the companies that make up the portfolio to have good 'under the bonnet' diversification - by geography and sector. We have been pleased, in this regard, to have added several holdings over recent years that all look attractive to us but operate in a wide variety of sectors with very different dynamics. The last four new holdings in the fund, for instance, have been Howden Joinery, Cisco, Moneysupermarket and Kone. Though they are all competitively advantaged and asset-light, they operate in very different sectors - both to each other and to the rest of the portfolio.

4. Free Cash Flow

Finally, to really boil it down to the basics, we continue to closely monitor the portfolio's free cash flow stream, which is ultimately what funds the dividend flow. In fact, a simple two-part checklist sums up the ingredients we view as most essential for the dividend growth investor:

1. Is the current free cash flow yield attractive?
2 Is it likely that this free cash flow will grow over the longer-term?

A portfolio that has these aggregate characteristics might sometimes look a little dull, like watching paint dry or grass grow. But it should be kind to the patient, long-term investor.

In terms of the Evenlode Income portfolio, recent free cash flow progress has been reassuring and we expect the first quarter dividend to increase by +4.5%[4].

Hugh Yarrow
Fund Manager
23rd May 2018

Please note, these views represent the opinions of Hugh Yarrow as at 23rd May 2018 and do not constitute investment advice.

1. Source: Financial Express to 23rd May 2018.

2. Launched as it was shortly after the 2008-9 downturn, Evenlode Income went for more than five years without a portfolio holding being taken over. The long-shadow of the crisis hung over the era and people weren't in the mood for taking big risks. Things subsequently loosened up a little with a takeover per year in 2015 and 2016 (Domino Printing and SABMiller respectively). Then in 2017 both WS Atkins and Aveva were

involved in M & A activity whilst Kraft unsuccessfully tried to buy Unilever. So far this year UBM and Fidessa have received takeover approaches.

3. *Bernstein Global Quantitative Strategy: Leveraging Up on the Low Leverage factor,* 18th May 2018. As the authors put it "[low leverage] remains unusually cheap globally, with valuation spreads unusually wide and even within each sector between stocks with low vs high levels of debt. This is remarkable given that the macro-economic environment is becoming progressively more risky for highly indebted companies"

4. B Income, estimated at 1.61p, ex dividend date 1st June 2018.