Evenlode Investment View

June 2018 - Reasonably Priced and Strong

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"Reasonably priced and strong, that's a very desirable combination"

Charlie Munger

May has been a quiet month for fundamental news, and the stock market has moved sideways, leaving returns for the year as a whole slightly positive. As I write the FTSE Allshare has risen +1.6% year-to-date compared to a rise of +5.7% for the Evenlode Income fund.*

The backdrop over recent months has been relatively investor-friendly, with corporate earnings generally making good progress thanks to a benign global economic backdrop. As usual however, there are no shortage of potential worries: interest rates have been gradually rising, quantitative easing is on the wane, and global economic indicators (though remaining positive) have begun to cool a little. The overall valuation environment is also not, in my view, brilliant.

Reasonably Priced and Strong

However, the Evenlode Income fund has received cash proceeds from the takeover of UBM this month, and we have been happily redeploying this capital into a broad spread of the fund's existing positions where we see a good combination of dividend yield and prospects for sustainable dividend growth.

To paraphrase Charlie Munger, these are businesses that we believe are *reasonably priced and strong*. In particular, we like businesses that are able to invest – at good rates of return – into industries that enjoy a combination of high barriers to entry and good long-term 'growth runways'. Businesses that enjoy this synthesis tend, we have found, to be capable of delivering healthy long-term dividend streams through a wide range of conditions.

Growth Runways

In terms of structural growth opportunities, there are three broad themes that I see as particularly interesting in the current investment era, and I suspect all have a long way (i.e. decades) to run:

1) Emerging markets
2) Digitalisation and data analytics
3) The drive for efficiency

They are all to some degree inter-connected and many businesses are exposed to two or all three of them in various different ways. It should also be noted that these themes create challenges as well as opportunities, many of which I have discussed in past investment views (e.g. the growth in the online distribution channel in relation to consumer branded goods companies). We are looking for businesses that have the competitive advantages and cultural characteristics to, on balance, take advantage of these trends.

Emerging Markets

Emerging markets were deeply fashionable six or seven years ago, but over the subsequent few years became increasingly less popular as a cyclical downturn hit many of these regions. 'Emerging markets' is a slightly clunky concept, composed as it is of a heterogeneous group of countries with, in many cases, economies experiencing quite varied dynamics. This was seen in the recent slowdown as certain countries (such as Brazil and Russia) were much harder hit than others. However, the long-term potential is massive for this overall group. Populations are growing whilst per capita consumption increases for many of the necessities and little luxuries we take for granted in the developed world. Companies that have strong, entrenched positions, and sell products that these customers are very keen to consume, are at a distinct advantage. Growth won't be in a straight line, but Unilever's** chief executive Paul Polman summed up the opportunity in a recent interview:

*We now have 60% of our business in these emerging markets and, while some people try to continue to hold that against us, I still feel that this is common sense and a very good position to be in. 80% of the world's population is going to live there and they're not going to accept living in ways that they have had to endure, in my opinion, for too long already. So, I think we're well placed there and we should see our numbers picking up over time in these markets.****

Most Evenlode Income holdings are multinational companies, and many of these have quite significant exposure to emerging markets (the overall portfolio now generates more than 30% of its revenues from these parts of the world). We would expect the percentage of the portfolio's cash flow from these countries to steadily increase over time.

Digitalisation and Data Analytics

Software and data are 'eating the world', as venture capitalist Marc Andreesen puts it. I have discussed the excellent growth potential traditional information and software businesses such as Relx, Informa, Euromoney, Fidessa and Sage are exposed to as a result of being able to use their proprietary data and software analytics to add value in a wide range of industries. However, it has also been interesting to witness the recent spread of data analytics into a much wider range of end markets, including industrial applications as 'the internet of things' becomes a reality. Holdings such as Spectris, Rotork, Smiths Group and Aveva are benefiting from these trends as their customers increasingly employ Chief Digital Officers and Chief Information Officers to transition to more software-enabled business models, and look to digitalise many aspects of their research and operations in order to improve product quality and efficiency whilst minimising outages and downtime. Spectris's chief executive John O'Higgins discussed this shift at recent results, and noted the added potential benefits it can have for customer relationships and revenue recurrence:

There's just a huge growth in the various levels of conversation that we're having with customers .... rather than talking about selling a piece of test equipment or a piece of test software, it's very much more a partnership discussion with those clients now around their plans for program development and how we can be part of that, in terms of our ability to test, over a multi-year time period.

Efficiency

The drive for efficiency is not limited to the digital realm. Other business-to-business franchises are generating very healthy growth rates thanks to the value they can add to their customers by offering outsourced services in specialised niches. Good examples in the Evenlode Income fund include Compass (a global leader in food catering) and Pagegroup (a global leader in white collar recruitment). Compass's global market is interesting - approximately 50% of the food catering market is currently outsourced but every year this percentage gradually ticks up as companies and institutions appreciate the benefits of switching to a specialist. This is driving consistent market growth, of which Compass are taking more than their fair share. It's a similar story for Pagegroup: outsourced recruitment still represents a small proportion of overall recruitment globally (particularly in areas such as Continental Europe, Asia, South America etc.) but this segment is in healthy structural growth. Pagegroup have an organically-built local presence in many of these key markets, and the company's asset-light business model is well placed to turn this market growth into healthy, compounding free cash flows over the long-run.

It is worth noting that none of the businesses mentioned above are without their challenges. However, their growth runways, competitive advantages and compounding free cash flows lay a solid foundation for future dividend growth. When this dividend growth potential combines with a healthy current dividend yield, we think these 'reasonably priced and strong' companies offer an attractive proposition for the patient income and growth investor.

Hugh Yarrow
Fund Manager
20th June 2018

Please note, these views represent the opinions of Hugh Yarrow as at 20th June 2018 and do not constitute investment advice.

*Source: Financial Express to 20th June 2018.

**Source: *Bernstein: CEO Unplugged....an Exclusive Q & A with Paul Polman - May 2018*

***On the subject of Unilever, we have had a few questions this month regarding the potential for the stock to be removed from the UK index if shareholders vote this autumn for the company to unify its structure in the Netherlands. It is therefore worth briefly addressing the question here. Whether a company is classified as 'UK' or not for Evenlode Income's mandate is decided by the Investment Association (rather than whether or not it is included in the UK index). If the proposal to 'go Dutch' is voted through, the Investment Association would then need to make a decision on how to categorise the UK line of Unilever's stock. Either way, we wouldn't anticipate making any major changes to the portfolio and would continue to hold Unilever whether or not it is classified as a UK listed stock (assuming all other things such as valuation/yield/fundamentals etc. were equal at the time). The fund always holds more than 80% in UK listed companies (Currently about 85%) but we can also hold up to 20% in overseas listed companies.