Evenlode Global Investment View

May 2019 – Upside Volatility

The Evenlode team has been examining the opportunities and difficulties of investing in Japanese businesses, on which we have written separately. However, our attention has not strayed from the rest of the global universe of investable businesses. Over the last few months we have had updates on the full year of 2018 and the first quarter of business in 2019, and things have been going broadly well for the firms that we follow.

Cast your mind back only four or five months, and from an equity market point of view things looked glum. Equity prices were tumbling, ostensibly for a number of macroeconomic and geopolitical reasons. I always remind myself of Stein's Law: 'if something can't go on forever, it will stop' when it comes to the equity market. Prices had been rising and, unless we think they will end up at infinity, they are bound to stop doing so at some point, whatever the reason.

Then we had the opposite manifestation. 'Volatility' is often used as a euphemism for falling prices, but a price can go down gradually every day and have low volatility. Since the start of the year we have experienced broad-based upside volatility, retracing the losses previously experienced. Then very recently a tweet sent everything into reverse again. Tariffs have real-world consequences for companies, so perhaps the market reaction is warranted. Then again, can the market really analyse and digest, in a matter of hours and days, the complex set of economic ripples that result from changes in taxes and tariffs? Should we be reacting fast or taking it slow?

Making the fast paced slow

Our approach to the macro is to not try and analyse and predict, but to choose companies that we think can withstand a broad range of scenarios and then stick with them. It's a long term approach, which means that we avoid having to worry overly about market moves, and can use them to invest or divest if we think that the long run valuation picture has changed. Our modus operandi is what we call the portfolio *nudge*, making incremental changes should they be warranted in response to the changing relative attractiveness of businesses in the market. That way we tend to be long term holders, but sometimes we nudge so far that we exit a position. And sometimes a zero position warrants nudging up to be a holding in the portfolio.

In the year to date we have had a few such opportunities, very much on a company-by-company, case-by-case basis. In January we bought a small position in global technology consultancy and outsourcing firm Accenture. The price had been caught in the year-end downdraft and the valuation got to a point that we thought was attractive as a starter. It has since appreciated significantly, and so we have not built the position further (it is worth remembering that for savers, low equity prices are a good thing!). In March we exited the fund's positions in healthcare businesses Astrazeneca and Johnson & Johnson, both for valuation reasons. These had been 'nudged' down to reflect the better valuation opportunities elsewhere in the healthcare sector. In May, we exited Finnish liftmaker Kone, and introduced consumer goods firm Reckitt Benckiser, and US travel IT company Sabre to the portfolio.

This represents reasonably significant activity for the Evenlode team under our investment process, and is a function of not just the overall market volatility, but the relative movements between the high quality businesses that we have in our investable universe.

Market and sector aggregates do tend to hide the goings on at the individual company level. To take an example from our recent purchases, the consumer goods sector has generally been in favour with Mr Market, and we have nudged down the fund's exposure overall as a result. But Reckitt Benckiser is in the dog house because it has hit a slower patch having been a reliable top line grower for many years. It is also digesting the acquisition of infant nutrition business Mead Johnson and the associated debt burden, which we think is manageable but needs to come down (it is heading in the right direction).

To take another example, Sabre could be looked at as an IT company (a sector that has been performing well), but it is really a service company to the travel industry. The business operates the global distribution system for airline ticketing, and is diversifying into other travel-related services like hotel management software. It is moving its operating model from its own data centres to the cloud, which is causing some messiness in the financial statements, but fundamentally operates in a market with good network effects and a value proposition to airlines, travel agents and others in the hospitality industry. Cash generation is therefore good, and its pricing model means it is not heavily exposed to cyclicality in ticket pricing.

Tin hats, not tin ears

So our focus is on business rather than macroeconomic and geopolitical noise, looking for businesses with tin hats to protect against external impacts. But if things really have changed for a company as a result of a political situation, we should take that seriously. On the tariff question, as there are real-life implications it does make sense to think about the areas of the Evenlode Global Income portfolio that might experience a significant impact.

There are two firms that are obvious candidates – off-road vehicle maker Polaris, and consumer electronics firm Apple. The latter probably needs no introduction, the former perhaps more so to a UK-based audience. Polaris sells small off-road vehicles, snowmobiles, motorbikes and (more recently) boats, largely in North America. It has very good market positions in these niche markets and has a different business model to a large automobile manufacturer in that it is essentially an assembler of simple products. The firm's competitive advantage lies in the brand loyalty of customers, and the sales and service network. However, the parts it uses to assemble into finished products come from outside of North America, notably China. Whilst the business can, and has, taken steps towards offsetting the effects of tariffs on goods that it needs to import (shifting sourcing and production, passing costs on to customers), it can only do so much. The recent escalation of the tariff situation will affect profitability significantly if it persists. We keep a watching brief on the situation; we do not want to be trading frenetically every time President Trump touches his iPhone for fear of what might be emitted onto the internet, but where action is warranted we will be active.

Apple is less exposed as it is a very multinational business and has immense financial resources at its disposal to cushion any blows. Overall the Evenlode Global Income fund's direct exposure to US-China tariffs is low because of the underlying global diversification of the businesses in the portfolio, and the small position in Polaris reflects the risks that we perceive the business faces.

Taking the rough with the smooth

If things do take a more global downturn, whatever the confluence of reasons, then most businesses will be affected. What we have as a result of our approach is confidence that the businesses in the Evenlode Global Income portfolio have a good chance of emerging in good shape, and in the better times will thrive. Ups and downs are a fact of life for all businesses and economies. It's how they deal with them that counts.

Ben, Chris and the Evenlode team
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Please note, these views represent the opinions of Ben Peters and Chris Elliott as at 17th May 2019 and do not constitute investment advice.