Evenlode Investment View

April 2019 – Resilience and Change

"Markets will fluctuate"

John Pierpoint Morgan

Mr Market's mood has changed considerably since the end of 2018. Back then, concerns were widespread regarding rising interest rates, trade tariffs and a global economic slowdown. Though the economic and political outlook is still mixed and uncertain, a marked shift in tone from the US Federal Reserve has led to a significant reduction in interest rate expectations, which has been taken well by investors. At the same time, optimism regarding talks between the US and China on trade tariffs has grown, global economic data has muddled along, and corporate results have on the whole been quite reassuring. In the UK, the question of Brexit remains unresolved, but an agreement between the UK and the EU to extend Brexit's deadline by six months has helped calm investor nerves, for now at least.

All this has contributed to a strong recovery in global stock markets. Since the start of the year, the FTSE All-Share has now risen +12.5% and Evenlode Income +14.1%[i]. As a result, the UK market has clawed back most of the losses it experienced between May and December last year.

Nudging the Portfolio

The stock market has a tendency to lurch around by a far greater magnitude than fundamental business performance, and price movements over the last few months are a reminder of that fact. We were finding the valuation environment increasingly compelling towards the end of last year - the best we'd seen for approximately three years. This year's rally has reduced this opportunity somewhat. However, as the investor Peter Cundill used to put it, *there's always something to do*, and though many boats have risen with the tide, individual stock volatility remains a provider of opportunity. We continue to gradually 'nudge' the portfolio towards the areas of the investable universe we think look most interesting in terms of both quality and valuation appeal.

This year we have added to several holdings with a diverse range of business models including Relx, Reckitt, Howden, Informa, Hays, Page Group, Spectris, Unilever, Smiths Group, WPP and Victrex. We have also introduced a new holding in Intertek, a global market leader in the quality assurance industry. The company has an asset light business model and a good track record of steadily compounding free cash flow. It operates in a sector enjoying structural growth drivers such as increasing consumer focus on sustainable products, increasing regulation, faster innovation cycles and more complex product ranges. Intertek's cash flow valuation appears attractive to us, dividend growth prospects look good, and the recent +39% increase in the dividend means the current dividend yield has increased. This year we have also removed J & J and Novartis from the portfolio and reduced the fund's position size in Diageo, all for valuation reasons. We remain open to evolving the portfolio as the opportunity set shifts and are currently considering one or two potential new holdings where recent share price underperformance has begun to make relative valuations look quite interesting.

First Quarter Results

After a quieter March for company results, April has been busy with first quarter reporting season underway. Results have been quite robust and we have been encouraged by the organic growth that a variety of business models in the portfolio are achieving. Perhaps the stand-out theme is the growth coming from companies that are benefiting from the trend towards more digitalisation, such as Microsoft, Aveva, Relx and EMIS. The global economy continues to shift rapidly towards more digital products as all companies look to improve their efficiency and cope with increasing complex operations and information. Microsoft chief executive Satya Nadella summarised it well at recent results:

Digital technology today is not about tech companies doing innovation. It is about the rest of the world doing innovation with technology, and Microsoft is uniquely positioned to enable that.

Microsoft is a good proxy for this trend given its global leadership in the provision of technology to businesses of all sizes. The company reported sales growth of +16% and earnings growth of +27% in its most recent quarter. This is impressive growth for a business of Microsoft's size. But as Satya Nadella notes, the global trend towards digitalisation and efficiency is not just of benefit to technology firms. Almost every company in every sector can harness these trends to help improve their own operations, products and services. I have recently discussed, for instance, the significant investment that Moneysupermarket has made and continues to make in its technology platform in recent investment views. The company reported sales growth of +19% for the first quarter, thanks in no small part to the improvements that these technology investments have made to the customer experience.

Resilience and Change

"Excellent firms don't believe in excellence - only in constant improvement and constant change."

Thomas J. Peters

More generally, the need for constant investment, innovation and improvement has been a very clear theme through recent results. Companies that optimise their flexibility and adaptability whilst consistently investing are able to drive growth even in this quite challenging economic and political environment. It's a theme we keep coming back to (and I admit it's a very old theme - the quote from Tom Peters above is from the 1980s!) but it is certainly an important and enduring one.

We think several Evenlode holdings from the consumer branded goods sector are doing a good job of embracing this mindset. Last week Unilever released first quarter results and reported +3.1% organic sales growth whilst guiding to +3-4% growth for 2019 as a whole. In the same sector, Pepsi and Procter & Gamble also released quarterly results this month, both reporting +5% organic sales growth. This is reassuring progress, particularly as the sector is facing no shortage of challenges. As Unilever management put it:

This growth is in the context of continued geopolitical uncertainty around trade wars, some key elections in many countries, and a rise in popular protests. Though these factors impact currencies, inflation and consumer demand, our local businesses are experienced at responding rapidly and effectively and I think you can see this in our solid delivery.

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The economic backdrop over the last year has included everything from hyperinflation in countries such as Argentina and Turkey to deflationary conditions in certain categories and channels in Western Europe. There are also several key transitions underway in the industry (changing consumer preferences, the shift to digital channels, local competition, new brand launches, the shift to sustainable packaging etc.). But these companies are working hard to engineer their businesses in a way that makes them increasingly able to react and adapt quickly. All these organisations have re-focused their portfolios over recent years, introduced a flatter management structure, overhauled their approach to innovation and brand launches, invested heavily in digital, and are pursuing ambitious sustainability agendas (Unilever, for instance, have reduced carbon emissions by more than 50% and waste by more than 30% since 2010 despite significant growth).

There will, of course, be many missteps and challenges along the way for any business, and growth won't develop in a straight line. But those companies most willing to adopt a mindset of continual improvement are best placed to turn today's challenges into tomorrow's opportunities.

Hugh and the Evenlode Team
26th April 2019

Please note, these views represent the opinions of Hugh Yarrow as at 26th April 2019 and do not constitute investment advice.

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[i] Source: Evenlode, Financial Express, total return, bid-to-bid, 31/12/2018 to 26/04/2019.