Evenlode Investment View

June 2019 - On Risk

EVENLODE
INVESTMENTS FOR LIFE

Investors should always keep in mind that the most important metric is not the returns achieved but the returns weighed against the risks incurred. Ultimately, nothing should be more important to investors than the ability to sleep soundly at night.

Seth Klarman

It's been a quiet month for corporate news during June so Mr Market has been more focused on geopolitical and economic developments. In particular, with the global economy struggling along and inflation pressures falling, there is an increasing willingness from central bankers to increase monetary stimulus (as demonstrated by recent accomodative statements from both the US Federal Reserve and the European Central Bank). This change in tone has led to a significant reduction in both interest rate expectations and bond yields. In sympathy, global stock markets have moved higher, adding another leg to this year's recovery. Since the start of the year, the FTSE All-Share has now risen +12.7% and the Evenlode Income fund +20.2%.*

Treading Carefully

There is no doubt that this upward move in the market has reduced the overall attractiveness of the valuation environment (which had been getting more interesting in the last quarter of 2018). However, the rising tide has not been uniform in terms of individual share price moves. We have therefore been 'moving the portfolio on' over the last few weeks, as we continue to aim to strike an appropriate balance between quality, valuation and dividend yield. The primary rationale for recent changes has been valuation considerations. We have, for instance, begun to reduce some of the fund's larger holdings in Diageo, Compass, Smith & Nephew and P & G and trimmed smaller positions such as Microsoft and Cisco. We also exited the fund's position in Aveva last month. With these proceeds we have initiated a new holding in Bunzl and added to several existing holdings such as Reckitt Benckiser, Smiths Group, WPP, Victrex, Burberry and Informa.

This process of portfolio evolution is a by-product of our ongoing efforts to manage risk, of which we consider valuation risk to be an important sub-category. More generally, I would go as far as to say that ***we see our primary job as investors as one of risk management***. On this note, and in a quiet month for company newsflow, I would like to spend the rest of this investment view briefly discussing the way we think about risk at Evenlode.

Insulation Rather Than Prediction

"The only certainty is uncertainty"

Pliny The Elder

If the world were perfectly uniform and predictable the concept of risk management would not be necessary. However, the future is inherently uncertain and therefore risk management needs to be embraced and thought about carefully. Acceptance of this fact implies that any attempts to make big bets on one particular future outcome, whether related to the global economy, interest rates, inflation, political outcomes or any other factor, will not necessarily end well (as the Nobel prize winning economist and mathematician Kenneth Arrow put it, '*vast ills have followed a belief in certainty*'). With this in mind, our approach at Evenlode is to try to *insulate* the portfolio, as best we can, from a wide range of possible future outcomes by managing various types of investment risk, rather than make big predictions about the future.

Managing risk does not eliminate risk, of course. However, careful risk management should help an investor to 'stay the course', reducing the number of problematic investments over time, and minimising their impact on the portfolio when inevitably they do occasionally occur.

Pattern-Spotting

We have worked hard to develop an approach to risk that is systematic but at the same time interdisciplinary.

We aim to combine qualitative and quantitative business model analysis, valuation analysis, financial risk analysis, behaviourial psychology, lessons from corporate/financial history and our own experiences**. We have found that all these inputs help us spot recurring patterns that indicate significant risk. For instance, over-valuation presents a clear risk. When certain areas of the stockmarket have, historically, become crazily highly valued (radio stocks in the late 1920s, the 'nifty fifty' stocks of the 1970s, technology stocks in the late 1990s etc.) it has set the stage for very poor subsequent outcomes. Another classic risk pattern that regularly recurs through history is when financial and operational leverage coincide with deteriorating free cash flow in a company. This reliably leads to an unenjoyable investment experience, often accompanied by dividend cuts and cancellations. Similarly, when a business model faces a high risk of technological substitution this has tended to lead (ultimately, at some point) to the destruction of previously attractive economics. Once these patterns are acknowledged, it makes sense to carefully control their associated risks (valuation risk, debt levels, free cash flow, disruptive risk etc.) at both the individual stock level and at the level of the portfolio. As Charlie Munger once put it, *all I want to know is where I'm going to die so I won't go there*.

Three Types of Investment Risk

We have identified three categories of risk which we think are particularly important: ***valuation risk, liquidity risk and fundamental corporate risk***. The first two categories are quite straightforward. In terms of ***valuation risk***, we have developed a methodology to value each stock using a long-term free cash flow approach, and we also pay attention to various other key valuation metrics as a sense-check. Whilst equity valuation will always be imperfect, we believe this methodology is a useful tool, and helps one avoid 'falling in love' with a company when it becomes very expensive relative to other opportunities. In terms of ***liquidity risk***, we always look to maintain a portfolio that is highly liquid (i.e. one in which the shares held are in aggregate easy to buy and sell) so that we are able to make the changes we want to the portfolio over time.

For the third type of risk, ***fundamental corporate risk,*** we have divided the category up into eight key characteristics, and we grade these risk factors from A to E for each portfolio holding. Depending on our assessment of these risks, the Evenlode team determine a maximum position size which we won't exceed, even when that company's valuation looks particularly attractive to us. These 'maximum position sizes' are regularly updated by the team as fundamentals change over time. The eight key categories we consider for each company are as follows:

1. **Strength of Competitive Position** (the 'Economic Moat')
2. **Long-Term Industry Outlook**
3. **Economic Resilience**
4. **Diversification** (by geography, category, brand, business model etc.)
5. **Balance Sheet Strength**
6. **Free Cash Flow Strength** (particularly in relation to how well free cash flow covers the dividend payment)
7. **Management Quality** (including overall cultural quality across the organisation, governance strength etc.)
8. **Social Impact** (including regulatory risk etc.)

As well as this company=specific assessment of risk, we also have a 'dashboard' of key risks that we carefully monitor at the level of the overall portfolio:

1. **Overall Portfolio Quality**
2. **Free Cash Flow Strength** (the free cash flow yield on the Evenlode Income portfolio is 5.0% this year and forecast to be 5.6% next year).
3. **Balance Sheet Strength** (the Net Debt to EBITDA ratio of the portfolio is 1.0x this year and forecast to be 0.8x next year).
4. **Economic Resilience** (83% of the portfolio scores A to C on economic resilience, and 66% A or B).
5. **Diversification**
6. **Overall Portfolio Liquidity*****

Scoring Ones and Twos

Share prices will always bounce around a lot in the short-term (an inherent fact that any long-term investor needs to accept). Also, no risk management framework will ever eliminate all mistakes. However, we think managing the key fundamental risks described above should significantly reduce the number of situations which end up presenting the potential for the permanent loss of capital and income.

With the Cricket World Cup underway this summer, a cricketing analogy seems apt. Our aim is to score runs slowly, keeping the ball on the ground and taking low-risk ones and twos, rather than making big risky swings for the boundary. This approach is arguably a little boring, is incremental in nature, and requires detailed work, thought and patience. It is though, we think, in the best interests of our clients to proceed in this way consistently over the very long-term.

Hugh and the Evenlode Team
26th June 2019

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

*Source: Evenlode, Financial Express, total return, bid-to-bid, 31/12/2018 to 26/06/2019.

**The tension between subjective and quantitative risk analysis is an interesting one. The best book I have read on risk is *Against The Gods: The Remarkable Story of Risk* by the financial historian Peter Bernstein. Bernstein points out that *"there is a persistent tension between those who assert that the best decisions are based on quantification and numbers, determined by the patterns of the past, and those who base their decisions on more subjective degrees of belief about the uncertain future. This is a controversy that has never been resolved."* We think it helps to use quantitative tools to assess risk but that they work best when combined with qualitative judgements, and always in the context of an understanding of very long-term corporate, financial and investment history.

***For Evenlode Income, larger companies (defined as those with a market capitalisation of £5 billion or more) currently comprise 75% of the portfolio and only c.3% of the portfolio is invested in companies with a market capitalisation of less than £1 billion. The average weighted market capitalisation of the portfolio is £47 billion. All figures as at 31st May 2019.