Evenlode Investment View

July 2019 - Evenlode Income Second Quarter Review

"There's always something to do"

Peter Cundill

An increasing number of our clients have requested a regular quarterly update on the Evenlode Income fund: detailing the main drivers of fund performance over the last three months, any significant changes we have made to the portfolio, and the key themes we are thinking about in relation to the portfolio and the broader corporate and investment environment. In response to these requests, we have decided to use the investment view that follows the end of each quarter to publish this update (i.e. the April, July, October and January investment views). In the January investment view, we will also give an update on the full calendar year as normal. I hope that this additional information will be helpful.

Performance Summary

The second quarter was a positive one for global stock markets. Various geopolitical question marks continue to linger (trade tariffs, Brexit, Iranian tensions etc.) but the bigger news for investors during the second quarter has been the downward shift in interest rate expectations. With inflation falling, the message from central banks is that they have the capacity to ease monetary conditions if necessary. This change in tone led to a significant reduction in bond yields and interest rate expectations, particularly in the US. The risk posed by rising US interest rates was one of the key catalysts for the fall in stock markets at the end of last year, so it is perhaps not surprising that the reduction of this risk over recent months has improved sentiment. Corporate results overall have been a little mixed (with UK companies in particular vulnerable to disappointment relative to expectations) but the overall message from most businesses has been reasonably reassuring, which has also helped the mood.

The Evenlode Income fund rose +10.3% during the second quarter compared to a rise of +3.3% for the FTSE All-Share and +3.6% for the IA UK All Companies sector. The key performance drivers within the fund were stock specific and primarily related to positive trading updates. The biggest share price increases in the portfolio came from WPP (+26.9%) and DMGT (+26.7%). The share prices of both companies staged a recovery (after recent underperformance) thanks to reassuring trading updates. WPP is in a transitional phase under new management, and we have been impressed by the steps taken so far in terms of simplifying WPP's portfolio, investing in technology and people, and aiming to more tightly integrate the content they produce with their digital offering. The balance sheet has been stengthened by recent portfolio disposals and free cash generation continues to be very reassuring. DMGT have been going through a similar process of portfolio simplification over the last two years. We think this has been a sensible move and, as with WPP, has led to a significant stengthening in the company's balance sheet. The majority of DMGT's portfolio is in business-to-business media franchises with attractive economics and long-term growth prospects. After adjusting for position size, the most positive contributors to the fund's second quarter performance were Relx, Unilever and Sage. These companies contributed +1.1%, +1.1% and +0.7% to the fund's performance respectively. All three businesses benefited from positive trading updates. In the case of Relx and Sage, structural demand for digital services is driving growth. For Unilever, it is the emerging market opportunity, which now represents c.60% of the company's sales.

There were no significant negative contributors to performance. However Bunzl, Halfords and Reckitt Benckiser all acted as a slight drag on performance (each detracting -0.02% from the fund's performance). As mentioned below, Bunzl was added to the portfolio during the period. Halfords released reassuring final results but negative UK consumer sentiment continues to restrict growth and weigh on the company's shares. Reckitt shares were not helped by an announcement in April that pharmaceutical business Indivior was under investigation by US authorities regarding marketing practices used for its Suboxone drug several years ago. Though Indivior was demerged from Reckitt in 2014, investors worried that the company might face some legacy liability in the result of Indivior receiving a fine. We acknowledge this risk, but view it as manageable and one-off in nature. Longer term, we continue to think Reckitt owns an excellent portfolio of health and hygiene brands with significant structural growth opportunities, particularly from emerging markets.

Portfolio Changes

To paraphrase Peter Cundill, *there is always something to do*, and we have been relatively active over the past three months in terms of portfolio changes. We introduced a new position in Bunzl during May, following a disappointing trading statement that led to quite a significant fall in the company's share price. Bunzl's business model is ostensibly rather dull but, on closer inspection, the company enjoys significant competitive strengths and good diversification both by geography and by end market. Bunzl provides its business customers with not-for-resale products such as

napkins, plates, foil and safety glasses ('nuisance' products) and is the only global operator in a fragmented market with good long-term growth prospects. These products represent a low share of customer's overall spend but if not delivered on time and in full can cause significant operational issues. Bunzl becomes a trusted partner, taking ownership of this element of the customer's supply chain through long-term relationships. The predictable, repeat-purchase nature of its business and consistently high cash generation have led to a 26-year track record of dividend growth, with the most recent dividend increase +9%. We added Bunzl on a 2.5% current dividend yield covered by a free cash flow yield of 6.2%. In May, we also exited the fund's remaining position in engineering software group Aveva. Aveva is a high-quality business with good growth prospects, which we hope to return to again in the future. However, the share price had risen nearly 50% since the start of the year and more than trebled since we built the fund's holding up in early 2016. This left the free cash flow valuation and dividend yield less compelling relative to other opportunities.

In terms of other changes, we trimmed several positions during the period for valuation reasons, including Diageo, Compass, Smith & Nephew, P & G, Microsoft and Cisco. We also added to several existing holdings, again for valuation reasons. These included Reckitt, Relx, Informa, Smiths Group, Page Group, Hays, WPP, Howden Joinery, Victrex, Informa, Glaxosmithkline and Burberry.

Some Themes

Several key themes continue to be at the forefront of our minds and have implications for our approach to portfolio construction. Here are three examples:

1) **Free Cash Flow and Balance Sheets**: We have been very pleased with the health of the aggregate free cash flow stream that the portfolio is generating, particularly given that the economic backdrop isn't brilliant currently. The current free cash flow yield of the portfolio is 4.9% and is forecast to grow to 5.5% next year.** When compared to the fund's 3% dividend yield this gives a nice safety buffer. This excess cash generation also help companies retain a strong balance sheet, particularly important at present given that we view high levels of corporate debt as one of *the* key risks presented by the current investment environment.

2) **Adaptability**: We remain most impressed with companies that are committing to consistent, meaningful investment in the future. One of the most significant investments that is being made in the current era is in digitalisation, which continues to be a ubiquitous theme across sectors. Though it creates some disruptive pressures, we view this theme as a net positive when looking at the Evenlode Income portfolio. This is both in terms of businesses harnessing new technology to make their own operations, products and services better (many Evenlode companies fall into this category), but also in terms of the growth runway available to companies that are selling software, data analytics and other technology services to their customers (Sage, Relx, Informa, Euromoney, DMGT, Microsoft, Cisco etc.).

3) **Valuation Management**: With the recent rise in the market, the valuation environment has become less attractive. As important as ever, therefore, is the need for us to manage valuation risk in the portfolio. We will continue to do this to the best of our ability, always looking to combine the portfolio's valuation appeal with quality characteristics and a sensible risk management overlay.

Looking ahead we do not, as normal, know quite what will happen to the global economy or share prices in the short-term. However, we continue to believe that *businesses with sound fundamental economics and reasonable valuations tend to produce healthy compound income and capital growth for shareholders over longer-term periods* (sometimes quietly, and a little unnoticed). So this is the furrow we will continue to plough.

Hugh and the Evenlode Team
4th July 2019

Please note, these views represent the opinions of Hugh Yarrow as at 4th July 2019 and do not constitute investment advice.

*Source: Evenlode, Financial Express, total return, bid-to-bid, 31/03/2019 to 31/06/2019.

**Source: Evenlode, Factset, data as at 31st June 2019