Evenlode Global Income Investment View

Paying Dividends - January 2022

EVENLODE
GLOBAL INCOME FUND

Market data is from Factset and FE Analytics.

Having enjoyed a very positive 2021, global equity markets have started 2022 with a weaker tone, although the UK's FTSE All Share has bucked this trend and is in positive territory. We are only three weeks into the year so it's a little early to be calling this any kind of a trend for 2022, and we certainly won't be getting the crystal ball out and making any market predictions for the year. But on the back of very positive multi-year returns it's unsurprising that there is a pause for breath. The weakest sectors so far this year were the strongest ones over the course of the pandemic, notably information technology and related companies like data and analytics firms. Energy and financial companies have seen a resurgence having suffered their way through lockdown. As ever there is a mixture of drivers at play: market forces (likely driven by valuation considerations amongst other things), geopolitics (oil, gas, the situation in Russia/Ukraine), and macroeconomics (particularly the pathway for interest rates).

When analysing investments we focus more on the fortunes of the individual companies, rather than solely on macro considerations, but there are interesting dynamics at play and they set the scene of the operating environment for the businesses that we select. The path of interest rates most directly affects the financial sector, and the price of oil and gas the basic resources and energy sectors. There is no direct exposure to those industries within the portfolio. However, the experience of those firms does have knock-on consequences for the businesses that are owned. Most obviously that has come in the form of broad-based input cost inflation, which has been augmented by ongoing supply chain disruption globally. More positively, companies are seeing robust demand for the goods and services that they offer, and that is positive for the cash that they generate. This cash generation is key to our investment approach.

Income's Return

The Evenlode investment process, as applied to our income funds, is intended to deliver a steadily growing income stream to investors over the long term through the dividends paid by companies. Companies can only continue to pay dividends if their operations are successful in delivering profits and, more importantly, cash. They can only grow distributions sustainably if they grow cash flow through time. The process thus boils down to assessing the ability of companies to generate cash and to see through any short-term challenges that come along. It follows that, to us, investing for *dividends* or *income* is not the same as investing for *yield*. The market offers up many high yields, but most are not sustainable.

For the fund, we did see some disruption to the dividends being paid by companies in the early days of the pandemic. The distribution from the fund fell by about 10%, but since those days the businesses that faced more disruption have adjusted, realised that they can cope with the pandemic, and have re-instated their dividends. Most companies in the portfolio actually saw limited disruption to their cash flows and dividends, although they all certainly had to figure out how to work in the 'new normal' of the pandemic. Some felt the effects of the pandemic more acutely, and others paused payouts for the sake of prudence in the face of uncertainty.

The fund's income stream is back at around the level seen pre-Covid, and we see good reasons for growth into the future, not least from the 5% free cash flow yield that more than twice covers the cash required to pay the current dividends. Where companies had paused their dividends the reinstatements have been across markedly different industries, whether it's EsssilorLuxottica in eyewear, Bureau Veritas in business services, or Hexagon in sensing and positioning technologies.

We certainly did not have any great foresight about the pandemic and its potential effect on companies. We owned Sabre, an airline ticketing technology company, as Covid-19 took hold in late-2019 to exemplify that point. But the fund has experienced robust underlying business performance overall. This is in part, to our minds, because the search for companies with solid cash flows leads us to businesses whose products and services are needed or wanted by customers almost come what may. There is no business that has not been affected by the coronavirus pandemic in some manner, but the fund's portfolio was biased towards more positive business outcomes.

2021 – Performance and Income

The fund ended 2021 up 23% in sterling in total return terms for the calendar year[i], marginally ahead of its benchmark, the MSCI World index. The prior year the portfolio lagged the benchmark by 8.8 percentage points. To outperform during 2021 in a strong market is not what we would normally expect, but it might be understood given the prior year underperformance. Indeed, the most positive contributors to return were companies that looked good value to us at the start of the year. Media companies Wolters Kluwer and RELX, consumer goods giant Procter & Gamble, and software company Sage feature at the top of the list of contributors. The former three put through double-digit year-on-year percentage increases in their per share dividends, whilst Sage's increase was lower as the company re-prioritised spending on the development of its business.

Also at the top of the charts are 'pandemic winners' – Microsoft and Accenture in the IT space, Quest Diagnostics and Siemens Healthineers in diagnostic healthcare. We must be careful that the valuation appeal of the companies remains after perhaps some market exuberance centred on the 'winners' in 2020. Our analysis suggests that prices do remain sensible for these firms albeit not quite the opportunity that was there before the share price gains. These businesses' operating performance led to solid increases in dividends, although in the case of Microsoft and Accenture that comes from quite a low base when compared to the cash flow that they generate.

Not everything went the portfolio's way in the market of course. German industrial and consumer conglomerate Henkel's share price was weak as it grappled with the aforementioned input cost inflation and slow growth in the consumer goods part of its business. Medical devices company Medtronic is exposed to reductions in the number of elective surgery procedures, has lost share in its diabetes business, and had several high profile recalls in late 2021. And Unilever, currently a hot news item due to its approach to buy the consumer healthcare division of GlaxoSmithKline[ii], was already weighed down by slow sales growth and, again, input cost inflation. These businesses have seen lower, but positive, progression in their dividends recently as a result of their slower underlying performance.

Stronger performers outweighed the slower ones last year, both in fundamental business performance and in market returns. Where we maintain positions in the weaker performers, we must satisfy ourselves that there is a good chance of them growing in the future, in business terms first, and then in dividend terms. For Henkel, Medtronic and Unilever we continue to believe that this is the case, and to take a counter-example from last year we re-assessed the prospects for Intel and decided to dispose of the fund's position in the company in the first half of the year. Assessment and re-assessment of any investment case is another important part of the process. This allows us to separate a market narrative from fundamental changes in the outlook for a company.

Looking ahead

The prospects for the portfolio depend on the growth it can achieve, and the price that we're currently paying to access that growth. We think mid-single-digit free cash flow growth is a realistic ambition on average, taking into account those currently racing ahead and those growing at a more leisurely pace but with arguably more 'tortoise & hare'-type certainty. The free cash flow yield of the portfolio at 5% is around the average for the portfolio over its history, despite the unit price having appreciated, and this indicator of value is corroborated by our longer-term free cash flow modelling. The dividend yield underlying the portfolio is 2.3% and the historic yield 2.1%[iii]. The scope for progress in that yield is backed by solid, real-world cash flow growth, which both supports the opportunity for good risk-adjusted returns through time, and manages the risks that will come to bear, whether from coronavirus or the next thing. We're looking forward to seeing what 2022 brings.

Ben, Chris, Bethan, Rob and the Evenlode team
27th January 2022

Please note, these views represent the opinions of the Evenlode Team as of 27th January 2022 and do not constitute investment advice.

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For full information on fund risks and costs and charges, please refer to the Key Investor Information Documents, Annual & Interim Reports and the Prospectus, which are available on the Evenlode

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Source: Evenlode Investment Management Limited. Evenlode Investment Management Limited is authorised and regulated by the Financial Conduct Authority, No. 767844.

[i] *Source: FE Analytics*
[ii] *We have written recently on the proposed acquisition, see: https://evenlodeinvestment.com/news/review-and-outlook*
[iii] *B Inc GBP shares. Source: T. Bailey Fund Services*