Evenlode Global Investment View

May 2022 – Supply Constraints

EVENLODE
GLOBAL INCOME FUND

Last month we discussed the challenges that global companies are seeing in managing their cost bases in the face of input cost inflation. These and other worries have hit equity markets, with stocks declining in part due to diminished expectations of profitability. US retailers have been a particular focus, with the share prices of Target and Walmart falling sharply as they reported weaker than expected margins.

The Evenlode Global Income portfolio does not hold such general retailers, and in April we said that the challenges being reported by portfolio companies were in the main around the price of inputs, rather than the security of supply. We have now seen in some cases that supply constraints are affecting revenue growth. Networking equipment and software giant Cisco reported that the covid-related lockdowns in China had caused a shortage of electronic components, particularly power supply units. As a result, it was unable to ship as many products as its customers had demanded and it reported revenues below those expected by analysts. Not only that, but the company said that the next quarter would see a similar trend. The result was a -14% fall in Cisco's share price in the trading session following its results announcement. Swedish technology company Hexagon reported something similar for the first quarter of the year but, perhaps as it is growing more quickly, the immediate impact on its stock price was less dramatic than Cisco's.

Both Cisco and Hexagon were sure to point out that any unexpected weakness in their financial figures were not caused by a lack of demand for their products. Far from it; Cisco's order book is at a record level. When thinking about what we should do in response to these pieces of information, the Evenlode process encourages us to consider the long-term consequences of the news on a firm's competitive position, the outlook for demand for the industry more broadly, and a number of other risk factors. Should risk factors be unchanged, then a share price decline provides a better valuation opportunity.

Value vs the narrative

Share prices bounce around for any number of reasons, some clear like the challenges discussed above, some more mysterious. In Target, Walmart and Cisco's cases, there are clear drivers of the market action and perhaps Cisco is worth 14% less than it was prior to its third quarter results announcement. However, another factor that matters is how much hope and expectation was baked into the share price before it moved. The portfolio has a position in Cisco, but at a relatively small weight compared to what it could be. This reflects our estimation that the stock looked fine in terms of its valuation, but that there are also other good quality companies across a range of sectors that look just as good or better. At a lower price there is more scope for a higher position size, and our investment process guides us in this direction over time.

The valuation starting point matters to the global equity market at large also. The S&P500 index in the US is down -18% in dollar terms in 2022 at the time of writing but is still up by +23% since the end of 2019 (Source – FE Analytics, Total Return terms, USD). That's not bad for a period that included a global pandemic, global supply chains being pushed to their limits, and inflation of a magnitude not seen since the 1980s. Following the decline, valuation metrics look commensurately a little more comfortable; for example, the free cash flow yield of the MSCI World index stands at 4.6%, the price/earnings ratio at 17x. Whilst there is a lot of narrative around the challenges being faced by companies, it is also the case that these and other valuation metrics have deflated from what looked like high levels.

The silver lining of share price declines is that as patient investors we can sit a little more comfortably, with valuations more adequately reflecting the balance of risks and opportunities that companies face. Regular readers will know that we have been active in managing valuations in the last couple of years within the Evenlode Global Income portfolio. This has led to a little more portfolio turnover than we have historically been used to at Evenlode Investment. Whether this continues depends on quite what comes to pass in the market. What is also important in our process is that we manage other risk factors as well as valuation. The cash generating ability of the portfolio has proven to be resilient through the pandemic and provides a good buffer against the worst of the headwinds being faced by global businesses.

To return to Cisco, demand for its networking products waxes and wanes naturally through economic and technology investment cycles. It happens to be seeing strong demand at a time when it temporarily has a challenge in meeting it with supply. We don't diminish the work that will have to happen to manage this in the coming quarters, but longer term we agree with the company's assessment that the demand drivers for networking equipment and software remain undiminished. The market price got cheaper, reducing price risk, therefore providing more of an opportunity. It is just one example of a company dealing with the challenging job of managing the global supply and demand picture in order to secure its returns on capital and ultimately returns to investors, whilst the equity market washes around outside of it.

Research (re)continues

Given the current geopolitical and macroeconomic challenges, we might expect more 'washing around' of the prices of equities and other assets. Whilst this happens we continue with the job of assessing and re-assessing investment cases of portfolio companies and new ideas alike. At present six of the Evenlode team are in the US where they are conducting a total of 38 meetings with current and potential investee companies. To be able to go and see these companies in person is both instructive and, as the last two years have shown, not to be taken for granted. Whilst we have made much use of Teams, Zoom and the old-fashioned telephone to stay in touch with companies through the course of the coronavirus pandemic, there's nothing quite like sitting in the same room to get the dialogue going. We look forward to updating you on the team's findings in the coming months.

Ben, Chris, Bethan, Rob and the Evenlode team
20th May 2022

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