Evenlode Investment View

Wise Funds

JANUARY 2014 – OUTLOOK 2014

Review of 2013

Despite some mild wobbles, 2013 was another good year for the stock markets of developed economies – not least the UK market, which rose by +21%. A resurgent optimism triumphed over slow progress in company fundamentals, with the bulk of the return driven by a significant expansion in valuation multiples, rather than earnings growth.

Another 12 months have been added to Evenlode's life, and below are the results by calendar year versus the fund's benchmark, the FTSE Allshare:

Year	Evenlode	FTSE Allshare	Relative
2009*	+3.2%	+2.3%	+0.8%
2010	+20.1%	+14.5%	+5.1%
2011	+2.6%	-3.5%	+5.6%
2012	+12.5%	+12.3%	+0.2%
2013	+26.7%	+20.8%	+5.9%
Total Cumulative	+81.2%	+53.4%	+27.8%
Total Annualised	+15.3% p.a.	+10.7% p.a.	+4.6% p.a.

Source: Financial Express, total return, Evenlode B Inc shares.
*From 19th October to year end.

Returns in 2013 were high for both the market and the fund, and were certainly at the top end of what we would expect in any given year. Evenlode's performance was helped by a rise in all the stocks in the portfolio, although some rose far more than others during the year. In particular WS Atkins (+91%), Daily Mail (+78%), Britvic (+75%) and Hays (+61%) benefited from the continuing improvement in sentiment towards stocks with exposure to developed market economies (particularly the UK and US), where economic leading indicators have moved significantly higher. Other key performers included Reed Elsevier (+44%), IG Group (+43%), Sage Group (+41%), Microsoft (+42%),and Halfords (+40%).

The main laggards in 2013 came from our consumer staples exposure. Although these stocks all contributed positively over the year, a weaker second half meant they underperformed the market as a whole, and this provided a drag given their high weighting in the portfolio. As well as coming off a period of very good performance, these stocks have suffered from an increasing aversion to emerging market economies over the last year. We, however, remain positively disposed to the micro-economics of these companies. In the current world of rapid technological development and creative destruction (Google began life in 1998 but is now the third largest company in the world, which gives a sense of the speed of these changes) the business of selling low ticket, fast-moving consumer goods retains several key qualities that we find reassuring, namely:

- A low likelihood of obsolescence
- A mature, rational, slow-changing competitive environment
- Customer loyalty
- Repeat-purchase revenues
- Steady volume growth
- Pricing power

and as a result of the above factors....

- An ongoing ability to generate consistently high, compounding returns on invested capital
- A history of coping well in both deflationary and inflationary environments

Our top two holdings in this sector, Unilever and Reckitt Benckiser, currently trade on 4% and 3.2% dividend yields, and have grown their dividends on average by +8% and +18% over the last ten years. There will be set-backs along the way of course, but we think the long-term wealth-building credentials for these business models remain very compelling.

Some Changes to the Fund at the Margin

We look to operate at the intersection of quality and value, which is always shifting subtly from one area to another. It is worth highlighting a couple of key trends that have become increasingly pronounced over the last year and have led us to make some changes to the fund. The first has been the sharp rally in small and medium sized companies. This led us to exit several positions in the year such as Diploma, ITE Group, Euromoney, Halma and Nichols. We are the first to admit that all of these moves were 'too early' in retrospective, but we are committed to our valuation discipline rather than any momentum-based considerations. The second is the shift in sentiment towards developed economy cyclical businesses. This has led us to significantly reduce or exit several positions (such as Britvic, WS Atkins, Halfords and Daily Mail). We see a declining margin of safety in these stocks and the opportunity to 'upcycle' disposal proceeds into higher quality businesses on better valuations. The third trend is the flipside to this second trend – namely, the significant deterioration in sentiment towards emerging market exposure, and related themes such as the commodity and energy sectors. We suspect that this trend has further to run, but we are spending a lot of research time on this general area and have begun to build some small positions. I would point out that, due to our focus on asset-light companies, the mining and oil producing stocks are not of interest to us. It is the 'pick and shovel' companies that fit our investment criteria (specialist engineers, consultancies etc.)

Outlook 2014

"It's tough to make predictions, especially about the future"

Yogi Berra

The fifth anniversary of the bull market that began in March 2009 is nearly upon us, with the UK market having risen +142% since then. The FTSE Small Cap index and the FTSE Mid Cap index have both performed even more strongly, rising +221% and +224% over the same period. Thanks to these rather compelling five-year returns, investors are feeling more relaxed about the world. Positive sentiment towards equity markets is reaching levels that were last seen before the 2008/9 crisis, while signs of reviving animal spirits are starting to reappear. Twitter's stock market debut last autumn was representative of a more general resurgence in initial public offerings (IPOs). With Twitter floating at a valuation of more than 20x revenues this loss-making, seven-year old company is now valued on a market capitalisation of more than $35 billion. Meanwhile, 2014 forecasts from the big investment banks are pretty much unswervingly positive on equities, and negative on bonds.

Sentiment among business leaders is also picking up, with indicators of corporate confidence reaching highs not seen since the crisis. Recruitment companies are reporting an upturn in trading, and there are early signs that global corporations are beginning to take a more relaxed attitude to capital spending. Another sign of this more expansionary mind-set is the resurgence in acquisition activity. Global deal volumes for the most recent quarter of published data (Q3 2013) showed a rise of +118% over the same period in 2012. And since the start of 2014 (i.e. in the last two weeks) more than $130bn of takeover offers have been announced, most notably the $61bn offer for Time Warner Cable by Charter Communications and Suntory's offer for Beam Inc ($16bn)**.

All of the above is helping to sound the all-clear klaxon for global markets. Few people worry about the Euro-crisis anymore. Emerging markets are slowing down but developed market consumers are receiving a big boost via falling commodity prices. And although developed market economies are picking up, inflation is contained and interest rates remain very low, goes the narrative.

Wise Funds

The Slow, Steady Swing of the Pendulum

Since Evenlode was launched, the market cycle's pendulum has swung a long way. In 2009, valuations were very compelling but the economic risks felt cripplingly high. Now, in 2014, valuations are significantly less compelling, but economics worries have dissipated. We certainly preferred the former environment – there were more high-returning investment opportunities to pursue. As the general level of valuations rises, the need for prudence increases.

However, I don't want to paint too gloomy a picture. The Evenlode portfolio is a collection of resilient businesses with good, steady, long-term compounding potential and sensible starting valuations (see footnote below for current quality and value characteristics versus the UK market***). And as some doors shut on us others begin to creak slowly open.

So we proceed with cautious optimism, a long term disposition, and our usual eye to managing both fundamental risk and valuation risk within the portfolio.

Hugh Yarrow
Investment Director
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Please note, these views represent the personal opinions of Hugh Yarrow as at 20 January 2013 and do not constitute investment advice.

Performance data for stocks and indices mentioned in the piece are from Financial Express and Factset
**Source for M & A data – Bloomberg

***__Some quality and value characteristics of the current portfolio:__

1) The free cash flow yield is 6.2% (after all capital expenditure, not just maintenance spend) versus 4.2% for the market.
2) The fund's dividend yield is +3.4%. Annual dividend growth has been between more than +7% since launch and we continue to expect good dividend growth from underlying holdings.
3) The portfolio's return on equity is 35% versus 14% for the UK market.
4) This return on equity continues to be achieved with very little debt in the capital structures of the underlying businesses. Net debt to EBITDA is 0.5x (versus 0.8x for the UK market). 11 of the 31 stocks in the portfolio have no debt at all.