Evenlode Investment View

March 2015 - Stock-by-Stock

After a pause in the second half of last year, animal spirits are rising again in global markets.

As I write the FTSE 100 has just broken through the 7,000 level for the first time. Year-to-date the UK market is up +7.3%, and Evenlode has returned +10.1%*. The most powerful upward force on stock markets continues to be the backdrop of extremely easy monetary policy. Eurozone quantitative easing (QE) began this month, and though the US completed its latest round of QE in October last year, Janet Yellen was keen to stress this week that the Federal Reserve is in no hurry to raise interest rates - her position is helped by a very benign level of inflation. Extraordinary low bond yields and interest rates continue to provide a relative argument for equities, but the low cost of borrowing also makes takeover activity more likely, and some big deals (such as Valeant's $11bn recent approach for Salix in the pharmaceutical sector) are making the headlines. Evenlode has benefited in its own way from this theme due to the fund's 3% holding in Domino Printing. Domino announced a takeover approach from Japanese firm Brother earlier in March, and its shares have subsequently risen c+30%.

Meanwhile, the oil price fall will act as a major dividend to global consumers in coming months, and is beginning to feed through into leading indicators.** Falling input prices are also beginning to have a positive impact on the cost base of many companies. For high quality franchises with pricing power, most of this benefit will be converted to profit. As Reckitt's CEO Rakesh Kapoor put it last week, *I don't believe the commodity tailwinds the consumer branded goods industry is currently experiencing will be reinvested in price. I think they will be used to finally deliver some good margins.*

Another boost for the UK market has been the dramatic weakening of the pound against the dollar in recent weeks. This is good news for both the earnings and dividend potential of those UK multinationals that have a significant exposure to the US dollar.

Valuations Continue To Rise

We acknowledge all these positive factors at work, but the recent rally means compelling valuation opportunities are harder to come by. In today's market, as I discussed last month, we think there is a risk of 'reaching' too far for returns (both reaching too high on the valuation front and reaching too low on the quality front). Meanwhile, though lower oil has boosted leading indicators, the structural economic picture remains tough, as demonstrated by the recent 2014 final results season. There are pockets of strength but deflationary pressures remain high, particularly in Europe, and revenue growth is commensurately tough to come by (as it has been, in fact, since the 2008/9 crisis).

Stock-by-Stock

Individual stock volatility has been quite high in recent months, despite a generally upward market. We are long-term minded investors, but we also look to take advantage of individual stock volatility, as it helps us manage valuation risk in the portfolio.

As an example, several engineering stocks we follow have been weak recently: they derive a proportion of their revenues from the oil and industrial metals sectors, which are currently under pressure. In our view current negative sentiment and difficult industry conditions are masking intrinscially attractive business models and good valuations. Last year we added Spectris, IMI and Smiths Group to the fund, and at the end of February we added a new position in Weir Group.

Weir Group's recent share price performance gives a sense of the level of weakness in this sector, particularly in the context of a market that is generally headed upward:

Weir Group Total Return: 31/12/2013 to 20/03/2015. Source: Financial Express, Wise Investment

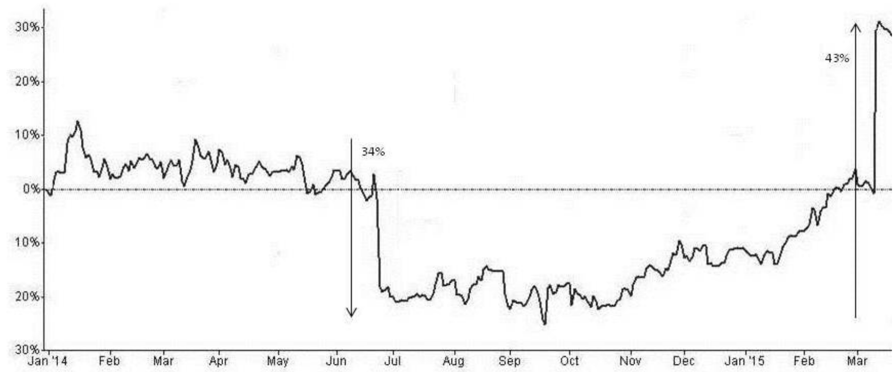
Industry conditions will be tough for Weir in 2015, as you might expect. The company sells pumps and valves to the mining and energy sectors, and with oil and mining capital expenditure being cut back, demand for new products is falling sharply. However, Weir has a very strong position in the niche markets it operates in, selling critical products that *have* to work, and a large part of its business comes from its 'aftermarket' (spare parts and servicing of its equipment once installed). This more stable aftermarket business comprises approximately two thirds of sales and a significantly higher proportion of earnings and cash-flow. Reassuringly, the company's cash generation also improves in a downturn due to its working capital cycle. These attributes have helped Weir generate resilient cash-flow and dividends over the years (the company recently increased its dividend by +5%, the 31st year of consecutive dividend growth).

Valuation vs Timing

I suspect we are 'too early' with this new position in Weir Group (i.e. the share price may well continue to fall in the short/medium term). But a healthy portfolio needs some holdings that are coming to fruition, some that are beginning to work out, and others *that are yet to work out****. For this to be the case you need, from time-to-time, to refill the hopper with unloved stocks. Several of the stocks we are currently reducing (such as Reckitts and Reed Elsevier) were unloved three or four years ago but have increasingly become market darlings. Weir Group, conversely, was a market darling back then, when Mr Market craved exposure to emerging markets and the 'commodity supercycle'. Since then, the pendulum of sentiment has swung a long way in the other direction.

Also, *you never quite know*. In my view valuation is more important than timing. As the recent bid for Domino Printing demonstrates, sometimes good things happen to high quality stocks even where they are experiencing short-term adversity:

Domino Printing Total Return: 31/12/2013 to 20/03/2015. Source: Financial Express, Wise Investment



Domino's share price weakness last summer (following a weaker than expected trading statement) gave us a great opportunity to significantly increase our position. I would stress that *we weren't buying Domino Printing in anticipation of a takeover approach*. We were buying it because the valuation looked attractive to us, as did the 4% dividend yield. Like Weir Group, a large proportion of Domino's cash-flow is derived from its repeat-purchase aftermarket business (printer ink, spare parts and servicing). This stable cash-flow stream has supported healthy and consistent dividend growth over the long-term. Despite these attractions, we thought we were probably 'too early' in increasing our exposure, given a tougher short-term backdrop for the company. But sometimes share price moves reflect value quicker than you might expect.

Turning back to Weir Group, rumours have circulated in the last couple of weeks that a private equity approach may be in the offing. It is likely that nothing will come of these rumours, as has been the case in the past. But it does underline the general point: *you never quite know if you are 'too early' or not*. What matters long-term is owning good businesses at sensible valuations.

Hugh Yarrow
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March 2015

Please note, these views represent the personal opinions of Hugh Yarrow as at 20th March 2015 and do not constitute investment advice.

*Source: Financial Express, total return, 31/12/2014 to 20/03/2015
**Though as recent data from the US economy has demonstrated, some of this bonus is likely to be saved rather than spent by consumers
***Some ideas, of course, *never* quite work out as planned. In the context of a long-term investment project, the importance of limiting the number of these mistakes cannot be underestimated.

Postscript: In Memory of Irving Kahn

Irving Kahn, the world's oldest investor, died on 26th February at 109. I have mentioned Kahn in previous investment views. Kahn started working on Wall Street in 1928, just in time to witness the Great Crash of 1929 first hand. Kahn was an assistant to Benjamin Graham, the father of fundamental security analysis, and adopted a long-term, valuation-based approach to investing from the 1930s onwards. Last year, at the age of 108, he was still working three days a week, commuting one mile from his Upper East Side apartment to the firm's midtown office. He saw a lot in his time, and had the following to say about investment in a recent article, after all those years in the industry.....

You must have the discipline and temperament to resist your impulses. Human beings have precisely the wrong instincts when it comes to stocks. If you recognise this, you can resist the urge to buy into a rally and sell into a decline. It's also helpful to remember the power of compounding. You don't need to stretch for returns to grow your capital over the course of your life.

......sensible words, distilled from a marathon of a career.