Evenlode Investment View

Wise Funds

NOVEMBER 2013 – EVENLODE FOUR YEARS ON

Markets moved sharply higher in October following compromise over the US government debt ceiling, and have treaded water in November. As I mentioned last month the current bull market has on our analysis brought UK market averages from nicely under-valued at the launch of Evenlode four years ago, to a little above fair value today*.

Markets may well head higher from here. The feel-good mood is back and meanwhile, the economic backdrop is decent enough. Monetary conditions remain extremely easy (whether the Fed 'tapers' its programme of quantitative easing or not) and consumers are receiving a massive stimulus from falling commodity prices – particularly the oil price which will act like a huge tax cut for developed world consumers.

However, it can't be denied that *rising valuations are making future returns increasingly hard to find*. This is the case for the overall market, and we are finding it to be the case for Evenlode too. As a result of this narrowing opportunity set, Evenlode is about as defensively positioned as it has been since launch. As I said at the start of the year, our general approach is to *prepare for the worst and hope for the best*. We think the current portfolio is reasonably well-equipped to cope with any volatile financial and/or economic storms that may lie ahead (the underlying stocks grew their average earnings through the 2008-9 downturn, for instance). This is the 'preparing for the worst' bit. But the current holdings are not just portfolio padding - as well as being resilient they offer genuine long-term growth prospects for profits and cash-flow (and this is where we 'hope for the best').

Below are some up-to-date thoughts on three key sectors for the fund:

Consumer Branded Goods

Despite the recent slowdown in emerging markets, sales for our consumer branded goods holdings continue to move steadily in the right direction (even for Unilever, which was in Mr-Market's-most-hated list for much of the third quarter). Management of Reckitt, P & G and Unilever have also reaffirmed the potential for future profit margin expansion along with third quarter updates.

Just taking one of these companies, Reckitt, for a moment, it's worth taking a step back to consider the bigger picture of really long term growth potential (i.e. ten to twenty years). I struggle to think of a market segment with more compelling growth prospects than the health and hygiene categories, particularly in emerging market regions such as Indian and Sub-Saharan Africa. These categories are now almost 70% of Reckitt's business, and they have uniquely well positioned brands such as Durex and Dettol, to take full advantage of demand growth. Reckitt is often referred to as a 'defensive' and chucked into the same bucket as utilities and oil majors. But unlike the stocks in those two sectors Reckitt is a true, capital-light, long-term growth stock. Ditto for Unilever, P&G, SABMiller et al.

Software

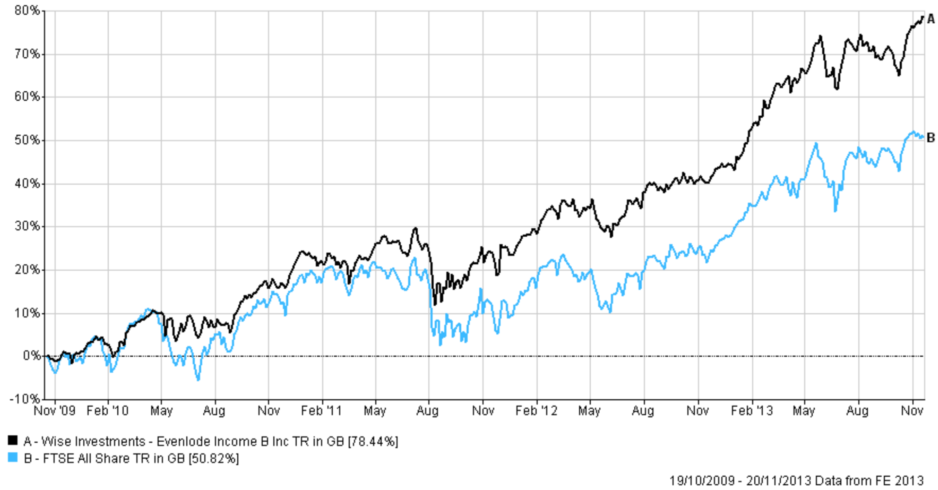
SAP, Microsoft and Sage have continued to make good progress with their offerings to business customers, despite a tough overall industry backdrop. The successful transition that these companies are making to the 'cloud' is a reminder that customer loyalty and entrenched habits play a key role in this industry and its resilient performance (just as they did when SAP made the move, along with its customers, from IBM mainframe computers to personal computers back in the early 1990s). Unilever, for instance, a big customer of SAP, have now adopted their systems across the business. To give a feel for the scale of this operation, 50,000 individuals use SAP's systems every day, with 30,000 transactions per minute across the whole of Unilever's supply chain. You can see how this type of hugely complex, sophisticated software becomes very embedded in everyday workflow, and also how useful the analytical output can be for employees and management. In light of the continuing growth in demand for data analytics we think these software holdings have plenty of growth to go for. And again, like consumer staples, capital investment requirements to achieve this growth are low.

Healthcare

Many investors look at the large healthcare companies as sluggish behemoths with structural growth issues. They *are* big, and they *do* have growth issues at the moment, but I would recommend reading *Shaping the Industrial Century* (Alfred D. Chandler, Jr.) for anyone that doubts the stability, competitive advantages and excellent economics that the main players enjoy in this long-standing industry. As with all holdings in Evenlode, our healthcare holdings are capable of producing highly cash generative, asset-light growth, notwithstanding current industry difficulties. The knowledge bases embedded in these businesses combined with entrenched distribution networks and financial strength have allowed them to enjoy wide economic moats for decades. Although much has happened in the last 30 years (including the emergence of a whole new sub-industry in the form of biotechnology) the overarching economics of the industry (as well as the competitive landscape) have remained very stable. And now, after a tough decade, product pipelines are being rebuilt.

Evenlode Four Years On

The Evenlode fund had its fourth anniversary last month, and as a result we are beginning to build a longish track record, as shown below against the fund's benchmark, the FTSE Allshare:



(Source Financial Express. Performance data is bid-bid, total return, net of fees and UK witholding tax. Past performance is not a reliable indicator of future performance)

The annualised compound total return since launch is +15.2% versus +10.5% for the FTSE All Share. Operating in a market (and a sector of the market) which is very competitive, we think this is a reasonable result so far. It has been achieved by a sole focus on quality (i.e. high return, asset-light) stocks. This approach has consistently proven to work long-term, but is an approach which regularly falls in and out of fashion over shorter time periods as the market cycle waxes and wanes (which is in fact a major part of the reason for its long-term success). This is something we are keen for our investors to understand. The quality investment team at GMO describe the process very well:

Despite the benefits of this approach to low-risk investing, it appears that not many have the will power to stay true to the concept. Stability is simply not exciting enough for most investors. Many investment managers find it hard to resist the temptations of minimizing tracking error, following the herd, or going for a little excitement offered by "story stocks" (those false pretenders to true growth). End investors – who really should be focused on real returns – want absolute returns in bear markets, but tend to seek relative performance in bull markets, an example of what J.K. Galbraith described as the "extreme brevity of financial memory." All of these factors act as distractions, forcing the focus from the fundamentals.

I have taken up the sport of long distance swimming in the last couple of years**, which in the British Isles often involves swimming in very cold fresh-water lakes wearing only a pair of speedos, goggles and a swim hat (it's fun, honestly!). There are some definite similarities between this sport and our long-term investment approach. Both disciplines require a combination of psychological resolve and good technique. As with swimming, the calmer you stay and the less you churn your arms around, the more effectively you'll move though investment waters. But most importantly, both require endurance and the ability to cope with boredom, pain and discomfort (i.e. *the mental strength to stay the course*).

My colleague Ben and I remain committed to staying the course with the Evenlode fund, and we have an ambition to build a track record into the decades, not just years.

Hugh Yarrow
Investment Director
November 2013

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

*we assume fair value is a 6-7% real total return per annum, in-line with the long-term historic average. At current valuations we estimate a real total return p.a. of 4% for the UK market over the next 7 years (i.e. alright but not great).
**Thanks to my friend Mark Sheridan. He writes the blog Reminiscences of a Long Distance Swimmer (*http://reminiscencesofalongdistanceswimmer.blogspot.co.uk*) which I would recommend reading, even if you're not interested in swimming as Mark has an amazing story to tell (in the latest post Reflections on the 2013 open water swim season there is a photo of me nearing the end of a six-mile swim in Lake Bala – it took me somewhat longer than Mark to finish!)