Evenlode Investment View

February 2016 - The Profit Seeking Paradox

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INVESTMENTS FOR LIFE

"In the City, they sell and buy. And nobody ever asks them why. But since it contents them to buy and sell, God forgive them, they might as well."

Humbert Wolfe

We are nearly two months into the year, and the signature theme of stock markets during 2014 and 2015 - huge price volatility with little to show for it - has continued unabated. Year-to-date, the UK market has returned -3.6%. But at one point in early February it was down more than –11%, before clawing most of it back in the last two weeks.

Perhaps the most notable development this year has been the degree to which deflationary worries have gripped market participants once again, as the global economy continues to fail in its attempts to achieve an 'escape velocity' from the Global Financial Crisis. Six months ago, investors were worrying about the impact that rising interest rates, particularly in the Anglo-Saxon world, might have on the global economy and financial markets. More recently, all eyes have turned to negative interest rates, now put in place by central banks overseeing a very significant chunk of the planet's economic activity (Japan, the Eurozone, Switzerland, Sweden etc.)

Negative interest rates are an unprecedented experiment in monetary policy and potentially present some rather odd, hard-to-predict effects. Financial stocks in particular were hit hard in February's sell off as investors digested the potential impact this *Alice In Wonderland* world of monetary policy might have on their business models.

Nudging The Portfolio

As regular readers know, we take a long-term approach to investment (of Evenlode's top ten holdings currently, seven were top ten holdings in the fund five years ago). And we tend to change the portfolio incrementally over time (we call it 'nudging') as valuation appeal and dividend opportunities gradually change.

It's worth noting that in the last few weeks, the bifurcation in performance amongst the stocks in our investable universe has stirred us into action (relative to normal, at least). Specifically, we have been reducing some of our larger positions (more 'boring' businesses, particularly healthcare and tobacco companies, that have outperformed strongly of late) whilst adding to some of the fund's other positions. These changes have been made on a stock-by-stock basis and are a reflection of changing valuations primarily. In some cases we are also seeing an opportunity to upgrade the dividend growth prospects of the portfolio*. In terms of purchases, we have been particularly focused on companies with very strong balance sheets.

Two examples of positions we have added to significantly this year are Spectris and Fidessa, which I discussed previously in my investment view last November (*Earnings Will Jiggle*).

Both released reassuring results last week and their share prices have subsequently begun to perk up. Whilst operating in completely different industries, both companies share several features we are attracted to:

- Resilient performance despite a slowdown in each company's end markets (test and measurement solutions and investment banking software respectively).
- The sale of mission-critical products that improve customers' efficiency and product quality, but represent a very small part of their customer's cost base.
- Healthy cash generation and reassuringly strong balance sheets, enabling healthy dividend payouts.
- Consistent and heavy investment in the future of the business.

Given all that is going on in the world, we are particularly impressed with this last feature – the willingness to continue to invest relentlessly in future growth. This is a subject regular readers will be familiar with.

All corporations are, more than ever now given the low growth backdrop, focused on improving their efficiency. Spectris and Fidessa are well placed to help their customers in just this area. Spectris traditionally sold test and measurement equipment but has increasingly moved into providing software and service solutions, and this is a key focus for current research and development. This might involve, for instance, monitoring hundreds of wind turbines on multiple sites, and identifying turbines that need replacing before they fail, saving considerable cost and downtime for the customer. Or networking a manufacturing facility and analysing the data it produces to improve efficiency and product quality. Fidessa are automating the manual workflows of their customers to help purchase, process and settle trades more efficiently. Operating costs tend to reduce signficantly, and manual errors are removed too. Once Fidessa's software becomes embedded, customers don't move back to spreadsheets and paper and pencils in a hurry - renewal rates for software subscriptions are close to 100%. Fidessa's strategy is to continue to invest heavily over coming years in both developing its core equities offering and diversifying into newer asset classes such as derivatives.

The Profit Seeking Paradox

"No one will be buried with the epitaph 'He maximised shareholder value".

John Kay

As economist John Kay noted in his book *Obliquity*, the most profitable and successful companies over the long-term don't tend to be the most profit-oriented. This profit seeking paradox is something we at Evenlode are very interested in.

It is best illustrated when, like Spectris or Fidessa, a company has an engrained cultural imperative to invest in the future. And this is perhaps one of the ways in which companies that are too relentlessly (or directly) focused on 'maximising shareholder value' can come unstuck. In too much of a hurry to deliver results today, a cultural preference for steady organic development may get short-circuited by top management. In his book, John Kay uses the example of ICI before and after the early 1990s to demonstrate this point. ICI's culture following the Second World War led, among other things, to the development of a British global pharmaceutical industry. As Kay puts it, this was 'perhaps the greatest achievement in post-war British business'.

We are currently in the process of building a new position in a software company for Evenlode. I thought their management team summed this point up well when we met with them recently:

Research and development is the future of our company. It's why customers come to us rather than the competition. And customers are looking to us to make them more efficient, so we need to make sure we develop our business to maximize this ability.

It's not just for speciality engineers and software companies that we think organic investment is important. In other Evenlode sectors such as media, consumer branded goods, support services and healthcare it's just as critical - whether that be investment in innovation, new products, service and support, geographical development or expansion into closely adjacent markets. These investments might not do much for this year's Earnings Per Share number, but they should be cherished by the patient shareholder and are key to the long term progression of free cash flow and therefore dividends.

Hugh Yarrow
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Please note, these views represent the personal opinions of Hugh Yarrow as at 25th February 2016 and do not constitute investment advice.

*On the dividend front, I would reiterate my comments from last month. The provision of a dividend stream that grows in real terms over time remains a key aim for Evenlode. The broad UK dividend outlook remains challenged and dividend cuts have continued, particularly in the commodity sector. In this context, we are reassured by Evenlode's focus on steadier, capital-light businesses with strong finances.