Evenlode Investment View

JULY 2012 – SOME THOUGHTS ON QUALITY

Wise Funds

Europe Hangs In The Wind

Not much has changed on the economic front since my last monthly, although a €100 billion injection into the Spanish banking system in June did enough to move investor focus temporarily away from Europe and towards some slightly better news from the US economy. The prospect of further monetary stimulus from central banks also helped the mood.

Despite this improved sentiment, a proper solution to the Eurozone crisis remains a distant prospect. This crisis is at root one of financial insolvency, uncompetitiveness and poor governance, rather than of liquidity. It is hard to see, therefore, how liquidity injections can provide a permanent cure. Until the more fundamental problems are addressed it looks like Europe will continue to hang in the wind. More panics and summits lie ahead, we can be sure.

All Is Not Lost

Despite this backdrop of financial crisis, people don't change much (even Europeans!) and continue to consume the little luxuries and essentials of life – products that form the bedrock of the Evenlode portfolio. Coca-Cola's recent interim results are a reminder that while all may not be well in the world, life does go on. Volume growth in Coca-Cola's key divisions for the first half of 2012 were as follows:

Eurasia and Africa +11%
Europe -2%
Latin America +4%
North America +1%
Pacific +8%
Total +5%

These numbers are a pretty good check on the global consumer's pulse, and while growth rates might not look quite as good as they did in the pre-2008 years, the world has by no means ended. As Muthar Kent, Coke's CEO put it "We've always been used to crises coming and passing like a river, and then going, until the next one."

I do enjoy owning these global businesses that work quietly for shareholders all round the world, day and night. In Coca-Cola's case, it is literally billions of transactions a day that contribute to its steady, round-the-clock shareholder value creation.

Protection Against The Unknown

I have been asked several times recently whether I deliberately designed the Evenlode process (i.e. focusing only on high quality, asset-light businesses) for the current, crisis-prone economic environment. The short answer is no. I chose this approach because of its potential to produce attractive total returns across all kinds of market cycles. It also helps me – and hopefully my investors – to sleep well at night.

However, it's true that these stocks do have some very good things going for them into today's market. I apologise to regular readers for repetition here, but one particularly interesting trait is, in my view, their ability to deal with both deflation and inflation in a world where both possibilities seem entirely credible. The more I think about this point, the more important it seems. It's a characteristic shared with very few other investment assets. Bonds and cash will make you money if we get deflation, but could produce big losses if we end up with high inflation. Conversely, commodities and real estate will do a good job of protecting against inflation, but both asset classes expose you to the risk of big losses if we end up stuck in a deflationary quagmire. Personally, I would not be comfortable placing my savings so definitively on either economic outcome. I want insulation from both, and quality stocks help achieve this (though no strategy, of course, is perfect).

Are Quality Stocks Becoming A Crowded Trade?

The concept of 'quality' has begun to attract interest from the investment community over the last year. Some commentators and market participants have begun to suggest that 'quality' is becoming something of a consensual idea, or even that quality stocks might be in some kind of valuation 'bubble'.

I have several observations to make on this. The first is that a consensual idea is not always a bad one. In my view 'ignore the crowd' is a much better motto than 'be contrarian'. As Philip Fisher put it very well many years ago:

"A basic ingredient of outstanding common stock management is the ability neither to accept blindly whatever may be the dominant opinion in the financial community at the moment nor reject the prevailing view just to be contrary for the sake of being contrary."

The quality stocks we invest in do not on aggregate look expensive. Quite the opposite – on the forward cash return methodology we use, the fund continues to trade on a more attractive valuation than the overall stock market. Using a more conventional valuation yardstick, Evenlode's free cash flow yield is 7.5% compared to 5.5% for the market*. Despite the fund's outperformance since launch, these measures have not seen significant compression when compared to the overall market.

The relative valuation of Evenlode has stayed attractive for two reasons. First, because we are always, at the margin, looking to shift the fund to those stocks in our investable universe that offer more value –quality stocks don't always move in lockstep with each other. So although we still invest in quality, the fund has evolved since we launched in 2009. Back then we had 60% in small and medium sized companies. Currently we have only 20% in this area as several of these smaller stocks have outperformed strongly over the last two years. But there is also another, important reason – *even without a revaluation, quality stocks are generally able to generate positive, market-beating returns from fundamental growth alone.* Quality is a gift that keeps on giving. A glance at the valuation of Evenlode's current top ten holdings, today and ten years ago, is a good way of illustrating this point**:

Stock	**2002 PE Multiple**	**Current PE Multiple**	**10 Year Total Return Per Annum**
Unilever	16.9	16.2	+6% p.a.
Glaxosmithkline	17.7	11.6	+4% p.a.
Procter & Gamble	21.4	16.6	+8% p.a.
Reckitt Benckiser	19.5	14.3	+18% p.a.
Diageo	17.8	16.4	+7% p.a.
Pearson	23.4	14.4	+16% p.a.
Johnson & Johnson	23.7	13.0	+10% p.a.
Imperial Tobacco	13.9	11.8	+14% p.a.
Sage	19.5	12.9	+13% p.a.
Reed Elsevier	21.5	10.4	+9% p.a.
Average	**20.3**	**13.8**	**+9% p.a.**

These stocks are hardly in bubble territory. In aggregate, they have endured a severe de-rating over the last ten years – from an average Price/Earnings (PE) multiple of 20.3x in 2002 to a PE multiple today of 13.8x. But despite this massive valuation headwind, solid fundamentals have led to a very respectable +9% total return per annum (versus +6% per annum for the UK market and +4% for the US market).

To sum up, we still see plenty of opportunity in the quality universe, and valuations remain attractive. Stocks such as Unilever (PE 16x, dividend yield 3.8%), Reckitts (PE 14x, dividend yield 3.8%) and Johnson & Johnson (PE 13x, dividend yield 3.6%) continue to provide long-term investors with an excellent combination of quality and value. And just imagine if Mr Market decided to *rerate* them over the next decade...

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Please note, these views represent the personal opinions of Hugh Yarrow as at 18 July 2012 and do not constitute investment advice.

*Source: Canaccord Genuity Quest, Wise Investment
**All fundamental and price data sourced from Canaccord Genuity Quest, Financial Express and Wise Investment