Evenlode Investment View

Wise Funds

JULY 2013 – A SHORT-LIVED CORRECTION

Global markets fell in June for the first time in several months. Mr Market started to worry that something previously dismissed as a far-off investment risk – the weaning of the global economy from its diet of extremely loose monetary policy – might need to be considered sooner rather than later. The mere hint from Ben Bernanke that the Federal Reserve might start slowing its rate of money printing this year caused consternation in bond markets. US 10 year government bond yields moved rapidly higher from 1.6% to 2.6%, and the US stock market sank. Most other asset classes around the globe fell in sympathy. Elsewhere, liquidity tightening from the Chinese central bank caused panic with the weekly Chinese interbank lending rate briefly hitting 30%.

Last month I suggested this rising panic was beginning to throw up opportunity, with stock-by-stock volatility starting to rise. However, the negative vibes did not last for long! Central bankers have become increasingly sensitive to investor's mood swings in recent years and the change of tone from policymakers was almost immediate. In early July, European Central Bank president Mario Draghi stated that monetary policy would remain extremely loose for 'as long as necessary', while the Federal Reserve rephrased their statement to a more market-friendly formulation - playing down the likelihood that significant monetary tightening would arrive anytime soon. The result? Stock markets have roared back up and once again investors are worrying more about momentum chasing than preservation of capital.

Staying Patient, Seeking Opportunity

As animal spirits have risen over the last two years, our investment process has naturally led us to exercise an increasing level of discipline and prudence. At some point in the future I'm sure small and medium sized businesses will approach 50% of the Evenlode portfolio again, as they did in 2009. But valuations have led us in the opposite direction. As regular readers will know, the main changes we have made to the fund in the last 18 months have been to sell several smaller companies and recycle this money elsewhere (this year we have placed a particular emphasis on larger companies in the technology, media and healthcare sectors). This process is part of a continual effort to manage valuation risk in the portfolio, an effort that should increase the fund's ability to compound shareholder money long-term. But it requires patience, because it generally involves taking money out of fashionable stocks where momentum is good and investing the proceeds in stocks that are falling in price and short-term prospects are not considered so attractive. Recent purchases of SAP (a new position) and Microsoft (adding to an existing position after poor quarterly results) are good examples of such opportunity. In both cases we see a strong long-term franchise in enterprise software available at an attractive valuation (in SAP's case thanks to worries over a cyclical slowdown in industry sales, in Microsoft's case due to the on-going decline of PC sales globally and a lukewarm reception to Windows 8).

I am also watching the recent souring of sentiment toward emerging markets with interest. Much of the slowdown can be attributed to the fall-out from China's slowing economy and the resultant weakness in resource-dependant economies such as Brazil and South Africa. Although domestic consumption growth trends have held up well (with smaller markets in Africa, South East Asia and Latin America remaining particularly robust), the 'easy' narrative relating to emerging market exposure has become much less straightforward for investors. I think this is a healthy development - it's helping take the froth off valuations and has already led us to increase exposure to stocks such as SABMiller and Domino Printing, which we view as very well placed for the longer-term. I wrote the falling in March 2012, which still stands today:

We are under no illusions – the positive trends [in emerging markets] will not develop in a straight line. There will be business cycles, there will be set backs and there will be all the normal competitive pressures. However, I think an ability to 'hold the thought' on these global growth opportunities will be a crucial element of navigating the noise that will buffet financial markets over the next few years. Most stock market participants are either unable or unwilling to do this, which I believe is to our advantage.

It is also worth reiterating Unilever CEO Paul Polman's comment from an analyst presentation last year which serves as a reminder of how difficult investors and financial analysts find it to 'stay the course' with an investment thesis:

Some of you naysayers out there have always worried about the emerging markets. I remember when I joined Unilever in 2008, all you guys loved emerging markets. Then in 2009, you all worried about competition coming into emerging markets. Then in 2010 and 2011, you all got worried about input costs in emerging markets. Then I suggested emerging markets were slowing down, and you got worried about that. I don't know what you guys do in your private time, but you're making your life incredibly miserable. We will continue to look for opportunities as two billion people come into this world and improve their standards of living.

Update on The Current Portfolio

To finish, I include an update on the quality, value and long-term growth credentials of the current Evenlode portfolio. The underlying holdings continue to compare well to the UK market*:

	Evenlode	**UK Market**
Free cash flow yield	6.5%	4.5%
Dividend Yield	3.4%	3.3%
Return on Equity (ROE)	35%	15%
Net Debt/EBITDA	0.6x	0.8x
10 Year Dividend Growth P.A.	+12%	+2%
10 Year Earnings Growth P.A.	+10%	+6%

As shown above, the very long-term track record for dividend growth is excellent for Evenlode holdings, at 12% on average for the last ten years. Recent news on this front has also been encouraging, and below are the most recent dividend announcements for the top 10 holdings in the fund**:

	Dividend Yield	**Latest Dividend Increase**
Glaxosmithkline	4.7%	+6%
Unilever	3.4%	+11%
Reed Elsevier	3.1%	+7%
Reckitt Benckiser	3.0%	+11%
Sage Group	3.3%	+6%
Procter & Gamble	3.0%	+7%
Pearson	3.9%	+7%
Smith & Nephew	2.4%	+53%
Imperial Tobacco	5.7%	+11%
Jardine Lloyd Thomson	3.2%	+7%

This underlying growth helped us increase the first quarterly dividend by +10%, and prospects for future growth remain positive.

Hugh Yarrow
July 2013

Please note, these views represent the personal opinions of Hugh Yarrow as at 22 July 2013 and do not constitute investment advice.

*Source: Canaccord Genuity Quest, Wise Investment. Figures for UK market's FCF yield and ROE are excluding financials.
**Source: Canaccord Genuity Quest, Wise Investment. Dividend increases are from latest quarterly, interim or final dividends (currency as reported).