Evenlode Investment View

Wise Funds

MARCH 2013 – WHAT YOU SEE IS WHAT YOU GET

Markets Up, Risks Rising

Global stock markets have continued to rise over the month, hardly missing a beat when bits of bad news (including poor economic data from China, the Italian elections and the Cypriot banking crisis) have hit the newswires. Shares have become, in the eyes of Mr Market, the best house in a bad neighbourhood. As discussed last month, the efforts of central bankers to keep both short and long-term interest rates low have resulted in cash and bonds offering prospective returns of next to nothing. We are now in the midst of a very significant compression of yield, global in scope and affecting virtually every class of financial asset. Mongolia can now issue a ten year bond at a yield of less than 5%, and Turkey at less than 3.5%. In the corporate world US high yield bonds recently hit record lows. Amazon issued a five year bond at 1.3% and Microsoft set a record low for five year bonds at just under 1%. Prime US farmland has risen so much in price that the pre-tax rental yield on prime Iowa corn ground has dropped to less than 3%.

With all this in mind, it's worth stepping back for a moment, and appreciating how strange and potentially dangerous the investment landscape is becoming. In a recent interview, hedge fund veteran Stanley Druckenmiller laid out the unquantifiable risks that are building as a result of today's extremely low interest rates:

"I thought we were done with wage and price controls back in the 1970s. But this is the biggest price control of my lifetime. It's one thing to control short-term interest rates. It's another thing to take 75-80% of the bond supply and hold long-term rates down. We had a lot of capital misallocation back in the 1970s as a result of price controls. At some point we're going to find out – and it may be years – exactly where we had a misallocation of resources here, but this is a big, big gamble – to be manipulating the most important price in all of free markets."

Zombie businesses can now survive and stumble along, where in more normal times they would have failed. And almost any investment project, however silly it would look if the cost of capital were at historically normal levels, doesn't look so silly today. As Charlie Munger once put it, *easy money corrupts and really easy money corrupts absolutely.*

Meanwhile, despite this ongoing yield compression, most of the structural problems in the world's financial system remain unresolved: sovereign debt levels remain very high; Eurozone policymaking continues to lack unity and any kind of long-term strategic plan still fails to materialise; China's unsustainable dependence on fixed capital formation is unchanged; the European and Chinese banking systems remain extremely fragile, and the list goes on. None of these issues will be permanently solved by a policy of inexorably low interest rates.

In addition to these longer-term structural concerns is a shorter-term cyclical risk – inflationary indicators have been rising worldwide, and the prospect of higher inflation is beginning to impact consumer confidence globally.

In summary, the following three trends have characterised the first three months of the year for financial markets:

1) Valuation risk has increased.
2) Structural risks have not gone away.
3) Cyclical risk has increased and the chance of an economic slowdown is building.

Sticking To Our Script

The above may sound rather gloomy, but it has little bearing on what we are doing on a day-to-day basis. The Evenlode project is a simple one – to generate long-term compound growth in both capital and dividends for shareholders. We aim to do this by remaining fully invested (or near enough) at all times in high quality, high Return on Equity (ROE) businesses that are priced to offer attractive forward returns (*see Footnote 1 for more on this).* It is an entertaining distraction to talk about economics and central banking policy, but in our view it is far more important that we continue to invest one stock at a time. We have designed our investment process to provide an objective framework for managing the fund through the full spectrum of both market sentiment and economic conditions, so it is crucial we stick to it through thick and thin (*see Footnote 2 on Walter Schloss*).

Where Our Process Is Leading Us Today

Recently, and as discussed last month, our valuation discipline has led us to be quite active since the start of the year. We have removed several stocks from the portfolio as a result of recent price appreciation (Diploma in January, Halma and Euromoney in February, and ITE Group this month). These are great businesses that we hope to return to in the future, but at current valuations we think there are better options. We have also reduced the position size of some of our consumer branded goods holdings following the rather good run this sector has had of late. Conversely, we have increased holdings in several stocks that on our estimates of forward cash return remain very attractively priced. These include GlaxoSmithKline, Smith & Nephew, Sage, Reed Elsevier, Pearson, Microsoft, IG Group and Jardine Lloyd Thomson. The scale of these additions has been quite significant – an incremental 10% of the fund has been re-allocated to these eight holdings since the start of the year.

What You See Is What You Get

As the portfolio stands today, I remain comforted by its quality and value credentials*:

	Evenlode	**UK Market (ex Financials)**
Free cash flow yield	7%	5%
Return on Equity (ROE)	35%	15%
Net Debt/EBITDA	0.6x	0.8x

I find the portfolio's free cash flow yield of 7% particularly reassuring. This figure is quoted after tax, interest and all the capital investment needs of the underlying companies (both for maintenance and future growth). As such, it is a true reflection of the 'owner's return' that the Evenlode portfolio is currently offering.

This free cash-flow can be used on behalf of shareholders for four main purposes:

1) Paying and increasing dividends
2) Buying back shares
3) Strengthening the balance sheet (by paying down debt or building cash reserves)
4) Making acquisitions

Given the robustness and longevity of the underlying businesses in the portfolio, and their high incremental returns on investment, I expect this free cash flow stream to grow nicely over coming years. Incidentally, Evenlode's free cash-flow yield remains unchanged since the start of the year (it was also 7% at the end of December), despite the year-to-date rise in the fund's unit price. This is thanks to two factors:

1) The growth in 2012 free cash flows as announced by the fund's underlying companies over the last 3 months.
2) The changes we have made to the portfolio.

We will work hard to retain this combination of high quality and good value as the year progresses.

A Last Word On Dividends

At the end of February, Evenlode went ex its final dividend for the financial year ending February 2013. The dividend history of the fund for its first three full years is therefore as follows:

	Dividend Payment	**Year on Year Growth**
February 2011	4.33p	n/a
February 2012	4.67p	+7.9%
February 2013	5.02p (Estimated)	+7.5%

The new financial year has started well on the dividend front with encouraging growth in full year dividends for underlying holdings. I also find it encouraging that Evenlode's current 3.5% dividend yield is twice covered by the fund's above-mentioned 7% free cash flow yield (it is one thing for companies to increase their dividends, but a more important question is whether they can afford to). It remains our aim to deliver good real growth in the dividend over the long-term.

Hugh Yarrow
March 2013

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

**Source: Wise Investment and Canaccord Genuity Quest*

Footnote 1 – On Being Fully Invested:

It would be a very rare and exceptional set of market conditions for us to struggle to find things to do that we were comfortable with. Even if we had been managing Evenlode in 2000 or 2008 I suspect we would not have run particularly high cash levels (although perhaps with 20/20 hindsight we would!). There was a good deal of value to be had at the height of the technology bubble (a few key new-economy sectors became extremely expensive, but many high quality old-economy shares remained attractive, as was demonstrated by their subsequent relative performance). Likewise, in 2008 many high quality names were available at perfectly reasonable valuations (this didn't stop them dropping in price of course, but quotational losses were subsequently recovered as fundamentals for the underlying businesses resumed their upward march). Warren Buffett put it well in the recent Berkshire Hathaway annual report:

"Since the basic game is so favourable, Charlie and I believe it's a terrible mistake to try and dance in and out of it based upon the turn of tarot cards, the predictions of "experts", or the ebb and flow of business activity. The risks of being out of the game are huge compared to the risks of being in it".

Footnote 2: Walter Schloss – On Sticking To Process

For an example of the importance of sticking to one's investment process through thick and thin, look no further than the great value investor Walter Schloss. A student of Benjamin Graham, Schloss died last year at the age of 96 and produced one of the most phenomenal track records in the history of investing, compounding at more than 16% per annum over 47 years versus the US market's compound return of 10%.

Schloss had a very different investment style to our own. He focused on net asset value, whereas we focus on free cash flow and Return on Equity (ROE). He owned about 100 companies, whereas we own about 30. He worked out of a cupboard-sized Manhattan office for more than fifty years, whose one window overlooked an air shaft. We work on the edge of a field in Oxfordshire. But I think we can learn some profound lessons from Schloss – they relate to the great benefits of following a disciplined, risk averse approach, tempered by patience and the concept of margin-of-safety every step of the way. As Buffett put it once, regarding the simplicity of Schloss's thought process when making investment decisions,

"Walter knows how to identify securities that sell at considerably less than their value to a private owner. And that's all he does. He doesn't worry about whether it's January, he doesn't worry about whether it's Monday, he doesn't worry about whether it's an election year. He simply says, if a business is worth a dollar and I can buy it for 40 cents, something good may happen to me. And he does it over and over and over again ...... I don't seem to have very much influence on Walter. That's one of his strengths; no one has much influence on him".

In a rare interview, Schloss was once asked whether he thought a recession was looming. His reply was as follows:

"Your guess is as good as mine. I don't know if we're going to have a recession. I find that I like to buy stocks on the basis of what they're worth, and not try to figure out what's going to happen in business. It saves me a lot of grief."

We are with Walter on that one.