Evenlode Investment View

Wise Funds

MAY 2012 – MR. MARKET CHANGES MOOD

After a slight fall in April, stock markets have taken a more significant turn for the worse in May. As I write, the UK market is now down -6.2% since the start of the month. Evenlode has fared better, but has still lost money, -2.0% since the start of the month.

The two most pressing concerns on the mind of Mr. Market – the Eurozone financial crisis and the Chinese slowdown – are not new ones. They have both been part of the economic landscape for some time now, but were brushed aside in the rally of the last six months as a combination of massive money printing from the ECB and a recovering US economy trumped these underlying concerns. Below I discuss each in turn, but conclude this month's view by making some more optimistic observations.

The Europeans Say No To Austerity

The latest leg of the Eurozone crisis has been triggered by the recent elections in both Greece and France. In particular, fears have focused on Greece's potential exit from the euro. Stuck between a rock (austerity) and a hard place (a euro exit and massive depreciation of the drachma), it became apparent over last week's elections that the Greek populace is now more seriously contemplating the 'hard place' option.

I do not venture a prediction on the exact path this currency and debt crisis will take. However, I do believe we are only at the very beginning of European money printing on a massive scale. Why choose austerity when you can print money to finance your deficits? It is the 'easy' (but by no means risk-free) route for policymakers and politicians to take. Ultimately, while a combination of austerity, debt default and economic growth will play their part, it is a persistent inflation combined with low base rates ('financial repression') that is likely to play the most significant role in reducing the real value of government debts over coming years. This is the historical precedent, at any rate*.

Evenlode holds no banking stocks and no European-listed stocks (both of which are right in the epicentre of this crisis). However, most of the businesses in the fund are globally diversified and I estimate that c25% of the revenue from underlying holdings arises from Continental Europe. Two thoughts reassure me, however. Firstly, Europeans are not going anywhere. Whatever happens to their currency regime over the next few years, history and human nature suggest that Parisians, Berliners and Romans will carry on consuming a steady volume of toothpaste, shampoo, painkillers, contact lenses, fizzy drinks, ice cream, dog food, nappies and other such essentials and little luxuries. These are the products that form the bedrock of the Evenlode portfolio. Secondly, portfolio holdings are in very good financial health and are already coping admirably with European adversity. The following four companies in the portfolio have reported results in the last two weeks – Diploma, Sage, Experian and Euromoney. All do a decent portion of their business in Europe. However, they are also asset-light businesses with low investment requirements and as a result are 'drowning in cash'. Combined with global diversification and resilient products, this means they're in good shape. Dividend increases accompanying these results announcements were as follows:

Diploma +20%
Sage +30%
Experian +14%
Euromoney +12%

China Syndrome

The second major concern for investors at present involves the ongoing slowdown in Chinese economic growth. I have mentioned our caution toward what we perceive to be an unsustainable credit boom in China several times over the last two and a half years (see *Rusting Away In The Yard (June 2010)*, *In Dr Bernanke We Trust (November 2010)*, *The Paradox Of Debt (March 2011)* and *Some Thoughts On China*

(June 2011)). My view remains unchanged, and our current exposure to companies that have benefited from China's construction and infrastructure boom (directly or indirectly) is of no significance.

Engineering stocks such as Rotork, Spirax-Sarco and Weir Group are of particular relevance for us in the context of China, and we are keeping a close eye on them. These stocks are on our watch list but are not in the current portfolio. They are great British businesses with first class reputations and difficult-to-replicate intellectual property (the kind George Osborne wants more of – they actually make things that the rest of the world wants). However, they have benefited in direct or indirect ways from the rise of China's property and infrastructure boom and their profit margins and returns on capital are, as a result, much higher at present than their long-term averages. I look forward to owning meaningful positions in these stocks in years to come, but I'm happy to wait until they present themselves at more run-of-the-mill valuations. We're not there yet.

A More Upbeat Take On The Current Gloom

Something very positive is going on right now, but it isn't making the headlines of the mainstream press. Due to the economic concerns discussed above the oil price has fallen more than 15% over the last month and other commodity prices have fallen even further. This is good news for many of our consumer branded goods companies (whose business models involve 'buying commodities and selling brands'). But more importantly, it will act as a huge stimulus for the global consumer, just as it did when commodity prices fell in late 2008, mid-2010 and mid-2011.

This is a point worth holding onto, particularly when so many bits of negative news bunch up into a short period as they have this month (and as they did last August). A big risk in the current investment market is to be sucked in by short-term economic trends and attempt to extrapolate this pattern into an investment strategy. There are too many cross currents in the global economy to do this with any certainty (it would be hard enough at the best of times). And here's some positive news – US leading economic indicators remain incredibly upbeat (in part due to the recent fall in inflationary pressures). A reminder that the negative news of the last three or four weeks won't necessarily continue in such unrelenting fashion.

Portfolio Quality Very High

I remain of the view that a patient, long-term, objective approach not only helps us cope with current economic and stock market volatility, but also means we can actively take advantage of it.

The strong market rally that began last Autumn and ended in April led us to increase our holdings in certain high return, stable, multinational businesses that underperformed the rising market. These included Procter & Gamble, Johnson & Johnson, GlaxoSmithKline, Reckitt Benckiser, Pearson and Sage. I have increased the portfolio's exposure to these six holdings alone by 18% over the last two months. Generally, this reallocation has been at the expense of economically sensitive companies that performed well as investors became more enthusiastic about recovery prospects (including the recent exit of both UBM and Intercontinental Hotels Group). However, the market has been more complex than that. Other stocks that one might have expected to fall into the former category, such as Diageo and Coca-Cola, have strongly outperformed the rising market too. I have reduced these positions accordingly.

In the round, I think the quality of the current portfolio (in terms of both returns on equity and the long-term durability of the underlying business models) is as high as it's ever been. Despite this, valuations remain very compelling and Evenlode is fully invested (the portfolio's current forward cash return is 12%, which compares very well to history). While the portfolio will of course exhibit price volatility, the underlying companies have limited balance sheet risk and I think could, on aggregate, continue to grow cash-flows and dividends even in a very adverse economic environment (the underlying holdings did this, for instance, in 2008-09).

Relative performance in the last few weeks has been helped by Evenlode's current bias towards these stable, large-cap multinationals. However, we're not operating a stopped-clock investment process. Where high-quality opportunities begin to present themselves elsewhere, we will steadily steer the portfolio towards them to take advantage.

Hugh Yarrow
May 2012

Please note, these views represent the personal opinions of Hugh Yarrow as at 16 May 2012 and do not constitute investment advice.

*I discussed this point in more detail in my November 2011 Investment View – *Inflation: The Path of Least Resistance*. Carmen Reinhart's paper *The Liquidation of Government Debt* is a good resource on the subject of financial repression. (*http://www.imf.org/external/np/seminars/eng/2011/res2/pdf/crbs.pdf*)