Evenlode Investment View

November 2014 – Animal Spirits Rising Again

Global markets have rallied strongly since mid-October – to such an extent that the UK market is nearly back to the multi-year highs it reached in July. The market has managed to shrug off plenty of negatives over the last few weeks, not least signs of European recession and deflation, the continuing structural slowdown in China, and several geopolitical worries (Ebola, ISIS, Putin etc). Helping the more positive tone is the prospect of monetary easing in Japan, Europe, and latterly China. Meanwhile, the US economy is in something of a sweet spot – growth is solid but inflation remains contained (despite strong employment) thanks to both weakness in other global economies and falling commodity prices. Leading indicators suggest that the first half of next year could turn out to be very positive for the US economy, and many companies with exposure to the US consumer are beginning to report an upturn in trading.

The Odd New Opportunity...

As I mentioned last month, at an individual stock level, we have seen some new opportunities emerge in the recent sell-off. Several stocks in our investable universe have experienced a drawdown of more than -30% from their high point earlier in the year (Domino Printing, Spectris and IMI for instance). These are quite big moves in the context of a market that is broadly flat on the year (as I write the FTSE Allshare has produced a total return of +3.0%, or -0.3% excluding dividends). These businesses are high quality franchises with far more stable profitability profiles than their recent share price volatility suggests. Domino Printing, Spectris and IMI have produced average annual dividend growth of +16%, +12% and +9% respectively over the last ten years, and grew their dividends steadily through the 2008/9 crisis. We also see the potential for healthy cash flow and dividend growth in the future. Over the last few weeks we have been able to purchase all three stocks on starting dividend yields of between 3% and 4%.

...But We Continue To Tread Carefully

Overall however, market volatility remains low relative to history, and the aggregate valuation picture has not changed much since the start of the year. On our estimates the UK market is currently trading a little above fair value. We therefore continue to tread carefully - from current valuations, the prospects for future returns are clearly not as attractive as they were three or four years ago.

Nearly three quarters of the Evenlode portfolio is invested in four key sectors – consumer branded goods, healthcare, media and software companies. These businesses generate a large portion of revenue from habitual customer purchases, both in terms of repeat-purchase branded goods and subscription-based products with high renewal rates. In our view these franchises continue to offer the prospect of attractive annualised total returns for the patient, long-term investor.

Some Thoughts on Healthcare

This month I'd like to focus on one of these four sectors, the healthcare sector, in a bit more detail. One of Evenlode's top ten holdings, Astrazeneca, held an investor day last week*. Chief executive Pascal Soriot reminded investors that, since the company's last investor day two years ago, some very solid progress has been made in terms of pipeline development. And though the next two years present some clear headwinds for the company (as patents for some key products expire), he reminded investors that things should have progressed even more significantly in two years time.

I continue to view the healthcare sector as an attractive home for long-term capital. Valuations remain good and the sector has limited exposure to the economic cycle. A combination of innovation, demographics (we are all getting older!) and growth in emerging market healthcare spending should act as positive tailwinds for these business models over coming years.

Innovation is on the increase in many areas of healthcare. Advances in biological therapies ('biologics') such as immuno-oncology look particularly promising (More than 50% of Astrazeneca's pipeline is now in biologics, for instance). Cancer treatment over the years has relied on three key pillars - surgery, radiotherapy and chemotherapy**. Immuno-therapy is now emerging as the fourth pillar. This is a significant development that is beginning to transform the landscape in several areas of cancer treatment. As a cancer specialist at the John Hopkins School of Medicine recently put it, *I'm still reluctant to use the term "cure," but what I say to the patients is that, "we all have to die of something, but I think there's a real possibility you are not going to die of your cancer." That is really transformative****.

As well as being good for patients, the move towards biological therapies (in many areas of healthcare - not just cancer treatment) will also improve the economics of pharmaceutical companies. Patents for 'biologics' tend to be stronger and last longer. Even when they expire they are less easy to copy, so revenues are more defendable than for more traditional 'white pill' therapies.

At the same time demand for effective therapies is growing strongly in both speciality areas such as cancer treatment and in primary care areas such as respiratory and diabetes. As Astrazeneca noted last week, over 8m adults die of cancer every year and by 2030 that number is expected to rise to 13m. Similarly, in primary care areas such as respiratory disease and diabetes, there is a growing population of patients. It is estimated that by 2030 the number of diabetics worldwide will grow to 330 million from a current population of about 190 million, the vast majority of whom will be sufferers of type 2 diabetes (not helped by all of us eating processed food and sitting at desks all day!). Market growth will also be expanded by an increasing percentage of sufferers being identified and treated (particularly in emerging markets) where historically they would have gone undiagnosed.

There Are Negatives - Of Course

I should stress than my views on the sector are by no means Pollyannaish. Despite the positives mentioned above, pricing will remain an ongoing negative for pharmaceutical companies. Healthcare systems remain very focused on keeping costs down and continue to demand value-for-money. This has been very evident this year in some areas of the US primary health care market such as the respiratory and diabetes sectors. Stocks such as Glaxosmithkline and Sanofi have under performed in sympathy with these trends (we have initiated a position in Sanofi this month after the recent share price fall - the stock now yields 4.0%). The cost of speciality therapies in areas such as cancer (where individual treatment programmes can be very costly) will also remain under scrutiny. We don't think this dynamic is going away, though its intensity will ebb and flow. But we do think it will remain a manageable trend for the industry over coming years, just as it has been over the long-term history of the sector (i.e. for more than fifty years). Effective, innovative drug therapies remain a key 'displacement factor' for healthcare systems worldwide. Less than 10% of total healthcare costs are spent on drug therapies, but the benefits that come from this expenditure in terms of saving costs elsewhere is significant.

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Please note, these views represent the personal opinions of Hugh Yarrow as at 24th November 2014 and do not constitute investment advice.

*It is worth stressing that our investment case for Astrazeneca is premised on the potential for long-term growth in free cash flow and dividends rather than the possibility (or lack thereof) of Pfizer returning with a revised takeover offer.
**A story very well told by Siddhartha Mukherjee in his biography of cancer, The Emperor of All Maladies, which I would recommend.
***Dr Drew Pardroll. Source: Bernstein Research