Evenlode Investment View

October 2014 – Fifth Anniversary

EVENLODE
INVESTMENTS FOR LIFE

Global stock markets fell sharply in the first half of October. At the low point last week the UK market was off almost exactly -10% from its September peak, the first correction of this magnitude since August 2011.

I don't profess to be an expert at predicting short-term stock market movements. However, I would make the point that - while it never feels like it at the time - market corrections are a healthy part of the long-term investment process, blowing the froth off markets and providing a more attractive valuation base to move forward from. The first half of October has been unpleasant, but share price falls have injected a non-trivial amount of value back into many stocks in the market. Some stocks have been punished more than others, providing opportunity. We have made some changes to the portfolio as a result of this stock-by-stock volatility, including the addition of some new holdings to the fund.

Much of the worry in the market over the last few weeks has been economic, and it is therefore worth adding that our focus as ever is on businesses capable of generating high and stable cash-flows. This won't of course completely insulate them from share price volatility, but at a fundamental level the portfolio has good micro-economic characteristics for coping with a sluggish economic environment.

Third Quarter Results - Some Themes

Many company updates for the third quarter have come in, and the two major themes evident in the first half of 2014 have continued. First, the world economy is muddling through in patchy fashion: the US economy is showing signs of life; emerging markets continue to grow but at a slower rate; and Europe remains difficult. Second, currency headwinds for UK listed businesses with global operations remain a feature. Reckitt Benckiser and British American Tobacco, for instance, saw a currency impact of -9% and -12% on their revenues, respectively. There are signs, however, that these currency headwinds will finally start to abate as we move into the new year. Some companies which earn a high proportion of their money in US dollars (such as Reed Elsevier) are already starting to see earnings upgrades due to currency - something that hasn't happened for some time.

Update On Two Unfashionable Stocks

I have noted before that, in my view, a healthy investment portfolio is one that contains some unfashionable stocks, some stocks with which the market is beginning to become interested, and others that are really working out. We have had several positions in the latter two categories this year. Early this year we exited several smaller company positions which had performed extremely well for us. Latterly, stocks such as Astrazeneca, Reckitt, Reed Elsevier, Microsoft and Smith & Nephew (now exited) have also taken up the baton.

This month I'd like to focus on two companies that currently fall into the 'unfashionable' category - Unilever and GlaxoSmithkline, currently the fund's largest positions.

Unilever

If consumers look to get an extra day or two out of a bottle of shampoo this obviously has an impact on volume growth

Jean Marc Huet, Unilever Finance Director

On any given day, two billion people around the world consume a product made by Unilever - shampoo, deodorant, soap, ice cream etc. Its earnings releases therefore give a sense of how the global consumer's feeling, and third quarter results released yesterday continued to show a difficult picture, particularly in Europe and certain emerging markets such as China and Brazil. As the quote above from Unilever's finance director suggests, the most defensive industries do still have a small amount of cyclicality to them - even if it only comes down to squeezing the shampoo bottle a little harder than normal before going to the shop to buy a new one. However, Unilever's underlying sales for the year are still up by +3.2% and the business continues to generate high profitability and cash-flows, a testament to its excellent franchise and economic resilience, and an ability to adapt to the changing operating environment. The long-term industry growth potential remains very significant in emerging markets and, for the patient investor, the group is in a strong position to take advantage. And interestingly, for the first time in recent history, Unilever noted yesterday some signs of a pick up in the US consumer staples market. Though too early to call a trend, this perhaps represents an early sign that the sharp fall in oil prices is feeding through to the US consumer's pocket.

Unilever's yield is currently 4.0%, and as noted last month we view the long-term potential for dividend growth as very good.

GlaxoSmithkline

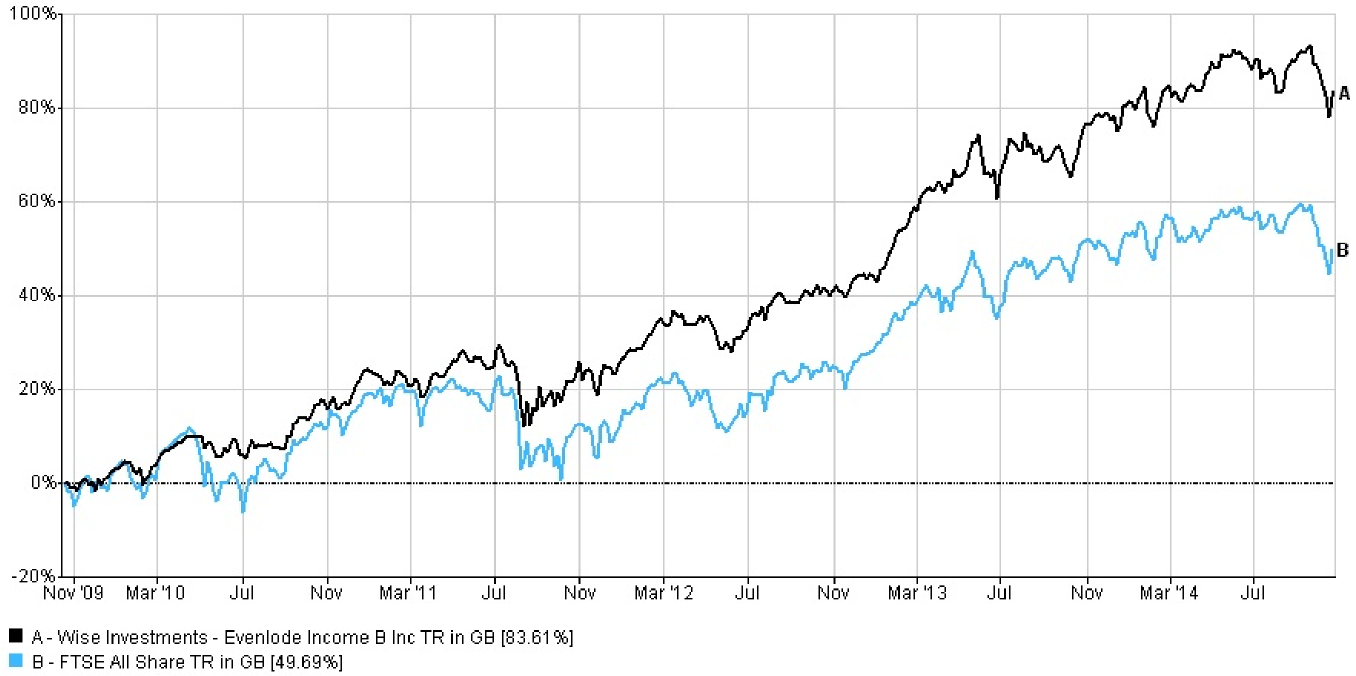
GlaxoSmithKline also released third quarter results this week. 2014 has been a challenging year for the healthcare group. The company's US respiratory business is in a transitional phase, as Glaxo looks to replace its ageing Advair therapy with a portfolio of new respiratory products. Changes to the structure of the US healthcare system mean that launching new products is a slower and more difficult process now that it was even a couple of years ago. However, Glaxo's management are learning to adapt to the new environment and as a result expect the respiratory franchise to return to growth in 2016. I continue to believe that the group looks significantly undervalued in terms of its long-term ability to generate cash-flows, and that long-term trends are supportive for both the stock, and more generally the sector. Management are beginning to explore ways to highlight the value embedded in the pharmaceutical portfolio - including a potential spin-off for its HIV business (Viiv), which could be worth more than £15bn. And once the Novartis transaction has closed (expected in early 2015), 40% of Glaxo's sales will come from its stable and market leading consumer healthcare and vaccine businesses. The potential for driving growth and efficiency across this new-look company is significant.

Glaxo's current dividend yield is 5.8%. Management expect to hold the dividend next year, with the intention of a continuation of dividend growth in future years, once the Novartis transaction is bedded in.

Fifth Anniversary

The Evenlode fund had its fifth anniversary this month. It is perhaps appropriate that the fund's birthday has come at a time of investor angst and uncertainty. Evenlode was born on 19th October 2009 as the global economy emerged from the ashes of the Great Financial Crisis of 2008 and 2009. At the time, Ben and I stated publicly that we saw the Evenlode project as a very long-term investment project (twenty years or more), and our aspiration remains very much the same.

The track record so far is shown below against the fund's benchmark, the FTSE Allshare:



Since launch, to date, the compound total return per annum, after fees, has been +12.9% per annum for Evenlode compared to +8.4% for the FTSE Allshare. The average annual dividend growth, from a starting yield of 4.3%, has been a little over +8% per annum.

Operating in a market (and a sector of the market) which is very competitive, we think this is a reasonable result so far. It has been achieved by focusing only on quality (i.e. high return, asset-light) stocks, with a disciplined valuation and dividend filter. This approach has consistently proven to work long-term, but it also involves us doing things very differently to the UK market. The fund's performance will, therefore, fall in and out of fashion over shorter time periods as the market cycle waxes and wanes. This is something we are keen for our investors to understand.

Though we are pleased with the progress to date, we are acutely aware that what matters most for our investors is not the past but the future. In that respect, our efforts remain focused on retaining an attractive combination of quality and value within the portfolio, and on companies capable of achieving resilient growth in cash-flows and dividends over the next five years and beyond.

Hugh Yarrow
Investment Director
October 2014

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