Evenlode Investment View

Wise Funds

SEPTEMBER 2011 – INTERIM REPORT

During the six month period under review (to 1 September 2011), Evenlode Income A and B shares fell -4.3% and -4.0% respectively. This compares to a fall of -8.0% for the FTSE Allshare and -7.3% for the IMA UK Equity Income sector.

Since Evenlode Income's launch (19 October 2009), A and B shares have risen +18.5% and +19.6% respectively. This compares with +10.3% for the FTSE Allshare and +10.8% for the IMA UK Equity Income Sector. (All sources: Financial Express. Performance figures for the fund are quoted after all fees and costs incurred.)

Performance Review

In a weaker market, the fund's strongest performers were consumer staples and healthcare stocks, which currently make up nearly half of the portfolio. Glaxosmithkline, Unilever and Johnson & Johnson were the top three contributors to overall return. Other positive contributors included Microsoft, Pearson, Diploma and MITIE, all reporting good results and healthy dividend growth during the period.

Our media exposure was the main contributor to negative return, with stocks such as Vivendi and Reed Elsevier declining. We have used this weakness to add to our holdings in this sector, which now make up 18% of the fund. Amidst worries of a global slowdown, other more economically sensitive stocks such as Hays and WS Atkins also fell. The biggest negative contributor to performance, however, was Smith & Nephew. The share price fell after talks of a possible takeover (emerging just before the start of the period) subsided.

The Great Deleverage

At the heart of recent stock-market weakness is a creeping realisation that the global economy is not recovering as strongly as hoped from the banking crisis and subsequent recession of 2008-9. The third anniversary of the collapse of Lehman Brothers recently passed, but UK and US unemployment, currently running at 7.9% and 9.1%, remain close to crisis highs of 8.0% and 10.1%.This compares to pre-crisis lows of 4.7% and 4.4% respectively. Quantitative Easing has not had as positive an effect on economic prospects as central bankers hoped it might. Meanwhile, the Eurozone crisis lurches from one insufficient policy measure to another. Unless European politicians find sufficient political will to make bolder moves than those made so far, this crisis will rumble on.

All these problems (weakness in economic demand, high unemployment and sovereign debt issues) have their root in the same thing - the credit boom and subsequent banking crisis that went before them. The new era we are in - the 'Great Deleverage' – is characterised by consumers and governments paying down their debts and restoring their financial health. Although we are 3-4 years into this process, history suggests that at least the same amount of time may need to pass before the world can return to a more sustainable, healthy level of economic growth.

Life Goes On

All is by no means lost, however. An entertaining article was published recently on Irving Kahn, the oldest living investment professional, aged 105. He started on Wall Street in 1928, the year before the Great Crash, and still wakes up every morning at 7am to go to work at his investment firm.

"This may surprise you, but there were a large number of valuable buys during the Depression. Then and now, the smart money was on companies with sound fundamentals. You always had a long list of what I'd call legitimate businesses, the ones that produced food, clothing, and other essentials. Everybody still wanted a clean shirt."

And his view on today's market?

"There are a lot of opportunities out there, and one shouldn't complain, unless you don't have good health."

We agree. There is no shortage of growing businesses in the current market, selling things society needs and desires, even in more difficult times. The pervading apathy towards equities as an asset class is serving up some of the most enduring franchise businesses of the world, at valuations investors from previous decades would have salivated at. Time tends to treat these businesses well. They have risen to the challenge of economic booms and busts, inflation, deflation and changing currency regimes on countless occasions before, and we suspect they will do so again. For the long-term investor, with patience and a strong constitution, we think compounded annual returns from today will look very satisfactory when viewed from the more comfortable vantage point of hindsight.

Take Johnson & Johnson, one of four US stocks in the fund. In the 1980s and 1990s it was a stock market darling, valued on a glamorous earnings multiple of between 20x and 40x. Currently, the stock market is unhappy to assign more than a 12x multiple to the very same earnings stream. That is despite average annual growth of about 10% over the last ten years. We suspect that J & J can keep producing results of a similar magnitude over the next decade – its long history suggests it most probably will. Even if J & J's valuation remains depressed, shareholders will benefit from this growth and from a rising dividend stream. But if Mr Market decided to restore J & J to anything like its previous glory, then things would really start to get interesting.

Elsewhere, whilst care is required, opportunities are presenting themselves and will continue to. We'll work hard to scrub down these possible candidates and act when they look worthy for inclusion in the portfolio. A general point worth noting is that businesses have now had a long time to get used to the current economic environment. It is a strong vindication of any business model to have survived the last four years in good shape, remaining self-sufficient in terms of cash requirements and continuing to operate with a healthy balance sheet. Those that have should continue to trade well even if times remain hard.

The Dividends Keep Coming

In previous reports I have mentioned our preference for businesses that we describe as 'cash compounders'. Owners of intangible assets such as consumer brands, intellectual property and lasting customer relationships, these businesses tend to generate high profits relative to requirements for capital reinvestment in the business. The outcome for shareholders is generally high and rising excess cash-flow, and a steadily rising stream of dividend payments.

Despite the many uncertainties in the world, the dividend change in the fund's top ten holdings for the most recent financial year was as follows:

Unilever +11%
Glaxosmithkline +7%
Diageo +6%
Reed Elsevier +0%
Astrazeneca +16%
Johnson and Johnson +9%
Sage +5%
Smith & Nephew +15%
Pearson +9%
Reckitt Benckiser +15%

These holdings represent more than 50% of the current portfolio. There is something very reassuring and solid about this underlying progress and, in our view, far more significant and tangible than day-to-day fluctuations in share prices. Share price volatility is currently higher than usual, with the stock market regularly bouncing up and down 1-2% a day. Nonetheless, for businesses with excellent economics, the passing of time tends to be a great friend to shareholders, not an enemy. I feel positive for the portfolio's prospects, and continue to invest all of my own long-term savings in the fund.

Hugh Yarrow
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Please note, these views represent the personal opinions of Hugh Yarrow as at 16 September 2011 and do not constitute investment advice.