Evenlode Investment View

Wise Funds

JANUARY 2012 – PREPARE FOR THE WORST, HOPE FOR THE BEST

2011 is now consigned to the history books, and another 12 months have been added to Evenlode's life. The results by calendar year (31 Dec to 31 Dec total return) versus the FTSE Allshare total return are set out in the table below:

Year	Evenlode 'A' Shares	FTSE Allshare	Relative
2009*	+3.1%	+2.3%	+0.8%
2010	+19.6%	+14.5%	+5.1%
2011	+2.1%	-3.5%	+5.6%
Total	**+25.9%**	**+13.1%**	**+12.8%**

Source: Financial Express
*From 19th October to year end.

The drivers of the fund's performance in 2011 were quite different to 2010. In 2010 it was mostly smaller businesses such as Domino Printing, Diploma and Halma that drove performance – the 'hidden champions' of the portfolio. But in 2011, and particularly in the second half of the year, it was mainly blue chip multinationals (Unilever, Diageo, Coca Cola, British American Tobacco, Sage, Glaxosmithkline, Johnson & Johnson, Microsoft et al) that provided the out-performance.

Below I discuss my thoughts on 2012 and beyond. There is not much in the way of a forecast here – I'm realistic about the limits of our powers as investment managers. As John Kenneth Galbraith put it, 'the only function of economic forecasting is to make astrology look respectable'. What we *do* think we can do, however, is construct a portfolio that is well insulated from the diverse range of outcomes and risks that we see, but still offers the potential for high returns.

Untangling The Cyclical From The Structural

Much ink has been spilt regarding the difficult ***structural*** economic backdrop that the world faces over the next few years, and it would be hard to find an investor that expects the resolution to these problems to be straightforward. The developed world appears to be mired in a balance sheet recession that will likely take years to resolve. As a result, the risk of sovereign default in the developed world (and most particularly in Europe) is a clear and present one, for the first time in several decades. Meanwhile, unemployment remains high and the propensity for both the private sector and the public sector to spend has been significantly curtailed. Other parts of the world have their own problems. China's huge economy, for instance, now faces the challenge of transitioning from export and construction-driven growth to a consumption-driven expansion – unlikely to be a straightforward process.

However, the existence of these structural pressures does not mean the business cycle is dead. ***Cyclical*** pressures are still alive and well, and something very positive happened in the second half of 2011; inflationary pressures – globally – fell very sharply. So it is that we enter 2012 with the global economy, and in particular the US economy, having made something of a miraculous recovery from its deathbed back in August and September last year. Leading indicators stabilised in October and have been on an improving trend ever since. This better news has allowed the market to hold its nose to the continuing bad smells emanating from Europe's political elite, and stage a strong recovery.

More generally, cyclical factors have been very quick to change over the three years since the 2008 banking crisis. It is worth noting that both 2010 and 2011 have been very unusual relative to recent history, in the sense that both years saw two inflection points in the global economic cycle– a peak

in the springtime and a recovery later on in the year (summer in the case of 2010 and autumn in the case of 2011). This is pretty much unprecedented relative to the 1980s and 1990s experience. I suspect it is something we will have to get used to.

Staying Objective

From an investor's perspective, this rapidly changing cyclical backdrop calls for a calm, patient objectivity. The market likes to project current sentiment much further into the future than is normally justified by fundamentals. 2011 provides the perfect example. In springtime, the investment community was worried about a QE2 induced 'inflationary melt-up', but by autumn worries had turned to the possibility of years of deflation. I wrote the following in February 2010 (*Rules Of Engagement*), which is just as relevant today as it was then:

'Given that almost none of the present value of dividends a company pays in its life (i.e. its true intrinsic value) will be determined over the next 5 years, market optimism and pessimism driven by short-term economic and industry conditions tend to exaggerate true value. These swings in sentiment are plentiful – the average stock price in the UK, including those of large companies, varies by more than 30% a year. For us, this fact has two implications. The first is a bit of an investment platitude – not to get too caught up in the moment and treat market volatility as a friend. The second is the harder one – to avoid a 'stopped-clock' investment mentality in terms of stocks held within a portfolio. As Will Rogers once said, 'even if you're on the right track, you'll get run over if you just sit there'.

A current example in the Evenlode portfolio of 'not just sitting there' has been the reduction in our healthcare exposure since the year end. Back in 2010 I wrote, of Glaxosmithkline, that 'in the current world of miniscule base rates there are very few assets – money market instruments, stocks, bonds or property – that offer as attractive a combination of initial return and growth'. While I still broadly agree with these sentiments, it's important to acknowledge that the relative merits have declined. Glaxo shares have appreciated by +35% since then, versus a return from the UK market of +10%. I would also stress that Evenlode is not a 'defensive' fund, but is a 'quality' fund. We only invest in businesses with high returns on equity and low levels of debt, but many of the companies that fit this criteria are labelled by the market as economically 'cyclical'. We may be in for several tough years for the global economy, but I would far rather have some exposure to high-return cyclical businesses than to low-return defensives such as utility and telecom stocks. Recent markets have given us an opportunity, at the margin, to add to some of these more economically sensitive businesses.

Finding Runways Of Growth

In a world where economic growth is harder to come by, finding companies with the capacity to invest at high rates of return in growing markets are of considerable interest. If there is one 'theme' that runs through the Evenlode portfolio, it is a high exposure to businesses that will benefit from rising consumption in emerging markets. In particular, we are attracted to businesses that have an established, cash-generative franchise in more developed regions, which can now be deployed in new, fast-growing areas. Our consumer staples exposure is the most obvious example. Potential for these brand-owners isn't just about the 'BRICs' or even 'the next eleven' but is becoming truly global. Africa, for instance, is beginning to make a meaningful contribution to Unilever's results, but the growth opportunity remains huge. Ghana is Unilever's second biggest African market, but the spend per-capita on Unilever products in Ghana is a fifth of South Africa's (its largest African market). Spend in Kenya, Unilever's third biggest African market, is half of Ghana's. This gives a

sense of the future potential for compound growth. Such potential is available in other sectors too. Media companies such as Experian (particularly in Latin America) and Pearson (internationally) are using their strong reputation and intellectual property in western markets to roll-out their business models geographically. Another example is Intercontinental Hotels Group, a formidable franchise business and a collection of global brands that the emerging middle classes, worldwide, long to consume.

The capacity to steadily reinvest at high returns is persistently undervalued by investors. It's not something that can be captured in a PE multiple, or an annual free cash flow yield, and certainly not in a price-to-book multiple. To most conventional yardsticks of value, it is a hidden asset. Our valuation methodology – forward cash returns – is designed to value this asset as accurately as we can, and cherish it accordingly.

The Current Portfolio

As we begin 2012, the fundamentals of the Evenlode portfolio are in good shape. I expect, when all the results are in, that stocks in the portfolio will have grown their earnings by approximately +10% on average during 2011. Dividend growth should be in the high single digits, and all but two (Severfield Rowen and Hays) of the thirty three holdings in the fund will have increased their dividend for their 2011 full year.

The quality characteristics of the portfolio continue to look good too, with higher returns and lower debt than the market as a whole. Average return on equity for stocks in the portfolio is 29%, compared to about 13% for the UK market. Net Debt/EBITDA is 0.3x, compared to 0.6x for the UK market, and fifteen of the thirty-three holdings have no net debt at all. On the valuation front, the portfolio's weighted free cash flow yield is 8.2% compared to 5.9% for the market**.

I fully expect 2012 to be an interesting year, which will have plenty to throw at us. The likelihood of sovereign defaults in the West and a significant slowdown in economic growth in the East are key risks – whether they will need to be confronted by investors over the next 12 months is an open question. Regardless, the tools in our toolkit – high return stocks with low levels of debt – are well equipped to 'suck it up and cope'. And you never know, we might all be pleasantly surprised. As the old saying goes, 'prepare for the worst and hope for the best'.

Hugh Yarrow
January 2012

Please note, these views represent the personal opinions of Hugh Yarrow as at 20 January 2012 and do not constitute investment advice.

***Source: Collins Stewart. All figures ex financials*