EVENLODE
GLOBAL EQUITY FUND

Evenlode Global Equity 3 Year Retrospective

Q4 2023

A reflective review

We recently passed the three-year anniversary of Evenlode Global Equity. It has been quite the three years! The fund was launched with internal capital in July 2020, in the middle of the first wave of COVID-19 lockdowns. The economy quickly moved into a period of unbridled optimism in 2021 as society re-opened, before coming crashing down to earth, with war, inflation, and recession concerns in 2022. The current year has seemed sedate in comparison, although for those disposed to worry there is plenty of macroeconomic grist to the mill: rising interest rates, inverted yield curves, and controversy over the durability of the Western consumer.

While fund anniversaries typically mean more to managers than investors, who are rightly more concerned with future returns, they do provide us with the opportunity to evaluate our performance, both in absolute and relative terms. However, given the short time period[1], it is as important to assess the effectiveness of Evenlode's investment philosophy as applied to a global equity mandate, and our consistency with the stated approach.

The Evenlode philosophy

The Evenlode investment philosophy, which is common across all of our funds, can be summarised as follows:

"We invest in high quality, cash generative businesses at sensible valuations."

At Evenlode, we see investments as stakes in real businesses. The success of these businesses depends on their ability to generate cash flow, the rate of reinvestment of cash flow, and the return on those investments. If a business can continue to fund investment and maintain high returns on investments (particularly above the cost of funding those investments[2]) then the business will continue to grow and compound cash flows. We believe this is the primary long-term driver of shareholder returns.

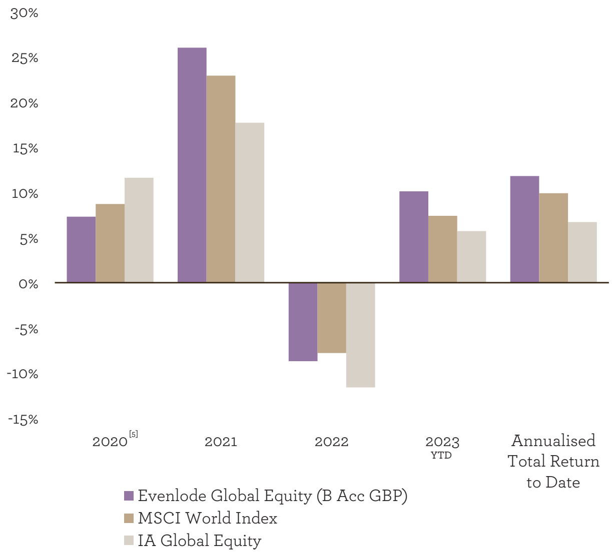
Companies that can maintain high returns on invested capital (ROIC) over an extended period meet our definition for quality, as stated in the philosophy statement above. As these high returns are attractive to peers or new entrants, a quality company requires a durable competitive advantage that differentiates it from peers. However, not all companies can maintain high returns on invested capital. We can all name companies that were unable to overcome disruption, from the designers of horse carriages to manufacturers of film-based cameras. Our primary task is therefore to continually assess the companies we invest in and to ensure that they preserve their fundamental competitive advantages.

[1]The stated fund aim is to outperform over periods of 5 years or longer.
[2] Often referred to as the weighted cost of capital or WACC

Performance so far[3]

Over the three years since launch, Evenlode Global Equity has returned 35.9% after fees[4]. This outperformed both the fund's comparator benchmark, the MSCI World Index (32.3%), and the IA peer group, IA Global (23.4%). While we are pleased with the relative performance, we would add the caveat that we prefer to judge performance over a longer period. Investing in equities is a long-term pursuit and we believe the compounding power of companies takes time to generate returns significantly above the market.

Total return of Evenlode Global Equity vs MSCI World Index and peers



	2020 [5]	2021	2022	2023 YTD	Annualised Total Return to Date
Evenlode Global Equity (B Acc GBP)	7.3%	26.0%	-8.7%	11.8%	10.8%
MSCI World Index	8.7%	22.9%	-7.8%	10.2%	10.3%
IA Global	11.6%	17.7%	-11.6%	6.9%	7.3%

Source: FE Analytics. GBP terms. Total Return, net of fees, 15/07/2020 – 31/08/2023.
Past performance is not a reliable indicator of future performance.

We are particularly pleased with the fund's history of capital preservation relative to peers during the declining market of 2022. The fund did slightly underperform its comparator benchmark, but we saw that as a reasonable outcome given our zero weight to the energy sector, which was up 68% in the year and represented a 217bps headwind to relative fund performance. The fund outperformed its peer group by a material margin, as well as the MSCI World Quality index[6], which we use to track the so-called 'quality' investment bucket.

Conversely, our longest period of relative underperformance came immediately after launch. In retrospect, July 2020 was a difficult time to launch the fund, since it came at the end of the period when 'quality' stocks had outperformed strongly through the very volatile early stages of the pandemic. From July onwards the broader index, and cyclicals, recovered as rates were slashed to zero and massive fiscal stimulus hit the developed world economy. The main lesson we draw from this is the somewhat hoary old one that 'time in the market beats timing the market'. Over time, the superior fundamental characteristics of the portfolio have overwhelmed the inopportune starting position.

These returns are no guarantee of future performance but are highly encouraging indicators that the Evenlode investment philosophy, which has proven successful in dividend investing[7], can also be applied to a non-income focused approach.

[3] Source - Financial Express. 2020 figures are 15/07/2020 to 31/12/2020. 2023 YTD figures are to 31/08/2023.
[4] Evenlode Global Equity, B class 15/07/2020 – 15/07/2023.
[5] 15/07/2020 to 31/12/2020
[6] Note that this is not a comparator index, in part because it is essentially uninvestable. There is an MSCI World Quality ETF but it materially differs from the benchmark.
[7] This refers to the Evenlode Income and Evenlode Global Income funds, launched in 2009 and 2017 respectively, which are both first quartile to date in their IA sectors as at 31/08/2023 over both 5 years and since launch.

Reviewing our approach

To measure our consistency with the approach stated above, we can evaluate returns on invested capital (ROIC) over the first three years of the fund. We define High ROIC companies as those companies with returns on invested capital above the long-term average cost of capital for companies, 7% [8]. Similarly, those defined as Low ROIC are below this cut-off.

The Sankey diagram below shows the proportion of companies with High and Low ROICs over the life of the fund and includes companies held by the Evenlode Global Equity fund at any point during the period since launch. We selected this full set of 52 companies, rather than only those held for the entire period, for completeness. The vast majority of these companies were in the fund's investable universe (and therefore deemed quality) at the start of the recorded period, so consideration of their ROIC over the period is valid.

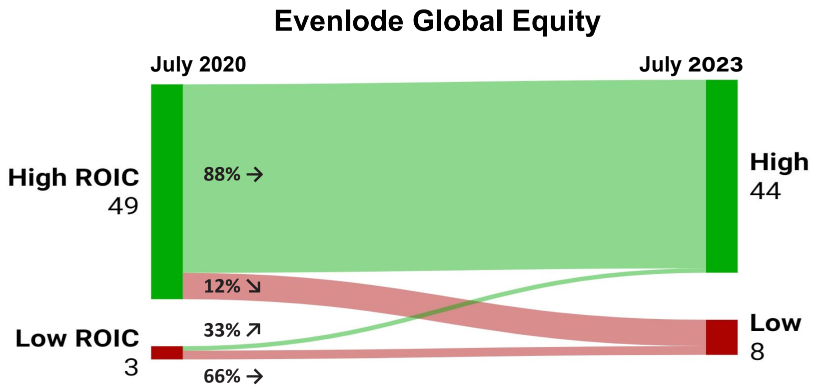


Figure 2: Evenlode Global Equity ROIC, 31/07/2020-31/07/2023 [9]

For the high return (ROIC over 7%) companies held in the Evenlode Global Equity portfolio over the period, 88% were able to maintain high returns over the period. This is a significantly higher proportion than the companies within the MSCI Index[10], and demonstrates that we have invested consistently with our stated strategy – identifying quality companies to invest in.

As discussed above, companies that are able to maintain high ROICs have enviable economics, which have the habit of attracting plentiful competition. For instance, over the last decade, Mastercard and Visa have experienced sustained competitive challenges from a powerful consortium of large retailers representing over $1trn of annual consumer revenue (MCX/CurrentC); a well-funded attempt by the biggest and most sophisticated bank in the world, J.P. Morgan, to develop a closed-loop payments system in the U.S.; the largest ecommerce payments company, Paypal, attempting again to create a closed-loop payments system; and a sustained attempt by regulators in the UK and Europe to reduce merchant discount rates and encourage open banking and account-to-account consumer payments. All of these have failed, and our expectation is that future challengers will likely have a hard slog to displace the payments schemes' competitive fortress.

Likewise, Alphabet's Google search franchise has come under sustained pressure, not just from the endless war-chest of Microsoft and Bing, but also from well-funded startups like Neeva, from regulators (particularly in the EU), and from competing Internet walled gardens like Meta and Amazon; yet Alphabet is thriving. Mastercard and Alphabet have returned 18% and 17% per annum[11], respectively, since the Evenlode Global Equity strategy launched. This illustrates the potential rewards from identifying these businesses, which will be discussed further below.

[8] Chosen as an approximation of the long-term cost of capital for companies.
[9] Factset data extracted using annualised ROIC for companies on stated dates.
[10] A similar analysis showed that 73% of companies in the MSCI World Index maintained their returns on invested capital over the same period.
[11] Factset, 15/07/2020 – 31/08/2023

What can we learn?

The return on invested capital data also highlights where we may be able to improve. We have invested in three companies that initially had low returns (ROIC below 7%): Medtronic, an American medical devices company, Pernod Ricard [12], a French sprits manufacturer, and Aveva [13], a UK software company supplying the engineering industry. However, the earnings of both Medtronic and Pernod Ricard were significantly suppressed in 2020, as the pandemic lockdown delayed medical procedures, and closed bars and pubs thus reducing the opportunity to consume spirits out-of-home. However, as of today, Pernod has recovered earnings, returned to the High ROIC classification and has generated an impressive return for investors. Medtronic has been more disappointing, as issues with their diabetes devices have slowed revenue growth. These challenges have been addressed and we would expect the company to return to the High ROIC category soon. Both Medtronic and Pernod remain in the portfolio.

In retrospect, we see investing in Aveva as an error. While there was much to like about the company– notably recurring revenues and high switching costs– the combination with Schneider Electric's software business left Aveva management subservient to a third party, which eventually (and perhaps inevitably) bought out the minority shareholders, following a slump in share price driven by market disappointment with the organic growth outlook. Aveva remains one of the worst (time-weighted) contributors to fund returns to date and is no longer in the investable universe.[14]

On the other side of the spectrum, we should also learn from those portfolio companies that started with high returns but failed to maintain them. There are six in this bucket: Intel, Siemens Healthineers, Cooper Companies, Amazon, Intercontinental Exchange, and London Stock Exchange. The first three of these positions were sold in December 2020, January 2021, and July 2022 respectively. In all cases, we exited the positions prior to a sharp decline in the return on invested capital, driven in each case by market concerns over commercial execution and capital allocation. All three companies have produced below market total returns to shareholders in the period since disposal and are no longer in our investable universe. Notably Intel has declined sharply, with the share price falling over 30% [15] since the date of exit. This illustrates the importance of retesting our investment thesis for each company and consistently asking ourselves whether the companies remain high quality.

The remaining three companies that moved into the Low ROIC category are Amazon, Intercontinental Exchange (ICE), and London Stock Exchange Group (LSE). All three companies are currently in the Evenlode Global Equity portfolio. Both Amazon and ICE moved into the Low ROIC classification within the last year.

[12] Medtronic and Pernod Ricard initiated at start of fund, 15/07/2020.
[13] Position initiated 15/12/2021.
[14] The list of companies deemed high enough quality to be considered for investment. This assessment is done independent of the current valuation.
[15] Factset, 06/01/2021-30/07/2023

For Amazon, the shift to Low ROIC has come from extending capital investment in response to post-pandemic demand, which has since slowed, thus reducing profitability. This investment still has the potential to be highly productive however. While one swallow does not make a summer, Amazon's most recent results showed much better cost absorption and operating leverage on the retail side. The Street seems to agree, and is discounting sharply better cashflow and profitability, suggesting that this was an 'air-pocket' rather than a structural deterioration in the franchise. With retail firing again, this only increases the attractiveness of the Amazon Web Services (AWS) business which is benefitting from the technological transition from on-premise servers to the public cloud. Amazon's competitive advantage in e-retail comes from the two-sided network effect between buyers and sellers on the platform, which in turns drives tremendous logistical efficiencies.

Looking at ICE and LSE, both of the financial exchanges' declining ROICs were driven by M&A. We are typically somewhat allergic to 'big-bang' M&A given the well-covered behavioural challenges to success in this area. But exchange M&A is a special case. ICE has had a very strong history as a consolidator, as aggregating the trading of different derivatives asset classes has a black hole-like network effect at its core: clients are typically engaged in multiple derivatives contracts which have relatively low correlation, allowing client collateral to be 'compressed' by netting off exposures, which has compelling results for balance sheet efficiency as well as regulatory surveillance. ICE's more recent acquisitions have been in less adjacent areas, but so far have shown promise as the company has built scale in the complex 'plumbing' of fixed income securities, and in the adjacent area of mortgage origination and securitisation. We expect ICE to rebuild ROIC and profitability over time, as it has done repeatedly in its consolidation cycles.

LSE similarly bought a large asset, Refinitiv, which included a range of services and products of mixed quality. For now, profitability is suppressed by the reinvestment cycle needed to restore the competitiveness of some of its screen-based businesses. The core bulk live price feed business is solid, and the Tradeweb franchise of rates, credit, and FX trading is a gem. Again, we expect LSE to 'earn its way' out of its suppressed ROIC as the compounding power of the acquired competitive advantages asserts itself and dominates the fixed stock of goodwill weighing on the balance sheet.

In summary, all three of these currently low(er) ROIC companies are continuing to invest behind their competitive advantages and operate in growing markets. This does not guarantee a return to High ROIC, but does increase the chances (in our opinion). However, we will limit our position sizes in all three companies, and they will continue to be areas of focus for our research.

From philosophy to performance

The final consideration is evaluating whether the adherence to the Evenlode philosophy has been responsible for the outperformance of the fund since launch in comparison to its benchmark. To do this, we must demonstrate that the thesis that high quality businesses can outperform is indeed true. There is little point in selecting businesses with persistently high ROICs if this virtue was already in the stock prices!

The table below shows the average annualised return of four possible groups within the MSCI World Index over the three years discussed, based on start and end ROIC[16].

Start ROIC	End ROIC	Average Annualised Total Return
High ROIC	High ROIC	12.4%
High ROIC	Low ROIC	7.5%
Low ROIC	Low ROIC	6.3%
Low ROIC	High ROIC	24.3%

Figure 3: Source Factset

As can be seen, the two groups that ended with a high return on invested capital finished with materially higher annualised returns to shareholders. However, the best performing group was those companies that moved from a Low ROIC into High ROIC. Many of these companies are within the energy, mining and banking sectors which have experienced cyclical upswings over the past three years, as energy prices, commodity demand and interest rates have all increased. We are sceptical that these cyclical trends will continue and expect the returns from these segments to normalise over time.

The second highest performing group was those companies that maintained high returns on invested capital, or those that meet our definition of quality companies. These businesses materially outperformed the market average. This is consistent with the experience of the Evenlode Global Equity fund. The 88% of the portfolio that maintained high returns on capital over the period (see Sankey diagram above) contributed close to 99% of the total returns. For us, this is evidence of the investment philosophy working in practice, and justifies our vigilance in searching for quality, and rigorously testing (and retesting) the conditions that drive it. We will be discussing these conditions, and the process we use to identify the risks that lead to declining ROIC, in an upcoming webinar[17].

[16] Again using 7% as the cut-off between High and Low ROIC categories.
[17] For more information please contact Spring Capital: +44 (0)20 3307 8086 or evenlode@springcapitalpartners.com

Into the future

The past three years has been an enjoyable first foray into non-income investing for Evenlode. Evenlode Global Equity is a natural extension of the Evenlode philosophy; “investing in high quality, cash generative businesses at sensible valuations”. However, in venturing beyond our natural heartland of dividend investing, there was no guarantee of replicating the attractive returns of the earlier Evenlode funds. The performance of Evenlode Global Equity over its first 3 years is a reflection of the hard work of the entire Evenlode team and (to our minds) a fitting reward for the faith shown by our early co-investors. We will continue to apply the Evenlode process as promised and look forward to further anniversaries to come.

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