

# Chawton Global Equity Income Fund

June 2024



**CHAWTON**  
GLOBAL INVESTORS

## Quarter Ended 31 March 2024

### Overview

The Chawton Global Equity Income Fund (the Fund) and equity markets generally are performing well as inflation falls to more normal levels. Approaching the end of its fifth year, the Fund has compounded at over ten percent per annum in a period that encompasses multiple different economic and market conditions. Warren Buffett states that investors should focus on business analysis and let the stock market serve you. We believe we have an edge through our ability to assess future business strategy and thereby the quality of capital allocation decisions. We start a discussion in this letter on the theories and models supporting our business analysis with the first topic being the link between the corporate lifecycle and corporate financial strategies.

### Performance

The Fund started the year strongly rising 7.9% in the first quarter of 2024 which was above comparators at 6.2% but below the Fund's comparator benchmark which rose 9.9%. A breakdown of performance is shown below encompassing the first quarter 2024 and preceding periods.

Discrete Performance	2019	2020	2021	2022	2023	2024 Q1
WS CGEIF B Acc GBP	9.3%	14.2%	18.2%	-8.3%	10.8%	7.9%
MSCI World TR in GBP	8.6%	12.3%	22.9%	-7.8%	16.8%	9.9%
IA Global Equity Income	7.0%	3.2%	18.7%	-1.2%	9.2%	6.2%

	WS CGEIF B Acc GBP	MSCI World TR in GBP	IA Global Equity Income
Since Inception (19/05/2019)	61.6%	77.3%	50.4%
Compound Annual	10.3%	12.5%	8.7%

Source: FE fundinfo as at 31 March 2024. Total return in GBP. Past performance is not a reliable indicator of future results. The value of your investments and the income derived from it can go down as well as up and you may not get back the money you invested

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The long-term compound annual growth (CAGR) of the Fund now stands at 10.3%<sup>1</sup> since inception almost 5 years ago. The Fund results are net of fees and charges and are compared to the benchmark index (MSCI World GBP) and the comparator group as represented by the Investment Association Global Equity Income sector.

The backdrop is that the trajectory of inflation is downwards globally now with, for example, the US core PCE rate at 2.8% in February having been 3.7% six months earlier. This reduces future interest rate expectations and therefore the return required by investors helping equities rise as we saw in the quarter.

The strong performance from the Fund was driven by companies from multiple sectors especially those in the growth phase of their lifecycle (ASML, Novo Nordisk) but also capital redeployment (Next, insurers). More mature compounders have fared less well (Nestle, Diageo) excepting where they have a defined and proven faster growth strategy (L'Oréal, Costco). However, stable slower growth compounders more focused on returning capital tend to prove their worth when economic conditions deteriorate and remain a significant part of the fund.

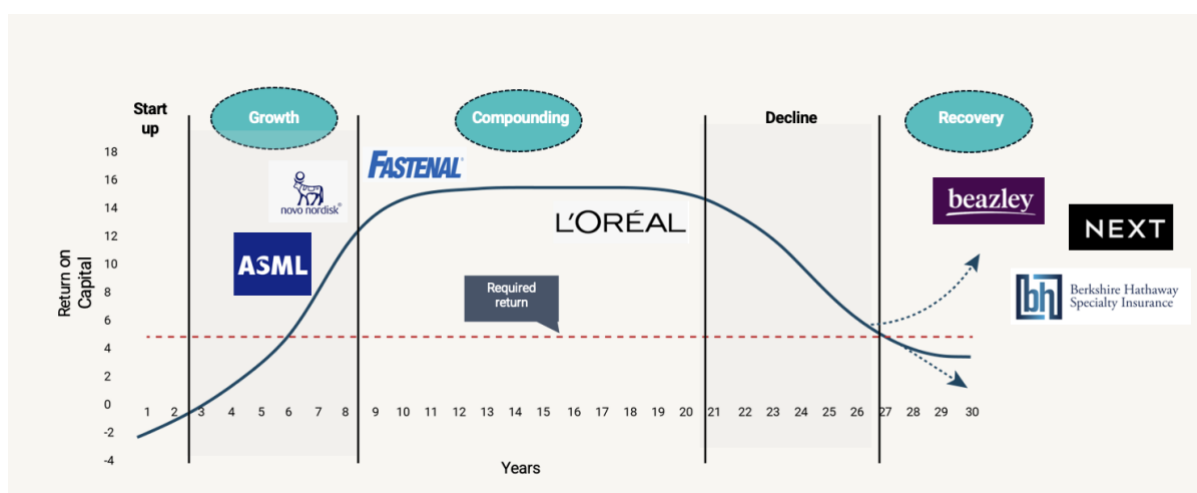


Chart 1: The Fund invests across the corporate lifecycle.

## Activity

No new positions were initiated in the quarter. We sold Jardine Cycle and Carriage which we discuss below and a small position in a US consumer staple company where we did not build enough conviction to take to a full holding.

<sup>1</sup> B Class ACC GBP

## Jardine Cycle and Carriage (JCC)

The company is Singapore listed but its main business is operating the Toyota auto dealership network and Honda motorbike dealership network in Indonesia through its majority owned Astra subsidiary. Astra originated as a family controlled conglomerate typical of South East Asia and retains other interests in areas ranging from mining to banking to toll roads. The holding company, JCC, allocates surplus capital and is part of the Jardine Group which has a long track record of investing in the region.

Two negative developments have led to our divestment. Firstly, we have become concerned that current retained capital allocation is not optimal despite their historic track record. Investments in a Thai cement company and a Vietnamese auto related company have proved disappointing so far and they are generating low returns on capital. Sub-optimal capital allocation risks diluting future shareholder returns.

Secondly, Astra became embroiled in a dispute over the development of a gold mine in a biodiversity area deemed critical for endangered animals and ecosystems. This is regarded by environmental groups as a threat to the existence of the Tapanuli Orangutan. Management have refused to backdown on this issue and we fear this reflects their underlying attitude to environmental sustainability.

Whilst we washed our face on our investment with the capital invested realised, there was an opportunity cost of holding it over a two year period. We fear this will continue and consider there are better opportunities to deploy our investors capital.

## **Theory (Part 1): Linking corporate lifecycle and financial strategies**

We believe we have an edge as a fund manager as we apply a comprehensive business analysis to the companies underlying an equity security and this improves our ability to predict corporate outcomes. I thought it would be useful in this and future letters to set out some of the financial theory behind our approach. In this letter we consider the link between corporate lifecycle and financial strategies.

In our Q3 2023 letter we described the typical corporate lifecycle of a higher quality company (as defined by the ability to generate returns above the cost of capital) which helps define optimal capital allocation and therefore influences corporate strategy. Understanding a company's position in its lifecycle helps management to determine, and the board to oversee, the optimal financial strategy.

As investors, understanding the optimal strategy enables us to find companies that will deliver our required rate of return from across the lifecycle improving the probability of outperformance across different economic and market conditions. In addition, it enables us to manage the fund to generate both capital growth and a growing income stream. Finally, we are able act promptly to divest holdings that are unlikely to achieve our expected returns as with JCC above.

We will start by outlining the basic theory and then go onto discuss, in future pieces, how strategies can be modified given that reality is more complicated and approaches can be more nuanced.

At all stages of the lifecycle, shareholder value is created if a greater return can be generated from allocated capital at a lower risk than alternative uses of the capital. In the early growth phases, risk is high but compensated for by potentially higher returns. Capital is retained within the business and its investment will result in increased cash flows in the future. Investors obtain their return as the net present value (NPV) of these increasing cash flows is reflected in an increasing market value. The price earnings ratio, which reflects the NPV, will tend to be high and there will be no dividends or share repurchases.

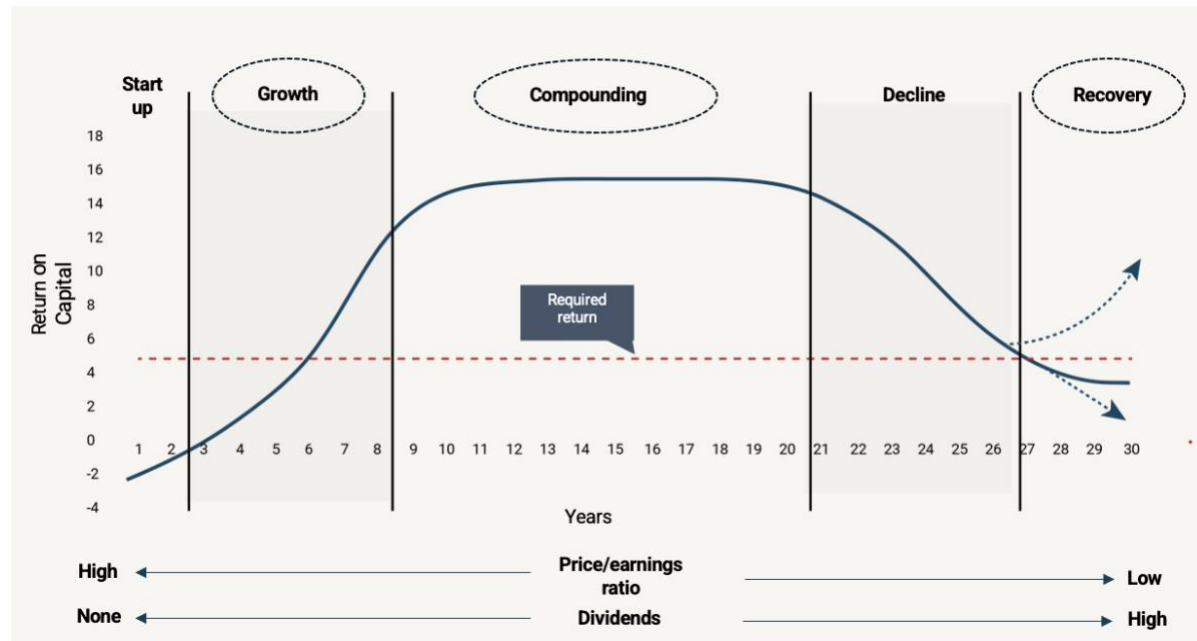


Chart 2: PE and dividend payout ratios change over the corporate lifecycle.

The issue for investors in this phase is that risk and return are both high and so the portfolio needs to have a number of such investments of which one or two will

generate substantial returns whilst most will fail. We have seen many examples of this dynamic in recent years in the technology arena.

We are looking for more predictability and therefore evidence of competitive advantage. Accordingly, the companies we invest in tend to be higher up the S-curve and nearer the compounding phase. Examples in the fund are ASML which is now a near monopoly in a key component of semiconductor manufacture and Novo Nordisk which is building a second growth leg in obesity reduction drugs equipped with the cash flow and knowledge gained from its first; insulin.

As a business matures, it becomes more difficult to invest all the capital generated. It then becomes financially sensible to increase the dividend pay-out ratio and/or commence share repurchases. Quality companies with a durable competitive advantage still have the opportunity to invest some capital and typically may retain half their earnings whilst distributing the rest. This can lead to a long and rewarding compounding phase. The inherent risk profile of the company will fall implying that investors will require a lower return. The price earnings ratio will decrease as more of the shareholder return is generated from the cash returned to them in the form of dividends and/or share count reduction. Example of companies we hold who have extended the duration of this phase and compounded, for very long periods of time are Procter & Gamble (founded in 1837) and Nestlé (1886).

Eventually competition enters the industry and excess returns start to be competed away. Many management teams react to this by seeking to deploy capital in new products or markets where it is questionable whether they have a competitive advantage. Financial theory suggests, if this is not possible, they should seek to run the business to maximise cash returns. Payout ratios should move towards 100% of earnings and/or it may be the case that assets can be divested. In this phase, price earnings levels will fall to low levels reflecting the finite nature of future cash flows but dividend yields and share repurchases will be consummately high delivering the bulk of the required return. An example of this in the portfolio is Svenska Handelsbanken, the Swedish Bank which last year returned 13% of its market capitalisation and is on a PE ratio of 7.

By assessing the appropriateness of the corporate financial strategy deployed by management based on the company's position in its lifecycle, we can evaluate the riskiness of the strategy. In future letters, we will explore some of the strategic models that help us do this.

## Stewardship

In Q1 2024 we participated in 5 Annual General Meetings and abstained from voting in relation to one proposal for the approval of the company's executive remuneration policy. To view our latest Voting Record and Voting Report, please go to the Stewardship section of our website. In conjunction with another fund manager who invests in the company, we sent a letter to an independent member of the Board of Directors of Next Plc, our largest holding. This is in order to arrange a meeting to discuss succession planning which we have through our monitoring activities identified as a critical factor, as well as two sustainability related issues. We expect to provide you with an update on this engagement in the next quarterly letter.

## Conclusion

The strong performance experienced in the last quarter of 2023 continued into the first quarter of 2024. The Fund is performing ahead of other global funds with an income objective. Fund activity was limited. Chawton continues to encourage strong governance and stewardship capabilities at owned companies and are seeking to engage with the board of our largest holding, Next plc. We look forward to further progress in 2024 after a good start.

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As a concentrated equity portfolio of typically less than 50 stocks the fund may involve higher volatility and therefore higher risk for those with shorter term investment time horizons (under 5 years). The value of an investment and the income from it can fall as well as rise as a result of market and currency movements and you may not get back the amount originally invested. You should therefore regard your investment as long term. Details of the risk factors are included in the fund's prospectus available at <https://www.waystone.com/waystone-fund-services-uk-limited/ws-chawton-investment-funds/>