Chawton Global Equity Income Fund

August 2024

CHAWTON
GLOBAL INVESTORS

Quarter Ended 30 June 2024

Overview

Markets were in consolidation mode in the second quarter after the rises in the first. The Chawton Global Equity Income Fund ('the Fund') compound annual growth rate (CAGR) since inception is strong.

We were more active than normal initiating a number of new ideas which we describe as well as what made room for them.

We discuss our process for managing the risks of new ideas and investments and the importance of discounted cash flow modelling in assessing value.

Performance

The second quarter of 2024 saw the Fund and comparator funds rise marginally whilst the benchmark MSCI World rose more meaningfully (+2.6%). This consolidates a good first half of 2024 with the Fund rising 8.7% above comparators at 6.8% but below the Fund's comparator benchmark which rose 12.7%. A breakdown of performance is shown below encompassing 2024 year to date and preceding periods.

Discrete Performance	2019	2020	2021	2022	2023	2024 YTD
WS CGEIF B Acc GBP	9.3%	14.2%	18.2%	-8.3%	10.8%	8.7%
MSCI World TR in GBP	8.6%	12.3%	22.9%	-7.8%	16.8%	12.7%
IA Global Equity Income	7.0%	3.2%	18.7%	-1.2%	9.2%	6.8%

	WS CGEIF B Acc GBP	MSCI World TR in GBP	IA Global Equity Income
Since Inception (19/05/2019)	62.8%	81.9%	51.2%
Compound Annual	10.2%	12.7%	8.6%

Source: FE fundinfo as at 30 June 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

The long-term compound annual growth (CAGR) of the Fund stands at 10.2%[1] since inception just over 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.

Process – New ideas, initial position sizing and categorisation

We look for new ideas across the Corporate lifecycle stages; growth, mature compounders and recovery, based on set criteria tailored for each phase. This chart summarises the model:

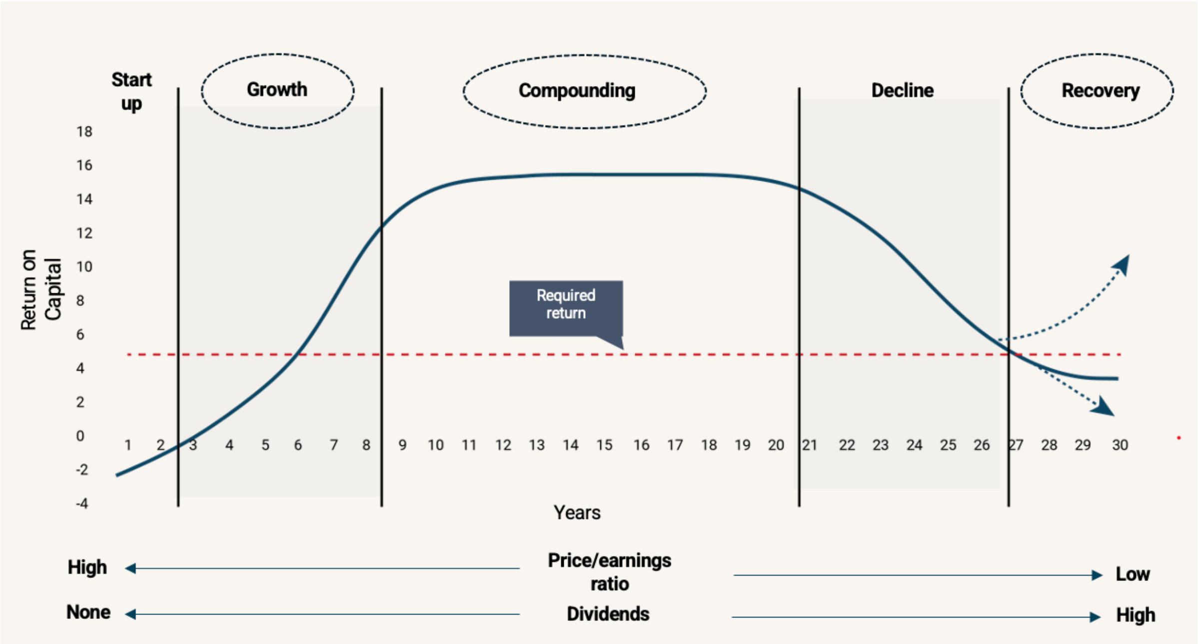

Chart 1: We source new ideas from across the corporate lifecycle.

Given large companies are widely followed, well researched and, in recent years, bolstered by passive investing, it can be difficult to identify new large-cap equities that will generate a superior risk adjusted return. Given also that history suggests the large companies of tomorrow are likely to be the small today, the main focus of our new ideas research is focused on mid and small capitalisation companies.

[1] B Class ACC GBP

When considering initial positions and their position sizing as well as monitoring investments in the early stages of purchase, we adopt two approaches. Both follow completion of our detailed research work, and if our business quality critieria are achieved, completion of discounted cash flow (DCF) based valuation work.

Firstly, where evaluation of our research is conclusive, we move to acquire a meaningful position in the company which we would define as at least 3% of the fund subject to risk profile. If our valuation work suggests a margin of safety on purchase, we can proceed to this weighting promptly. We term this a ‘conviction’ purchase.

In some cases the valuation margin is low we will stagger our entry to seek to reduce the aggregate purchase price. Sometimes, the price might move away from us during this accumulation phase and, if we fail to establish a meaningful position, we will sell what we have acquired.

Secondly the evaluation of our research might suggest a very interesting opportunity with high reward potential reward but where risks levels are high and are more difficult to assess based on available information. In such cases we will acquire a small exploratory position. In time, as new information becomes available we will either build on this or sell. We term this an ‘exploratory’ position.

Success in investing is partly based on turning over as many stones as possible and looking at the right company at the right time. This involves making some mistakes and the approach described allows us to the limit risk on these whilst increasing the probability of finding the few companies that can deliver sustainable value creation.

Activity

During the period, we added four new positions and sold four ending up with holdings in 33 corporate groups.

We initiated positions in US-listed KLA Corp (advanced metrology) and Lululemon (athletic apparel retailer), UK-listed Warpaint London (value cosmetics) and Swedish-listed Traton (industrial).

We sold our holdings in US-listed Johnson & Johnson (pharmaceuticals), Brown Forman (alcoholic beverages) and Hershey (confectionary) and UK-listed Renishaw (engineering).

KLA Corporation (KLAC)/Renishaw (RSW)

KLAC operates in the Wafer Fabrication Equipment (WFE) Market, a sub-sector of the semiconductor industry. We believe the industry is in the early stage of a long-term structural growth phase.

KLAC is credited with creating the process control segment of the WFE market. Today, it dominates this segment. We expect the company to capture further market share.

The company's Inspection, Process Control and Metrology solutions enable manufacturers to achieve higher yields (the percentage of functional chips per wafer), and, consequently, to increase their revenue per wafer processed.

KLAC has built competitive advantage through its technology leadership reinforced by high research expenditure and high switching costs. As well as higher demand, our analysis indicates the company is likely to benefit from higher process control intensity associated with advancements in node design in the next decade.

This company is in the growth phase of its corporate lifecycle consistent with its modest yield through retention of most of its earnings.

We have full conviction in this opportunity but after our initial and follow-on purchases the price shot up. We are not yet at a full position but have sufficient to make it viable. We will be patient.

Renishaw (RSW)

We exited our position in Renishaw, an engineering company with core skills also in metrology and precision machine tool positioning and calibration. However, in contrast to KLAC, innovation at the company appears to be stagnating at a time when opportunities are growing for metrology equipment in areas such as semiconductors.

Traton (TRA)

This is a recovery phase opportunity. The company is one of four global truck producers having added, through an industry consolidation phase, Scania and Navistar to VW and Man brands. Traton was put together, and is majority owned, by VW who are in the process of reducing their stake further after the initial IPO.

The industry has consolidated significantly and the four now act much more rationally in competing with one another. It is noticeable that demand volatility has reduced in recent years.

Manufacturing has become less capitally intensive due to increased outsourcing of component production, more efficient equipment and use of digital technology to optimise line productivity.

Management is in the process of capitalising on the group's scale by introducing modular systems to standardise components across the four brands. The CEO's bonus is entirely measured on improving ROIC.

Scania, often likened to being the Porsche of the truck sector; provides strong brand equity along with Man. With a Scania insider as CEO, we believe the emphasis on quality and great design will be spread through the group bolstering all brands.

Traton's competitive advantage derives from scale and brands. We expect ROIC to rise above the cost of capital.

Industry leader; Paccar of the USA, has been generating margins above 15% in recent years and ROIC of 18% and Traton has the potential to improve towards these levels.

A limited free float, the risk of VW selling down their stake further and higher leverage, which is being reduced, results in a market valuation well below our estimate of intrinsic value. The company generates surplus capital supporting a yield of 5%. The latter should improve once leverage targets are achieved. This is a conviction purchase.

Warpaint London (Warpaint)

The company supplies value cosmetics mainly under the W7 brand but also Technic. Warpaint's strategy is as a 'fast fashion follower'. They identify which prestige cosmetic products are selling well and then produce own branded imitations at a tenth of the price. It floated on AIM in 2016.

The co-founders continue to run the business. They started as East End street traders and together own 40% of the equity. This is a company in its growth lifecycle phase.

The brands have gained sufficient power that they are commanding increased shelf space in UK through Tesco (and others), Europe through Normal (and others) and increasingly, the USA.

We believe there is a counter-positioning competitive advantage here as large incumbents cannot match these prices or take as pure a cruelty free, natural ingredients stance.

We have established an exploratory position.

Lululemon (Lulu)

The company is a major global brand in the 'athleisure' market. Lulu's origins were in producing high end, stylish and comfortable apparel for Yoga with subtle branding. From this core base, it has built the business both in moving into additional sporting areas such as running and gym classes as well as casual and work wear.

It has expanded geographically from its home market in Canada into the USA and further afield, most notably, into China. The company had been adept at taking advantage of digital channels enabling higher ROIC.

Our view is that the concept and brand is durable. It is positioned at a high price point which is justified by quality, and this moves it apart from most of the competitive pack such as Nike and Adidas, almost into the luxury segment.

However, recently revenue growth has slipped markedly We consider this is because the company is starting to transition starting towards maturity

The share price has fallen 42% from its highs six months ago and is not reflecting the sustainable value creation the company is still capable of. Hence, we have started to build an exploratory position in the stock.

Johnson & Johnson (JNJ)

We sold our position in Johnson & Johnson as we consider there are better opportunities in healthcare with the rise of a new wave of drugs addressing metabolic health through obesity reduction. This could also be a long-term threat to JNJ's traditional drug franchise.

Brown-Forman, Hershey

We have become more concerned with consumer staples since attending CAGNY[2] in February and hearing company after company announce medium term revenue growth targets of 2-4%. This when global inflation at 2-3% plus real GDP growth of 3% gets you to 5-6% nominal economic growth.

Whilst the focus of these mature compounders should be ROIC optimisation and return of capital to shareholders, some asset base growth is required to deliver superior shareholder returns.

We completed our exit of Brown-Forman during the quarter having initially purchased at inception 5 years ago and experienced a disappointing flat return over the five year holding period.

In the previous decade, the shares had performed well as management divested lower return brands to focus on the high return core; however, they have been unable to really get the latter growing consistently.

Hershey was an exploratory position we lost conviction on also because revenue growth has proved disappointing.

Theory (Part 2): Linking corporate lifecycle and DCF modelling

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 aim to set out in these letters the financial theory behind our process to help investors understand our approach. In our last letter, we considered the link between corporate lifecycle and financial strategies. In this letter, I am going to discuss the importance of DCF modelling.

A DCF model involves the prediction of future free cash flows of a company. It then discounts these back to the net present value to determine value. It is important to realise that the intrinsic value of any cash generating asset is fundamentally anchored in the principles of a discounted cash flow model.

[2] Consumer Analyst group of New York annual consumer staples conference held in Florida.

The model should be constructed following in-depth fundamental research of the company and its industry enabling identification of potential drivers of the business. The importance of the model is that assumptions derived from the research can be incorporated enabling assessment of sensitivity and a more robust valuation estimate.

This links well with the lifecycle model, as, by identifying where a company is in its lifecycle provides greater insight into the likely future trajectory of revenue growth, margins and ROIC. These insights can be built into the DCF model.

Most investors utilise a simplistic short cut by using multiples which offer a quick, convenient shorthand for valuation. However, these lack the depth and rigour needed to truly understand the asset value and can lead to significant mispricing.

In addition, an increasing proportion of market participant pay very little attention to asset valuation at all. They are led by passive investors and include hedge funds competing for capital in pods and retail ‘meme’ investors.

Fund managers deploying a disciplined business fundamental approach reinforced with DCF modelling, are at an advantage over the longer term.

Stewardship

We participated in 19 general meetings during the quarter, voting upon a total of 323 resolutions. Cumulatively, we voted against management recommendations on 14 occasions, predominantly due to concerns relating to companies’ executive remuneration policy, the independence of external auditors, and weakening shareholder rights. To view our latest voting record and report, please go to the stewardship section of our website.

In May we attended the capital markets day of one of our holdings, Atlas Copco, where we had a chance to gain a deeper insight into the potential growth opportunities within each of the company’s four business areas and discuss and meet management, including CEO Vagner Rego, who was elected earlier in the year. He successfully ran the company’s largest division for a number of years prior to his promotion

We attended a meeting with ASML at their headquarters in June where we discussed the company’s technology roadmap, as well as the impact of AI and increasing geopolitical tensions between the U.S and China on their business. These meetings served to reinforce our conviction in the companies’ growth potential and competitive positioning.

Conclusion

Markets were more in consolidation mode in the second quarter after the strong first. As we start the second five years of the fund, we are investing to replicate and hopefully surpass the strong annual compound growth of the first half decade. This requires patience and discipline.

Whilst we are long term investors looking to hold holdings for a least five years and hopefully a lot longer, it is important that we identify, explore and risk manage new ideas. Our initial purchase process supports this.

We were more active than normal in the second quarter processing a number of new ideas which displaced some existing holdings.

Cash generating assets such as equities are best assessed and valued using discounted cash flow models. Using the corporate lifecycle model enables better models to be produced.

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/

T. +44 (0)1843 516 064
E. info@chawtoninvestors.co.uk
W. www.chawtoninvestors.co.uk