

Chawton Global Equity Income Fund

November 2024



CHAWTON
GLOBAL INVESTORS

Letter to Investors – Third Quarter 2024

Overview

The fund did not make progress in the third quarter in net asset value terms (which is driven by share prices) whilst equity markets rose. That said, with fund companies growing earnings and our valuation discipline leading to some sales and purchases, the aggregate fund valuation (driven by fundamentals) is the most attractive we have seen since inception. Importantly the fund is both better diversified than equity indices and less exposed to valuation risk or, in plain language, over exuberance.

Performance

The third quarter of 2024 saw the Fund's net asset value decline marginally, with the benchmark rising slightly and comparator funds more meaningfully. The Fund's year to date performance is a useful 7.4% but lags the performance of comparator funds (by 1.9%) and the performance of the benchmark (by 5.6%). A breakdown of performance is shown below encompassing 2024 year to date and preceding periods.

Discrete Performance	2019	2020	2021	2022	2023	2024 YTD
Fund ¹	9.3%	14.2%	18.2%	-8.3%	10.8%	7.4%
MSCI World TR in GBP	8.6%	12.3%	22.9%	-7.8%	16.8%	13.0%
IA Global Equity Income	7.0%	3.2%	18.7%	-1.2%	9.2%	9.3%

	Fund	MSCI World TR in GBP	IA Global Equity Income
Since Inception (21/05/2019)	60.8%	82.3%	54.8%
Compound Annual	9.3%	11.9%	8.5%

Source: FE fundinfo as at 30 September 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.

¹ WS Chawton Global Equity Income Fund B Acc. GBP

The long-term compound annual growth rate (CAGR) of the Fund stands at 9.3%² since inception over more than 5 years ago. Fund results are net of fees and charges and are compared to the benchmark index (MSCI World in GBP) and the comparator group as represented by the Investment Association Global Equity Income sector.

Although the net asset value of the fund has failed to rise as much as markets in the quarter, the companies we invest in have continued to make good progress.

Our activity has increased as a number of stocks we have held for some time have risen to valuation levels this year that reduce our expected future return levels to below our risk adjusted hurdle rates. The sale of Costco, described below, is an example. At the same time, we have found some high-quality new ideas at attractive valuations. Elopak, described below, is one.

The net effect is that the aggregate valuation of the fund in terms of price earnings, at 18x, and dividend yield, at 2.7% are the lowest they ever have been since we launched the fund. Quality ratios, such as aggregate return on capital of portfolio companies, remain high.

Some (rare) commentary on the global economy

As business analysts we focus most of our research on individual companies and their position in their industry. However, the wider economic implications of political developments can also be relevant.

As I write this letter, we have seen changes in three major western developed country Governments and a significant change in policy in China.

The changes in Government have resulted in new regimes with contrasting approaches to managing their respective economies over the next five years with, most likely, very different outcomes.

The UK and France have elected Governments that are choosing to spend more public money and finance this largely from taxation on businesses. They have also created narratives that discourage business aspiration.

² B Class ACC GBP

The USA has elected a Government which is likely to be unpredictable and therefore cause much volatility. However, there does appear to be an underlying message that business aspiration is to be favoured and excessive Government spending reduced.

China after a period of seemingly discouraging business success and sudden imposition of severe regulations on certain sectors, has introduced new measures to stimulate both consumers and securities markets.

We will be watching developments in these regions with interest. Whilst we continue to focus on the quality of companies and the likelihood that their strategy and associated capital allocation will drive shareholder value, these political developments are more likely to influence our regional capital allocation at the margin.

Most significantly, so far, we have decided to re-enter China judging the risk reward favourable given the very high quality and very low valuations of companies quoted there. The rationale for our investment in electric vehicle and battery supplier; BYD, is set out below along with a discussion of the wider China risks.

Activity

Material Sales

Costco

Costco is in the mature, compounding phase in our quality company lifecycle framework with a large-scale related low unit cost advantage leading to high returns on capital. This is evidenced by cash flow from operations being in excess of cash flow utilised for investment activities. In the year ended September 2024, the company generated \$11.3 billion from operations and deployed \$4.4 billion of this for investments in the business. This investment encompasses growth projects, notably international expansion. A company generating more cash than it can invest is indicative of the compounding phase.

We have held Costco since inception in May 2019 and it has risen a cumulative 260%. With a market capitalisation of over \$400 billion it is now amongst the largest companies in the world. We continue to regard the company, its management and its capital allocation strategy very highly.

Over the last five years, the company has grown earnings at a compound annual growth rate (CAGR) of 15%, a 100% cumulative increase. The reconciling factor between this and the much greater share price growth is the valuation, which has risen to over 50x earnings and a yield of 0.5%. At the same time we have noted new entrants into the bulk discount market globally (Amazon, Action, Aldi, Lidl, Temu) as one would expect in a maturing market.

As a company moves from its growth phase to compounding, the price to earnings ratio should fall as the relative growth rate subsides. The dividend payout ratio should increase. We therefore consider passive investment flows, or similar, have led to a mispricing of Costco given its lifecycle position.

From the current market valuation starting point, the company would need to deliver earnings CAGR of 20% for the next five years to achieve an annual total shareholder return (TSR) of 10%. If it replicated the outstanding growth of the last five years, which would be a great performance given the size of the company now, the TSR would only be 5% per annum. This is below our required rate. Hence, we have reluctantly sold.

Material Purchases

Elopak

This Norwegian listed company makes and distributes the fibre board cartons used to package milk, fresh beverages such as fruit juices and other liquids that have a limited shelf life. The cartons are pasteurised to increase internal hygiene and thereby increase the shelf life of the product. Being biodegradable as well, they have clear advantage over plastic and glass packaging which they are rapidly replacing in Europe. Elopak also has opportunities to invest to grow in the Americas, India and Africa. Demand, driven by staple beverage items, tends to be stable.

The business is also in the compounding phase of its lifecycle. The industry is highly consolidated with scale and 'high switching cost' barriers to entry as customers commit to buying Elopak filling machines and are therefore locked into the product supply.

We have not observed that this industry is attracting entrepreneurial talent leading to start-ups. In fact, in USA, there have been serious shortages of the carton packaging capacity as a key supplier seeks to retract from the industry. This is providing an

opportunity for Elopak, who have secured new US customer contracts, and are investing in a new plant.

As a compounder, cash flow from operations are considerably in excess of cash flow deployed in investing activities. This supports a significant dividend payout. The forward dividend yield on our purchase price is estimated at 4%.

The company is currently valued at around 11x forward earnings which suggests little future growth and imminent entry into the decline lifecycle phase. This is not our central scenario and our discounted cash flow analysis suggests considerable upside. We have therefore purchased a position.

BYD

Our interest in Hong Kong listed BYD was kindled by two observations.

Firstly, that it has been a longstanding and highly profitable holding for Berkshire Hathaway identified by Charlie Munger.

Secondly, we noted an industry news article³ that BYD is releasing an A\$15,000 (£7,500) compact electric car in Australia called the Seagull with a range of 300 to 400km and styling by ex-Lamborghini designer; Wolfgang Egger. This price point would remove the main barrier to electric vehicles (EVs); that they are too expensive. It would also undercut most legacy internal combustion engine (ICE) cars.

The car looks great and is to be launched into South America reflecting the company's global ambitions.

One of the reasons Munger recommended the investment at a time when the company was not profitable was the vision and excellence of its founder and CEO; Wang Chuanfu. He recognised the trend to battery electrification very early and introduced new battery technology resulting in the 'Blade battery' that has superior characteristics to the first iteration Lithium-ion batteries.

The Blade is a Lithium Iron Phosphate battery which is cheaper, not so environmentally damaging to produce and has a longer life. Although less energy efficient, by designing the batteries as a series of thin flat blade cells, more are incorporated into a pack therefore increasing energy output.

³ The Driven, April 2024

The company has a counter-positioning competitive advantage both through a focus on EVs, versus the traditional auto players, and a different use of technology, against EV competitors; Tesla now uses BYD Blade batteries in its Model Y. Most importantly, the company has used all of the above to build a scale advantage, with the lowest EV per-unit costs, that makes it very difficult for the rest of the industry to compete.

Up until 2019, BYD's cash flow from operations was below its cash flow deployed into investments putting it firmly in the growth lifecycle phase. Management are rightly seeking to gain market share through their competitive advantages rather than optimise profitability (which drives operational cash flow). Since then, as the China region business matures, profitability and therefore operational cashflow has grown massively – to \$24 billion in 2023. Of this, \$18 billion was invested i.e. most of it. We deem the company to still be in the growth phase given the global total addressable market although technically, it could be classed as moving into the compounding phase.

There are however, systematic risks to holding Chinese stocks. Most significantly there is the geo-political risk centred around Taiwan. Secondly, there is the risk of increasing protectionism due to both the new US Government and the threat BYD poses to the European car manufacturing complex. We believe there are mitigating factors and there is additional reward, in potential upside terms, for the additional risk we are taking.

We consider that China has become too integral to the global economy and the global economy too integral to the Chinese economy for the respective political leaders to push separation and conflict too far. The adverse consequences of doing so would lead to social unrest threatening their power.

We do expect the US and Europe to impose large tariffs on Chinese EVs. BYD are not currently addressing the US market and we have not factored that into our assumptions. In Europe, and other regions, BYD is building local plants which circumvents the problem through providing local jobs and export potential.

Based on our revenue assumption of mid-teen percentage growth over the next 5 years, associated operational gearing leading to margin expansion alongside a preferential corporation tax rate for being aligned with Chinese strategic objectives, we estimate intrinsic value at almost double the current share price. We have therefore initiated a position.

Stewardship

We participated in 4 general meetings during the quarter, voting upon a total of 50 resolutions. Cumulatively, we voted against management recommendations on 2 occasions due to restrictions in our voting policy related to approvals for political donations as well as due to concerns relating to a potential dilution of shareholder rights as a result of a proposal to shorten notice periods for shareholder meetings. To view our latest voting record and report, please go to the stewardship section of our website.

In September we attended a meeting with Peter Harrison, founder and CEO of Bioventix at the company's headquarters in Farnham. Bioventix specialises in the production of sheep monoclonal antibodies used in testing for various medical conditions as well as for medical research purposes. During the meeting we discussed the positive changes in board dynamics that had arisen as a result of the election of a new member as well as the company's product development efforts. The company is emerging as a key player in the nascent Alzheimer's testing market which is poised to grow considerably following the approval of first generation drugs designed to combat the effects of the disease.

Conclusion

We regard ourselves as business analysts investing in a focused number of strong businesses at different stages in their lifecycle. We monitor the businesses we invest in to ensure they continue to allocate capital effectively and appropriately given the strengths of the company and the opportunities generated by the external environment. Regional political and economic change can influence our assessment of the environment and change our assessment of risk. Similarly, investor 'over exuberance' can lead to excessive stock valuations reducing the prospect of future returns achieving our hurdle rates. We take action to reduce this risk. The end result, we target, is a fund that compounds at an attractive rate but is less risky than the market.

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/>