Chawton Global Equity Income Fund

December 2023

CHAWTON GLOBAL INVESTORS

Quarter Ended 30 September 2023

Overview

My main form of exercise nowadays, after hanging up my rugby boots, is jogging. This is a popular and even, fashionable, pursuit, but this was not always the case. When Phil Knight was building a new business in the 1960s and 70s that eventually became Nike, few people ran and those that did were pelted with soda cans. Knight focused on building industry changing company capabilities through allocating capital to innovate in running shoe design and marketing.

At exactly the right time for Knight, running became popular in the 1980s and has remained so since. Successful companies often emerge at the juxtaposition of internal capabilities and favourable external market developments. We do not currently own Nike but we do aim to deliver strong fund performance by carefully selecting companies that have both developed strong internal capabilities and that stand to benefit from emerging positive external factors.

In this letter, we first discuss a key capital allocation model we use in the assessment of a company's internal capabilities. We then go onto illustrate in the Portfolio section how in practice, external factors in the Global Industrial Sector provide opportunity for several companies held in the fund.

We can provide much further depth and cover other sectors in an associated presentation we have just prepared so please let us know if you would be interested in a meeting.

We also cover fund performance which has delivered growth in 2023, fund activity which details a couple of completed sales and an update on our Stewardship activities.

Capital Allocation

We define high quality companies as those which are capable of achieving returns on invested capital (ROIC) well in excess of the cost of capital. However, in order to both sustain this and grow shareholder value, management must allocate capital optimally in an ever-changing external environment.

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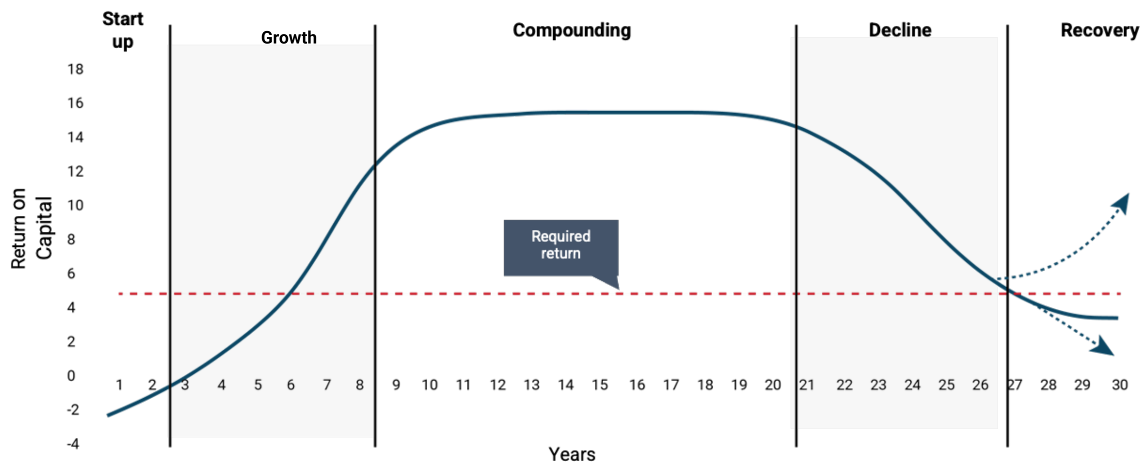
The model we utilise for assessing capital allocation is the Company Lifecycle Framework[1] which derives the optimal allocation strategy based on where a business is in its lifecycle. This both broadens the range of types of company we can select from and improves the probability of identifying those few investments where significant value could be created.

The lifecycle commences with company start-up, followed by fast growth but relatively low ROIC as management invest behind their product, then, slower growth but much higher ROIC as the product matures and finally eventual decline as competition enters. This is summarised in the following pictorial:



I would categorise Nike now as transitioning from the growth to compounding phase.

The importance of the model is that optimal capital allocation differs depending on where a company is situated on the lifecycle curve. For example, in the growth phase, management should be seeking to grow the capital base and invest behind marketing and innovation rather than optimising returns. Conversely, to recover from decline involves shrinking the capital base to exit low return businesses. Nike as a compounder should focus on optimising returns on capital and maintaining growth

[1] Michael Mauboussin, Trading Strategies in the Company Lifecycle, Counterpoint Global Insights, September 26, 2023

whilst returning surplus capital to shareholders. Indeed, the company has being purchasing shares and growing its dividend in recent years.

Combining quality criteria with capital allocation evaluation we believe gives us an information advantage in our stock selection.

Although this applies to the company as a whole, we find it useful also at a divisional level. Some of the companies we invest in are in the compounding phase shown on the infographic but they may have divisions or categories growing faster and others in decline. By reallocating capital from the latter to the former, they can create more value. Next plc, our largest holding, is a good example of this strategy in action where it is reallocating capital from physical stores to its on-line retail platform and fulfilment infrastructure.

Performance

Chawton Global Equity Income Fund performance is shown below for the third quarter 2023 and preceding periods. 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.

Discrete Performance	2019	2020	2021	2022	2023 YTD	2023 Q3
WS CGEIF B Acc GBP	9.3%	14.2%	18.2%	-8.3%	3.7%	0.9%
MSCI World TR in GBP	8.6%	12.3%	22.9%	-7.8%	9.5%	0.6%
IA Global Equity Income	7.0%	3.2%	18.7%	-1.2%	3.7%	0.3%

	WS CGEIF B Acc GBP	MSCI World TR in GBP	IA Global Equity Income
Since Inception 19/05/2019 – 31/09/2023	40.10%	51.30%	34.30%
Compound Annual	7.80%	9.60%	6.80%

Source: FE fundinfo as at 30 September 2023. 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 fund rose by just under 1% in the third quarter of 2023 ahead of comparator global equity income funds. This has improved the year-to-date gain to 3.7% which is similar to comparator funds. Global equity markets, as represented by the MSCI Word (GBP) index rose 0.6% and are up 9.5% year to date due to the strong performance of US markets which constitute 70% of this index. The fund is up 40.1% (B Class GBP accumulation shares) since inception (May 2019) which amounts to a compound annual growth rate of 7.8% per annum.

It is interesting to observe as we approach the end of the year that although the US large capitalisation technology and social media companies have driven index performance, they are not the only area of strength. Within the fund, alongside Alphabet, European companies Atlas Copco and Novo Nordisk have performed well as have UK companies such as Next and RELX.

Against this, consumer staples have generally been weak. Staples companies provide good long-term protection against inflation as they are able to raise prices to compensate for cost increases and demand is relatively inelastic. This time round though the combination of COVID demand volatility and the suddenness of inflationary increases has made it more difficult for management to judge appropriate inventory levels and balance the timing of price increases. This has temporarily impacted on sales volume growth. Spirits companies such as Diageo and Brown-Forman held in the fund, where products have longer shelf lives, have been affected more than other areas of staples. However, we regard this phase will pass soon and it has not materially impacted our valuations of the companies.

Activity

We fully sold out of two positions. Firstly, we sold Kenvue Inc, the consumer healthcare spin-off from portfolio holding, Johnson and Johnson. The division had become relatively immaterial to J&J and their management considered it would gain greater focus and therefore success as an autonomous entity. Whilst we like the strong consumer brands the company owns, they are mature and growing slowly. At the same time, management have not articulated a clear strategy for capital allocation to drive future value creation.

Secondly, we sold Swedish Bank; SEB, after strong share price performance. We have recently been building a position in another Swedish bank, Svenska Handelsbanken discussed in our 1st Quarter, 2023 letter. SEB is now valued well above book value in contrast to most European banks, including Handelsbanken, which are valued below their book value. This is also reflected in the latter's higher estimated prospective dividend yield of 8%.

Portfolio

We have a sizeable weighting in the Industrial Sector amounting to around 13% of the portfolio. We also have positions amounting to around 8% in industrial distributors within the sector we categorise as Business Services. The individual holdings include Atlas Copco, Union Pacific, Geberit, Fastenal and Bossard. These companies encompass manufacturing, building products and transport. We consider there are some attractive common themes across these markets that provide a strong opportunity set currently.

The global manufacturing industry grew at a compound annual growth rate of 4% between 2010 and 2019 in terms of product sales[2]. China was a large contributor to this growth as the world economy 'globalised' to take advantage of its lower labour costs and intensely competitive manufacturing industries. We anticipate a similar level of overall growth from 2020 to 2030 in aggregate but with very different contributory factors.

The drivers over the next decade we believe will be somewhat different due to geopolitics resulting in reshoring, the net zero transition and technology advancements increasing automation and demand for semiconductors. This will cause the bifurcation of the industrial complex with much faster growth in these areas aggregating with slower growth in legacy industries to generate the overall growth estimated.

This provides opportunities but not only for companies solely focused on the new areas but also in companies able to redeploy capital and build on their existing strengths. Atlas Copco has built a division, that dominates the supply of the vacuum pumps for use in the most advanced semiconductor plant constructed to make ever smaller, more energy efficient and more powerful chips.

Bossard, an industrial distributor with its roots in the German auto manufacturing complex, is making progress in penetrating the electric mobility areas such as supplying to Tesla's factories in USA and Europe and to electric railway equipment suppliers in Europe and Asia.

[2] Source Statista, January 2023

Geberit has developed a new system of smaller diameter, advanced plastic water piping to replace the aging and inefficient copper piping systems used in residential and some commercial buildings. This reduces the demand for copper, a key material for general electrification and through thinner pipes, means less water is held within the system reducing the risk of Legionella. It is also quicker and simpler to install which is important in countries such as Germany where there is a shortage of trained installers.

Stewardship

The quarter was relatively quiet in terms of voting activities, with only four general meetings taking place. To access our voting record and associated report for the quarter, please click here. Upon accessing the voting record page, you will note that for the current quarter we have not provided separate records for votes cast through and outside of ProxyEdge. This is because we have sought to streamline and fully digitise the process through which ballots are received and votes submitted. As a result, from this quarter onwards all voting activities will be conducted electronically through ProxyEdge and presented in one record. Such changes were made following the identification in quarter 2, 2023 of an instance where due to mail delivery issues we were not notified of an upcoming general meeting and our subsequent engagement with Northern Trust, our contracted proxy voting service provider.

During the quarter we engaged with two companies, namely The Progressive Corporation and Costco Wholesale Corporation. Progressive provides personal auto and home insurance in the USA. Our engagement represented an escalation of our efforts to understand whether management intended to evolve its approach to include ESG objectives in their remuneration approach.

Management informed us they did not think it appropriate to target such matters in their incentive structure principally on the grounds that insurance is a highly regulated industry in the USA and regulated companies do not have much scope to make unilateral change. They consider they have met high standards of sustainability in areas they can control such as diversity. We note they are ranked as average by MSCI among 86 companies in the Property and Casualty Insurance Sector. Whilst the fund continues to be invested in the company which is a leader in its industry in using data analytics to pro-actively price contracts to optimise risk and reward, we are concerned they are not deploying a more forward-looking approach in terms of the impact of climate change on their business. This will be factored into our valuation of the company when we perform our next review.

A key objective of our engagement with Costco was to understand whether management is adequately incentivised to take account of capital deployed to achieve sales growth and pre-tax income growth targets, to which remuneration levels are linked. Through our discussion with the company, we were informed that Costco has an embedded culture, stemming from the founders, that values measured, organic growth. This is evidenced by the company's strong track record of generating high ROIC.

Conclusion

We have a robust investment approach which identifies and evaluates both internal company capabilities and positive external industry factors utilising the company lifecycle model. The model helps determine the most appropriate capital allocation policy depending on where the company, or a division of a company, is in its lifecycle.

The fund has risen in value in the quarter and year to date and has grown solidly since inception. Activity in the quarter was limited involving the sale of a spin-off and the completion of a switch in our bank holdings.

The fund is invested in a number of holdings in the Industrial and Industrial Distribution sectors and changing external trends suggest an attractive current opportunity set over the next decade.

We engaged with management of two companies during the quarter to discuss how their executive incentivisation structures encompass ESG and ROIC performance.

I hope this letter has provided greater insight into our process and progress. Please do not hesitate to contact me if you have questions or would like me to run through our associated presentation. In the meantime, I am off to dig out my running shoes….
