OCEAN EQUITY

2023 Second Half Review & Outlook

January 2024

Following on from our review of the first half of the year, in this report we will review the second half of 2023 and reflect on the year ahead. The second half of 2023 was dominated by similar themes to the first half, namely inflation, interest rates, the direction of the global economy and geopolitics.

The major development during the period was the decision by central banks – Fed, BoE and ECB – to pause their aggressive interest rate tightening cycle which saw the BoE increase rates to their highest levels for fifteen years. This was in response to falling inflation and economic data suggesting economies were weakening and may even enter recession. In the UK, inflation ended the year at 3.9% down from 11% at the start of 2023, largely due to falling energy and food prices. Central banks have been playing a high wire act whilst they are mandated to keep inflation to around 2% they do not want to push economies into recession with all the associated societal damage that can be inflicted in terms of job losses especially, as economies recover from the pandemic.

The other major development was the regrettable conflict between Hamas and Israel which adds another level of complexity and risk to the geopolitical backdrop. The major concern here is that other countries get dragged into the conflict and it spreads in the Middle East. Thus far, the conflict has been largely contained but in December several major shipping companies started to re-route cargo ships away from the Red Sea due to security concerns. Should this continue for a while, it has the potential to be quite disruptive to supply chains, whilst adding extra cost which could have inflationary implications. That said, an international coalition is deploying military assets to the region in an effort to ensure vessels can navigate this route safely and securely.

Performance

We are pleased with the progress and outperformance the fund has made in a challenging year. The fund returned 8.7% over 2023 which is ahead of our benchmark at 7.7% and 7.4% for the Investment Association (IA) UK All Companies sector. This outperformance is encouraging especially after a difficult 2022 and it is what we are here to do for investors. As we

look forward, the portfolio is well positioned for the future with our portfolio of high-quality companies driven by experienced and ambitious management teams.

Portfolio Activity

During the period we sold our small position in **XP Power** following an unexpected profit warning. In addition, we reduced our position in **Croda** as end customers continue to hold high levels of inventory thus delaying new orders which is impacting FY23 profits. We also reduced our position in **Watches of Switzerland** due to increasing investor concern over the Rolex purchase of rival watch retailer Bucherer. We reduced our holdings in **Relx** and **Microsoft** which have performed well during the year and allocated the capital to more attractively valued portfolio holdings including an allocation to **Telecom Plus.**

We introduced a new position in **Bunzl** which distributes a range of mission critical products for customers operating in the foodservice, grocery, safety, hygiene, and healthcare end markets. It has a strong and growing competitive advantage and is able to price competitively due to its growing scale. The business is well placed to grow and develop via a healthy mix of organic and inorganic growth. The former will be via new customer wins and by encouraging customers to spend more as their product range increases. The M&A growth enabler is a familiar and well-trodden strategic path that has seen management deploy an average of £366m into 12 businesses per annum over the last 6 years. The company has a strong reputation for buying, integrating, and nurturing acquired businesses and, as a result, they often retain incumbent management teams leading to rapid integration into the Bunzl ecosystem and generating strong operating performance. Currently Bunzl operates in 31 territories but critically is only in all segments in six of these. The ability to expand their footprint over the longer term is a significant opportunity for revenue and profit growth. We have admired Bunzl for a while and think it is a high-quality cash compounding business that supplies mission critical kit that businesses need for their day-to-day operations. In terms of valuation, the P/E is tracking below its 10-year average and the balance sheet is strong with net debt to EBITDA at 1.2x.

Outlook

The outlook for 2024 is highly likely to be dominated by the direction of interest rates and inflation and how they impact the global economy. In addition, whilst the geopolitical backdrop is unhelpful there could be resolutions to the situations in Ukraine and the Middle East. The Federal Reserve is openly talking about interest rate cuts in 2024, whilst the market is anticipating a reduction of at least 100bps. One of the big unknowns is how much impact the interest rate tightening cycle, that has dominated the economic landscape since early 2022, will have on economies in 2024. If economies do weaken or even fall into recession central banks may cut interest rates quite aggressively. 2024 will see almost 2 billion people head to the polls with the most notable elections being India in April/May, the US in November and the UK general election. The timing of the UK election is uncertain at this stage, but it must be held by Jan 2025 at the very latest. Commentators suggest May or October as being the most likely months.

Turning to the portfolio we think our high-quality businesses, many of which are global market leaders in their respective sectors such as; – Compass outsourced catering, LVMH global luxury retailing have the characteristics to grow and compound their earnings over the medium to long term. As we have mentioned before we are cautious about debt and our companies typically have strong balance sheets with net cash positions. We think in uncertain times strong balance sheets not only provide a margin of safety but critically allow companies to keep investing in their core operations and even deploying capital into strategic and accretive M&A opportunities. Those companies with leveraged balance sheets will be more inward looking and focused on paying the rising interest bills on those debts. As a consequence, they will likely struggle to participate fully in future growth opportunities. It is worth noting that management are indicating that vendors are being much more realistic when it comes to pricing. Arguably the strong grow stronger during periods of market dislocation even though it might not be obvious at the time and take a while to be realised in terms of share price performance.

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