AXA Framlington UK Equity - 31 January 2022

2022 has started with a ferocious style rotation that has left an increasing number of 'growth companies' valued at attractive levels. The secular economic drivers and corporate thematics that have provided many companies with the trading environment to grow and prosper remain wholly intact, although of course they will be affected both positively and negatively by the one thing guaranteed in life – change.

Growth companies, the definition of which is nebulous at best, have fallen indiscriminately so far this year as a result of Central Banks, in particular the Federal Reserve in the US, changing their rhetoric on inflation from temporary to something more entrenched. Expectations of interest rates rises have resulted in 10 year Treasury yields rising from circa 0.5% at the low (August 2020) to 1.8% at the end of January 2022. This impacts the discount rates used to value cash generating assets and will cause longer duration assets to fall further in value than shorter duration assets. In particular, companies that are loss making, where the majority of their perceived value accrues way into the future will naturally experience a fall in capitalised value if the discount rate applied to those future earnings and cashflows rises.

Simplistically, 10 year Treasuries **up**, long duration growth stocks **down**.

It is worth noting however, that US Treasuries are not forecast to rise above circa 2.5% and this remains at the low end of the range over the last 10 years, a time in which growth stocks have performed well. It is also worth noting that far from steepening (at the time of writing) the yield curve has flattened, perhaps telling us something opposite to what the value rotation is making us believe. Rates are moving higher because central banks are increasing rate expectations in an attempt to control inflation rather than as a result of rampant economic growth.

'Bottomline, real rates rising because of tightening Fed policy (with the yield curve flattening) is not the same as real rates rising because of positive revisions in forward growth sentiment/estimates (with the yield curve steepening). We are in the midst of the former (anti-cyclical), not the latter (pro-cyclical).' (Source: Jeffries, published 20.01.2022)

Inflation at its simplest level is generated by an imbalance of supply and demand. Covid has provided a myriad of micro economic events that have culminated in market distortions, resulting in unpredictable supply of many goods and services. Demand on the other hand, resulting from the support provided by governments, central banks and the increasing ubiquity of the internet (among others) has bounced back dramatically in many areas, resulting in demand outstripping supply. It is logical to assume that over time, supply issues will ease. It is also possible that a slowing economy or inflation induced demand destruction will contribute to balanced supply and demand, thereby reducing inflationary pressures.

When speaking to companies, we are certainly hearing of improving supply chain conditions, including freight, where companies are in some instances buying capacity forward at significant discounts to the spot price. Wage inflation and second order effects may persist for longer and these effects will need to be monitored. However, the implications of a flattening yield curve and easing supply constraints may result in stock market participants moving away from focusing on cyclical, ‘value’ stocks to those that can grow their earnings over the long term.

The ‘growth’ versus ‘value’ debate remains unhelpful when investing as each term comes with presumption and caricature in terms of what type of company or stock fits each grouping. Even within each group there is inevitably a huge variety of businesses and value can be found in the growth bucket as well as growth in the value bucket. A simplistic way of trying to assimilate a huge array of variation and complexity.

To many, Growth investing has become a messianic calling where valuation is irrelevant and even company shells with no intrinsic value can have a valuation attached, based on the expectation that something may happen in the future! When we look at businesses, we are interested in the ability of a company to give unit holders exposure to the power of compounding profitability and cash flows, where company management have proven competence and the balance sheet is sufficiently strong to support that growth. This is in contrast to companies that either have no trading business or are flawed to such an extent that their chances of generating sustained cash backed profits will be competed away before profitability has a chance to be proven.

Some are equating the ‘re-rating of growth’ to the Dotcom bubble. As the bubble inflated prior to the 2000 Dotcom crash, spending on technology boomed as investors became increasingly excited about the potential of the internet. Much of this spending was however incurred without economic justification and many of the companies lauded at the time failed. As a reminder of how dislocated business fundamentals and valuation had become in 2000, I remember investment bank research teams justifying a buy case for a company on the basis it was cheap on an EV/Eyeballs basis! As Steve Kelly our US Fund Manager says, ‘The comparison to the bubble bursting in 2000 is also flawed’.

When constructing a portfolio, we continue to run diversified portfolios of 60-80 holdings and focus on those companies that are increasing their economic output via increasing revenue and profitability. As a consequence of this, the portfolios we run tend to exhibit earnings growth in excess of the fund’s comparative benchmark. Whilst valuation is not the principal driver of an investment decision, it is important and will govern the ultimate return that you make. We do not ignore valuation and remain GARP (Growth At a Reasonable Price) investors in our outlook and mentality. Given this style bias, the extreme movements in 2022 have impacted our funds’ performance on an absolute and relative basis. Whilst this is disappointing, we remain committed to our investment philosophy and process and are becoming increasingly interested in the opportunities that this derating is affording us. Interestingly, on the whole our investments have performed well from a fundamental perspective, despite the headwinds that cost inflation is providing.

Companies such as Dunelm, Experian, Spirent and Darktrace have all reported earnings at the top end or ahead of market expectations, yet have fallen in value from between 3% and 16% this year. We remain alert to these price moves and have been taking advantage, adding to a number of holdings including Spirent, Future, Hill and Smith (Mid Cap) and Revolution Beauty. Many growth stocks have compressed from a multiple perspective but their prospects appear to continue to improve. In today's stock market environment, that is easy to dismiss but we firmly believe that opportunities are compelling and can provide strong returns over the longer term, even of the short-term returns are volatile.

It is worth noting that we continue to reassess the valuation of businesses in the context of the growth offered. In addition, these factors both need to be considered with a wider eye on the macroeconomic and geopolitical backdrop. With this in mind, we have reduced the holdings in Croda (Multi Cap only), Ashtead, Sage (Multi cap only) and Dechra Pharmaceuticals (Mid Cap only) since the start of 2022.

The stock market dynamics of 2022, although only a few weeks old have had profound short-term impact on the valuation ascribed to growth stocks. Given that the FTSE 100 is more exposed to value stocks than the FTSE 250 or FTSE Small Cap, the disparity of performance can also be seen when the UK Indices are compared. For example, the FTSE100 hit a new multi-year high on 17 January 2022, whereas the FTSE Mid and Small cap Indices both hit a high on 1 September 2021. Since 1 September 2021, FTSE Small Cap is down 9%, FTSE 250 is down 12% and AIM 100 is down 20%, whereas the FTSE 100 is up 2% (as at 25 Jan 2022).

According to Peel Hunt, this has left the FTSE 250 on a 2023 calendarised Price/Earnings ratio of 12.8X (Excluding loss makers) for an Earnings Per Share growth of 14.6%. This compares to the FTSE100, which trades on a Price/Earnings ratio of 12X on the same basis, for an Earnings Per Share growth of 2.8%. Perhaps the stage is set for GARP after all?

We remain optimistic that UK stock market will continue to offer access to companies that have the business models, management teams and balance sheet strength to continue exhibiting profit growth on a long-term basis. We continue to focus on those businesses that we believe are best positioned to deal with business opportunities available today and deal with an ever-changing world. Change is inevitable, but not predictable, therefore businesses need to be both managerially and financially robust to deal with change – these are qualities we seek.

Chris St John
Jan 2022

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