UK Multi-Cap strategy

Valuations fell due to stock market sell off, yet earnings growth remain unchanged

- Companies we own have reported good earnings
- We are hearing of improving supply chain conditions from companies
- The strategy added to its positions in Future and Revolution Beauty

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What's happening?

2022 started with a ferocious style rotation as 'growth companies' fell indiscriminately as a result of Central Banks changing their rhetoric on inflation from temporary to more entrenched. Expectations of interest rates rises 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 has led to investors purchasing 'old economy' companies in sectors that have historically provided inflation hedging such as Oil & Gas and Banks and 'long duration' assets such as Software and Clean Technology companies have been sold.

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, leading to unpredictable supply of many goods and services. Demand on the other hand 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.

It is also worth noting that US Treasuries are not forecast to rise above circa 2.5%. 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.

When speaking to companies, we are certainly hearing of improving supply chain conditions. 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.

When we look at businesses, we are interested in the ability of a company to give shareholders 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 growth. The companies we own who have reported in January, Dunelm, Experian, Spirent and Darktrace have all reported such characteristics but are between 3% and 16%[1] below the level they traded at on 31st December 2021. We remain alert to these sort of price moves and have been taking advantage. Many 'growth' companies have compressed from a multiple perspective but their prospects continue to improve. In today's 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 if short-term returns are volatile.

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 be seen when the UK Indices are compared. The FTSE All Share (-0.3%[1]), FTSE 100 (+1.1%[1]), & FTSE 250 (ex-Investment Companies, -6.4%[1]) and the FTSE Small Cap (ex-Investment companies, -3.4%[1]).

Portfolio positioning and performance

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 strategy tends to exhibit earnings growth in excess of the 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 the strategy's 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.

The strategy added to its positions in Future and Revolution Beauty. The January stock market sell off this month has led to valuations falling, yet we feel the prospects for material earnings growth remain undiminished.

We exited our position in Oxford Nanopore Technologies and reduced positions in Croda, Ashtead and Sage.

Outlook

As in January, market direction seems likely to be shaped by Covid and inflation. Inflation data seems likely to continue increasing in the first half of the year from already high levels and Central banks are likely to continue their hard line on it. However, striking the right balance between controlling inflation and not slowing the economy as it recovers will be hard to achieve, especially while governments withdraw their fiscal support.

There are of course reasons to be optimistic about equities in 2022. Economists are forecasting that global real GDP growth will remain above trend. In addition, global inventory levels remain low and the process of rebuilding them will be a further tailwind through 2022. Earnings forecasts are modestly set and valuations are in many instances trading at multi year lows.

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.

No assurance can be given that the UK Multi-Cap Strategy will be successful. Investors can lose some or all of their capital invested. The UK Multi-Cap strategy is subject to risks including; Equity; Smaller companies risk; Liquidity risk; Investments in small and/or micro-capitalisation universe; Investments in specific countries or geographical zones.

[1] Source: Bloomberg

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