

## TRANSCRIPT: EPISODE 299

1 February 2024 (pre-recorded 31 January 2024)

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## [INTRODUCTION]

**Staci West (SW):** Welcome back to the Investing on the go podcast brought to you by FundCalibre. We're focusing on the FTSE 250 this week, discussing not only the challenges it's faced in recent years but the potential for M&A activity and investment opportunities in the mid cap sector for the year ahead.

**Chris Salih (CS):** I'm Chris Salih, and today we're joined by Chris St-John, manager of the lead at AXA Framlington UK Mid Cap fund. Chris, once again, thank you for joining us.

**Chris St-John (CS-J):** Pleasure.

## [INTERVIEW]

**CS:** Let's start with the basics. For those who perhaps don't know too much about the fund, obviously this operates in sort of, as the name suggests, the mid cap sector, which is sort of hunting around the FTSE 250.

So, for those that perhaps aren't as familiar with the market, could you just start off with an overview of the types of companies that make the index and give us some idea of some of the companies that reside in the FTSE 250?

**CS-J:** Yes, of course I can. The FTSE 250, which is commonly referred to as the UK mid cap space, is made up of those companies in the [FTSE] All Share that go from company 101 to company 350 by value. So, anything in the FTSE 100 sits above the FTSE 250, and then essentially the small cap sits below it. It's rebased quarterly, so the index itself changes on a quarterly basis. The companies at the top of the index will get promoted up to the FTSE 100. Companies get demoted from the FTSE 100 and companies move in and out at the bottom end of the index as well.

In terms of size of company, there's a slightly unusual one at the top of the FTSE 250 at the moment, which is Carnival, the cruise liner holiday company. That's actually valued at £16 billion, but because it has a relatively low free float, it doesn't actually make up a particularly big part of the index. So, if you're looking for the sort of upward and the top and bottom bands, I would ignore that one.

The largest company in the index is Investec currently, which is nearly £5 billion market cap. And at the bottom end of the index, the smallest company is Tritax Eurobox REIT, which is a real estate investment trust, and that's valued at a little over £400 million. So there's a very, very broad spread of businesses within

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this index, and it's made up of companies that people on this call will know, and perhaps a number of companies that people won't know.

So, within the FTSE 250 itself, companies that you may recognise include easyJet, Trainline, Greggs - the bakers - and Dunelm. But there are also many companies that you perhaps haven't heard of that have market leading positions in what they do, they're very well known in the UK and on a global basis. Companies like Rotork which is an engineer, Bytes [Technology Group] which is a value-added reseller of amongst other things, Microsoft Software. Coats [Group], which is a company that manufactures and sells threads. I suspect there's some Coats thread in the clothing you are wearing at the moment, actually holds it all together! So, a great array of businesses, domestically and international, some you'd have heard of, some you won't.

**CS:** Okay. Just want to go a bit deeper on that. So, obviously you've got the FTSE 100 and that's got a full host of behemoths in there, and it's very internationalised. A lot of the earnings there are derived from overseas; that's not so much the case for mid cap.

Could you maybe just talk to us about some of the differences between the companies in the FTSE 100 to FTSE 250 and how that affects performance? For example, the fact that they're perhaps not as internationalised - although they are still to a reasonable degree - as the FTSE 100?

**CS-J:** Yeah, it's interesting, when I see people - and I've seen people over the years - people view the FTSE 250 as a very domestic UK index. 54% currently of the turnover that's generated in the FTSE 250 is generated inside the UK. And so 46% is actually generated from markets outside of the UK. So, it's a very varied index and does have significant exposure to international businesses.

You're right, it is very different to the FTSE 100 certainly in terms of its makeup; the FTSE 100 has much bigger holdings and some, what I would call, some of these older, more capital intensive, perhaps more environmentally harmful businesses. You know, mining, that sits with basic materials, big oil and gas companies, telco less so now. And healthcare, consumer staples are also very big. And consumer staples is made up of the FMCG [fast-moving consumer goods] companies and the tobacco companies as well. That's very different. The UK FTSE 250 index has much more consumer discretionary, more industrials, more financials, more real estate. So, you can get the feel just by those sectors, that you've got more exposure to the UK economy and the FTSE 250 index.

The other quite big difference I think is the concentration of the index. The FTSE 250 is a much broader spread of businesses in terms of what they do, but also valuation as well. The top 10 stocks in the [FTSE] 250 represent 16% by value, whereas the FTSE 100, about half of the index by value is in the top 10 stocks, with the largest stock in the FTSE 100 being around 9%, which I think at the moment is AstraZeneca. Whereas in the FTSE 250, the largest company in the index is around 2%. So, there are a lot of differences.

In terms of performance - given the higher UK economic exposure in the [FTSE] 250 - and by that, really we're talking about house builders, retailers, pubs, restaurants, property. Those companies by definition are more sensitive to interest rates to the UK economic output generally. The levels of employment, or unemployment in the UK, and the level of disposable income as well. So, when interest rates are moving in

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the way they have, in an upward direction, that has put quite a bit of pressure on a number of the UK domestic businesses.

International businesses within the index - as we talked about earlier, there's a number of companies that people won't have heard of - but the companies I mentioned, you know, so a company like Rotork, for example, is a very established international company, it has multiple offices very close to its end markets, it supplies the water industry, oil and gas. And so, particularly when you look at oil and gas companies and where they operate, Rotork has a very, very strong presence there. And those companies should at least theoretically behave a lot more like the international companies from stock price performance, very similar to the FTSE 100.

**CS:** Just quickly before we move on to that, do you find that when you look at stock selection, that you tend to have a preference for companies that are perhaps more internationalised in their earnings versus those that are domestic?

**CS-J:** I think over my career on balance, yes. Because I've typically been overweight industrials, overweight software as well, and underweight property companies and, I'd say for the majority of the time, underweight consumer discretionary as well. So the answer to the question, I think would have to be yes. But that's more an output rather than an input.

Within that, there have been plenty of companies that have been winners in the UK which are exposed purely to the UK economy. And really, when you're investing and when you are doing it from a bottom-up perspective and meeting a lot of company management teams, it's not really quite as simple as allocating perhaps to a different sector on the basis of whether it's domestic or international on the basis of say, what's happening to UK interest rates, for example. There are masses of nuances when you get down to the stock level. And, you know, circumstances, competitive environment can change a lot. And that can give companies an opportunity to flourish even in markets that are relatively difficult.

Marks & Spencer is a good example of that, where it's seen its supply side ... it's a business that's been sort of eternally under restructure and this time, it really feels as though there is some sort of momentum to the recovery. And that is not only because of what management are doing to the business itself but because of what you've seen on the supply side of the competitive landscape. Companies like Asda, Morrisons on the supermarket side, being heavily-leveraged businesses struggling to invest and make their store fit for purpose. And similarly on the clothing side, you've seen a lot of capacity coming out through the receivership of companies like Arcadia, for example. So, you do need to look at these businesses in the environment that they're operating.

Yes, over time, I think I have had more exposure to international markets than domestic, but that does not mean that there aren't fantastic opportunities within the UK.

**CS:** Well, let's go straight into the environment. So, obviously there are sort of long and short term pressures on the UK; there's a lot of poor sentiment with regards to it, but then by the same token, valuations look attractive. I mean, perhaps let's look at the [FTSE] 250 on its own and just sort of explain the push / pull factors around it. Are you finding a lot of opportunities? Are they at the top end? Are things dropping in from

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the FTSE 100 that perhaps you're finding attractive? Just talk about, as a basket, where the opportunities are they wholesale or not?

**CS-J:** Yeah, there are a lot of opportunities around at the moment. This is an asset class that, when we talk about performance of this area and the last couple of years have been very, very difficult. The FTSE 250, so up the end of December 2023, the FTSE 250 index, excluding investment trusts, was actually down 10.3%, whereas the FTSE 100 was up 13%. You know, that is a dramatic difference - a 23% difference - in the performance of those two indices over two years. This has been a very, very unusual period.

If you look back historically for 10, 20 or 30 years pre-covid or 40 years, the annualised return of this part of the market was around 10 to 11%. But actually, over the last 10 years, because of the effects of covid, I think because of the effects of the inflationary pressures we've seen, because of the extreme movements in interest rates, the annualised return over the last 10 years at this part of the market, it's only been 4.4%. So it's been a very, very unusual event in the FTSE 250 space. And even if you take it back longer, you can see this ongoing compounding effect of returns and total returns in the FTSE 250 space. Indeed, you go back to the December 1999, it's got a dramatic outperformance of 250 total return versus not only the FTSE 100, but also MSCI World. So, historically, this has been a place of great interest.

Now, I suppose the question could be asked, well, is this a place going forwards of interest?

And I would say from a company specific perspective, absolutely. We still have broadly the same number of companies to look at. This is within the index and, you know, we can to some degree go outside of the index in this fund as well. And there are many drivers that are around today that perhaps haven't been historically which are affording companies a great opportunity, whether that's technological disruption; I talked about supply side changes with a company like M&S; similarly, there's strong getting stronger. We're seeing companies taking a lot of market share at the moment, those companies with high levels of service, in very strong positions, companies that can differentiate through service are seeing increased sales numbers in terms of the services that they sell.

So, from a company bottom-up perspective, there is plenty to be excited about and plenty of interest. I think, because of what we've seen from a performance perspective - and yes, that is compounded by the outflows that you've seen from the UK markets - the FTSE 250 space has been left looking very cheap in the context of its own history certainly. It currently trades on a forward P/E [price-to-earnings ratio] of 11.7, and so would need to move up around 20% to be in line with its long run average.

**CS:** That was going to be my question quickly, you mentioned that sort of 20% uplift needed to be in line with that long term average. You focus on high quality companies and financials and in terms of management and sustained profitability, is there ever a point where price alone becomes a catalyst potentially investing in a company?

**CS-J:** No, not price alone. No, no, no. We invest in businesses on the basis of their fundamentals. I'm looking for those companies that can grow, compound, increase their economic output over time. Valuation is an important pillar in that; we go back to the Framlington days and nothing has changed. We view ourselves as GARP investors [growth at a reasonable price], which has sort of come back into vogue in about

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the last sort of three or four months, but, you know, growth at a reasonable price. So, valuation is important, but it is not the main driver of any investment decision.

**CS:** Just following on to that, we talked a little bit there about the dynamics of the market, et cetera, but just sort of beneath the surface, could you maybe talk to us about how other companies look on a corporate level just in terms of their balance sheets and a bit of insight into the market there?

**CS-J:** Yes. If you look back at the history of the mid-cap space, the fantastic compounding earnings that you've seen have been driven by ... sorry, the compounding returns you've seen and compounding dividend income has been driven by compounding earnings growth.

What you haven't seen in the mid-cap space over a prolonged period is companies gearing up their balance sheets to, for example, buy back stock, which you have seen in some international markets. Balance sheet strengths in the UK is, I think, a highlight at the moment. It is something that we've always focused on when investing. If you're going to invest in equities, which we view as high risk, you know, you are the least preferred creditor in the insolvency act. A strong balance sheet is very important, so, management decisions are made on the basis of and thinking at the front of their mind with equity holders in their mind and not with the debt holders. As an observation, balance sheets are strong, and, when I look at the fund itself, the balance sheets within the fund are on average, stronger than the market.

Now, that is important when you're an equity holder because it gives management teams optionality. And when we're looking to invest, we do talk to companies about their capital allocation policy and we've increasingly seen companies have a much more formalised capital allocation policy over time. So, and that capital allocation is dividends, is bolt on acquisitions, and increasingly, we've seen share buybacks within the mid-cap space. So, over 50% of the mid-cap funds, the companies in that by value, are buying their own shares back. They're not gearing the balance sheet up to do it, this is out of surplus free cash flow. And I think that is just reflective of companies that are in a very strong position with a lot of optionality.

**CS:** Just quickly as well: obviously the fund has the mid cap as the name and most of the areas it is focused on are mid cap, but you also have the ability to invest in some smaller companies and also allow companies in the mid cap space to grow into larger firms. Is that a constant theme? Just give us a bit of insight into that as well, please.

**CS-J:** Yeah, so yes, it is a mid cap fund. I think you should view it as a sort of core mid-cap fund, but can invest up to 15% in the FTSE 100. The reason that was put into place is so that if companies get promoted up to the FTSE 100, we're not a forced seller of those stocks, so, I can run companies into the FTSE 100. A company like Weir Group would be an example of a business that's come through the [FTSE] 250 and promote up to the FTSE 100. I mentioned Marks & Spencer's earlier, that may well be heading back at some point. So, we're not a forced seller when companies get promoted and similarly ... sorry, there has to be a minimum of 70% of the fund in FTSE 250 index stocks. That number is around 80% at the moment. So, that does leave a balance that can be invested elsewhere and that is the part of the fund that might end up in the small cap space.

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But I think for us to invest in small cap stocks, they need to have a reasonable chance of getting into the mid cap so, you know, we might find a very interesting company at a 100 million market cap, which might go to 150 [million market cap] - you know, that's still a long way from being in the [FTSE] 250. So, that's the sort of business that would go into the small cap fund. A holding that we took not that long ago Trustpilot, that was in the small cap space, and that is subsequently being promoted up to the [FTSE] 250.

**CS:** Okay. And just again, on the outlook for the UK equities, I mean, a lot has been made of M&A, do you expect UK companies to be continually targeted this year, or do you feel that that might slow down?

**CS-J:** Yes, I do. Yeah, I think they'll continue to be targeted. Last year, there was a lot of M&A in the mid and small cap space. It didn't get huge coverage in the press because the average market cap was comparatively small. But there were plenty of deals and I would expect that to continue. The valuations are attractive, balance sheets are strong, these companies have got great market positions. Interest rates look like they're peaked or falling, so there's some clarity and stability in terms of those companies that are looking to make acquisitions from their own funding perspective. And I think that is all a very positive backdrop for continued M&A. It'll just be a shame to see even more UK companies being taken either off the markets or bought by bigger corporations.

**CS:** Yeah. And just lastly, maybe just give us a snapshot of the positioning of the fund at the moment. Do you have certain, you have a bottom up sort of focus? Do you have any sectors you're particularly interested in? Just give us a bit of a view of the composition of the fund at present.

**CS-J:** We don't tend to allocate from a sector specific point of view. What we're interested in is the sort of corporate drivers of the underlying company. So, it ends up becoming very stock specific. So, the sector over/underweights are actually an output of the process rather than targeting any particular areas.

But to answer the question, we are overweight in technology. That is an area where we found some very interesting businesses that have incredibly long growth horizons, that are attractively valued. Industrials we spoke about that was an area where we're overweight as well. And within that, there's a great array of businesses. You know, Weir Group we mentioned, which sells into mining now. Cheering [Group] is within there, which is a defence business with a particularly interesting cyber business called Roke. Ashtead is still in there, which is an example of a FTSE 100 company that's been promoted, which is a tool hire business exposed principally to the US. So, those areas we are certainly overweight.

And then we actually remain underweight financials and real estate. And those have been - and consumer discretionary as well. Those have been very much long-term underweights, but are certainly less underweight than they were. We started adding some additional holdings in the more consumer discretionary and real estate space about six odd months ago on the basis of extreme valuation, as much as anything.

**CS:** And just quickly, you mentioned the tech side there. I mean, people perhaps don't associate tech so much with the UK, particularly in large cap, but also maybe in mid cap. Is it something that's always been present or is it a growing presence in the UK market in your segment?



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**CS-J:** No, it's always been here. I mean, there's a combination of companies. It's a slightly odd sector in the UK in that there are those companies that I would say are out and out technology companies, which are, you know, providing technology for other businesses to make them more efficient and effective. And there are quite a few companies in there that are using technology to differentiate themselves. So, a business like Autotrader, which people will know that that started its life offline as a magazine, is now a completely online business. I'm sure people would've gone on and had a look at the Autotrader website that actually sits within technology. Now, you could sit and debate whether that is a technology company or not, but it's certainly a business that has used technology to build a very, very strong market position with strong competitive moats around it. But you probably wouldn't call that an out and out technology company. So, a real mix.

**CS:** Chris, thanks for joining us once again on the podcast.

**CS-J:** Pleasure. Thanks for having me.

**SW:** This fund's flexibility to invest in the FTSE 100 and small-cap space lets the manager run winners and invest early in strong growth stories. For more information on the AXA Framlington UK Mid Cap fund visit [fundcalibre.com](http://fundcalibre.com) – and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.