SHINING A LIGHT ON...... AXA FRAMLINGTON UK MID CAP FUND

At a glance

There is little doubt that the UK space, in terms of investment funds, is very crowded with many good managers. The good funds, with a consistent track record, are often harder to find. Coupled with this is the challenge of where to invest; are you investing for income or growth or a combination of the two and are you searching for small, mid or large cap or an all cap fund.

It is therefore much harder to decide where to invest and with whom. In our latest review of funds we talk to Chris St John of AXA Framlington. He has 15 years' experience in the small and mid-cap space. He originally ran the AXA Framlington UK Smaller Companies Fund before handing over the reins in 2012, he remains as the number 2 manager on the fund.

The UK Mid Cap Fund was launched in 2011 and has a strong track record, outperforming the FTSE 250 index. In the meeting the aim was to understand more about the fund, his style and mid cap in general so investors can consider whether mid cap is where they want to be and in particular whether this is the right fund for them.

Q: "What makes this fund stand out from the market?"

Chris' response initially surprised me, he started by saying that there wasn't anything unique in what they do.

He expanded by saying that the point he was making was that "it is what it is". However, it is the subtle things that make this different. As he called it, it is the intellectual and physical shoe leather; the meeting of companies, the fact that it is pure mid cap and 15 years make experience that make it different but it doesn't necessarily make it unique.

He went on to explain that this is a pure mid-cap fund and therefore it will be fishing in the same space as other mid-cap funds. However, there are three areas that he is looking to get value for the fund. Firstly, strategy, secondly stock picking and thirdly valuation.

Q: "Can you expand on the three areas that you are looking to extract value from?"

We discussed strategy first. Chris is searching out those companies which are operating with economic tail winds rather than those with head winds using a three to five year time horizon.

He explained the fund is not about making macro calls and in fact he is benchmark agnostic. So an example he used focuses on what Chris describes as 'service, service, service'; Spirax Sarco are specialists in steam system engineering. Their engineers provide advice in the development of chemical plants and then develop their products into the final solution.

Another part of strategy is pricing power; with Spirax the cost of the product is built into the cost of developing the chemical plant. Their absolute cost is low but they come with a high level of functionality which is priceless. So if the product is good and doesn't fail then that is good for the plant. An unplanned failure costs money. So this is where pricing power works for the likes of Spirax.

Another example of strategy is technological disruption and the example Chris gave was Rightmove who have the ability to scale up quickly on relatively low levels of capital. It is an extremely cash generative business and provides the potential for good capital return. Another an example that falls into this would be auto trader.

Stock picking is the second part and we discuss this further below.

The final measure is valuation. Chris explained that he looks at absolute valuation. It is not just about the Price/Earnings 'PE' ratio but also thinking about for example return on equity and dividend. He is looking for those companies that can grow earnings over the long term and it is this that he focuses on rather than single valuation metrics.

Q: "Explain how you pick stocks?"

Chris explained that stock picking is key to the success of the fund. He carries out between 200 and 300 meetings a year.

A key area of focus is the balance sheet, he is looking for companies who have less debt than the overall market. Effectively he is looking to avoid heavily indebted companies and focus on those where the balance of 'power' is with the equity holders rather than the debt provider.

We expanded on this further, a company might appear on paper to have more debt than the market but it is whether it can service that debt and whether it has a strong balance sheet and a management team in charge of the business plan rather than the debtors being in charge. So what we might consider has heavy debt might not be so when looking at the overall picture.

We asked him whether share ownership was important and his response was mixed on this. Chris likes to see managers own shares but it is not essential. He explained about a company called Earthport where the CEO has shares only and takes no salary as the type of company with the right incentive. Normally a three year incentive programme is something he is looking for.

He did explain that during the credit crunch some companies which had high family holdings seemed to be more focused on the family than the other investors, so care needs to be taken.

In meeting companies he prefers meeting the CEO and CFO; experience shows that listening to other businesses and holding more informal meetings means that he can often pick out the good from the bad.

Again we expanded on this further point, his aim is to have a small number of key questions which he can rattle through quickly. This then enables him to touch on the softer side (and this is the informal bit he refers to) — so for example supply chain, management and trying to discover other opportunities.

As an example the supply and demand of bricks came up after speaking to a number of companies, if they are all talking about bricks then he will look to see what opportunities are in the market. If the demand is such that suppliers can control price then there could be opportunities.

He best describes the informal part of the meeting like putting together a jigsaw, the more you listen the more you can see a bigger picture emerging.

He also explained that as long term holders of stocks (up to 5 years) it opens more doors than short term speculators.

Q: "What is the advantage of investing in the mid-cap space and is there any value left?"

Chris explained that the mid-cap space has a natural refresh button. Companies at the bottom move up through the index; as an example either coming into the FTSE 100 or in merging with another company.

The manager can hold FTSE 100 companies and Chris does, he holds for example ITV and he explained that just because a company moves into the FTSE 100 he doesn't want to be forced into selling it if he still sees value.

It is not just about the refreshing of the index but also, for example, the diversification within the index, the M&A activity and the performance.

With the fund the P/E ratio is at a premium to the index but always has been. He doesn't seem concerned about this. As he explain in 2001 the net income of all the businesses (pre-tax profits) was £5.5 bn and today it is £17.2bn. So both the earnings and value of the index have gone up threefold but importantly the P/E ratio is about the same.

In summary his view is that over the long term these companies offer attractive long term valuations mixed with dividend income driving strong returns for investors.

Q: "How many holdings does the fund typically have?"

The fund targets between 60 to 80 stocks and is currently sat at around 71 stocks.

He can hold less than 60 and more than 80. Although this seems high Chris feels this provides a more diversified mix of holdings to lessen the downside risk. Effectively his fund is not reliant on the success of one or two funds but the portfolio as a whole. What he worries about is the downside risk and this is why the fund is built in this way.

Q: "What should investors worry about?"

Chris explained that Europe is accelerating which is good for the UK but the US and China are two areas to watch. He is watching for any material slowdown in the US which could be sparked by the a sudden rate rise and consequential slowdown in growth – effectively a policy error. In China the hard landing is something to watch. The rate drop is positive but it could have a negative impact going forward.

COMMENT

When compared to the iShares FTSE 250 ETF the fund does outperform this significantly. We selected three other mid-cap funds to compare – Franklin, Neptune and Old Mutual. Since launch the Neptune UK Mid Cap Fund has outperformed this fund. The Old Mutual and Franklin Funds are slightly behind.

All these funds have highly concentrated portfolios both Neptune and Franklin have 35 holdings and Old Mutual 46. Both Franklin and Old Mutual have about 40% of the fund in the top 10 and Neptune 55%. To compare AXA has about 20%. The potential risk is therefore greater in the more concentrated portfolios should some of the holdings fall out of favour. For example Neptune has 17% of its holdings in Carpetright and Dechra Pharmaceuticals. If both these companies dropped in value this would impact performance.

There is also a big difference between the funds – based on Morningstar analysis Neptune is weighted as 16% mid-cap and 80% towards the small/mid-cap. Old Mutual is 73% small/mid-cap and 26% mid cap. Only Franklin is close to AXA with a 62/37 split in favour of mid-cap – the AXA Fund is 60 / 35.

One would assume that AXA would have the lower volatility. In reality over 3 years it is Neptune that has the lowest volatility at 9.54%, then AXA at 11.54%. Franklin is at 12.09% and Old Mutual 12.67%.

For investors looking for a pure mid-cap fund than this and the Franklin Fund are possibly the closest match of the four. Performance wise since launch the AXA has a slightly better track record than Franklin with lower volatility. The higher number of holdings may hold back some performance but it likely to protect on the downside which you don't have with the other three funds.

In summary investors will need to decide whether they are prepared to protect on the downside and therefore sacrifice some return, or whether they are more focused on return and be prepared to accept downside risk.

Fund performance

Performance since launch – 4 March 2011 to 30 April 2015

	2011*	2012	2013	2014	2015**
AXA Framlington UK Mid Cap Fund	-6.15%	29.14%	42.00%	3.94%	9.09%
Franklin UK Mid Cap Fund	-6.69%	27.18%	36.77%	1.24%	10.57%
Neptune UK Mid Cap Fund	0.85%	41.00%	26.63%	11.92%	10.67%
Old Mutual UK Mid Cap Fund	-10.86%	30.60%	37.42%	7.36%	11.56%
iShares FTSE 250 ETF	-11.52%	25.41%	31.74%	2.95%	9.50%

^{*}From 4 March

^{**}To 30 April 2015

	1 Year	3 Years	4 Years	Since
				launch
AXA Framlington UK Mid Cap Fund	12.54%	78.86%	93.40%	95.14%
Franklin UK Mid Cap Fund	14.58%	65.86%	73.69%	81.64%
Neptune UK Mid Cap Fund	19.32%	88.43%	117.80%	123.04%
Old Mutual UK Mid Cap Fund	21.44%	83.56%	86.21%	91.61%
iShares FTSE 250 ETF	12.44%	63.07%	58.97%	64.79%

Performance data and volatility ratings sourced from Morningstar. The total return reflects performance without sales charges or the effects of taxation, but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced.

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