

Does value rotation really have legs?

1 April 2021

Or should investors hang on to their quality growth positions?

It has been a fascinating and volatile first quarter for equities as the rotation into value stocks has continued. But what happens when it runs its course – will the current flavours of the month be able to deliver when expectations rise? Meanwhile, although quality growth stocks may have underperformed, indeed an S&P 500 tracker would have been a better, cheaper bet recently, there is still an argument for sticking with quality.

Report by Phil Oakley

Why a S&P 500 tracker is hard to beat

By the time you read this the first quarter of the year will be over. In general, owning shares has been beneficial, but with a difference.

What we have seen is that the period of quality growth stocks outperforming value and cyclical stocks has come to an end. Leading quality growth funds have lagged the returns of markets in general both in the UK and globally. My Fantasy portfolios, which follow the same approach, have followed suit.

Fantasy Sipp vs comparators year to date

Portfolio % returns	1 month	Year to date	1 year	2 years	3 years
iShares S&P 500 ETF	3.6	5.8	39.2	36.9	61.1
iShares MSCI World Acc	2.8	4.2	38.2	30.7	46.7
Fundsmith Equity T Acc	0.9	1.3	29.2	30.1	60.4
Mid Wynd International Inv Trust	1.9	0.3	35.6	40.6	54.8
iShares NASDAQ 100 UCITS ETF	-0.6	-0.5	48.7	67.2	104.0
Phil Oakley Fantasy Sipp	2.5	-2.4	24.5	28.7	50.5
LF Blue Whale Growth Fund	-0.7	-2.5	33.2	38.7	71.8
Lindsell Train Investment Trust (The)	6.2	-3.1	43.5	0.2	45.7

Smithson Investment Trust	3.3	-3.6	49.0	43.8	
Martin Currie Global Portfolio Trust	-4.0	-3.8	35.6	37.2	60.6
Scottish Mortgage Investment Trust	-9.0	-10.5	94.5	114.0	148.0

Source:SharePad

There have been many reasons for this. For some time, quality growth stocks have been richly priced, if not overvalued, and the rise in bond yields has hurt them more than cheaper value stocks. Some of the froth that has been seen in tech stocks has also waned.

There has also been growing expectation that there is light at the end of the tunnel as far as Covid-19 is concerned in some parts of the world such as the UK, US and China, which have been a lot faster at vaccinating their citizens. This has seen a switch into domestically-focused, economically-sensitive and cheaper shares.

UK Quality Shares vs comparators year to date

Portfolio % returns	1 month	Year to date	1 year	2 years	3 years
FTSE All-Share – Total Return	2.6	5.8	30.2	3.9	10.5
Vanguard FTSE 250 UCITS ETF	2.0	4.9	50.4	16.8	17.3
Vanguard FTSE 100 ETF	2.8	4.3	24.5	0.0	7.4
Baillie Gifford UK Growth Fund	-0.2	3.3	60.4	35.3	44.8
Castlefield CFP SDL UK Buffettology Fund	0.6	-0.7	39.0	24.0	30.4
Phil Oakley UK Quality Shares	2.1	-0.9	25.8		
Finsbury Growth & Income Trust	1.5	-1.6	18.3	7.9	21.3

Source:SharePad

How long this current trend will continue for is anyone's guess. My concern is that once value stocks have been revalued and profits have recovered, where do they go if they don't have sustainable earnings growth?

I remain convinced that the shares of high-quality global businesses that are capable of growing their earnings and cash flows will continue to offer the best risk-adjusted returns for UK investors over the long haul. The strategy will not always outperform, but remains sound with a good risk-return trade-off for those with a longer-term outlook of more than five years.

The question is: What is the best way to invest with this approach?

Warren Buffett has been a big advocate of index investing over stock-picking for most private investors. He easily won a bet that an S&P 500 tracker fund would beat the performance of most highly paid hedge fund managers. He has also said that he has instructed the trustees of his estate for his wife to invest 90 per cent of it in an S&P 500 tracker fund and the remainder in short-term US government bonds.

I think there is one very good reason for this. The S&P 500 is home to many of the world's outstanding companies that are capable of compounding in value in the years ahead. It is a benchmark that has been very hard for professional fund managers to beat. Despite the currency risk, UK investors would have done a lot better by owning it, compared with all but one UK investment fund over the past 10 years and all for a management fee of less than 0.1 per cent.

Even Terry Smith's Fundsmith Equity Fund has struggled to beat it over the past five years and has lagged it over the past three. I am a big fan of Terry and have my Isa invested in his fund, but I am very impressed with how a cheap S&P 500 tracker has squared up against his stock-picking recently.

S&P 500 ETF vs Fundsmith & MSCI World ETF

Fund % total return	1 year	2 years	3 years	5 years	10 years
iShares S&P 500 ETF	39.2	36.9	61.1	118.0	311.0
iShares MSCI World ETF	38.2	30.7	46.7	95.7	200.0
Fundsmith Equity T Acc	29.2	30.1	60.4	125.0	428.0

Source: SharePad

My actual Sipp (I am not allowed to own individual shares I write about as part of my employment contract) has a big weighting in an S&P 500 ETF, which is complemented by additional sector exposure in S&P 500 Consumer Staples and Healthcare ETFs, which are sectors I like long term.

Will this trend of S&P 500 performance continue?

I don't know, but I think its make up can continue to serve investors well. The concentration of the index in big tech names is a valid concern, but I would counter this with the view that most of them have very decent growth prospects and enviable competitive advantages.

The S&P 500 has also given some exposure to the rotation into value and cyclical stocks, which has seen it outperform the Nasdaq 100 so far in 2021.

I don't advocate an end to stock-picking, but having at least some of your portfolio in a cheap S&P 500 ETF or index fund will give you some exposure to very good companies that can help you meet your investment goals at a very cheap cost.

James Halstead



I've written many times that **James Halstead (JHD)** is a business that I have a lot of admiration for. It manufactures top quality flooring products in the UK and sells them across the world with great success. Brands such as Polyflor are bought time and again for use in commercial premises such as shops, hotels, cinemas, restaurants and factories, as well as schools and hospitals. Karndean is a premium vinyl flooring product that is fitted in people's homes and I can say from personal experience that it looks great.

Class-leading products, backed by great distribution and customer marketing, have made James Halstead a great business, in my view. This is backed up by high profit margins, high returns on operating capital and good free cash flow generation.

I also like its no-nonsense approach to accounting with not an exceptional item in site and a focus on proper measures of profit rather than ones such as earnings before interest, tax, depreciation and amortisation (Ebitda). A comment from its half-year results statement is worth mentioning in this respect:

"Each year has its challenges and its successes and adjusting profit for the trials and tribulations of that year has not seemed appropriate to this board and for a capital-intensive business adding back costs such as depreciation (by use of, for example, Ebitda as a performance measure) is, we believe, to ignore an important charge on profit. Our key performance measures are turnover, profit before tax and cash generation."

The key issue for its shares has been unchanged for a while now. Despite being a very good business, James Halstead has been struggling to grow its profits in recent years as it has faced one challenge after another. This explains why its shares have broadly traded within a share price range of 450p-550p for the past five years and have struggled to break out from it.

The shares remain well liked by many investors for good reasons, but a trailing 12-month PE of 30.2 times at the current share price is a punchy valuation that needs forecast upgrades to move the price higher and they are not forthcoming right now.

Despite this, James Halstead has proven to be a remarkably resilient business in what has been some of the toughest trading conditions it has faced. Half-year revenues for the six months to December 2020 matched the previous year's record levels with cost savings on new product launches and marketing helping pre-tax profits to nudge up by just over 3 per cent to £26m.

Cash generation was very good due to the running down of stocks and good management of payables. As a result, net cash balances are £10m higher than a year ago at £74.4m.

While this seems like something to welcome, the running down of stock levels was due to production difficulties caused by Covid-19 and the company entered 2021 with too little stock for its liking and had around 7-8 per cent below what it normally has. This cash flow benefit is therefore actually negative rather than positive and is an example of why investors should be very careful when looking at cash flow performance and using measures such as free cash flow to value shares. Rebuilding stock levels should see cash outflows in the second half of the company's financial year.

The company's outlook statement is typically candid and highlights the continued challenges that the business faces. The UK's new trading arrangements with the EU – the company's biggest export market – have caused delays and problems with sourcing. Some of these have been overcome, but not all of them have.

Covid-19 lockdowns in Europe and Australia have also negatively impacted trading.

There have also been supply shortages of some raw materials as well as price increases. Despite supplier rationing of some raw materials, James Halstead has been able to fulfil all its orders so far.

The encouraging news is that demand for its products remains “consistently solid”, according to the company. Retail and hospitality demand is fairly weak, but there is good demand from healthcare facilities across the world.

My gut feeling is that while this outlook is somewhat mixed, James Halstead should be able to meet current consensus forecasts for the year to June 2021, but is unlikely to beat them, in my view. Its operating profit for the year to December 2020 was £45.1m and is not far off the forecast of £46.8m.

James Halstead has been in my UK Quality Shares portfolio since the outset and it hasn't done it much good in terms of performance. Its quality as a business is not in question, but quality without growth is not the basis for a good investment. I sold them from the Fantasy Sipp last year on growth concerns and it is only the absence of a credible and attractively-priced alternative that stops me from doing the same now.

James Halstead forecasts

Year (£m)	2021	2022	2023
Turnover	249.1	259.1	269.5
Ebitda	53.1	56.2	59.4
Ebit	46.8	49.7	52.6
Pre-tax profit	46.5	49.4	52.3
Post-tax profit	36.3	38.6	40.9
EPS (p)	17.5	18.6	19.7
Dividend (p)	14.7	15.3	16
Capex	5.3	5.3	5.3
Free cash flow	34.2	39.7	41.3
Net borrowing	-69.1	-76.5	-84

Source: SharePad

Continued on the next page...

Oxford Instruments



For me, **Oxford Instruments (OXIG)** is one of the most interesting businesses listed on the London market. I like it and see it as a great example of a business making good profits out of clever niche products that help its customers. It is backed up by good financial performance on measures such as operating margins and return on operating capital employed (ROOCE).

I added it to my UK Quality Shares portfolio back in August and since then it has delivered a total return of 33 per cent.

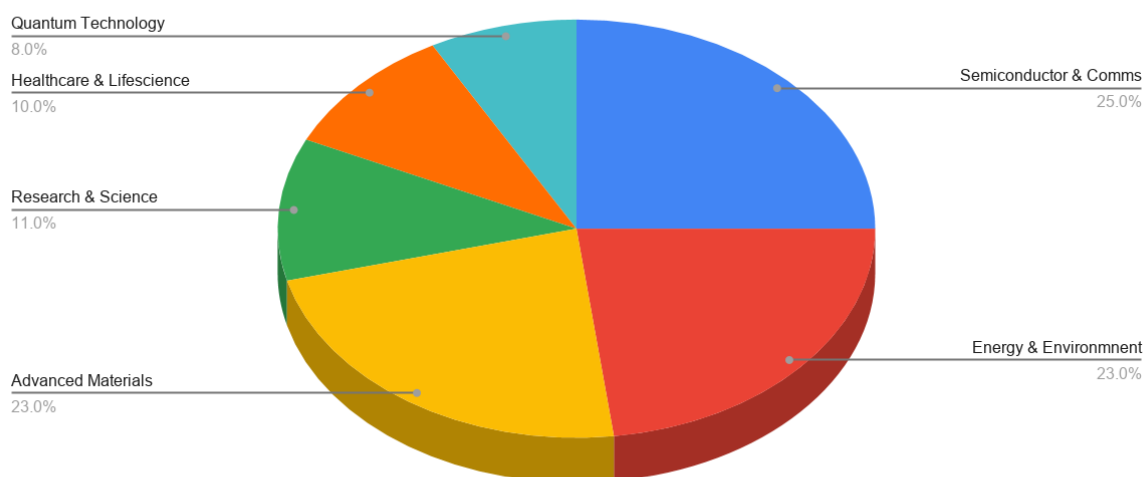
The company makes its money by selling the following products to the research and development departments of businesses and university research customers:

- Scientific digital cameras
- Microscopy systems including atomic force microscopy.
- Spectrographs
- Magnetic resonance products
- Nano analysis tools
- X-ray and electron analysis
- Etching and deposition processes

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Its end markets are spread across the following sectors:

Oxford Instruments: Revenues by End Market



Source: Annual Report

Around half its revenues come from North America and China, while its biggest end market is in the value-added segment of the semiconductor industry.

These exposures are serving the company very well as evidenced by its trading update at the end of last week. The company has seen good order growth in Asia and China, in particular, and very strong demand across its semiconductor business. Trading in other sectors was described as resilient.

This is a very creditable result given the disruptions caused by Covid-19 within company and university research departments and revenues for the year ending March 2021 are expected to be slightly ahead of last year (£317.1m), which implies a decent pick-up in the second half of the year.

The impact on profits is much better than expected due to efficiency gains and operating profits for the year are now expected to be in the range of £55m-£57m, compared with previous expectations of around £48m and profits of £50m in 2020.

This level of expected profit is almost as much as was being forecast by analysts for 2023. However, it seems that forecasts after 2021 have not changed that much.

Oxford Instruments forecasts

Year (£m)	2021	2022	2023
Turnover	308.9	324.6	338.7
Ebitda	60.9	65.1	71
Ebit	56.2	55	59.4
Pre-tax profit	50.3	54	59.3
Post-tax profit	39.2	42.6	43.8
EPS (p)	69.8	74.1	79.4
Dividend (p)	14.2	15.6	17.3
Capex	8.8	10.6	10.4
Free cash flow	25.7	30.3	33.3
Net borrowing	-84.6	-103.8	-130

Source:SharePad

This does not bother me as I think the exposure of this business to favourable end markets can drive long-term earnings growth. That said, this may not be delivered smoothly as research budgets can be cut back at short notice.

Oxford Instruments and the niche, problem-solving and enabling nature of its products is similar in make up to a business such as Renishaw, which has done so well over the years. Given this, I think the valuation of 25.9 times the next year's rolling EPS represents reasonable value that I'm happy to hang on to in my UK Shares portfolio.

Bioventix



Very few listed companies can match **Bioventix's (BVXP)** outstanding levels of profitability. The manufacturer and seller of sheep monoclonal antibodies is leveraged off a small team of scientists at Farnham in Surrey.

Its gross profit margin of 91.2 per cent means it is the equivalence of making antibodies for just under 9p and selling them for £1. Given that its other costs are not big, its profit margins and free cash flow generation is prodigious and this is unsurprisingly attractive to investors.

This is another company where growth has become the main issue. Just under half of its revenues in recent years have come from Vitamin D antibodies where the number of tests globally has been expected to plateau. Bioventix also stands to lose an annual revenue stream of £1.2m from its NT-pro BNP antibody which tests for heart failure and other cardiac problems from July this year. This is not a small issue for a business with revenues of £10.3m last year.

Half-year results released this week gave grounds for encouragement. Revenues were down 1.3 per cent to £5.2m as Vitamin D related sales performed better than expected. Revenues from areas such as thyroid and fertility testing was lower. As a result, pre-tax profits fell from £4.1m to £3.7m.

The big hope for growth is its troponin antibody which tests for heart attacks. Here the news was encouraging as sales grew significantly (but were not quantified in the results statement) and the roll-out of testing machines bodes well for continued growth. Good progress was made in other areas such as the development of pollution exposure testing where trials continue to go well.

This is a business that is hard for me to weigh up. It has many attractions and the leverage effect of sales growth from new products can be significant, especially as the research costs have been fully expensed upfront. Investment in the research laboratories and manufacturing footprint at Farnham have been completed so the company has what it needs to cope with growth when it comes.

The key issues are the timing of new product sales and to what extent they can offset the loss of revenues from NT-pro BNP and Vitamin D, where the latter has defied expectations over the past year or so.

There are no published broker forecasts on this company that can be accessed by investors. Diligent shareholders who know this business very well may be able to have a go at estimating the potential impact of growth, but I think this is hard to do.

As a benchmark for valuation we can look at the past 12-month's EPS and free cash flow per share, which are 130p and 129p, respectively. At 4,285p, this puts the shares on a trailing PE of 33 times and a free cash flow yield of 3 per cent, respectively.

This is a high valuation and one that needs growth to come through. If it does then the shares are probably still attractive, but the uncertainty over timing and magnitude could equally lead you to think that the shares are at best fully valued and possibly even overpriced.

This has been a successful part of the UK Quality Shares portfolio since January last year, with total returns of nearly 30 per cent. However, it is a share that I do have concerns about at the current valuation and opaqueness on its future prospects. It may therefore be a candidate for sale in the next few months, but is also something that can look better very quickly if fresh revenues come through better than expected.

Michelmersh Brick



In general, I very much like the economics of UK brick makers. The UK market has a shortfall of domestic capacity and is reliant to some extent on imports to meet demand. The ownership of clay reserves is a substantial barrier to entry and competition. Despite selling bricks to powerful buyers in the form of housebuilders, brick makers with their own clay reserves can make good profit margins and returns on capital invested.

The only thing that puts me off is the cyclical nature of the industry which makes it hard for these companies to compound in value over the long term. That said, as I wrote with regards to Forterra recently, I think brick companies are a reasonable place to be for UK investors right now.

Michelmersh Brick (MBH) looks well placed to exploit the fact that the UK government will literally seem to do whatever it takes to stop UK house prices falling and stimulating new construction. What I think is particularly attractive about Michelmersh is that it has a

very diversified business model with a big exposure to the repairs, maintenance and improvement market, as well as domestic new-build and commercial construction.

2020 was a rough year as evidenced by the 15 per cent fall in operating profit revealed this week. 2021 should be better and the company looks well placed to serve its core UK market (it also has a smaller business in Belgium) for many years to come.

Michelmersh specialises in premium bricks and paving stones that are used in upmarket new-builds, extensions and commercial buildings. These are sold with decent gross profit margins of just over 41 per cent, which can convert to operating margins of over 19 per cent in a good year with production shutdowns and Covid-19 safeguarding costs. Last year, operating margins were still more than 16 per cent.

The company is now back running at full capacity from its six UK manufacturing sites and has boosted its access to clay reserves by opening up land next to its brickworks at Romsey, while it is in the process of building a road at Telford to access reserves there.

The start of 2021 has seen a strong order intake in a UK market that is currently suffering from capacity constraints and disruption to imports. This bodes well for the pricing environment and profitability this year. That said, based on current forecasts, operating profits aren't expected to quite get back to 2019 levels of £10.3m.

Michelmersh Brick forecasts

Year (£m)	2020	2021	2022
Turnover	51	55.1	58.4
Ebitda	11.1	13.2	14.4
Ebit	8.2	9.8	11.2
Pre-tax profit	7.6	9.5	10.9
Post-tax profit	6.1	7.6	8.4
EPS (p)	6.3	7.9	8.7
Dividend (p)	2.3	2.8	3

Source:SharePad

With a fair wind behind it and a UK market that holds up, there are grounds for optimism on future profits. That said, rising unemployment, a less favourable Help to Buy scheme and an end to the stamp duty holiday represent real risks to the outlook.

At 142p, the shares trade on a one-year forecast rolling PE of 17.9 times, which is similar to Forterra on the same basis. This suggests that a lot of good news is priced in.

That said, I see Michelmersh as a very decent business. I still prefer Forterra given the big efficiency gain and capacity boost it will get from its new Leicestershire manufacturing site in a couple of years' time, which should allow it to take market share from imports.

AG Barr



In Irn-Bru, **AG Barr (BAG)** has one of the strongest soft drinks brands in the UK. The company has also been very well managed over the years, but I can't help feeling that it has lost its way over the past five years.

An attempt to merge with or effectively take over rival Britvic failed, while it also mishandled the sugar reduction of its iconic Irn-Bru brand. It has not really been able to leverage its manufacturing footprint from licencing other drinks brands in the UK. Orangina has long gone, while the recent loss of the Rockstar Energy licence following its acquisition by Pepsico will hit profits next year.

The acquisitions of Rubicon fruit flavoured drinks and Funkin cocktail mixers have been solid additions, but have not really accelerated the company's growth trajectory.

However, there are signs that the company is being more innovative and is doing a lot with its Irn-Bru brand.

For die-hard Irn-Bru fans who like their drinks laced with sugar as it was before the introduction of the sugar tax, Barr has launched Irn- Bru 1901. It is also taking Irn-Bru into the energy drink sector, presumably in an attempt to replace the lost revenues from Rockstar. It is also launching a Rubicon energy drink as well to capitalise on this very important and growing sector of the soft drinks market. Whether it can compete with established brands such as Rockstar, Red Bull, Carabao and Monster remains to be seen.

Another interesting development is the launch of Irn-Bru still drinks. Rival Nichols has shown with Vimto that a combination of still and carbonated drinks from the same brand can be a great success. However, it has done this over decades so I expect any success for Barr to take some time to come to fruition. It will be interesting to see how it gets on, nonetheless.

One of the underappreciated successes of Barr in recent times has been the strong growth from its flavoured carbonated drinks. These come in the form of lemonade, cola, ginger beer and a variety of fruits. Combined with Irn-Bru, carbonates provide nearly 90 per cent of Barr's gross profits and give it an attractive and resilient portfolio. As results in 2020 proved, it also seems to be one that has a decent amount of pricing power.

As with so many good companies, we often come back to the subject of growth or the lack of it. Barr should see some decent underlying revenue growth in 2021 as hopefully the UK economy opens up, but the loss of Rockstar revenues and some cost inflation are likely to see flat overall revenues and profits for the year.

At 500p, the shares trade on a one-year rolling forecast PE of 20.2 times. I think that's fair enough and not overly expensive for a very good business, but one that lacks a catalyst for a rerating right now. I'm happy to hang on to Nichols in the UK portfolio where the strong momentum in Vimto and the uplift that should eventually come from its out-of-home business makes me still prefer it to Barr and Britvic right now.

AG Barr forecasts

Year (£m)	2021	2022	2023
Turnover	227	237.7	250.4
Ebitda	45.8	48.6	51.7
Ebit	32.9	35.4	38
Pre-tax profit	31.1	34.8	37.5
Post-tax profit	22.6	28.1	30.5
EPS (p)	22.6	24.8	26.9
Dividend (p)	6.4	13	13.6
Capex	6.3	13.3	13.3
Free cash flow	34.6	24.5	28.7
Net borrowing	-44.9	-56.7	-66.8

Source: SharePad

Ten Entertainment Group



Ten pin bowling companies have been hammered by Covid-19 lockdowns and are going to have to wait until probably 17 May before they open up again.

When they do, I think they make for quite attractive investments. Bowling remains a very affordable and value for money family leisure activity. The likes of Ten and Hollywood Bowl have been making them more attractive places to visit by investing in better food and drink services and alternative attractions to utilise the space available in their premises. The money spent has generated very good incremental profits.

Whilst Hollywood Bowl has focused on a strategy of refurbishment of its existing centres and a conservative pace of new openings in prime locations, **Ten Entertainment Group (TEG)** has been hoovering up independent bowling centres and doing them up with very good results.

In a return to what were viewed as more normal living conditions, there's still plenty of scope for Ten to get back to this strategy.

Its refurbishment strategy with initiatives such as pins and strings in the bowling lanes which save staff and energy costs should see the business start making good profits again.

Ten has historically traded at a valuation discount to Hollywood Bowl given the perceived quality difference in locations and more reliance on acquisitions to grow. This still exists with the shares trading on a 2022F PE of 14.7 times, compared with Hollywood Bowl on 17.2 times.

Granted, the expectation of a profits recovery has been partly factored in, but in the absence of another UK lockdown, I see both companies as having more upside potential from here as profits could bounce back faster than people currently expect.

Ten Entertainment Group forecasts

Year (£m)	2021	2022	2023
Turnover	57.1	87.6	94.3
Ebitda	13.9	31.9	36.4
Ebit	4.7	16.8	20.6
Pre-tax profit	2.8	12.8	14.9
Post-tax profit	-0.9	10.5	14.1
EPS (p)	2.1	15.3	18.3
Dividend (p)	2.3	7.9	9.6
Capex	8.1	9.4	9
Free cash flow	-3.7	10.4	16.7
Net borrowing	4.1	-3.8	-13

Source: SharePad

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ISSN 0261-3115.