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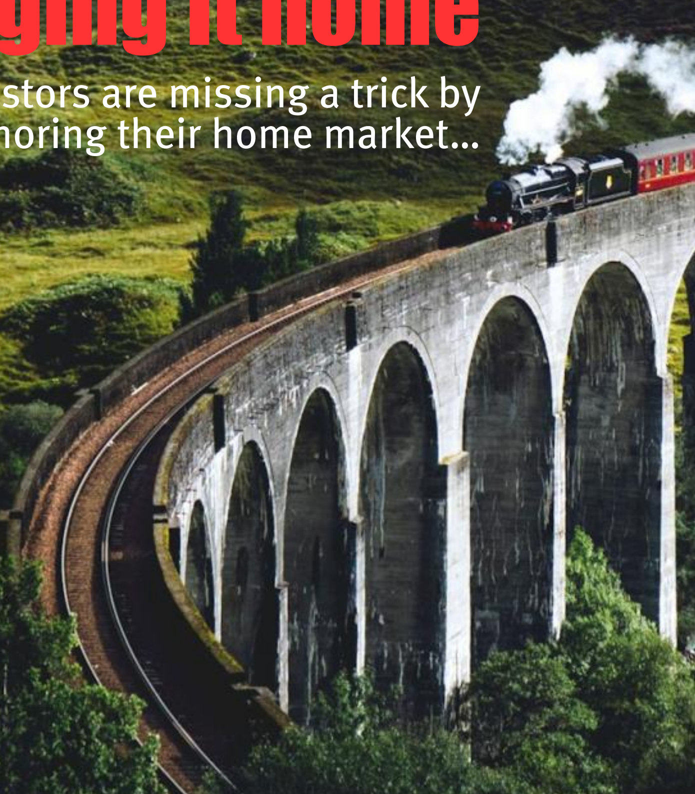
Bringing it home

Why investors are missing a trick by ignoring their home market...



As investors know, bias is supposedly the nemesis of rational decision-making. There's a veritable A-Z of biases to avoid (from overconfidence to past performance and so on) but let's focus on one alone: home bias.

Home bias describes a tendency for investors to prefer domestic equities, often due to a comfortable familiarity with home-grown companies. But is this such a bad thing? First-hand knowledge of a company, underpinned by research, can arguably lead to better decision-making, particularly if investors unearth an undervalued gem before others cotton on.

The patriotism of our Atlantic neighbours certainly extends to their investment portfolios, with US retail investors allocating 85% to US equities, according to Charles Schwab. In stark contrast, the UK is suffering from the falling confidence of investors in their home market, prompting a consecutive 31-month outflow from UK equity funds and leaving valuations of UK equities languishing in the doldrums.

This prompts the question: given current valuations, are UK investors missing a trick by ignoring their home market? History shows that investors keeping the faith (when all around are losing theirs) are often handsomely rewarded, particularly when there's a wide divergence between investor sentiment and the underlying fundamentals.

Rock-bottom valuations

Valuations of mid-caps can be sensitive to inflation and interest rates, and a challenging macroeconomic situation has undoubtedly been a major headwind to recent performance.

This has left the FTSE 250 (ex-ITs) trading on a forward price-earnings ratio of 11 (as at 18/04/2024), relative to a decade -average of 14, according to Goldman Sachs. As shown in the chart on the next page, it's also trading well below the valuations of its mid-cap peers, being 38% and 32% below the respective price-earnings ratios of the MSCI USA and MSCI World Mid-Cap indices.

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Yet the FTSE 250 encompasses high-growth companies at the leading edge of innovation and has delivered a 20-year total return of more than 430%, not far below the 470% return for the S&P 500 (in local currency) and significantly above the 360% return for the MSCI World Index (as at 22/04/2024). With a more positive macroeconomic outlook, some would argue that the valuation of UK mid-caps remains in the 'bargain basement' category.

Searching for jewels

It would be fair to say that the FTSE 250 is waiting patiently for its moment in the spotlight but, in the meantime, the expertise of active stock-picking funds such as **Schroder UK Mid Cap (SCP)** has come to the fore. Managers Jean Roche and Andy Brough view the FTSE 250 as a dynamic universe, thanks to regular movements in both directions between the FTSE 100 and Small-Cap indices, as well as M&A and IPO activity.

They run a high-conviction, 'best ideas' portfolio of around 50 companies, thereby avoiding the dilution of returns from a larger portfolio (which becomes more akin to a passive fund). SCP is a pure mid-cap fund and the managers take the opportunity to refresh the portfolio with the 'next rising stars' when portfolio companies are promoted to the FTSE 100.

Jean and Andy look for companies with a proven management team with a clear strategic vision, robust balance sheet and strong ESG credentials. Portfolio companies will typically have strong pricing power, often due to scarcity value or franchise-type models, or operate in market niches with strong structural growth.

One such example is Games Workshop which manufactures and retails fantasy miniatures. Its main consumer-facing brand, Warhammer, has a loyal global fan base running into the millions. The licensing of Games Workshop's intellectual property in video games, as well as a recent deal with Amazon Studios (for exclusive rights to the Warhammer 40,000 franchise) has further diversified its revenue stream.

As with many FTSE 250 companies, Games Workshop has a strong overseas presence, with almost 80% of revenue generated from outside the UK. Its vertically-integrated business model (design, manufacture, distribution and retail) translates into strong gross margins and the company is highly cash-generative.

Games Workshop has delivered a five-year total return of around 190% compared to 10% for the FTSE 250 (ex-IT) index (as at 22/04/2024) and is trading on an attractive dividend yield of 4.4%, comfortably above the 3.8% average yield for the FTSE 250 (ex IT) Index (as at 22/04/2024).

Despite a challenging trading environment, some of SCP's best-performing companies have been in consumer-facing sectors, with homeware retailer Dunelm and food manufacturer Cranswick also outperforming the index.

FIG 1: 'UK Mid-Cap valuations well below peers'

Price-earnings ratio by index

Source: Bloomberg (as at 22/04/2024)

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These demonstrate the ability of active fund managers such as Jean and Andy to generate alpha through stock-picking when broader valuations remain subdued.

The power of buybacks

In addition to share price growth and dividend income, the FTSE 250 has also proved its credentials in returning cash to shareholders via share buybacks, with almost a quarter of UK mid-caps buying back 1% (or more) of outstanding shares in 2023.

Jean recently wrote: "Of all the uses of cash flow, share buybacks are among the most attractive if they are conducted when a company's share price is depressed. We are delighted to see more share buybacks among selected UK mid-caps because it demonstrates sensible capital allocation decision-making in the current environment."

SCP has benefitted from share buybacks by investment manager Man Group and banking provider Paragon in the last year. Similarly, industrial services company Bodycote has chosen to embark on a share buyback program, due to the board's belief that it would generate a higher return on capital than a potential acquisition.

The catalysts for recovery

The challenge for investors is timing the recovery and investors are still sitting on their hands as far as UK equities are concerned. But, as we explore **in our recent report on investing in the UK**, the key catalysts for a recovery are becoming more visible with an improving macroeconomic outlook and likely resolution of political uncertainty. The recent proposal for an additional British ISA allowance also aims to increase UK investors' appetite for their home market.

While UK investors may be giving their home market the cold shoulder, others have seen the potential upside from depressed valuations. The last few years have seen a noticeable upturn in the number of acquisitions of UK companies, particularly from overseas corporates and private equity firms, with an average bid premium of more than 50% in 2023, according to Schroders.

Jean observed in a recent note: "Due to their size, small and mid-sized companies are much more likely to become acquisition targets than large companies. Despite this, the number of bids being received by UK mid cap companies was surprisingly low last year. This may signal pent-up demand, which could point to greater M&A activity among UK mid-caps over the next couple of years."

Despite subdued valuations across the UK mid-cap sector, SCP has continued to deliver strong returns for investors. It has achieved a total net asset return of 17% over the last five years, outperforming the 10% return of the FTSE 250 (ex IT) Index (as at 19/04/2024). It is also trading on a current dividend yield of 3.8% and a discount of c. 15%, which could provide a boost to returns if the discount narrows.

Looking ahead, the UK mid-cap sector looks well-positioned for a recovery in valuations, although it can be hard to time a change in investor sentiment. However, investors rediscovering some love for their home market ahead of the crowd may well be rewarded if the long-awaited recovery comes to fruition. ■

Read our analysts' latest research on Schroder UK Mid Cap Fund

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