Special Report

Here comes the sun

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Why the clouds are starting to clear for UK equities…

In a speech to the House of Commons in 1941, Winston Churchill candidly observed: “The British nation is unique in this respect: they are the only people who like to be told how bad things are, who like to be told the worst…but when you go to other countries, [they urge] that we should be careful not to indulge in too-gloomy forecasts.”

It would be fair to say that UK equities have been shrouded in gloom for some time, with an unprecedented outflow of retail and institutional money alike. But, while UK investors may have largely eschewed their home market, others have been noticeably more upbeat on the outlook for UK plc. The last few years have seen corporate and private equity buyers snapping up UK public companies at bargain prices and the proportion of overseas investors holding UK shares recently hit a record high of nearly 60%, according to the ONS.

This begs the question: are UK investors missing a trick? Given the current valuations on offer and the opportunity for a sustained recovery in UK equities, the answer is: quite possibly. As we will explore in more detail, this may well prove an opportune time for investors to reconsider their exposure to UK equities.

Roll up, roll up...

The prevailing pessimism about UK equities has certainly weighed on valuations. This has left UK mid-caps trading on a ‘double discount’, whereby UK mid-caps are trading on lower valuations than UK large caps and UK equities on lower valuations than their European and US peers. The MSCI UK Index is currently trading on a forward price-earnings ratio of just over 11 (as at 19/04/2024), significantly below its 20-year average, according to Yardeni.

As a result, UK equity valuations have significantly diverged from their global peers. Figure 1. shows that the MSCI UK Index is trading at a discount of 33% and 45% to the forward price-earnings ratios of the MSCI All Country World and USA indices respectively (representing one of the steepest value gaps for several decades).

Part of this valuation differential is attributable to valuations in US equities, and the increase in the earnings multiples of the ‘magnificent seven’ mega caps, which have a disproportionate effect on US indices. However, the valuation of UK equities remains below their European counterparts, in spite of their similar fundamentals.

FIG 1: ‘UK valuations are well below their peers’

Price-earnings ratio by index

Source: Yardeni (as at 19/04/2024)

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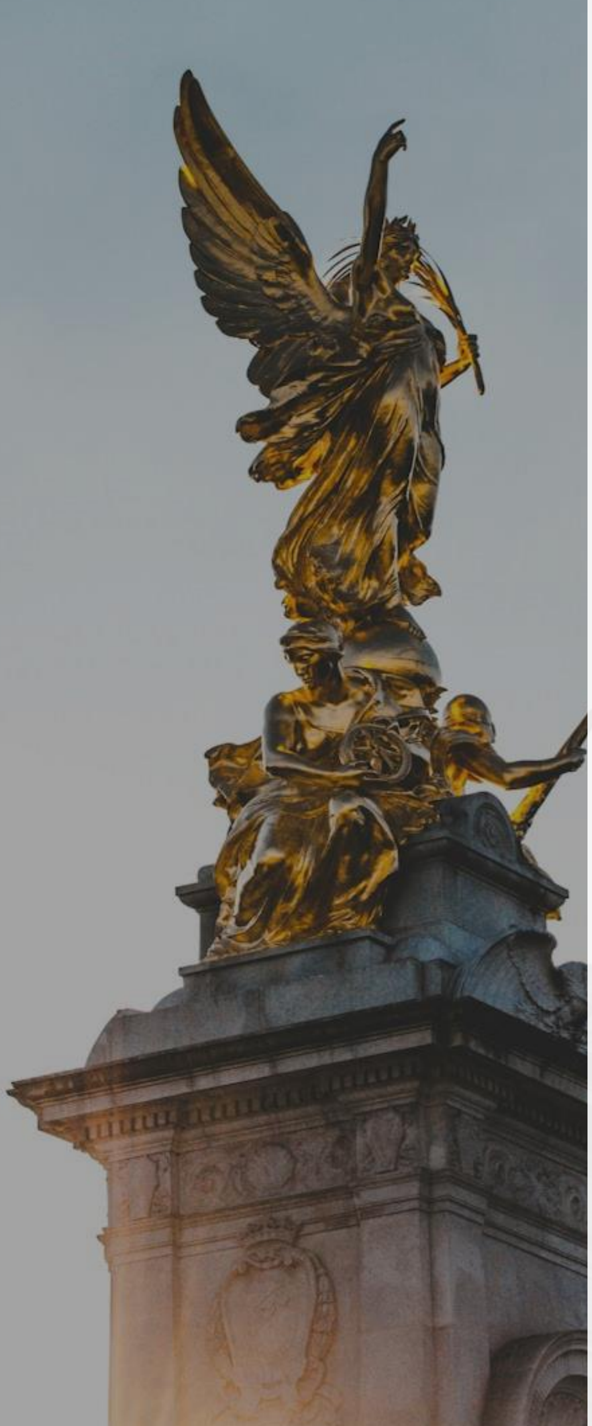

Mind the (value) gap

Low interest rates have often had a positive effect on the performance of UK mid-caps, as seen in the post global financial crisis decade of ultra-low interest rates, with the FTSE 250 (ex-ITs) Index chalking up a total return (including reinvestment of dividends) of more than 400% from 2009 to 2021.

Unfortunately, 2022 ushered in a distinct reversal in fortunes, as the steep hike in energy prices and spiralling inflation contributed to the 30% fall in the value of the FTSE 250 Index in the first nine months of the year. Fears of an inflation-led squeeze on consumer spending and, more broadly, a possible recession, weighed particularly heavily on the domestically focused mid-caps and the hike in base rates compounded investors' preference for 'safer' alternatives.

However, some would argue that the pessimism about UK equities appears divorced from the economic reality. The OECD's consumer confidence index (CCI) seeks to measure consumer sentiment towards factors such as household finances and the general economy. Lower values indicate pessimism towards the future economic outlook and a propensity to save more and spend less. Conversely, the composite leading indicator (CLI) is designed to provide early signal of turning points in business cycles by looking at economic activity around its long-term potential.

Comparing these two indicators can help to identify a potential disconnect between consumer confidence and the underlying economic data. Figure 2. below quantifies this difference, with a negative number representing a lower level of consumer confidence than the corresponding economic indicator.

And it seems that Winston Churchill may well have had a valid point: the UK is an outlier as far as pessimism is concerned, with consumer confidence well below the economic data. As for our European neighbours, consumer confidence in France and Germany is more closely aligned to the state of their economy, albeit there has been a noticeable improvement in confidence in the last few months across the board.

Although there can be a clear dichotomy between economic and stock-market performance, pessimism around the state of the economy can have a knock-on impact on the performance of equity markets. This has been evident for UK equities, which have struggled to mount a sustained recovery amid record fund outflows. But, as we know, fortune favours the brave and history shows that UK small and mid-caps have typically performed particularly well after a period of difficult performance.

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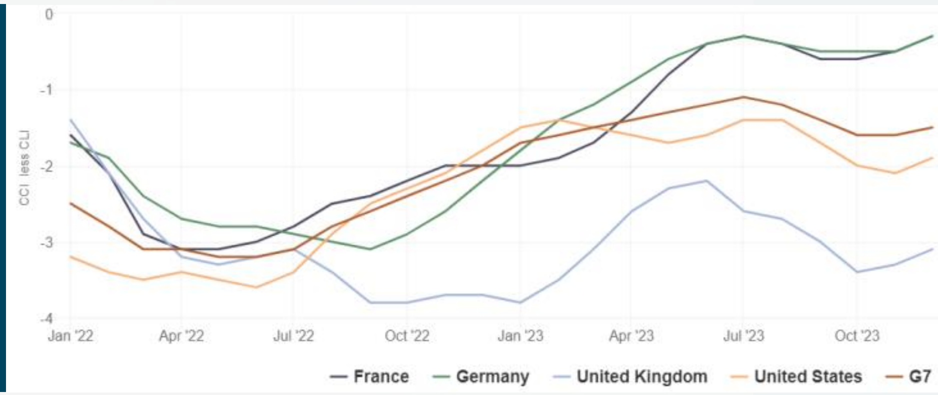
FIG 2: 'Gap between CCI and CBI by country'

Consumer confidence v economic indicators

Source: OECD (as at 30/11/2023)



Time to shine?

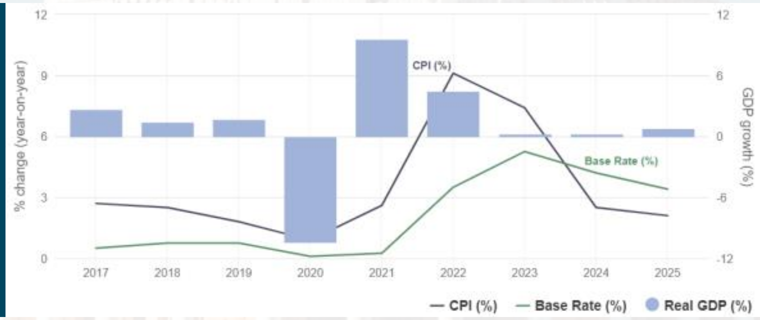
The perennial challenge for investors is identifying the catalysts that will drive the recovery, and this holds true for UK equities which have yet to reach a clear tipping point.

Improving macroeconomic outlook

One of the key catalysts is a more positive outlook for the macroeconomic environment in the UK. As shown in the graph below (Figure 3), inflation is forecast to fall towards its 2% target over the next 12 months, which could provide some wriggle room for the Bank of England to cut base rates. GDP is also expected to grow over the next two years, albeit at a fairly modest rate, after a shallow recession in the second half of 2023.

FIG 3: 'Inflation, interest rates and GDP growth'

Macro-economic indicators



Source: Bloomberg (as at at 6/4/2024), forecast numbers for 2024–2025

Track record of superior returns

Investors will also be cognisant of the historic outperformance of smaller-cap companies over the longer term. The chart below (Figure 4) shows that the mid-cap FTSE 250 (ex IT) Index has comfortably outperformed leading indices, such as the high-growth S&P 500 and MSCI World indices on a total returns basis over the last 25 years.

FIG 4: 'Outperformance of the FTSE 250 Index'

25-year total returns by index

Source: Bloomberg (as at 16/04/2024) Past performance is not a reliable indicator of future results

Veteran investor Jim Slater remarked that "elephants don't gallop" and it's true that some of the highest growth companies are found outside the large-caps sector. The FTSE 250 (ex-ITs) Index achieved a 17% growth in EPS in the last year, compared to negative growth for the FTSE 100.

Looking forward, this trend is expected to continue with forecast EPS growth of 16% for the mid-cap index over the next 12 months, compared to negative EPS growth of 1% for the FTSE 100 (according to Bloomberg, as at 16/04/2024).

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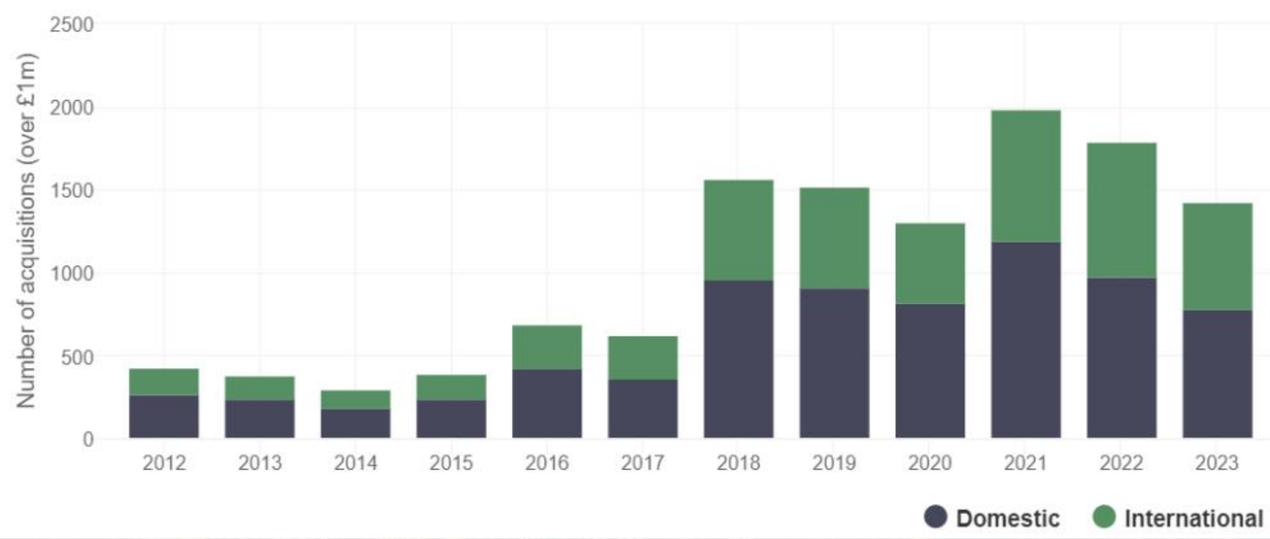
FIG 5:
'Upturn in M&A of UK companies'

M&A activity in UK public and private companies

Source: ONS



Broad universe of opportunity

The FTSE 250 Index offers a large investable universe spanning a variety of sectors, with a greater weighting in financial, industrial and real estate companies than the larger-cap FTSE 100 Index. There is also a lower level of analyst coverage, with the smallest FTSE 100 company currently followed by 13 analysts, compared to only three for the smallest FTSE 250 company. This creates an opportunity for active fund managers to deploy their stock-picking skills to exploit pricing inefficiencies down the market-cap spectrum.

There is often a misconception that FTSE 250 companies are primarily focused on the domestic economy, but almost 60% of their revenue comes from overseas, according to FTSE Russell. Mid-cap companies with substantial international revenue include Warhammer specialist Games Workshop, engineering company Renishaw and direct marketing firm 4imprint. This means that companies have the potential to perform well even during periods of relative weakness in the UK economy.

Resolution of political uncertainty

Political uncertainty has also been hanging over the UK with a likely change of government after the election this year. That said, with over 50 elections scheduled globally for 2024, the UK is not an outlier in this respect. Recent research by AJ Bell revealed that the UK stock market typically welcomes change, with an average uplift of 13% in the FTSE All-Share Index in the year following a change of government (based on data from 1962 onwards).

Another political factor worthy of mention is the concerted effort by the government to stem the waning popularity of UK companies with retail and institutional investors. A British ISA has recently been floated to boost retail demand, which would allow investors to contribute an additional £5,000 per year into UK listed companies. On the institutional side, pension funds will be mandated to disclose their UK holdings with the aim of encouraging a higher allocation to domestic equities. These seem fairly limited moves so far but it will be interesting to see if the next government takes things further.

In addition, the regulatory landscape is evolving, including the FCA's proposals for reforms to the UK Listing Regime (which aims to encourage a more diverse range of

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companies to list and grow on UK markets, while promoting more investment opportunities for investors) and the UK Secondary Capital Raising Review. The proposed rolling back of MIFID could also increase the supply of information and research on smaller UK companies.

Elevated M&A activity

The last few years have seen a noticeable increase in M&A activity, as shown in Figure 5 on the previous page. There has also been a rising proportion of overseas buyers, particularly from the US due to the strength of the dollar against the pound.

However, more than 80% of the £100m plus acquisitions in 2023 were in the FTSE Small-Cap and AIM sectors, according to Peel Hunt. While 10% of the FTSE Small-Cap Index was acquired in 2023, there were only three acquisitions of mid-cap FTSE 250 companies. That said, acquisitions of mid-cap companies may start to catch up with their smaller-cap peers in 2024, with bids for Redrow, Spirent, Virgin Money, Wincanton, Direct Line and Tyman in the year-to-date, to mention but a few.

The average premium for acquisitions of UK companies was 50% in 2023, according to Peel Hunt, which can provide a tailwind to investor returns. However, shareholders may not necessarily perceive offer premiums as fair valuations, given that valuations remain well below long-term averages.

M&A activity is forecast to remain at elevated levels going forward, given the attractive valuations of UK companies. Financial buyers represented more than 70% of £100m plus acquisitions by value in 2023, and, with global private equity ‘dry powder’ hitting a record $4 trillion, the FTSE 250 could prove a fertile hunting ground.

The benefits of active management

Active management can be beneficial in UK equity sectors, whereby fund managers can draw on their in-depth research capabilities to identify the best opportunities in a broad universe of potential investments.

Schroder UK Mid Cap (SCP) which aims to own a high-conviction portfolio of around 50 UK mid-cap companies and has delivered consistently strong returns. The managers see the UK mid-cap sector as offering an attractive blend of the innovation and steep growth trajectories of small caps with the proven business model and strong balance sheet characteristics of large caps.

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Lead manager Jean Roche, together with Andy Brough and James Goodman, boast a combined investment experience of almost 70 years and draw on the extensive resources of the Schroders research team to identify the market leaders of tomorrow. Although investors may not always perceive UK companies as leading innovators, Jean points to UK mid-caps extending a competitive advantage in sectors such as fintech, cyber security and the transition to clean energy.

The SCP portfolio is split into two main categories: 'unique' and 'flex'. Unique companies have the ability to raise prices without damaging demand and typically operate in sectors with attractive structural growth drivers. Flex businesses are in more cyclical sectors or in transition (due to management or industry changes), which should generate superior returns on capital in the future.

The managers also seek to manage the downside risk for investors, which has proved beneficial given the challenging conditions for UK mid -caps in recent years. Portfolio companies tend to have low levels of debt (or be in a net cash position), which has protected against the sharp rise in financing costs. Around 80% of the portfolio has a net debt: EBITDA ratio of one or less, which is substantially lower than the aggregate index.

One of SCP's best-performing investments is Games Workshop, which recently signed an agreement in principle with Amazon to license its intellectual property for film and television productions. This helped to power Games Workshop to deliver a total return of 20% in 2023, more than double the average return for the FTSE 250 (ex IT) Index. Games Workshop has also achieved '30-bagger' status, having appreciated in value by more than 30 times over the last 30 years (based on total returns).

SCP has been the top-performing trust in the AIC All Companies sector by net asset total returns since its launch in 2004 and has also been awarded our **Kepler Income and Growth Rating**. Although the trust focuses on capital growth, the dividend has increased ten-fold since the trust's inception. As with many UK investment trusts, it is trading on a substantial discount to net asset value, which may prove an additional kicker to returns if the discount narrows.

What UK equities offer income-seeking investors

As well as the potential for capital growth, UK equities offer another benefit in the way of attractive income streams. Many FTSE 100 companies are known for their generous dividend policies, however, the income-generating capabilities of smaller-cap companies is perhaps less widely recognised by investors.

The chart on the next page (Figure 6) shows that both the large- and mid-cap UK indices are currently trading on significantly higher dividend yields than their peers, and double the yield of the Dow Jones and MSCI World indices.

Notably, the FTSE 250 Index is trading on a dividend yield of 3.8% that is only marginally below the 3.9% yield of the FTSE 100 Index. This is testament to the highly cash-generative nature of many mid-cap companies in this space and current low valuations.

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Although special dividends have fallen over the last three years, regular dividends paid by UK companies increased by 5.4% in 2023, according to the Computershare Dividend Monitor Report, ahead of inflation, with CPI up 3.9% over the year. Dividends are also forecast to continue to grow in 2024, albeit at a lower rate.

In addition to dividends, UK companies have returned billions of pounds to investors via bumper share buy-backs over the last two years. The impact of buy-backs on dividend growth calculations has masked headline dividend growth, with Computershare calculating that adjusted underlying dividend growth would have been an impressive 7.2% in 2023.

Why UK equity income investment trusts offer an advantage

One of the key benefits of investment trusts is their ability to hold up to 15% of annual income in reserves, which can be utilised to maintain consistent payouts in more difficult markets. **Schroder Income Growth Fund (SCF)** takes full advantage of this facility, and has been awarded 'dividend hero' status by the AIC for consistently increasing its dividend for 28 consecutive years.

The trust aims to deliver income growth in excess of inflation, achieving annualised dividend growth of 4.2% from 1996 to 2023, comfortably above the average inflation of 2.3%. SCP has also been awarded a **Kepler Income and Growth Rating**.

The trust offers a differentiated approach to equity income, combining higher yielding companies with companies offering a lower yield but the potential for significant alpha generation. As a result, SCF is overweight small- and mid-cap companies relative to the FTSE All-Share Index due to their superior growth runway. However, this does not require a significant sacrifice in income: the difference between the

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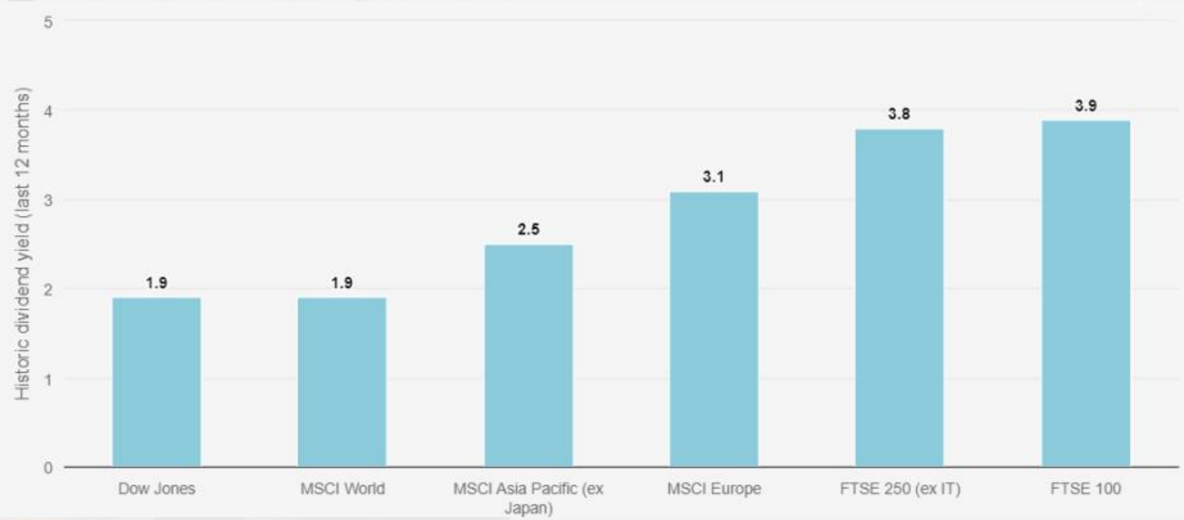
FIG 6:
'UK equities lead the way for income'

Dividend yield by index

Source: Bloomberg (as at 16/04/2024)



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dividend yield of the FTSE 100 and 250 indices is currently among the smallest seen over the last 20 years.

Managers Sue Noffke and Matt Bennison have a combined investment experience of 44 years and are supported by the wider Schroders research team. They hold a concentrated portfolio of between 35 to 50 companies, with a focus on healthy finances, a proven management team and a strong competitive advantage. As with SCP, the trust's sweet spot is companies with pricing power, unique assets and in sectors with structural tailwinds. They can invest 20% of the trust in overseas companies but are not currently using this option due to the valuation opportunities they see in the UK market. SCF is also currently trading on a wider discount to net asset value than the AIC Equity Income peer group, which could provide a boost to returns if the discount narrows.

Looking ahead

The conditions for a recovery in UK equities seem to be in place: strong company fundamentals, attractive valuations, an improving economic outlook and a more positive regulatory environment. The missing piece of the jigsaw is the corresponding shift in investor sentiment and the timing of this is harder to predict, however investors taking a longer-term view have historically been rewarded with strong returns.

The final word goes to the late US investor John Templeton, who remarked: "Bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell.

Read more about the Schroders range of UK trusts

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