

TRANSCRIPT: EPISODE 305

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. This week we have something a little different in terms of our format. We are joined by four fund managers and our very own research director, Juliet Schooling Latter, to take a closer look at UK equities.

[INTERVIEW]

SW: So Juliet, let's jump in and start with the Spring Budget, where we heard the anticipated announcement of the British ISA, designed to give a boost to UK companies. Will this be a meaningful change for investors?

Juliet Schooling Latter (JSL): Well, I suppose only time will tell. I mean, I'm not sure that the sums likely to be invested are going to be enough to boost the UK stock market. It's a maximum of £5,000 on top of your ISA allowance, but actually the majority of ISA investors don't even utilise their full £20,000 allowance.

Matt Tonge (MT): I mean, I've seen different reports. Rough maths, assuming it comes in probably in 2025, I guess would be the earliest could come in. But you know, we're looking at a range of £1 - £1.5 billion extra capital from investors because most people don't fill up their ISA. Whether or not that makes a difference kind of depends on where it ends up and what part of the market it goes into. As with everything, the devil's in the detail, right? So it could be quite meaningful depending on where that capital ends up.

Hugh Sergeant (HS): To me it's much more about the principle. And then the principle is that UK companies, UK equities, matter, and that they're a very important part of the UK economy. It's always been the case in the UK that we've had a strong public equity market. You've got to go back a hundred plus years and we've had that. And at the moment, UK equities are very unloved and very low valuation. So anything the government can do to act as a catalyst, as a sponsor for people to look at this, to shine a light on the issue. So, that's what the British ISA represents.

SW: One way to deploy meaningful capital would be through mandated pension contributions. Concerns about this were highlighted in the budget, but nothing was *actually* done in terms of mandating a greater allocation to the UK. Is this not an obvious missed opportunity?

MT: Well, that's really interesting. So, if you think the budget wasn't supportive really of the BRISA (British ISA), which as I said, if it all ends up in index funds, it isn't going to massively support buying there. I think actually what they said about pension funds was the key thing in the budget. So, what he actually said was, what is going to force pension funds to do, is to publish how much they have in in UK equities.

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JSL: In other developed economies, pension funds largely have a considerable overweight their own home market. Whereas here, we're actually underweight UK equities, which I find quite shocking. Other developed markets sort of allocate between sort of 20% to 60% in their own domestic market, and that's a huge overweight compared with their weighting in a global index. Whereas in the UK, we own less than 3%, which is actually an underweight I think of about almost 40% to the UK's weighting in global markets.

Richard Hallett (RH): The chancellor Jeremy Hunt has talked about this before in the Mansion House Reforms, and this is a good starting point. But we believe really, if it comes through, it could be a really important boost for the UK smaller company market. And this could really boost valuations over the longer term, reinforcing the opportunity presented by smaller companies that are really low and compelling valuations at the moment. So, we think whilst the British ISA is a good starting point, what we really need to see is an unlocking of the pension fund industry and focusing and directing more of those flows into domestic stocks to really get things moving in the right direction.

JSL: It's actually a bit of a vicious circle because as we invest less in the UK, valuations go down, overseas investors see that [and] they reduce their holdings, the UK becomes cheaper and sort of round and round we go. I mean, I don't know if the government are actually going to do this, but I don't quite understand why they haven't already done it. You know, we've got British companies that are choosing to list overseas because valuations are so low here and we need to back British businesses now more than ever.

Scott McKenzie (SM): Essentially, we really have to find a way of making the UK stock market a more attractive place for companies to list. You know, we're not seeing any IPOs and, in many cases, we're seeing UK companies going and listing in Nasdaq, ARM Technology being a good, recent example.

I mean, regardless of whether you look at large, medium, or small companies in the UK, most observers would probably acknowledge that the UK market is very lowly valued at the moment. It's not been a good place to be in recent years, pretty much since the Brexit vote in 2016, you know, there's been a flight away from the UK and there are lots of good reasons for that.

SW: Do you think the Brexit vote hurt sentiment and UK companies more than anyone expected?

JSL: Prior to Brexit, I think we traded roughly in line with global markets, on approximately 15 times. But, since 2016, the UK's just sort of drifted lower and lower, hitting a discount of about 40% to the rest of the world at the end of last year. Companies are struggling without the supply of European labour, most notably in the hospitality business. And also Europe used to be our largest trading partner, but now trading with Europe involves so much red tape that this has hurt businesses that are both importing and exporting.

And on the sentiment side, your stock markets don't like uncertainty. And there was a wall of money that left the UK post-Brexit due to these concerns. And this money has sadly yet to return, hence the current low valuations. I think if we could just encourage UK investors to invest here, that could lead to a small uptick, which could then tempt the overseas investors back. We just really need to show the world that we're not irrelevant in the post-Brexit era. And if we don't believe in ourselves, how can we expect others to believe in us?

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SW: Okay, so, back to valuations. How do we get UK investors back? Why is it such a good time to be adding to UK equities?

HS: Well, there's various reasons. I mean, the starting point is UK equities are on sale, they're exceptionally cheap at the moment; you are paying less than 11 times earnings. And if you have in equities, a PE of 11, you've got an earnings yield of 9-10%, you should be getting at least that sort of return, 9-10% without a re-rating from UK equities. And that's a significant real return. So, it's a very strong reason in itself for allocating money to UK equities, the low starting valuation.

Now, obviously some of the biggest companies in the UK are exposed to what are seen as traditional industries and they're clearly not giving you the kind of NVIDIA type of growth dynamic.

SW: Well, as you say, the UK isn't exactly known for growth stocks. So aren't the opportunities in these traditional, 'old' businesses? I'm thinking oil & gas, miners, banks etc.

SM: Yeah, I mean, the composition of the UK stock market is very different to that of the US in particular. It's correct to say that there are some old economy sectors represented in the UK, particularly in the FTSE 100, you know, the larger indices do have a lot of exposure to sectors such as oil, mining and banks and those are relatively mature low growth sectors.

And as most people will understand, we also have a very low exposure to technology. And clearly technology has been a very significant driver of global stock market returns over the past decade. So, yeah, I think as a starting point, the FTSE 100, I would definitely agree has got a lot of mature sectors within it. I think as we move further down the market capitalisation, it becomes more interesting. The small and mid-cap sectors that we invest in predominantly, it's a much more diverse group of sectors there. There's more exposure to technology, far less exposure to banks, oils, mining, consumer staples, et cetera. So, it's a different nuance as you go further down the market cap.

HS: But they're good businesses, you know, they are global leading businesses - The Royal Dutch Shell is a global leading business; Unilever is a global leading business; Diageo is the largest spirits company in the world; HSBC has probably the biggest global footprint as a bank. And they're making attractive return on capital, they're not badly run businesses with low return on capital. They're attractive franchises with high return on capital, which should be able to generate attractive returns for from shareholders.

RH: I mean, there's a multitude of these really powerful structural growth stories right the way through the UK equity markets, across different sectors and different market capitalisations as well. And also what we're finding is that there's really good opportunities to buy global businesses listed in the UK, which have trading valuations of significant discounts to international comparisons.

SM: I think what's interesting about where we are today is it depends really on one's attitude towards risk and reward. My view is that investing in the UK today, there's a very, very significant margin for error as an investor. You've got very depressed valuations and a very, very poor general sentiment towards the market. So, that means that the vast majority of sectors and companies are trading very cheaply compared to those in other markets. So, it really depends on your risk-reward appetite. But you know, from my money as we sit here today, you're paid a huge margin for error to invest in UK stocks today.

SW: We had a guest a few weeks ago, Simon Murphy from Tyndall, who told us effectively valuations today are a once in a generation opportunity. And it's clear that valuations are so poor in comparison to their international peers as we've touched on a bit here, but are you seeing specific opportunities in the market? Is there a particular sweet spot of the market, or sector even, that's just too good to ignore?

RH: Well, I mean what we do is we have the flexibility to roam right the way across the market cap spectrum, and we're looking for companies with really the strongest long-term, growth potential, irrespective of their size. And the UK market is really just generally unloved by global investors and smaller companies are in particular out of favour. So, investors have sold out of them because concerns about global economic

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uncertainty, inflation and higher interest rates and so you're seeing this sort of double discount that you're getting right at the lower end of the equity market in smaller companies. We believe that's creating some really interesting opportunities.

So, looking ahead with inflation easing and expectations that central banks will start to cut interest rates this summer, we believe that there's a really good opportunity longer term for these sorts of companies. But we're also seeing plenty of good opportunities in the larger and the big cap companies that are really world class in their sectors and global leaders in their fields.

MT: I'd say the most interesting part is in the smaller companies part of the market, in some of these AIM companies. So, the AIM index has had a really bad two years of performance; it's down 30% in 2022, had another 7% last year. But if you look at all the FTSEs [indices], they were all up last year, the 50 small cap was up 10. There's been a big divergence in performance. A lot of that performance has come from rating compression whereby the multiples you're paying for companies, say the price earnings multiple is a lot lower than it has been historically. So, if I look back at all the data across my funds, segments of the market, the biggest valuation opportunity is in these smaller companies at the moment.

SM: One of the interesting things going back to that comparison with the US, if one looks at all of the comparable sectors in every category, the UK equivalents are far, far more lowly valued than they are in the US, whether that be engineering companies, oil companies, technology companies. No matter where we look, the UK equivalent companies tend to be much more lowly valued. And that's really across the board. As I say, across all the major sectors we can see this observation. So, it's not just about the technology aspect. You know, clearly technology is a huge part of the US and other global markets. It's a very small part of the UK, but even when you take that into account, you know, the individual sector comparisons are also, you know, at a huge discount.

If I look at our own area of a small and mid-cap, you know, what we've observed is that's the part of the market which has been hit hardest in the last three years.

SW: Hugh, you're our value expert here today so where are you finding the best value opportunities?

HS: I mean, it's a bit of a problem answering that question because there's so many opportunities. Small and mids is an interesting area. There are lots of areas of structural growth which have aggressively derated, you know, digital companies like Trainline, for example, which have de-rated over the last few years. So we find that sort of area attractive.

There's some traditional value sectors out there that look really attractive. Banks on four or five times earnings multiples, mining companies that are on very low multiples that are global leaders, like Rio, which are good inflation hedges if inflation comes back. There are quality compounders that have derated like Diageo, for example, has had a difficult last couple of years because everyone was drinking spirits during Covid and people are drinking less spirits at the moment.

And then the last area would be strategic value. So, we're seeing M&A. Acquirers know UK assets are completely the wrong price and therefore they're very active in buying UK companies. And one reason why we need more genuine, long-term capital into UK is to stop all these companies being taken private. But as long as the valuations remain so distressed, then that will happen.

SW: Is there anything else that can be a potential catalyst in the fortunes of UK equities?

SM: I mean, obviously there was chat in the budget last week about the BritISA, that in itself will not move the dial, but it reminds people that the UK market is open for business, and hopefully at the margin it will attract additional capital.

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HS: From my perspective there's a lot more they could be doing. Things they could be doing, for example, look at NatWest, they should get on with the retail offering of that and at a decent discount to the market price. They could be thinking about things like a sovereign wealth fund. You know, why not use the cash windfall taxes, for example, from the North Sea to start a sovereign wealth fund to invest in UK-quoted companies. Again, that will shine a light, act as a strong signal.

Stamp duty, we're actually uncompetitive with respect to that in the UK market, they should be looking at stamp duty. Can it be lowered or taken away completely. So, there are lots more that the government could be doing to shine a light on this very important issue.

I do think it's government and other institutions that just act as a catalyst - shine a light - that's what it is. You know, to say, Britain is back in business in terms of equities, we believe in our equity markets. It's an important component of the economy. It generates new capital and it's very important for creating wealth for investors. So let's do as much as we can do to shine a light.

SW: On that note, we'll leave it there. Britain is back in business. Juliet, Matt, Richard, Scott and Hugh, thank you all for talking to me today and helping to shine a light on the UK market and all it has to offer for investors.

For more information on the British ISA, the Spring Budget or to start researching UK equities today, please visit Fundcalibre.com and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.