

London Trip Report

The Case for UK Equities: Valuations Are Attractive Again

June 3 - 4, 2019

Executive Summary

Brexit is not expected to pose a major risk to equity portfolios, as managers prepare for the event and cut back risk

Carbon ETS was hit by an almost perfect storm in 2018 due to the collapse of gas prices, but in the long-run the issuance amount will be relevant and the MSR reform will eventually lead to an undersupplied market and prices above EUR 50

Value stocks with a quality bias were hurt most by the ongoing preference of growth over value, suffering from multiple compression - even though their earnings have not deteriorated

The start of the rate cutting cycle in Europe will create significant deflationary revenue headwinds for European banks, while the best emerging market financials and Fintech (payments) should continue to deliver strong growth

The equity market has seen extreme leadership changes leading to a large spread in the valuations of defensive stocks with their perceived secure growth (high) and cyclicals on fear of delay of the earnings recovery story (low)

Fund managers are poised to dive back into cyclicals after a correction and are preparing their wish list

The anticipation of further rate cuts has driven over USD 13 tn of worldwide debt into negative yields

UK Equity View

UK Equity Valuations Look Cheap

Martin Hughes from Toscafund Asset Management recently remarked that UK mid cap stocks are being hit by a perfect storm and that UK valuations are simply too low, while Ian Lance from fund manager RWC claimed that the valuation of UK equities as a group has dropped “back to the 90’s”.

A confluence of factors is at work and has de-rated – or even dislocated – UK equities. Both Martin Hughes, who runs the Tosca Opportunity Fund, and Ian Lance, the manager of the TM RWC UK Equity Income fund, maintain that valuations of UK equities look attractive versus other regions and therefore present buying opportunities, maybe even – according to Toscafund Asset Management - a “once in a generation investment opportunity into the UK equity market”.

So let us look at some of the factors that have affected UK equities. One of the obvious reasons that investors seem to have given up on UK equities is Brexit and its aftermath, i.e. the inability to find a solution to the impending exit from the European Union and the uncertainty associated with it. The new Prime Minister, Boris Johnson, is only the latest example of this development when he promised to lead the UK out of the European Union by 31st October – with or without a deal. Clearly, Brexit and its messy aftermath has spooked investors.

Since Brexit in 2016 investors have withdrawn £ 12 bn out of UK equity funds, as the figures of the Investment Association show. This testifies to the fact that UK equities are deeply out of favour and the international asset allocation to the UK remains close to an all-time low, while the outflows have added to the selling pressure.

More recently, the gating of Neil Woodford's eponymous UK Equity Income Fund has dealt another blow to the British equity market. The fund has liquidity problems and had to gate in June 2019. This aggravated the dislocation of the UK mid cap space, as it involved the forced selling of some positions at prices below normal valuations. As UK mid caps are more exposed to the domestic economy, they have borne the brunt of the Brexit fears.

Since 2016 UK equity income funds have suffered substantial redemptions – again with fears over Brexit underpinning poor returns. All in all, net outflows in the space totalled £ 18.4 bn. Obviously, Woodford's fund which had AuM of £ 10 bn two years ago and was gated at £ 3.5 bn in June was a big and specific contributor to those outflows.

As sentiment has soured and dragged UK mid caps down, the valuation gaps have become more pronounced. Toscafund Asset Management visualized the opportunity and published a table that shows that valuation metrics are between 20% (P/E ratio) and 50% (EV/EBITDA) lower than the longer-term levels, even though company fundamentals are as good as recent years:

FTSE 250 – Valuation history

Year end Dec	2015	2016	2017	2018	2019 E	2020 E
Valuation Metrics						
Price/Earnings	16.30	17.30	17.05	14.15	13.79	12.58
Price/Book Value	2.27	2.12	2.18	1.53	1.61	1.53
EV/Sales	1.54	1.56	1.61	1.13	1.18	1.13
EV/Ebitda	13.9	13.43	12.30	8.22	7.58	7.10
Dividend Yield	3.15	3.05	2.75	3.86	3.20	3.39
Fundamentals						
Return on Assets	2.70	2.16	2.54	1.61	2.21	2.32
Return on Equity	9.99	9.11	10.98	7.56	10.45	10.83

Source: Bloomberg

Source: Toscafund Asset Management, June 2019

Ian Lance also pointed out that the valuation of UK equities is “now standing at the biggest discount to MSCI World we have seen since the 1990s, while the gap between UK dividend yields and bond yields is as extreme as it has been since the First World War”.

These valuation gaps also become visible if we compare the valuation of the UK equity market to the rest of the world:

Valuations UK and Rest of World (January 2009=100)

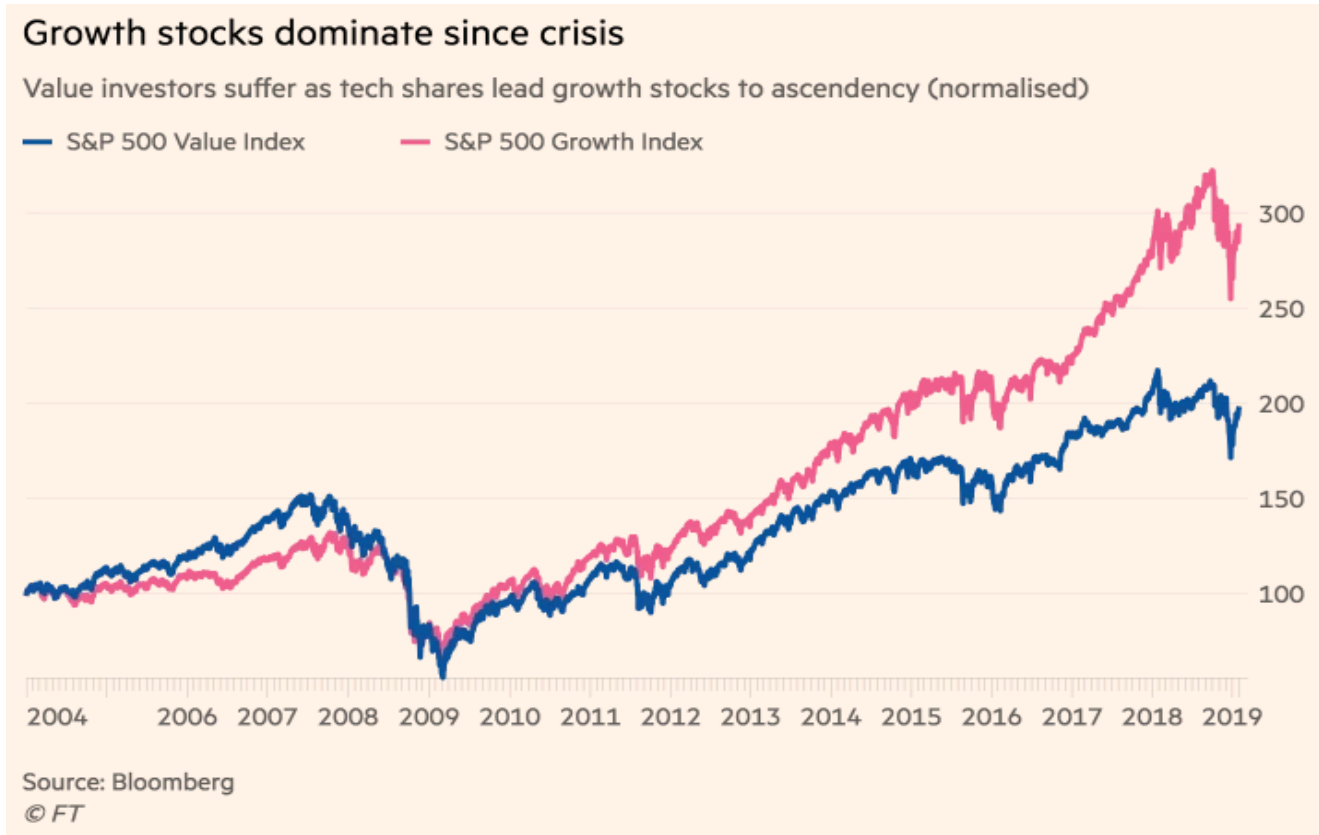


Source: Panmure Gordon, Refinitiv

Source: Toscafund Asset Management, June 2019

Next, a more global factor comes into play that has also heavily affected UK equity markets: Value stocks have globally underperformed growth stocks by a wide margin for a variety of reasons. It seems that the boom in passive investing siphoned more and more money off into

a limited group of tech stocks (i.e. such as the FANG stocks) that delivered strong earnings growth. As investors chased fast-growing companies, the return of the S&P 500 Growth Index (+71%) in the U.S. was more than double that of the corresponding Value Index (+34%) in the last five years.



Ian Lance was quick to note that the value style was particularly hard hit in the UK market and that the “poor performance over the last two years is entirely due to a valuation de-rating more severe than any time during the last 30 years”. The continued trend to de-rating of value has created valuation differences between value equities and growth equities not seen for several decades. And, as Lance highlighted, the companies themselves are doing well. Instead, it is sentiment that has de-rated value companies.

What does it mean for investors? Obviously, both fund managers are talking their book and their assessments should be taken with a grain of salt.

It seems, however, that notably equities at the intersection of UK value stocks and mid caps have suffered most from the recent developments. Yet the UK is the fifth largest economy in the world and will eventually continue to grow over time – despite a Brexit dent. The fundamentals of long-term underlying growth is supported by rising population numbers due to the birth rate. And it is not inconceivable that a pragmatic Brexit solution will be brokered. As most of the negatives are already priced in and the currency has already considerably devalued, the case for investing in UK equities with a three to five year horizon looks compelling. Not least because you probably want to buy value when investors are asking: “Is value dead?”