AA View

UK equities: The pandemic is not the only headache

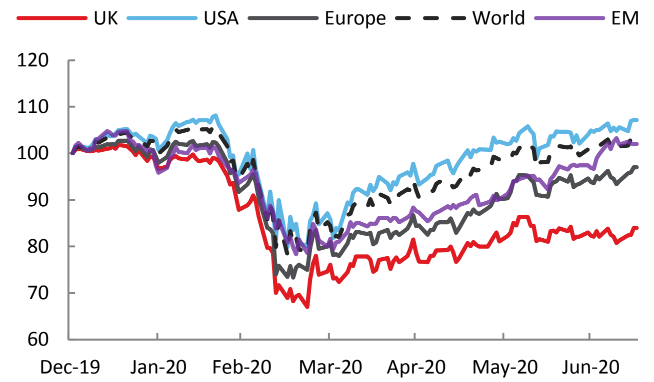
Summary

- UK equities have performed poorly this year but have also underperformed since the Global Financial Crisis.
- Brexit is not the only cause – the struggle for profits in the financials and energy sectors, as well as the structural underweight to technology are major factors.
- However, Brexit will likely be a major headwind to UK equities, should only a "thin" free-trade agreement be signed.
- Dividends are also under threat in the medium-term.
- Standalone UK allocations should be managed carefully to offset these drags to performance, whilst a long-term target towards more global market-weighted exposure makes sense.

UK equity underperformance is marked this year

Equity markets have been on a rollercoaster ride this year. They fell into a bear market in March as the full extent of the pandemic revealed itself, but then bounced back sharply as governments and central banks reacted with huge stimulus measures, propping up failing troubled sectors, mitigating an unemployment surge and easing liquidity in the markets. However, as the chart shows, the UK has been an outlier, with barely any bounce back at all. To July 15th, the MSCI UK index is still down around 16%, whilst the MSCI World and the MSCI USA indices are now up 3.5% and over 7% year-to-date in sterling terms. Of course, the depreciation of sterling has helped to boost non-UK returns, but the UK underperformance is stark whichever way we look at the numbers.

UK stocks fail to bounce as they have elsewhere
MSCI total returns in GBP, January 2020 = 100



Source: Factset, data as at July 15th, 2020

Is this underperformance due to the UK being especially hard hit by Covid-19? Or is it due to Brexit? These are some of the

Market data sourced from Factset.

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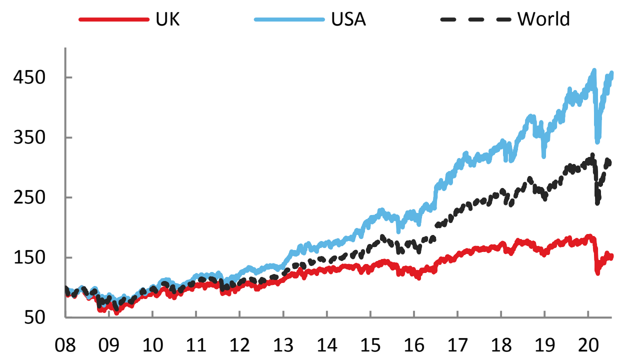
reasons for this year's poor performance, but they really can't explain the longer-term underperformance.

The underperformance since 2008 is equally stark

The chart below shows a massive 300% underperformance of UK equities relative to US equities since the onset of the Global Financial Crisis in 2008. Indeed, this is the major reason why UK equities have lagged the MSCI World index too.

UK equities underperform the US since the GFC
MSCI total returns in GBP, January 2008 = 100



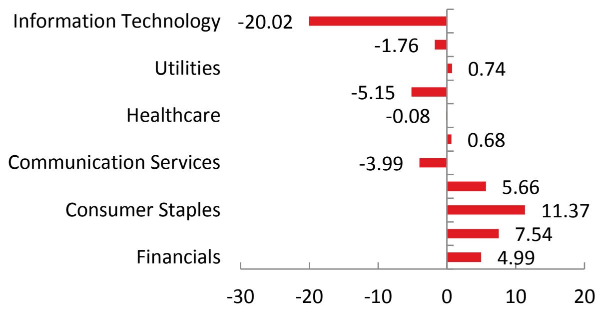
Source: Factset, data as at July 15th, 2020

However, it is also important to note that the outperformance of US equities is similarly large relative to European and Emerging Market stocks. So, the story of the past decade is more about US outperformance than UK underperformance. A major underlying reason is well-known – a small number of US technology stocks have grown to dominate, both the US index and the World.

The UK index has few technology stocks

The fact that technology has led the way in the past decade is an important headwind for the UK, as it is significantly underweight this sector.

Big underweight to technology in UK vs World
Sector weight of MSCI UK relative to MSCI World index



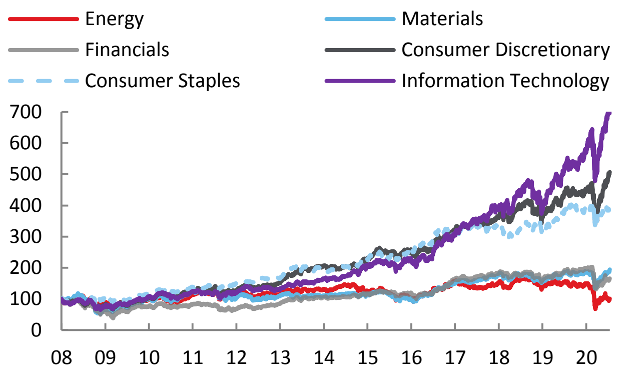
Source: MSCI, data as at end-June 2020

To add some context to the 20% underweight of technology companies, the UK index only has a 1.3% weighting to the sector – there was simply no way for the UK index to participate in the tech rally. But other weightings also provide clues to the drivers of UK equity underperformance. In particular, the overweight in the financials and energy sectors are important.

In terms of financials, many have struggled to earn strong profits since the global financial crisis, as increased regulation and ultra-low interest rates (meaning a low net interest margin) have limited scope to outperform.

Meanwhile, the energy and materials companies may be UK-registered, but virtually all of their profits come from global operations and their performance is not linked to the strength of the UK economy. Indeed, almost 75% of earnings for the MSCI UK companies is from overseas. Here, the same arguments for the underperformance apply as in our global value note[1] - commodity price volatility, falling profit margins and rising substitution to renewables.

All the action is in IT and consumer stocks
Total returns in GBP, selected MSCI World sectors, 2008 = 100



Source: Factset, data as at July 15th, 2020

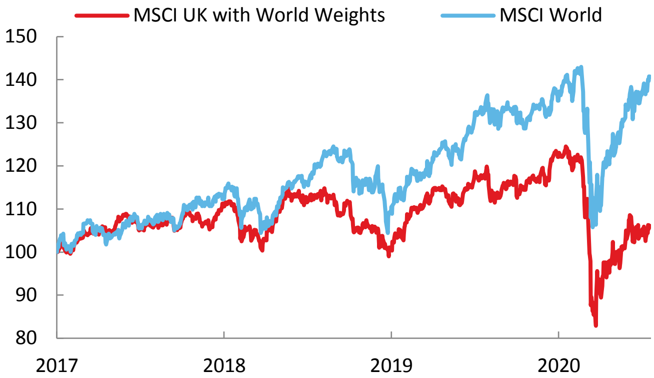
As the chart above shows, the poorest performing sectors in the MSCI World index include Energy, Financials and Materials – three of the largest weights in the UK index. Meanwhile, the best performing sectors in the World index include technology, consumer discretionary and consumer staples – only the consumer staples sector is overweight in the UK index whilst the other two are underweight.

We can go a little further by looking, not only at the impact of sector weights, but also at the specific companies within the UK index in those sectors. The chart below looks at the total returns of the MSCI UK index but with the weights of the MSCI World (static from January 2016), compared with the performance of the MSCI World. This way, we can see the relative performance of the two indices but without the impact of different sector weights. The marked underperformance of the UK index is clear.

[1] Will value stocks ever make a comeback? - 26 June 2020

Past performance is no guarantee of future results.

UK stocks underperform even within sectors
World weights from January 2016, Jan-2017 = 100, total return



Source: Factset and Aon calculations, data as at July 20th, 2020

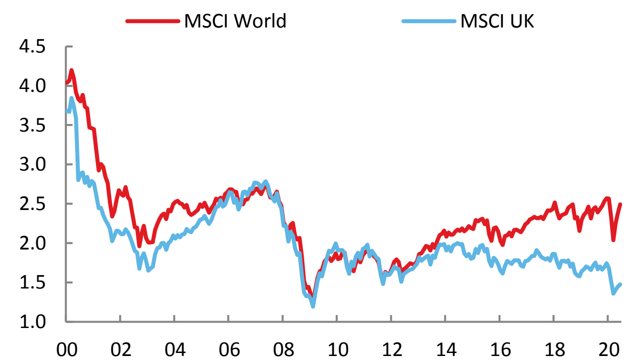
This begs the question, if even the companies within the sectors are underperforming and this is especially apparent since 2016, isn't this revealing the negative impact of Brexit? It is fair to say that there has been a headwind from Brexit but there is more at play here. The impact of equalising weights between the MSCI World and UK indices is to raise the allocation to technology stocks hugely and to lower those of financials, energy and consumer staples a little. The upshot is that the type of technology companies contained in the UK index have not participated to the same extent as the US tech stars. The Brexit headwind may be strongest for UK financials, but neither can we dismiss the impact from ultra-low interest rates and a flat yield curve. Brexit is not helpful, but the pain goes deeper.

The UK equity market has a value bias

We can look at this another way. The UK index has a clear value bias when we look at the prominent sectors, whilst it is deeply underweight the most important growth sector of the past decade. This is evident when we look at the price to book ratios of the MSCI UK index relative to the MSCI World index (see chart). This is the measure most commonly used to select value stocks.

Here we can clearly see that, not only are UK equities cheaper on this measure, the gap has grown significantly in recent years.

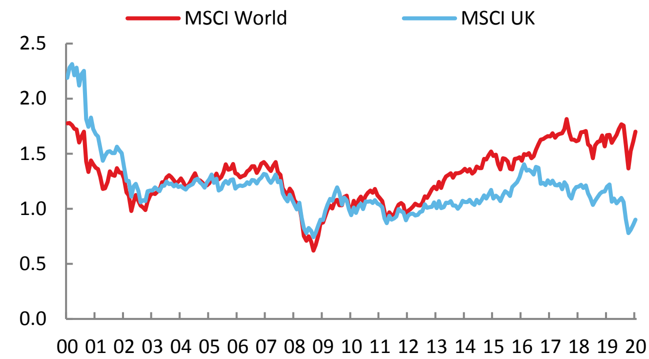
P/B valuation gap grows in the past decade
Price to book ratio of MSCI World and MSCI UK indices



Source: Factset, data as at July 15th, 2020

However, this is not the only valuation measure that is pointing to UK stocks being cheap relative to the World index. We can see this in price to earnings, price to cash flow or price to sales measures as well.

Most valuation metrics reveal a growing UK valuation gap
Price to sales ratio of MSCI World and MSCI UK indices



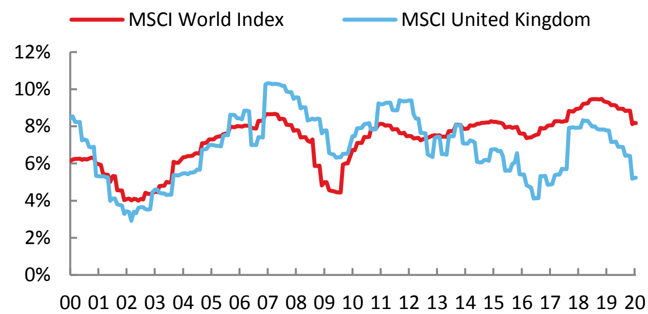
Source: Factset, data as at July 15th, 2020

Aside from the clear sector and style biases in the UK equity market, does its cheaper valuations merit an increased allocation? We do not think so.

UK stocks struggle for profitability

One important driver of the UK market's cheap valuations is the very real struggle for profitability. Net profit margins for the UK market was 5.2% at the end of June, compared with 8.2% for the MSCI World index. At the same time, just as can be seen in the valuation measures, the gap in margins has grown too. The woes in the financial and energy sectors have played a role, of course, while the fall in the value of sterling has seemingly not improved the profits picture for companies with global operations.

Profit margins are heading in the wrong direction
Net margins for MSCI World and UK indices



Source: Factset, data as at July 15th, 2020

Brexit unlikely to improve the picture

UK equities have been held back by the lack of technology firms in the index, as well as ongoing headwinds in its most important sectors, such as financials and energy. This year, the shutdown of the global economy has also hit UK equities especially hard.

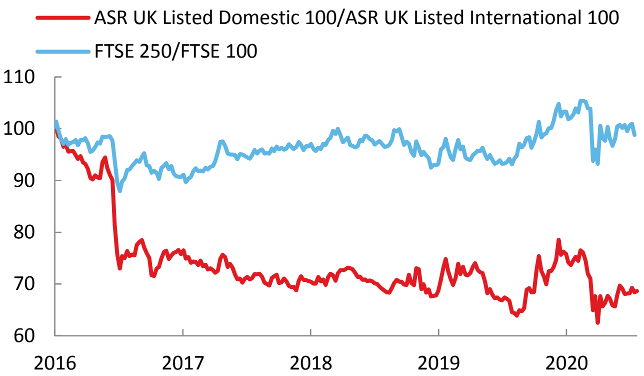
Past performance is no guarantee of future results.

Looking ahead, we do not see conditions getting better as the Brexit transition period ends and pandemic risks likely continue.

In terms of Brexit, the latest expectation seems to be that a rather basic or "thin" free-trade agreement is now likely and that several key services sectors, including finance, will see new barriers being erected. The kind of companies that will likely be relatively unaffected by a "thin" FTA are goods manufacturers and heavy industrials. Whilst there are certainly a small number of important players in these categories, the reality is that the UK equity market does not currently contain enough of the kind of companies that would thrive with the UK outside of the EU without specific trade agreements.

We can see the significant impact that the Brexit vote has had on the most domestically exposed UK stocks in the chart below. Note that a comparison of large and mid-cap stocks shows less impact. A falling line indicates the underperformance of domestic (FTSE 250) stocks relative to internationally exposed (FTSE 100) stocks. The domestic index, as constructed by ASR, remains over 30% below pre-referendum levels.

Domestic stocks have not recovered from the EU vote

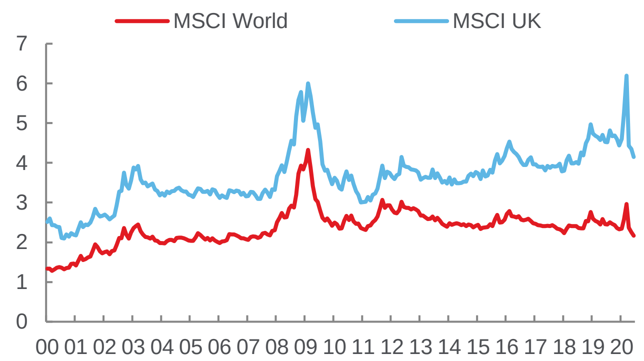


Source: ASR, data as at July 20th, 2020

Beware the dividend advantage

One of the major attractions of UK equities is the high level of income from dividends. Indeed, the dividend yield of the MSCI UK has far outstripped the World index for decades.

Income from UK equities is an advantage
Dividend yield of MSCI World and MSCI UK indices

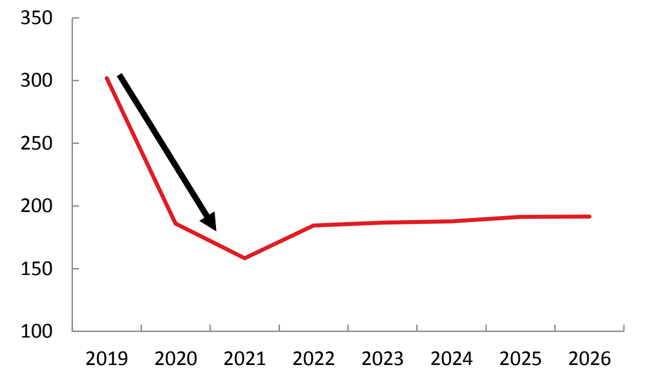


Source: Factset, data as at July 15th, 2020

This is as much a reflection of corporate culture than profitability as we have shown. By far the most important channel of investor value in the US is share buybacks, for example, so the attraction of higher yields is very much dependent on the investor's needs.

Nonetheless, the outlook for dividends is also uncertain now. In response to the enormous fall-off in demand, many of the largest UK companies have been announcing dividend cuts for this year. 48 members of the FTSE 100 have cut, deferred or cancelled payments this year. This would be the second consecutive year of falling dividend pay-outs and would take them back to levels last seen in 2014.

Dividends cut back sharply with little recovery seen
FTSE 100 dividend futures, dividend per share in £



Source: Factset, data as at June 30th, 2020

So far, many companies are hoping for a strong second half of the year and further improvement in 2021. This is the hope of many, of course, but it's an outcome that is still highly uncertain.

Our strategic view – avoid any excessive home bias

Overall, the outlook for UK equities looks uncertain over the medium-term, with several headwinds that are unlikely to ease soon. Given this outlook, UK allocations need to be managed carefully to offset any potential drag to portfolio returns.

Over time, we recommend a target of reducing large UK weightings and moving them closer to their global market capitalisation weights. We recognise some UK investors will have a preference for having a bigger investment presence in the home market than its relative size in global equity markets would merit. However, this approach remains unfriendly from an investment return standpoint.

Past performance is no guarantee of future results.

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We believe that the medium term (1–3 years) has been under-exploited as a source of investment performance. Maintaining medium term views that complement our expectations for the long term, we help our clients to determine when to make changes to their investment strategy.

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