BROOKS MACDONALD

Is It Time To Look At The UK?

May 2024

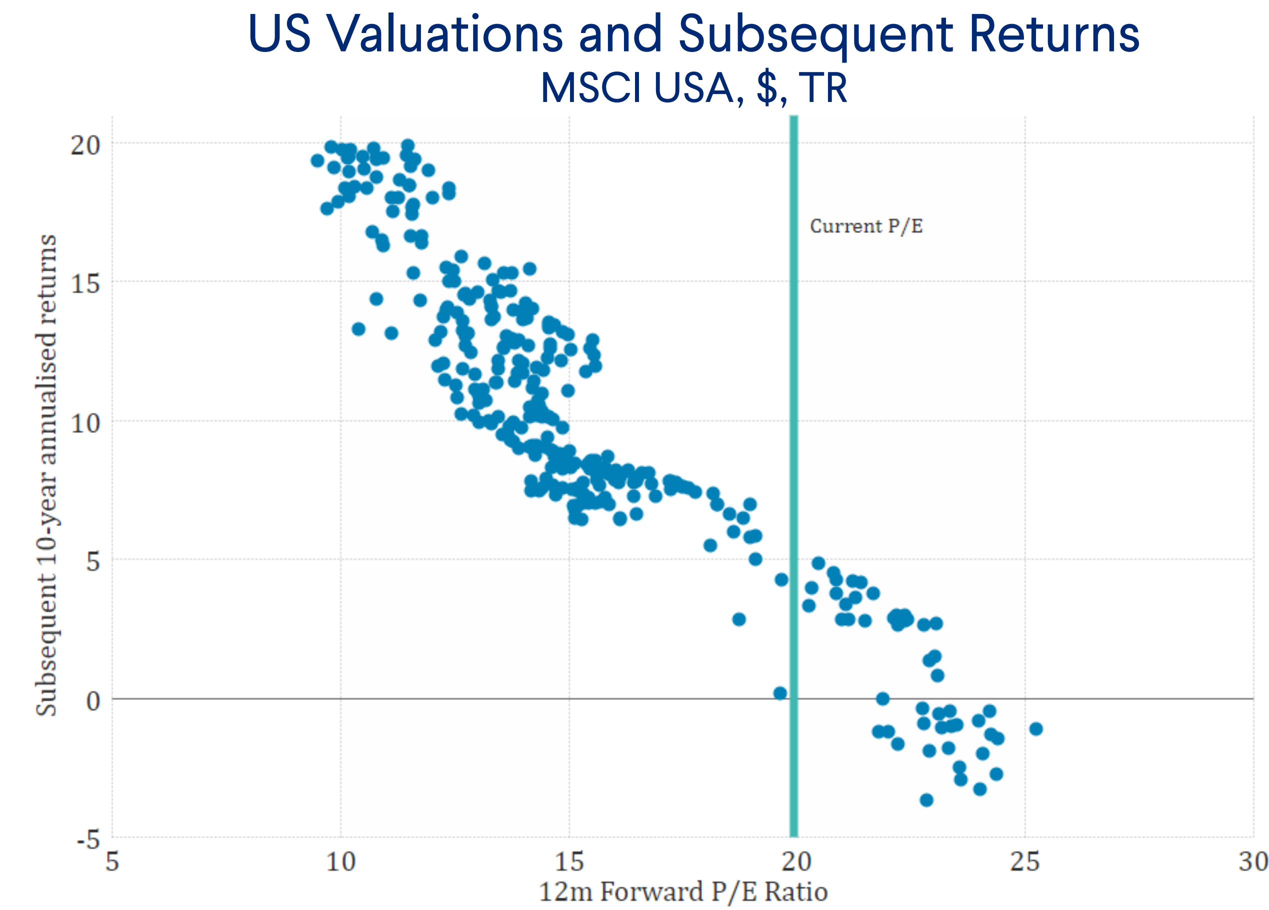
Michael Toolan & Joshua Herson take a look at the column inches and emotive headlines that have been dedicated to the decision, by a number of high profile UK Investors, to materially change their allocations to UK assets in favour of US assets.

Headlines touting the continued demise of London as a world leading financial centre to patriotic criticism for lack of support for 'our domestic market', continue to cause concern for investors. While all interesting perspectives, we approach it from a slightly different angle.

Our first priority for our clients, regardless of risk profile or specific mandate, is to generate the best possible risk-adjusted returns. While we fully appreciate the need for a healthy and well capitalised London market to provide working capital for private business – a critical part of the UK domestic economy – our fiduciary duty of care is to our clients and their financial security, not the UK economy.

The US stock market gives investors access to world leading businesses, but this typically comes at a price. Undoubtedly, we want meaningful exposure here, but we know we need to tread carefully. The most enduring correlation in financial markets is the relationship between the price you pay for an asset and the longer-term returns you get from it. This is often overlooked by a common mistaken belief that buying a great business automatically means that you will get great returns. Microsoft is the most valuable company in the world today and therefore arguably the 'best business' but had you bought it at its high in the TMT bubble in 1999, you would have had to wait 17 years to be up on your investment. Price matters more than any other factor.

US Valuations and Subsequent Returns
MSCI USA, $, TR



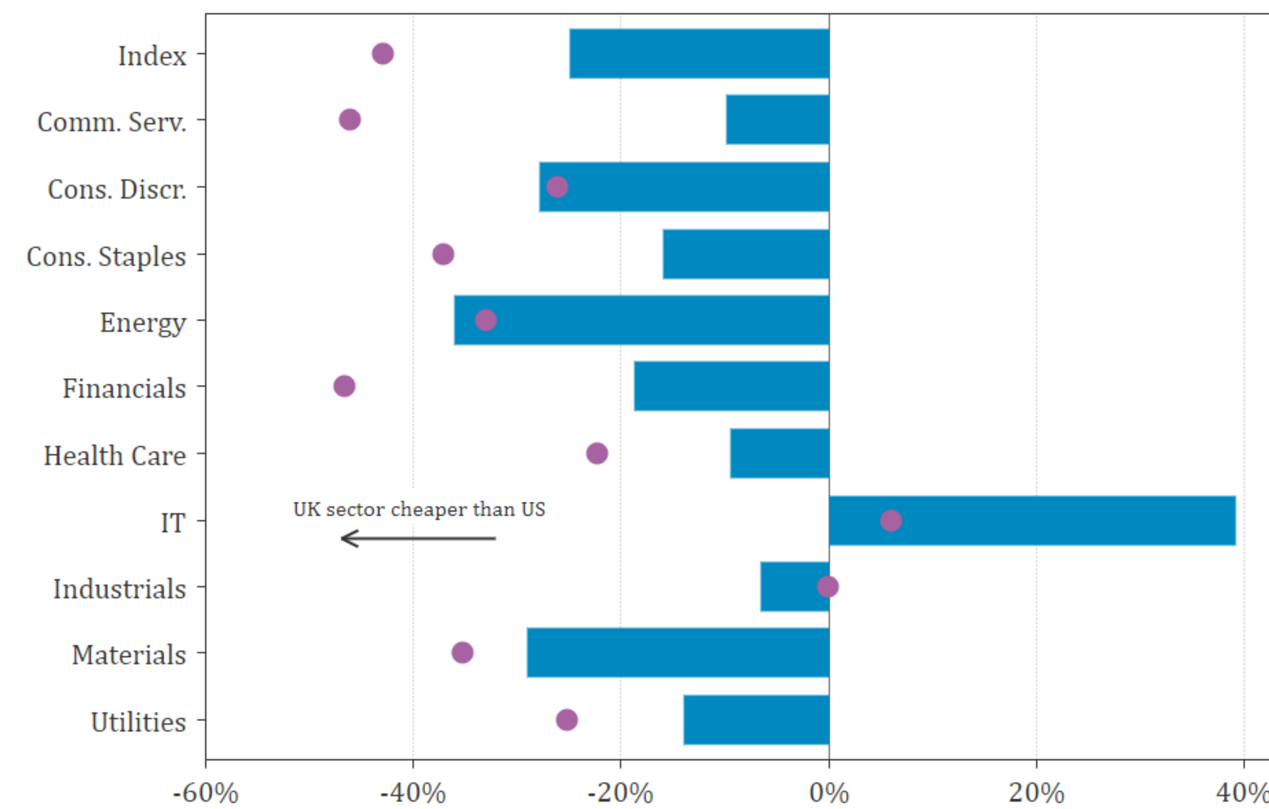
Source: LSEG Datastream. Data as at 30th April 2024.

Trying to pinpoint a single catalyst for UK re-rating is impossible. Instead, we see a powerful combination of factors that could lead to strong investment returns.

Valuation

Fundamentally valuation matters. While the UK does not offer exposure to any of the largest and most dominant technology companies, there are other sectors that are important to get exposure to in a balanced portfolio. These can be bought materially cheaper in the UK than the US. Despite the strong recent performance of UK equities, the market remains cheap on both an absolute and relative basis. Importantly, the market is cheap against its own history. This is key. The composition of the UK and US market are structurally different and therefore like for like comparisons on P/E alone are far too simplistic.

MSCI UK relative valuations versus MSCI US
% relative discount/premium based on 12-month forward P/E ratios



Source: LSEG Datastream. Data as at 2nd May 2024.

But what we can say is that US peers demand a significant valuation premium to equivalent UK listed assets.

The energy majors provide a fine example. Shell and BP are highly efficient energy businesses that are also at the forefront of the energy transition, investing heavily into renewables. In contrast, US listed energy giants are a long way behind in this inevitable transition and still demand a significant valuation premium. UK businesses from this perspective are being penalised for investing in the future. It could be argued the walk back from some renewable investment in recent months reflects managements' frustration in that not being appreciated.

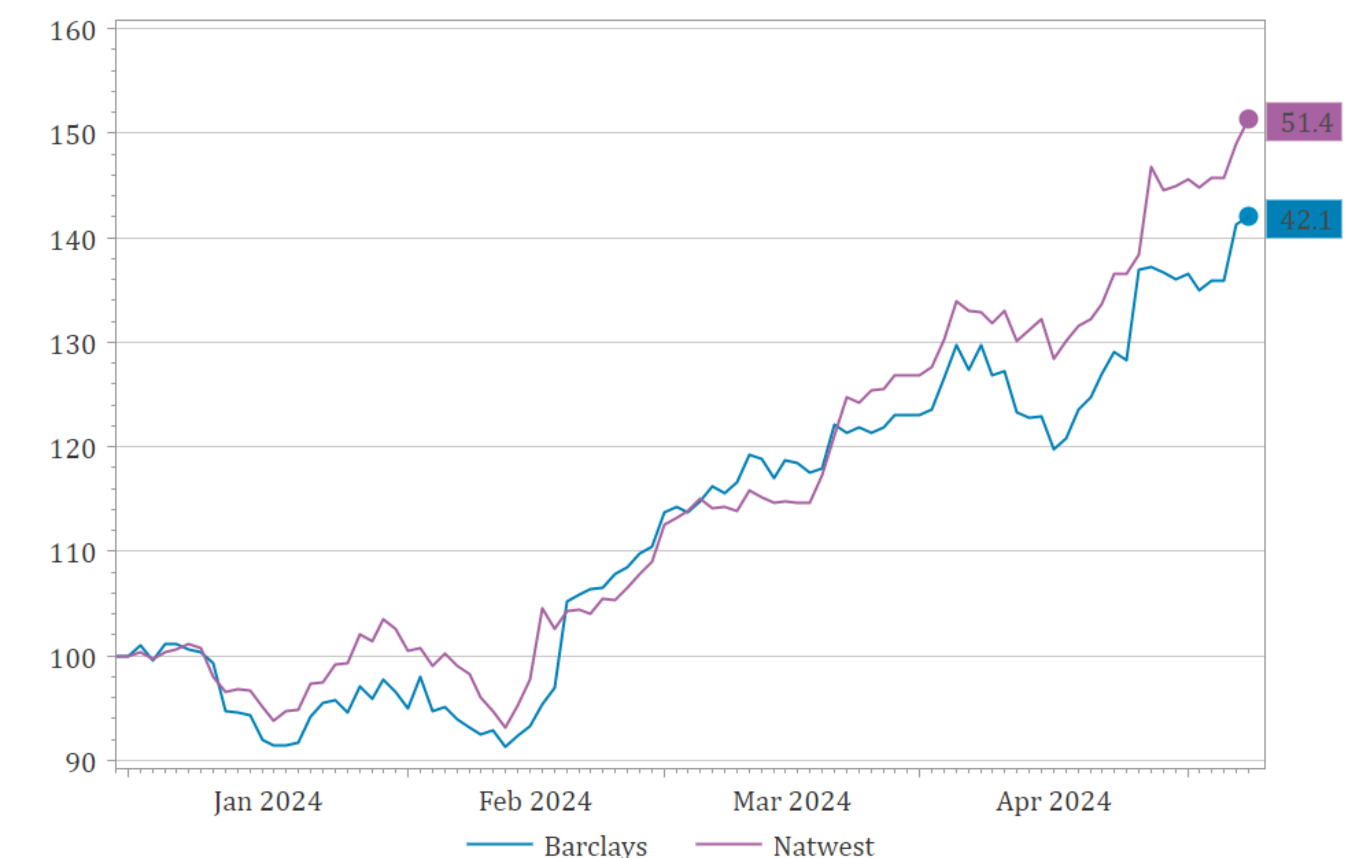
Buybacks and De-equitisation

We think this is a very powerful trend. The operational performance of UK PLCs has been strong, and the market in aggregate demonstrates robust cash flow generation while balance sheets are healthy. However, many management teams have not seen this reflected in share price appreciation. We think this is primarily due to a lack of marginal buyers as the herd moved to 'international benchmarks'. As a result, many companies are simply buying back and cancelling their stock, thereby increasing both earnings and dividends per share.

UK banks as a case study, have been using their strong free cashflows to buyback stock well below book value, with a significant amount of their entire market cap having been returned to shareholders in the last couple of years. We believe this is one factor that has resulted in encouraging share price appreciation. More broadly, around half of companies included in the MSCI UK Index have bought back shares in the past year, the highest percentage of any market in the world.

YTD gains for NatWest and Barclays

Rebased to last year end, number shown is % return YTD, TR, £



Source: LSEG Datastream. Data as at 8th May 2024.

Macro

Inflation has been falling rapidly and it is probable that it will hit the 2% target later this year. This may give the Bank of England room to cut rates and it is possible this cut will come before the Fed. This policy divergence will draw international attention back to the UK.

Furthermore, UK savings ratios remain elevated at c.10% and the UK consumer could be in a position to drive a powerful cyclical recovery. This coupled with robust PMI data, the strongest in the G7, leads us to believe that only a small amount of monetary easing could materially increase consumer confidence and lead to a strong economic rebound.

Domestic political risk

UK politics is no longer the tail risk that has plagued confidence since the Brexit vote and the election here is less divisive than the US. Instead, both major parties appear relatively business friendly and understand the importance of functioning capital markets. In this sense we anticipate more market reform, and the British ISA is likely just the start.

M&A

It has become clear that overseas investors have started to take notice of the valuation opportunity. This is reflected in the significant pick up in M&A we have seen from both PE and corporates. Shareholders are actively defending premiums, but we also sympathise with management teams, who for years have delivered strong operating performance but not seen this reflected in share prices.

We would also highlight how much of this activity is occurring in the cyclical part of the market, where valuations are particularly attractive, rather than the 'fallen angels'. This has largely gone unnoticed as the majority has occurred in the mid and small cap stocks. However, the bid for Anglo American is the kind of bell ringing M&A that really grabs attention.

In conclusion, we believe both the US and UK markets justify a meaningful allocation of the equity exposure in a balanced portfolio today.

While the US has been a significant contributor to returns over the past decade or more, the UK has more recently been generating stronger returns and critically, from a risk adjusted perspective, those returns are coming from different parts of the market to the US. In an uncertain world, diversification and price remain paramount and the valuation opportunity in the UK market is, we believe, too good to ignore!

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