THE LEEDS COLLECTIVE

MARTIN CURRIE

UK EQUITIES

NOVEMBER 2022

FIREWORKS AT WESTMINSTER

As the nascent Conservative cabinet grapple with an explosive inauguration, UK equity investors can draw parallels with the foiled gunpowder plot of 1605.

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Executive summary

- The UK has navigated significant reform since the thwarted 'gunpowder plot' of 1605. Profound distinctions can be drawn between macro indicators, markets and defence spend.
- Political turmoil in the UK has subsided since the "Trussenomics" era, but the market is still longing for clarity under the nascent conservative leadership.
- Resilience has prevailed in large cap UK assets, which is the best performing asset class year-to-date amongst global indices.
- Inherent 'value' characteristics have buoyed UK large cap returns. However, these returns are concentrated amongst a modest selection of individual FTSE 100 constituents, providing opportunities for fundamental, active managers.
- Despite strong relative returns, the UK is trading on its lowest forward P/E ratio vs global markets on record.
- The UK continues to offer a healthy dividend yield, where sterling weakness is providing a tailwind.
- Real returns for UK small-and-mid cap businesses have outstripped that of all other UK asset classes over the last 20 years.
- The current period of relative small-and-mid cap underperformance vs the broad UK market exceeds that of the Covid-19 pandemic, Brexit, and indeed the Global Financial Crisis.
- Indiscriminate selling pressure has led to a de-rating of FTSE 250 stocks, now trading 30% beneath their long term average.
- Fundamentals remain strong in many small-and-mid cap businesses, which are exposed to structural growth trends. Weak sterling increases the value of overseas earnings and the prospect of enhanced M&A activity.
- By investing in quality businesses in strong cash positions, we believe that compelling opportunities are presenting themselves amid small-and-mid cap markets.

Remember, remember the 5th of November...

417 years after the infamous gunpowder plot of 1605, Guy Fawkes' thwarted conspiracy is still rhymed across the United Kingdom as children attempt to comprehend such a sinister plot of treason.

A Roman Catholic convert, Guy Fawkes had earlier left for mainland Europe to gather support for a Catholic rebellion in Protestant England. Generating little success, he made a name for himself enlisting in the Spanish army to fight Protestant Dutch Reformers in the Eighty Years' War. It was not long before the adventurous soldier – relatively unknown on English shores – caught the attention of a band of Catholic rebels. Rebel leader Robert Catesby dispatched a follower to The Netherlands to repatriate Fawkes, pledging commitment to an audacious plot to assassinate the Protestant King James I in reprisal for the increasing oppression of Roman Catholics in England. In the months that followed, the daring intricacies of the plot were formulated and prepared. On the opening night of parliament, Fawkes manned the 36 barrels of gunpowder strategically positioned in a rented undercroft beneath the House of Lords. Primed to detonate and destroy the House and its members, it was only an anonymous letter which aroused the suspicions of the Monarch. King James I ordered a search of the parliamentary cellars in the early hours of 5th November 1605, where a startled Guy Fawkes was promptly arrested, and then interrogated, tortured, and executed. Londoners were encouraged to rejoice the King's narrow escape from assassination by lighting bonfires across the city in an act of thanksgiving.

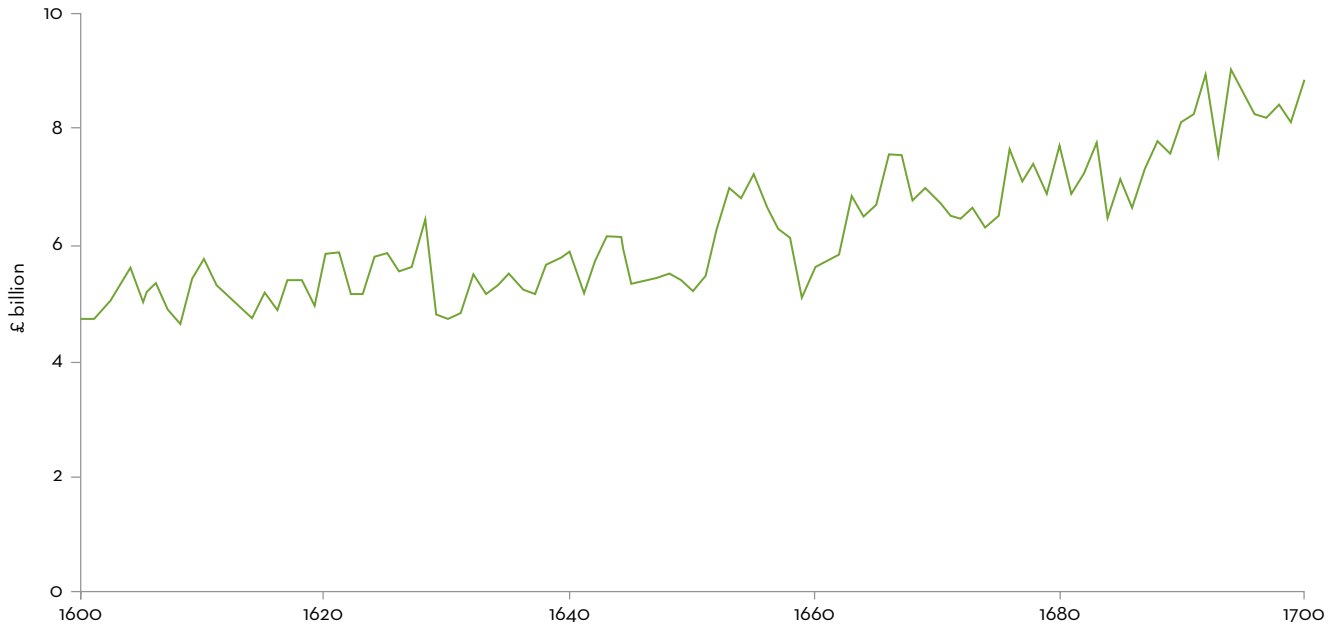
Although Guy Fawkes was by no means the mastermind behind the plot, his enduring legacy remains prominent today. One is hard pressed to visit a British community in the early stages of November and not encounter a local 'bonfire night', acknowledging Fawkes' existence through a blazing effigy. But the nation has evolved since the Elizabethan era and indeed the subsequent rule of the Stuart dynasty from 1603. Capital punishment was abolished in 1969 – were this the case in 1603, ill-fated Fawkes may have avoided execution. And the nation was over a century away from the birth of today's Kingdom of Great Britain, although some may argue that the union of the Scottish and English Crowns in 1603 was a meaningful step towards a united parliament.

"Primed to detonate and destroy the House and its members, it was only an anonymous letter which aroused the suspicions of the Monarch. King James I ordered a search of the parliamentary cellars in the early hours of 5th November 1605, where a startled Guy Fawkes was promptly arrested."

As expected, the 17th century economy had also been subjected to profound development. Stuart London was the fastest expanding city in Europe, growing from 200,000 inhabitants in 1600 to around 575,000 in 1700. The capital further exploited its geopolitical advantage to establish itself at the centre of a growing international network of trade with both the east and west. English GDP boomed as a result, nearly doubling during the 17th century. Naturally, the economy remained largely based on agriculture and traditional industries such as coal mining, wool, cloth, and fishing. Early Stuart governments cashed in on commerce by selling exclusive monopolies on trading in specific goods. As opposition to such monopoly capitalism grew, these licences were later abolished. However, the eventual reintroduction under the guise of a 'patent,' still exists in today's legal framework[1].

Although London remains the largest contributor to GDP (per capita) today, the inter-era parallels extend no further. Considering the production-heavy nature of the 17th century economy, stark contrasts are observed in today's core drivers of GDP. Emphasis has refocussed on services industries including technology and finance, which now account for the lion's share of UK GDP[2].

GDP in England (adjusted for inflation): 1600-1700



Source: *https://ourworldindata.org/*, as at 31/10/2022

The predominant stock exchange of the period was the Amsterdam Stock Exchange, founded in 1602 along with the incorporation of the Dutch East India Company. Still in existence today, it remains the oldest stock exchange in the world and contributed to the emergence and subsequent collapse of the tulip bubble in 1637. The London Stock Exchange was not far behind Amsterdam, leveraging the growth in shipping trade driven by the Iberian empires. The Muscovy Company was a product of these evolving commerce habits, first chartered in 1555 and later owning the monopoly on trade between England and Muscovy. In fact, the company traded until 1917 and is broadly considered to be the first major chartered joint stock business on record. The origins of the London Stock Exchange can be traced to the trading of shares in such shipping companies amongst 17th century coffee houses[1].

Today's stock exchanges are very different places both in operation and composition. The main market of the London Stock Exchange is one of the world's most diverse stock markets, where constituents from 40 different sectors can access real-time pricing, deep pools of capital and significant media and research coverage. The growth in electronic trading has swiftly condemned physical share certificates to defunct status. Although nearly a quarter of the FTSE All Share is allocated to real asset/commodity companies, today's precious metal and oil giants are vastly distinct to the agricultural operations of the 17th century traders.

[1]Source: www.english-heritage.org.uk, as at 31/10/2022.

[2]Source: https://ourworldindata.org/, as at 31/10/2022.

Defence spend was increasing in 17th century England, particularly as prevailing religious unrest culminated in civil war in 1642. Domestic suppliers of weapons and military equipment prospered beyond capacity and the Royalists in particular sought alternatives amongst foreign markets. Simultaneously, entrepreneurial innovation emerged as food and clothing for soldiers were sourced through 'general contractors', each looking to turn a profit through a supplying chain of subcontractors.

Defence companies remain prominent in today's UK market, including names such as QinetiQ and BAE Systems. European nations have moved to firm their defence budgets in recent months in response to the humanitarian tragedies witnessed from Russia's invasion of Ukraine. UK defence spend is expected to embark on a similar trajectory – most recently Ben Wallace committed to doubling military spend to £100bn by 2030. Whilst Mr Wallace will continue in his role as defence secretary under the nascent conservative leadership, prime minister Rishi Sunak has so far been tight-lipped on whether he will honour the enhanced defence spending pledged (3% of GDP) under the short-lived "Trussenomics" era.

The political turmoil that led to the collapse of the Liz Truss government is perhaps where some may draw closer comparisons to the events leading up to 1605. In recent years, Guy Fawkes has become the face of post-modern protest and anarchy. Whilst Fawkes chose to adopt radical measures to instil political change, Liz Truss was subjected to a Tory revolt after her failed 'pro-growth mini budget' led to devastating volatility amongst UK assets. Uncomfortably close to a systemic catastrophe, this eventuality was only circumnavigated by the decisive action of the Bank of England who stepped in to stabilise the spiralling gilt market. As Rishi Sunak prepares to stabilise his government, restoring public finances and trust in the Conservative party will be a priority. Despite Chancellor Jeremy Hunt's reversal of nearly all of Kwasi Kwarteng's 'mini budget' measures, public finances still require an additional £40bn per year in order to balance the books.

The government has earned some breathing space though, as markets have calmed amid the perception of an economically pragmatic cabinet. Relatively benign market conditions have moderated the government's borrowing costs but markets are still longing for the clarity that will not be assured until the Office for Budget Responsibility (OBR) issue their fiscal report. Now tabled for mid-November, Rishi Sunak has inherited a daunting task to overturn the largest Labour poll lead in 25 years, all before the next general election which will likely be held in 2024. We are hopeful that this near-systemic miss will resonate with politicians as a reminder that market forces must be considered in the formulation of future fiscal strategy.

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UK large cap assets

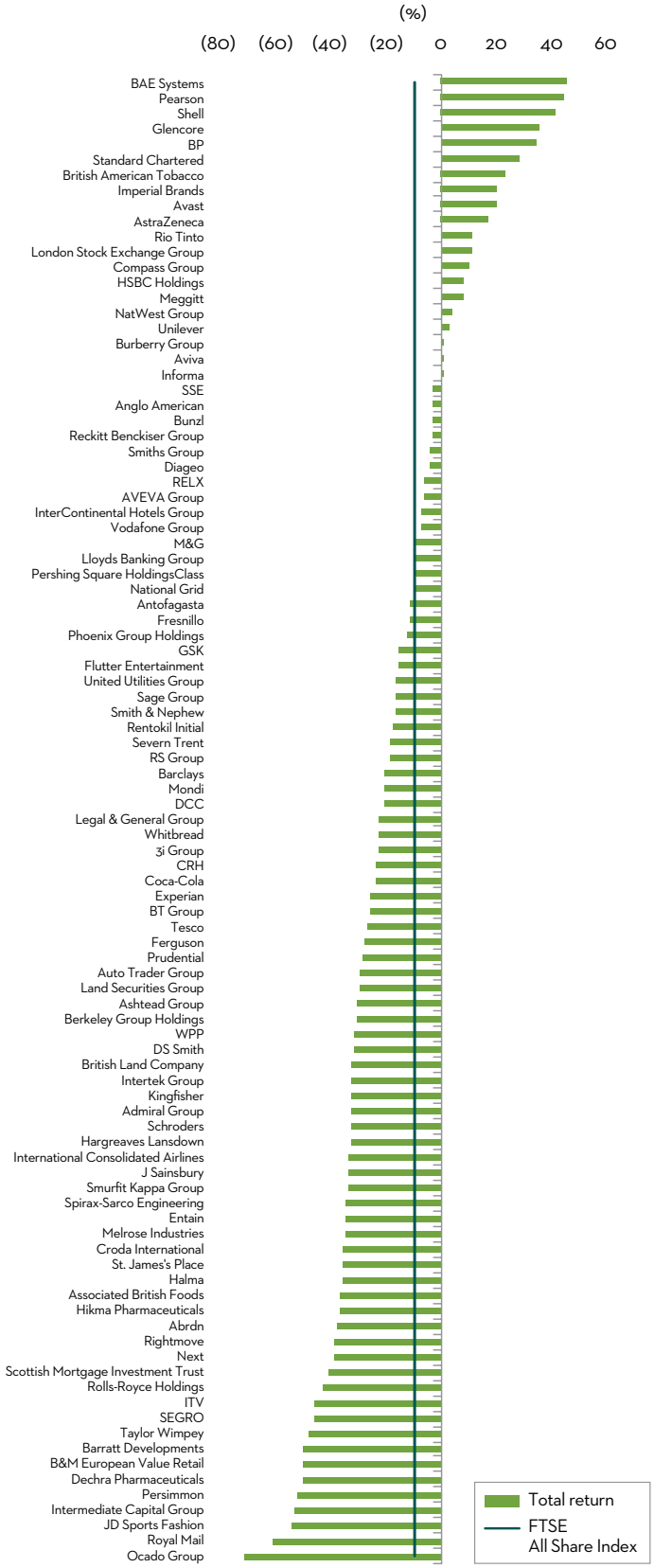
Invariably, global risk assets have struggled on a year-to-date basis. The UK has been no exception, where broad equities have retrenched by around 10%. However, UK investors have gained comfort on a relative basis where the resurgence of the region continues to outstrip that of global indices – the MSCI world has plunged 22% year-to-date[3]. Facing into the inflationary, economic, geopolitical, and indeed the UK's idiosyncratic political headwinds, the resilience of the UK market is innately present amongst large cap names.

The FTSE 100 is representative of around 80% of the UK market so the strong positive correlation amongst returns should come as no surprise. Considering the composition of the FTSE 100, we observe significant weightings to defensive havens such as tobacco, utilities, and healthcare. To some extent, these areas offer inherent inflation protection and have consequently fared well on a relative basis in response to the challenged economic outlook. Furthermore, commodity companies continue to report supernormal profits amid stubborn inflation and the persistently elevated price of oil. Although the oil price has somewhat moderated since the eye-watering peak of $120 per barrel, Q3 profits for both Shell and BP have more than doubled year-on-year. Shell's chief executive has even advocated renewed demands for windfall taxes to protect society's most vulnerable.

Large multi-nationals have also been a beneficiary of the weakened sterling environment year-to-date as the value of overseas earnings denominated in US dollars increases.

The prolonged style rotation in favour of value names continues to establish the FTSE 100 as a leading darling of global markets, at the expense of the growth-oriented benchmarks commonly utilised by technology or smaller company investors. But, despite the strong relative performance of the blue-chip index, there has been an overwhelming variance in the returns profile of each constituent year-to-date. A hypothetical passive allocation to the FTSE 100 at the start of the year would expose an investor to 63 companies that have lagged the broad UK market year-to-date[3]. Moreover, they would only be invested in 20 companies trading in positive territory since the turn of the year. This profound concentration of returns amongst a handful of large businesses presents a compelling opportunity for active UK large cap managers to add value through pragmatic, fundamental research.

FTSE 100 constituents vs FTSE All Share: Year-to-date returns



Source: Morningstar, as at 31/10/2022.

[3]Source: Morningstar, as at 31/10/2022.

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Despite leading global markets (measured in both local currencies and US dollar), the fact remains that the broad UK market has fallen 10% year-to-date[4]. Headwinds have engulfed the region in recent years subjected to Brexit uncertainty, societal lockdowns, and fractious political divide. Entering the decade, international (ex-UK) equities had scaled dizzying heights in the wake of one of the longest bull runs on record, as the market continued to re-rate highly valued US technology stocks. Notwithstanding this significant disconnect and the extraordinary market conditions endured in the past 2 years, we believe that UK equities remain exceptionally attractively priced.

Investors have considered the UK market a natural hunting ground for income for many years now - presently offering a dividend yield of 3.8%[5] – of which the FTSE 100 accounts for a colossal 91%. The UK's concentration in the mining sector continues to contribute significantly to the overall dividend despite dropping by 20% year-on-year[6]. Miners had been delivering record special dividend payouts through 2021 and 2022 as commodity companies continued to benefit from an inflationary windfall. As metal prices unwind, we expect to see a reduction in the growth rate of mining dividends. But, these mature businesses will no doubt continue to add a meaningful absolute contribution to the total UK payout.

Optically, we believe that oil and gas companies will continue to favour share buybacks over an increasingly scrutinised bumper dividend. Shell have announced a buyback aggregate of $10bn over the last two quarters alone. Buybacks can illustrate capital discipline and are often reflective of the confidence that management have in the valuation of the business.

A resurgence in banking dividends is of particular interest to investors as the sector is buoyed by hawkish central bank policy and the prospect of enhanced interest income. In Q3 2022, banks were the greatest contributor to dividend growth as NatWest delivered a record dividend to shareholders. We are mindful of the opacity of banking business models and the degree to which their destiny remains in their own hands – the regulatory halt on banking dividend payments is a not-so-distant memory, and suggestions of an interest income windfall tax are increasingly considered. The sector is however considered to be diverse in terms of constituent revenue drivers. Comparing Lloyd's – a pure-play on the UK consumer – to a globally exposed HSBC presents challenges in forming a broad sector opinion.

Significantly, 40% of UK dividends are declared in US dollars or Euros. The extraordinary retrenchment of the GBP is set to add a record £5.7bn to UK dividends this year[5]. Currencies are innately volatile, and many other factors are at play including the broad repricing of assets as a result of soaring bond yields, and the ongoing fallout from the Covid-19 pandemic. However, this FX adjustment serves as salient reminder of the geographical diversity inherent within UK large cap companies.

[4]Source: Morningstar, as at 31/10/2022.

[5]Source: FTSE Russell, as at 30/09/2022.

[6]Source: Link Group Q3 UK Dividend Monitor, as at 30/09/2022.

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UK small-and-mid cap assets

Presently, a 'rollercoaster ride' is one of the most appropriate analogies for the UK financial markets. A day doesn't seem to pass without another announcement from either Threadneedle St or Westminster condemning the markets into further negativity and selling pressure. This has been compounded within the UK small-and-mid cap area of the market given the lower levels of liquidity and being perceived as a proxy for the UK economy, resulting in a significant selloff versus the broader UK market.

Unfortunately, there are no indicators that the selloff has ended. Lights do not turn green, bells don't ring and even the most experienced investors are unable to call the exact bottom of the market. The critical point of capitulation presents itself when the marginal selling reverses into marginal buying – a guessing game clouded by futility.

Thus, focusing on company fundamentals, expected future returns, and the price being offered to participate presents itself as a pragmatic solution to the enhanced 'noise.' Amongst the barrage of negativity and selling pressure, opportunities are emerging within the UK small-and-mid cap market, and we believe that the compelling value in UK small-and-mid cap businesses should not be overlooked.

As a reminder, UK small-and-mid cap indices have generated annual real (ex-inflation) returns of 8-10% over the last 20 years, exceeding all other UK listed equity asset classes[7]. In part, this can be attributed to higher earnings growth of the constituent businesses, as well as mispricing opportunities through the compromised market efficiency which increases as one descends the UK capitalisation spectrum. Yet during times of heightened risk and a flight to safety, investors often overlook the long-term opportunity inherent within active management.

The material disconnect between large cap and small-and-mid cap returns has been particularly distinct year-to-date. The relative underperformance vs the FTSE All Share now surpasses significant historical periods of underperformance, including the March 2020 pandemic-induced selloff, the June 2016 Brexit slump and indeed the 2007/08 Global Financial Crisis. Small-and-mid cap companies are typically UK-centric, more exposed to UK sentiment and thus more sensitive to domestic earnings and economic challenges. Although business fundamentals remain strong in many cases, we continue to observe an indiscriminate selloff for many FTSE 250 companies, particularly amongst businesses considered cyclical or overly sensitive to rising rates and inflation. For example, industrial and consumer businesses are a material weighting within the small-and-mid cap realm. Both of these sectors are particularly sensitive to rising input costs and discretionary UK spend. Thus, headwinds emerge as inflation soars and the UK consumer grapples with a crippling cost-of-living crisis. In contrast, relative underweights to innately defensive businesses are prominent in the small-and-mid cap indices. As investors flock to safer havens such as tobacco, utility, or oil and gas companies, tailwinds have propelled the predominantly large cap businesses.

[7]Source: Morningstar, as at 31/10/2022.

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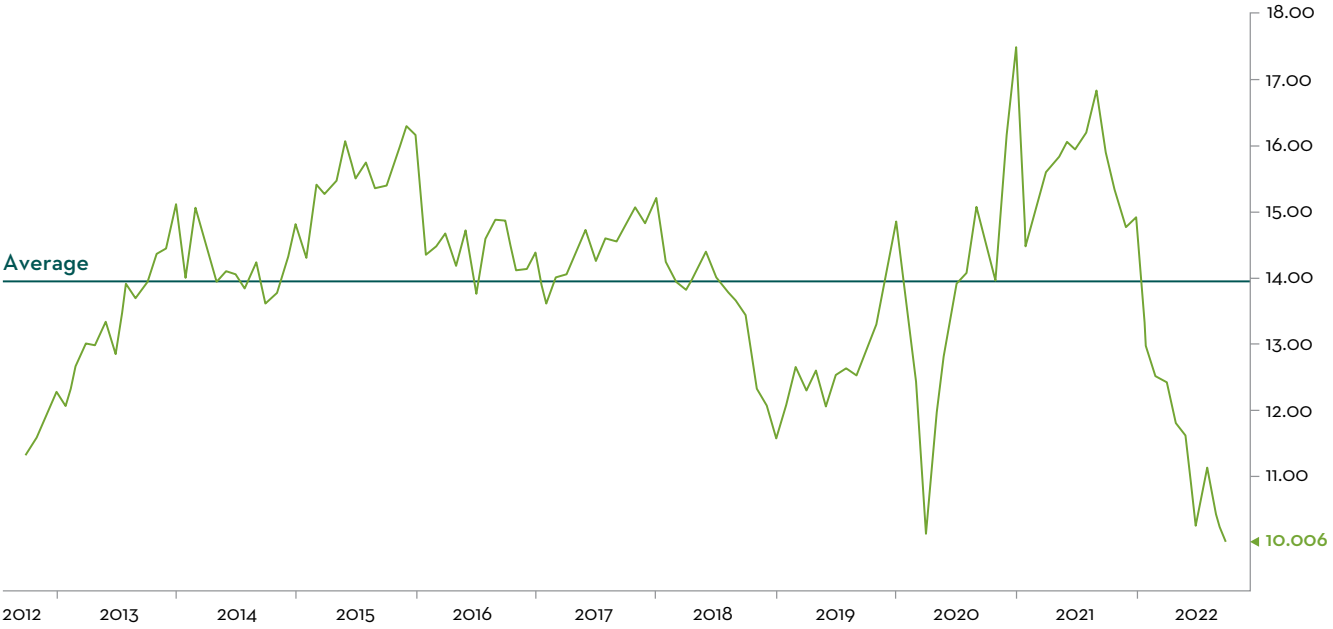
Therefore, the indiscriminate selling pressure on UK small-and-mid cap companies has led to a material de-rating of valuations. A price/earnings (P/E) ratio measures a business's earnings relative to their share price, and is broadly considered a measure of how 'cheap' company shares are. The estimated 12-month forward P/E ratio of the FTSE 250 index currently sits around 9.5x. Comparing to the long-term average of c.13-14x, a c.30% valuation discount attempts to price in the profit impact from an expected period of challenged macro data. To put this into perspective, FTSE 250 earnings retrenched by approximately 30% vs a 6% GDP contraction in the wake of the Global Financial Crisis. Assuming we are not entering a re-run of 2007/08, a wide margin of safety is priced in at these levels.

FTSE 250: PE ratio vs long term average PE ratio



Source: Bloomberg as at 31/08/2022.

Past performance is not a guide to future returns.

But one must remember, not all companies are the same, not all earnings are ultra-cyclical and not all companies are exposed to this magnitude of expected profit contraction. Many small-and-mid cap companies are aligned to structural growth markets, and this will continue to provide end market support as economic conditions worsen. Many companies are exiting a disruptive pandemic period through which they have strengthened financially, operationally, and competitively. The flexibility and resilience engrained in many companies during this period should not be underestimated.

Many small-and-mid cap companies generate revenue in overseas markets and are not wholly reliant on domestic UK operations. Given sterling's weakness, especially against the US dollar, overseas earnings are worth more in sterling terms which provides an underpin to profit forecasts. Within our Midcap portfolio, c.45% of the portfolios revenues are from markets in regions such as US, Europe, and Asia[8].

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[8]Source: Morningstar, as at 31/10/2022.

Equally, the weakness of sterling is enhancing the attraction of UK assets amongst overseas buyers. Private equity firms are harbouring significant dry powder which is now under pressure to be spent considering the inflationary upsurge. We continue to expect an increase in merger and acquisition (M&A) activity within the borders of the UK, where £41bn of deals have already closed this year[9]. Not only from these cash rich private equity investors, but also from other corporate buyers whose typical hunting ground has been the fertile UK small-and-mid cap territory. This can present a double-edged sword for shareholders – the average premium paid by an acquirer in H1 2022 was over 40% relative to pre-announcement valuations[10]. However, incumbent investors run the risk of foregoing even greater upside potential should they succumb to a take-out price that undervalues the company's long term earnings potential.

Our approach during such turbulent environments is to tune out the unnecessary noise. By focussing on the business and its end market fundamentals we can formulate an inherent valuation relative to the price inferred by the current market conditions. By adopting a long term, pragmatic, and proven investment approach we can assemble high conviction portfolios of quality companies. In our minds, this inherent resilience will not only survive the prevailing economic headwinds but will thrive once the turbulence settles. A core component of our research process is to identify businesses with strong balance sheets. In practice, over 50% of our UK small-and-mid cap portfolios hold net cash on the balance sheet. This enables the business to continue to invest and take advantage of the opportunities which will inevitably arise. The types of companies we favour are run by experienced management teams that are both operationally competent and are also long-term strategic operators. Key attributes for this environment.

We are seeing an increasing opportunity within the UK Small-and-mid cap area given the persistent weakness, where the risk/reward opportunity is starting to look compelling over the long term. We are not calling the bottom, we are not hearing bells ring, but our indicator lights are starting to flash green.

[9]Source: FTSE Russell, as at 30/09/2022

[10]Source: Morningstar, as at 31/10/2022.

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