Tellworth Insights

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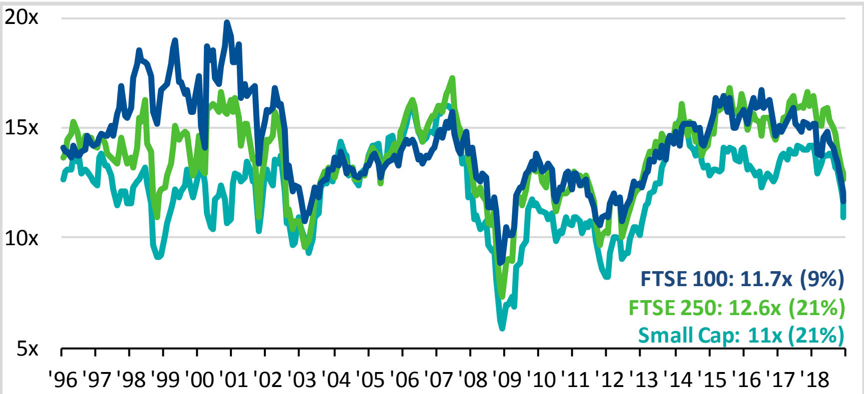
A 1-in-10 year opportunity: UK equities should not be ignored

For most of what has been termed 'the most hated bull market in history', investors have whinged about valuations. Since the start of 2014 multiples have rested at what was called a 'permanently high plateau' and excepting a repeat of the tech-bubble, it was clear that significant further expansion was unlikely. Mean valuations are high to start with hence, in the absence of strong earnings growth, slim long term returns are implied.

But as 2018 has progressed, developed markets – particularly the UK – have provided cheaper and cheaper entry points. Whilst the S&P 500 12 month forward P/E could now be described as merely inexpensive at 15.3x, the Stoxx 600 and FTSE All-Share P/Es are pretty low by modern standards at 12.5x and 11.9x. Indeed, the median FTSE 100 P/E is currently in the cheapest 10% of readings since 1996 – i.e. a 1-in-10 year event (Fig 1). Long-term investors and asset allocators should be licking their lips: UK equities ostensibly present the sort of value opportunity that managers have been demanding for most of this cycle.

Fig 1: By median P/E the FTSE 100 is at the 9th percentile over 20+ years. SMID multiples are at 1 in 5 year lows

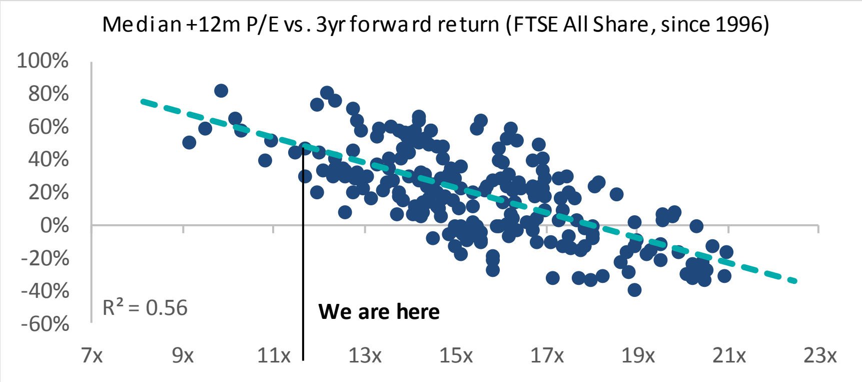


Source: Datastream, Tellworth Investments. NB: Priced as of close 12/12/2018, inverse earnings yield aggregation method

But in each and every fund manager survey, published by BAML , that lands in our inbox, we note a significant underweight on UK assets. This currently sits at -24% net, i.e. there are 24% fewer managers with an overweight on UK assets vs. an underweight. Now this isn't particularly surprising given we are reaching the climax of the Brexit process. It is a handy scapegoat for a 'default' UK underweight. No one wants to have to explain a big UK allocation as the country crashes out of the EU without a deal.

The thing is, there are several reasons to be outright positive – and contrarian – on UK equities. The first is that if one ascribes the substantial UK discount (c. 20% vs. global equities, the highest since the global financial crisis) to Brexit, then a major mitigating factor would be a currency depreciation on 'No Deal' since c.70% of UK's listed revenue is from overseas. We saw this play out right after the referendum – an eventual FTSE All Share rally. The second is that – disregarding the fundamentals – **the market multiple is so low that a significant positive future return is virtually guaranteed** (Fig 2). *Starting valuations are the biggest determinant of long-term returns* – one can forget about earnings at extremes.

Fig 2: And the starting valuation is the biggest determinant your future return

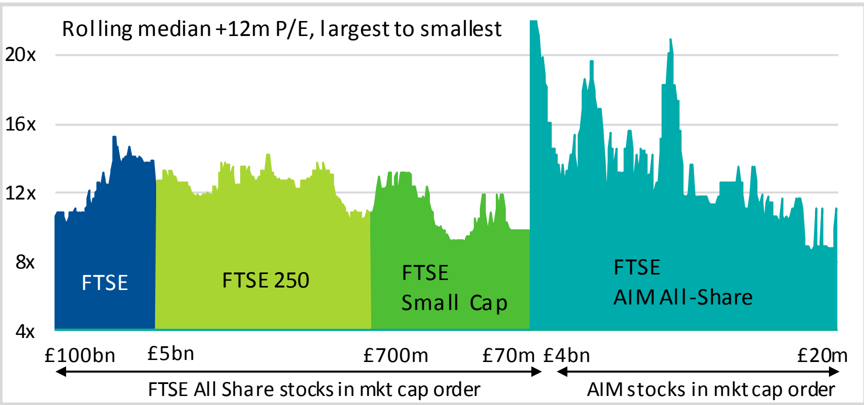


Source: Datastream, Tellworth Investments. NB: 'Biggest determinant' because the R^2 of this variable is over 50%

How is it possible then, that UK equities seem to present as close to a win/win as we get in markets? We think it is the one-off complexity and 'scare' factor of Brexit, and this presents a fantastic opportunity for investors that can take this type of risk. Ignore it and there is, we think, serious opportunity cost.

This doesn't imply that the UK market is attractive in its entirety. One can make an argument for Large Cap exporters (FX upside, cheap against similar companies listed elsewhere), perhaps domestics (many on sub-7x P/Es, though more exposed to Brexit) and certainly stocks in the unloved FTSE Small Cap, which remain on a healthy discount vs. the FTSE 250 (Fig 3), though care must be taken to avoid structurally declining value traps. However, stocks at the upper end of AIM remain expensive – the 'bubble years' driven by inflows and momentum chasing have only unwound by about half, we think – and the growth style still looks precariously perched, especially if economic growth worsens.

Fig 3: However stock picking remains crucial both to avoid expensive 'growth' and value traps



Source: Datastream, Tellworth Investments. NB: Priced as of close 12/12/2018, inverse earnings yield aggregation method

So our message is a simple one – the risk-reward on UK equity indices is very attractive currently, and particularly for global businesses and large caps. They should not be ignored by default, indeed the complexities of Brexit are what has caused this opportunity. Stock picking within UK equities can help investors avoid exposure to the wrong types of company (domestics that aren't cheap enough, growth shares, AIM) and outperform regardless of the outcome at Westminster.

Seb Jory - Head of Data Driven Strategies

Notes to Editors

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