UK EQUITIES: STRUCTURALLY UNFIT OR SIMPLY UNLOVED?

Baillie Gifford's Iain McCombie makes the case for investing in UK stocks on Hyman Robertson's investment podcast

Your capital is at risk.

Penny Cochrane: Hello and welcome to Hymans Robertson on… Investment, a podcast series for everyone and anyone interested in all things institutional investments*. In this series of short podcasts, we aim to cut through the noise to discuss the investment topics that we believe are the most pertinent and, dare I say, most interesting for institutional investors. My name is Penny Cochrane and I'm an investment research consultant here at Hymans Robertson, and I'm also your host today.

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Today, we'll be focusing our discussion on UK equities, which today is only a small percentage of the world's developed equity markets, which is overwhelmingly dominated by the US. And we'll talk about some of the background on the UK equities market, different considerations of an allocation and the importance of active engagement with the companies. But as usual, luckily, it's not just me here to tackle this topic.

Here to talk through our somewhat unloved domestic market in a bit more detail are our two expert guests. I'm delighted to be joined today by Oriana Mezini, Hymans' own head of equity research, and Iain McCombie, head of UK equities and lead portfolio manager of the UK Core Strategy at Baillie Gifford. Thanks to you both for joining today. So, let's kick things off with a quick introduction first and your view on where we are in UK equities today.

**This episode of Hymans Robertson's on… Investment podcast series was originally produced for institutional investors. It is also suitable for retail investors. Iain McCombie manages the Baillie Gifford UK Equity Core Strategy.*

Oriana Mezini: Hello, everyone. Oriana Mezini, senior investment research consultant at Hyma's Robertson. I lead the listed equity research and I'm responsible for selecting and monitoring equity managers across a range of different styles and approaches, along with identifying key market themes and trends. One of the regional areas which we cover is UK equities. Over recent years there's been a decline of the UK equities within broader global indices, alongside a decline in UK equities allocations in UK pension schemes.

What has happened? A lot of the schemes have diversified into global equities and reduced their UK equity allocation, although for some, the home buyers, investing in domestic equities continues but not as significant as it was more than a decade ago. So why should we consider investing in UK equities? There are several reasons why investing in UK equities can be beneficial.

They provide diversification within global investment portfolios, reducing risk. It allows one to take advantage of different industries and sectors that may not be readily available in other regions. The UK has strong corporate governance standards, which ensures transparency and accountability to investors, and many UK companies, particularly those listed in the FTSE 100 Index, offer attractive dividend yields. And to discuss this question in more detail today we have Iain McCombie, who is a partner and head of UK equities at Baillie Gifford.

So, without further ado, I'll let Iain introduce himself and his views on the UK equity market.

Iain McCombie: Hi, Oriana. Hi, Penny. Hi, everyone. Thanks for inviting me onto your podcast. I've been investing in UK equity market for almost 30 years and it's fair to say, as Oriana has said, that a lot has changed over that time. When I started, John Major was prime minister. The world wide web had just been launched. I remember somebody in the IT department actually showing me it, which was a kind of a big, big thing at the time.

And more importantly, I think, more relevantly, UK pension funds held over half their assets in equities, which nowadays sounds fantastical, but that's what it was. So obviously things have now changed considerably. And as you said, Oriana, the allocation to UK equities has declined significantly. But there's an irony in that it's now created a fantastic hunting ground for active stock pickers in the UK market, because valuations are now at a significant discount to global peers.

Now that's not to say that cheaper is always better as bottom-up stock pickers at Baillie Gifford, we think that stock selection is really important. So, for example, I'd love to talk to you about companies, but the Hymans Robertson lawyers just won't let me, and there's someone outside who will give me that kind of finger across their throats if I say too much.

But if I talk about, for example, a kitchen company in the UK, that if you go to a trade park in the UK, you can see it everywhere. There are hundreds of these depots all over the UK. The number one player. It's grown as business by 40 per cent since 2019. So, despite Covid, despite all this worry about, you know, the economic conditions in the UK, it's going really well.

And that's what bottom-up stock picking as all about. So, to really summarize, Oriana, the devil's in the detail when you invest in the UK market. I think there are some fantastic opportunities out there for active investors to have the patience and the resource to uncover these hidden gems.

Penny Cochrane: Thank you and that certainly does sound like quite the changed picture today. You mentioned potential opportunities for investors who may be coming back or looking afresh to the UK equity market, or do you think it's perhaps important to go back to basics for our listeners who are maybe not as familiar with our home market? So, Oriana, perhaps I'll hand over to you first if that's okay.

Could you please fill us in on some of the background? Can you tell us some of the key features of the main UK equity indices?

Oriana Mezini: Yeah, of course, Penny, and I'm glad that you put it that way. So back to basics. Yes, I mean, there are sort of the main UK indices, so the three one so FTSE 100, 250 and FTSE all share. It is composed of various sectors industries across these three main indices that I just mentioned and they're all different.

So, the FTSE 100 represents the 100 largest companies by market capitalisation. It does include some wide range of sectors, but it is more sort of heavily weighted towards financial services, oil and gas, pharmaceuticals, and consumer goods. And these some of these sectors represent about 40-45 per cent, depending on market moves of the of the overall index. So, these indices, obviously the composition of those can change over time, just like with any other indices.

But yes, there are obviously smaller companies, and this is the other hunting ground for other active managers. So, the FTSE 250 and, again, it is different from the from the main index in terms of sectors such as construction, retail, technology, and engineering. So, there is diversity essentially in all of the main indices that represent the UK equity market.

But typically, a lot of the managers will have the FTSE All Share as the as one of the benchmarks aiming to outperform it over a market cycle by 2 or 3 per cent per annum. And that's why it's good to have Iain here, who is an expert on active management. And what are your thoughts, Iain, on using market cap indices as the performance benchmark? And do you think the UK equity index is a good thing**?**

Iain McCombie: It's interesting question, Oriana, in some ways that the broad FTSE All Share index is as good a reference point as any when it comes to benchmarking, I think, performance over long periods of time. As you said, you know, there's diversity. However, it is dominated by a small number of large multinational companies and oil and gas companies, which obviously I can't name, some big banks, which I'm sure you can think of too, and that can in the short term skew performance.

But it is a good thing that that index? Well, I think it matters more if you're investing passively where you can have that debate about, you know, is it a good thing or a bad thing to have large weightings and, you know, energy stocks and so on. What we do is, as you said, we are active stock pickers.

So, we don't start with the benchmark. We start with picking a portfolio of stocks that we like. So we don't set out to be overweight or underweight a particular sector industry. It's very much a function of can we find companies that we like, or we don't like. So, this bottom up approach means that, you know, really our portfolio looks very different to the benchmark and we think in the long run that will work for us as active managers.

But obviously in the short run that can go against you. But it's ultimately about explaining to people like yourselves and the clients for what we're trying to do there.

Oriana Mezini: Just to continue that point on, again, some of the biases of the UK equity markets. As I mentioned, some of the more traditional sectors which are more value biased and, for example, the UK has less weighting say in technology, unlike some of the other developed markets, for example, the U.S. equity markets.

In your style of investing, by being a growth style of investing, and with investors associating the UK with the more value biased, looking at these indices, what are some of the structural themes that are important looking forwards, and some of the growth opportunities for an active investor in growth like yourself.

Iain McCombie: Oriana, you're obviously far too polite. I mean because most people generally say,' how on earth can you be a growth investor in the UK?' And I would say it's actually very simple, because at Baillie Gifford we have with a team of very active investors, we focus on the UK, and we have this fantastic opportunity to look beyond the headlines and the big companies and get in amongst the weeds and find the more interesting opportunities across the whole market cap spectrum in the UK.

So not necessarily always household names, but world leaders in their fields. And the UK does have these companies. Now you said, you know, 'oh, the UK doesn't have much in technology' and in one sense you're right, but there actually are technology companies in the UK. Now again, I'm not allowed to, I can see the lawyer kind of making the slitting throat sign and I don't want to get Hymans into trouble.

But there's an online supermarket business, and you'll know it. You'll have heard of that annoying jingle, you know the brand I'm not allowed to talk about is just for you. But you know the one I'm talking about. Now people think of it in this country as, you know, a supermarket, but actually it's a technology business.

It's using its proprietary technology for, you know, picking and so on. They're selling it around the world to other supermarkets who are wanting to do that. Now it's very unfashionable at the moment to talk about online supermarket shopping. But I think in the long run, the trend, if you take out Covid, the boom and the bust of it as it were, is still upwards. And I think in the long run people will be spending more money online over time.

But it's not just that, Oriana. I'm allowed to talk about themes, I think. You know, we can find niche financials in the UK. There's a number of them that are world class businesses.

There are research and development innovators in the UK. So, they're using technology to build on their market leading positions and they're also digital consumer stocks, you know, kind of platform businesses in the property area, in the car market, I'm sure people can start thinking about what I'm talking about there. But these are really strong market positions and they're using technology to make life better for their customers, whether it's on the business side or on the consumer side.

So actually, I think from a bottom-up perspective, there are companies, and you can find technology driven businesses in the UK that are doing extremely well and making very good money. So, you're right, in one sense, yes, there's more opportunities in some ways, but actually it doesn't mean that in the UK there aren't world class businesses because there are.

It's very British, Oriana, for everyone to always run this country and say, you know, there's nothing good in this country and you read the papers or whatever. But I say if you get behind the wave of the headlines, look at individual businesses, which obviously I can't talk about, there are lots of interesting things to talk about.

Penny Cochrane: Thanks Iain. It’s definitely a different perspective, particularly around growth versus value and certainly more companies that are fundamentally based on technology more than meets the eye, shall we say. But Iain, you did mention something which I think is quite important, you know, in terms of kind of everyone likes to be quite negative on the UK, it's something that we're hearing day in and day out.

It’s about the worsening macro environment, with interest rates rising here in the UK, the economic outlook worsening and earnings provisions continuing to be cut. So, I'd like to kind of touch on that a little bit more. So perhaps, Oriana, you can speak from a Hymans Robertson perspective, how do these macroeconomic considerations shape your view on the UK equity market relative to other developed markets?

And do you think this might change with the more normalised interest rates in the future being a potential headwind for a growth-oriented investor?

Oriana Mezini: The potential change obviously to higher interest rates, as we've seen more recently, or a more normalized interest rate environment can become a headwind for growth-oriented investors. So typically, growth investing can thrive in a low interest rate environment because lower rates make future cash flows more valuable. A shift to higher interest rates can pose challenges essentially for growth-oriented investors.

However, the impact will depend on various factors, including the reasons behind the rate increases and other market dynamics. But here at Hymans, our view remains neutral on UK equities, mainly on some of the fundamentals and that being on high inflation, higher normalised rates, a recession risk and all of these providing additional challenges essentially to companies that operate here in the UK.

I mean, these are very high level, again, thoughts. But Iain, what other factors are important to consider in such an environment from an active growth investor perspective, which is a more long-term approach to selecting companies?

Iain McCombie: Yeah, it's a really important one. And I think that the key thing I would say, Oriana, is you've got to be long term in your approach. And I think a lot of the factors that you and Penny link to are clearly headwinds in the short run for growth investors. And look, I'm not I'm not going to argue with that. I think you're spot on in terms of some of those factors, and that's why there is a lot of pessimism out there.

But what we believe is that, in the long run, share prices follow fundamentals. So, what we are trying to focus on is the growth, the quality, the resilience of the businesses in our portfolios. So, what we're trying to think about is do the companies in our portfolio have higher margins, lower debt levels, and can they generate higher growth compared to the broader UK market?

And I think this is a really impportant point, Oriana, that the quality of the management running businesses that we invest in is really important. At Hymans, you're actuaries. I'm an accountant, okay? So, it is almost like it's calculators at twenty paces when we talk about things like future cash flows.

But the question is what are future cash flows? It is the growth and how you get that. And it's not just about someone like us sticking in a number for a growth rate and a cash flow statement. It's actually how does the business do that? And that's where the management point comes in because does the management of the business have a growth mindset or not?

And that is really, really important because what a spreadsheet doesn't tell you, and it will never tell you - and this is why we're still kind of almost a little bit sceptical of spreadsheets - is [what is] around the corner. Because a spreadsheet won't tell you what might happen in the future.

But what great management teams do is find new markets that don't exist at the moment, you know, be able to look round the corner. You and I can't see it, but a good management team will find that. The other good examples, again, which I will not talk about, because I see that lawyer looking at me nervously, but it's examples of where businesses have grown, they've developed new markets.

The business we invest in, and not just in the UK but elsewhere around the world, are doing so. It's not just a British thing. It's not just an American thing. It's just 'do we have a growth mindset or not'. And I think what's happened over in this country is we've been dominated by some very big companies with management teams that don't have a growth mindset and therefore everyone thinks all UK companies are like that, but it's not – it's absolutely not the case.

And actually, I think that's a really exciting thing. That's the perception thing that Penny was hinting at. There's a lot of people are saying the UK doesn't have growth companies, it's just not true. It's just not true.

Penny Cochrane: Thanks, Iain. Very bold statements. I like it. If it's okay, I'd like to shift tack just a little bit. The currency consideration is often mentioned for investors in the UK equities market, particularly for non-sterling investors, but with our client base being mostly UK, how important is currency within the manager research work you do, Oriana?

Oriana Mezini: Thank you for bringing this important subject into our discussion. In terms of the manager research, our work is more on selecting the best-in-class active managers and assessing their investment processes, team expertise, portfolio construction capabilities, risk management, that these managers remain true to their style of investing, whether being growth or value. Currency can be part of the company specific assessment for many managers, but it is not part of the selection criteria.

In fact, we prefer managers that do not hedge currencies within their portfolios. It's a different level of expertise and that is best left outside of the active management, essentially. However, as you said, sterling is important, of course, for UK based investors with liabilities in the UK. They may want to hold sterling assets for these liability matching purposes.

And of late, sterling has been more volatile. But it is also important to note that the percentage of the overseas revenue, when you look at the FTSE 100 companies, it is highly dependent on overseas business and with 70% per cent or so, according to the latest stats, of revenues coming from abroad. So, it is important to consider, as I said. Many managers do have that assessment around company specific due diligence.

Iain, do you worry about currency as a being a UK equity investor?

Iain McCombie: Well Oriana and Penny, I'm going to say something that's going to shock you. No, I don't. And I don't want to sound flippant or complacent there. But in our portfolio, over half the portfolio's been held for over ten years, which is quite a striking number.

And I bet you if I ask you what sterling has done over those ten years, you'd probably have to think about it a little bit. And because I'm dealing with Oriana, who's head of head of research, she'll probably give me an answer! But most people would not be able to give you an answer. And that's the thing, people worry about something in the short run, but actually in the long run it doesn't really matter.

Because, again, one of the factors that we're talking about is 'is it transactional or is it translational?' And for people wondering what I'm talking about. What I mean by that is if you've got a subsidiary in the US, in a way sterling going up and down doesn't impact on that business.

But if you're exporting to other currencies, yes, it can have an impact. But again, I go back to I was saying, Oriana before, companies don't just sit there and just watch the currency go up and down and twiddle their thumbs. Companies do try to manage their businesses. They'll switch production between the UK and overseas. And, actually, if you look at the UK market and our portfolio, it's a very international market.

I think, again, it's always very good to run down the UK, but actually the high proportion of the UK's earnings actually come from outside the UK. So actually, in a way, the currency thing can be a bit of a red herring in our view, and ultimately to my mind it's 'where does the growth come from?'

That's the thing that really matters. And the currency thing can be a good thing or a bad thing in the short run, but in the long run I don't think it matters. It's do you have a product? Have you got a competitive market position that you can grow that business the long run, and you know, companies will figure out a way to make that possible.

And it's a truism. I remember speaking to one of my colleagues who ran in Latin America. Now, they had very volatile currencies. And I remember what he always said was, 'well, you have to be really good managers to manage that'. And again, you're picking really good management teams that can manage their way through that. That's the thing you don't get in the share prices. And so actually, rather than a weakness, I see it as a strength all around. So that's why I don't worry too much about it.

Penny Cochrane: Perfect. Thanks Iain and thanks Oriana. It's always good to hear different views on currency. It's always a hot topic, I think. We've got to move on to another equally hot topic. Responsible investing is, as ever, very high, if not at the very top of our clients' priority list. And looking at UK equities, it's no different. So, I was wondering, Iain, if you could touch on how valuable ESG integration is as part of the investment process, particularly in regards to UK equities, I guess whichever investment house you may sit in?

Iain McCombie: As you say, Penny, it's a really important point. I think, in our opinion, effective stewardship is about being thoughtful and being an active and responsible investor. I think the UK is actually very good in this respect. There's a lot of engagement with managements and boards. We do it, other people do it too, and I think what we are certainly trying to do is go beyond just the headlines.

For example, talking about net zero, it's not just about the slogan, it's actually about how we can get to net zero. And that's the kind of discussions I see. I'm sure other people are having the same kind of types of discussions with companies about that journey, the trade-offs are going to have to be done. And does the technology even exist for some things at the moment?

And I'll tell you, Penny, that's the thing people don't talk about. There's still a lot of uncertainty out there, but that is what capitalism is great at. We find solutions to problems. Even at the moment we don't know how we're going to get there. But if you bet against the opportunity and ingenuity of humans, you're betting against history.

Although there are undoubted challenges out there, as an investor, I feel actually really upbeat about the opportunities there because there are a lot of very smart people that we are employing thinking about these issues. I think the UK, frankly, is well ahead of a lot of other international markets on these points because your clients are pressurising managers like me to do this well.

And I think we're trying to do that.

Penny Cochrane: Thanks Iain. And I think the UK does seem to be ahead of some other markets, particularly around the net zero challenge for sure.

So, without further ado, I think that brings us nicely to the 'what do you know now' segment of the podcast. This is the part where I'll ask Oriana to ask some quickfire pop quiz style questions, and I'll try my very best to answer them. Although I would like to say off the bat, and as an excuse even beforehand, that I'm just back from a holiday and my brain still isn't back into gear.

So, if it's not too much trouble, I'll ask Ian if you could please keep score, and Oriana when you're ready.

Oriana Mezini: I think these are quite easy, hopefully, and it's based on some of the discussion we've had, so it will help you get the 100 per cent score. So, the first one is a very easy one. What are some of the dominant sectors in the FTSE 100 index?

Penny Cochrane: That one definitely is relatively easy. Thanks Oriana. So, we definitely talked about the FTSE 100 being more weighted towards financials and oil and gas. I think that's something that you both mentioned.

Oriana Mezini: Correct. Right. Maybe this one is a little bit more open-ended but try and answer as best as you can. What factors can influence, based on what we talked about, stock prices in the UK equity markets and we talked about the growth and value and the challenges as well, and some of the things that Ian mentioned. And don't forget the dividends.

Penny Cochrane: Thank you for all the all the hints, but I was going to talk about what Iain mentioned - what you both mentioned actually - in regard to a large part of the revenues being overseas revenues for UK companies. So hopefully, even despite a worsening macroeconomic environment, if companies can keep up their revenues, hopefully their stock price would be good.

Oriana Mezini: Yes, correct. Great answering. Thank you. And one final question. This is again based on some of the points of the discussion this morning. What are some of the advantages and disadvantages of investing in the UK equity market?

Penny Cochrane: So, the advantages are that potential diversification for UK investors. It's a sterling-based market, even though, as Iain said, sterling currency doesn't really make much of an impact over the long term. I suppose a disadvantage is it's such a small part of the overall global equity market, and, as we discussed, it maybe doesn't have as many 'quote unquote' tech stocks at headline face value, anywhere close.

Oriana Mezini: And the very last one, just based on this conversation that I thought was interesting. Iain mentions at beginning - when did Ian start investing in the UK equity markets?

Penny Cochrane: When the World Wide Web had just been invented. What's that, 30 years ago?

Oriana Mezini: Excellent.

Iain McCombie: 100 per cent. Obviously, Penny has been cheating on her holidays! She's been looking at her iPad too much.

Penny Cochrane: Trying to keep up with the news!

Well, an extraordinarily adequate performance from me on that pop quiz. Well done to Oriana for keeping me on my toes. And thank you both. With that, we've reached the end of today's episode. So I suppose to wrap up, it goes without saying that the UK equity market is a very interesting area that schemes may wish to explore, although it's not without its risks.

The UK equity market is small compared to other developed equity markets around the world, but that doesn't mean it should be overlooked. And despite the pessimism that we may see in the news, there could be interesting opportunities in the UK market, particularly for UK based investors. For our listeners, if you have any questions on any of the topics covered today, please get in touch with your usual Hymans consultant. Or if easier, feel free to drop any of today's presenters an email and we would all be happy to help.

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And with that, all it remains for me to say is a big thank you to our guests, Oriana and Iain. And of course, thanks to all our listeners for joining us today. All the best and goodbye.

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