Don’t downsize your dreams

Is it time to revisit the UK as an asset class?

allianzgi.com

March 2022

Virginie Maisonneuve
Global CIO Equity

Simon Gergel
CIO UK Equity

Matthew Tillett
Senior Portfolio Manager

UK equities have grown increasingly unloved over the past decade. Could that be about to change? A recent uptick in performance reminded investors what they are missing, and the market could offer growth and value opportunities.

Is the “Made in the UK” label about to regain its lustre? The popularity of UK equities has declined in recent years – a trend that was established before the Brexit vote and accelerated after the UK’s separation from the European Union. Globally, many pension and sovereign wealth funds have reduced their exposure to the UK, in some cases to zero. But recent months have seen performance improve and investors who shunned the UK equity markets may have been caught out. While the recent political turbulence in the UK has made headlines around the world, it could be worth looking beyond the noise and taking a fresh look at the opportunities of this neglected market.

Key takeaways

- UK equities have fallen out of favour with investors, but a recent improvement in performance underscores the long-term investment case and could prompt inflows to return
- Many UK stocks appear undervalued, with companies trading at significant discounts to their equivalents overseas
- The UK’s culture of strong governance provides a transparent environment where factors that may cause a company to underperform are more likely to be addressed and rectified
- Over recent years, active managers of UK equity-focused strategies have proven more likely to outperform the benchmark than their peers in global equity markets, demonstrating the opportunities that the UK may offer

Access to global businesses – at a discount

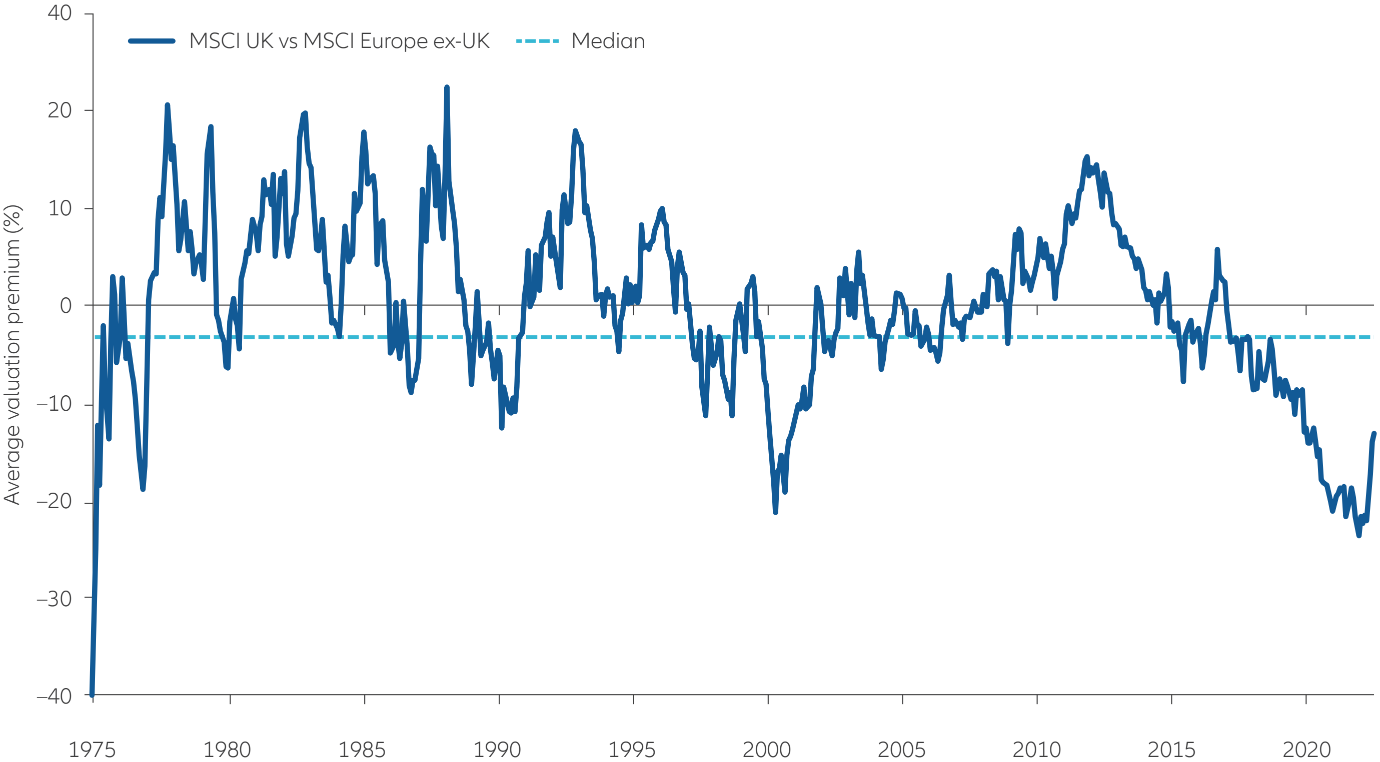
UK equities represent a sizeable market, accounting for around 4% of the MSCI All Countries World Index by volume.[1] That measure makes it the largest market in Europe, roughly equivalent in size to China’s equity markets.

Valuations across the UK market currently appear cheap compared with the rest of the

Value. Shared.

Allianz Global Investors

Exhibit 1: UK vs Europe average valuation premium



Source: Morgan Stanley as at 2 March 2022 (includes sources from MSCI, IBES). Average valuation premium between MSCI UK and MSCI Europe ex-UK indices, based on price/earnings, price-to-book value and price/dividends ratios. Past performance is not a reliable indicator of future results.

world, in particular Europe and the US. The difference between average valuations of UK and European stocks has grown since the 2016 referendum and has continued to widen, even as the dual threats of Brexit and Covid-19 have receded. As Exhibit 1 shows, the UK's value discount against Europe stood at a 40-year low at the end of 2021. The gap has narrowed slightly so far in 2022, but the UK still looks attractive.

Many of the companies in the FTSE 100 – an index of the UK's largest 100 listed companies by market capitalisation – conduct most of their business outside the UK. Around 70% of revenue from FTSE 100 firms comes from overseas trade, compared with 29% for S&P 500 companies in the US.[2] This means that the fortunes of UK large caps do not necessarily reflect the UK economy. A key advantage resulting from the lack of correlation is that investors can access what are, in effect, global businesses, but at the significant discount that comes with the low valuations currently seen in the UK.

Growth opportunities – and dividends too

As well as the giants of the FTSE 100 index, smaller firms in the UK are also currently trading at similarly low valuations – and can offer growth opportunities as well. UK small- and mid-cap businesses are more likely to be domestically focused. As a result, they are more likely to have their fortunes tied to the UK economy, which is forecast to grow quicker than most of the developed world this year, coming out of the pandemic. There is potentially some pent-up demand still to be satisfied, due to the cumulative effects of several years of Brexit uncertainty on investment and consumption, as well as the disruption during the pandemic.

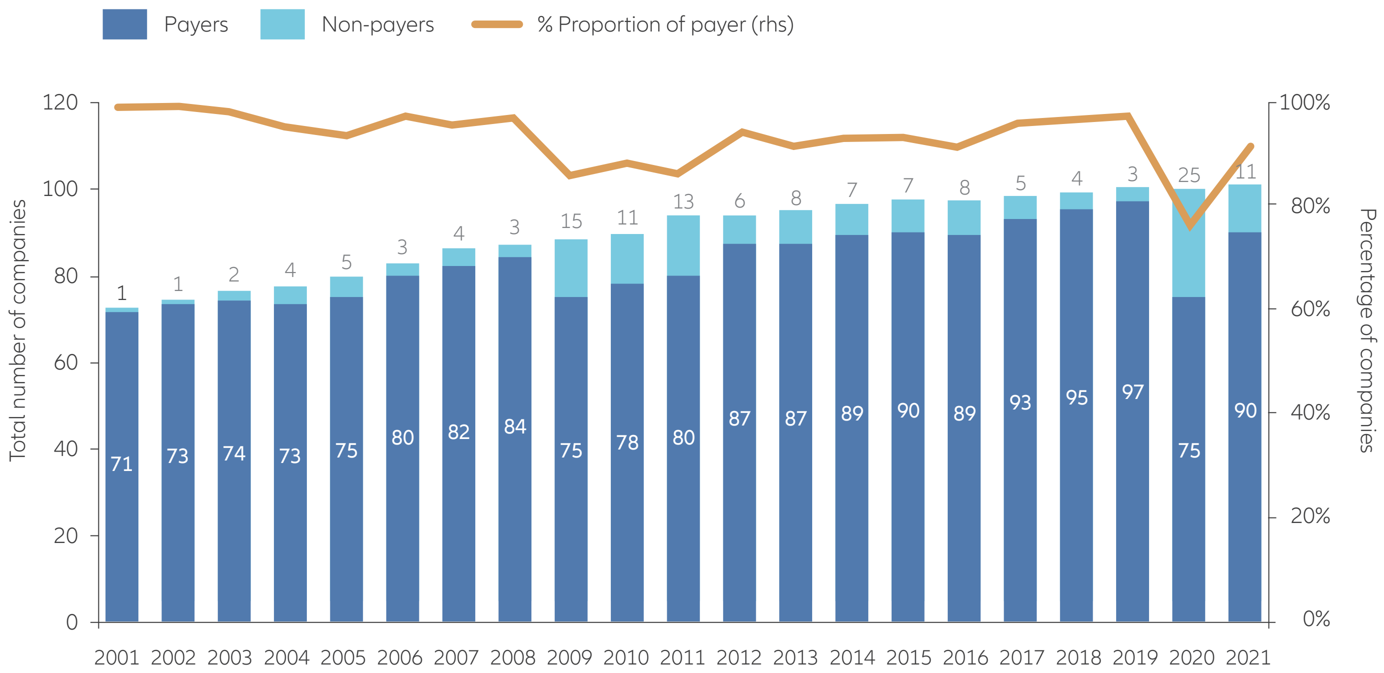
Many of the most promising small- and mid-cap companies come from innovative tech-based sectors. The UK is home to a burgeoning fintech industry, and the government has invested heavily in preserving the country's status as the centre of biotech in Europe. As such, the small and mid-cap sectors are home to some high-growth businesses. What's more, the potential growth companies in these sectors also often offer value, typically being priced cheaper than equivalents in the US.

UK equities are also typically more likely than stocks in other regions to provide regular dividend payments. As Exhibit 2 shows, the majority of FTSE 100 companies have continued to provide a steady and reliable stream of dividend payments each year. Even in 2020, in the face of the Covid-19 pandemic, three-quarters of firms paid a dividend to investors. In today's persistent low-yield environment, dividends can prove a useful source of income.

More opportunities for active investors

The UK market is sizeable and diverse. Across the growth and value companies available, history shows that UK equities can offer particularly rich pickings for active stockpickers. S&P Dow Jones data suggest that almost 60% of active managers running strategies in the S&P UK BMI index outperformed the benchmark over the five years to June 2021. For context, the equivalent figures for active managers in the S&P Global 1200 index (covering global equities) stood at 12%.[3]

Exhibit 2: Number of FTSE companies which paid dividends in the years 2001 – 2021



Source: Datastream, Allianz Global Investors. Data as at 3 December 2021. Past performance is not a reliable indicator of future results.

Strong governance gets our vote

The UK has a global reputation for its high standards of corporate governance. Our proxy voting figures are one indicator of this: As Exhibit 3 shows AllianzGI voted against only around 4% of company proposals in the UK during 2021, compared with around 10-20% of proposals in EU member states – peaking at 32% in Italy – and 40% in the US. This tends to show that UK companies generally uphold the highest governance standards and require less intervention on the part of investors.

This strong record of corporate governance contributes to a relatively open and transparent market – corporate boards are more likely to address any factors contributing to failings or underperformance.

Divergence after Brexit?

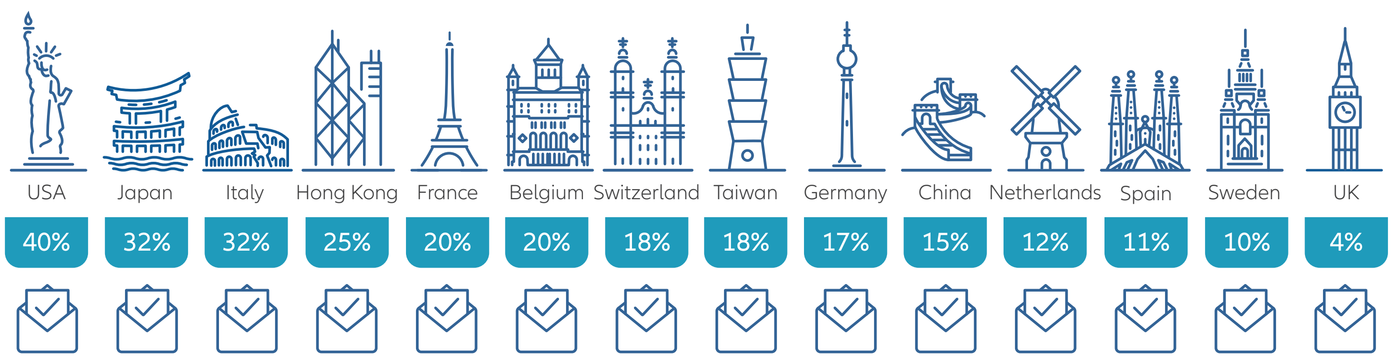
There is speculation that the UK will take advantage of Brexit to diverge in terms of its regulatory standards.

As an EU member, the UK was a leader in defining the continent's governance framework so – whatever happens – we expect it to maintain the same high standards of governance. But the UK may choose to flex its regulatory regime. Any evolution would likely deliver a framework tailored to the UK's needs, which may enhance its capital markets.

UK "independence" could bear fruit

Following Brexit, investors are starting to see the UK as a separate asset class to Europe. The distinction between the UK and continental Europe will be further strengthened if the UK can secure more trade deals with the rest of the world. The potential to negotiate deals on its own terms was heralded as a key advantage of leaving the European Union. Progress has been slow, but the potential for these deals remains and they could provide a further boost to UK-based firms.

Exhibit 3: Allianz Global Investors' total percentage votes against all proposals by location in 2021



Source: Allianz Global Investors

What's ahead?

Recent UK news flow has been dominated by speculation about the future of Prime Minister Boris Johnson's government. Overall, however, the country represents a low level of political risk. Even the opposition parties are centrist in their approach and would likely continue a non-interventionist policy towards the stockmarket if they came to power.

In summary, the UK offers a broad, diverse equity market, with cheap valuations available to active investors. With promising growth companies and undervalued large caps, it adds up to a strong long-term case for investment. UK equities may have fallen out of favour with many investors over the past decade or so, but recent performance will not have escaped notice, and we expect investment in the UK to return.

Endnotes

1. MSCI, 28 February 2022
2. S&P Global Market Intelligence, 18 June 2020
3. S&P Dow Jones Indices LLC, Morningstar, 30 June 2021