The Return of UK Equities

The UK equity market, which has been in the doldrums since 2017, has begun to perform once again. Why has the UK been such a poor investment for such a long time, and why might it now be presenting an attractive investment opportunity?

Although the immediate effect of the unexpected 'Leave' victory in the 2016 Brexit referendum was to send shares sharply lower, the fall was very short-lived. In the months that followed, the more important impact was from the collapse in Sterling, which boosted the value of overseas earnings for UK companies. Hence the FTSE 100 rose by more than 12% during the second half of 2016. The ensuing four years, however, was a decidedly different story. Over this time frame the FTSE 100 saw a return of -9.5%, with the majority of that fall coming in 2020, after Britain had left the EU and began to struggle with the complexities of finalising a trade deal with the bloc. This was in stark contrast to the return of +38.2% from the FTSE World Index over the same period.

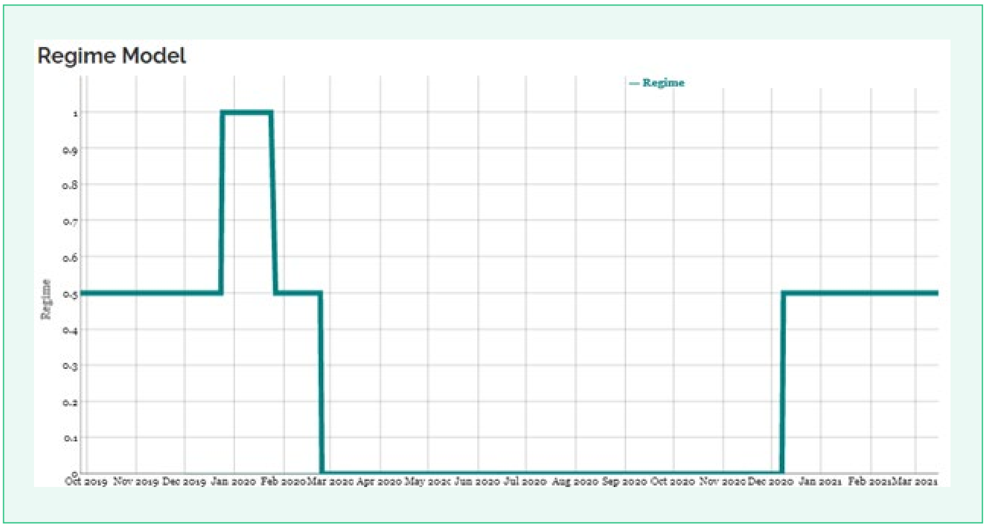
In part, the poor performance might be ascribed to government gridlock, as well as a lack of effective government in other areas whilst all attention was focused on Brexit. However, the overriding consideration is that markets hate uncertainty more than anything else. Despite the very high yields (both absolute and relative) that UK companies were offering, and relatively benign economic circumstances, most global investors shied away from UK equities.

Ian Woodbridge
Senior Investment Strategist

www.collidr.com
hello@collidr.com
(+44) 0808 281 2900
Connect on LinkedIn
Follow us on Twitter

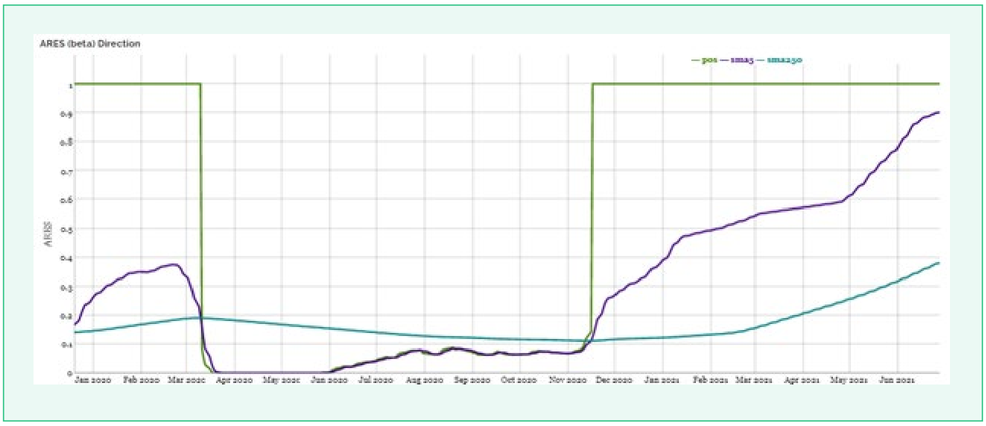
Even when the UK market is performing poorly, it is a big decision to exit completely from your investors' home market, but following the Covid collapse of Q1 2020, the signals from our various tools were indicating that the UK equity market was extremely unattractive.

The chart below is from one of those tools, and shows our regime analysis for the FTSE All Share Index over the past eighteen months:



In this tool, we analyse whether the Index is in a low, medium, or high-volatility regime. A high-volatility regime is an environment in which we would expect a greater likelihood of poor returns, and is represented, in our graphic, as the signal falling to the bottom of the chart. In the graph above, we see the UK market moving into a high-volatility regime in March 2020, and remaining there for the rest of the year.

This view was confirmed by the signals from our tool – ARES – which identifies a target level of beta (exposure) to the market, given the prevailing conditions. As can be seen from the chart below, ARES moved the FTSE All Share Index from full exposure to zero or minimal exposure in March 2020.



Hence, there was a very strong suggestion that returns from the UK were likely to be unattractive last year, and so we began, over the following few months, to remove direct UK exposure from portfolios.

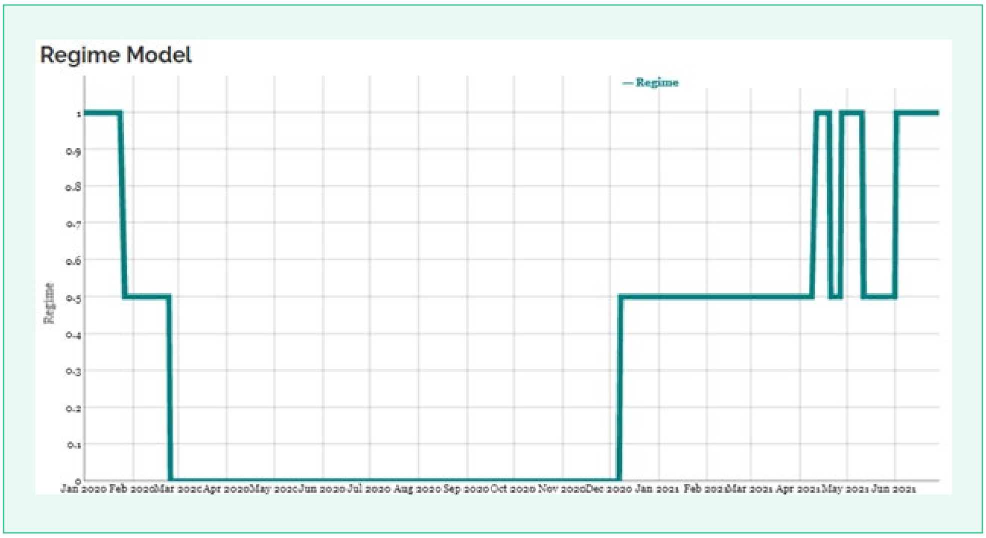
The chart below shows how the UK market performed between 1st March and 31st December 2020, compared with the World Index and other major market indices.

The decision to remove direct UK exposure and deploy the money into the US and Asia was clearly the right one, based on what followed. Not only did UK shares perform poorly, they also exhibited a higher level of volatility over the period.

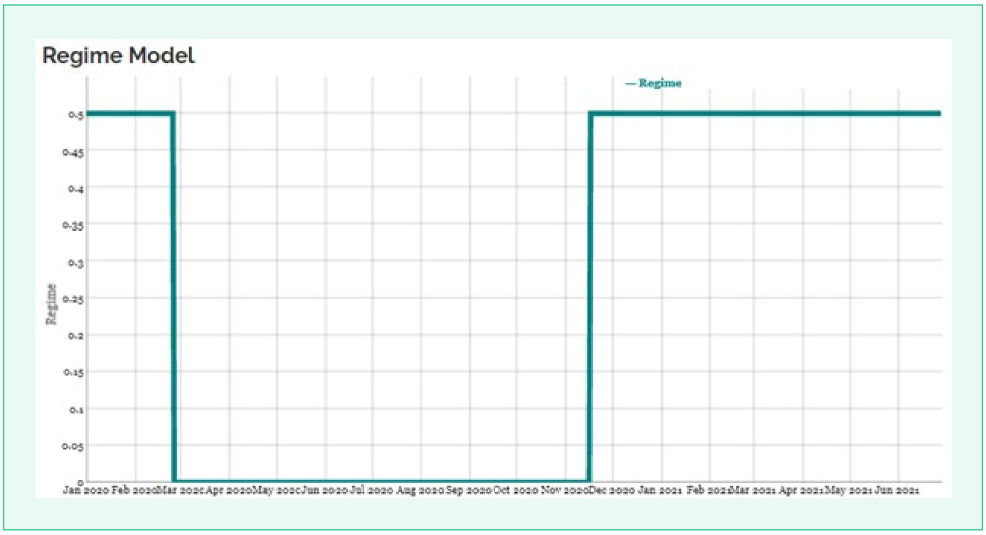
So what are our tools telling us about the UK market right now? The graphics above show that we are now seeing a somewhat more benign outlook for the UK, but as we have added UK equity exposure back into models, we have focused on the mid-cap section of the market. Over the past year, and particularly since the fourth quarter of 2020, as expectations of a Brexit trade agreement grew, Sterling has strengthened considerably against other major currencies. This has provided a headwind for the FTSE 100 Index, whose constituents derive two thirds of their earnings from overseas, but has had a much smaller effect on other parts of the market that are more domestically focused. Over the past year, UK mid-cap stocks have given double the return of the FTSE 100 (see the below chart).

This has been reflected in our analysis; the two graphics below show the current regime analyses for the FTSE 100 and for the Mid 250 Index.

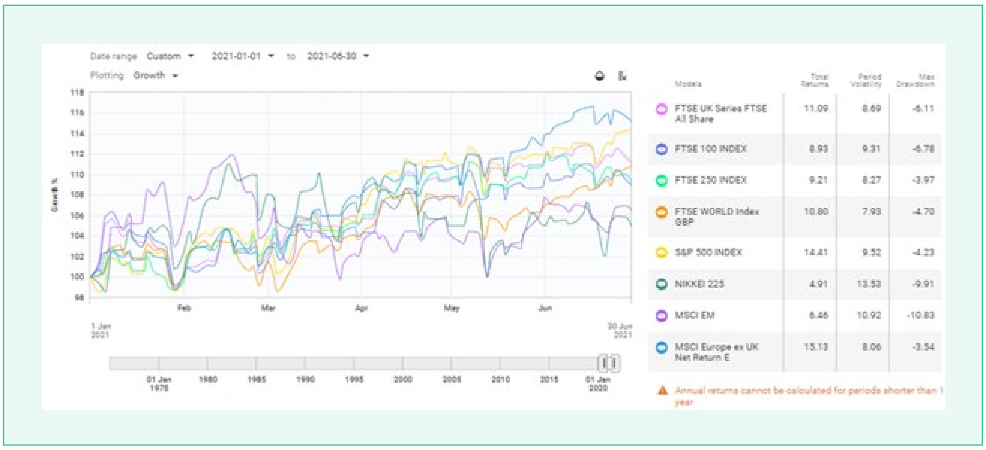
The FTSE 100 regime analysis shows the Index fluctuating between a medium and low-volatility regime:



Meanwhile, the Mid-cap Index shows itself to be firmly in a low-volatility regime:



Whilst the UK continues to adjust to the new post-Brexit world, and Covid continues to present problems, it appears that the UK market, having experienced years of lagging behind the rest of the developed world, may now be finding some support among international investors, who see good-value investment opportunities among unloved UK equities. Whilst the FTSE 100 Index has, so far, been impacted by the strength of Sterling, and has not firmly established itself in a low-volatility regime, the signals from the Mid 250Index are much more clear-cut, showing a direct and sustained move into low volatility at the start of this year.



Whilst UK shares have enjoyed some strong months this year, the overall performance for H1 has been roughly in line with world markets: below the US and Europe, but ahead of Asia. Since the underweight in UK exposure has resulted in a naturally higher exposure to the US (still underweight vs the World Index, which is c.62%), the benefit of staying out of the UK has persisted well into 2021.

The key factor in the decision to re-enter the UK market now, has been the establishment of a level of volatility comparable to, or lower than, other world markets, which suggests that the UK market is now in a much better position to produce steady positive returns for investors.