# Morningstar Investment Management Insights

## U.K. Equities Amid Brexit: A rose among the thorns

August 2018

**(Estimated Read Time: 7 Minutes)**


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### Key Takeaways

- We continue to like U.K. equities from current levels.
- The U.K. is unloved, reasonably cheap, and fundamentally healthy.
- True risk comes from valuations (overpaying for an asset), fundamentals (asset quality deteriorates), and financing (gearing, redemptions, crowded trades). The U.K. stacks up well in this regard.
- Brexit does temper our conviction, but we believe much of the danger is already reflected in prices.

U.K. investors are a depressed bunch. Even global investors can empathise, because let's face it, Brexit is forcing some incredibly difficult decisions. Yet, in a perverse way, the distaste towards the U.K. is making the equity market a rose among the overpriced thorns.

Yes, we have a positive view on U.K. equities and have had so for quite a while now. It ticks most of the boxes: unloved, reasonably cheap, and fundamentally resilient. We do see downside risks, but much of this appears priced in, especially on a 10-year-plus view.

### How on Earth Can We Like the UK Equity Market?

With Brexit continuing to be a major fundamental risk to the economic and equity market outlook, nervousness is taking hold and outflows are persisting. This comes at a sensitive time as some economists "predict" an impending global downturn, often citing trade wars, a global housing slump, high household debt, an inverted yield curve in the U.S. and cyclically-high corporate profits. Any one of these "catalysts" could turn on a dime, which is hardly a recipe for a boom in asset prices, you may think.

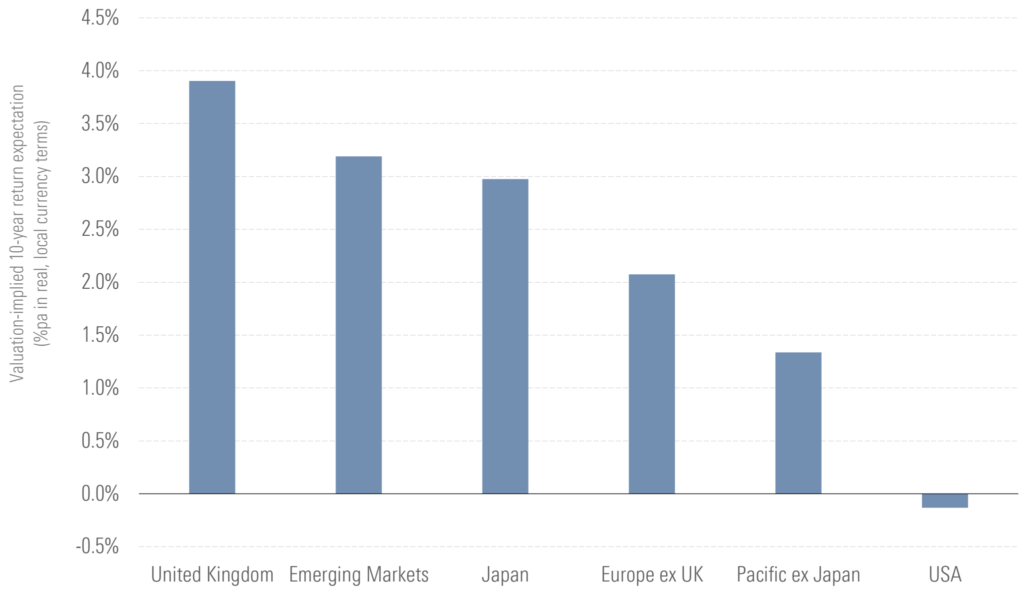
But, consider this. We believe true investment risk is a function of three key inputs: valuations (overpaying for an asset), fundamentals (asset quality deteriorates), and financing (gearing, redemptions, crowded trades). This is based on our view that true investment risk is not volatility, nor can it be captured in modern portfolio theory measurements such as conditional value at risk; instead, true investment risk is the permanent loss of capital, and it should be viewed holistically in a portfolio.

Let's bring this to the present discussion, where we find U.K. equities to be somewhere between 30% to 45% cheaper than the U.S. market on a combination of valuation metrics. Asset quality in the U.K. has a long history of durability, and we see no evidence of change. Leverage is under control and below pre-crisis levels. Plus, excitedly for our contrarian hearts, it is one of the least crowded trades in the marketplace.

## Valuation Risks

Let's start with the fun realities. What if we said that the U.K. is not only cheaper than the U.S., China, and Switzerland, but also Portugal, Ireland, and even Mexico. Depending on the metrics you use,[1] this could be quite an astounding observation and shows the considerable dislike being priced into this market.

**Exhibit 1** The valuation-implied return for the UK is superior because prices reflect much of the downside risk




Source: Morningstar Investment Management calculation, Morningstar Direct, to 31/07/18

When thinking about the relevance of this chart, there is an important point of note. Most prominently, the U.K. market is often considered a combination of the multinationals (which derive approximately 70% of revenues offshore) and those lower down the market capitalisation scale (which are far more domestic-oriented and derive closer to 40% offshore). Based on current valuations, we note that the U.K. opportunity is most pronounced among the multinationals, especially given the added benefit of a currency buffer.[2]

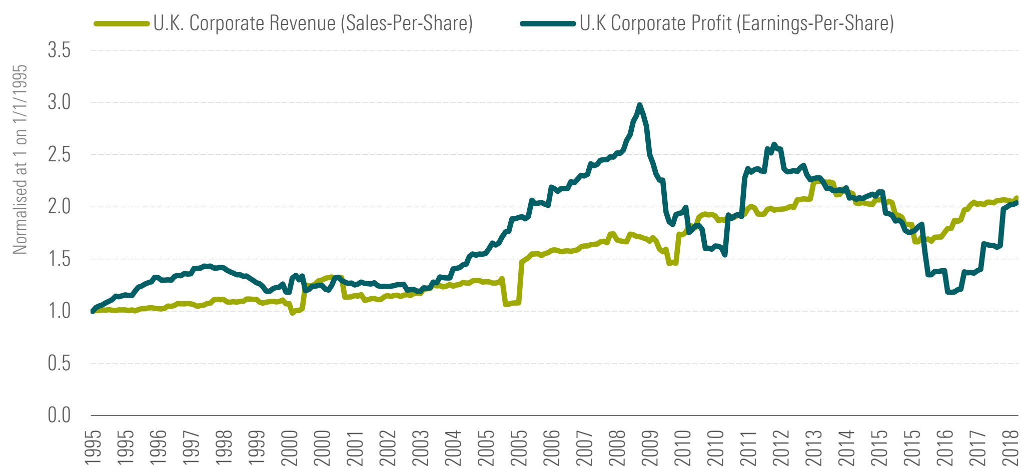
## Corporate Profits vs. GDP

The first thing to acknowledge about the fundamentals is that the U.K. economy is not the U.K. equity market. We do not need to predict the U.K. economy to know what might happen to U.K. stocks. In fact, we are avid believers in anti-forecasting, resisting the urge to predict and preferring to look instead at what is actually happening to the drivers of those returns.

[1] We track various valuation metrics such as CAPE, ROE and Margins that are supported by empirical evidence. Based on a compilation of these measures, we create an expected 10-year valuation adjustment (assuming prices revert to the historical average over this period). By doing so, we find the U.K. to be in the cheapest quartile of the 199 equity markets we cover (as at 31/07/18). By contrast, the U.S. is in the bottom quartile.

[2] Sterling is the first place U.K. investors tend to reflect their concerns, where a falling pound helps boost the profitability of U.K. exporters. This could help protect the multinationals if a major downturn transpired.

**Exhibit 2** U.K. companies have a solid track-record of durability



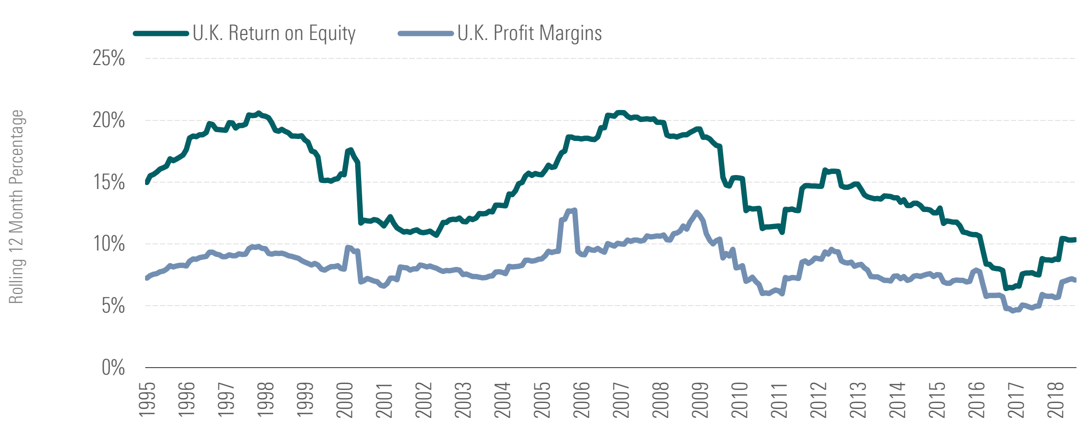

Source: Morningstar Investment Management calculation, Morningstar Direct, to 31/07/2018

In this sense, revenue and profit growth of U.K. companies have lagged global peers in the recent past, however remain fundamentally durable. One should also remember that a lot of the prior earnings declines were wrapped up in commodity price weakness affecting large energy and mining companies, which now account for a smaller portion of the U.K. stock market. One can also see that the Brexit vote has had a muted impact on company fundamentals thus far.

### Leverage and Turnover Risks

A lot of hype surrounds the high levels of household debt and the flow-on effects this could have on the banks. This is a valid concern, but it is important to reiterate as a global phenomenon rather than an isolated one. What we really care about here is the health of corporate Britain. We can measure this in many ways, but one of the more effective ways is to look at the difference between profit margins and return on equity. [3] Specifically, a high ROE relative to profit margins can raise alarm bells about any underlying leverage or turnover risk. As you can see below, in the U.K. we simply don't see this risk.

**Exhibit 3** Leverage and turnover risk (the gap in the two lines) is far lower than in the 1990s and 2000s




Source: Morningstar Investment Management calculation, Morningstar Direct, to 31/07/18

[3] For those that aren't doused in financial theory, a much higher return on equity is only possible if companies are using leverage and/or asset turnover. While depressed sales could impact this gap, it tends to reduce both margins and ROE. Therefore, the gap itself mostly reflects a change in leverage, whilst asset turnover can also have a modest impact.

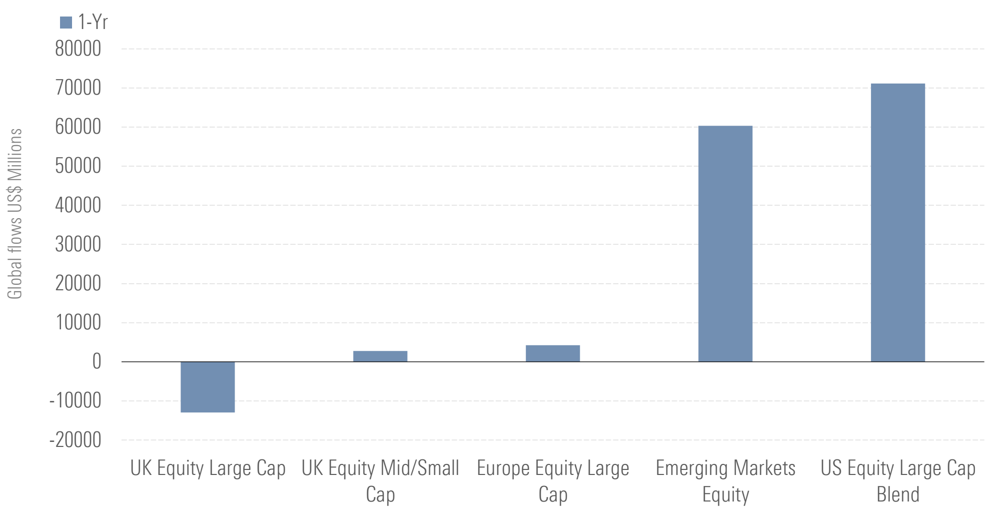
## The U.K. as One of the Least Crowded Trades

Last, we want to show the extent of the dislike and fear being priced into the U.K. market. We believe that the most dangerous time to be invested in a market is when optimism meets disappointment. We rarely know when the disappointment will hit, but we do know (more or less) when investors are overzealous.

One of the more well-defined ways to judge this is to assess fund flows. While all fund flows ultimately net to zero (i.e. there must be a buyer and seller on each side of a trade), we can substantiate the type of investor putting their money on the line. In the chart below, we can assume the "majority of individuals" (via open-end and exchange-traded fund flows) are increasingly moving their investments away from the U.K. equity market, likely meaning that largely value-oriented and institutional investors are on the other side of the trade.

From the data, we recognise significant concern is getting priced into assets by these investors, which offers the potential for an independent investor to go against the herd and patiently wait for the masses to return. Moreover, as the supply of these assets exceeds demand, we may have the opportunity to buy them at a discount.

**Exhibit 4** Fund flows (including ETFs) are moving out of the UK into other regions




Source: Morningstar Investment Management calculation, Morningstar Direct, to 31/07/2018

## The Dangers of Brexit

Given the unprecedented nature of Brexit, many investors are understandably erring on the side of caution. This means they are inclined to invest elsewhere, which is no doubt influenced by the noise of daily politics.

Yet, the truth is that the Brexit uncertainty is well recognised, so while people are confused on how to price it, we have reason to believe it is a fear-driven response. Here are the typical risks that are driving such fears:

*What people are seemingly scared of:*

- A lack of confidence in the U.K. economy could result in capital outflows and reduced investment.
- The labour force could fall due to a European exodus, where household consumption could decline, lowering domestic revenues.

- Exports to Europe could be hampered by higher tariffs, and imports could become more expensive due to a cheaper pound sterling.

However, what would happen if these investors instead focused on the fundamental inputs? For example, what if they considered the downside risk Brexit could have by looking at domestic profit margins? How likely is it that payout growth becomes permanently impaired? And most importantly, how much is already priced into assets?

*What people ought to be thinking about:*

- Domestic profit margins could compress on the back of stagnating sales and higher import costs.
- Dividends could become unsustainable, as payout ratios are already high.
- Investors could price in a structural de-rating of quality, which could increase the cost of equity.

By thinking about these inputs comprehensively, one can overlay the dangers Brexit may pose and conduct scenario analysis to help articulate how much is built into current prices. The overall intention in undertaking this analysis is not to scare oneself out of an asset, but to better grasp the potential range of outcomes and understand reward for risk.

Doing this puts an investor in a good position to take a probabilistic view of whether the fear of Brexit is warranted or not. By extension, one should consider reward for risk holistically. While this can quickly become a complex body of research, one must also consider whether any fundamental impairment is likely to be permanent or temporary, as this would impact the sensitivity to loss. It is in this honest appraisal that we can assess the validity of holding U.K. equities.

While nothing is certain, there is sufficient reason to believe that permanent impairment of the equity market is unlikely. This acknowledges that a short-term impairment is distinctly possible following Brexit but is not about to structurally decline forever. Furthermore, when conducting the range of scenario testing, our research also shows that the impact of a temporary but severe impairment to fundamentals would still offer a positive net outcome under most scenarios. This is especially true for the U.K. multinationals, as they are coming off a lower base and would benefit from a currency tailwind.

To close, we should reiterate that fundamental uncertainty is ever-present, but often overhyped. Meanwhile, sentiment is clearly still negative for the multinationals, and this negativity is being priced into the asset class. Therefore, while the economic relationship with the U.K.'s largest trading partner will remain unclear for some time, we are pragmatically and patiently positive on multinational U.K. equities.

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