# An inside look at UK Equities

## To make sense of change, join the dance

*"The only way to make sense of change is to plunge in to it, move with it, and join the dance" Alan Wilson Watts*

- Geopolitical and macroeconomic news has dominated markets and capital flows as investors focused on the growing risk of an economic slowdown
- But the transformative effect of structural change and technological advancement should not be overlooked
- We remain focused on well-capitalised, well-managed companies that we are confident can compound their earnings over the long term

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### What's happening?

The effect of progressive, secular, structural change – often characterised by technological advancement – on companies and economies should not be underestimated. Management teams, companies and investors cannot tap their collective feet by the edge of the dancefloor - they must join the dance.

As investors, we continue to meet numerous company management teams and use the information we gather from this, and from other sources, to build an understanding both of individual companies and the dynamic environment in which they operate. Although the cost and availability of credit remains a vital constituent part of a functioning economy, we investors at times give undue emphasis to cyclical macroeconomic issues and overlook the overwhelmingly transformative – and sometimes destructive - effect of change.

To coin a cliché from the world of football, the six-month period to the end of March was 'a game of two halves'. Geopolitical and macroeconomic news dominated capital flows throughout 2018, resulting in a dramatic fall in multiple asset classes, particularly in the final three months of the year. Although global economic growth remained positive, investors increasingly focused on the growing risk of an economic slowdown, together with the rising cost of capital, driven principally by quantitative easing unwinding.

Anticipation of slowing economic output contributed to volatility in many financial instruments, including currencies, the oil price, interest rates, bonds and equities. At the stock specific level, top-down macroeconomic influences overwhelmed trading fundamentals and on many occasions, individual share prices fell materially even when companies reported trading in line with stock market expectations. Of the many influences on the UK stock market, the effects of the US/China trade wars and Brexit were most prominent, with the latter explaining much of the underperformance of the more UK domestically-focused FTSE250 versus the FTSE100.

A deterioration of global economic conditions has reversed an explicit desire by the US Federal Reserve to raise interest rates and this increasingly dovish stance has contributed to a significant rise in equity markets since the start of 2019.

## Technological change: The shifting economic landscape

However, technological advancement remains a powerful force and has resulted in a fundamental shift in the economic architecture of some corporates. Low levels of capital intensity, combined with genuine global markets, have resulted in corporate behemoths of such proportion that governments are increasingly intervening. In 2018, Facebook generated revenues in excess of the GDP of Croatia (according to 2017 United Nations data). The combination of increasing power and influence with minimal regulation appears anomalous and - similar to industries such as tobacco, banking and healthcare, 'big tech' is firmly in the sights of regulators. The impact on innovation, creative destruction and investor returns remains unclear and we must be alert to both the risks and rewards that this will inevitably create.

*"Nobody should expect these technology platforms to regulate themselves…Our job is to figure out the responsible way to regulate these large platforms so that we are promoting competition, protecting privacy and making them responsible stewards of lots and lots of data."* David Cicilline – Chair of the US Congressional anti-trust committee

The listed UK technology sector remains small compared to countries such as the US. However, there is no shortage of innovation and the UK's 'Flat White' economy – start-ups, entrepreneurs and small businesses, created by merging the digital and creative sectors - continues to thrive. In 2018, this represented the largest sector within the UK economy, with one of the most important parts being the digital marketing that results from the UK's remarkably high share of online consumers. In 2018, when economic growth in the UK fell to 1.4%, this sector grew three times as fast at 4.6%, even if a bit more slowly than the 6.8% it grew in 2017.

An example of a business that has benefited from this economic tailwind is media company Future. Run by Zillah Bing-Thorne, Future publishes specialist content both in physical format and online. By attracting special interest groups, such as photography enthusiasts, Future is able to monetise the content directly, sell premium advertising space and generate commissions by offering the opportunity for its consumers to buy products like cameras, tripods, lenses and bags. This is an illustration of digital experts and creatives working together to generate wealth for employees, suppliers and the providers of capital.

## A shift in the retail balance of power

Online spending as a percentage of all retail sales exceeded 20% for the first time in November 2018, according to the Office for National Statistics. As recognisable high street names meet their demise, the remaining retailers have sometimes had to take drastic steps to shore up their businesses in the face of a changing retail landscape and the continued growth of e-commerce. Many have struggled with an inflexible, long duration cost base, while others are trapped by an increasingly outdated mindset around the traditional retail model. But it isn't all at the expense of the retailer – when it comes to the landlord/tenant relationship, the balance of power has shifted. A commercial landlord would often prefer to rent a property for nothing than have the cash flow liability of business rates on an unoccupied property. As a result, WH Smith is one retailer that has achieved an average rent reduction of 30% across its estate over the past 12 months, and in some cases has negotiated zero rent.

The changing retail model has also thrown up a new obstacle for sellers. As online sales have grown, so have returns, and with them additional costs and complexity. According to the Centre for Economics and Business Research, around 25% of goods bought online in the UK are returned. They estimate that of the £19bn worth of products sold online in the 2018 Christmas period, £4.86bn of this may have been returned. Once the customer has sent the product back – often with the retailer covering postage – they need to be cleaned and repackaged for re-sale. With each item passing through up to seven pairs of hands before it can be re-sold, it can cost the retailer up to £30 to process each return. As always however, there will be winners and losers - Eddie Stobart Logistics, for example, appears well positioned to deal with this expanding industry born from change.

Despite the well-publicised difficulties in the retail industry, our long-term holding in Dunelm appears to have coped well with this change. Dunelm has benefited from a focused management team executing a cash generative strategy of self-help and market share gains. A multi-year discipline approach to their property portfolio in terms of location and rent structure remains a differentiating feature.

## Brexit: The 'flat white' economy could become cold tea

A UK equity composition would not be complete without at least a begrudging reference to Brexit. The lengthy political paralysis has contributed to the UK stock market being cheap relative to history and under-owned by global investors. While parliament has dithered, plenty of UK listed companies have continued to compound their earnings, cashflows and dividends - to the benefit of equity holders.

However, the UK economy has certainly felt the effects of the Brexit impasse. In some areas, capital investment decisions have been deferred and economic data has experienced distortion. For example, UK GDP is currently being boosted by the effects of Brexit-related inventory build.

Many UK businesses rely on importing human intellectual capital. A reversal of the desire or ability of talented individuals to contribute to the growth, innovation and wealth of the UK economy would be detrimental to all of us. Worse still, the emigration of internationally mobile talent from the UK could turn the flourishing 'flat white' economy in to a mug of cold tea.

Earnings delivery remains crucial to individual stock performance and with UK earnings expectations set at realistic levels, and monetary policy loose, this should bode well for UK stock pickers. From a currency perspective, as the risk of a hard Brexit has receded, sterling has rallied, helping contribute to some recovery in UK domestically-focused equity prices.

The consequences of Brexit will affect both the UK economy, UK stock market and sterling. We will not try and anticipate the outcome, but will remain focused on well-capitalised, well-managed companies that we believe can compound their earnings over the long term. The investment philosophy and process applied to each of the UK Equity funds remains consistent.

We are committed to seek out those businesses that are growing their earnings and cashflows, and where balance sheet strength is supportive of that growth.

## Portfolio positioning

*"A stock is not just a ticker symbol or an electronic blip; it is ownership interest in an actual business, with an underlying value that does not depend on its share price." Benjamin Graham*

The fund strategy retains a preference for longer-term structural trends and for well capitalised companies with the ability to compound growth. As active managers we continue invest locally, think globally, physically visit companies and allocate capital to the best stewards, where return on investment appears attractive and where the company is operating in a trading environment where it can thrive, rather than in an environment where its business model is being disrupted. In addition, we continue to engage with companies on corporate and environmental matters to maximize the likelihood that their earnings growth is sustainable over the long term.

**Investment involves risks, including the loss of capital.** Source: AXA IM as at 1 May 2019