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The UK's demise is overstated

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UK equities reached all-time highs in 2017, but relative to world stocks (in US dollar terms) they were laggards. Global investors, exposure to UK equities has fallen as low as it was in 2009 when the banking system was under threat. That has reflected concerns about sterling's decline and the UK economic prospects as Brexit negotiations drag. But it has created opportunities for 2018.

Stock markets discount the future, so a lot of political uncertainty is already reflected in valuations. As active investors, it is all about valuation not news flow! It is impossible to have an edge on how Brexit negotiations will progress or impact the economy, yet the UK stock market is the third biggest in the world and home to a broad range of multinational companies, so it does not just reflect the UK's fortunes. Over 70% of the sales of FTSE 100 index companies come from other countries. These stocks are trading at significant mark downs to their European and US peers, which cushions UK equities against a lot of the implied misery.

Ironically, although in absolute terms the UK market is at a high, there are more opportunities to buy inexpensive stocks than there have been for years. Not only is the UK being left behind by rising international markets, but within the UK stock market performance has become increasingly polarised. Whole swathes of the market are deeply out of favour, either because they are judged victims of Brexit or because they are viewed as candidates for technology-related disruption.

Looking at a variety of valuation metrics, whether it be dividend yield or price/earnings, UK equities are cheap versus other developed markets. On a price/book basis, valuations relative to the US have touched lows not seen since the peak of the telecom, media and technology bubble in 2000. In fact, 85 of the stocks in the FTSE 350 index recently hit 53-week relative lows.

If investors continue to shun UK equities, and valuations remain relatively low, then international corporates are likely to continue to exploit the UK valuation discount, as well as sterling weakness, and bid for their UK peers. Examples of this in 2017 included WS Atkins, an engineering services business, and Berendsen, a laundry services company, which were both acquired by international counterparts, not to mention the Kraft approach for Unilever.

Brexit victims?

Those companies loosely described as Brexit victims are among the most undervalued. Some stocks in sectors such as leisure, retail and media are trading on valuations not seen since the economic slowdown of 2009. Which of these can navigate through a potentially weaker economic background and gain market share? Alternatively, which stocks are already pricing in economic Armageddon? Are these UK domestic shares having their own Q1 2009 moment – which proved the last great buying opportunity?

Twists and turns in Brexit negotiations are hard to predict but company management should always be preparing for the future rather than complaining that Brexit is chaotic. Business is all about uncertainty. So rather than waiting for clarity, management should future-proof the business, if necessary re-evaluating the business model.

> “There’s always uncertainty in business [...] I think uncertainty is an opportunity, and the opportunity here is actually that the rest of the world is growing at a far greater rate than Europe”
>
> Sir James Dyson

Brexit is a classic acrimonious divorce. It is about money versus access – not to kids but to trade. If the final money settlement extracted by the EU is deemed penal, then any subsequent currency weakness will positively adjust our access to trade. The peak of that rancour will come early in 2018. But that’s not something that we will focus on. Instead, we concentrate on the value of companies based on their fundamentals.

Candidates for tech disruption

Technology fever is driving the other area of undervaluation. While investors are pushing technology stock prices higher, on the other side of the trade they are punishing the perceived victims of technology-related disruption.

At the time of writing, the US Nasdaq 100 tech index had risen approximately 40% in 2017. Just five stocks represent over 40% of Nasdaq, so every time someone buys a Nasdaq ETF they buy more of these stocks and so the momentum continues.

By contrast, a lot of old economy businesses are under pressure as Amazon and others threaten established business models. But how often has the market reaction been overdone? Active investors have an opportunity to find companies perceived as victims of disruption that can adapt their business models to survive, or perhaps have cash flows that will prove surprisingly resilient.

Value investing's long-term power

There are echoes of 1999-2000 in today's markets, as shown by the fact that the UK market has not been this cheap versus the US for 17 years.

Therefore, you could consider UK equities an each way bet for 2018. If equities around the globe grind higher, then at some point UK equities should be a catch-up trade. But if global equities correct, then UK equities ought to be more resilient due to their low valuations and the fact that there is no 'hot money' in the UK market.

We are optimistic that we can continue to find interesting valuation opportunities in 2018, by focusing on company fundamentals. After a year where growth stocks have strongly outperformed, particularly the US tech giants, one could be forgiven for questioning whether classic investing principles that have worked so well over time will ever do so again. But over the long term, the principles of value investing have always proved powerful!

> "Although value is a weak force in any single year, it becomes a monster over several years. Like gravity, it slowly wears down the opposition."
>
> Jeremy Grantham, GMO

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