Invesco

Investment Insights | UK Equities

UK equities: and now for something completely different

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Key takaways

- The next 10 years in markets will look very different to the past 10 years, characterised by (on average) higher interest rates and higher inflation than we have experienced since the GFC. Value as a factor will be more important.
- An environment that is different, calls for equity exposure that is different. And sector exposures in the UK are very different to other global equity markets. The FTSE All-Share Index offers low correlation to US markets, but still has scale, breadth, and depth of companies.
- UK equities offer attractive exposure to the 'Value' factor, though internationally orientated and cash generative companies, which in many cases trade at valuations below global peers.
- The Invesco UK Opportunities Fund and the Invesco UK Equity Fund each have a particularly low correlation with the S&P 500: they are part of a strategy that offers something 'completely different'.
- The strategy has been consistently managed as large-cap, core-value. It has shown an ability to add value to investors over the long term, even in challenging markets, through a consistent, repeatable process and strong bottom-up stock selection.

Overview

UK equities have been out of favour for many years. Underperformance relative to global markets – whether coincidentally or not - started around the time of the Brexit referendum in 2016. There was a partial rebound in 2022, however this has faded somewhat in 2023 as a result of euphoria around a narrow cohort of US tech stocks, spurred on by a frenzy around Artificial Intelligence.

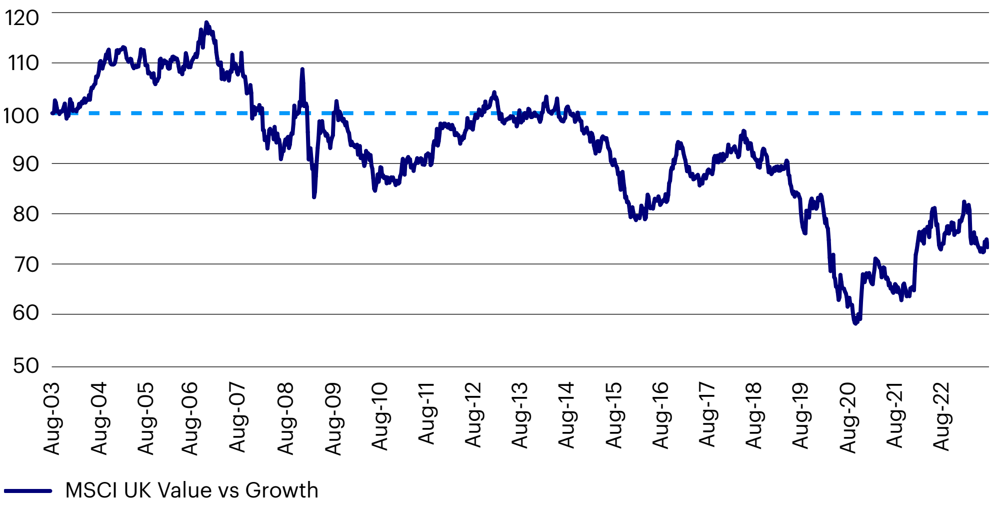
Although UK equities have long been overlooked, we argue that the asset class should not be ignored – not by UK, nor by international asset allocators. It offers something that is as **different** as it is **attractive**. And both these qualities are important.

The Invesco UK Opportunities Fund (UK) and Invesco UK Equity Fund stand out among their peer groups. The funds have been consistently managed as large-cap, core value funds. The strategy has shown an ability to add value to investors, even in challenging markets. Over the past ten years, against a tough backdrop for 'Value', the funds have still outperformed the FTSE All-Share Index as a result of strong stock selection.

Background – Value at the point of purchase really does matter

Since the time of the GFC, 'Growth' has been the dominant style in global equities, fuelled by loose monetary policy, against a backdrop of low inflation.

Figure 1. Relative performance – Value vs growth in UK equities



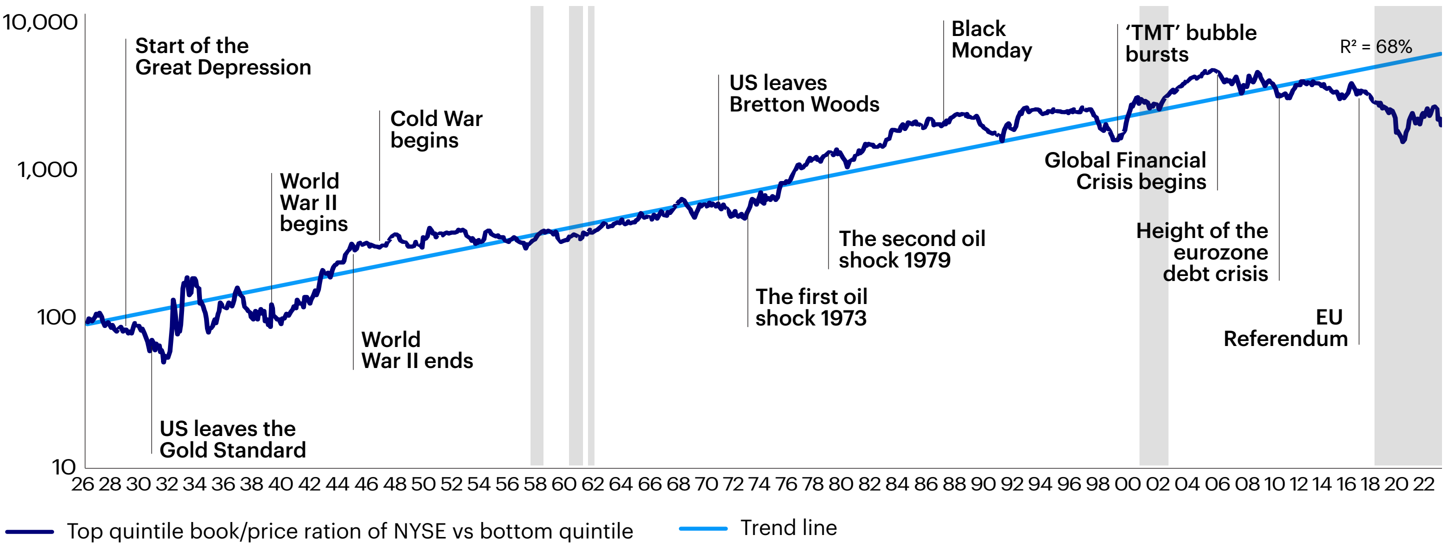
Past performance does not predict future returns.
Source: Factset, as of 31 July 2023. Indexed 31 July 2003 =100.

But by historical standards these have not been 'normal' conditions.

Figure 2. below illustrates almost 100 years of performance in the US, of stocks valued in the lowest quintile, compared to those in the highest. The dominance of 'Expensive' since the GFC mirrors the recent dominance of 'Growth' in the UK. But the lesson from history is clear: in the long run, value at the point of purchase **really does matter**.

We believe that the next 10 years in markets will look very different to the past 10 years, characterised by (on average) higher inflation and higher interest rates than we have experienced since the GFC. In such an environment, nominal earnings growth will become less special, and the consequent increased cost-of-capital will weigh more on the present value of growth in outer years of projections. The obverse is also true – cash generated today will be increasingly important compared to the hopes of reward tomorrow. Focus on valuation at the point of purchase will re-assert itself as a key discipline.

Figure 2. Long term relative performance of US Equities – The importance of valuation



Source: Ken French Data Library, Bernstein and Invesco, 30 June 2023 (latest data to 31 May 2023).
The chart compares the performance the top quintile book/price ratio companies in the New York Stock Exchange with the bottom quintile. Shading denotes a period where value has underperformed on a ten-year rolling basis. The logarithmic scale allows for the assessment of the magnitude of earlier deviations from trend.

We don't expect that Value will out-perform Growth all the time. There will be volatility on the way. But we believe that Value will outperform more often than not.

At the very least, in a world in which US 10-year yields are 4.0% (1 August 2023) - not high relative to a 50-year average of 6.0%, but fundamentally changed from the average of 2.3% over the past 3 years - why would you now not want at least some exposure to Value as a factor?

An environment that is different, calls for exposure to something that is different.

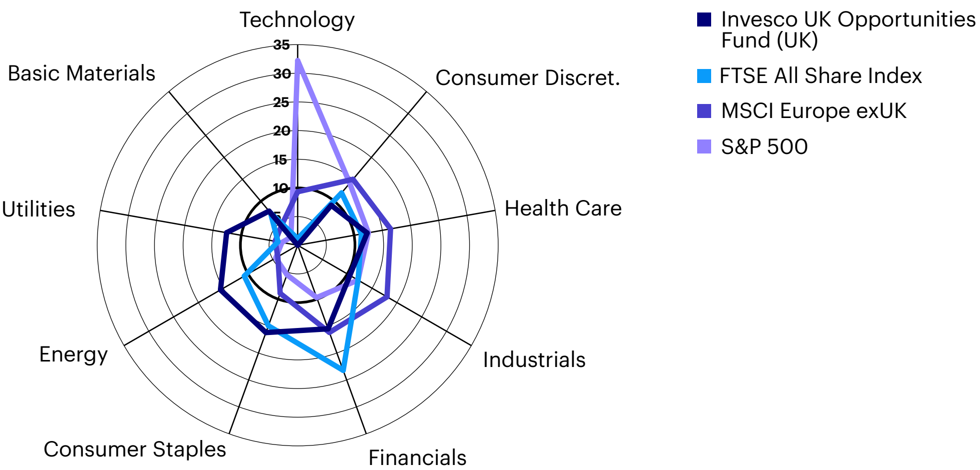
"And now for something completely different"

UK Equities offer exposure to the Value factor through a very different mix of companies, that are in many cases lowly valued relative to their global peers.

Quite how different the mix of companies is, is illustrated in Figure 3 below.

The chart compares the weightings of each of the major sectors in the S&P 500, the MSCI Europe ex-UK Index and the FTSE All-Share Index, along with weightings in the Invesco UK Opportunities Fund (UK).

Figure 3. Key sector weights



Source: Invesco, Factset, 31 July 2023. Chart shows distribution of weightings by major sector.
Excludes: Real Estate,Telecoms and transactional cash held in the Fund as not significant to the comparison

After an extended period in which Growth has been the dominant factor driving equity markets, there is now a significant skew in the sector weighting of the S&P 500 to the Technology sector. Almost 1/3rd of the entire index is comprised of Tech stocks, which are valued (across a range of measures) at over 2x standard deviations above their 20-year sector average. We make no judgement other than to observe that this is consistent with the concentration of absolute risk in the S&P Index.

The sector weights mapped for the MSCI Europe ex-UK Index, show there to be more moderate exposure in Europe to Tech, but otherwise display a similar shape of sector exposures to the S&P 500.

The overall shape of the FTSE All-Share Index is however very different. There is minimal exposure to Tech, but greater exposure to Consumer Staples, Energy, Basic Materials and Financials. The Invesco UK Opportunities Fund (UK) offers still greater exposure to global Energy, to large cap Consumer Staples, and to diverse stock specific drivers among cash generative Utilities.

So much for structure. The correlation data in Figure 4 quantifies how this translates in terms of actual performance.

It is evident from the data that total returns from the FTSE All-share are less correlated with the S&P 500 and MSCI Japan, than is the MSCI Europe ex-UK. For an asset allocator with significant equity exposure to the US, the UK therefore offers greater diversification than does Europe.

Figure 4. Correlation of total returns (%)

	Invesco UK Opps	FTSE All-Share	Europe ex UK	S&P 500	Japan	China H
Invesco UK Opps		85	48	9	8	14
FTSE All-Share	85		74	24	16	11
Europe ex UK	48	74		39	26	4
S&P 500	9	24	39		25	0
Japan	8	16	26	25		3
China H	14	11	4	0	3	

Source: Invesco, Factset, 31 July 2023. Chart shows coefficient of determination (R2) of rolling monthly total returns in GBP, daily, since 31 July 2020. Invesco UK Opportunities Fund (UK), FTSE All-Share Index, MSCI Europe ex-UK Index, S&P 500 Index, MSCI Japan Index, MSCI China 'H' Shares Index

The Invesco UK Opportunities Fund has a particularly low correlation with the S&P 500 and MSCI Japan: it offers something **completely different**. Furthermore, the Fund has significantly outperformed each of the indices over the 3-year period, at notably lower levels of volatility (i.e. realised risk) than US, Europe, Japan or China based indices.

A concern of some is that the UK equity market might be a small pool in which to fish. The MSCI World Index is indeed dominated by US companies which comprise 72.7% of the Index, but of the remaining countries, the size of the UK at 4.0% is second only to Japan (6.1%) and is significantly larger than either France (3.4%) or Germany (2.4%). The size of the UK market provides both breadth and liquidity in many world class companies listed in the UK that are global in their activities. The FTSE All-Share Index is not the same as the UK economy. Less than ¼ of the revenues of the FTSE All share index are derived from the UK. There are more revenues in the Index derived in US-dollars than in Sterling.

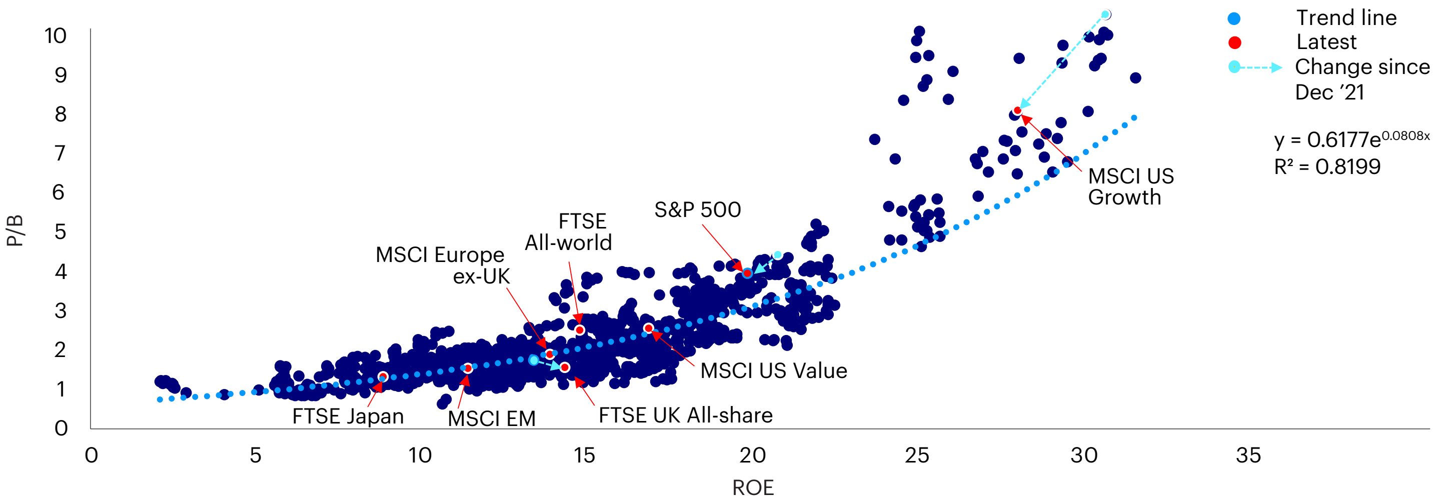
Back to valuation

Let's look at the current valuation of UK equities. The model below can help us assess whether they are offering fair value by:

- Showing how price-to-book has varied with returns, globally, over a 20-year history, and
- Comparing the latest price, against the 'fair value' implied by the model, given latest forecasts.

The model implies that there is a much as 27% upside to the current valuation of UK Equities.

Figure 5. Returns adjusted valuation model



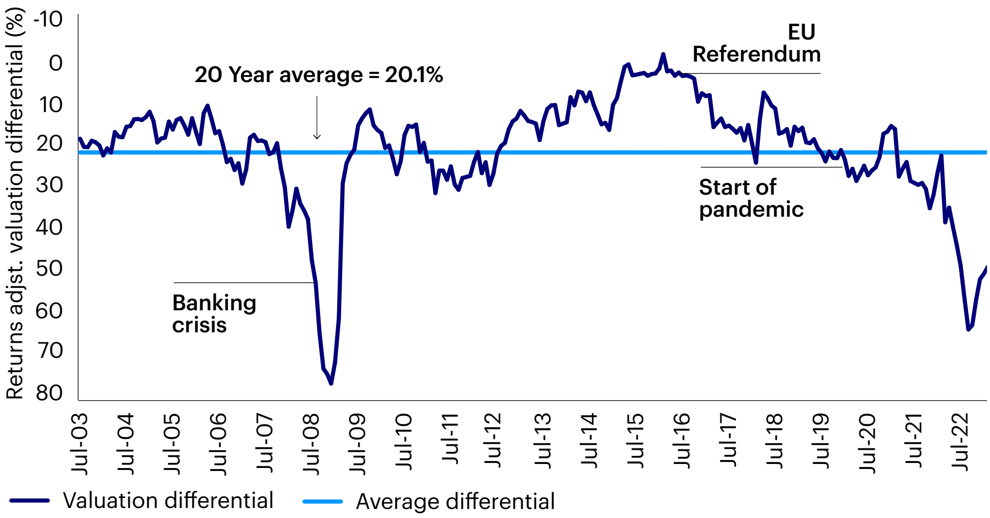
	FTSE All-world	FTSE All-share	Europe ex-UK	Japan	EM	S&P 500	US growth	US value
Current ROE	14.8	14.3	13.9	8.9	11.4	19.9	20.8	16.9
Current P/B	2.5	1.6	1.9	1.3	1.5	3.9	8.1	2.5
Implied P/B: 20yr regression	2.0	2.0	1.9	1.3	1.6	3.1	5.9	2.4
Difference	-18%	27%	1%	-4%	2%	-22%	-26%	-5%

Source: Invesco, Factset as at 31 July 2023. Indices used: FTSE All-world, FTSE UK All-share, MSCI Europe ex-UK, FTSE Japan, MSCI EM, S&P 500, MSCI US Growth, MSCI US Value. Plots show monthly Price to Book (P/B) ratio against monthly mean rolling 12month estimated Return on Equity (ROE), beginning 31 July 2003. The Implied P/B is the value derived from application of the algebraic equation of the trend line, substituting Current ROE for "x".

By contrast, the S&P 500 is now trading at a 22% premium to its own implied valuation, despite negative revision to earnings since the beginning of 2022.

The difference in the implied valuation premium / discount represents a returns-adjusted valuation differential, illustrated in the chart below.

Figure 6. Returns adjusted valuation differential: US vs UK equities



Source: Invesco, Factset as at 31 July 2023. Based on regression of monthly Price to Book (P/B) ratio against monthly mean rolling 12month estimated Return on Equity (ROE), beginning 31 July 2003. Indices used: FTSE All-world, FTSE UK All-share, MSCI Europe ex-UK, FTSE Japan, MSCI EM, S&P 500, MSCI US Growth, MSCI US Value. The Implied P/B is the value derived from application of the algebraic equation of the trend line, at a given level of ROE (See slide 6) . Valuation gap is the difference between the Implied P/B and the actual P/B. Returns adjusted valuation differential is the difference between the valuation gap for UK, less the valuation gap for US.

After the most recent outperformance of the S&P 500, the differential has again widened to 49%.

Over the past 20 years, the average valuation differential has been 20%. So even returning to the median (and not to fair value equivalence, last seen around the time of the EU Referendum in June 2016) implies significant valuation upside potential.

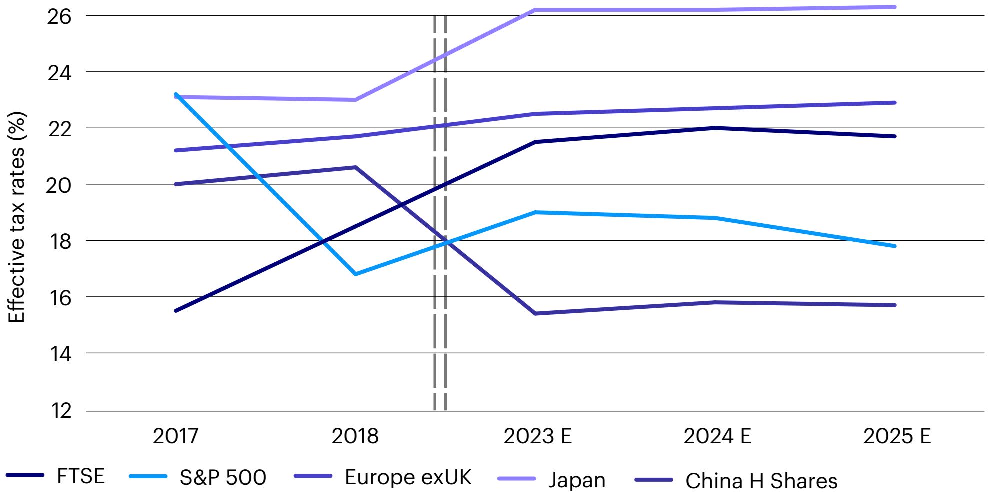
The exponential shape of the fair value frontier in our returns adjusted valuation model (Figure 5) implicitly recognises the value of higher returns being reinvested for higher growth in earnings. It recognises that the prospect of higher growth in earnings merits a higher PE multiple.

But here again the 'quality' of earnings growth in the US is perhaps not all that it might seem.

Post tax returns are affected by tax **policy**, and whilst change in policy does translate over time into cash, the rate of change in earnings due to tax policy is not sustainable. Earnings growth due to tax policy should therefore not merit an increased multiple.

Figure 7 illustrates how the effective rate of taxation borne by companies listed in different jurisdictions, has changed from the pre-pandemic era to the post-pandemic era.

Figure 7. Effective tax rates pre-pandemic and post pandemic



Source: Invesco, Factset, 31 July 2023. Chart shows actual weighted average effective tax rate in the income statement for pre-pandemic periods CY 2017, CY2018, and consensus estimates of weighted average effective tax rates for post-pandemic periods CY 2023 E, 2024E and 2025E. No data shown for periods 2019 to 2022, as effective tax rates are distorted. Data shown for, FTSE All-Share Index, MSCI Europe ex-UK Index, S&P 500 Index, MSCI Japan Index, MSCI China 'H' Shares Index

The analysis shows the effect of taxation policy response, in the wake of the pandemic, has been to increase the burden of tax on UK listed companies, bringing the effective tax rate more into line with European levels, but at the cost of reducing earnings. By contrast, effective tax rates have fallen in the US and China, providing a boost to corporate earnings.

Analysis of consensus earnings expectations shows that the annualised growth in EPS in the US is expected be 9.5% over the 8-year period, compared to 5.5% in UK. However, half of this EPS growth differential is explained by taxation, and the underlying difference in rate of growth in pre-tax income less than 2%.

Against this backdrop, earnings multiples have in the US expanded from 16.8x consensus expectations for the next 12 months (in January 2017) to 19.6x (31 July 2023). By contrast in the UK, they have contracted from 14.3x to 11.0x, over the same period.

This seems both anomalous and excessive.

Risks to equity returns

From a top-down perspective, there are a number of macro factors at play that we believe will continue to challenge global equities over the medium term.

We believe inflation is likely to remain stronger for longer in developed markets. In some cases, central bank models of how inflationary pressures are transmitted through the economic system have also been proven to be out of touch. The precise mix in the inflationary cocktail varies from market to market. But it remains potent whatever form.

With inflation set to remain higher for longer, we also expect interest rates to remain higher for longer. Such is the likely persistence of inflation, we have become increasingly concerned at the possibility of policy error by central banks.

Added into the mix, we sense there is a degree of complacency in energy markets. These muddled through last winter through a combination of mild weather, reduced economic activity in China (still largely shut because of Covid), and a physical and financial destocking of oil (especially, of strategic petroleum reserves).

As we look out to the rest of the year and beyond, we are not calling for a recession in any particular market, but the risks of a slowdown of GDP in national economies and of earnings momentum in individual businesses are there to see.

Despite the caution engendered by macro views, we remain optimistic at the medium to long-term outlook for UK equities, particularly on a relative basis.

The bottom line is that UK equities are an attractive source of value. The opportunity set includes many world-class, internationally orientated companies with good earnings momentum. They are undervalued versus their own history and versus the US, and sterling is undervalued too.

UK equities are also an attractive source of real income. Higher inflation and volatility are both likely to continue, but dividends should keep pace with inflation over time. Equity income will be attractive in challenging markets.

Attractive, different, ... and available through Invesco Funds which form a consistently managed large-cap, core-value strategy, that has demonstrated an ability to add value to investors over the long term, even in challenging markets.

Invesco UK Opportunities Fund (UK)

Net performance as at 31 July 2023 - Z (accumulation) share class (%)

12 month rolling periods	31/07/18 - 31/07/19	31/07/19 - 31/07/20	31/07/20 - 31/07/21	31/07/21 - 31/07/22	31/07/22 - 31/07/23
Invesco UK Opportunities Fund (UK)	-6.6	-15.5	32.4	20.2	8.4
FTSE All-Share TR	1.3	-17.8	26.6	5.5	6.1
IA UK All Companies Sector NR	-1.1	-14.7	32.3	-4.6	2.6
MSCI Growth	10.9	-5.0	18.7	5.2	5.6
MSCI Value	-2.0	-28.8	25.6	17.8	6.7
MSCI Europe ex UK	5.0	-2.8	26.4	-6.5	16.1
S&P 500	15.7	4.4	28.8	9.0	6.9
MSCI Japan	2.8	-5.1	18.6	-1.7	9.3
MSCI China ‘H’ Shares	5.5	-12.1	5.0	4.3	2.7

Past performance does not predict future returns.

Source: Lipper. Fund performance figures are shown in sterling, inclusive of reinvested income and net of the Ongoing Charge and portfolio transaction costs. Sector average performance is calculated on an equivalent basis. The IA UK All Companies Sector is a comparator benchmark. Given its geographic focus the Fund’s performance can be compared against the Benchmark. However, the Fund is actively managed and is not constrained by any benchmark. Please note the Indices shown are not a target, constraining or comparator benchmark of the fund. The comparative information shown here is to illustrate the fund manager’s active investment approach and provide broader market context.

Invesco UK Equity Fund

Net performance as at 31 July 2023 (Z AD Shares Class %) in GBP

12 month rolling periods	31-Jul 2014	31-Jul 2015	31-Jul 2016	31-Jul 2017	31-Jul 2018	31-Jul 2019	31-Jul 2020	31-Jul 2021	31-Jul 2022	31-Jul 2023
Invesco UK Equity Fund	8.5	8.0	-5.9	20.5	2.8	-9.1	-22.2	38.2	22.2	7.6
FTSE All-Share Index	5.6	5.4	3.8	14.9	9.2	1.3	-17.8	26.6	5.5	6.1

Past performance does not predict future returns. Returns may increase or decrease as a result of currency fluctuations.

Source: Invesco, © Morningstar 2023 (see disclaimer at end of document).

Fund performance figures are shown in GBP, inclusive of reinvested income and net of the ongoing charges and portfolio transaction costs. The figures do not reflect the entry charge paid by individual investors. Sector average performance is calculated on an equivalent basis. The performance data shown does not take account of the commissions and costs incurred on the issue and redemption of units. As the Fund is actively managed, it is not intended that the performance of the Share Class will track the performance of FTSE All-Share Index (Total Return - net) (the "Benchmark"). The EAA Fund UK Large Cap Equity sector is shown for performance comparison purposes only. The Fund does not track the sector. The historical performance shown in the table above up to 5 October 2018 relates to the historical performance of the Irish domiciled fund, which was merged into the Luxembourg-domiciled fund on that date. This change has no impact on the investment objective, strategies, risk profile or fee structures of the fund. In addition, the ongoing charge of the Fund is the same as the ongoing charge of the previous fund, at the date of the merger. As at 2 August 2021, this share class is now the Primary share class for this fund. As this share class was launched on 08 October 2018, for the periods prior to this launch date, performance figures are that of the A AD share class, without any adjustment for fees.

Please note the Indices shown are not a target, constraining or comparator benchmarks of the fund. The comparative information shown here is to illustrate the fund manager's active investment approach and provide broader market context.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Invesco UK Opportunities Fund (UK)

As the Fund typically has a concentrated number of holdings, it may carry a higher degree of risk than a fund which invests in a broader range of holdings or takes smaller positions in a relatively large number of holdings.

The fund may use derivatives (complex instruments) in an attempt to reduce the overall risk of its investments, reduce the costs of investing and/or generate additional capital or income, although this may not be achieved. The use of such complex instruments may result in greater fluctuations of the value of the fund. The Manager, however, will ensure that the use of derivatives within the fund does not materially alter the overall risk profile of the fund.