Economic Advantage

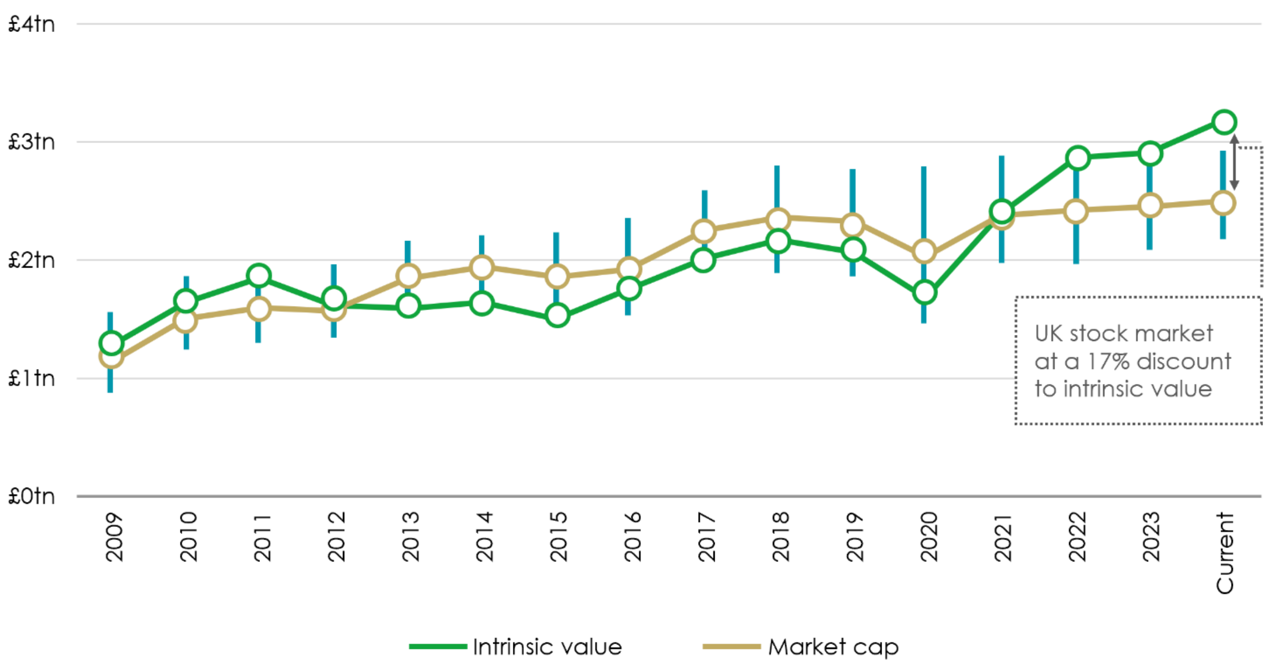
July 2024

Will the UK election provide the catalyst we have all been waiting for?

UK equities are cheap. Everybody knows that, but the key is what will catalyse a change.

For some time now, we have been discussing with clients the significant investment opportunity in UK equities as a result of their extremely low valuations. Canaccord Genuity Quest's long-term discounted cash flow (DCF) analysis shows that the UK currently trades at a substantial discount to 'intrinsic value'. The capitalisation of the entire UK stock market sits 17% below Quest's estimate of fair equity value. The opportunity is particularly pronounced among small caps, where the discount to fair value is 29%.

Quest estimate of intrinsic value vs market capitalisation



Source: Liontrust, Canaccord Genuity Quest, 10.06.24. Intrinsic value based on Quest default 40-year DCF valuation for the UK market. Market cap represents aggregate capitalisation of all stocks in Quest UK market universe.

We can see from the chart that this gap, while growing, has been in place since 2022, so it's reasonable to ask what catalyst might lead to a correction.

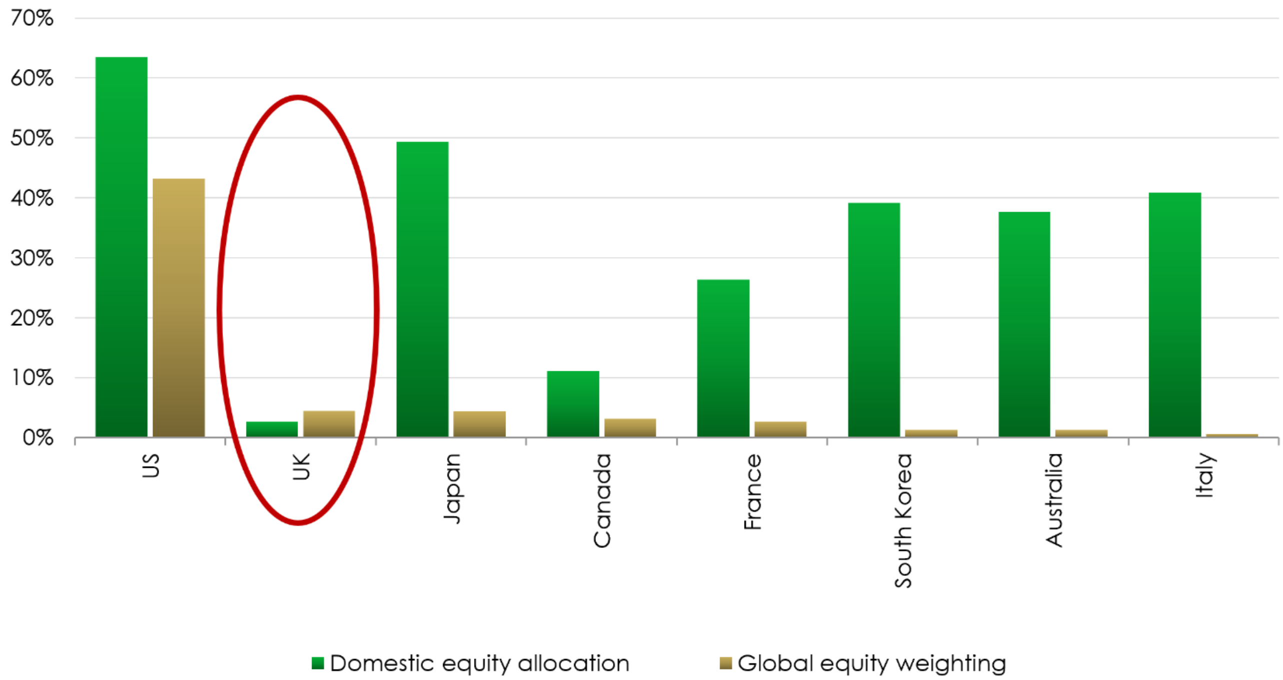
Sentiment towards UK equities has been on an improving trajectory in 2024 – partly reflecting positive economic growth and inflation which is returning to target – and we believe there are more positive catalysts on the horizon.

With the UK general election looming and a Labour majority government looking likely, the potential for positive policy intervention is one of the most impactful and imminent sources of impetus.

Over the last year, we've been actively lobbying to encourage government initiatives to promote a more supportive backdrop for UK equities. We were therefore pleased to see the chancellor introduce the British ISA in the Spring Budget. The budget contained an even more meaningful statement of intent, in the form of requirements for defined contribution and local government pension funds to disclose their level of investment in UK equities. This was coupled with a warning shot that action will be taken if "we are not on a positive trajectory towards international best practice."

The UK's pension funds are a significant outlier in their allocation to the domestic stock market. The chart below clearly demonstrates a glaring discrepancy between other countries' pension funds "domestic bias" and the underweight position of our own.

Pension fund domestic equity allocation



Source: CMIT (Capital Markets Industry Taskforce), November 2023. Domestic equity allocation is a simple average of up to three of the largest pension funds, where asset and geographic allocation is publicly disclosed, in each country. Global equity weighting is calculated using the total market capitalisation of all listings, including dual/secondary listings, on each exchange as a proportion of the aggregated market capitalisation of the largest 65 exchanges globally

The need to stimulate investment in the UK stock market is an area of political consensus. We were delighted to see in the Labour Party Manifesto an explicit commitment to increase investment by UK pension funds in the domestic stock market. Reform such as this would be transformative to the capital flow dynamic in the UK market following ten years of net outflows from the IA UK All Companies sector.

> "Labour will also act to increase investment from pension funds in UK markets. We will adopt reforms to ensure that workplace pension schemes take advantage of consolidation and scale, to deliver better returns for UK savers and greater productive investment for UK PLC. We will also undertake a review of the pensions landscape to consider what further steps are needed to improve pension outcomes and increase investment in UK markets"
>
> Labour Party Manifesto, June 2024

Sufficient flows of capital to the UK market are vital to support both existing companies and new market entrants via initial public offerings (IPOs). We have found some fantastic, entrepreneurial, fast-growing companies on the UK market over the years, but if these types of business are to continue seeking stock market listings, the attractions of raising capital this way need to outweigh the regulatory costs of being a publicly listed company. Ultimately this has implications for the future of the UK economy through productivity growth, skilled employment and individual prosperity.

When capital inflows and share prices dwindle, opportunistic takeover activity often surfaces. Merger & acquisition (M&A) activity has picked up recently across the UK market, and we have felt the impact of this on the Economic Advantage funds. Across the fund range, 26 companies have experienced bid interest over the last two years, equivalent to approximately 18% of our universe of holdings.

This M&A activity is very much a double-edged sword: while money coming back into the hands of fund managers to reinvest in the market is a potential catalyst to highlight depressed valuations and latent value, this needs to be balanced against the opportunity cost of forgone long-term compounding when a company is taken off the market.

We feel that the clear valuation gap presents a compelling opportunity for investors in UK shares with the market poised to benefit from more imminent catalysts. After the election a number of stars should align – a stable government, interest rates falling, inflation stabilising and growth returning. This, coupled with likely policy intervention, should help turn the tide following decades of outflows. We hope the next government recognises the opportunity to promote economic growth and domestic prosperity via a thriving stock market sooner rather than later.

Natalie Bell, Fund Manager.

For a comprehensive list of common financial words and terms, see our glossary at:
https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

Key Risks

Past performance does not predict future returns. You may get back less than you originally invested. We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments.

The Funds managed by the Economic Advantage Team:

May have a concentrated portfolio, i.e. hold a limited number of investments. If one of these investments falls in value this can have a greater impact on a Fund's value than if it held a larger number of investments.

May encounter liquidity constraints from time to time. The spread between the price you buy and sell shares will reflect the less liquid nature of the underlying holdings.

May invest in companies listed on the Alternative Investment Market (AIM) which is primarily for emerging or smaller companies. The rules are less demanding than those of the official List of the London Stock Exchange and therefore companies listed on AIM may carry a greater risk than a company with a full listing.

May invest in smaller companies and may invest a small proportion (less than 10%) in unlisted securities. There may be liquidity constraints in these securities from time to time, i.e. in certain circumstances, a fund may not be able to sell a position for full value or at all in the short term. This may affect performance and could cause a fund to defer or suspend redemptions of its shares.

Outside of normal conditions, may hold higher levels of cash which may be deposited with several credit counterparties (e.g. international banks). A credit risk arises should one or more of these counterparties be unable to return the deposited cash.

May be exposed to Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

The risks detailed above are reflective of the full range of Funds managed by the Economic Advantage Team and not all of the risks listed are applicable to each individual Fund. For the risks associated with an individual Fund, please refer to its Key Investor Information Document (KIID)/PRIIP KID.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

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