UK EQUITIES

SEPTEMBER 2024

THE MID-CAP ODYSSEY

Celebrating the silver anniversary

- **Martin Currie's UK mid-cap strategy has delivered strong returns over the past 25 years**
- **The UK mid-cap market is currently undervalued, providing an exceptional opportunity for investors**
- **Three areas we see opportunities in the UK are: construction, consumer focused and global industrial stocks**

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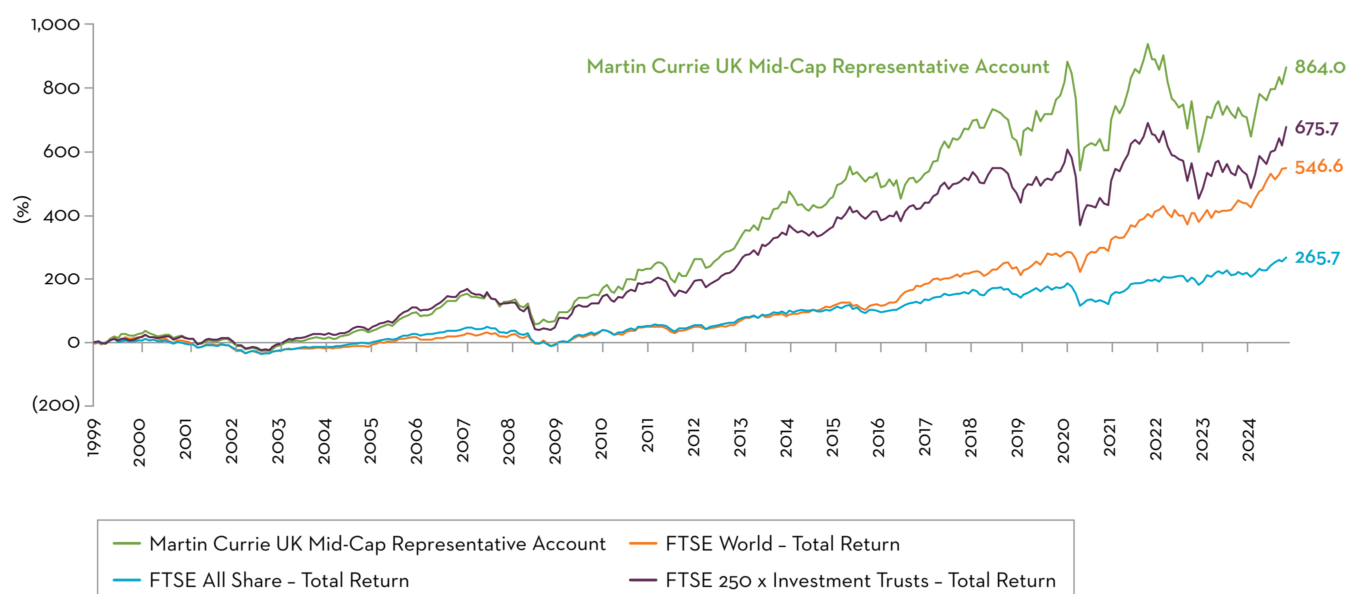
This summer we celebrated the silver anniversary of our UK mid-cap strategy. If you'd invested £1,000 in our strategy at launch, it'd be worth £9,640 today (31 July 2024). Representing an annual return of over 9% for 25 years – not too bad! Even better, it has provided an active return of 24%, ahead of the FTSE 250 ex Investment Trusts, since inception.

Performance: 12 July 1999 to 31 July 2024



Past performance is not an indicator or a guarantee of future performance.

Source: Franklin Templeton and Martin Currie as at 31 July 2024.

The UK mid-cap space offers an attractive hunting ground for investors where the companies are large enough to be resilient, yet small enough to be dynamic, adaptive and offer opportunities for growth. This sweet spot in the market offers a diverse array of investment options, especially for active managers looking to add value.

Patient investors have enjoyed a remarkable two and a half decades. But we think things could get even better from here. We may not be able to predict the next 25 years, but we are certainly excited about what's in store for UK mid-caps in the next 2-5 years!

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Valuations – the elephant in the room

The UK equity market is currently extremely cheap – offering an exceptional opportunity for investors. Low valuations have been a persistent feature of the UK equity market since the outcome of the Brexit vote. However, the tides are turning. The FTSE 250 ex Investment Trusts has returned 18.5% in the 12 months to 31 July 2024[1]. Positive momentum is building, and the market is slowly beginning to re-rate after almost a decade in the doldrums. The Bank of England has also begun cutting rates, which has historically marked the early stages of a multi-year rally in UK mid-cap stocks.

Private equity firms and corporations with deep pockets have noticed the UK offers quality investments at bargain prices. There were 32 UK transactions of more than £100 million announced in the first half of 2024[2], which was the second largest, globally, after the US. Of which 14 and c.£36.7 billion of market capitalisation related to FTSE 250 constituents. Ongoing interest in takeover activity will contribute to upward price pressure across the market.

However, upon closer examination, you'll see the UK equity market offers much more than undervalued stocks. It has an array of companies with excellent fundamentals, about to benefit from strong trends that will help drive returns. Our UK mid-cap portfolio is positioned to benefit from:

[1]Source: Franklin Templeton and Martin Currie as at 31 July 2024.

[2]Source: Peel Hunt as at 2 July 2024.

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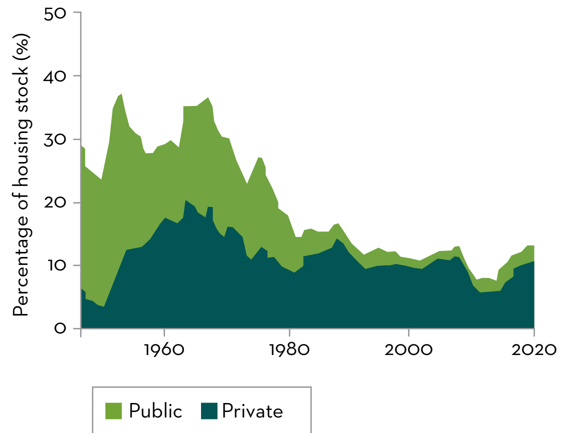
Construction and the supply chain – demand pull and Government push

The construction industry has faced a difficult 18-24 months of lower demand and volumes, most recently seen with the collapse of ISG. However, the strongest industry players are well positioned from the recovery on the horizon. The UK is experiencing easing mortgage costs as interest rates reduce, improving customer confidence, relatively resilient employment levels, and a supportive backdrop for a positive recovery of the construction sector.

The Labour party have committed to building 1.5 million new homes through an overhaul of the existing system including relaxing planning laws, utilising the "grey belt" and reinstating local housing targets. Their target amounts to 300,000 new homes a year during their parliamentary term, by comparison 176,000 houses were built in 2023[3].

Construction company prices had been discounting a recession like environment, and given this didn't materialise, construction companies have performed well in recent months. While the upside has reduced somewhat, prices have only reverted to historic averages, we continue to see good value in the sector. We are focused on identifying the resilient areas of the supply chain who will be the greatest beneficiaries of a medium term stronger period for the housebuilding sector.

Gross rates of housebuilding



Source: Centre for Cities and United Nations, Bulletin of Housing and Construction as at February 2023. From 2000 Tenure and housing stock data is from the Office of National Statistics.

UK housebuilder that is trading at book value as the sector is still at the foothills of recovery.

Manufacturer of sustainable water, climate, and ventilation management solutions for construction. Genuit are helping homes meet the increased environmental requirements of the future.

Distributor of building materials and DIY products, making it a key part of the housebuilder's supply chain.

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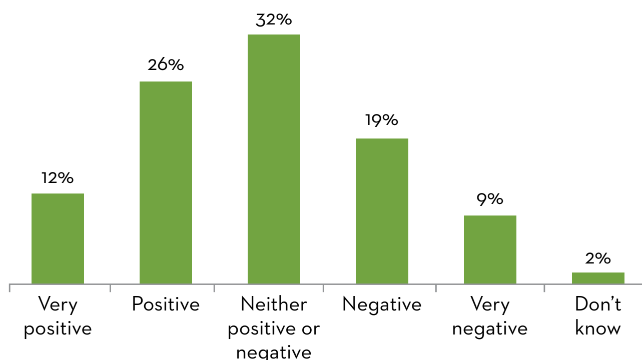
[3]Source: Office for National Statistics as at 24 April 2024.

Consumers' confidence is growing

UK consumers are now more likely to rate their economic situation positively than negatively. This is a massive improvement following a period of rampant inflation and a cost-of-living crisis. Inflation is now within range, real wages are in positive territory and rate cuts have begun; all helping living standards and disposable incomes. We're at an inflection point where consumer confidence is ticking up into positive territory, an upwards trend that we anticipate will continue, despite the recent gloomy rhetoric of the incoming government.

UK consumer rating of own economic situation



Source: Statista Consumer Insights Global as at May 2024.

Periods of inflection are the most interesting times to be an investor. It's difficult to predict and trying to time the market can be foolhardy. We focus on when we believe too much pessimism is priced into a stock and look to the long-term value creation the business can achieve. For the last 12-18 months, we've seen the steady drip feed of positive economic data, which contrasts so starkly with the negative market sentiment. We are ready and waiting for the resurgence of the UK consumer.

We are focused on identifying the quality run, domestically focused businesses that should benefit from an uptick in disposable incomes. Some examples:

UK food producer specialising in premium, fresh, and added-value meat products. Cranswick are set to benefit from increased volumes as real incomes increase.

Leading UK home furnishings retailer offering bedding, curtains, furniture, and home decor. Dunelm will benefit from an uptick in housing activity.

The high street favourite! Greggs will continue to benefit from the growth of on-the-go convenience items through increased demand for its expanding menu which is being served at all times of the day.

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Opportunities in specialist global industrials

The industrial sector is a broad church, covering areas such as aerospace and defence, engineering and machinery and transport and logistics. Many UK mid-cap industrials hold world-leading positions, and often operate in niche areas of expertise, with differentiated products and services. Yet they are trading at valuations well below their international peers.

Economic growth is on the up. After a shallow recession late in 2023, we've seen two quarters of positive economic growth in the UK, beating expectations. Gross Domestic Product (GDP) is currently growing at 0.6%[4], and is anticipated to be growing at 1.7% by 2026[5], which is just behind the US and Canada, and just ahead of France and Germany. Industrials benefit when global activity is on the rise.

Many industrials have faced supply chain problems, due to global trade routes disruption, and an inventory build-up through the Covid years. This was reversed through the subsequent period of de-stocking in a bid to manage the surplus. Supply chain improvements have been needed. Ongoing domestic investment is also becoming more prevalent as companies look to reshore or nearshore to get a tighter grip on their supply chain*. This is another driver of demand. In response, many well-run industrials have been implementing changes that ensure they can better manage costs and meet demand, all of which is beneficial to their bottom line. Operational improvements, combined with moving to an expansionary stage of the economic cycle, means quality industrials are primed to fare well.

Given the breadth of companies in this sector, the team are focused on identifying companies that will outperform the broader industrials sector through being exposed to sub-sectors that are expected to offer a higher rate of growth. We outline three examples of such holdings that we are hopeful will deliver outsized returns to the wider sector:

Leading global provider of heat treatment and specialist thermal processing services which help to improve properties and extend the life of key metallic components. Bodycote is an early cycle operationally geared recovery play expected to benefit from the wider economic recovery.

Leading engineering and technology company focused on the defence and security markets principally in the UK, US and Australia. In a world of increasing geopolitical instability, demand for the sophisticated products and services it provides is growing. As a result there is increasing pressure for all NATO countries to meet the 2% GDP target for defence spend and in fact some are now seeking to exceed this with the UK having committed to raise defence spending to 2.5% by 2030[6].

Global leading manufacturer of industrial flow control equipment. Rotork's products are used to electrify flow control processes in hydrogen, carbon capture, storage and battery production giving it a key role in the energy transition. The UK has pledged to be net zero by 2050, with interim targets of a 68% reduction in emissions, compared to 1990, by 2030 and 78% by 2035. Similar targets exist around the world.

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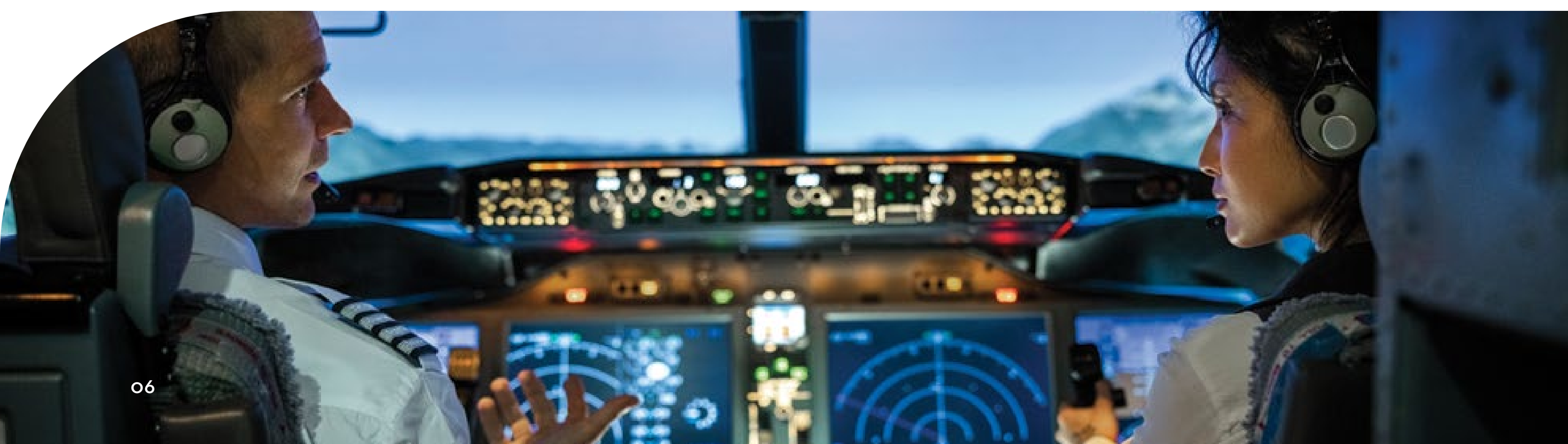
[4]Source: Office for National Statistics as at July 2024.

[5]Source: International Monetary Fund and World Economic Outlook database as at April 2024

[6]Source: GOV.UK as at 23 April 2024.

*Reshore = To move a business or part of a business that was based in a different country back to its original country. Nearshore = Involves shifting your company's business operation to a nearby country.



25 years past, and many exciting years to go

Investing during times of change is exciting! The UK has moved from experiencing rapid inflation with concerns of stagnation, to an economy in recovery with growth taking off. This backdrop is a big positive for a range of industries and companies but is not yet captured in valuations.

With 25 years of experience in the thriving UK mid-cap equity market, we've learned to recognise critical turning points. We believe in investing in quality companies ahead of these changes and are confident and patient enough to wait for the market to catch up. We couldn't be more excited about the prospects for UK mid-caps, particularly those in our portfolio, over the next 2-5 years.

As we celebrate our 25-year anniversary, we are thrilled about the investment opportunities ahead in the coming years. However, given the vibrancy of mid-cap companies, we have no doubt the next 25 years look bright too!

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- Investing in foreign markets introduces a risk where adverse movements in currency exchange rates could result in a decrease in the value of your investment.
- This strategy may hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the strategy's value than if it held a larger number of investments.
- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.

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