INVESTING IN UK EQUITIES: A CHOICE, NOT AN OBLIGATION

Why pension funds should be considering their allocation to UK equities

SEPTEMBER 2024

For professional investors only

"And we will turn our attention to the pensions system, to drive investment in homegrown businesses and deliver greater returns to pension savers[1]."

Rachel Reeves, first speech as Chancellor, 8th July

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Labour was primed to hit the ground running upon gaining power. Just five days after the election, they kicked off the process of aligning the UK Infrastructure Bank and the British Business Bank under a new National Wealth Fund[2]. Just over a week later, the King's speech confirmed a new Pensions Bill[3], which was swiftly followed by the announcement of a landmark pensions review, part of the government's mission to "boost growth and make every part of Britain better off[4]". Rachel Reeves is not wasting any time.

The Autumn Budget, scheduled for 30th October, should provide more details of what the government are looking to implement. However, details are slowly emerging as they test the water with their ideas. They're interested in directing investment to UK assets, further pooling for Local Government Pension Scheme (LGPS) and Defined Contribution reforms too; areas that are already splitting views of the pensions industry. There's one thing we all can agree on, fascinating times are ahead, the new government's "big bang" approach to pensions is coming.

Productivity puzzle: pension plan panacea?

Economic growth was a central theme in Labour's election campaign. The UK economy's growth has lagged the Organisation for Economic Co-operation and Development (OECD) economies for over a decade and if it had grown at the average rate of OECD economies since 2010, it would be £143.3 billion larger[5].

One of the main challenges that's faced the UK economy has been its low productivity growth. The UK government has recognised the importance of boosting productivity to achieve long-term economic growth. An array of growth focused policies will be employed to address this. When launching the pensions review, it was noted:

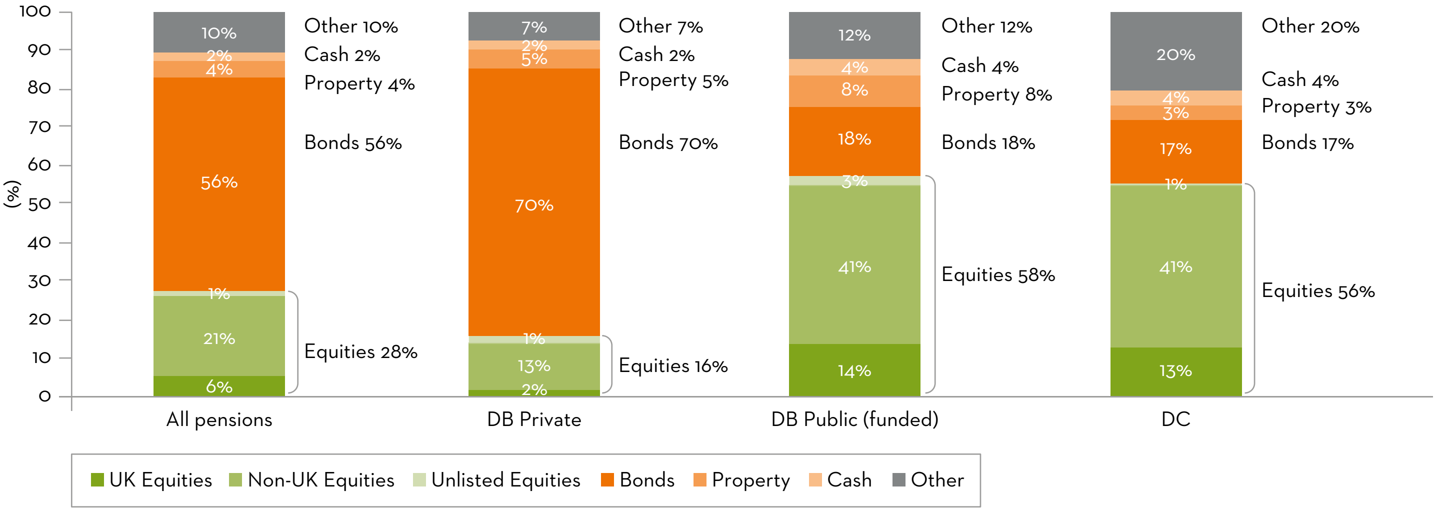
- An investment shift in defined contribution schemes could deliver £8 billion of new productive investment into the UK economy[6]
- Action will be taken to unleash the full investment might of the £360 billion LGPS to make it an engine for UK growth[6]

It's not surprising that the government have had their eyes set on UK pension pots as a way of providing investment to stimulate growth. The total amount of UK pension investments is estimated to be approximately £3 trillion by 2030, with around 15% of this in LGPS schemes[7].

It's unclear if the government is solely focusing on private investment, particularly via the new National Wealth Fund, or if listed equity investments are in scope too. UK equity investments by UK pension schemes have fallen significantly over the past 40 years, more than halving in the period 2006-2020. Whatever they're planning, the government is more than aware that the current low allocations to the UK gives a lot of headroom for an uptick in schemes' domestically focused investments.

[1]Source: GOV.UK as at 8 July 2024. https://www.gov.uk/government/speeches/chancellor-rachel-reeves-is-taking-immediate-action-to-fix-the-foundations-of-our-economy
[2]Source: GOV.UK as at 9 July 2024. https://www.gov.uk/government/news/boost-for-new-national-wealth-fund-to-unlock-private-investment
[3]Source: GOV.UK as at 17 July 2024. https://www.gov.uk/government/speeches/the-kings-speech-2024
[4]Source: GOV.UK as at 20 July 2024. https://www.gov.uk/government/news/chancellor-vows-big-bang-on-growth-to-boost-investment-and-savings
[5]Source: GOV.UK as at 8 July 2024. https://www.gov.uk/government/news/chancellor-unveils-a-new-era-for-economic-growth
[6]Source: GOV.UK as at 20 July 2024. https://www.gov.uk/government/news/chancellor-vows-big-bang-on-growth-to-boost-investment-and-savings
[7]Source: Pensions and Lifetime Savings Association as at June 2023. Pensions and growth a paper by the PLSA on supporting pension investment in UK growth

Asset allocation



Source: Pensions and Lifetime Savings Association. Pensions & Growth: Creating a pipeline of investable UK opportunities as at August 2024.

However, they're bound to face some serious resistance if they try to dictate investment choices. Trustees and committees are more than aware of their fiduciary duties, but their decision making is driven by more than a legal requirement. Most hold these positions as they want to make decisions they believe are in the best interests of those they represent. Any obligations that could infringe this, will not be implemented lightly.

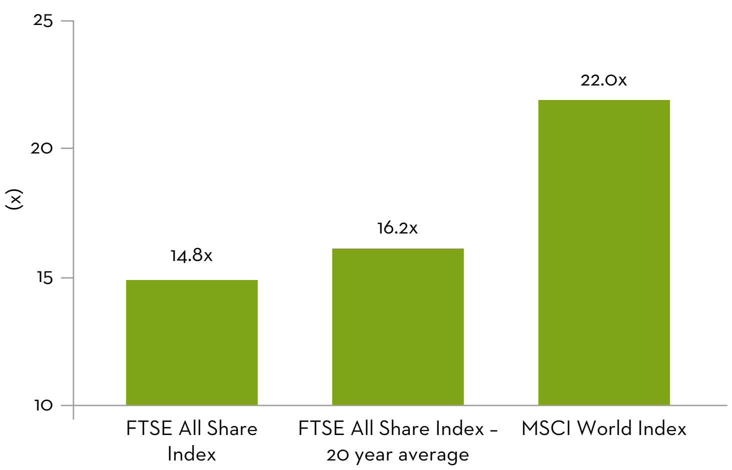
UK equity investing offers great value

Yet, if we move away from the debate around how government intervention may evolve, on a standalone return focused basis, there is an extremely strong case for increased allocations towards UK equities.

Labour have talked a lot about the need to revitalise UK growth. They've talked less about how the UK economy was already on an upwards trajectory when they took power. Inflation has come back into target, GDP growth numbers are beating expectations, consumer debt and corporate borrowing are at reasonable levels, and rate cuts have begun. We may still be at the beginning of a recovery, but UK confidence is certainly on the up.

Despite a rapidly improving economic backdrop, UK equity valuations are below their historical averages and lower than most of their international peers. I don't know about you, but I find the potential of a UK valuation rerating, coupled with strong economic growth, a tantalising investment prospect!

Trailing Price/Earnings Ratio (x)



Source: Bloomberg as at 30 June 2024.

Yet, many pension scheme asset allocations are in line with the standard textbook recommendation of moving towards global allocations. The MSCI World index as of July had only 3.8% in UK equities[8] – this is such a small proportion as it's backwards looking based on market capitalisation, not forward-looking based on future return opportunities. Active funds are not much better, typically having 6% in UK equities[9]. Whether active or passive, global investing limits your exposure to the UK market, which means limiting your exposure to an asset class with exceptional return potential.

[8]Source: MSCI as at 31 July 2024.

[9]Source: Morningstar as at 30 June 2024. Median UK equity exposure shown for investment vehicles in the IA Global sector.

Beyond bargains: the UK's long term investment potential

Investing in UK equities isn't just a valuation story. It's easy for us to note that valuations are cheap and overlook all the strong positive drivers that make the UK investable for the long term.

Structurally, the UK benefits from world leading universities, a solid legal backdrop, and an ability to draw talent and investment internationally. These elements support the UK in sustaining its leadership status across several industries and markets. We have a competitive edge in areas such as digital innovation, financial services, green technology, and creative industries, which can drive future growth and productivity. This gets even more interesting when coupled with the new government's ambitious growth plans to invest in infrastructure, skills, research and development, and regional development.

Additionally, measures are being implemented to support the UK market for the long term. At the beginning of July, the Financial Conduct Authority (FCA) announced a simplified UK listings regime that has already come into force. This is the biggest change to their listing regime in three decades, with reforms aimed at modernising the rules and making them more flexible and competitive while maintaining high standards of governance and disclosure. The FCA hope the revised listing rules will encourage increased UK listings, which is important to support a vibrant UK small-cap market, with long-term positive implications across the market-cap spectrum.

Our approach to investing is to consider both macro drivers and the individual companies in which we invest. If you're interested in some of the up-and-coming UK smaller companies that offer great potential, we'd draw attention to our Transformative Trends series. Click on the icons below to find out more:

Content and IP Creation

Decarbonisation

The Digital Economy

Consumer Brands

Take a second look...

The next parliamentary term will be significant for the future of the UK pensions industry. Some policies will be controversial, any requirement to direct investment will certainly raise significant questions. However, looking through potential regulations and legislative change, it's certainly worth revisiting your UK allocation. There's a lot to be excited about with UK equity investing, perhaps you should take a second look.

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- 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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