Investment companies | May 2024

SCOPE FOR FURTHER UPSIDE IN UK LARGE-CAP STOCKS

EDISON THEMES

As one of the largest issuer-sponsored research firms, we are known for our bottom-up work on individual stocks. However, our thinking does not stop at the company level. Through our regular dialogue with management teams and investors, we consider the broad themes related to the companies we follow. Edison themes aims to identify the big issues likely to shape company strategy and portfolios in the years ahead.

ANALYST

Melanie Jenner

+44 (0) 20 3077 5700

investmenttrusts@edisongroup.com

EDISON

BRILLIANT KNOWLEDGE

EDISON

UK stock market

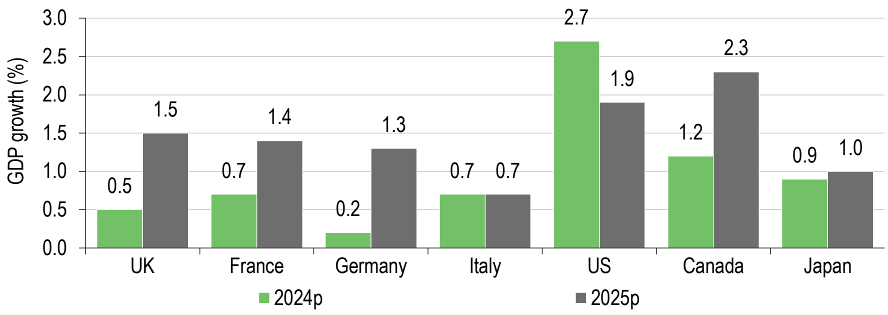
Scope for further upside in UK large-cap stocks

Edison themes

16 May 2024

The reasons why UK stocks have been out of favour with global investors for a very long time, particularly since the June 2016 Brexit vote, are well documented, and the lack of interest in UK companies has resulted in very attractive absolute and relative UK valuations. To provide some context, in 1997, UK pension funds and insurance companies owned more than 45% of the UK market. However, by the end of 2023 their ownership had fallen to 4.2%, which is a record low. With the largest 100 UK companies index recently hitting a new high, in this brief note we discuss why this is happening and whether the improvement in investor sentiment towards large-cap UK stocks can continue.

IMF GDP growth projections for G7 countries



Source: International Monetary Fund (IMF), World Economic Outlook, April 2024 update. Note: p is projection.

Recently released data points show that the UK economy is improving and, based on IMF projections looking out to 2025, the UK has the highest growth outlook of the G7 nations outside of North America. UK inflation is proving to be less sticky than in the US, as UK core inflation continues to decline, which means that the Bank of England could lower interest rates before the Federal Reserve is able to do so. A reduction in UK interest rates is likely to put pressure on sterling and boost the translated value of the earnings of UK multinational companies; around two-thirds of the largest 100 UK companies' earnings are generated overseas.

Regarding overseas appetite for UK stocks, according to Gervais Williams (head of equities at Premier Miton Investors), the UK large-cap index hitting new highs could encourage further interest due to a 'fear of missing out'. This behaviour was apparent in Japan in 2023 when the Nikkei 225 Index rallied by c 30%, reaching levels not seen for around 25 years.

If there is further appreciation in large-cap UK stock prices, Williams suggests that local sellers could be overwhelmed by demand from UK corporates, which are increasingly returning cash to their shareholders, including via share repurchases. This is likely to fuel further demand for UK large-cap stocks.

Although there is an upcoming UK general election, UK political risk has diminished as there is less divergence between the policies of the two main parties. Both party leaders are very mindful of the negative market reactions to former Prime Minister Liz Truss's plans for unfunded tax cuts.

Edison themes

As one of the largest issuer-sponsored research firms, we are known for our bottom-up work on individual stocks. However, our thinking does not stop at the company level. Through our regular dialogue with management teams and investors, we consider the broad themes related to the companies we follow. Edison themes aims to identify the big issues likely to shape company strategy and portfolios in the years ahead.

Analyst

Mel Jenner +44 (020) 3077 5700

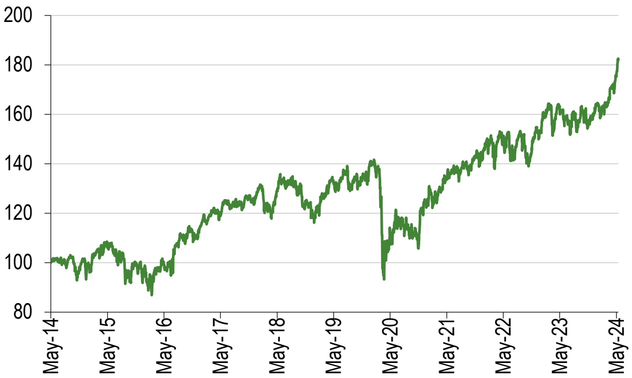
investmenttrusts@edisongroup.com

UK market performance and valuation

As shown in Exhibit 1 (left-hand side) the largest 100 UK companies index has hit a new high. However, in aggregate, UK stocks continue to look very attractively valued. On a forward P/E multiple basis, the Datastream UK Index is trading at around a 30% discount to the Datastream World Index. The UK is trading at a c 10% discount to its 10-year average compared with global equities, which are trading at a c 7% premium to their 10-year average. Also, in aggregate, UK stocks offer a superior dividend yield.

Exhibit 1: Market performance and valuation

Performance of UK 100 Index over the last 10 years



Valuation metrics of Datastream indices (at 15 May 2024)

	Last	High	Low	10-year average	Last as % of 10-year average
UK					
P/E 12m forward (x)	12.0	15.8	9.6	13.4	90
Price to book (x)	0.8	1.7	0.7	1.1	78
Dividend yield (%)	3.2	6.4	2.7	3.6	89
Return on equity (%)	8.8	15.7	2.0	9.4	94
World					
P/E 12m forward (x)	16.7	19.9	12.5	15.7	107
Price to book (x)	2.3	2.3	1.4	1.9	123
Dividend yield (%)	2.1	3.4	1.8	2.4	90
Return on equity (%)	12.2	14.0	7.4	11.3	108

Source: LSEG, Edison Investment Research

Mergers and acquisitions

An acceleration in M&A activity would send a clear signal that even if there is a general lack of appetite for UK stocks, there are some major investors that see value in the UK market. So far this year there has been a series of deals announced. These include UK packaging company Mondi’s bid for DS Smith, which was subsequently trumped by a higher bid from US-based International Paper. More recently, cybersecurity firm Darktrace was bid for by US private equity firm Thoma Bravo; the two companies had previously held informal talks in 2022. Also, Anglo American, the world’s largest platinum producer, is trying to fend off a revised bid from BHP. A couple of examples of domestic transactions are Virgin Money, which was bid for by Nationwide Building Society, and a pending merger between two UK housebuilders, Barratt Developments and Redrow.

General disclaimer and copyright

This report has been prepared and issued by Edison. Edison Investment Research standard fees are £60,000 pa for the production and broad dissemination of a detailed note (Outlook) following by regular (typically quarterly) update notes. Fees are paid upfront in cash without recourse. Edison may seek additional fees for the provision of roadshows and related IR services for the client but does not get remunerated for any investment banking services. We never take payment in stock, options or warrants for any of our services.

Accuracy of content: All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report and have not sought for this information to be independently verified. Opinions contained in this report represent those of the research department of Edison at the time of publication. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations.

Exclusion of Liability: To the fullest extent allowed by law, Edison shall not be liable for any direct, indirect or consequential losses, loss of profits, damages, costs or expenses incurred or suffered by you arising out or in connection with the access to, use of or reliance on any information contained on this note.

No personalised advice: The information that we provide should not be construed in any manner whatsoever as, personalised advice. Also, the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The securities described in the report may not be eligible for sale in all jurisdictions or to certain categories of investors.

Investment in securities mentioned: Edison has a restrictive policy relating to personal dealing and conflicts of interest. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report, subject to Edison's policies on personal dealing and conflicts of interest.

Australia

Edison Investment Research Pty Ltd (Edison AU) is the Australian subsidiary of Edison. Edison AU is a Corporate Authorised Representative (1252501) of Crown Wealth Group Pty Ltd who holds an Australian Financial Services Licence (Number: 494274). This research is issued in Australia by Edison AU and any access to it, is intended only for "wholesale clients" within the meaning of the Corporations Act 2001 of Australia. Any advice given by Edison AU is general advice only and does not take into account your personal circumstances, needs or objectives. You should, before acting on this advice, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs. If our advice relates to the acquisition, or possible acquisition, of a particular financial product you should read any relevant Product Disclosure Statement or like instrument.

New Zealand

The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (i.e. without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision.

United Kingdom

This document is prepared and provided by Edison for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This Communication is being distributed in the United Kingdom and is directed only at (i) persons having professional experience in matters relating to investments, i.e. investment professionals within the meaning of Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended (the "FPO") (ii) high net-worth companies, unincorporated associations or other bodies within the meaning of Article 49 of the FPO and (iii) persons to whom it is otherwise lawful to distribute it. The investment or investment activity to which this document relates is available only to such persons. It is not intended that this document be distributed or passed on, directly or indirectly, to any other class of persons and in any event and under no circumstances should persons of any other description rely on or act upon the contents of this document.

This Communication is being supplied to you solely for your information and may not be reproduced by, further distributed to or published in whole or in part by, any other person.

United States

Edison relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. This report is a bona fide publication of general and regular circulation offering impersonal investment-related advice, not tailored to a specific investment portfolio or the needs of current and/or prospective subscribers. As such, Edison does not offer or provide personal advice and the research provided is for informational purposes only. No mention of a particular security in this report constitutes a recommendation to buy, sell or hold that or any security, or that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person.