Headwinds and tailwinds: Review and outlook for the Liontrust UK Equity Fund, December 2022

Chris Field, Fund Manager, Liontrust Global Fundamental team, examines the performance of the Fund in 2022 and assesses the case for UK equities going forwards

Introduction

This review sets out our analysis of the headwinds that markets and the Liontrust UK Equity Fund (*the 'Fund'*) faced in 2022 and the potential tailwinds it faces, with the holdings in the portfolio representing the positive case for UK equities generally.

2022 – What were the headwinds?

We entered the year believing inflationary pressures were building from rising energy costs. We thought that supply chain issues, which had caused shortages of goods and services, would gradually ease and mitigate the impact of the higher energy prices. Central banks were intent on raising interest rates to give themselves some flexibility ahead of shrinking their balance sheets through Quantitative Tightening. All this was against a background of a global economy that was "normalising", with consumers having accumulated substantial savings post the pandemic and corporate balance sheets that were generally strong by historic standards.

The Russian invasion of Ukraine dramatically changed the near, medium and long-term economic outlooks. Food and energy prices surged, causing a cost-of-living crisis in many parts of the world. This included the UK, which faced the added pressure of a sharp rise in mortgage rates caused by the failed mini-budget in late September and the subsequent weakness in sterling.

Despite the slew of "bad news" during this tumultuous year, the FTSE All Share Index has returned +0.3%, which is respectable compared with many other markets. However, this headline return masks a considerable dispersion between large and smaller companies. The FTSE 100 Index, which comprises 80% of the All Share, advanced 4.7% and the FTSE 250 Index fell 17.4%, which was an unprecedented divergence in performance in such a short period. The FTSE 250 underperformed the FTSE 100 by 28.4% over just less than the 13 months to 12 October 2022, which compares to the widest mid cap underperformance in the history of indices (31% over the 30 months to 20 January 1999). As such, the Fund's modest 51% exposure to FTSE 100 stocks and its bias towards small and medium-sized companies was a significant headwind to performance.

The UK market's significant exposure to the resources sectors was also a key contributor to a positive index return. The Fund's underweight position in the oil and mining sectors, largely through not holding **BP** and **Glencore** (which enjoyed a huge windfall from high coal prices), caused around 3% of the performance differential (compared with the index return of 0.3%, the Fund returned -9.7%, total return net of fees*).

Our bias towards consumer companies contributed another around 3% of underperformance. The main detractors here were **Fevertree**, which has struggled with increased costs from supply chain disruptions, and **Made**, which we sold. This sale crystalised a loss after the company burnt through its significant cash balance by building inventory at a time when trading became more difficult.

Elsewhere, having no tobacco holdings (which performed well), underperformance by **Ascential** (discussed below) and share price weakness in **Marshalls** and **Genuit**, the UK buildings products companies, largely accounted for the underperformance during the year.

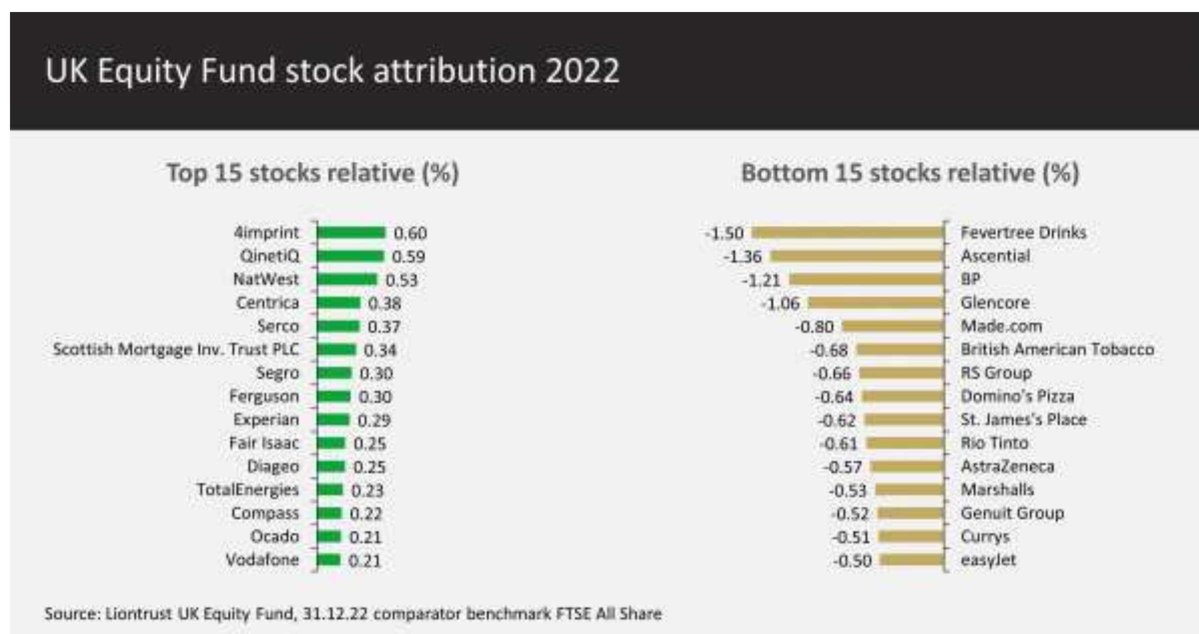
As we navel gaze, the permanent capital impairment (less than 1%) was limited to **Made**. The rest is recoverable. Indeed, we already note strategic moves happening in some of the underperformers. An interesting case study is **Ascential**. It comprises three businesses, two of which are highly attractive, high-margin trophy events and information businesses. A year ago, these businesses were expected to make up around 65% of 2022 group EBITDA and have seen profit expectations increase by over 30% over the year. The other division, Digital Commerce (DC), which helps branded consumer companies such as Procter & Gamble and Diageo optimise their increasingly important digital sales (products distributed through online platforms such as Amazon, Walmart.com, tesco.com and MercadoLibre), has seen its 2022 revenue forecast increase but profit expectations halve.

Investors were disappointed to see a collapse in the first-half margin in this division after the company responded to a slowing in the sales growth rate by accelerating spend in the business. The material outperformance of the other two businesses through 2022 was ignored and the share price halved. The DC business is a global leader in what is a nascent market that is widely expected to grow at double-digit rates for several years but investors are in no mood to give it the benefit of the doubt.

Finally, **Ascential** has invested around £70 million into a business called Hudson MX that has built a digital media platform through which brands and media agencies can channel their advertising. Around $200 billion of the $330 billion global advertising market is currently placed through an "analogue" company called MediaOcean, which we believe Hudson MX is well positioned to disrupt and is therefore an exciting investment opportunity with enormous potential. We believe **Ascential** has over 100% upside based on the sum of our valuation of the underlying businesses. Furthermore, the company's directors are currently evaluating a break-up of the group – which would, in our opinion, unlock the value we identify.

Fig. 1: The most significant contributors to the performance of the Liontrust UK Equity Fund in 2022 (sectors)

Fig. 2: The most significant contributors to the performance of the Liontrust UK Equity Fund in 2022 (stocks)



Potential catalysts for future outperformance

We have discussed corporate Darwinism for many years and it remains a key theme in our investment selections. The competitive landscape post the Global Financial Crisis (GFC) for many leading companies has been very supportive of strong businesses and created opportunities to grow market share. We are beginning to sense that for some of these companies, the pandemic has created a competitive landscape that is meaningfully better for them. This can be seen in operational performances and this advantage should endure for several of these businesses, which is not reflected in either profit forecasts or valuations.

Ever since the GFC, markets have been dominated and largely driven by macro-economic factors, central bank policies, politics and geopolitics. Overlay an environment of near zero interest rates, which has facilitated the introduction of disruptive business models, plus the advances in technology, and there has been a lot for investors to process and navigate.

For, example, the number of companies listed on the London Stock Exchange has fallen over the last 15 years from 3,305 to 1,996. This is due to corporate failures, public-to-private takeovers and M&A activity. It is part of a UK corporate landscape that has been evolving for many years and in which the post-pandemic environment looks quite different for several companies and industries. All of this creates opportunities.

The last 15 years have seen brands such as BHS, Maplin, Debenhams, Joules, Karen Millen, Dorothy Perkins, Top shop, HMV, Mothercare, McColls, Harveys, Jaeger, Laura Ashley, Beales and TM Lewin all disappear from the high street. The disruption caused by online retailers has led to the demise of the less well managed bricks and mortar businesses that were often laden with higher costs and debts. This is not a bad outcome for the Darwinistic survivors, as some of the more questionable ecommerce consumer businesses no longer have access to an abundance of cheap funding due to higher interest rates and greater risk aversion on the part of lenders.

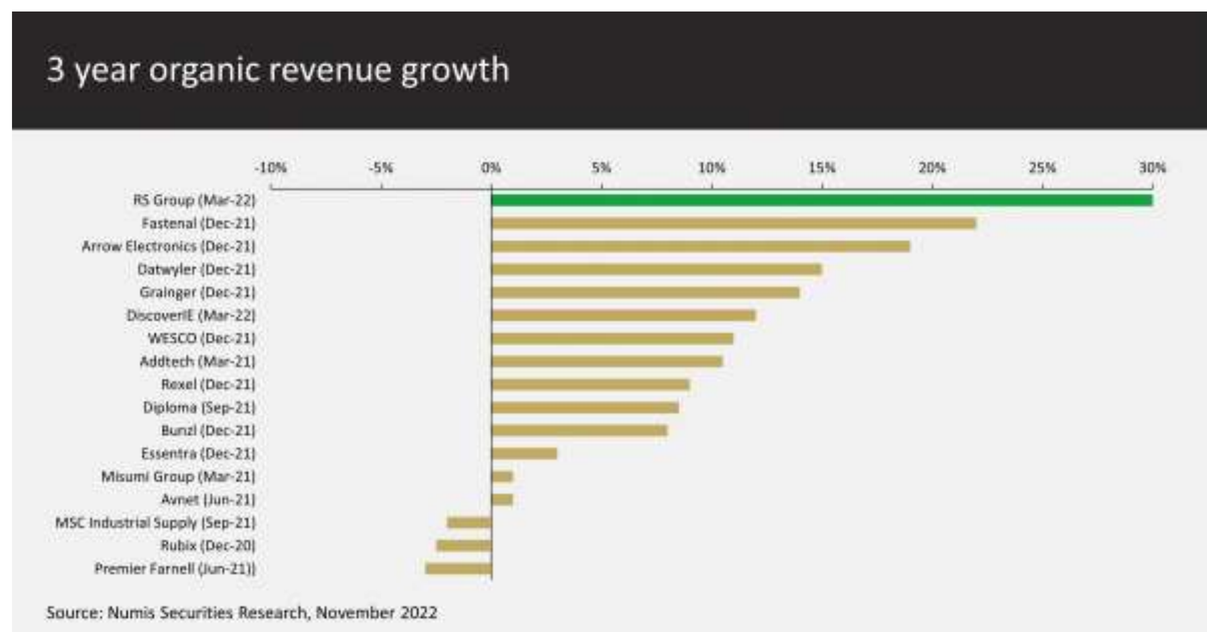
The impact of the return of rational players in the consumer space should not be understated for those incumbents that have fought for years against well-funded, loss-making businesses that now face a bleak, capital-scarce future. We believe this is borne out by the latest, slightly better than expected trading performances of companies such as **Marks & Spencer** and **Dunelm**. There is plenty more to go for.

Another feature of today's corporate landscape is the increased complexity of running a business in some sectors and the necessity for investment in technology to grow, or at least to retain business levels. Such investment might be made in the automation of warehouses and processes, dynamic pricing, marketing tools using Artificial Intelligence and Machine Learning and supply chain management. We track several industries in which the market structure is highly fragmented with lots of "mom and pop" businesses but they also have a handful of relatively large players that can afford the technology investment and can then recover the costs over a much larger customer base. These market-leading companies have competitive advantages that have stepped up post-pandemic and they are growing market share at the expense of smaller businesses.

UK stocks outperforming their global peers

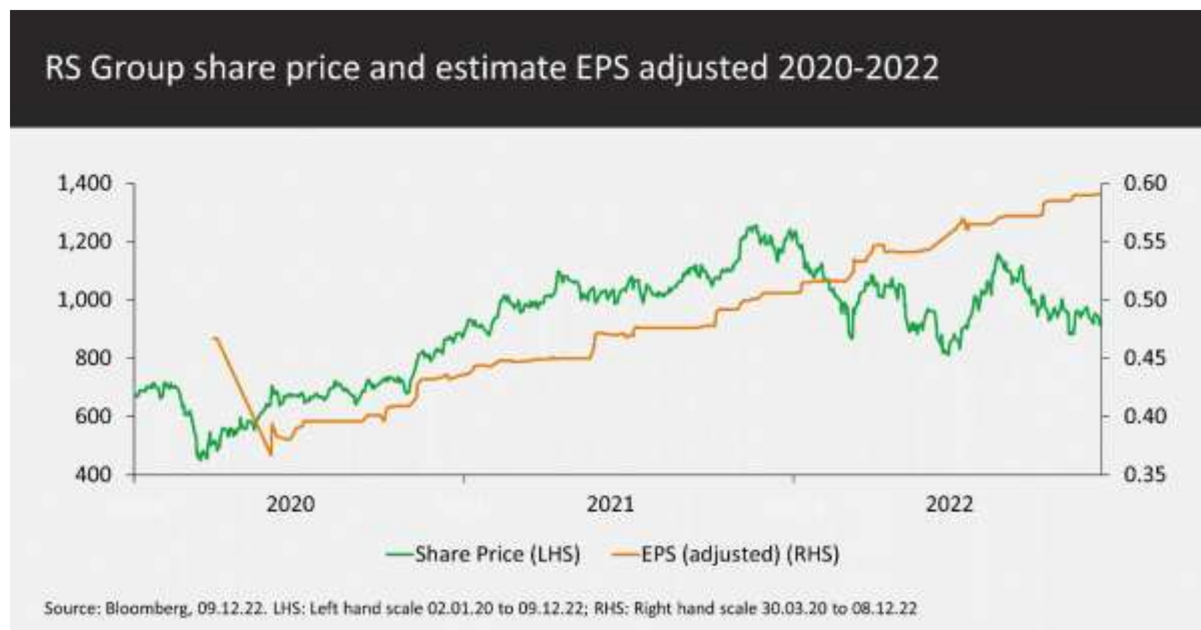
RS Group (previously called Electrocomponents) is benefiting from this dynamic and is a good illustration of how UK companies can become global leaders. The company has invested heavily in technology, now has two-thirds of its revenue online and has state of the art warehouses and marketing systems. It has used its scale to expand its product range to 3.7 million products. The result of this strategic investment can be seen in **Fig. 3** – its organic sales have significantly outperformed those of all its major rivals around the world.

Fig. 3: The three-year organic revenue growth of RS Group versus its global rivals



This is a truly extraordinary business performance relative to its peers and this success is reflected in **Fig. 4** in the earnings per share upgrades (in orange) we have seen for **RS Group** over the last few years. **RS Group** operates, however, in a cyclical industry and the share price (in green) has suffered as a result in 2022.

Fig. 4: Earnings per share upgrades for RS Group, 2020 to 2022



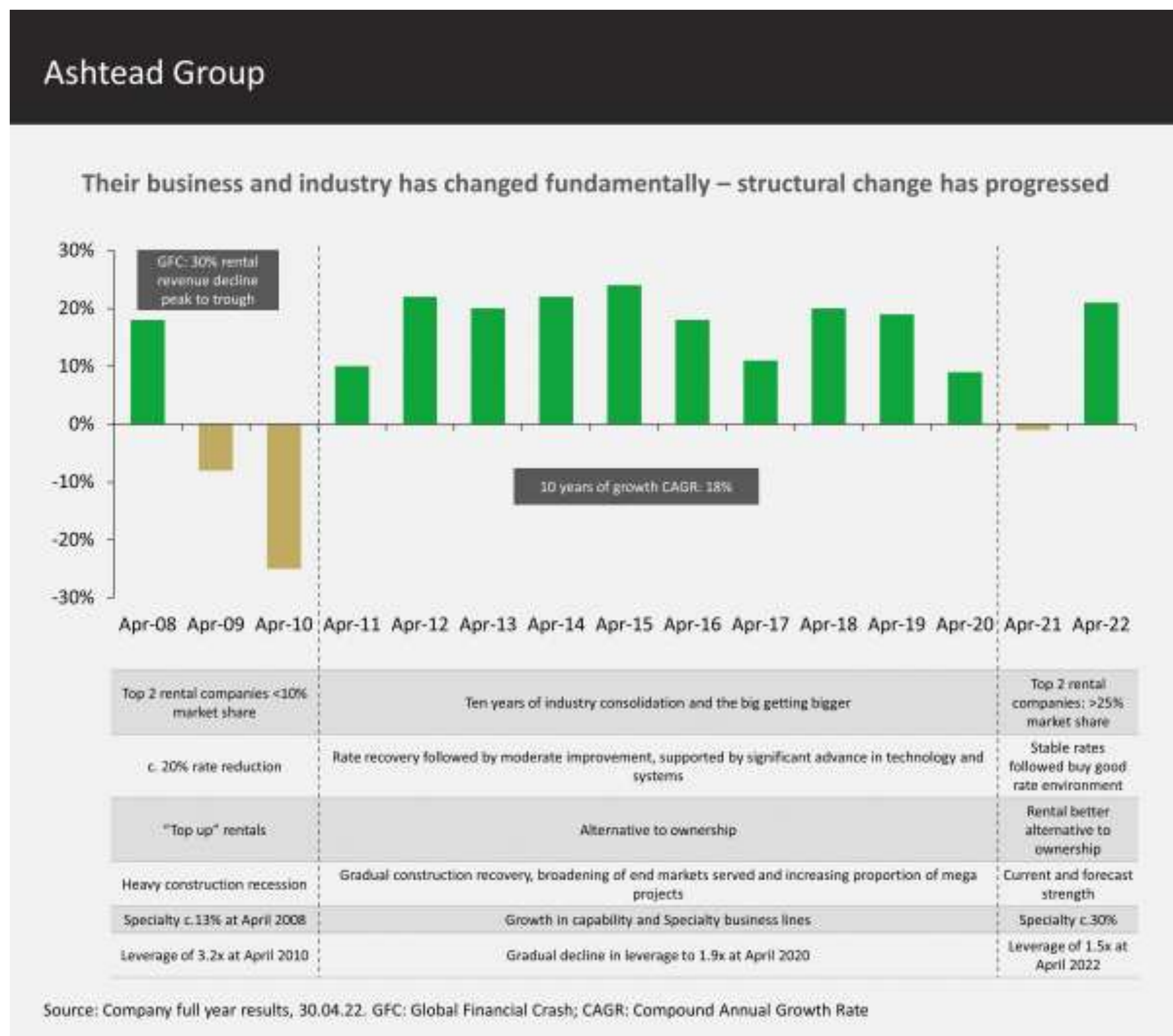
We would argue, however, that **RS Group** is much less cyclical today. Electronics represent less than 10% of its sales, its own label products are likely to benefit from some trading down and a growing proportion of its sales is derived from managed services for its customers. Furthermore, RS Group has not had such a strong competitive advantage going into a downturn before, so we believe its business will be materially more resilient in the current one. The management believes it has a good chance of bucking recessionary trends.

RS Group recently purchased a Mexican company called **Risoul**. Exposure of global supply chain vulnerabilities caused by the pandemic and the Russia/Ukraine war has led to strategic re-thinks globally by companies and governments who feel compelled to improve their resiliency and reduce future risks. Near-shoring of some critical elements of supply chains for US companies will see a significant increase in the manufacturing and distribution capabilities in the northern countries of South America. Owning **Risoul** positions **RS Group** well to benefit from this trend.

The equipment rental industry shares similar market dynamics except that there are some additional factors that leave the larger, well invested, technology-enabled players such as **Ashtead** in a particularly strong competitive position. **Ashtead** operates largely in the US through a brand called Sunbelt and it has a share of around 10% in what is a fragmented market. This scale affords the company a 10-15% cost advantage in buying the equipment versus most of its peers and its higher level of profitability is also a function of the density of its locations in cities.

There is also a structural shift underway from ownership to equipment rental following a prolonged period of supply constraints and the decarbonisation benefits of “sharing” equipment through higher utilisation. Add in the growth tailwind from re-shoring/near-shoring parts of the supply chain of US companies and **Ashtead** is superbly positioned to exploit these trends. **Fig. 5** shows a slide from its recent investor presentation.

Fig. 5: Changes in the business and industry of Ashtead Group



Apr-08 – Apr-10	Apr-11 – Apr-20	Apr-21 – Apr-22
Top 2 rental companies <10% market share	Ten years of industry consolidation and the big getting bigger	Top 2 rental companies: >25% market share
c. 20% rate reduction	Rate recovery followed by moderate improvement, supported by significant advance in technology and systems	Stable rates followed buy good rate environment
"Top up" rentals	Alternative to ownership	Rental better alternative to ownership
Heavy construction recession	Gradual construction recovery, broadening of end markets served and increasing proportion of mega projects	Current and forecast strength
Specialty c.13% at April 2008	Growth in capability and Specialty business lines	Specialty c.30%
Leverage of 3.2x at April 2010	Gradual decline in leverage to 1.9x at April 2020	Leverage of 1.5x at April 2022

Source: Company full year results, 30.04.22. GFC: Global Financial Crash; CAGR: Compound Annual Growth Rate

The current economic downturn is unusual in many ways but what stands out to us is the very low unemployment levels. There is both a skilled and unskilled shortage of labour in many countries and many sectors. The services sector in particular has been suffering staff shortages ever since economies started to re-open early in the pandemic. Companies or public sector employers that provide food and beverages to their staff on-site have found conditions extremely challenging because not only have they had trouble staffing their canteens, but also as they have had to cope with employee numbers at their customer premises that have been considerably lower and much more unpredictable than before the pandemic. Managing rampant food price inflation has added to the problem. **Compass Group**, the global leading contract catering company, faced huge challenges throughout the pandemic for similar reasons – staff shortages, reduced demand and inflation – but its latest quarter saw its revenue at 119% versus 2019 and there has been a structural shift in its growth rate.

Fig. 6: Net new growth for the Ashtead Group in North America and Europe

This is because there has been an acceleration in its customers outsourcing what had previously been in-house catering services due to cost reduction, greater certainty, less food waste and more innovative offerings for what has become a more demanding and flexible working environment. First-time outsourcing used to comprise 30% of new business wins – it now stands at nearly 50%. **Compass** in particular has benefitted given its scale and its decision to accelerate investment in in-house digital capability that allows it to serve its customers better, increase average transaction value by 20-40%, reduce labour costs by 15-35% and cut food waste by 30-50%.

These metrics are highly compelling. This is not just to new clients – retention rates for existing clients have increased by 1% over the last year. We anticipate higher growth rates for **Compass** and have increased the Fund's holding in the company.

4imprint (2% of the Fund) is predominantly a US-based business that provides branded promotional products. It is a fantastic example of how the stock market can ignore how the post-pandemic competitive environment for many companies in various industries has changed dramatically.

Fig. 7: Order levels, revenue and average transaction values for 4imprint

4imprint

Customer orders – new and existing

£m	2018	2019	2020	2021	2022
New	420	457	268	426	566
Existing	969	1,130	692	1,003	*1,320
	1,389	**1,587**	**960**	**1,429**	***1,886**

£m		2018	2019	2020	2021	2022
Group Revenue		738	861	560	787	*1,166
Average Transaction Value	14%	532	542	583	551	*618

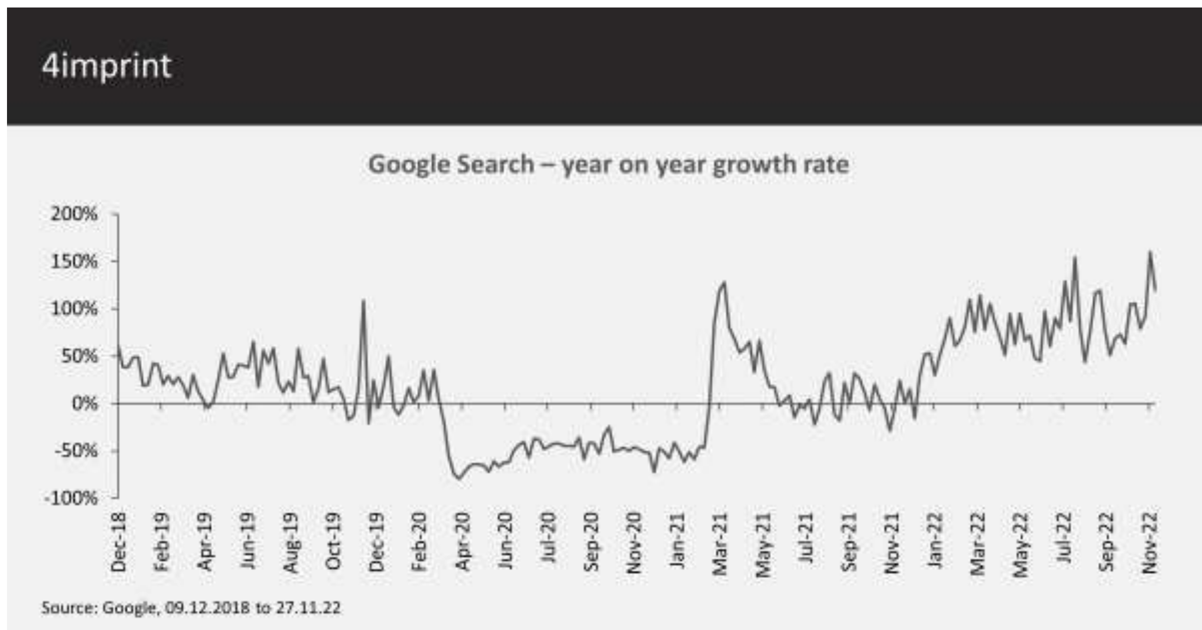
Source: 30.11.22. *Liontrust estimates

Fig. 7 illustrates the number of orders received from new and existing customers, the revenue and average transaction value over the last five years. It shows that growth has accelerated. This is not a temporary phenomenon in our view, yet its current valuation of the company is not reflecting the change in the underlying market dynamics.

4imprint kept all its staff on during the pandemic while competitors struggled with restaffing post Covid and, as the largest player with around a 4% market share and a strong balance sheet, the company invested in brand advertising nationally (it is the only national player) for the first time. These are key issues. Another interesting development has been the increase in average transaction value, which reflects customers' desires to purchase higher quality goods that have greater practical uses - customers are thinking increasingly about wastage and the environment. This also happens to be more profitable for the company, so margins are now exceeding those achieved prior to the pandemic. Earnings forecasts for 2022 have been revised upwards by up over 100%.

Fig. 8 shows the year-on-year growth in the frequency of Google searches for **4imprint**. There has clearly been a step change, which gives us the confidence that this business should continue to grow beyond current expectations.

Fig. 8: The frequency of Google searches for 4imprint



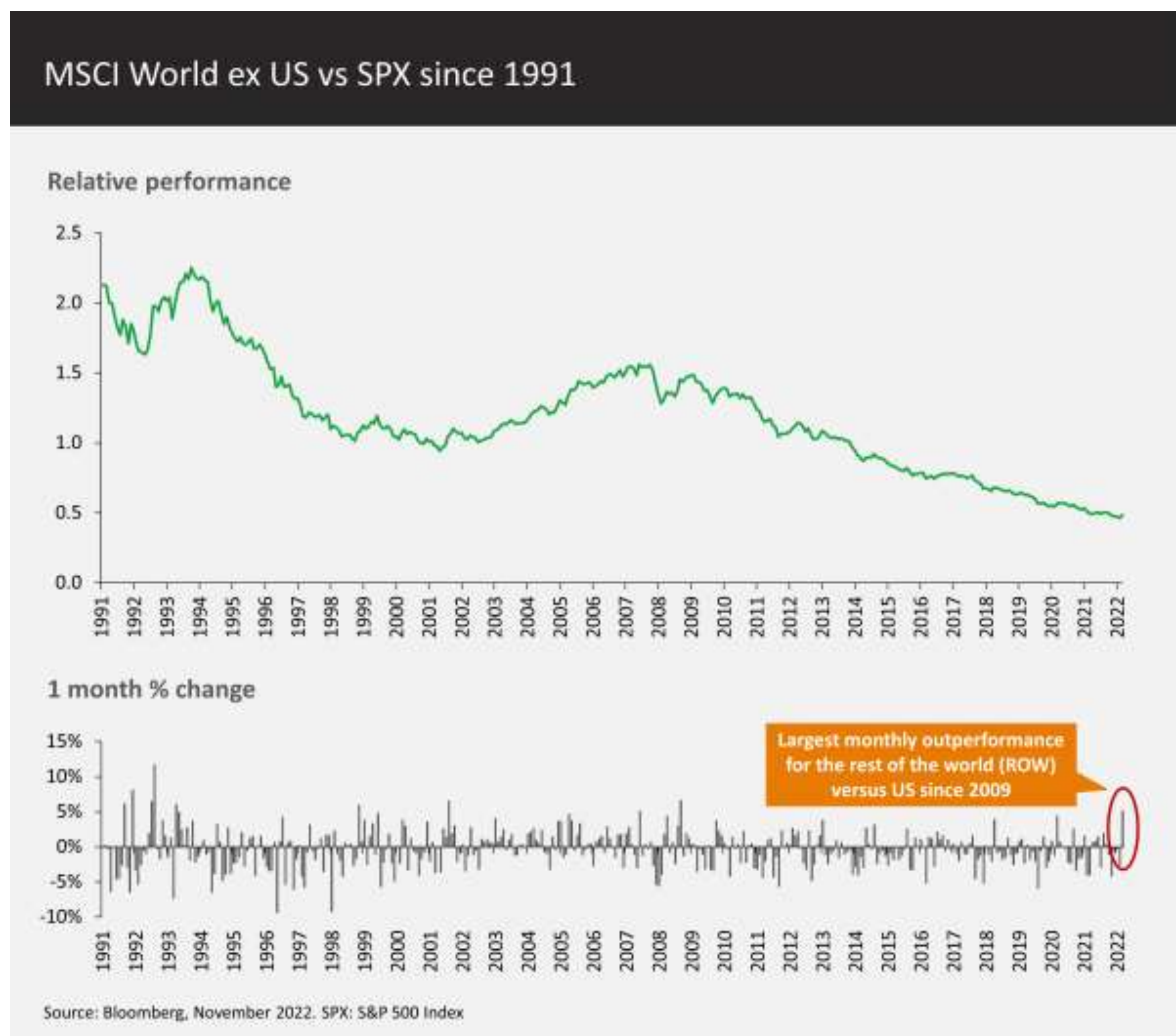
The geopolitical and economic environment will continue to impact the evolution of the corporate landscape and ultimately will, in our view, favour well invested, well managed and innovative businesses such as **Compass**, **Ashtead** and **RS Group**. The UK market is peppered with such businesses and we strongly believe that they have never held before the competitive advantages at the scale they now enjoy. As a result, we see their revenue and profit growth expectations as being too low, meaning they are materially undervalued.

We have been increasing the Fund's exposure to such investments, particularly where cyclicality has been weighing on the share price as we enter a tougher economic environment. Share prices have, in many instances, fallen a long way as investors have become cautious. We see this as an opportunity to buy great businesses at a discount to their intrinsic value.

Why UK equities

Fig. 9 has two thought-provoking charts that show the performance since 1970 of the MSCI World Ex US Index relative to the wider US market as measured by the S&P 500 Index. The top chart highlights that the US equity market has been on a rip of huge proportions relative to the rest of the world. The bottom chart shows that the latest month of November 2022 recorded the worst performances of the US market relative to the rest of the world for 13 years.

Fig. 9: The performance of US versus non-US equities



Is this a sign of regime change? Possibly, but how are investors positioned for this? Global equities, of which more than 50% are US, have benefitted from UK equity outflows that accelerated post both Brexit and the recent UK mini-budget disruption (**see Fig. 10**). Could these flows begin to reverse? We believe so.

Sterling has recovered and stabilised after its collapse following the disastrous September 2022 mini-budget. With UK bond yields currently below those in the US and a fiscal plan that is comforting to gilts' owners who have allowed the UK to term out its debt longer than any other G7 country, sterling looks very cheap on a purchasing power parity basis. The UK political landscape is also looking more

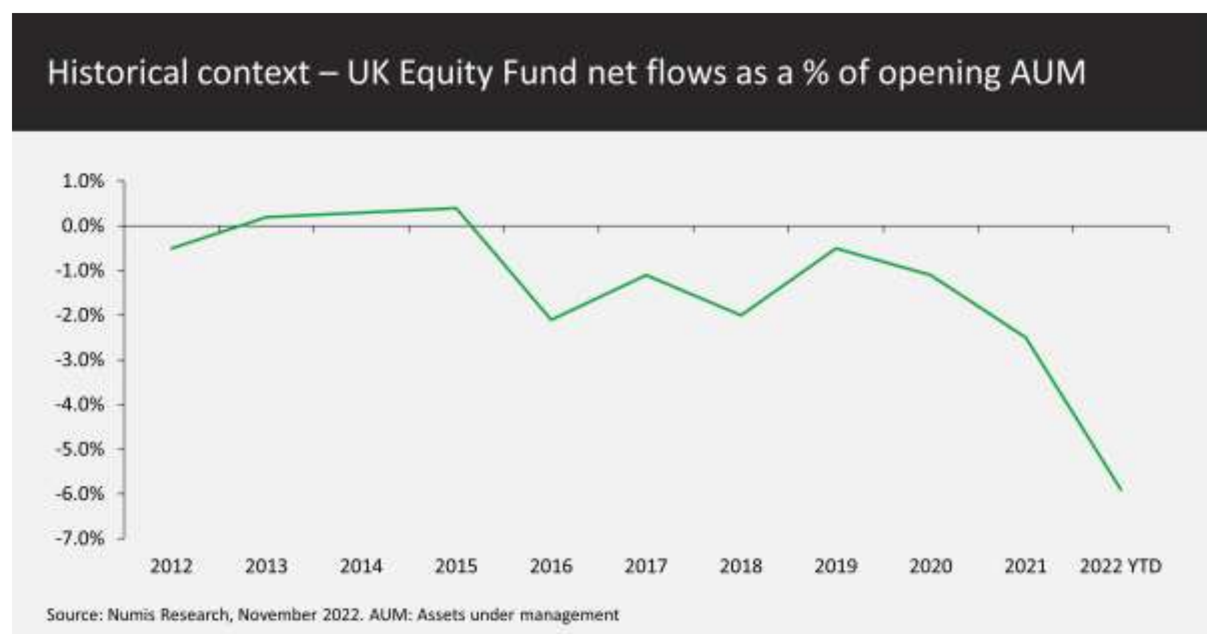
reassuring as the opposition leader Keir Starmer has clearly shifted towards the centre, which is an important point given that he is 5/2 on at the bookies to be the next UK Prime Minister.

Fig. 10: Investment outflows from UK equities, 2012 to 2022

Historical context – UK Equity Fund net flows and performance

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022 YTD
Opening (£bn)	157.5	179.6	222.0	226.3	237.4	233.1	253.6	221.7	247.8	216.1	237.6
Net Flow (£bn)	-0.9	0.4	0.6	1.0	-4.9	-2.6	-4.9	-1.2	-2.8	-5.3	-12.5
Performance (£bn)	23.0	42.0	3.7	10.1	0.6	23.1	-27.0	27.3	-28.9	26.8	-25.6
Closing (£bn)	179.6	222.0	226.3	237.4	233.1	253.6	221.7	247.8	216.1	237.6	199.4
Net flow % of opening (%)	*-0.6*	*0.2*	*0.3*	*0.4*	*-2.1*	*-1.1*	*-1.9*	*-0.6*	*-1.1*	*-2.4*	*-5.3*
Net flow % of opening annualised (%)	*-0.6*	*0.2*	*0.3*	*0.4*	*-2.1*	*-1.1*	*-1.9*	*-0.6*	*-1.1*	*-2.4*	*-5.8*
Performance % of opening (%)	*14.6*	*23.4*	*1.7*	*4.5*	*0.3*	*9.9*	*-10.7*	*12.3*	*-11.7*	*12.4*	*-10.8*
Comparator: weighted FTSE All Share / MSCI ex IT (%)	*13.0*	*21.5*	*1.0*	*1.4*	*16.5*	*13.4*	*-9.8*	*19.5*	*-9.4*	*18.6*	*0.3*
Out (under) performance (%)	*1.6*	*1.9*	*0.6*	*3.0*	*-16.2*	*-3.5*	*-0.3*	*-0.8*	*-7.2*	*-6.2*	*-11.2*

Source: Numis Research, November 2022



Source: Numis Research, November 2022. AUM: Assets under management

For what other reasons might one buy UK equities? It is unlikely that there are many markets that have companies across the size spectrum with such strong leadership positions in their industries as the UK – many on a global basis. The UK's strong science and technology franchise is gently being nurtured by successive governments. Overlay this with the many secular trends from which these companies benefit and the significant UK valuation discount versus international peers, and it is easy to get excited about the number of investment opportunities that we now see in UK equities.

***Source: Liontrust/ Financial Express, as at 31 December 2022, total return, net of fees, income reinvested**

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