UK Equities: fewer uncertainties and recovering dividends

Richard Marwood, Senior Fund Manager in the UK Equities team at Royal London Asset Management, discusses companies he likes, lessons learnt from 2020 and his outlook for the market in the year ahead.

Q1 How do you think the UK economy dealt with the onset of Covid-19? Is the UK in a stronger place now?

RM In 2020, the UK market was not very popular for a number of reasons. The UK equity market is quite heavily exposed to many sectors that were hard hit by Covid-19 restrictions, such as travel, leisure, retailing and oil (which is heavily reliant on transport) but far less exposed to many of the technology businesses that were seen as resilient to, or even beneficiaries of, lockdown. On top of Covid-19, Brexit negotiations continued to loom during the year creating further uncertainty around the UK in terms of whether a trade deal would actually be reached with the EU. With the Brexit trade deal now concluded that uncertainly is behind us. The UK's vaccine roll-out has also been extremely encouraging, with the proportion of the population vaccinated among the best in the world.

The situation is less positive in other countries, where a combination of vaccine scepticism, worries about vaccine side effects and political wrangling about vaccine supplies, has hampered programmes. Indeed, some European countries had to re-enter full lockdown measures. That suggests that while the prospects for further easing of UK lockdown measures are good, any hopes of a full return to unfettered international travel in the near term may be misplaced. That could lead to the gradual reopening of the UK leisure sector seeing strong demand, as more people look to holiday in the UK. That extra demand could also be against the backdrop of reduced supply, as some businesses will have failed over the last year. Add to that the pent-up demand after lockdown, as well as demand that could be fuelled by many households having increased savings over the last year, it's not hard to see why many commentators are talking about possible inflationary pressures. Those concerns are by no means confined to the UK.

In the US we have seen bond yields edging up as commodity prices recover, spurred on by the prospects of huge economic stimulus packages. There are still plenty of deflationary forces at work, such as technological shifts and a likely rise in unemployment as government support packages introduced in response to Covid-19 fall away, but it will be important to monitor the situation as inflation worries can be self-fulfilling. If people expect prices to rise, then that can get factored into things like wage negotiations and investment decisions.

Q2 Do you feel the UK equities market is an attractive place to invest right now? Which part of the market are you the most optimistic about?

RM With the UK market so out of favour last year, it lagged other global markets and has been left trading at a relatively attractive valuation. Indeed, some of that undervaluation is being recognised by corporates and private equity companies and we have seen a number of UK companies attract takeover bids. In our UK Equity Income portfolio, McCarthy and Stone and Signature have both been acquired. Additionally, those sectors that were hardest hit by Covid-19 restrictions are now those with the greatest recovery potential, although admittedly the equity market has factored some of this recovery in already.

For investors seeking income, the equity market offers yields well above those available on cash and bonds, and the UK equity market is higher yielding than most.

Q3 2020 was a volatile year for financial markets. Did you make any major changes to your portfolio during the pandemic?

RM We did not make any major changes to holdings during the pandemic. Quite a lot of activity was around providing additional equity funding to existing holdings in 'survival mode' to see them through the crisis, for example Restaurant Group and WHSmith.

Q4 What is your investment style? What kind of companies do you aim to invest in?

RM We look for businesses that have robust business models and strong market positions, which have appropriate balance sheets and crucially are able to generate cash to invest in and grow their business, while still paying dividends. Although our mandate is to seek income and to build a portfolio that has a dividend yield greater than that of the market. That does not mean just investing in those companies with the highest yields, as often those are the dividends most at risk of being cut. Instead we look to focus on companies with sustainable dividends. We look to invest in a broad range of companies who are in control of their own fates, irrespective of market conditions.

Q5 What is the landscape for UK income? Will there be more dividend cuts? What is your view on yields?

RM 2020 was characterised by the widespread cuts in UK dividends. In some cases, this was mandated by regulators. In others, due to uncertainty and as businesses battled to reduce cash burn as they fought for survival, as end markets ground to a halt. Many companies that have an accounting year that ends on 31 December have recently been reporting their 2020 results and while the Covid-19 impact has been apparent in all businesses, overall results have probably held up better than some might have feared – many are resuming dividends which were deferred or suspended last year.

Q6 Across the various sectors, which companies do you like right now?

RM In the mining space, we hold a large position in Rio Tinto. It is very exposed to iron ore, but also building out its copper assets. Copper will be crucial to the economy in the transition to using more electricity rather than fossil fuels to achieve carbon emission reductions. In healthcare, we hold AstraZeneca and GlaxoSmithKline (GSK). The former is almost a victim of its own success – many people invested here during the pandemic as a defensive play and despite developing a vaccine, people sold out and moved towards recovery shares. GSK is interesting because it will be split into two companies later this year: drugs and consumer healthcare. In financials, we do not own any of the big banks as they are quite commoditised – we prefer more specialised businesses such as Paragon, Close Brothers, Brewin Dolphin and IG because they tend to be more manageable and subject to less political pressure.

Q7 What remain as the main risks that could curb the positive outlook for the UK equities market?

RM A resurgence of Covid-19 leading to a slip of the UK's economic re-opening timetable or, at the extreme, further lockdowns. The other issue that cannot be overlooked is the risk of rising inflation. If that occurs it may not hit the overall level of the market, but it would probably shift the mix of those sectors that perform well. A higher inflation world, where growth was easier to come by, might make some businesses that have been seen as having more inherent growth, less attractive. That would particularly be the case as many such businesses have seen their valuations driven to relatively high levels in the low inflation, low interest rate world of recent years.

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