ARE UK EQUITIES OVERVALUED?

Mitchell Fraser-Jones, 3 February 2017

The views expressed in this article are those of the author at the date of publication and not necessarily those of Woodford Investment Management Ltd.

Financial markets appear to be sending mixed signals. Ultra-low sovereign bond yields around the world imply that bond markets fear the prospect of continued economic stagnation. Meanwhile, global stock markets are near all-time highs and market leadership suggests that a reflationary economic recovery lies just round the corner. Both can't be right but does this suggest that equities are overvalued? Is a UK stock market correction overdue?

Answering these questions would, of course, rely on a prediction of what may happen in the short term and you shouldn't expect to see such a thing on these pages. From a longer-term perspective, however, we continue to believe that the UK stock market can deliver attractive returns from here and the chart below demonstrates why.

UK equities: starting valuation has a strong influence on long-term returns

Source: The Lazarus Partnership, Woodford, based on FTSE All Share (excluding investment trusts) total return data in UK sterling, adjusted for CPI inflation

The chart shows the starting valuation of the UK stock market, in terms of its price / earnings ratio (PE), at the end of every year since 1974. This valuation is plotted against the real annualised total return that investors would have received over the subsequent 10 years if they had invested at that point.

We can see that, if an investor commits capital to the market when its valuation is low, as it was in the 1970s and early 1980s, the prospective returns can be very attractive indeed. Investing at the end of 1974, for instance, resulted in a real return of 18% per annum over the following 10 years. The start of this period was extremely bleak for the UK economy but, as Warren Buffett famously advocated, ‘be greedy when others are fearful’ – it can pay off handsomely.
Conversely, if an investor buys when the market is expensive, prospective returns can be very disappointing. For example, at the end of 1990s, with the UK stock market gripped by the dotcom bubble, a PE of 28x meant negative real returns for index investors over the following decade.

A key feature of the chart is the strong correlation of the plots around the line of best fit. Clearly, there is no guarantee that future data will mirror the past exactly but the relationship between starting valuation and subsequent long-term returns is a very strong one that is likely to hold. (Interestingly, the correlation is nowhere near as strong over shorter time periods. Further evidence to vindicate a long-term investment approach – valuation and fundamentals can be supremely irrelevant in the short term.)

So, where are we now? And what should investors therefore expect from here?

The UK stock market's current PE of about 15x this year's anticipated earnings, implies a real annualised total return of approximately 8% over the next 10 years, based on the historic trend shown on the chart. This isn't bad, in our view, especially when compared to the likely returns available from other asset classes.

Now, as you will know, we continue to be cautious about the medium-term outlook for the global economy and feel more sympathy towards the bond market's view of the world than that of the equity market. This is relevant here for a couple of reasons.

First, market returns may well disappoint from here. We are confident that the relationship between valuation and subsequent returns will hold going forward, but the correlation is not perfect and is entirely plausible that the outcome sits to the left among the data points that have been below those predicted by the line of best fit. Indeed, it is probably no coincidence that the two most recent data points (starting in 2005 and 2006) are amongst the most disappointing outcomes we have seen in this relationship.

Second, lacklustre growth from the global economy over the next few years may mean returns from the UK stock market from here are better in the second half of the decade than in the first half.

Importantly, however, we don't believe that the equity asset class is broken. As the chart demonstrates, UK equities are poised to deliver attractive long-term returns from here. It is, of course, as essential as ever to be selective. Even in the dotcom bubble when the overall market was ludicrously overvalued, there were cheap stocks. Genuinely active fund managers were able to find ways to make attractive returns even though the broader UK stock market stagnated for the best part of a decade.

Today, the environment is different but truly active fund managers, such as ourselves, can add substantial long-term value. The broad market valuation is always an average of cheap and expensive stocks. Our investment approach aims to avoid the overvalued stocks (and there are plenty of them around!) and focus the portfolios towards the most attractive investment opportunities, wherever we find them.

As such, we remain confident in the UK equity asset class but believe we can do even better than the market and deliver very attractive returns in the long run.

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