Investment update
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UK equities: after the lost decade, do better times lie ahead?

Simon Murphy discusses the prospects for medium term equity market returns in the years ahead

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Simon Murphy has been the manager of the Old Mutual UK Select Equity Fund since he joined OMAM in March 2008. Prior to joining OMAM, Simon worked for almost 10 years at M&G Investments, spending the last three as the manager of the M&G UK Growth Fund. He is a qualified chartered accountant and a specialist in corporate taxation.

Well what a decade that was. The often overused expression 'rollercoaster ride' certainly seems apt for an equity market which saw the implosion of not one but two bubbles - the technology bubble at the beginning of the decade and the housing/credit bubble towards the end of the period.

The effect on equity markets of those bubbles bursting was profound and we endured two of the four worst bear markets in the last 110 years in this period alone. The net effect of this was that UK equities delivered a negative real total return of -9.7% over the decade. This poor long term return, together with the associated high levels of volatility, has left even the most ardent equity fans battered and bruised.

In light of this the obvious question is to what extent can we expect better returns in the next decade? Based on history the outlook is considerably more positive. Since 1900 there have been only two other decades which produced negative real returns in the UK - the 1910s and the 1970s. These were followed by annual real returns of 9.3% in the 1920s and 15.4% in the 1980s.

Admittedly this is a limited sample, but the pattern is consistent in both the US and the World (ex US) markets. The one notable exception has been the Japanese experience since 1989.

"But look at all the problems the world faces today" is a common retort. There are debt mountains, ultra loose policy positions to unwind, sovereign risks, commercial real estate problems, escalating protectionism rhetoric, pension deficits, regulatory uncertainty - the list goes on. How can we be so optimistic given that backdrop?

The key is in remembering that equity market returns frequently exhibit very little correlation with either GDP growth or corporate earnings growth. As a consequence of many of the issues noted above, we fully expect a period of sub-trend economic and profits growth into the medium term. However, that does not necessarily mean poor stock market performance in the period ahead.

To illustrate the point, let us take the recent 10 year period to the end of December 2008. During this decade UK GDP grew by about 60% and UK corporate earnings grew by about 110%. What happened to UK stock market returns ? The total return on the FTSE All-Share over the period was just 12%, or -13% in real terms.

What caused such relatively poor returns in light of such strong growth? The answer is valuation. At the end of 1998 the FTSE All-Share was trading on a 12 month forward price to earnings ratio (P/E) of 17x. By the end of 2008 the forward P/E had fallen to 8x.

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The expansion of the P/E multiple is typically the most powerful influence on the scale of positive returns seen in any bull market (and conversely so in bear markets). The most notable exception to this was our recent experience in the 2003-07 bull period. In this period we saw no expansion in the valuation multiple applied to the market. Instead we had a bull market simply because profits grew so rapidly on the back of strong synchronised global growth.

So why was there no multiple expansion during this period? In our view it was a consequence of the consistent net selling of UK equities by major institutional investors. Pension funds and life assurance companies found themselves with an overly high allocation to UK equities at the end of the 1990s and have generally been reducing their exposure ever since.

We estimate that the current forward earnings multiple on the FTSE All-Share is in the region of 12x, compared to a long run average of somewhere in the region of 16x. Even in an environment of relatively modest growth, some multiple expansion should lead to reasonable stock market returns and certainly considerably better than recent history.

Logically it will require buyers to return to the equity market in a meaningful way to see this level of multiple expansion and given our poor recent experience and extremely low confidence levels that will take time. However, given the relative valuation attractions of equities compared to several other asset classes (in our view and a topic for another day) it is just possible that those buyers might return sooner than is generally expected. That would give us brow-beaten equity investors something to cheer.

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