MARKET INSIGHT

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ISSUE 27 - AUGUST 2023

Banking On Buybacks

IN THIS ISSUE

BANKING ON BUYBACKS

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IN THIS ISSUE

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Summer is usually a quieter time for financial markets with both news and dealing volumes noticeably lower. Despite this, there have been some interesting developments in recent months to provide plenty of discussion points ranging from the cheapness of the UK stock market relative to its history and peers, to a recent headline grabbing downgrade of US Government debt by a credit ratings agency. Despite wobbles earlier this year, the banking sector remains of interest with recent reporting showing a continuation of the theme of improved profitability and balance sheet strength.

The UK stock market has been unloved for some time with global investors favoring the US and its flagship companies which have driven a 17% gain through the first half of the year. Away from the near-term negative sentiment to our domestic market we've seen a significant change in the investor participation mix through time which is likely to be a key driver behind the persistent and growing discount of the UK market against global peers. Looking back to the early 90s, insurance companies and pension funds were dominant players, accounting for 50% of UK share ownership at their peak in 1992, followed by individuals with c.20% ownership. Progressing through to the present day we can see that the change has been dramatic. Today, insurance companies and pension funds own around 5% of UK listed companies and individuals representing ownership in the low teens. Instead, the principal ownership of UK shares now rests with international investors. Coinciding with the changing ownership, the UK market's valuation discount to the MSCI World Index has moved out to the widest level seen since 1975, exacerbated in the last decade by the performance of the highly valued US market. So cheap has the UK market become that companies are buying back large volumes of their own shares, creating a consistent theme of de-equitisation in the UK market. Our *Topic of the Month* explores this theme in greater detail. UK markets remain a rich hunting ground, especially for income investors. In this edition we explore Merchants Trust, an income-focused, UK-listed investment trust with 'dividend hero' status on the back of forty-one consecutive years of dividend growth. Managed by the Allianz UK Equity team within a robust and repeatable process, the manager looks to buy companies trading below his estimation of intrinsic value with conviction while mitigating downside risk. Strong business franchises make up the majority of the portfolio, with key themes emerging from the growth of the digital economy to sustainable living. With the final portfolio trading at a discount to the FTSE All Share and yielding through 5%, Merchants holds some attractions for those seeking income in the discounted UK market. Early August saw the attention-grabbing announcement of a rating downgrade of US Government debt by ratings agency Fitch. With the firm citing "expected fiscal deterioration over the next three years" within the rationale, along with comments around the recent debt ceiling standoff, the US found its credit rating reduced from the highest possible to the second, on par with the UK's. With US Treasuries still very much viewed as a risk-free asset from a default perspective, the downgrade is likely to be an event that has little effect on the functioning of the US Treasury market. Finally, we return to the European banking sector, an area which has received considerable attention this year on the back of US bank failures and the controversial debt write-off associated with Credit Suisse's takeover by UBS. Despite this, recent earnings reports indicate continued improvement in the resilience of the European banking sector, with further improvements in both profitability levels and balance sheet strength. Still unloved and maybe untrusted with memories of 2008 lingering, the sector could be too cheap to ignore, especially in the UK where domestic banks trade on some extremely cheap valuation multiples.

STOCK FOCUS

A BALANCING ACT: MERCHANTS TRUST AND THE SHIFTING TIDES OF THE UK MARKET

OSCAR SHEEHAN | INVESTMENT EXECUTIVE

We recently wrote at length in this publication about the challenges and opportunities that the recent bouts of market volatility have generated for investment trusts in the UK. Discounts have reached their widest levels since 2008 and market sentiment is far from optimistic. Given this backdrop, we thought it would be interesting to examine an investment vehicle that has bucked this trend.

Merchants Trust has weathered the recent storms better than most, despite being out of favour for much of the preceding decade. At the time of publication, the fund was trading at a premium of 0.5%, meaning the shares in the Trust were actually valued above its net asset value. The fund focuses mostly on UK large cap exposure with some smaller companies thrown into the mix when valuations look appealing. It has outperformed the FTSE 100 by 21.53% over the past five years and provided an absolute return of almost

40%. The fund's change in fortunes is emblematic of the swing away from ultra-high growth, investors are increasingly favouring companies with strong balance sheets and well covered dividends. These types of companies have been a cornerstone for Merchants Trust since its inception and, in times of market stress, people will pay for stability.

"The Trust has provided its investors with 41 years of consecutive dividend growth and is classified as one of the Association of Investment Companies 'Dividend Heroes'. "

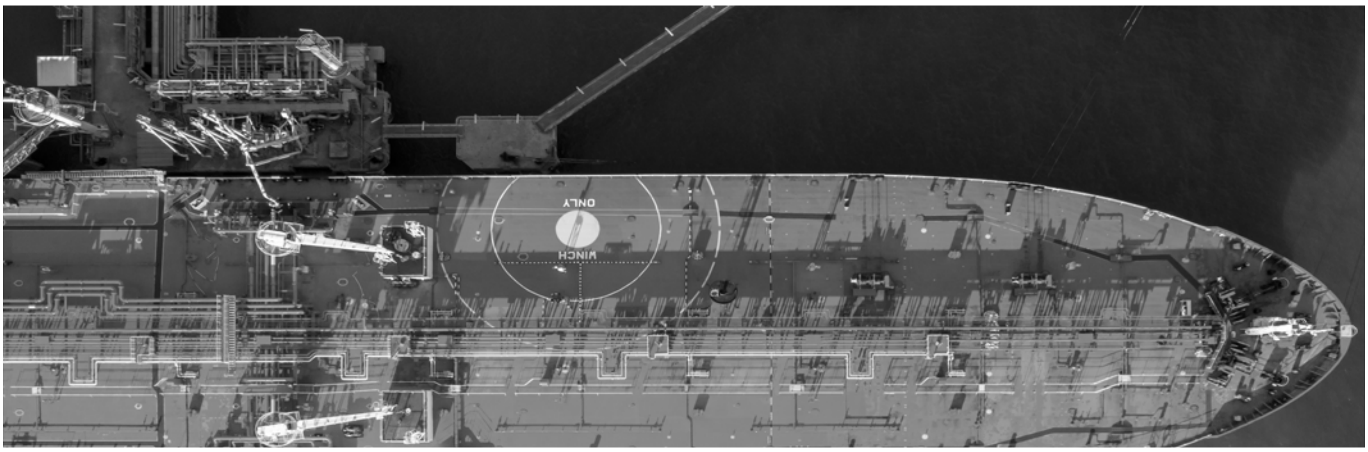
Merchants has long placed dividend payments at the heart of its investment strategy. The Trust has provided its investors with 41 years of consecutive dividend growth and is classified as one of the Association of Investment Companies 'Dividend Heroes'. Currently, the Trust has a dividend yield of around 5.3% and, to ensure that this dividend is sustainable, it has primarily invested in established blue chip companies such as Shell, Barclays, BP, and Rio Tinto, all of which currently sit within the Trust's top twenty holdings. The last few years have seen these industries swing back into favour. Banks have benefitted from rising interest rates as the returns they can achieve on loans have increased dramatically. Companies such as Shell have benefitted from high energy prices, but also from the strength of their balance sheet with the company generating high levels of free cash flow dating back to 2016. In times of market stress, this type of predictability becomes attractive to investors.

Many of the companies held in the Trust have now announced that they will be using the cash they have generated over the last few years to start buying back large portions of their equity, which should further bolster their share prices. Barclays recently announced that it will be buying back an additional £750m worth of its own shares, while Shell has announced that it will be purchasing a massive $4bn worth of its own equity. This shows that they see themselves as undervalued and are attempting to create value for their existing shareholders. UK stocks have been out of favour since the 2016 Brexit referendum, however, the uptick in buybacks provides cause for cautious optimism in certain corners of the market and this Trust is well positioned to benefit. Currently, over 45% of the fund is concentrated in financials, industrials, and energy, all sectors which have been cash generative over the past few years and many of the Trust's holdings are starting to buy back shares in large quantities.

The Trust is also one of a select few to currently be trading on a premium. This is reflective of the management team's demonstrated ability to navigate the recent bouts of market volatility, the prospects of the underlying portfolio to continue to generate returns for investors, and the consistency with which Merchants has paid out a dividend. The persistent premium has allowed the Trust to issue new shares on several occasions. This has the effect of diluting the value of the shares, but also provides additional liquidity for the Trust and allows for more widespread trading activity.

With hindsight, it might appear that Merchants Trust was destined to outperform over the last few years, but such hindsight bias ignores how out of favour the Trust had been for much of the preceding decade. Many of these industries were seen as dying and their resurgence was far from guaranteed. With inflation likely to remain high and interest rates unlikely to drop back down below 1% any time soon, the Trust's immediate future looks rosy, but as few would have predicted its resurgence since 2019, it would be foolish to take this as a given. ■

Please note that this communication is for information only and does not constitute a recommendation to buy or sell the shares of the investments mentioned. The value of investments and any income derived from them may go down as well as up and you could get back less than you invested.



INSIGHT

US GOVERNMENT BOND DOWNGRADE

GREG LODGE | PERFORMANCE & RISK ANALYST

Early this month, Fitch Ratings took the unusual step of downgrading US government bonds from its highest triple-A rating to double-A, the next tier down. Citing "expected fiscal deterioration over the next three years" as the reason for the downgrade, the ratings agency also alluded to the recent debt ceiling crisis, which was only resolved at the eleventh hour, thus narrowly avoiding a default. Bond and currency markets were largely unshaken by the news, however, with no significant movements. The US stock market was already closed for the day when the announcement was made, so little market sentiment insight could be gained.

To understand the significance of what happened, it first helps to examine the ratings agencies and why their views are so influential in bond markets. There are three main bond ratings agencies: Fitch, S&P and Moody's. There are others which have been established by governments and information providers, such as the Japanese government and Morningstar, but the big three are the best-known and have the largest share of ratings business. These ratings agencies assess the likelihood of default on a bond issue, by request of the issuer, and award the bond a grade. As a credit rating is a reflection of the creditworthiness of the issuer, it will have a large impact on the issuer's borrowing costs. As the likelihood of default increases, investors will require a higher yield to compensate them for taking on the additional risk.

Each agency has its own alphabetic grading scale, although they are broadly similar. All three consider a triple-A rating to be the highest they can award, indicating that they consider default risk to be remote. Countries currently holding this honour include Germany, Switzerland and Australia. The UK has lost its triple-A crown from most agencies and currently holds a double-A. Now joining the UK in this lower rating tier, the US Treasury will be able to commiserate with the Bank of England.

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Let us also consider the size and characteristics of the US government bond market. As the world's dominant economy, it will not come as a surprise that its bond market is correspondingly enormous. The outstanding issues are collectively worth $26tn. In 2022 the government paid $534bn in interest. Banks are one of the largest domestic buyers of US government debt, holding approximately $4.2tn. The US government bond market is often used to deposit customer funds due to its safety and liquidity.

In 1917 the US established the 'debt ceiling' – a notional borrowing limit intended to encourage the federal government to be fiscally responsible. In the years since, it has been raised many times and is often a source of conflict between The White House and Congress. In 2011 President Obama attempted to raise the debt ceiling, but was hamstrung by Republicans in Congress who demanded deficit reductions. The ensuing crisis led to S&P downgrading its own rating of US Treasury debt from triple to double-A, which it had previously held for over 70 years. So, this is not the first time US government bonds have been downgraded and the circumstances today are not dissimilar to what happened in 2011.

The recent troubles began in January, when government borrowing officially reached its existing debt ceiling of $31.4tn. The Treasury could continue to fund its obligations up to the 5th June, after which not all of its outstanding debt could be serviced – i.e. a default. After lengthy and contentious negotiations, Congress agreed to pass a bill to suspend the debt ceiling for two years, in exchange for a cap on federal spending. The bill was passed on the 1st June, mere days away from default. Ratings agency Moody's has estimated that a default on US Treasury bonds could lead to share prices falling by a third, and perhaps prompting a recession as severe as that experienced in 2007-2009.

Clearly uneasy with the debt ceiling debate antics, Fitch referred to an 'erosion of governance' as one of the reasons for the downgrade in its assessment. The agency also highlighted a growing debt burden and poor growth projections. It forecasts a recession in the final quarter of this year and the first of 2024. So far, the impact has been slight, and the market has taken the downgrade in its stride, with benchmark 10-year yields rising by 0.04% in response to the news. When S&P announced its downgrade in 2011, the impact was minimal. A wholesale selloff of such an important asset class was always manifestly unlikely. The loudest noises instead came from the US Treasury. Secretary of the Treasury Janet Yellen issued a statement in which she described the downgrade decision as "arbitrary and based on outdated data." She went on to criticise Fitch's ratings model and emphasised the fundamental strength of the US economy.

With Moody's now the last of the big three to maintain a triple-A rating, the Biden administration and those in the future will hope to hang on to this remaining fiscal honour. While the downgrade will have little impact on the Treasury's day-to-day activities, or the prominence of the US government in international debt markets, the reaction of the Treasury speaks more to hurt feelings than a debt crisis - physically unscathed but perhaps just a little embarrassed. ■

TOPIC OF THE MONTH

UK EQUITIES: SENTIMENT, VALUATIONS AND BUYBACKS

JAMES EADES | INVESTMENT RESEARCH

It would be fair to say that the UK stock market has faced its fair share of challenges over recent years. Economic fragility, political turbulence, and market volatility have cast shadows over the landscape of UK equities. Consequently, domestic institutional investors have chosen to reduce their exposure to this segment of the market, seeking more promising growth opportunities with less political and economic volatility on foreign shores. This shift in investor sentiment over a prolonged period has triggered significant outflows from UK companies, exerting influence on liquidity, share price performance, and company valuations. Given the scale of migration away from British companies, the door of opportunity looks evermore enticing for value-seeking investors looking for a bargain as the UK trades on its most significant valuation discount to global peers in over a decade. Highlighting sentiment, valuations, and buyback activity as three key areas to watch over the next year could provide some insight into how UK companies might come back into favour over the long term.

Firstly, it is important to understand why UK companies have been so out of favour in recent years. The uncertainty which followed Britain's decision by referendum to leave the European Union in 2016 cast a long and dark shadow over UK businesses. The prolonged negotiations, coupled with the threat of a "no-deal" scenario, left investors anxious about the potential disruptions to trade, supply chains, and access to the vast European market. This uncertainty led many investors to reduce their exposure to UK assets and seek less volatile investment destinations overseas. Political instability has further exacerbated the gloomy sentiment with four different prime ministers at the helm since 2016. This revolving door of leadership has hindered the government's ability to provide clear and consistent economic policies. Most notably, this was seen through September 2022's mini budget as 'Trussonomic' theory created chaos within financial markets with equities, real assets and bonds all falling considerably. Of course, these events have been reflected in real investment behaviour for some time now, but investors are still waiting to see a material change in the UK economy before reconsidering their strategic UK equity allocations.

As sentiment continues to sour around UK stocks, the value of companies listed on the London Stock Exchange (LSE) has also faced a sustained downturn. Historically, the United Kingdom has maintained an average valuation discount of approximately 18% compared to its global peers. However, at the start of 2023, this discount had widened significantly, hitting 40%. This notable disparity underscores that UK companies are presently trading at their most attractive price levels in over a decade. While this deep discount may suggest a bearish outlook, it's essential to examine the factors contributing to this situation, including misconceptions regarding the international exposure of these companies. Many investors often mistake UK companies for being domestic-focused in terms of their revenue sources and are thus vulnerable to domestic economic downturns. Contrary to this belief, the reality is quite different. Approximately 75% of the revenues generated by companies listed on the LSE originate from international markets, positioning them as truly global players in the business world.

Take Unilever, for instance. While it is a UK-listed company, only 4% of its total revenue is generated domestically. The remaining 96% comes from a diverse range of markets including the United States, Asia, Europe, and various emerging markets. Although this international revenue diversification better insulates companies like Unilever from the potential adverse effects of a recession in the UK, the company has still been tarred with the same brush as the wider market. By using the price-to-earnings multiple as a way of valuing the company, measuring its current share price relative to its earnings per share (EPS), it is quite apparent to see a drop in the company's value since 2016. In fact, Unilever is currently trading at a valuation approximately eight times cheaper than in 2016. This striking divergence between performance and valuation underscores the profound impact that weak sentiment has had on company valuations in the UK market.

Beyond the compelling valuation discount, there are other factors contributing to why UK equities are potentially being overlooked by equity investors. Notably, the prevalence of share buybacks. This strategy involves companies repurchasing their own shares from the market and, assuming that it is done correctly, it will improve shareholder value. This is because, as the share count decreases, the value of shareholder ownership rises, leading to an improved earnings per share and dividends per share (DPS) value. In many cases, a business will do this is if they believe the market has discounted their shares too steeply, suggesting that they are currently undervalued, and inferring that the management team have confidence in the business over the long run.

In recent years, UK companies have embarked on a spree of equity retirements. The numbers speak volumes, with over £51bn allocated to share repurchases in 2022 alone, translating to a noteworthy buyback yield of nearly 3% on the FTSE 100 index. More recently, this summer's earnings season featured over seven major buyback announcements, primarily within the banking sector as these companies are beneficiaries of a higher rate environment. Although concerns similar to those impacting US regional banks spread into the UK economy, a closer examination reveals that the quality of British bank loan books, their diversified client base, and better source of funding would suggest that the issues seen in the US don't necessarily read across to the UK. In response, many banks opted to repurchase their own shares, signalling their belief that the market had undervalued their stock. NatWest Group, for instance, announced a £500m share buyback program, while HSBC unveiled a $2bn return to shareholders through its buyback scheme.

The power of buybacks, when executed effectively, could be massive. Beyond the immediate impact of reducing outstanding shares and boosting metrics like earnings per share and dividends per share in the short term, it also possesses the remarkable ability to compound returns over the long term. Through a combination of increased ownership stakes, higher stock prices, reinvestment opportunities, and potential dividend growth, the power of compounding share buyback returns can deliver substantial benefits to both companies and their investors. Given the extent of buybacks we are currently seeing, it is quite apparent that many UK companies are realising how undervalued their equity is currently trading at, raising questions around whether investors should be reading from the same book.

Of course, not every UK company is a long-term bargain. Some companies appear to be value traps, meaning that while the companies look like a value opportunity, the discounts they trade at continue to widen over time with no real upside. However, there is potential for investors who can identify companies currently out of favour, but with the potential to generate robust free cash flows in the future. While it may seem like things could deteriorate before improving, as long as these companies maintain strong and growing returns while managing their debt levels, investors who see the current discount as an opportunity for long-term gains may be well-positioned to reap returns when market sentiment eventually improves. ■

BANKING COMEBACK

ALASTAIR POWER | INVESTMENT RESEARCH MANAGER

When discussing investable sectors, banking is one which has consistently divided opinion post-Global Financial Crisis (GFC). Many have considered the sector un-investable on the back of significant regulatory reform, dwindling profitability, and the legacy cost issues of products such as Payment Protection Insurance (PPI). While not fully back in vogue, sentiment seemed to have been changing to the banking sector at the start of the year as the positive effects of higher interest rates began to feed through. Increasing costs of loans and little change on the return on deposits helped near-term profitability metrics trending higher along with the share prices. Cue the failure of Silicon Valley Bank and the takeover of Credit Suisse by rival UBS and the wind has seemingly been removed from the sails.

With confidence still seemingly limited, markets could be considered to be behind the curve in the pricing of a sector with improved resilience over time and potential profitability tailwinds going forward. If the GFC revealed anything, it is that banks failed to maintain sufficient capital buffers to absorb losses in their risk assets. Regulatory changes post-

GFC, however, required banks to increase said capital buffers, improving resilience through time and the stability of the banking system. While stability did improve, profitability declined as interest rates moved lower and profit margins became squeezed. Valuations of the UK's banking sector followed suit to the point where domestic names such as Lloyds and NatWest both currently trade on 0.6x book value, calculated as assets minus liability, an optically cheap valuation which is generally considered a signal of an undervalued company.

Optically cheap valuations should never be a sole reason for purchasing shares in a company; deciphering whether the company warrants the cheap valuation is required. Declining profitability metrics generally warrant a cheap valuation, while sustained improvements in profitability warrant higher movements. The real questions for the banking sector are: 'Is profitability improving?' and 'Is it sustainable?'.

On the question of profitability, the answer is clearly a 'yes,' if recent results are anything to go by. NatWest, for example, recently reported strong first-half growth in total income, return on tangible equity (a key profitability metric) and net interest margin (net interest income/earning assets). The balance sheet also looked strong, with customer deposits significantly exceeding net loans.

While profitability, at least in the short-term, is improving, the sustainability of these metrics is the real question. A simple heuristic could lead us to the view that profitability metrics above the cost of equity should result in a company's market value trading above its book value. So, with numbers now showing this, the fact that banks such as Lloyds and NatWest continue to trade below their book values raises eyebrows. An opinion piece from Fidelity's UK equity desk highlighted this point, with NatWest's management guiding for sustained return on equity in the 14-16% range, the author noted their expectations for the bank to trade closer to 1.5x book value, way above the 0.6x multiple it currently trades on. Clearly the market remains skeptical over the sustainability of current profitability levels going forward.

With profitability higher and valuations low, banking shares are being bought in droves. The biggest buyer is the banks themselves, with swathes of share buybacks being announced within the broader trend of de-equitisation in the UK market on the back of strong capital positions and cash generation. Sticking with NatWest, its recent earnings report announced an on-market buyback program of up to £500m for the second half of 2023. Virgin Money followed suit with announcements of £175m of anticipated buybacks at the end of year results. At the upper end, HSBC unveiled its second $2bn share buyback following the bumper $8.8bn of quarterly profits.

From a high level, the outlook is positive for banks, but concerns remain. In its recent financial stability report, the Bank of England highlighted the continued uncertainty of the global economic outlook and challenged risk environment.

The report also noted the effects of higher interest rates on household and business borrowing risks, but retained the expectation of the UK corporate sector remaining resilient to higher interest rates and weak growth.

At a bank specific level, net interest margins, the measure of the net return on the bank's earnings assets, have increased markedly over 2022, but pressure looks to be feeding through given the headwinds of mortgage and deposit repricing. Operating costs also look to be on the rise with the previous example of Lloyds and NatWest showing high single-digit increases in operating costs.

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Nothing in financial markets is clear-cut and the key question remains whether we are being compensated for associated risks. With healthy and growing dividend yields in the region of 6-7% on offer for companies trading at less than their book value, banking is clearly offering attractions for some, while others are expected to remain unconvinced. ■

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