MARKET INSIGHT

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Redmayne Bentley

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Looking Back at 2023 and Ahead to 2024

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REFLECTIONS AND CONSIDERATIONS AS WE MOVE INTO 2024

ALASTAIR POWER | INVESTMENT RESEARCH MANAGER

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Over the festive period, most of us will at some point reflect on the events of 2023. Starting with optimism, the UK markets looked to shake off the experiences of 2022, rallying through the initial months before facing challenges in the summer and a late-stage rally starting in November.

Progressing through the year, a small group of names in the US dubbed 'The Magnificent Seven' failed to receive the message that 2023 was to be a tough year. This cohort provided an outsized impact on US equity market performance year-to-date, accounting for majority of the S&P 500's 20% gain to the end of November. The composition of this exclusive club and the drivers of performance will be explored later in this publication.

Despite some of the challenges experienced in 2023, financial markets shrugged off some recent declines, rallying through November and the early stages of December. In the Christmas spirit, our Topic of the Month explores the Santa rally. A potentially statistically significant phenomenon of the stock market which describes the tendency for markets to climb 1-2% in the last five business days of the year. Whether it stands up to scrutiny will be explored later, but given the challenges of 2023, a repeat of the effect would be welcomed by many.

With all the hype around the phenomenal growth of the Magnificent Seven, our Stock Focus article comments on a sector within UK equities which can best be described as ex-growth. The tobacco sector, specifically Imperial Brands and British American Tobacco, was once a darling of the UK market, providing significant returns to investors through the early two-thousands and twenty-tens. Today, they operate in markets of declining volumes, focusing on returning the huge cash generation to investors through healthy dividends and share buybacks. Unlike the growth stories of US tech, this is one of cash release to investors and the decline in share count through significant share buyback policies. The question now posed is whether there will be no more listed tobacco companies before there are no more smokers?

Throughout the year, we have commented on the renewed attractiveness of the corporate bond market with yields of the higher quality section of the sterling market showing yields in the 6% range. Our additional article focuses on some first principles associated with corporate bonds, aiming to arm readers with some of the foundation required to understand commentaries focusing on the asset class.

Finally, we wish all readers and clients of Redmayne Bentley Season's Greetings and a Happy New Year.

STOCK FOCUS

IMPERIAL BRANDS

OSCAR SHEEHAN | INVESTMENT EXECUTIVE

The tobacco sector has long been seen as a controversial destination for investors to park their money. In many respects the scepticism is justified. Environmental, social and governance (ESG) concerns surrounding the sale of cigarettes are hard to argue with. The sector is also undeniably in decline. The number of people who smoke in developed nations has been in decline since the 1970s and growth in emerging markets seems to be grinding to a halt. That said, large amounts of institutional money is still invested with companies such as British American Tobacco (BATs) and Imperial Brands (IMB). These are companies with market capitalisations in the tens of billions and we ignore them at our peril. While the industry is in decline, the speed with which it does so remains to be seen. If markets have overestimated how quickly demand will dry up for so called 'combustibles' then there might be an opportunity for investors to generate a good return based on cash conversion, dividend yields and revenue growth driven by price increases.

In this article we will look at both the sector and, more specifically, at Imperial Brands. We have chosen to focus on Imperial Brands due to some substantial outperformance when compared to the likes of BATs in recent years. We are aware that this is a controversial topic, and we would like to stress that this is not investment advice. However, this is an interesting case study in how investment opportunities can arise in decaying markets and it certainly warrants discussion.

There should be little doubt that the wider tobacco sector has passed its peak. The investment rationale for any of these companies is not based on increasing future demand or expansion as is often the case for companies that we analyse in this publication. Earlier this month, British American Tobacco made headlines when £25bn worth of its American business went up in smoke on the back of several write-downs. This was paired with a reduction in the speed at which earnings are predicted to grow, which together caused significant harm to the share price. It is evident from this that concern for the wider sector is warranted. Businesses that operate in sectors such as this generally have two options available to them; generate as much revenue as possible while liquidating stock, or transition into new markets. Philip Morris and British American Tobacco have attempted to transition away from the 'combustibles' market with varying degrees of success while Imperial Brands seem content to keep the majority of its business focussed on its established tobacco brands.

This is what makes Imperial Brands interesting. The company is buying back shares at a truly incredible rate and its new management team has demonstrated an ability to set and meet realistic targets for itself, helping to boost shareholder confidence. In 2022 it bought back £1bn worth of shares, representing 5.5% of its total market capitalisation and management have indicated this a trend that is set to continue. At this rate it will have bought back all outstanding shares decades long before cigarettes become culturally insignificant. This buyback program is one of the things that has fuelled IMB's outperformance relative to the wider sector in recent times. BATs has stated that it has no intention of starting a buyback program until its debt levels become more manageable and, with growth in its next generation products (i.e. electronic cigarettes) being called into question due to legislative pressure across the western world, its inability to engage in share buybacks has hamstrung it when compared to IMB.

From an investor's perspective, IMB's dividend yield and cash conversion are things that make it attractive. While there is the prospect for mid-single digit revenue growth over the short and medium-term, this will largely depend on price increases and not an increase in the volume of sales. The number of smokers is declining and there is no escaping this. The investment case that is to be made here is that the speed of this decline has been exaggerated in market predictions and that investors will be able to make a good total return once the 8.03% dividend yield is factored in. There does appear to be some evidence in support of this claim. Analysts have pointed out that even if absolute bans on smoking do come into place for people of a certain age, the population of smokers will still take decades to dwindle. This provides companies such as IMB with decades of predictable cash flow.

"Betting against market expectations is never going to be a risk-free move, but Imperial Brands is an interesting example of a company that appears happy to generate as much profit as it possibly can from a declining industry."

Ultimately only time will tell if smoking's decline has been exaggerated or not. There is a good deal of political will behind banning and further taxing cigarettes in much of the western world with countries such as New Zealand banning future generations from purchasing them altogether. Betting against market expectations is never going to be a risk-free move, but Imperial Brands is an interesting example of a company that appears happy to generate as much profit as it possibly can from a declining industry. It serves as reminder that returns can be found in a variety of places, not just in emerging growth companies. Cigarettes kill, but it remains unclear if quitting tobacco will be good for your portfolio's health. ■

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INSIGHT

THE MAGNIFICENT SEVEN

SAMANTHA CORY | INVESTMENT RESEARCH TEAM

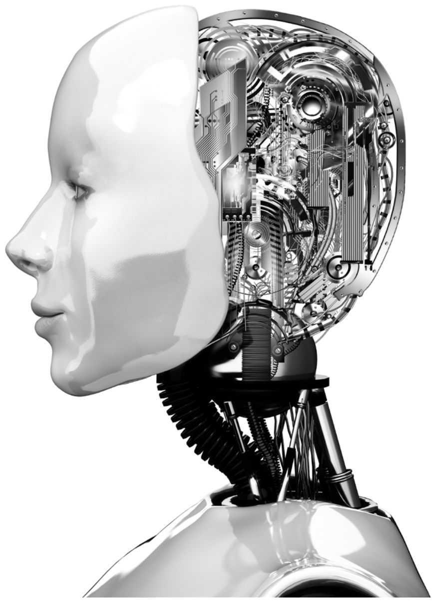
Had we started 2023 with the foresight of further interest rate increases, conflict outbreaks, and banking industry wobbles, predicting a near 20% return for the US stock market via the S&P 500 would have resulted in a few raised eyebrows. Rather astonishingly, this is the position we find ourselves in, with nearly all the index's returns generated by a small cohort dubbed 'The Magnificent Seven.' Names within this exclusive club include Apple, Amazon, Alphabet, Meta, Microsoft, NVIDIA, and Tesla.

This group of high-profile stocks dominated both headlines and attribution tables in 2023. In its 2024 US Equity Outlook, released in mid-November, Goldman Sachs' strategists highlighted the scale of performance with the group, returning 71% in 2023, while the other four hundred and ninety-three names in the S&P 500 index rose just 6%. The report also highlighted the meaningful underperformance of the cohort in 2022, declining 39% against the -11% return of the remaining names in the index, indicating a share price reversal as a contributing factor. While the group's returns are impressive, the spread within is wide. NVIDIA leads the bunch with 2023 returns to the end of November of 220.2% and a five-year figure of 1,053.6%. Amazon lagged with 73.9% and 72.9% over the same time periods, while the S&P 500 posted figures of 19.0% and 65.5%.

Most of the seven are expected to be household names, but NVIDIA is one which may not be initially recognised. A pioneer of Graphics Processing Units (GPU), a specialised computer chip, the company has arguably been the greatest beneficiary of the Artificial Intelligence (AI) uplift. It is not just hype behind NVIDIA, fundamentals are supporting the share price performance with net income expected to reach $27.6bn in the current financial year from the $4.4bn reported in the last financial year. AI is a consistent theme behind the Magnificent Seven's performance with both Amazon and Microsoft benefitting from cloud computing, while Meta and Alphabet are profiting from returning advertising revenue and cost control.

"The Magnificent Seven have produced impressive returns in 2023 thus far and looking forward, a repeat performance feels unlikely given the positive market sentiment which surrounded the constituents of the group and the AI trend generally."

The returns from these seven companies this year have caused concern for some regarding their 29% collective weighting at the top of the S&P 500, the highest concentration seen in the index's history. This effect is even more pronounced in the technology-focused NASDAQ 100 Index, where the seven names account for almost 46% of the index. July saw NASDAQ make moves with a special rebalance to address overconcentration in the index by redistributing the holding weights. This concern is starting to feed through, with high profile names in the industry trimming US exposure for other developed and emerging markets.



Concerns around concentrated positions in a handful of names is understandable given the rise in index-based investment and potential for significant asset flows to push prices further with positive sentiment or create a forced selling effect in a drawdown. While conscious of this risk, expectations are positive for the 'Magnificent Seven.' For NVIDIA, 94% of covering analysts hold a 'buy' rating with an implied upside of 43% given the expectation for a long-term growth rate of 40.2%. Trading on 38x next year's earnings, the valuation is not excessive but with expectations so high, even a slight miss at the next reporting date in February could see the share price head lower. For the other six names, implied upsides are more muted with analysts predicting returns in the 0-20% range.

The Magnificent Seven have produced impressive returns in 2023 thus far and looking forward, a repeat performance feels unlikely given the positive market sentiment which surrounded the constituents of the group and the AI trend generally. Despite this, the tailwinds remain positive, but the question remains as to whether outcomes will match expectations for a handful of names which now comprise a high weighting in the US flagship equity index. ■

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TOPIC OF THE MONTH

UNWRAPPING THE SANTA RALLY

GREG LODGE | PERFORMANCE & RISK ANALYST

What a year it has been for investors. After another five base rate increases by the Bank of England, inflation is falling but still well above target, and lacklustre market returns mean you might not be feeling all that festive. UK equity markets in particular have had a rough time. With such a mixed bag for investors to contend with, wouldn't it be nice to round out the year with a little boost in the form of a Santa rally? Let us unwrap this market phenomenon and see if it stands up to scrutiny. Firstly, what exactly is a Santa rally? It describes a tendency for the stock market to climb by 1-2% over the last five business days of one year, and the first two days of the incoming one. The event occurs in roughly eight years out of ten according to the Wall Street Journal, although we all know that nothing in the investment world is certain.

The phenomenon was first identified by Wall Street guru, Yale Hirsch, in his 1972 edition of the 'Stock Trader's Almanac,' a compendium of market cycles and patterns for ordinary investors. Along with the Santa rally, he highlighted several others including the 'January barometer' and 'best consecutive six months.' Of these, it is the Santa rally that has become perhaps the best known. In his almanac, he examined the period from 1952-1971 and found that a rally had occurred in 17 out of the previous 20 years, with the S&P 500 making an average gain of 1.35%. Initially, his definition included only the last four trading days of the outgoing year, but this was later extended to the full five. To be classified as a true rally, the market simply needs to make a positive return. In 2006 we technically enjoyed a Santa rally, with a return of 0.0003% - faced with such meagre returns, a humble lump of coal might have offered more to celebrate. Hirsch also suggested that a Santa rally, or lack of, could serve as an insight into what the market might do over the next year. To this end, he penned the couplet 'If Santa Claus should fail to call, bears may come to Broad and Wall.'

Hirsch only examined a return in a relatively small timeframe, and this was over 50 years ago now. How has his theory stood up in the proceeding years? Market spectators and academics have attempted to apply some more analytical rigour in the search for answers. One study published in the Journal of Financial Planning in 2015 found the phenomena was statistically significant; higher average daily returns were found in the US stock market, and several large overseas indices. Other studies have concluded the opposite, however, so the consensus is not unanimous. The upshot seems to be that the Santa rally is an ethereal entity; we are not quite sure if it exists or how we can study it. But if it does, how significant is it, and what could be the cause?

A variety of factors have been put forward about what causes Santa rallies. One suggestion is that as the traders at institutional investors take a break for Christmas, market activity is dominated by more bullish retail investors who inflate stock prices with enthusiastic buying. There is a flaw in this theory, however, as pointed out by Forbes. Investment bankers are not exactly known for their abundance of leisure time. It does tie into another idea which suggests that simple optimism could be the cause. If investors are buying on the expectation that markets will rise, then it becomes something of a self-fulfilling prophecy and markets will indeed rise. This good mood effect could also be exacerbated by companies and governments being reluctant to release bad news close to Christmas. Employees spending and investing their annual bonuses has also been considered as a factor. This seems fairly plausible, until we consider that companies do not all pay annual bonuses at the end of the year. Of those that do, they may not materialise until January payday, so any impact is likely to be minimal.

This year to date, the FTSE 100 has returned a grand total of -0.55%. This is an index very much in need of some Christmas spirit. What are the chances of it receiving some? According to research by Fidelity International, quite good. Its analysis showed that in the 30 years since 1993, the FTSE 100 rallied in December on 24 occasions. While, of course, no investment is guaranteed, perhaps if we have been good then Santa will bring the markets a festive treat. ■

"The upshot seems to be that the Santa rally is an ethereal entity; we are not quite sure if it exists or how we can study it. But if it does, how significant is it, and what could be the cause?"

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FIRST PRINCIPLES: BOND RETURNS

Much has been written throughout the year regarding the renewed interest in corporate bonds. Alastair Power, Investment Research Manager, revisits some of the basics of corporate bonds.

In its simplest form, a corporate bond is a debt instrument issued by a company to raise funds. Three key items to know are the bond's face value, coupon, and maturity date. The face value is the monetary value of the bond when issued, usually £100, which is repaid to the investor when the bond matures. The coupon is the return offered to the investor throughout the life of the bond, given as a percentage, it tells the investor just how much income is to be paid out. A bond with a coupon of 6% and face value of £100 will pay out an income of £6 each year until the bond matures, at which point the investor receives the final coupon and the face value, £106 in this case. Finally, the maturity date gives the life of the bond, a bond issued today with a maturity date in 2028, has a life of five years. As such, anyone buying that bond when it was initially sold to the market, at T=0, can expect to receive the income from the coupons and their initial value back at the maturity date.

TIME (T = YEAR)	T=0	T=1	T=2	T=3	T=4	T=5
CASHFLOW (£)	-100	6	6	6	6	106

The level of coupon assigned to the bond is decided before the instrument is issued and is comprised of two parts. The first involves matching the corporate bond to a government bond of a similar maturity date. Using the example above, if the 2028 UK government bond is currently yielding 4% then this will form the starting point of the coupon. Given we are lending to a company, investors require extra compensation, or 'spread,' for the risk taken. This spread is decided by several factors, but mostly reflects the creditworthiness of the issuer. Assuming investors require an extra 2% of return, the combination of this spread with the government bond yield mentioned above results in a bond coupon of 6%.

Once issued, the market value of the bond will fluctuate around its face value given changing market conditions. Due to having fixed payments, the market value is most sensitive to movements in the yields of government bonds, but this level of sensitivity, or duration, declines the closer the bond gets to its final maturity date. Bonds with lots of sensitivity to government bond yields are 'long duration' and will have longer periods of time till they reach their final maturity date. Those with less sensitivity are 'short duration' and expected to mature in the non-too distant future. This is driven by the fact that provided the issuer of the bond is expected to pay back the debt, the bond will always trend back towards its face value as it approaches maturity in what we call 'pulling-to-par.'

Thinking back to the composition of the return, a bond's price will also have sensitivity to the level of spread investors require. If the probability of the company paying back the money at maturity is declining, investors will demand more compensation. As a result, the bond's price will decline to reflect this with the sensitivity known as 'spread duration.' This can work in the opposite direction, with the spread demanded declining in favourable economic conditions, pushing the price higher with investors willing to accept less compensation.

Having broken down the two return components of a corporate bond, it is important to remember that the two sensitivities can work in tandem and against each other to cause the bond's price to fluctuate around the face values. In March 2020 for example, concerns around the pandemic caused a significant move higher in credit spread, while government bond yields fell as central banks flooded the system with cheap money. Corporate bond markets initially sold-off sharply but recovered as both government bond yields and credit spreads moved to all-time lows.

Given the market price of bonds can fluctuate around the face value, we need to introduce another measure in bond pricing, the yield-to-maturity. This is the yield on offer through a combination of income and the price movement back to face value at maturity. If a 6% coupon bond is issued at a face value of £100, the yield-to-maturity issuance is 6%. If the bond trades below the face value, then the investor can benefit from some capital return when the bond matures along with the coupon income, resulting in a yield-to-maturity above the 6% mark. The yield-to-maturity is a useful guide to the potential return on offer if the intent is to hold until maturity. A pitfall comes in the assumption of coupons being reinvested at the current yield, a figure constantly changing with market fluctuations and as such it is not a guarantee but a useful guide.

Having been through an extended period of low yields in the corporate bond market, higher government bond yields and greater compensation via the credit spread has returned corporate bond yields to levels not seen since the financial crisis. With the yield-to-maturity on the sterling corporate bond reference index trading around the 6% mark, it is easy to see why there's renewed interest in this recently unloved area of the market. ■

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