STILL FINDING WINNERS IN THE UK

There have been so many ‘speed bumps’ threatening to impact the global economy over the last couple of years, it’s easy to assume that unprecedented, fundamental change in the world economic order may be inevitable. Certainly, for the last year or so we have been in unchartered – and potentially choppier – waters, with various global developments threatening to ‘rock the boat’. Torturous Brexit negotiations, dramatic elections across Europe, the first full year of the Trump presidency (and the politically divisive implications of the ‘America First’ policy) come to mind immediately, but there are many more. But do seemingly momentous events like these really signify a fundamental economic turning point or rather just the latest chapter in an ongoing story?

Historic as recent events may seem, with time their significance may fade. As Manager of The Merchants Trust, I am investing mainly in higher-yielding large UK companies, so I’m often asked about my views on Brexit and its current and eventual impact on the UK economy and stock market. I don’t have concrete answers, of course, but the risk profile for the UK economy has clearly risen and the current political and economic uncertainty is challenging. Although the UK stock market had a decent 2017, UK shares lagged those of other global markets. And 2018 has been tricky so far.

Politics and Brexit have been concerning potential investors. Global exposure to UK equities has been falling as investors have been taking their money out of the UK and investing it elsewhere. Yet, corporate buyers seem to have ignored the doom and gloom and have been targeting UK companies. We have seen several takeover approaches or full bids for UK mid-cap companies in the last few months. Corporate appetite for ‘UK PLC’ backs up our own view that the UK stock market is one of the cheapest markets in the developed world right now with many domestically exposed sectors trading on low valuations due to concerns about Brexit, political risk or structural factors. For corporate buyers willing to look longer term, these valuations can represent rare opportunities to buy sound businesses at bargain prices.

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Many domestically exposed stocks have been feeling the pain, partly because of concerns that the nature of post-Brexit trading arrangements may cause the domestic economy to slow down. Although we take account of macro-economic trends, our focus is on the fundamental qualities of individual businesses and we have been able to unearth sound companies in out-of-favour sectors. The Trust’s portfolio has a high exposure to modestly rated companies and their underperformance over recent months has made this a fertile investment area for us.

Differentiation is crucial. As a stock picker I would say there are lots of opportunities out there right now. You must do your homework, of course, analysing and understanding the specific issues that could affect specific companies. However, in many cases, Brexit may not play out to be such a big issue although the knock-on effect on the economy overall is something we will always need to bear in mind.

In uncertain times it can be helpful to look back. During my career there have been some incredibly tough times, like the 1987 crash and, more recently, the 2008 bear market and recession, which many consider to be the worst financial crisis since the Great Depression of the 1930s. I’ve been running The Merchants Trust for 12 years but the Trust itself was established in the 19th century and will celebrate its 130th birthday next year. Not only has it survived global conflicts and crises, but its resilience through markedly different market conditions has enabled it to generate notable long-term returns for its investors. I’m sure there must have been many a time along the way when investors felt they too were embarking on an era of fundamental change.

The UK economy may be under a cloud right now but, as well as domestically focused businesses, the UK is home to some of the world’s largest and best known “mega cap” businesses so investing in UK stocks can still provide access to the global economy. These companies choose to call the UK ‘home’ because, structurally, we have some of the highest standards of stewardship and corporate governance anywhere in the world. And for those UK stocks that are truly domestically focused (i.e. deriving most of their revenues from within the UK and where clouds have gathered since the June 2016 EU referendum result) there will still be long-term winners, even though they may be almost universally lowly valued today.

Looking ahead, the outlook is tough to call. Losing access to the EU’s free trade area may be an economic negative but it will give the UK the opportunity to change the way it trades with the rest of the world, potentially for the better. I’m certainly not ready to write off the long-term prospects for the UK economy and, in the meantime, my focus remains on strong franchises with distinct businesses models – companies that have a good chance to do well, even if the short-term environment is uncertain. ■

To find out more about Simon’s investment philosophy and stock selection process, view the latest Merchants annual report which is available at www.merchantstrust.co.uk.

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Allianz Global Investors

Simon Gergel
Portfolio Manager
The Merchants Trust PLC

Simon Gergel is CIO of UK Equities at Allianz Global Investors and is portfolio manager of The Merchants Trust PLC. Merchants has for many years focused on a simple proposition to deliver a high and rising income together with capital growth for its shareholders. Although past performance is no guide to the future, Merchants has paid a rising dividend to shareholders for 36 consecutive years.