VT Lyndon Fund

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ContraCapital

All the bankers getting' sweaty beneath their white collars, as the pound in our pocket turns into a dollar

Well, another rather too interesting and consequently nasty quarter in what has so far been a grisly year for investors. Equity markets continued to tumble around the world, whilst bond markets have, remarkably, suffered even bigger losses in many cases. The most widely followed global equity benchmark, the MSCI World Index, is now down by -25% year-to-date (in US dollars), whilst the U.K. equity market has performed rather better. The MSCI UK Index, for example, is down by -19% in US dollar terms, but very much less in sterling, due to the pound's sharp fall.

The pound's death swoon to a new all-time low and close to parity with the US dollar may have grabbed more of the headlines, but the chaos in the U.K. government bond (or "gilts") market was of far greater moment. About that pound, though, despite bouncing off its historic low of $1.035, it was still down -8% for the quarter against the dollar and so off by -18% for the year. The decline against the also weak euro has been much less dramatic, but sterling is still down by -5% year-to-date against the beleaguered European currency.

The more important action was in the gilts market, where the benchmark 10-year gilt, having started the year yielding less than 1% and the quarter at 2.26%, ended Q3 with a yield of 4.09%. These are extraordinary and seismic moves in what is supposed to be the stable, long-term risk-free rate, and it is relied upon to function as such by pension funds and other market participants with a long-term time horizon. Hence the problems when it is anything but stable.

A bond's price is inversely related to its yield, so yields sharply up means prices sharply down, and the longer dated a bond is, the more sensitive its price is to changes in yields (in technical terms, this greater interest rate sensitivity is referred to as higher "duration"). So, at the time of writing (mid-October), the benchmark 10-year and 30-year gilts are down by c. -25% and -50% year-to-date, respectively. The carnage in the index-linked market has been even worse, with the S&P UK Index-Linked Gilt Index, which is a broadly based index designed to track the overall performance of index-linked gilts, down by an eye-watering -30% YTD.

Interest rates up and the currency down is an unusual combination in a developed economy and speaks of international capital's utter loss of confidence in the abjectly incompetent U.K. government, whose economic credibility has been comprehensively shredded. With the IMF getting involved and openly criticising the U.K. for fiscal incontinence, the not-so-roaring 20s are increasingly echoing the 1970s. So far we have had an energy crisis, runaway inflation, an upsurge in strikes and a plunging pound, but all telescoped into a few short months rather than spread over a decade. One question though; where's all the good music?

In more echoes of the 1970s, this is shaping up to be by far the worst year for the classic 60/40 equity/bond portfolio since the early years of that largely unloved decade. There really has been almost no place to hide, and the few asset classes not yet showing big losses, such as property and private equity, will likely get their time in the woodshed soon enough. Commercial property valuations, already under significant pressure, will be further compressed by rising discount rates, whilst the residential property market looks set for a substantial tumble. The structure of the U.K. mortgage market has been transformed over the last decade or so, with floating rate mortgages, which used to be the default option and accounted for c. 70% of outstanding loans in 2012, now a minority interest, and only around 10% of the market.

In the current rising rates environment this is very much a good thing and means that most mortgaged homeowners are currently insulated from the recent rises in interest rates. However, this will prove to be only a temporary respite, as most U.K. fixed rate mortgages are typically fixed for, at most, five years, with two-year fixes generally having been the most popular. It is estimated that every quarter about 300,000 borrowers come to the end of their fixed deal, with the peak expected to be 375,000 in Q2 2023. Most of these mortgages will be paying less than 2% interest, as rates were at around this level only 12 months ago, but will have to be refinanced at very much higher rates. The average 2-year fix rate is currently above 6%. If mortgage rates stay at their current levels (or go higher), it is hard to see how a housing market crash and a very deep recession can be avoided. The ”if” is important in the previous sentence, as such is the fragility of the U.K. economy and its gearing to the over-mighty housing market, that mortgage rates of 6%+ are likely to prove untenable.

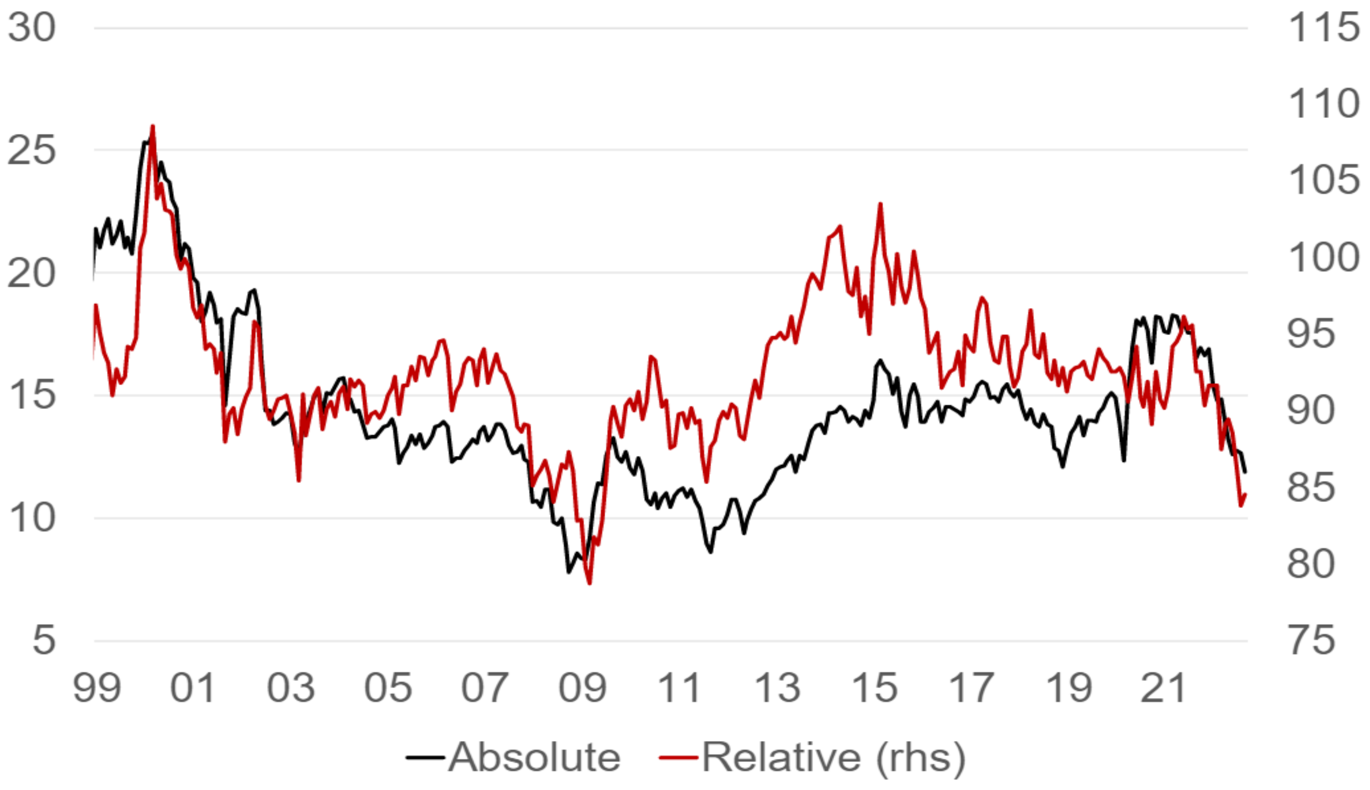
It is one of the slightly tiresome truisms of the markets that, above all else, they hate “uncertainty”. This being so, the market reaction to the haplessly chaotic, almost comical ineptitude of the Truss administration has been precisely what one would have expected. As elsewhere in life, confidence in financial markets is hard won but easily lost. Truss and her band of revolving-door mediocrities can therefore perform as many screeching U-turns as they like, but the market’s mind is made up. You can’t unburn toast.

Some investors now reportedly regard the U.K. market as “uninvestable”, but even for those courageous enough to go there, the U.K.’s “risk premium” has gone up, which is really just another way to say that asset prices have come down. In particular, and yet again, domestically focused U.K. mid-caps have borne the brunt of the selling pressure, with absolutely dreadful share price performance. As at the end of September, the U.K. mid-cap index was down -27% for the year, whilst the decline in U.S. dollar terms is now -40% YTD. Just how far U.K. assets have declined in dollars is cited, as it is clearly very relevant to potential U.S. acquirers, either corporate or private equity, both of which have been very active in the U.K. market over recent years. The U.K.’s current “everything must go” closing down sale will surely pique further overseas interest.

The distaste of investors for U.K. assets is understandable, but some of the valuations available are hard to reconcile with any sense of long-term value. As equities represent economic claims on businesses with potentially infinite life spans, the stock market theoretically functions as the ultimate long-term discounting mechanism. However, it frequently does not behave in the prescribed manner, shifting its focus to much shorter-term considerations. Human nature determines that this short-termism is particularly prevalent when the macroeconomic or political environment is highly unstable, which leads investors to become excessively fixated with all the bad stuff that is happening *right now*. What are actually cyclical or ephemeral issues are instead treated as being permanent or long-term in nature and Irrational degrees of pessimism can become ubiquitous. Scenarios such as this provide the contrarian investor with the richest of all opportunity sets and when they present themselves, typically once every decade or so, full advantage needs to be taken.

We would argue that the U.K. market is currently suffering just such a crisis of confidence. As well it might. Yes, we are being governed by weak, vacillating and flagrantly venal inadequates, but this too shall pass. And when it does, and some semblance of calm, competence and normality is restored, valuations will likely be very much higher. As shown below, the U.K. stock market is already almost as cheap as it was at the bottom of the market in 2009, on both absolute and relative bases.

27. 12m Forward PE
12m Fwd PE at 11.9x, 15% discount to MSCI AC World



Source: Citi Research, MSCI

If the U.K. market is cheap and unloved, then the constituents of our portfolio are positively bargain basement and detested. In aggregate the U.K. equity portfolio is now trading on below 7x trailing and 6x current year consensus estimates of operating profit, so very much the levels that proved to be the trough in March 2009 and March 2020. And these are weighted average multiples, so many portfolio holdings are trading at much lower valuations. Special mention once again to Grafton Group, which just to recap is a well-managed and well-positioned distributor of building materials, active across several European markets. Having sold its U.K. merchanting business for cash proceeds of over £600m – with what now looks exquisite timing (deal completed 31st December 2021) and also now to have been a remarkable price – the group is only 40% exposed to the U.K. *and* is sitting on a large pile of net cash. Indeed, the cash on the balance sheet accounts for more than one-third of the group's equity value, such that the operating business is valued at less than £1bn, and this for a business that generated £260m of operating profit last year. We can only conject that investors have not properly apprehended the transformation in either the group's balance sheet nor its geographical exposures.

There are many other examples of aberrant valuations in the portfolio, but one that bears mentioning is that of the furniture retailer, SCS, whose equity is currently valued at less than the cash on its balance sheet. That is, the operating business, which produced £18m of operating profit in its last fiscal year, is being valued at less than nothing. Surely at least a little harsh.

Given these kinds of valuations, and very much in spite of the political and economic train wreck that is the U.K. right now, it is hard not to harbour some bullish sentiments. Indeed, on our calculations, the current equity portfolio now offers c. +125% upside to a conservatively derived estimate of fair value. This will clearly not be an accurate number, but there's a very large margin of safety on offer.

The sort of stocks we buy – those on very low multiples of operating profit and high cash flow yields – look much better placed in the current environment than more highly rated equities, and not only because cheap stocks are generationally cheap. Historically, lowly valued, high cash yielding stocks have tended to perform relatively well in downturns (2020 was an arguably anomalous but significant exception) and also in high inflation environments. This may seem counterintuitive, but it is readily explicable (as well as being empirically true).

The simplest explanation is that, as the perceived level of economic and political risk grows, the attractions of stocks that generate a lot of cash relative to their valuations rises, with investors preferring the here and now certainty of cash in the hand rather than airy promises of a potentially fabulous payoff many years hence. In the case of the more "blue sky" growth stocks, these cash flows have every chance of never arriving, which is why stocks like these go to the moon when markets and investor sentiment are super bullish, but come crashing back down to earth when sentiment turns sourer (or just more grounded in reality).

Alternatively, we could discuss the role of interest rates in determining investor preferences, of how lowly rated value equities are "low duration" assets (relatively insensitive to interest rate movements) and highly rated growth equities are long duration (more sensitive to interest rates). However, the simple logic of a bird in the hand being worth rather more than two in the bush to an anxious investor, is not just the simpler explanation, but also we think the better explanation for the observed tendency for value to outperform growth in downturns precipitated by increasing interest rates (which most are).

And it is a downturn that we will be getting and a substantial one at that. There is no sensible denying that there really is a lot to be gloomy about and whoever occupies 10 Downing Street will face a Herculean task righting the ship of state. Cleansing the Augean stables may look like a cakewalk compared to fixing the mess left by a dozen years (and counting) of Tory misrule. However, it is when things appear bleakest that it is most necessary to consider what could go right.

So, in no particular order: Ukraine could "win" and do so without Russia melting down dangerously (nuclearly or otherwise). Commodity prices would consequently fall sharply, bringing inflation and interest rates down with them and spurring an economic recovery. The U.K. could get a functioning government, one that acts in the real long-term interests of the nation (work with me here) and would therefore establish much better relations with the E.U., spur investment in infrastructure (including a green energy transition), build hundreds of thousands of new houses and invest in the public services that have been neglected over the last 12 years.

From the deep hole in which we find ourselves there's no realistic prospect of a "one bound and we're free" resolution to our tribulations, but sentiment and markets can turn with surprising rapidity and ferocity. There are no perfect analogues, but the political and economic chaos around "Black Wednesday" is an interesting case study. At the time, the U.K.'s ejection from the Exchange Rate Mechanism and associated collapse in the pound was seen as something of a disaster and very much a national humiliation. However, the U.K. stock market, having drifted sideways for the preceding five years, spiked up by +10% within a week of this calamity and embarked upon an eight year bull run that would see the equity index almost treble in value.

Or perhaps the current depth of pessimism and sense of ineluctable national decline is more redolent of the mid-1970s (it probably is), a decade that is remembered as a generally dismal one for U.K. investors, which it absolutely was. However, being out of the market at the point of maximum despair would have been exceptionally costly, as in the single calendar year of 1975 the U.K. equity market rose by an astonishing +150%. We are not in 1975 yet, but in terms of dismal returns we are in a market that has been flat for more than two decades, with the FTSE 100 Index at the same level it was in December 1999. That's really very dismal. So, whilst there is every chance that things will continue to get worse before they get better and we have not quite reached bottom, any improvement in economic fundamentals or inflection in investor sentiment could take us a surprisingly long way.

(Source: for all share price and index movements is S&P CapitalIQ and are quoted in local currency unless otherwise noted).

David Lynch, Fund Advisor, VT Lyndon Fund, October 2022

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