VT Lyndon Fund

Quarterly Commentary 31st March 2023

ContraCapital

Stop Me If You Think You've Heard This One Before

The rally in global equity markets that kicked off in mid-October last year continued through the first couple of months of 2023, before faltering a little in March, as the stability of the financial system came into question. Over the course of five days in early March, three smallish U.S. banks failed, spooking global financial markets. The most significant of the failures was Silicon Valley Bank which, with assets of $212bn, was not really all that small. This was followed soon after by Credit Suisse having to be rescued by its Swiss rival, UBS, at the behest of the Swiss government. Although Credit Suisse had been slow motion failing for years, its collapse is still a big deal, as it was one of just 30 banks rated as globally systemically important by the Financial Stability Board, an international body that monitors the global financial system. Moreover, whilst one bank failure may be considered unfortunate, what might Oscar Wilde have had to say about four in less than a month? The unusually rapid ratcheting-up in global interest rates since the beginning of 2022 was always going to cause strains in the financial system and further implosions are to be expected, including some in areas that are not so expected.

The Fund was up by +12.1% during the quarter (performance for B Acc units), with very few stocks down and several up significantly. Recent and atypically glamorous addition to the portfolio, Spotify Technology, was the stand-out performer, being up by +69% over the quarter. A more typically grubby investment for us, SIG plc, was also to the fore, after welcoming a new CEO, Gavin Slark, at the beginning of February. We know Mr Slark very well from his enormously successful tenure at another portfolio holding, Grafton Group, which he left after more than 11 years towards the end of last year. His stated intention was to have a bit of a break, but he apparently could not resist getting back in the game when the top job at SIG became available. As an aside Mr Slark was offered the CEO position at SIG some years back but turned it down, so his change of heart is both intriguing and encouraging for SIG's long-suffering shareholders.

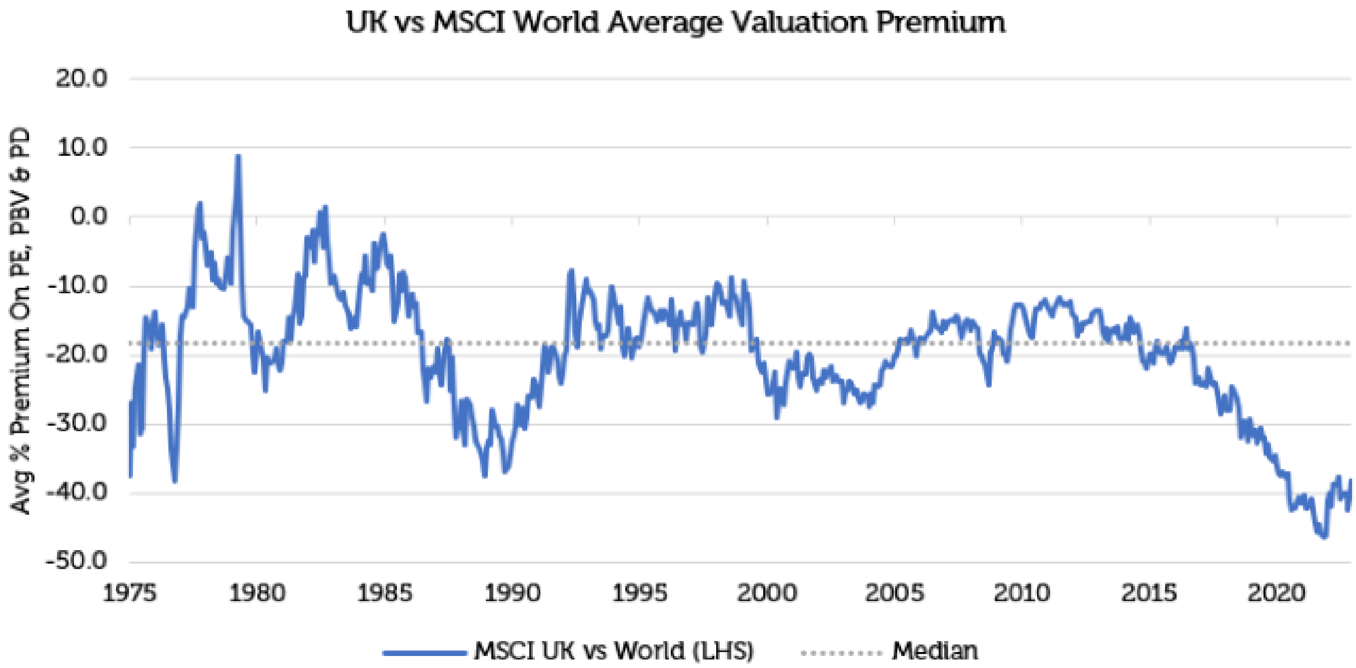
As to why both we and other investors are so enthused by Mr Slark's arrival at SIG, his record at Grafton was undeniably impressive. Under his stewardship the group's operating profits nearly sextupled, from a little below £50m in 2011 to not far shy of £300m in 2022, with operating margins expanding from 3% to 12%. Grafton's portfolio of businesses was migrated from lower to higher margin areas and the geographic reach of the group was much expanded. The group evolved away from being a predominantly low margin UK builder's merchanting business to a much more diversified and higher margin European distributor of construction products. Crucially, shareholders profited greatly from this transformation, with the total shareholder return generated of +275% being well over double that of the UK equity market over the same period and hugely outperforming peers. One such peer was SIG itself, which "returned" -57% to shareholders over the same period, so there is definitely scope for improvement.

Prior to his 11 years at Grafton, Mr Slark also had a notably effective five year spell as CEO of plumbing and heating distributor, BSS, which culminated with the group being sold to Travis Perkins in 2010 for a very good price and with excellent timing. For clarity, the timing and price were excellent for BSS shareholders rather than those of Travis Perkins. Two successful CEO stints puts Mr Slark in very select company indeed, can he make it a hattrick? Amongst those who presumably believe he can are SIG's largest shareholders (with a 29.8% stake), our old friends CD&R. The private equity group have been very active in the UK equity market over recent years, acquiring Morrison's amongst other esteemed assets.

Another prominently positive performer during Q1 was the support services group, Capita, which finally managed to report a full-year profit. The seemingly Sisyphean task of cleaning up the group's balance sheet and streamlining its operations is now more or less complete and so, we trust, is the litany of unpleasant surprises that have emanated from the group over the last few years. By the end of this year it is likely that the group will carry no net debt, so financial risk has been much reduced, and there are not many probable asset disposals left for which the group can obtain surprisingly poor prices.

Everyone's favourite estate agent, Foxtons, also performed strongly on the back of its trading statement, with investors perhaps finally waking up to the fact that the overwhelming majority of the group's revenues and currently all of its profit are derived from the relatively stable and robustly performing lettings business rather than the volatile sales operations. Should the sales side of the business ever generate a meaningful profit, as it surely will at some point, then the shares really will be meaningfully higher.

Stop us if you've heard this one before, but the UK equity market remains very cheap, both against its own history and also against its peers (as shown below). As in all markets, prices in the stock market are set at the margin, by the marginal buyer and marginal seller, so small changes in the views of participants on either side of the market can have larger than expected effects. This is especially so at market extremes and so, with sentiment on the UK market as depressed as it is, relatively minor improvements in news flow and/or investors' attitudes could drive a surprisingly hard and fast bounce from current levels.

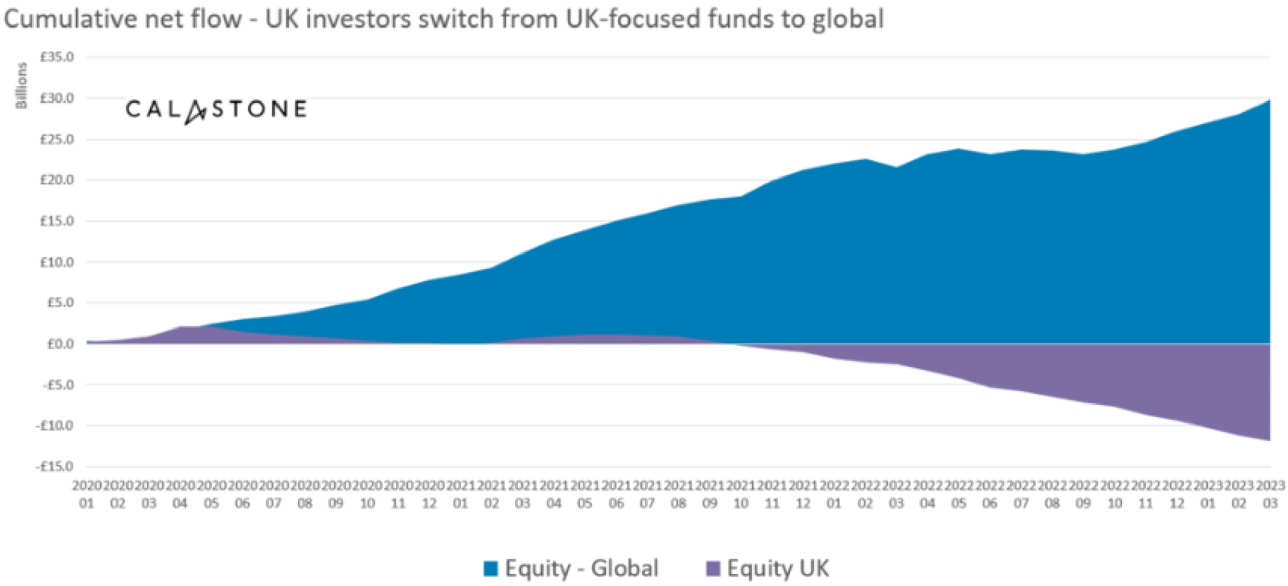


Source: Morgan Stanley

Heaven Knows I'm Miserable Now

There is a veritable cottage industry in the investment world of sentiment surveys conducted by stockbrokers in an attempt to divine investors' opinions on various asset classes. Over recent years these have unfailingly shown that sentiment on the UK equity market is very negative and, as yet, no reversal in this now well-established assessment has been noted. However, there really is no real need to consult any such surveys, as the valuation of the UK equity market eloquently attests to its on-going pariah status for investors. But even more compelling evidence of the distaste felt for UK equities by investors is provided by flow of funds data, which show where investors are actually putting their money rather than where their mouth is at. As shown below, investors have been selling UK-focused funds (and buying globally mandated ones) more or less continually for the last couple of years. As at the time of writing, there have been 23 consecutive months of net outflows from UK equity funds, with aggregate net sales of nearly £14bn.

The unceasing selling pressure is not only a cause of recent weakness in the UK market, it is also a consequence of it. There is what George Soros refers to as "reflexivity" here, as weakness in the market begets selling, which begets more weakness and thereby more selling and so on. A vicious feedback loop is created and can continue for quite some time, but very much not *ad infinitum.* Eventually a point of such absurdity in a market will be reached that some who were previously eschewing it will feel compelled to start buying and a savage snap-back will ensue. Such an inflexion point for the UK equity market is surely getting closer.

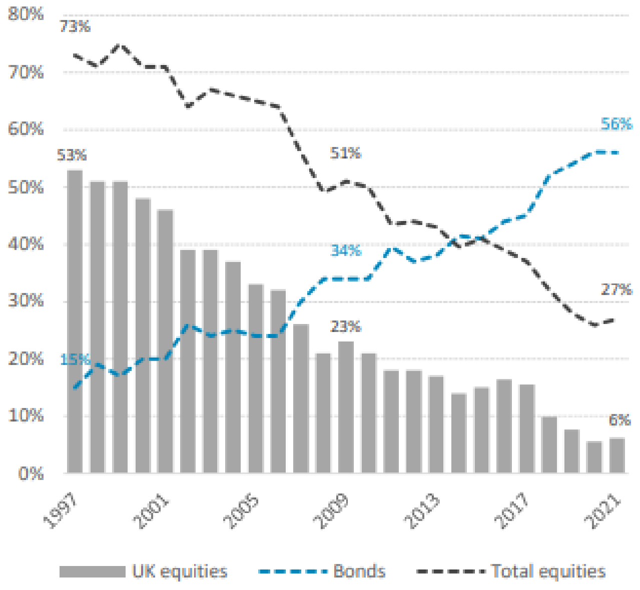


Source: Calastone

The relative weakness in UK equities clearly goes back a lot further than the last couple of years depicted in the chart above, but then so does the selling pressure. The chart above is based on data from UK-focused funds (OEICs and other unitised funds) domiciled in the UK, but such funds are far from the only large pool of assets with substantial exposure to UK equities. A more important long term depressant of UK equities has been the actions of the UK pension fund industry, which has been a relentless seller of UK equities for the last 25 years or so.

The scale of the UK pension industry's retreat from the UK equity market is astonishing. In 1997 UK pension schemes allocated c. 53% of all their assets to the UK stock market, by 2021 this figure was just 6%, a near-90% decline (source: New Financial, a think tank focused on European capital markets). This reduction in exposure to UK equities was in part driven by a move away from all equities, with overall pension fund exposure to equities declining from 73% to 27% over the period. However, within the equity allocation the share devoted to UK equities declined even faster than this, falling from more than 70% in 1997 to a little over 20% in 2021 (all shown below).

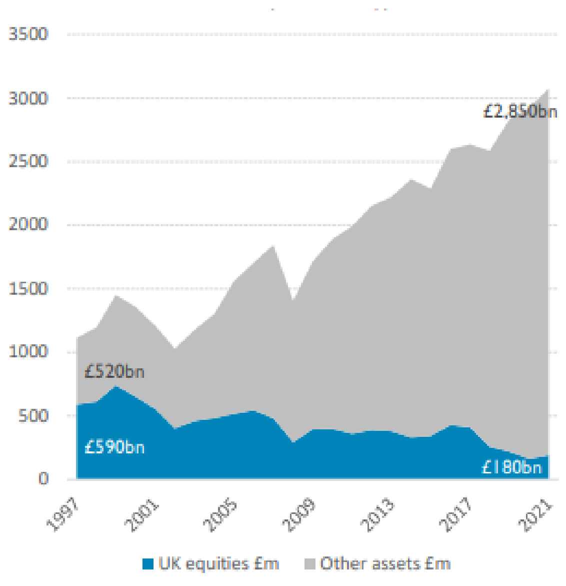
Allocation of UK pensions to UK equities, all equities & bonds 1997 to 2021



Source: New Financial analysis of data from the ONS, LGPS Advisory Board, PPF, Willis Towers Watson, UBS

To put these figures in some context, the value of UK pension assets has roughly tripled in real terms since 1997, from a little over £1 trillion to just more than £3 trillion (in 2022 money). So, as shown below, the exposure of UK pension funds to UK equities has declined by c. £400bn in real terms over this period. The real terms fall versus a constant proportionate exposure is well in excess of £1 trillion, but in the context of a UK equity market whose total capitalisation is c. £3 trillion, either of these are very substantial, indeed market moving sums.

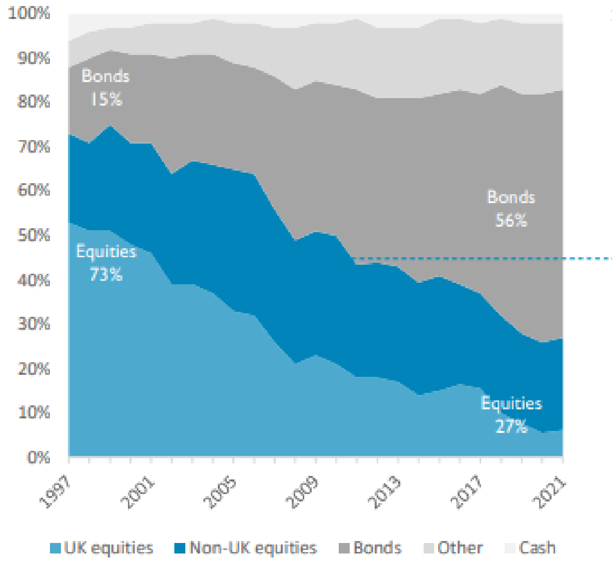
Value of UK pensions assets 1997 to 2021 in real terms (2022 money)



Source: New Financial analysis of data from the ONS, LGPS Advisory Board, PPF, Willis Towers Watson, UBS

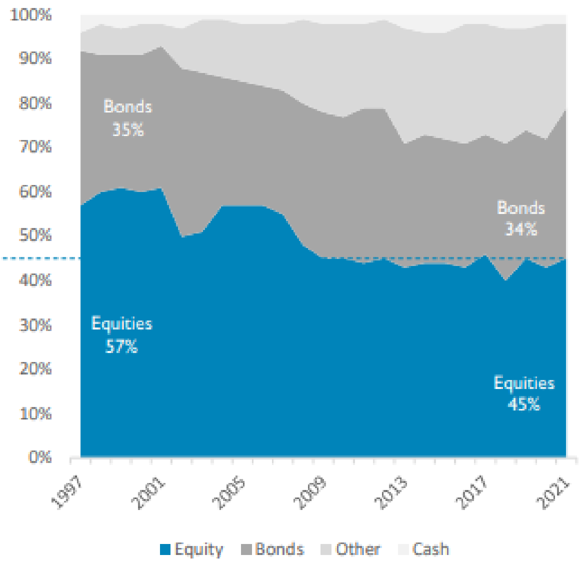
What is especially notable is that the changes in pension asset allocation in the UK over the last 25 years mark it out as a massive outlier in global terms. A comparative analysis of the seven largest pension markets* shows that whilst a decline in equity exposure has been the average experience, the quantum of the decline in the UK has been wholly exceptional. As shown below, at the beginning of the period the UK was an unusually equity-focused market, making its decline from 73% to 27% weighting all the starker versus the average experience of a decline from 57% to 45%. Moreover, whilst other major pension markets saw equity exposure fall over 2000-2009 and hold steady at around 45% thereafter, the UK's experience has been very different, with the rate of decline, if anything, accelerating post-GFC.

Headline allocation of UK pensions 1997-2021



Source: New Financial, ONS, LGPS Advisory Board, PPF, Willis Towers Watson, UBS

Headline allocation of global pensions 1997-2021



Source: Willis Towers Watson

Other points of interest from the above charts are that, having started the period with a very low allocation to bonds (15% vs peer group average of 35%), the UK ended with an exceptionally high one (56% vs 34%). The UK pension system now has the lowest allocation to equities and the highest allocation to fixed income of any of the seven biggest pension markets. It can also be observed that UK pension funds have notably low weightings in other risk assets (such as property, hedge funds, private equity and infrastructure), with these totalling about 11%, little more than half the global average of 19%.

So, why is this? The finger of blame can be squarely pointed at Robert Maxwell. After his demise in 1991, it was discovered that the fraudster had plundered £450m from his own companies' pension funds, having freely used them as his private piggy bank. Not unreasonably, this set in chain a whole series of reforms, many of them absolutely necessary. But whilst they were all well-intentioned, their combined effect has been catastrophic for the UK pension market, most especially private sector defined benefit (DB) pension schemes, also known as final salary schemes, of the type looted by Maxwell.

The changes to accounting standards, regulation and tax that were enacted post-Maxwell have been described by the economist, John Kay, in the Financial Times as "one of the great avoidable catastrophes of British public policy. You had a system that worked pretty well, which was replaced by one that constrained investment strategies and effectively killed UK private sector defined-benefit schemes." Perhaps the most consequential of the changes was the introduction of the accounting standard FRS17 in 2000, with this mandating that companies calculate the surplus or deficit on their defined-benefit pension schemes at each year-end and disclose any deficit as a financial liability in their accounts, just as they would any other form of debt.

The volatility that these newly disclosed liabilities lent to company balance sheets led to two pernicious outcomes. Firstly, there was a scramble by corporate sponsors to close their defined benefit schemes, first to new joiners and then to any further accruals. Secondly, in an attempt to dampen reported volatility by better matching pension schemes' assets with their liabilities, there was a flight from equities and an embrace of bonds, especially government bonds. One inevitable consequence of this has been poorer overall returns on pension fund assets, as equities are the best performing asset class over the long-term. These weaker returns have meant that pension funds' corporate sponsors have had to pay more money into their schemes than if they had retained a higher weighting in equities (and other risk assets).

The desideratum of lower volatility has therefore been bought at a terrible cost. The most obvious adverse consequence is much less attractive pension provision for UK employees, but to this we can also add diminished cash flows from UK plc and therefore a weakened corporate sector. UK companies have clearly been disadvantaged against global competitors not so burdened by unnecessarily elevated pension expenses. A further baleful outcome is depressed UK equity valuations and weaker, less attractive capital markets. Why would an exciting, innovative company with multiple alternative options choose to list its shares on the UK market, where valuations are so miserable? Vicious cycles at work wherever one looks.

It's very far from obvious that the current arrangements work for anyone. Indeed, the list of victims includes employees, corporate employers, the capital markets and we can probably chuck in the government (lower tax receipts via lower company profits) and the overall vibrancy of the economy (via weaker corporates). So that's basically everyone. The more you think about this, the worse it gets.

Money Changes Everything

Much of this damage is unfortunately baked-in; closed defined benefit funds are not going to be reopened and there's absolutely no incentive for fully funded schemes to move their asset allocation away from bonds and into equities. However, with DB schemes in the UK now only allocating c. 2% of their assets to UK equities, the scope for further selling pressure from this source is very limited. The great asset reallocation is something that has happened, not something that is happening. The giant sucking sound of pension money fleeing UK equities should be quietened and there are reasons to expect a partial reversal of the flows.

After many years years of hefty top-up payments and, more recently, the normalisation in interest rates, DB pension schemes in the UK are now in their rudest health in decades. The Pension Protection Fund (the body that underwrites most private sector DB pension schemes in the UK) has recently been reporting record estimated surpluses and funding levels for the schemes that it covers, with a £359bn surplus at the end of March and a funding level of 133%.

Funding level in the PPF index for DB schemes, 2006-2022

Source: Pension Protection Fund

The large surpluses being run by many DB schemes are allowing their corporate sponsors to offload their pension liabilities to insurance companies and they are doing so at a record pace. One of the major participants in this transfer of risk from companies to insurers, Phoenix Group, estimates that £60bn in liabilities will be shifted to insurers this year. This could be the new normal according to JP Morgan, a US bank, which recently forecast that £600bn of the c. £1.7tn of the pension liabilities currently sitting on UK companies' balance sheets could be transferred to insurers over the next decade.

These are serious sums and their movement will likely have consequences for UK asset markets. It is at least possible that DB pension schemes transferred to insurance companies will take just a little more risk with their asset allocation and invest more in equities, including UK equities. They could scarcely go much lower than the 2% typically held by corporate DB schemes, after all. Figures from New Financial support this thesis, as insurers' asset allocation to equities is at least somewhat higher than that of the typical corporate DB schemes (21% versus 15%) and appreciably higher in UK equities (5% versus 2%).

There is another long-term trend in pension markets that should be supportive of flows into UK equities, which is the growth of defined contribution (DC) schemes (also known as money purchase schemes). Whilst the Maxwell-inspired demise of the UK's defined benefit pension industry and replacement with DC schemes is regrettable in many ways – defined benefit schemes are greatly superior for pensioners – there is realistically no going back. There are now only about 1 million active members of private sector DB schemes, as against 18 million active members of DC schemes. However, because DB schemes have been around so much longer and are typically far more generously funded, they are still much the larger pool of assets, at around £1.7tn, as against DB schemes' £550bn. But what matters from here is the shape of future flows and how they will impact asset markets.

Currently about £25bn is still being contributed to DB schemes annually, but this figure is falling every year. Approximately double this figure is flowing into DC schemes and this is rising swiftly, such that a total of £670 billion is forecast to be contributed to DC schemes in the ten years to 2030, which it is estimated will take total DC assets to £1.3 trillion from the current £550bn. This is important because whilst DB schemes only hold c. 15% in equities and 2% in UK equities, DC schemes have a very different asset allocation, typically committing c. 55% to equities and 13% to UK equities (Source: New Financial).

The on-going growth of DC schemes should therefore result in UK pension funds devoting an increasing share of their assets to UK equities for the foreseeable future. We are absolutely not going to see pension fund allocations to UK equities on anything like the level of the past (and nor should we, as the 50%+ allocated in the 1990s never was appropriate), but the drag of remorseless selling should be removed and at least somewhat reversed. What has been a substantial headwind for the last couple of decades should turn into a tailwind.

There have also been recent suggestions that the government is contemplating nudging the UK pension industry to invest more in risk assets. Specifically, the Chancellor, Jeremy Hunt, said that he was considering "measures to unlock productive investment from defined contribution pension funds and other sources." In addition, there have also been some governmental grumblings about the accounting standard FRS17 levying a "performance penalty" on UK investors as it means that "far too much UK capital is trapped in short term, low yielding investments." This observation is undoubtedly accurate, albeit about 20 years too late.

Even more on the money, though, is Andrew Warwick-Thompson, a former pensions regulator and professional trustee, quoted here in the Financial Times:

"It is not pension regime reform that is needed to increase investment in UK assets . . . but coherent, stable and sustainable economic and industrial policies to make the UK fundamentally more attractive to investors. In a global market competing for their capital, investors need to be attracted not coerced."

We can but dream.

** Australia, Canada, Japan, Netherlands, Switzerland, UK, US. They account for c. 85% of total global pension assets (source: Thinking Ahead Institute).*

(Source for equity returns and index movements is S&P CapitalIQ and are quoted in local currency unless otherwise noted).

David Lynch, Fund Advisor, VT Lyndon Fund, April 2023

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