

Moving beyond the peak in market beta

FUND MANAGER

Gervais Williams

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Introducing Gervais Williams



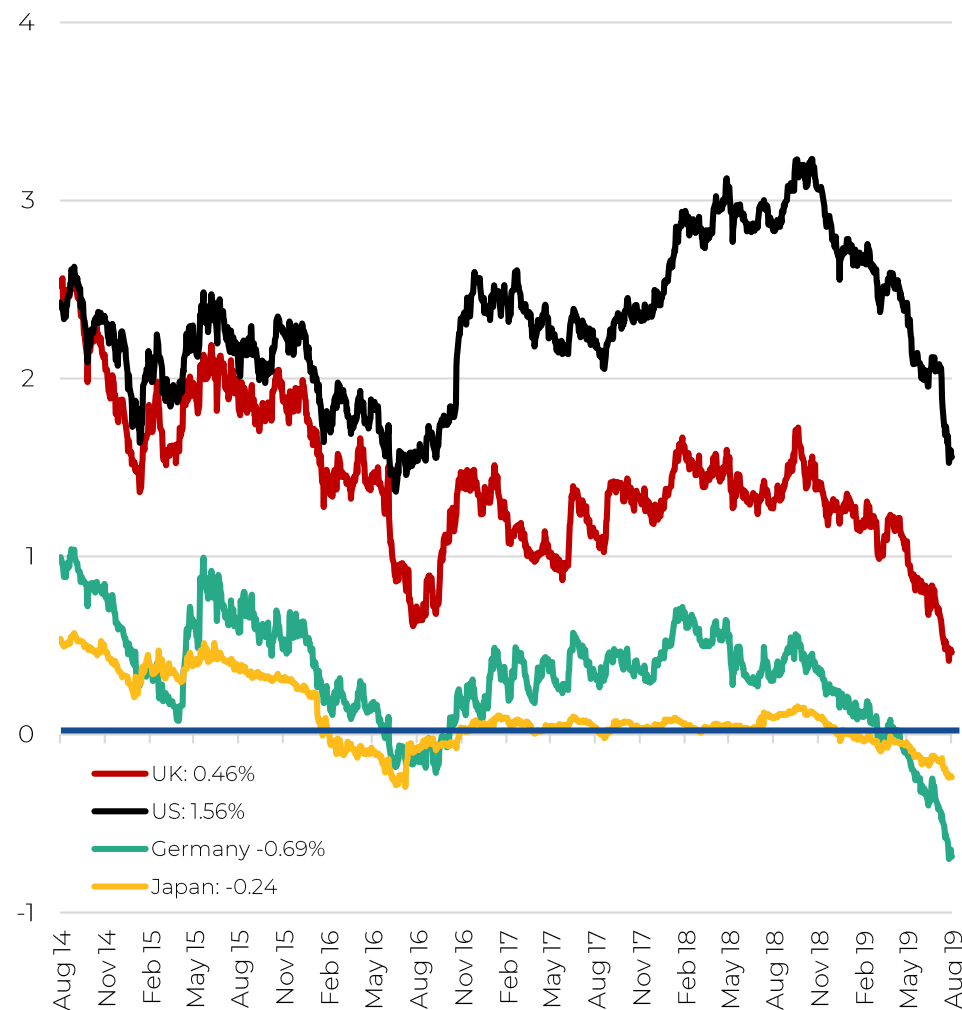
34 years' investment experience in UK Equities:

- Gervais joined the Group in 2011 and is Head of Equities.
- He manages a number of funds and trusts that aggregate to over £1.5bn.
- His fund management career extends to over 30 years including 17 years at Gartmore Group Ltd, where he was head of UK Small Companies.
- Gervais is a member of the AIM Advisory Council, and a board member of the Quoted Companies Alliance

Quantitative Easing has boosted the returns from index, growth and momentum strategies

- Quantitative Easing (QE) may offset an absence of corporate vitality, but it does so by distorting market prices so that capital is allocated further up the risk curve
- As QE has been used and reused repeatedly, it has driven up the valuation of stock markets, so that stock market returns have been consistently so good, that many have bought into the ongoing momentum of ETF and index strategies
- As bond yields have fallen to ultra-low levels, stocks with the highest growth expectations have frequently performed better than the stock market indices
- Some commentators believe that market distortion and the risk of asset misallocation may explain why productivity improvement may have stagnated

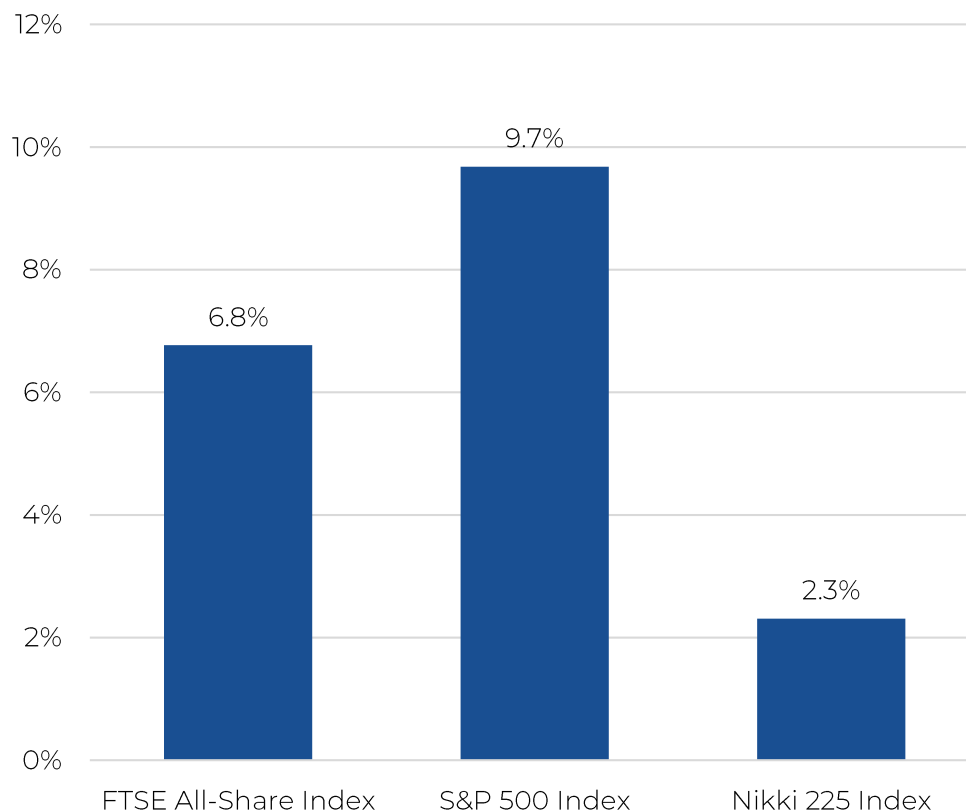
World markets: 10-year benchmark bond yields



Source: Peel Hunt, 20/08/2014 – 21/08/2019

Market appreciation since 2008 is additive to the stock market rises due to globalisation

Annualised returns of the FTSE All-Share Index, the S&P 500 Index and the Nikki 225 Index since March 1996

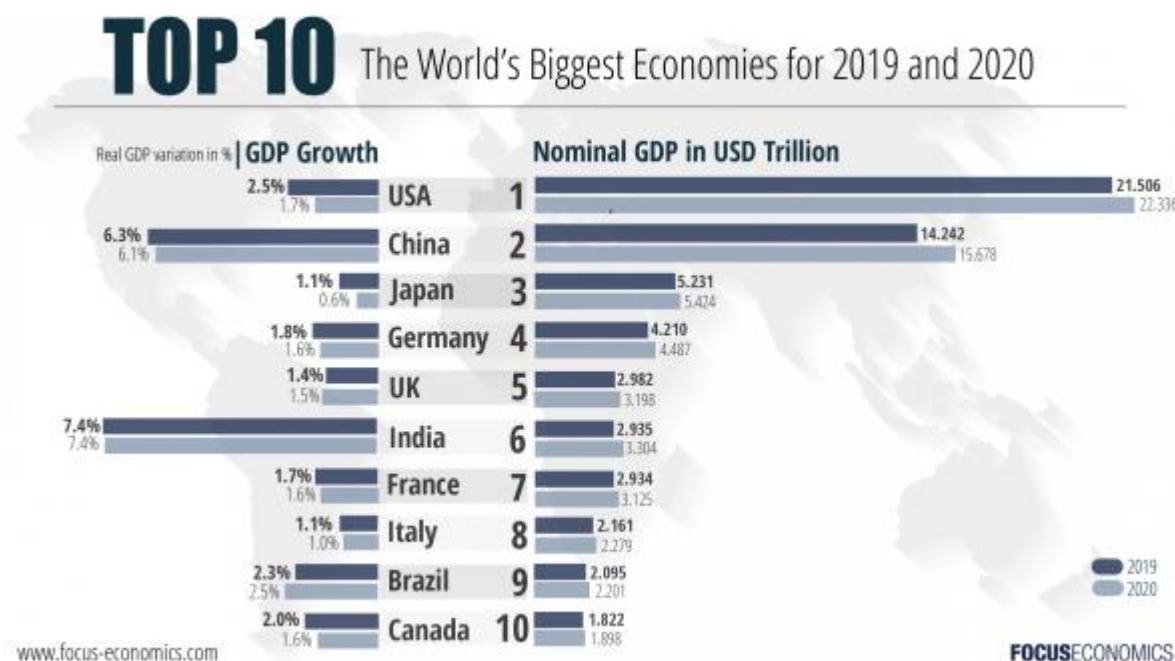


- During the period of Globalisation, there have been ample opportunities to access excellent stock market returns
- Returns on the FTSE All-Share Index have been strong, with particularly strong returns on the S&P 500 Index
- In general, market beta has been plentiful and cheap to access, and many fund strategies have become aligned with mid and large caps
- It is clearly unwise to come to rely on strong market appreciation in the future
- For example, the stagnation of the Japanese economy after 1990 has led to much more modest returns on the Nikki 225 Index over recent decades

Meanwhile, the ongoing decline of the UK means it is looking ever less relevant to outsiders

- There is little difference in the scale of the fifth, six and seventh biggest economies in the world
- Currently the Indian economy is growing faster than that of the UK or France, so it appears likely it will overtake
- Furthermore, the UK economy would shrink behind France if Scotland were to leave the Union
- The squabbles and political logjam in the UK parliament have been something of a turn off to overseas investors
- There is a risk that the UK does fall to the bottom of the G7

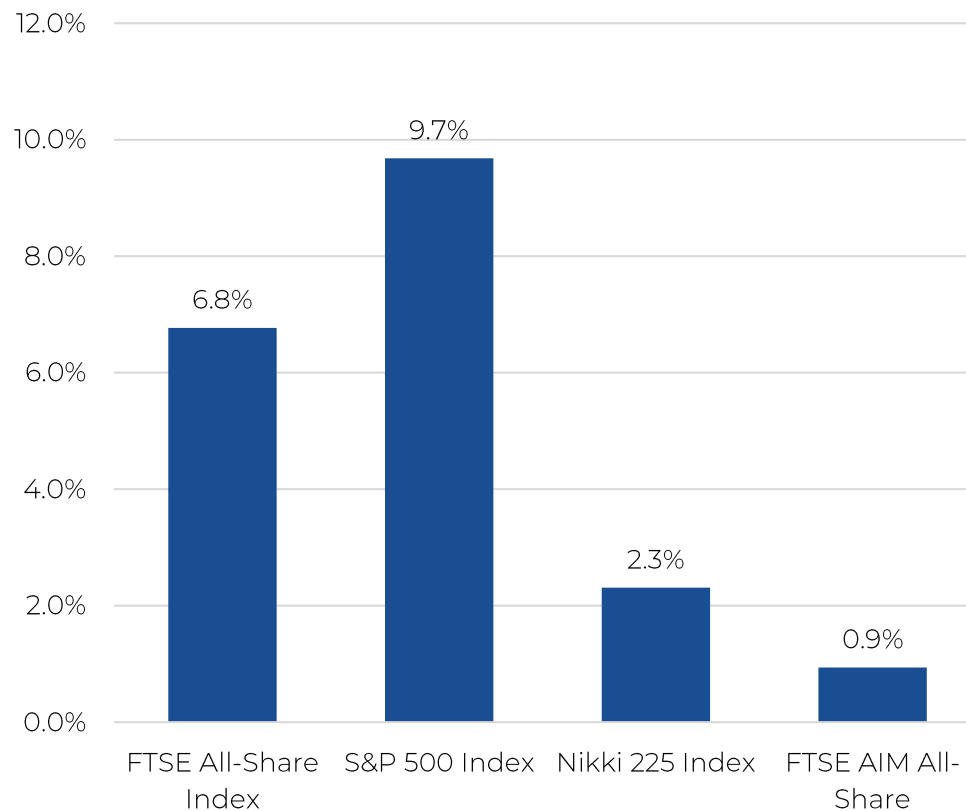
The World's Biggest Economies As of 2019 and 2020



Currently the UK is slipping from the
5th to the 7th largest globally

Alongside, UK small caps appear irrelevant to most global asset allocators

Annualised returns of the FTSE All-Share Index, the S&P 500 Index, Nikki 225 Index FTSE Aim All-Share and the since March 1996



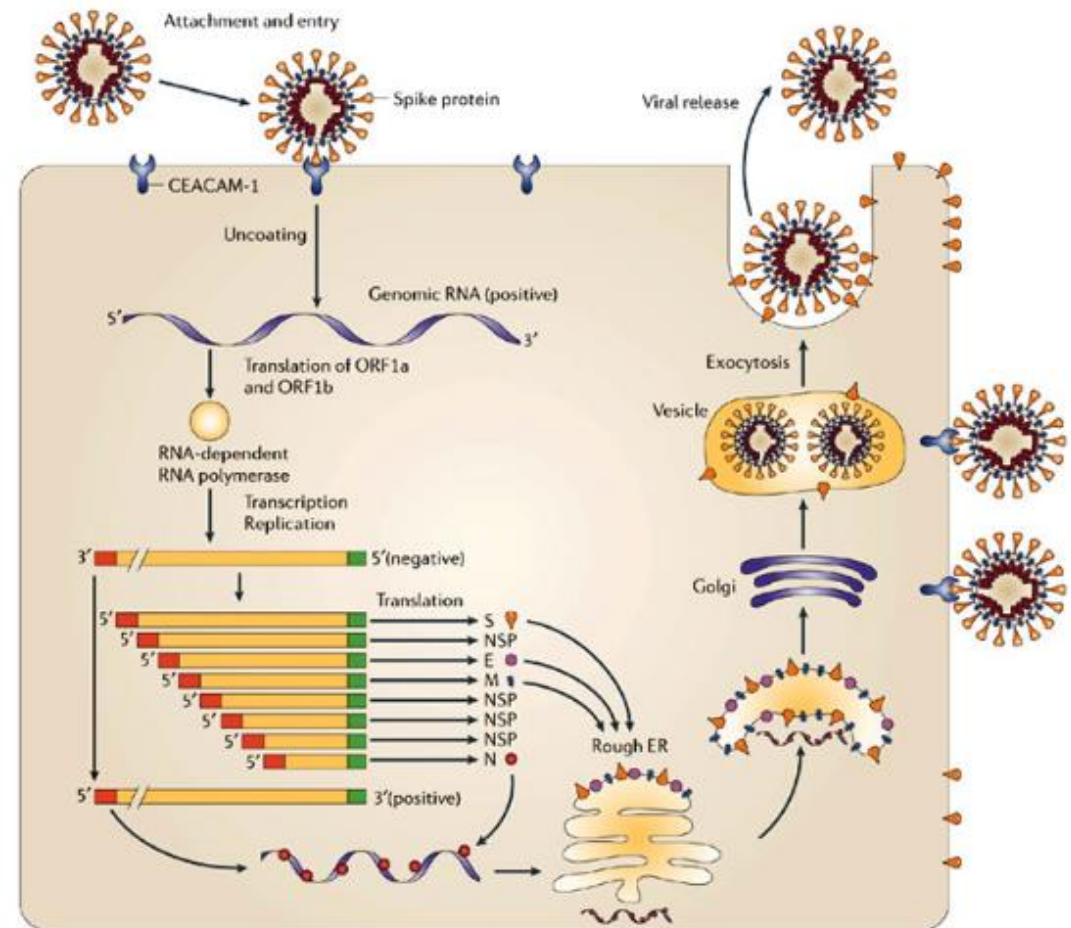
- Although the returns on most of the mainstream stock market indices have been good, there have been exceptions
- For example, the returns on the FTSE AIM All-Share Index has been remarkably weak for decades, even falling behind that of the Nikki 225 Index
- One reason for the disappointing return of the FTSE AIM All-Share Index has been the flood of speculative IPOs, and numerous secondary issues from early stage mining and oil exploration companies that have listed
- The scale of the new funding's appear to have offset the longer-term pattern from the LBS where regular mid caps have delivered premium returns

If you are looking for reasons to keep clear of small caps, it is easy to find plenty

- Anxiety about the past adverse momentum/ recent underperformance of small caps
- Natural avoidance of stocks with lesser market liquidity such as small/micro caps
- The rising number of geo-political risks make it easy to stick with conventional strategies
- Ongoing anxiety about a potential disorganised exit from EU
- The risk that Sterling could weaken further
- Fear of numerous small caps failures/liquidations, compared to the mainstream

Current trends tend to persist until something significant destabilises them

- Over recent years, a series of one-off events that have bubbled to the surface and led to some market anxiety
 - North Korean nuclear tensions
 - Combat on the Indian/Pakistani border
 - Middle Eastern missile attacks
 - Imposition of US/Chinese trade tariffs
 - The terms of the UK's exit from the EU
 - US QT/interest rate normalisation
- Currently the Wuhan Coronavirus is the principal one-off worry, but the aggressive closure of Chinese cities is expected to contain the epidemic
- Going forward we need to continue to remain attentive because at some point a more persistent issue will eventually destabilise the current status quo



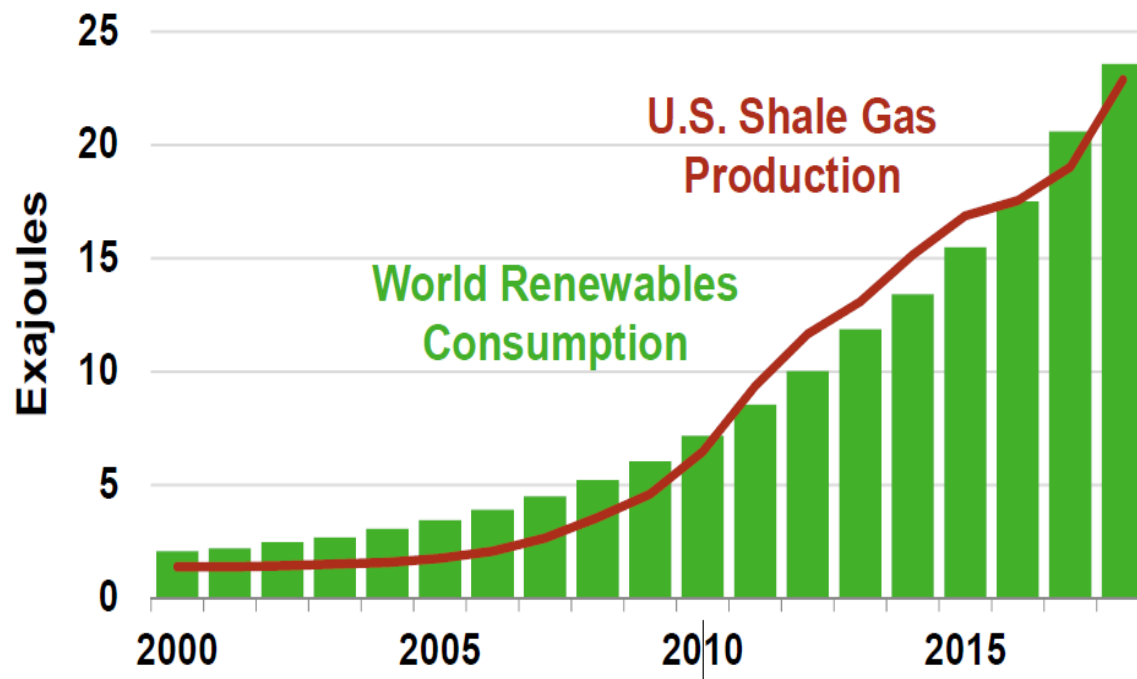
For example, investor attention has moved on to other priorities

- Over recent quarters, funds with an ethical bias have started to become more important to clients
- Alongside, most fund buyers are now stating that they won't buy funds from fund management groups that haven't signed the UN PRI code
- Hence global institutions now equate their willingness to embrace Environmental, Social and Governance with their future commercial success
- In time, we expect that fund buyers will become dissatisfied with funds that merely exclude various sectors
- In future, we believe that funds will need to find ways in which they can demonstrate that they are selecting stocks that will deliver a positive environmental impact



As yet, capital allocations have hardly started to embrace this change

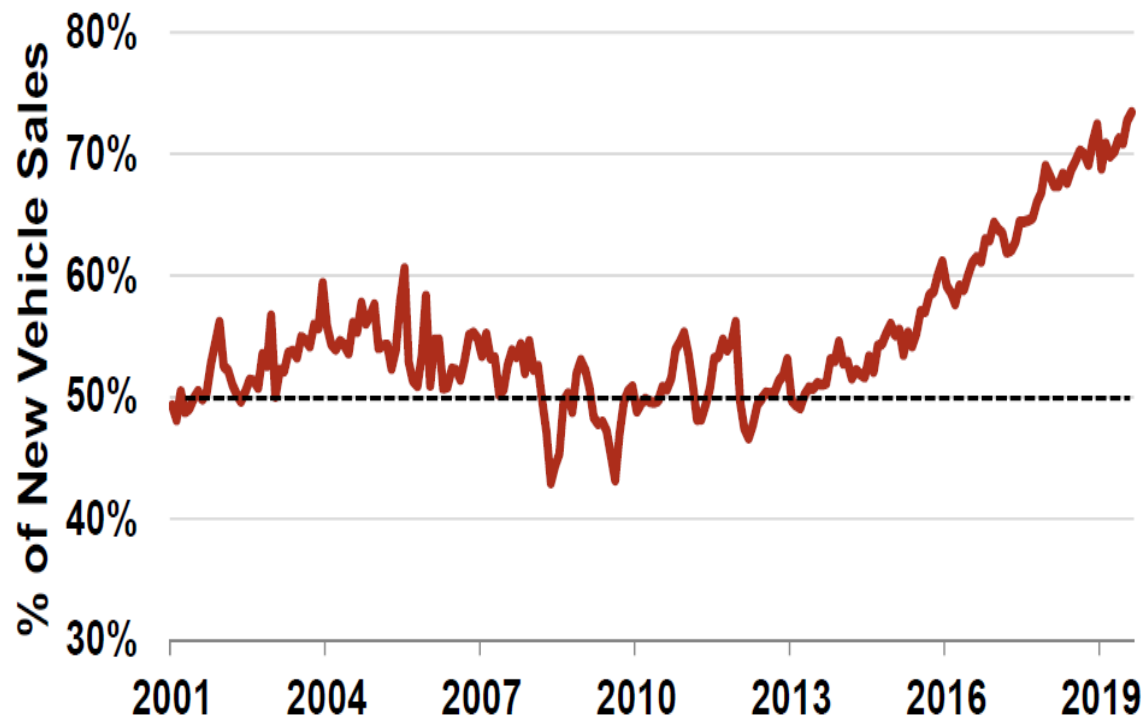
The two largest energy trends since 2000



- Many institutions have addressed the climate change debate by setting up ethical funds, where they have been scaling back investment in quoted companies that are involved in arms and alcohol manufacture, gambling and those that involve animal testing
- Alongside there's been a growing interest by mainstream funds investing in businesses that will prosper as governments step up policies that address climate change
- ARC Energy Research Institute estimate that \$4.1 trillion has been invested in renewable investments
- Whilst this sum is substantial, it should be read in the context of the growth of US shale gas that is of the same order of magnitude

There's a good deal of inconsistency between words and actions

US market share of two-axle, four tyre vehicles including SUVs, pickups and vans less than 8500lbs



- Over recent decades, car manufacturers have found ways to steadily improve the efficiency of new cars
- However, in spite of increasing concern about climate change, it is noteworthy that to date few consumers have significantly changed their preferences when buying new cars
- This is illustrated by the growing trend to purchase larger, heavier cars over recent years in spite of the fact that they tend to emit larger volumes of carbon into the atmosphere
- Meanwhile, governments around the world have offered subsidies to persuade consumers to start buying electric vehicles
- Even with subsidies, at present EVs only account for around 2% of new vehicles in the US, and this percentage is dwarfed by the increase in sales of larger, heavier cars in the US over recent years

As it happens, the UK is a global leader in terms of quoted governance

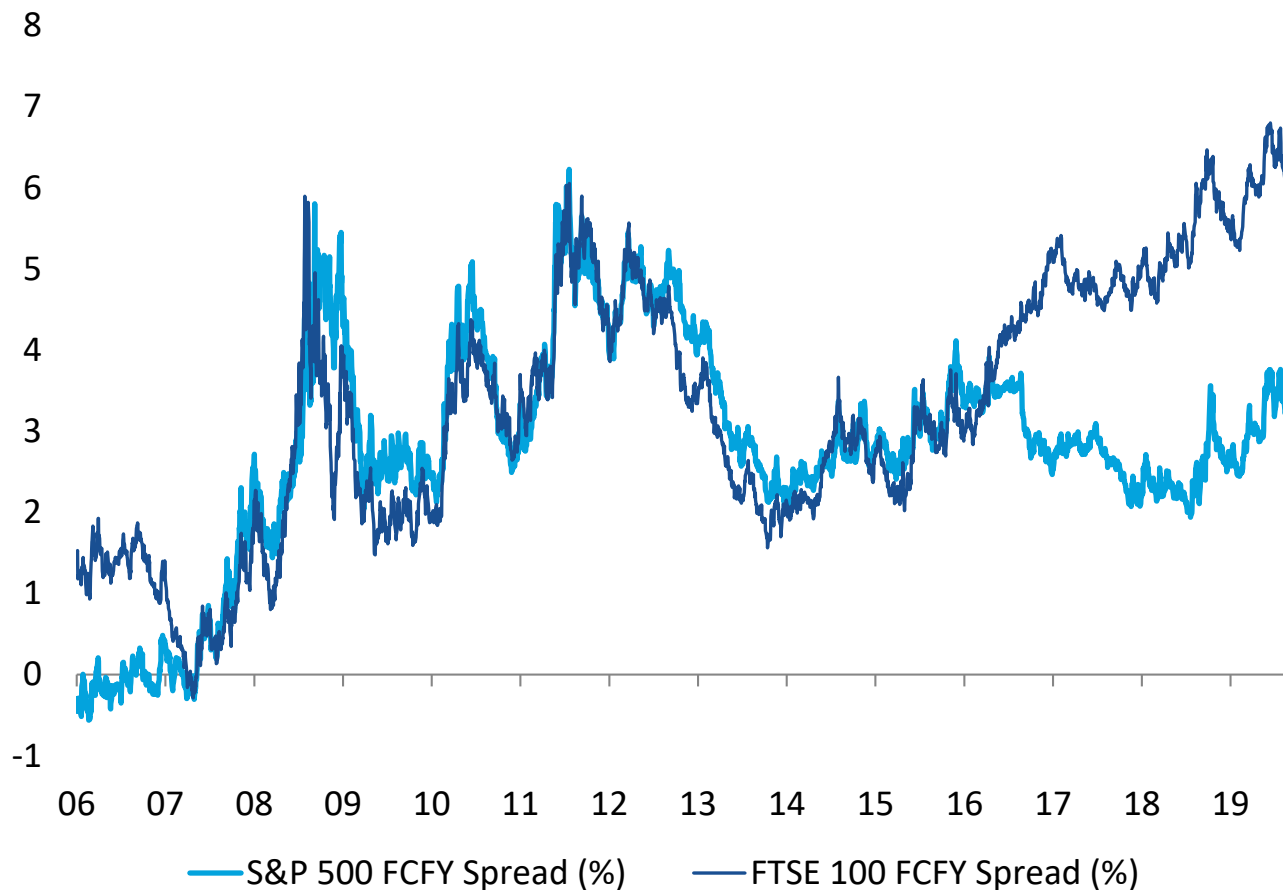
- Over 25 years ago the UK stock market was one of the very first to identify ways in which investors could positively engage to improve corporate governance
- Subsequently, this discussion led to the UK publishing a comprehensive governance code for listed companies in 2010
- More recently investor interest has widened to address issues around diversity and the gender pay gap
- Overall, it is widely acknowledged that the UK is one of the world leaders in terms of driving good corporate governance standards
- And good governance and corporate leadership is expected to lead to better risk management within these businesses

1992 – The Cadbury Report
1995 – The Greenbury Report
1998 – The Hampel Report
1999 – Turnbull Committee
2003 – The Higgs Review
2005 – Revised Higgs Review
2010 – The UK Corporate Governance Code
2012 – Action on Boardroom Diversity
2014 – New guidelines on Risk & Viability
2016 – Audit Updates
2017 – Comprehensive Code Review
2018 – The QCA Corporate Governance Code

Going forward, the UK could become a world leader for those looking to address climate change

UK valuations – cheap and unloved. There is plenty of potential upside in time

The FTSE 100 and the S&P 500 Indices
Free Cash Flow Yield Spread (%)



- For much of the decade prior to the Brexit referendum the Forward Free Cash Flow Yield of US and UK equity markets largely moved together
- Following the Brexit referendum, many asset allocators adjusted their portfolio holdings and it appears that this is one of the reasons why the valuations of these indices have diverged subsequently
- After the election of a clear majority for a business-friendly government we expect these valuation to converge

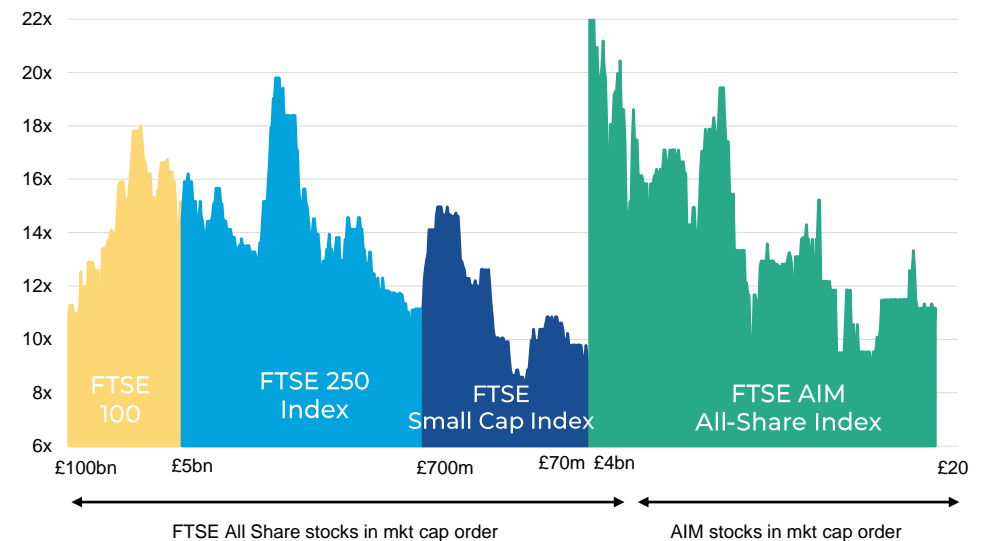
Source: FactSet, Bloomberg, Jefferies, 17/03/2006–11/12/2019.

Note: FCFY Spread measures against 10-Year Government Bond Yield respectively.

At some point the beta of mainstream markets will peak out

- After several years of strong market returns, many of the most popular stocks are now standing on elevated valuations
- Returns on momentum strategies have been particularly strong with many of the best growth stocks now on standing on demanding valuations
- Meanwhile the corollary is that many regular small caps are standing on sub-normal valuations
- As it happens a number of these are already delivering positive environmental impact
- So expect growing flows into UK small cap stocks, mainly from funds seeking to deliver positive impact regarding climate change, since these funds are largely unconcerned about issues such as whether the stocks are included in the mainstream indices or their geography of listing happens to be in the UK

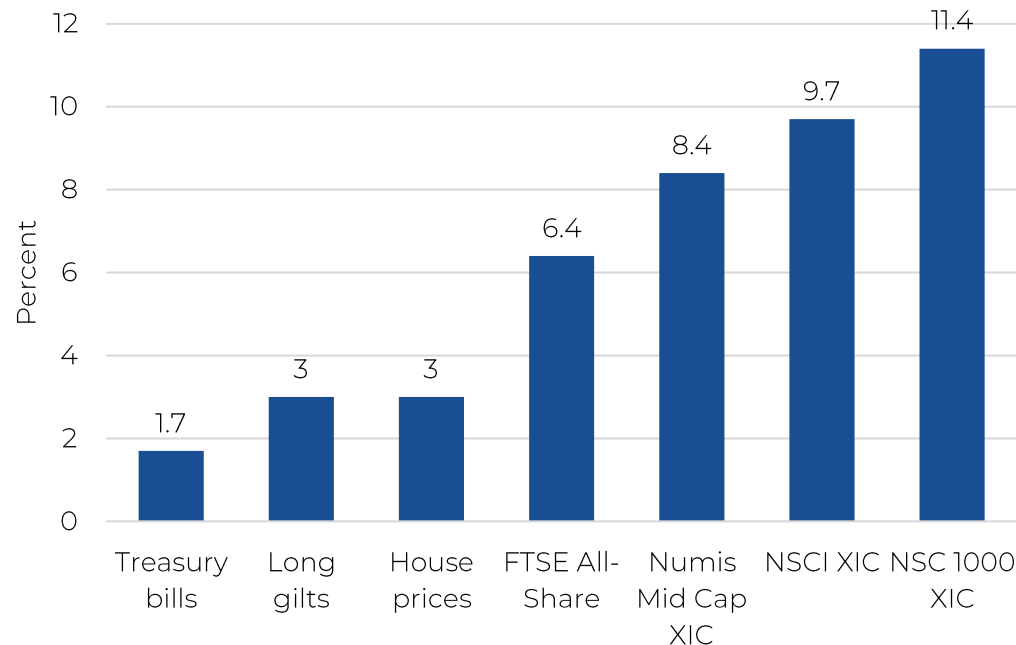
Rolling median 12 month forward P/E –
Largest to smallest



UK small caps are unusually well-positioned to pick up the slack

In the past, traditional small caps have had a long history of delivering premium returns

Bar chart of annualised real returns of Treasury Bill, Long Gilts, the FTSE All-Share Index, Numis MidCap XIC, Numis Smaller Companies Index XIC*, and Numis 1000 XIC, 1955-2018



- The London Business School has compiled comprehensive UK stock market data since 1955
- Institutional investors including traditional small caps in their portfolios may find that their returns are enhanced as the past tailwind in the sector resumes
- Those funds with an inclination to hold micro caps could generate some of the best returns
- As the small cap trend of renewed outperformance becomes established, expect the momentum to bring in additional interest
- Being small, ultimately it only takes small amounts of sustained capital to start the new cycle

Conclusions

- After decades of strong stock market returns, many portfolios have converged into the mid and large caps
- A decade of QE may have kept stock markets going, but note that productivity improvement has stagnated
- Over recent years, interest in the UK has faltered because it may drift down the global league table
- The FTSE AIM All-Share Index has delivered particularly poor returns since issue, which is another good reason for asset allocators to disregard small cap strategies
- And yet, the UK's premier status in governance could be a foundation for those seeking to invest in a universe of quoted companies that are able to deliver impact regarding climate change
- With bond yields dropping to ultra-low levels, there is a significant risk that a one-off event could precipitate a major change in investor allocations away from the mainstream indices as well
- These factors come at a time when the UK happens to be superbly well positioned to meet the changing agenda, since many in the UK small and micro cap universe are also well-positioned for share price recovery

The risk/reward ratio of UK small caps appears to be unusually attractive

Important Information

Source for data: Link/Premier Miton Investors and Bloomberg, as at 31/01/2020 unless otherwise stated.

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