*GAM UK EQUITY INCOME

Marketing material for professional, institutional and accredited investors

GAM Investments' Adrian Gosden examines the reasons behind the underperformance of the UK equity market this year and suggests the return of dividends will unlock value in the sector heading into 2021.

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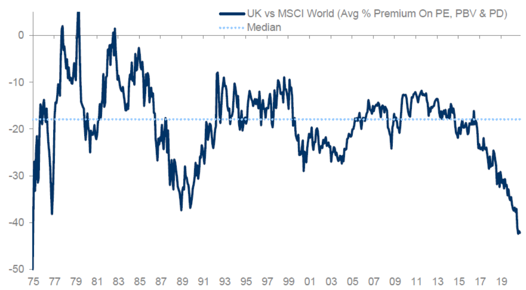
2020 has been a horrible year for investors in UK equities. At the time of writing (20 November), the FTSE 100 is down more than 15% year-to-date. This compares poorly with most other equity markets across the globe and looks quite wrong when compared to China CSI 300 which is up 28% (year-to-date in GBP) and the US Nasdaq which is up 33% (year-to-date in GBP). The reasons for this huge underperformance are varied but can best be assigned to four key issues: Brexit, the Covid-19 pandemic, dividend cuts and a lack of technology in the UK index. Other considerations include the impact of low interest rates on banks and an ESG push against big oil stocks, both of which were important parts of the UK index. However, for the purpose of this article, I will focus on the four big issues mentioned above.

Having acknowledged the terrible performance of the UK equity market in 2020 year-to-date, the question is whether UK equities might now present a good opportunity for investors. As the graph below shows, UK equities are at a 50-year valuation low compared to world markets. This is only of academic interest unless we can identify a reason why this might change - a reason linked to the UK market rather than assuming world markets fall.

Certainly corporates and private equity companies have noticed the valuation opportunity presented in UK equities. Within the GAM UK Equity Income fund, we have recently received offers for William Hill and Hastings Insurance. In the wider market stock market, bids have landed in house building, insurance and property. The variety of sectors involved is encouraging and suggests a wide undervaluation of UK equities. However, these corporate and private equity attentions are welcome but on their own, they will not propel the UK stock market back to more respectable levels.

Chart 1: UK versus MSCI World Average Valuation Premium



Source: Morgan Stanley. Past performance is no indicator for the current or future development. For illustrative purposes only.

Considering the four key reasons for underperformance

Beginning with the composition of the FTSE 100, it is unlikely that the UK market will become populated with large technology companies in the near future, so we will have to do without the influence of this sector for now.

A swift rollout of a vaccine and a quick, accurate mass testing system could help us to overcome many of the challenges posed by the Covid-19 pandemic, including being able to go about our business rather than staying at home. Certainly in Asia, we have seen the positive impact that combatting the virus has had on local stock markets.

At the time of writing, the world equity markets are being propelled higher on the news of good preliminary data from phase III trials of four vaccines - Pfizer-BioNTech, Sputnik, Moderna and the AstraZeneca and University of Oxford collaboration. This is clearly worthy of celebration.

* Full legal name: GAM Funds – GAM UK Equity Income

There are more hurdles to clear in assessing safety and dosing regimes but this is a major breakthrough and it now seems likely that a suite of vaccines will be available in 2021. Just as Asian economies have bounced back, it would not be unrealistic to expect European economies to also return to growth. Even the much forgotten about UK would see economic growth and that would usually result in a better performance from the UK stock market.

With regards to Brexit, UK stock market investors have hoped for progress ever since the vote to leave was received in 2016. Falling out with our biggest trading partner was always going to very unsettling for businesses. Could we have some clarity in 2021? My hopes for this have significantly waned over time.

So that brings us to the final of those four key issues: dividend cuts. Here, I am much more optimistic. The dividend cuts in 2020 were severe. Between 40% and 50% of dividends were lost. Some dividend cuts were directly attributed to the economic downturn caused by the pandemic, some dividend cuts were companies taking the opportunity to rethink their dividends after years of over distributing and some companies were prevented from paying dividends by regulators. All in all, this was a heavy blow for investors. Dividends are an important source of returns, making up nearly half of all UK equity returns in the last century (Dimson, Marsh and Staunton – Triumph of the Optimists). To have such an important part of the investment case damaged, I believe, is the biggest reason for the UK market's huge underperformance year to date.

Fortunately, as we approach the end of 2020, there is change in the air. Dividends are starting to return. Within our own portfolio, companies are returning to paying dividends from a wide variety of sectors, from Devro in Food production to Close Brothers in Merchant Banking to Wincanton in Logistics. This will have a significant impact on how the companies are perceived by investors. In my view, the biggest influence on the UK market by returning to dividend payments will come from the banks. As soon as the regulator allows this activity to recommence, I believe that investors will once again return to the UK market for the reasons they always used to…**dividends**.

I believe as we move into 2021, UK equities offer a very compelling investment case. They are undeniably undervalued compared to other markets but this time, we have a catalyst to unlock that value…the return of dividends**.**

Adrian Gosden

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