Global Matters Weekly

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A turning point for UK mid-caps

by Mark Wright, CFA Portfolio Manager

So far, the year 2022 has been one that investors in UK mid-capitalisations (mid-caps) would probably prefer to forget. The first six months of this year witnessed the worst relative performance of UK mid-caps vs UK large capitalisations (caps) on a rolling six-month basis since 1986 (as far back as I could find data). By 30th June, they had underperformed UK large caps by a staggering 18%. The performance gap has since widened a little to over 19% on a year-to-date basis[1]. The absolute performance of UK mid-caps is not as stomach churning, but at -15% it is still poor.

The miserable returns are not because earnings have fallen. They have grown significantly. Profits in the first six months of this year (H1 22) were 80% higher than the first six months of 2021 (H1 21), because companies benefitted from increased demand for their products and services, as COVID-19 restrictions were loosened.

Earnings were clearly depressed in H1 21, making for an easy comparative. However, earnings in H1 22 were still ahead of the last six months of 2021 (H2 21) by 6%. If forecasts are to be believed (questionable), earnings in the second half of this year (H2 22) are expected to increase by a healthy 36% on H1 22.

So, it's clearly not earnings that are the problem. Or maybe I should be more precise with my words... it is not THIS year's earnings that are the problem. Of course, stock markets are a discounting mechanism, and all eyes are on the outlook for profits in 2023.

One needn't be a member of Mensa to see that there might be a squeeze on corporate earnings next year (higher interest rates, higher taxes, higher costs etc.) and that will no doubt be one reason why UK mid-caps, which generate a much larger percentage of revenues from the UK economy than UK large-caps, have suffered so much this year.

But have they suffered too much? We all know markets overshoot in both directions, because ultimately share price moves are the result of human behaviour which itself is victim to the uncontrollable influence of animal instincts (fear and greed).

Fearful investors heading for the exit have crushed valuations this year by driving down share prices. At the start of 2022, UK mid-caps traded at 1.8x book value (net assets). On 12th October they traded at just 1.1x book value. That is the lowest valuation they have traded in the last two decades, matched only during the first quarter of 2009, in the nadir of the Global Financial Crisis (GFC), and in the depths of the pandemic during the first quarter of 2020.

Pricing the equity of companies at close to book value implies that investors don't believe those companies will be able to earn a return over and above their cost of equity ever again. I find that hard to believe.

There are simply too many vested interests in improving returns for shareholders. Companies do not stand still, boards and management work hard to improve returns on equity, regardless of the environment they are operating in. Over the last decade, prior to the pandemic, UK mid-caps earned a return on equity exceeding 10%, which is above any reasonable estimate of the cost of equity for a developed market such as the UK.

It is also notable that companies have much stronger balance sheets now than when they were heading into both the GFC and the pandemic. So, as is customary as we enter December, I am going to put my head above the parapet and make a prediction for 2023 (hopefully no one will remember if I am wrong). I think there is a very good chance that the market for UK mid-caps bottomed on 12th October and that returns in 2023 will be much better than they have been this year, which is why we have an overweight position in our portfolios.

Aside from attractive valuations and stronger balance sheets, the 4% upward move in UK mid-caps on the day of softer than expected US inflation data (10th November) warrants attention. It was the second biggest daily rise in the market this year. For the chartists out there, there is a growing number of companies with share prices now trading above their 200-day moving average. This is presently the case for almost half of UK mid-caps[2]. Less than two months ago, the figure was just one in ten company share prices.

Going back to valuations, a look at history provides further reason for optimism. If we look back at 18-month returns following similarly low valuations, such as 18 month returns from the end of Q1 2009 and end of Q1 2020, the numbers are +73% and +57%. Maybe this time is different, but that's usually a phrase that leaves people with egg on their face.

Sources
1 31st December 2021 to 24th November 2022
2 As of 24th November 2022
Unless stated, all data from Bloomberg Finance L.P.

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