Research

Surveying the UK equity market and economic landscape

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Executive Summary

- Launched in 1962, the FTSE All-Share Index encompasses 98%-99% of UK market capitalization, making it one of the broadest measures of the overall UK equity market, with large UK-focused money invested in funds tracking it.

- The UK equity market stands out most starkly from global peers in its pronounced overseas business exposure. Even the FTSE 250, which is thought to be a relatively more domestic index, produces roughly 35% of its sales from outside the UK.

- The FTSE All-Share and FTSE 100 share a similar sector profile: Financials, oil & gas and consumer goods are their largest exposures, combined making up more than half of each index.

- For both the FTSE All-Share and the FTSE 100, consumer goods and oil & gas companies generate 60% or more of their sales from outside the UK.

- The FTSE All-Share and FTSE 100 also differ in important ways; the FTSE All-Share is more comprehensive and diversified than the FTSE 100.

- Consensus estimates that year-over-year UK GDP growth has been lowered by approximately one percentage point since 2016.

- Multiples based on 12-month-forward EPS estimates have returned to levels last seen in 2013 for both the FTSE All-Share and FTSE 100, representing significant discounts to those of the rest of the world.

The UK equity market: a long history of innovation

- 1931: Inception of the FT Actuaries All-Share Index
- 1962: FT Actuaries All-Share Index changes its name to FTSE All-Share Index
- 1982: The FTSE 100 Index is created and added as a sub-index of the FTSE All-Share Index
- 1984: Inception of the FTSE 100 Index as a tradeable index of the top 100 UK companies
- 1992: Inception of the FTSE 250 Index which is also aggregated as a sub-index of the FTSE All-Share Index as part of continued enhancements
- 1993: FTSE All-Share, FTSE 100, FTSE 250 and FTSE SmallCap become single FTSE UK Index series
- 2001: Introduction of free-float thresholds for the FTSE UK Index Series
- 2011: New minimum (25%) free-float requirement
1. Setting the scene: UK equity market

Launched in 1962, the FTSE All-Share Index embodies all eligible companies listed on the London Stock Exchange's main market. The index is an amalgam of the blue-chip FTSE 100, the mid-cap FTSE 250 and the FTSE SmallCap Indexes. It encompasses 98%-99% of UK market capitalization and, as such is one of the broadest measures of the overall UK equity market, with large UK-focused money invested in funds tracking it.

The UK equity market stands out most starkly from its global peers in its pronounced overseas business exposure. Around 54% of the sales of companies listed on the All-Share are generated abroad, versus 62% for the FTSE 100. That compares with roughly 36% for the FTSE US and 50% for the FTSE Europe ex UK. Even the FTSE 250, which is thought to be a relatively more domestic index, produces roughly 35% of its sales from outside the UK (Chart 1).

Chart 1. The UK equity market has a distinct overseas tilt

The international tilt of the UK equity market means that global macroeconomic factors tend to impose a significant influence on UK stock performance. Pre-2016, the performance of the FTSE All-Share and FTSE 100 relative to developed-market peers (as measured by the FTSE All-World ex UK Index) moved in tight unison with sterling. That relationship has since deteriorated (Chart 2) and the FTSE All-Share and the FTSE 100 have significantly underperformed their global peers since June 2016. Sterling has been relatively resilient after falling in the immediate aftermath of the referendum.

The UK equity market stands out starkly from its global peers in its pronounced overseas business exposure.

UK stocks are greatly influenced by global macroeconomic trends.
Chart 2. The FTSE All-Share’s correlation with sterling has deteriorated since 2016

Source: FTSE Russell and Refinitiv. Data through September 28, 2018. Past performance is no guarantee of future results. Please see the end for information legal disclosures.

2. FTSE UK Index Series attributes

The sheer market-cap size of the companies comprising the FTSE 100 means they account for roughly 80% of the All-Share index. As can be seen in Chart 3, the FTSE All-Share and FTSE 100 share a similar sector profile: Financials, oil & gas, and consumer goods are their largest exposures, with these three industries combined making up more than half of each index.

By contrast, the sector composition of the FTSE 250 and FTSE SmallCap are far more concentrated, with financials accounting for 41% and 61% of each index, respectively.

Chart 3. Three sectors make up over half of the UK equity market


As a result, the All-Share also shares the FTSE 100 index’s prominent international slant. Among the three largest industries by weight, consumer goods and oil & gas companies are heavily dependent on global markets, with 60% or more of sales coming from overseas (Charts 4–6).
Interestingly, smaller UK consumer-goods companies have expanded their overseas businesses since 2016 as they benefited from favorable exchange rates.

**Charts 4–6. FTSE UK Indexes breakdown of consumer goods, oil & gas and financials overseas sales**

As expected, international markets have accounted for the lion’s share of the FTSE All-Share and FTSE 100 oil & gas companies over the past decade. While generating a smaller, yet still significant, portion for their midcap and smaller-cap energy counterparts, overseas sales for these smaller oil & gas firms has declined since 2016, to around three-fourths for the FTSE 250 and to just under half for the FTSE SmallCap.

Financial firms in both the FTSE All-Share and FTSE 100 only derive roughly one-quarter of their sales from outside the UK, although this figure drops sharply for the smaller-cap companies, whose exposure is almost entirely domestic.
3. Close inspection reveals important distinctions

The FTSE All-Share and FTSE 100 also differ in important ways. The FTSE All-Share is more comprehensive and diversified than the FTSE 100, mainly because it has 541 more constituents (Table 1) and a greater exposure to the historically higher return potential of smaller-cap stocks. It is also less concentrated, with its top 10 holdings representing 35% of market cap, versus 44% for the blue-chip index. This contrasts significantly with the composition of the smaller-cap UK indexes, in which the top 10 stocks account for 11.3% and 7.7% of the total, respectively, and the weights of the largest constituents are much smaller than those of their larger-cap counterparts.

Table 1: Characteristics of the FTSE UK Indexes

<table>
<thead>
<tr>
<th></th>
<th>FTSE All-Share</th>
<th>FTSE 100</th>
<th>FTSE 250</th>
<th>FTSE SmallCap</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of Constituents</td>
<td>642</td>
<td>101</td>
<td>250</td>
<td>291</td>
</tr>
<tr>
<td>Dividend Yield (%)</td>
<td>3.8</td>
<td>4.0</td>
<td>2.9</td>
<td>3.3</td>
</tr>
<tr>
<td>Top 10 Holdings (%) of Index Market Cap</td>
<td>35.4</td>
<td>44.0</td>
<td>11.3</td>
<td>7.7</td>
</tr>
<tr>
<td>Net Market Cap (£, Mil.)</td>
<td>2,431,194</td>
<td>1,956,507</td>
<td>385,070</td>
<td>89,616</td>
</tr>
<tr>
<td>Weight of Largest Constituent (%)</td>
<td>5.5</td>
<td>6.9</td>
<td>1.4</td>
<td>0.9</td>
</tr>
</tbody>
</table>

Source: FTSE Russell. Data as of September 28, 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Although roughly alike in overall composition, Chart 7 shows that the FTSE All-Share has a bigger exposure to financials and industrials than the FTSE 100 (by a combined total of 7.4 percentage points) and is less exposed to oil & gas and consumer-goods companies (by a combined 4.6 percentage points).
Chart 7: The FTSE All-Share favors financials and industrials vs FTSE 100

These distinctions give the All-Share a greater domestic tilt than the FTSE 100, particularly in the case of the former’s overweights in financials and consumer services, which tend to include businesses with bigger shares of UK-based sales (Chart 8).

Chart 8: FTSE All-Share has a bigger domestic tilt than the FTSE 100

Its greater diversification and smaller-cap exposure have allowed the FTSE All-Share to generate higher annual returns with the same or less volatility than the FTSE 100 over time. Over the past 20 years, the All-Share has delivered an additional 0.7 percentage points of annualized total return versus the FTSE 100, with roughly similar volatility, translating to a higher return/risk ratio of 0.5 versus 0.4 (Table 2). Drawdowns for the two large-cap indexes have also been similar for 10-year period ended September 2018.
Overall, however, the FTSE 250 has fared better than both of its larger-cap counterparts from a risk-adjusted return perspective for both the 10- and 20-year periods, though its drawdowns have been steeper.

### Table 2. Performance & Risk Statistics (GBP)

<table>
<thead>
<tr>
<th></th>
<th>Annualized Returns</th>
<th>Volatility</th>
<th>Return/Risk Ratio</th>
<th>Drawdown</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>10Y</td>
<td>20Y</td>
<td>10Y</td>
<td>20Y</td>
</tr>
<tr>
<td>FTSE All-Share</td>
<td>9.1%</td>
<td>6.3%</td>
<td>14.1%</td>
<td>14.1%</td>
</tr>
<tr>
<td>FTSE 100</td>
<td>8.4</td>
<td>5.6</td>
<td>14.1%</td>
<td>14.0%</td>
</tr>
<tr>
<td>FTSE 250</td>
<td>13.0</td>
<td>10.8</td>
<td>16.4%</td>
<td>16.9%</td>
</tr>
<tr>
<td>FTSE SmallCap</td>
<td>12.3</td>
<td>8.4</td>
<td>17.1%</td>
<td>18.0%</td>
</tr>
</tbody>
</table>

Source: FTSE Russell. Data from September 30, 2008, through September 28, 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Over the past 10 years, the FTSE All-Share has outperformed the FTSE 100 on a cumulative basis by 7% with similar volatility, while both have trailed the higher-return, yet more volatile FTSE 250 and FTSE SmallCap.

### Chart 9: Smaller-cap UK indexes lead the performance charts

The more domestically oriented smaller-cap indexes have outpaced their large-cap peers over the past 10 years.

Source: FTSE Russell. Data from September 30, 2008, through September 25, 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

The UK equity market's behavior since 2016 – and more recently since the release of the EU-UK withdrawal Agreement in November – provide a reasonable guide to how it may likely perform in the coming months.

Sectors with the most direct exposure to the UK economy – such as telecommunications, utilities and financials – have struggled most during times when the chances of a “no deal” Brexit have been at their highest.
This weakness has been offset by a show of resilience from the more globally oriented oil & gas and basic materials sectors, which are much less dependent on the UK economy and tend to benefit from weakness in sterling (Chart 10). Smaller-cap indexes, notably the FTSE SmallCap, which tend to be more sensitive to domestic developments and do not profit as much from a weaker currency, have also typically underperformed during periods of heightened concern of a hard-Brexit this past year.

Chart 10. Global industries outpaced domestic peers since mid-2016

FTSE All-Share Select Industry Returns (GBP, Rebased)


4. Brexit’s Economic Impact

More than two years have passed since the United Kingdom voted to leave the European Union. Fears of recession prior to and immediately after the vote have not come to pass, but Brexit uncertainties have weighed on the UK economy. According to the Office of Budget Responsibility’s (OBR) Economic & Fiscal Outlook, released in late October 2018, average quarterly GDP growth slowed from 0.6% between 2013 and 2015 to 0.4% since the beginning of 2016, moving the UK from near the top of G7 growth league tables to near the bottom.

As Chart 11, next page, shows, consensus estimates for year-over-year UK GDP growth have been lowered by approximately one percentage point per annum since 2016.
Chart 11: UK GDP forecasts have been cut 1% per annum since 2016

Consensus UK GDP Growth Forecasts (% YoY Change)

This slowdown is attributable mainly to the depreciation of sterling (Chart 12), which pushed up inflation and squeezed household incomes and consumption, while doing little to boost net trade.

Chart 12. Sterling has depreciated sharply since 2016

Sterling vs US Dollar and Euro (Rebased)

Although UK consumer price inflation appears to have peaked from recent highs above 3% (Chart 13, next page), stagflation concerns are likely to persist, given sterling weakness and the recent uptick in wage growth. With unemployment hovering around a multi-decade low of 4%, annual pay gains, excluding bonuses, have begun to outpace CPI in recent months.
Real business investment has barely grown as companies have held off on spending as they await more clarity around the post-Brexit trade picture. Although leading economic indicators are still registering above 50, or levels indicating expansion, key Purchasing Managers’ surveys show that the momentum in manufacturing and construction has deteriorated in recent months (Chart 14).

Chart 14. Leading indicators show economic activity waning


Current consensus GDP forecasts look for GDP growth to pick up slightly in 2019, to 1.4% from an estimated 1.3% in 2018, the slowest growth since the 2008-09 recession. Next year’s modest expansion reflects the weak sterling, which should help bolster this heavily export-driven economy. However, these projections rank the UK – along with Japan – among the weakest of the major economies (Chart 15, next page).
5. Valuations

Valuations have suffered a dramatic reset in the global sell-off that began in October 2018, but the toll has been especially harsh on the UK indexes, which have been further weighed down by the continued uncertainty surrounding the Brexit withdrawal treaty. Multiples based on 12-month-forward EPS estimates as of 15 November, have returned to levels last seen in 2013 for both the FTSE All-Share and FTSE 100, representing significant discounts to those of the rest of the world (Chart 16).

Regional relative forward PEs (versus the rest of the world) have also narrowed, with the two broad UK indexes now below their respective five-year averages on this basis.

Examined from an earnings growth perspective, the FTSE All-Share is priced at 1.2 times current consensus forward-looking long-term EPS growth (PEG) forecasts, or well below its 10-year average of 1.5 times and roughly akin to the PEG discount of the Russell 1000 Index (Chart 17).
As Chart 18 shows, the oil & gas sector has seen the biggest upgrade to 2018 EPS growth forecasts over the past six months and is expected to register the strongest growth. Basic materials and financials have seen the steepest downgrades.

Based on our proprietary multi-metric valuation Z-scoring methodology – which considers six valuation metrics (including PEG ratios) on an absolute and relative basis, as well as returns on equity (ROE) – the FTSE All-Share valuation stands at an even deeper discount to developed-market peers (Chart 19) than it does on 12-month-forward EPS growth alone.
6. FTSE Russell Governance Process

The FTSE UK Index Series has changed over time and continues to evolve as does the governance process that supports it.

FTSE Russell has a long history of collaborating with independent practitioner committees that assist in the index governance process. (The first committee was set up in 1930 to oversee the management of the Actuaries Investment Index, the forerunner of the FTSE All-Share Index.)

This independent committee structure supports the FTSE Russell Product Governance Board by helping to ensure that all indexes reflect their underlying market and that the Index Methodology (a strict set of rules by which FTSE Russell indexes are governed) evolves in line with the highest standards of the industry.

The FTSE UK Index Series (which includes the FTSE All-Share Index) is overseen by the FTSE Russell EMEA Regional Equity Advisory Committee. The committee consists of senior market practitioners who are representative of the appropriate sectors of the investment community.

The FTSE UK Index Series methodology is subject to regular review to ensure that it continues to meet the current and future requirements of investors and other index users and to lead global standards in indexing.

Changes to the index methodology may originate as a result of recommendations from internal governance bodies, feedback from external advisory committees and clients or in response to changes in the underlying market. Proposals for amendments to the index methodology may be subject to consultation with the advisory committee and where significant changes to construction are considered, with other stakeholders.

As a general principle, advisory committees are consulted on changes to the rules that dictate how we manage the index. In the case of fundamental modifications, for example, those with the potential to change the composition of the index, a wider consultation which includes all relevant stakeholders may also be undertaken.
About FTSE Russell

FTSE Russell is a leading global index provider creating and managing a wide range of indexes, data and analytic solutions to meet client needs across asset classes, style and strategies. Covering 98% of the investable market, FTSE Russell indexes offer a true picture of global markets, combined with the specialist knowledge gained from developing local benchmarks around the world.

FTSE Russell index expertise and products are used extensively by institutional and retail investors globally. For over 30 years, leading asset owners, asset managers, ETF providers and investment banks have chosen FTSE Russell indexes to benchmark their investment performance and create investment funds, ETFs, structured products and index-based derivatives. FTSE Russell indexes also provide clients with tools for asset allocation, investment strategy analysis and risk management.

A core set of universal principles guides FTSE Russell index design and management: a transparent rules-based methodology is informed by independent committees of leading market participants. FTSE Russell is focused on index innovation and customer partnership applying the highest industry standards and embracing the IOSCO Principles. FTSE Russell is wholly owned by London Stock Exchange Group.

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