Heartwood
Investment Management

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Investment Insight

Weekly Insight

UK investment markets: Let's not talk about Brexit

Offering insight into UK investment markets feels like an impossible task, given the fluidity of the Brexit situation and ongoing political volatility. Instead then, let's focus on a couple of the longer-term issues in UK markets facing investors today. First, the global nature of UK equities; second, the usefulness (or otherwise) of UK government bonds.

UK equities: Is it really possible to access the domestic economy?

When it comes to the UK equity market, we are already 'Global Britain'. A simple glance at the UK's largest companies bears this out. When aggregated, only 23% of these companies' sales take place in the UK; the remaining 77% is spread across the rest of the world. Effectively then, investors buying large-cap UK equities are not really buying exposure to the UK economy.

There are pros and cons to this reality. On the plus side, it means that a UK equity approach can equate to a globally diversified product. On the downside, if an investor wants to gain explicit exposure to the UK economy, domestic equities can struggle to provide it.

Buying individual stocks which offer specific UK exposure could solve this, but would hinder portfolio diversification. UK property is another option, though access to the sector can be somewhat limited in public markets. Buying investment vehicles focused on smaller and mid-sized UK-listed companies (which are generally more domestically oriented) is perhaps the most attractive option, and of late, has been Heartwood's choice of approach within portfolios.

Large-cap British equities are already global

Aggregate sales

Region	Sales
UK	23%
Americas	29%
Mainland Europe	19%
Asia-Pacific	23%
Africa and the Middle East	6%

Source: Factset

UK government bonds: Can they still serve a purpose?

Traditionally, there have been three reasons to invest in government bonds. First, income; second, capital gains when interest rates fall; and third, to create diversification within a multi asset portfolio (UK government bonds have traditionally rallied when the stock market has faltered).

Do these reasons hold up today? The first, income, has diminished significantly, as the yield on UK government bonds has fallen from 4.4% to 1.5% over the past decade – an income reduction of 66%. The second, related to falling interest rates, has also lost some strength – the Bank of England recently began raising interest rates and has indicated further gradual rate rises ahead.

This leaves only the third reason: diversification versus equities. In our view, this one probably does hold true. In a meaningful 'risk off' scenario (where the economy or

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investment markets deteriorate sharply), we would expect bonds to rally and protect investment portfolios, though not to the same extent as in the past (given current low yields).

How should investors respond to these changes?

First, in seeking income, one option is to take a more creative approach, investing in niche markets where reasonable yields still exist, such as infrastructure debt, European asset-backed securities, and insurance-linked bonds.

Second, in combatting near-term price vulnerability amid (slowly) rising interest rates, a shorter time frame can help – i.e. moving to shorter-dated bonds and holding them to maturity (when the principal amount of the bond is repaid).

Third, for diversification, investors could look instead to other defensive assets, from hedge funds and gold to insurance policies and the Japanese yen. None of these assets are perfect, and none are guaranteed to work, but as part of a diverse blend, they could offer a robust chance of protection.

Of course, investors need not be restricted to just one of these solutions – a truly multi-asset portfolio can comfortably deploy all three.

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