State of Play

Is the UK back in fashion?

23 February 2023

Last year, we witnessed the worst year for bonds in history. Stock markets also suffered a difficult year, except for the UK stock market, which despite the high level of volatility, finished the year ahead of their peers. Now that loose monetary policy and low interest rates have come to an end, will the UK market remain popular and outperform others? Or is this just a coincidence of timing? Why does diversification remain so important for investors? Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Key highlights from this week's State of Play

- Stock market index history
- Understanding the FTSE 100
- Is the UK stock market back in fashion?
- Why diversification still matters

A brief history of Stock Market Indices

It was 1571 when the Royal Exchange was established by Sir Thomas Gresham as the centre of commerce in the City of London, where all kinds of goods were traded. At that time, stockbrokers were seen as loud and uncouth in such a royal institution and were banned soon after. However, their behaviour was more than acceptable in the seventeenth century social centre and therefore began to trade informally in the city's coffee houses – most notably Jonathan's Coffee House owned by John Castaing who started to publish a list of prices for stocks and commodities which in 1698 he named 'The Course of the Exchange and Other Things'.[1] Whilst the UK and other stock markets have evolved considerably since these early days, most investors would acknowledge the most recognisable expression of the London based market is the FTSE 100 index or affectionately known to many as the 'footsie'.

What is a Stock Market Index?

An index is a group or basket of shares, derivatives, or other financial instruments that represents and measures the performance of a specific market or asset class, whether this be by sector, country, or region. Put another way, an index is a statistical representative sample of a given asset class measuring the change in value over time. As the combined value of the shares being measured moves up or down, the numerical value, or the index level, changes to reflect that movement.[2]

However, whilst the UK has a long history, it may come as a surprise to many that the FTSE 100 is a very modern index when compared to some of its international counterparts. The oldest index in the world is the Dow Jones Industrial Average, founded in 1896 by Edward D. Jones and Charles Dow, who was also one of the founders of the Wall Street Journal.[3] Interestingly, the Dow Jones began as a simple calculation of 12 companies and dividing their share prices by 12 to measure the average. Whilst the index expanded to 30 companies, as it is today, it remains the only major index quoted internationally which is price weighted – the company with the highest share price sits in top spot, regardless of the value compared to the other constituents. The Standard and Poor's 500 Index was launched much later, in 1957, which contains the top 500 companies listed on the US market, but importantly is weighted by value - companies with a higher market valuation make up a greater share of the index.[4] The MSCI World Index was then launched in 1969 measuring large and mid-cap companies across 23 developed markets, with 1,508 constituents.[5]

Understanding the FTSE 100

The Financial Times started listing companies in the UK in 1935, copying the US, measuring the top 30 companies in what was called the FT 30. It wasn't until 1962 that the FTSE All Share index began (again following the S&P 500 lead) and covered all listed companies in the UK market.[6] The FTSE 100 finally launched in January 1984, listing the top 100 companies, again by market value. The most famous index in the UK is updated quarterly based on the change in share prices of the very bottom companies when compared to the next largest companies at the top of the FTSE 250, which lists the next most valuable companies in the UK beyond the top100.[6] Only 23 companies remain from the original 100 when the FTSE 100 began in 1984.[6]

One aspect of the index that is misunderstood by many UK investors is the international exposure of the companies listed and the investment concentration. Around 75% of their total revenue derives from abroad, often in dollars or euros, not pound sterling. Even though the index covers the prices of 100 companies, it is a weighted index, much like many other indices around the world. This means if you simply invest into an investment fund that tracks the FTSE100 your money is spread based on the values, not evenly. In practice, nearly half of your investment would be invested in just the top 10 companies, and nearly one third in the top 5. The reality is that your investment is concentrated across a small number of constituent companies, many of which are in the same sector, with oil and gas, healthcare and mining companies dominating.

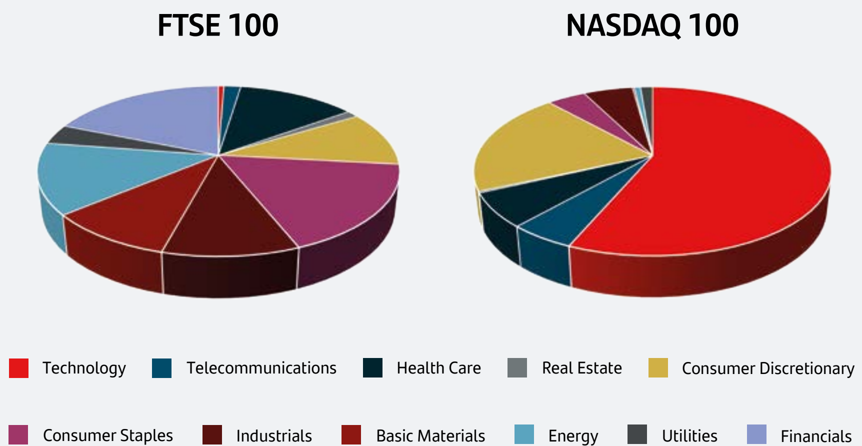
Dates when FTSE 100 first broke each specific threshold[7]:

- 1000: 30/12/1983
- 2000: 04/03/1987
- 3000: 11/08/1993
- 4000: 02/10/1996
- 5000: 06/08/1997
- 6000: 01/04/1998
- 7000: 20/03/2015
- 8000: 16/02/2023

Is the UK market back in fashion?

One crucial aspect of the global financial crisis in 2008 was the start of ultra-low interest rates and loose monetary policy, which lasted for nearly 15 years. This 'golden period' offered significant advantages to growth companies, especially those operating in the technology sector, as they accessed cheap borrowing to help grow their businesses much quicker than in the preceding years. The 'FAANGS' (Meta, Apple, Amazon, Netflix and Google) became the darlings of investors as their rapid expansion and success translated into a sharp rise in both their earnings and their share price. When you compare the NASDAQ, where all of these are listed, to a more traditional index, like the FTSE 100, the differences are stark. The UK market has less than 1% in technology and over two thirds across basic materials, consumer products and financials.

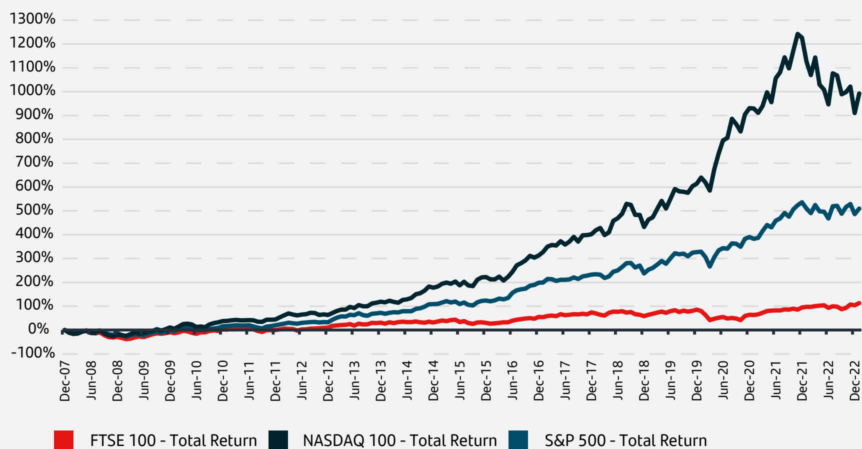
Index sector exposure



Source: Aladdin
Data as at 20 February 2023

Why does this matter? Well, since 2008, the FTSE 100 has provided investors with returns of 140%, which sounds decent until you compare this to the NASDAQ 100, which over the same period has delivered 1200%!!! (Yes, that is over thousand percent!) The FTSE 100 index has barely moved in value as the vast majority (105% of the 140%) of investor return comes from the dividends paid from profits, rather than the increase in share price. When comparing this to the NASDAQ 100, over 80% of investor returns derive from the increase in the prices of the company shares that make up the index.[8] The FTSE 100 took just two years to double from 1,000 to breach 2,000 and sailed through 3,000 to 6,000 between 1993 and 1998. It has taken 25 years to increase from 6,000 to the new high reached last week of 8,000!

15 Year index returns

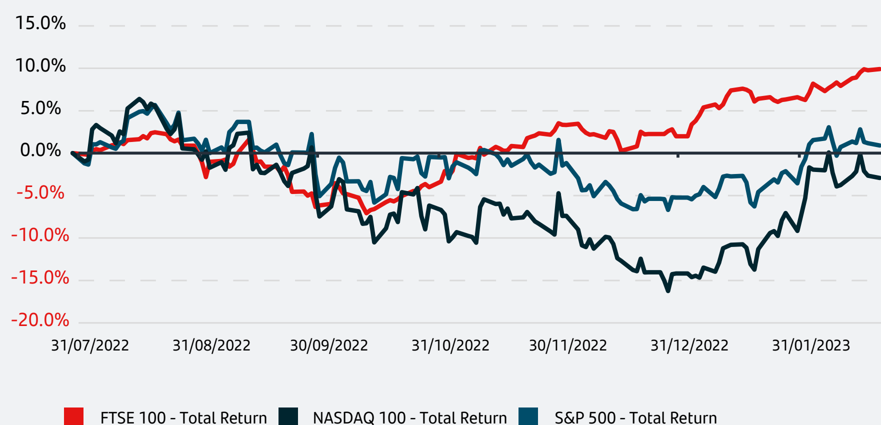


Source: Eikon
Data as at 20 February 2023

Ever since the launch of vaccines in 2020 that enabled the eventual ending of restrictions from the pandemic, the UK market has performed much better. In fact, it was the only stock market last year not to fall in value at the year's end. Given the underperformance versus other international peers since the global financial crisis, why has the UK market performed so well recently?

Last year saw the normalisation of interest rates as high inflation forced central banks to act. This changed the market outlook for company's future earnings and profits as investors repriced their shares. Those that benefited from low rates and a change in consumer behaviour in the past 15 years saw a sharp fall in their share values. In addition, a large part of higher inflation came from higher commodity prices and increased margins for banks as interest rates increased sharply. The UK market benefited from these drivers of stock market momentum as more traditional companies, which have arguably been out of favour and unloved for many years, became attractive to investors. Energy and mining companies have had a bumper 2 years as their profits have soared. Since the start of October, the FTSE 100 has returned investors 17% compared to the NASDAQ 100 return of just over 5%.

6 Month index returns



Source: Eikon
Data as at 20 February 2023

The key question investors may now be asking is: Will this momentum for the UK continue? Clearly, it is impossible to say with any certainty. However, the normalisation of interest rates does at least level the playing field between growth and old-fashioned companies – often referred to as value shares. The challenge for the UK will be the expectation from many forecasters, including the International Monetary Fund (IMF), predicting the UK economy will underperform its international peers over the next couple of years. Whilst the stock market does not always reflect the economic picture it may deter some international investors from moving their money to the UK, despite it being seen as still undervalued regardless of the new high reached last week.

Diversification remains the key for retail investors

The last few years have been an ideal demonstration of why investing in a range of asset classes, regions and sectors is crucial to smoothing out the investment journey whilst still offering the potential to achieve an investment return in line with your expectations and long-term financial goals. History has shown that a balanced portfolio that mixes shares and bonds across the world in different proportions in line with your attitude to investment risk and time horizon helps increase the probability of less volatile positive returns over the long-term. Since the pandemic struck, different types of assets have performed well and then poorly at different times.

Last year was unusual in history because both bonds and shares fell at the same time for much of the year. Ordinarily, an investment portfolio aims to capture what is described as negatively correlated assets to smooth this journey. The principle being that when shares fall bond values may rise and vice versa. The US has outperformed the UK stock market for a generation as financial conditions helped tip the balance in favour of growth companies. In the new world of financial normalcy, perhaps the UK will, after all this time, seem attractive to investors across the world. Only time will tell whether the recent success catches on.

The value of seeking guidance and advice

It is important to seek advice and guidance from a professional financial adviser who can help to explain how to build an appropriate financial plan to match your time horizons, financial ambitions, and risk comfort. If you already have a plan in place, or have already invested, it is important to allocate time to review this to ensure this remains on track and appropriate for your needs.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing **here**.

Note: Data as at 22 February 2023.

[1]British History Online, 21 February 2023
[2]SP Global, 21 February 2023
[3]Britannica, 21 February 2023
[4]Citywire, 4 June 2020
[5]MSCI, 21 February 2023
[6]London Stock Exchange, 21 February 2023
[7]Modo Visione, 16 February 2023
[8]FE Analytics, 20 February 2023

Asset Management

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