AXA Investment Managers

UK Equities in Focus

Active investment: The ability to rapidly respond to change

"Invention, it must be humbly admitted, does not consist in creating out of void, but out of chaos" Mary Shelley

Chris St John, Portfolio Manager

The past six months have, once again, shown that the only thing we can be certain of is change. It may seem almost difficult now to remember where we were at the start of 2020. We had just seen a stellar year for equity returns in 2019. Companies exposed to the UK economy in particular, were poised to benefit from an economic and political landscape with a level of certainty not seen for many years. Following the decisive general election result on 12 December 2019, UK sterling, investment intentions and consumer confidence rose – the sunny uplands of the 'Boris Bounce' had emerged. Then everything changed.

The emergence of the COVID-19 pandemic has resulted in an unprecedented global economic supply and demand shock – change will accelerate, and the world must adapt.

The initial outbreak in China focused investors' minds on the ability of supply chains to function and meet the global demand for goods. As the virus has spread internationally, concerns over supply have quickly switched to the destructive impact on economic demand.

In the face of such a severe demand shock, many companies have been forced to abandon business plans and run their businesses for cash. Central banks and governments have been quick to respond, with significant stimulus aimed at ensuring the smooth functioning of financial markets, and to minimise the economic pain for both businesses and individuals.

The aim is to prevent a liquidity crisis from turning into a solvency crisis. Governments and central banks are determined to prevent the permanent destruction of productive capacity. If successful, this should maximise the chance of the COVID-19 pandemic being a transitory event and should allow economic growth to return once the effects of the virus recede.

The demand shock being experienced by both large and small companies has been sudden and dramatic. Government-imposed lockdowns are resulting in precipitous falls in economic growth that, without government intervention, would inevitably lead to immense hardship by many in society. The 'social contract' between the government and the people has remained intact, to date, by the promise of material financial assistance. For example, through the system of furlough, the government is now effectively paying 80% of the salaries of furloughed staff up to a maximum of £2,500 per month. This is not a situation that can remain in place for long.

Short-term change: Survival mode

Companies are reacting logically and reasonably by focusing on short-term liquidity and survival. This is affecting those with strong, differentiated business models, not just the uncompetitive and weak. Capital expenditure is being delayed, operational costs are being cut, working capital is being squeezed, and colleagues are being made redundant and furloughed. In addition, dividend payments are being deferred or cancelled. It is rapidly becoming socially unacceptable to pay dividends to shareholders if any level of government assistance has been received.

In the case of banks, the UK's Financial Conduct Authority has stepped in and requested that no dividends are paid in 2020. Regulators have forced banks to rebuild their capital since the global financial crisis. Consequently, rather than being part of the problem, banks will need to be part of the solution. Evidence is growing that banks are 'looking through' the COVID-19 crisis and are showing leniency at the point of covenant test. Outside the banking sector, Elementis and Melrose are examples of companies that have announced that covenant tests and potential breaches will be waived for 2020.

> "It is only by keeping productive capacity in place that material returns can be made once the virus is brought under control"

The economic symptoms of the crisis have developed rapidly and with a severity and duration that is difficult to quantify; as such, management teams are looking at whether additional capital is required. As the least-preferred creditor, it is vital for shareholders that the balance of power is in the hands of the equity holders and away from the debt holders, particularly in times of distress. It is logical, therefore, for listed entities to at least enquire into the possibility of raising equity. In extremis, it is better to trade some dilution to take away the risk of insolvency. It is only by keeping productive capacity in place that material returns can be made once the virus is brought under control.

Long-term change: Ideology, behaviours and morals

The longer-term effects remain difficult to predict, but they are likely to be profound. Investors must work to ascertain the long-term opportunities and threats that will arise, as this will inevitably affect how capital is allocated going forward.

For example, the initial supply shock has led business leaders to question the structure of their supply chains. Those businesses reliant on supply from China were quick to recognise that the economic benefit of cheap labour and goods may not be enough to fully compensate for the risk of not being supplied at all. This plays well to US President Donald Trump's 'Make America Great' rhetoric and may further precipitate anti-Chinese sentiment and an increase in 'near shoring'.

The gravitation to internet shopping, working from home, wireless connectivity, cashless societies, digital leisure, telehealth, video gaming, automation across industrial sectors and home food delivery is likely to accelerate. This, in turn, will mean faster creative destruction – something new which brings about the demise of what existed before it – generating winners and losers.

Societal and governmental behaviours will surely change. The stimulus package launched as a direct result of the economic impact of coronavirus was £350bn. This must

surely herald the end to austerity. Going forward, the UK government will in my opinion be in a morally difficult position if they resist a rise in (for example) the £20bn UK social care budget, when £350bn can be raised to offset the financial damage caused by coronavirus.

Change creates opportunity

We continue to believe that our investment expertise can offer returns in excess of the market, with historic alpha generated principally from our stock-picking ability. However, companies do not operate in isolation from the economy and the geopolitical environment in which they exist, and all businesses are susceptible to the economic and secular forces of change. Recognising these forces and how they shape corporate and consumer demand is key when analysing the merits of an investment case. Some of the stocks that have fared best recently reflect, for example, the demand for increasing connectivity and data usage, infrastructure spend precipitated by fiscal economic stimulus, increasing geopolitical instability, and a keen focus on total shareholder return and operational excellence.

Examples include Spirent Communications which offers test and measurement, analytics and assurance solutions for next-generation devices and networks. As the demand for faster connectivity grows, Spirent is well-positioned to supply services and products, including to the next-generation 5G networks. Breedon Group has also performed well over the last 6 months, as investors became increasingly optimistic about a construction and national infrastructure build programme. Increasing expectations of UK fiscal stimulus leaves Breedon well positioned, in our opinion, to supply product and take market share through its unrivalled service levels.

Chemring, meanwhile, operates in the military, government agency and corporate markets, solving critical problems using countermeasures, sensors and energetic solutions. Through Roke, its higher-margin, intellectual capital-rich business, Chemring is moving into areas of high margin and secular growth, such as cyber security. Retailer Dunelm's management continues to invest and allocate capital for the long term. The company has taken market share, generated cash and remained relevant both through its physical store estate and increasing online presence.

Equity markets have fallen significantly in 2020, as the stock market has attempted to price in the inevitable earnings downgrades caused by the coronavirus-related drop in global GDP. Selling has appeared rational on a short-term basis and has been exacerbated in terms of speed by the pools of passive and algorithmically-controlled capital. We believe the effects of this virus will be transitory, although the duration and severity remain unclear. Therefore, we do not believe it is logical to annuitise the earnings of 2019, but to look through this crisis and invest on the basis of long-term economic output.

> **“Companies do not operate in isolation from the economy and the geopolitical environment in which they exist, and all businesses are susceptible to the economic and secular forces of change”**

The spread between earnings yields and the cost of debt remains wider than at any time in recorded history other than the First World War. According to Bain and Co, private equity firms have accumulated an estimated $2.5trn across all fund types. As soon as confidence returns, we expect UK-listed businesses to be targeted once again.

As active investors, we believe effective stock selection is key to successful investment management. Our investment philosophy and process remain unchanged. We remain focused on domestic and internationally-exposed UK-listed businesses, where the fundamental profit drivers remain entrenched and equity holders benefit from the capital allocated and risks taken by management. We continue to believe that a rewarding strategy is to actively invest in UK-listed companies that are increasing their economic output by compounding their earnings and dividends, where corporate governance is world leading, where contract law and title law are dependable, and where company management teams are permanently accessible.

AXA Investment Managers

Not for Retail distribution: This document is intended exclusively for Professional, Institutional, Qualified or Wholesale Clients/Investors only, as defined by applicable local laws and regulation. Circulation must be restricted accordingly.

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

Due to its simplification, this document is partial and opinions, estimates and forecasts herein are subjective and subject to change without notice. There is no guarantee forecasts made will come to pass. Data, figures, declarations, analysis, predictions and other information in this document is provided based on our state of knowledge at the time of creation of this document. Whilst every care is taken, no representation or warranty (including liability towards third parties), express or implied, is made as to the accuracy, reliability or completeness of the information contained herein. Reliance upon information in this material is at the sole discretion of the recipient. This material does not contain sufficient information to support an investment decision.

Issued in the UK by AXA Investment Managers UK Limited, which is authorised and regulated by the Financial Conduct Authority in the UK. Registered in England and Wales No: 01431068. Registered Office: 7 Newgate Street, London EC1A 7NX. In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.

Design & Production : Internal Design Agency (IDA) | 04/2020| 18-UK-010573