

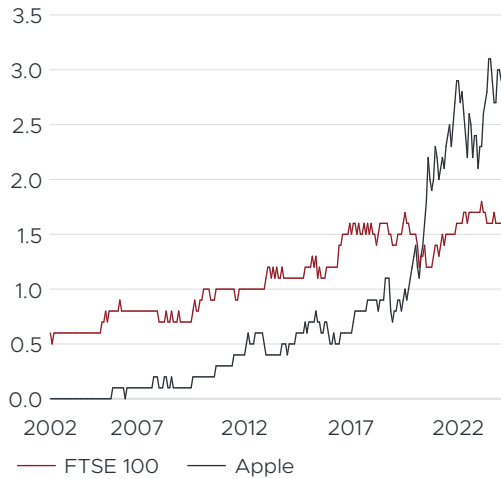
## *Investment roadmap*

FEBRUARY 2024

### AT A GLANCE

- This month's main feature is on **the UK equity market**. UK equities have underperformed US equities over an extended period. This is not unusual: most markets have. Some have argued that this partly reflects a long-standing inability to develop small companies into large ones. The average year for the origins of the top ten companies in the UK is the mid-19th century, well over a century older than their US equivalents, and the 'youngest' was formed prior to the first world war. In the US, two of the top ten emerged this century, and nine were formed well after the Beatles. The rate of US outperformance has been less evident in recent years, and a large valuation gap has opened up between the UK and US markets. However, this largely reflects the fact that the UK has a material exposure to companies which are on low valuations globally, not that UK companies appear attractive on a like-for-like basis. UK companies still comprise only a small exposure in Saranac's global equity portfolio.
- The **global economy** has started the year firmly, with growth coming in somewhat ahead of expectations in many regions. While we think recessions can be avoided, we still believe that much of the global economy is trapped in a low-growth cycle. The dominant theme is likely to remain 'stagnation' rather than 'recovery', although the US remains for now an outlier in this context.
- In **fixed income**, credit spreads remain below 'normal', and we think the market has become slightly too aggressive in pricing a low inflation environment and scope for very material rate cuts. We prefer to wait for better entry levels to reinvest cash. Given inverted yield curves, we continue to prefer four- to five-year maturities to longer-duration exposures.
- Global **equity valuations** are now on average very extended, as markets have continued to rally strongly in the absence of material corporate earnings growth. The dispersion in valuations remains significant, as US megacap valuations remain very high, but the broader equity market has also experienced valuation stretch. This aggregate market rating is not speculative, but it requires strong earnings growth to be sustained.
- In the private markets section, we take a closer look at **distressed exchanges**, and explain our concerns about their potential to reduce bankruptcy risk in the long term.

**Chart 1: Market cap of Apple and FTSE 100 (\$ trillion)**



Source: Saranac, Bloomberg.

*Recent months have seen renewed focus on a range of perceived structural deficiencies in the UK equity markets.*

## UK equities – the forgotten market?

### ***The UK equity market – indicators of decline***

Recent months have seen renewed focus on a range of perceived structural deficiencies in the UK equity markets. Concerns are wide-ranging. A larger number of UK companies have moved their prime listing from London to the US; high-profile companies like ARM have chosen to do their IPOs outside the UK; the allocation to UK public equity markets by pension funds and insurance companies has been in long-term decline and their allocations to UK venture capital remains low; the share of UK equities in global equity market capitalisation is now negligible; and liquidity in share trading in London is very low by international standards.

These perceived deficiencies have interacted and cumulated. For example, large pools of international capital require large and liquid markets to invest in, so the diminished relevance of the London market in a global context has contributed to a further decline in its importance. In particular, US-based private equity firms have not needed to explore the UK market in particular depth, given the opportunities in their own market.

Some examples help to flesh out this gloomy picture:

- In the mid-1990s, UK pension funds on average invested around 70% in equities, of which around a half was in the UK. The equity weight is now under 30%, of which a negligible proportion (1.5%) is invested in domestic equities. Overseas investors are now the largest owners of UK quoted shares.
- Four UK asset managers dominated pension fund investment in the 1990s, but these companies and their corporate brands no longer exist.
- UK equities have declined from almost 10% of global equity market capitalisation in the 1990s to around 3% at present. Apple alone has a larger market capitalisation than the FTSE 100 index (chart 1).
- The number of listed stocks in the UK has declined and is now below the number in China.

**Chart 2: Immunocore performance since US float**



Source: Saranac, Bloomberg.

**Table 1: Top 10 US and UK companies – year of formation**

US		UK	
Exxon Mobil	1876	GSK	1715
Broadcom	1961	Diageo	1759
Berkshire Hathaway	1962	BAT	1786
Microsoft	1975	HSBC	1865
Apple	1976	Rio Tinto	1873
Nvidia	1993	Unilever	1885
Amazon	1994	BP	1886
Google	1998	RELX	1880
Tesla	2003	Shell	1890
Meta	2004	AstraZeneca	1913
<b>Average</b>	<b>1974</b>		<b>1845</b>

- The FTSE 100 is commonly described as dominated by global multinationals, but on a global basis they are not large companies. For example, the two largest UK companies in terms of market capitalisation are not big enough to be in the top 50 global companies on this criterion.
- The liquidity in UK equities is low by international standards. There are over 300 companies in the UK market where average daily trading volume is \$1 million or more, but this is less than half the equivalent in other European markets, and one tenth the number in the US. Moreover, the number of liquid companies in the UK on this measure is less than it was 20 years ago, the only major market for which this is the case.
- Consider Immunocore as a case study. The biotech company had British origins, which in its early stages raised funds from British investors. However, these domestic capital pools were insufficient to finance additional development, and US investors filled the gap. It was then natural for the company's IPO to be done in New York rather than London. Since the float in 2021, the stock has almost trebled (chart 2). Had it delivered similar performance if floated in the UK, it would now be in the FTSE 100. New York's gain was London's loss.
- The failure of the UK equity market to develop companies like Immunocore has contributed to UK equities being over-represented by industries with a long heritage (mining and finance) rather than the newer industries. In the US, the more contemporary sectors such as IT and communication services, account for around a third of market capitalisation, but the equivalent number in the UK is only 5%.
- The UK market's lack of dynamism is illustrated in table 1. This shows that the oldest of the top ten companies in the FTSE 100 can trace its roots back to the early 18th century, and the youngest UK company was already in existence by the time of the First World War. By contrast, five of the top ten companies in the US have been around for only some 30 years or less. The average age of the top ten UK companies is well over a century older than their US peers.

The main point of this article is to consider how investors should respond to this situation. Has the UK equity market's move closer to the periphery of global equity markets – despite the continuing importance of London as a financial centre – created opportunities as investors have focused elsewhere? Or now that the UK market is on the periphery, does the starting point mean that it is more likely to stay there?

### ***How did this happen?***

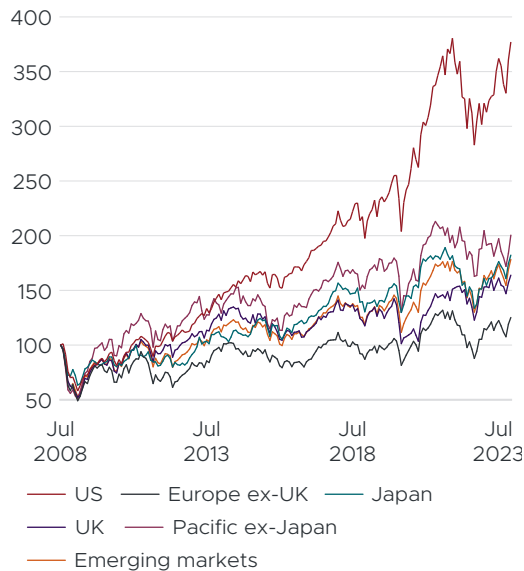
Some awareness of the factors relevant for the current position is helpful, and we focus on three.

First, economic historians can point to a long track record of the UK financial system struggling to finance small companies, particularly equity finance. The Macmillan Committee explored the issue in the 1930s, and the Wilson Committee in the 1970s and the long-standing nature of the problem suggests that it is problematic to resolve. More recently, the focus has since moved away from the banking system, which in the UK has always shied away from the provision of equity capital, to institutional investors. In this context, it is not that institutional investors have had no interest in venture capital per se, or equities in general. Rather their investment strategies have not been particularly aggressive, and private debt markets rather than equity markets have been more of a natural hunting ground for them.

Second, UK policy – notably the abolition of the dividend tax credit for pension schemes by the Blair government, and the application of mark-to-market accounting for corporate defined benefit pension schemes – has been perceived as exacerbating the problem. John Kay, a respected commentator in the issue, described these measures as creating “one of the great avoidable catastrophes”. This remains controversial, with the counter position being that the shift to a more transparent accounting system for corporate pension schemes made their economic risks more visible to investors. However, it is less controversial that the change in the regulatory background did make equity investment, whether in public or private markets, less attractive for UK institutions.

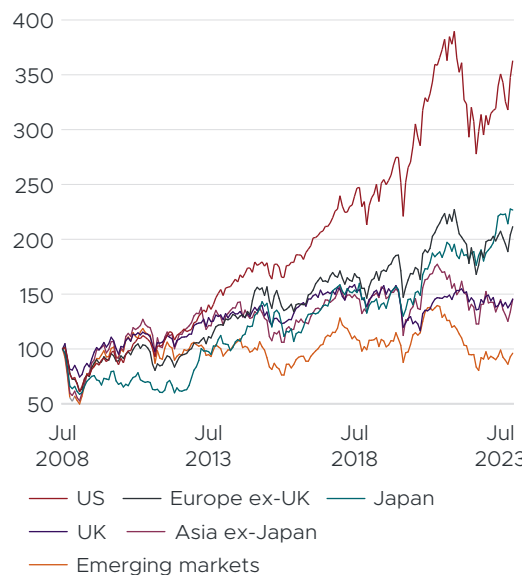
*Has the UK equity market's move closer to the periphery of global equity markets – despite the continuing importance of London as a financial centre – created opportunities as investors have focused elsewhere?*

**Chart 3: Dollar returns from global equity markets**



Source: Saranac, Bloomberg.

**Chart 4: Real equity returns to domestic investors**



Source: Saranac, Bloomberg.

Third, it is worth putting the UK in a broader international context. From this perspective, the story is less UK decline, rather US dominance. It is not that a wide range of markets have delivered much better public market equity performance than the UK. We show in charts 3 and 4 that over the past fifteen years or so the UK is “in the pack” of non-US markets in terms of performance, whether measured in terms of dollar returns or the returns to domestic investors in each market after allowing for inflation. The US has, however, clearly been the standout performer: domestic investors have virtually doubled the value of their equity assets since 2017, but in the UK equity returns have barely matched inflation. From this perspective it is not that the UK has a particular problem, rather the US has arrived at a bespoke solution which has not been close to being emulated in any other market. The relatively high weight of US equities in market capitalisation indexes, around 70% recently, is indicative of this dominant performance.

It is interesting that some of the trends deemed to have undermined the UK equity market have also been evident even in the US, where pension funds have also been net sellers of equities. One factor at work here is a common demographic structure between the two countries. Baby boomers are drawing on their pensions rather than contributing to them, and the younger but smaller cohort is not adding equivalent contributions. An important difference is that in the US there have been other sources of private capital, such as foundations and individual investors, who have created and sustained a deeper ecosystem in public and private equity markets. Moreover, the UK was always likely to be more exposed to the demographic influence, given a relatively high initial equity exposure compared to many other countries in the 1990s, and also the relatively high exposure to UK equities. In a world in which capital mobility was rising, this concentrated exposure in a relatively small market was more likely to be diluted over time as opportunities in other markets became investible.

**Chart 5: US–UK relative equity market performance (\$)**  
2019 = 100



Source: Saranac, Bloomberg.

*Significant capital has indeed been committed to US public equity markets by UK investors, but over the past 15 years the annual return to this exposure has entirely warranted given the outperformance of US equities.*

One possible conclusion from this analysis is that in some way UK institutions (including private wealth managers!) have contributed to the structural problems of the UK market by having a global—rather than a UK-based investment strategy. Had additional resources been committed to the UK, particularly to venture capital, the fishing pool of larger successful companies would have become bigger, to the benefit of all, and returns would have been higher: more Immunocores.

However, there is a challenge to this thesis. Investors have a primary responsibility to their clients. Significant capital has indeed been committed to US public equity markets by UK investors, but over the past 15 years the annual return to this exposure has entirely warranted given the outperformance of US equities. The US index return to UK investors been around 15%, which is not dissimilar to the median gain made by investors in UK venture capital over the same period.

***The investment implications for UK equities***

So much for how we got here, but what next, from an investment perspective? Two things are changing. First, in private markets, more of a venture capital infrastructure is emerging in the UK (and indeed in Continental Europe) linking potential investors to investment opportunities. To some extent this is being fostered by family offices and private investors, but the government is also pressurising UK institutions to commit more to this space. Momentum is gathering, if only slowly.

Second, in public markets, the relentless outperformance of the US over the UK has at least tailed off in recent years. Indeed, in common currency terms the UK outperformed the US in 2021 and 2022 (chart 5), although some of these gains have been unwound more recently. Moreover, prior to the Covid crisis, US corporate earnings had been systematically stronger than in the UK, and this relative strength was a fundamental reason for the outperformance of the US market in this period. More recently, however, this relative trend has flattened out. The outperformance of the US last year and so far in 2024 has resulted more from

**Chart 6: US and UK PE ratios**



Source: Saranac, Bloomberg.

a rise in the US market's PE ratio, at the same time that the UK market has derated – the UK PE has fallen. The current PE ratio in the UK of a little over 10 is close to its lowest level in 20 years, and the valuation gap between the two countries is at an exceptional level by historical standards (chart 6).

Does this imply that substantially more capital should now be devoted to the UK's public equity markets? If US and UK companies were broadly similar, the answer would be unequivocally yes, given the valuation discrepancy. However, as noted earlier, around a third of the US index comprises companies in IT and communication services, where valuations are higher, and the UK has very few comparable companies. So comparing aggregate valuations is not to compare like with like. In addition, the sectors in which the UK is over-represented (financials, mining, pharma) have relatively low valuations in all markets, including the US.

So to some extent, the low valuation of the UK market can be seen as a consequence of global valuation trends, not a self-evident signal that UK companies have become uniquely attractive. If these sectors were to be systematic outperformers globally, the UK market would be likely to outperform, but this would be more a reflection of global trends rather than any distinctive characteristics of UK companies. There is little evidence to suggest that UK companies are particularly attractive against global peers in the same sectors in other markets. Over the past decade and more, the US has outperformed the UK in most sectors, not just those focused on newer industries.

In the Saranac global equity portfolio, which is a focused strategy of some 40 holdings, two stocks are listed in the UK, representing around 4% of the total portfolio. In our view, whatever, the characteristics of the aggregate UK market, it is still not the case that in a global context the UK has a particularly attractive companies which would warrant a higher exposure.

*There is little evidence to suggest that UK companies are particularly attractive against global peers in the same sectors in other markets.*

# Public markets

## EQUITIES



- Asset class outlook +

### Valuation



### Earnings



### Positive

Healthcare; Energy;  
Japan

### Negative

Financials; IT; Emerging  
Markets

### Market background

Equity markets continued to push higher thanks to supportive macro data and moderately positive earnings season. However, in the last few hours of trading, US equities tumbled as Fed Chair, Jerome Powell, challenged the market's expectation of an imminent rate cut. The Global Equity Strategy gained 2.5% in January versus 1.3% for the MSCI World.

### Targeted exposure

Healthcare suffered some headwinds last year. We believe these will turn into tailwinds this coming year. Energy companies continue to exhibit cost discipline despite oil price volatility leading to strong cash flow generation. We believe banks are well capitalised but expect them to face some revenue challenges as interest rates fall and commercial real estate concerns linger. Tech stocks continue to command high valuations so we are targeting quality in this sector. We expect corporate reform in Japan could finally push the market higher.

## GOVERNMENT BONDS



- Asset class outlook +

### Short maturity



### Long maturity



### Targeted exposure

7-10Y sovereign bond  
exposures

### Positive

20-30Y US TIPS, 10Y  
Australian government  
bonds

### Negative

>5 year European  
sovereign bonds,  
Japanese government  
bonds

### Market Background

We now think that the major global central banks have reached the end of their tightening cycle (excluding the BoJ perhaps) and are likely to start cutting interest rates at the end of the first half of 2024. Following the recent pick-up in yields and revisions to earlier overly optimistic rate cut projections, we now believe that the market pricing for rate cuts is about right. Similarly, 10Y Treasury and Gilt yields have rebounded above 4%, in line with our 12 months target.

### Targeted exposure

After cutting the average portfolio duration of our core fixed income strategy to 3.8 at the turn of the year, we are now looking at options to raise it back towards 4.0, our neutral stance.

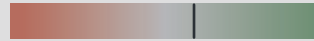


# Public markets

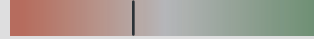
## CORPORATE AND EMERGING MARKET DEBT



**Investment grade credit**



**High yield**



**SUB**



**EM debt**



**Positive**

Subordinated bonds, AAA/A securitisation, US Agency MBS

**Negative**

US B/CCC junk bonds

### Market background

We now view credit spreads as too tight, with \$IG and \$HY spreads ending January at respectively at 99bp and 379bp, well below their long term average of 128bp and 455bp. We continue to find better value in the European subordinated bond space, with subordination premium still trading at generous level. Complexity premium offered in the structured credit space remains attractive. For instance, \$ AAA CLO tranches trade at a 147bp spread above SOFR, compared to just 99bp for the 1-10Y \$IG credit segment which has A- average rating. Finally, MBS spreads remain attractive compared to \$IG credit, especially considering the improved convexity profile of the asset class and as we expect the Federal Reserve's to start tapering its Quantitative Tightening program sometime during the summer.

### Targeted exposure

We continue the rebalancing of our core fixed income strategy away from traditional IG and HY corporate bonds, reallocating towards (i) instruments with a lower credit sensitivity (MBS, government bonds, high quality securitisations) and (ii) higher yielding subordinated bonds issued by IG companies. These include AT1s, Solvency II grandfathered insurance bonds and corporate hybrids. This "barbel" approach provides diversification benefits and allows to maintain a relatively high average credit quality while preserving a yield advantage against the global bond index. It reduces credit sensitivity and increase interest rate duration, whilst allowing to harvest attractive credit and liquidity premium in higher-yielding niche market segments.

## STRUCTURED PRODUCTS



### Market background

The volatility picture and the outlook for structured products is relatively unchanged on the month. Equity volatility continues to sit around a multi year flow, with the VIX trading in the 12-14 range and put pricing about as cheap as it has been in decades – we view this as an opportune time to hedge for investors who are bearish. Given the low volatility environment and elevated funding in light of a still elevated front end in rates, we look to allocate towards opportunities to buy cheap optionality rather than selling volatility at present. Our structured product allocation sits towards the bottom of its historic ranges at the moment, reflective of our view that the opportunity set is more compelling elsewhere for the time being.

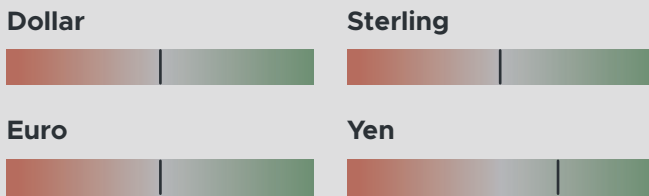
# Public markets

## HEDGE FUNDS



**Global Macro:** the current environment remains relatively attractive for hedge fund strategies given ongoing central bank policy divergence and still elevated FX and rate volatility. **Credit L/S:** heading into 2024 the opportunity set for stressed credit continues to improve at the margin with corporate defaults ticking up slowly. Credit spreads have become tight as the market has fully priced in a soft landing. As such, we remain biased towards low beta managers who focus more on process/legal/liquidation oriented idiosyncratic outcomes. **Reinsurance:** this was by far one of the best performing sub strategies on our platform in 2023 with returns driven by the combination of historically high premiums and limited catastrophic losses. Despite the elevated returns in 2023, capital formation has been limited heading into 2024 resulting in pro forma returns which are in a similar range as last year. Coupling the high absolute return potential with the natural correlation benefits, we remain constructive on this strategy for 2024 albeit monitoring closely changes in the ENSO effects (sea surface temperatures and air pressures).

## CURRENCIES



**Market background**  
 We have seen US economic data surprise to the upside so far in 2024 as the loosening in financial conditions into the end of last year took hold, the best recent example being January’s non-farm payroll (employment) data coming in much stronger than even the highest estimates. We have also seen the Federal Reserve being very clear that markets had gotten ahead of themselves in backing a first rate cut in March, with market-implied probabilities projecting that the first rate cut is more likely to occur in the Fed’s May or June meetings. As a result of this better data and a slightly more hawkish Fed, the dollar has traded 2.7% higher so far this year.

**Market outlook**  
 We note the Swiss Franc has turned negative since the end of January as the SNB now appears comfortable with the prospect of a weaker CHF due to lower threats from import inflation, meanwhile all eyes will be on the Bank of Japan decision on March 19th, with a number of high profile investors calling for a first rate hike, although markets are currently only assigning a ~20% probability for a March hike.

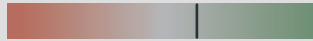
# Public markets

## COMMODITIES

### Gold



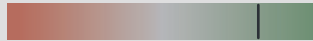
### Energy



### Industrial metals



### Softs



### Market background

Struggling commodity price action has persisted into the new year, with weakness across industrial metals, ags and energy. The latest bout of China weakness has provided the impetus for another leg lower, whilst concerns over slowing EV adoption have also fed through in the form of a severe correction on the rare earth metal side. Ahead of a global rate cutting cycle we have also discussed increasing exposure to gold, which continues to benefit from strong central bank buying and is poised to benefit if real yields begin to tighten. Away from this we retain our medium term conviction in the soft ags trade and have exposure to the space in a lower correlated expression via the commodities carry implemented using capital protected notes.

# Private markets

### Distressed exchanges

In previous articles, we have stressed that the private loan market is an area we have been particularly cautious about. Higher rates, covenant lite transactions and a weakening economic outlook were just some of the reasons we were highlighting concern. However, whilst we've seen default rates and distressed ratios spike up materially in the last 12-24 months, we've not seen the widespread distress that we expected.

There is a number reason why this could occur, and we use this publication to touch upon a more prominent lever we have seen being used by private sponsors as a way to avoid / defer the issues within their portfolios – distressed exchanges.

Distressed exchanges are generally proposed by sponsors / companies as a primary way to avoid having to complete bankruptcy proceedings, allowing restructures to occur in a more timely and cost-effective manner outside of court proceedings. In addition, completing restructures through distressed exchanges typically allow the sponsor to maintain control, increase the probability of equity protection, and they have, historically, increased the recovery value relative to those that have gone bankrupt. As a result of these dynamics, it is no surprise to see that over the last few years there has been a material uptick in the proportion of sponsored loans vs non-sponsored loans that have gone through these exchanges – in 2023 90% were sponsored driven vs c.55% in 2021.

Whilst the use of distressed exchanges seems to be a perfectly reasonable and useful option for sponsors to utilise to protect capital, we do see a fundamental flaw in the context of today's environment. The key issue is that many of the business that go through this process, by nature, are facing significant headwinds, and hence whilst distressed exchanges serve as short-term solution, higher rates, tighter credit conditions, and weakening macroeconomics limits the long-term probability of these businesses going on to succeed.

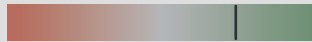
As a result, we view distressed exchanges as a tool for sponsors to kick the can down the road. In fact, and despite the short time horizon, we have seen that 33% of the companies that had completed a distressed exchange in 2022 have returned with either a payment default or full bankruptcy. KKR's Envision Healthcare portfolio company is a great example of this playing out. In April 2022, the company used collateral transfers to remove assets from its collateral packages in order to raise new debt against them. The company then repurchased approximately \$1.5 billion of its existing first-lien term loan at a blended price of 66% of par. The transaction closed in July 2022 and brought in \$300m of new money and a restructure of the entire debt stack. However, despite the level of financial engineering that had occurred in May 2023, the company eventually filed for bankruptcy. This is just one example of many similar cases we have seen.

Whilst market-wide distress has not yet come to realisation, and distressed exchanges are a factor in why not, we still are very bearish on the ability of sponsors to delay the issues within their portfolios companies for long enough for material rate cuts to occur. Hence, we maintain the core view that allocating to distressed credit is still timely for those seeking to allocate capital.

# Private markets

## ALTERNATIVE SOURCES OF RETURN

### Secondaries



Record levels of secondary volume as investors seek to rebalance portfolios has resulted in a very attractive pricing environment

### Special situations



Favourable market environment given the likely stress corporates will face in a higher rate environment

### Venture capital



Early-stage venture has benefited from the correction in late-stage valuations, providing an opportune time to invest in long-term productivity gains, labour replacement and other venture investment qualities

### Infrastructure



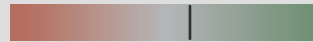
More attractive given supply chain issues and geopolitical uncertainties

### Real estate



Pricing is unattractive given the narrow spread (in some cases negative) between cap rates and the risk-free

### GP stakes and financing



Opportunity of higher yield and greater downside protection as a result of attractive secondary pricing dynamics

### Real assets



At risk from weak growth environment

### Private debt



A negative economic outlook with the potential for above-trend default rates and extension risk make private direct lending unattractive on a risk-adjusted basis

### Leveraged buyouts



EBITDA multiples have begun softening and hence in time valuations could again become attractive

### Mid-market growth



A prolonged period of weak/negative earnings growth as a result of a weak economic environment and increased cost of capital will see valuations struggle in the short term

### ABOUT SARANAC PARTNERS


We founded Saranac Partners to do things differently. To create a community based around like-minded people, shared wisdom and collective learning. To work as partners, creating compelling opportunities and effective solutions. To offer unfailing support, honest challenge and thoughtful inspiration.

Our business combines the personal touch of a private office with the capability and breadth of a large institution. Our firm has strategic shareholders, outstanding technology, broad capabilities and the highest standards of corporate governance. Saranac Partners is a signatory to the United Nations Principles of Responsible Investing (UNPRI).


### OUR SERVICES

We start with the question. We listen and seek to understand. We don't make assumptions or force solutions. Rather we co-create a path with our clients.

 **Strategy.** Planning, governance and oversight

 **Financing.** Access to diverse sources of capital

 **Investments.** Allocation and deployment of capital

 **Corporate advisory.** Supporting corporates and business owners

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