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White Paper

Active management of UK Equities: understanding historical underperformance and identifying long term opportunity

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Summary

Much has been made of the fact that UK equity tracker funds have outperformed active managers over recent years. The questions arise: what has been the cause of the underperformance, and why might active management still offer value to investors in future?

In a new White Paper, we have analysed detailed (anonymised) data from the Investment Association ("IA") covering 208 funds over 36 months to 31 December 2023. For the first time, we have been able to create a model of a composite IA portfolio, and to look at performance at the individual stock level.

Our analysis of the data shows that the IA All Companies sector underperformed the FTSE All-Share Index over this period, because of a significant underweighting to a small number of the very largest, internationally orientated companies, which had outperformed smaller stocks over the period. We conclude that the difference in weights held by active UK fund managers compared to the FTSE All-Share Index is largely structural, arising from ownership of the largest stocks by international regional and global funds. And that is then magnified by the growth in UK domestic tracker funds and ETFs that very largely follow the FTSE 100.

The analysis goes on to show that although the structural differences may well endure, this is not necessarily a long-term disadvantage. Instead, the long-term outperformance of smaller and mid-caps, and the 'oxygen' of increased volatility that fuels opportunity for stock picking, suggests that (after 3 years of underperformance) the long-term outlook for UK active managers, relative to passive funds, remains especially attractive.

Over the 3 years to 31 December 2023 the average fund in the Investment Association All Companies sector ("the IA") returned 14% net of fees. This compares to a return of 28% on the FTSE All-Share Index. Only 40 Funds out of 208 in the IA actually beat the index. And of those, 12 funds were passive funds, mainly following the FTSE 100.

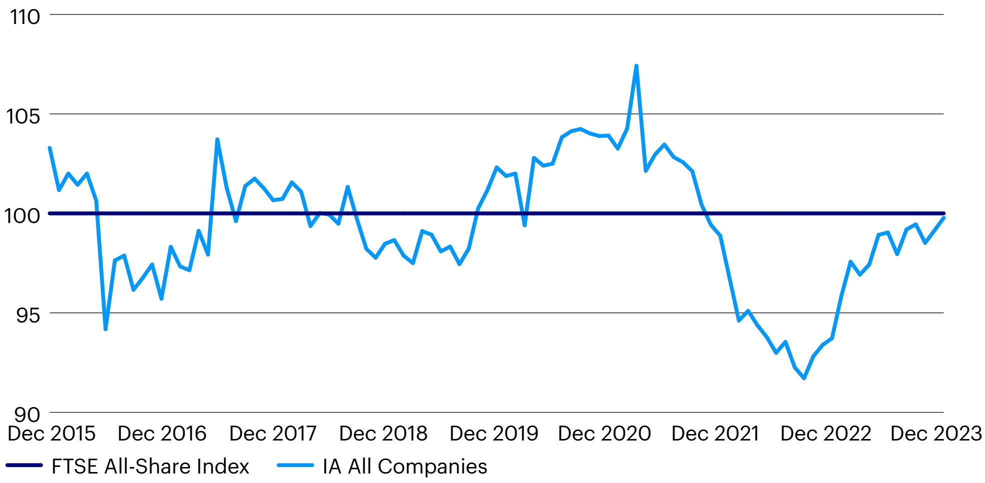
With the odd very notable exception, not a great advert for active management then!

Two questions immediately arise:

1. Is it normal for active managers of UK Equity portfolios to underperform?
2. What causes divergence in performance by active managers, from the Index?

The chart in Figure 1 below shows the performance of the IA relative to the FTSE All-Share, on a rolling 12-month period from December 2015 to December 2023.

Figure 1: Total return Investment Association relative to FTSE All-Share Index, rolling 12 months



Source: Invesco, Investment Association

Past performance does not predict future returns.

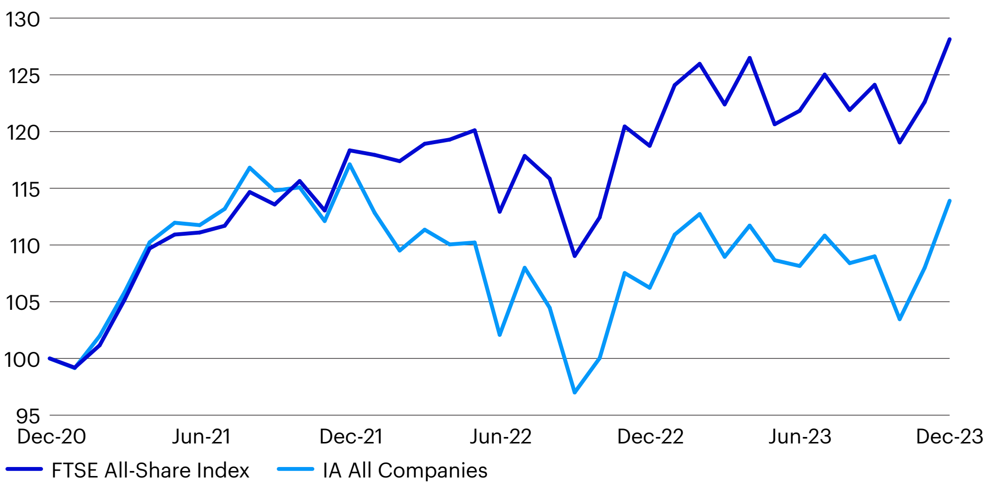
Between December 2015 and October 2021, the rolling 12-month performance of the IA was actually ahead of the FTSE All-Share index almost 60% of the time. Peak relative out-performance by the IA occurred in March 2021, but active performance then faded such that by September 2022, there had been a swing of 16 percentage points in favour of the FTSE All-Share Index.

Relative performance of active management vs the index therefore appears to move in cycles. The rotation that we can observe over the past 3 years in favour of the FTSE All-Share is not unusual in its incidence. But what sets it apart from previous rotations, is its magnitude.

To look into the cause of relative underperformance over the past 3 years, it is necessary to breakdown the performance of each of the IA and the FTSE All-Share, and then make comparison.

The first stage in the process is to look at the monthly performance of the FTSE All-Share Index and of the IA All Companies. This is illustrated in Figure 2 below.

Figure 2: Total return FTSE All-Share Index and IA All Companies, indexed 31 December 2020 = 100



Source: Invesco, Investment Association

Past performance does not predict future returns.

Analysing the absolute performance of the FTSE All-Share is a relatively straightforward exercise. Portfolio management systems commonly used by fund managers are readily able to break down the aggregate total return of a portfolio into the contribution by individual stocks (simplistically, this is the return of each stock, multiplied by its weight in the portfolio).

The challenge comes in analysing the performance of the IA, which is based on the top-down performance of 208 constituent funds, as disclosed to the IA on a weekly basis. The only bottom-up disclosure of the holdings in each fund is made monthly to the IA, and with detailed breakdown of month end holdings embargoed for anything up to 3 months. In short there is no readily available up to date "index" of the constituent stocks that ultimately make up the IA.

Undaunted, the Invesco UK Equity team in Henley, working closely with our EMEA Investment Analysis team colleagues in London and Frankfurt, set out to create a synthetic model of the IA Index (a "Model IA") by:

- Creating a composite portfolio (using the Morningstar Direct analysis tool) of equal weights in each of the 208 portfolios that make up the IA
- Downloading the top 50 holdings in the composite, each month over a 36-month period from 31 December 2020 to 31 December 2023 (a period substantially clear of embargoes)

The analysis showed that the top 50 positions in the Model IA comprised (on average) 45.2% of the aggregate Model portfolio weight. The same stocks however comprised (on average) 72.9% of the FTSE All-Share Index.

Analysis of the top 10 underweights and overweights (on average) in the model IA (compared to the FTSE All-Share) is given in Figure 3 below:

Figure 3: Top 1 — underweights and overweights, IA All Companies vs FTSE All-Share Index

	FTSE All-Share Index (%)	IA All Companies (%)	Difference (%)
Shell PLC	6.40	3.15	-3.25
HSBC Holdings PLC	4.42	1.55	-2.87
AstraZeneca	6.22	3.37	-2.85
Unilever PLC	4.35	2.35	-2.00
British American Tobacco p.l.c.	2.80	1.04	-1.75
Diageo PLC	3.37	1.76	-1.61
Glencore PLC	2.28	0.83	-1.45
BP p.l.c.	3.24	1.93	-1.32
Rio Tinto plc	2.51	1.41	-1.10
GSK PLC	2.80	1.76	-1.04
AVEVA Group PLC	0.10	0.25	0.15
Burberry Group PLC	0.32	0.48	0.16
Future PLC	0.09	0.27	0.18
OSB Group PLC	0.08	0.26	0.18
St. James's Place Plc	0.28	0.46	0.18
RS Group Plc	0.19	0.38	0.19
Smith & Nephew PLC	0.46	0.69	0.23
Intermediate Capital Group PLC	0.19	0.46	0.26
Next PLC	0.37	0.64	0.27
Sage Group plc	0.34	0.61	0.27

All figures based on average position data 31 December 2020 to 31 December 2023.
Source: Invesco, Factset, Morningstar

The clear inference from this analysis is that the average fund manager represented in the IA is significantly underweight a relatively narrow base of the very largest companies in the FTSE All-Share index, with active overweights spread more broadly across a larger number of smaller companies (not just in small and mid-caps) below the top tier.

The impact on performance of each of the under and overweights can be readily approximated by taking the monthly difference in weight, then multiplying it by the monthly total return ("Differential A").

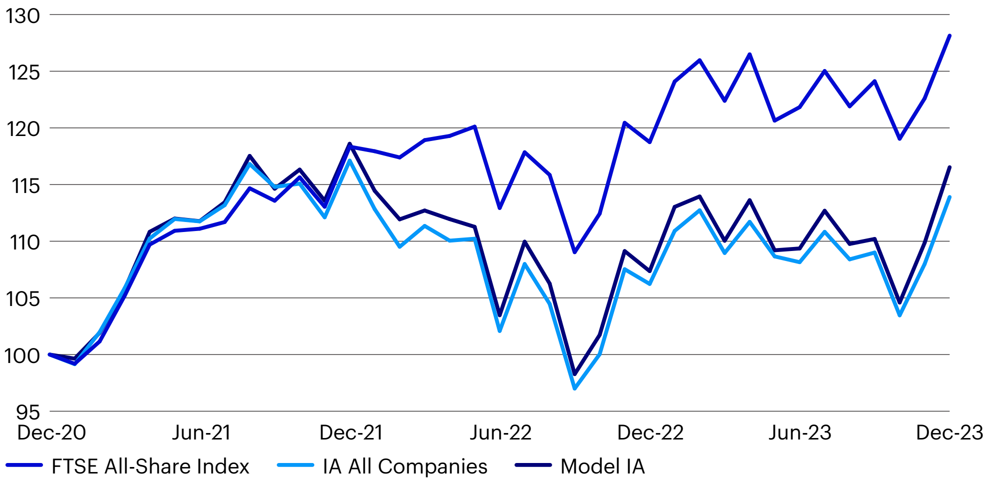
It is then necessary to look at performance generated by re-investing that overall underweight elsewhere (outside the top 50 stocks in the IA). We have approximated the impact of re-investing the overall net underweight by taking the aggregate difference, and assuming that it delivers a monthly return equal to that of the FTSE 250 (an approximation of performance of companies below the top tier) ("Differential B").

The performance of the Model IA can then be calculated as:

TR Model IA = (TR FTSE All-Share Index – (Differential A – Differential B))

Putting all this together, we can expand the chart in Figure 2, to look at the monthly performance of the FTSE All-Share Index, the IA All companies and the Model IA. This is illustrated in Figure 4 below.

Figure 4: Total return FTSE All-Share Index and IA All Companies, Model IA, indexed 31 December 2020 = 100



Source: Invesco, Investment Association

Past performance (actual or simulated) is not a guide to actual returns.

It is clear simply from observation that the total return of the Model IA fits closely with the actual IA All-Companies (statistically, the R^2 is 98.9%).

The tight relationship then lends credibility to substituting analysis of performance of the FTSE All-Share relative to the IA, with analysis of the All-Share relative to the Model IA.

Armed with the confidence gained at the aggregate level, the table in Figure 5 below (an extension of Figure 3) shows the 10 largest companies by average weight in the FTSE All-Share Index, the average weight of those companies in the Model IA, and from that, the average underweight (in all cases, underweight) exposure within the Model IA. The table then illustrates the impact on Total Return of the Model IA as a result of the underweight ("Contribution Difference" — shown here simply as the sum of monthly: weight differential x Total Return). The final column shows for information purposes, the company total return (%) over the 3-year period ending 31 December 2023.

Figure 5: Impact on Total Return resulting from weight differences between FTSE All-Share and IA All Companies

	FTSE All-Share Index (%)	IA All Companies (%)	Difference (%)	Contribution Difference (bps)	Total Return Index (%)
Shell PLC	6.40	3.15	-3.25	-253	126
AstraZeneca	6.22	3.37	-2.85	-107	56
HSBC Holdings PLC	4.42	1.55	-2.87	-193	95
Unilever PLC	4.35	2.35	-2.00	12	-3
Diageo PLC	3.37	1.76	-1.61	-11	6
BP p.l.c.	3.24	1.93	-1.32	-89	110
GSK PLC	2.80	1.76	-1.04	-25	23
British American Tobacco p.l.c.	2.80	1.04	-1.75	-10	7
Rio Tinto plc	2.51	1.41	-1.10	-45	42
Glencore PLC	2.28	0.83	-1.45	-116	147

All figures based on average position data 31 December 2020 to 31 December 2023.

Source: Invesco, Factset, Morningstar

Past performance (actual or simulated) is not a guide to actual returns.

Key inferences from this analysis are:

- The Model IA weighting of the ten largest stocks in the FTSE All-Share was just 19.1"%, almost exactly half the weighting of 38.4% of the same stocks in the FTSE All-Share itself.
- These 10 Stocks delivered a weighted average Total Return of 64% over the period, compared to Total Return of 28.1% for the FTSE All-Share as a whole.
- The effect of being underweight the largest (and some of the best performing) stocks over the period was a significant drag on the performance of the Model IA. We estimate that around 95% of the underperformance of the Model IA, relative to the FTSE All-Share Index, resulted from being underweight the 10 largest positions in the FTSE All-Share Index.
- There was some additional detraction from remaining 8.4% net underweight, largely offset by contributions from deemed reinvestment of the aggregate underweights into the FTSE 250, which generated only a modest Total Return over the 3-year period, of 5.5%.

The overall simple conclusion from all the above detailed analysis (and the answer to Question 2 near the beginning of this note!) is that the IA underperformed the FTSE All-Share over the 3 years to 31 December 2023, because of a significant underweighting to a small number of the very largest, internationally orientated companies, which had outperformed smaller stocks over the period.

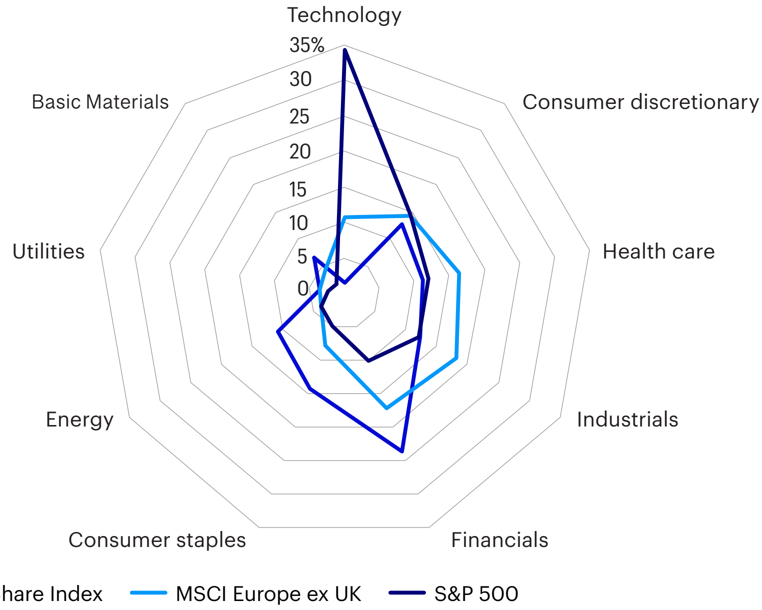
Which rather begs a third question:

3. Why is the IA underweight the largest stocks?

The short answer is that the underweight to the largest stocks is (at the aggregate level) largely a function of opportunity, rather than fund manager choice.

Standing back for a moment to look at sector weightings of the FTSE All-Share in comparison to other global indices (Figure 6), it is clear that the biggest sector overweights of the FTSE All-Share relative to the S&P 500 and the MSCI Europe ex UK are Financials, Consumer Staples, Energy and Basic Materials.

Figure 6: Sector weights



Source: Factset, Invesco. All data as of 29 February 2024

Looking back at Figure 5, as many as 8 out of 10 of the largest stocks in the FTSE All-Share come from these 4 sectors. For fund managers running Global equity mandates, or even Pan-European mandates, these stocks are likely to be prime candidates for inclusion as significant components of the regional mandate. If you are running a Pan-European mandate and want exposure to Industrial Metals, there is little choice but to consider Rio Tinto and Glencore. This then reduces the availability of stock to the domestically orientated IA Fund.

There are also historical reasons why significant portions of some of the largest companies are held in regional or global mandates. Until recently, the market capitalisation of each of Shell and Unilever was split between the UK and The Netherlands, so it is natural that there are still residual holdings in European mandates. With HSBC, the clue as to why there might be significant holdings in global mandates is in the name of the company: the Hong Kong and Shanghai Banking Corporation.

By way of further context, as of 29 February 2024, the 10 largest companies in the FTSE All-Share index comprise 10.5% of the MSCI Europe Index.

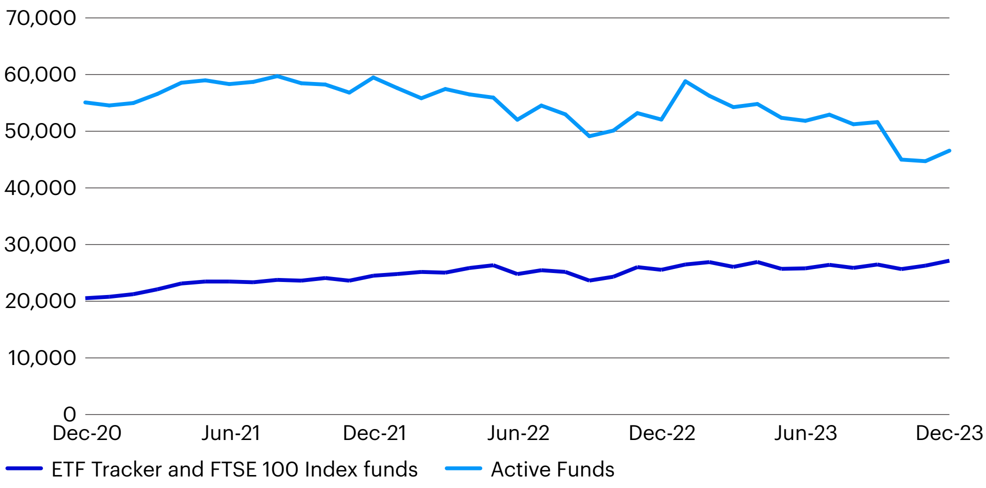
Size also presents a challenge to the manager of UK domestic funds. Absolute risk considerations can make it hard for a UK manager to be full weight (never mind overweight) the very largest companies in the FTSE All-Share Index, because of the concentration of absolute risk in an individual position.

It is perhaps also relevant to consider that 5 out of 10 of the largest companies in the FTSE All-Share Index are exposed to either fossil fuels, alcohol or tobacco. Ownership of these by active managers following ESG focussed mandates — a particular area of growth especially during 2022 — may further be subject to limitations.

But there is still another reason why UK active managers are underweight the largest stocks — it is that imbalances arising from non-UK owners (discussed above) are then magnified by the growth in tracker funds and ETFs that very largely follow the FTSE 100.

The chart in Figure 7 shows AUM across 17 ETF Tracker and FTSE 100 Index funds, and 92 actively managed funds, for the three years ending 31 December 2023 (disclosed to the IA). Over this time, FTSE 100 Index funds have increased in AUM by 32.2%, whilst active funds have witnessed an AUM decline of -15.5%. As of 31 December 2023, passive tracker funds comprised 36.8% of AUM and active funds 63.2%. This compares to (respectively) 27.2% and 72.8% just three years earlier.

Figure 7: AUM held in ETF Tracker and FTSE 100 Index funds, and in actively managed funds (£ millions)



Source: Invesco, Morningstar

By definition, the passive funds must physically hold benchmark weights in the largest stocks in the All-Share. But in the case of the passive funds, the benchmark weight is the weight in the FTSE 100, which is even greater than the corresponding weight in the FTSE All-Share. As of 31st December 2023, the aggregate weighting in the FTSE 100 of the companies listed in Figure 5 was 47.3%, compared to 39.6% in the FTSE All-Share. Inevitably the equity available for active managers must be lower. The average fund in the IA — including both active and passive — holds 19.1% weighting in these stocks, the logical inference being that the average active manager holds even less.

The overall conclusion is that for reasons associated with ownership of some of the largest UK listed companies in non-UK funds, and the growth in passive funds tracking the FTSE 100, the opportunity set for active managers is structurally very different from the FTSE All-Share, and weighted more to companies below the top quintile.

Which rather begs a fourth and final question:

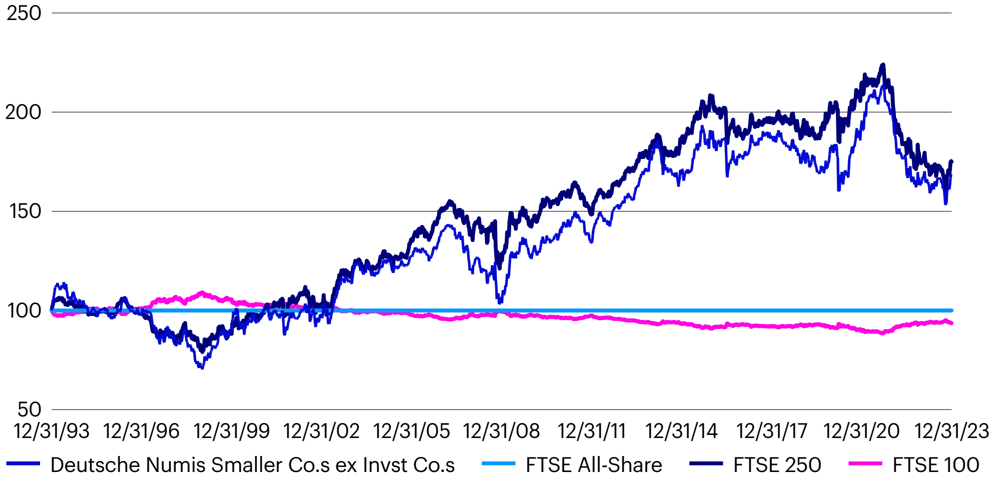
4. Given the structural differences, does this put UK Active managers at a long-term disadvantage?

The short answer is no.

Such is the liquidity in UK equity markets, Individual active managers are not restricted from buying the larger companies; just that the average is necessarily underweight. It is also possible for many UK active managers to buy limited exposure to companies listed overseas — for a UK manager wishing to have a full index weighting in say Energy and in Pharma, it may well be possible to diversify idiosyncratic risk associated with a large holding in either Shell or AstraZeneca, by partial substitution of a holding in, say TotalEnergies and Sanofi.

The residual question as to whether there is long-term disadvantage arising from structural differences in average market cap, is addressed in the Figure 8 below. The chart shows Total Return for the large cap FTSE 100 Index, and for two smaller and mid-cap indices (Deutsche Numis Smaller Companies ex Investment Trusts Index, and FTSE 250), all relative to the FTSE All-Share Index.

Figure 8: Total Return relative to FTSE All-Share Index, (Indexed, 31 December 1993 =100)



Source: Invesco, Factset

Past performance is not a guide to actual returns.

It is clearly evident that the past 3 years has seen significant underperformance of the smaller and mid cap indices, and outperformance of the FTSE 100 — entirely consistent with the underperformance of the IA relative to the FTSE All-Share, and of active managers in general.

But in the longer term, the opposite is true.

There have been times (in the build up to the first dot.com boom, during the GFC, around the Brexit Referendum of 2016, the first wave of Covid in April 2020, and the most recent period since September 2021) when smaller and mid-caps have underperformed.

But the long-term outperformance of smaller and mid-caps, and the 'oxygen' of increased volatility that fuels opportunity for stock picking, suggests that the long-term outlook for UK active managers, relative to passive funds, remains especially attractive.

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Data as at 31 December 2023, unless otherwise stated.

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