

MARKET INSIGHT

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New Highs



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ALASTAIR POWER | INVESTMENT RESEARCH MANAGER

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As we approach the end of the first quarter, it is alarming to look back and think about how fast time passes. One of the longer months, January kick-started an important political year with notable elections in Taiwan and Pakistan, February proved quieter, and March has thus far seen the Spring Budget from Chancellor Jeremy Hunt and the completion of the US Primaries with a Trump vs Biden rematch for the seat in the Oval Office. While politics has grabbed headlines, financial markets broadly have been experiencing a more muted time of things, in the UK at least.

Many investors had been hoping for a continuation of the share price momentum experienced at the back end of 2023. For those investing in the US, Europe, and Japan, their wishes were met. In the US, the Magnificent Seven continues to drive returns with NVIDIA and Meta Platforms up 78% and 39%, respectively, for the year-to-date at the time of writing. Not all the seven remained magnificent, however, Apple and Tesla are struggling in 2024, down 10% and 35%, respectively. While the S&P 500 is nearly 8% higher than at the turn of the year, European equities are neck and neck. Continental Europe has performed well in recent times, aided by the global nature of its companies, leading to yet another acronym to describe the largest listed companies in the region, the GRANOLAS; we will leave you to Google that one. While seemingly infatuated with dreaming up acronyms for a region's largest listed companies, financial journalists had further material with news of Japan's Nikkei index reaching an all-time high, an event some thirty-four years in the making. Shareholder friendly corporate reforms are finally feeding through and sentiment towards the region is positive. It's important to remember a nuance of the Nikkei, unlike other major indices such as the S&P 500 and FTSE 100: it's a price-weighted construction methodology, meaning the largest constituents are those with the highest share price. Japan's other major stock market index, the TOPIX, a market capitalisation-weighted index which makes it a more accurate representation of Japan's largest listed companies, remains just off its previous high in 1990.

Away from financial markets, Chancellor Jeremy Hunt delivered his Spring Budget in early March. Cuts to National Insurance and capital gains on second home sales were announced, along with the prediction of inflation falling closer to 2% in the coming months, potentially teeing up Bank of England interest rate cuts in the summer. The Chancellor also announced the creation of the British ISA, a further £5,000 allowance on top of the current £20,000 ISA allowance. We await further details on the qualifying criteria, but it would be nice to see investment trusts qualify given the difficulties currently being experienced in the sector. While we have not commented on the budget in this edition of *Market Insight*, our financial planning team provided analysis which can be found on the [Redmayne Bentley website](#).

Within this edition of *Market Insight*, our Insight Article covers the competition within the UK investment platform industry and our Stock Focus article looks at Smith & Nephew, the medical equipment manufacturing company. In our additional articles, we discuss consolidation in the listed real estate sector and reflect on the wobble in the banking sector experienced in March 2023.

STOCK FOCUS



SMITH & NEPHEW PLC

OSCAR SHEEHAN | INVESTMENT EXECUTIVE



Smith & Nephew plc (SN) has been a staple of the FTSE 100 for many years now. They are a medical technology company that specialise in the manufacturing of artificial knees and hips, sports medicine, and technology designed to help serious wounds heal. While joint repair and replacement is the corner stone of the business, it also conducts research in a variety of areas, including ear, nose and throat (ENT) surgery. It has a truly global presence and, despite being based in the UK, it does the vast majority of business overseas. Given how rapidly populations around the world are ageing, there are some

serious societal tailwinds that make Smith & Nephew and the wider orthopaedic healthcare sector worthy of our attention. Given that we might expect the number of replacement hip and knee surgeries to increase in tandem with the number of pensioners within a society, the company's recent performance on the stock market might surprise you. Over the last five years, the company has lost over 25% of its market capitalisation, with its share price falling from £14.80 to £10.88. Despite recent financial results being largely in line with its own predictions, and life returning to normal following the

pandemic, SN's share price has continued to struggle. At the time of writing, the company is down around 9.2% from where it was this time 12 months ago and has seen only a 2% uptick this year. While performance in 2024 has been more in line with the FTSE 100, over 12 months and five years there has been significant underperformance. In this month's Stock Focus, we will take a deeper look at why this is the case and also try to evaluate whether or not the future is any brighter.

As is so often the case at the moment, we must start this analysis by first examining the effect of the pandemic and the global supply chain crisis on SN's performance. Its top five markets (the United States, China, the United Kingdom, Germany, and Japan) account for 70% of its business and all of these countries experienced serious outbreaks of the COVID-19 virus. This led to long lockdowns and health services being stretched, which in turn resulted in the cancellation or delay of many 'optional' or 'elective' surgeries. The manufacturing and sale of artificial knees and hips is the company's primary source of revenue and the cancelling of operations in which these would have been used understandably led to a fall in revenue. Disruption to supply chains and the increased cost of the raw materials used in its products also hit SN's margins over the short-term. Any conversations about Smith & Nephew's recent performance should take these factors into consideration.

That said, other major companies within the sector have performed much better over the same time periods. The US-based Stryker, which also has a large presence in orthopaedic medicine, has seen its share price climb almost 83% over the last five years. It faced the same pandemic and geopolitical headwinds and has a similar concentration of its business within developed markets. So, why has Stryker thrived while SN have struggled? Some of this can be attributed to the market penetration of its products. Its Mako robotic surgery assistant is used in around 40% of global knee replacement surgeries and approximately 20% of hip replacements in 2023. In the US, these numbers are even higher. Stryker is also a larger company with more resources at its disposal, providing it with a slight economies of scale advantage over SN. It has consistently outperformed British rivals in terms of revenue growth, and this is expected to continue with Stryker expecting growth of 7.5 - 9% compared to Smith & Nephew's 5% - 6% over the next year.

However, we should give as much weight to Smith & Nephew's shortcomings as we do to Stryker's success. Unfortunately, SN's management team have been criticised in recent years due to the company's poor margins and low profitability. In its end of year 2023 numbers, Smith & Nephew reported higher gross margins than Stryker at 66.7% vs 60.95% but net margins were only 4.74% compared to Stryker's 15.44%, over three times higher. Generally, when we see numbers like this, we have to call the efficiency of the business into question as it indicates that operating costs are too high. Put simply, Smith & Nephew are struggling to turn sales into profit. Even more concerning is that 4.74% is half of the profit achieved in 2021. This is a story that is echoed across both companies'

performance metrics, and it is hard to find a measure by which Smith & Nephew has outperformed its rival.

“While the conversation around Smith & Nephew's poor margins does seem to be shifting, and the company has been seen to make progress on this front, it remains a long way behind the likes of Stryker.”

Anyone who has invested in anything over the last decade will undoubtedly have read that “past performance is no guarantee of future returns.” So, while we must be aware of Smith & Nephew's prior struggles, we should also ask if it is starting to turn a corner. Analysts around the industry are starting to think the firm might be. This is an understandable approach to take when the company is viewed in isolation, it has met its recent expectations and future growth projections seem reasonable, if underwhelming. SN are also now entering year three of its 12-point plan designed to increase efficiency and streamline the business. The progress so far seems promising and with this in mind a discount of around 20% when compared to its wider peer group does seem high.

While the conversation around Smith & Nephew's poor margins does seem to be shifting, and the company has been seen to make progress on this front, it remains a long way behind the likes of Stryker. Whether the potential for future growth and increased profitability makes the current share price attractive is difficult to judge, and much depends on supply chains continuing to ease and the company being able to deliver on its promised efficiency savings. The wider sector remains appealing, but the company most deserving of our attention is difficult to determine. ■

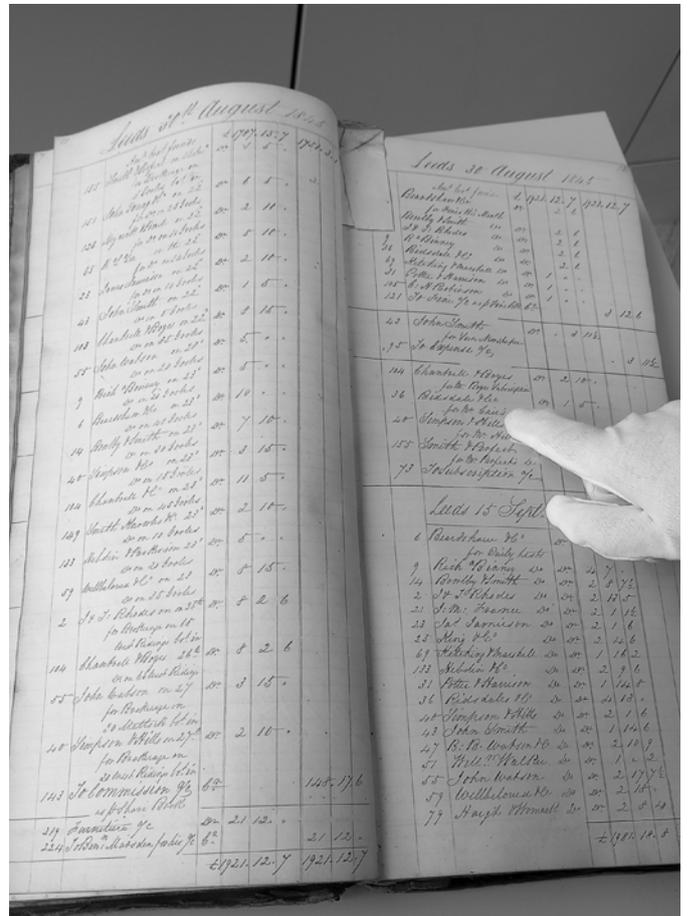
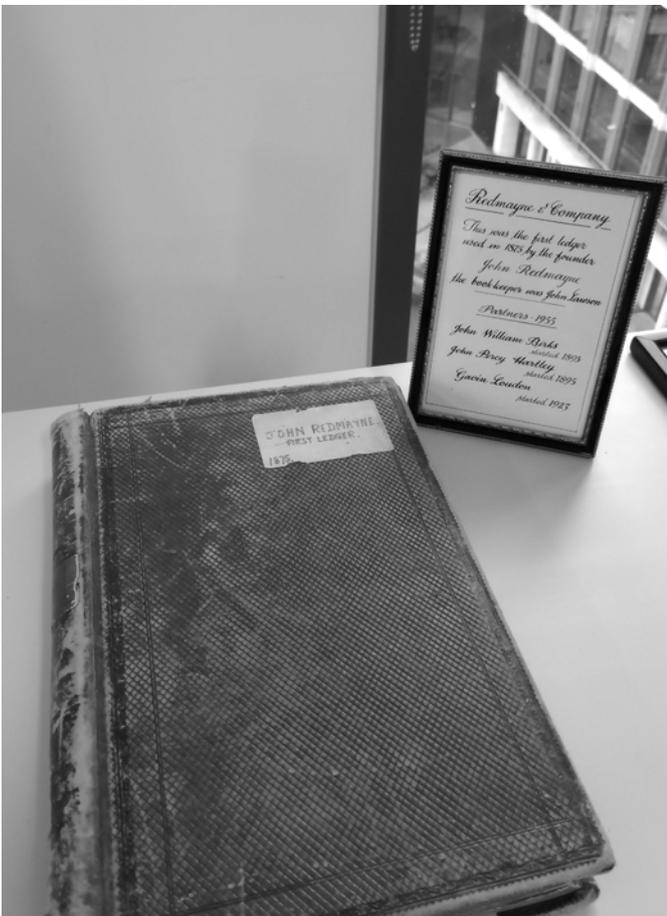
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INSIGHT



COMPETITION IN UK PLATFORM INDUSTRY

GREG LODGE | PERFORMANCE & RISK ANALYST



Investing looked very different when bank clerk John Redmayne set up his own stockbroking firm in 1875. I've recently had a look through some of the documents the firm still has from those early days. Neat columns in a leather-bound ledger list the various transactions in an elegant hand and it still smells faintly of what I think is pipe smoke. Nearly 150 years later and stockbroking has been through some changes. The Leeds Stock Exchange is gone, merged into the London Stock Exchange, and the dealing team don't wear top hats to the office

anymore. Perhaps one of the most significant changes, however, is the increased accessibility of stockbroking and investment management to everyday people. No longer the sole preserve of the already wealthy, today anyone can invest in one way or another, be it through a dedicated investment manager, or an execution-only service. Tax incentives in ISAs and SIPPs have helped to create interest in investing and attract a wider audience. A recent survey by finder.com revealed that 23% of Britons had invested in the stock market as of 2024.

Given what we might call the democratisation of investing, coupled with the possibilities presented by technology, various platforms have emerged over the years aimed at DIY investors. One of the best known is Bristol-based Hargreaves Lansdown, founded in 1981 by Peter Hargreaves and Steve Lansdown. Initially an advisor on unit trusts and tax planning, the company has grown to become the largest DIY investment platform in the UK. It holds more than £134bn of client assets. Having listed on the London Stock Exchange in 2007, it became a FTSE 100 constituent and the share price reached an all-time high of over £24 in 2019. Today, however, the share price has fallen to around £7 and the company has dropped out of the FTSE 100. Once seemingly unassailable, the intervening years since 2019 have seen the company confronted with a litany of challenges.

“The start of the troubles can perhaps be pinpointed to the high-profile collapse of Neil Woodford’s flagship fund, Woodford Equity Income... Once regarded as a star fund manager, Woodford was obliged to close and then wind up the fund. Thousands of investors were left with large losses.”

The start of the troubles can perhaps be pinpointed to the high-profile collapse of Neil Woodford’s flagship fund, Woodford Equity Income. Loaded with unlisted small companies, the fund was compelled to sell down its more liquid investments to meet rising redemption requests following poor performance until it could no longer meet the flood of redemptions. Once regarded as a star fund manager, Woodford was obliged to close and then wind up the fund. Thousands of investors were left with large losses. Hargreaves Lansdown had promoted the fund via its ‘Wealth 50’ list and offered its clients a fee discount for buying through its platform. Woodford

Equity Income remained on the list right up until the day it was suspended. Thousands of investors were affected and the company took a significant hit to its credibility. The fallout is ongoing, as a case against Hargreaves Lansdown worth potentially £200m is being pursued on behalf of investors.

The company has also had to contend with increasing competition from online brokers like eToro and Trading 212, while tech-focussed challenger banks like Monzo and Starling also frequently offer a trading platform. Manchester-based rival AJ Bell has been close on Hargreaves Lansdown’s tail, reporting record revenues for its latest financial year. Such challengers have a much smaller market share than Hargreaves Lansdown however, which continues to enjoy prime position, although as ever these things are subject to change. This does present the broker with something of a demographic issue, as the newer trading platforms are increasingly popular with younger investors. The average age of a Hargreaves Lansdown client is now around 46 and the customer growth rate has slowed. As its client base approaches retirement, Hargreaves Lansdown has had to consider how it will retain clients in a ‘decumulation phase,’ a term describing when clients in retirement begin to draw down on their savings.

Co-founder, Peter Hargreaves, who remains the company’s largest shareholder, has also weighed in to express his displeasure at the direction the company is taking. In 2022, Chief Executive, Chris Hill, announced plans to roll out a hybrid advisory service using robotic technology as part of a wider £175m investment in fintech. This was funded by suspending the company’s special dividend. The market did not greet this news with much enthusiasm, as shares fell by nearly 16% on the day of the announcement. In an interview with the Financial Times, Mr Hargreaves said that the board had “indulged in completely unnecessary irrelevant programmes” and that the falling share price was “hardly surprising”. He also levelled criticism at the number of employees and the board’s salaries. In the wake of these comments, the company began succession planning to replace Deanna Oppenheimer as Chair, who had held her role since 2018.

As the investment landscape continues to evolve, there will be opportunities and challenges ahead for Hargreaves Lansdown and other investment platforms. The recent Spring Budget delivered by Chancellor Jeremy Hunt promised an additional ISA allowance of £5,000 for investing in British companies. Technology will be a significant factor. The increasing capabilities of AI will no doubt influence the way we invest in the not-too-distant future. How investing will look in another 150 years, however, is as much of an unknown to us as it was to John Redmayne when he set up his venture all those years ago. ■

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THE BANKING WOBBLE: ONE YEAR ON

SAMANTHA CORY | INVESTMENT RESEARCH TEAM



On 10th March 2023, a significant intervention unfolded, involving the US Government and leading US banking institutions in reaction to issues at a select few US regional banks. In just a few days, three previously unknown banks - Silicon Valley Bank (SVB), Signature Bank, and First Republic – were bought by larger players in the sector to prevent a collapse. Events were not limited to the US, as the Swiss banking system also experienced issues. Credit Suisse was acquired by rival UBS, as deposits continued to decline in the wake of a succession of scandals and failed restructuring plans.

Amid the news of issues at SVB, the S&P 500 financial sector declined nearly 15% in a matter of days as market participants battled with concerns around more widespread issues in the financial sector. European banking shares also wobbled, with Swiss giant UBS down 19%, along with other names listed in the region. It was not just the share prices that took a tumble, however, given the nuances of the takeover of Credit Suisse. Some holders found their bonds had been repriced to zero as part of the UBS takeover deal, causing the European subordinated banking debt sector to experience a sharp decline. The securities in question were Additional Tier One (AT1) bonds, a debt instrument lower down the quality



spectrum in the capital structure that forms a part of a bank's regulatory capital. Subordinate bonds of other European banks followed suit, with prices declining over fears of the security of the bonds.

In the following weeks, a wave of stabilisation took place in the banking sector, buoyed by the proactive measures taken by government bodies and industry leaders. Consolidation occurred, as large multinational institutions acquired smaller banks, in a concerted effort to restore confidence in the sector. Notably, SVB, renowned for its focus on serving technology and innovation companies, was in a pivotal position as it was acquired by First Citizen Bank – and the UK arm was sold to HSBC for £1.

Among this, First Republic Bank was also in the spotlight, receiving funding offers from the Federal Reserve and JP Morgan. In a collaborative effort to gather liquidity and secure the bank's position, US\$70bn was provided from JP Morgan, alongside a liquidity pool from eleven other banks, amounting to US\$30bn. This, amongst the increased monitoring of the financial system and heightened liquidity levels, bolstered confidence and restored faith in the resilience of the banking sector.

Since the issues, the banking sector has performed well. We have seen a rewarding recovery in the European market, with many posting record profits and double-digit gains in their shares. A year on from the strategic acquisition, UBS's share price has shown a remarkable increase of 60%. This surge not only highlights investor confidence but also attests to the success of the integration of Credit Suisse. The synergy between the two entities has begun to materialise, evidenced in

a substantial US\$3bn in cost savings and it is hoped these will expand further in the future. Additionally, it has anticipated a 27% increase from its 2023 dividend and the restart of share buybacks this year. This is not only specific to UBS, as the higher interest rates have aided banks profitability, enabling banks NatWest and HSBC to report significant dividends and take part in buyback schemes.

Many investors will remember the banking sector issues experienced during the financial crisis. Still, the industry has come a long way since, and the recent wobbles experienced appear to be cast aside as the more prominent names in the industry have proved their stability. Banks have de-levered and strengthened their balance sheets, lending practices have improved considerably, and the risky activities once seen within some institutions are no longer. These events are all positive from a credit risk perspective, and it is no surprise to see financials as the largest sector within many fixed-income fund managers' portfolios. On the equity side, higher levels of profitability via returns on equity, increased dividends, and announcements of large-scale buyback programmes could prove positive for share price returns. Banks in general are on sound footing, but their revenue models will be tested over the next year, as they adapt to the new competitive dynamics. ■

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CONSOLIDATION IN THE REIT SECTOR

KONRAD PIETKA | INVESTMENT RESEARCH TEAM



Last year proved to be a lacklustre one for Real Estate Investment Trusts (REITs), especially so when considered against certain equity and fixed-income sectors, which offered historically attractive levels of income and capital appreciation.

A combination of macroeconomic factors and poor investor sentiment around the sector has resulted in discounts becoming widely available. At the time of writing, Tritax Big Box shares trade at a discount of c18% to Net Asset Value

(NAV) and Primary Health Properties at c15%. Having historically traded at premiums, the downward slide of share prices in the sector has been a pain point on portfolio valuations. On the flip side, the wide discounts offer a potentially appealing entry point for income seeking investors. It is not just investors who are drawn to the current discounts on offer, many property funds have also been seeking out opportunities to purchase entire portfolios for a relatively cheap price, leading to an uptick in Merger and Acquisition (M&A) activity this year.

LondonMetric, for one, is no stranger to snapping up competitor portfolios, with a string of acquisitions in recent years, recently acquiring CT Property Trust for £200m in 2023 to take the total combined portfolio to £3.2bn in size. LondonMetric CEO Andrew Jones was not done there though and endeavoured to go after a much bigger catch, namely its peer, LXI REIT. A £1.9bn acquisition offer was sufficient to sway over the LXI shareholders, with the merger finalised on 6th March 2024 to create a combined entity with a portfolio value of £6.2bn. The move also marked the creation of the UK's largest triple net lease focused REIT. For those not familiar, a triple net lease is an arrangement whereby the tenant is responsible for covering all, or most of, the costs related to the rented building, such as insurance, taxes, and maintenance. This structure can be particularly advantageous to the landlord given the potentially significant reduction in operating costs.

“While the larger players in the sector are seemingly making things look easy, in the mid-range of the REIT space, activity requires the boxing gloves to come out, with competition intense as vehicles struggle to complete the task of acquiring peer portfolios at attractive valuations.”

As a result, LondonMetric has been able to keep expenditure substantially below that of its peers, with a costing ratio (operating expenses as a percentage of gross rental income) of 11.5%, compared to the sector average of 24.5%. The new entity will be managed and administered internally, enabling the REIT to axe LXI's investment management agreement with the prior manager. This decision will create cost savings of £13m per annum, helping to bring the costing ratio further down into the 7-8% range by 2026, and improve alignment between management and shareholders.

Merger synergies are also conducive to improvements outside of the company's cost base. Greater scale offers improved

liquidity and potentially draws in a wider range of investors. Alongside the improved access to debt markets and lower debt costs, there is also a wider range of potential financing arrangements.

It is unsurprising then to see others within the sector watching with interest, waiting to get in on the merger action. Tritax Big Box, the industrial logistics focused company, is the latest significant player in the industry to try its hand at merger activity, with a proposed takeover of UK Commercial Property REIT (UKCM) announced recently. Both have significant exposure to logistics assets, making the portfolios broadly complementary, but with 40% of UKCM's portfolio allocated to non-logistics assets in areas such as retail and student accommodation, a few eyebrows might be being raised. Another point of interest crops up in the deal, the composition of the shareholder register. Nearly 60% of the UKCM shares are held by two institutions, which quickly followed the announcement with their own letters of support. This poses a question as to whether the Tritax team are acquiring the best portfolio possible or simply the easiest one.

While the larger players in the sector are seemingly making things look easy, in the mid-range of the REIT space, activity requires the boxing gloves to come out, with competition intense as vehicles struggle to complete the task of acquiring peer portfolios at attractive valuations. A prime example of this is the battle between Urban Logistics REIT and Custodian Property Income REIT (CREI), both competing to acquire ABRDN Property Income Trust (API). Despite Urban Logistics' offer coming in at a 13% premium to CREI's bid, the API board has urged shareholders to back a merger with CREI instead, citing how a tie-up with the latter represents “a strategically consistent and significant enhancement to the status quo for API shareholders.” API shareholders are to decide on both proposals in late March.

Clearly, the recent macroeconomic environment has not been particularly pleasant for REITs. Resetting property yields, concerns over higher debt costs, poor investor sentiment, and abundant opportunities for yield elsewhere have all proven to be headwinds. However, consolidation induced by these circumstances is undoubtedly positive for the sector. The merging of smaller REITs into larger entities brings about various benefits, such as cost-savings and liquidity, as seen in the examples above. This, together with the prospect of future interest rates cuts, renders the larger REITs more viable for investors from a liquidity, income, and capital appreciation perspective. Consequently, some leading REITs are now well positioned to benefit from a potential reversal in macroeconomic conditions and sentiment in the medium-term. ■

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