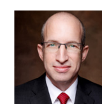
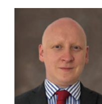
Home Bias Can Hinder Performance for UK Equity Investors

Excessive allocations to UK stocks may limit risk-adjusted returns.

July 2020



Yoram Lustig
Head of Multi-Asset Solutions, EMEA



Michael Walsh
Solutions Strategist, EMEA

KEY INSIGHTS

- Many UK investors display home bias in their equity allocations as overseas markets are often perceived as riskier and more difficult to access.
- Too much home bias will likely result in heavy exposure to sterling and an overweight to "old economy" value stocks over "new economy" growth stocks.
- UK investors who allocate more to overseas markets may achieve better risk-adjusted returns.

Home bias in equity portfolios is common in the UK, as it is in other countries. According to industry research,[1] UK institutional investors recently held almost 30% of their equities in UK companies; among retail investors, the figure was more than 45%. To put this in context, the weight of the UK stock market in the MSCI All Country World Index (ACWI) is about 4%.[2]

It is easy to understand why many UK investors display home bias. Overseas markets are often perceived as riskier and more difficult to access than the UK market, requiring greater levels of research and expertise. By comparison, the London Stock Exchange, with its long-established reputation as one of the world's leading financial centres, is seen by many an easier, cheaper, and safer place to do business.

However, foreign equity markets are becoming more accessible, and the risks associated with investing in them have diminished as currency hedging has become more widely practiced. What's more, globalisation has meant that UK investors are just as familiar with foreign names like Samsung and Apple as they are with Tesco or Barclays. As overseas markets open up, UK investors with too much home bias may be missing the opportunity to diversify their portfolios and boost risk-adjusted returns.

The Impact of Home Bias on Portfolios

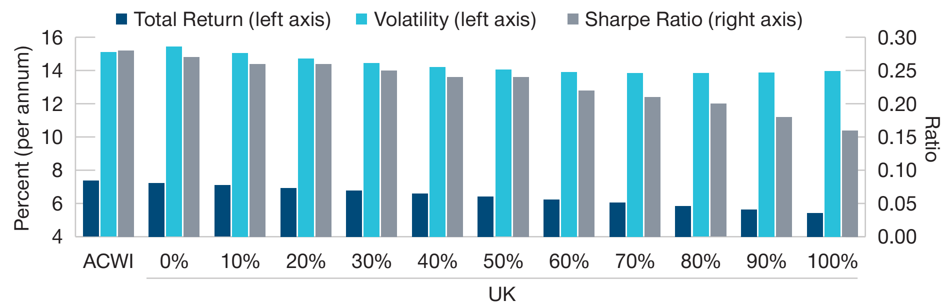
Because the UK stock market includes a large number of stocks and is well diversified, UK home bias is not as risky in terms of concentration risk and volatility in comparison with other countries with narrower local

[1] Pension Protection Fund. 2019. "The Purple Book 2019." Simple average UK equity exposure of UK defined benefit schemes.
[2] MSCI (see Additional Disclosures) as of 31 May 2020.

> Overseas markets are often perceived as riskier and more difficult to access than the UK market...
>
> **— Yoram Lustig**
> *Head of Multi-Asset Solutions, EMEA*

Too Much Home Bias Hinders Returns

(Fig. 1) Hypothetical risk-adjusted return of equity portfolios with different levels of UK home bias



Past performance is not a reliable indicator of future performance.
As of 31 May 2020.
MSCI All Country World Index (ACWI), MSCI ACWI excluding UK, FTSE 100. X% UK represents X% allocation to the FTSE 100 and (1-X)% allocation to MSCI ACWI excluding UK. Calculations based on monthly index total returns measured in GBP over the period January 1990 through May 2020.
Sources: MSCI and FTSE/Russell (see Additional Disclosures); analysis by T. Rowe Price.

stock markets. However, according to our analysis, over the past 30 years, stronger UK home bias would have resulted in lower risk-adjusted returns as measured by the Sharpe ratio of a global equity portfolio (Figure 1).

This is partially because of the underperformance of the FTSE 100 relative to ACWI excluding the UK and partially because of the depreciation of the British pound sterling, boosting foreign stock investments denominated in other currencies.

The FTSE 100 and Sterling: An Inverse Relationship?

Although the FTSE 100 used to be the bellwether of the UK economy, international corporations have largely replaced the UK-focused businesses and conglomerates in the index, reflecting the globalisation of the UK, its greater focus on overseas markets, and takeover and merger activity. From an index that reflected the fortunes of the UK economy in 1984, the FTSE 100 has evolved to reflect the fortunes of the global economy in 2020.

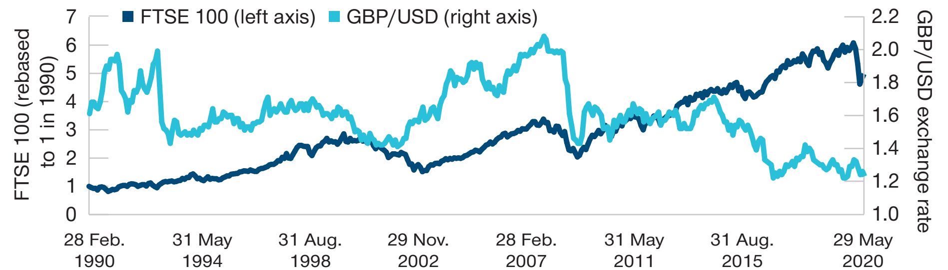
The increasingly global focus of the largest UK-listed companies has meant that their share prices can be driven to a large extent by moves in sterling. While stocks incorporated and traded in the UK are denominated in British pounds sterling, the export-oriented nature of the FTSE 100 companies has meant that the index has tended to have an inverse relationship with the currency in recent years. When the pound appreciates, exports of British companies with overseas sales suffer because what they sell becomes less competitive, and vice versa. The FTSE 250, representing the next 250 largest listed UK firms, is more appropriate for investors whose base currency is the pound and who would prefer that currency moves have less impact on the value of their investments.

In periods of high uncertainty for sterling, currency movements can have a major impact on how the FTSE 100 fares relative to the FTSE 250. For example, following the UK's referendum decision to leave the European Union in June 2016, the resulting fall in sterling was a major factor in the FTSE 100's relative outperformance against the FTSE 250 over the remainder of 2016—the FTSE 100 was up 15% by the end

> ...stronger UK home bias would have resulted in lower risk-adjusted returns as measured by the Sharpe ratio...
>
> — **Michael Walsh**
> *Solutions Strategist, EMEA*

An Inverse Relationship

(Fig. 2) The British pound sterling and the FTSE 100



As of 31 May 2020.
FTSE 100 monthly total returns measured in the GBP and the GBP/USD exchange rate over the period January1990 through May 2020.
Sources: MSCI and FTSE/Russell (see Additional Disclosures); analysis by T. Rowe Price.

of the year, while the FTSE 250 only saw a 6% rise over the same period.[3]

The Sectors of the FTSE 100: Old vs. New Economy

Investing in UK stocks also means taking a view on certain sectors. Compared with the S&P 500 and the MSCI ACWI indexes, the FTSE 100 overweights the four sectors most associated with value—financials, utilities, consumer staples, and energy—and underweights the two sectors most associated with growth—information technology and consumer discretionary.

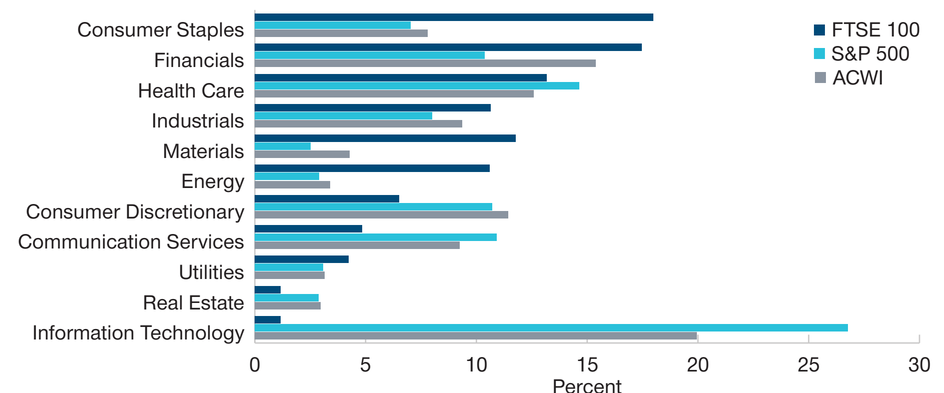
Investing in the UK stock market is therefore to take a view that "old economy" sectors are likely to outperform "new economy" sectors and that value stocks are likely to outperform growth stocks—indeed, this has been a major reason for the underperformance of the UK market versus global equities in recent years.

Looking to the Future: Yield Scarcity and Dividend Yield

The UK faces major secular global geopolitical changes. These include Brexit, U.S.-China trade tensions, the

Bias Toward Value Over Growth Has Led to Underperformance

(Fig. 3) Sector weights of the FTSE 100, S&P 500, and ACWI

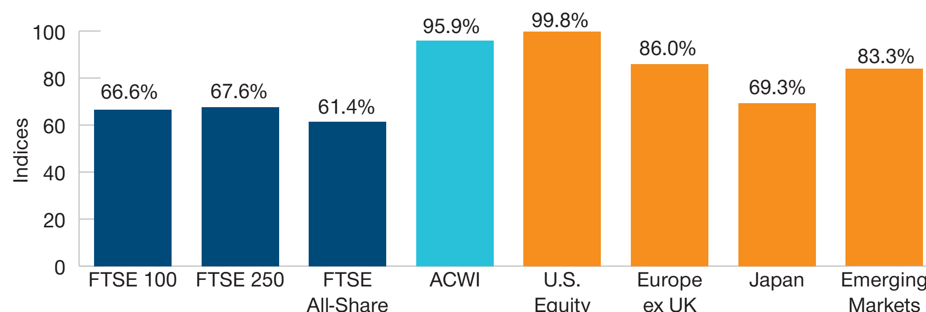


As of 19 June 2020.
Sector weights of FTSE 100, S&P 500, and MSCI All Country World Index (ACWI) as of 19 June 2020.
Sources: FTSE Russell, S&P, and MSCI (see Additional Disclosures); analysis by T. Rowe Price.

[3] Source: FTSE Russell (see Additional Disclosures); analysis by T. Rowe Price. Total return from 24 June 2016 through 31 December 2016.

The UK Market Is Currently Undervalued

(Fig. 4) Valuation of equity markets as of June 2020 relative to history



As of 30 June 2020.
Indices used: FTSE 100, FTSE 250, FTSE All-Share, ACWI, S&P 500, MSCI Europe excluding UK, MSCI Japan, and MSCI Emerging Markets. Percentile of valuation metric as of 31 May 2020 compared with past levels over the last 15 years. Valuation metric is an average of 1-year forward-looking P/E (price to earnings), P/B (price to book), and P/CF (price to cash flows).
Sources: FTSE Russell, S&P, and MSCI (see Additional Disclosures); analysis by T. Rowe Price.

"...any change to UK home bias should be implemented gradually.

— **Yoram Lustig**
Head of Multi-Asset Solutions, EMEA

future of the European Union, and the changing post-coronavirus world. While change means risks, it also means opportunities. During turbulent times, prices may fall, making valuations attractive, and when certainty returns, depressed prices may climb. Coming out at the other side of the uncertainty of Brexit and COVID-19 (the disease caused by the coronavirus), the UK may be attractive for investments.

We expect the UK stock market to perform relatively well compared with other stock markets over the next five years. The five-year annualised expected return for UK equity is 7.7%, compared with 5.7% for global equity, 4.7% for U.S. equity, and 6.7% for emerging market equity.[4]

However, completing Brexit is likely to impair UK economic growth as domestic firms face costs of doing business with their largest trading partners in Europe, pushing up wages and inflation. In this environment, the British pound sterling is likely to strengthen marginally but remain relatively weak. Because the UK equity market is so internationally focused, a weak currency will help to lift earnings and boost the dividend yield. The UK equity market also benefits from a relatively attractive valuation following years of underperforming other equity markets (Figure 4) and high dividend yield compared with other equity markets, an advantage in an environment of low yields.

Casting a Wider Net

The size and breadth of the UK equity market means UK stocks have a place in global equity portfolios and not only those of British investors. While some UK home bias is understandable and should not materially impact long-term results, an extreme home bias might cause a global equity portfolio to become suboptimal. Reducing exposure to the UK market does not mean that all holdings need to be global in nature. Exposure to UK companies can continue to be obtained through strategies investing in the UK stock market, or through European or global strategies that can select the best UK stocks. Additionally, investors who are looking to obtain more targeted exposure to the UK economy via an equity investment may

[4] Source: T. Rowe Price. 2020. "Capital Market Assumptions: Five-Year Perspective 2020." Annualised forecast in British pounds sterling.

find it worthwhile to consider a portfolio benchmarked to the domestically focused FTSE 250, rather than to the global behemoths of the FTSE 100.

Given the current attractive valuations of the UK stock market and weak British pound sterling, any change to UK home bias should be implemented gradually. This will help investors to avoid selling stocks and sterling at depressed prices and, instead, would average out the prices of selling and buying rather than betting on a price at a single point in time. This pound cost average is an approach we look to adopt, especially when making larger strategic changes to investor portfolios.

Additional Disclosures

London Stock Exchange Group plc and its group undertakings (collectively, the "LSE Group"). © LSE Group 2020. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company's express written consent. The LSE Group does not promote, sponsor or endorse the content of this communication.

MSCI and its affiliates and third party sources and providers (collectively, "MSCI") makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI. Historical MSCI data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. None of the MSCI data is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such.

The S&P 500 Index is a product of S&P Dow Jones Indices LLC, a division of S&P Global, or its affiliates ("SPDJI"), and has been licensed for use by T. Rowe Price. Standard & Poor's® and S&P® are registered trademarks of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"). T. Rowe Price's products are not sponsored, endorsed, sold or promoted by SPDJI, Dow Jones, S&P, their respective affiliates, and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability for any errors, omissions, or interruptions of the S&P 500 Index.

INVEST WITH CONFIDENCE℠

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T.RowePrice®

Important Information

This material is being furnished for general informational and/or marketing purposes only. This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request.

It is not intended for distribution to retail investors in any jurisdiction.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA ex-UK—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

© 2020 T. Rowe Price. All rights reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the bighorn sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc.

ID0003507 (07/2020)
202007-1249033