

TRANSCRIPT
PENSIONS FOR PURPOSE PODCAST SERIES 2, EPISODE 10
INVESTING IN THE UK

Laasya Shekaran: Hello everyone, and welcome back to the Pensions for Purpose Podcast, I'm your host Laasya Shekaran. Today, we're joined by Judith MacKenzie, Partner and Head of Fund Managers at Downing. Judith, it's great to have you here.

Judith MacKenzie: It's great to be here, thank you.

Laasya Shekaran: My Pensions for Purpose Co-host today is David Brown. David, it is great to have you back on the podcast today.

David Brown: Yeah, it's great to be here, with so much focus in the news today on global markets and politics, such as tariffs, I'm really interested in the topic of the podcast today, focusing on our home market in the UK.

Laasya Shekaran: Yes, absolutely, because this has been an area that's been a big focus, especially in the UK pensions world at the moment. We've been hearing lots of talk about how UK pension schemes can invest in a way that supports the UK, how this could benefit members in the long-term, but also how you actually do it in practice, and how can you align these broader economic goals for the country with the financial goals of pension schemes. We're really going to be getting into all of that in today's discussion with Judith. Let's start at the beginning, what does the investable universe actually look like when it comes to investing in the UK?

Judith MacKenzie: I'm going to concentrate predominantly on what is called the AIM (Alternative Investment Market). That is the junior market of the London Stock Exchange, and that's got about 600 companies on it, and it's this area of the market that Mansion House Compact has been urging pension funds to look at.

So, what is AIM, and what does that look like. It's been around for about 30 years. In fact, it has its 30-year anniversary this year, and over the last five years it's raised 54% of all growth capital in European markets. So it really deserves its own merits, or it goes on its own merits.

Since inception in 1995, it's supported more than 4,000 companies and raised about £135bn, so it's a well-established market, and if you look at actually what it contributes to the UK, it's contributed £68bn in gross value added to the UK economy and has supported over 770,000 jobs. So nearly a million jobs.

In terms of what it's contributing, £35bn per annum is contributed in salary. So that's actually paying for people's jobs, which is great. Just looking at it as an investable universe itself, it's an index that does have quite attractive metrics. It's got 22.7% forward earnings growth. And you compare that to the FTSE and the FTSE 250, they're on about 10% earnings growth for the next few years. So it's also giving some really decent growth to investors.

We've touched on it there, what's happening in international markets. I actually think, compared to some international markets, the UK is looking very investable at the moment. So it's cheaper, it's a growth market and it outperforms over the long term.

I've been running these AIM portfolios now for about 13 years, and we're up 165% since we started. So that's about compound growth rate of about 7.8%. Compare that to the FTSE All Share at about 6.5%, so it's a good, vibrant place to be investing.

David Brown: So there's some great financial analysis that you've shared with us, Judith, around the AIM market, and obviously, we've got now a much greater focus on domestic investing in the UK, not just by the current government, but also the previous government. I'm thinking here of things like the Mansion House Accord and the Mansion House Compact. So, against that background, what do you see as the pros and cons of investing more broadly in the UK, given the current geopolitical context?

Judith MacKenzie: Yeah, it's been said now quite a few times that the US is almost making itself uninvestable. I think, in contrast, the UK actually looks pretty stable. Tariffs are obviously on everybody's mind at the moment, and if you look at the inflationary impact of tariffs, it's said to be about 1.3% for the US. Then, if you look at the UK market, which is far more service led, then it's pretty much flat in terms of tariff impact, apparently.

You're not really getting that GDP drag that you might get in the US at the moment. So actually, I think there's going to be more likelihood of UK banks cutting interest rates, which is always good for UK equity markets. So yeah, it just feels a lot more stable in terms of a worldwide economy than some of our international peers at the moment, and it's cheap. We're seeing quite a lot of M&A (mergers and acquisitions) activity, large companies coming in and taking out some of our domestic earners, and therefore, if other companies in private equity think that our companies are cheap, we should be investing in them ourselves as well.

David Brown: Lots of pros there then, Judith. Are there any cons that our listeners should be thinking of too?

Judith MacKenzie: Yeah, the elephant in the room with regard to AIM, the smaller junior market of the London Stock Exchange, is that the number of companies on it has reduced about 36% since 2018. There used to be about nearly 2,000 companies. There's now about six or seven hundred companies. So that's not great, and the reason that they have been declining is – well, it's probably a multitude of reasons.

It's probably about that dequitting of the UK market that we've seen over the last 10 years, but I do think that is turning. We've had quite a lot of companies taken out; 16 companies so far have gone due to mergers and acquisition, and 44 companies are considering leaving the AIM market.

Judith MacKenzie: Some are moving to the main market, and there's quite a few companies delisting, but AIM itself, the London Stock Exchange has put it under a bit of a review, and I do think it will probably come with a little bit of a kickstart over the course of the rest of the year. So that's really my caution: we need more IPOs (initial public offerings) coming to the UK market to create the vibrancy that is healthy.

Laasya Shekaran: I guess, even with that con, you've given quite a clear financial case for investing in the UK, just from a pure risk-return diversification point of view, but one of the main reasons that the Government is so interested in getting pension schemes to invest in the UK is to actually support the UK economy more broadly. So, supporting UK jobs, and supporting the standards of living that people in the UK have.

How can you make sure we're not just investing in companies that happen to be listed in the UK, but are having their economic impact elsewhere, how do we make sure we invest in the UK in a way that actually supports the UK?

Judith MacKenzie: To be honest, on AIM and small cap, it happens for you anyway. The majority of companies have got a UK postcode and UK employees, so it's not like the FTSE 100, or some European companies who, as you say, might have a listing in the UK or in Europe, but are operating elsewhere. Over 60% of their earnings are domestic earnings, and then, when they've got international earnings, it tends to be because they've got export businesses as well. So it really does happen for you. And I think that's one of the real benefits of investing in the UK and the UK market, and in AIM in particular, you're buying a widget manufacturer that's in Manchester or Birmingham, or whatever; there are some really good clusters of companies throughout the UK that you can literally go and touch, feel and kick. So it's a real benefit, I think, to investing in this side of the market, and given the number of employees that we were looking at as well.

I mentioned nearly a million, and that's just on AIM. That's people that are employed here, and just thinking about what you might see in the high street, you've got companies like The Works, you've got Ramsdens, you've got Harvey and Thompson pawnbrokers, you've got Card Factory. These are all household names, and household names that employ people in our high streets, so really contributing to local economies.

David Brown: So really upbeat message there, then, Judith. I'm going to just change the emphasis if I may, just for a moment, in thinking about many pension funds have set their net-zero goals, or other people and planet sustainability and impact goals potentially linked to the sustainability development goals. So, against this backdrop of sustainability and impact, how does investing in the UK fit with these sustainability and impact goals?

Judith MacKenzie: Some of those would entail supporting affordable housing, for instance, infrastructure, development and job creation that we just talked about. I can immediately think of a handful of companies that we've invested in, and are on our list to invest in as well. So you've got companies like Springfield Properties and Hargreaves Services. Springfield Properties, for instance, they provide affordable housing in the north of Scotland, an area that really needs affordable housing, as there's a dearth of supply up here. Hargreaves Services is quite an interesting business, so it almost contradicts itself when I tell you what they used to do; they used to be the largest producers of coal in the UK, but now they're no longer producing coal, and they're using their old coalmines to reclaim land. They've got housing projects in Edinburgh and the North of England, for instance, and, more importantly, they employ over one thousand people in the UK, direct employees in the UK.

Then you've got climate aspects, I would say you always have to be a stock picker when it comes to investing in Alternative Investment Market, because sometimes the information that you get through the company's report accounts might not be as good as some of the information you'd get if you're investing in a large FTSE company, but if you do a little bit of digging, you can really find some really great climate-focused companies. One of them is a little business that we've invested in, called Anpario plc, and they provide natural food additives for animal feeds, and with a real look in mind on climate and net-zero. We've actually helped them with some of their disclosures when it comes to their net-zero commitments. We've got some great companies that are making these contributions that you probably wouldn't know that you could stumble on in the UK.

Laasya Shekaran: What would your approach be if as you said, there's lots of different companies within that AIM market, and the stock picking approach is one that can help you identify ones that are doing good for the climate. For other ones that perhaps aren't so positive on climate, would your stance be just not to hold them, or would you hold them and engage with them and work on transition, how would you think about those companies?

Judith MacKenzie: I think the investors in this space are quite proactive. Maybe, when we're buying a share, we are thinking about buying the whole company. We actually take the social responsibility ourselves, because when we're investing in the Hargreaves, I want to make sure that we're a long-term investor supporting them, whether they want to do mergers and acquisitions, where they want to maybe invest in a factory — or maybe not Hargreaves, invest in a site that's maybe out with their core area. Or if it's a widget manufacturer, if they're trying to increase their own footprint. So we really are working in partnership with these companies.

And you're right, sometimes they don't always fit all the criteria all of the time. And we find that our responsibilities, when it comes to governance, are particularly important. So when I talk about that, I mean that we will get involved with boards, we'll introduce new non-exec directors and we'll work alongside management teams to help them hopefully get the best out of their companies. So it's not just money that we're providing. It really is that governance aspect as well.

And as we're going through that, we often find companies that are not very good at the disclosure side, and especially when it comes to sustainability credentials, but actually, once you start doing the work with them, you realise that they're doing all the aspects of good employment and net zero quite well, but they're just not very good at articulating it. So that's where we can come in and hopefully help, and give them a bit of a framework as to how to communicate with their market, and other shareholders.

Laasya Shekaran: It sounds like that collaborative approach is really important, and that you're not just investing it, and then forgetting about that you have that ongoing collaboration.

Judith MacKenzie: Definitely, and we pride ourselves in spending more time with our investments than probably, maybe, some of our peer groups higher up the market cap curve. We're lucky enough to invest in between 25 and 40 companies; it's myself and my colleague doing it. So it means that we can be pretty hands on, and, as I say, it goes back to that partnership aspect. We've had companies in our portfolio for 13 or 14 years. I've invested in some of those companies for 20-odd years. And they provide the returns for us as well. We're not just doing it for social reasons. We're doing it for investment reasons as well.

Laasya Shekaran: Absolutely, another big word that comes up when we talk about investing in the UK is this idea of mandation, and there are a lot of strong opinions on either side. Some people think it's not going to happen, or not going to happen at a sufficient level without mandation, and others are really worried about what that means for financial goals and diversification. So what's your take on all of this, and what do you think about mandating investments in the UK for pension schemes?

Judith MacKenzie: I think when anybody's told to do something, they tend to do the opposite... I certainly do, anyway. So I think, AIM itself; it's a market that deserves investment in its own right, so I think certainly having more of a nudge and education around AIM and UK smaller companies is important, so I don't think mandating itself is the solution, but we're already seeing quite a lot of inbound interest from pension funds to look at the space, because of the attributes that I've already just talked about. So I think we will see, and through the

course of this year, I already know that there is some pension fund money starting to flow into AIM and small cap in the UK.

So, it goes back to what I was saying at the beginning: these companies, they provide growth in terms of employment, they provide growth in terms of investment returns, and really they deserve to be invested in, because they're cheaper than they've been at any point in my career, really. So it's an interesting juncture to be making a decision to allocate to this area of the market.

Laasya Shekaran: What size allocations do you see pension schemes making to AIM within the overall portfolio context?

Judith MacKenzie: It's a good question. So different schemes are different sizes, but I would certainly see an allocation. I know some pension funds are looking at £1bn plus allocations, I would say, if I even just look at it from a portfolio allocation point of view for individuals, the likes of myself investing; I probably invest way too much in small cap, so I'm not a good example, but I would say for UK, small cap and AIM, there should be 5 to 10% of a portfolio, really. At least to get the exposure that you're looking for and the returns that you're looking for. We've got people that are dramatically more than that, and it's not done them any harm over the years, it is a really good long-term place to be investing in terms of UK small cap. They've driven returns that are in excess of some US markets, even some international markets.

David Brown: It is really good to hear some examples of pension funds actually allocating monies to AIM without mandation. Another area, potentially, where mandation has been thought about in the past, and that's around the place-based investing agenda. So we do see some good examples of LGPS (local government pension schemes) pension funds adopting a place-based lens. Greater Manchester Pension Fund comes to my mind straight away to name just one. But more generally across the pensions industry, how do you see regional and place-based investing fitting into investors' decisions to invest in the UK?

Judith MacKenzie: I think it goes back to the point I was making earlier that, you know, these are companies with UK postcodes, and if I look down the list of 600-odd companies and look at where they are throughout the UK, not that many are in London, so it does actually lend itself to place-based investing because of that. I think you always have to be a little bit careful when you're limiting the universe that you're investing in, and it's a relatively good, but a relatively small, universe. Then you might end up with clusters of maybe 30 to 40 companies in any one area, so I would certainly say, don't narrow it down too much, but if you've got a bias towards the northeast or northwest, then you've certainly got enough companies there to be able to cherry pick from.

Actually, they're not all doing the same thing, the UK has got a good service-based economy, as we know, and therefore you're getting a good mix of technology companies alongside the widget manufacturer that might be down the road. So, I wouldn't take a blanket approach to it, but I do think the AIM market itself lends itself to that investing. I think it's also self-propheying to a certain extent. We've talked about some of the negative aspects of not having as many companies as we'd want on the market. It will only take a very small amount of capital. I'm talking about maybe one of the first or second allocations from pension funds into AIM and small cap for that to change, because as soon as there's capital available, the companies will come, and there's more than sufficient unlisted companies that are not on the market, who will be enthused and end up coming to market to make that overall ecosystem a lot healthier than it is today, or more healthy than it is today. So it is self-perpetuating in terms of that. If money comes, the companies will come, and then performance comes on the back of it as well.

David Brown: So that's really interesting, because that's always one of the comments you hear, that maybe if we provide the capital to the UK, is there the investable universe for that money to be deployed and it seems as though from your experiences that clearly is the case.

Judith MacKenzie: Most certainly, there's certainly enough. There are sufficient companies to make it justifiable now, and when further capital comes in, then there will certainly be more than enough, more than more companies coming to market, and it'll be a very, very vibrant market for us here.

Laasya Shekaran: The other thing that's really interesting to me about that is that we seem to also be getting a lot of interest in investing more in unlisted assets. So there's encouragement for pension schemes to invest in unlisted UK companies. But actually, the idea you presented is a little different: that if you invest in the listed market, some of those unlisted companies will then be more likely to list, and obviously there are some real liquidity benefits to investing in liquid markets versus unlisted, that makes them more accessible to many pension schemes. What do you make of that?

Judith MacKenzie: I'm obviously going to be an advocate of listed markets and AIM. That's much my first choice, but I've invested in many an unlisted company, a private company in my time, and I think the benefit of the AIM market is that, as you say, you've got the liquidity, you've got the visibility, you've got the governance, you've got the reporting structure, and these companies are reporting on their net-zero and their ESG credentials. You don't get that necessarily in a private company, and you've got far, far more transparency than you would have in private markets, and they're listed on exchange, so you should be able to buy and sell those companies.

So I think investing, or trying to get that growth exposure that you can get in both private and public markets, it's far, far more accessible on the AIM market than it is in private markets. And these companies are there. You don't have to go out hunting for them.

Laasya Shekaran: What do you make of this? There's sometimes an argument that you can be more impactful if you're investing in private companies, so that's where the impact assets are, but if it's the same companies that are then going from being unlisted to listed. Do you still see the same impact opportunities in the listed space, or do you see them becoming available there?

Judith MacKenzie: Yeah, I think you can be as impactful in an AIM company as you could be in a private company. If we're, for instance, investing maybe 10% in a company or 15 to 20% in the company, then we've got the ability to help the impactful nature of that management team, we can help shape them. It's very difficult to do that sometimes in a private company, and actually have the same investor rights that you would have in a quoted company.

You've got to remember some of these companies have almost doubled in size. When we first started looking at Hargreaves Services, it would have been a company that was maybe employing a hundred-odd people. Now, it's a thousand, or, in fact, more than a thousand. So you've got the ability to get the benefit of investment growth, but also the impact growth as well.

Lots of our companies would be going out and looking at merger and acquisitions. So you're not just growing organically; you've got the ability to acquire other companies and help businesses grow. So I think you can be very impactful on the AIM market and in the smaller company market, more generally, probably more so, actually, than the private markets.

David Brown: Today, we've been focusing very much on the UK, but when you aggregate private markets and DA markets, how does the UK compare to other pension systems around the globe that you often hear about, and I'm thinking of the likes of Canada and Australia?

Judith MacKenzie: We're not scoring too well actually, when it comes to investing in our own backyard, which is a real shame, I think. As you probably know, Australia, they allocate around about 40% to domestic companies. Canada's been through probably a little bit of what we've been through as well in terms of deequitisation, and probably turning their heads towards the US. Of course, the US themselves, they invest exceptionally heavily in their own companies. A lot of the asset base in the UK has probably tended to tilt towards the US.

Going back to that point that we're making earlier, there's so much concentration in investing in the Magnificent Seven companies of the US, and that's a frightening concentration actually, when you think about it, and what we're seeing is much more of a tilt, a bit like Canada did as well, or is doing, where I think they're still investing about 10 to 12% of their assets, but they used to invest about 40%.

They're again like the UK, they're really pushing for more investment in domestic companies, and again, like us they've got the domestic companies that support that investment, and they're much cheaper than some of those international US markets. So there's a really good reason to be looking at our own back door as opposed to across the water.

Laasya Shekaran: Yes, especially as there seems to be some stuff going on politically across the water, that is, concerning many investors at the moment.

Judith MacKenzie: Yeah, exactly. Very much so. We don't have that political risk that we've got elsewhere. It might not be that absolutely perfect environment in terms of politics sometimes, but it's far more stable.

Laasya Shekaran: Absolutely, thank you so much for joining us today. It's been a fascinating discussion, and I think it's really brought to life how wide the opportunity set is to invest in the UK: how this aligns with sustainability and impact and place-based investing, and how you can do this in the listed space. If there was one thing you wanted listeners to take away from this, what would it be?

Judith MacKenzie: The UK AIM in particular really needs to be part of an asset allocator's thoughts at the moment. It's cheaper than it's ever been in my lifetime. It provides excellent diversification in terms of investment, it's right in our back door and these are great little companies that deserve our investment.

Laasya Shekaran: Brilliant, thank you so much for joining us today. Listeners, if you want to make sure that you never miss an episode, hit the follow button and remember that you can find us wherever you get your podcasts. Thank you for listening, and we'll see you on the next one.