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Why not UK equities?

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Over the past few years, investors in the UK have become acutely aware of the debts the government has taken on to meet their expenditures. One less known fact is that UK companies have also increased their debt burdens over the past 20 years with the aim of 'optimising' their balance sheets for investors. This all works well when things are going well, but as with our government, when things go wrong, it is investors in those companies that carry the can. Typically, it is the equity holders who have to stump up more cash by subscribing for additional new shares. This will almost certainly arise when the share price has already fallen to reflect the stress which the company balance sheet is under.

Leverage is the amount of debt a company takes on relative to its equity and assets, and it is a key driver of both risk and potential return for shareholders in UK-listed companies. In simple terms, more leverage means more borrowing and a commitment to greater interest payments. If all goes well, the additional borrowed capital generates higher profits to the benefit of equity investors; when the business model falters, equity investors carry the can.

In the UK market, companies use debt because it is often cheaper than issuing new shares and interest payments can reduce taxable profits, which can lift earnings per share when trading conditions are stable. This can support a higher share price because investors tend to reward firms that deliver growing profits and efficient capital structures. However, this positive effect relies on steady cash flows, access to refinancing and a backdrop of manageable interest rates.

When leverage becomes high, the balance shifts and risks to the share price increase markedly. Debt holders are paid before shareholders, so if trading weakens or financing costs rise, more of the company's cash is diverted to interest and repayments, leaving less available for dividends, reinvestment and growth. Equity investors then demand a higher return to compensate for this financial risk, which can push valuation multiples down and weigh on the share price.

Periods of economic stress in the UK have shown how highly levered businesses can see their share prices fall sharply as investors worry about breaches of banking covenants, credit rating downgrades or even the risk of insolvency. In contrast, companies with moderate or low leverage tend to have more flexibility to absorb earnings setbacks, invest through downturns and avoid forced equity raises at depressed prices, which can be supportive for long?term share price performance.

Leverage is therefore a central risk that investors must consider because it directly affects both the resilience of the company and the volatility of future returns. While some borrowing can enhance value when used prudently, too much leverage can quickly turn a business from an attractive growth story into a distressed investment if conditions change. For long?term investors, assessing not just the level of debt but also how easily it can be serviced is essential to understanding the true risk profile behind a share price.

Our strategies have a relatively low exposure to UK equities even though they appear cheap at headline level. In reality, we have found cheaper, faster growing exposure in Asia with significantly less debt on the company balance sheets as Asian management teams saw the damage excessive debt caused in the late 1990s. This provides a better risk/reward trade-off in our view in a world where unexpected events are occurring almost daily. This does not mean we do not like UK businesses, just that the way their balance sheets are structured requires close examination before we see the investment opportunity.