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CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

THE EVOLVING U.K. EQUITY MARKET

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The Evolving U.K. Equity Market

The U.K. equity market is significantly different from many other large developed markets. Some of those differences are long-standing (e.g., its concentration and exposure to non-domestic economies), while others reflect more recent developments, but each affects the market's investment characteristics.

What Hasn't Changed—*Heavy* Concentration and *Heady* Foreign Exposure

The London market has for years been extraordinarily concentrated in the shares of the largest firms. The broad FTSE All-Share Index contains 667 companies, but the smallest 75% of constituent firms account for only 9% of the index's overall market capitalization, while the largest 50 account for 76% and the ten largest, 44% (Table A). Contrast this with other broad market indices, such as the United States' Russell 3000®, where the largest 50 names account for 39% of the index by market capitalization and the ten largest names represent just 16%.[1] The implication of this concentration for index-oriented investors is, of course, that if HSBC sneezes, the U.K. market catches cold.

Another long-standing factor is the heavy dependence on foreign revenues of the large firms that dominate the index. For the past six years, firms in the FTSE Top 50 Index have generated half of their revenues outside the United Kingdom (Table B). While U.K.-listed multinationals and their shareholders have benefited from exposure to fast-growing developed and emerging markets for their products and services (and likely will continue to do so), this factor may have actually served as a bit of a millstone in recent years as the pound sterling galloped higher.[2] However, with the U.K. housing market beginning to buckle and the economy showing weakness, the pound sterling is now looking much less vigorous and the heavy exposure to foreign revenue sources could again prove beneficial if the currency's slump persists.

Fund Raising for Miners and Drillers

While the pound sterling has lost value versus other paper currencies, nearly all currencies have lost value versus hard commodities. And as the prices of metals and hydrocarbons have skyrocketed, so have the U.K. market's weightings in energy and mining firms. A decade ago, oil & gas companies accounted for less than 8% of the FTSE All-Share, and basic materials contributed an additional 3%. Today, the two sectors combined account for one-third of the index (Table C). Of course, the sector weightings of energy and materials have increased in virtually every stock market in the past few years, but in the United Kingdom they have increased at a much faster rate. In fact, in 1998 the FTSE All-Share had roughly the same

[1] The FTSE All-Share and the Russell 3000® each capture 98% of the total market capitalization of their respective markets.

[2] In contrast, many U.S. firms with a global footprint have benefited from the U.S. dollar's recent weakness; for example, two-thirds of second quarter 2008 revenue growth reported by Johnson & Johnson originated from translating non-U.S. revenues back into weak dollars.

allocation to the two sectors as the FTSE World Index, but by the end of June the All-Share was 12 percentage points overweight (Table D).[3]

If metal and oil prices continue to climb and the extractive industries continue to raise capital to increase their mining and drilling activities, then we expect the U.K. market to continue to have a strong natural resources bent. Capital raising in London has an illustrious history. Four centuries ago, hopeful leaders of trade-centered expeditions to China and India sold equity stakes to optimistic investors. Today, London remains a global liquidity hub, and has also become once again a preferred location for raising capital. Thus, seven mining firms and one oil & gas firm were added to the FTSE All-Share in 2007. In May, a Mexican silver mining firm with a market capitalization of about £3 billion chose to list in London and will likely be added to the FTSE 100 in due course. A JP Morgan Cazenove banker told *The Times* in April that "New York used to be in the backyard for Latin American companies but they are increasingly turning to London, particularly resources companies, as so many others are listed here." Another mining company is pushing for a £100 million London IPO for its Kazakhstani gold mine later this year, which will value the company at £500 million. Others will undoubtedly follow.

The implications of this increasing allocation to mining and energy shares are clear: returns for the U.K. equity market are becoming increasingly dependent on the shares of miners and drillers, and their returns are in turn dependent to a significant degree on commodity prices.[4] The FTSE All-Share returned -13.0% for the 12 months ended June 30, 2008, but if one excludes oil & gas and basic materials shares,[5] the return is more than 10 percentage points lower, -23.4% (Table E). Commodities have had a strong run over several years, with phenomenal price increases in the past 12 months alone. While we believe long-term demand continues to be strong (particularly stemming from the rapid development of China and India), the recent meteoric ascent suggests that prices may have gotten ahead of fundamentals, and if the U.S. slowdown continues to spread to other regions, July's drop in commodity prices may signal further declines to come.[6]

Dividends Pressured

Historically, the dividend yield of the U.K. market has been considerably higher than that of other developed markets—especially the United States and Japan. Indeed, until recent decades, the primary focus of U.K. investors was dividend coverage, since they often regarded the earning of dividends as the whole point of equity investing. Although this is no longer the case, the stability of dividends remains an important concern in a shifting market. Over the past year, financials paid nearly 30% of the index's dividends (more than their roughly 23% share of market capitalization), but it is likely that some financials will cut their

[3] The FTSE World Index was used in this analysis, rather than the more commonly cited MSCI World Index, so that sector classifications were consistent for both indices.
[4] Interestingly, this dependence is not showing up currently in correlations of daily returns. The FTSE All-Share is uncorrelated with daily gold bullion price changes, and while it is 22% correlated with the Dow Jones-AIG Commodity Index over the last 12 months, that correlation is a bit lower than the correlation of the commodity index with global equity indices.
[5] And the index is reconstituted so that the weights of the removed shares are distributed pro rata to the remaining shares.
[6] See our June 2008 Market Commentary *Commodities: Is the Investment Well Running Dry?*

dividends as a way of conserving capital. Oil & gas shares contributed about 21% of dividends, roughly in line with their allocation in the index, but basic materials shares, making up 14% of the index, paid just 4% of its dividends (Table F). If the allocation to materials shares continues to increase, the index's dividend yield is likely to fall materially, unless these firms dramatically ramp up either their payout ratios, their net incomes, or both.

Conclusion

As it has been for decades, the U.K. equity market is highly concentrated and heavily reliant on foreign revenue sources. In recent years, however, it has also grown increasingly dependent on energy and mining firms, which results in a lower dividend yield on the FTSE indices and greater market volatility, since commodity prices (and energy and mining firms' earnings) are more cyclical than those of most other sectors.

Table A

CONCENTRATION OF VARIOUS DEVELOPED MARKETS INDICES

As of 30 June 2008

Concentration	FTSE All-Share	MSCI Europe ex U.K.	S&P 500	Russell 3000®	MSCI Japan
Top 10 Stocks (%)	44.4	22.1	19.5	15.6	23.3
Top 20 Stocks (%)	59.4	34.5	30.3	24.3	34.6
Top 50 Stocks (%)	76.5	56.9	48.3	38.5	55.5
Total Market Capitalization US$ Millions	3,129,157	5,726,777	11,162,576	13,963,262	2,628,422
Number of Stocks	667	390	500	2,987	351

Sources: FactSet Research Systems, Frank Russell Company, FTSE International Limited, MSCI Inc., Standard and Poor's, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: The figures for the FTSE All-Share combine the market values for Royal Dutch Shell "A" shares ($145,645.7 million) and "B" shares ($111,216.0 million) to treat them as one individual holding in the index.

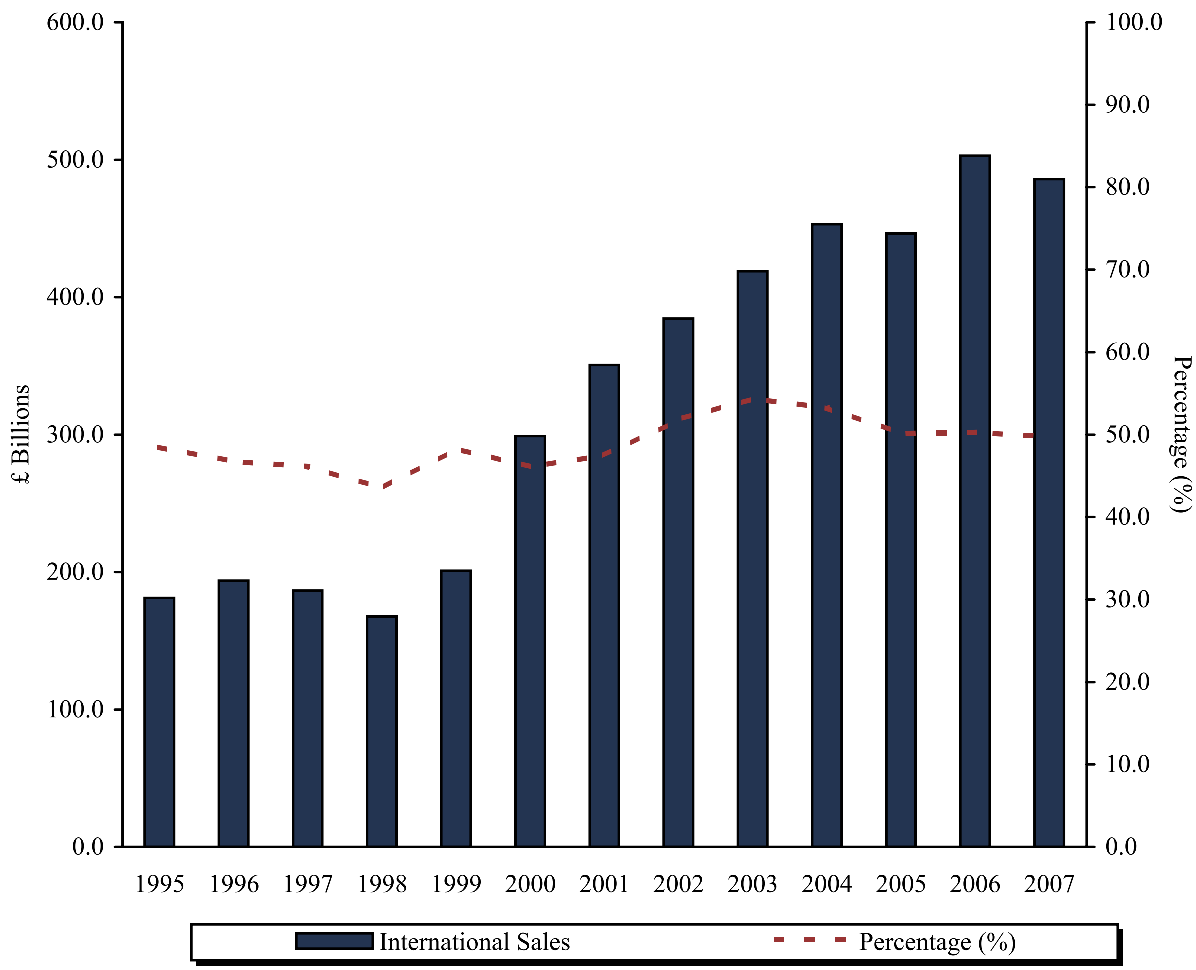
Table B

INTERNATIONAL SALES OF FTSE TOP 50 COMPANIES

1995–2007

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
# of Companies	38	37	33	35	39	42	46	44	43	43	37	41	40
Percentage (%)	48.5	46.7	46.1	43.5	48.3	46.1	47.5	51.8	54.4	53.3	50.1	50.3	49.7

International Sales (£) and % of Total Sales

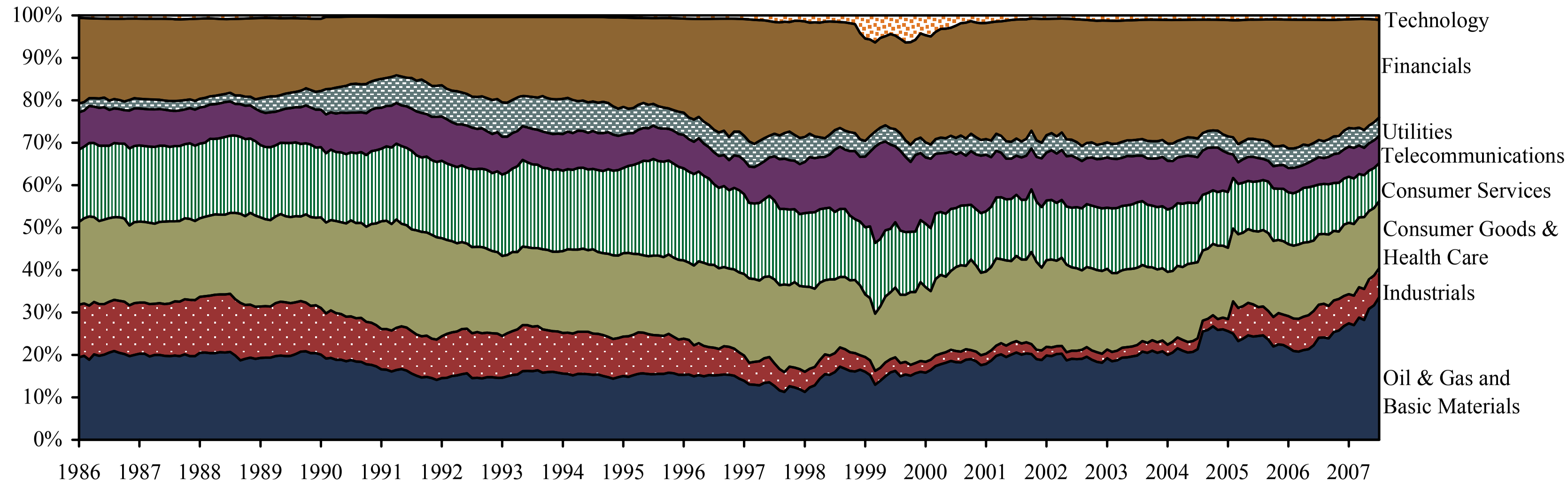


Sources: FactSet Research Systems and FTSE International Limited.

Notes: FTSE Top 50 represents an index of the top 50 companies by market capitalization of the FTSE All-Share Index. The number of companies analyzed for each time period is less than 50 due to data availability.

Table C

FTSE ALL-SHARE INDUSTRY WEIGHTS



Annual Industry Weights (%)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Oil & Gas and Basic Materials	15.33	13.88	11.29	16.01	15.84	17.87	19.86	19.20	20.00	25.57	21.72	27.41	33.59
Industrials	8.49	5.98	4.70	3.53	2.51	2.40	2.04	2.11	2.45	2.85	7.44	6.90	6.81
Consumer Goods & Health Care	18.43	19.24	20.12	14.71	17.58	19.35	20.42	19.00	17.11	16.80	16.95	16.84	15.84
Consumer Services	21.74	18.78	17.28	15.85	14.97	14.20	14.08	14.34	14.70	13.12	12.18	10.84	8.93
Telecommunications	7.85	7.99	12.08	16.62	15.60	13.36	11.28	11.84	11.47	9.16	5.73	7.10	6.43
Utilities	5.24	5.73	5.84	3.68	3.57	3.70	4.07	3.57	4.04	3.99	4.63	4.39	4.38
Financials	22.20	27.51	27.24	24.15	25.26	27.38	27.49	28.76	29.17	27.42	30.35	25.57	22.98
Technology	0.72	0.89	1.44	5.45	4.67	1.74	0.77	1.18	1.07	1.09	0.99	0.93	1.05

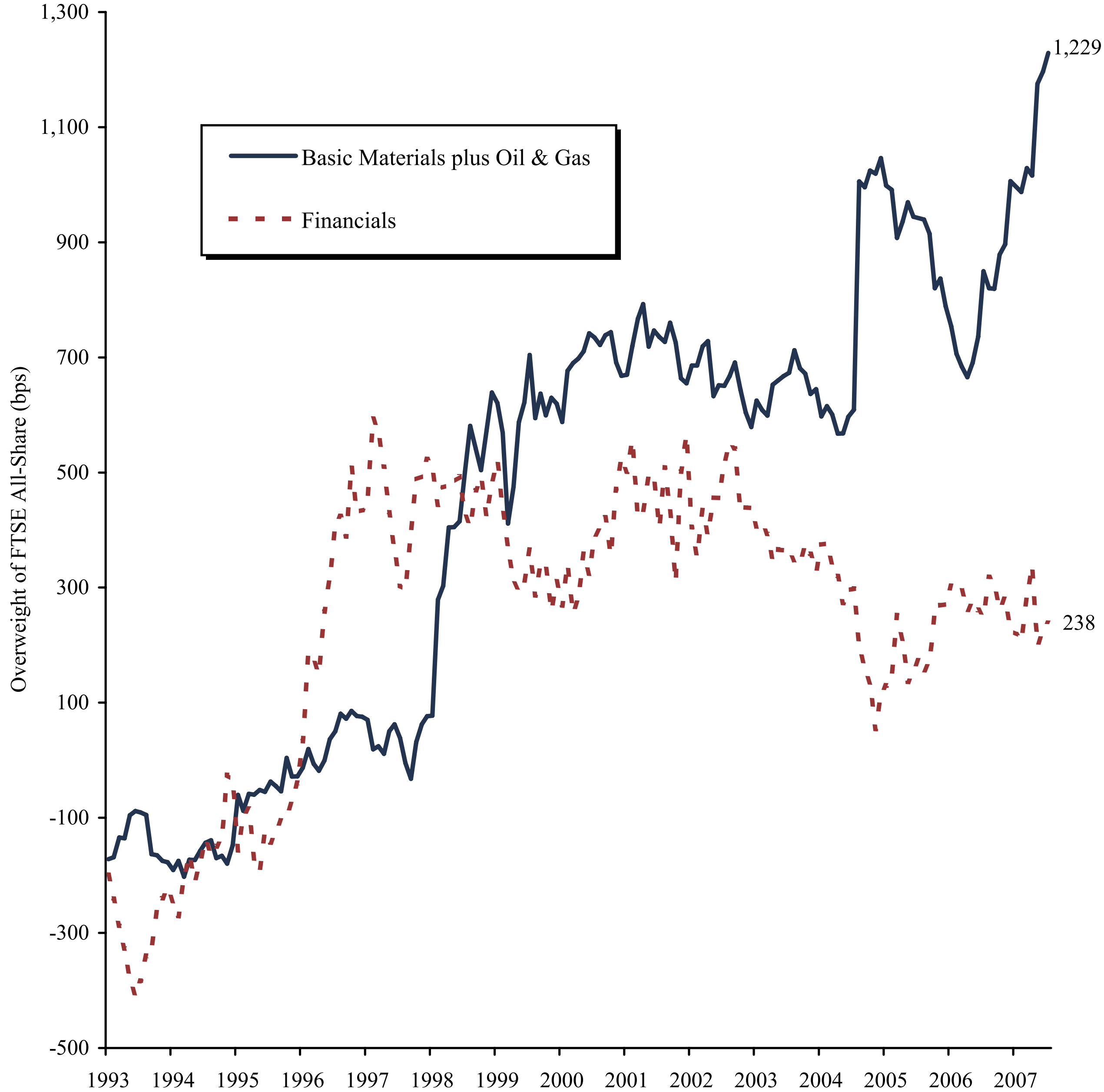
Sources: FTSE International Limited and Thomson Datastream.

Notes: In July 2005, "A" shares of Royal Dutch Shell were added to the index, increasing the size of the oil & gas industry by approximately 4.5 percentage points. The oil & gas and basic materials industries are combined in this exhibit to avoid confusion arising from the reclassification of several mining companies into the basic materials industry in January 2006. Similarly, the consumer goods industry and health care industry are combined to avoid confusion stemming from the January 2006 creation of a health care industry (28 firms with a total weighting of 8.2% were moved into this new industry from non-cyclical consumer goods). Data for 2008 are as of 30 June.

Table D

INDUSTRY OVERWEIGHT OF THE FTSE ALL-SHARE RELATIVE TO THE FTSE WORLD INDEX

31 December 1993 – 30 June 2008



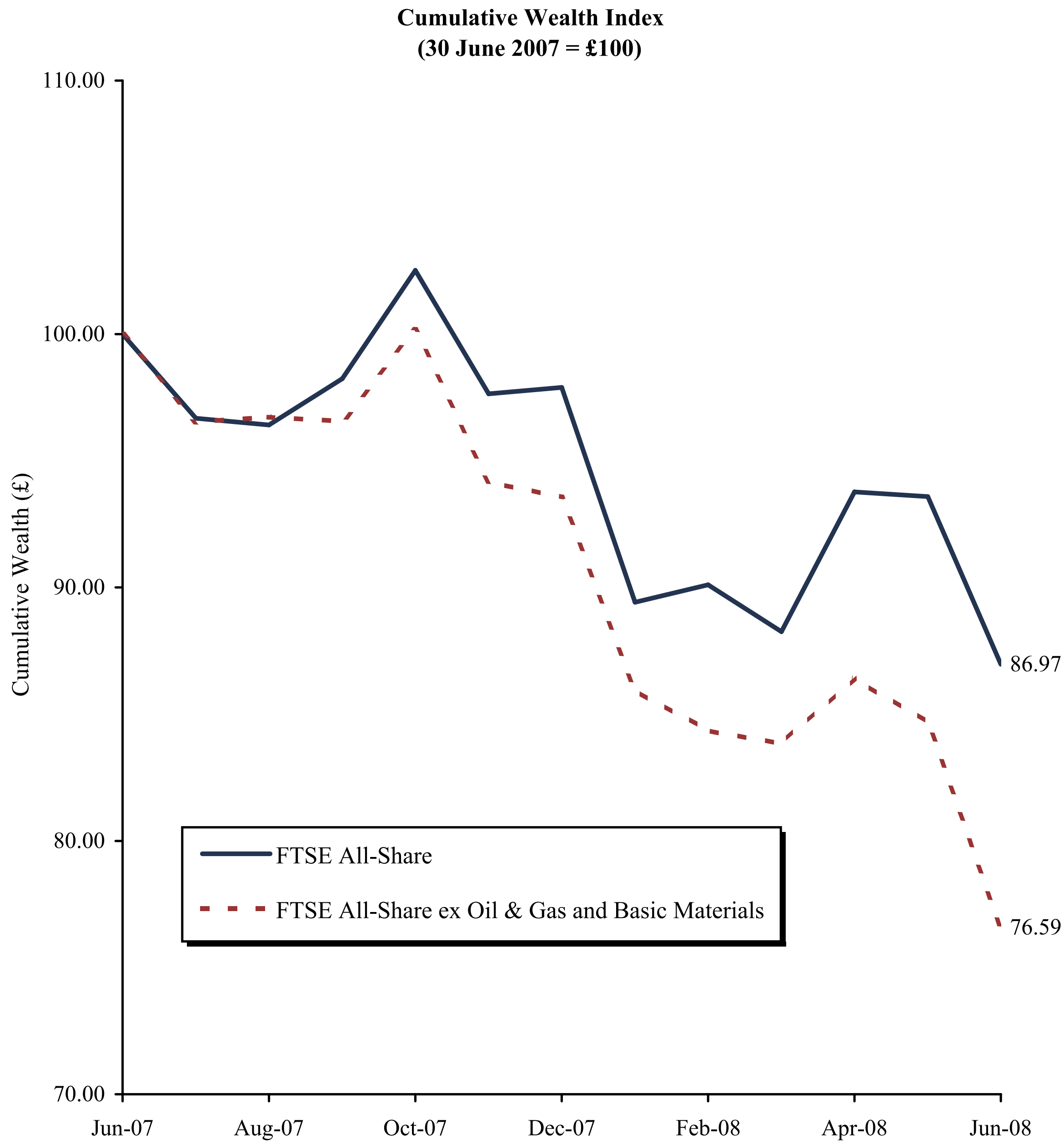
Sources: FTSE International Limited and Thomson Datastream.

Note: Basic materials and oil & gas are combined in this exhibit to avoid confusion from a reclassification of four firms from oil & gas to basic materials at the beginning of 2006.

Table E

**CUMULATIVE WEALTH OF FTSE ALL-SHARE AND
FTSE ALL-SHARE EX OIL & GAS AND BASIC MATERIALS**

1 July 2007 – 30 June 2008



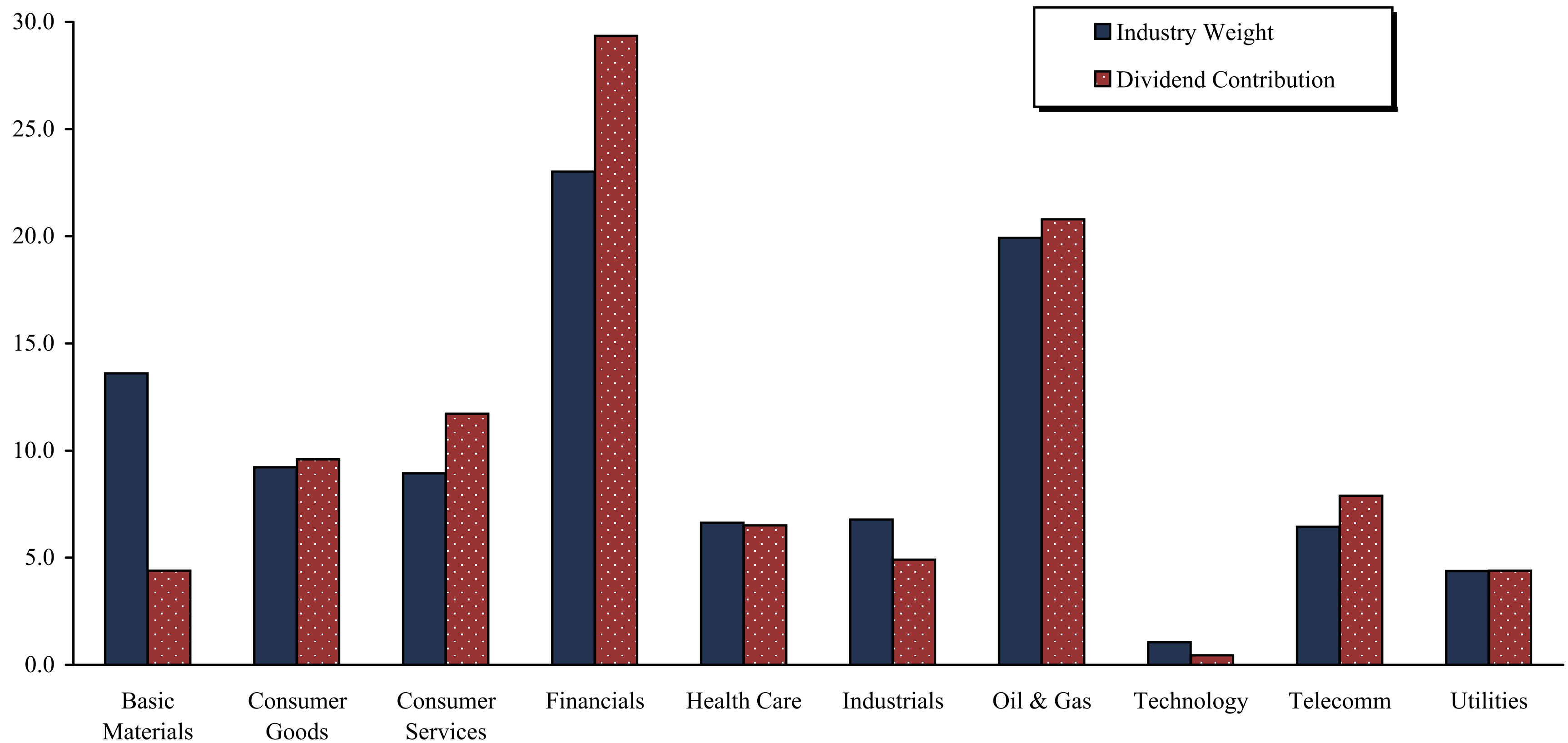
Sources: FTSE International Limited and Thomson Datastream.

Note: In the FTSE All-Share ex oil & gas and basic materials, the weights of these two missing industries have been re-allocated to the eight industries that remain.

Table F

PERCENTAGE OF CASH DIVIDENDS PAID BY INDUSTRY FOR THE FTSE ALL-SHARE INDEX

As of 30 June 2008



Sources: Bloomberg L.P., FactSet Research Systems, and FTSE International Limited.

Note: The dividend contribution represents the total cash dividends paid for the 12-month period ending 30 June 2008.