ESG and Impact Performance in light of recent events

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Since the start of 2021 we have seen a sustained period of relative underperformance for ESG and Impact portfolios, reversing a much longer trend of outperformance. There are number of reasons for this, many of which we had long prepared investors for. In addition, other unexpected reasons have compounded the underperformance. Adding to the pain for new investors who had not experienced the outperformance, this current year has been exceptionally difficult for lower risk investors as fixed income has fallen sharply whilst the equity element of the portfolio has not benefited from the oil and gas boom.

Impact and ESG portfolios require more complex choices than unscreened investments, and these choices have either positive or adverse financial ramifications at given times. Rather than falling back on the previous good times, we feel it is important to understand the current reasons; assess the timeframes involved and also the future financial prospects of our investments and then set this within the wider ESG and Impact objectives of our portfolios. In this brief paper we will set out our current investment hypothesis as it stands right now: by looking at inflation and interest rates; the economic outlook; how the current and potential future conflicts are impacting our world; social and political developments and the increasing impact climate change is already having on our world.

Inflation and Interest Rates

For all the political and geopolitical noise in the world, the surge in inflation with rising interest rates has had the biggest impact on portfolios. Even for older City hands, inflation belonged to the last century, and although many may attribute the long period of low inflation that followed to strong independent Central banks and sound monetary policy; history may well prove that globalisation and technology played an equally significant role. The main problem with this period of low inflation was that it was accompanied by a period of low growth in the developed world.

In fact, just prior to the pandemic a slightly higher level of growth and inflation was the direction monetary policy was dictating; as zero inflation and low growth in the developed world was an increasing concern in an otherwise growing world. The pandemic of 2020 then caused a major reset as Central Bank policy was focussed on supporting government policies. This meant keeping monetary policy loose, allowing government policy to focus on the social consequences of the pandemic. This meant reversing some recent tightening that had taken place in the UK and the US and a continuation of the already very loose policy in Europe. By the middle of 2021 this loose policy was causing alarm as asset price inflation (property, shares, bonds etc) remained rampant.

Whilst it is easy to say that loose monetary policy was the cause of inflation and that raising interest rates to reverse it would solve the issue, our view is there are more significant factors behind the rise. On the demand-pull side, demand may have risen from the pandemic lows, but in many instances, it has not risen beyond pre-pandemic levels. The higher cost push inflation, resulting initially from the pandemic reducing capacity and driving up costs of business and then the subsequent shortages of essential items, such as microchips and containers, have been significant drivers of price inflation. These shortages did not manifest as higher asset price inflation, but directly drove up business costs and therefore directly to the price of goods.

Simultaneously the change in lifestyle caused by the pandemic also impacted the labour market, as sources of cheap labour, quickly discarded in the pandemic, realised they had better prospects elsewhere and have not returned. As the world began to recover, core commodity prices recovered, further driving inflation higher.

As these three factors become increasingly apparent around the middle of 2021, expectations for interest rate rises increased, only for them to be scaled back as the Omicron variant spread. As we progressed further through 2021 and into 2022, these higher costs could no longer be absorbed and prices began to rise rapidly. Markets took fright with interest rate rise expectations rising rapidly at the beginning of the 2022 and Central Banks, being on the back foot, began to aggressively up their rhetoric, adding fuel to the fire.

As Russia began its attempt to invade the Ukraine, in addition to the immediate effect of a spike in oil, gas and food prices, it also laid bare a major geopolitical fault line with a significant part of the EU's high dependency on cheap Russian gas. The ramifications have impacted both the global gas and grain markets and therefore the global economy. This created a second exogenous inflation shock for markets to absorb. Central Bank rhetoric, still fighting the first fire and focused on immediate headline numbers, did not change. In fact, they appeared to ratchet this hawkish tone at Jackson Hole, and global markets took further fright.

In addition to the global dynamics, the fiscally aggressive actions of the new UK cabinet added further fuel to the fixed income panic. The unorthodox approach taken has pros and cons depending on one's political standpoint, but the crux of the issue is more uncertainty is not welcome.

The rapid rise in interest rate expectations impacted both fixed income investments, and consequently growth-based equities hard. Whilst we can understand the need to remain vigilant on inflation, and the need to curb a rising cycle of inflation expectations, the failure to acknowledge the main causes are outside of central banks immediate control, the two exogenous shocks have contributed to much of the inflation, as well as economic uncertainty, is a cause for concern. The immediate risk of stagflation is now reality as growth falls whist inflation rises, and the risk of recession is increasing, which will not necessarily reduce inflation as much as expected.

Until the interest rate scenario is settled, the cost of capital and levels of bonds will continue to create uncertainty for both bond and equity markets. This has been the worst year for global bond markets since 1949.[1] As economic data is now pointing to a technical recession in a number of leading economies, we see this point coming soon. Once we have more certainty on interest rates and therefore the longer-term cost of capital, it will be easier to price growth equities and we feel markets will stabilise.

Economic Outlook and ESG and Impact considerations

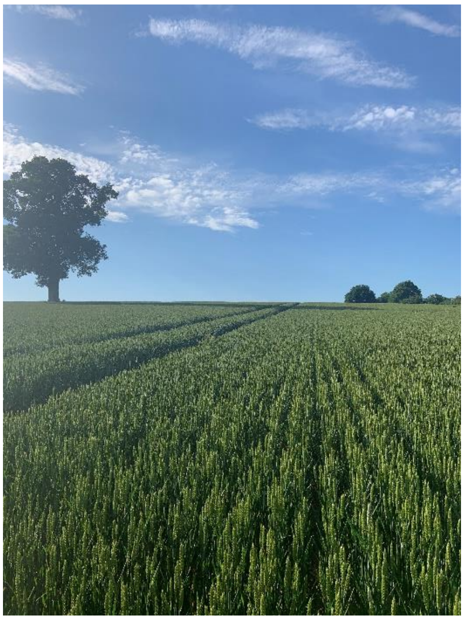
The pandemic, as the first major shock, both changed the way many people live and accelerated a number of long-term core ESG and Impact trends. The second shock, whilst initially favouring the oil and gas sectors, has created a longer-term boon for renewable energy. Energy is an absolute essential

[1] Bloomberg TV, 26th September 2022.

that impacts every aspect of the economy, it's a large and significant market sector and it is also a truly global market.

Post the current winter crunch, no one will ever again want to be held hostage on energy again. Now that renewable energy is both affordable and achievable for almost all nations, we see the move towards renewable energy accelerating. The wind and sun are still free and no one can stop or control them. Whilst the energy market is truly global, countries with higher renewable energy production, such as the UK, should have been able to control energy costs in a better manner and we expect there to be wholesale shake ups of energy markets to address these issues.

The inflation shock initially hit many renewable energy equipment manufacturers, such as Vestas Wind Systems, as key input costs rose sharply decimating the profit margins in the short term. As they have raised prices and some costs are falling back, they have begun to restore their margins and the order book and outlook continues to be strong. This blip is typical for a number of companies as they recover from the economic shock.



Food has been another key sector not only impacted by the conflict in Ukraine, but also by global warming. Away from the headlines, heat domes in a number of key locations such as India, Canada, Europe and the US, as well as droughts, have all had an impact on the food chain and subsequently food prices.

The supply of certain strategic goods, notably microchips, has also sped up the trend to near shoring, a move away from single super-efficient global supply chains to more local and more secure production. This will create economic redundancy as supply chains become less efficient and this will lead to higher level of base inflation once things settle down.

The inflationary ramifications have been significant on almost all businesses and we expect a period of economic stress at a time when government resources are already stretched and in many cases finances are exhausted. This will create a further period of economic and possibly political stress around the world with a bumpy recovery and some creative destruction. The quality of assets, be it either balance sheet strength, quality of earnings or pricing power will be become very important.

In essence the global economy has been more resilient than expected, mainly as governments and central banks have been very supportive. Going forward we expect this support to reduce, but we also anticipate a move away from the chaos of the last few years (unless someone else starts a war) and a return to some form of normality. There will be some tough choices ahead, and therefore some creative destruction and change.

Current outlook

We are in very uncertain times as the two exogenous shocks have exposed fault lines, and markets are now adjusting.

Our view on fixed income had been negative for many years, our asset allocation was at the lowest level and often focussed on shorter durations. As fixed income began to fall rapidly, while portfolios were not immune, we benefited from the lower exposure. This benefit was offset by having a higher exposure to global equities and no exposure to oil and gas. Year to date, the UK's sectors of oil and gas, tobacco, banks and aerospace, are its top 4 performers, and the first two by a significant margin.[2] This masks previous years of under-performance and we will address this point further down.

As the fixed income markets fell, from March to May, we began to extend the duration and raise the asset allocation in both bespoke and model portfolios. Long term interest rates were reaching more sustainable levels (ca 3% in the UK and US) and yield curves were normalising. The recession word was now beginning to be heard as markets, governments and Central Banks all assessed the inflationary environment.

Our view remains that we were going to experience a short period of stagflation, high inflation mainly driven by two exogenous global shocks in little more than two years. These events coming off a long period of low inflation has and will ripple shockwaves across the economy, exactly what we are seeing now.

Shock waves do not last forever, our view was and to a large extent remains, that interest rates and fixed income markets would begin to level out. Given the volatile and difficult economic environment, our focus on fixed income has been to add into the weakness, and we are now closer to our neutral level in terms of asset allocation. The other move has been to improve the credit quality of our fixed income exposure.

Infrastructure

Over ten years ago, infrastructure assets began to feature in our bespoke portfolios and direct equity models. The number of investments available in this sector have increased (not all of great quality) and later on we were able to add some open-ended funds that hold a number of these to replicate this asset sector in our fund-based model portfolios. These assets are mostly investment trusts that own infrastructure, such as buildings, windfarms, solar parks, battery parks, AD plants and hydroelectric assets around the UK and the World. This enabled portfolios to be directly exposed to pure play producers and supporters of clean energy, adding to the positive environmental impact of portfolios.

Whilst some of these may contain a degree of development risk, the main element is the revenue achieved from producing renewable energy or providing a service, less costs and debt costs. These assets have tended to have long term sales agreements and long-term debt arrangements and have mainly paid out good levels of dividend income. In 2022, these assets have ranged from positive to stable in terms of total returns to the portfolio.

In terms of the renewable energy assets, there has been some benefit from the energy crisis as surplus energy is sold into the grid at market prices. Until recently this was regarded as negative, in the current political climate its under pressure. To many of these operators, this is only marginal to their business and the fact that they have continued to supply energy to the market at much lower long-term prices remains a benefit that cannot be overlooked.

With the cost of capital largely fixed on existing projects, and power purchase agreements in place, we see the main short-term risk being from external political factors (government policy, windfall taxes etc), although we see these risks as controlled at this point given the lower prices of clean energy.

[2] Source Bloomberg – UK Index sector returns year to data to 20th Sept 2022

Property

Across bespoke and direct model portfolios our focus continues to be on socially driven property investments, in the fund only models, the fund selected includes these but has broader property investments as well. These more social focussed investments have performed better than conventional property investments by some margin over 2022 and we see demand for their services continuing to grow. The contracts are broadly inflation linked and the cost of capital is fixed, demand and requirement for the premises, ranging from quality rental homes for families to homeless housing, remains strong.

Equities

Interest rates, inflation, economic cycles and expectations all have a strong impact on equities, and on growth equities in particular. Like-wise the ethical choices about including and excluding sectors will impact a portfolios performance.

Over the years we have often shared in meetings and presentations that our model portfolios, with no exposure to oil and gas exploration and production, mining, as well as a being more limited to banks, have benefited from not being exposed to these lagging and often more volatile sectors. We always said that from time to time there would be years when the opposite would happen, and this has been the case since the global reflation began in 2021.

To give some perspective, the UK's main fossil fuel sector has returned 37.8% year to date. However, the returns for this index since the end of 2018 is -39.48%, highlighting the prior under performance.[3] In comparison, even the lightest screened global ESG leaders index is down 6.95% in 2022, but to highlight the prior outperformance, it returned has returned +64.29% since the end of 2018.[4]

Whilst global equities have had a difficult 2022, the oil and gas sector has been a strong performer, not just in the UK market but also other major markets such as the US where they account for 5 of the top 10 performing sub sectors. In addition, looking at the UK equity market, the other best performing sectors have been tobacco, aerospace and then banks. This year the ethical choices have meant the equity element of the portfolio was not cushioned by holding some of the best performing sectors.

The impact of inflation on earnings, and therefore share prices, will become more apparent in the corporate reporting due from mid-October, and a great deal of attention will be given to the outlooks at that stage. As with fixed income, we see times of economic stress impacting equities and again we favour quality as this stage. Uncertainty and change will create both opportunities and threats. However, we expect overall sentiment to remain muted and fearful until the interest rate scenario and rhetoric from central banks begins to stabilise.

In addition to quality, we also see the growth opportunities around certain core sectors. Electrification remains a global megatrend as global warming remains a growing and more visible problem. This in turn will be increasingly driven by renewable energy, as countries continue to secure their energy supply. Food security, cyber security, healthcare, urban infrastructure, connectivity, waste, recycling and resources, and finally water all remain core themes where the trend has accelerated rather than reversed. Many of these areas are trading at multi-year lows as a consequence of the events detailed above, but this provides an exciting time to look for new opportunities and commence investments.

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[3] Source Bloomberg, Oil, Gas and Coal total return numbers in Sterling.
[4] Source Bloomberg, Global ESG leaders Sterling total return.

Conclusion

We do not want to be defensive or complacent about the difficult year 2022 has been. The worst year for fixed income in over 70 years has been especially painful for lower risk investors, and exacerbated by ethical screens in place, excluding some of the cushions that would have helped this year such as oil & gas.

Two exogenous shocks have left their mark, and are now being worked out of the system. At some stage a new equilibrium will be established. Much of this depends on central banks and the interest rate scenario, and they too are wrestling with unprecedented global dynamics.

The short-term noise, and occasional panics continue to cause alarm, but the ripples are getting smaller. We expect 2022 to remain volatile and fear driven, but sticking to the old mantra, buy when everyone is fearful, our mind is as much on the opportunities than the threats.