COVID-19 INVESTMENT UPDATE: SUSTAINABLE FUNDS UPDATE – 16 OCTOBER 2020

What is happening?

The laundry list of negative issues that investors have to contend with continues to be long but ultimately, for equity and credit investors, not especially price moving. It does beg the question: if a pandemic, the risk of a hard Brexit and a contentious presidential election can't stop the upward move in asset prices, what will? Taking these issues in turn, we do think a second wave of Covid infections was largely expected and those companies most affected by it have already seen their share prices fall considerably to the point they have become small parts of indicess thereby reducing their influence on overall asset class returns. We also think a hard Brexit would be a positive for the UK stock market given the almost inevitable fall in sterling that would follow, and the benefits of that to what is a very international market. Finally, we don't believe presidential cycles are that consequential for markets. Donald Trump was elected with a pledge to support the US oil and coal industries, and to tackle large technology companies. The former have been the worst investments over the last four years, the latter the best. Equity markets and industries do well despite US politics, not because of it.

It seems likely to us that the primary influence on asset prices remains that of central banks. In particular, markets are trying to understand and discount the generational shift in the change of policy from the US Federal Reserve. Since Paul Volcker in the 1980s the tone from the Federal Reserve has been one of keeping inflation down. Recently this changed under Chairman Powell to getting inflation up. Under the former policy the bias was to raising interest rates to control economic activity and therefore inflation. Now the bias is to keep interest rates down to encourage growth and inflation. This essentially means no interest rate increases until at least 2023 under the analysis provided by the Fed. But consider this: the 2% inflation target in the US was implemented in 2012 and has never been met in strong economic times; how likely is it now in weak economic times? Maybe interest rates will remain at current levels beyond 2023? Were this to happen the value of equities, as investors would be willing to take a lower return to hold them, would continue to rise and maybe significantly so. This is what we believe we are seeing today. An over focus on pandemics and politics is missing the key variable in the room, a generational shift in central bank policy in the largest economic region in the world which may have major and not yet discounted consequences for asset prices.

What will happen next?

As we enter winter and second lockdowns, it is easy for morale to fall. We do think though there are grounds for optimism when we look forward. It seems more likely than not to us that the pandemic will be largely over by this time next year. There are currently over 350 vaccines in development, with a number of promising candidates. Those vaccine companies we speak to think a working and safety tested vaccine by Q1 2021 is achievable. Then it will come down to how fast it can be manufactured and rolled out by governments around the world, with estimates suggesting that by Q3 2021 large parts of the population will have received a vaccine. Of course there are many hurdles to overcome, but our point is if this were to occur and we were free to go back to life as it was, where would asset prices be then and what would perform well?

Under this scenario many (but not all) investments that have fallen of late will rise again, and equally those who have been more attractive as they have not been impacted by Covid will seem less relatively attractive. This could be the basis for some kind of rally in what are considered 'value' stocks in the short term. Unusually a value rally has been missing in the recent market rise; following a bear market this is usually a high probability bet, as investors want to buy less liquid, more indebted and cyclical companies. Beyond any short-term rally though, the key question will be what has structurally changed in all our behaviours that has increased or impaired the value of key sectors and industries. That is clearly still to be seen, but we believe that many value sectors (airlines, oil, retail, property) will be structurally impaired and that the winners will be areas such as healthcare and technology. Beyond a short-term rally in 'value' we do think what has done well this year will continue to do well in the future.

How are we performing?

We continue to be happy with the performance of our sustainable funds. All remain significantly ahead of benchmarks and peer groups year to date, itself a consequence of having largely avoided the key areas of capital destruction this year, and having been positioned in those companies seeing their future prospects improve in a post pandemic world. Our preference for equity over credit (within the parameters of their mandates) has served the mixed asset funds well. We still think the hurdle rate for equities to become more attractive than credit is still low enough for us to have confidence in preferring equities. Credit does however remain a valuable source of income and stability given the continued turbulence in markets. Our new Global Sustainable Equity Fund has performed well since launch in February and we think it is ideally placed relative to key sustainable and financial trends over the coming years.

What have we been doing?

One common question we get is about whether or not there is a valuation bubble forming in those equities with strong sustainable credentials. These stocks will be benefiting from the large increase in flows into sustainable funds and, as inflows generally have to be invested, will have less price sensitive buyers. Our answer to this is nuanced. First of all, as noted above, nearly all equities are becoming more expensive, so this isn't simply a sustainable issue. We do think however that we are noticing certain leading sustainable companies becoming prohibitively expensive for us to own. These tend to be smaller, less liquid companies where there is not much trade in the underlying shares. This lack of liquidity makes them more prone to mispricing occurring. We have recently started to reduce our position in Tomra, a Norwegian company operating in the circular economy and plastic recycling. Despite mixed operational performance, the shares have done exceptionally well and are priced at a level similar to more liquid, higher growth, higher returning and equally sustainable businesses we can own. Descartes was another investment we have sold; a small Canadian software company making software to make supply chains more efficient which became unattractive due to its price. Of course both Tomra and Descartes could be successful investments but we think the probabilities of this have been reduced to unacceptable levels for us. We do however think there are ample opportunities for us to invest in elsewhere, and we have been building a holding in Nordson, a US engineer providing sophisticated equipment to make key manufacturing processes more efficient and environmentally friendly.

Anything else

A number of clients have recently commented to us how complicated investment markets are at the moment, to the point where making decisions has become difficult. Acting effectively and rationally in investment markets is a key ability any fund manager needs. To understand how best to do this it is worth looking at two distinct sets of circumstances where decision making goes awry: when we panic and when we choke.

Panic is an undue focus on one issue and one issue alone. Investment markets in March were in a panic and unable to think beyond Covid, leading to suboptimal decision-making, particularly when selling after markets had fallen so far. Choking is thinking of too many variables. This is actually more prevalent in the sports world. If anyone has seen a sports person choke from a winning position, or just generally, afterwards they will often talk about losing their flow and trying to correct too many things. Arguably it would be easy to choke in investment markets today given so many uncertain issues exist. The key is to find balance between focusing unduly on one issue, and focusing on too many.

The way we think about current investment markets is really to try and find a small number of big things from which to make decisions around. We won't get everything right, but it gives us an effective framework for day-to-day decision making. Financially we think the generational shift in Fed policy is critical, Sustainably we think about digitisation, decarbonisation, health and hygiene as key trends. These are the key things which are influencing our thinking currently, allowing us to make effective decisions on your behalf.

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