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FUND MANAGER QUARTERLY REPORT

Fund Manager Quarterly Report June 2023.

Three years On by Wayne Bishop

Three years ago, ESG and Impact portfolios were basking in the sun. Lockdown was in full swing across much of the developed world, but instead of everything grinding to a halt, the world carried on and Work from Home looked here to stay. It was a hot but also breezy summer and renewable energy was on a roll, the first coal free electricity production days were recorded in the UK.

Those days feel like a long time ago, reflation following covid, the war in Ukraine, inflation, dire politics around the world and interest rate rises have all taken their toll and, in many cases, favoured sectors outside of the ESG and positive-focussed universe.

Looking at the broader global indices and across the spectrum of capital, performance out to three years has swung from favouring sustainable and impact investments to unscreened investments. Not only that; fixed income, property and infrastructure have all fallen into negative returns.

Whilst we are long term investors, the last three years have begun to feel like a long time and the positive investment thesis feels very tested. By its very nature, investing in positive sectors tend to be more future focussed and in sectors where growth is expected, with a large portion of cash flows in the years ahead. This report is a little more detailed than usual as we will examine each asset class held and what we are expecting from each of them.

Interest Rates and Inflation

Since early 2022, interest rates around the world have chased inflation. In late May 2023, we began to feel for the first time that inflation and interest rate expectations had become more realistic in the UK following a hotter than expected CPI print. This saw bonds fall and the yield on a UK ten year cross the 4% mark, making them once more attractive. At this level, we took the decision that adding to duration was less of a risk but that we would do so incrementally given the risks that remained.[1]

Since then, we have seen interest rate expectations rise once more which has further impacted our bonds, property and infrastructure holdings. The causes of inflation have shifted from supply chain and energy costs to wages and margin rebuilding or expansion. At the same time, concerns about a hard economic landing have risen and we share these concerns. It is less than 18 months since interest rates began to rise and the impact of these rises takes time to manifest. In the UK, for example, around 2.4 million households will see their fixed rate mortgage expire by the end of 2024. This would suggest that much of the monetary tightening that has occurred is yet to be felt.

The renewed inflation concern is driven by stronger employment and higher wages, this is a longer term and more structural reversal. Whilst short term interest rate rises have risen, long term Sterling interest rates (that were about 4% in May) are now 4.6%, with expectations of a global recession

[1] UK inflation and the Bond Market May 23.pdf (kingandshaxsonethical.co.uk) for further commentary.

increasing. This pattern is similar for Euro and Dollar interest rates. The recent recovery of Sterling from Brexit related lows will also act as a break on inflation, acting in the same way as an interest rate rise.

Depending on risk profile, between 30% to 60% of a portfolio is in fixed income, property and infrastructure; the path of interest rate expectations will largely determine the turning point for these assets. Whilst we have seen these expectations move out a little further, we stick by our decision to begin increasing duration in the quarter. We know that expectations can turn back very quickly, we see this as increasingly likely and are positioned for it.

Fixed Income

The inflation and interest rate backdrop have been, and still remain, headwinds for fixed income. Less reported but of equal importance is the tapering of Central Bank support for the bond markets. Although most of the decline in fixed income was in 2022, the market remains subdued whilst Central banks wrestle with inflation.

Although it seems counter-intuitive to be adding to fixed income during a period of interest rate rises, experience has taught us that sentiment can change very quickly as it did in early 2022 when fixed income fell sharply. The UK was the quickest to raise interest rates and inflation has been stickier (where prices remain stubbornly high) than other markets. Much of this is down to outdated energy pricing policies in the UK that focus on the wholesale gas price, as well as an overreliance on cheap imported labour and Brexit related disruptions causing things such as food inflation to be worse than elsewhere. However, when stripping out these volatile aspects, inflation remains high, as seen in the core inflation reading which strips out energy and food. Nonetheless, given base effects, we do expect inflation to head lower and our view is interest rate rises are fully priced in, and the risk of a recession is not.

Around these levels (the UK ten-year Gilt is 4.6% for example versus base rates of 5.0%) bonds are reasonably priced. A total return (a combination of the interest and capital) of over 4% means that after a turbulent period, fixed income is finally doing its job again; providing a return, and from these levels, a degree of risk protection.

Given this investment rationale, the quarter saw us add to duration in fixed income as we saw less risk in doing so given the move in yields. This coincided with the maturity of shorter-dated holdings in Floating Rate Notes the proceeds, of which were recycled into some of our longer-dated holdings such as the 2035 SNCF bond. In addition, the positive outcomes of bonds are a key factor, especially as some target areas not always met by equity investments. We added a 2028 bond from the International Development Association, which is part of the World Bank, and focuses on development projects in the 75 poorest countries in the world. We also increased our exposure to the 2032 Eurofima bond which finances the electrification of railway infrastructure in Europe. Furthermore, given the strength of sterling against the dollar in the quarter, we sold remaining positions in the dollar IFFIM bond in favour of the sterling holding.

Property

The revival of fixed income as an asset class has come at the expense of property and infrastructure; higher costs for debt and the availability of higher risk-free returns has crimped demand for these asset classes. Property was the worst performing asset class last year, which given the difficulties with retail and office space was no surprise to us, and we remained uninvested in these sectors. What did surprise was the negative impact on social housing and medical properties, where the higher social nature of investments and more stable income have partially been overlooked.

All property investments are in closed-ended listed property companies or Real Estate Investment Trusts (REITS) which have been trading at a high discount to their NAV (between 30 to 50%).[2] This has happened before in the past, most recently with the Brexit vote and also with the pandemic, and over time the discount narrows. With any discount between the price to NAV the question arises "which is right?". In the recent past with Brexit and COVID it was quite clear the price reaction was more of a reflex, and being the easiest of these assets to buy and sell, quite often the reflex choice that is also easier to buy back once other assets are sold or the outlook becomes clearer.

This time things are a little different, by their nature these assets borrow money and therefore interest rates play a significant role in their NAV and valuation, and asset prices are more vulnerable to lower valuations. The sector has also been plagued by concerns about rent collection following issues with individual REITs. The counter to this is the stable and index linked income level, and the fact that debt has been well managed and often fixed. Whilst we see no significant risks to the NAV, the markets may take a little longer to buy back.

We have been re-assured this quarter as a social housing REIT was acquired by a foreign infrastructure investor for 75% of the NAV. This was a significant premium to the price at the time which was only about 50% of the NAV, and the fact that a large number (but not large enough) of shareholders did not accept the offer, because they saw it as too low, is also encouraging.

Property is about 10% of portfolios and we have used this weakness to add to the investments, including the introduction of a healthcare REIT that invests in care homes. Over the coming years we see the NAV discount narrowing, which in addition to the higher level of dividend income should provide some stable returns in the order of 10% or more over the coming years. Our focus remains on investments with a strong social purpose rather than offices and retail outlets.

Infrastructure

Infrastructure has suffered the same fate as property in terms of substitution by fixed income for low-risk investors, and by being closed-ended, they are trading at a discount to NAV. The level of discount is closer to 15-30% which is not quite as extreme as property.

The issues with the discount between price and NAV are similar, with concerns about discount rates, forward electricity prices and taxation being the main issues. In some cases, assets under development have experienced inflation and higher debt costs, and these projects remain the main sources of concern. Against this, in the solar, wind and AD investments, the electricity produced was sold on long term power purchase agreements (PPA) and only surplus energy was sold at spot. Therefore, the price risk is more limited and these investments were not behind the high energy costs that have helped drive European inflation. In energy storage, the absolute price level is less of an issue as it is largely about buying and selling energy at different times of the day.

This sector has also been tainted by recent news and actions of infrastructure investors in the UK water sector, please see our recent note for more information - [UK Water Investments June 2023.pdf (kingandshaxsonethical.co.uk)]

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[2] [King & Shaxson AM Property Comment.pdf (kingandshaxsonethical.co.uk)] for differences between open & close ended property.

Most of our investments focus on renewable energy production by wind, solar or anaerobic digestion; on energy storage, energy efficiency and on water and waste. We have a more general infrastructure investment that focuses on renewable energy grid connections, social buildings and railway infrastructure. These investments make up between 10 and 15% of portfolios. Most of these have a strong positive environmental focus and are part of the decarbonising energy with the remainder having a social focus on health, education, public transport and justice.

In addition to interest rate clarity, the political backdrop will play a role in the recovery of the share price and this is more about stability than which party is in power. We also expect a recovery towards the current NAV and in the meantime over a 6% level of income, so like property we are looking for over 10% in the next few years.

Equities

In previous reports we have covered the performance differential between those sectors that benefited from reflation and the war in Ukraine versus the more positive investment sectors. The start of 2023 saw a strong revival in air travel but recent strength has returned to FAANGs, and automobiles, alcohol, semiconductors, and in Europe, Banks are doing well.

The initial euphoria from the US Inflation Reduction Act reversed and the renewable energy sector performed poorly in the last quarter. Solar stocks in particular were hard hit. This was a sector we had avoided for a while and we used the weakness to re-enter with a US based investment. This sector requires care given the high level of Chinese involvement and labour and human rights issues in the supply chain. The demand for wind and solar is strong and as supply chain and cost issues are resolved, the outlook will continue to improve.

Either side of the quarter end there were positive developments in healthcare, as efficiency and AI technology are applied to core issues. We have seen a strong recovery in one firm who maintain social housing after being in the doldrums for a number of years. Whilst construction itself still remains mixed, longer term investment opportunities exist even if we are in no hurry to add in the short term, portfolios holding green cement production recovered following some good news flow.

We increased investment in resource and recycling, focussing on metal and battery recycling. Resourcing the green recovery is a key growth area, with assessing how it is being done as relevant to what is achieved. Electrification is a core long-term trend and performed well, against this we saw poor performance and losses in EV infrastructure as costs and delayed development impacted growth. The long-term thesis remains intact and investment in this sector continues to grow.

In finance, the last year has been more subdued across the spectrum that ranges from insurance to microfinance. In IT, our focus has been on cyber defence and we have seen some recovery after concerns around business spending added some pressure. We continue to avoid the FAANGs such as Apple, Amazon etc for a number of reasons. Whilst the lighter green ESG funds will include them they fail our screens on a number of counts, such as employment and taxation. These stocks have flattered ESG performance in the last year.

Although more positive focussed investment lagged both the main market and the ESG indices over the last year, we see them as later cycle investments. As the consumption focussed recovery is now under threat from high interest rates, the focus for growth will shift to efficiency, electrification and green technology, as stimulus in this area moves from plans and finance to real projects on the ground. This will come in a range of forms such as battery recycling and metal recycling plants in the US, EV infrastructure worldwide and windfarms and solar parks around the UK and the rest of the world.

Conclusion

Financial markets around the world remain hostage to the inflation and interest rate cycle and when it will end. It has moved from whether the economy will land, to how and when. The strains are showing around the World, from Thames Water in the UK, Casino Supermarkets in France, to construction in China as those “swimming naked” are exposed. At the same time new opportunities are opening.

We expect noise to remain, even if the political backdrop is more secure around the world. The short-term volatility is expected to continue and high-quality fixed income offers a short-term haven whilst longer-term opportunities will present themselves along the way. The issue is timing and experience has taught us that things can change very fast, so keeping a broad spread of investments is a key short-term consideration.

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