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Fund Managers Report
First Quarter

Fund Managers Report – Long Version - 31st December 2020 to 31st March 2021

Reflation

Exiting the pandemic has dominated market sentiment over the last quarter. In itself, this is a double-edged sword. One side is the positive end to "lockdown" and an end to the social and economic damage caused by the pandemic. Many businesses can begin returning to new levels of activity and start to rebuild. Equally sharp though is the other side, not only for those who gained from the pandemic, but more important is the anticipated end of the unprecedented fiscal and monetary support that has kept much of the global economy from imploding in the last year. This, and the savings glut caused by lockdown, has driven demand for investments, whilst the government blanket has supported a number of businesses that will not survive. Therefore, with a slight twist on an old cliché, as the tide starts to go out, we are beginning to see who has been swimming naked.

For ESG and impact investors like us, this has been a more difficult quarter, many of the investments held either benefited directly from the pandemic or from being a more future focussed investment. In our December report we noted that we had trimmed back some holdings and become more defensive, and many of these sectors underperformed as the market focussed on buying back some of the sectors that had lost out in the pandemic. In comparison to the moves seen last year this was only a small step back, and by the end of the quarter, it appears to have run its course.

What has become clear over the last quarter is the different pace at which leading economies will exit the pandemic. Two factors play a key role in this, one is the vaccination programme and the other is politics. Just looking at the major G7 economies alone shows a sharp contrast, but this is far more significant and runs far deeper than the tabloid politics that makes all the noise.

The leading G7 economy, the US, is behind the likes of the UK, Israel and UAE in terms of vaccinations per head, and the individual US states have relaxed their lockdown rules based on their own political dimensions. Markets are still watching the new political leadership in Washington, especially in relations to China, social media and taxation. The recent stimulus package has actually caused some concerns that it was excessive and inflationary. As the Federal Reserve have been clear, they will want to see evidence of the recovery before acting, and we have seen a rise in bond yields (falling bond prices) on this expectation.

From an ethical perspective, the drive for more offshore wind energy is longer term positive, but on the immediate term, we feel the boom time for the FAANGs is over, so the headline markets may be more subdued and the opportunity will be rotation from technology to more infrastructure and cyclical related growth.

The pandemic started in China and they lifted restrictions earlier. As a manufacturing-based economy, they have recovered more quickly, but longer term their growth rate was already slowing. The main issue with China is more social and political, with global trade and security issues being compounded by events in Hong Kong and the Xinjiang province. The latter is, rightly, becoming a far more serious issue and we note that a number of clothing companies have already taken steps to avoid cotton from suspected Uighur slave labour, even in the face of a backlash in China (H&M for example). China remains the world's second largest economy and there are some interesting companies in the battery technology area, but despite the EU's poorly timed investment agreement with China, they are now facing a more united world on a number of social issues.

The other major economies in the region, Japan and India have also been impacted. Japan, the world's third largest economy is more industrial and the recent Tankan survey was more positive than expected. Covid has been rampant in India and although the population initially appeared to have been more resilient, we are seeing another wave and if this continues, it will be a longer-term drag. This has had an impact on microfinance investments in India and the surrounding regions as many of those who benefit from microfinance have seen their incomes suffer, however there is a great deal of forbearance from the lenders making the issue more about timing.

The EU includes Germany, the world's fourth largest economy, and France the sixth largest economy, both of whom initially dealt well with the COVID pandemic, but then failed terribly with the vaccine. There are many issues behind the vaccine failure but the more critical issue has been the response, where they have broken trust with many key partners. In addition, internal bickering (especially towards favouring the French Sanofi vaccine that has yet to launch) also does not help in a politically important year. German elections in the autumn point to the Green party becoming part of a government, but there is little certainty about who the senior partners will be. French regional elections follow as well as the presidential election next year, this will only add to the tension and uncertainty as well as unhelpful political noise.

The delays in the vaccine in a more aged economy means delays in the recovery, and the Eurozone went into the Covid pandemic with the economy already on life support with negative interest rates and aggressive bond buying by the ECB. This has continued to a point that puts the banking system at a level of risk not seen since the sovereign debt crisis, and with the delayed vaccine role out, few options remain but to continue pumping money into the economy.

That said, whilst the outlook for the European economy and politics remains a major concern, a number of European companies (in and outside the Eurozone) remain world leaders in key impact areas. This includes interesting investments that have global exposure, with the megatrends of sustainable food, renewable energy and healthcare intact. As a result, bespoke portfolios have a number of selective European names.

As the UK continues to emerge from its self-inflicted Brexit malaise, it has clearly benefited from getting the vaccine right. In turn, this comes from the UK being home to a number of global leaders in medical science and technology. These two factors combined mean economic data has been better than feared, and the outlook remains more optimistic as lockdown eases and vaccinations continue. Conversely this also means the UK will be first to see the other side of the equation, not only the winners and losers of Brexit will become clear, but also the casualties from the pandemic. Our investment stance has been more pro-UK since early 2020, including many exciting areas in energy storage, and we still see more interesting opportunities in the UK.

Exiting the Pandemic

On a more global scale, inflation continues to fall down the list of policy priorities for central banks. In fact, some inflation is desirable, and with the high levels of bond buying, in particular from the ECB, the risks for fixed income investments continues to increase. Index linked bonds are already very expensive, pricing higher inflation, and for some time we have favoured Floating Rate Notes instead. Whilst we do not see interest rates rising in the UK or US in the short term, things may change, and we expect that expectations at least, will change after the summer. Long-term interest rates have already risen and impacted bonds, especially in the UK, as future inflation expectations change. We therefore remain at best cautious when it comes to UK or US fixed income and negative to European fixed income.

For a number of years we have avoided conventional property REITS in favour of more positively focused social, affordable and homeless housing REITS. The pandemic vindicated this decision and we still regard retail property in particular as an area of elevated risk as we exit the pandemic. Given so much will change with regard to city centres (not particularly negative), we prefer to remain more focussed on the positive areas for both investment and ethical reasons. The newly added HOME REIT and the PRS REIT (affordable new rental homes) both did very well in the last quarter.

Equity investments are placed into three categories: Infrastructure based yield companies, larger companies with either a good ESG rating or a positive focus and finally higher risk investments with a positive focus ranging from small capitalised companies, AiM and unlisted.

The first category consists of infrastructure, the owners and operators of wind farms, solar parks and other renewable, water and waste assets. These assets are less volatile but still high impact investments and tend to have a more income focussed investment objective, albeit they are also more interest rate sensitive. Over the last year, these assets have been a victim of the rise of renewable energy in the UK, as the spot electricity price can plummet on windy and sunny days. These investments generally have longer-term PPA contracts and therefore the risk is more implied with future prices/contracts than current, meaning less cash flow related. We also see the dynamics of the sector changing as energy storage is built up and this will reduce the current electricity price volatility in the future. We added a small amount to these investments in the last quarter.

Over the last quarter the more renewable energy/positive impact focussed companies gave back some of their recent gains, notably Orsted, Vestas Wind Systems and Tesla. We had taken some profits on these holdings last year and we used the weakness to add back in the cases of Vestas and Orsted. These losses were more than offset by broader gains in the other shares, notably Biffa and National Express as recycling, waste and public transport recover. As we mentioned above and in our reflation paper last month, we have seen many of the shares that were hard hit last year (fossil fuels, travel etc) recover strongly and this has the portfolios giving up some of its outperformance from last year. We feel this process ran its course in the last quarter and we added back some renewable energy shares that we sold or trimmed last year.

High-risk investments continue to do well, in particular in the rapidly growing energy storage, green hydrogen and medical areas. Some of this is driven by strong savings levels and a liquidity driven search for growth in the markets, and therefore this could go as easily as it came. However, there is a noticeable change in tone since the pandemic, especially around frontier scientific areas that provide solutions to food, health and energy issues, with a new lease of life to push these frontiers. Energy storage and green hydrogen are moving much closer to being a commercial reality and have been attracting investors.

Conclusion

After 2020, the first quarter of 2021 has been a more subdued and realistic start to the year. As the pandemic unfolds, we expect the next quarter to be more exciting as lockdown ends and many parts of the economy unfreeze. As we have noted this will have both positive and negative aspects.

Given the desire of Central Banks not to act too soon on inflation and the political need for an economic recovery, the visible risks to the recovery seem still be some way away. It is a question of when markets choose to react to them, and at the moment there seems to be little appetite to do so.

This leaves the risk of bubbles; the bond bubble is being sustained by the ECB and Europe but has clearly began to deflate a little in the UK and the US. As Central Banks remain on standby, we see limited risks in the short term. With reflation now priced in, and the “exceptional items” of last year now in the past, we see the next quarter as one of recovery, punctuated by the odd reality bump in certain areas (Deliveroo IPO for example).

From an ethical perspective, the crisis pushed forward many key impact areas such as renewable energy, electric vehicles, online living and modernised healthcare. These trends may have been overshadowed by the end of lockdown, but they remain firmly in place. Those who argued impact and ESG investing was a poor investment choice, and more recently that it is just a fad, are now beginning to find themselves on the wrong side of history.