Fund Managers Report 30th September 2020 to 31st December 2020

What a year!

The last year has been a definitive year in many different ways. The unprecedented and unexpected global pandemic shook the world and with it brought bereavement, loss of income, anxiety and uncertainty for many people. Speaking to some well nuanced medical professionals last week, the main encouragement we can take is that "it could have been a lot worse" than it was.

As we take stock on the year, there has been much more than the virus to look back upon and it has been both a positive and watershed year for ethical and impact investments, with a year of solid outperformance which also favoured higher risk investments.

This year portfolios have benefited from the negative screen applied to your investments, by not holding fossil fuels, large banks, airlines, airline manufacturers, automobile producers, hospitality, tobacco, commercial property and tourism stocks, the portfolios were able to avoid the areas that were hardest hit by the pandemic. In all, the only major negative areas that have fully recovered or done better during the crisis has been mining.

At the peak of the crisis in late March, the outperformance between the lightest screened ESG global indices and conventional global indices and was 2%, widening to 13% when compared to the UK market (more on this later).

13%

The outperformance of global ESG versus the UK's main equity market

As an aside, we have noticed that many of the latecomers to ESG/ethical or impact investing have been justifying ESG investing on the basis of only risk mitigation, rather than for the purposes of doing good, we touch on this in another blog post "Why ESG". Within this style of investing some take the view that many of the sectors we exclude, such as fossil fuels, should be invested in on the basis of reducing investment risk. We disagree with this, seeing it not only as a form of Greenwash, but more so we are not convinced the investment or risk case is justified in the long term.

This then touches on the issue of a reversal of this trend. Here we feel any rebound would be limited, with maybe tourism being the only significant sector to rebound, with pent up consumer demand and better personal finances. Whilst demand for fossil fuels may increase again once the world becomes more mobile, we feel the dynamics for the sector have changed so significantly that oil and gas will remain in a longer-term decline. The sector is over supplied and highly indebted following the shale binge, whilst still under pressure to pay unsustainable dividends.

Other sectors such as commercial property, especially for non-food bricks-and-mortar retail, have been in long term decline, and the virus has only accelerated this process. European car manufacturers, who were heavily invested in diesel, have fallen too far behind on electric cars. China has become the world's biggest car market and worldwide the future is electric. Large banks are seeing technology, regulation and disintermediation erode their business model, whilst working from home will be increasingly part of the future, albeit to varying extents, with further implications for the future of offices and city centres.

Concentrating on the negative screen only catches half the story at best. The pandemic initially benefited the technology sector as the move from office to home was far more widespread and seamless than expected. This rally included the FAANGs (Facebook, Apple, Amazon, Netflix and Google) and other technology names like Zoom and DocuSign, but we also saw a strong interest in many of the more impact focussed sectors that we align to.

Two key factors influenced this drive, the first being the focus many of the world's governments have placed of using the stimulus money they provide for environmental infrastructure, as the UK government put it, "building back better". Similarly, the EU and various US states also placed emphasis on the environmental sector, a shift exacerbated by the results of the US election in November.

At the same time, we have seen other areas: in particular electric vehicles; offshore wind and solar as well as vegan faux meat all mature to such an extent that their trends become exponential as they move from fringe to mainstream. Therefore, these impact investments have become more mainstream (Tesla is now in the S&P 500 index for example) but also remain areas of genuine growth. This has led to significant outperformance in many of the non -UK based investments in these positive sectors, such as Orsted, Vestas, Tesla, Beyond Meat as well as some of the very high risk AiM investments held where permitted.

On the negative side, equities invested in public transport, recycling and the housing sector (construction and servicing social housing) were hit hard by the pandemic. Much of our exposure to public transport is through government backed bonds and here there was a positive return, but the equities werehard hit. We added, and later on the bounce reduced equity exposure to this sector. We expect housing to continue to rebound sharply as demand still exceeds supply, remaining an area of social need. We also added to recycling into the weakness as this is a function of economic activity which we expect to see resume in 2021.

Having less of the hard-hit sectors and more of the good has in turn led to a good year of relative performance for ESG and Impact investments, and in our view this is the market catching up with the megatrends and as mentioned, the increasing maturity of many of the sectors we focus on.

The relatively poor performance of the UK equity market compared to global markets will have impacted lower risk or lighter green portfolios more as there would have been more exposure to the UK. The poor performance has nothing to do with Brexit but reflects the UK equity markets bias towards cyclical global companies, the main UK benchmark of the top 100 hundred stocks was negative on the year, largely due to its exposure to oil and gas, mining and large banks.

Bonds, both fixed and floating, only generated low returns as the upside for fixed income was limited as interest rates were already low before the crisis and the main gains were in the longer dated or risker bonds, as the lower rates for longer view buoyed the market. We see very limited upside for fixed income in the long term but immediate term we see the current fears continuing to support the current levels.

Some time ago we took the stance to avoid conventional office and retail property investments and focus on the more social property. This led to a focus on social housing, affordable and quality residential and healthcare properties. As a result, the property investments in the UK performed well with one exception. Only the investment in affordable residential homes was negatively impacted due to a slowdown of building construction, as its focus is building new homes, not buying existing homes to let.

HOME REIT

A new investment in portfolios that provides housing for the homeless

In October we participated in the IPO of the first Real Estate Investment Trust to provide homes for homeless people, the HOME REIT. This trust invests in properties that are then let long term to housing charities and trusts, to enable them to provide longer term homes for homeless people. There has been a substantial need for long term properties in this sector and we consider this a core investment for portfolios.

In December we also participated in a second IPO, the first Social Impact Investment Trust which is managed by Big Society Capital, established by the UK government in 2012 to channel funds into areas of social need (they then used unclaimed dormant bank deposits). The funds three main areas of investment are social housing, charity finance and social outcome contracts. This investment channels further funds into areas of high social need with realistic financial returns. This is a higher risk investment but with a lower correlation to traditional assets (similar to infrastructure).

Remaining with UK infrastructure, your portfolio has a high exposure to renewable energy, which includes companies who own and operate wind farms, solar parks and some biogas and hydro-electric. Some of these companies generated a negative return in 2020 when UK electricity prices fell sharply at the start of the crisis. Before the crisis there was some pressure on these companies as they performed very strongly in 2019 and were overvalued (we did trim back in some cases), so we do regard last year's pull back as a correction and remain happy owing these investments.

The third (and final) IPO we participated in this quarter was a new energy efficiency technology trust. This includes a range of projects from combined heat and energy for tomato growers, to social housing and industrial retrofits for energy efficiency, as well as rooftop solar and vertical farming. This was to recycle some of the profits from the existing investments and to diversify the portfolio a little further.

Outlook

We must not forget that 2021 also heralds a new US president and a United Kingdom outside the EU. Ironically renewable energy did well under Donald Trump (your portfolio has investments in US renewable energy infrastructure), as states and corporations carried on regardless of the President's agenda. Obviously, a less confrontational and more environmentally focussed US president should help many of the impact sectors. Of less concern directly to our portfolios but more to the market will be the new administration's approach on tax and technology regulation.

As far as Brexit is concerned our main issue has always been uncertainly, and this has moved from the political to the practical, but the market has welcomed the end to four and half years of political tension.

The pandemic has, of course, overtaken all of these events. As far as markets are concerned valuations are based on 2022 and ahead. In the short-term lockdowns continue and the focus is on the vaccines and progress of the virus. In terms of vaccinations it's a race to move out of the pandemic, the UK, US, Israel and UAE are by far the nations most advanced here.

From an economic perspective, we expect central banks and governments to remain on emergency footings for the first quarter if not the first half of 2021, with either low or negative interest rates, and monetary and fiscal support. Any unwinding of this will be expected to take place with rising economic activity, savings ratios have risen very sharply over the pandemic and a great deal of latent demand is expected to be unleashed after the virus.

Some sectors, including many of the impact sectors, do now look over valued and we see risks more elevated than in our September 2020 report. Expectations are based on a post pandemic world and accelerating growth, and whist this is not outside the realms of reasonable probability, it does require expectations being met or exceeded. This is turn means any negative surprises or more hawkish central bank comments could spark a rapid correction.

With the IPOs in this quarter we added more defensive investments into the rally and we expect to broaden and trim risky investments over the coming quarter.

In the meantime, we wish everyone a happy, healthy and prosperous 2021.

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