KING & SHAXSON
ethical investing

Fund Managers Report
Fourth Quarter

The Next Phase

The starting pistol has been fired

About the only things we can be certain about this year is that we will see the cost of capital rise and the quantity of money shrink. Central Banks around the world will begin the process of withdrawing the unprecedented stimulus they provided during the Covid Crisis. In the case of some region's such as the Eurozone, ultra-loose monetary policy had been in place well before, with the crisis only adding

Comments from the US Federal Reserve, the Bank of England and the ECB have already flagged this, and in December the Bank of England fired the starting gun by raising interest rates and reversing the emergency cut for Covid. The timing of the Bank of England certainly caught the market by surprise, but regardless of that, the market was expecting this process to begin in earnest during 2022. The subtler shift in sentiment has been an increase in the expected speed of tapering and tightening as flagged by the US Federal Reserve. Perhaps more significantly is the sense that there is more resolve to follow this through regardless of Covid developments. In our last quarterly comment at the end of September we had expected to reach this point during the last quarter of 2021, but the sudden arrival of the Omicron variant led to a pause. Now that this variant appears both less dangerous and disruptive, the need to quell both asset price bubbles and real inflation takes precedence; as a result, the need for action, however careful, has increased in urgency.

This is also taking place despite the fact that inflation expectations appear to have peaked when looking at index linked breakeven prices, and so may seem counter intuitive. Current inflation, however, is only part of the story. Longer term supply chain issues will continue to cause some inflation in the short term, and this will be regardless of interest rates. More than inflation, the main issue is the unsustainable nature of excessive stimulus which is bad for the long-term health of any economy/financial system. The need for some normality, before the next crisis, sharpens the resolve to move on. Whatever happens with Covid (excluding a major crisis), we can expect a less favourable environment from Central Banks.

Governments may also be less speedy with help, now they understand Covid better. In fact, the UK has already planned tax increases for April 2022, and then further corporate tax rises in 2023, which we regard as a potential risk for growth and investment. We now face a new phase where both economies and companies will need to be more resilient and expect less largesse; as a result, we may see more failures in 2022 as normality is restored.

Outlook - does the music stop?

January always brings with it the temptation to predict the future, and those with memoires of the taper tantrum of 2018 may be inclined to think that an end to easy money means the music stops, and the markets fall. Even more so if we add rising geopolitical risks, some high valuations and three strong equity market years to the equation.

Fixed income markets are already pricing in the higher interest rates, the only questions are speed and timing, and as we start 2022 this seems to be accelerating. Whilst we still remain cautious to fixed income, the UK Ten Year Gilt has declined about 8% since the start of 2021, and we see UK bond yields in the region of 1.20% as more reasonable. The fall in gilt prices and rise in yields reflects both the economic recovery seen in 2021, as well as the expectations for inflation and interest rate increases. Our investment stance remains that the only reasons for holding bonds are risk mitigation or exposure to investments with a strong impact profile that can only be accessed via bonds (such as IFFim – provider of Immunisation in the developing world). That said, we have recently added a little more exposure with higher coupon bonds, as we see more limited downside as well as potentially more volatility in equities. We still prefer to keep a sizeable element of low-risk debt investments in floating rate notes to balance the interest rate risk.

Our property exposure remains focussed on property investments with a higher social impact such as homeless, social and affordable rental properties. In the previous quarter, we sold Primary Health Properties on valuation grounds; by mid-December the share price had fallen over 11%, and wanting to maintain income and exposure we added this stock back to portfolios where it was ethically acceptable. Homeless and affordable property performed well over the period, performing better than recovering retail and office properties. Our social housing investment, whilst positive for the quarter, was not as good as the others after being impacted by problems with another social housing company that we are not invested in, but nonetheless cast a cloud over the industry. We do not see the same issues affecting the company we favour and have kept this investment. There remains a pressing need for good quality property across the social sphere, so we expect activity and interest in this sector to remain strong.

It has been both a busy quarter and year for infrastructure. We added two new investments in the last quarter, one investing in roof top solar for commercial buildings, and the other was based on Asian renewable assets; these new investments complement the existing investments in wind, solar, storage and infrastructure. We trimmed some existing investments to add these new names. During the year we saw a proliferation of new investments come to the market, and with this we have become concerned about quality and saturation and we rejected a number of investments on these grounds. In the short term, the sector itself faced headwinds from higher interest rates, and that also led to the rush to bring investments to market. These investments have a direct link to many core impact areas (owning wind farms, solar parks, battery parks etc.) and the sharp rise in fuel prices towards the end of the year have highlighted the need for improved energy infrastructure around the world.

The headline numbers from equity market indices looked good for 2021, but much of the rally was driven by a small number of stocks. The reflation trade (stocks that did poorly in 2020, but recovered in 2021) verses the growth trade was a theme for 2021. The SDG Impact index total return in Sterling was just below flat for 2021, the ESG leaders index returned positive 26% and the world equity index returned 20%. A substantial part of the rally was in the last quarter as Omicron delayed Central bank action.

There is more potential for volatility in 2022 as markets grapple with inflation and higher costs of capital. Add to this the fact that Central Banks have flagged their plans to the market, the main risk is them acting faster or going further than markets expect. In addition, whilst there are always geopolitical issues to be aware of, the current ones are somewhat nastier than usual at the start of this year. Although, we take comfort from the fact that the rally in 2021 was very narrow and not all stocks are over-valued. We would see any short weakness as an opportunity to add.

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