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MARKET COMMENTARY

December 2023 - Near term performance

It is already well documented that the more focussed ESG and Impact sectors have had a torrid time. Following the King and Shaxson ethos of openness, we have regularly updated both advisors and investors of the reasons why portfolios have experienced a difficult three years. Especially in the light of a strong run up until 2021. In fact, as early as 2019, when relative performance was very strong, we were explaining the performance dynamics to ensure that advisors understood the unsystematic risk and performance impact of both positive and negative screens.

These last three years have been far harder than expected, and given the sharp growth seen in ESG and Impact funds over the last five years, this unsystematic risk has been felt by a much larger and broader number of investors than before.

Understanding the broader context is essential, over the last 10 years, ESG and Impact portfolios have still outperformed the unscreened markets. The last five years saw an intense and concentrated set of events, that first led to high outperformance before reversing into underperformance.

A core point, repeatedly stressed in a number of our quarterly and ad-hoc reports, remains the role of interest rate expectations on the performance of the portfolios. Something that stretches from the text book fixed income yield curves, to the cost of capital for infrastructure and then further to the pipeline expectations for property and infrastructure, to finally the ability to price growth investments.

It is therefore no surprise that the recent turnaround in interest rate expectations that started gaining traction at the start of this quarter has had both a material and positive impact on the performance of portfolios. Since the start of November all portfolios have enjoyed a strong positive real and relative return, as highlighted in our model portfolio performance return below:

Performance 31/10/2023 – 15/12/2023 – Source FE

Portfolio	Performance (net of fees)
K&S Defensive	6.25%
K&S Cautious	7.96%
K&S Balanced	8.26%
K&S Balanced-Growth	9.13%
K&S Growth	9.68%
K&S Adventurous	9.96%
Income	9.48%

(For reference, the AFI benchmarks returned the following: Cautious 6.52%, Balanced 7.35%, Aggressive 7.55%)

The real return for portfolios has been broad based. Starting with recoveries in fixed income, as rate expectations first stabilised and have now begun to fall, we still favour lower duration in the longer term, as there is some debate in the market about the high levels of government and corporate debt, and we remain vigilant at this point.

As seen in mid-December, Central Banks still provide some hawkish rhetoric and talk of the inflation risks, seeking to temper the markets. Despite this, the fact that expectations have pivoted from higher rates for longer towards peak rates, stability and eventual easing, is enough to change the background narrative and improve the outlook. As well as in fixed income this has been keenly felt in the infrastructure and property investments in our portfolios.

We have covered the investment and impact reasons for holding infrastructure and property in various reports over the last few years which can be accessed through the views page on the website. The recent recovery in these assets has been pronounced, reducing the gap between the price and the Net Asset Value by between a third to a half. These moves have supported portfolios as highlighted in the recent performance of some of our core holdings in the asset class:

Property and Infrastructure Performance 31/10/2023 – 15/12/2023 – Source FE

Investment Fund	Performance (net of fees)
Foresight Sustainable Real Estate	18.85%
Gravis Clean Energy	13.04%

(For reference, the MSCI world infrastructure index has returned 8.93% and the UK Property index has returned 21.52% over the same period).

The recovery remains incomplete and although there may be some bumps in the road, more certainty and sight of lower interest rates will help this sector further.

Finally, the change in the interest rate narrative has provided a needed boost to real growth equities. The market rally in 2023 has been dominated by seven technology giants (known as the magnificent seven) that in 5 cases do not meet the ethical screen such as aggressive tax practices, labour and data issues. We have commented on this before.

Now that businesses can make plans with more confidence; we have seen some strong rallies in the equities (often large companies) that benefit from infrastructure investing. Wind turbine makers and global industrial focussed companies have all rallied sharply as this was the final piece of their jigsaw as supply chain issues, input process and pricing for contracts have all slowly resolved themselves too.

The absolute rise in portfolio values since the beginning of November is due to a combination of the above factors. The relative performance of portfolios has also been strong, and we are now beginning to see a reversal of the relative underperformance of the last three years.

Tobacco shares have fallen back to their 2021 levels on the back of further litigation news, and writing down the value of their business. The global tobacco index has returned -2.36% quarter to date, with valuations now as low as some of the major banks as markets factor in major risks. The economic slowdown in China has impacted some commodity prices and therefore certain mining shares. Oil and Gas shares have been fading, with the all-country oil & gas index returning -7.67% quarter to date - demand for oil has fallen more sharply than expected according to the International Energy Agency.

Only Aerospace and Defence remains a strong outperformer given the continued focus on defence in the current geopolitical environment.

Investment is set to remain strong and there are record cash levels in money market instruments which will potentially support equities moving forward. The focus is moving away from sectors reliant on personal consumption and post pandemic spending boom, towards investment in business and growth. Renewable energy has resolved many of its growth and supply chain related issues and is the focus of government backed spending for energy security alongside the environment. Global warmings impact on food supply has become more pressing and both science and society are only now getting to grips with the importance of biodiversity. Artificial Intelligence has been a dominant trend of 2023, which presents opportunities and challenges, whilst healthcare is seeing some new M&A activity having been out in the cold post the pandemic.

Whilst two months of progress is still early days and it may appear too soon, what matters is the interest rate dynamics we have been waiting for and talked about has happened. Stability with interest rates leading to a confident investment outlook that favours long term and more capital-intensive infrastructure and growth investments. Although there may be the odd bump, we see this trend as established, and in fact, there is a possibility European, UK and US growth could weaken faster and harder, accelerating the pace of easier financial conditions. Either way the outlook for consumption-based investments is tired and more vulnerable and a more confident market favours a broader based market, not just one dominated by the passive drive to the biggest shares.

The economic noise may become more mixed, but as inflation and by implications interest rates stabilise, markets will focus on the future and we expect (as has happened in the past) that the market rally will now broaden to other large cap, mid and smaller cap investments across more growth focussed sectors. Portfolios should continue to benefit from this.

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