SAUNDERSON HOUSE

Investment Bulletin

Responsible Investing 2021 Performance Review and 2022 Outlook

2021 Recap

Last year, the pandemic catapulted ESG into the mainstream. The investment industry asserts ESG has always been a priority, and existed long before its ubiquitous initialism. This is true to some extent, but the impact of the virus shone a light on longstanding global challenges in a way that promoted ESG from a niche, 'nice to have' area of the corporate world, to an ever-present topic in boardrooms, AGMs, and governments.

This year tasked these actors with putting their words into action, and challenged them to do so in a world rocked by new coronavirus variants, supply-chain capitulation, and inflation.

Capital markets felt the impact of these challenges too. In the first half of the year, sectors containing long-term, structural 'winners' (like renewables, technology, etc.) slumped, as rising inflation expectations pushed bond yields higher, and lofty expectations of their future performance were curtailed.

By contrast, cyclical, 'real economy' sectors (like fossil fuels, mining, retail, and financials) performed strongly, driven by the re-opening of economies and successful real-world vaccine data.

However, restarting the hyper-connected global economy posed new challenges. The cost of shipping containers (the large metal boxes used to transport goods across seas) surged, sewing seeds of inflation on top of an already loose money supply. Supply chain breakdowns also affected semi-conductors, which then led to a shortage of new cars, causing the price of used cars – the obvious substitute – to rise.

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Some small and mid-cap companies with less power to raise prices felt the impact of rising inflation expectations. In particular, companies heavily dependent on well-functioning supply chains (manufacturing, certain industrials) faced challenges.

In Spring, the Delta variant of Covid-19 took hold in India and quickly spread around the world, taking the wind out the sails of the 're-opening' trade. Investors reduced their cyclical bets, rotating back into more quality names, as well as the growth-driven names that were oversold earlier in the year.

Investment markets progressed reliably over the summer, shaking off Evergrande default fears in China and a chaotic military withdrawal from Afghanistan.

The next source of volatility came in September, as Europe experienced an acute shortage of natural gas. This spurred inflation further, increasing energy input costs across the board, in particular in gas and coal. Rising input costs also exacerbated existing supply-chain constraints, impacting our favoured renewable energy and environmental strategies.

Although asset prices quickly recovered, with leadership coming from a handful of high-profile names in the US, rapidly increasing Covid-19 cases in South Africa were confirmed to be driven by a particularly novel variant of the virus, later termed Omicron.

This news led to the sharpest sell-off across global markets in over a year. Early reports that Omicron was causing less severe illness helped to becalm markets, but multiple sources of volatility remained – in particular, central bankers now had a further wave of infections to consider when discussing the path for interest rates.

So, how did our Responsible Investing approach fare throughout 2021?

Evaluating the Performance of Our Responsible Investing Approach

The headline return for 2021 for our Wealth Management Balanced – Responsible portfolio was 6.05%. Our corresponding conventional approach returned 8.18% (Fig 1).

Figure 1: Performance of the conventional and Responsible WMB models in 2021

Since the Responsible Model inception in September 2020, the Wealth Management Balanced – Responsible portfolio returned 16.2% versus 18% generated by the conventional model (Fig 2, overleaf).

Figure 2: Performance of the conventional and Responsible WMB models since inception

Source: FE Analytics; 09/09/2020 is the date when the new Responsible models were formally approved by the Investment Committee.

Though the headline return for each approach is relatively similar, over shorter time periods the two approaches reacted differently to different sources of volatility.

In our review of 2020, for example, our outlook for 2021 highlighted the risk that the track records of ESG labelled funds would be tested. Many strategies began during a generally fruitful period for investors, and none had faced a sustained period of rising inflation expectations and yields.

In February, bond yields jumped from their pandemic lows as economic recoveries gathered pace, and inflation expectations climbed. Whereas our conventional approach was more geared to this economic recovery – the Oil & Gas sector, for instance, performed particularly strongly – our Responsible Investing approach was less able to access this re-opening momentum.

As explained in our H1 2021 recap, this is because ESG strategies are more likely to emphasise sustainable advantages in their stock selection processes – note that, here, 'sustainable' describes enduring advantages that competitors struggle to replicate, rather than 'greenness'. This emphasis is a by-product of attaching greater importance to a greater range ESG factors when valuing stocks. As a result, strategies in the ESG space tend to exhibit less sensitivity to economic growth and slowdowns.

Last year, this approach protected significant value as economies ground to a halt, and we have discussed in various papers the body of evidence identifying positive associations between ESG integration and investment performance over the last decade.

Figure 3: Performance of the conventional and Responsible WMB models in H1 2021

After years of benign inflation, investors began to consider how rebounding economies would interact with generous stimulus, loose money, and supply chain bottlenecks – in particular in raw materials markets. This tested central banks' messaging that inflationary pressures would be 'transitory', and that they would unwind as economies loosened up after months on ice.

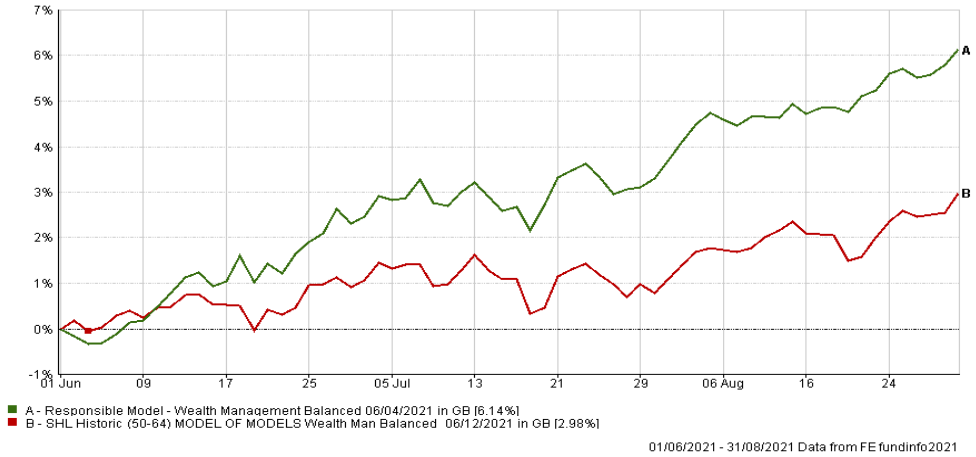
As a result, bond yields rose and investors rotated away from longer duration 'growth' stocks, including those which had performed strongly during the crisis. The value of these companies is more closely linked to growth of earnings and payoffs in the future, which are less valuable in an environment of rising interest rates and inflation.

Investors therefore favoured cheaper cyclical stocks more closely tied to the re-opening of economies, including travel, retail, energy, and materials, which are more widely held in our conventional portfolios.

Although this rotation was pronounced, the Delta variant quickly took the wind out of the sails of rising optimism. After taking hold in India, the Delta variant soon became dominant, and cooled expectations of a smooth economic rebound, driving rising infections even in well-vaccinated populations. Although these populations were trying to ease restrictions at the same time, investors considered their risk exposure regardless, with background 'noise' including the US withdrawal from Afghanistan and a strategic crackdown on certain industries by the Chinese government.

Investors began to re-embrace more quality stocks, taking profits from cyclicals which had enjoyed a strong re-opening rally. Particularly strong Q2 earnings in the US were supportive of this.

Figure 4: Performance of the conventional and Responsible WMB models during the Delta wave

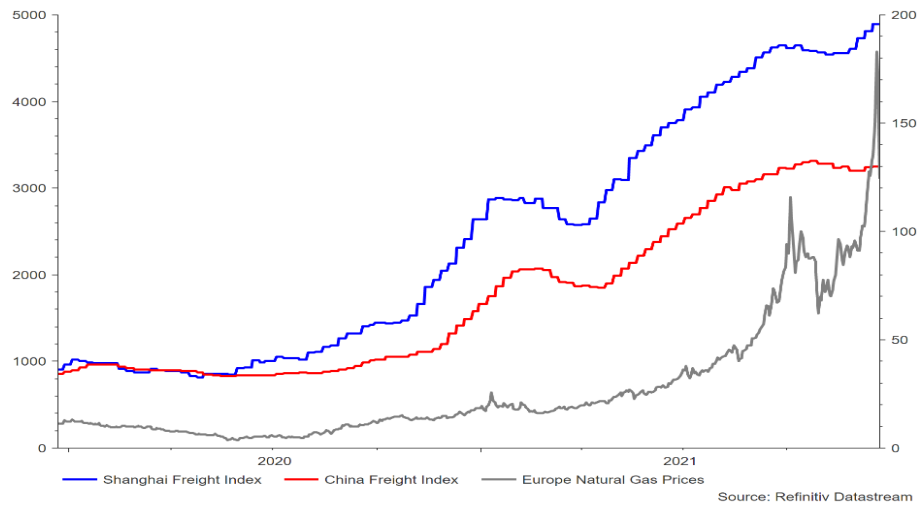


As Delta was a source of uncertainty for the global growth outlook, fears of runaway inflation and rising interest rates were calmed. In response, investors rotated back into the areas of the market they rotated away from earlier in year.

For the Responsible approach, this was positive, allowing companies in our impact-led and renewable energy funds to recover losses that followed the uptick in bond yields in the Spring, and even go on to outperform.

September brought with it a new source of volatility – an acute natural gas shortage in Europe. Shipping container prices (the cost of a container to move cargo long distances across oceans) had already surged, and rising natural gas prices led to further cost pressures in supply-side inputs. In turn, investors returned to being fearful of inflation.

Figure 5: Shipping and gas container prices since the inception of our Responsible models



This was a drag on the performance of our Responsible portfolios, which have limited exposure to the commodities whose prices were rising. Moreover, logistical logjams and rising input costs put pressure on some manufacturing names in the green energy equipment space.

Figure 6: Performance of the conventional and Responsible WMB models in September 2021

Volatility in markets remained until year end, heightened further by the emergence of the Omicron variant of the coronavirus. In November, Omicron caused the largest drops in indexes in over a year, and investors are still digesting data on vaccine efficacy and severity of symptoms.

Figure 7: Performance of the conventional and Responsible WMB models in Q4 2021

As seen following the emergence of Delta, and indeed the first lockdowns in March 2020, cyclical stocks (energy, mining, financials) were impacted most. However, vaccines, greater knowledge of how to treat Covid, and uncertainty around the severity of Omicron illness saw markets yoyo, and the presence of already elevated inflation made investors' previous reaction to the virus (buying long duration growth stocks) a less obvious response.

Outlook for the ESG Landscape and Models in 2022

Renewable Energy and Environmental Stocks to Begin Year at More Compelling Valuations

'Green' sectors (including renewable power generation, equipment, battery technology etc.) were one of the standout winners of an extraordinary 2020.

In 2021, elevated valuations, supply-chain challenges and high input costs left many names exposed to the 'value' rotation discussed earlier. Despite this, the underlying investment thesis – not least the additional investment and spending required to meet global climate goals - for these names remains exceptionally strong.

As we move into 2022, many businesses in the space are trading at meaningful discounts to their peak valuations of early 2021. Although President Biden has yet to pass his 'Build Back Better' bill, the sector remains well-placed to benefit from further public and private investment.

We had COP26 recently, which brought a lot of media attention on climate change and all stuff sustainable. Some of the measures taken or agreed will have a positive effect on many of the names held within the responsible models.

We welcome the developments agreed at COP26 because, without progress this decade, meeting 2050 climate targets will be impossible. Encouragingly, countries will now be invited back annually to further their commitments, rather than doing so every five years.

We cannot say with certainty that governments will step up and allocate enough funds to mitigate climate change effects. However, it becomes more clear that consumers and corporates are taking more meaningful action to seek more environmentally friendly solutions and products.

Therefore, we are particularly positive on the outlook of our recommended Thematic and Positive Impact funds, which stand to benefit from the investments to come and from developments focused on combating and adapting to climate change.

Strong ESG Characteristics May Help Businesses Navigate post-Covid Environment

Investors, journalists and commentators are increasingly trying to pin down exactly what ESG 'is', and whether it might ever be considered an uncorrelated 'factor' in investing, like 'value', 'momentum', or 'size'.

Although this is a worthwhile thought exercise, ESG as a set of risks has already proven to be an effective proxy for helping investors identify 'quality' and growing businesses – those with robust processes, governance, and stakeholder management.

These businesses are often well-equipped weather economic slowdowns and changes to regulation, regimes and monetary environment. As economic growth and inflation moderate following the post-Covid recovery, businesses with strong ESG characteristics – a good predictor of quality – could prove resilient.

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