CAMRADATA

Global Equity Whitepaper

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Welcome to CAMRADATA's Global Equity Whitepaper

Most clients of asset managers acknowledge the difficulty of market timing. But during severe downturns such as we have experienced in 2022, they readily go and participate in market timing by pulling out of liquid risk assets such as equities. The withdrawal is understandable but usually emotional, with no disciplined rationale for either the exit or a future return.

In such times, equity managers are left to be as rational as possible, explaining why their process will carry on functioning well enough when a. market sentiment is negative b. interest rates are rising c. inflation persists.

It is hard for any manager today to refer to earlier periods of their career when they succeeded through similar conditions. They can, however, refer to consistency of process. This might manifest itself in short-term volatility, but institutional investors ought to recognise the longer-term benefits of a consistent process (not least transparency in communication).

This whitepaper will endeavour to find out whether asset owners have tolerated depreciation of their equity portfolios this year; or decided to indulge in market-timing.

Global Equity Roundtable

The CAMRADATA Global Equity Roundtable took place in London on 12th October 2022.

CAMRADATA's October 2022 roundtable began by defining the role of global equities within asset owners' portfolios. Alasdair Gill, head of equity research at XPS, a pension fund consultancy, said that in the world of Defined Benefit (DB) pensions, the requirement for growth assets is ticking down. Some schemes are finding themselves fully funded and ready to exit to the insurance market.

But DB clients are only one type of institutional investor. For endowments, charities and DC clients," Gill said, "growth assets make sense because there is less need for contractual income if you have a longer horizon. You don't need to go to linkers. Equities can deliver real income."

Ben Matthews, head of equity research at another pension fund consultancy, Isio, echoed Gill's points. "Many of our clients are corporate DB schemes; their trend has been towards managing risk and income-type assets, not necessarily equities. The majority of these schemes are on a journey to their end-goal. With the increase in government bond yields that we have seen this year, this has significantly improved the funding position for a large proportion of our clients and re-emphasized our messaging concerning risk reduction."

Matthews said that the majority of Defined Contribution (DC) pension schemes and endowments had a longer-dated time horizon. "For these clients, having equities as a long term strategic allocation in the portfolio makes sense. We are coming from a world of cheap money but this year has seen a complete shift in market dynamics. Equity assets in particular are trading at lower multiples, being reflective of the macroeconomic concerns present."

Matthews was challenged as to whether equities could fall further. "There is still significant downside risk for markets," he responded. "There are a lot of challenges out there, therefore clients should be aware of potential drawdowns and further shocks over the short to medium term."

Robert Doyle, head of equity manager research at bfinance, an adviser to institutional investors, said that pretty much everything he had seen in Requests for Proposals on equities from asset owners this year had been core. "Active risk tolerance is low. Asset owners want to avoid structural biases - whether style factor, sector, region, size," he said. "They are looking instead to grind out some alpha with lower-risk, lower-return strategies."

He described this approach, where asset owners in all parts of the world are positioning themselves in the middle of the 'style box', as very unusual. "I've not seen anything like it before," said Doyle.

Tudor Poiana, equity manager research at SEI, an investment

“ Style drift is to be avoided but we do want to allow managers a little more flexibility.”

management company, said that in contrast to much of what had been said, the majority of SEI clients haven't opted to de-risk. “At the heart of our investment solutions lies the Strategic Asset Allocation (SAA) approach tailored for each client's individual financial goal” he said. “And equities are still an important part of the SAA, needed to achieve those goals.”

Poiana explained that SEI uses a factor framework built on three alpha sources: Quality, Value and Momentum, implemented either through external investment managers or SEI's own internally-managed solutions. “Styles work,” he said, “and in spite of all the literature detailing why and how, they still work because they rest on behavioural biases. He suggested, for example, that investors often underappreciate the earnings power resilience of some exceptional businesses by modelling returns too quickly to the mean, which offers a Quality premium.

For Aon, equity manager researcher, James Jackson said: “We tend to use equity strategies as building blocks to create a composite with a beta of one and low tracking error. That equity block is modelled with asset classes to meet clients' specific long-term risk and return objectives.”

He said it was quite easy to paint different scenarios where different investment styles are going to perform differently to one another and warned that you have to be careful in manager-of-manager constructions of Growth and Quality correlating.

“We have moved a little away from the rigid style box approach to permit managers more freedom,” Jackson. “Style drift is to be avoided but we do want to allow managers a little more flexibility.”

Simon Edelsten, co-manager of the Artemis Global Select Fund, said he was surprised by what he had heard. “Most people who run global equities would feel puzzled by and sorry for investment consultants. We used to run large amounts of equities for UK pension funds in the 1990s and 2000s. Then the Global Financial Crisis led to accountants leading the discussion. They got behind companies' finance directors with the message: Let's buy lots of bonds. And then leverage those holdings to buy more bonds, and private equity.

“Over the last ten to eleven years, we have had a free cashflow Growth trend in equities while pension funds have bought gilts on increasingly risky valuations. The risk model consultants have used requires a more negative view of equities. When inflation comes along, as it has with a vengeance, gilts become even more risky based on the price you are buying them for.”

Edelstein's question for the CAMRADATA panel was which assets pension funds want, given that we don't know what inflation will be. He suggested that buying a 10-year gilt at 4.5% yield was fine if you know what inflation will be and that works in your calculation. Otherwise, you are taking a massive bet on inflation.

On defining Quality as an equity style, Edelsten saw little ambiguity. “Quality companies are those that can cope with inflation,” he said. “They have decent barriers to entry and the free cashflow has a relationship with inflation. So you don't know the exact figure for inflation, but you do know the company's earnings have a link to it.”

Gill's response was that pension scheme trustees are not unconstrained investors. They are not seeking the best return but to secure future benefits for scheme members.

Edelsten continued. “My way is to invest in High Quality stocks. Eighteen months ago they were certainly overvalued. Now Quality is critical in an inflationary environment. The last heavy bout of inflation was not during the oil crisis of the mid 1970s but the five years after. It took the arrival of Paul Volcker at the Federal Reserve in the early 1980s for the U.S. to get over inflation. But even during this consumer squeeze, equities did fantastically well on a real return basis while bonds did really badly.”

Edelsten did note that price/earnings on the S&P500 were 9x in 1978. They are 15x today.

So that demands caution. He noted, however, that the biggest companies back then were the likes of General Electric, General Motors and Exxon: behemoths whose wealth creation rested on huge spending and were massively cyclical.

He contrasted the likes of Microsoft and Apple today, whose recurring revenues are far less dependent on capex.

Mark Whitehead, manager of Sanlam's Sustainable Global Dividend Fund said he tended to look for companies with strong

“We are trying to communicate to clients different ways to be defensive, for example via Income or classic Quality strategies”

cashflows to help protect against inflation. “We don’t invest in deep value areas. We don’t do cyclicals because we want our companies to generate strong dividends supported by strong cashflow throughout the business cycle. ”

Instead, Sanlam looks for strong cash generation and returns on capital. Whitehead said for more than two decades, multiples have driven a large part of equity returns. “Now, however, dividend yields are back: cash returns are back. They should form a major part of our equity total return: 50-60% on average.

“Cashflow is really important if you can find that,” he continued. “Companies that consistently grow the top line and generate free cashflow will stand you in good stead.”

But Whitehead was phlegmatic that returns of 6-7% - rather than 10-12% - from equity were likely in the years ahead.

Matthew Page, co-manager of the Guinness Global Income strategy, said that he did not generally like cyclicals. Nor did he like utilities where regulators step in with extra taxes. Quality cyclicals, however, were really important for balance in an income portfolio because “trying to predict what will predominate over the short to medium term is a fool’s errand,” he explained.

“Cyclicals are not all weak businesses. Some have high levels of recurring income,” he said. Rather than poring over official datapoints for inflation as a determinant of weighting of portfolio companies, the Guinness strategy focuses rather on a balance of income sources.

Jackson said that balance was a great characteristic. “You want the broadest range of return drivers. Don’t get trapped by a narrowest investment style because markets are idiosyncratic in the short term – every market draw down can have different stock market leadership.”

Given the state of markets this year, Doyle was asked about Defensive Equities, of which bfinance has identified five sub-categories. “We are trying to communicate to clients different ways to be defensive, for example via Income or classic Quality strategies,” he said. “There is a misperception that Defensive strategies are interchangeable.”

A recent bfinance paper looks to shed more light on the options. Apart from positioning for higher inflation by upping exposure to stable earnings sectors such as pharma and banks, Doyle mentioned potential client demand for listed real assets, such as listed infrastructure or REITs: “History doesn’t repeat but it rhymes. We have been looking at what has done well in previous inflationary environments.”

Doyle did quiz the asset managers on small caps, which he did not feel were particularly defensive, especially for a high inflation environment, but nevertheless might be nimbler in harsher times than their larger brethren. Page responded that large caps have secured long-term debt at low rates whereas small caps have had to go to more expensive lenders and are much more highly leveraged than large caps. He noted that average net debt for S&P500 is currently about 1.2-1.5x EBITDA. "Back in 2004, it was 4-5x," said Page.

The greatest peril

The CAMRADATA panellists were then asked whether they perceived rising rates or inflation as the bigger threat. Gill said that for lots of DB schemes, inflation isn't their biggest threat because many will have a cap on inflation-linked rises to benefits.

Poiana said that higher interest rates, which are employed to fight high inflation, affect longer-duration assets through the discounting mechanism. He reckoned that Quality would suffer to some degree but made the distinction between Quality and Growth. "Generally, Quality investing with a strong valuation discipline performs well through time. You can't say the same about Growth, and this is in fact a key reason why we shy away from Growth strategies at SEI," he said, noting that there was also a big difference between Value as a factor and Value investing. "In this environment, Value should perform stronger due to its shorter duration profile, and one could make a case that the Momentum manager would also do well as it picks up the trend," he said.

"Lots of companies I own have ridden the inflation shock so far," said Whitehead. "They got through pricing but now consumers are going to be checking their spend. On margin pressure, cyclicals such as in the consumer discretionary sector have sold off. High Quality has derated a bit but perhaps that was to be expected. A fall in earnings next year sounds realistic to me."

The best defence in that scenario was to find businesses with stable margins through cycles, according to Whitehead. He suggested that complacency among investors – in part created by a 'lower for longer' rate environment - was now getting cleansed from markets as inflation and other problems such as supply chains and China's strict lockdown policies prove to be sticky.

"Our companies have been able to get through, growing from 5% to 10% in the second quarter of 2022," he said. "There is some attrition now but these good companies have got what people want. Being flexible in cutting costs is really important."

Page said inflation is the key risk. "Our consumer staples have achieved 12% year-on-year revenue growth: 9% from raising their prices and the other 3% from volume increases. That elasticity in demand hasn't come through yet. We'll see once company results for Q3 come through."

Page agreed with Whitehead that the effects are bit behind the curve. The biggest question for Page was what happens if a global recession occurs. "Who can deal with high prices and a slowdown in demand?" he asked. "Companies with leveraged balance sheets using cash to refinance debt at higher rates will be strained."

Whitehead then chipped in on inventories, which he claimed were at a 10-year high for some firms, at 12% of sales. "That is eating into cashflow," he said. "Supply chain constraints are one reason why firms have been stockpiling."

A silver lining?

Looking beyond any major recession, Page reckoned that a big part of the puzzle is how to position for a rebound. "We know about a dash to trash when things start to recover," he said. "It's that balance of what is going to get through this cycle."

His second query was who will thrive on the rebound? "Acquisitions will be a possibility for those in a strong position."

Edelsten referenced Professor Aswath Damodaran of Stern Business School in New York on the resilience of modern tech giants to inflation shocks. "In the 1970s, giants such as GM took out long-term financing without factoring in too much tolerance for inflation," said Edelsten. "They got damaged – and projects suffered – if inflation didn't behave as expected.

"Nowadays giants are less capital-intensive. Yes, Amazon needs a lot of cash for AWS. So does Google. But nothing like GM or GE of fifty years ago."

In terms of defensiveness, Edelsten said that much depends on how bad you think the next period is going to be.

"Looking back to 2008, companies' cashflow didn't go down that much," he noted.

In response to Doyle's search for assets that provide some defence against rising inflation, Edelsten noted that real estate is great when it is not overgeared. "I love REITS – better investment than gilts," he said. "But in a panic, everyone will be asking to have lower leverage."

He referenced the takeover by Vonovia, Europe's largest property firm, based in Germany, of its nearest rival for cash last year. Now there is talk of the unified entity selling E15bn of property in Berlin.

On tech giants and the likelihood of mergers or acquisitions in that sector, Whitehead said that if you wind back 20 years, intangibles accounted for 10-15% of value. Now the average is more like 50%. "Cashflow is king because how do you value intangibles? he asked. "You know they are worth less if bond yields go up, but by how much?"

Page said it was evident that capital-intensive businesses will not be worth what they were. Long duration assets are not going to be worth what they were. "So which companies are asset-light, generating cash and not reliant on debt financing?"

He noted that in first quarter of 2020, as the pandemic became apparent, companies – like so many other organisations - didn't know what would happen. "We did scenario analysis. We ran companies through the Global Financial Crisis even though those were different conditions." He

noted that half of UK and European companies cut their dividends in 2020. Some were ordered by regulation to do so. "Guinness had one cut out of 35 holdings. Of the rest, 28 grew their dividend," said Page. "That demonstrates high levels of profitability."

The CAMRADATA panel on global equities closed with a discussion of ESG. Edelsten said that High Quality portfolio managers who knew their investee companies thoroughly had always been ESG investing, just not under the label. Regarding the energy sector, he said that Artemis didn't hold Big Oil because it didn't see long-term growth in hydrocarbons. "But we do buy into oil services," he noted. Gill said that XPS wasn't keen on sector exclusions but preferred engagement. Edelsten agreed that the demonisation of fossil fuels and attendant praise of low-carbon sectors as ESG-friendly was simplistic.

"The question is how we engage with carbon-intensive companies?" said Matthews. He saw answers in how companies, asset managers and pension funds report on ESG issues, especially regarding climate.

Jackson said that common standards for ESG were welcome but stressed that it is a mainly qualitative exercise, so shrinking observations and analysis down to a single rating was not that helpful. "Two strategies can be both deemed Article 8-compliant under the EU's Sustainable Finance Disclosure Regulations but one is head and shoulders above the other in terms of ESG-commitment," said Jackson. "We have to educate clients on what this means."

"Two strategies can be both deemed Article 8-compliant under the EU's Sustainable Finance Disclosure Regulations but one is head and shoulders above the other in terms of ESG-commitment, we have to educate clients on what this means."

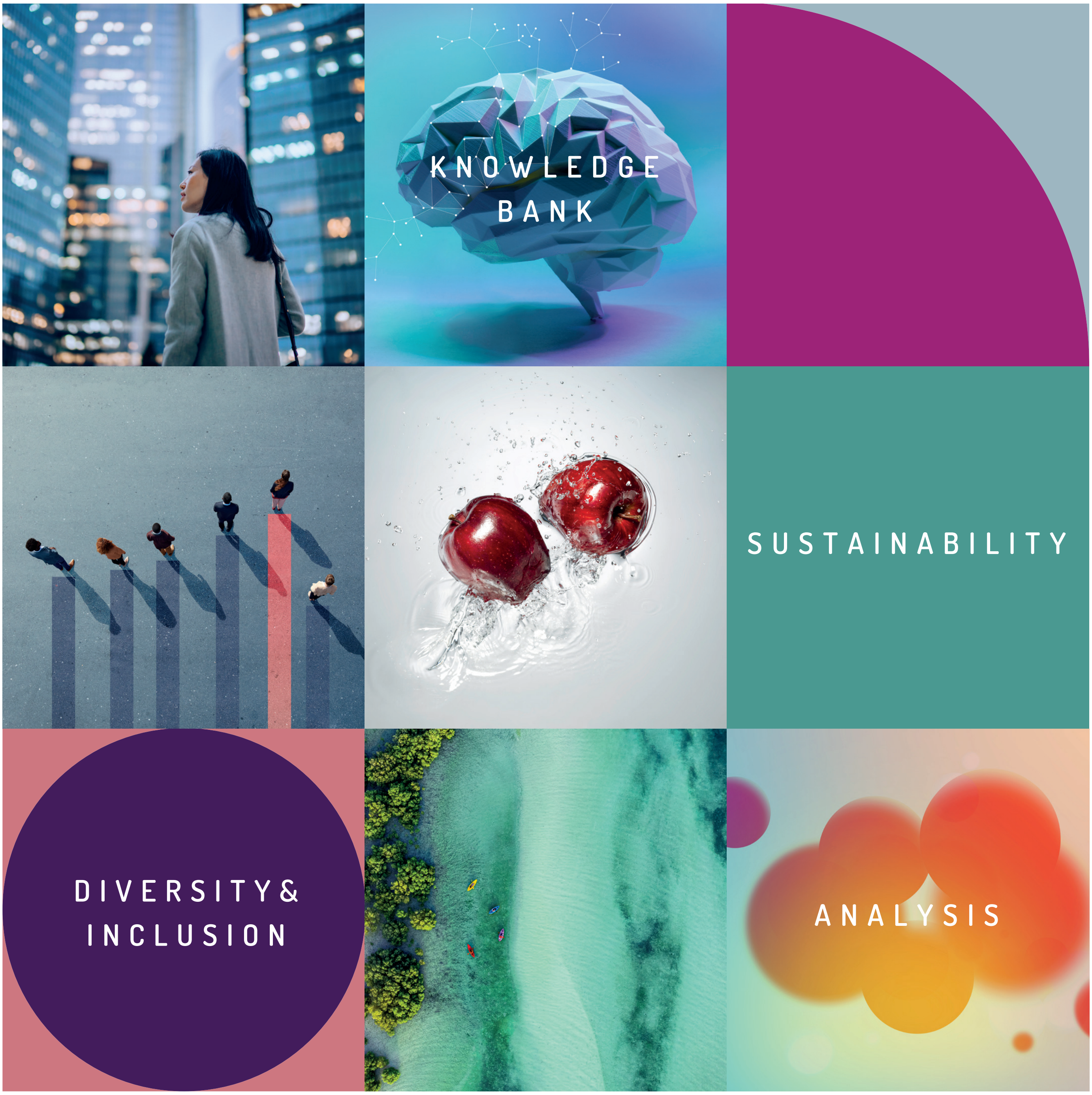
In answer to the question of who polices ESG ratings, Jackson replied: "Markets collectively, I hope."

Poiana agreed that the real challenge is defining what managers, clients and regulators actually mean when by the term ESG. "SEI thinks there should be clear differences and expectations of what we should see in strategies that simply integrate ESG considerations into their decision-making versus those that have a more explicit sustainability oriented objective," he said. "What is common across both these types of implementations though is the increasing role of stewardship and engagement which we view as a positive development and something SEI puts particular focus on when selecting managers for these types of mandates."

Whitehead explained the origins of his Sanlam fund: "Two years ago when we set this fund up, we went for Article 8 designation. It is good to integrate ESG with company analysis and it is good to use the power of a shareholder's vote. We do vote against management where we disagree strongly with policies and performance."

Page said that the ESG conversation varied depending on whom you were speaking to. "In Germany or Austria, for example, they don't want you to own any defence stocks," he said. "SFDR is a minefield. Coupled with the quality of data that needs to be assessed, this is taking up a lot of our time as a team. I do worry that we are going to end up stretched, in part because third-party ESG ratings firms are indirectly making decisions about what we can own."

He distinguished between a rating and a signal. Following Jackson's argument, Page warned that reducing ESG to a score introduced a tendency toward certainty which should be resisted.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Roundtable Participants

Simon Edelsten

Manager of the Artemis Global Select Fund & Mid Wynd Investment Trust

Personal Profile

Simon manages Artemis' 'global select' strategy with Alex Illingworth. After graduation from Trinity College, Oxford, he joined Phillips & Drew in 1985 and moved to Dresdner Kleinwort Benson in 1997 as head of European equity sales.

From there he went to Taube Hodson Stonex (THS) in 2001: in a five-man team, Simon had joint responsibility for global equities. He joined Artemis in 2011.

Artemis

Company Profile

Artemis is a leading UK-based fund manager, offering a range of funds which invest in the UK, Europe, US and around the world. As a dedicated, active investment house, we specialise in investment management for both retail and institutional investors.

Matthew Page,CFA

Portfolio Manager

Personal Profile

Matthew is portfolio manager on the Guinness Global Equity Income strategy and the Guinness Global Innovators strategy.

Prior to joining Guinness, Matthew joined Goldman Sachs on the graduate scheme in 2004 working in Foreign Exchange and Fixed Income, he then joined Guinness in 2005. Matthew graduated from New College, University of Oxford, with a Master's Degree in Physics and is a CFA Charter holder.

Guinness Global Investors

Company Profile

Guinness is independent and focused purely on investment management. Our in-house economic, industry and company research allow us to take an independent view and not be led by the market.

Our size and specialist nature also enable us to respond quickly and efficiently to market movements.

At heart, Guinness Global Investors is a value (or growth at reasonable value) investor. We combine strategic sector selection with a fundamental screening process to identify stock opportunities.

Roundtable Participants

Mark Whitehead

Head of Sustainable Global Equities

Personal Profile

Mark joined Sanlam in December 2020 to launch a sustainable global dividend fund.

He has 15 years of experience in global income investing with an increasing focus on sustainability.

In 2007 Mark launched one of the first global equity income funds and has experience of managing both open-ended and closed-end products as well as charity and institutional portfolios.

Sanlam Investments

Sanlam Investments

Company Profile

Sanlam Investments UK is the global asset management arm of the Sanlam Investment Group both of which are wholly owned entities of Sanlam Limited. Sanlam was founded in 1918 in Cape Town, South Africa and is now a global financial services group with a footprint in 45 countries, is the largest non-banking financial services group on the African continent, a market capitalisation in excess of £6.5bn and a AA+(zaf) National Long-Term rating from Fitch Ratings.

Sanlam Investments UK is a boutique asset management business which brings distinctive asset management expertise across a range of high conviction active strategies encompassing equities, fixed income, and alternative asset classes. Our sole focus is asset management and our offerings are housed in UCITS, IFSL pooled fund structures and segregated accounts. The business was originally established in 2006 as Four Capital with Sanlam taking their first stake in 2009 and subsequent transactions resulted in the business becoming a wholly owned entity.

James Jackson, CFA

Senior Equity Manager Researcher, Emerging Markets

James joined Aon in 2011 and works as a Senior Equity Researcher in the Investment Manager Research team. James is responsible for research of Global, Emerging Markets, China, Frontier and regional equity strategies, with a focus on Emerging Markets. James is based in Switzerland and has worked on a range of manager searches and portfolio construction exercises for Global clients.

Prior to joining Aon, James worked for PricewaterhouseCoopers in its Investment funds practice and was involved with mutual investment fund audit, tax and other consulting services. He graduated from the University of Leeds in 2005. James is a CFA charterholder.

Aon
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Robert Doyle

Senior Director

Robert is a Senior Director at bfinance and leads the firm's equity manager research function. Robert joined bfinance in 2015 and has since advised the firm's institutional clients on the deployment of more than USD 15 billion across active equity strategies.

Prior to joining bfinance, Robert spent five years as an equity manager research analyst at a UK-based private wealth management firm.

Robert holds an MSc in Investment Management from Cass (now Bayes) Business School and a first class honours degree in Accounting and Finance from the University of Warwick.

Robert has previous experience within the Private Client team at EY LLP. Robert is a Chartered Fellow of the Chartered Institute for Securities & Investment (CISI).

bfinance

Roundtable Participants

Ben Matthews

Head of Equity Research

Ben Matthews is the Head of Equity Research at Isio. Isio is a spin-off of KPMG's UK pensions advisory practice. His responsibilities include coverage of equity manager research and selection, whilst also dedicating a portion of time to ongoing client management.

Prior to working at Isio, Ben has worked at Exane BNP Paribas as an equity research analyst in the Telecoms sector.

Ben holds an MSc in Finance and Investment, and a BSc in Business Management from the University of Leeds. He has also passed all three levels of the CFA examinations.

Tudor Poiana

Investment Analyst

Tudor Poiana is an analyst within the Investment Management Unit for SEI Investments, focusing on active public equity strategies. He is responsible for in-depth manager research based on both quantitative and qualitative assessments, with a coverage on UK, Europe and Global equities.

In addition, Tudor works closely with portfolio managers in providing customised portfolio analytics, market commentary and insights.

Tudor is a CFA® charterholder and holds an MSc in Finance from EDHEC Business School.

Moderator

Alasdair Gill

Partner and Head of Equity Research

Alasdair heads up XPS's Edinburgh-based investment team and is also head of Equity Research at XPS Investments.

Alasdair is a Fellow of the Institute of Actuaries and has 25 years of investment experience, providing advice on all aspects of investment strategy, structure and manager selection advice to a range of defined benefit and hybrid pension schemes.

Alasdair started his career in pensions at Clay and Partners (now part of Aon) and qualified as an actuary in 1994. He has worked exclusively in investment since 1997 when he joined Mercer, where, alongside his consulting role, he led the charities and endowments team for 10 years and built a substantial client base in this sector, alongside his pension scheme clients.

XPS Investment

Brendan Maton

Freelance Journalist

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.

Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles.

Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE. Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management,

Survive inflation by balancing your portfolio

It is funny how often old song lyrics come to mind when I think of investment markets. I am currently stuck on the late Kenny Rogers' advice: "You've got to know when to hold 'em, know when to fold 'em, know when to walk away and know when to run."

"Investment involves risk, but smart investors focus on mitigating risk. Inevitably that means selling stocks at some point — something that is probably not discussed enough"

Though I may be remembering "The Gambler", investing is not gambling. An equity investor's time horizon is measured in years, a gambler's in furlongs. Yes, investment involves risk, but smart investors focus on mitigating risk. Inevitably that means selling stocks at some point — something that is probably not discussed enough. I am sure many investors reviewing their portfolios today are asking whether it is time to hold or fold.

The UK's 30-year-high inflation numbers merely underline what we are seeing in our monthly bills. Central banks are raising interest rates to tame inflation but how far and fast? The economic recovery anticipated after Covid seems too fragile to cope with sharp rate rises.

Russia's invasion of Ukraine has squeezed commodity prices. And then there is China's struggle with Covid. China's GDP at $14tn is on a similar scale to the whole of the eurozone's. Sluggish growth there could cause global waves.

Investors are seeing the effects of all this. Equity markets have also suffered since the start of the year – and currency moves have added to the turmoil. The US S&P 500 index has fallen over 15 per cent in dollar terms, but the dollar has risen against sterling, making that a 7.5 per cent loss for UK investors. The Japanese market, by contrast, has fallen 8.6 per cent but the weak yen makes that 11.6 per cent in sterling. In comparison, the FTSE 100 has only fallen 2.7 per cent, helped by oil and mining stocks dominating the index.

Most active equity managers value shares according to the current worth of future cash flows. In recent years that has meant fast-growing tech stocks being priced at high multiples of earnings as investors relished the juicy profits promised one day. Inflation means investors have become more concerned about today. They are examining the numbers more critically, less forgiving of management errors. Disappointing results from companies such as PayPal, Shopify and Netflix have seen their shares drop by more than half since the turn of the year.

Author:

Simon Edelsten,

Manager of the Artemis Global Select Fund & Mid Wynd Investment Trust

Consumer stocks have generally performed well as markets anticipate more spending, but as we saw with Netflix recently, higher bills may trigger consumers to curtail that spending. Many look fragile. Companies like retailers tend to have large headcounts and often significant debt. If interest rates are rising then indebted companies have problems both with lowered income and higher interest charges. Transition periods are tough for equity investors. Some may be tempted to count a decade of profits and leave the table until there is greater clarity on interest rates, fearing that central bankers will kill any recovery and even cause a crash by getting the time and scale of rises wrong.

You take a risk with inflation if you do exit the market. Elements of today's inflation are transitory, but not all. The US labour market has tightened rapidly; shortages are appearing in a range of jobs. Workers in these roles can negotiate significant pay rises. These conditions can lead to an inflationary spiral. In the UK much has been made of price inflation, but wage inflation (including bonuses) is not far behind.

It is arguably safer to assume the current conditions will continue, and maybe for some years. With inflation at its current rate that could mean cash halving in value in just 12 years. Yields on equities may be below inflation, but they are often better than those on bonds and certainly better than the return you will get in cash.

Remember, too, that recessions do not always cause equity markets to fall. The FTSE was stable through 1990 and 1991 when the UK was in recession. Most would argue that the financial market collapse in 2008 caused the recession rather than vice versa and the recession in 2020 caused by Covid saw markets finish the year strongly. However, in each of these periods some sectors performed much better than others. Avoiding vulnerable sectors was vital.

It might therefore be time to rebalance your portfolio, tilting towards sectors that cope well with inflation. Be discerning. I am wary of companies that people argue are able to pass cost pressures on to customers. Not all can, as Greggs pointed out recently.

Do not be tempted just to ditch all your high-growth tech stocks. Those with modest headcounts, low costs of raw materials and strong pricing power should be little affected by inflation. The less mature "one day" companies have been dramatically re-rated for good reason. Senior citizens such as Microsoft, Alphabet (which owns Google) and Amazon have also taken a hit (down between 15 and 18 per cent this year). Yet they have delivered strong profit announcements, are still growing and might be argued to represent fair value at their current prices and worthy of a place in the pack.

Many of the best-performing shares this year belong to oil companies. If you have held them does there come a time when you should bank your gains? My view is that fossil fuel producers will eventually return to oversupply, with every Western government having a long-term plan to reduce use of their product significantly. It will take time, but when it does the rush for the exits could be a stampede. So I believe in walking away early rather than waiting until you have to run.

In contrast to oil stocks, many industrial minerals, such as copper, are an essential ingredient for a lower carbon future. We invest in mining despite the environmental challenges. Indeed, we welcome the extra spending the best miners are making to improve environmental and safety factors even if shareholders will see no direct benefit for years. It is better to have listed miners mining well than miners with lower standards plugging the gap.

I also like telephone, railway and healthcare stocks. These industries have long records of resilient cash flows during periods of inflation and even recession. The last time US inflation rose higher than it is doing now was in the late 1970s and early 80s. It peaked at 14.8 per cent in 1980. Between January 1976 and December 1980 the Dow Jones Transport Index outperformed the Industrial Index by 103 per cent.
More generally, I like companies with high barriers to entry, high returns on invested capital and little debt. These look best able to raise dividends in real terms.
This feels like a moment to lower expectations of growth and focus on ensuring your portfolio is well balanced and resilient. Get through this period relatively unscathed and you will be well placed when economic and investing conditions improve. At which point we will all be singing a happier tune. Simon Edelsten is co-manager of the Artemis Global Select Fund and the Mid Wynd International Investment Trust.

HOW GLOBAL EQUITY INCOME CAN HELP INVESTORS IN AN INFLATIONARY ENVIRONMENT

POSITIVELY DIFFERENT

GUINNESS GLOBAL INVESTORS

How global equity income can help investors in an inflationary environment

As 2022 kicked off, inflation was rearing its head, but most economists thought it was a temporary phase. However, a combination of the prolonged Ukraine conflict, soaring energy prices and supply chain issues has meant that higher prices will be a fact of life for longer than expected. Investors have had to explore different segments for returns as the growth stocks which once fuelled markets are no longer as attractive. Equity income, though, can help fill the void. They may not grab the headlines in the same way as growth stocks, but companies which can sustain and grow dividends can generate greater income and act as a buffer against the current rising inflation and interest rate environment.

Equity income

While there are no panaceas, equity income strategies have weathered the storm better than most other sectors, during this year. They may not be as exciting as growth companies, but can often provide more stable prospects for earnings growth, albeit at more modest levels, which over longer time periods can build up meaningfully. The latest figures from the Investment Association bear this out. They show that over the last year to 31 October 2022 its global equity income fund sector was up 0.7% while UK equity income was down 5.6%. This is in sharp contrast to global equities which were down 9.2%, UK gilts and corporates, off 22.1% and 17.8%, respectively, while Europe excluding the UK equities, recorded a 13.9% drop (FE fundinfo in GBP).

"Equity income strategies have weathered the storm better than most."

Equity income funds also often comprise a greater proportion of total returns in downturns, when capital returns dominate. Around 40% of S&P 500 Index returns emanated from dividend income over the past 90 years, according to S&P Dow Jones Indices (SPDJI). In periods of low growth this can be even more striking. The 1940s and 1970s, for example, were both periods of sluggish economic growth, rising inflation, and high unemployment. In each decade, dividends accounted for an average of 57% of total returns. Even in the good times, such as the booming 1990s or 2010s, dividends still represented over 25% of the overall total return.

Another attribute is these companies tend not to excise their dividends in worsening conditions. Since 1940, there have been eight years of dividend cuts during 25 years of earnings declines. In fact, this year, the pay-outs have been increasing. A report from funds group Link showed that dividends from UK-listed companies jumped by 38% in the second quarter to £37bn, compared with the year before. The UK as well as Europe were strong drivers of robust global dividends in the same time frame. They reached a record high of $544 billion in the three months ending 30 June, up 11.3% from last quarter, with Europe recording a 28.7% rise, according to the Janus Henderson Global Dividend Index.

Equally as important is that dividends have a good track record of keeping pace with inflation, which is of particular relevance today. This is because income grows in line with or often at a higher rate. In other words, companies that pay a steady and growing dividend often have the potential to grow their cash flow to keep pace with rising prices.

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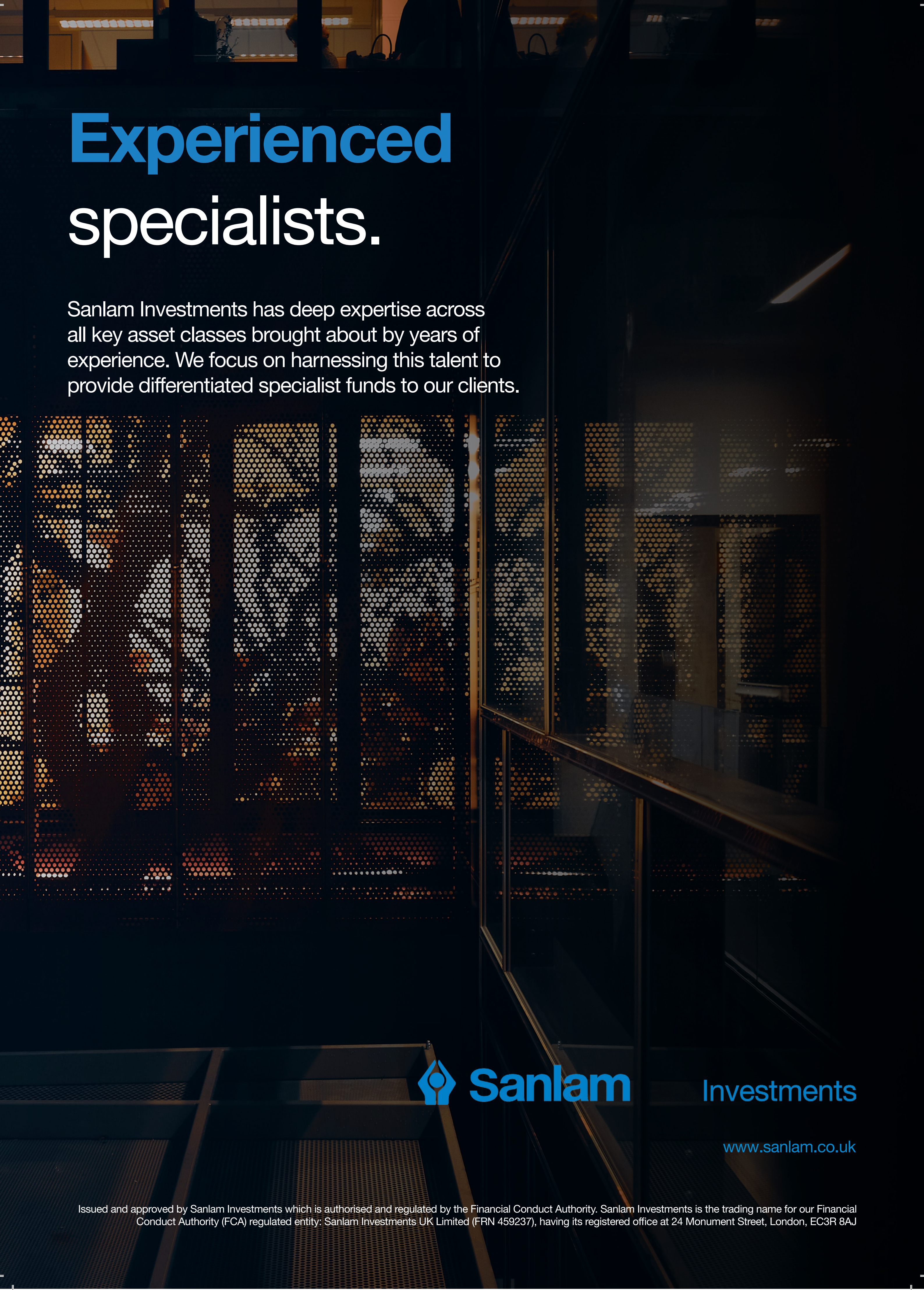
The dividend universe

As with any investment, selectivity is the key. The past is not always a guide to the future and the best performing dividend stocks today may not necessarily be those of the past. Typically, they are companies which are more established and have steady streams of cash flow. The focus though is not just about the ability to make a payment but also to sustain and grow that dividend. A closer look at the return on capital is a good indication as to whether a company can achieve this goal. Otis, the lift and escalator manufacturing company, is a case in point. First half results showed that it is being impacted less than its competitors in China. Its all-important maintenance revenues are growing at mid-single digits and accelerating, and it is gaining share in new equipment.

Historically, defensive sectors such as consumer staples were the main constituent of equity income funds. This is still the case today, but companies need to have products where the demand is strong despite price increases. This enables margins to be maintained in times of higher inflation, since costs are passed on to the consumer. Cyclical and high-yield stocks and sectors are off the list as they can perform poorly in market selloffs, and especially in recessionary environments, because they are either more economically sensitive or in tightly regulated industries. Banks, for examples, have seen many instances of dividend payments being curtailed by the regulators.

Conclusion

The economic outlook is deteriorating as we look towards 2023, as the conflict in Ukraine continues. Just as they proved in other low-growth periods, dividends can offer income and capital appreciation, which is why they are expected to be much greater than 2020 or 2021 as a proportion of total return. However, careful due diligence and research is needed when selecting these stocks.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PLUS CA CHANGE, PLUS C'EST LA MEME CHOSE

Sanlam Investments

The more things change, the more they stay the same

Most years are eventful for the global equity investor and 2022 proved no different. Inflation, ongoing COVID disruption, particularly in China, and the Ukrainian conflict were key features. Investors grappled with weighing up three resultant economic scenarios: a soft landing; recession; and stagflation. Which would be most likely and how should they position their portfolios to reflect this?

As we come to the end of 2022 thoughts naturally turn to what kind of 2023 investors might expect. The intelligent investor would likely point out that thinking in calendar years doesn't make much sense. Predicting what macro events lie just ahead and how markets will react to them is a fool's errand. Nonetheless, as 2022 draws to a close, several themes remain top of mind for the sustainable global dividend investor.

"Predicting what macro events lie just ahead and how markets will react to them is a fool's errand"

We expect that regulators will tighten up on their scrutiny of all things relating to sustainability. We have written that strong reporting processes do not necessarily mean strong sustainability credentials, and equally, strong sustainability credentials can be masked by poor reporting processes. Companies and fund management firms with large marketing and communications teams can make visually impressive Sustainability Reports but nothing beats looking under the bonnet and doing your own due diligence. This is as true for investors in companies as it is for investors in funds.

For us, several things are key to help ensure credibility in sustainable investing. In addition to negative screening, where certain subsectors are excluded, sustainability analysis must be embedded in the research process for choosing which companies to invest in. A clear test of this is that you can demonstrate that companies that fail your sustainability analysis will not be invested in. In the same way that you wouldn't invest in companies that you felt had weak business models or were expensive. We employ a sustainability scorecard as the first part of any company analysis. If a company scores negatively we will not proceed.

Engagement with companies is also an important part of sustainable investing. Voting allows for scrutiny of a board's actions. We vote on all items and proposals on behalf of our clients. When we vote against management proposals, we let the company know why we have voted the way we have. This naturally leads, in most cases, to engagement and we can then further assess the responses we are given. We believe external validation of sustainability credentials by the likes of Morningstar and MSCI is key as is having targets for portfolios related to such bodies. We target an MSCI ESG rating of AA or AAA, the top two ratings, for our fund, always.

A combination of negative screening, integration, engagement, and external accreditation is powerful proof that greenwashing is not at play. We believe there will be further action by research providers, and hopefully, regulatory authorities, to ensure a level playing field with transparency in all facets of sustainable investing. In 2023 expect more criticism of companies' sustainability efforts and expect more funds to change their sustainability claims and accreditation.

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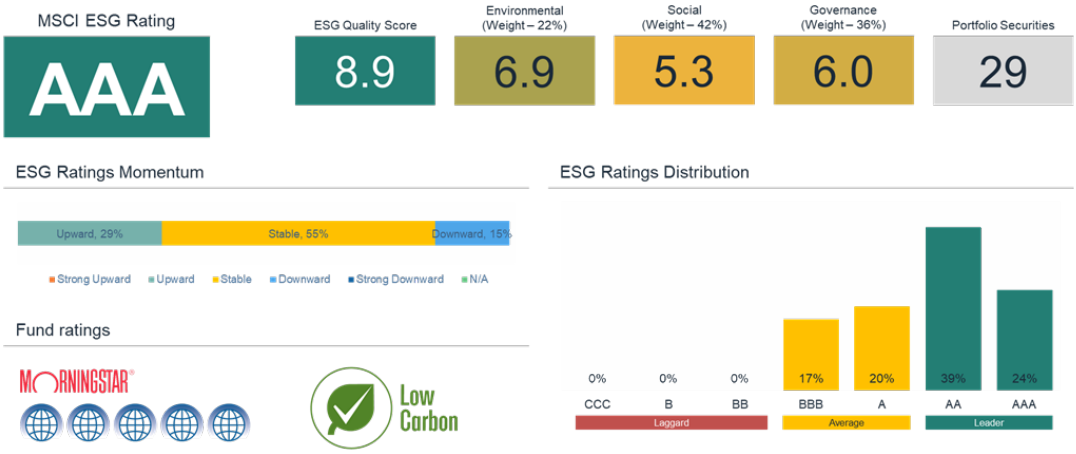
Sanlam Sustainable Global Dividend Fund: sustainability credentials



Source: MSCI as of 31/08/2022.

2022, like 2021, was a good year for the dividend investor. Gross dividends are likely to have grown over 10% again as the recovery following a weak 2020, when many companies cut their dividends, continues. Strong free cash flow growth and strong balance sheets are key to the delivery of sustainable dividend growth. In 2023 expect free cash flow growth to be harder to come by. Profitability is likely to suffer at the hands of recessionary or slow growth environments. Higher interest rates mean debt is more expensive. Continuing supply chain blockages will likely mean higher levels of inventories. Elevated inflation will mean those inventories held are more highly priced. These factors are all headwinds for free cash flow growth. In 2023 dividend growth may not match that of 2022 and 2021.

At the start of 2022, the MSCI World Index was at a historic high and has since declined. This has been in part due to the starting valuations; the declining macro and geopolitical environment; and to higher discount rates. These factors are all interlinked. How these factors play out in 2023 will be key to the direction of travel of equity markets. In 2023 expect investors to be grappling with the same three scenarios mentioned in the opening paragraph. Plus ca change, plus c'est la meme chose.

In 2023 our focus, as always, will be on ensuring our portfolio holdings have a combination of strong dividend and sustainability credentials and all that entails. We will also remain focussed on whether the valuations of these attractive companies are fair. They will remain holdings if they satisfy these criteria and this should enable us to withstand whatever 2023 has in store for us.

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The Fund has holdings which are denominated in currencies other than sterling and may be affected by movements in exchange rates. Consequently, the value of an investment may rise or fall in line with the exchange rates.

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