# COVID-19 INVESTMENT UPDATE: SUSTAINABLE STRATEGIES – 30 APRIL 2020

## What is happening?

Equity markets continue to rally strongly and credit markets are well supported. The Nasdaq index is now unchanged year to date, and the S&P 500 only down 9%. The S&P has rallied more than 30% since its lows. Whilst this seems counterintuitive given we are still in lockdown, there is a roadmap to explain this. The market panic of mid-March has subsided with more rational thinking in evidence, central bank and government support has helped take some of the pressure out of the investment and corporate worlds, and finally we had news this week of an effective treatment for covid-19 from Gilead, a US pharmaceutical company. This, combined with the low returns from assets such as cash, has resulted in strong support for risk assets such as equities. In addition, the corporate results season in the US has been better than expected, or perhaps better described as 'better than feared'. There is even a modest outbreak of optimism in the media (notable, as the saying goes if you want to be a successful journalist be a pessimist, if you want to be a successful investor be an optimist).

We have to confess that we think equity markets have gone far enough for now. The reality of reopening the global economy will be one of gradual, but by no means steady, progress. Now is the right time to consider the impact of covid-19 on the business models of the companies we can and do invest in, as well as some of the longer-term consequences of recent stimulus measures. To be clear, we still think by the end of 2021 the global economy will be largely recovered and this will support higher risk asset prices, but we see this happening at a much more measured pace with the potential for some volatility. Of course, markets could go higher (or lower) as they are complex, dynamic, entities about which no one has perfect knowledge, but when we look at the investments we have made, their valuations and their prospects we think they are nearer to where they should be.

## What will happen next?

This is the time to start thinking about the relative winners and losers post the crisis. Here are some of the things we are thinking about:

- **Bytes versus bricks** – for many years the strategy of physical asset owners has been to sweat them as hard as possible. Smaller seats on planes, more desks in offices, more tables in restaurants, more stock in retail shops, fewer seats on trams. It has been a conscious business strategy to give us less space. Will this be culturally accepted anymore in a post pandemic world? We doubt it. If social distancing remains, then the leisure, retail and transportation industries will become structurally less profitable and we must encompass this in our thinking. For some it will be easier to evolve than others, virtual queues for example in fast service restaurants. For others it will be impossible without reducing profitability. On the other side digital businesses have unlimited space and social distancing. An acceleration to digital services is almost inevitable. Companies such as Adobe and

Salesforce will be key beneficiaries on this trend. Less physical contact and more digital interaction is here to stay.

- **Cash versus credit** – investing (maybe life!) is about tail events. Low probability events that have a big impact, which unfortunately we will all face at some point in our corporate and personal lives. Very few people, investors or businesses plan for them, often assuming that life will carry on as normal forever. Clearly this crisis has challenged that view. One implication is that corporates need less debt and more equity (and consumers more cash than credit); they may even be required to have it if governments ask for a greater buffer before they have to bail them out. We have already seen equity issuances from the leisure sector, reflecting this new normal, but we think there will be more to come. We certainly will continue our preference for cash rich, conservatively financed, companies over their indebted peers.
- **Local versus global** – globalisation of supply chains and businesses has been a defining corporate trend of the last decade. It has helped improve profits and keep inflation down by moving to cheaper labour countries, and enhanced growth due to the new business opportunities in emerging markets. This may now go into reverse, with just in time stock inventory management replaced with just in case, and it being politically unacceptable to have vaccine and mask manufacturing solely in places like China. Onshoring will be a trend in the same way offshoring was in the previous decade. Unfortunately this will not been a boom for jobs as we expect any new factories built to be highly automated – particularly , in a world of social distancing. More localisation is a trend we struggle to see much upside from, although industrial building owners such as Segro and Prologis are bright spots, as it could end up with lower growth, more inflation and fewer jobs.

There are of course many other topics worthy of consideration. The most important point though is that we challenge our previous thinking on a range of opportunities and risks to make sure we are appropriately positioned in what will be a very different world going forward.

## How are we performing?

Our mixed asset sustainable funds have benefited from the recent recovery in equities, especially as they outperformed into the downturn. Our single asset equity funds have lagged a little in the last week as more cyclical, lower quality investments have performed the strongest. This is to be expected given our investment criteria. That said, some of the additions we made to the Leaders fund in March, such as Greggs, Legal and General, Vistry and Prudential have performed particularly well and made sure we've captured a good proportion of the recent rally. Our new Global Sustainable fund has launched well and will be a prime beneficiary of the trend towards digitisation noted above. Year to date we are very pleased with the performance of our sustainable funds.

## Anything else? Corporate Governance Special

During April and May, RLAM's corporate governance team will be voting at hundreds of company Annual General Meetings, including those held in the sustainable funds. A robust understanding of a company's corporate governance practices is a core part of the fund's process, and the team have shared some insights from the proxy season so far relating to a number of holdings within the sustainable range of funds.

- Some management teams at businesses more likely to be impacted by the coronavirus outbreak in the near term have shown prudence in requesting cuts to their own salaries during the lockdown. At Severn Trent, where revenues are likely to be more stable over the period, we were impressed by director's commitments to voluntarily take pay cuts in order to contribute to local charities in the region which they serve as part of a broader basket of initiatives.
- There is often a temptation from remuneration committees to begin to increase variable pay incentives during periods of strong share price performance. However, despite a strong showing from the London Stock Exchange Group in recent months, we are pleased to see the Board exercising restraint as it set its new pay policy.
- Some of the UK's largest companies often compete for talent with international firms who are more open to making excessive pay awards. While we sympathise with their predicament, we will not support unjustified increases to executive pay in the sustainable funds. We will therefore not be supporting AstraZeneca's new pay policy, which has attracted criticism for the further increase to the CEO's LTIP and decision not to phase the CEO's pension to workforce levels (in line with market best practice)
- However companies are open to constructive feedback from shareholders. One material holding in the sustainable funds had recently completed a significant acquisition and was pushing for an additional one-off award to management, contingent on them realising the benefits of the deal. Following discussions with the team earlier in the year, where we shared our concerns about this, the company pulled the award (and will likely see strong shareholder support for pay at their forthcoming AGM).

We think our internal corporate governance team is an important competitive advantage in our ability to deliver good investment returns. Poorly governed companies are rarely good investments and hard wiring in an assessment of incentives an board structures is a highly effective way of maximizing reward and minimising risk when making investment decisions.

**Please note that this is a fast moving environment and markets and impacts on portfolios are changing. Opinions contained in this document represent views of our fund managers at time of writing, and performance numbers are estimates and not audited.**

**Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature**