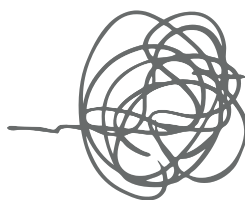


DISCUSSION: GLOBAL EQUITIES

What equity strategies are asset owners following?

Neil Mason: We are bullish on equities. About 60% of our portfolio is exposed to the asset class, of which 10% is in UK and the rest split across global mandates.

We are not over-allocated to market cap. We have mixed in our benchmark, so we have some GDP cap in there.

We are also bullish on emerging markets. When we reach our optimum asset allocation, around 10% of the portfolio will be looking at emerging markets.

Anthony Petalas: We have global and UK equity strategies. We are trying to create a blend of styles and themes to get diversified exposure to various markets.

As we are trying to outperform by a certain percentage, they are highly concentrated, high tracking error strategies. We are not biased towards a single factor or style across the equity spectrum.

In the UK, allocations to equities are falling as investors turn to income-generating assets. Are your schemes reducing their exposure to equities, Duncan?

Duncan Willsher: There is a divergence of approaches. There are schemes that continue to hold high allocations to equity, often because they need the additional return but cannot deal with the complexity of some of the other asset classes.

However, many schemes are moving to income-generating portfolios, so are using more credit. Then there are schemes who have received positive equity returns over the past few years and are now mostly in credit as they are close to buyout.

However, even in these last two examples, some schemes hold between 5% and 15% in equity as a hedge against esoteric risks; but the direction of travel is towards credit.

Neil Goddin: It is nice to hear positive comments about equities. Reading the headlines over the past couple of years you would think they were done for.

For us, they are an extremely good long-term investment, over any time horizon that is not three months or a scare around inflation.

It is interesting to hear the hedge talk. Our portfolio is exposed to high-growth companies, which look expensive until you dig deeper. They are a great hedge against traditional equities and all the change going on in the world.

Peter Abrahams: Many of the pension schemes I advise have seen funding improvements, due to rising interest rates and the performance of their growth assets.

We have had conversations about if there is an opportunity to take some risk off the table. Is it possible to trim some equity allocations? But I recognise the divergence Duncan talked about where some schemes are more eager to do that than others.

Then there are the sponsors. Some sponsors are not keen to reduce equity allocations if it means the scheme might ask for more contributions in the future.

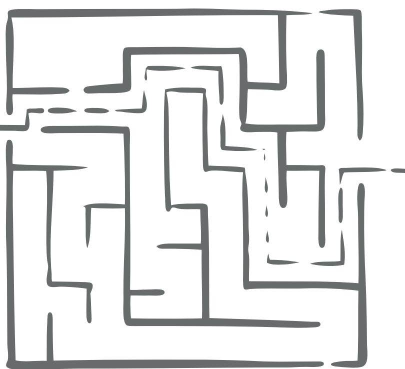
Mason: We are an open scheme that is cashflow positive into 2025 and do not have the issue of buyout, so we can afford to be bullish.

Growth, value, momentum – what are investors favouring?

Mason: We have seen opportunities in value stocks. Our investment strategy provides a combination of approaches. We have a risk budget in there so we can provide returns irrespective of any fad that comes along.

There is value. The UK is undervalued and, longer term, so are emerging markets.

Willsher: It will not surprise you that my schemes have diversified their approaches. There are no strong views on calling how markets will play out in the next few years. If there was a theme it would be about how we integrate ESG into our equity portfolio, rather than, for example, debating growth versus momentum.



Equities have traditionally been a cornerstone of long-term investment portfolios. However, their influence over those saving for retirement is falling as final salary pension schemes close in on their endgame. Indeed, growth is being swapped for bonds and alternative assets as investors look to generate regular income streams and limit portfolio volatility. Yet their influence on conversations in the City is growing. First, the volatility caused by Covid created buying opportunities in equity markets around the world, while fears that inflation could jump means that asset owners are already looking at their portfolios again. To find out what is happening, we brought players from across the investment chain together to discuss the role equities are playing in asset owners' plans and how portfolios are changing.

Where equity allocations are coming down materially, passive makes up a thick chunk of that as potentially making an extra 1% to 2% from active returns on a small allocation makes less sense in many cases.

Abrahams: Some of my clients have benefited from the rally that growth stocks saw in 2020 while others have been stung by the general under-performance of value strategies in recent years.There is a theme of moving away from strategies with growth or value tilts for something a little more all-weather. These include clients who have done well from a growth strategy and are looking for something that is not reliant on one style, as well as investors who have not benefited from value.

Following last year's volatility, have investors missed the boat in terms of picking up some bargains?

Petalas: There are always bargains in the equity markets, irrespective of what has happened.

It is interesting that in the past eight months there has been a rotation from growth to value. However, this is due to the Covid impact on cyclical stocks and the low-base effect.

When you look at longer term performance, growth investing has dominated performance in the past three years, but it is not about pure value or growth. These abstract labels are too generic and quite dangerous. A good investment cannot be confined to a single descriptive characteristic, whether it is valuation multiple or earnings growth. There are companies within the value bucket which we would classify as "value traps" because they are operating in structurally declining industries or there are significant ESG headwinds that translate into higher financial risks.

On the flipside, you cannot ignore valuation when paying for growth. There is not an infinite price that investors should be willing to pay because a company is growing faster than the market.

Overall, we can't ignore that the value dispersion between the average growth stock and the average value stock is at an all-time high, so the probability of finding something more attractive in the value bucket is higher than in the growth bucket.

Which emerging markets stand out for you, Neil?

Mason: South Asia is an area we like, but we need to caveat that with there being a lot of work to be done in the ESG space. This is a concern for us as pension fund managers.

How is Artemis managing valuation risk?

Goddin: We specialise in growth stocks, but that oversimplifies this discussion. We chose to focus on positive impact stocks with high-growth characteristics because we can get to know one part of the market well. That does not mean there is not good value in value stocks. It does not mean that there are times when it is better to be in value than growth. Over the long term it is about picking stocks than picking a theme.

What we do see is periods like 2020 when the valuation gap was expensive for growth and now has flipped back to almost the norm.

It is less of a concern and may well go to the point where value looks expensive, but if you focus on the longer term that does not matter. What matters is, are the stocks you own mis-valued? It does not mean they are value stocks or growth stocks, it means that you have found an edge in the way you are looking at a stock that makes you believe it is undervalued. It could have a price-to-earnings ratio of 100, 3 or negatively earning and could be undervalued or overvalued depending on the research.

Are equities overvalued?

Willsher: In the past few years, people were saying, "Surely, they can't go any

THE PANEL

Neil Mason
Strategic finance manager – pensions
Surrey County Council

Anthony Petalas
Portfolio manager
Border to Coast Pensions Partnership

Duncan Willsher
Trustee director
20-20 Trustees

Neil Goddin
Fund manager
Artemis Investment Management

Peter Abrahams
Investment consultant
Lane Clark & Peacock

higher?" The reality is that no one really knows. It is all best guesses and then something you do not expect happens.

Are they overvalued? Chances are they will continue to rise in value. For me, it is about having a balance of risks. Equities have paid out over history and continue to do so. We need to make sure we are part of it, it is just about "right sizing" it. Setting the right level of risk are the conversations trustees are having.

Should index investors be worried by reports that the valuations of some US tech stocks are a little hot?

Abrahams: There has been a lot of press on their valuations in recent years. The example often given to say you should not worry about US tech stock valuations is Amazon.

In the late 1990s to early 2000s it was viewed as overvalued. People saw it as an online book seller branching out into other retail lines but today it is a massive conglomerate with different business lines, including cloud computing.

The argument is that you cannot value these businesses on what they are doing today. You have to consider the clever ideas they could come up with that might not exist today. That thinking supports a lot of US tech stock valuations.

Of course, not every stock is going to be an Amazon. Some will develop fantastic new business lines and others will not. As an index investor, you own them all and own them in the proportions that the market assigns to them. So, there is an argument for an active manager who can make those decisions and decide if something is fairly valued or not.

Inflationary fears are expanding. Will this be an issue for equities?

Petalas: We are seeing signs that inflation is becoming an issue. The million-dollar question is whether this is transitory or a long-term effect.

Covid has created a new low-base effect, so the CPI numbers are higher than we would expect.

I am leaning towards this being a transitory effect because we have not really solved two of the key issues in the past 10 years: productivity and demographics. In developed markets, we are seeing aging populations and low productivity. If these two long-term drivers of economic growth are not there, I struggle to see how this can be a more sustained impact.

We should note, however, that one of the key differences that Covid has brought to the table is that we are seeing more fiscal stimulus than we have ever seen in the last 10 years. Broad money supply is increasing across the globe and this is not just in terms of increasing liquidity to financial institutions but actually putting money into peoples' hands.

These nuances are different to what we have experienced during the latest rounds of quantitative easings, but I don't believe they are enough to offset the headwinds of productivity and demographics.

Goddin: The demographics are not changing. If anything, Covid will make them worse. It takes 50 years to change demographics. For 10 years we have spoken about that and then we get to a bit of inflation driven by Covid and suddenly we forget about the demographic's argument.

Productivity is interesting. You could argue that Covid is improving productivity. It is probably deflationary because software like Zoom makes us more produc-

tive, but we do not move so we are not spending as much money.

Mason: There is an assumption that inflation is necessarily a bad thing. That could be linked to the economic theories of the 1970s. Inflation is not necessary a bad thing, particularly if it affects wages.

Many companies cancelled or reduced their dividends following Covid. When do you expect a dividend recovery?

Mason: This is another million-dollar question. When will we get through Covid and companies start making reasonably predictable cashflows again?

Changes in government policy, if we continue along this modern monetary theory view, will give stimulus to the economy and allow companies to recover faster than in an austerity narrative. As we come out of lockdown and economies start building up, we will see a return of dividends next year.

Abrahams: There has been bad press around the payment of dividends by some companies that have benefited from government policies during the lockdowns. We saw that when supermarkets paid dividends. If they had received government money, it was reported by the press as them paying tax-payers money to shareholders.

There will be an element of that which will make boards cautious about how paying dividends will be viewed by the wider market.

How important is ESG to asset owners when investing in equities?

Mason: It is fundamental. Our stakeholders demand it and the residents of Surrey require us to have a view on that. It runs throughout our portfolio and in our discussions with our asset managers, whether we are trying to engage with companies to act in a certain way or tilt towards certain asset classes where we might be a passive owner. It runs throughout our business.

We map our portfolio against the UN's sustainable development goals. We make positive decisions regarding that within our portfolio. It is fundamental.

Petalas: It is an absolute fundamental principle and it is embedded in our culture. This is the case across all our partner funds.

We view ESG as being highly correlated with financial risk and, therefore, should be embedded into the investment process. But the real added value in ESG comes through engagement rather than passing the can down to the next investor, which is often done through exclusion lists. Overall, we need to see evidence of a more sustainable future.

The way we implement ESG is through the various stages of our investment process. As an example, during our manager selection process we need to see clear ESG integration as part of their process, which includes idea generation, screening, research and due diligence. Finally, when blending these strategies as part of our portfolio construction process we also look at how the portfolio measures in terms of ESG including climate risk and carbon footprint.

It comes at no surprise that when you look at our high alpha strategies and despite having quite a big allocation to value, we have at least 30% - 50% reduction in carbon footprint relative to the benchmark.

Willsher: It is difficult to implement, to tell the truth. There is a lot of conflicting information out there about a topic that is multi-faceted.

We are seeing investing through passive and tilting indices. They are not perfect. There are lots of reasons why they do not do the full job, but they are a good, helpful step in the right direction and, hopefully, they will evolve and get better over time.

The other side of it is active management where you have more flexibility to do what you need to do. You can engage and threaten to exclude if you need to.

As an asset owner, it is difficult to know what is happening behind the scenes. The implementation statements where we put forward practical examples of how this has been undertaken is helpful in focusing everyone's minds, but it is tricky.

> **There is an assumption that inflation is necessarily a bad thing.**
>
> Neil Mason, Surrey County Council

Goddin: I manage a positive future fund, so by its nature it is going to be at the higher end of the ESG scale.

It is important to highlight there is a scale, and there is no right or wrong answer. There is a baseline we should not dip below in terms of ESG, but apart from that it is okay to own stocks that need to get better.

We choose not to do that. We focus on stocks that are trying to change the future. Exclusionary lists have been around for 30 years and not much has changed by not investing in them.

The same could be said by investing in quality companies. Things are getting incrementally better but not materially better. We focus on companies which are making that impact today or looking to make that impact in the future.

Whether it is an environmental issue or a social issue, such as lowering costs in US healthcare or renewable energy which is helping to solve the issue of one in five people in 2018 dying from the burning of fossil fuels, you are looking at specific issues and trying to solve them. It does not mean that any of the other points are

wrong, they are all valid, but the best way of implementing change in the financial world is to focus on companies that are focusing on transformational change.

Our companies tend to do one thing. If they get it right, the share price will go multiple times higher and the impact on the world will be positive. If they do not, they may shrivel away to zero. That is the risk you take. You do not need to find many Amazons to run a good portfolio.

How are you measuring outcomes?

Goddin: There is more than one way to run an income fund, but no one moans about the complications of it. It is the same for ESG funds. Personally, we had problems with a lot of third-party methodologies. They blatantly conflict with each other or they focus on operational issues, which is understandable because it is easy to measure how many women are sitting on the board, but they tend not to focus on the product so much.

Coverage is another issue. We invest in companies that often are not covered or are young, so despite being a renewables company, for example, they have a bad score because they do not have an environmental report.

Measuring stuff is not without its challenges, but every month that goes by, companies are reporting more and more and we interact with them to get these types of reports. Most of the companies we invest in have a strong ESG culture, so they are keen to understand what we expect from them.

All the time, it is improving and our coverage of companies that report on ESG goes up every three, six, nine months. There is lots to like in the sector from that perspective.

How reliable is this third-party data?

Goddin: You need to be careful how you use it. I have seen impact calculators and I am cautious on the data underlying them. I do not know how you manage some of these companies' CO_2 emissions and the impacts of their products. It is difficult, but it does not mean you should give up. Understand your companies, speak to them, speak to peers, speak to experts. Understand what they are trying to do. Challenge them on things like net zero and understand how they are having an impact.

We keep a lot of that data ourselves from our companies. I am more cautious on the third-party side in terms of some of these numbers. I am not convinced that they are always correct or that it is relevant to have a go at software companies for not having an environmental report. British American Tobacco scores highly on some ESG methodologies. It is nuts.

Petalas: The biggest issue we have with ESG data is that it is backwards looking. It does not capture future opportunities especially when it comes to energy transition. This is where active management could add value.

Future performance is generated by future cashflow and future risks, rather than what has happened in the past, so having an eye on the future is crucial in identifying sustainable companies.

Abrahams: It is not the most reliable of data. Certainly, for some ESG risks you can find more reliable data than you can for others.

For example, you can look at the proportion of a company's revenue that is generated from certain sources. That is probably the most reliable you can get in terms of data looking at ethical factors.

How do asset managers prove to their clients that they are serious about ESG?

Goddin: It is becoming more of an issue. ESG is being talked about by all asset managers; some of them I believe and some of them I am sceptical of.

One of the most important things that we look for in a company is the culture. You cannot change the culture of a company easily. Good companies on day one, tend to stay good for a long time. If I were looking for a manager, I would look at their culture rather than what they may or may not report.

Willsher: There are instances of funds that have the word green inserted in it in a refresh, but if you look at the portfolio, little has changed.

I look to make sure it is something that is spoken about beyond just the selection exercise and is not the last couple of pages in a deck. What I want to see are ESG metrics, in particular carbon metrics, reported alongside performance tables. Recognise that they are not perfect but put them in whatever form we can get our hands on now, and let's see them evolve and go down over time.

If it is not going down, that is also okay. Let's have a conversation about why it is going up and if the company or asset manager has a plan to address it. It is not a stick to beat anyone with, but let's start putting some of these things front and centre, rather than the traditional look at quarterly performance.

I also want to see talk about other aspects. Let's broaden the conversation into how we should think about biodiversity in the portfolio. I want to get this language into more of our meetings.

Exclusionary lists have been around for 30 years and not much has changed by not investing in them.

Neil Goddin,
Artemis Investment Management

Let's broaden the conversation into how we should think about biodiversity in the portfolio.

Duncan Willsher, 20-20 Trustees

Petalas: There are three key figures: evidence, reporting and transparency. We are close to our stocks and fully understand them, which gives us an edge going into manager meetings.

ESG data is not perfect, but it gives us an indication of what is happening. It gives us a good base to have a conversation with managers.

We are looking for evidence of what our managers have implemented, how they have thought about ESG risk and why they invested in these companies.

We then communicate this to our clients by showing them which stocks score the lowest on ESG, however, more importantly provide them with the rationale why we hold these companies and why we expect for an improvement in the future.

As long as you have those three figures, especially transparency, you can get the message across that you are trying to implement this as part of your process.

Mason: There are mature metrics in the carbon space and we understand that they are not perfect.

In other areas, in the S in ESG, for example, we welcome the government's consultation. It is part of how we look at other metrics to manage our portfolios through. Overall, we are working with Anthony at Border to Coast where we are in the trenches when building the portfolios out. We are contributing to the request for proposal process, which allows us that insight and then we hold Anthony and his colleagues to account. We make sure that we are getting those key insights from our asset managers.

What are you expecting to see in the global equity markets during the next 12 months?

Willsher: Global equities will continue to be a meaningful part of the overall portfolio. It is about making sure that the risk is "right sized" relative to all the other risks you are facing.

What is going to happen to equities? Who knows? That is the beauty of the "right size" bit and the beauty of employing people like Anthony and Neil to do that hard thinking.

My best guess is there is going to continue to be a rocky road, but that is not particularly insightful.

Mason: It is a mystery from our point of view as we have a new pension fund committee. I have no idea what their aspiration will be. We will support them as officers, but it could be that our attitude to risk is completely different, so we are prepared for that.

As for the long-term outlook, with the stimulus in economies we should continue to see good returns from equities.

Petalas: I have no insight into what is going to happen in the next 12 months. My team tries to look long term, at how the world will change in the next five to 10 years.

Obviously, we were on the wrong side of the fence last year with the pandemic, but we stuck to our guns and came out of it stronger.

There are two primary risks to markets. The first is that Covid is still with us and any mutation could render current vaccines ineffective and derail a lot of things in the short term. The other is that if Covid disappears we will get economic growth and inflation risk.

If inflation proves to be more sustainable than transitory, it will potentially affect valuations, especially in the higher growth areas of the market.

Abrahams: Equity markets are facing headwinds. What could inflation and rising interest rates do in an economy where we have seen house price inflation and a lot of people taking out mortgages at high levels.

There is also the unwinding of government support schemes and firms being asked to stand on their own two feet again. And then, of course, there is the threat of continued disruption from Covid-19.

Those are the headwinds, but if inflation does not pick up to the degree that some market participants expect, if the government does not turn the taps off too early on the support they have provided and if there is this consumer driven economic recovery, we might see earnings growing at a sufficient pace to keep valuations on track.

Goddin: 12 months is a horribly short-term view on the world. It is difficult to call. Having looked at yearly returns in the S&P500 since 1970, there is about an 80% chance that returns will be positive.

On 12 months, I see inflation as a risk. Some inflation is not a bad thing, but too much would be painful for equities.

I saw a headline today that read, "UK inflation surges to 2.1%." That sounds more like a tap trickling than a surge, but I am not an expert and do not know where it will go.

This often gets called the most hated bull market of all time and the chances are that it carries on being the most hated bull market of all time.

If interest rates do not go up materially and Covid peters out, you will look back in five years to find that you were right to hold equities, you were right to hold good companies.

I am generally a positive person, so there is a good chance that we will have another good year of equities.