SARASIN & PARTNERS

Q1 2023
HOUSE REPORT

PATIENCE PLEASE

CENTRAL BANKS ARE NOT QUITE FINISHED

- China – the year the rabbit leaps with hope
- How might private equity assets behave in a prolonged public equity market downturn?
- How investors can make a difference on diversity
- Building resilience in 2023

INTRODUCTION

MELANIE ROBERTS
EDITOR

Welcome to the Q1 edition of the House Report

2023 marks the Year of the Rabbit in China, a symbol of hope and luck, and one that might offer more promising prospects than the brutal Year of the Tiger we are glad to leave behind us.

Somewhat surprisingly (for those of us who have ever housed them as pets) rabbits are associated with skill, culture and creativity. All such traits will be much-needed in the months ahead if we are to navigate investment markets successfully. No wonder well-known brands such as Burberry, Dior and Apple have launched 2023 campaigns giving prominence to the animal, to tempt Chinese consumers back to the shops.

With a keen focus on China, our economist Niloofar Rafiei considers the impact of lockdown lifting, both domestically and on the global economy. Restrictions in China couldn't go on forever and whilst rising COVID cases will likely cause disruption to production lines and consumption, she expects growth to resume around springtime, as tourism and demand for commodities recover. Clearly, the ramifications for the Chinese economy are as uncertain as they are for the rest of the world; these could take some time to play out.

In this issue, Guy Monson's lead article asks for 'patience please' as we observe central bankers' actions in the coming months. Treading a fine line between recession and inflation, the results will depend on how high interest rates peak and for how long. There will certainly be assets that suffer in the near term but with patience, Guy suggests reasons to be optimistic, highlighting some of the thematic opportunities that abound for the longer-term.

Private equity might well be one of the more difficult asset classes short-term, not typically a beneficiary of higher rates and lower growth. But this edition introduces the Sarasin Bread Street team, who set out some of the benefits of private markets and explain why recessionary conditions can often lead to advantageous entry-points for this asset class.

We have continued to support diversity and inclusion initiatives throughout 2022, both internally at Sarasin and externally via our investee companies, promoting the benefits of a diverse pool of talent and avoiding groupthink. Our stewardship analyst, Therese Kieve, shows how we have tackled this topic and the progress we have made to date, whilst recognising that we still have some way to go.

Our Charity Focus examines how to build resilience into portfolios in 2023. Richard Maitland looks at a number of ways to achieve this, from shifting to a fully global equity allocation within a multi-asset portfolio, to adopting a total return approach to distributions. He also notes the challenges posed by negative ethical screens in a year when many of the 'sin' sectors have outperformed wider markets.

Few, if any, financial commentators are suggesting an easy run for markets as we are still working through the hangover of COVID. Let's hope for brighter times on the horizon as we enter 2023. Please do send us your suggestions for articles at housereport@sarasin.co.uk.

CONTENTS

GUY MONSON
CHIEF MARKET STRATEGIST
& SENIOR PARTNER

Market View

PATIENCE PLEASE

Central banks are not quite finished

> Long-term opportunities abound for today's global investors but patience is needed before central bankers sound the all clear

As we said in our last report, a return to normality was never going to be easy after nearly a decade of super-easy money. 2022 illustrated this all too clearly, with the US Federal Reserve lifting rates seven times – four of them super-sized moves of 75 basis points. The result for investors was anything but plain sailing. All major asset classes declined and global balanced accounts suffered particularly as bonds and equities fell in tandem – the first time we have seen this on any scale in nearly 30 years.

As we enter 2023 there is some light at the end of the tunnel. US core consumer prices are down from a peak of 6.6% in September to 6% today, which suggests that central bank policy is finally gaining traction. This echoes developments elsewhere, with German and French inflation rates also falling, alongside a very welcome decline in oil and European gas prices. We may then be past the peak of the great inflation shock, but rising labour costs and sticky prices suggest that getting back to central bank target levels will not be easy.

Better inflation and energy data also explain the improving backdrop for financial markets last quarter. After a brutal start to 2022 across all asset classes, markets finally rallied in October, with global equities climbing 9%[1] through to the year end, bond yields stabilising and credit spreads narrowing. We are a long way from erasing 2022's market losses but the decline in volatility in both bonds and equities and a retreat in the US dollar together suggest a more stable backdrop for 2023.

It's too soon to sound the all clear

There remains a chorus of central bankers who look at today's inflation, which is still a multiple of their targets, and say rates 'still have a way to go', as Federal Reserve Chairman Jerome Powell commented after last month's US rate rise. Madame Lagarde at the ECB echoed this two weeks ago, saying she is 'not yet done,' and even the Bank of Japan joined the fray with a surprise decision to lift its target level for Japanese government bond yields last month.

This is significant because Japan is the world's largest creditor nation, so a change in policy rates in Tokyo could materially alter global fund flows. In short, interest rates are likely to rise higher and stay there a little longer than markets currently expect.

Between Scylla and Charybdis

If central bankers squeeze too hard, then the US's predicted soft landing could turn into a global recession and a collapse in corporate profits. On the other hand, if central banks ease interest rates while the inflation genie remains out of the bottle, then bond markets will take fright, risking another market-wide correction.

The journey is further complicated by two giant geopolitical events. The first is the brutal Russian invasion of Ukraine, which could become a multi-year stalemate. The second is the abrupt lifting of Chinese COVID restrictions, which offers real support for global growth later in the year, but greater risks and suffering in the short-term.

So investors have a delicate balancing act in 2023, navigating between the Scylla of global recession and the Charybdis of renewed inflation. It will take strong nerves, ample reserves of patience and the ability to act quickly when opportunities arise.

Most importantly, managers need a clear eye on the longer-term goal – namely the steady accumulation, at the right price, of equities that will be at the core of a new world order. Whether it is renewing the world's energy and transport infrastructure, automating factories and farms, or capturing a new wave of emerging market growth, it is an extraordinary time to accumulate long-term thematic exposure, but investors must remain wary of over-zealous central bankers.

Rising rates have claimed many scalps – there will be more

When global stock markets peaked a year ago the Fed projected US interest rates ending 2023 at around 1.6%; its current forecast is 5.1%. Tighter policy on this scale has already claimed scalps in listed markets, but it has also cleared away many of the absurdities of a zero or negative interest rate world:

1. The global sum of negative yielding debt has largely evaporated. The total now stands at US$254bn, down from US$18.4tn two years ago. Government finances will be the principal losers but more rational capital allocation will ultimately support global growth.
2. Long gone are the days in 2019/20, when Mrs Merkel could issue German 10-year bunds at yields of minus 0.5% and be overwhelmed with demand - today they yield plus 2.45%. The end of negative rates is a sign of a more stable and mature Eurozone and a currency that is a more credible challenge to the US dollar.
3. Crypto's fall to earth surprised few traditional investors and the recent FTX debacle is typical of a market mania brought low by tighter money. Crypto may re-emerge as a genuine asset class – but good regulation and good title are two necessary first steps…

Where will the axe fall next? Probably in less liquid assets, namely commercial property and private asset markets, that have yet to reprice. The latter (see later article) could provide a very interesting entry point for new money in late 2023 or 2024.

Reasons to be cheerful

There are three factors that may help central banks contain global prices. Europe's gas reservoirs are now 28% fuller than they were a year ago, and it would now take an extraordinary event to cause the catastrophic, zero-gas outcome feared in the early days of Russia's invasion. In fact, Europe may be able to secure much of next winter's energy supplies with minimal inflows. Gas prices in Europe are three times what they were two years ago – but six months ago they were nearly ten times!

Second, global supply chains are returning to normal. The Federal Reserve Bank of New York's global supply chain index is close to its five-year average, echoing positive comments from the management of many of the companies we visit. For China the journey is just beginning, but the speed of reopening suggests that the transformation in Chinese manufacturing output might be very significant.

Third, US and EU trade restrictions forced China to focus on intra-Asian trade – a boon for smaller Asian markets and emerging markets more generally. China's trade with ten of its neighbours has grown a staggering 71% since US tariffs were applied in 2018, and its trade with India grew 49% over the same period. By contrast, trade with Europe and the US grew by only 23% and 29% respectively. This surge in Asian trade will only accelerate as China reopens.

The policy implications for us are clear: a decade of underperformance in Asian and global emerging markets may be reversing. Liquidity conditions in these markets will also rise sharply if the US dollar's decline continues and oil prices are contained. All of the above argue for a marked increase in our exposure to Asian and global emerging equity markets over the coming year.

This increase will not be achieved overnight – travel to Asia has been limited and corporate governance and transparency can be weak in these regions. But in some areas these markets are already leading the West – including take-up of electric vehicles, surging solar generation across Asia and the extraordinary efforts to automate government payments in India.

Treading with care

Global markets are full of long-term opportunity, equity valuations are close to fair value (but not yet cheap), and corporate bond yields offer returns well above two-year inflation forecasts.[2] But we still worry that the shadow of central bank policy hangs over markets. Tighten too much and you trigger Scylla's global recession and a collapse in corporate earnings; throw in the towel too soon and you have the Charybdis of resurgent inflation. If Mr Powell and his colleagues had to choose one fate, our feeling is it would be Scylla – so the risks of over-tightening policy in the war on inflation are real.

Hence, we are treading with care, keeping equity exposure modestly underweight except where we are deploying portfolio protection, reducing our positions in less liquid alternatives and gradually beginning our pivot toward emerging markets. In private markets we have close to zero exposure today, but as valuations adjust downward and debt bites our Bread Street team will be ready to deploy in Summer 2023 or early 2024.

In all of this we will be quick to respond as conditions change – if inflation gaps downward and central banks back off or if recession threatens corporate earnings, you will be sure to hear from us again.

[1] Bloomberg, MSCI, 31.12.22
[2] Bloomberg, Sarasin & Partners, 31.12.22

NILOOFAR RAFIEI
ECONOMIST

" In the Chinese calendar, the year 2023 is the year of the rabbit, the zodiac sign which symbolises hope and luck – missing ingredients in recent economic fortunes

Investment Landscape

CHINA

The year the rabbit leaps with hope

For almost three years after the initial outbreak of COVID in the city of Wuhan, the Chinese economy has been closed to the outside world as the authorities pursued an uncompromising Zero-Covid Policy (ZCP) to suppress infections at all economic cost. While the policy initially proved successful compared to those pursued by western countries, the arrival of effective vaccines in 2021 made it less justifiable, and 2022 saw growing citizen protests demanding its removal.

The Chinese government – typically known for its measured and well-telegraphed policy responses – surprised the world by suddenly reversing its ZCP at the end of 2022, accelerating a policy change that had been expected to play out over many months. What does this abrupt volte-face hold in store for China and the global economy, both in 2023 and in the longer-term?

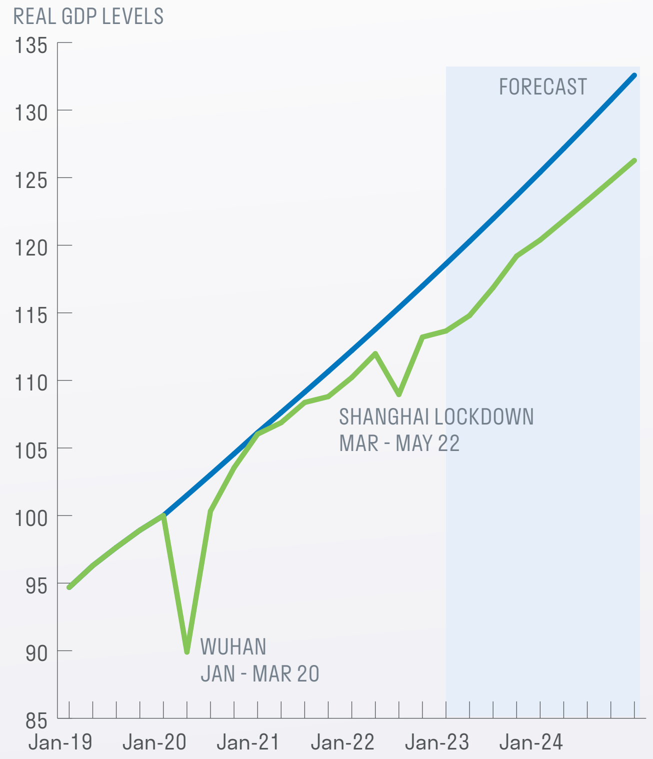
Health economics

The western experience of opening up economies suggests that the initial path to normality will be rocky and dependent on health outcomes. In China's case, the health outcomes are likely to be even more challenging. First, China's National Health Commission recently suspended reporting of asymptomatic case counts and ceased daily releases of case numbers. Without a clear understanding of the scale of infections and where the disease is spreading, it will be difficult for people to adjust their behaviour to prevent transmission, making even higher peaks likely. By one estimate, new cases are running at 2.3m per day and are expected to peak at 4.2m by early March.[1]

Secondly, China's high share of elderly population (250 million over the age of 60) and limited ICU capacity (3.6 ICU per 100,000 people vs 34.7 in US) makes its health system especially vulnerable. Vaccine hesitancy remains high, especially amongst the elderly, who are fearful of potentially tainted vaccines and have poor confidence in domestically produced vaccines. According to the World Health Organisation, only 40% of China's over-80s have had the recommended three COVID vaccine doses.

There is also the question of the timing of China's reopening, which is taking place during the winter flu season and the Chinese New Year holiday (21-27 January), when many people travel to see friends and relatives. Rural areas, which so far have experienced relatively low infections and have little herd immunity, are likely to be least prepared and worst affected.

CHART 1 CHINA'S GDP: KNOCKED BACK BY LOCKDOWNS



SOURCE: MACROBOND, JANUARY 2023

The rocky road to re-opening

Given the significant health risks, we expect the toll on the economy from the rapid transition to reopening to be significant. During the first lockdown of 2020, GDP contracted by 10% over the quarter, and during the Shanghai lockdown of Q2 2022 GDP contracted by 2.7% over the quarter (chart 1).

Even if the economy does not contract in Q1 2022, and only grows feebly as we expect, it remains in an exceptionally weak position. Three years of lockdown have put China on a weaker economic trajectory compared to its pre-COVID trend, with GDP 3-4 % lower than otherwise. We expect that households will greet reopening with caution and voluntarily limit their interactions, thus delaying a much-needed recovery in consumption. Retail sales in November 2022 were down almost 6% compared to a year ago, and consumers are likely to be less open-handed than usual during this year's Chinese New Year festivities.

Given the surge in sickness, production lines will struggle with absenteeism. Surveys suggest that manufacturing activity has been declining for almost six months, with demand, staffing and logistics all disrupted, and that the services industry is contracting even more sharply. Measurement issues also exist: economic data is released with a lag, and data at the start of the year is always fraught with seasonal adjustments issues as the Chinese New Year tends to fall in January or February, making annual comparisons and interpretations difficult.

Hope springs

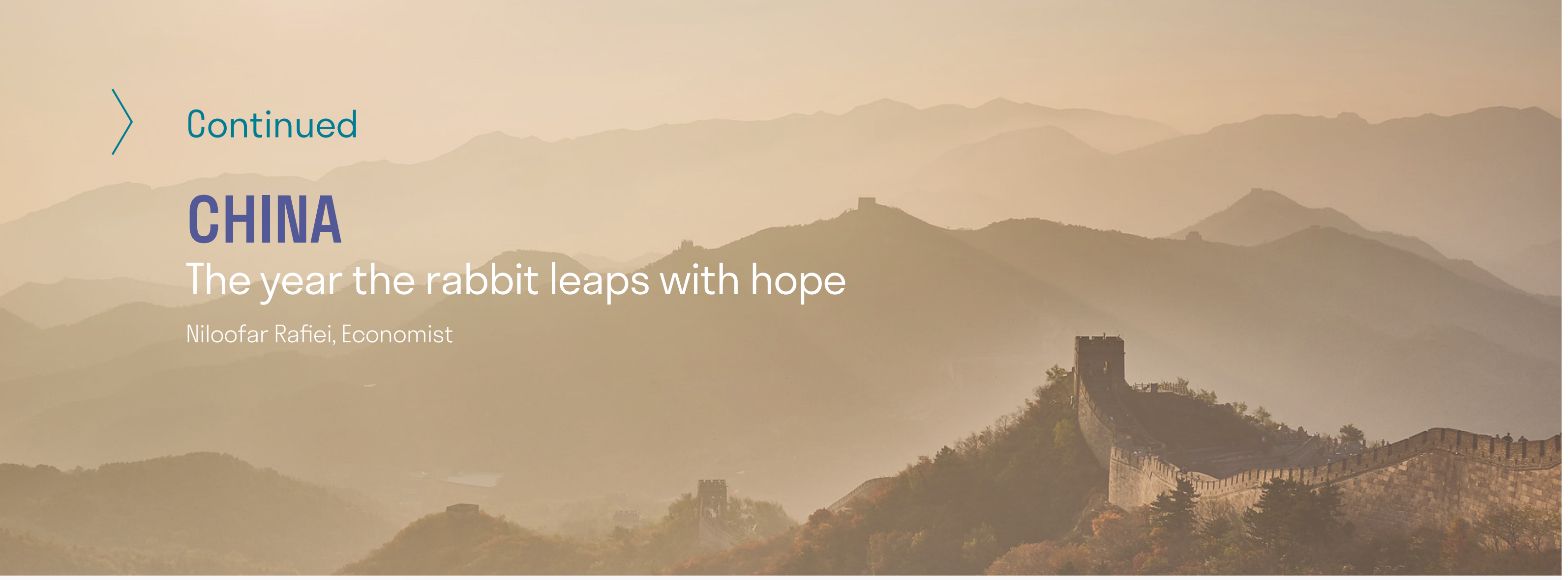
After the spring and peak infections, revenge spending is likely to dominate. Household consumption will accelerate as people spend their lockdown savings, and experience-deprived households will shift to services spending. With demand picking up and supply constraints in production easing, it is unclear whether domestic inflationary pressures will mount as they did in western countries. Consumer price inflation is currently below 2%, and labour supply is plentiful, with the official urban unemployment rate at around 5.5%, but in reality is probably substantially higher given reported wage falls of 10-20%. Unemployment is likely to be much higher in rural areas, which are not included in the official statistics. If workers who lost their jobs return to their posts quickly, this could steady the economic transition and reduce the risk of mis-matched jobs and skills – one of the key labour market issues currently faced in Europe and the US.

Additionally, the crisis in the property market – driven by both lockdowns and government regulatory policy – appears to be near its trough. In November, the government eased property developers' access to financing, and more recent communication suggests that policy in 2023 will be supporting 'fundamental demand' such as from first-time home buyers. This could mean lower mortgage rates and changes to down-payments.

We are hopeful that, after a painful start, the remainder of 2023 will be a year of economic recovery that could see GDP growth rebound from an expected meagre 3% in 2022 to around 5% in 2023. For this to happen, the drivers of China's economic growth will need to rotate and the economy to rely less on government infrastructure spending and exports, and focus on a more sustainable and resilient source – household consumption.

What does this mean for the rest of the world?

As the world's second-largest economy and contributing one-third of global economic growth in typical years, China's economic rebound will cause significant spill-overs internationally. Given China's outsized share of global consumption, one key transmission channel will be commodity markets. While commodity-producing countries like Brazil, Chile and Australia stand to benefit, importers will struggle. For Europe, which is desperately substituting away from Russian natural gas, a resurgent China could mean greater competition for limited LNG imports, resulting in a shortfall of 27bn cubic metres of gas (equivalent to 7% of its annual consumption) and the prospect of energy rationing in 2023.[2] Similarly, greater Chinese oil imports could push global oil prices higher, with analyst estimates suggesting a boost of as much as



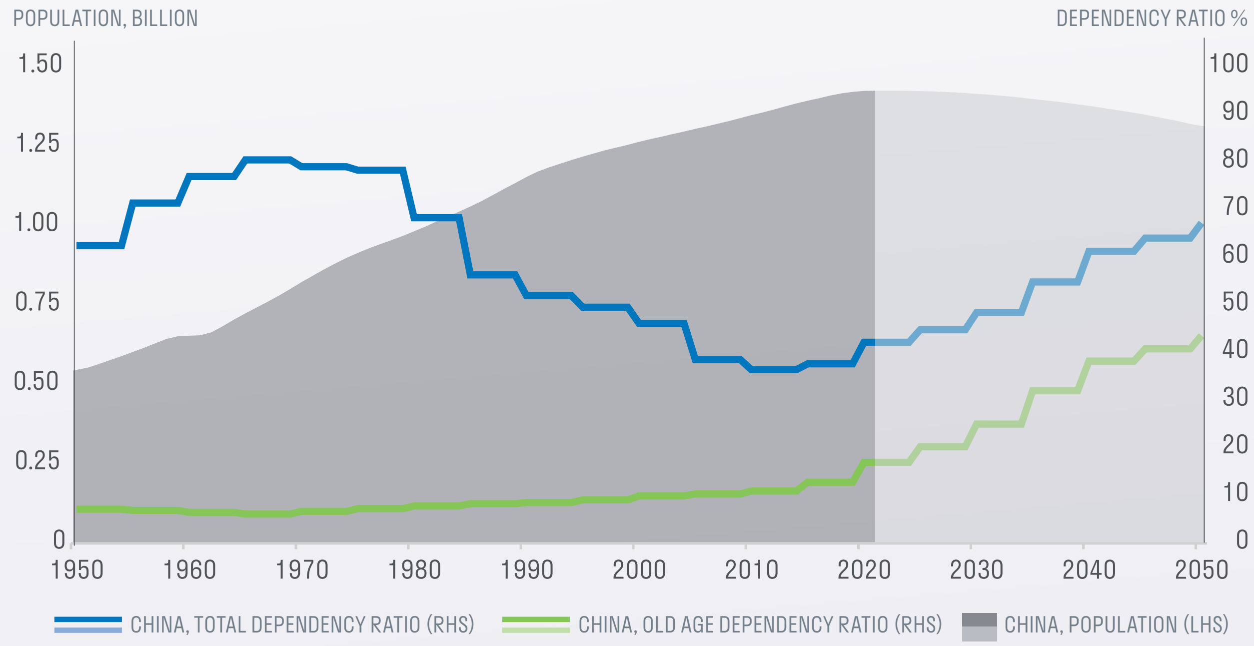
Continued

CHINA

The year the rabbit leaps with hope

Niloofar Rafiei, Economist

CHART 2 CHINA'S AGEING POPULATION



SOURCE: MACROBOND, JANUARY 2023

US$15 per barrel that would see Brent crude prices return to US$100 per barrel. In a world facing double-digit inflation and on the precipice of recession, this added inflationary impulse would be a difficult for many economies to absorb.

The other key transmission channel is likely to be via tourism exports. Pent-up demand by China's vast middle class – which once accounted for almost 20% of international tourism spending – is likely to benefit nearby Asian countries like Hong Kong and Thailand. However, this channel may take longer to play out, as many countries have recently announced Covid test requirements for Chinese tourists, weighing the benefits of Chinese spending against the risk of importing Covid.

Longer-term projections are hard to make, but some observations are possible. China already faced significant growth challenges in the medium term due to poor demographics. The old-age dependency ratio is expected to rise from around 17% today to 43% by 2050, according to the UN (chart 2). This will be a significant strain on China's growth prospects and its contribution to global growth.

As production lines normalise and supply chains heal, the re-opening of the economy is likely to reveal permanent scars. The young who missed out on vital education during the three Covid years may face difficulties in training and integrating into the labour market.

Meanwhile, foreign investors, given their aversion to policy uncertainty, are likely to have relocated operations to alternative destinations, leaving a void that is unlikely to be filled quickly. Perhaps most important of all, is whether confidence and credibility in the government's leadership has been damaged as President Xi begins his third term in office. He may be hoping for some good rabbit luck.

[1] Airfinity, 4 January 2023

[2] How to avoid gas shortages in the European Union 2023, IEA

HOW MIGHT PRIVATE EQUITY ASSETS BEHAVE IN A PROLONGED PUBLIC EQUITY MARKET DOWNTURN?

ALEX BARR
PARTNER, HEAD OF SARASIN BREAD STREET

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2021 was a record year for the private equity industry in terms of new capital raised, public offerings of private-equity-backed companies and investors' returns [2]. But looking ahead, the outlook for the sector is changing as the world adjusts to sharply rising interest rates designed to combat inflation.

This has created a much tougher investment environment. However, our experience shows that some of the best private equity returns have been made from funds raised during recessions, when entry pricing is under pressure and competition for new deals less fierce. It should also be noted that the success of private equity across cycles reflects the transformation that private equity has undergone since the 1980s, when deals such as KKR's record-breaking buyout of RJR Nabisco in 1987 relied heavily on debt.

Rather than relying on leverage for returns, private equity managers now use a systematic approach (developed by KKR in the 1990s) based on thorough analysis of the businesses being targeted and a formula for operational improvement and strategic development of the companies they acquire. This approach, which is now ubiquitous among buyout firms, relies on highly capable company management who perform hands-on operational roles in underlying portfolio companies, and are able to act quickly to implement change. It is this that gives experienced private equity investors confidence in the asset class.

How will private equity fare as the growth cycle ends?

The decisive return of inflation for the first time in 35 years has forced central banks to raise interest rates aggressively in an attempt to contain it. This raises the risk of a low-growth, high-inflation economy, leading to diminished investment returns across asset classes. Private equity will not be immune: the declining stock market values that we have experienced this year will reduce the valuations of many private-equity-backed companies.

Private equity firms generally use a 'valuation football field' approach – a spread of techniques that creates a valuation consensus. Different weight is applied to different techniques, depending on the nature of the underlying business, but for most companies the public markets' comparative price-to-earnings (P/E) ratio is a key valuation driver. If listed companies' valuations decline, this will lead to lower private company valuations.

> Private equity has enjoyed a remarkably strong run of performance[1] and endured three major cycles of growth and recession over the past 40 years. Can it continue to deliver the returns that investors have come to expect?

Sarasin Bread Street is the specialist private markets business of Sarasin & Partners LLP

Continued

HOW MIGHT PRIVATE EQUITY ASSETS BEHAVE IN A PROLONGED PUBLIC EQUITY MARKET DOWNTURN?

Alex Barr, Partner, Head of Sarasin Bread Street

James Witter, Partner, Head of Sarasin Bread Street

Our view is that private-equity-backed companies are unlikely to fail en masse, but neither will they be exited at valuations that generate the mid-teens IRR[3] and two-times cost money multiple that investors are accustomed to. Yes, valuations will decline, but businesses are likely to survive, provided they can cover their costs. For investors considering investing in private equity for the first time this highlights the need to be extremely selective, to only invest with proven teams and to commit capital gradually.

A valuation is purely a snapshot of a company's worth at a point in time and is unlikely to be what it will be realised for. Private equity managers will not sell until the price is right to generate the targeted required return, unless a company faces a liquidity crisis that they cannot refinance. This may lower the potential for an attractive return on exit, but it generally averts lost investments.

The banking system supported this strategy following the 2008 global financial crisis and regularly consented to amend and extend the terms of debt packages rather than force a default and risk the return of the loan principal. Debt has historically comprised approximately half the capital structure of a typical buyout investment but the majority of debt packages are borrower friendly and do not contain covenants that give the lender a right to control the business if the borrower defaults.

The advantages of private equity in challenging times

Private companies are unencumbered by the constraints and time pressures of public governance and investor reporting, and the cash drain of equity buybacks and dividends. This frees up private company management, with the support of private equity owners, to take rapid operational and strategic action that can enable businesses to thrive in good times and survive during recessions.

As an example, in 2013, Dell expected its annual PC shipments to drop 9% and its recent acquisitions were not bearing fruit. The company's solution was to borrow US$18bn[4], take itself private and implement an ambitious revival plan. The debt service cost of going private was considerably lower than the outflow of cash had been from dividends and buybacks in the public realm. Forbes magazine noted: "…unshackled by Wall Street's 90-day attention span, Dell has boiled the priorities down to just two metrics: cash flow and growth".[5]

Prior to joining Sarasin, the Bread Street team invested directly in the Dell 'take-private' transaction[6] and saw first-hand how a relentless focus on cash flow and execution of a clear growth plan turned a business around in a way that would be hard for a public company to achieve. Not all take-private and buyout scenarios succeed, but past experience gives us confidence that privately-owned entities can thrive in challenging times and – with the right financing, strong deal sponsors and smart incentivisation – remain attractive investments. Indeed, in periods of economic uncertainty and market volatility, private equity, with its long-term, committed capital funding model, is ideally placed to take advantage of investment opportunities.

Emerging value in the secondary market

Severe indigestion is the current order of the day in the leveraged loan and high yield bond markets. For example, Elon Musk's acquisition of Twitter this year will add a further US$12.7bn of debt to the balance sheets of Morgan Stanley, Bank of America and Barclays that will need to be sold at a significant discount to par to provide the higher yields now demanded by debt investors.

They are not alone: other large global banks also have substantial acquisition debt underwritings on their balance sheets with similar mark-to-market losses. Our market conversations suggest that the higher cost of large debt facilities is already acting as a brake on buyout deal activity, as is the difficulty of negotiating acquisition pricing given increased uncertainty of future revenue and value growth.

By contrast, the private equity secondary market has been exceptionally active due to the emerging of attractive investment opportunities and a significant stock of uninvested capital available to be deployed into the market. Funds specialising in secondary fund investments and single-asset deals remain popular, with mega-pools of capital being raised by investors seeking seasoned fund investments at discounts from pension funds and institutional investors, many of whom are trimming private equity exposure in order to rebalance their portfolios following falls in public markets.

We estimate that the highest quality buyout funds with seasoned portfolios may now be available[7] at discounts approaching 20% relative to their most recently available net asset values (NAVs), and that less seasoned and/or lesser quality funds will trade at much wider levels. We are also seeing more opportunities to invest in established venture funds, which are traditionally less liquid in the secondary market. We recently reviewed a high-quality portfolio of funds from a well-known venture manager being marketed with an aggregate discount considerably greater than the c20% being seen in buyout funds, though as most buyers right now would concur, that is only considered a starting point to a valuation discussion.

Following the collapse of crypto exchange FTX and the book value write-offs taken by its venture backers, the industry will be looking very closely at venture businesses' governance models and the quality of venture houses' oversight. It will take time for confidence in venture capital to be restored; in the meantime, we are likely to see further good opportunities to acquire venture holdings in the secondary market.

The secondary market is now pricing in expectations that underlying portfolio company exits will take longer to achieve and that distributions will be delayed. The slowdown in general private equity deal activity and a decline in performance will make new fund raisings more difficult.

However, once buyer and seller price expectations adjust and deal activity resumes, there will be more attractive entry pricing for new investments and, over time, more desirable returns on investment when the new crop of acquired businesses are ultimately exited.

We estimate that the highest quality buyout funds with seasoned portfolios may now be available[7] at discounts approaching 20% relative to their most recently available NAVs

[1] Based on long-term private equity (PE) returns (IRR basis, 1980 to 2021), calculated by the BVCA, who estimate that during this period (to 12/2021) PE funds with various geographical exposure and vintages between 1980 and 2017 delivered an IRR of 14.9%. The BVCA fund universe numbers 155 funds spanning large and generalist PE to early-stage strategies. Source https://tinyurl.com/ytwwx3h7, see p.16. By comparison, the annualised total return from UK equities for the period 31.12.1979 to 31.12.21 is 11.1% (source: Sarasin and Partners LLP Compendium of Investment 2022). We choose UK equites given the significant UK fund exposure in BVCA data. PE IRRs vs long-term public equity index returns are not a like-for-like comparator and take no account of the additional returns available to PE investors who can invest undrawn capital in other risk-seeking strategies (including equities) prior to realising ahead of capital calls.

[2] Bain & Company: "In 2021, global buyout deal value ended the year at US$1.1tn, double 2020's total of US$577bn and shattering the old record of US$804bn set back in 2006…". Chartered Alternative Investment Analyst Association: "…2021…produced an extraordinary 54% return for private equity, 12% better than the public stock markets." https://caia.org/blog/2022/07/20/long-term-private-equity-performance-2000-2021

[3] Internal rate of return, one of several private market performance metrics.

[4] FT.com, Dell: the tricky maths of a reverse merger, 9/12/2018.

[5] Forbes.com, Dell officially goes private, 30/10/2013.

[6] Co-investment for Aberdeen Private Equity Fund Ltd, an LSE-listed investment company.

[7] As at 30.11.22 and based on professional market counterparty conversations. September NAVs are not yet fully published.

THERESE KIEVE
STEWARDSHIP ANALYST

HOW INVESTORS CAN MAKE A DIFFERENCE ON DIVERSITY

> " A diverse and inclusive workforce is increasingly a priority for companies – and for their employees

As responsible investors, we want to make sure that the companies we invest in are genuinely moving the dial in the right direction, and taking steps to remedy issues when they find them. In 2021, we intensified our efforts to drive change.

Why diversity and inclusion matters

Research points to the value of a diverse board, suggesting that embracing diversity at a board level helps guard against groupthink, facilitating input and challenge from a range of perspectives. A proactive approach to diversity also builds in the advantages of a wider talent pool for candidate selection. A diverse board is also likely to be able to better understand the needs of a diverse customer base, ensuring that a company's management is aligned with end consumers. It is our belief that companies with diverse boards make better investments and are better placed to navigate a rapidly changing world.

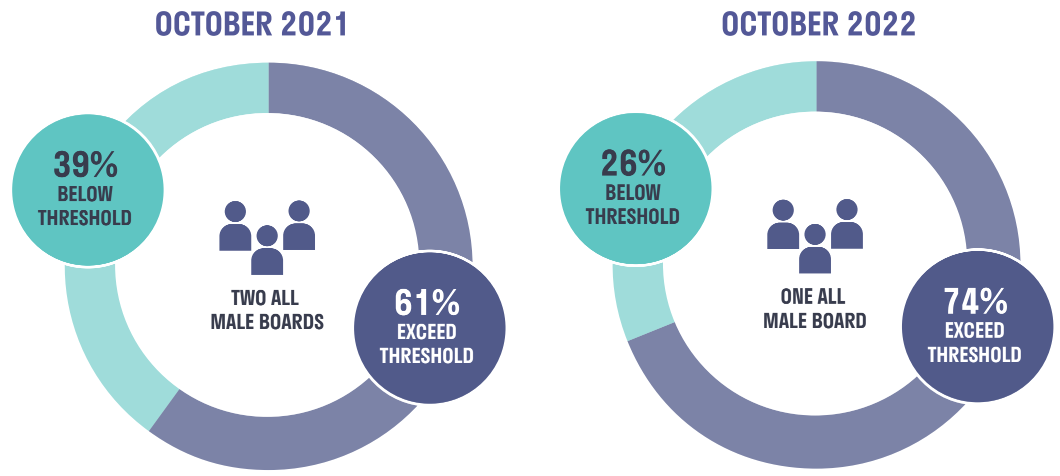
If the carrot is not enough, the stick may provide an impetus for change. NASDAQ board diversity rules now require most companies trading on the exchange to have (or explain why they do not have) at least one female director and at least one director that is either a member of an ethnic minority or the LGBTQ+ community. In the UK, as at April 2022, the FCA has set targets requiring at least 40% of board members to be female, with at least one senior board position to be occupied by a woman. At least one member of the board should come from a minority ethnic background.

Assessing the challenges

Making progress on diversity targets can be challenging, not least because there is a high level of variability between regions. Countries with mandatory gender quotas, which are increasingly common in Europe, are making fast progress. Voluntary targets, such as the UK's best practice board-level quota of 33%, are also effective in driving change. In 2022, women held 38% of board seats in the UK, with Western Europe coming in at 35.5% and the US trailing slightly at 30.4%. In Asia, the picture is quite different. In South Korea, only 10% of board seats were held by women in 2022, and in China only 11.9% seats were held by women.

Diversity also varies by industry. Companies within the healthcare, consumer staples and utilities sectors score highest on board diversity, while those in energy, materials, IT, industrials and financials lag significantly. What this means for us as an active investors is that a standardised approach to engagement is unlikely to be effective.

GENDER DIVERSITY



Tiers	Criteria	Number of companies	Number of companies
Tier 1	>40%	27	32
Tier 2	30-39%	40	54
Tier 3	15-29%	31	25
Tier 4	0 or 1 female director	11	5

SOURCE: MSCI ESG MANAGER, BLOOMBERG AND SUPPLEMENTED WITH DESK BASED RESEARCH, NOVEMBER 2022

An action plan for change

While we want to see companies make broad improvements in gender and ethnic diversity, we focused our efforts on one of the most well-established metrics – gender diversity at board level. We also sought to make substantive progress on ethnic diversity.

In 2021, we identified three mechanisms through which we could effect change.

1. **Tailored engagement for laggards**

   A number of companies on our buy list had a lack of diversity at board level. Having written letters to these companies to express our concern, we developed tailored engagement plans for any companies that had not responded to us, employing tools such as letters to the chair, post proxy votes and letters, and calls.

2. **A tougher voting policy for gender diversity and a new ethnic diversity voting policy**

   Voting is one of the core levers shareholders have to drive change, so we regularly review our voting policies to ensure they evolve along with our thinking.

3. **Carry out policy outreach on ethnic diversity through support of the 30% Club**

   We are a signatory to the 30% Club UK Investor Group and publicly support both its engagements and its targets:

   - at least one person of colour on FTSE 350 boards and executive committees by the end of 2023
   - half of the target 30% of board seats allocated to women to go to women of colour.

How well did it work?

Our tailored engagements were successful; in 2021, we wrote to 24 key companies, achieving a response rate of around 80%. Seven companies now meet our guidelines and three more have made meaningful progress.

Our engagement with Mastercard had a positive impact. We met with the LID and Chief Inclusion Officer in 2021 to discuss our expectations. We were reassured that diversity was a top priority and were pleased to see the board complete a refresh in 2022, with an emphasis on diversity and independence. The board now meets our expectations but we will continue to engage with Mastercard on pay equity.

In 2022, we made some key changes to our voting policies. We now expect that all companies globally have at least 30% gender diversity at board level (33% for the UK). This builds on our 2021 requirement, which increased our demand for global developed markets ex-Japan boards from 25% to 30%. With respect to ethnic diversity, we expect UK and US companies to have at least one director from an ethnic minority background. In 2021, we voted against 64 directors for insufficient board diversity, and have voted against 124 directors so far in 2022 for the same reason.

As a signatory to the 30% Club UK Investor Group, we participated in a number of bilateral engagements and policy outreach efforts, spearheaded an investor statement on the 30% Club's expectations for ethnic diversity data and transparency, and took part in a number of collaborative engagements. Following these engagements, both DS Smith and 3i have confirmed new director appointments. We also voted against 44 directors in 2022 for insufficient ethnic diversity.

Continued

HOW INVESTORS CAN MAKE A DIFFERENCE ON DIVERSITY

Therese Kieve, Stewardship Analyst

We have seen solid progress on the diversity of our buy list. As of October 2022, 74% of companies on our global buy list are now achieving 30% gender diversity at board level, up by 21% from 2021. We believe this reflects a number of factors – increased regulatory focus, wider investor pressure, as well as our efforts on engagement.

Are we practising what we preach?

As strong believers in the power of diversity and inclusion, naturally we want to see these values reflected within our own company.

Our own work on diversity and inclusion has taken positive steps forward in the last year. We continue to report on our gender pay gap and are making incremental progress. We are conscious that the financial and insurance sector has the worst mean pay gap of any sector in the UK and are firmly committed to closing this. Our experience with the companies on our buy list helps inform how we approach diversity at our own organisation, and we will continue to promote diversity and inclusion – not just at the companies we hold on our clients' behalf – but within our own workforce.

Looking ahead

Looking ahead, we will continue to push forward on diversity, through further tailored engagements for laggards, our ethnic diversity voting policy, a focus on gender diversity within executives and senior management (as opposed to board), pay equity and through our leadership of the 30% Club UK Investor Race Equity Working Group.

Following successful engagement with FTSE 100 companies on ethnic minority representation in March 2022, the 30% Club UK Investor Race Equity Working Group has extended this engagement to companies within the FTSE 250 and seeking progress by the end of 2023 – ahead of the Parker Review's target of 2024. Reaching out to smaller companies is a key step in achieving ethnic diversity – smaller companies may not traditionally have been subject to as much investor scrutiny and smaller boards have specific challenges that the 30% Club can support on.

Ultimately, ethnic representation at board level is just the first step. Progress within the workforce is a key focus for us, and we will look to see evidence of this through explicit company strategies and public reporting.

TABLE 1 DIVERSITY BREAKDOWN

	Total	UK	US	EU	ROW
Gender Diversity - Board- % satisfying our guidelines	73%	90%	75%	91%	33%
Female Chair	5	1	2	1	1
Female CEO, CFO	5	0	3	2	0
Ethnic Diversity - Board- % satisfying our guidelines		100%	100%	n/a	n/a
Ethnic Minority Chair		1	ND		
Ethnic Minority CEO, CFO		1	4		
Gender Pay Gap Report		90%	48%		

% OF GLOBAL BUYLIST SATISFYING OUR GUIDELINES
ND - NO DATA

SOURCE: DATA EXTRACTED FROM MSCI ESG MANAGER, BLOOMBERG, AND SUPPLEMENTED WITH DESK-BASED RESEARCH, NOVEMBER 2022

CHARITY FOCUS

BUILDING RESILIENCE IN 2023

RICHARD MAITLAND
HEAD OF CHARITIES

" We have seen a shift from negative screening towards more nuanced evaluation of environmental, social and governance (ESG) factors.

Few investors will reflect on 2022 with fondness. The armed conflict in Ukraine, spiking commodity prices that added a blow torch to already elevated post-COVID inflation and dramatically higher bond yields resulted in a year of volatility and negative returns.

While positive commentators will suggest matters have stabilised, uncertainty still abounds: the global economy is sluggish, conflict in Ukraine has not abated, the aftermath of China's zero-Covid policy is still biting and corporate earnings expectations are likely to be lowered.

In summary, economic, geopolitical and reputational risks remain elevated. We have used this edition of the House Report to consider several ideas and concepts that should enhance investment resilience.

Unconstrained global investment

Many of our segregated client portfolios already operate on a global basis: we think the time has come to adopt a fully global equity allocation within our range of CAIFs. Although the UK equity market derives a high proportion of its revenues (70-80%) from overseas, these are skewed to a limited number of sectors. We believe we are most likely to meet our clients' investment objectives via an unconstrained approach.

Moving fully global does not mean avoiding UK companies. It just means that when we allocate to UK-listed companies, it is because they have achieved their place in the portfolio on merit alone.

A fully global equity allocation appears to result in a lower exposure to sterling. However, this is optical as opposed to actual. UK-listed companies generate 70% to 80% of their revenues from overseas: investing internationally does not have a material impact on the portfolio's exposure to overseas revenues. In the immediate aftermath of the Brexit referendum, UK-listed companies with international revenues rose in value as sterling fell. The age-old convention of showing UK-listed securities as sterling assets – even if they are inversely correlated with our local currency – results in a sterling weight of 60% in the Sarasin Endowments CAIF. However, on a 'look through' basis, this figure falls to 42%, which is almost identical to both the headline and look through estimate for a fully global allocation. In practice, we do not expect a significant change in the actual exposure to sterling as a result of these changes.

Continued

BUILDING RESILIENCE IN 2023

The benefits of diversification apply to income generation as well. In the UK, approximately 40% of all dividends come from five companies, resulting in an unpalatable level of risk. Companies that generate these dividends are also focused in a few industries. While UK dividends look attractively high, pay-out ratios are amongst the highest of all developed markets. These factors concern us.

The corollary to this is that the absolute level of income from the equity allocation within portfolios will fall. While bond yields have risen and counter this, it is likely that overall portfolio income will fall and trustees will need to consider topping income up with some capital.

Total returns and income

If each asset class was invested in line with the current average yields, the global portfolio we envisage would yield about 2.2% However, as table 1 draws out, this is only about half of the real – and thus expendable – total return we expect such a portfolio to generate over the longer term.

Many of our clients have already adopted a total return approach to spending: yields have fallen dramatically are now well beneath the amount that could be spent sustainably. Since 1900, we have shown in our Compendium of Investment that between 4% and 4.5% could have been spent on average each year while retaining the 'real' value of one's capital. This is shown in table 2.

Table 2 also shows that before the end of the 1970s yields were so high relative to total returns that it was generally necessary to reinvest some income if capital was to retain its real value. Since the 1970s, one could have spent about 6.5% per annum, against a yield that now stands at 2%. What both ancient and recent history draws out is that attractively simple 'income only' spending formulas have rarely worked.

We embrace the concept of total return spending. However, we do feel that trustees should keep track of what they spend. Legislation allows managers of charity funds to distribute a mix of income and capital and The Charity Commission has stated that, from an accounting perspective, these distributions can be treated as income. Several investment managers have embraced this opportunity but we fear that trustees might not keep in touch with exactly what they are being paid. It also makes comparisons between different managers and strategies much harder.

TABLE 1 SARASIN ENDOWMENTS STRATEGY – ASSET ALLOCATION AND PROJECTED RETURNS

Asset class	Neutral allocation (%)	7-10 year projected total return (%)
Bonds	15.0	5.0
Equities	70.0	7.4
Property	5.0	6.0
Alternatives	10.0	6.5
Cash	0.0	2.5
Total	**100.0**	**6.9**
Inflation		**-2.9**
Target 'real' long-term return		**4.0**

SOURCE: SARASIN & PARTNERS LLP, JANUARY 2023

PLEASE NOTE THAT THESE ARE ESTIMATES, AND THERE IS NO GUARANTEE THAT THE PROJECTED RETURNS WILL BE ACHIEVED.

While it might be easiest to have your manager effectively take control of your spending policy, we would suggest this is something that should be owned by trustees. We suspect there are quite a few charities invested in CIFs and CAIFs who currently believe their regular 'income' distributions are just that, income, or possibly income topped up with a little capital. In actual fact, the capital element might now make up 30-50% of the distribution. Is this camouflaged treatment of income fully understood?

Our conclusion is that we will not move to total return distributions for our CAIFs. It is easy to set an annual spending figure and top up natural income distributions with small sales of units over the year. In this way, an appropriate amount can be spent and each generation of trustees can track the performance and their stewardship of the capital for which they are responsible. Trustees will also be aware of the underlying income yield of the assets they own. Yields can be an important figure to analyse, with low yields suggesting over-valuation, or a significant style or geographic bias. If you are only being shown an inflated 'income' figure boosted by capital, have you lost sight of an important data point for historical and peer comparison?

TABLE 2 ENDOWMENTS MODEL RETURNS, YIELDS AND EXPENDABLE WITHDRAWALS OVER DISCRETE DECADES (% P.A.)

Asset class	Total absolute return	Inflation	Real return	Average income yield	Re-invest income or spend capital?
1900s	2.4	1.3	1.1	4.2	-3.1
1910s	5.0	8.3	-3.0	3.9	-6.9
1920s	5.9	-2.9	9.1	4.9	4.2
1930s	4.2	0.4	3.8	4.2	-0.4
1940s	5.4	2.8	2.5	4.0	-1.6
1950s	13.1	4.1	8.6	5.0	3.7
1960s	8.7	3.7	4.9	5.1	-0.2
1970s	12.4	13.1	-0.6	7.0	-7.6
1980s	21.1	6.9	13.2	6.1	7.1
1990s	13.1	3.5	9.2	4.4	4.8
2000s	2.5	2.3	0.2	3.5	-3.3
2010s	8.9	2.3	6.5	3.0	3.5
2020s so far	4.2	5.5	-1.2	2.8	-4.0
Since 1900	8.3	3.8	4.4	4.5	-0.1
Projection	6.9	2.9	4.0	2.0	2.0

SOURCE: BARCLAYS EQUITY GILT STUDY / © ELROY DIMSON, PAUL MARSH & MIKE STAUNTON / SARASIN & PARTNERS LLP, DATA TO DECEMBER 2022

PAST PERFORMANCE IS NOT A GUIDE TO FUTURE RETURNS AND MAY NOT BE REPEATED.

The evolution of ethics and negative screening

We have seen a shift from negative screening towards more nuanced evaluation of environmental, social and governance (ESG) factors. Whilst this can result in divestment, this is at the discretion of the manager, which can result in ownership of companies whose practices cut against beliefs central to a charity's existence. Consequently, negative screens that forbid investment in certain sectors remain part of most investment policies. However, ethics and morals shift.

The invasion of Ukraine last year prompted many to question whether arms manufacturers should continue to be grouped with other 'sin' sectors? Quite a few trustees have remarked that helping fund the 'defence of the realm' and protecting others less fortunate shouldn't be considered a sin. We wouldn't expect Quaker charities to take this point of view, just as many Catholic charities avoid companies involved in the production of abortifacients. But, we suspect that some trustees might wish to reconsider what they want to avoid. Another area worth reviewing might be junk and sugary foods; whether it is best to avoid or engage with the extractive industries and whether now is the time to shine a torch on Russian and Chinese companies?

There is no definitive answer to these questions, either from a performance or ethical point of view. Where possible, trustees should make decisions based on their own specific objective and missions. However, a pragmatic approach is often required and it is worth reminding oneself that the most common restrictions do not exclude large swathes of the investible universe. From a global point of view, the five classic 'sin' sectors make up no more than 5% of the MSCI All Countries World Index.

Like so much else, 'hard' negative screens need to be reviewed to ensure they continue to align with your charity's particular mission. It will remain equally important to feel comfortable with your investment manager's overall ESG Research and Evaluation Process: this will probably influence your performance more than any negative ethical screens you ask them to embrace.

Conclusions

A New Year starts with a smorgasbord of opportunities and risks. Markets are volatile and unpredictable and regularly make fools out of investors! However, a robust strategy that is well-diversified, evolves over time and is transparent in terms of income, liquidity and what one owns are all important elements in the formula for long-term success.

Sarasin & Partners'

EVENTS –

January-March calendar

How to register for our events

To join any of our virtual events or for more information, please visit our website, sarasinandpartners.com, or contact our events team at **events@sarasin.co.uk**

9 February
Charity Times Leadership Forum.
Virtual

9 March
ACEVO Dynamic Duo for Charity Chairs and CEOs.
Virtual

13 – 15 March
BUFDG Financial Festival.
Virtual

13 March
Sarasin & Partners presentation at BUFDG Financial Festival.
Virtual

14 March
ACEVO Conference.
London

Trustee Investment Training in conjunction with Charity Finance Group

This training is free of charge and further details can be found on our website:

FOUNDATION TRUSTEE TRAINING

Virtual training:
8 February 2023
9.30am-12.30pm

ADVANCED INVESTMENT TRAINING

Virtual training:
21 March 2023
9.30am-11.30pm

2023 Spring Investment Seminars at Royal Society of Medicine London

Thursday 9 March
Afternoon seminar

Wednesday 15 March
Morning seminar

IMPORTANT INFORMATION

If you are a private investor, you should not act or rely on this document but should contact your professional advisor.

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