SARASIN & PARTNERS

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HOUSE REPORT

STAYING THE COURSE

Quality and focus will be crucial for the route ahead

- Future returns: what can multi-asset investors expect to achieve?
- Growth without inflation? Immigration can help
- Private markets: is the journey worth it?

STEPHEN ROTHWELL
EDITOR

Welcome to the first edition of the Sarasin House Report for 2024.

Welcome to the spring edition of the Sarasin House Report. Investors have experienced a positive first quarter of the year, with markets reaching new highs against a backdrop in which economic and market traffic lights have increasingly turned green.

As Guy Monson outlines in his lead article, Staying the Course, the prospect of a global economic soft landing and encouraging signs of broadening equity market leadership augur well for global thematic investment portfolios. However, this is precisely when investors can become complacent, making quality and focus key as we seek to benefit from these supportive trends while navigating the inevitable risks.

One contributor to the health of developed economies that we find has largely moved under the radar is immigration. Sarasin economist Adam Hamilton explains how the recent surge in immigration in developed economies has been good for growth without adding much to inflation, and could boost companies' earnings potential – and hence investment returns.

As James Hutton and Kamran Miah highlight, the analysis of future investment returns in the new 2024 Compendium of Investment is encouraging. Particularly heartening for investors is their retrospective roundup of how assets have typically performed in the wake of major market shocks, and their conclusion that the current economic and market environment suggests healthy returns for long-term multi-asset investors.

Keeping the focus on future returns, Richard Maitland asks: Is private equity worth the journey? With far fewer companies opting to list on public markets, the diversification and growth opportunities of private markets look appealing, but many investors will need an experienced guide.

Understanding how climate change could influence the growth prospects of listed companies has become highly relevant for long-term investors. Ben McEwen and Natasha Landell-Mills lift the lid on CVaR, a proprietary analytical tool developed by Sarasin to gauge individual companies' prospects as the world warms.

In March we were delighted to welcome many of you to our annual Spring Seminars at the Royal Society of Medicine in London, where our expert speakers' talks ranged from the outlook for investment returns to the uses and abuses of AI and the importance of food security. Recordings are available on our website.

We publish the Sarasin & Partners Compendium of Investment every two years. The new 2024 edition has provided key insights for the articles in this House Report on future asset returns and the pros and cons of investing in private markets.

We welcome your feedback and suggestions, so please do not hesitate to get in touch at housereport@sarasin.co.uk. Readers who wish to take a deeper diver into our 2024 Compendium can request copies via their Sarasin account manager or at https://sarasinandpartners.com/compendium/.

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GUY MONSON
CHIEF MARKET STRATEGIST
& SENIOR PARTNER

View from the Chief Market Strategist

STAYING THE COURSE

The world economy looks set to achieve a remarkable soft-landing in 2024 – this will continue to support global equity markets, but quality and focus will be key.

> Should investors embrace the soft-landing narrative and add to equity risk, or is this the moment to step back and raise cash?

The MSCI World Equity Index has risen by almost 8%[1] this year, delivering its best first-quarter return in five years. Gains came both from rising corporate earnings, especially among AI-linked technology names, and from higher valuations in Europe and Japan, as last year's US-centric market has begun to broaden.

Investor sentiment has been buoyed by a global economy that should see inflation return to close to central bank targets by year-end, without triggering recession. Engineering a soft landing such as this is notoriously difficult, but a near picture-perfect one looks increasingly possible in 2024.

Yet, as markets reach new highs, investors could be forgiven for feeling queasy. It was little more than a year ago that they faced near double-digit inflation and one of the most aggressive interest rate tightening cycles in recent history.

In addition, geopolitical challenges have emerged in quick succession, including Europe's biggest land war since 1945, the risk of regional escalation in the tragic Israel-Hamas conflict and, of course, an uncertain US election.

The key question for 2024 is not hard to frame: should investors embrace the soft-landing narrative and add to equity risk, or is this the moment to step back and raise cash, in the face of rising market complacency?

It looks like a global soft landing

The economic transformation achieved over the past 18 months is certainly impressive. High inflation appears to have been quelled across the western world, with little penalty in terms of growth or employment. True, US consumer prices ticked up modestly last month (from 3.1% to 3.2%, driven by used cars and housing), but we expect a further fall to around 2.5% by the end of 2024. In the UK, the year-end figure could be even softer, at 2.1%.[2]

At the same time, US growth has remained robust (annualised GDP grew at 3.4% in Q4 2023) while unemployment, at 3.8%, is very close to the lows of the last 50 years. Indeed, the IMF now sees something close to a soft landing as the most probable outcome not just for the US, but for 15 of the G20's members.

It is worth remembering that soft landings are typically difficult to achieve. The US has only truly succeeded in making two soft landings: in 1995 under Chairman Greenspan and before that in 1965, under the longest-serving Fed Chair, William McChesney Martin. A simultaneous global soft landing, as we are seeing today, is particularly rare.

[1] All data in this article sourced from Macrobond, Bloomberg, 04.03.20224-07.03.2024

[2] Sarasin research, March 2024

Can controlled disinflation continue?

So, what lies behind the rapid decline in inflation rates worldwide? First, the remarkable transformation of US domestic energy production has made America both the largest oil producer and gas exporter in the world. This has stabilised global supply and offset restrictions on Russian exports. Despite conflict in Ukraine and Gaza, and OPEC production cuts, oil prices are little changed from the eve of the Israel-Hamas conflict, while European gas prices are 80% lower than their peak, after Russia's invasion of Ukraine. Yes, there are risks today, particularly in the aftermath of the attack on the Iranian consulate in Damascus this month. Encouragingly, non-OPEC production continues to rise – Canada, Brazil and Guyana, alongside the US, have all increased output.

Second, supply chains that were severely disrupted by the pandemic have healed remarkably quickly. Even with today's challenges in the Red Sea (Suez Canal traffic is down 50% year-on-year[3]), measures of transport costs, delivery times and supply chain stress remain at or close to pre-Covid levels. This has helped suppress inflation and underpin corporate profits.

Third, sharply higher interest rates have been a lot less destructive than commentators initially feared. Households in the US and UK have been shielded by fixed mortgage rates while global corporations had already locked in much of their financing at lower rates. The large technology stocks in particular have unprecedented cash reserves and so actually benefit when rates rise.

Sticking with equities and right-sizing risk

To us, equities continue to be the most attractive asset class. Robust earnings and dividend growth, combined with the prospect of lower interest rates from mid-year, continue to be supportive, even after this year's rally.

Yes, US valuations are high but there is no shortage of other opportunities. Global dividend portfolios are attractively priced, as are many international markets that are trading at near-record discounts to the US. Corporate activity too is re-accelerating. Our climate change theme looks particularly interesting, as de-carbonisation gains impetus after world temperatures again hit new highs in 2023.

To stay the course with our global equity exposure we do need to de-risk other areas of our portfolios. Bond yields, in particular, are trending higher as governments seek to raise near-record new borrowings. A recent OECD report forecasts that debt issuance by 38 industrialised countries will rise by 12% to $15.8 trillion this year.[4] This has been exceeded only once, in 2020, when governments were scrambling to support economies at the height of the pandemic.

Whatever the result of the presidential election, the US – already home to half of OECD sovereign debt – will likely see even higher issuance. A Biden administration will tend to keep spending elevated, while a Trump administration will try to cut taxes (or make previous cuts permanent). Against this backdrop most central banks will no longer be natural buyers of government bonds: instead, they will be actively selling the government debt they accumulated via QE programmes to support the economy and markets.

The risks have not gone unnoticed. The director of the Congressional Budget Office, the US government's financial watchdog, recently warned that a repeat of the disastrous Liz Truss budget fiasco is possible, even in the US. Central banks are alert to this and will be quick to pause or slow bond sales if market volatility rises, but the disruption could still be substantial. We have reduced exposure to government bonds across portfolios.

Equity concentration risks are ebbing

Encouragingly, equity market leadership has finally started to broaden this year. At the end of March all but one of the S&P 500 sectors delivered a positive return for the quarter, while returns from Asia actually outstripped the technology-rich S&P 500. However, market concentration remains a concern. The first quarter saw both Meta and Nvidia add, in a single day, more in terms of capitalisation than has ever occurred in market history.

Managing concentration risk doesn't require investors to sell down positions in all AI-related companies. Indeed, their robust growth dynamics provide good reasons to retain them. But it does mean managing position sizes, being disciplined about valuation targets and putting portfolio insurance in place (or overwriting positions), where appropriate, ahead of any unwelcome increased volatility.

Rising real interest rates will squeeze leveraged assets

A further worry is the increase in real interest rates as inflation falls but nominal rates remain high. This has the potential to expose strategically fragile assets and penalise high leverage. Our principal worry here is commercial real estate, where investors are already facing multiple challenges, including remote working, sharply higher funding costs and the need to upgrade buildings to meet tougher emissions goals.

Indeed, many older buildings may have little equity value remaining. Newmark,[5] a US real estate advisory company, estimates that $2 trillion of US real estate loans will mature by 2026, of which $670 billion may be troubled. This argues for caution on more leveraged assets, and in particular toward commercial real estate developers and those who have lent to them.

Quality and focus will be key in 2024

With these caveats, the prospect of a soft landing across multiple economies provides powerful support for global thematic equities. But to benefit we must reduce portfolio risk elsewhere – this will mean lowering bond allocations, managing concentration risks and reducing exposure to leveraged, climate vulnerable assets.

So yes, we will stay the course, but quality and focus will be key to maximise our ability to ride out the shocks that will – almost inevitably – occur.

[3] IMF: Red Sea Attacks Disrupt Global Trade, 07.03.2024

[4] OECD, Global Debt Report 2024, 07.03.2024

[5] Newmark Group, Financial Results Presentation, 22.02.2024

ADAM HAMILTON
ECONOMIST

Economist's View

GROWTH WITHOUT INFLATION?

Immigration can help

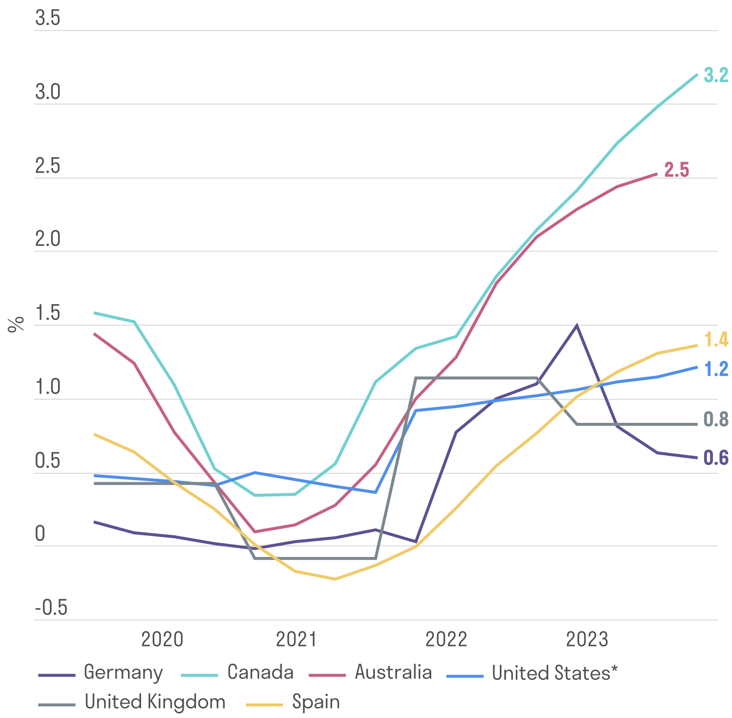
> When people consume and produce in similar amounts, immigration can boost GDP growth without adding much to inflation.

Rich economies are benefiting from higher growth with moderate inflation thanks to a surge in immigration. That could boost companies' earnings potential – and investment returns.

The economics of immigration is complex, but one thing is clear: the recent surge in new arrivals to developed economies has been good for growth, without adding much to inflation. With immigration into the US, Canada, the UK, Spain, Germany and Australia at extremely high levels, the benefits for investors are being felt widely.

Some of the recent surge reflects a catch-up in well-established migration patterns that were interrupted by the pandemic. Success attracts success: booming economies attract people. In addition, deteriorating geopolitics and outright conflict have created a wave of people seeking a better life elsewhere (or at least safety), with Europe and North America receiving millions of Ukrainian refugees. Immigration is showing up in much faster population growth.

CHART 1 POPULATION GROWTH IS SURGING



*Congressional Budget Office working-age population estimate
SOURCE: MACROBOND, 04.04 24

Population growth is usually a slow-moving affair, so it often doesn't feature prominently in forecasts of the business cycle.

Immigrants mostly comprise workers, international students and humanitarian visa holders. Tourists are not counted as immigrants or in population statistics. However, drawing a bead on actual immigration levels can be difficult.

US census population figures underestimate immigration due to difficulties in measuring illegal immigration. The Congressional Budget Office recently estimated net migration in 2023 and 2024 to be around 3.3 million per year (close to 10,000 per day), figures that suggest that migration is almost certainly having a major impact on production and consumption in the US economy.[1]

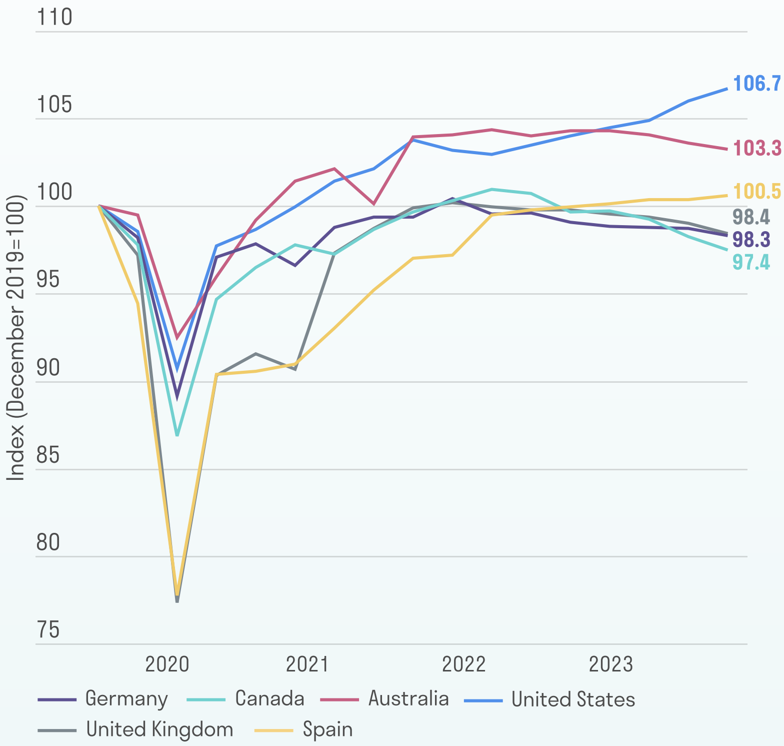
Demand holds strong despite higher rates

Major economies defied near-unanimous predictions of recession in 2023, partly because simply adding more people meant that each person would need to cut spending by more for GDP to fall in aggregate. At the time, this went largely unnoticed: population growth is usually a slow-moving affair, so it often doesn't feature prominently in forecasts of the business cycle.

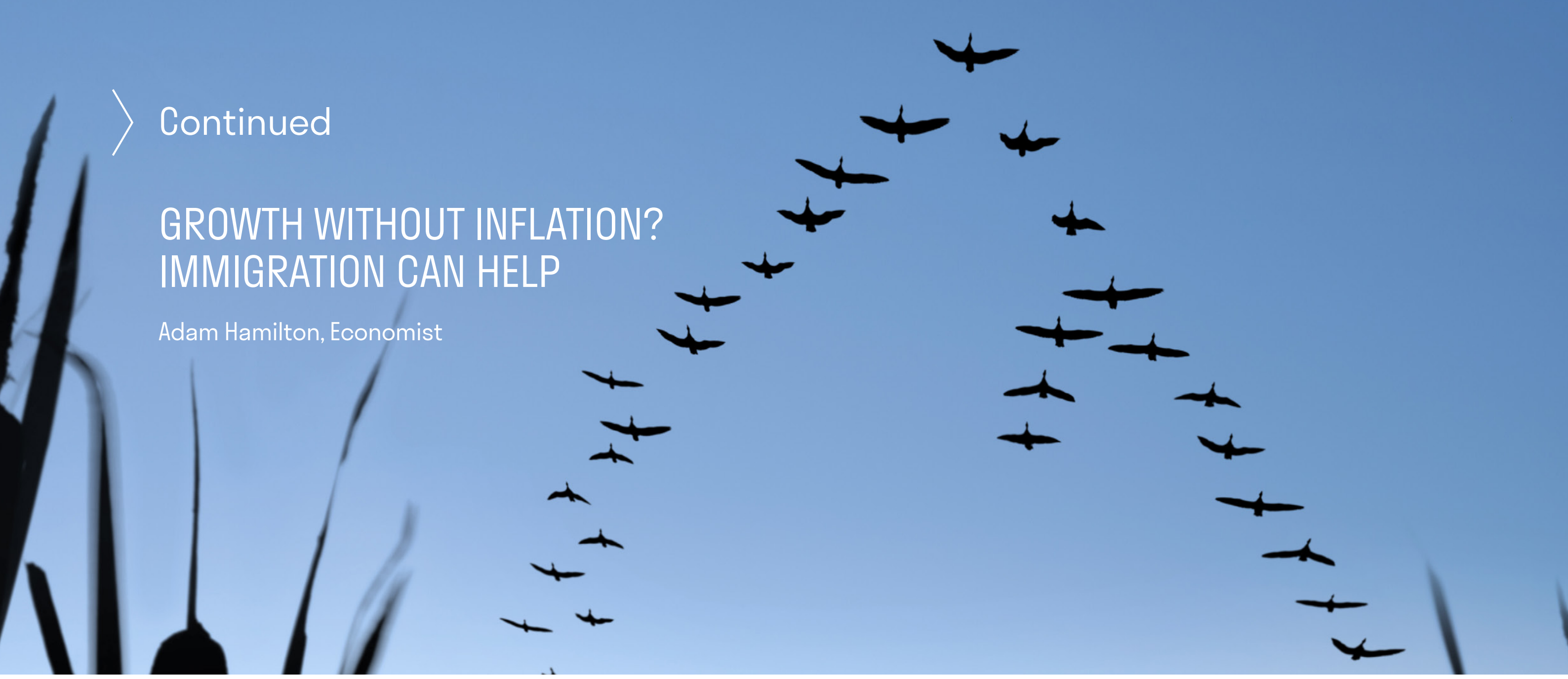
Extra people add to demand by consuming goods and services. This typically boosts the consumption component of GDP, the exception being international students, whose spending is captured in exports. The investment component of GDP may also have to increase for the economy to supply this additional consumption and exports over the longer term.

Under the surface, GDP per person has actually been falling in developed high-immigration economies. Although the US appears to be an exception, it is less so once you adjust for under-reporting of net migration. The decline in per-person GDP gives us some confidence that higher interest rates from early 2022 (alongside higher energy prices) have indeed helped to slow previously rapid growth – a

CHART 2 REAL GDP PER PERSON
ECONOMIES ARE SLOWING AS HOPED



SOURCE: MACROBOND, 03.04 24



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GROWTH WITHOUT INFLATION? IMMIGRATION CAN HELP

Adam Hamilton, Economist

fact which is less obvious in the aggregate GDP data, particularly in the US.

But we have to be careful of compositional effects: falling per-person GDP may also occur if incoming migrants spend or earn less than the existing population. That means we need to keep an eye on the labour market as well.

People are both consumers and producers

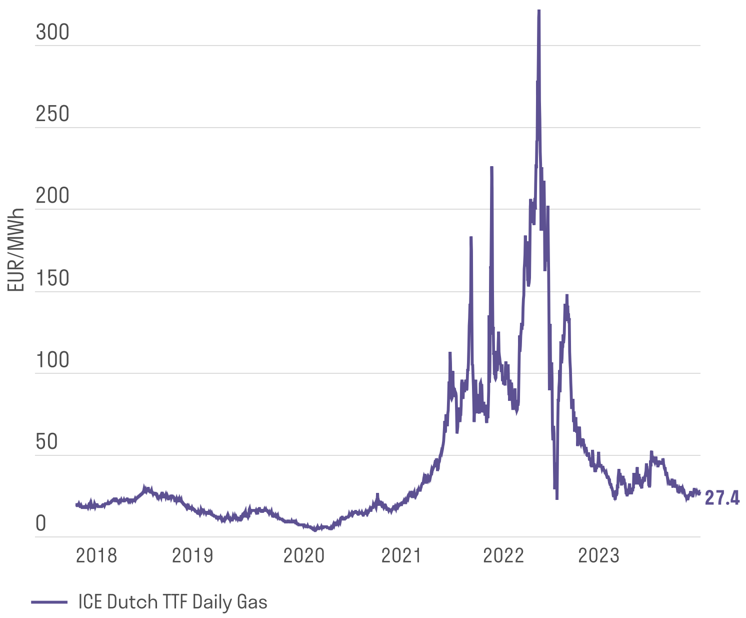
Most people work, which adds to labour supply in the economy, and everyone is a consumer at some level. Some migrants, such as international students, may consume more than they produce, partly because of restricted working rights. Other migrants are likely to be net savers. The same person may be either at different points in time. When I first moved to the UK, I was temporarily a net consumer, living off my personal savings until I found a job.

With a lot more people looking for work, the US economy was able to add a massive 3 million extra jobs in 2023 and still see the unemployment rate trend up marginally. Slowing wage growth also suggests that labour supply is increasing faster than demand at the moment, even if some of that extra labour supply is not being captured in official statistics.

In Canada, Australia and Germany, where GDP growth has been slower, the number of jobs created has not kept pace with the number of people looking for work. This has seen unemployment rates in these economies tick up from their post-pandemic lows.

Oddly, despite the UK also experiencing the same combination of weak GDP and strong population growth as these other economies, the official unemployment rate from the Office for National Statistics (ONS) has been falling, calling into question the reliability their labour market data.

CHART 3 EUROPEAN WHOLESALE ENERGY PRICES ARE PLUMMETING



SOURCE: MACROBOND, 03.04 24

Disinflationary boom

When people consume and produce in similar amounts, immigration can boost GDP growth without adding much to inflation. So the US could experience stronger-than-usual GDP growth while its inflation falls towards the Federal Reserve's (Fed's) target of 2%.

In other economies, however, a mix weak growth and rising unemployment is likely to cause headline inflation to return to target earlier than in the US, despite a much higher starting point at the start of 2023.

Indeed, recent monthly inflation data has been lower outside of the US. Price increases for goods have slowed rapidly compared to services as energy prices and supply chain pressures have normalised despite ongoing geopolitical issues.

European wholesale energy prices are plummeting as supply and export capacity of liquified natural gas continues to grow. The significant historical price difference between US and European gas looks likely to be arbitraged away in coming years as gas markets become increasingly globalised. This is positive news for energy importers like the UK, Europe and Japan, and could support their currencies.

Cheaper Chinese imports are also helping bring inflation back to target (but I doubt they will receive a thank-you letter). China is trying to offset a housing market downturn by exporting manufactured goods and building yet more infrastructure.

Housing markets feel the strain

The housing market is one part of the economy that can't expand supply rapidly to meet extra demand. Even in areas where building is permitted, housing takes time to build. The influx of people, together with a preference for more living space prompted by the experience of pandemic lockdowns, has seen rents skyrocket.

High rents have meant property price falls have been modest relative to the increase in interest rates. In the US, rents account for around one-third of the consumer prices index (CPI) and are a major reason behind persistent inflation. In the UK, the ONS has recently revised its approach to calculating rent inflation. Its new methodology reveals that over the past year UK rents have been growing at close to 10% rather than 7%, as was previously thought.[2]

The Fed still has scope to cut interest rates

Disinflationary booms are positive for risk assets because stronger GDP growth means better earnings potential. At the same time, the Fed should still be able to start cutting interest rates, even with GDP growth modestly above 2%, provided it still thinks inflation is coming down.

However, an economy with strong population growth can sustain higher interest rates over the medium term, and investors will need to take this into account – particularly when valuing fixed-income investments.

This reinforces our view from last quarter where we wrote that the long-run destination for the Fed Funds rate is more likely to be 3.5%[3] than the median estimate of around 2.5%[4] from the Fed itself. We are entering a new regime in which inflation, interest rates and asset price volatility will all be higher than during the 2008-to-covid era.

CHART 4 HOUSING RENTAL CPI INFLATION
INFLUX OF PEOPLE SEES RENTS SKYROCKET

SOURCE: MACROBOND, 03.04 24

[1] Congressional Budget Office, 'The Demographic Outlook: 2024 to 2054', January 2024

[2] Source: Office for National Statistics, Private rent and house prices UK, March 2024

[3] Sarasin research, January 2024

[4] US Federal Reserve, 'Summary of Economic Projections', March 2024

RICHARD MAITLAND
SENIOR PARTNER

Introducing private equity

The majority of companies are not 'listed' on public markets. Their shares (and bonds) are held directly by individuals, families, institutions and in many cases, specialist funds set up to own these illiquid assets.

Whilst many are not for sale, some are via 'private markets', as they are typically described. Specialist managers exist to seek out and invest in these opportunities.

PRIVATE MARKETS: IS THE JOURNEY WORTH IT?

They are illiquid, hard to access, difficult to research and not especially transparent. So what accounts for the 16x growth of private assets over the past 30 years to become an £8 trillion juggernaut[1]?

Not long after the dawn of my investment career – let's say the 1990s – investors in US listed equities were spoilt for choice, with a smorgasbord of over 8,000 companies to choose from. Today, that number is closer to 4,500.

The US market is by no means alone in seeing its ranks thinned out. In the UK, the number of listed companies has fallen by roughly 40% since 2007.

Something else has changed, too. Today, investors face an extraordinary degree of equity market concentration, with a mere 10 companies accounting for nearly 20% of the MSCI All Countries World Index.

Just as listed markets have shrunk and concentrated, the private markets have ballooned, diversified and evolved.

And therein lies the rub for today's investors: opportunities for genuine diversification and for long-term growth from industries of the future are becoming scarcer in listed markets. But do the returns from private markets justify the effort, fees, illiquidity and opportunity costs of allocating to them?

We believe they do, though with some carefully considered caveats.

Does private equity do it differently?

The returns from unlisted and listed equities flow from exactly the same source: economic growth leading to profits growth and creation of enterprise value. From an absolute return perspective, one might therefore expect that listed and private investments should, on average, perform similarly.

However, private markets managers (known as general partners, or 'GPs') cite a number of factors that they believe enable private market investments to achieve higher returns than equivalent listed opportunities. A shortlist of these includes:

- Access to high-growth companies long before they are accessible via public markets
- Ability to apply expertise to improve private companies' operational efficiency
- Better access to capital, use of debt and efficient balance sheet management
- Ability to focus on long-term objectives, not short-term performance

As we outline in the 2024 Sarasin Compendium of Investment, various studies have investigated whether these factors can be directly linked to returns. However, an essential take-away for investors is that each private equity manager and vintage[2] will show different biases, and that there is a very wide range of returns between the best and worst managers, funds and vintages.

It is therefore difficult to make generalisations that apply across private markets investments and vintages. This highlights the importance of choosing an experienced team of private markets specialists who can offset the risks of making poor investment decisions in this area through sound research and diversification between managers and across multiple vintages.

How big is the illiquidity premium?

Anyone who invests in private equity must be prepared to have their capital tied up for a number of years. In return, investors naturally expect to receive an illiquidity premium – a higher return as recompense for not having access to their capital.

A great deal has been written about whether or not a private equity illiquidity premium exists once fees and other costs are taken into account, and the subject has generated lively (often heated) debate, both in academic circles and in the press.

Underlying the sometimes stark differences of opinion on the subject is the fact that, historically, it has been difficult to provide private markets returns that are relevant and easy to compare with other asset classes. However, the increasing transparency of private equity and the availability of better (but by no means perfect) measures of performance such as Public Market Equivalent ('PME'), do now enable investors to make absolute and relative judgements about the asset class.

Notably, a recent independent study by CEM Benchmarking of 200 public and private sector pension funds between 1998 and 2021 found that private equity has produced a significant illiquidity premium relative to listed equities – if one compares gross returns (i.e. returns before costs).

Of course, gross returns are not what an investor receives and the costs incurred when embracing private assets are very significant: having analysed a range of academic and industry sources, we factor in about 4% per annum, acknowledging they can range between 2% and 8% per annum depending on how you implement your allocation and how much you end up paying in performance fees.

However, even after the costs of management are factored in, an illiquidity premium remains. While it effectively halves, the net average return for private equity has still been 1.7% to 3.9% per annum higher than similar listed market equities, equating to a premium of 18% to 56%.

Please note though, that in the model of future returns published in the Compendium (see also the Charity Focus article in this edition of the House Report), we factor in a more conservative premium return for private equity for the period ahead of 1.35x above listed market returns, net of costs.

How liquid are private assets?

In its early years, private market investment was truly illiquid. Over the past ten years, huge growth in secondary markets for funds of private assets has gone some way to improve liquidity. However, secondary market prices in the current market cycle are at discounts to net asset value (NAV). For good-quality buyout assets these discounts are around 7-10%, with riskier or longer-duration assets, such as venture investments, often at 25%-50% discounts.

Whilst secondary private markets offer a route to liquidity, we would not recommend that investors depend on being able to sell their holdings at a decent price in the secondary market. These types of assets should be considered illiquid and not readily realisable at their full value until they wind up.

A second key liquidity consideration is the pattern of cash flows when investing in private equity. When a private equity fund launches, investors commit their first instalment of capital, which is invested as the GP finds opportunities. Then, part-way through the life of the fund, capital starts to be returned to investors as investments are realised. When all investments have been exited, the fund winds up.

After a reasonable length of time (around 5-7 years), further capital calls[3] can be covered by the return of capital from investments made in prior years, thus maintaining a relatively neutral cashflow.

There are times, however, when demand for fresh capital exceeds the return of capital. This is particularly likely if private assets valuations are depressed. GPs will not wish to sell existing holdings but they will want to invest in new assets at depressed levels, and may require investors to commit further capital. Again, we would urge investors to treat private markets as illiquid and not rely on hopeful short-cuts to realising gains or meeting cash flow demands.

Not for everyone

We fully acknowledge that making an allocation to private markets is not a straightforward decision. The range of returns between managers and the importance of identifying and accessing the best managers should not be underestimated, and nor should the implications of holding illiquid assets. Investors also need to consider how their ethical requirements might be applied within illiquid and sometimes opaque private market vehicles.

Lastly, there is a much greater difference between gross and net returns in private markets than elsewhere. Asset owners will reach their own conclusions as to whether the net results make the journey worthwhile. Certainly, anyone considering allocating to private markets should read widely on the subject and discuss the pros and cons with advisers who have expertise in constructing global multi-asset portfolios.

If one can manage the issues of manager selection, access, illiquidity, ethics and cost, it appears logical to us that genuinely long-term investors should consider allocating to private markets.

Looked at another way, if you wish to own an equity portfolio with similar overall risk, return, maturity and industry exposure characteristics to one of 20 years ago, today it would be made up of a mix of listed and unlisted investments.

1 The data cited in this article is from The Compendium of Investment, 2024 edition, Sarasin & Partners, pp59-67

2 'Vintage' refers to the year in which investment capital is delivered to a private markets project or company

3 Capital calls are periodic additional capital commitments that are required during the life of a private markets investment in addition to the initial investment.

BEN McEWEN
CLIMATE CHANGE
INVESTMENT ANALYST

THE DEVIL'S IN THE DETAIL

Spotting climate winners and losers

We get to know our companies comprehensively. When it comes to climate change, we use a proprietary, forward-looking approach to weighing individual companies' prospects as the world warms.

Active investment managers spend a lot of time assessing the outlook for individual companies. But when it comes to estimating how climate change might improve or seriously impair a company's prospects, it is often assumed that homogenous assumptions can be applied across the board.

For example, an estimated price for carbon emissions in 2030 might be applied to all companies being analysed, regardless of their plans to reduce carbon emissions, their competitive position, or whether such a carbon price is likely to apply in the jurisdiction where they operate.

Similarly, companies' carbon footprints are often used as a guide to climate risk exposure, but these can only tell us about emissions today. They are not helpful in assessing what a company's emissions might look like in five, or ten years' time.

The reality is that climate change will affect individual companies in a much more nuanced way. This is partly because its effects will differ across the globe. The picture becomes increasingly complicated when we consider individual companies' plans for decarbonisation, likely government policy responses in different regions, societal preferences and access to technology that can help alleviate the effects of a warmer world.

Faced with this, some investors consider climate impacts too complex and intangible for meaningful analysis. We beg to differ. To our mind, it calls for two key attributes of sound active management: professional judgement and investment experience.

The key to making sense of how climate change affects individual companies lies in gaining insight on company-specific climate data and then quantifying our findings before incorporating them into traditional financial analysis. We do not expect to achieve perfect predictions, but our findings can help in two important ways – avoiding major risks and uncovering misunderstood investment opportunities.

Staying focused on the big picture

With global tensions growing and question marks hanging over the economy, it is natural for investors to focus on what they believe to be near-term risks, at the expense of addressing what are perceived to be longer-term risks. However, climate change is already happening around us; the markets' failure to recognise this has the potential to wreak damage on all economic activity and on our quality of life.

Climate change will affect how all companies do business, not just the carbon-intensive companies that most readily spring to mind. For investors, understanding how climate change might affect their portfolios should therefore be of paramount importance.

Sarasin's Climate Value at Risk

This where Sarasin's Climate Value at Risk (CVaR) methodology comes in. Estimating value at risk (VaR) is a long-standing technique that investment managers use to examine and quantify potential threats to an investment thesis. Although it has the word 'risk' in its title, value at risk analysis can also help flag up promising opportunities. CVaR takes the concepts used in VaR and applies them to the complexities of climate change.

In essence, CVaR is a forward-looking fundamental analysis and modelling exercise, based on a scenario in which the increase in global temperatures is limited to 1.5°C above pre-industrial norms. By quantifying a company's exposure to accelerating decarbonisation and physical risks, CVaR helps us gauge possible valuation impacts.

CVaR builds on traditional financial analysis techniques, such as discounted cash flow analysis, that investment managers often use to estimate how much they should pay for a stock today. Some of the information we use in CVaR is publicly available, such as the Taskforce on Climate-Related Financial Disclosures (TCFD) that some companies are required to provide, which includes an assessment of the risks and opportunities they face.

CVaR in action: Hydro One

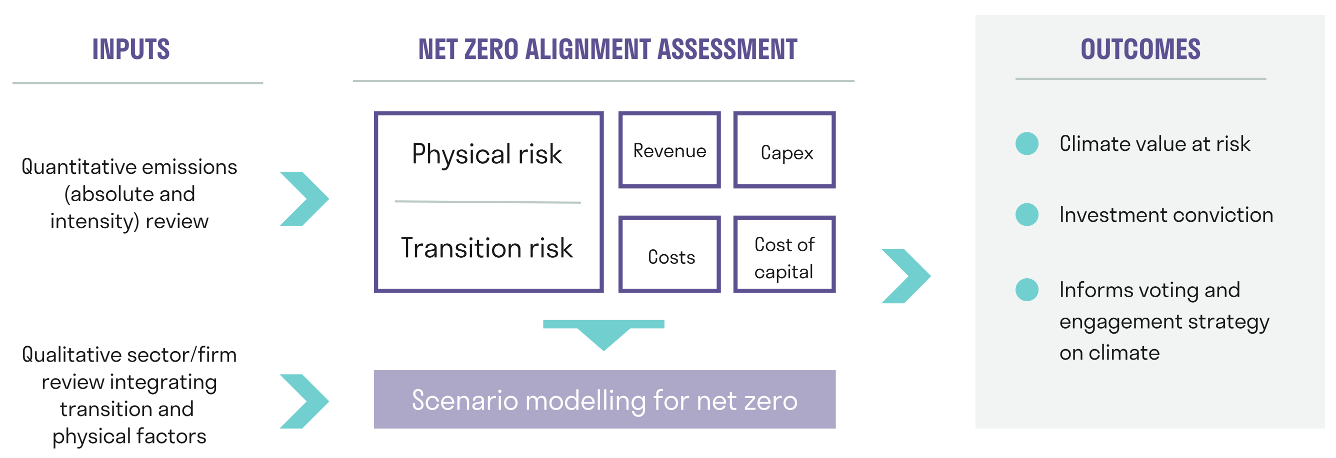
Hydro One Ltd is a Canadian electric transmission company that enables renewable and low-carbon energy projects to be connected to the power grid.

Our CVaR analysis showed that a 1.5°C temperature outcome could be beneficial for the company's equity value, with the CVaR analysis indicating a potential 27% upside in fair value versus a business-as-usual scenario.

In terms of physical risks, Hydro One's significant fixed asset base could be vulnerable to fire and flood risk as global temperatures rise. However, the company is well insured, making a cashflow shock due to replacing damaged assets unlikely.

Hydro One could benefit substantially from the transition to a lower-carbon economy. If there is an acceleration in renewables projects, the transmission system would need to grow. This would enlarge the company's asset base on which to derive a return.

IDENTIFYING RISKS AND OPPORTUNITIES IN THE TRANSITION TO NET ZERO



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THE DEVIL'S IN THE DETAIL

Ben McEwen, Climate Change Investment Analyst

We are also able to draw on information that is not as widely available, such as insights from our ongoing engagements with companies into their plans for transitioning towards a lower-carbon economy.

In turn, our CVaR results feed back into our engagements with companies. Companies that CVaR reveals as being at risk from climate change could still take steps to address these risks. This is exactly what we encourage when we engage with companies that have climate induced risks but have the opportunity to ameliorate, if not capitalise, upon an ability to move towards a net-zero-aligned path.

Misunderstood risks and opportunities

As one might expect, most oil and gas companies subjected to CVaR analysis do not come out well. Once the impacts of higher carbon prices, the growth of renewables and declining use of fossil fuels are taken into account, we can expect lower volumes, margins and revenue, as well as increases in the cost of capital.

But climate risks are not always where you expect. Our work on banks, for instance, has pointed to potentially material risks to capital from loan books overly exposed to carbon-intensive sectors. Banks are essentially a derivative of the global economy, so they internalise the risks of their borrowers. By analysing banks' lending practices, we are able to get a better idea of this risk exposure and incorporate it into our CVaR analysis.

Some companies may also be substantially underpriced when it comes to climate change. For example, future demand for copper, lithium and rare earths – all crucial to the energy transition – appears be underestimated. This plays to the strengths of mining companies such as Lynas Rare Earths. Likewise, Air Liquide, a global leader in the production of hydrogen, is well placed to benefit from the decarbonisation of industry and travel.

Consultancies such as Tetra Tech, that advise on systems and infrastructure needed for adapting to climate change, may also be deeply under-appreciated. Likewise, firms such as Quanta Services, which provides the skilled labour needed for building smart electrical grids and renewable power networks, have pronounced and positive exposure to decarbonisation.

Be prepared

Climate change presents major risks but also significant investment opportunities, some of which are deeply misunderstood by the equity and bond markets. We cannot say exactly when the risks will become realities, but climate change is progressing faster than many expect.

We are also likely to experience tipping points – events such as the collapse of ice sheets – that will accelerate climate change. The speed at which climate change is happening and the likelihood of tipping points make financial and economic models based on backward-looking climate data increasingly irrelevant.[1]

The acknowledgement at COP28 that decarbonisation will require a transition away from fossil fuels shows that governments are finally waking up to the dangers of climate change. We can expect increasingly strong policy responses as governments scramble to introduce decarbonisation regulations. When this happens, the markets' focus will likely rapidly switch towards identifying which companies will be compromised by climate change and which will benefit.

We believe that investors should be well prepared ahead of these events; and should play their part as responsible shareholders in driving corporate action to mitigate it. Thorough company-level research into who is prepared for decarbonisation is not just about minimising risk – it is also about the potential to identify rewarding investment opportunities.

[1] The Emperor's New Climate Scenarios, The Institute and Faculty of Actuaries and University of Exeter, July 2023

JAMES HUTTON
PARTNER, CHARITIES

KAMRAN MIAH
SENIOR INVESTMENT MANAGER

WHAT CAN MULTI-ASSET INVESTORS EXPECT TO ACHIEVE?

The new macroeconomic regime means a mixed outlook for global economic growth and investment returns, but lower inflation and robust performance from equities and bonds could stand multi-asset investors in good stead.

What can multi-asset charity investors expect to achieve?

In the last few years, investors have been confronted with one of the most aggressive bouts of inflation seen in decades. The effects of this were amplified by the falls seen in both equity and bond markets in 2022. While there has been a strong recovery in portfolio values over the last year, questions still remain as to what the future holds.

To answer some of these questions, we believe it is important to consider:

1. **The past** – how have portfolios historically behaved in these market environments? What lessons can be drawn from these patterns?
2. **The future** – what do we expect to drive returns going forward? What is different about the next decade?
3. **Your portfolio** – what are the implications of our forecasts for asset allocation?

The findings we will describe are sourced from our Compendium of Investment.[1] For over 25 years, we have produced this document with the aim to empower trustees and share our long-term outlook for the asset classes we include in our clients' portfolios. These projections are the basis of how we establish long-term investment strategies.

History favours the patient

To build a clear understanding of the past, we have sourced the longest available history of investment markets. With the support of our data providers, we have produced a long-term multi-asset portfolio track record, the Endowment Model, an investment strategy used by our charity clients. Our analysis traces all the way back to 1900, reminding us of the many periods of growth, collapse and recovery that an investor would have experienced in the last 124 years.

Given the surge in inflation experienced during 2021-23, we have specifically reviewed how our multi-asset approach has performed following periods when inflation outpaced the absolute return,

Every two years we update the data in the Sarasin Compendium of Investment and set out our projections for returns from core asset classes over the next 7-10 years.

The returns we cite here and in the Compendium are the average annual returns that investors could achieve over the next 7-10 years, rather than in any single year.

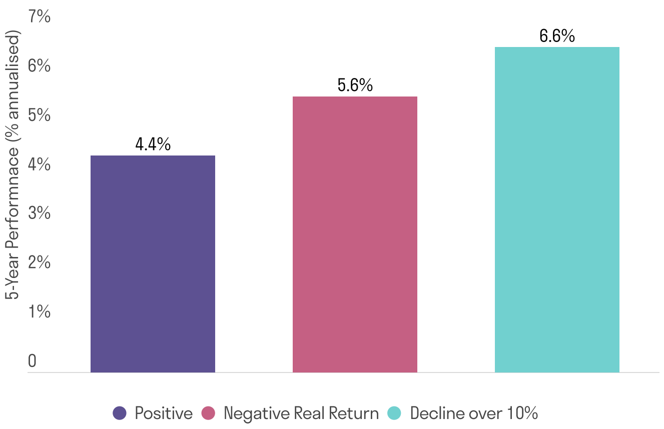
Our projections are also base-case 'index' returns. Active investment management could add or detract from them, and the effect of investment management fees and other costs must also be taken into account.

resulting in negative real returns. The results make for heartening reading, showing a general trend of rebounds in performance.

We found that, following a period of negative real returns, investors in the Endowment Model experienced average real returns of 5.6% per annum over the next five years. However, particularly sharp losses – where real returns have declined by more than 10% in any one year – have typically been followed by even stronger real returns of 6.6% per annum over the next five years.

The chart below shows the average five-year performance of the Endowment Model after a period of positive real returns, negative real returns and a sharp decline in real returns of -10% or more.

CHART 1 5-YEAR PERFORMANCE OF ENDOWMENTS MODEL FOLLOWING PERIODS OF POSITIVE/NEGATIVE REAL RETURNS (% ANNUALISED)



SOURCE: SARASIN & PARTNERS LLP
PAST PERFORMANCE IS NOT A RELIABLE INDICATOR OF FUTURE RESULTS AND MAY NOT BE REPEATED.

Perhaps the key insight from our analysis is that the worst decision for many investors would have been to sell in the depths of a market decline and then miss out on the recovery. If history serves as a guide, investors in multi-asset strategies are likely to experience a rebound in returns, as has already been seen in 2023 and in the first quarter of this year.

The fundamentals that drive projected returns

While the past offers helpful lessons, the key driver of our market projections is the prevailing economic environment and how we expect it to shape investment markets.

Over the long term, returns from equities are driven by the rate at which capital is returned to shareholders (via dividends and buybacks), which is ultimately a function of earnings and economic growth. Over the near term, GDP is expected to grow a little quicker as inflation begins to recede, and interest rates are lowered. Growth declines gradually thereafter, as the working-age population grows

TABLE 1 PROJECTED LONG-TERM (7-10 YEAR) INVESTMENT RETURNS (%)

Asset class	Trend return per annum
Private equity	10.4
Global equities	7.7
UK property	6.7
Alternatives	6.5
Corporate bonds	5.2
Gilts	3.8
Sterling cash	3.3

SOURCE: SARASIN & PARTNERS LLP
FORECASTS ARE NOT A RELIABLE INDICATOR OF FUTURE PERFORMANCE AND MAY DIFFER TO ACTUAL PERFORMANCE ACHIEVED.

at a slower rate. This, together with a range of other factors detailed in the Compendium of Investment, sets the tone for 7-10 year expected investment returns.

These returns are lower than the historical average since 1900, as UK equities and gilts have typically generated 9.0% per annum and 5.0% per annum, respectively.

However, we are also expecting inflation to be lower – an average 2.3% per annum, while the average since 1900 has been 3.8%. This is positive for investors' spending power.

Our projected return for global equities, the primary engine of growth for our clients' portfolios, is 7.7%. Once we account for the expected level of UK inflation, this translates into a real return of 5.3%, which is slightly higher than the long-term average of 5.0%.

Having experienced over a decade of low bond yields, the projected return from gilts is now 3.8% which equates to a return of 1.5% after inflation. Real returns from corporate bonds appear more encouraging at 2.9% per annum.

What are the implications for today's portfolios?

To help charities understand the impacts of our forecasts on both their medium-term and long-term portfolios, we have used the following:

- **Reserves Model** – medium-term time horizon (2-4 years). Predominantly invested in UK gilts and corporate bonds, with the balance allocated to equities and alternatives.
- **Endowment Model –** long-term time horizon (5+ years). Predominantly invested in equities, with the balance allocated to bonds, alternatives and property.

Given the more conservative asset allocation and the expectation of bonds generating a lower return than equities, our Reserves Model is projected to earn a return of 5.2% per annum, or 2.8% after inflation. This is materially higher than one might have expected from such a portfolio a few years ago, largely because higher interest rates have boosted potential returns from bonds.

The Endowment Model, which has a higher exposure to equities, is forecast to generate a return of 7.0% per annum, or 4.6% after inflation. Interestingly, this is in line with the long-run real returns generated since 1900 of 4.4%.

The higher projected return available from equities may tempt investors towards the Endowment Model. However, it is crucial to understand your time horizon and that equities are typically more volatile than bonds. Such a portfolio may therefore not be appropriate for investors with a short-term time horizon.

What could materially change our outlook?

Forecasting the global economy 10 years from here is complex, as is assessing the implications for multi-asset investment returns. Many things could change, but two particularly merit our attention. These are the rapid advances we are witnessing in technology and the transition to net zero, both of which could have major implications for productivity.

Unlike slow-burning demographic trends, the effect of technology on productivity growth is harder to predict. Technological change can be sporadic, rapid and disruptive – as well as a significant investment opportunity.

Two of its biggest drivers are economic necessity (for example due to scarcity of labour, energy, resources or capital) and major threats (such as pandemics, conflict and climate change). These are already very evident in today's world.

Real improvement comes when a technological breakthrough not only allows an economy to overcome increases in costs, but also achieve higher production levels than before the cost pressure occurred.

The rapid development of generative artificial intelligence (AI) may prove to be an example of this. And despite adding to inflationary pressures and social and political strife, climate change and the transition to net zero economies could be another.

Summary

Our view of the current economic and market environment suggests healthy returns for multi-asset investors. With a projected real return of 4.6% per annum from the Endowment Model, investors can ensure that they are able to adequately plan current spending requirements, while preserving the real capital value and longer-term needs.

If the historic trend of outperformance following periods of weak real returns does repeat itself, then investors may benefit even further.

TABLE 2 RESERVES MODEL (%)

Asset Mix		Trend return per annum
35	Gilts	3.8
35	Corporate Bonds	5.2
20	Equities	7.7
5	Alternatives	6.5
5	Cash	3.3
100	**Total Fund**	**5.2**
Expected inflation		**2.3**
Projected real return		**2.8**

TABLE 3 ENDOWMENTS MODEL (%)

Asset Mix		Trend return per annum
7.5	Gilts	3.8
7.5	Corporate Bonds	5.2
70	Equities	7.7
5	Alternatives	6.7
10	Cash	6.5
100	**Total Fund**	**7.0**
Expected inflation		**2.3**
Projected real return		**4.6**

SOURCE: SARASIN & PARTNERS LLP
FORECASTS ARE NOT A RELIABLE INDICATOR OF FUTURE PERFORMANCE AND MAY DIFFER TO ACTUAL PERFORMANCE ACHIEVED.

About the Sarasin Compendium of Investment

Published since 1997, the Compendium of Investment is designed to arm investors with the knowledge they need to consider a range of investment options and allocate assets in ways that meet their particular circumstances. The Compendium provides an objective view of asset classes, style biases and ethical investment policies and how costs can affect returns.

For more information, or to order a copy, please scan the code or visit our website www.sarasinandpartners.com/compendium

[1] All data in this article sourced from The Compendium of Investment, 2024 edition, Sarasin & Partners.

WHAT WE ARE READING

Here is a selection of what is on our reading lists, helping our team understand some of the greatest drivers behind our complex world.

Books

The Code Breaker, Walter Isaacson

This follows the career of Jennifer Doudna and her colleagues in their discovery of CRISPR, a gene editing tool that has the potential to transform healthcare. CRISPR's major breakthrough was seen in the novel RNA vaccines used to defend against Covid, but it has the potential to do so much more including curing genetic diseases, fending off viruses and possibly to treat certain cancers. The team won the Nobel Prize on the back of this discovery, but it has also led to a moral conundrum about whether it is appropriate for mankind to edit our DNA and take evolution into our own hands.

Edward Lloyd,
Senior Investment Manager, MPS

The Golden Spruce – A True Story of Myth, Madness, and Greed, John Vaillant

The felling of a celebrated giant golden spruce tree in British Columbia's Queen Charlotte Islands takes on a potent symbolism in this probing study of an unprecedented act of eco-vandalism. In a land of virtually infinite natural resources, a deep-reaching account of the clash between wilderness values, the voracious logging industry, white settlers, and First Nations people.

Ian Craik, Senior VP

Chip War: The Fight for the World's Most Critical Technology, Chris Miller

Starting in the 1960s, this book explains how semiconductors have developed through the decades and which companies have driven innovation. Highly topical given today's market.

Marcus Hill, Investment Manager

What I Learned Losing a Million Dollars, Jim Paul and Brendan Moynihan

It takes a look at different investment strategies with a view to understanding any similarities. The conclusion being: there are many approaches to making money, but the similarity among successful investors is that they have a plan for what to do when they are losing.

Tom Wildgoose, Senior Portfolio Manager

The Coming Wave: AI, Power and the Twenty-First Century's Greatest Dilemma, Mustafa Suleyman

Thought-provoking book on the opportunities and risks of AI from one of the technology's leading lights. Suleyman makes a compelling case for the urgent requirement of a regulatory framework which is being listened to by businesses and policymakers alike.

Ben Gilbert, Senior Associate Partner

The Girl with the Louding Voice, Abi Daré

This fictional novel is set in a small town near Lagos, Nigeria and touches on many real and disturbing themes around sexism, poverty, child labour and child marriage. It tells the story of a teenage Nigerian girl, Adunni, whose life is riddled with hardship and many challenges due to being forced to marry at a young age, exploitive treatment from her employer and poor access and funds for female education in the country. However, determined to face up to the dire challenges, she finds her way, and importantly her voice, in education which frees her from her oppressions. The book highlights the importance of providing access to education to all children and how some less developed countries are significantly behind the curve in offering and funding education in women.

Charlotte Bostock, Senior Investment Manager

EVENTS
Q2 2024

How to register

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

Visit our website, sarasinandpartners.com for more information

Ethical policy setting

Tuesday 14 May | 10:00 – 14:15

St Hilda's College, Oxford University, Cowley Place, Oxford, OX4 1DY

Trustee training and economic update

Wednesday 5 June | 09:30 – 14:15

The Jockey Club Rooms, 101 High Street, Newmarket, CB8 8JL

Economic update and T20 cricket

Friday 14 June | 17:00

Somerset County Cricket Ground, St James Street, Taunton, TA1 1JT

Charity Forum Lunches

We host a monthly Charity Forum Lunch at our offices; if you would like to receive further information or to attend, please email charityevents@sarasin.co.uk.

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 sessions

18 June

09:30 – 11:30

In-person sessions

23 April | 1 October

14:00 – 17:00

Scan for more information

Advanced trustee training

Virtual sessions

12 Nov

09:30 – 11:30

In-person sessions

21 May | 10 Sept

14:00 – 17:00

Scan for more information

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