SARASIN
& PARTNERS

Q3 2022
HOUSE REPORT

THROUGH A GLASS, DARKLY

OPAQUE MARKETS URGE CAUTION - FOR NOW

- UK interest rates – how high can they go?
- Alternatives – an alternative to inflation?
- Innovation for income
- Know thyself – risky behavioural biases

INTRODUCTION

MELANIE ROBERTS
EDITOR

Welcome to the Q3 2022 edition of the House Report

'...Rough winds do shake the darling buds of May...' If we thought the start of the year was tough, the past few months have continued to challenge, with the ongoing war in Ukraine, higher inflation, rising interest rates and excessive valuations continuing to test markets. Most multi-asset portfolios have suffered negative returns, with few asset classes offering any respite. Recession is looming both here and in the US, staff shortages, strikes and an aggressive tick-up in COVID numbers are disrupting our lives once again – not the summer any of us had planned.

In our lead article this quarter Guy Monson sets out the reasons for the volatility, explaining in particular why UK inflation is still on the rise. He considers the implications of tightening monetary policy on portfolios, with different scenarios as to where interest rates might ultimately peak. Our economist, Niloofar Rafiei, suggests that this is the key question for UK investors, as she asks: 'How high could they go?' With an increasingly fragile state of the UK economy (not helped by a government in flux) she outlines the fundamental differences between the UK and US economies and argues why UK rate rises might be more limited than others currently think.

As always, it is important to continue to seek opportunity amongst the volatility. We have included in this edition an article from our alternatives analyst, Adil Aloui, who has analysed and recommended a number of investments such as infrastructure, real estate investment trusts (REITs) and specialist hedge funds. These have been owned across portfolios for some time now, providing diversification whilst benefitting from the inflationary backdrop.

Similarly, our equity analysts and portfolio managers have sought out 'quiet disruptors' within our income mandates, searching within our thematic investment process for companies able to provide sustainable dividends, and even dividend growth, at times of stress. As equity markets have shifted to prize 'value' over 'growth' it is more important than ever to ensure such investments in traditional value and dividend-paying stocks are able to adapt and innovate, whilst generating much-needed cashflow for shareholders.

Finally, our Charity Focus is a test of the psychology of investing: Know Thyself! With markets falling, how do investors tend to react? Richard Maitland offers some thoughts for charity trustees on how to navigate the investment world as bear markets set in, or, ideally, ensure portfolios are well-prepared when they arrive.

We are all acutely aware of the economic challenges that are starting to bite. Perhaps the best tonic is to try to enjoy the summer and finish the rest of Shakespeare's Sonnet 18.

Please do offer your feedback for future articles by emailing us at house.report@sarasin.co.uk

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GUY MONSON
CIO & SENIOR PARTNER

Market View

THROUGH A GLASS, DARKLY

" The first half of 2022 saw the worst start for US equities since 1970, with no single sector in positive territory except energy.

The financial outlook is particularly opaque – yes, some real value is starting to appear as markets fall, but while central banks continue to throttle demand, caution is needed for a while longer.

The first half of 2022 saw the worst start for US equities since 1970, with no single sector in positive territory except energy. The sell-off has been extraordinarily widespread, with government, corporate and junk bonds all showing negative returns, alongside bear markets in most equity markets. Two unlisted asset classes showed surprisingly strong positive returns – private equity and global real estate. US residential house prices rose by an extraordinary 20.4%[1] in the year to May, while prime London rents climbed by the greatest extent in two decades.[2] This was of little help to investors in listed markets where the past six months, especially for balanced mandates, have been among the most difficult on record.

The causes of the sell-off are not hard to find

The causes of the sell-off are not difficult to find; war, inflation and high valuations are all contributors. Most important, though, is central banks' determination to tighten policy and bring demand back into balance with supply, which has been seriously damaged by the pandemic and the invasion of Ukraine. This will almost certainly trigger a recession – probably at the end of 2022 – as the price of bringing inflation back close to target by 2024.

Western central bankers are acting aggressively because they were slow to anticipate the problems last year. In mid-2021, consumers were flush with cash from stimulus cheques and enforced saving during the pandemic. They were prepared to spend liberally as economies reopened, while on the supply side delivery chains were seriously impaired by the pandemic and China's prolonged COVID-19 restrictions. From microchips to car parts, manufacturers across the world were unable to meet demand, underpinning much of the inflation shock we face today. Better late than never, central bankers are now tightening interest rate policy, and rapidly. It is this that has most destabilised markets.

Inflation risks are still climbing, especially in the UK

Three factors add to today's inflationary challenges. First, labour markets are exceptionally tight, with job openings exceeding the unemployed for the first time in recent history in the UK and at unprecedented levels in the USA. Second, the surge in European gas prices and a potential cessation of Russian gas exports to Europe risks further inflationary pressures and recession risks. Inflation in the euro zone was already running at 8.6% in June, the highest since the bloc was created in 1999.

Third, UK inflation continues to climb, principally because sterling is weak, down 4% this year on a trade-weighted basis and 11% against the US dollar, and this has pushed up energy and import costs. Political turmoil and a rapidly widening trade deficit mean this is unlikely to be reversed quickly.

How likely is a 'mild' recession?

We forecast a US recession in late Q4 2022 or early 2023, but there is hope that it may be relatively mild. First, personal balance sheets are in good shape after the enforced saving of the pandemic years – we estimate there are USD$3tn of surplus savings compared to pre-COVID trends. Second, US and global banks are robust, in marked contrast to 2008. Last week all 33 major US banks passed the Federal Reserve's stress tests. Third, labour markets are in rude health, so a deep recession, given unemployment rates at just 3.8% in the US and the UK, would be very unusual. In other words, expect a shallow, 'jobful' recession.

What does this mean for interest rates?

The outlook suggests three possible paths for interest rates (we focus on US interest rates for this section):

- The first, and most likely scenario, is a series of rapid rate increases that slow the economy and inflation, and, most importantly, cap inflation expectations. Under this outcome we see US rates peaking at around 3.25% in H1 2023.
- The second scenario sees inflation being much stickier – particularly if the energy crisis worsens. Rates move higher for longer (to around 4%) and a deeper recession is needed to squeeze prices back close to target.
- The third envisages a major market dislocation or financial crisis occurring as rates rise. Possible causes include widespread emerging world defaults, a collapse in the shadow banking system (China may be vulnerable) or a systemic failure that freezes the crypto ecosystem. In this case US rates peak at around 2.5% and then retreat.

For clients who remember the 1970s these rate increases may seem modest, considering that UK CPI is already at 9.1%. However, there are clear differences between then and now; in the 1970s inflation had been rising for longer and led to higher and more ingrained inflation expectations. The price of oil during the 1970s rose by a multiple of the rise seen over the past year, and the US economy was then almost three times more energy dependent (in terms of barrels of oil per unit of GDP). Finally, governments today are far more indebted now than they were in the 1970s – a material rise in interest rates today would likely result in a ruinous decline in government finances. A shallow recession, with rapid but limited rate rises, remains our base case.

Investment implications

For much of the past decade the rule of 'don't fight the Fed' has meant staying fully invested to benefit from generous central bank policy – culminating in the extraordinary post-COVID equity rally of March 2020. Today, this phenomenon may reverse. If, as we have argued, central bankers genuinely want to tighten financial conditions and slow global demand, then the message for investors is clear – stay cautious for a while longer. Yes, we have seen substantial repricing of assets this year, with world equities declining more than 20%, but that was achieved by a contraction in valuations. By our measure, world equity PE multiples[3] have fallen back from a peak of nearly 25 times to around 15.5 today (the 20-year average is 15.9 times). Corporate confidence is surprisingly robust, with share buy-backs continuing at record rates, but early signs of caution abound. Global corporate fundraising has cooled sharply, falling by 25% from the first half of 2021, while US equity fund raising fell to just USD$40bn, the lowest since 1999.[4] Bond yields are also rallying on recession fears. All these signs indicate a heightened risk of profit warnings in the months ahead.

Our response has been to keep our underweight equity allocation for a little longer and retain a focus on defensive franchises and sustainable equity income. We do not intend to reduce equities dramatically from here. We note, for example, that declines in US equities of greater than 15% in the first half of the year have historically been followed by positive returns in the second half of the year. Across other assets, slower economic growth has led us to start reducing our aggressive underweight in government bonds. At the same time, we continue to overweight alternatives, which have produced standout returns over the past year. These exposures include gold and other inflation-linked assets, such as infrastructure and renewables. Finally, we continue to keep precautionary positions in cash to provide funds for opportunistic purchases should any substantial sell-offs occur.

So caution today, but as the economic glass starts to clear there will be a host of opportunities. Equity yields in Europe are already mouth-watering, and the massive capital investment needed to create a low-carbon economy will provide a huge source of future earnings. Our thematic equity holdings should be the long-term winners and, as the world reopens for travel, our analysts will be hot on their trail.

[1] Case Schiller House Price Index June 2022
[2] Savills June 2022
[3] Global PE Multiple 1 year forward Factset
[4] Financial Times 2nd July 2022

NILOOFAR RAFIEI
GLOBAL MACRO ECONOMIST

Economist Outlook

UK INTEREST RATES –

How high could they go?

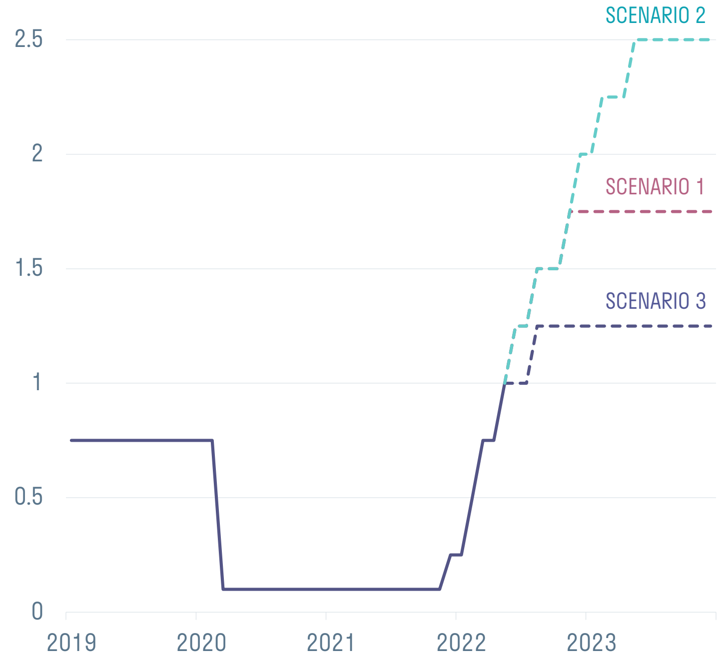
> Our judgement is that much of the rise in UK inflation has been driven by external forces – especially energy input prices, supply shortages and import prices.

UK interest rates are on an upwards trajectory, but the economy's increasingly fragile state means further hikes could be modest.

In the depths of lockdown, few people imagined that UK inflation would surge to a 40-year high of 9.1%, or that interest rates could rise so swiftly from their pandemic emergency levels of 0.1% to 1.25% today. As inflation globally began to accelerate in a world awash with liquidity, central banks were adamant that this would be a 'transitory' phase caused by the pandemic's dislocation of supply and demand. Inflation would fall back naturally as the world got 'back to normal'.

Whether high inflation could have been avoided, given the vast levels of stimulus by governments and central banks, is difficult to gauge. What is clear is that any hope of a return to normal was dashed, first by a resurgence of COVID-19 that prompted China to re-implement draconian lockdowns, and secondly by the twin shocks to energy and food markets delivered by Russia's brutal invasion of Ukraine.

FIGURE 1 UK RATE EXPECTATIONS (%)



SOURCE: MACROBOND, JUNE 2022

A large proportion of current inflation is due to high global energy prices, resulting in electricity and gas prices in the CPI basket rising by 54% and 95% respectively over the year to May. The surge in inflation, however, is also becoming more broad-based and 85% of the CPI basket is now recording inflation above 3%. Core inflation, which excludes alcohol, food and energy is at around 6%.

Ensuring price stability is an important anchor for economic stability, which is why central banks' policy focus has changed so dramatically in a short space of time; their most pressing problem is no longer unemployment but inflation.

Financial markets currently imply UK policy rates to reach 3.25% by the middle of next year. We believe that such levels of rates are unlikely given a combination of factors, including long-term economic fundamentals, the current state of the UK economy, and underlying drivers of current inflation. In our baseline scenario, we expect policy rates to reach 1.75%.

Finding neutral

The Bank of England (BoE) has tightened policy at a relatively gradual pace so far, raising rates in 25bp increments since December 2021. This contrasts with the US Federal Reserve, which recently raised policy rates by 75bp in just one month. Comparisons between the two economies firstly lie in the fact that BoE began its rate tightening cycle several months earlier than the Fed. However, it also reflects fundamental differences between the two economies and their current state of health.

The BoE will be aiming to achieve a 'neutral' interest rate – the Goldilocks level for inflation-taming, at which monetary policy is neither expansionary nor contractionary and thereby keeping inflation constant. The appropriate neutral rate varies from country to country and depends upon an array of factors that includes demographics and productivity growth. Our analysis indicates that the neutral rate for the UK lies between 1.5% and 1.75% (see figure 1), whereas for the US it is likely to be significantly higher, at around 2.5%.

As such, our base case scenario is that the Bank of England raises policy rates a further two times to take interest rates to 1.75% (scenario 1).

In contrast, we expect the Fed to raise rates to 3.25%, higher than the neutral rate, to cool the overheating US economy and create sufficient slack in the labour market by raising the unemployment rate.

Inflation trajectory is key

The other key reason for our rates outlook relates to the health of the UK economy. GDP monthly outcomes suggest that the UK economy has stalled since January . We see a rising risk of recession, as high inflation, waning fiscal support and higher interest rates push the economy to the brink. Surveys suggest that consumer sentiment is currently at the lowest level since records began in 1974, and consumers are spending less on essentials.

It will be difficult for the BoE to raise rates and engineer a soft landing, and the path for rates largely will depend on the inflation trajectory. In the short term, we expect that inflation will continue to rise, reaching a peak of over 10% in October when the energy price cap for 15m households increases. Thereafter, base effects will force inflation to trend sharply downwards, reaching 2.5% by the end of 2023.

Yet, the risk lies clearly on the upside. For central banks, the worry is that the longer inflation remains above target, the greater the risk that inflation becomes embedded in price-setting behaviour, causing a change in inflation expectations, and in turn, wage demands. Once wage growth accelerates in response to high inflation, it can set off a vicious price-wage spiral, reminiscent of the late 1970s inflationary episode.

Supply constraints and sterling

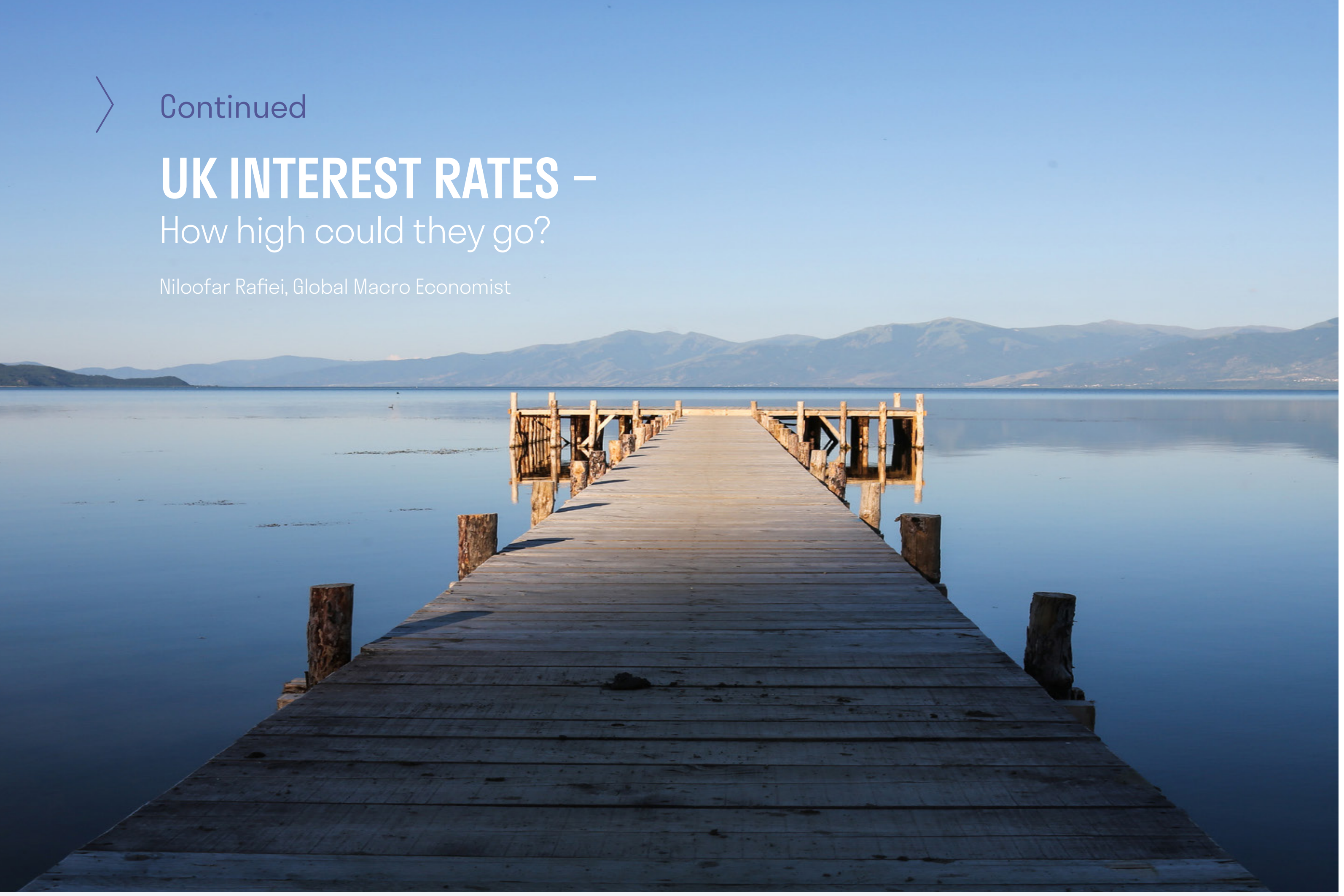
The question of how much higher policy rates can rise also depends on an assessment of the drivers of inflation and whether monetary policy can address the underlying source.

Our judgement is that much of the rise in UK inflation has been driven by external forces – especially energy input prices, supply shortages and import prices. The costs associated with the UK leaving the EU has also played a role, but this effect appears to be diminishing, according to the BoE's Michael Saunders.

On the other hand, if domestic sources of inflation prove to be larger, then the calculus could be different and more policy tightening may be necessary, resembling our scenario 2 where policy rates reach 2.5%.

In the UK, similar to the US, many workers left the labour force over the past two years; some grappling with long-term sickness, others with care-taking responsibilities, and some have emigrated as the UK left the EU. This reduction in the labour force participation rate has pushed the unemployment rate to around 50-year lows at 3.7%. Job vacancies at 1.3m is close to the total number of people unemployed, pushing wage growth to elevated levels. It remains to be seen whether workers return to the labour force, or indeed to their previous jobs, and whether the economy cools sufficiently that wage pressures ease.

Another consideration is the exchange rate. As a small open economy, the UK's interest rate differentials with the rest of the world heavily influences its inflationary dynamics via the exchange rate. The prospect of sterling depreciation is a key consideration for Catherine Mann, one of the hawkish members of the Bank of England's Monetary Policy Committee, who has voted for a more aggressive increases in policy rates. With the US embarking on an expeditious path of policy tightening, the risk is that sterling could see further depreciation pressure if the BoE fails to match those by the Federal Reserve. This would also argue for higher policy rate settings.



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UK INTEREST RATES –

How high could they go?

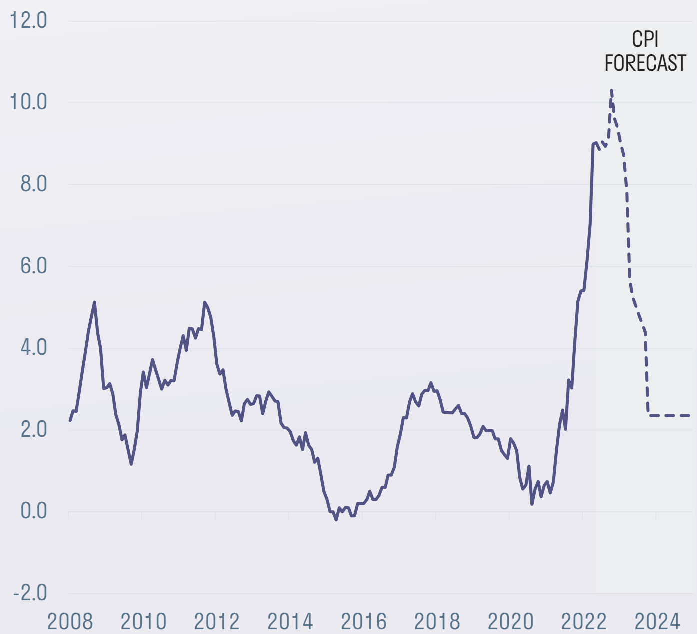
Niloofar Rafiei, Global Macro Economist

Risks abound

If the past two years have taught us anything, it is to expect the unexpected. We must therefore be prepared for further economic and political shocks that could push interest rates away from our central scenario and towards a more hawkish outcome.

In the event of a complete halt in Russian supplies of gas to Europe, and further increases in the oil price, we could be faced with more difficult tradeoffs between inflation and growth. Policy makers will need to be data-dependent and nimble to adjust policy settings. Inflation prints, wage outcomes and domestic activity will be closely watched by the MPC to strike the right balance.

FIGURE 2 UK CPI GROWTH (%)



SOURCE: MACROBOND, JUNE 2022

ALTERNATIVES

An alternative to inflation?

ADIL ALAOUI
ALTERNATIVES ANALYST

"While a moderate level of inflation is desirable for economic growth, high inflation impacts investors primarily through its ability to erode returns.

Midway into 2022, hopes for a year of diminished uncertainty and geopolitical tension remain misplaced. A poor outlook for growth, rising interest rates and stubbornly high inflation have seen global equity markets drop precipitously while bonds, historically one of the key diversifiers to equities, have suffered their greatest downturn in decades. Investors reliant on the conventional playbook – equities for growth and bonds for diversification – have found themselves wrongfooted.

As we have written before , we do not think this necessarily sounds the death-knell of the traditional 60:40 style mandate, but it does suggest that investors seeking diversification and attractive real returns may wish to look beyond equities and bonds. Interest in alternative asset classes has been growing for some time, and is now even more pronounced as investors reckon with an extremely challenging macroeconomic outlook.

The wrong kind of inflation

While a moderate level of inflation is desirable for economic growth, high inflation impacts investors primarily through its ability to erode returns. UK inflation is currently at a 40-year high of 9.1%. If inflation were to continue to run close to 9%, a portfolio returning 6% would actually have achieved a negative return of -3%, after adjusting for inflation. The many investors who have recently increased their cash holdings will also suffer, as high inflation rapidly erodes the real value of cash. Inflation-linked bonds can offer some protection against inflation, but these benefits can be offset by the impact of rising interest rates.

Alternative investments are often thought of as having the ability to mitigate inflation, with both gold and property frequently cited as examples of assets that can hold or even increase their value as inflation rises. However, the alternatives universe is broad – and getting broader. It is important to remember that alternatives are not just one asset class but instead a collection of different asset classes, all of which are 'alternatives' to equities and bonds.

At the highest level, we categorise alternative investments into correlated and uncorrelated assets. Correlated assets – such as private markets exposure, including renewables, property, infrastructure, or private debt or equity – are those, whose performance is likely to be influenced by volatility within the equity and bond markets. Uncorrelated assets, such as hedge funds or selected/certain commodities are likely to perform in a way that is unlike either equities or bonds, and may even be negatively correlated with those assets.

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ALTERNATIVES –
An alternative to inflation?

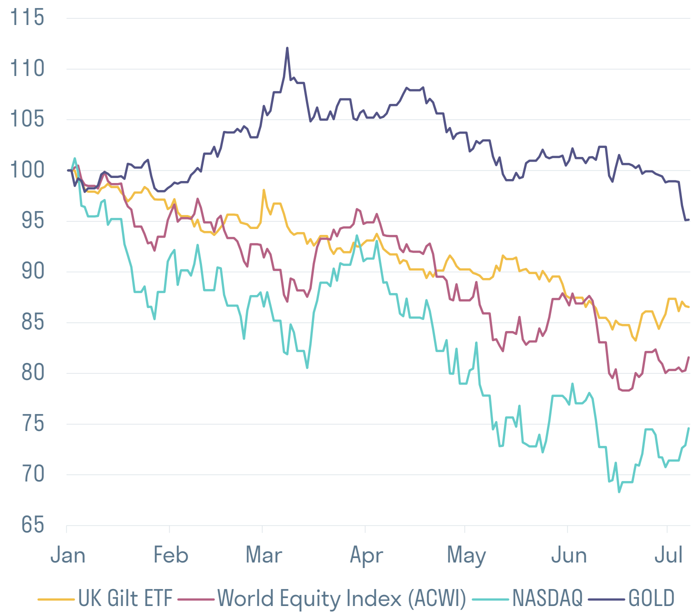
Adil Alaoui, Alternatives Analyst

Investors seeking to add alternative sources of returns and diversification to their portfolio – as well as protection from inflation – need to understand the varying characteristics of alternative assets on offer. With the potential for attractive returns comes the inevitable risk trade-off. Alternatives have distinct risks and investors need to assess whether the asset they are considering fits within their overall risk appetite. Alternatives offer different levels of liquidity and may therefore be difficult to sell quickly. Some may also be more volatile than equities or bonds – at the furthest end of the spectrum the recent 'crypto crash' provides ample evidence of this.

Finding the sweet spot

Within our alternatives allocations at Sarasin, we have identified three areas we think have the potential for positive real returns, a good level of income, and diversification, without exposing investors to unnecessary risks or overpaying.

FIGURE 1 2022 HAS SEEN A DECLINE ACROSS ALMOST ALL ASSET CLASSES TO DATE (chart rebased to 100 on 01.01.22)



SOURCE: MACROBOND, JULY 2022

1. Infrastructure investments

Infrastructure – defined as the physical structures necessary for society and the economy – has become an increasingly popular investment. Investors can choose to gain access to either economic infrastructure, such as transport or utilities, or social infrastructure, such as schools or hospitals. Infrastructure investments typically exhibit stable and predictable cashflows and generally, provide inflation-linked distributions.

Energy storage is a key infrastructure that will help the UK to decarbonise as more renewable energies come on to the grid. We hold the Gresham House Energy Storage Fund PLC (GRID), which capitalises on the opportunities in the battery storage market. The UK's increasing reliance on renewable sources of energy means it needs a solution for supply/demand imbalances. Battery storage systems represent a cost-effective way of addressing this issue. The trust has performed strongly, as a beneficiary of high power price volatility and strong operational performance. GRID continues to be the market leader for battery storage in the UK, with around a 30% market share.

2. REITS

Probably the best-known alternative asset, property offers some inflation protection – as both rental income and property values tend to increase with inflation – along with steady income. We gain exposure to property through real estate income trusts (REITS), which are companies that manage a portfolio of income-producing properties, from which they pay out dividends to shareholders. Investing in REITS allows investors to access the potential benefits of property without sacrificing too much liquidity, as REITs can be bought and sold far more easily than the underlying properties themselves.

We invest in Home REIT PLC (HOME), a REIT that manages a diversified portfolio of homeless accommodation assets let to registered charities, housing associations and other regulated organisations that receive housing benefit or comparable funding from local or central government, on very long-term and index-linked leases. As the homeless population in the UK has risen, there is a critical shortage of affordable, high-quality accommodation for homeless people. Local authorities have a duty to house the homeless but the severe shortage of fit-for-purpose accommodation has meant councils have been forced to house people in B&Bs or guesthouses, which can be significantly more expensive than the properties HOME lets.

3. Hedge funds

There are many different kinds of hedge funds offering different risk/return profiles, and carefully selected hedge funds can be an invaluable part of a well-diversified portfolio. Today's more volatile market conditions are particularly well suited to many hedge fund strategies, providing greater opportunities for them to deliver attractive returns.

The ability to generate positive returns even when equity or bond markets are falling makes hedge funds a particularly attractive proposition for investors right now – provided they can identify the right strategy at the right time.

Our holding in Neuberger Berman Uncorrelated Strategies Fund provides exposure to a basket of different hedge fund strategies, all of which aim to generate returns that are uncorrelated to equity and fixed income markets. The hedge funds themselves also have a low level of correlation with each other, which reduces the overall risk of the fund and gives it the ability to withstand different market environments. We like how diversified the fund is, thanks to Neuberger Berman's rigorous fund selection process, as well as its performance-based fee structure, meaning investors don't pay for returns they don't get – both features that buck the 'expensive and risky' hedge fund stereotype.

When constructing multi-asset portfolios, Sarasin looks to understand the risks associated with the combination of assets so that we can make an informed judgement on whether the expected return offers suitable compensation for the risks being taken. Alternatives may offer the potential for positive real returns and diversification in a high-inflation environment, but investors need to understand the characteristics of the alternatives they are considering – and ensure that their investment process seeks out high-quality, diversified holdings based on fundamental research rather than overly opportunistic, speculative investments.

NEIL DENMAN
PORTFOLIO MANAGER

ALEX HUNTER
PORTFOLIO MANAGER

INNOVATION FOR INCOME

Quiet disruptors offer durable sources of dividend growth

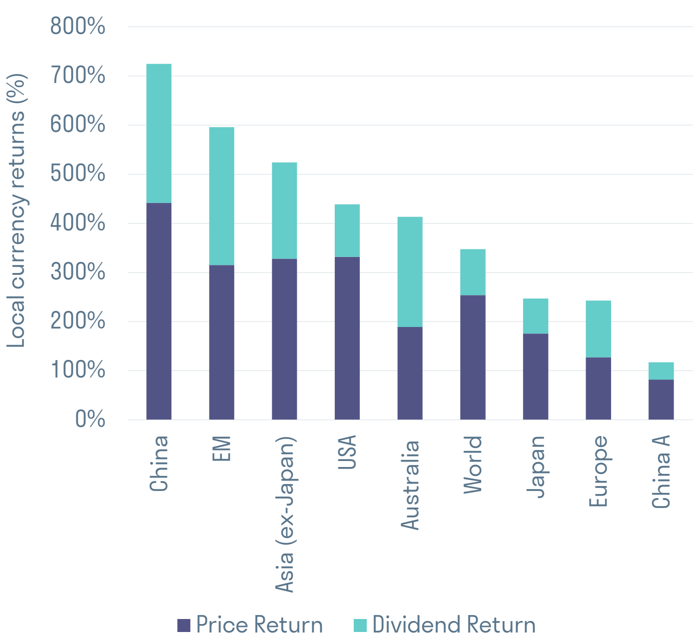
> "Our thematic approach points us towards well-run, responsible companies that are likely to thrive as society changes.

As economic conditions decline we can expect lower investment returns to become the norm, with dividends comprising a bigger share of the total returns available. But how are investors to identify which companies' dividends will endure and, just as importantly, provide dividend growth that can help fend off inflation?

Perhaps most dangerous for many investors are 'inflation traps' – companies that appear able to pass inflation through to customers but, because of the cyclical nature of their businesses, cannot be relied upon when recession bites.

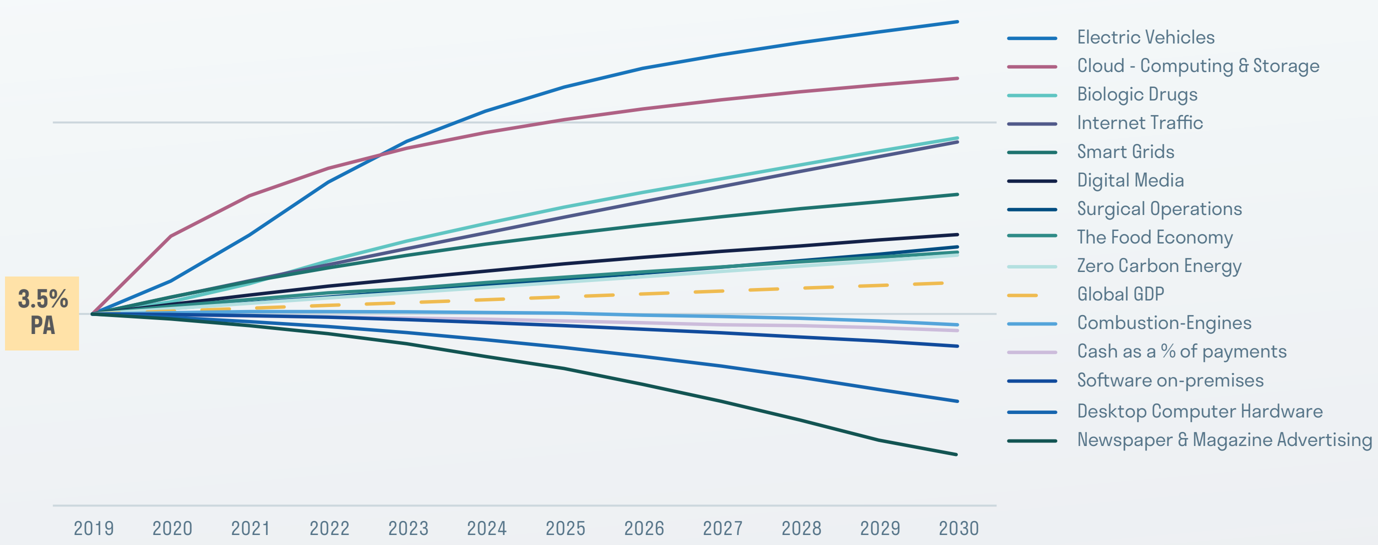
Our thematic approach points us towards well-run, responsible companies that are likely to thrive as society changes, and share an increasing amount of their profitability with shareholders. In particular, we are drawn to innovative businesses whose intellectual property provides a long-term, protected source of earnings that is often misunderstood, and therefore mis-valued, by equity markets.

FIGURE 1 DIVIDENDS ARE A MAJOR COMPONENT OF GLOBAL EQUITY RETURNS



SOURCE: MACROBOND, JUNE 2022

FIGURE 2 FUTURE GROWTH DRIVERS - INDICATIVE GROWTH TRENDS OVER 10 YEARS (SARASIN FORECASTS)



SOURCE: SARASIN & PARTNERS FORECASTS AND MULTIPLE INDUSTRY SOURCES, 2020. FOR ILLUSTRATIVE PROPOSES ONLY.
Information containing forecasts are intended for information purpose only and are neither projections nor guarantees for future results and could differ significantly for various reasons from actual performances.

After the carnival

Equity investors have always had a strong affinity with dazzling innovations. History is littered with examples of high expectations leading to steep valuations and dashed hopes, from the Railway Mania of the 1840s to the Dotcom bubble.

Innovative breakthroughs have yielded amazing benefits for society, but most have taken a lot longer to come to fruition than investors initially suspected. Bill Gates' observation that we "...always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten..." is oft-repeated. His following words are usually omitted: "Don't let yourself be lulled into inaction."

After the equity market carnival has moved on, the less glamorous, laborious and time-consuming work of implementing disruptive innovations gets under way. The real long-term benefits of an innovation often accrue to what we call the 'quiet disruptors', companies that put in the leg-work of applying innovation in practical ways that make a real difference. The second mouse gets the cheese.

Stealth wealth

'Innovative' and 'disruptive' are two adjectives that rarely surface in the context of equity income investing. Higher dividend stocks are often assumed to be twilight companies in sunset industries that are seeing out their remaining days in quiet dotage or are likely to find themselves on the wrong side of history as the world moves towards a low-carbon economy.

This is partly due to equity markets' (and the media's) bifurcation of companies into opposing camps of predators and prey, old and new economy, disruptors and the disrupted, which makes for a dramatic narrative but is usually an oversimplification. By looking at the world through a thematic lens, we have identified a category of companies that are behind-the-scenes, quiet disruptors. These are established and growing businesses, where investors can be on right side of history and also benefit - today - from healthy cashflows, profits and dividends.

When investors think of innovative disruptors, it is usually long-duration, higher volatility, higher return stocks that spring to mind. These are the 'extrovert' disruptors beloved of high-conviction growth investors. Some of these companies have produced incredible risk-adjusted returns and become household names. However, they are not what we are seeking to include in our clients' equity income portfolios.

Quiet disruptors, by contrast, present a very different risk profile that sits near the opposite end of the equity risk spectrum. Their lower risk and lower return profile is more typical of mature cyclical or defensive franchise companies. To many investors they do not look like disruptors and the full implications of their innovations are often missed.

Our experience in running global thematic equity income mandates over the past 15 years has taught us that these less volatile, quiet disruptors produce superior risk/returns over time, not least because the market underestimates their potential and misprices them accordingly. Since 2001 nearly 50% of the total returns across all major equity markets have come from reinvested dividends.[1]

Continued

INNOVATION FOR INCOME

Neil Denman and Alex Hunter, Portfolio Managers

Strength in diversity

Quiet disruptors tend to provide durable income streams from businesses that can look forward to long-term organic growth but they can hail from very different industries. This is clearly desirable for well-diversified, resilient portfolios.

One example is Air Liquide, the world's second-largest supplier of industrial gases and part of our Climate Change investment theme. The company doesn't garner the lofty valuations of a fuel cell start-up company but it is instrumental in expanding the world's ability to generate clean hydrogen, which will be in increasing demand as an alternative energy source. In addition to being a central player in a key industry of the future, Air Liquide's business has proved to be robustly defensive in downturns.

Turning to our Ageing investment theme, Medtronic is a US-based company that specialises in minimally invasive surgery, miniaturisation of medical devices and medical robotics. Medtronic's development of its Hugo device brings welcome competition to robotic surgery. This is raising the pace of innovation and, we believe, will give patients around the globe unprecedented access to surgical skills at relatively low cost.

A third quiet disruptor is DS Smith, the second-largest producer/supplier of corrugated packaging in Europe and a Sarasin portfolio holding under our Evolving Consumption theme. DS Smith's innovative approach to circular-use packaging is enjoying strong organic growth due to e-commerce and demand for recyclable/reusable packaging. DS Smith is committed to manufacturing 100% recyclable or reusable packaging by 2023 and aims for all its packaging to be recycled or reused by 2030.

Volatility brings opportunity

As investors who focus on long-term thematic trends, short-term market volatility can provide us with buying opportunities. Most recently, a number of 'pandemic winners' have fallen out of fashion in the stock market but continue to pay durable dividends flowing from underlying businesses that can look forward to long-term structural growth.

One such example is Prologis, whose highly capable management has successfully used acquisitions to build a world leader in logistics real estate that can cater for companies such as Amazon. Despite recent slowing of internet sales, the growth of e-commerce has many years to run, and we have therefore taken the opportunity to increase our exposure to Prologis.

Furthermore, some COVID winners (Prologis included) now have significant cash hoards. Perhaps the most striking of these is the pharmaceutical sector, which has a US$500bn war chest available to spend on acquiring smaller biotech players – many of which are currently trading at extremely low valuations. Pfizer alone has capacity to spend about $80bn over the next five years that would add to Pfizer's portfolio of intellectual property and R&D capabilities.

Income investors DO have a choice

Most investors want to do the right thing. Anyone who doubts this need look no further than the vast sums that have flowed in recent years into funds that offer an ESG focus. When it comes to equity income investing, however, many fund managers are curiously content to retain exposure to high dividend payers in harmful industries such as traditional energy and tobacco.

Some may believe that they will be able to exit these companies before the music stops – or perhaps they hope that the music will never stop. To our mind, neither of these positions is defensible for any asset manager who is engaged as a long-term steward of their clients' capital.

Income investors do have an alternative to traditional income stocks, and the long-term performance of funds such as the Sarasin Global Higher Dividend and Global Dividend funds bears testament to this. We passionately believe that income-orientated stocks can be interesting and disruptive. We thoroughly enjoy the challenge of seeking new income ideas for our clients among overlooked quiet disrupters.

[1]Source: Jefferies Global Equity Research, Dividend Watch, 17.03.2022

CHARITY FOCUS

KNOW THYSELF

Lurking behavioural biases are an often-overlooked source of risk. Investment success is as much about keeping a level head as it is about picking winners.

"Why do we have cycles?… If the stock market was a machine, it might be reasonable to expect consistent performance." Howard Marks, co-founder of Oaktree Capital Management.

As COVID-19 hit in 2020, the S&P fell over 30% from its February high in a matter of months before bouncing back up to pre-COVID levels by August that year. Moving forward to the end of 2021, mega-cap tech valuations spiked to extraordinary levels, with the NASDAQ up 26.6% for the year, before entering a downward spiral in 2022 after Russia's invasion of Ukraine.

How do we explain such fluctuations when the underlying story of many of these companies has not changed materially? Howard Marks posits this answer: excesses and corrections. Stock markets abound in behavioural traps for the unwary, influencing investors' decision-making psychology, led by greed, fear and vanity.

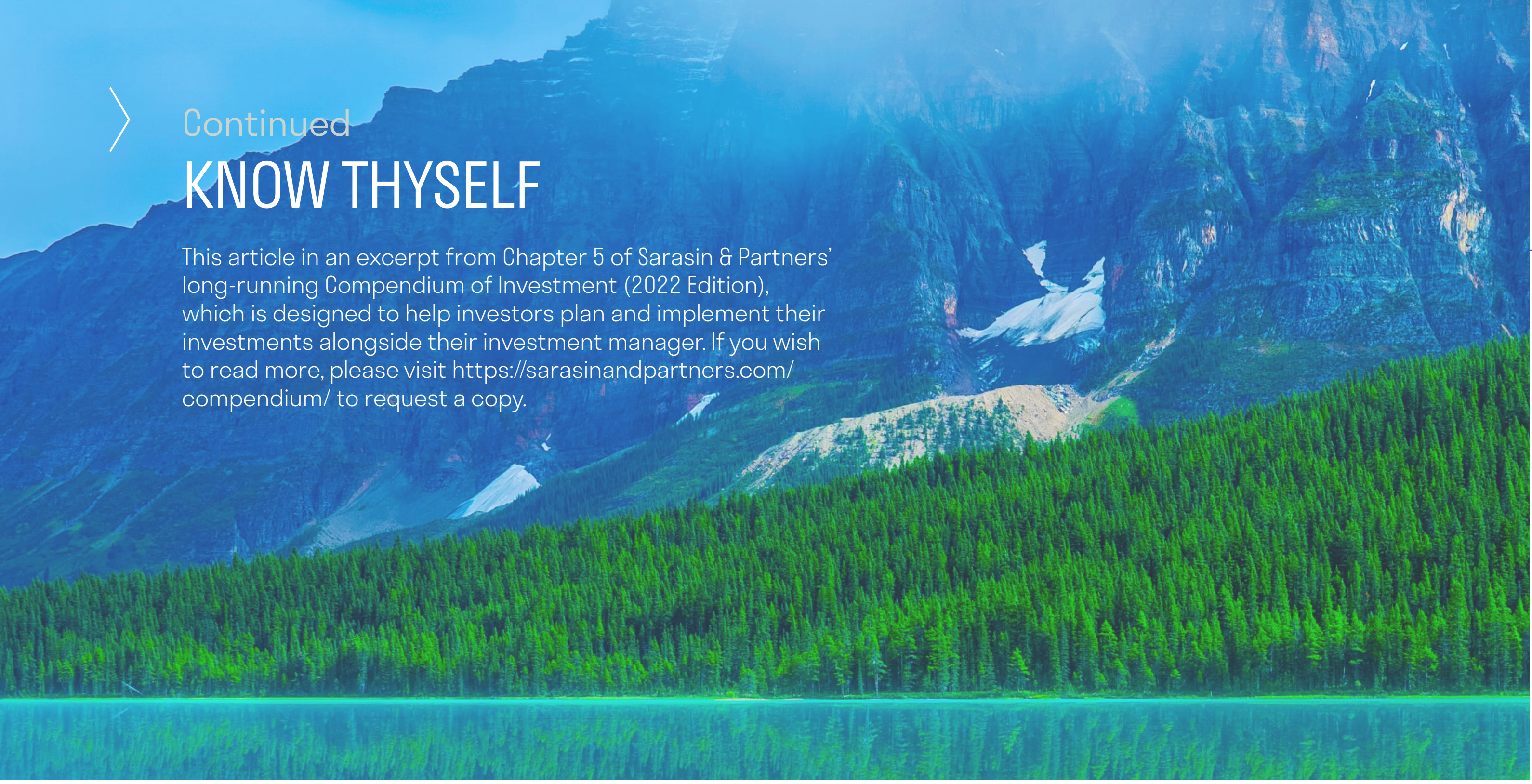
A rising market probes for greed in the investor's make-up. When it finds greed, it plays on it, tempting the investor towards a higher-risk strategy with the promise of higher returns. The higher the market rises, the greater the temptation investors face to increase their level of risk, abandoning the principles that have governed their investment policy in the past. Yet, the higher the market goes, the lower the incremental return is likely to be, leading to greater chances of a setback.

A falling market probes for fear in the investor's make-up. It tempts the investor towards a lower risk strategy with the threat of further price falls. The lower the market goes, the greater the temptation investors face to reduce their level of risk, abandoning their fundamental belief in stock market investment. Yet history shows that the lower the market falls, the greater the future returns.

The circle is complete when an investor is lured into buying at the top and terrorised into selling at the bottom. The trap is obvious in principle - and absurdly clear in retrospect - but it rarely repeats itself in the same way. It is invariably camouflaged with good reasons for the investor to believe that 'it will be different this time round'. One only has to think of the extraordinary boom and bust in technology shares at the turn of the millennium.

This turned out to be a classic stock market bubble masquerading as a 'new paradigm'.

> " The higher the market rises, the greater the temptation investors face to increase their level of risk.



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KNOW THYSELF

This article in an excerpt from Chapter 5 of Sarasin & Partners' long-running Compendium of Investment (2022 Edition), which is designed to help investors plan and implement their investments alongside their investment manager. If you wish to read more, please visit https://sarasinandpartners.com/compendium/ to request a copy.

Vanity, hubris and chaos

When not inciting fear or greed, the market probes instead for vanity. At the level of asset allocation, the market invites investors to interpret the trend of political events and anticipate the cycles of economic growth, currencies and inflation to choose between the major investment markets of the world. At the level of stock selection, the market invites investors to form a view of broad industrial trends around the world and assess the strengths and weaknesses of tens of thousands of companies at home and abroad.

In short, it plays to the vanity of sitting in judgement on others. Tom Wolfe satirised the Wall Street investment bankers in Bonfire of the Vanities as 'masters of the universe' for good reason! In investment, it is often quickly apparent if a judgement has been right or wrong. Even if the underlying judgement is correct, the timing may still be wrong. Share prices move by the moment and investment performance is calculated quarterly. Every 13 weeks, the outcomes of all these decisions are tested to a decimal place. Having encouraged their vanity, the market is brutal in confronting investors with the fact that they are often wrong, tempting them into abandoning the application of principles in their investment policy.

Once detached from fundamental beliefs about the right way to approach investment, investors are likely to fall back on opportunistic trading, setting themselves up to be doubly exposed to the distorting influences of greed and fear.

Keeping behavioural biases in check

Greed, fear and vanity are elemental weaknesses. How should investors proceed, knowing that both they and their investment managers are prey to these powerful forces? Experience suggests that a good starting point is to have realistic expectations about what can be achieved by stock market investment. The next step is to appoint an investment manager whose methodology is persuasive and whose philosophy the investor can share in both good times and bad. Finally, it is important to allow the manager to apply this methodology over a period of five to seven years without seeking to influence policy, unless the investment objectives change. At the end of this period, the results should speak for themselves.

Unfortunately, it is not as simple as this. No single approach to investment is right all the time, so there are bound to be periods of underperformance. Investment managers want to keep their clients when performance passes through a difficult period so, in weaker moments, there may be a temptation to change course and adopt an approach that seems more in keeping with market fashions. However, the disciplined application of clear principles, based on deeply held convictions, is the key to resisting the play of the markets on the emotions and breaking the distorting cycle of greed and fear. Therefore, investors need to take care in setting the tone of their relationship with their manager at such times if they are not to contribute to an amplification of the problem.

Provided their confidence in their manager's methodology is intact, the best contribution that investors can make during a period of underperformance is to buttress their manager's determination to persevere. This means re-testing the arguments on which the methodology rests and exploring the manager's investment process. If the manager can demonstrate reasonable grounds for thinking that the process remains sound and ought to produce satisfactory results in due course, there need not be criticism.

How to manage your manager

There may also be times when weak performance is the result of the manager falling prey to fear, greed or vanity. A manager's methodology may have become more aggressive the further a bull market has risen or uncharacteristically cautious the further a bear market has fallen. A run of success may encourage vanity and lead to an insufficiently self-critical investment process, resulting in the taking of bigger risks. Knowledgeable investors will be watching for such signs as they probe the manager's investment process.

In short, the best way for investors to protect themselves against the potentially damaging emotions which stock market investment can unleash is to remain diligent in the way they manage their relationship with their investment manager. If the relationship is a partnership, combining obligation with tolerance and goodwill on both sides, the manager should have the confidence to stick to their knitting and resist the market's assault on their emotions. The savage bear markets of 2000-2003, 2007-2009 and the COVID-inspired collapse and recovery in 2000, together with the current economic concerns, are salutary reminders of the risks inherent in investment.

Loaded for bear

A pertinent question for charities in today's markets – and indeed for all long-term investors – is 'what steps can we take to weather bear markets when they occur?' As table 2 on the right illustrates, there are two sorts of bear markets. The most common is the short, sharp variety, while the other is the slow, lingering type. Bear markets are invariably rooted in deteriorating economic conditions, which are magnified dramatically by investors revising down their valuations of financial assets in the worsened environment.

In practice, bear markets begin when least expected. They often follow a euphoric bull market, in which many new investors have been sucked into the belief that the risk of investing is much lower than it really is. They are usually well under way by the time most commentators are willing to accept that the bull market is really over.

Once a bear market is an established fact, the world looks very different: investors question whether the stock market is really an appropriate medium of investment at all. It is scarcely necessary to say that this sense of shock is not to be underestimated - bear markets shatter investor confidence in ways scarcely imaginable at the peak of a bull market.

Win by not losing it

Greed is one thing, fear is quite another. The long-term evidence in favour of equity investment counts for a great deal less if you are a trustee who has just suffered a 25% fall in the value of your charity's equity portfolio, possibly in just a couple of weeks, and there seems little prospect of recovery in the foreseeable future.

All this is instantly recognisable from the experience of recent years and there is every chance that future bear markets will be equally savage. Despite the rapid recoveries witnessed in 2009 and 2020, investors should not expect central banks to ride to the rescue after every collapse in confidence and asset values.

Far better is to ensure that an investor's mind-set and their portfolio are well-prepared ahead of time to cope with bear markets – whether short and sharp or slow and lingering – that will inevitably occur from time to time.

TABLE 1 A RECENT HISTORY OF UK BULL MARKETS

	Months	Change %
Feb 1995 - Apr 1998	39	116
Oct 1998 - Apr 1999	7	31
Oct 1999 - Dec 1999	3	13
Mar 2000 - Aug 2000	6	11
Feb 2003 - Oct 2007	57	122
Mar 2009 - Apr 2011	26	67
Oct 2011 - Feb 2012	5	16
Jun 2012 - Feb 2015	33	43
Oct 2015 - Jul 2018	34	42
Jan 2019 - Jul 2019	7	15
Nov 2020 - Dec 2021	14	39
Average	**21**	**47**

SOURCE: MSCI INC. / SARASIN & PARTNERS LLP

TABLE 2 A RECENT HISTORY OF UK BEAR MARKETS

	Months	Change %
Feb 1994 - Jun 1994	5	-15
May 1998 - Sep 1998	5	-14
Jan 2000 - Feb 2000	2	-10
May 2001 - Sep 2001	5	-16
Apr 2002 - Jan 2003	10	-32
Nov 2007 - Feb 2009	16	-40
May 2011 - Sep 2011	5	-14
Jun 2015 - Sep 2015	4	-13
Aug 2018 - Dec 2018	5	-11
Jan 2020 - Oct 2020	10	-25
Average	**7**	**-19**

SOURCE: MSCI INC. / SARASIN & PARTNERS LLP

Sarasin & Partners'

EVENTS –

July-November 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**

6 July
ACEVO Virtual Forum

12 July
CFG Alumni – Juxon House,
London

8 September
Trustee Training and Economic Update – Jockey Club,
Newmarket

14 September
Charity Times Awards –
London

20 September
ACEVO Annual Conference –
London

21 September
Charity 2020 Forum – Juxon House,
London

4 October
Association of Provincial Bursars Conference –
Hoddesdon

6 October
Charity Finance Summit –
London

11 October
CFG Annual Dinner –
London

17/18 October
Economic Update Dinner and Trustee Training –
Wetherby, Yorkshire

2 November
Alzheimers Scotland Charity Economic Lunch –
Glasgow

3 November
Charity Authorized Investment 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 TRAINING

In-person training London:
27 September 2022
2.00pm-5.00pm

ADVANCED

Virtual training :
15 November 2022
9.30am-12.30pm

In-person training London:
13 September 2022
2.00pm-5.00pm

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