Taking the longer-term view on Sustainable investing

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As clients will be well aware, our Sustainable Future (SF) strategies have seen a sharp reversal of long-term outperformance over the last nine months, both in absolute terms and relative to their respective benchmarks and peer groups.

While the scale and speed of this underperformance has been dramatic, the pattern is similar to previous periods over the 20-plus years we have been running these funds. In this article, I want to take a longer-term view to help put this in perspective and explain why we are confident about the future returns our strategies can deliver. Several commentators have also questioned whether sustainable investing has become a 'punt on growth' given so many funds in this area have struggled in the ongoing value rotation, or whether recent underperformance indicates a previous bubble in these stocks. We continue to feel this vastly oversimplifies what is going on.

At the outset, it is important to be clear that the primary trigger for the recent change in our performance has been macroeconomic in nature, namely the rise in inflation and associated reaction of central banks to dampen demand as they try to prevent imbalances becoming embedded. Interest rates have risen, rhetoric around recession has increased, and uncertainty about the future abounds, and this has led to a sell-off in growth (long duration) assets in favour of more defensive, value and inflation-aligned investments. We believe this sell-off has been indiscriminate and overdone in the case of the companies held across our portfolios.

Benjamin Graham's adage that the market is a voting machine in the short term but a weighing machine in the long run carries great weight in our team; but even longer term, markets can still be very wrong in assessing the value a company will deliver.

As a case in point, take our investment in Trainline, the market leader in train ticketing in the UK and also growing strongly in Europe. We see it as enabling a cleaner, more efficient and less congested transport system and therefore exposed to strong long-term growth but, as would be expected, Covid lockdowns saw near-term revenues disappear and a dramatic fall in its share price. If you take a longer-term perspective, what happens in any particular year becomes insignificant in the fullness of a company's lifetime, so the loss of one year's worth of revenues should not have led to such a decrease in the value of the business. We therefore used the opportunity of the price fall to add to our position and the shares have since recovered strongly as uncertainty around lockdowns cleared and the company's longer-term prospects became more evident.

We are currently experiencing a sell-off across several stocks in our portfolios, which we feel rhyme strongly with the Trainline experience. Spotify's shares remain weak, for example, with concerns around user numbers and performance from associated businesses like Netflix. Again, Spotify is a company for which we believe operational performance continues to be excellent, with user numbers still increasing, albeit less quickly than before, and signs of monetising this growing base.

We remain confident this business can be profitable over our longer-term investment horizon and the same goes for a range of currently sold-down businesses such as Masimo (patient monitoring technology) or Smurfit Kappa (sustainable packaging) where recent derating has created significant upside potential over the next five years and beyond. Across these companies, we believe their longer-term prospects remain robust and, importantly for improving performance from our SF funds, are significantly underestimated by the market.

Given the fact we have seen similar weaker spells from the SF funds in the past and yet longer-term returns remain strong, the inference is that our strategies have always bounced back and more than made good any drawdowns. Despite this, however, it is incumbent on us to examine whether this time could be different and where we could be wrong. The following are some questions we have asked ourselves and our answers.

1. **Could our sustainable investment themes have expired**?

   Could the progress of our societies to a cleaner, healthier and safer future have stalled permanently? Reading dismal news on Ukraine, China-US tensions and UK politics could lead people to support this view, while the positive rhetoric around last year's COP26 event on climate change also seems a distant memory. Despite such concerns, however, sustainable themes have persisted for decades and are well embedded. While individual themes may come to an end (and, over the years, we have retired several), the overall suite is intact.

   In energy, for example, the attractiveness of renewable energy and energy efficiency trends has only increased over recent months as the insecurity of fossil fuel supply is laid bare by events in Europe. With more than 80% of global energy still coming from fossil fuels, however, many understandably question whether this may be a challenge too far. We believe not: change is rarely linear, and when a cheaper, better solution is developed, it can displace the old at an exponential rate. Yes, progress has been slow, but we are confident the rapid growth in renewables and adoption of electric vehicles is exactly one of these exponential transitions.

   For years, renewables plodded along supported by regulation and subsidies, then there was a tipping point where, in region after region, it became the cheapest form of new energy generation. Since 2010, solar has fallen by 90% in price and onshore wind by 60% – and this cost deflation continues. The consequence of such growth is the picking off of fossil fuel generation, starting with coal. Since 2008, regardless of the US President in power, coal power has fallen by 61%.

2. **Is the valuation of 'growth' stocks too high, meaning they will underperform for years to come**?

   Much is made of charts showing the valuation premium of growth versus value, and, interestingly, it has compressed dramatically over the last six months. But this is a one-dimensional metric to use in assessing a share price; to echo Warren Buffett, we do not see a distinct line between value and growth and feel the debate is ultimately reductive and unhelpful for investors.

   Taking a step back, what are active investors trying to achieve? We are all, whether considered value or growth, trying to identify mispriced securities where the current market price does not reflect intrinsic value **–** the sum of all future cashflows discounted back to today's value. The only real difference between investors is their time horizon: some (including us on the Sustainable Investment team) focus on the long-term growth potential of cashflows whereas others prefer to concentrate on near-term cashflows that are underappreciated. This is the critical point that is currently moving markets so violently – what rate do we use to discount those future cashflows?

   Of prime importance to us is the ability of a company to compound longer-term earnings/cashflows. For instance, on a five-year view, a business that delivers 20% growth will see earnings go up by 2.5 times. If that can be reinvested in the company, the magic of compounding makes it ultimately insignificant if the multiple on which we buy the shares today is 10 or 20% higher than the market average. The trick (and it is not easy) is to find those rare companies that can actually deliver these types of return.

3. **Have we selected the wrong companies in which to invest?**

   There is a possibility that our themes are solid, the idea of compounding growth delivering share price returns is sound and yet we as a team have selected the wrong companies in which to invest. While this clearly could happen, our analysis focuses on whether companies have a maintainable competitive advantage, due to a technological lead (ASML in semiconductor manufacturing), organisational edge (Softcat in software reselling), or scale advantage (Illumina in gene sequencing), which will enable the business to grow, reinvest and compound for at least the next five years.

4. **Have we missed an opportunity in turnaround stocks?**

   We are often asked whether we invest in turnaround situations, such as oil companies pivoting to renewables, for example. This sounds like a potentially attractive strategy but we avoid it for two reasons. First, it is rare for companies to execute such a pivot successfully (think Kodak and the digital camera or Nokia and the smartphone) and, second, we like to stick to a strategy we know well and that has demonstrated long-term success.

Over recent months, I have asked myself and the team whether we could have done better. Could we have further reduced our positions in stocks that had performed so strongly into 2021, for example? While we did act on numerous companies we felt were fully valued on our five-year view, with hindsight, we could have done more to mitigate the sell-off.

This is always easy to say after the fact, but what forward-looking adjustment to our investment process would consistently work? The answer is not straightforward and has to balance factors such as portfolio turnover and selling winners too early, with benefiting from times when market prices become too elevated. Nevertheless, as a team, we always try to improve our process and will be examining this over the summer.

Over the 20-plus years of managing the SF funds, I have taken great pride in our ability to deliver strong returns by investing in sustainable companies. The current short-term performance is difficult but having agonised over the questions above and many others, we are confident that, over the coming years, we will be able to re-establish our long-term trend of outperformance.