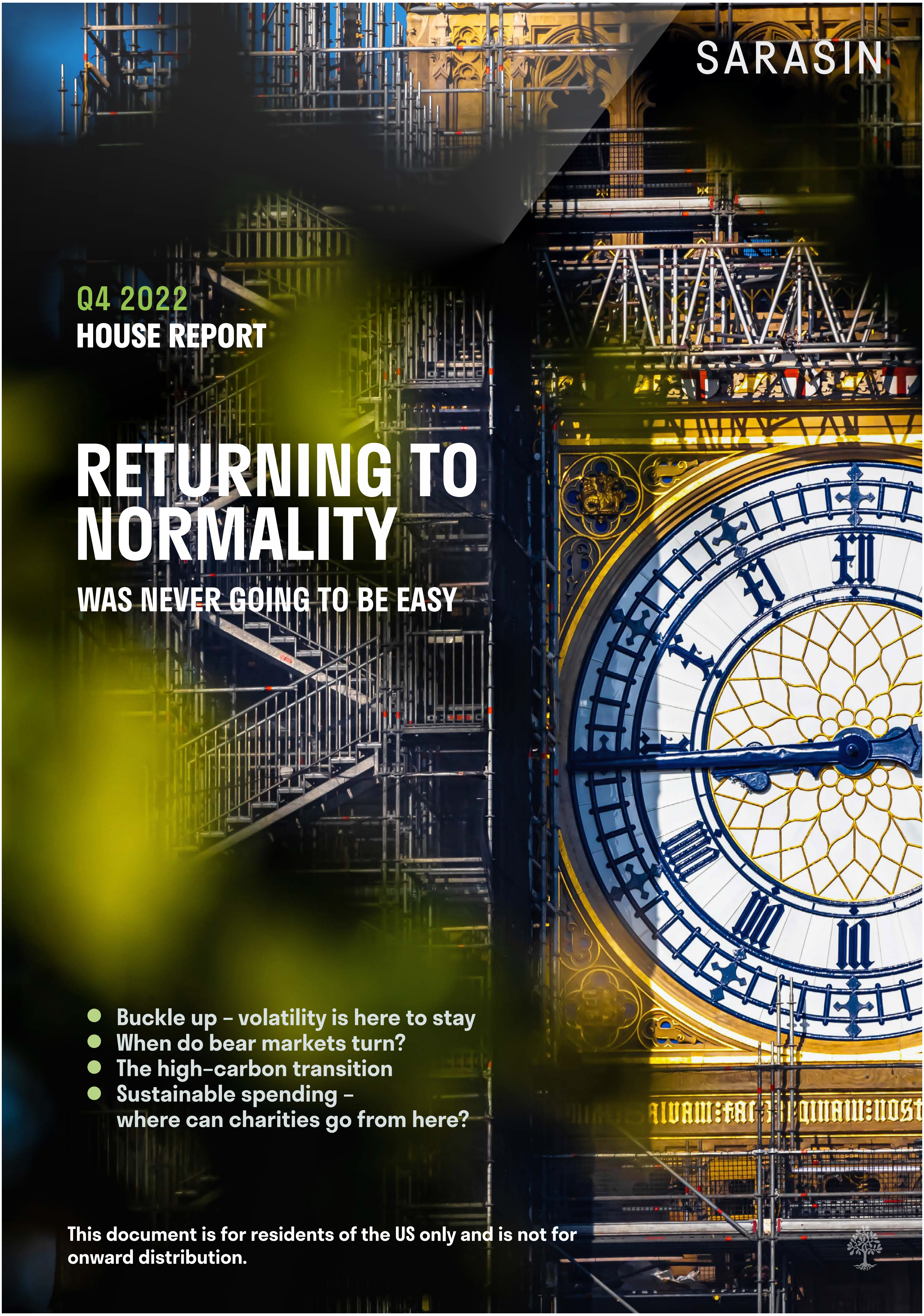

SARASIN

Q4 2022
HOUSE REPORT

RETURNING TO NORMALITY

WAS NEVER GOING TO BE EASY

- Buckle up – volatility is here to stay
- When do bear markets turn?
- The high-carbon transition
- Sustainable spending – where can charities go from here?

This document is for residents of the US only and is not for onward distribution.

INTRODUCTION

NICK WOOD
EDITOR

Welcome to the Q4 edition of the House Report

Investment markets are in the process of reassessing risk, which was never going to be an easy journey. After years of enjoying the benefits of extraordinarily low interest rates, the return to normal has begun. Central banks have started to raise rates against a backdrop of ongoing conflict in Ukraine, extended lockdowns in China as well as a political merry-go-round in the UK, leading to another three months of extreme gyrations in markets.

As we move into this new phase, the more immediate aspects of change are painful and we are already seeing the fallout of increased debt costs, plus higher food and energy prices, weighing heavily on households. The transition to more normal levels of interest rates, however, is arguably a genuine vote of confidence in the world economy. For the first time since before the financial crisis, bonds and cash are at least capable of generating a return and investors finally have a feel for the direction in which rates are headed.

Guy Monson outlines three reasons for cautious optimism in his Market View, highlighting the opportunities which are likely to emerge: healthy corporate balance sheets combined with rock-bottom investor sentiment; an investment boom to achieve worldwide decarbonisation; and value emerging in the UK corporate bond market following the UK's budget crisis.

What about inflation, could we be over the worst? Subitha Subramaniam and Colm Harney consider the consequences for inflation as the investment landscape shifts from the 'Great Moderation' to a new regime. Unemployment remains low and longer-term demographic trends may exacerbate labour shortages, putting pressure on wages. There is a distinct retreat from globalisation and the impact of climate change is also adding to price increases. But the expectation is for inflation to retreat from its recent, more harrowing levels, to settle slightly higher than we've seen during the past decade.

Bear markets are never comfortable for investors. What do we think this means for the direction of global equity markets? Jeremy Thomas considers the key indicators that might signal markets are turning. And Ben McEwen and Natasha Landell-Mills delve into Sarasin's new high-carbon transition subtheme, looking for companies that will deliver superior financial returns alongside maximum carbon reduction in our drive to source clean energy.

The recent pain in markets has been felt across almost every asset class but markets are cyclical and often recover when we least expect them to. For now, we must hold our nerve and search for opportunities amongst the turmoil. We hope you enjoy this issue and please get in touch if you have suggestions for articles at house.report@sarasin.co.uk

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GUY MONSON
CHIEF MARKET STRATEGIST
& SENIOR PARTNER

After a 25% decline in nine months, the S&P 500 index has now suffered its third-worst performance at this point in a year since 1931. So how should investors respond?

Market View

RETURNING TO NORMALITY WAS NEVER GOING TO BE EASY

Transitioning to more normal levels of interest rates is a genuine vote of confidence in the world economy, but getting there was never going to be easy.

World markets remain in the grip of rising interest rates and Vladimir Putin's war. Yes, equities remain extremely oversold and value is clearly appearing in many areas, but the spark that triggers a lasting rally has so far proved elusive. After a 25% decline in nine months, the S&P 500 index has now suffered its third-worst performance at this point in a year since 1931. So how should investors respond?

What we are seeing across markets is more logical than it looks – a straightforward repricing of assets that reflects a much more rapid normalisation of interest rates than was conceived of nine months ago. It is worth remembering that at the December 2021 Federal Reserve meeting, US interest rates were 0.1%, with a forecast for end 2022 of 0.9%. At last month's meeting the same projection for the end of 2022 had soared to 4.4% Valuations unsurprisingly, are de-rating in response. This has been painful for almost every asset in the short term but is probably to be welcomed in the medium term: it is a vote of confidence in a world that no longer needs super-loose money to prosper and grow.

Did 2022 mark the death of diversification?

There were further challenges for investors in 2022. In addition to price falls, portfolio diversification singularly failed to deliver. Unlike the 2020 Covid-led sell-off, where a steep decline in equities was offset by soaring bond prices, this year has seen a synchronised correction in almost every asset class. Indeed, the end of the third quarter saw parallel bear markets (a fall of greater than 20%) in three entirely different assets; the S&P 500 (-25%), the yen/US dollar rate (-20%) and the copper price (-23%). Apart from 1994, I cannot remember a global market downturn with so few places to hide.

As well as high correlations, investors have also had to contend with the loss of the 'central bank put.' This is loosely defined as the tendency of central banks to step in with aggressive monetary support, in the face of every economic crisis. Such a policy was possible in recent years because global inflation remained stubbornly low, meaning there was little economic cost to zero or negative rates. The side effect of this strategy was, of course, to inflate assets – often dramatically. In the months following the outbreak of Covid in 2020, for example, the world economy contracted sharply, triggering massive central bank intervention. Global equity indices rapidly fell, by more than 30% in a month, but then rallied to actually exceed pre-Covid highs just four months later, despite a still-raging pandemic. It was perhaps the sharpest v-shaped recovery in stock market history.

Today, the picture could hardly be more different. Monetary stimulus now has a very real cost in terms of exacerbating inflation, while central bankers tacitly *welcome* asset price falls, as a tool to dampen demand and so control prices. Yes, in a complete breakdown of market operations, monetary authorities will still intervene (as the Bank of England did in the gilt market last month) but the barrier to action has certainly been lifted.

Raising rates 'til something breaks...

As Warren Buffet famously said of rising interest rates "only when the tide goes out do you find who has been swimming without clothes." This time the naked swimmer was not in the emerging world or in some arcane leveraged financial product, but right here in the heart of Westminster. Our new chancellor's arguably naïve and cavalier budget was the trigger for a dramatic sell-off in the gilt market and sterling. A toxic mix of politics, inflation and interest rates resulted in extraordinary volatility, as investors (both foreign and domestic) took fright. In one day the 30-year UK index-linked bond yield moved more than it normally does in a year.

What technically 'broke', was liquidity, in a far corner of the giant UK pensions market; margin calls on complex derivatives led to forced sales of gilts and then further sales. For investment old-timers, it was a victory for the 'bond market vigilantes', a term coined in the early Clinton administration when bond investors pushed up yields to curtail fiscal profligacy. Last week the UK gilt market vigilantes claimed two scalps in just a few days – the reversal of the 45% income tax cut and the early publication of the chancellor's fiscal framework. Over the weeks to come it wouldn't be a surprise if the bond markets rein in more of this government's tax-cutting agenda, as they force fiscal orthodoxy on a fragile UK economy.

Indeed, fiscal prudence (or as Margaret Thatcher would have called it, 'good housekeeping'), imposed by bond markets, will likely become a global theme over the coming months. After a miserable 2022 for fixed income, this offers the hope of better returns ahead, and certainly supports our recent allocations to high-quality UK corporate credit.

Managing the Russia risk

Added to the difficulties of tighter money and poor diversification has, of course, been the continuing war in Ukraine, where there sadly seems scant prospect of even the most limited ceasefire. Indeed, Putin's annexation of captured Ukrainian regions marks the 'most serious escalation since the start of the war' according to Nato Secretary-General Jens Stoltenberg. By effectively declaring that any attack on the annexed regions would be treated as an assault on Russia itself, Moscow appears to see itself in an almost existential war with the West. Yes, Ukrainian strategic successes have been extraordinary but they seem only to drive the Kremlin to further escalation.

This suggests that while a recovery in equity markets from oversold levels is probable, the move will likely be capped by winter energy risks in Europe and threats of military escalation (that may yet target NATO). US dollar strength may moderate and European asset returns may start to improve, but for a convincing next leg up in European value and a long-term pivot away from the US dollar, we will need at least the outline of a roadmap to peace.

Portfolio strategy

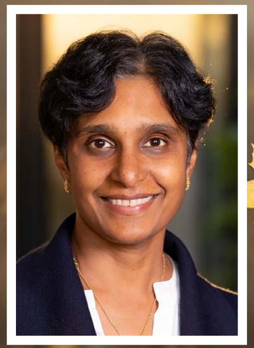
For even the most patient of investors, this year has been tough; valuations have contracted, balanced portfolios have experienced simultaneous declines across all assets while the war in Ukraine still hangs over any long-term rally in Europe. Cash held in US dollars has been king, while almost every other asset is in, or close to being in, a bear market.

However, I see three good reasons for a little, cautious optimism. First, leading global companies are financially robust, with banks in particular boasting near-record reserves (in sharp contrast to 2008). Corporate earnings have been surprisingly resilient (note that inflation helps company revenues) and dividend flows are still prodigious (our equity income strategies are clear beneficiaries). Sentiment toward equities is also extraordinarily negative, so a little good news goes a long way. In short, much of the bad news is probably now priced in.

Second, the global decarbonisation agenda has been made all the more imperative by Russia's actions. Europe will lead one of the greatest post-war investment booms the world has ever seen, with the twin goals of climate and energy security driving long-term earnings across every major industry. This will benefit our climate theme and many of the global industrial holdings we hold that will play a key part in this massive re-plumbing of the world economy.

Third, there are few crises that do not throw up opportunities, and this is true of the UK's recent budget crisis. We see increasing value in UK investment grade corporate bonds, particularly from issuers in less cyclical or global industries. Yes, we expect a UK recession, but we think it will be mild (especially with energy prices capped, employment strong and savings robust). The sterling corporate bond index now yields about 6.5%, the highest since 2009, presenting a particularly tempting backdrop for the managers of our responsible corporate bond strategy.

In summary, we are all on a journey back to financial normality. It is one where we can hopefully say goodbye to the unnatural world of zero or negative interest rates, and to the wall of central bank bond buying, which has so distorted global asset prices. It's been a painful start to date but it was probably always going to be. As I hope we have shown above, the next leg should be more rewarding - opportunities for the patient investor are already emerging.



SUBITHA SUBRAMANIAM
CHIEF ECONOMIST AND PARTNER

COLM HARNEY
ANALYST & PORTFOLIO MANAGER

> "The pandemic, the war in Ukraine and climate change have wreaked havoc on prices, and inflation has re-emerged as a serious challenge.

Investment Landscape

BUCKLE UP – Volatility is here to stay

Over the past few decades, investors have enjoyed the fruits of the Great Moderation – a period when the volatility of inflation and output declined steadily and economic cycles lengthened. Central banks' management of short-term demand are credited with bringing inflation under control, but from the mid-1980s there were big contributions from long-term changes in the supply side of the global economy.

First, the coming-of-age of the Baby Boomer generation and higher female participation in the workplace expanded the labour force. These favourable demographics and social changes were then amplified by the end of the Cold War and globalisation, which brought an unprecedented flow of new workers, particularly from China and Eastern Europe, into an increasingly interconnected global labour force. Thirdly, a diffusion of new technologies around the world reduced production costs and increased productivity, providing further deflationary impetus. Demand became the limiting factor for growth, while supply appeared infinite thanks to the deflationary impacts of globalisation and technology.

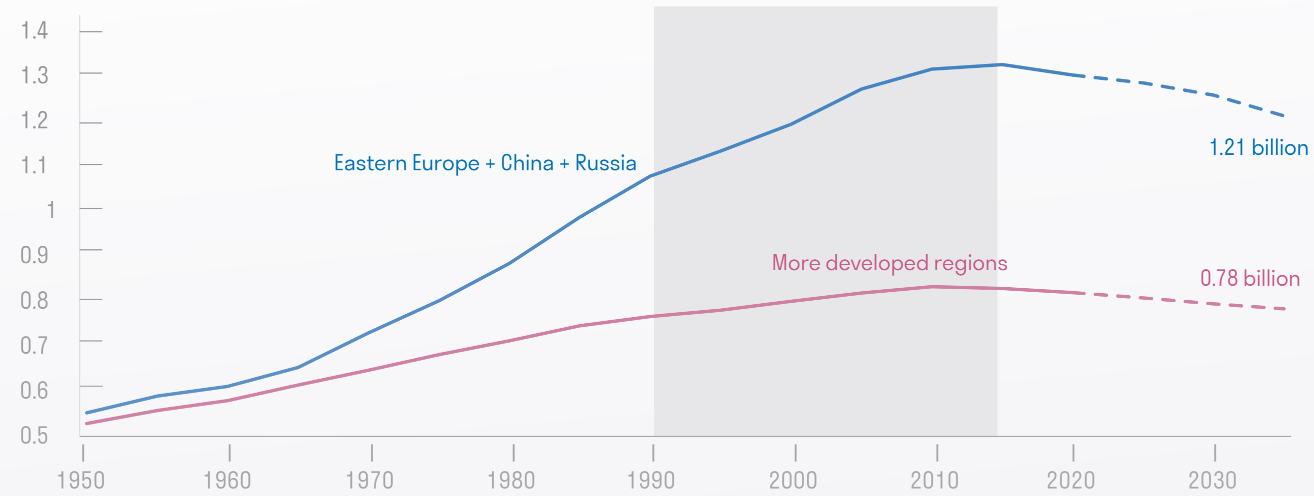
Over the past few years, however, the world has been buffeted by supply-side shocks. The pandemic, the war in Ukraine and climate change have wreaked havoc on prices, and inflation has re-emerged as a serious challenge. While the impact of these shocks will fade over time, we believe structural supply-side shifts driven by three factors – changing demographics, slowing globalisation and increasing impacts from climate change – mean a return to the Great Moderation is unlikely and the next regime will look very different.

Staff wanted

About 1.3bn new workers were integrated into the global trading economy as a result of the end the Cold War in 1990 and China's accession to the WTO in 2001. To put this in perspective, the size of the labour pool in advanced economies was just over 800m people. The effect of this new labour pool on the global economy was dramatic – the offshoring of labour and a rapid increase in cross-border trade resulted in lower real wage growth and investment in advanced economies, offset by cheaper goods and services imported from overseas.

This rapid expansion of the global labour supply has already begun to slow or even decline, as populations in China, Eastern Europe and advanced economies age and fertility rates fall. The rising populations in India and Africa are unlikely to replicate China's miracle of rapid integration and convergence with advanced economies due to differences in geography, culture and governance. Nor are ageing

FIGURE 1 GLOBALISATION ADDED 1.2BN WORKERS TO THE WORLD ECONOMY



SOURCE: MACROBOND, OCTOBER 2022

populations in developed countries likely to be fully offset by increased participation from elderly workers or immigration. In the absence of new sources of labour, the global economy will bump up against labour supply constraints.

In addition, the old-age dependency ratio in advanced economies is projected to increase from under 30% to over 45% over the next decade, and ageing in less developed regions is also projected to pick up sharply. Resources will need to be diverted to provide low-skilled, labour-intensive care for older people, reducing economic productivity and exacerbating labour shortages.

Retreat from globalisation

Escalating geopolitical tensions are a second factor constraining the global economy's supply curve. These tensions are set to continue as China increasingly challenges the existing world order, and this strategic rivalry drives a restructuring of global trade, finance, defence and security arrangements. In this siloed, less cooperative world, finance will become more balkanised, defence spending and tariff and non-tariff barriers will increase, and businesses will bring supply chains closer to home as the focus switches from maximising efficiency to ensuring security and stability of supply.

Globalisation will likely continue, but at a much more modest pace, making supply less flexible. Weaker demographics and the re-ordered geopolitical landscape will slow the pace of convergence in emerging markets, reducing the deflationary impulse generated by emerging market productivity growth.

The heat is on

A third contributing factor is climate change, which will negatively impact the flexibility and productivity of global supply chains in two major ways.

Firstly, efforts to transition to a decarbonised global economy will necessarily include significant extra costs to companies and consumers, both to incentivise the shift towards less carbon-intensive options and to pay for the required reshaping of activity towards these more sustainable but often more expensive alternatives. The IPCC estimates that to shift the economy onto a path compatible with limiting global temperature increases to 1.5°C would require increased investment of 0.5-1.0% of GDP every year between now and 2050. This is equivalent to 2.5% of global savings and investment over this period.

Secondly, the direct impacts of climate change are increasingly salient. While precise impacts are heavily debated, it is widely accepted that rising temperatures will have a significant, negative impact on GDP as labour productivity falls, sea levels rise and increasingly erratic weather impacts agriculture, transport and other sectors. In addition, most academic studies exclude the impacts of 'acute events' - natural disasters that are increasing in frequency and intensity as the climate warms. The range of outcomes are asymmetrically skewed to the downside; we know the higher the temperature increase, the more exponential the costs to the global economy.

A world of scarcity

The confluence of these factors will have multiple impacts on the fundamentals of economic growth over the coming years, most notably in the labour markets of advanced economies.

Slowing growth in the effective global labour supply and ageing populations will increase scarcity of labour in advanced economies, driving the NAIRU (non-accelerating inflation rate of unemployment) higher, and reversing its multi-decade downtrend. As the NAIRU rises, the Phillips curve, an inverse relationship between unemployment and real wage growth, is likely to reassert itself once again, leading to upward inflation surprises and higher interest rates and bond yields.

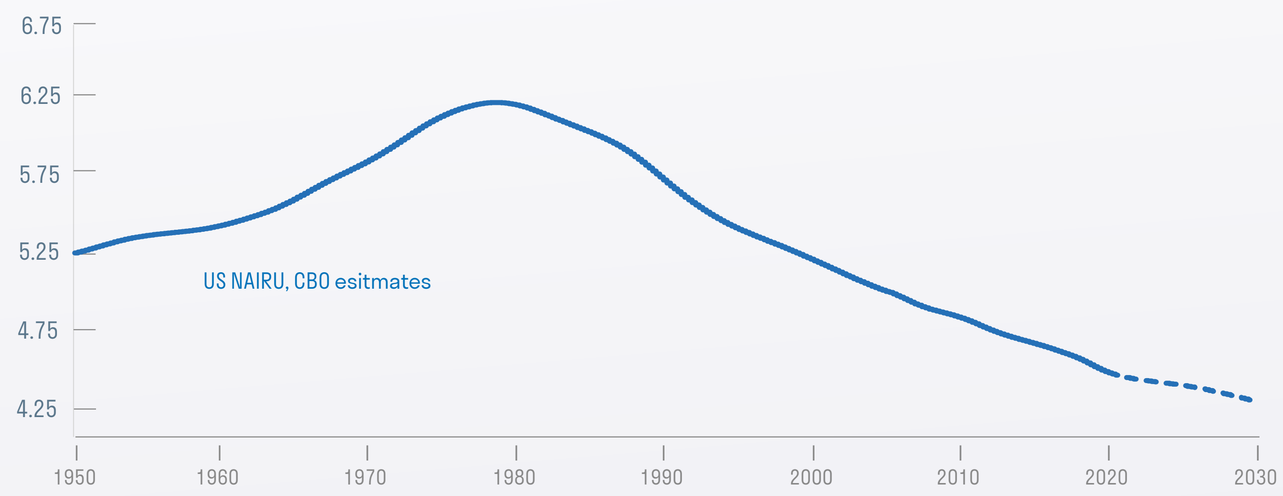
Labour scarcity will have other notable effects: participation rates are likely to rise (particularly among older cohorts), people might retire much later and

Continued

BUCKLE UP –
Volatility is here to stay

Subitha Subramaniam, Chief Economist and Partner
Colm Harney, Analyst and Portfolio Manager

FIGURE 2 NON ACCELERATING RATE OF UNEMPLOYMENT (NAIRU) (%)



SOURCE: MACROBOND, OCTOBER 2022

immigration could increase. Stronger real wage growth will see the labour share of economic value grow, likely at the expense of corporate profit margins, but could also boost consumer demand, investment in productivity-enhancing automation and perhaps even reduce income and wealth inequality.

Deglobalisation and climate change will have similar effects. Slower growth in trade and a greater focus on security of supply will pressure margins, and reduce the flexibility of the supply of goods and services. While necessary, the significant costs of shifting the economy to a more sustainable carbon trajectory will ultimately fall on companies and consumers, and the need to divert a proportion of global savings towards this goal will increase the cost of capital for the wider economy. The direct impacts of rising temperatures and more frequent and intense natural disasters will also act as rolling supply shocks to the global economy.

Inflation will come down from current levels as supply disruptions fade, but we expect inflation in advanced economies to average about 2.75% over the coming decade – about 1% higher than during the pre-pandemic Great Moderation era. To match the pick-up in inflation, we expect central banks to edge up neutral policy rates. Even so, high indebtedness suggests that nominal interest rates will be held below nominal GDP levels to enable deleveraging of the global economy.

Embrace the volatility – and get more active

Investors would be wise to buckle their seatbelts and prepare for greater market turbulence over the coming years, and not expect a swift return to the smooth ride of the Great Moderation.

In this environment, traditional 'risk' assets will be more challenged for a period, as increasing interest rates reduces the present value of future cashflows generated from equities, bonds, property and other traditional assets. However, some less traditional asset classes may come into their own, particularly those that target alternative return premia, such as currency carry or trend-following. In an environment of heightened volatility, risk-management investments such as commodities or option protection might also prove valuable.

Active investors may also fare better in this tougher world. While a more challenging and volatile outlook for traditional asset classes could reduce overall market returns, greater volatility increases the opportunities for active investment approaches, both in terms of tactical asset allocation and stock selection.

The ongoing correction in asset prices may be painful but is also jolting valuations back to more historically normal levels. This bodes well for investors' future expected returns, and is creating opportunities for long-term thematic investors to build diversified, resilient portfolios for the decades to come, whatever they might bring.

WHEN DO BEAR MARKETS TURN?

How can investors tell when a bear market has run its course and a new market cycle is beginning?

The summer rally in equities is firmly behind us. For optimistic investors it proved to be a false dawn, while for the realistic (ourselves included) it offered a good opportunity to rebalance equity weightings in multi-asset portfolios.

Rallies are a common feature of bear markets, and this bear market is no different. At the time of writing (September), we have had four rallies so far in 2022. The most recent, from mid-June to mid-August, saw the MSCI ACWI rise by 13.2% in US$ terms and has now largely reversed. There may be more to come and patience is needed – but how can investors discern when a bear market has truly reached its nadir and is on the cusp of a new upward cycle?

The history of bear markets inevitably offers a limited dataset and the cause of each sell-off is different. Having said that, there is still much to be gleaned from the information available. Russell Napier's book - 'Anatomy of the Bear: Lessons from Wall Street's Four Great Bottoms'- provides a fascinating description of the extreme lows of the great bear markets in 1921, 1932, 1949 and 1982. These lows were accompanied by cheap valuations, low inventories and depressed corporate margins. They tended to occur when a period of inflation turned to deflation and commodity prices stabilised, with copper providing a good lead indicator.

Napier observed that bond prices tend to lead equity prices from the low, and that the market bottomed only when the Federal Reserve (Fed) was reducing interest rates. In each case, corporate earnings continued to fall after the market bottom, and improving economic news was ignored. The impending recovery was not obvious to market participants: commentators worried that a worsening fiscal position would prevent recovery, but this proved to be misplaced. Mirroring the 'blow-off' last hurrah seen at the top of bull markets, the low point for stock prices in a bear market typically comes with a final slump.

Armed with abundant data and processing power, modern-day equity strategists are in a slightly better position than their predecessors when it comes to gauging whether a bear market is nearing its trough. In particular, three handy rules of thumb for assessing bear markets can be found in:

- The level of leading economic indicators, such as the ISM Manufacturing PMI
- Changes in the Fed's monetary policy stance
- The rate of decline in earnings expectations.

" Armed with abundant data and processing power, modern-day equity strategists are in a slightly better position than their predecessors when it comes to gauging whether a bear market is nearing its trough.

Continued

WHEN DO BEAR MARKETS TURN?

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Jeremy Thomas, CIO, Global Equities

Looking at these in turn, purchasing managers' indices provide a useful indication of future economic growth via the levels of activity experienced by supply chain managers. A PMI reading above 50 usually indicates growth. In mild recessions PMIs tend to bottom in the high 40s, while hard landings send them to the low 40s.

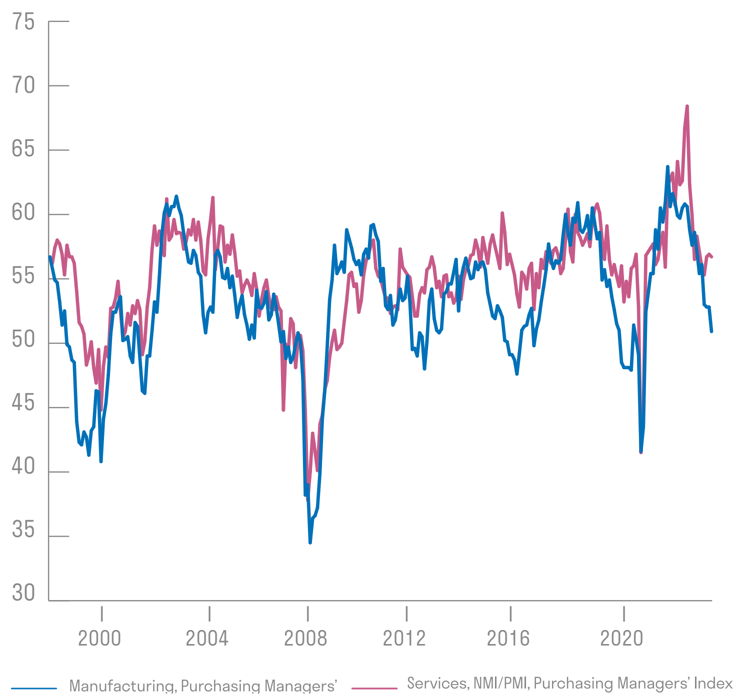
The September 2022 reading for the US Institute of Supply Management's Purchasing Managers Indicator Survey was 50.9, within which the new orders component was 47.1. From this, we can reasonably conclude that the US economy is losing momentum but is some way off reaching its low point for this cycle.

Fed watching

The Fed has emphasised its intention to stay the course in fighting inflation. Jerome Powell made this abundantly clear in August at the Jackson Hole Economic Symposium, perhaps in recognition of Paul Volcker's false step in 1980, when he prematurely reduced interest rates only to be forced to resume raising them for a further 12 months. Persistently strong inflation data released after Jackson Hole has strengthened this view.

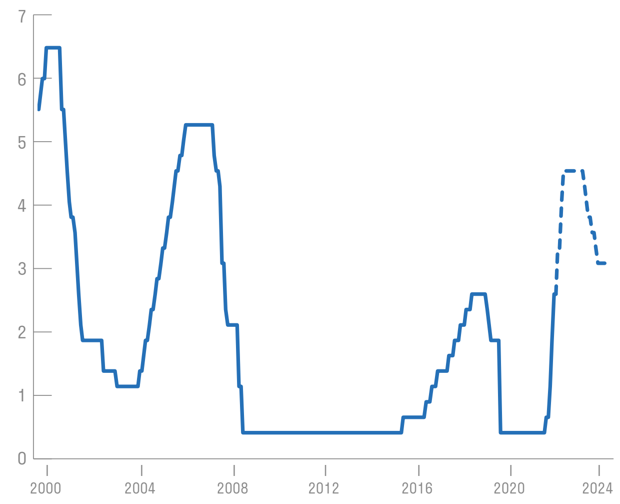
Current market pricing implies that US rates will peak in the first quarter of 2023 at c.4.5%, and that US interest rates will be cut in the second half of 2023.

FIGURE 1 US ISM MANUFACTURING PMI



SOURCE: MACROBOND, OCTOBER 2022
PAST PERFORMANCE IS NOT A GUIDE TO FUTURE RETURNS AND MAY NOT BE REPEATED.

FIGURE 2 SARASIN FORECASTS FOR US INTEREST RATES (%)



SOURCE: SARASIN & PARTNERS AND MACROBOND, OCTOBER 2022

It should be remembered, however, that both the Fed and the bond market have proved to be poor forecasters of inflation and policy in this cycle. For the current headline US CPI rate of 8.3% to reach the 2% inflation target by mid-2023, month-on-month inflation would need to slow rapidly from 0.7% to 0.1%. If inflation does not cool, assumptions around the terminal rate could conceivably rise to 5% or higher. For the moment, the best that we can do is to assume that monetary easing is not imminent.

Quantitative tightening (QT), or the removal of liquidity from the economy, is a feature of this market cycle that has not been present in the past and further complicates the outlook. The Fed has laid out a plan to reduce its US$9tn asset portfolio, and as at September 2022 aims to reduce this by US$95bn per month. It is unclear how QT will impact the shape of the US yield curve, the value of the US dollar and therefore the tightness of financial conditions. It is also hard to judge how the Fed might adjust this plan according to circumstances, or how the markets will respond.

Eyes on earnings

Our third tell-tale of having reached a durable bottom in equity markets is a turn in expectations for corporate profits. Specifically, we are looking for a slowing in the rate of decline in earnings expectations, as this tends to presage a return to growing earnings expectations.

Most companies experience a decline in earnings during recessions, but the size of this decline varies significantly, and is only partially dependent on the extent of GDP weakness. The large economic contractions in 1975, 1980 and 1981 coincided with relatively small declines in earnings, whilst the Global Financial Crisis of 2009 caused the worst decline in profits since WWII. By contrast, the recession after the Dotcom Bubble was fairly mild, but the earnings impact was disproportionately large as expectations for technology sectors collapsed. According to Bloomberg, the average earnings per share (EPS) decrease associated with recessions since 1960 is 31%. Excluding 2001 and 2009 gives an average EPS decrease of 17%.

So earnings behave very differently in different bear markets. But one unifying factor is that when the rate of decline in earnings expectations begins to slow, equity markets start to price in an improving outlook, even if the economy is in recession and profits are still falling.

As with PMIs and interest rates, we are far from this stage. Earnings expectations in the US are just beginning to fall, with S&P 500 earnings expectations registering a mere 3% decline since the start of Q3 2022. Current aggregated bottom-up expectations are for US company profits to grow by 9% in 2023 and 7% in 2024. Unless a recession can be avoided, earnings expectations for 2023-4 appear to be as much as 25% too high, even if we are blessed with a soft landing. We may be months away from any slowdown in the rate of change in earnings downgrades.

Today the outlook for earnings is increasingly challenged by slowing global economic momentum, just as liquidity is being withdrawn by central banks. Higher prices, as companies pass on the impacts of inflation, will tend to reduce demand, while labour costs (which tend to lag inflation) are likely to rise in 2023.

Should price inflation moderate in 2023 it will reduce nominal revenue growth just as labour costs rise, squeezing margins and reversing the lift many companies had in 2022, when they benefited from higher nominal growth as prices increased. A similar effect was seen in 1974, when inflation peaked at 12% and earnings subsequently fell dramatically as lagged cost pressures and higher interest rates caught up with them.

FIGURE 3 GLOBAL SALE GROWTH 1-YEAR FORWARD ESTIMATES

SOURCE: MACROBOND/FACTSET, OCTOBER 2022

As Napier notes, bear markets tend to end with a final slump. A drawdown to a more attractive entry point in equities could happen quickly in the event of investor capitulation. We do not assume that we can time the market bottom precisely and we believe our framework is more useful for risk allocation within a portfolio. We must nonetheless be ready: there would be plentiful thematic companies trading on appealing valuations.

The impending recession could be mild relative to past cycles; this makes market timing difficult, but potentially less important for long-term equity investors. The Fed is determined to bring inflation to heel and this might happen sooner than generally expected if supply chains continue to ease and commodity prices fall.

With this in mind, we have moved to a neutral position in our multi-asset strategies' corporate credit allocations. The recent turmoil in UK bond markets might be evidence that we are entering a classic disorderly period in this bear market that could herald the eventual trough.

BEN MCEWEN
CLIMATE CHANGE INVESTMENT ANALYST

NATASHA LANDELL-MILLS
HEAD OF STEWARDSHIP

THE HIGH-CARBON TRANSITION

> Investing in low-carbon stocks is only one part of the picture.

Awareness of the urgent need for clean energy has been turbo-charged by a scramble for energy security. Sarasin's new High-Carbon Transition sub-theme seeks out leaders in dirty industries who are cleaning up their act to deliver the carbon emission cuts the world needs to get onto a 1.5°C temperature pathway. By leveraging Sarasin's active ownership expertise, through this theme we seek to deliver both maximum impact from carbon reductions alongside superior financial returns from being on the right side of the transition. This, for us, is what securing tomorrow is all about.

One lasting impact of the invasion of Ukraine is that it has turbo-charged the shift towards clean energy. Ensuring domestic energy security at affordable prices is now paramount for many countries, and wind, solar and hydrogen will be an important part of making this happen. This in turn is adding to the pressure on high-carbon industries to change what they produce and how they produce it.

In response to the challenge ahead of us and the rapidly falling costs of clean energy, many investors are turning to low-carbon companies. These companies are important actors within the energy transition and offer attractive long-term return prospects; we too invest in companies such as wind turbine maker Orsted and heat pump manufacturer Daikin through our Climate Change mega-theme.

But investing in low-carbon stocks is only one part of the picture. It's no good investing in windmills, if steel mills which supply them don't decarbonise, for instance.

The most difficult part of the energy transition – and what underpins our ability to reach a 1.5°C temperature pathway – is the need to transform high-carbon, hard-to-abate sectors. This requires engaged and supportive shareholders with the ability and willingness to challenge and reject unsustainable corporate strategies.

It is these companies we are targeting in our new high-carbon transition investment sub-theme.

Investing in the transition

Our process begins with the identification of high-carbon companies that can create value through transformation. We look for opportunities in three broad categories:

INVESTING IN THE TRANSITION

TIER 1
High-carbon energy creators and users in transition

TIER 2
Producers and suppliers of devices, processes and services enabling tier 1 companies to transition

TIER 3
Suppliers of base materials used in tiers 1 and 2

Tier 1 includes names such as Equinor, an energy company whose gas production will be increasingly in demand as a relatively clean interim energy source. Looking longer term, Equinor's ambition – and that of the Norwegian government which holds a large stake in the company – is for the company to become a preeminent operator of offshore wind and carbon capture facilities as it moves towards a net zero business model.

Helping companies such as Equinor make the transition to cleaner and more responsible business practices are an array of tier 2 companies such as Aker, a carbon capture provider and Fluor, a specialist in renewable fuels, hydrogen production and energy storage. Further along the supply-chain are companies such as Flowserve, Ingersoll Rand and Alfa Laval that supply precision pumps, heat exchangers and other components for the carbon transition.

In tier 3 we have suppliers of the vital materials without which transition will not be possible. Rio Tinto is a household name whose copper and aluminium will be in high demand as energy use switches from fossil to renewable. Less well-known is France's Air Liquide, which supplies industrial gases and is a world leader in developing large scale green hydrogen – a low-carbon store of energy made using renewable power.

Other examples include building materials (particularly concrete) producer CRH, one of the largest carbon emitters on our buy list, but with an ambition to be sector-leading in carbon reduction. As the world adapt to climate change, we will need more cement. This needs to be low carbon.

For each and every potential investment, we undertake bottom-up analysis of fundamentals, including an assessment of upside potential from a 1.5°C transition using our proprietary Climate Value at Risk methodology.

This leads us to companies offering attractive value enhancement opportunities associated with a net zero transition.

Engage for change

The opportunity for low-carbon businesses to thrive in hard-to-abate sectors is clear. The challenge is delivery. There are often a range of technological, economic, legal, policy or social barriers to change. Our role as supportive and engaged shareholders, therefore, becomes critical to delivering the long-term returns.

Sarasin's long experience with active ownership is key in this sub-theme. Success requires careful analysis relating to the key asks put to Boards, a strong understanding of the governance arrangements, thoughtful voting to ensure director accountability (see Box on our Net Zero Voting policy) and a willingness to be public.

Sarasin votes for net zero alignment to underpin long-term value creation

A key element of a successful engagement strategy is clear and robust voting. We have integrated climate governance into our voting policy since 2018, and in September this year, we published the [latest update as a standalone document.]

Continued

THE HIGH-CARBON TRANSITION

Ben McEwen, Climate Change Investment Analyst,
and Natasha Landell-Mills, Head of Stewardship

Active ownership delivers results

Our track record shows that we can deliver impacts through our engagement. Take the leading US power company, NextEra. Despite having the largest renewables capacity, it is one of our largest carbon footprint companies due to its extensive gas generation and distribution network, primarily focused in Florida. Until this year, it lagged its peers in terms of its commitments to decarbonise. Following intensive engagement as co-lead of the CA100+ investor initiative, we were delighted when the company committed in June to a 'Real Zero' carbon emissions target by 2045. This covers the vast bulk of emissions resulting from its energy generation and distribution.

We have carried out other successful engagements, further details of which are on our website, across a range of sectors, such as with Shell, BP and Total on climate accounting and audit, with HSBC on financing of fossil-fuel-intensive activities and Weyerhaeuser, one the world's largest timberlands management companies.

Our policy outreach to the audit industry has also gained considerable traction with investors globally, with a rising number of auditor reports providing commentary on how climate risks are being integrated into their audit processes.

Divestment won't get us to net zero

It would be easy for Sarasin, like other asset managers, to decarbonise our clients' portfolios by selling shares in hard-to-abate sectors. But we do not believe this would help decarbonise the global economy. Shares will pass to less concerned shareholders. Moreover, by walking away from these companies, we risk turning our backs on transformation opportunities that offer attractive long-term returns.

Instead of focusing our gaze on a relatively narrow green opportunity set today, we are investing and engaging across all sectors to deliver a more sustainable future tomorrow. Our new high-carbon transition sub-theme complements other climate sub-themes to enable this holistic approach. This is not only right for the planet; we believe it will deliver more sustainable financial rewards for our clients .

[1] For example, In March 2022 the EU announced its REPowerEU plan to scale up renewables infrastructure rapidly and quadruple current 2030 targets for green hydrogen. The EU aims to become independent of Russian fossil fuels "well before 2030". https://www.independent.co.uk/climate-change/news/eu-russia-oil-gas-ukraine-war-b2031117.html

[2] This approach is in keeping with our Net Zero Asset Managers commitment. Please see our NZAM Action Plan here.

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