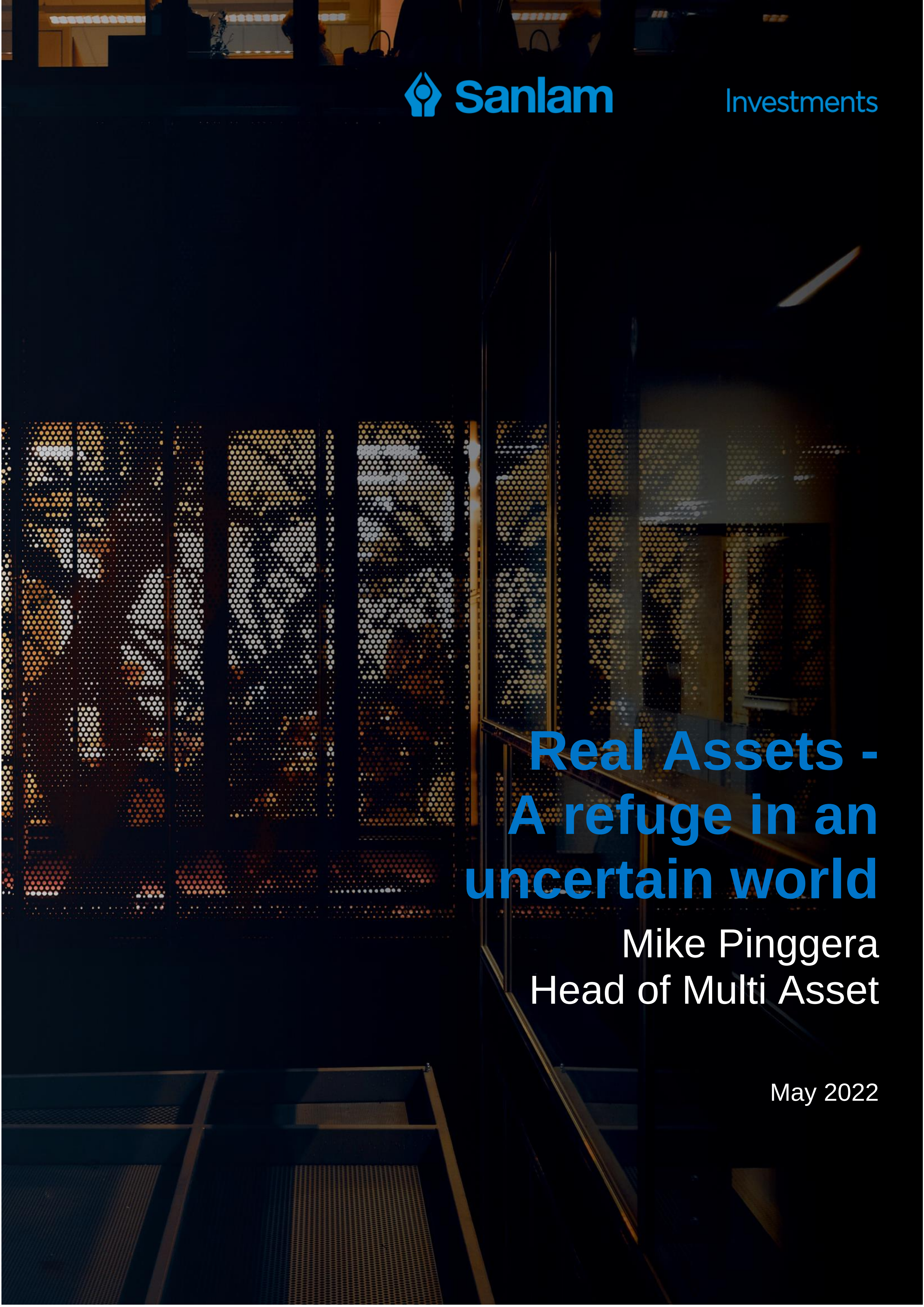

Sanlam Investments

Real Assets - A refuge in an uncertain world

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We’re only just over halfway through H1 2022 but already investors have had to face a plethora of challenges – problems in global supply chains that just won’t go away even though the pandemic is now more than two years old, uncertainty about the timing and magnitude of interest rate rises, the return of an old foe – inflation – which had been largely absent from developed world economies in recent decades, and the first major European war since 1945.

On paper, things may look bleak, but as I often to say to clients, Europe has (metaphorically) been at war with itself for years (see for example Brexit and more recently the reaction from the far right and far left in France to President Macron’s victory in the presidential election). Perhaps more importantly when looking to Eastern Europe, whilst a madman in charge of a superpower is never a welcome scenario for financial markets (regardless of the prevailing global macroeconomic backdrop), it is far from a new phenomenon. As active investors, all we can try and do is break down the challenges, opportunities and risks that we know about, seek to understand them as best as we can, and ensure that our portfolios are as resilient as they can be given the multitude of possibilities that could play out in the months and years ahead. At the back of our minds, we remember that whilst the more bearish sell-side strategists out there may forecast the end of the world on a reasonably regular basis, it seldom comes to pass.

Of all the challenges referenced above, inflation has certainly grabbed its share of the column inches, although to focus on one (albeit high-profile) macro issue is perhaps to focus on the wrong risk. In the (in)famous words of Donald Rumsfeld, inflation is what could be called a ‘known known’ – we know that we know about it, and we certainly know that it is likely to be a challenge for the remainder of this year. Whether it proves to be a more persistent problem well beyond 2022 remains to be seen, particularly as Fed chair Powell’s comments at a recent IMF discussion panel made it very clear that 75 bps hikes are now on the table. The US yield curve inversion that we saw in late March and early April tells us that financial markets remain uncertain about the longer-term outlook for growth.

While we never focus overly on one specific macroeconomic issue, and would not advocate doing so, it is perhaps worth revisiting why real assets can be so useful in periods of inflation, as this is something we continue to receive questions about. However, it is also worth remembering that real assets can perform across a range of economic scenarios, not just the high-inflation/slowing-growth environment that we appear to be seeing now.

So why are real assets a useful thing to own in periods of inflation?

The most obvious reason is that the leases and revenue streams associated with real assets often have explicit or implicit inflation linkage. However, it's also worth bearing in mind that in periods of GDP growth and high inflation, demand for real assets will go up, because they are the very things that underpin the functioning of a normal, healthy economy – fundamentally, this is why we think real assets are so important and why we think they should be attractive to genuinely long-term investors. Moreover, for assets like property or infrastructure, replacement costs will rise as raw materials and labour costs climb (something that we have seen a lot of recently as there has been a 'double whammy' of materials shortages globally and tight labour markets). This, in turn, means high replacement costs and the high costs of building out new capacity can deter new entrants to some sectors, which leaves the incumbents in an even stronger position.

It is worth considering, of course, that inflation sensitivity will vary depending on the asset – in energy markets, for example, the biggest price moves this year have been seen in spot prices, and it is companies with exposure to those spot rates which effectively have had a licence to print money (albeit, of course, with the associated risk of windfall taxes as governments try to provide some comfort for embattled consumers and sectors that consume a lot of energy). However, contractual agreements linked to a specific inflation measure (say CPI or RPI) can also provide useful inflation protection, even if producers of renewable energy are not selling that energy at current spot rates. Of course, contractual agreements will be renegotiated over time and when this happens, they will tend to reflect prevailing rates whilst still benefiting from inflation linkage within the terms of the contract, so that the 'real' (inflation-adjusted) payments stay ahead of inflation over time. Either way, it's a win-win in an inflationary environment.

For the long-term inflation bulls out there (for us, the jury is still out, but clearly the longer inflation continues, the more likely it is to become embedded), it is worth reminding ourselves why things like real estate and infrastructure are useful inflation hedges if they are held over the longer term. Looking at real estate as an example, the leases for offices, industrial and other buildings (such as supermarkets, social housing and student accommodation) will typically include an annual adjustment at given rate, with inflation (e.g., CPI or RPI) referenced explicitly in the calculation. For infrastructure, such as power and utility providers, the inflation linkage will come in the form of contracts, regulation (e.g., through X% p.a. plus CPI-type pricing) or concessionary agreements, all of which essentially 'bake in' inflation protection in some form. It goes without saying that in periods of high growth and high inflation, demand for power and infrastructure will increase, perhaps significantly, which provides a very attractive backdrop for such assets.

Whatever you think of inflation, or its persistence, what is clear to us is that real assets can perform well in periods of reflation (as we saw when markets like the US and UK began to exit the pandemic) but also crucially in periods of stagflation (which is what markets may face now and which may or may not prove to be more persistent than markets expect). High growth periods, as we've outlined above, are also supportive for real assets. It is only periods of outright recession/demand destruction where the outlook for real assets is more challenged – and even then, there is some protection as in a recession people still need water, housing, places to buy food, heat and light, power for vehicles/transport as well as schools, hospitals/healthcare and other forms of essential infrastructure. Moreover, there is a growing and now probably irreversible focus on the sustainable production and delivery of these essential requirements which will create a new and exciting range of opportunities for investors.

Assuming inflation does move to the rear-view mirror at some point, it is worth thinking about some of the other structural and long-term drivers of asset returns, and here again we think that real assets will play a crucial role over the longer term. ECB President Christine Lagarde recently highlighted 'Green Swans' as one of the key issues that investors should really think about, and the existential risks posed by climate change have now been proven beyond all reasonable doubt. We have always sought to align ourselves with businesses that can deliver positive ESG outcomes and sustainable, long-term solutions to some of the world's most pressing problems. However, as the IMF has said, it is an unfortunate reality that policymakers tend to behave like 8-year-olds playing football whenever they are faced with a major crisis – everyone runs towards the ball rather than covering the rest of the field and staying alert to other (perhaps bigger) risks. Ukraine is the current crisis 'football' that almost everyone is focused on, not least because of the risks to energy security and food prices; inflation was the major crisis before that (and one that has, in turn, been amplified by the tragedy in Ukraine). However, focusing on just one known risk means that investors are vulnerable to being blindsided by something else. We know that inflation is a problem but whatever happens it is unlikely to be an existential threat and it may not be persistent. The threat posed by, say, climate change (or even a 'hot' war between NATO and Russia) is rather different. And, to return to Rumsfeld, there will always be 'unknown unknowns' – the things that we don't know that we don't know about. These would include the 'Black Swan' events that are so disruptive (and usually damaging) to financial markets, but which are currently getting little or no consideration because investors have little or no bandwidth to deal with any additional issues. In our minds, that complacency is probably one of the biggest risks to markets now.

So, what is there to be cheery about?

While the lead portfolio manager of Sanlam Real Assets has been investing in listed real assets since 2006, in 2014/2015 we took the view that real assets were a sensible place to navigate increasingly uncertain markets where we could see potential problems (Brexit, Trump, Tapering). Taking a long-term view in long-term assets allowed us to look beyond the short-term noise. This stance has been well-tested with most of the (perceived) negative cases coming to fruition in the early years, and more recently with the pandemic and now the war in Russia, we feel that the strategy has survived some formidable market stresses.

Since we launched the Real Assets Strategy, it has delivered double digit annualised returns with a Sharpe Ratio of >1, a Sortino of >2 and a Beta to the MSCI World Index of ~0.3, , comfortably ahead of our global composite measure of inflation (1.7%) over the period. Without doubt, the current backdrop remains noisy and investments that allow us to look beyond the noise remain compelling.

We are always happy to discuss the strategy and the diversification benefits that listed real assets can bring, so please contact your usual Sanlam Investments representative if you would like to meet with us.

Thanks for reading and stay safe and well.

Mike

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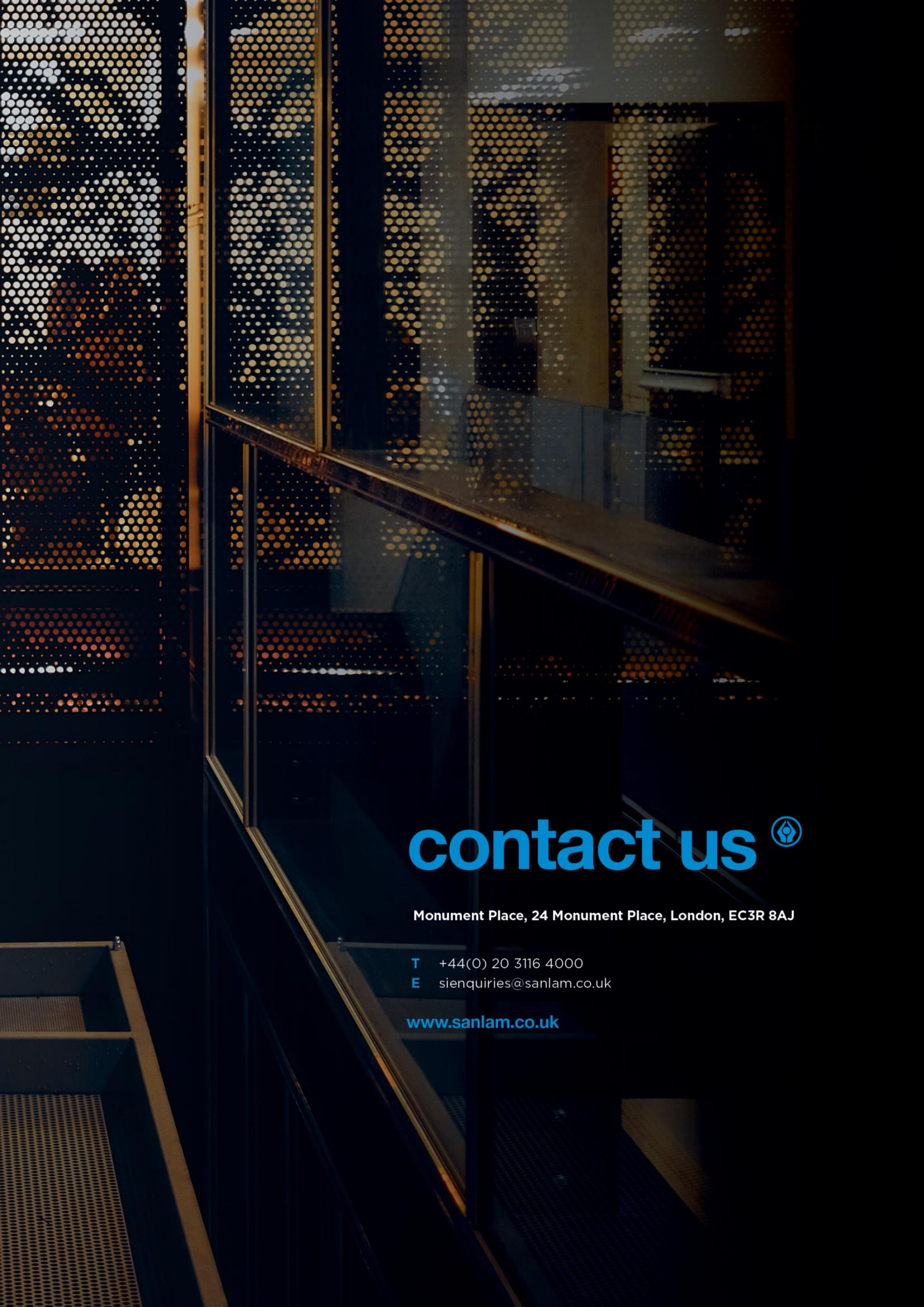

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