SARANAC
PARTNERS

Investment roadmap

NOVEMBER 2023

AT A GLANCE

— This month's main feature is on **ESG investing**, and the extent to which portfolios that score highly in this context may compromise more conventional objectives such as high return, low volatility and adequate diversification. We do not believe this issue can simply be dismissed. There are no compelling reasons why ESG investments should systematically outperform more conventional approaches, and some arguments to suggest why they do not. The empirical evidence is inconclusive, with the results depending on the definition of ESG, time period and methodology. Many investors see establishing a high-quality ESG portfolio as an achievement in its own right, and indeed it is. However, it is important to understand the extent to which other objectives may be affected, albeit in this instance for entirely legitimate reasons.

— Our **market views** are broadly unchanged. Saranac portfolios continue to hold lower weights in equities than usual, with more in corporate credit and a diversified selection of alternatives. Positioning within asset classes remains conservative.

— **Equity valuations** on average are now close to normal. However, the dispersion in valuations remains significant. US megacap valuations are extended, but perhaps some 30% of global sectors are clearly priced for economic distress. We regard the potential for weakness in corporate earnings as the main threat to global equities.

— **Long-term interest rates** have risen further in recent weeks, despite more stable short-term rates. We attribute this to a higher risk premium arising primarily from concerns over the US fiscal position and quantitative tightening. Our long-held view that there was upside risk to policy rates in the developed markets has given way to a more symmetric evaluation of the risks, in part given diminishing risks on the US inflation outlook.

— We also take a closer look at the **IPO** market, where economic stresses have brought about a sharp decline in activity. Moreover, those companies that have made it to market have seen disappointing subsequent outcomes. The market appetite for these issues remains very limited, to some extent reflecting the previous surge in issuance associated with SPACs, whose subsequent performance was in general underwhelming. It is feasible that the IPO market remains in limbo for some time, absorbing only a select number of profitable companies.

ESG investing with your eyes open

1. ESG investing is now widespread

There was a time, not so long ago, when the vast majority of investors not unreasonably made their decisions on what to buy and sell based very largely on financial considerations. To some extent, however, such focus has been eroded in recent years, as an increasing number of investors have also incorporated broader societal considerations into their target portfolios. At the same time, many asset managers have introduced new products designed to cater for this demand.

The common acronym for this approach is ESG, with the three dimensions covering environmental, social and governance issues. The first is self-explanatory, and is typically associated with limiting or eliminating exposures to fossil fuels. The social aspect covers issues such as workplace conditions, relations with local communities and an ethical stance towards a company's customers. Governance relates to the way firms are run, and can include the extent to which a company may prioritise integrity and diversity in selecting senior personnel, and uses accurate and transparent accounting policies.

There are different ways to implement an ESG strategy, including not holding in portfolios companies that do not meet certain criteria; engaging with companies over their broad strategies; tilting portfolios towards companies with higher ESG scores; and 'impact investing', which incorporates particular projects designed to achieve specific ESG goals, such as investments in wind and solar energy.

Assets in this area have expanded substantially in recent years in all asset classes, notably in equities, although the ESG trend has been more evident in Europe and the US. A local peak in ESG assets was probably reached in late 2021 at over $50 trillion, although the market correction since that time will have depressed that total. Perhaps around 5% of global equities are in ESG funds, although different areas of the market have much higher or lower levels (e.g. more in clean energy, less in fossil fuels).

Not so long ago, most investors based their decisions on what to buy and sell on financial considerations. In recent years, investors have increasingly incorporated broader societal considerations into their target portfolios.

2. Assessing ESG Investments

i. Potential conflicts in ESG investing

In this article, we consider the challenges of integrating ESG factors with other objectives an investor might have. From one perspective, ESG investing works by definition: socially motivated investors can construct portfolios on clear criteria that can meet their aspirations in this area in a transparent fashion. However, this is to ignore possible conflicts with other portfolio objectives. In a broader context, however, it is important to be clear in advance concerning what the implications might be for important portfolio properties, such as the expected return, the potential for significant volatility in returns, and particular biases in exposures – sectoral and regional for example – which may result from integrating ESG factors into a portfolio.

Saranac works closely with clients to implement portfolios that reflect their ethical beliefs (not Saranac's) and it is important in this role to be clear about potential issues and trade-offs which may arise. In our view, there is no necessary reason why ESG investments should consistently either out- or underperform other parts of the market in the long term, although in particular periods it is highly likely that there will be material swings in relative performance. Moreover, ESG portfolios are likely to be less well diversified, as the tilts constrain exposure to parts of the market that are driven by different factors than those which influence the securities in the portfolio. This is not to suggest ESG investing is inappropriate, but that the potential consequences should be transparent in the design of an effective ESG strategy.

One position which has been articulated is that there is in fact no trade-off. On this view, ESG investing will bring about better returns as well as being socially beneficial because markets will recognise and reward the social benefits. There is, in this case, no conflict between a firm's long-term profitability and its willingness to implement a strategy based on wider societal norms. We argue in this paper that this is complacent.

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Chart 1: BAT performance relative to FTSE 100

Source: Bloomberg/Saranac

ii. Origins and examples of conflicting objectives

The case for the absence of competing objectives is sometimes merely assumed rather than articulated clearly, but several claims have been put forward in this context. One argument is that a company following a robust ESG programme is inherently less risky because it is transparently embedded in a network of favourable societal norms, leading to a lower cost of capital and better returns to investors. This may be true in some cases, perhaps more so in smaller niche markets, but it is not clear why it holds in all cases. Indeed, if a company does become less risky, finance 101 would suggest that it would have lower returns, not higher returns.

A further related argument has been that companies which do not meet ESG criteria will be starved of capital, and hence less likely to deliver long term returns. However, this ignores the 'fungible' nature of capital flows. For example, a public company facing ESG pressures may delist and go private, which is an area of the market where ESG concerns tend to have a lower priority. It may also relocate to a geographically different public market where investors' ESG concerns are less intense. Therefore, initial underperformance may give way to subsequent outperformance. An additional argument has been that investors may under-recognise the potential outperformance of ESG strategies, laying the ground for future outperformance. However, it is unclear why investors en masse would ignore this information if it were potentially so valuable.

More generally, companies systematically shunned by some investors may acquire a risk premium, making them more attractive to other groups of investors. One example is tobacco, which was for an extended period a very strong relative market performer even as a societal backlash against smoking became very apparent. Indeed, up to a few years ago BAT, a large tobacco company, had been the strongest performer in the FTSE 100 since its inception in 1984, despite an increasingly disadvantageous regulatory background in developed markets (chart 1). Perhaps incongruously, it outperformed pharma companies making drugs to mitigate the impact of smoking-related cancers.

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This may seem paradoxical, but the apparently highly challenging environment may in reality have supported rather than suppressed BAT's returns. For example, one support for the company's very strong cash flows was the fact that the regulatory environment made the industry unattractive for new entrants, thereby strengthening the position of incumbents. This hostile environment may have reassured investors that these high cash flows were less likely to be devoted to unprofitable new investments. At the same time, BAT developed its operations in emerging markets, where the challenge to smoking was much less intense. The combination of high profitability and low investment made BAT an attractive stock on fundamental grounds. In this context, but more speculatively, it may be the case that if (implausibly) a much earlier ban on the extraction of fossil fuels were imposed, this could support the performance of the sector in the run-up to the cut-off date. 'Sin' stocks should not, therefore, be expected to underperform other stocks systematically. Indeed, the evidence is that many do not, even over extended periods, and they do not underperform because of, and not despite, their pariah status.

Moreover, a company targeting a higher ESG rating in the marketplace may in fact deliver worse performance for investors as a direct result of trying to implement this objective. For example, it may diversify into areas beyond its core competence, or face a higher level of costs as it restructures to reflect ESG influences. Alternatively, a company may find it hard, or even impossible, to deliver a feasible commercial policy when considering the multiple potentially conflicting issues that ESG brings to the surface. For example, if an active corporate ESG strategy involves higher costs, who pays – customers, employees, suppliers or shareholders?

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Moreover, there is some evidence that companies may focus on ESG issues if earnings fall short of expectations, but not if expectations are exceeded. If capital is devoted to companies publicly associated with ESG principles, investors may become over-exposed to structurally weaker companies. Finally, if there are areas of the market that are more likely to receive capital if deemed to

Chart 2: iShares Clean Energy ETF

Source: Bloomberg/Saranac

be good for ESG investment, the scale of the capital inflow may be large relative to the investment opportunities, leading to low levels of profitability even for the winners. For example, there was a slight speculative feel to the scale of ESG inflows in late 2021, which may have contributed to the subsequent underperformance. We would also point to the recent strong underperformance of parts of the new energy industry (chart 2) which, while the result of a number of factors, may to some extent also reflect the abundance of capital that had previously been allocated to the sector.

3. Defining ESG and measuring performance

One major problem in exploring the potential impact of ESG investments is that the term itself is hard to define consistently. The 'E', 'S' and 'G' terms cover very different aspects of corporate behaviour. It may fortuitously be the case that they converge, with a poorly-run company with little concern for the local community having a deleterious environmental impact. However, there is no necessary reason why this should be the case, which is why it rarely is the case. In these more common instances, aggregating the individual components to a single score delivers a precise number whose interpretation is open to question: these scores measure everything, but at the same time measure nothing. Furthermore, individual companies also publish their own qualitative assessments of their ESG activities. Whatever the scores, investors in ESG investing may in some instances face higher costs to cover the identification of particularly attractive and unattractive securities in this area.

More generally, a number of providers, such as Bloomberg and MSCI, provide ESG scores for individual funds, but there can be a frustrating lack of consistency between them – although this is perhaps unsurprising given the subjective nature of some of the inputs. For example, among auto manufacturers, Tesla has in the past received simultaneously the highest and lowest ESG score from different providers. In addition, asset managers who run ESG-oriented portfolios may have their own scoring systems, without making these transparent to investors. It is unclear, though, how these scores

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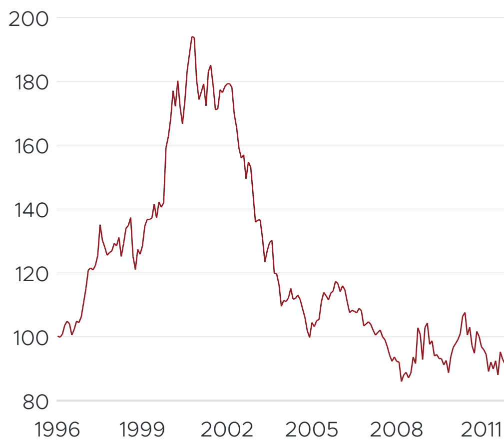
Chart 3a: Robeco Sustainable Equities Fund (1996–2011)



Source: Bloomberg/Saranac

Chart 3b: Robeco Sustainable Equities Fund (2011–2023)

Source: Bloomberg/Saranac

Given the material problems in defining ESG, it is not straightforward to give an answer to the question concerning the relative performance of ESG investing.

actually relate to future financial performance of these companies, and whether these scores really do map onto the 'true' ESG ranking of a company. To the best of our knowledge, it is very much the rare exception for quantitative managers – in their relentless search for 'signals' that predict future performance – to use ESG scores in addition to more conventional financial market indicators as robust guides to future prices.

4. Consistent evidence on ESG relative performance is uncompelling

Given the material problems in defining ESG, it is not straightforward to give an answer to the question concerning the relative performance of ESG investing. A number of 'meta' studies have been completed, which summarise the voluminous literature. These do point to some evidence of outperformance by ESG investing, but with the significant proviso that this positive result has been identified only for particular periods, not consistently. In addition, even when ESG investing has performed better than more conventional investment styles, one interpretation of this relationship could be that outperforming companies are more likely to have the resources to support costly ESG programmes, not that the ESG stances themselves were responsible for the outperformance. This variability in investment performance is not surprising given that ESG investing on a widespread basis is a relatively new phenomenon, and a range of different statistical techniques have been used to explore the data.

To highlight some of the most important issues in this area, we show in charts 3a and 3b the relative performance of the Robeco Sustainable Global Stars equity fund, a global strategy chosen because it is a representative fund with a long track record. We show the performance relative to a global index in two phases – 1995 to 2011 and then 2011 to the present. In the first period, extreme outperformance in the early years was all given back. This volatility was not due so much to the fund's ESG characteristics, but because a byproduct of this exposure was that the fund had a strong style bias to 'growth' companies, or more highly valued companies. Therefore, the relative performance

was strongly influenced by the 'boom and bust' of this style exposure in that period. In the more recent period, ESG tilts have been associated with outperformance of growth as a style – particularly in the immediate post-Covid market recovery, rather than ESG factors isolation. A further factor has been the oil priced: its collapse in 2014 supported ESG relative outperformance, but its strength following the invasion of Ukraine lead to significant underperformance of ESG strategies. Once again, any ESG influences on performance were swamped for extended periods by other factors.

5. Conclusion: eyes wide open

The objective of this paper has not been to undermine ESG investment as a style. Saranac has supported many clients in developing bespoke investment strategies consistent with their varied ESG ambitions. The point has rather been to examine some of the complexities and potential costs. We are sceptical of the view that successful ESG investment can be relied on systematically to deliver superior investment outturns based on more traditional parameters such as return, volatility and diversification. This may be the case, but our analysis suggest this is far from inevitable, it is hard to forecast with confidence even if it does emerge, and there may well be periods when more traditional approaches outperform ESG strategies.

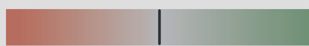
Saranac has supported many clients in developing bespoke investment strategies consistent with their varied ESG ambitions.

For many investors, implementing a comprehensive ESG investment strategy represents a success in its own right, and so it is. However, awareness of the other facets of investing allows this success to be assessed in a broader context, in which awareness of possible downsides is an important element.

Public markets

EQUITIES

Valuation



Earnings

Positive
Energy; Healthcare; Japan

Negative
IT; Financials; Emerging Markets

Market background
A number of factors weighed on equity prices in October. Even though US earnings announcements have generally beaten forecasts, the forward-looking comments were less constructive. With the exception of energy, most sectors are witnessing a slight downward revision to sales and earnings for 2023 and 2024. This is not the catalyst required to offset the pressure from higher real yields and conflict in the Middle East.

Targeted exposure
The portfolio's sector allocation detracted from relative performance but this was more than offset by stock selection. Positions held within IT, energy and health care generated the greatest relative returns. Two of our energy stocks, Pioneer Natural Resources and Hess, have agreed to be bought by the two largest global oil companies, Exxon and Chevron. We continue to tilt the portfolio towards the cheaper, more defensive areas of the market that we believe have some growth potential.

GOVERNMENT BONDS

Short maturity

Long maturity

Positive
US Treasuries, US TIPS, MBS, Australian Govies

Negative
>10 year European sovereign bonds, Japanese government bonds

Market trends
In October, US treasuries underperformed other sovereign markets with long-dated Treasury yields rising some 40bp, mostly driven by a further rise in real yields. This happened as fiscal woes, the Fed's quantitative tightening and supply/demand imbalances fuelled the repricing of the long-dated tenors. Conversely, weak economic data and signs that inflation is on the retreat benefited European government bonds.

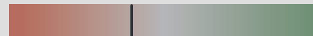
Targeted exposure
Rising yields have made duration exposures more attractive. Still, in the near term, technical factors weighing on sovereign bond markets remain and there is a risk of further rise in long-dated bond yields. Hence, as yield continue to rise, we gradually add to duration, introducing agency MBS positions in portfolios and adding to 10-year government bonds. Following a strong outperformance of £ fixed income, we trimmed our allocation and are considering adding Australian rate exposure to portfolios on a currency hedged basis. Market-based inflation expectations have increased but remain low, supporting our preference for inflation-linked bonds.

Public markets

CORPORATE AND EMERGING MARKET DEBT

Investment grade credit

High yield



EM debt

Positive
$ and £ IG credit, 0-5Y € IG credit, subordinated bonds, AAA/A securitisation, US Agency MBS

Negative
US B/CCC rated issuers and High Yield Emerging Markets

Market background
After reaching overly tight levels over the summer, credit spreads have widened for a second month in a row to ~1.35% for $IG and ~4.5% for $HY. We believe these spread levels are consistent with a discounted soft-landing scenario for the US economy. European credit continues to offer attractive relative value compared with the US, with European IG spreads still in excess of 160bp across tenors.

Targeted exposure
In light of solid credit fundamentals, we maintain elevated corporate IG allocations in portfolios. Still, we have started to reallocate some government and corporate exposure towards US Agency Mortgage Backed Securities, which offer compelling relative value and diversification characteristics in our view. Despite the recent widening in HY spreads, we expect corporate bankruptcies to increase over the next two years and steer away from companies with elevated debt ratios and deteriorating interest coverage ratios. We maintain our preference for subordinated debt (AT1 and corporate hybrids) over high yield.

STRUCTURED PRODUCTS

Market background
The last month has continued to bring increases in implied volatility on a cross-asset basis, from equities to FX to rates. We view the window to place attractive equity downside hedges as having reduced somewhat, with equity implied volatility having spiked from the lows, but still not rich on a multi-year lookback. The combination of higher rates and higher volatility makes for some interesting structured product expressions generally – although we still do not view index implied volatility here as being attractive enough to look at index-linked autocallables. Selling rates volatility via structures like range accruals looks more attractive. For investors concerned about a further equity market sell off, we view put spreads as more attractive than puts at present.

Public markets

HEDGE FUNDS

Are they worth it when interest rates are high?
We recently explored the potential impact of higher cash rates on investing in hedge funds. A hedge fund that could deliver a 5% return when deposit rates were close to zero had a good business, but why invest in hedge funds when a similar return is available by keeping money in the bank? We see hedge finds as falling into three categories in these circumstances. First, funds that invest partly or wholly through derivatives should see some link between cash rates and their own returns. Second, funds that lack this mechanism, but have delivered substantial returns in the past and are likely to do so in the future, would still have an effective model. The third group will be the most challenged, specifically those funds that lack the cash link, and do not have the alpha generating skills to returns systematically above cash rates. Their business models are likely to be the most challenged, and this group may be over-represented in the UCITS universe.

CURRENCIES

Dollar

Sterling

Euro

Yen

Market background
Following solid gains in August and September, the US dollar traded broadly flat in October. US macro data continued to surprise to the upside and outperform Europe/UK. However, we also encountered a more balanced Fed, which toned down hawkish rhetoric compared with previous months, signalling a pause in rate hikes. At the trade-weighted dollar level, further USD gains have been capped by interventions from both Japan and China.

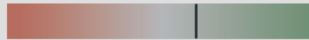
Targeted exposure
The most meaningful recent development for foreign exchange markets has been the Bank of Japan's shift in its approach to Yield Curve Control (YCC), opting for a flexible target rate rather than an explicit level. The market's initial reaction to the adjustment and accompanying dovish rhetoric drove weakness in the Japanese yen. However, within 24 hours of the BoJ meeting, we had confirmation from authorities that they are prepared to defend against further weakness in the yen, and 152 appears to be the current USDJPY trigger for intervention. We continue to see upside in the yen from current levels.

Public markets

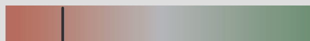
COMMODITIES

Gold

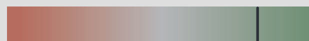
Energy



Industrial metals



Softs



Market background
Commodity volatility has continued over the last month as geopolitical escalation has persisted in the Middle East and China has continued to falter. On the energy side, we view upside tail risk as having risen, with concerns over possible restrictions of supply should the conflict continue to escalate. Headline action has actually been fairly modest, with oil having fallen 1.5% over the last month, but peak to trough moves of 10–11% have taken place in that time. Given the repricing across the renewable / clean energy space, associated metals continue to be hit hard, while industrial metals struggle on the back of the Chinese slowdown. Agricultural commodities are holding up relatively well on supply concerns.

Targeted exposure
Gold and oil provide the most effective hedges for investors concerned of geopolitical risk premium increasing, in our view.

Private markets

Is the IPO back open?
As we look back over the last 12 months one area that we note has seen a substantial tail-off following the highs of 2021 is the IPO market. As higher rates and an uncertain macroeconomic environment have resulted in a very risk-off position for investors, appetite for taking venture capital (VC) backed companies' public via the IPO market has been one of the hardest hit areas. To help illustrate the extent of the decline, during 2021, the peak of this market, we saw 102 VC backed, technology companies go public via the IPO market, as at the end of Q2 2023 that number stands at only nine. This sharp fall from grace has left many investors wondering whether the IPO market is dead, how long it could be dead for and what the possible implications could be for the VC portfolios they hold that are ready to exit.

While the overall number of IPOs are nowhere near their peak, as we have moved through 2023, largely the last two quarters, we have seen some more activity in the IPO market, with a number of high-profile companies successfully completing the process. However, before jumping to the conclusion of business as usual, it is important to highlight the recent outcomes. The table below highlights some of the IPOs that have taken place this year. A key area to note is how they have performed since being IPO'd relative to the market.

As you can see, performance has been negative across the board since their initial offering, which has left many investors still uncertain about whether the IPO market has reopened, and even if it has, whether now is the right time to take their companies public. While a number of these and their relative performance could be due to wider market sentiment towards their related sectors and geographies (Birkenstock and Oddity are two examples), we can see that all of these companies, as at the date of writing, are underwater relative to their IPO price. Hence, while all these companies were able to IPO, with a number of them being able to achieve the top end of their IPO price range (we believe these were able to due to them either being profitable or close to profitable), the broader public market appetite for these companies still remains limited.

In addition, a core component of the strength of the IPO market during the highs we saw a few years ago was due to the proliferation of SPACs (special purpose acquisition companies). In 2021, when the IPO hit its record high, SPACs accounted for 59% of new listings. This number is extremely important when thinking about the future of the IPO market relative to the boom period we saw. SPACs have always been around, but it was only during 2020 that they really took off, following a few, high profile successes. However, despite all the hype at the time (and there are a number of reasons we avoided them that we will seek to discuss another time), SPACs performance has proved to be underwhelming. The pressure on sponsors to complete transactions in order to monetise fees meant most of the SPACs completed were with relatively poor and unprofitable companies, that a standalone business would most likely have never made it. The chart on the next page helps display just how badly they have done since their boom period.

Pricing IPOs

Company	Initial price range ($)	Final price range ($)	Date: opening trade	IPO investor price ($)	Current stock price ($)*
Birkenstock	44–49	44–49	10/11/23	46.00	38.54
Klaviyo	25–27	27–29	9/20/23	30.00	27.50
Instacart	26–28	28–30	9/19/23	30.00	27.90
RayzeBio	16–18	16–18	9/15/23	18.00	18.80
ARM	47–51	47–51	9/14/23	51.00	47.90
Oddity	27–30	$32–34	7/19/23	35.00	26.26

as at 31 October 2023

Private markets (continued)

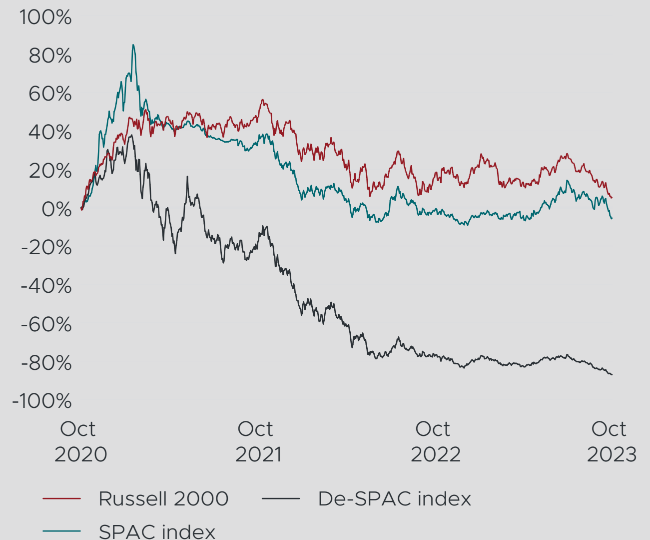
The chart highlights the performance of SPAC, De-SPACs (vehicle used to merge a private company with an existing public shell company that was formed as a SPAC), and the Russell 2000 since the highs on 2020 through to today.

This underwhelming performance and stain that has now been associated with the SPAC market, makes it highly unlikely, in our view, that SPACs will be used as a viable route for IPOs for the foreseeable future (at least until everyone forgets how badly they did), ultimately killing what was a large portion of the IPO market.

Therefore, when we combine weak public performance, reduced investor appetite, and the death of the SPAC market, we are of the view that the IPO market will remain in this period of limbo for the foreseeable future; completing a select and limited number of IPOs for companies that are at or very close to profitability.

In addition, a higher rate environment for longer also dampens our view that the IPO market will be back to normal levels any time soon; given the valuation disconnect and broader shift across asset classes we are seeing from investors (moving from equities to fixed income).

The popularity of SPACs has fallen

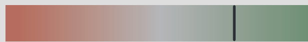


Source: Bloomberg/Saranac

Private markets

ALTERNATIVE SOURCES OF RETURN

Secondaries

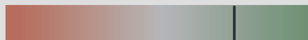


Record levels of secondary volume as investors seek to rebalance portfolios has resulted in a very attractive pricing environment

Special situations

Favourable market environment given the likely stress corporates will face in a higher rate environment

Venture capital



Early-stage venture has benefited from the correction in late-stage valuations, providing an opportune time to invest in long-term productivity gains, labour replacement and other venture investment qualities

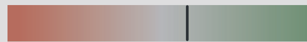
Infrastructure

More attractive given supply chain issues and geopolitical uncertainties

Real estate

Pricing is unattractive given the narrow spread (in some cases negative) between cap rates and the risk-free

GP stakes and financing



Opportunity of higher yield and greater downside protection as a result of attractive secondary pricing dynamics

Real assets

At risk from weak growth environment

Private debt

A negative economic outlook with the potential for above-trend default rates and extension risk make private direct lending unattractive on a risk-adjusted basis

Leveraged buyouts

EBITDA multiples have begun softening and hence in time valuations could again become attractive

Mid-market growth

A prolonged period of weak/negative earnings growth as a result of a weak economic environment and increased cost of capital will see valuations struggle in the short term

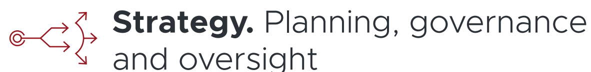
ABOUT SARANAC PARTNERS

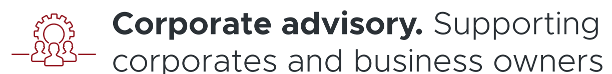
We founded Saranac Partners to do things differently. To create a community based around like-minded people, shared wisdom and collective learning. To work as partners, creating compelling opportunities and effective solutions. To offer unfailing support, honest challenge and thoughtful inspiration.

Our business combines the personal touch of a private office with the capability and breadth of a large institution. Our firm has strategic shareholders, outstanding technology, broad capabilities and the highest standards of corporate governance. Saranac Partners is a signatory to the United Nations Principles of Responsible Investing (UNPRI).

OUR SERVICES

We start with the question. We listen and seek to understand. We don't make assumptions or force solutions. Rather we co-create a path with our clients.





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