Investment Spotlight

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COVID-19, Climate Change and the Implications for Thematic Investing

Dear Reader,

Nearly a year into the COVID-19 pandemic, some clear implications for thematic investing can already be observed. In many ways, the risks and challenges posed by the pandemic are similar to those presented by another global threat – climate change. Both crises will change our world permanently, and in this Spotlight we explore some of the long-term fundamental shifts happening in our world, as well as what this means for thematic investors.

COVID-19 has also aggravated today's low growth environment, making it harder for investors to find returns. However, we believe excess returns can be captured by combining a long-term thematic approach together with an integrated sustainability investment process. It is clear to us that sustainability, in particular, will be a key performance driver going forward, as one of the largest capital needs will be fuelled by the necessity to address climate change. Moreover, this powerful combination of sustainable and thematic investing is key to being well-positioned for the transition into a greener and more sustainable future. J. Safra Sarasin Asset Management aspires to be at the forefront of the transition, and in May, it launched a Climate Pledge aiming for a carbon-neutral outcome in assets under management by 2035.

Kind Regards,

Giles Money
Lead Portfolio Manager

Nevena Schaller
Investment Specialist

Long-term thematic investors assess investments based not only on developments over quarters, but on fundamental and structural changes that occur over the span of decades. Indeed, many long-term trends have already been in place for some time, but the onset of the COVID-19 pandemic has certainly amplified the magnitude and accelerated the pace of change in many cases. Nearly a year following its outbreak, clear implications the pandemic is having on thematic investing can be seen.

COVID-19 and climate change will change our world in permanent ways

In some respects, the risks and challenges posed by COVID-19 and climate change share many similarities. COVID-19 will have lasting implications, not unlike climate change, and the notion that the pandemic will not have permanent effects on society on the economy is extremely far-fetched. Already, the market has seen a huge amount of "stranded" capital with high debt loads, from the bankruptcies of many firms like retailer JC Penny to car rental firm Hertz. In this regard, there is a substantial similarity to climate change and its ultimate impact if carbon emission levels are not reduced significantly. COVID-19 has shown us what a global threat looks like, and it did so at breakneck speed.

How are they similar? The "revert to normal" theory assumes that COVID-19 is just like many other natural disasters, which typically end with a rebuilding and/or a redistribution of people and assets. However, the Fukushima nuclear disaster in 2011 has proved to be an example where this is not the case. It was a natural disaster that dramatically altered the outlook for the use of nuclear energy and many countries' desire for a nuclear future. The price of uranium, which has fallen over 50% since the nuclear meltdown, illustrates this story well. Germany has decommissioned many nuclear plants and cancelled plans to open any new ones. Even in China, the number of nuclear facilities actually built has fallen short of initial expectations[1]. Likewise, we believe COVID-19 and climate change are disasters that will not

[1] Source: World politics review – MIT technology review

follow a “revert to normal” pattern, but instead will change our world in lasting ways.

Implications of COVID-19 over the medium-term

COVID-19 will result in permanent losses, not least the tragic human toll. It is also likely to claim other victims, as it permanently alters certain areas of society and the economy. One such example is **office space.** In a global survey from Jefferies, respondents indicated that going forward, they expect to work from home anywhere between an extra 0.5-1 day a week. If that was evenly distributed through the week, which is doubtful, there may be anywhere between 0-20% of excess office space. Of course this is a simplistic calculation, and it should be taken into account that offices are generally only 80% occupied. However, it gives a good indication of the general trend of falling occupancy rates, and the impact of remote working on office space. How that affects office construction or rents and asset prices remains to be seen, but it should be clear that there is a degree of permanence we will observe.

Offices are not the only area that face huge changes. The **airline industry** too, looks poised for an upheaval. The pandemic has hastened the demise of “jumbo jets” like the Boeing 747 and Airbus A380. Faced with an unprecedented drop in air travel, airlines were forced to ground fleets of planes. Yet, looking beyond the short-term implications of this, we believe there are also permanent reasons that “jumbo jets” are parked in the desert to be stripped for parts. Current survey data[2] suggests that one in five business trips is unnecessary, given the productivity gains achieved through emergent technologies such as Zoom. Whether companies cut business travel to save costs or because of climate considerations, air travel looks set to fundamentally change. Even as the world recovers from COVID-19, flying in huge jumbo jets will likely be replaced by smaller and nimbler aircraft. Both Boeing and Airbus are already ceasing production of the 747 and A380 models respectively, and in July, British Airways announced the early retirement of its entire fleet of 747s.

Exhibit 1: COVID-19 has hastened the demise of jumbo jets

Another example is **contactless payments**. Before COVID-19, only one in eight credit or debit cards in the US was contactless. There are many reasons why penetration is much lower than in Europe, but today, living with an ongoing pandemic, contactless payments have become the preferred choice. Its usage has already accelerated dramatically and it is hard to imagine that consumers, once used to its convenience, will turn back. Banks without a good infrastructure to support online banking would hardly have a choice but to invest in that today if they were to remain competitive. It is very clear that digitalisation has been the major beneficiary and in many cases, investment opportunities have become larger and are materialising sooner.

Distinguishing between enduring trends vs. transient fads

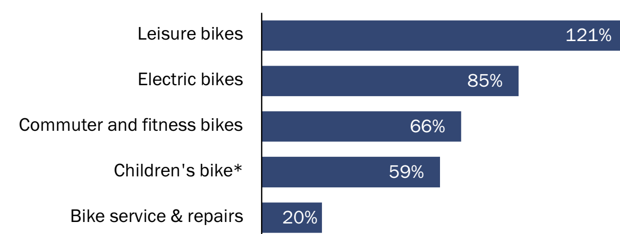
As long-term thematic investors going through such unprecedented times, we are acutely aware of the importance of distinguishing between enduring trends with longstanding impacts, versus fashionable fads that will soon fade away.

While the direct link between COVID-19 mortality and obesity over the long-term is hard to understand and establish, studies have clearly shown that people have become more conscious about health and dietary choices. Search activity for outdoor activities has spiked, while demand for cycling has boomed. As shown in Exhibit 2, bicycle sales in the US soared in March, with leisure bicycles seeing a 121% jump year-over-year. A survey from US bike manufacturer Trek reveals why. 85 percent of Americans said they consider cycling to be safer than public transportation during the coronavirus outbreak, while 63 percent of respondents felt that it helped to relieve some pandemic-induced stress or anxiety. Although we believe that cycling as a trend benefits from the pandemic, it remains to be seen how permanent these gains will be in the longer run.

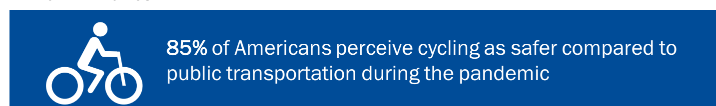
Exhibit 2: Soaring demand for bicycles in the US

COVID-19 pandemic fuels bicycle boom

Year-over-year cange in bicycle and bicycle service sales in the US in March 2020



* Incl. BMX bikes



Source: the NPD Group, Trek, Engine Insights.

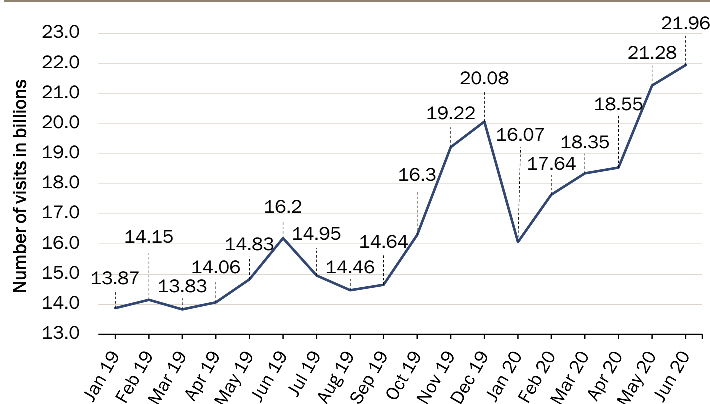
Similarly, it is estimated that 300 million people will join the emerging middle class income group over the next five years. This is expected to drive demand for travel and luxury goods, which regularly feature as some of the most-coveted goods for this group. COVID-19 may have temporarily dampened their demand, but this could bounce back strongly once lockdown measures ease again, and we do not expect demand for luxury goods to be permanently impaired. However, how long will we have to wait till this rebound occurs and what will the capital structure of companies look like by the time a recovery happens? These questions do not have clear answers at this point in time. Almost a year into the pandemic, less than half of people surveyed are comfortable booking holidays for 2021, and shopping malls remain 40 percent empty[3].

[2] Source: Jefferies Research “Cooped up but coping – A fresh look at consumer intentions”, 10.09.2020

[3] Sources: Jefferies Research, Prodo and Bloomberg Intelligence

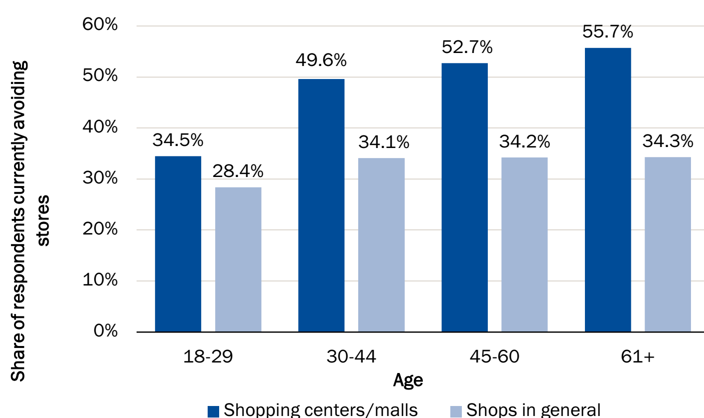
On the other hand, the growth of e-commerce as a trend is likely to stay over the long-term. Without doubt, COVID-19 and the resulting lockdowns around the world have spurred a boom in e-commerce sales, as more people avoid going to stores, turning instead to online sources for their shopping needs. From Exhibit 3, we can see the drastic impact the pandemic has had on site traffic to e-commerce sites, such as Amazon and eBay. According to Coresight Research, 56% of people in the US aged 61 years and above are avoiding shopping malls, more than any other age group (Exhibit 4). As more people in this age group who were once regular visitors to stores and supermarkets become used to purchasing goods online, many could become online shopping converts and even loyalists. Even after the pandemic ends, this may have been enough to sufficiently alter the buying behaviour of many people. Moreover, the e-commerce penetration rates in most countries are still very low, meaning there is ample room for growth.

Exhibit 3: COVID-19 impact on global retail e-commerce site traffic 2019-2020



Source: SEMRush, January 2019 to June 2020; data is based on over 2'000 of the world's most visited e-commerce websites across multiple categories

Exhibit 4: Share of US consumers avoiding stores because of the coronavirus outbreak



Source: Coresight Research, as of February 2020.

Implications on portfolio construction

With the heightened market volatility, uncertainties, and acceleration of many trends, what are the implications for portfolio construction? We believe it is prudent to conduct stress-testing as meticulously as possible and explicitly avoid the "unknowns", even if valuations look extremely attractive. One should never invest in something one does not understand, but this has never been truer, given the significant risk of permanent capital loss. As investors, we have widened our nets. COVID-19 has changed the investment cases for many companies, and we have adjusted the allocations in our portfolio to take advantage of this. As a result, the turnover in the portfolio has never been as active as before.

With volatility also comes great opportunity, and the biggest question for us lies in predicting the normalisation of that volatility (e.g. utilisation of office canteens returning back to normal), and avoiding the types of volatility where we do not foresee it reducing sufficiently enough to be able to confidently price the asset (e.g. how much is an Airbus A380 worth?). We have found significant opportunities where investments were overly discounted against scenarios where behaviour has actually reverted back to near "normal" levels. We also hypothesize that there are clear and obvious beneficiaries, where the market has often underestimated the permanence of the trends that benefit them.

Having said that, valuations will be impacted in the nearer term by US politics, Brexit negotiations, unemployment rates and stimulus, and any progress in the development of COVID-19 vaccines. As such, we aim to be balanced and well-positioned on the trends that are evident in the market. Sometimes, the answer is simply "I don't know and I can't tell you with any certainty."

In recent months, there have been lively discussions around the "Value versus Growth" debate. Since the Global Financial Crisis in 2008, Growth stocks have generally outperformed Value stocks, buoyed by an expansionary environment and low interest rates. However, the next downturn could lead to the end of Growth's strong run, leading some to expect that the tables may turn soon. The dominant force influencing this is inflation and true underlying growth of the global economy. And today, the economy is on life support from aggressive quantitative easing and generous fiscal stimulus measures. We do not see a clear case for structural inflation to make a comeback, and ultimately, we believe that high debt levels, aging demographics and the looming threat of deflation will continue to drive the scarcity of growth. Instead of dwelling on the "Value versus Growth" debate, we focus on stock-picking, and finding compelling valuation arguments for all our investments, regardless of which style buckets they fall into.

Sustainable and thematic investing in the low-growth environment

In today's low growth environment, many investors are struggling to find returns. This new normal means they are often no longer choosing between more or less growth, but rather, growth versus decline. This is further compounded by COVID-19, which has hastened many structural changes. To be well-positioned for this future, we believe investors can capture additional returns by looking for attractive opportunities using the lens of sustainability, combined with a thematic approach. Where growth rates of economies are low and likely to remain so, finding thematic or structural growth becomes even more important. Applying a thematic approach allows investors to harness long-term structural growth opportunities to identify and invest in businesses that provide the right solutions for the future, while avoiding

companies that fail to address challenges. At the same time, integrating sustainability into an investment framework helps to capture valuable insights, painting a more holistic investment case.

Looking at this year alone, sustainability has been supportive for performance, but the big winner since the outbreak of COVID-19 has clearly been digitalisation. The share prices of FAANG[4] and other technology stocks have surged this year, helping to drive the performance of many so-called "sustainable" funds, which they happen to qualify as, thanks to their low carbon levels. However, stripping aside the funds' bias to digitalisation, we believe sustainability has not been a huge delta so far.

Sustainability will be a crucial performance driver in future

Yet going forward it is clear for us why sustainability will be a key performance driver. One of the largest capital needs in the future will be fuelled by the necessity to address climate change. In our view, climate change is one of the few externalities that has not been appropriately priced in by the markets yet. However, that time will certainly come, perhaps even faster-than-expected, and investors will not want to be caught on the wrong side when that happens.

The Spotlight began by arguing that COVID-19 is a good reminder of the true risk of climate change. Besides avoiding stranded assets and other climate-related investment risks, climate change also presents many attractive long-term opportunities. The Managing Director at the International Monetary Fund, Kristalina Georgieva said, "The best memorial we can build for those who lost their lives in the pandemic is a greener, smarter, fairer world." The European Union has already made it clear that all reconstruction efforts will be prioritised along the "New Green Deal", and much of the stimulus money doled out in Europe has been directed to green projects. Canada is making grants and credit conditional on climate-related reporting. Furthermore, the potential for a new green deal in the US will be even more impactful.

Kristalina Georgieva, Managing Director at the International Monetary Fund[5]

"The best memorial we can build for those who lost their lives in the pandemic is a greener, smarter, fairer world."

For J. Safra Sarasin Asset Management, it is thus clear that climate change has huge implications for the world and for the industry. In May it launched a Climate Pledge aiming for a carbon-neutral outcome in its assets under management by 2035. This means developing its sustainable investment processes further with the goal of achieving net-zero carbon emissions in its portfolios. There are three levers that are used. First, by investing in companies that enable emissions reductions and that take the progression of climate change into account in their operations and strategy. Second, by engaging with all companies, fostering collaboration in order to promote climate change mitigation and adaptation. Third, by focusing on analysing, mitigating and reporting financial risks of climate change in J. Safra Sarasin Asset Management's investment strategies. Indeed, with the integration of sustainability in its investment processes, many of its investment strategies already report carbon footprints that are significantly lower than their respective benchmark indices. This is expected to continue improving further, paving the way to achieve a carbon-neutral outcome by 2035.

J. Safra Sarasin Asset Management Launches Climate Pledge

While attention on climate change is extremely important, it reflects only one area in the much larger picture of sustainability. As leaders in sustainable investments with over 30 years' experience, J. Safra Sarasin is firmly committed to integrating sustainability throughout its investment processes. Moreover, having a long-term thematic investment approach with sustainability at its core, is key to being well-positioned for the transition into a greener and more sustainable future. COVID-19 has given us a glimpse into not only the possible impacts of ignoring climate and sustainability-related risks, but also the investment opportunities that can come with harnessing long-term trends and picking out the right winners.

[4] FAANG stands for Facebook, Amazon, Apple, Netflix and Google

[5] Image source: Wikimedia / Image under the Creative Commons Attribution-Share Alike 4.0 International license.

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