Insight INVESTMENT

MAY 2022

ABSOLUTE RETURN EQUITY TEAM MONTHLY DESK REPORT

MARKET BACKDROP

In May, the European equity market index fell slightly, while the S&P 500 Index briefly moved into bear-market territory (on an intraday basis), before recovering towards the end of the month. May was particularly volatile, and beneath the relatively stable headline return of the European index there was a wide dispersion across sectors. Oil and gas was the best-performing sector by some margin. Meanwhile, the food and beverage sector was the worst, affected by increasing concerns that companies will not be able to fully pass on rising input costs, and consequently experience squeezed margins.

May saw the conclusion of the first-quarter results season, which generally beat expectations. However, management outlooks remained cautious, given the widespread uncertainties. Market participants remain concerned about how the consumer will fare given the rising cost of living, and particularly how this will affect discretionary demand. The warnings from Walmart and Target in the US heightened these concerns. The ongoing Chinese 'zero COVID' policy remains a potential significant risk and headwind. News that Chinese authorities were preparing to reduce restrictions in Shanghai and gradually reopen, suggests that the country may be through the worst of its recent COVID-19 outbreak and accompanying lockdowns.

Inflation remains elevated, with consumer prices in the UK recording an annual increase of 9% in April. On the last day of the month, the flash annual consumer price inflation for May in the eurozone was reported as 8.1%. This is the highest rate since the formation of the European single currency.

CONTRIBUTORS TO STRATEGY PERFORMANCE

The strategy's return was marginally negative in May though our position in ING contributed positively over the month. Further positive contributors to performance in May were our long positions in three oil majors that are mainly hedged against the market. Oil prices, which rose significantly over the month, supported these positions. This provides a very strong backdrop for favourable future earnings reports, which is further enhanced by significantly rising refining margins. Repsol, where we hold a long position, is one of the most exposed stocks to refining. Low diesel and gasoline inventories, and the anticipated gradual departure of Russian products in the market, are driving higher margins. Refining in North America and Europe is also an area where there has been reduced investment over the last decade. Despite the performance of the oil majors, at the current oil price, they remain very lowly valued, in our view. As we have alluded to before, the behaviour of the majors' capital allocation has significantly changed, with a focus on returning excess cash to shareholders in the form of share buybacks. In a weak market, the share buybacks provide a clear support to the share price.

One area that detracted from performance was our long position in Segro, hedged against a bond-price-sensitive custom basket and the retail sector. Comments from Amazon after the release of its first-quarter results that the company is no longer chasing physical capacity caused weakness across the listed logistics real estate space. Segro has grown its net asset value (NAV) per share by c.17% (compounded annual growth rate) over the last five years and has already reported strong rental uplift and low vacancy rates for the first quarter. Its peers have echoed these comments and have also reported that demand for space is currently exceeding supply. Given the volatility in the shares, we trimmed our position, but they now trade at a discount to the reported NAV (as at December 2021), which has historically proved a supportive level for the share price.

One of the strategy's relatively new long positions is in RWE, a Germany-listed utility. We believe the company is a significant beneficiary of Europe's drive to reduce its dependency on Russian energy, particularly gas. RWE is a major renewables developer, and its growth ambitions are expected to benefit from the increased push to accelerate installed capacity. Additionally, RWE's lignite plants in Germany have suddenly become a very important strategic asset, and its earnings power has risen substantially, due to higher power prices. In an increasingly uncertain and fraught economic environment, RWE is in an interesting earnings-upgrade cycle. We have hedged the position against the utilities sector and a basket of regulated utilities names that do not have the same growth or earnings momentum.

OUTLOOK

Investors remain concerned that recessions may be difficult to avoid in coming quarters as broad-based inflation continues to erode real incomes for consumers and constrains discretionary spending. Corporate margins have so far held up in the face of inflationary pressures, but it may only be possible to increase prices so far before demand is choked off. We should also consider the effects of interest-rate hikes and the fallout from COVID-19 lockdowns in China and the conflict in Ukraine on both supply chains and overall demand.

In volatile equity markets such as we are seeing, investors would ordinarily seek safety in fixed income assets. However, these too are undergoing a repricing to reflect evolving inflation expectations, with accompanying volatility. With the outlook for equity and bond beta seemingly still fragile, in our view this presents an ideal opportunity for absolute return strategies such as ours to highlight the value they can bring to an investor's portfolio.

In response to the inflationary environment, we believe the European Central Bank is likely to begin hiking interest rates in July, with the market now pricing in almost 1¼% of increases by the end of 2022. Higher rates should provide a tailwind for banks' net interest income, and we believe our long position in ING will be a clear beneficiary. The position is hedged 50% against the wider market, and 50% against the banks sector. ING trades at what we believe is an attractive 0.75x tangible book value and the company has a significant amount of excess capital that it plans to return to shareholders over the next couple of years. This is expected to come in the form of special dividends and share buybacks, which should be positive for the stock.

As ever, we are actively managing our factor exposures as we aim to ensure idiosyncratic risk remains the dominant driver of returns.

IMPORTANT INFORMATION

TEN-YEAR PERFORMANCE RECORD TO 31 MARCH 2022

	Calendar year returns									
	2021	2020	2019	2018	2017	2016	2015	2014	2013	2012
Insight's absolute return equity strategy	3.78	2.03	-0.66	-3.04	3.42	0.86	4.74	2.88	8.76	8.49
Performance benchmark	0.06	0.21	0.72	0.60	0.29	0.41	0.51	0.50	0.49	0.62

	12-month rolling returns									
	2021-2022	2020-2021	2019-2020	2018-2019	2017-2018	2016-2017	2015-2016	2014-2015	2013-2014	2012-2013
Insight's absolute return equity strategy	3.00	5.40	-0.68	-5.43	5.58	1.46	2.92	1.13	6.78	12.31
Performance benchmark	0.13	0.07	0.68	0.66	0.35	0.34	0.51	0.50	0.49	0.55

Please refer to the following risk disclosures. Returns are shown gross of fees. The absolute return equity strategy (C0829) is in GBP. Inception date: 30 March 2011. Please note that, from 1 November 2021, the performance benchmark changed to SONIA 30-day compounded (Sterling Overnight Index Average). Prior to then the performance benchmark was 1-month GBP LIBOR.

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees, taxes and charges and these can have a material detrimental effect on the performance of an investment. Taxes and certain charges, such as currency conversion charges may depend on the individual situation of each investor and are subject to change in future.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies over time, and/or prevailing market conditions and are not an exact indicator. They are speculative in nature and are only an estimate. What you will get will vary depending on how the market performs and how long you keep the investment/product. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialize or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

- Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.
- Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.
- The investment manager may invest in instruments which can be difficult to sell when markets are stressed.
- Exposure to international markets means exposure to changes in currency rates which could affect the value of the portfolio.

- Where the portfolio invests in small companies, these may be riskier and less liquid (i.e. harder to sell) and more volatile than large companies.

FIND OUT MORE

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