Handelsbanken
Asset Management

Investment Outlook 2022

Contents

Welcome to the 2022 edition of our *Investment Outlook*.

As we enter another new year, economies and policymakers around the world continue to find their feet in a maturing pandemic. Meanwhile, inflationary pressures have captured media attention, having taken investors by surprise in 2021. Our first article – *This is what the end of an emergency looks like* – makes the point that while inflation is distracting, major central banks look relatively unconcerned for now, and pricing pressures should begin to ease off in 2022.

Meanwhile, COVID-19 vaccinations continue to reduce deaths and hospitalisations, and enable the economic recovery to progress. We believe this recovery still has momentum, but as our next article – *Where are we in the economic cycle?* – points out, we suspect we may already have passed the peak of economic growth this time around.

Being aware of our position within this longer-term landscape matters hugely for the precise mix of assets we choose to include in our investment strategies. In our third article, *Building investment strategies fit for the future*, we detail how our views on the outlook for the economy and financial markets are represented within our strategies. We also discuss the instruments we use to diversify risk, as well as those aimed at uncovering attractive financial returns.

We are convinced that the search for the most rewarding investment opportunities should include paying close attention to the global themes taking shape all around us. In our fourth article, *Investing in the world's megatrends*, we highlight just three of the themes at work in our strategies: healthcare, technology, and renewable energy. And with COP26 fresh in all of our minds, our next article – *Can investment save the world?* – reviews the aims of the UN climate event, and considers whether or not the conference really managed to deliver meaningful change. Given the growing amount of assets now managed within our sustainable range, we also assess what COP26 means for sustainably-focused investments.

Bringing this edition of our Investment Outlook to a close, we lift the lid on some of the more unusual features of our income strategies. Our final article – *An alternative approach to finding income* – outlines three unusual areas of investment which lie beyond traditional financial markets, deployed as part of our commitment to delivering reliable, regular income flows.

As ever, we welcome your thoughts and feedback.

G Bishop

Graham Bishop, Chief Investment Officer

This is what the end of an emergency looks like

Global financial markets are extremely fast moving. Share prices hit their pandemic lows in March 2020, but the related economic contraction took much longer to truly hit home. It follows, then, that while financial markets recovered in record time, the economic recovery took a little longer to emerge.

Today, while we believe that the recovery still has momentum, we also feel that we may already have passed the peak level of growth for this particular cycle (see our next article, *Where are we in the economic cycle?*). This is at least partly because some of the positive factors boosting economic growth in the wake of the initial COVID-19 crisis are now beginning to fade.

Central banks and governments are beginning to step back

The policy decisions taken by governments and central banks, who have pumped unprecedented levels of stimulus into the economy over the past two years, set the foundations for both financial markets and economies to recover. But these were emergency measures, and cannot go on forever.

Today, many major governments are beginning to step back from their ultra-supportive programmes, such as the 'furlough' and employment protection schemes that were so vital during the darkest days of the pandemic. Importantly, any action policymakers take at this point is increasingly unlikely to have a major positive impact on economic growth, and governments are also looking at ways to tackle the huge bills incurred by fighting the human and economic costs of the pandemic. Higher taxation is one obvious solution, but the key would be managing this without harming consumer spending (and by extension the economic recovery).

Meanwhile, financial markets are keeping a close eye on central bank decision makers. Interest rate rises are on the horizon, alongside not merely the removal of ultra-accommodative policies like quantitative easing (central banks purchasing financial assets in the open marketplace), but also the prospect of quantitative tightening (central banks reducing the level of liquidity in the financial system).

Significant shifts like these in central bank policy must be communicated clearly, and executed prudently. Without this, financial markets will take fright, potentially leading to a disorderly rise in the costs of borrowing and doing business. In turn, this could put the household and corporate sector recovery under threat. Such a negative scenario is, we think, unlikely. However, even the spectre of a disorderly transition could cause bouts of short-term volatility along the way.

For now, both household and business balance sheets are in fairly rude health – an indirect benefit of the economic stimulus enacted by global policymakers. This means that both companies and consumers should be able to manage a gradual rise in the cost of capital as ultra-supportive emergency policies are slowly withdrawn.

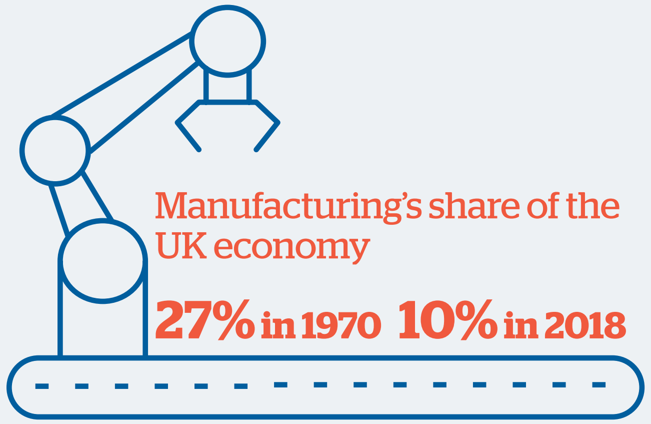
Inflation is distracting, but should begin to fade in 2022

Inflation is a headline-grabbing topic at the moment. We have even heard some market commentators using terms like 'stagflation', referring to the phenomenon of falling economic growth alongside rising inflation and rising unemployment. Is this feasible in 2022?

Put simply, we doubt it. Statistically, stagflation is a very rare occurrence – last truly experienced in the 1970s. We think a return to these conditions in the near future is extremely unlikely, least not because the global economy today looks very different to the 1970s. Forty years ago, manufacturing accounted for a much higher percentage of the economic landscape, which made the world economy very sensitive to commodity price changes. Union membership in the workplace was also much higher, creating upwards pressure on wages.

So, stagflation is unlikely, but what about plain old inflation? Our view is that the current inflationary pressures (created by a cocktail of factors including supply chain constraints and heightened commodity prices), are likely to persist in the very near term. However, over the course of 2022, these pressures should fade as supply chains normalise, commodity price rises ease off, and wage inflation in COVID-19-sensitive areas begins to fade. It is also worth noting that inflation is measured by comparing prices in the most recent time period to prices in a previous time period. This means that prices in 2022 will be compared to the elevated prices seen in 2021, which should automatically create lower inflation readings ahead.

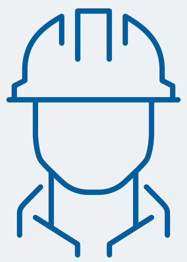
There are, of course, risks to our relatively sanguine view on inflation. Rising housing costs and wages can often set the scene for a more durable inflation scare, and both are going up at the time of writing. We are watching closely, but we are also mindful that central bank reactions are key in this scenario, and we do not believe that policymakers will act aggressively in response to inflationary pressures over the coming months. In the coming years, though, expectations of inflation among consumers and financial markets are likely to be higher than in recent history.



Gross Value Added (GVA) data. This is a measure of the contribution to the economy of the production of goods and services.

Source: UN, ONS.

Number of workers in the US manufacturing sector



July 1979
19.6million

October 2021
12.5million

Source: US Bureau of Labor Statistics

Where do we go from here?

As we enter 2022, we see a world of positive (if slowing) economic growth, with policymakers gradually stepping back from their ultra-accommodative emergency measures. Meanwhile, though the inflationary backdrop will continue to write the headlines in the near term, it should begin to fade and become less relevant as 2022 progresses.

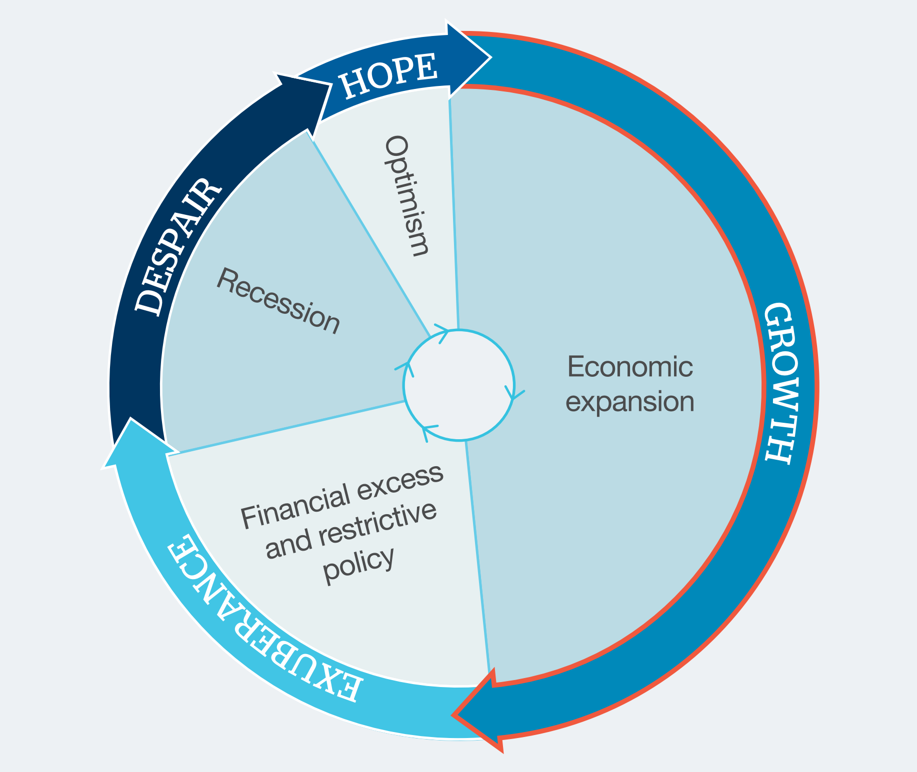
> "Statistically, stagflation is a very rare occurrence – last truly experienced in the 1970s. We think a return to these conditions in the near future is extremely unlikely, least not because the global economy today looks very different to the 1970s. Forty years ago, manufacturing accounted for a much higher percentage of the economic landscape, which made the world economy very sensitive to commodity price changes."
>
> David Absolon, Investment Director

Where are we in the economic cycle?

Pinpointing our position in the global economic cycle (sometimes referred to as the business cycle) is not an exact science. Some claim that the COVID-19 crisis simply paused a cycle which had been maturing since the 2008 financial crisis. However, we would argue that the pandemic brought the last cycle to a close, with drastic policies from governments and central banks setting the scene for a new cycle in March 2020.

The four phases of the cycle:

- **Despair** is a phase of economic recession, when risk assets like shares are hit hard, as we witnessed in early 2020.
- Next comes **hope**, when the financial cavalry arrives to steady the ship and set the foundations for economic recovery. Historically, the hope phase is very good for riskier asset types, as we saw when stock markets rapidly bounced back from their March 2020 lows amid stimulus from governments and central banks.
- We then move into the **growth** phase, which tends to be the longest of the four. This is an expansionary time, when lost output can be reclaimed, and new economic growth harnessed.
- The last phase of the cycle – **exuberance** – is characterised by excess and leverage (the use of borrowed money as finance) in the economic system, and central bank policy becomes more restrictive accordingly. In this phase, the prices of financial assets tend outstrip their underlying value, representing the last hurrah before returning to the despair phase.



Our current positioning

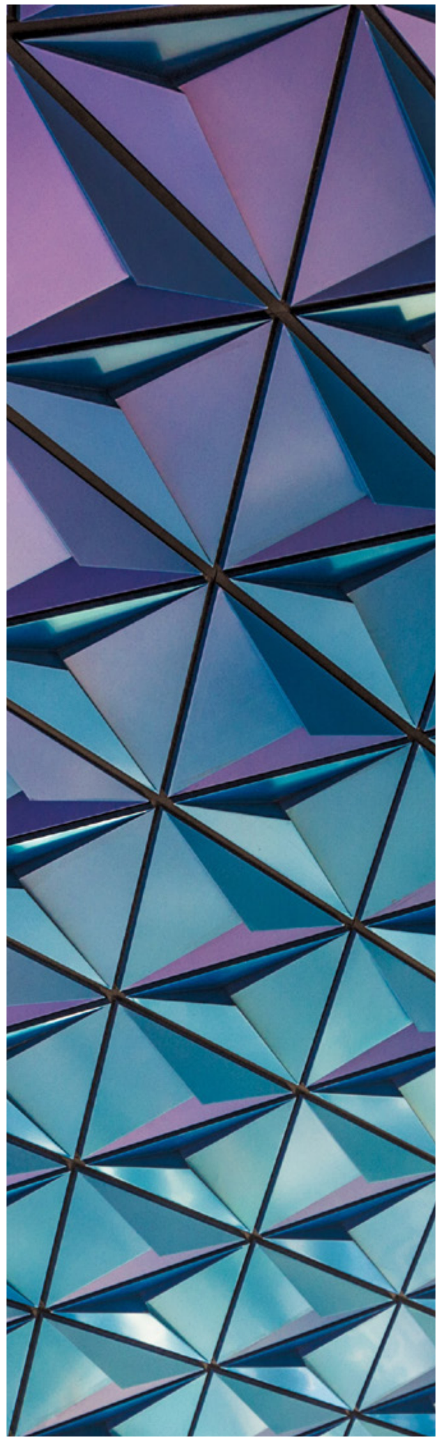
We believe we are currently in the growth phase of the cycle. Historically, this period favours riskier asset types like shares, but typically less so than the hope phase. Asset valuations are more elevated to begin with, and policymakers begin to step back.

Normally, in the early part of the growth phase, corporate and household balance sheets are being rebuilt, ready for deployment later in the phase. But average household finances actually improved during the pandemic, with household wealth rising faster than economic growth. As a result, the current growth phase might have been more potent than others in history in its earlier stages, due to the ready cash available to consumers and robust corporate balance sheets.

Our view on where we are in the economic cycle is critical to the mix of assets we hold across our investment strategies. In the next article, we explain more about our current positioning.

Building investment strategies fit for the future

When we talk about asset allocation, we're referring to the way in which we match up the types of assets in our investment strategies with our view of the world, and the outlook for financial markets.



How do we choose which assets to hold in our strategies?

Our approach to asset allocation is to first identify our current position in both the economic cycle (see our article *Where are we in the economic cycle?*) and the investment cycle (how asset prices are behaving, and what their prices already account for). The latter tends to be a good leading indicator for the former, which doesn't make tactical decisions about asset allocation any easier. Nevertheless, we use a wide selection of tools and analytics to assess our current position in the cycle, so as to estimate when the next phase will come around, and – equally importantly – what this might look like.

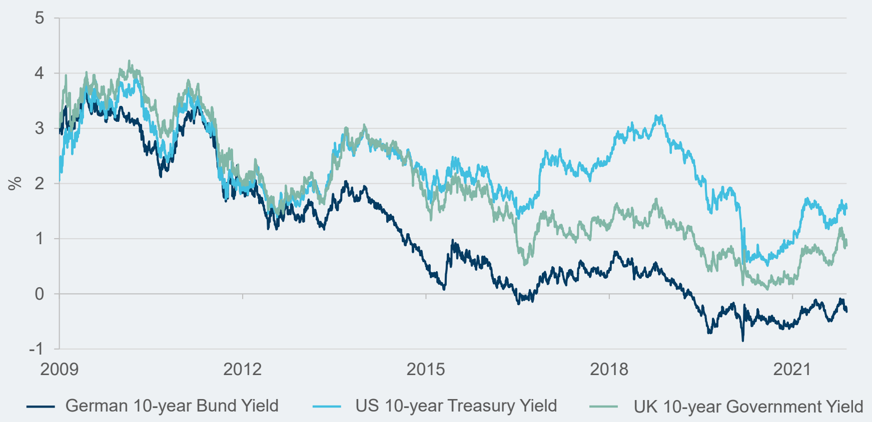
Implementing these views means using a broad selection of investment vehicles, including actively managed funds, passive (market-tracking) products and directly-owned assets. Passive products are great at keeping costs down, but are not designed to avoid the market losers, which is why we blend these positions with actively managed funds within our strategies. Evaluating whether or not these holdings are fit for purpose, and if they are adding value, is another important task.

It's commonly understood that diversification – avoiding putting all our eggs in one basket – should be a key feature of investment strategies. However, this is really only truly possible if investors are able to look beyond traditional asset types (like shares and government bonds) and think creatively. We spend a lot of time on this endeavour, as the range of competing investment opportunities on offer is constantly evolving and becoming more complex.

We strive for 'return drivers' (the assets we hold in an effort to secure attractive financial returns) that have different characteristics versus traditional shares – the historical 'go-to' asset type for returns. Similarly, we look for ways to diversify risk beyond government bonds, as we question their future efficacy in a world of incredibly low bond yields.

Low returns on government bonds reduce their appeal

US, UK and German government bond yields



Source: Bloomberg, Macrobond

How are our strategies positioned at the moment?

Returning to the economic cycle, we feel that COVID-19, though certainly not behind us, was akin to a natural disaster in both its impact and in the response from policymakers. Financial markets reacted to the hard stop of economic activity in early 2020 with some rigour, but this proved short-lived. Today, we believe the global economy has transitioned from the recovery phase to a more sustainable, 'back to normal' state of affairs. In this environment, we would expect drivers of financial returns, like shares, to still generate positive returns, but we would anticipate this being accompanied by more volatility. This phase can last many years, so we are optimistic that over-exuberance in financial markets is some way off, but this is something we are monitoring very carefully.

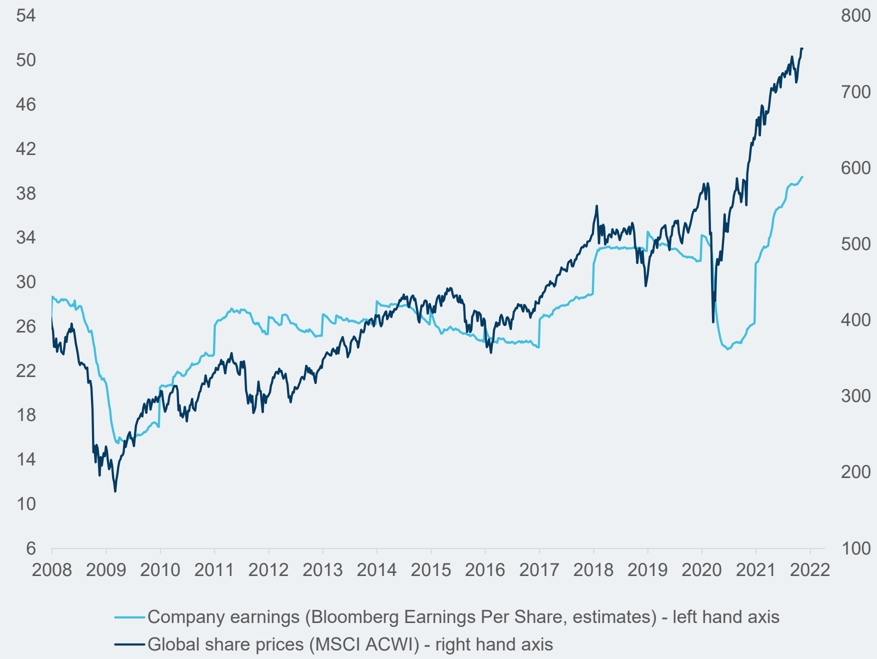
Another key characteristic of the current 'growth' phase of the economic cycle is that the inflation expectations implied by bond market signals tend to rise. This is certainly something we are seeing play out in the inflation data at the moment (as we discussed in our article *This is what the end of an emergency looks like*). We expect that inflation will eventually return to close to its longer-term average, though, and the world's leading central banks appear to share our view.

Shares are good assets to hold when inflation concerns are prevalent, as corporate earnings are intrinsically linked to inflation. However, share prices have advanced strongly, and have already accounted for a reasonable amount of good news (see chart, above right). Mindful of this, and the risks facing any growth phase, in 2021 we reduced our allocation to shares to close to our long-term average.

Our preference is for growth-orientated businesses like healthcare and technology. Despite intermittent political and regulatory headwinds, the stability and persistence of growth is something that we value at times like these. We also have meaningful exposure to the shares of small and mid-sized companies, who are playing catch up to larger dominant companies. This also represents one route through which we are playing the UK stock market. Other regions that appeal include emerging markets, partly for their growth potential, but also (and perhaps more importantly) as a way of capturing the lift in global economic activity, supply chain issues notwithstanding.

Company earnings are linked to inflation, but share prices have already risen strongly

Index values of global share prices (MSCI ACWI) and company earnings (Bloomberg Earnings Per Share, estimates)



Source: Bloomberg, Macrobond

> "Diversification should be a key feature of investment strategies. However, this is only truly possible if investors are able to look beyond traditional asset types and think creatively."
>
> Graham Bishop, Chief Investment Officer

On the flipside, our cash weightings are slightly above normal, as we wait for opportunities to present themselves. We have elected not to add to government bonds just yet, as we suspect bond yields (which move inversely to prices) will further rise, pushing prices down. This is partly related to inflationary concerns, but has more to do with desperately low yields on bonds, which make the potential trade-off between risk and reward unappealing. There are parts of debt markets which do look attractive, such as emerging market debt.

As we noted earlier, we are always on the lookout for creative return drivers. In essence, these are asset types or securities which are largely uncorrelated to either traditional financial markets or the economic cycle. With this in mind, we presently have exposure to music royalties, social housing and renewable energy, to name but a few. While these asset types are subject to their own unique risks, they also offer something different, and can help to smooth financial returns within our strategies over time. Among the assets we hold with the aim of diversifying risk, apart from cash, we are happy holders of gold, Japanese government bonds, specialist hedge funds and minimal quantities of UK government bonds.

Investing in the world's megatrends

We believe that exciting investment opportunities can be found in the global megatrends driving change across the world. These long-term trends don't always fit into conventional financial market classifications; they can cut across traditional industry sectors and traverse geographic borders.

Our investment strategies seek out positions across a number of global themes, aiming to capture attractive financial returns over the long run. In this article we explore three of these themes.

1. Harnessing healthcare innovation

What's the theme?

The demographic profile of our society is changing. Populations are ageing, and living for much longer. In 1950, around 10% of the UK population was aged over 65; today, that figure is close to 20%. Accompanying these statistics is the unwelcome reality that older populations cost much more to look after.

Against this backdrop, healthcare spending is picking up, driving technological advances and new medical solutions, which in turn drives further healthcare spending. From a financial markets perspective, we have observed a link between the relative performance of companies operating in and around the healthcare sector, and the amount of spending channelled towards this area. This also creates fertile ground for mergers and acquisitions among businesses, particularly in the biotechnology space, where many large pharmaceutical companies need to replenish their drug pipelines in order to deliver ongoing innovation.

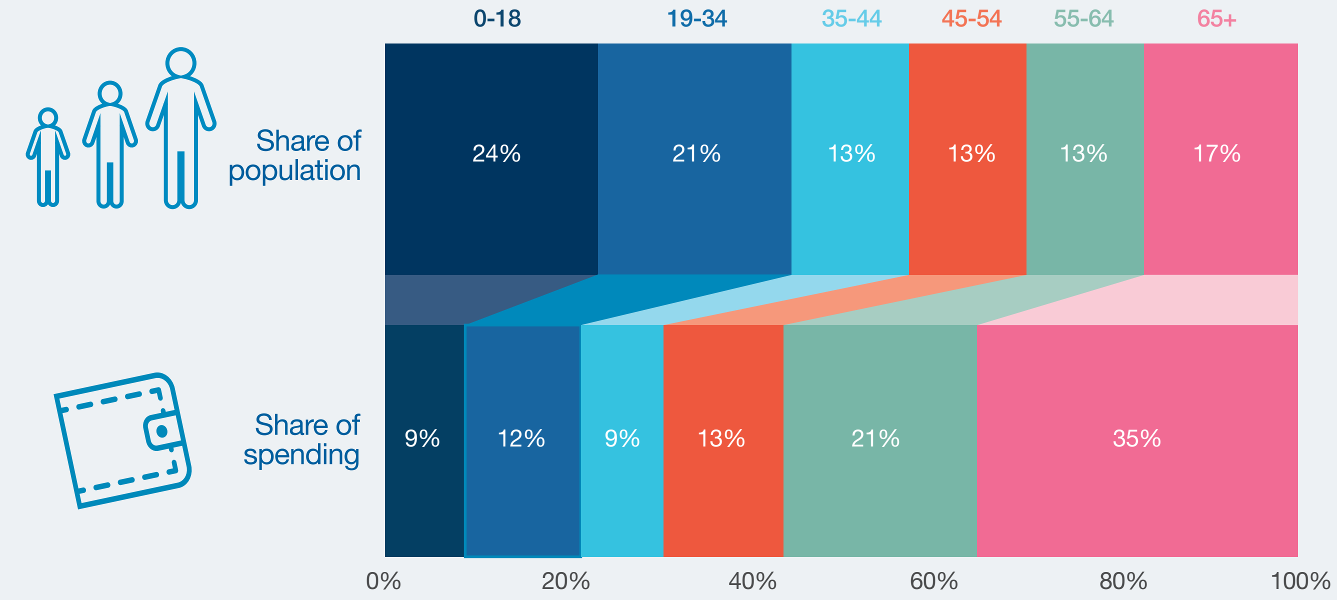
Taken altogether, this positive dynamic presents a virtuous cycle of significant long-term growth opportunities for investors. The healthcare sector also offers investors defensive qualities, as it has low sensitivity to wider economic events.

How do we integrate this into our strategies?

The complicated nature of the healthcare universe is well-suited to a specialist investment approach, and we invest in a number of funds whose managers have deep knowledge of the sector. Our chosen funds select investments based on a range of factors, from company size to 'best in class' healthcare and technology innovations. We also invest in broader financial market trackers centred on healthcare businesses pushing the boundaries in medical treatment and technology, allowing us to gain cost-effective exposure to some of the most exciting sub-sectors in the space.

Healthcare spending per person dramatically increases as people age

Share of total health spending by age group (years), 2019



Source: Peterson-KFF Health System Tracker

2. Backing a technological revolution

What's the theme?

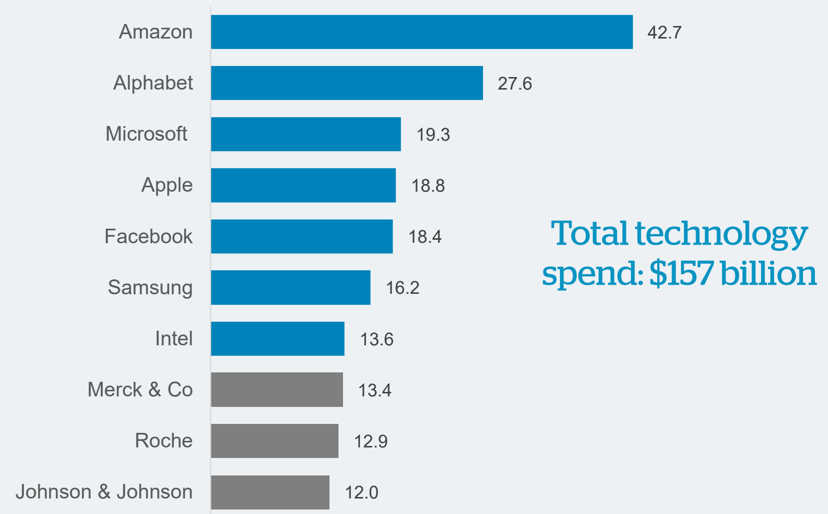
Innovation in the technology space represents a powerful global megatrend, and one which has only been accelerated by the COVID-19 pandemic. Key underlying drivers include the increased use of cloud technology by businesses, the adoption of digital payment systems by consumers, and the pursuit of autonomous vehicles.

All of this innovation is being driven by huge spending on research and development (R&D). In 2020, of the ten companies which spent the most on R&D, seven were technology-driven firms, with a total combined spend of over $150bn. This level of spending on developing ground-breaking new technologies, products and services puts these firms at a significant competitive advantage. It helps to drive their overall profit growth well in excess of economic growth, an attractive proposition for investors.

Many large tech companies are also sitting on piles of cash. Tech giant Apple, for example, has around $50bn in its coffers. The cash-rich nature of many tech firms should help them to maintain healthy R&D spending, even when companies in many other sectors may be forced to cut back, for example in an economic downturn.

The technology sector leads the way in self-investment

Top ten global spenders on R&D (US$bn) in 2020



Source: Bloomberg

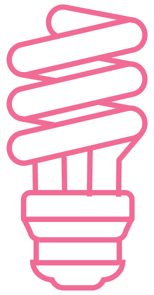
How do we integrate this into our strategies?

We implement our conviction in the technological revolution megatrend through a range of vehicles across our investment strategies. We invest in funds with broad exposure to the tech sector, which can be well-suited to the rapid pace of technological change and capturing new entrants to the leader board. Some of our investments take a more specialist approach, seeking to benefit from sub-trends like the long-term shift to digital in the global financial infrastructure. Tapping in to our conviction in emerging market investment opportunities, we also invest in a fund which aims to access the growing incomes, domestic consumption and demographics (so-called 'Gen Z') within developing economies.

3. Fuelling a sustainable future

What's the theme?

Environmental, social and governance issues are an increasing area of focus for world governments, companies and consumers. As part of this, the energy transition is set to be another key megatrend over the next decades, and one which aligns very clearly with the UN's Sustainable Development Goals around affordable and clean energy and climate action.



Energy accounts for around **60%** of total global greenhouse gas emissions

Energy accounts for around 60% of total global greenhouse gas emissions (making it the main contributor to climate change), so it is little surprise to see that gains in renewable energy are central to achieving the UN's climate goals. In recent years, rapid growth in hydropower, wind, and solar energy has taken place, and access to electricity in some of the world's poorest countries has been picking up pace. But there is still much work to be done.

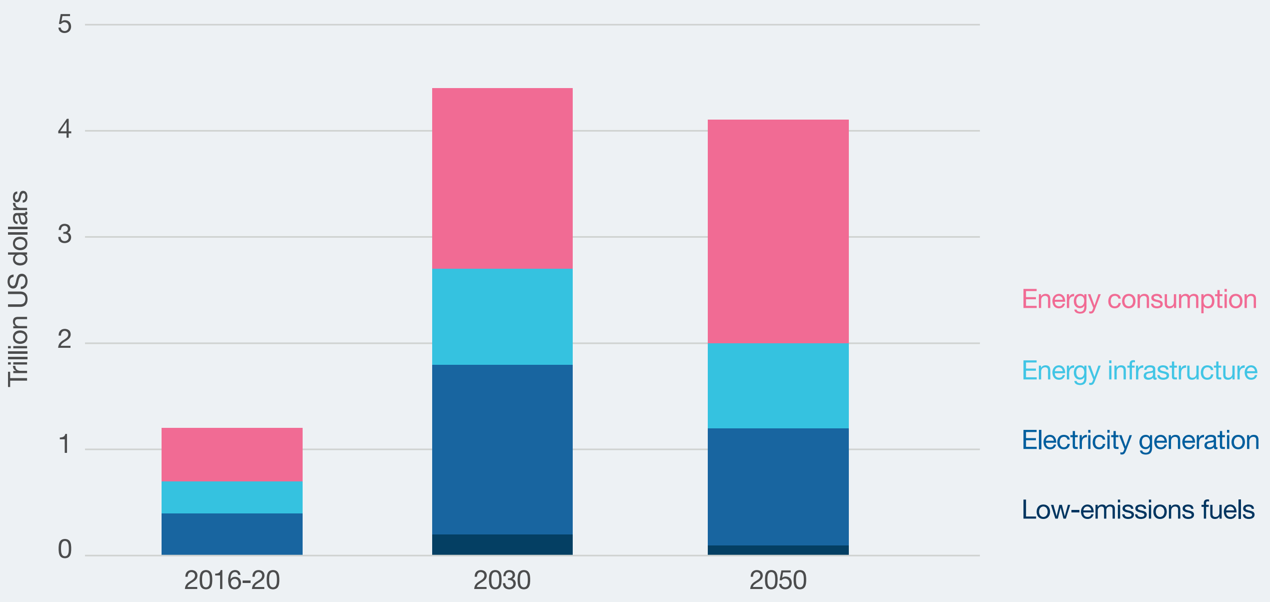
We talk more about the UN's latest climate-focused event (COP-26) in our next article. It's clear that large amounts of private capital will be required to support public policy and climate goals for a long way into the future, and this will create huge investment opportunities.

How do we integrate this into our strategies?

Our strategies have positions in a variety of clean-energy-focused funds. This includes exposure to companies involved in the generation, storage, efficiency and consumption of sustainable energy sources (such as solar, wind, hydro, geothermal, biofuels and biomass). We expect the dramatic social and regulatory shift towards a sustainable energy system over the coming years will be hugely beneficial for the companies associated with this space.

Clean energy investment is set to surge in the coming decades

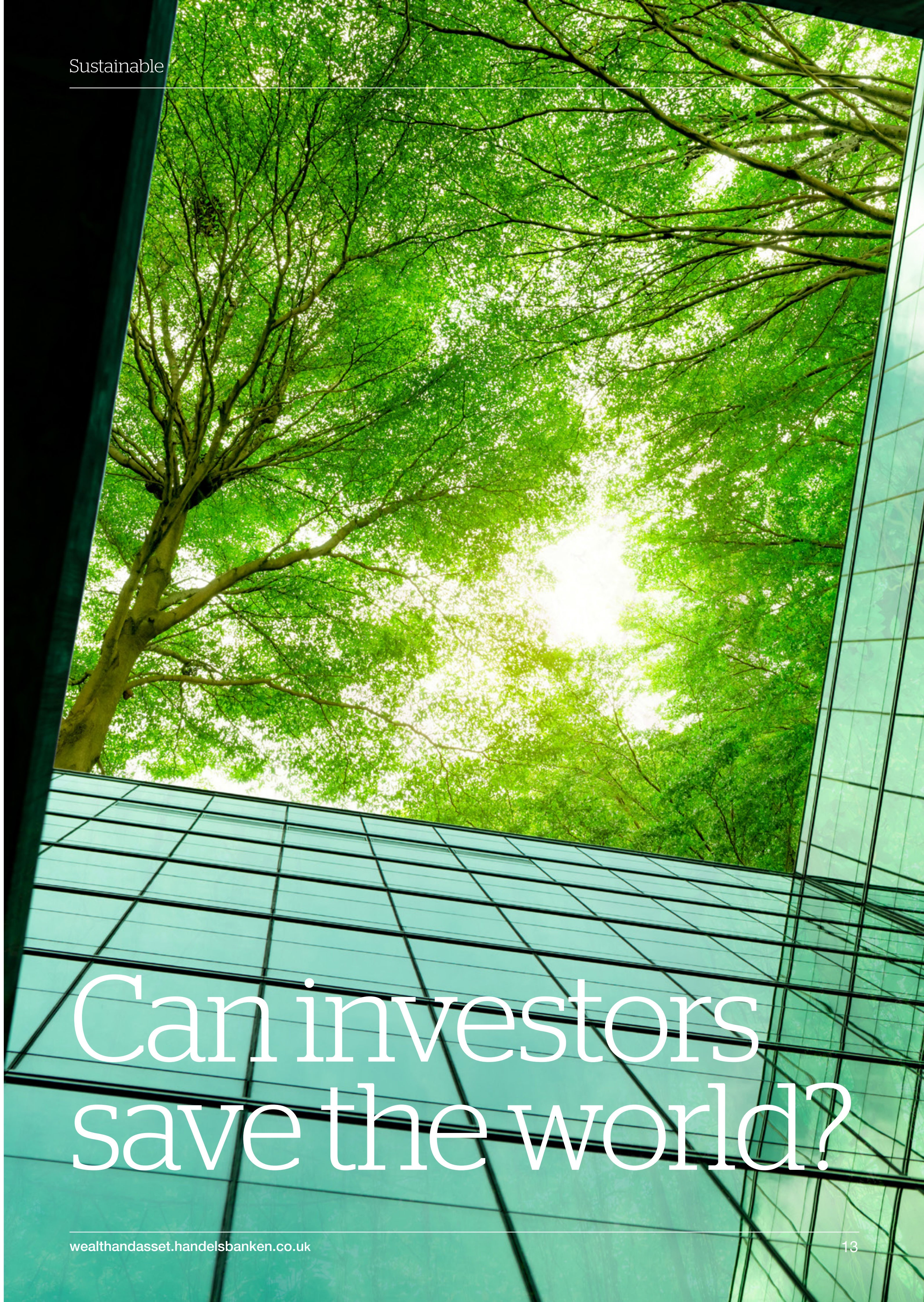
Predictions for clean energy investment in the net zero pathway



Source: International Energy Agency

> "It's clear that large amounts of private capital will be required to support public policy and climate goals for a long way into the future, and this will create huge investment opportunities."

Nikki Howes, Investment Manager

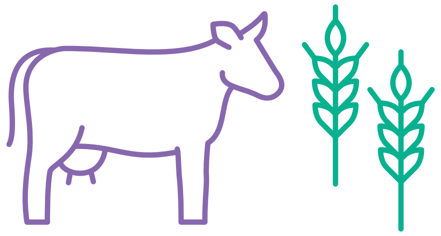


Can investors save the world?

Every year, the UN brings together almost every country in the world for a Conference of the Parties (COP) – a global climate summit. 2021 marked the 26th summit, hence the moniker 'COP26'.

COP26 was the biggest climate conference in history, with around 30,000 people in attendance, including 200 world leaders. Importantly, the US (the world's largest per capita carbon dioxide emitter) took part, having re-joined the Paris Agreement under President Biden. High-polluting emerging economies like China and India were also in attendance.

For some climate activists, the policies announced and agreed upon were disappointing. For others, they were encouraging, with sufficient goals set to create meaningful change, and a sense of urgency pervading the event. Crucially for our industry, one of the biggest shifts in tone at COP26 was a fresh emphasis on the importance of private sector finance, with investors placed at the heart of climate change solutions.



The **food sector** accounts for around **30%** of the **world's** total **energy consumption** and around **22%** of total **greenhouse gas emissions**.

Source: UN Sustainable Development

What did COP26 aim to achieve?

COP26 had a number of wide and far-reaching goals. At the COP21 summit in Paris in 2015, the Paris Agreement was born, focused on capping global temperature rises and halting climate change. The COP26 event was an important check-in point for these goals.

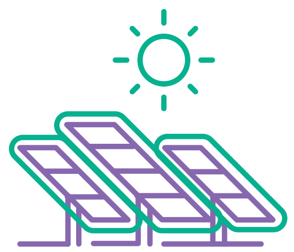
The intention was for attendees to work together, accelerating action to tackle the climate crisis through collaboration between governments, businesses and society. The ultimate target is to secure global 'net zero' emissions by mid-century – removing all man-made greenhouse gas emissions from the Earth's atmosphere. In practice, this would mean accelerating the phase-out of coal, curtailing deforestation, speeding up the switch to electric vehicles, and encouraging investment in renewables. The COP26 event was also aimed at finding ways to protect and restore natural habitats and ecosystems, as well as building defences, warning systems and infrastructure to avoid the loss of communities, homes and livelihoods.

Critically for the financial services sector, COP26 also aimed to mobilise sustainable finance. According to COP26's goals, developed countries must make good on their promise to muster at least $100bn in climate finance each year. What's more, international financial institutions must play their part in unleashing the trillions of dollars in private and public sector finance required to secure global net zero.

Did COP26 deliver meaningful change?

Under the Paris Agreement, countries agreed that they would come back with an updated plan every five years (delayed in 2020 due to the COVID-19 pandemic), reflecting their highest possible ambitions at that time. In reality, this means that the targets and intentions set at COP26 will not be judged until the next large COP event – COP31 – in five years' time.

> “In the run up to COP26, and at the event itself, a number of significant policy measures were announced by governments and financial regulators, with direct implications for our industry. This included the UK's green finance roadmap, which sets out the government's ambition to make the UK the world's best place for green and sustainable investment.”
>
> Ben Matthews, Investment Director



China has become the world's **biggest investor** in **renewable energy**, representing nearly **40%** of new **forecasted demand** for **solar energy** installations.

Approximately **70%** of all **water** abstracted **from rivers, lakes** and **aquifers** is **used** for **irrigation**.

Source: UN Sustainable Development

In the run up to COP26, and at the event itself, a number of significant policy measures were announced by governments and financial regulators, with direct implications for our industry. This included the UK's green finance roadmap, which sets out the government's ambition to make the UK the world's best place for green and sustainable investment. The UK also joins 36 other countries in endorsing the creation of an International Sustainability Standards Board, which will be formally launched in 2022.

From a geopolitical standpoint, COP26 played host to other significant developments. The issuance of a joint statement by China and the US was little short of remarkable, given the poor dynamics between these two superpowers in almost all other areas. And while last minute climb-downs from India and China on the move away from coal created unfavourable media headlines, it is perhaps more helpful to look at what these nations are doing, rather than what they will/will not commit to in a public forum. For example, China may not have devoted itself to phasing out coal at COP26, but it has become the world's biggest investor in renewable energy, representing nearly 40% of new forecasted demand for solar energy installations.

How does this impact our investments?

From an investment perspective, the focus of COP26 was on the environment – the 'E' in ESG (environmental, social and governance). We have a number of holdings in our sustainable investment strategies which directly target this, and these positions stand to benefit from the increased attention surrounding environmental issues brought about by COP26.

Our sustainable strategies include stock market positions in companies involved in the generation, storage, efficiency and consumption of sustainable energy sources. We also have exposure to businesses involved in water demand management and pollution control, as well as in water infrastructure companies. Further, our strategies are invested in solutions seeking to reduce resource intensity through the use of more efficient, scalable materials with lower lifetime emissions.

When it comes to bond markets, our strategies also have positions in 'green bonds' from international public and private issuers, including emerging market companies. And, as with our core strategies, our sustainable strategies also include a range of alternative (non-traditional) asset types, such as renewable energy infrastructure and battery storage assets.

What happens now?

As we enter the next stages of the fight against climate change, the role of the financial sector – including investors – will be critical. Investors must be focused on diversified solutions to the challenges around and ahead of us. This means directing our attention not only to flagship areas like clean energy, but also to solutions centred on water, agriculture, biodiversity, and transport.

Engagement from investors is essential, as is collaboration between businesses – across and within industries, and regardless of geographic borders. From this point onwards, commitments and promises must transform into action, and this includes being proactive in the way in which we invest. Private capital can be a powerful and effective mechanism for change. By thinking about how we invest our pensions and savings, we believe we can all contribute to meaningful improvements, whilst also seeking out attractive long-term financial returns.

Find out more

Learn more about our sustainable investment strategies

Read our latest Sustainable Impact Report

An alternative approach to finding income

For investors seeking to draw an income from their investments, traditionally, there have been two routes: interest payments on bonds, and dividends paid on shares. Today, though, with yields on bonds at ultra-low levels, bond markets are no longer a generous source of income for investors, pushing some investors into taking more risk via high dividend-paying shares.

Unfortunately, 2020 brought about unprecedented risks to dividend investing, when even companies with sound balance sheets were forced (least not by regulatory and political pressure) to cancel their dividend payments to shareholders.

Both bonds and shares are still capable of providing attractive returns, if investors know where to look, but more creative and pragmatic thinkers are increasingly turning to alternative types of assets to supplement their income streams. Here, we highlight some of the alternative assets – beyond traditional stock and bond markets – at work in our income strategies.

Pushing the boat out: investing in the shipping industry

Shipping has long been a fiercely competitive industry, marked by narrow profit margins and unreliable customers. But when the pandemic hit, everything changed. Following an initial drop in economic activity (and the sudden closure of many international ports), demand for containerships soon rebounded strongly. Shipping prices skyrocketed, pushed upwards by supply chains in disarray alongside heighted demand for consumer goods, as shoppers looked to spend their saved lockdown cash and businesses aimed to rebuild their inventories.

Today, shipping costs have started to ease off a little, but remain far above their pre-pandemic levels. The adjustment back down to significantly lower pricing is likely to take years, rather than weeks or months. The ongoing global economic recovery will depend on a reliable and sustainable shipping system, and this is encouraging news for investors looking for long-term income streams.

There are of course threats to the global shipping industry, including political pressure to 'reshore' manufacturing (in the US, for example). However, the total reshoring of industries to their home markets would be extremely complex, and prohibitively expensive. Global manufacturing supply chains are likely here to stay, even if adjustments need to be made. For now, shipping businesses have time and income to plan for the future of freight. The savviest will take this opportunity to grow and diversify their businesses, as well as making climate-friendly adjustments to their vessels – something we are already seeing among our own investments in this area.

In this current inflationary environment, it is also worth noting that shipping assets tend to perform well in periods of higher inflation (though this may be because higher shipping rates themselves help to drive inflation upwards). Historical data shows that the value of existing vessels also tends to appreciate in an inflationary environment, reflecting the higher shipping rates generating so much income for the sector.

Bricks and mortar with a twist: alternative property assets

It likely goes without saying that property is a vast and complex investable area, and one which lies beyond traditional bond and stock markets. One area of particular interest to us is the urban warehouse and industrial space. Consumer shopping and spending habits have evolved rapidly in recent years – accelerated by the COVID-19 pandemic – and online shopping has become the norm. And as e-commerce takes an increasingly large slice of the retail pie, the demand for well-placed facilities and digitally-enabled warehouse space is ballooning.

This is a structural growth story. The change in consumer preferences is highly unlikely to be reversed, and meeting consumer needs and expectations requires quality industrial property. Rental growth in the industrials sector has been strong for a number of years, and currently benefits from an imbalance between supply and demand (industrial new-builds have been relatively few and far between). This is fortunate for income investors seeking regular and sustainable yield.

Investing in property has another obvious potential advantage: the value of the underlying asset – in essence, the 'bricks and mortar' factor. But not all property is created equal, and we are extremely picky about which property assets gain a place in our income strategies.

You use it, you pay for it: investing in royalties

Investing in royalties can sound like a strange concept, but royalty investments present a very attractive way of receiving a regular income. A royalty is a payment made to the owner of an asset – which could be intellectual property (e.g. a piece of music) – which the owner has licensed for use. By way of compensation, the owner is paid a portion of the net revenues received through the asset's use.

When we think of royalties, we probably think of the music industry, and this is certainly one way to access royalty income. Funds which own the rights to songwriters' intellectual property can collect royalties from the music's use, which includes placements in advertisements or film, or music streaming services.

The emergence of low cost streaming services (e.g. Spotify, Apple Music) has also reduced the appeal of illegal downloads, and has seen the music industry return to revenue growth. New technology platforms also mean that more revenue can be collected, and more efficiently.

Against this backdrop, long-term expected returns for our music royalty investments look attractive. Importantly for our income strategies, music royalties are not particularly sensitive to wider economic events. For example, while the music industry was not immune to the disruption and uncertainty caused by the COVID-19 pandemic, lockdown conditions provided a boost to streaming services, creating a more resilient income generation outlook. Beyond the lockdowns associated with the pandemic era, the outlook for music royalties looks promising because of good news for those who hold the rights to in-demand songs. In the all-important US market, the amount of music industry revenue being allocated to songwriters is increasing, by 44%, as mandated by changes in US law.

Other assets can also deliver royalties. Within our income strategies, we invest in royalty income from healthcare investments too. This typically relates to medical patents, with the fund owning a royalty stream in which a pharmaceutical firm compensates a patent-holder for the use of their intellectual property. Like music royalties, these investments typically have relatively low correlation to moves in the wider economy, and offer rewarding income in an environment where attractive yields are hard to come by.

> “The emergence of low cost streaming services has allowed the music industry return to revenue growth. New technology platforms mean that more revenue can be collected, and more efficiently.”
>
> Jaisal Pastakia, Investment Director

Key investment terms

Alternative asset Any investment that dœs not fall in the traditional asset classes of stocks, bonds or cash. Alternative investments include private equity, hedge funds, commodities, real estate and infrastructure.

Assets Anything having commercial or exchange value that is owned by a business, institution or individual.

Asset Allocation Dividing the money invested in a strategy across different investments.

Balance sheet A summary of a company or institution's financial position, made up of assets, liabilities and (where applicable) shares. This can also refer to household or consumer assets and cash flows.

Bond (government or corporate) An investment in the debt of a government or corporation, where investors receive a fixed rate of interest over a specified time period, at the end of which the initial amount is repaid.

Capital Typically refers to cash that is being put to work for productive or investment purposes.

Dividend A share of profits which a company pays out regularly (typically annually) to its shareholders.

Diversification Holding different types of assets in a portfolio to spread the risk.

Economic cycle The fluctuation between an economy's periods of expansion (growth) and contraction (recession).

Emerging economy or market Countries that are progressing toward becoming advanced, usually shown by some development in financial markets, the existence of some form of stock exchange and a regulatory body.

Hedge fund An alternative investment that is designed to protect investment portfolios from market uncertainty, while generating positive returns in both rising and falling markets.

Income Money paid out by an investment, such as interest from a bond or a dividend from a share.

Inflation The rate at which the price of goods and services rises.

Quantitative easing The introduction of new money into the money supply by a central bank.

Quantitative tightening The reduction of money in the money supply by a central bank.

Recession A period of economic decline, technically defined as two consecutive quarters of negative growth.

Risk The level of risk in a portfolio is essentially the probability for loss (though it can technically refer to the probability of gain too).

Share/stock A stake representing part ownership of a company.

Share buybacks Share buybacks take place when a company buys back its own shares in the marketplace (i.e. from existing shareholders).

Volatility The degree to which the price of a given asset, or price levels of a given market, rapidly changes. The higher the volatility, the riskier the asset/market tends to be.

Yield The income from an investment, usually stated as a percentage of the value of that investment.

Investment team

Graham Bishop
Chief Investment Officer

Scott Ingham
Investment Director

David Absolon
Investment Director

Jaisal Pastakia
Investment Director

Charu Lahiri
Investment Director

Ben Matthews
Investment Director

Alistair Campbell
Investment Manager

Nikki Howes
Investment Manager

Nathan Henry
Investment Associate

To find out more please get in touch:

London Office
No.1 Kingsway
London
WC2B 6AN
Tel: 020 7045 2600

2021 Wealth Briefing European Awards

Winner: High Net Worth Team

Commended: Tax Team

Commended: Marketing or PR campaign

2021 PAM 50 Most Influential

Tracey Davidson, Chair of Handelsbanken Wealth & Asset Management has been named in the 2021 PAM 50 Most Influential list

FT Adviser – Top 100 Financial Advisers 2020

Handelsbanken Wealth Management was placed in the top 25 of FT Adviser's Top 100 Financial Advisers 2020 (17th)

Portfolios may include individual investments in structured products, foreign currencies and funds (including funds not regulated by the FCA) which may individually have a relatively high risk profile. The portfolios may specifically include hedge funds, property funds, private equity funds and other funds which may have limited liquidity. Changes in exchange rates between currencies can cause investments of income to go down or up. The value of investments and any income from them can fall and you may get back less than you invested.

Past performance is not a reliable indicator of future results.

Handelsbanken Asset Management is a trading name of Handelsbanken Wealth & Asset Management Limited which is authorised and regulated by the Financial Conduct Authority (FCA) in the conduct of investment business and is a wholly-owned subsidiary of Handelsbanken plc.

This document has been prepared by Handelsbanken Asset Management for clients and/or potential clients who may have an interest in its services. Nothing in this communication constitutes advice to undertake a transaction and professional advice should be taken before investing. Any observations are Handelsbanken Asset Management's commentary on markets and its own investment strategy. This material is not investment research and the content should not be treated as an offer or invitation to buy or sell securities or otherwise trade in any of the investments mentioned.

Registered Head Office: No.1 Kingsway, London, WC2B 6AN. Registered in England Number: 4132340