ARIA | CAPITAL

INVESTMENT INSIGHT

A weekly look inside the investment world.

Unlimited power is apt to corrupt the minds of those who posses it; and this I know, my lords: that where law ends, tyranny begins.
William Pitt, 1839

Friday, 31 March 2023

In this week's Investment Insight

Net zero
Make no mistake, sustainability is no longer a minor consideration for investment managers, a ticked box to satisfy niche demands from environmentally-focused investors. This extends not just to equity and fixed income investments, but to all asset classes, not least property. It's the reason why investment managers like Jeff O'Dwyer, head of the Schroders European Real Estate Investment Trust, with whom we met in London this week, have set about retrofitting commercial property portfolios to target 'net zero'. Net zero refers to the balance between the amount of greenhouse gas that's produced and the amount that's removed from the atmosphere. In this week's *Inside Track* we explain the far-reaching implications of a net zero carbon strategy for the commercial property sector and what's driving the move.

Debt begets
Debt can be a powerful tool of growth, if appropriately used. However, debt, or most of it at least, has to be repaid, and that can become a problem in the absence of growth. In *Pic of the Week* we look at how, in the case of the US (although there are analogies in many countries) the math is breaking down.

Newswire
Some interesting nuggets from this week's newswires.

Market view
A visual snapshot of recent market performance.

The Inside Track: Net zero

For the past couple of decades, the drive to embed sustainability in financial services and, specifically, investment management has been predominantly carrot, rather than stick, based. As most investment managers will concede, unless made compulsory, ‘greening’ portfolios at the potential cost of investment performance or the certain cost of additional compliance and reporting will tend to be tokenistic. This presents a dichotomy for asset managers with clients in both the US and Europe. Management in the US may see the pursuit of ESG criteria as unnecessary, even undesirable, while it is increasingly mandatory for their European counterparts. In his 2022 ‘Letter to CEOs’, BlackRock’s Larry Fink was one of the first high-profile US-based indistry leaders to put it up to corporates when he said: “every company and every industry will be transformed by the transition to a net zero world. The question is, will you lead, or will you be led?” Fink’s leadership has helped to turn the sustainability tide, but we know from our conversations with global asset managers that, particularly in the US, there is a long way to go.

But, looking specifically at the commercial property sector, with a requirement for ‘net zero’ as good as mandatory in Europe now, what are the implications? Buildings are a major contributor to climate change. For example, in the UK it is estimated that buildings are responsible for almost one quarter of all carbon emissions.

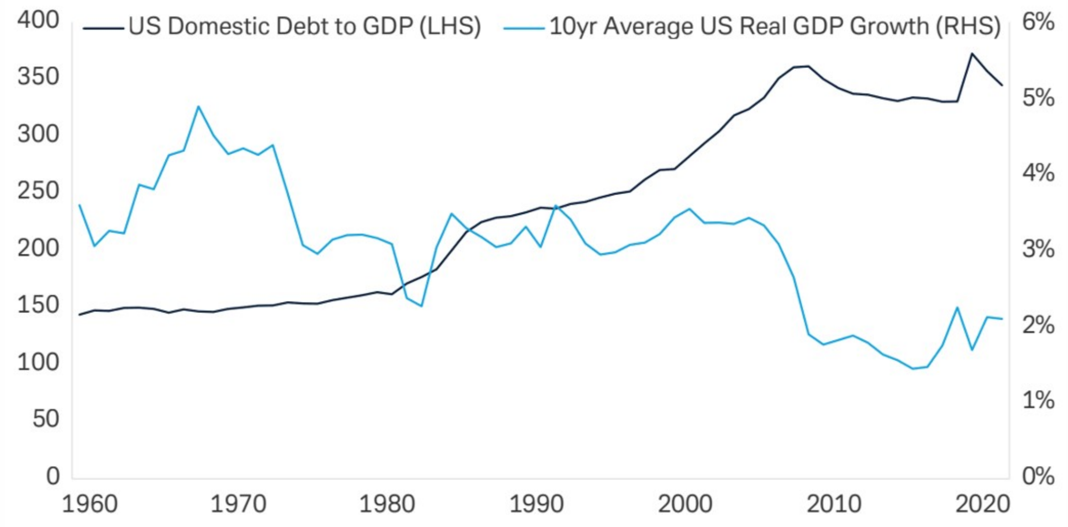
If it isn’t already the case, property portfolio managers will very soon find themselves unable to raise either equity or debt financing to fund the purchase or maintenance of buildings with poor sustainability characteristics. A measurable net zero strategy is now, in effect, an expected norm. Carbon reduction is beginning to play a major role in preserving the value of commercial property assets and the race is on to cut emissions.

As a result, there is a tidal wave of retrofitting on the horizon. Many large occupiers are themselves, as part of their ESG strategies, setting net zero targets and are beginning to engage with their landlords to work collaboratively through green leases. Commercial property agent, Colliers, has estimated the cost of retrofitting Europe’s real estate to bring it in line with modern sustainability standards is €7 trillion. To put this in context, this is more than 20 times the value of annual real estate transactions across the continent. In the UK, it is expected that the government will require all commercial property buildings to have an Energy Performance Certificate rating of B by 2030. It’s estimated that 80% to 90% of London’s stock is currently rated C or below, which could have a huge impact on its value with institutional investors in the future.

For investors, the implications are clear. Buildings that don't come up to acceptable, ideally net zero, standards will fall in value. By the same token, buildings that been built or retrofitted to a net zero standard will meet with increasing demand, command higher rents and experience better capital growth. Things won't change overnight, but property is a long-term asset class. The move to net zero is already a trickle and it will become a flood well within the useful life expectancy of most properties, so investors should discrimate carefully when it comes to allocating their capital.

Pic of the Week: Debt begets

At a simplistic, national level, why would a country borrow? It affords the populus the opportunity to live beyond its present means, a perfectly sensible counter-cyclical strategy, as long as spending is curtailed and debt repaid during better times. Otherwise, debt simply begets more debt. Looking at the US as an example, we can see from the chart that growth has been trending down while debt (to GDP) has been rising...inexorably throughout the post-WWII era. Inflation is much maligned at the moment. However, there may be a few central bankers and politicians quietly welcoming its erosive power. It's clear that something has to give. In these days of post-colonialisation and deglobalisation there are considerably fewer solutions to this growing problem than there might have been in the past.



Source: Haver Analytics, Deutsche Bank

Newswire

...on Monday
Unions in Germany launch the largest 24-hour strike in 30 years.

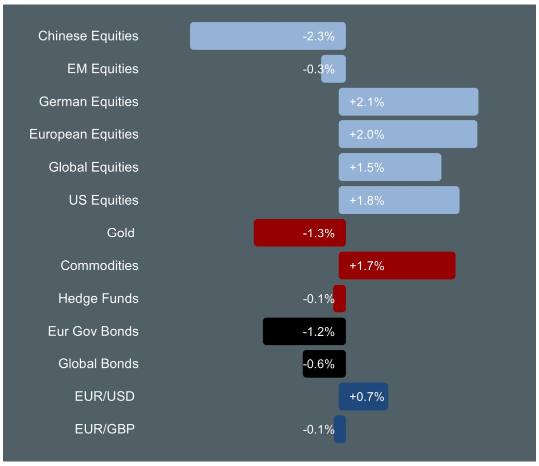
...on Tuesday
European markets give back gains on fragile banking sector.

...on Wednesday
US markets rally on upbeat corporate outlook.

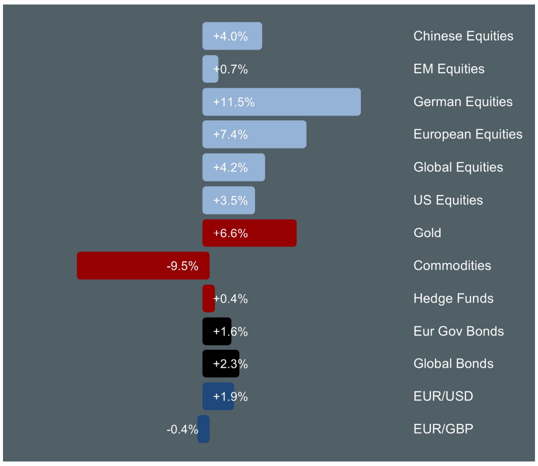
...on Thursday
As energy spike fades, German inflation slows sharply.

Market View

Last 7 days (€)



Year to date (€)



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