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This Issue

BMO Global Asset Management

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BMO Global Asset Management

A Portfolio Manager's Guide to War and Conflict

With Russia's recent invasion of Ukraine, institutional investors are once again questioning the historical relationship between war and capital markets. In response, Steve Shepherd, Director and Portfolio Manager with BMO's Multi-Asset Solutions Team (MAST), offers a practical roadmap to managing geopolitical risks within portfolios.

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Steve Shepherd

DIRECTOR AND PORTFOLIO MANAGER AT BMO'S MULTI-ASSET SOLUTIONS TEAM (MAST)

"Between two groups of people who want to make inconsistent kinds of worlds, I see no remedy but force."
— Oliver Wendell Holmes Jr.

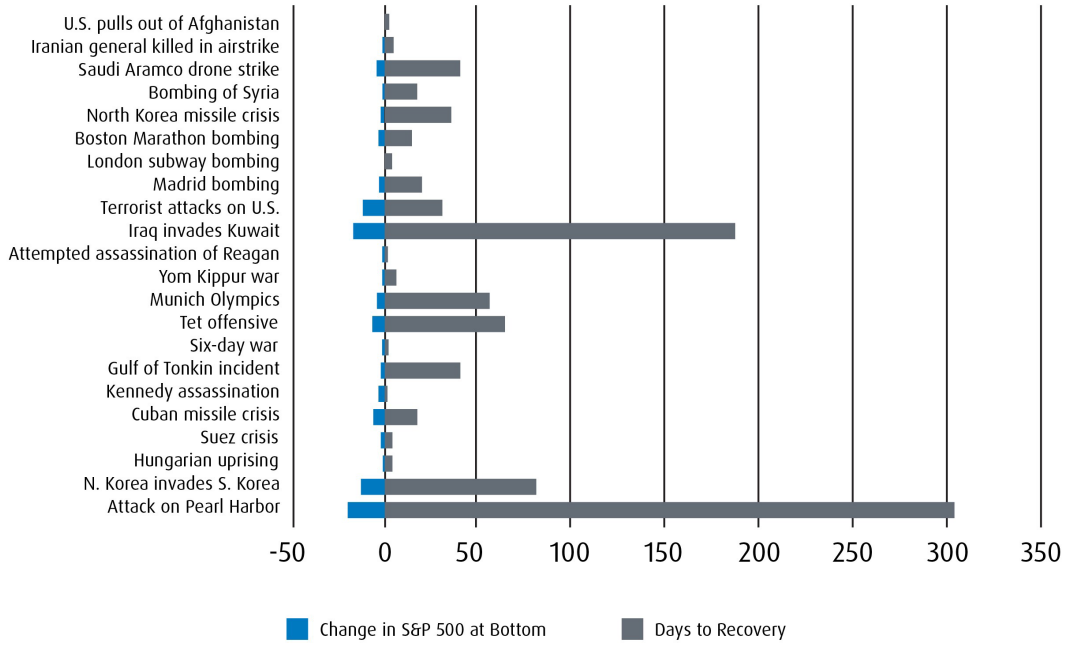
Lessons from history

War is a tragedy, from beginning to end. The human toll, paid in lives lost and horrors witnessed, exceeds any calculation that we as investment professionals can hope to make. As asset managers, our role is to manage risk and navigate through uncertain times on behalf of our clients, many whom themselves carry a similar fiduciary duty to protect capital within the portfolios they manage. In that spirit, this article will examine:

1. the historical impact of war on capital markets, and
2. the broad framework we use to consider a conflict's disruptive power.

We look at 22 major events that took place from 1941 to 2021, measuring the percentage drop in the S&P 500 from the inciting event to the bottom of the market, and also how many days it took to recover. The data reveals a clear pattern: markets often react quickly when conflict arises, selling off at the first tremors before eventually rebounding as the initial shock wears off. In fact, our research shows the average time from the market reaction to recovery is approximately 42 days.[1]

Impact of war on equity markets



Source: LPL Research, S&P Dow Jones Indices, CFRA.

Another takeaway is that conflicts come in different forms, and from different origins. For instance, the Boston bombing is not a sufficient proxy for understanding the nuances of the Yom Kippur War, and vice versa. Even when the underlying characteristics are similar, it's helpful to remember that the analogy only goes so far. Russia's recent invasion of Ukraine may be reminiscent of the Iraqi invasion of Kuwait, for example, given that both are territorial land grabs instigated by autocratic leaders in oil-rich regions of the world. But Russia is not Iraq, and Ukraine is not Kuwait. Russia plays a much larger role in the global economy than Iraq did at the time, and Ukraine's export profile differs significantly from that of Kuwait, not to mention that the world looks very different now than it did in the early 1990s.

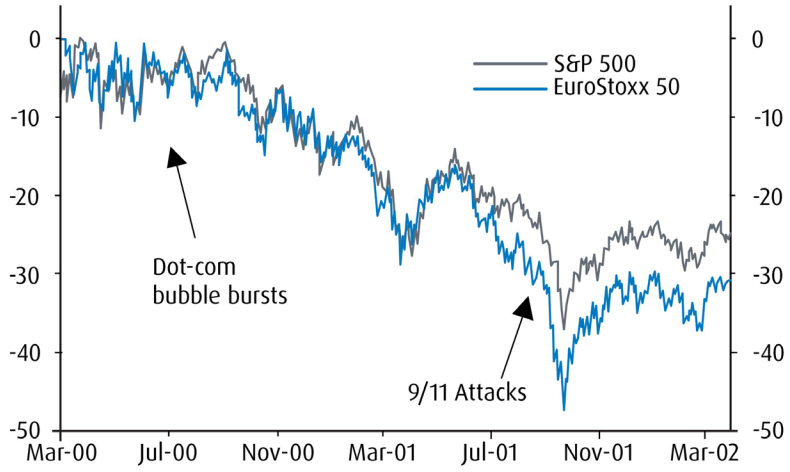
That being said, there are common parameters for all geopolitical conflicts. The questions we ask ourselves at the outset of any conflict allow us to put the event in its appropriate context, and hopefully help cooler heads prevail in our tactical decision-making.

Question 1: What was the prior sentiment in markets?

Headline events such as the war in Ukraine are so startling and disruptive, that they can often cause investors to forget the prior trajectory of markets in favour of the immediate. There can be a tendency to view the event in isolation rather than as a single data point in a longer series, which, of course, is the case with any new macro development. Markets always react based on a pre-existing narrative. If the global economy is doing well, the blow is softened. If asset prices are slipping, the decline becomes part of the trend. Investors' reactions to war are never free of context; conflict merely amplifies the sentiment that was there to begin with.

Consider the chart below, which shows the market drawdown before and after the 9/11 attacks. The pullback in the S&P 500 in September was marked by a sharp decline in equity prices *that were already trending down*. U.S. shares had been declining since July, when the Dot Com Bubble burst and exposed systemic issues with technology issuances on the stock market. In fact, the broad market was down nearly 50% from its peak when the attack took place. Similarly, investors' response to Russia-Ukraine was characterized as severe, but the S&P was never down more than 3% on a daily closing basis. Was it too harsh? Certain asset classes were harder hit, such as Russian bonds and equities, but otherwise the oft-quoted year-to-date numbers included losses from January that preceded the invasion.

9/11: Drawdown from peak (%)



Source: Refinitiv, Capital Economics.

Question 2: How vital are the countries to the global economy?

Another unfortunate reality of conflict is that not all countries have an equal impact on the global economy. Broad divisions exist between developed and developing nations, and going further still, each country has its own unique footprint on the landscape of international trade. For example: if an economy has the entire global supply of an asset—say, neon that's needed for computer chips—the outbreak of war in that region would have a severe impact on technology supply chains. This was the case in Ukraine. To make matters worse, the European energy network is heavily dependent on Russia, which accounts for more than 40% of the continent's oil and natural gas needs,[2] as well as being a major exporter of wheat and nickel.[3] Once the conflict began in earnest, it became clear that much of Europe would need to find alternate sources of electricity or else cope with extreme energy inflation.

When evaluating the ripple effects of a conflict, size also matters. Countries with large populations and landmass are more worrying given the sheer scale of potential warfare, as opposed to smaller nations that are both geographically and economically remote.

Question 3: What's the worst potential outcome?

Finally, we put ourselves through grim thought-experiments to see what the tail ends of the possibility curve look like. Short of nuclear war, the worst scenario imaginable is one in which the U.S. and China begin a full-scale military conflict (an eventuality which we glimpsed during the trade war initiated by President Trump). Most conflicts will not be on this scale, however; they will likely be confined to territorial disputes whose fallout is limited to the region. Nonetheless, the exercise helps us set goalposts with those outlier probabilities in case the situation does get out of control.

While the initial market reaction can be emotional, the final calculation must be based on tangible damage. Money is only lost when capital is destroyed, so ask yourself: what real assets are being destroyed? Beyond the physical, we do also have to consider the knock-on effects of financial sanctions, such as those that have crippled the Russian economy and tried to destabilize Putin's control from within the country. Although those sanctions are meant to be temporary in order to incentivize a Russian withdrawal from Ukraine, individual companies have taken it on themselves to stop doing business within Russia. Take, for example, the decision by British Petroleum to exit its 19.75% stake in Russian energy giant Rosneft at a cost of up $25 billion,[4] McDonald's closing its 850 locations inside Russia,[5] or banks like Société Générale, Goldman Sachs and Deutsche Bank winding down their business in protest of the war.[6] These actions must be viewed as permanent rather than transitory.

Investors' reactions to war are never free of context; conflict merely amplifies the sentiment that was there to begin with.

Finding signals in the noise

It's exceedingly rare that investors know the true impact of war immediately after it begins. Uncertainty causes the initial shockwave, but after the dust settles it's only the material changes to the world that determine long-run valuations. Whether through physical destruction or financial sanctions—or even the mere existence of heightened uncertainty—we need to identify the economic consequences that will seep into the broader world and influence intrinsic value, because those factors will determine returns. Ultimately, we must actively manage our natural impulses, and ask the question: what will this change about the world?

[1] LPL Research, S&P Dow Jones Indices, CFRA.

[2] International Energy Agency, "How Europe can cut natural gas imports from Russia significantly within a year," March 3, 2022.

[3] Douglas Broom, "What else does Russia export, beyond oil and gas?," *World Economic Forum*, March 18, 2022.

[4] "bp to exit Rosneft shareholding," *BP Corporate Website*, February 27, 2022.

[5] "McDonald's to Temporarily Close Restaurants & Pause Operations in Russia," *McDonald's Corporate Website*, March 8, 2022.

[6] "Here Are Some of the Companies That Have Pledged to Stop Business in Russia," *The New York Times*, March 9, 2022.

Value Hunting: The Return of Cautious Optimism

With macroeconomic data telling two different stories—one of low unemployment and robust earnings, another of high inflation and rising interest rates—Luke Casey of Pyrford International provides an inside look at the investing factor that's making a surprise comeback: Value.

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Luke Casey

PRODUCT SPECIALIST, PYRFORD INTERNATIONAL

A resurgence in value strategies

Supply chain disruptions, geopolitical conflicts and central bank policies devised in response to COVID-19 – all of these factors have helped create a volatile market in recent years, which in turn has seen institutional investors flock towards pockets of growth in the face of market fragility. We've seen impressive runs made by 'lockdown winners' and more speculative pockets of growth. And while a flight to growth can be natural, this unique run for growth-oriented equities has led to many investors missing out on a key investing trend: the return of value.

As the world settles into a begrudging acceptance of living with COVID-19, economies are more or less reopening. Current forecasts are realigning with pre-pandemic predictions for economic growth, and fundamentals are coming back into focus. This creates a very favourable environment for value portfolios, which are designed to compound steady earnings year after year and capitalize on equities that were acquired at an undervalued market position.

Consider how this contrasts with growth portfolios. While they continue to attract headlines and at times demonstrate eye-popping surges in share price and revenue, you'll notice that the cost for these assets is reaching exorbitant levels. In other words, you're paying a large premium for projected earnings at a time when interest rates are on the rise—a trend which disproportionately impacts growth assets.

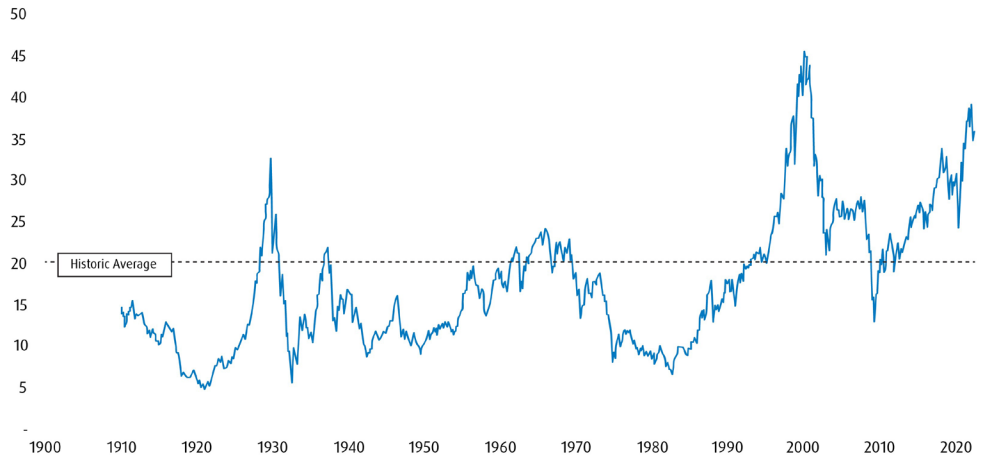
What's more, these strategies are known to sport a high degree of risk and volatility. Couple that with an unpredictable market still beset by uncertain inflationary effects—and an ongoing war in Ukraine—and it's no wonder risk-conscious investors are seeking out assets better designed to withstand the present volatility. It's our view that value investing offers the ideal solution to the ongoing challenges, as well as upside participation in a fully restored, post-pandemic economy.

Avoiding P/E traps

In general, price-to-earnings ratios (P/E) have perhaps diminished in terms of how much influence they hold on investors, with a long-term trend towards higher P/E ratios generally on the S&P 500.

It is now more or less common for investors to *feel* as if they need to stomach high P/E ratios in order to obtain decent earnings growth. As value investors, we disagree—we simply don't believe in growth at any price, preferring instead to look for quality companies that have pulled back far enough for their stock price to be attractive.

Real S&P 500 10Y P/E Ratio



Source: https://www.currentmarketvaluation.com.

With economies reopening and the market re-settling (at least in terms of lockdowns and restrictions common of the pandemic era) you are more able to buy reasonably valued stocks – which is to say stocks that trade at reasonable P/E multiples and dividend yields – because economic growth is, broadly speaking, healthier.

This healthier economic growth will naturally be a boon to a greater variety of sectors, leading to higher potential for improved earnings growth across a wider range of assets. Looking back, this contrasts with the pandemic mindset where some investors felt you had to search out speculative assets operating in niche industries or subsectors, and that these assets had to dominate their niche in order to ensure sufficient earnings growth.

While all holdings must adhere to strict quality criteria, not all high-quality assets in the world will meet our tough valuations standards.

But the most recent quarter has demonstrated that more seasoned industries (and assets within those industries) have been able to compound their earnings because of economic growth that's more evenly distributed. Which isn't to say that no remaining issues exist with respect to supply chains or continued inflation. But compared to the past couple years – which were marked by total economic shutdowns – the "rising tide" of broader growth is a marked improvement.

Under the hood: BMO value strategies

With the BMO International Value Fund, we favour quality stocks that display compounding value and stable returns through dividends and share price growth. While all our holdings must adhere to strict quality criteria, not all high-quality assets in the world will meet our tough valuations standards. Take quality technology names in Europe: some became more attractive to us throughout the past several months, but they remained too overpriced to be included in our portfolio. Instead, we've opted for patience—rebalancing according to the changes in the European market, but ultimately leaving our portfolio largely untouched in regards to new positions. Our most recent new country allocation being Indonesian assets due to the currency retrenching to a more reasonably valued level through 2020.

Other assets did become more attractive, growing cheaper over the past several years, especially among several European banks. But their cheapness was offset by the quality of their earnings. These banks needed steeper yield curves to increase profitability. Short-term rates are increasing at a much faster pace than the long-end rates, which effectively means the yield-curve is going against them.

Our preference tends towards true quality investments, ones that are positioned to benefit long-term amid economic recovery and restored health. What's more, our bias towards quality assets with strong industry positions, has our portfolio positioned to be better protected in the event of prolonged inflation with many names having previously exhibited the ability to pass on cost increases.

While some investors are looking for compelling turnaround stories, it's important to remember one critical fact: there's a reason they were down in the first place.

While many assumed inflation to be transitory, the reality is that inflation continues to be top-of-mind for many economists and investors. Furthermore, continued pressure from the war in Ukraine could accelerate price growth in the next several quarters, perhaps longer.

As market leaders, many of the companies in our portfolio have the pricing power to offset inflation pressures, making them more durable through a tough economic climate. While there may be margin pressure in the near term, over the longer term these durable, high-quality names will be better positioned to adapt to an inflationary environment. It's also worth noting that larger sectors, such as telecom, have been generally less impacted by inflation, which makes them good areas to overweight in our portfolio.

Why compounding matters

The market has seen some tech, freight and healthcare companies fluctuate from "highly overvalued" to simply "overvalued" during recent months. However, we're still cautious. While some investors are looking for compelling turnaround stories, it's important to remember one critical fact: there's a reason they were down in the first place. Our value and quality biases ensure that we avoid these potentially volatile picks in favour of more sustainable growers.

Another area of interest to deep value hunters has been the market for initial public offerings (IPOs), which experienced a boom in recent years due to the introduction of Special Purpose Acquisition Corporations (SPACs). These highly speculative vehicles allow companies to go public without the regulatory reporting standards required in a traditional IPO, and in our experience, they are not very indicative of long-term value, nor quality for that matter.

We've witnessed these types of speculative assets slam into a roof and collapse. Sometimes they bounce back, sometimes they stay down, and other times the cycle repeats. But with a focus on value, quality and fundamentals, we're able to leverage the "Low Volatility Anomaly" to produce compounding gains year over year—no matter the market. Time and again, research has shown that it's nearly impossible to time markets exactly right. So, if you have capital that needs protection but you also want to grow, then low volatility offers a powerful core holding, especially at a time when the macro backdrop features significantly higher geopolitical risk and inflation.

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Riding the $100T Renewables Infrastructure Wave

Joe Idaszak, Portfolio Manager, Brookfield Public Securities Group (PSG), offers his take on why institutional investors interested in the "E" of ESG should consider investing in the one specific area with $100 trillion of global investments expected by 2050: renewables infrastructure.

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Joe Idaszak

VICE PRESIDENT, GLOBAL INFRASTRUCTURE SECURITIES, BROOKFIELD ASSET MANAGEMENT

Setting the stage for renewables growth

In 2015, the monumental Paris Agreement established a global framework to deal with the ramifications of climate change. Nations came together and acknowledged that we have a real climate crisis, and that a plan must be put in place quickly in order to reach our carbon neutral target by 2050. It also provided the impetus for the massive growth in the renewable energy sector around the world, with individual countries having used it to varying degrees to kick-start the movement.

A few years later, the COP26 Climate Summit in Glasgow established that while it's necessary to have a plan in place for the next three decades, it's critical that strict interim targets be set from now until 2030. It was a call from the United Nations down to individual governments to figure out what it will take to set the wheels in motion and accelerate change by the end of this decade. In essence, it added considerable urgency for the decarbonization movement to establish some nearer-term goals.

Based on the best available data from the International Renewable Energy Agency, our research team estimates that the total dollar value of infrastructure commitments from now until 2050 is equal to $100 trillion—with approximately one-fourth dedicated to renewable generation capacity and the remaining three-quarters to grid infrastructure and modernizations.[1]

The drive for change will come from governments around the world, who will work directly with companies to implement the necessary actions. However, a country can only deliver so much by itself, and hence they must work in lock-step with the private sector as well. From our perspective, we're seeing both of these trends happening now – with nine of the top ten largest economies in the world committing to net zero by 2050, and large-scale owner-operators of renewable assets creating targets that mirror those from COP26. It's only when companies take more concerted action on their climate commitments, and governments devote sufficient resources to the problem, that net zero becomes an achievable goal.

A plan needs to be put in place quickly in order to reach our carbon neutral target by 2050.

The economics of renewables

The move towards decarbonization aims to address the lowest hanging fruit first, which in this case is the dirtiest of all fossil fuels: coal. Once existing coal plants are shuttered, countries will then need to tackle the more pervasive sources, such as oil and natural gas, replacing them with renewable options like wind and solar energy, battery storage, electric vehicles, etc.

In fact, we can remove a lot of carbon over the next 10 years, in part by the implementation of CCUS (carbon capture, utilization and storage) technologies, along with investing in new wind and solar to replace the legacy energy sources. However, with demand for energy only getting stronger, we will need to maintain some existing resources, such as nuclear power and natural gas, in order to bridge the gap to fully clean power.

The more challenging issue will be how we effectively transition an energy grid used to baseload power from fossil fuels to one based on intermittent use of wind and solar to one that incorporates storage where renewables provide the baseload power. To make this a viable solution, both storage capacity, as well as its cost of development, must improve.

What's extremely enticing is the fact the cost curve for both wind and solar has decreased substantively over the past decade due to technological innovation, heightened demand and, in the early stages, government support. It's now possible to build a wind or solar plant at a very competitive internal rate of return (IRR), with a lower capex relative to a comparable fossil fuel plant, while also offering consumers a cheaper price.[2] Best of all, this is now possible in the absence of subsidies or tax incentives, which have become virtually unnecessary in the wake of growing demand.

What's extremely enticing is the fact the cost curve for both wind and solar relative to fossil fuels has decreased substantively over the past decade plus.

More recently, we've seen a material connection between the price for fossil fuels and broader power prices, with both moving in lock-step more often than not. Although this might imply a negative for renewables, the opposite is in fact the case.

That's due in large part to the lower costs today to produce renewable energy, which provide a competitive advantage when natural gas prices are rising and make the case for renewables all the more compelling. And though supply chain issues have also impacted the renewables industry, the price increases are nowhere near to the same degree as with commodity pricing surges over the past six to nine months. The more predictable and stable pricing structure for wind and solar energy presents an added financial incentive to kick-start this shift, further accentuating the argument in favour of renewables.

Deep dive: BMO Brookfield Global Renewables Infrastructure Fund

In managing this fund, we employ a bottom-up strategy focused on listed securities that own and operate real assets. These companies should ideally have sufficient market share within their respective niches to give them pricing power, which will help insulate them from inflationary pressures.

What differentiates the **BMO Brookfield Global Renewables Infrastructure Fund** from traditional clean energy strategies is our focus on infrastructure, and on our belief that power generation is ground zero for decarbonization. We believe this issue needs to be addressed first before we can do anything else. We're buying companies with competitive moats that have recurring revenue streams and strong cash flow over multiple decades – 10 to 30 years, in fact. These securities deploy capital accretively to create further value, offering institutional investors a better risk-reward trade-off over the long term.

A renewables success story

Orsted, a global powerhouse in renewable energy, is an example of a true success story. We were attracted to the firm's offshore wind farms in the UK, which is the best proof-of-concept, so far, that offshore wind can generate consistent production power closest to the baseload over a longer time horizon. It has scaled very quickly from a technology and efficiencies perspective, and while all of Europe has recently been a good adopter of offshore wind, the UK market has really embraced it, enabling them to zero out coal production across the country.

When investing in renewables infrastructure, we abide by our "Three Pillars of Sustainability in the Power Market," which prioritize decarbonization, equitable access, and reliability and resilience as core tenets we actively support with action. Other key elements of our investment strategy include:

- **Limited exposure to manufacturing companies:** Many of these firms don't have a competitive advantage, and will struggle to remain profitable over the long term. Conversely, renewable infrastructure offers greater long-term revenue and growth potential, inflation protection with the ability to be a dominant player.
- **Investing across the electric grid spectrum:** We're investing in companies building new wind and solar farms, as well as companies that are stewards of the grid building new transmission and distribution infrastructure to control the node centres of supply and demand.
- **Choosing to be benchmark-agnostic:** While the FTSE Global Core Infrastructure 50/50 Index is our benchmark, it's not representative of our fund, as we are focused solely on renewables infrastructure that is almost entirely off-benchmark, whereas the benchmark includes several companies that don't pass our screening.

Another strength of our team is the ability to leverage our relationships with the broader Brookfield organization, tapping into their localized, "boots on the ground" expertise to provide us with a deeper understanding of global markets. The enhanced knowledge sharing provides insights on public versus private markets, enabling a more informed decision-making process for listed securities.

Renewables as a global phenomenon

While the Paris Agreement and COP26 were critical milestones, the major work needed to reach net zero emissions still lies ahead. At present, no country can honestly claim they've made significant progress toward full decarbonization.

Europe and North America currently present the most enticing opportunities for institutional investors, no doubt due to their market size, leadership position and broad social awareness of ESG. As such, the portfolio is tilted toward companies based in these geographies. We find that emerging markets will likely exhibit much slower adoption and growth for renewables simply because they still have so much infrastructure to build.

Every country has a long way to go in moving away from fossil fuels and towards more sustainable renewables as their primary energy source. With $100 trillion in global investments required over the coming decades through to 2050, we believe that renewables infrastructure is a powerful megatrend that will continue in the coming years and decades

[1] Brookfield Public Securities Group LLC, International Renewable Energy Agency. As of December 31, 2021.

[2] *Ibid*.