Riding the megatrends

With new ideas constantly jostling for attention, investors need to identify the major forces at work in the economy to grasp those opportunities that will play out over decades. Matthew Craig examines a number of potential candidates.

Megatrends, or major changes that will affect the economic environment over many years, if not decades, are part of the big picture that investors should be aware of when formulating plans.

Pension funds are by their nature long-term investors, so they may have a particular interest in using megatrends as a guide for investment policies. One important megatrend is global warming and how it will affect economic development. Other frequently discussed megatrends include the ageing populations in many countries and the growth of the BRIC (Brazil, Russia, India and China) economies. In addition, some commentators see megatrends or macro themes resulting from public policy issues, such as global exchange rate imbalances, geopolitical factors or technological developments, such as the rise of the internet as a social and economic force.

However, due to intense media coverage and its potential effects on us all, global warming, or climate change, is for many the most significant megatrend. In a report on climate change, Deutsche Bank global chief economic officer Klaus Martini noted that despite its undoubtedly negative impact, climate change also presents opportunities to investors. Martini commented: "At the sector level, manufacturers of power plant technology as well as companies which supply technologies for exploiting renewable energy sources should be among the winners. Genetic engineering and biotechnology firms, as well as companies which provide products and services to make buildings more energy-efficient, stand to profit from climate change as well."

Lehman Brothers is another major financial institution which has researched the possible economic impacts of climate change. It recently issued a study on climate change which looked at the use of pricing

Genetic engineering and biotechnology firms, as well as companies which provide products and services to make buildings more energy-efficient, stand to profit from climate change...

mechanisms to control greenhouse gas emissions. John Llewellyn, Lehman Brothers' senior economic policy adviser, said: "Where the implicit cost of carbon is excessive, it is going to distort markets. This distortion will harm some companies, for example the European car industry, or boost others, for example companies which make photovoltaic cells. Share prices will be affected accordingly and yet in both cases the distortion raises the cost to society."

The recognition of climate change as a megatrend has meant environmental issues are no longer the province of those investing on an ethical basis. As the Lehman Brothers study notes, carbon taxes and pollution charges will hit some companies, so "cleaner" stocks will benefit in comparison with polluters, and investors are already looking for ways to exploit this. For example, GLG Partners, a hard-headed hedge fund provider, recently launched a long-only fund investing in companies with a lighter than average impact on the environment.

Price of oil

Public policy initiatives to reduce pollution have also boosted venture capital interest in "cleantech", particularly in North America. Cleantech is defined as a range of industries that are developing new technologies for cleaner and more efficient use of natural resources, from energy generation through to recycling and waste.

Braemar Energy Ventures is a venture capital fund making early and mid-stage investments in companies developing cleaner, more efficient energy versions of traditional energy sources and also alternative energy sources. Braemar managing director Neil Suslak comments: "Within the venture capital world, this is a relatively new area but is getting a lot of attention right now. There are a range of drivers for cleaner energy and alternative energy, which are predominately related to the price of oil. The costs of pollution are going to drive ways of cleaning up how we produce fuel and power. People are also looking at this from a security standpoint, as many countries import most of their fuel. If you look beyond that, existing power systems are inefficient and a lot of electricity is lost in the system."

Suslak says many new companies are carrying out the research and development work that traditional energy companies have neglected, in part due to regulation. He adds that venture capitalists such as Braemar tend to invest widely, due to the risks in individual companies. "It makes more sense to have a portfolio of technologies addressing these issues. Some will gain traction and sometimes there is more than one solution for an issue."

On renewable energy, Suslak comments that a lot of money is going into bringing down the costs of solar and wind power energy and increasing the efficiency of its conversion into power. However, he adds: "Going out 20 to 30 years, as fast as alternative energy is developing, it is still going to be a small part of energy use overall."

...many new companies are carrying out the research and development work that traditional energy companies have neglected, in part due to regulation.

The Universities Superannuation Scheme (USS) is a £30bn (€43bn, $60bn) pension fund for academic staff in the UK and it sees clean energy as an investment trend worth following. USS co-head of responsible investment David Russell says it has put over £100m into cleantech and renewable energy investments to date.

Over-weighted section

"It is not a huge percentage of the fund's total assets, but in terms of exposure we have over-weighted this sector and in future allocations it will grow. We have been watching this area for a number of years to find ways that we can address the implications of climate change, as it is a long-term issue which we need to tackle."

Russell says USS has also invested in renewable energy and related infrastructure, as well as clean energy, through private equity type investments. He adds that it sees investments in this sector as ones that will produce positive returns and this was the primary reason for these investments. ►

"All of USS's investments are for performance reasons. The fund has invested in cleantech and renewable energy because we think it will make the returns we need to pay our pensions, and there is no ethical motivation for these investments," Russell states. "The fact that they help address climate change is an additional benefit for the fund."

Two major Dutch pension funds, ABP and PGGM, are investing in clean technology and sustainable energy through vehicles such as Climate Change Capital's Carbon Fund II, which aims to take advantage of the commercial possibilities in the low-carbon economy.

Sustainability on agenda

Phil Page, client manager at investment and risk consultants Cardano, says that very large Dutch pension funds place a strong emphasis on socially responsible investment (SRI), partly due to their wide membership and position in the Dutch economy. "Sustainability is very much on the agenda in the Netherlands, much more so than the UK, so they have a much greater focus on SRI."

If global warming is a factor behind clean energy, it is also seen as affecting the demand for agricultural commodities, such as wheat, corn and other foodstuffs. Greater incidence of drought and flooding resulting from climate change could raise food prices, along with increased demand from the growing middle classes of India and China, who are predicted to switch from a largely grain-based diet to a more western meat-based diet as their average incomes rise.

Rising prices for agricultural commodities can be seen as part of the investment megatrend related to the emergence of populous economies such as Brazil, China, India, Indonesia and Russia. As well as sucking in demand for commodities now, in the future these countries are likely to become major markets for consumer goods. Not only could their own economies grow, but by reducing reliance on western consumers the world economy should benefit according to consultancy Watson Wyatt in its comments on "Chindia" in a report on macro factors affecting global equity prices.

However, it noted: "The concern is that managed exchange rates and inflexible labour markets (for example in western Europe) could impede this effect. It may be then that this factor has a different impact on different equity markets (positive for those serving Chindia's economic expansion, negative for those competing with it)."

Rising prices for agricultural commodities can be seen as part of the investment megatrend related to the emergence of populous economies such as Brazil, China, India, Indonesia and Russia.

Another megatrend for investors to ponder is the demographic changes which will occur in many countries, due to increased life expectancy and falling birth rates. These could increase demand in certain sectors, such as pharmaceuticals, healthcare and financial services. In the UK, Sovereign Reversions is a listed company specialising in equity release plans, which enable older citizens to use their properties to obtain additional finance for their old age. This market is still relatively small but is expected to grow as the population ages and the lack of pension provision for many in the UK bites.

Nigel Hare-Scott, sales director at the Home & Capital Group, part of Sovereign Reversions, says: "Those in retirement hold property assets of £1.25 trillion and the value of equity release policies totals £7bn, so there is an enormous gap of funding potential to help elderly people get through the pensions crisis."

For investors, though, it is important to remember that while a megatrend may exist, it is not always clear how its effects will play out or who the winners will be. Watson Wyatt's report stated: "The hypothesis that macroeconomic developments influence equity returns has strong intuitive appeal but, thus far, little empirical support." In other words, the theory might look good, but in reality, things could be different.

Nevertheless, it is clear that there are long-term trends, such as the demand for clean energy, that are creating investment opportunities. And many asset managers are, or should be, considering the impact of megatrends as part of their standard investment screening process. So at the very least, investors should be aware of megatrends, and ask their managers how they are positioning themselves to cope with them, even if they do not structure their investments around them. ■