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Investment Insights

Megatrends

Using long-term trends to build a sustainable portfolio

RISK | PENSIONS | **INVESTMENT** | INSURANCE

Megatrends are long-term economic trends that we expect to drive the trajectory of the global economy, shaping businesses and society, today and in the future. In this note, we will focus on a selection of these trends we believe will have a significant impact on the global economy over the next 30 years.

There are two reasons why investors should care about megatrends:

1. True long-term investors are able to take into account both short-term and long-term information. By contrast, much of the market focuses on short-term information – such as quarterly earnings and the latest central bank decision – and is less interested in correctly pricing long-term information. This creates mispricing opportunities that investors with a long enough time horizon can capitalise on.

2. Given their broad impact, megatrends will have a major influence on your portfolio whether you actively choose to participate or not.

In other words, being aware of and understanding megatrends is useful in identifying long-term risks and opportunities.

We have split this note into two parts:

1. Firstly, we set out five key trends we expect to be particularly influential in the coming years.

2. Secondly, and perhaps more importantly, we touch on how investors might use this knowledge when making investment decisions.

The danger of ignoring megatrends

As mentioned above, every investor will participate in a megatrend, whether they chose to do so actively or not. In some cases, the impact of ignoring a megatrend is just a missed opportunity. In other cases, ignoring the trend can mean taking on risks without realising. Happily, the assets that are likely to suffer from the disruption caused by a megatrend are often more easily visible than assets that will benefit.

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Thinking about megatrends

The specific impact of megatrends can be difficult to predict. Before making decisions, investors should take account of the following:

Spotting a megatrend

You do not need to be able to predict the future to capitalise on megatrends. You only need to spot a change that is already evident in the present, but where the impact has still to play out. An example is Climate Change. The evidence shows the climate is already changing as a response to human activity. However, as the level of carbon dioxide in the atmosphere rises, scientists expect the size and breadth of the impacts to become much greater. You have probably already heard of each of the five trends we have spotlighted, but that does not mean their impacts are fully priced into the market – in fact, we believe they aren't.

Evidence for megatrends

The existence of a megatrend can usually be well argued with a wealth of evidence backed by data, although some are more certain than others. For example, we can have confidence in the forecast that the working age population in the developed world will shrink relative to the population aged over 65. This is because all the young people who will enter the workforce during the 2030s have already been born. This reduces the sources of uncertainty and allows the discussion to focus on a more limited set of topics. On the other hand, developments in technology are inherently uncertain – companies we expect to benefit from current trends in technological developments could conceivably become irrelevant if a superior technology is announced tomorrow.

Megatrends interact and are multifaceted

All trends, including the five we cover below, are interlinked. What happens with one trend can affect all the others. Sometimes they can reinforce each other. At other times, they can conflict.

For example, one risk to the rise of China is its rapidly ageing population.

Megatrends are also multifaceted. For example, on demographics we have focused on the ageing populations in the Western world, when the rapidly expanding young populations of Africa are also an important factor.

Megatrends can develop in unexpected ways

Even if the trend is correct, and is not countered by other trends, it may not unfold in an obvious way. In particular, the effects can play out very differently in individual countries and regions. Trends can also undergo long periods in which they appear to stall before resurfacing. For example, the trend of rising debt levels in the developed world accelerated in the aftermath of the global financial crisis, before plateauing during the 2010's; however, because of the COVID-19 pandemic debt levels are rising rapidly once more.

Megatrends end eventually

All megatrends have a natural lifespan, and we cannot always know how close trends are to the end or the beginning of their life. In years past, the "Rise of Japan" was an important megatrend. However, once their GDP per head caught up with the West in the 1980s, the trend began to reach the end of its natural life.

Key trends

In this note, we focus on five key megatrends: Climate change, demographics, global debt, the rise of China and technological development. This list is far from exhaustive but, crucially, all of these trends:

- Are built on observable facts about the present but have significant implications for the future;
- Have significant long-term implications for the global economy and markets;
- Are likely to play out; and
- Have a clear direction of travel.

01 Climate Change: Increasing costs of tackling temperatures rises

Climate change poses a major risk to the global economy through two main pathways. Firstly, the cost of dealing with the direct impacts of a changing climate. The chart to the right shows how these costs have increased since the 1980s. Looking forward, the National Oceanography Centre estimates that, without mitigation, rising sea levels alone could contribute to annual flooding costs of $14 trillion by 2100 and the Cambridge Centre for Risk Studies estimates climate change could add 20% to the global cost of extreme weather events by 2040.

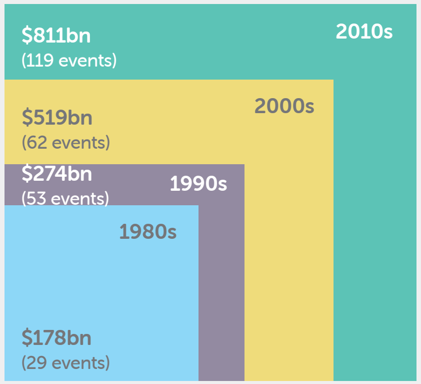

Figure 1: The rising frequency and cost of climate disasters in CPI adjusted U.S dollars. (Source: National Oceanic and Atmospheric Administration)

The second impact comes through the regulation needed to combat climate change. States representing around 97% of global emissions have signed up to the Paris Agreement, an international treaty through which parties have committed to limiting the global average temperature rise to around 1.5°C. As a result, there is already growing pressure on governments to act, leading to an increased burden of regulation and taxes on companies responsible for significant emissions. Further action will require increasingly ambitious plans for regulation, meaning the impact on governments and companies is likely only just beginning.

> Climate change is an example of a trend that, if ignored, can lead to investors taking unnecessary risk in their portfolio. Investors might look to protect their portfolio by reducing their allocation to investments most likely to be affected – for example, they might avoid properties that are at risk from flooding or weather damage. It also presents opportunities, for example investment in renewable infrastructure or companies that develop safeguards against extreme weather events.

02 Demographics: An ageing population

The world is in the middle of an unprecedented demographic transition. Across the developed world, people are living longer and having fewer children than ever before. This means the proportion of the population over 65 is rapidly rising at the expense of the working age population. For example, the UN estimates over 65's could make up 28% of the EU population by 2050 (currently 19%).

The increase in the elderly population means an increasingly large proportion of national income is needed to provide support in the form of pensions and healthcare.

PERCENTAGE OF POPULATION AGED 65+

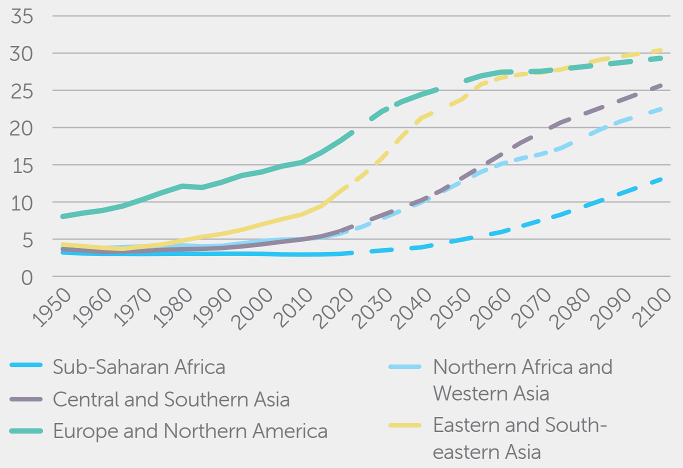

Figure 3: The rising elderly population of various regions, and projections for the future (Source: United Nations)

This will act as a drag on economic growth and contribute to lower inflation and interest rates. We have already started to see these changes to the investment landscape coming through but, crucially, this effect is likely to last for some time, with implications for global debt, as outlined below.

However, there are also investment opportunities provided by the ageing population. The shift in spending could create opportunities for businesses catering to the needs of the elderly, for example, in the healthcare sector.

03 Debt: Rising debt burden

Global debt as a proportion of GDP has never been higher. According to the Institute of International Finance, the ratio of global debt to GDP hit an all-time high of over 320% in the third quarter of 2019, with total debt reaching close to $253tn. This trend has been exacerbated by the COVID-19 pandemic, but the underlying forces long predate 2020.

NON-FINANCIAL DEBT (% OF GDP)

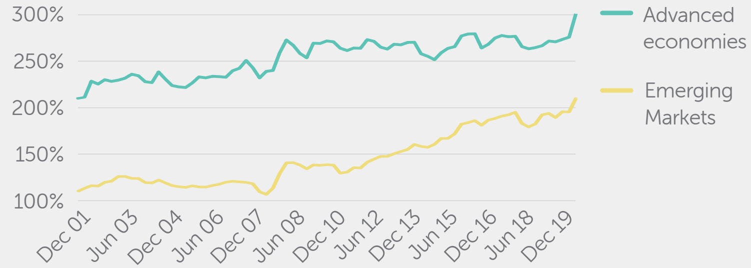

Figure 4: The rise in Non-Financial Debt over time (Source: Bank for International Settlements). Non-financial debt consists of credit instruments issued by governmental entities, households and businesses that are not included in the financial sector.

Since the financial crisis, the burden of new debt has shifted from households to corporations and governments. These institutions are able to take on a greater debt burden than individuals but this does not mean this comes without cost. Firstly, the interest payments required on rising debt are a drag on future economic growth. Secondly, rising levels of debt make raising interest rates increasingly unpalatable to policymakers.

Investors need to be aware of the constraints both global debt levels and an ageing population can place on global growth, and that a low interest rate environment could persist as a result.

In light of these megatrends, investors should think carefully about their exposure to yields and avoid overestimating the probability that long-dated yields will rise significantly.

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04 The rise of China: The rise of the middle class

Since the 1980's, China has developed from a small economy – among the poorest in the world – into a superpower, and the only rival to the United States' economic hegemony. The International Monetary Fund estimates Chinese Gross Domestic Product ("GDP") in 2020 was only around $5tn smaller than the US, closing the gap from c. $12.5tn as recently as 2007. On current estimates, the Chinese economy will surpass the US in the near future.

The Chinese economy presents many opportunities for investors as the growing middle class continues to increase the demand for consumer goods and services. If China manages to reach Western levels of income-per-head, this market could become far larger still.

> As the financial system continues to develop, investors might gain exposure to this trend by increasing their exposure to Chinese companies, which are under-represented in indices, rather than relying on exposure through Western-listed companies. We talk more about accessing this megatrend in our dedicated note on investing in China.

GDP IN CURRENT PRICES ($tn)

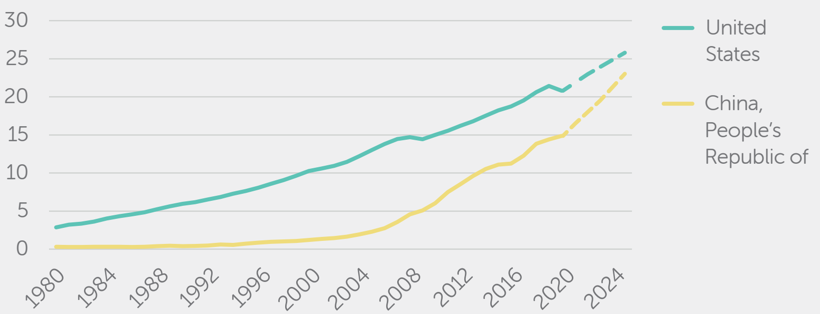

Figure 5: China v USA GDP in terms of current prices, USD (Source: IMF)

05 Technological development: Digital innovation

Technological development goes beyond a megatrend; it provides the backdrop for all human history. However, at any one time there are a small number of key technologies driving the change. In recent years, this has largely focused on communications and information technology. The changing sectoral breakdown of the S&P 500 demonstrates this perfectly. The Information Technology and Communication Services sectors' combined share of the index has grown from 22% to 39% in the decade to 2020.

CHANGE IN S&P EXPOSURE BETWEEN 2010 AND 2020

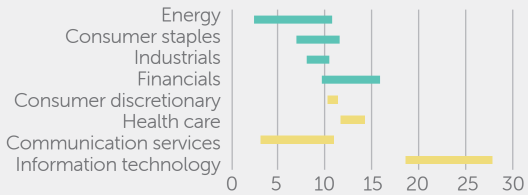

Figure 6: The emergence of information technology and communication stocks in S&P 500 (Source: S&P)

This trend looks set to continue, but the next wave of innovation could come from other sectors. Artificial intelligence, big data and robotics are among the key technologies that could once again transform the world over coming decades.

> One way to access this megatrend is through venture capital – small innovative technology companies are risky but offer the best opportunity to capture the latest wave of high-growth disruptive technology.

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Return-boosting or risk mitigation?

As mentioned at the start of this note, investors may reflect megatrends in their portfolio in order to boost returns or they may do it to mitigate risks. This is illustrated in the examples below, which expand on how investors might reflect the China and climate change megatrends in their portfolios.

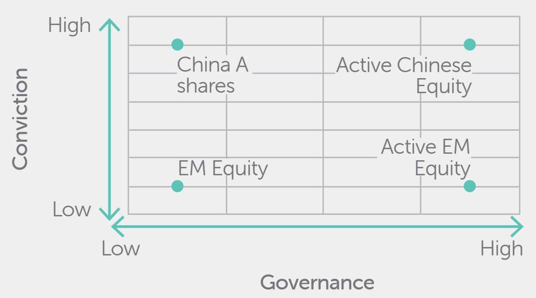
Return boosting: Rise of China

Investors might capitalise on this trend by adjusting the level of specialisation and active management in their growth asset portfolio. Low governance clients can gain exposure through passive index funds, such as an overweight allocation to an Emerging Market equity index. Higher conviction investors could opt for a more concentrated allocation, such as a China-only equity index fund. If you have a higher governance budget, you can start to think about taking an active approach by finding a manager that matches your level of conviction.

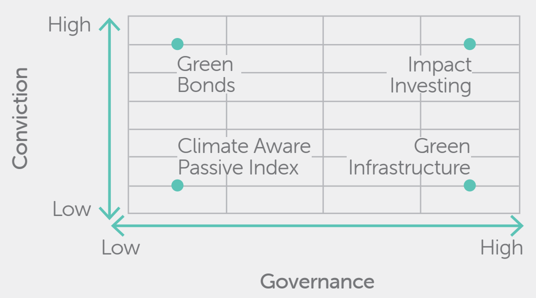
Risk-mitigating: Climate change

Here, investors should start by identifying and attempting to mitigate their exposure to companies that might suffer as a result of climate change or the associated regulations. Low governance clients can move passive equity funds into climate-aware versions of their existing holdings. Higher governance investors with strong conviction around the trend might look to private markets and impact investing.

INVESTING FOR EXPOSURE TO RISE OF CHINA



INVESTING TO MITIGATE CLIMATE RISK



Using megatrends to build a portfolio

We have now tackled the question of why it is important for investors to be aware of megatrends and set out what we think are the key trends. This section focuses on how you, as investors, might use this knowledge when building your investment portfolio.

Megatrend investing and you

Before anything else, in order to decide how to reflect megatrends in a portfolio, investors must analyse their own ABCs (Aims, Beliefs and Constraints). The first step for investors should be an analysis of their own position regarding the following key factors:

1. **Time horizon:** If you are not able to wait until the megatrend has a chance to play out, then you will not be able to reap the benefits of following a megatrend.
2. **Your beliefs around megatrends:** Take some time to work out your own beliefs and the beliefs of other key decision makers. For example, how likely do you think a trend is to play out? How much of an impact on assets do you expect? Does it conflict with other high conviction trends?

   Be prepared to take some time for education about the trend and to challenge your beliefs before investing.
3. **The level of Governance you are willing to devote to the trend:** How much of your governance budget are you willing to devote to monitoring your investment?

Only once you understand your own position, can you then look into the specific methods of investment listed below.

Reflecting megatrends in your portfolio

We believe there are four ways investors might reflect megatrends in their investment portfolio in order to build a portfolio that has a truly long-term focus:

1. **By reflecting the impact of megatrends on long-term risk and return targets**
   In the previous section, we noted some trends that will affect prospects for economic growth and interest rate rises far into the future. Being aware of this as an investor allows you to adjust your expectations for returns over that period and, if appropriate, adjust your risk approach accordingly.
2. **By being able to accept short-term volatility (but acknowledging there are limitations to investing in trends and knowing when a trend has run out)**
   One of the most common issues with building long-term portfolios is investors struggle to weather short-term volatility, leading them to make changes to their portfolio that move against the long-term trend. Obviously, this has to be weighed against the possibility the trend was wrong or has run its course.

   Linked to this, private markets may be the best or only way to access some megatrends. However, investors should think carefully about this as the lock-up time for private assets reduces the ability to adjust your allocation as different scenarios play out.
3. **Through asset allocation decisions**
   There are instances where asset allocations decisions can be used to take advantage of opportunities presented by megatrends – for example by adjusting your exposure to climate risk or China – we mentioned a number of these in the previous section. Investors should look to back strategies that can capitalise on these trends and, crucially, avoid those likely to fall by the wayside.
4. **Through fund manager selection**
   Select fund managers that take a long-term view and reflect megatrends in their allocations.

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Conclusion

Megatrends will continue to shape the future of the world over the coming decades. Investing in order to ride the waves generated by these forces has the potential to boost returns for those willing and able to get ahead of the curve. There is no single best way to allocate your investment to reflect a trend, but the first step should always be to understand how they interact and fit in with your own aims, beliefs and constraints. Not all approaches will be suitable for every investor, but every investor will have exposure to the trends in their portfolio and should be willing to recognise the opportunities and risks that they offer.

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Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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