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Mid-month update in view of drawdown in equity markets

14 March 2020

We wanted to give you an update on the status of our strategies given the exceptional volatility and cascading effects of the COVID-19 outbreak.

As of Friday evening (13 March), the MSCI AC World Index has declined by 19.9% year-to-date (in US dollars) while our strategies have seen declines in their net asset values of between 7.7% and 20.2%, entirely owing to moves this month.

Clearly March has become a terrific storm of volatility which relates to the chaotic progression of government policies trying to control the pace of infection rates within European and now North American populations. We think the primary 'new news' is that the virus has spread substantially farther in reach and more deeply within populations such that increasingly negative scenarios of an outbreak cycle are being presented (larger and longer). It has also become somewhat clearer in the last two weeks that the response framework and protocols in the West are asymmetrically weak compared to those seen across Asia during this crisis and, worryingly, particularly so in the US. Lastly, it is clear that investors, who are also citizens of these regions, are reacting to increasing personal uncertainties with a severe risk-off response.

The increased severity of the infection rate in the West is now leading to more drastic responses by governments (such as Italy) that, in turn, are having a profound negative impact on businesses in the short run. Putting it simply, many sectors of non-essential activity which require any form of physical interactions are being (or will likely be) curtailed or shuttered temporarily, in efforts to slow the progression of the virus. This then leads to significant uncertainties over not just near-term operating metrics, but the likelihood of short-term negative cash flows and increased risks on solvency. As more sectors are impacted, a network effect of increasing risks is created.

The other 'surprise' that has occurred relates to energy markets, where Saudi Arabia and Russia (ostensibly) failed to reach an agreement on short-term production cuts to stabilise energy prices, in light of the cascading demand shock for oil products. This has resulted in a disorderly change in equilibria price and a major shift in perception that the US will need to accommodate more production cuts ahead. This has created a major dislocation in the energy sector and an attendant blow-out in high yield spreads across affected regions/industries. This is likely to be a structural shift, given progressions of market share losses ahead for oil due to the energy transition and drive for decarbonisation.

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What does all this mean for our strategies?

First, markets have already reacted – a lot. To put things in perspective, the VIX (implied volatility indicator) has spiked to levels associated with the global financial crisis (GFC). Global interest rates have dropped even further and synchronised to the lowest levels in history, particularly now even in the US. Implied default rates have spiked, and rapid negative revisions to GDP imply that, at a minimum, we have entered a short-term recession.

Equities have fallen by circa 20% year-to-date and by substantially more since recent peaks in February – all in a just a few weeks. Many cyclically exposed equities have already fallen by twice as much. Firms with leverage or negative cash flow have, predictably, performed the worst. By any reasonable measure, the market has quickly become somewhat 'cheap', certainly compared to bonds, but also on long-term P/Es, expected growth rates, etc.

The ability of governments to get the infection rates under control and turn them over, as accomplished in Asia, will be a key metric to watch. It is difficult to envision that markets can really stabilise until there is some evidence of such an event.

We are confident that governments will underwrite much of the disruptive financial impacts for individuals and companies, such that we will see limited insolvencies or defaults. Already measures have been announced by the Bank of England and central banks, implying policymakers understand they must stop contagion in populations from becoming contagion in financial markets. This will require more coordination amongst legislators underwriting rescue and stimulus measures. It is worth noting that governments know that the crisis becomes exponentially more expensive to underwrite (in terms of disruptive economic effects and real financial costs) if it continues to grow. This provides a strong incentive for a "whatever it takes" strategy, much like the GFC.

From an investment perspective, we believe this is one of those periods where the priority is to not over-react. Our portfolios are significantly overweight asset-backed businesses in clean electricity and waste. The events unfolding are unlikely to have a material impact on utilities' underlying businesses, either in a short-term or structural way. We could argue that, as long duration assets, there should even be some upside pressure on valuations, perhaps offset by market risk premia impacts.

As regards the impacts of lower oil prices, we would note two things. First, oil is an almost non-existent part of the global electricity supply mix, save for within the Gulf States/Africa and a few island nations. The only bearing oil has is via pricing for LNG, which is derived by a mixture of long-term contracts and oil-linked price formulas. As such we do see some downward pressure on imported natural gas prices ahead (on those formulas) which, paradoxically, may create some headroom for additional renewable development, as a complementary resource. The second point is that US natural gas prices are extremely depressed, in large part due to the growth in shale oil production and 'associated' gas. If we believe US oil production will need to reverse in volume, it is likely that associated gas production will also fall, perhaps rapidly. This could put some upside pressure on gas prices in the intermediate term, which generally would be supportive of slightly higher power prices, particularly in the US. For now, the demand shock of lower energy needs would counter any of those impacts. We don't believe that a sharp decline in electricity demand in the West is likely through this crisis, but we will see some impact.

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As for the remainder of our portfolios, some of which have exposure to various forms of industrial verticals, we see varying degrees of the same impact. This is an exogenous and transitory shock and, as such, is not the kind of event that we seek to exploit or use to reposition strategy. Factors associated with the energy transition and sustainability may be slightly disrupted in the short-term, but we can't see many risks emerging derailing any of our core investment themes or overall positioning over the medium term.

We continually examine the portfolios for robustness, in terms of how well the portfolio investments can weather events like these, and if we see anything that presents as a real structural change, we can act accordingly. We are looking for opportunities to either increase weightings in existing holdings or establish new positions in great companies if relative valuations and performance accommodate. And, while we may not be at the end of this large market correction, we are certainly now some way from its beginning, and stocks in our portfolios are demonstrably cheaper and thus more, not less attractive.

Global Renewables Infrastructure Strategy

Year-to-date the strategy has outperformed the broad market and the infrastructure universe. Volatility has risen substantially, however, and the correlation of all equities has increased, including the companies in our typically 'low correlation' investment universe. The intrinsic value of most companies we invest in remains broadly intact as their largely regulated and contracted business models provide good cash flow visibility and low exposure to cyclical drivers and energy prices. Moreover, their dividends provide an attractive source of return in absolute terms, especially in the context of interest rates falling further. The investment team is slowly preparing to use the broad market weakness to increase position weights in long-term structural growth names which we view as attractive.

Sustainable Listed Infrastructure Strategy

After proving able to generate strong returns in rising markets, the strategy has been showing its defensive characteristics year-to-date, outperforming both the general equity markets and the relevant global infrastructure indices. This investment universe is dominated by asset-backed companies providing services generally under fixed-term contracts. The long duration of those contracts provides a high degree of predictability for future cash flows and promotes the sustainability of dividend flows. While the typical 4-5% dividend yields – which have increased further in the recent stock market turmoil – contribute to capital preservation, the strategy, critically, is exposed to the secular growth trends generated by the disruption introduced by clean power generation sources. The underlying businesses for the holdings in our portfolios are not materially affected by the turmoil in the global economy such that, for the most part, we expect marginal effects on their earnings and return profiles. These companies are, as well, largely immune to commodity price fluctuations given that most renewable energy projects are based on fixed prices for the duration of the contract. Furthermore, the regulated part of our investment universe would be a net beneficiary of persistently low interest rates worldwide.

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Energy Transition Strategies

Long-only

Year-to-date this strategy has performed similarly to the MSCI All World Index. The underlying fundamental themes remain intact in the mid- to long-term, and the investment team is very slowly using the broad market weakness to increase position weights in long-term structural growth names which we view as attractive. The strategy continues to maintain a balance between exposure to asset-backed growth which generally includes companies with business models fundamentally less exposed to Coronavirus disruption, and industrial cyclical businesses which will be impacted short-term but longer term remain on track to benefit from the broader energy transition themes the investment team has identified. The team believes that the potential exists for any major stimulus programmes to accelerate the adoption and penetration of energy transition businesses.

Long/Short

The alpha generated between the long and short books of the strategy year-to-date has been beneficial to overall performance. The net exposure of the strategy was reduced at the start of March. The long book year to date has performed similarly to the MSCI All World Index while the short book has underperformed the MSCI All World Index. The underlying fundamental themes remain intact in the mid- to long-term, and the investment team is very slowly using the broad market weakness to increase position weights in long-term structural growth names which we view as attractive. The strategy continues to maintain a balance between exposure to asset-backed growth which generally includes companies with business models fundamentally less exposed to Coronavirus disruption, and industrial cyclical businesses which will be impacted short-term but longer term remain on track to benefit from the broader energy transition themes the investment team has identified. The team believes that the potential exists for any major stimulus programmes to accelerate the adoption and penetration of energy transition businesses.

Sustainable Global Water Strategy

Following a strong beginning to the year, the strategy has been resilient in the volatile market, proving its defensive qualities and outperforming both the general equity markets and relevant water indices.

Water companies are essential in connecting water supply with areas of demand and ensuring water quality through the treatment of water/wastewater. The critical nature of their activities provides support for sustainability of earnings and cash flow generation. Water utilities are particularly well positioned due to their regulated asset base, earning stability, and attractiveness in the low rate environment. The recent focus on improved sanitation as a result of COVID-19 may also present earnings tailwinds for companies with products/technologies that disinfect water/wastewater to improve water safety and general sanitation. Longer term, we believe the water sector offers attractive secular growth as companies execute on a robust slate of infrastructure projects and technology offerings aimed at ensuring a safe and reliable water supply.

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Global Renewables Infrastructure Strategy

	MTD	YTD
Global Renewables Infrastructure Strategy (USD)	-15.8%	-13.6%
S&P Global Infrastructure Index (USD)	-19.0%	-25.6%

Sustainable Listed Infrastructure Strategy

	MTD	YTD
Sustainable Listed Infrastructure Strategy (GBP)	-14.9%	-16.3%
S&P Global Infrastructure Index (GBP)	-16.3%	-20.0%

Energy Transition Strategies

	MTD	YTD
Energy Transition Long-only Strategy (USD)	-17.5%	-20.2%
Energy Transition Long/Short Strategy (USD)	-10.1%	-7.7%
MSCI AC World Index (USD)	-11.9%	-19.9%

Sustainable Global Water Strategy

	MTD	YTD
Sustainable Global Water Strategy (USD)	-8.4%	-12.0%
S&P Global Water Index (USD)	-11.9%	-17.7%

Source: Tortoise UK, Bloomberg. Strategy data is net of fees. Strategy data and index data are total returns. Total return includes dividends paid, if any, and reinvested. Index returns do not reflect any fees or costs.

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PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. Index returns are shown for reference purposes only.

The Energy Transition Unrestricted Carve-Out Composite includes all portfolios managed in the Energy Transition strategy which includes the long-only carve out of an existing Tortoise Fund alongside other standalone funds. Performance is net of 1.5% management fee on the carve-out portion and uses actual net performances for other standalone funds.

The Renewable Infrastructure Broad Standalone Composite includes all standalone portfolios. Performance is calculated using actual net performances for the standalone portfolios.

For both composites above, Tortoise UK claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Tortoise UK has been independently verified for the periods 01/01/2013-31/12/2018. The verification report(s) is/are available upon request. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report.

The Sustainable Listed Infrastructure Strategy composite includes the simulated gross performance (unlevered and in USD) of a fund (listed investment trust) under the management of the adviser since its inception on 26 September 2016 and the gross performance of a UCITS fund (also in USD) under the management of the adviser since its inception in August 2019. Net performance has been calculated on the basis of (1) a fee of 1.25% until March 2019 and 1% thereafter for the listed investment trust and (2) on the actual net performance for the UCITS fund which has an expenses cap of 1.35%. Neither fund has a designated benchmark, so the S&P Global Infrastructure Index is presented as a reference point only.

The Tortoise Sustainable Global Water Strategy Composite includes all portfolios managed according to this strategy and performance is calculated net of 0.75%, the highest management fee charged to any client whose account is included in the composite (actual fees for accounts within the Tortoise composite vary).

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