Investec

OUT OF THE ORDINARY

WEEKLY DIGEST | 11 October 2021

For want of a nail

John Wyn-Evans
Head of Investment Strategy

Jimmy Muchechetere
Equity Research Analyst

Many of you will no doubt be familiar with the proverb that begins with the want of a nail - maybe fewer with the opening track of Todd Rundgren's 1989 album Nearly Human! To remind you: For want of a nail the shoe was lost; for want of a shoe the horse was lost; for want of a horse the rider was lost; for want of a rider the message was lost; for want of a message the battle was lost; for want of a battle the war was lost; for want of a war the kingdom was lost... and it was all for the want of a nail.

The proverb has apparently been around in various forms since the thirteenth century and alludes to how something that initially appears to be immaterial can ultimately have extremely serious consequences. Those medieval sages certainly understood a few things about the way the world works and might have been well employed today examining the economic effects of the COVID-related disruption on supply chains. As a result of these disruptions, political offices, if not actual kingdoms, might be lost in future elections. But, more immediately, we are caught in a pincer movement between rising inflationary pressure and slowing growth, a situation that has put upward pressure on bond yields while also stopping the equity market rally in its tracks.

I wrote in some detail about the supply-chain problems two weeks ago in Solving The Inflation Equation. Since then, we have witnessed some extraordinary movements in commodity prices, not least that of natural gas in the UK, which doubled again to more than 400 pence per therm briefly, before almost halving when Russia's President Putin suggested he might be willing to alleviate the situation (in return for some favourable treatment). To put the latter move into context, the twenty-four-hour fall in the gas price of 198 pence between Wednesday and Thursday mornings last week was bigger than the highest price gas had ever been until about three weeks ago.

At the same time the UK's petrol shortage, owing to a lack of tanker drivers as opposed to actual fuel, lingers, while pigs that were destined to be eaten are being culled on farms owing to a lack of carbon dioxide with which to kill them humanely at the slaughterhouse.

UK new car sales in September fell to the lowest level for that month since the new registration system was introduced in 1999, owing to the shortage of semiconductor chips that are an integral component of new cars today(long gone are the days when a Haynes manual and socket set were all you needed to undertake most maintenance!). The Financial Times even had an article about a shortage of the paper that wedding invitations get printed on. Never underestimate the desire of journalists to dig for emotive copy, even if (with apologies to those organising weddings) this is not exactly mission-critical stuff. Even so, we must brace ourselves for many more weeks of stories in this vein, especially when it comes to anything to do with Christmas.

I still want to dig deeper into how this will play out in financial markets. As I mentioned in the last Weekly Digest, an awful lot will hang on the reaction of central banks: should they tighten policy to stave off inflationary pressures or should they hold off owing to the reduction in overall activity? Two members of the Bank of England's Monetary Policy Committee (including the Governor) have definitively come out in the former camp in interviews conducted over the weekend. But even then, how far can they go given the levels of debt that prevail? It remains very hard to see a return to positive real interest rates any time soon. And neither is it clear that all central banks will have similar views, which could well lead to more currency volatility than we have been used to for a while.

My colleague Jimmy Muchechetere approaches supply chain risks from an equity research perspective. While my role is to help to steer the tactical asset allocation to different asset classes relative to the strategic asset allocation benchmarks, the analysts in the Investment & Research Office get their hands much dirtier under the

bonnet. I hope this will provide another example of the depth of our investment process.

Jimmy explains: “At Investec we think carefully about supply chain risks when we make investment decisions on behalf of our clients. As long-term investors, we evaluate the strategic planning and resilience of companies, and look for an ability both to weather short-term disruption and to adapt to long-term structural changes.

Before Covid-19, many companies’ supply chains were geared towards 'just-in-time' inventory levels: carrying too much stock is a drain on working capital, tying up cash that could be used elsewhere in the business. But disruptions to the movement of goods and provision of services caused by Covid-19 restrictions exposed a weakness in this model. A recent report from consultants McKinsey on the pharmaceutical industry is a timely reminder that not all supply chain shocks are created equal in either timing or impact. But the best businesses have been able not just to survive, but to adapt and emerge stronger from this crisis.

Adaptation took many forms. Whereas, historically, the cheapest supplier usually won the business, the emphasis moved to local or regional supply; many companies moved to multiple sourcing to spread the risk, rather than relying on perhaps as few as one or two suppliers. Some inefficiency was deliberately reintroduced into the supply chain, with higher inventory levels seen as a sensible price to pay to ensure business continuity.

Unfortunately, not all companies, or indeed whole sectors, have been able to make these changes. Many Western clothing companies, some of which source almost all their product from Asia, have been unable to switch quickly when their existing suppliers have been forced to close by government mandate, for example in Vietnam. Other structural impediments can be longer term, with shortages of truck drivers being a case in point, while capacity constraints in (for example) the semiconductor industry have been exacerbated by Covid-19 and will take time to resolve, with clearly negative implications for the automotive and computing industries. And some resources simply cannot be increased to match rising demand: certain rare earth minerals, used in the manufacture of high-tech components, are in finite supply.

The consequences reach far beyond companies’ bottom lines. For consumers, fuel or food shortages can go beyond the merely inconvenient, while inflation can be stoked up in situations such as this when demand outstrips supply. How do we factor these risks into our equity investment process?

As stewards of our clients’ capital, we play the long game. We look for companies that have strong pricing power or that can pass through higher costs, for example via the structure of their contracts – or, in some cases, both. There are many facets to this. Such companies typically have multiple suppliers and so are not price-takers. Global supply chains and multiple production facilities mean that constraints in one market may be compensated for by increasing production elsewhere. Furthermore, for many companies that we find attractive, their competitive advantage lies in their intellectual property and proprietary processes. This means that the critical parts of the value chain are almost entirely within their control. Factors such as these can demonstrate the resilience of a

company’s supply chain.

But what of its sustainability? Companies with strong long-term relationships with their suppliers tend to have a sustainable competitive advantage. This frequently involves significant investment in their supply chain. This can include building local infrastructure, such as transport links, schools or hospitals where suppliers are located. Or, in the case of several major food companies, it may take the form of providing loans to farmers to help them become a part of the supply chain in the first place. Greater oversight of the supply chain and close relationships with suppliers mean that the best companies have a greater chance of securing supplies at times when there are shortages. Importantly, we look for companies which have a firm eye on the future, which can help ensure supplies long into the future. Again, this can take many forms – responsible land use, reduction in deforestation, reducing plastics usage, sustainable farming and fishing to name but a few.

The companies we seek to invest in continuously innovate to improve the efficiency of both their supply chains and their production processes. Technologies such as artificial intelligence and data analytics are being deployed to predict demand and, as far as possible, match it with supply – often in near-real time. Cutting waste has an important role to play and a particular focus for us in this regard is the concept of a circular economy – where waste is reduced through the reuse and repurposing of materials. This naturally reduces pressure on supply chains.

The biopharmaceutical sector provides a good example of this, against a background of the world producing some 380m tonnes of plastic every year, 80% of which is simply thrown away. According to a Circularity Gap report, committing to a circular economy could cut greenhouse gas emissions by 39% and ease the pressure on virgin materials by 28%. Biopharmaceutical companies have embraced these concepts through the 3R Initiative (Replace, Reduce, Refine) to improve animal welfare. 3R extends to all aspects of the supply chain and product consumption, with the benefits extending far beyond easing supply chain pressures. 3R has spawned several new business models, while simultaneously tackling climate change and biodiversity loss.

Covid-19 has changed our lives in many ways. It has forced businesses to rethink the way they operate, with far-reaching adaptations to their supply chains. The best, which we seek to invest in, are able to thrive where their competitors struggle and to do so in a sustainable fashion. At Investec, we actively engage with management teams and boards of directors to challenge them to balance profit with purpose; we see value creation for shareholders as an output from a sustainable approach benefiting all stakeholders, which creates enduring worth – living in society, not off it. We are therefore able to look beyond the short-term vagaries of the market, and indeed the supply chain, to focus on the long term while also being willing to take advantage of any short-sightedness in the market."

Economic Commentary

FTSE 100 weekly winners

Tesco PLC	11.2%
HSBC Holdings Plc	8.0%
Pershing Square Holdings Ltd Public Class USD Accum.Shs	4.9%
BP p.l.c.	4.6%
Polymetal International Plc	4.2%
Royal Dutch Shell Plc Class B	4.2%
Fresnillo PLC	4.2%

FTSE 100 weekly losers

BT Group plc	-7.9%
Next plc	-7.4%
Melrose Industries PLC	-4.6%
International Consolidated Airlines Group SA	-4.4%
Whitbread PLC	-4.3%
DS Smith Plc	-4.0%
ITV PLC	-3.8%

FTSE 100 index, past 12 months

The information in this document is for private circulation and is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. The Company and its related Companies, directors, employees and clients may have position or engage in transactions in any of the securities mentioned. Past performance is not necessarily a guide to future performance. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore we strongly recommend you consult your Professional Adviser before taking any action. All references to taxation are based on current levels and practices which may be subject to change. The value of any tax benefits will be dependent on individual circumstances.

investecwin.co.uk

Member firm of the London Stock Exchange.
Authorised and regulated by the Financial Conduct Authority.
Investec Wealth & Investment Limited is registered in England.
Registered No. 2122340. Registered Office: 30 Gresham Street, London, EC2V 7QN.