

Don't lead, follow The Money

Published on: 12 November, 2021 | Author: Investment Team

Environmental investing has gained prominence over the last few years. As the evidence showing the human impact on the climate piles up, companies and governments are increasingly voting with their wallets instead of just paying lip service to the issue. This naturally has implications for us as custodians of your investments.

The trend towards sustainable investing has the ability to direct investment towards certain industries and away from others. This could lead to a change in pricing behaviour and the long-term valuations attributed to certain sectors and companies. This is a concept known as “reflexivity”, coined by the financier George Soros. It essentially means that people's beliefs can influence reality, regardless of how accurate the belief is.

Changing investor perceptions, thereby classifying some industries as “good” or “bad” based on their compliance with certain environmental, social and governance metrics will affect how easily an industry can tap capital markets in order to grow. Industries classified as not sustainable will increasingly find it more difficult to raise capital for future growth projects. Corporate bonds and dividends may need to yield slightly higher rates than usual in order to attract otherwise unwilling investors, thereby raising the cost of capital. For industries classified as sustainable, the opposite would be the case and, all things being equal, they would find it easier to raise capital from a sea of willing and able investors.

This has happened many times throughout history. In 1830s Britain, the first modern railroad was built between Liverpool and Manchester. By 1842, Queen Victoria made her first train ride. By 1845, almost 200 new railway companies had come to existence, and railway industry saw stock market gains of over 100% in this period. In the summer of 1845, the British parliament published a report showing the identity of 20,000 investors that had invested at least £2000 in railway stocks (that's about £250,000 in 2021). Spurred by this revolutionary new mode of transport and a huge untapped market, this list of investors included Charles Darwin, the Bronte Sisters, several members of parliament and clergymen, and thousands of ordinary middleclass citizens. By 1850, the price of the railway index had fallen by almost 70%.

Increased investment created increased supply and overcapacity. This led to rabid competition among different railway companies and, ultimately, lots of bankruptcies.

But it wasn't all bad news, at least on a broader scale. Some bubbles can be hugely beneficial to the wider society since overinvestment in an industry can act as a permanent anchor on prices. In this case, offering a cheap means of transport to the masses. By 1855, there were over 13,000 km of railway tracks in operation. Today, that number is about 16,000km. Therefore, almost 80% of the current length of the railway lines in Britain were built during the railway bubble.

The same pattern was observed in the dot-com bubble. A new technology – the internet, promised quick riches to would be investors. Telecom companies raised over \$2.5 trillion from investors through stock and bond issues. This money was used to lay down more than 80 million kilometres of fiber optic cables. These cables are like the railways of the internet, shuttling bytes of data across the globe. Most of these cables remained unused for several years. This overcapacity, however, reduced the cost of bandwidth by almost 90%, creating the internet as we know it. In both the railway and dot-com bubble, investors and speculators lost their shirts, but society gained tremendously from the secondary effects of overinvestment and investor frenzy. The cost of transport and internet bandwidth fell significantly, creating the world as we know it today.

What are the lessons from history? Clearly in 1830s Britain, it would have been a bad idea to invest in a long haul horse and carriage rental company just as the railway industry was booming. But there is another lesson. When following a new trend like ESG and climate friendly investing, it is important to avoid companies or industries at risk of being commoditised. Solar panel manufacturers are a prime example. Low-cost manufacturers from China, subsidised by the Chinese government, have decimated their US competitors. Excesses of capital, whether from the government, investors, or both (as is the case with ESG investing) can increase valuations to unsustainable levels, which almost guarantees poor medium-term returns. Excessive investments can also reduce the cost of capital thereby sowing the seeds of overcapacity and future price declines to come.

Whether it's the falling cost of transport after the railway bubble, the falling cost of bandwidth after dot-com bubble, or now, the falling cost of renewable energy during what some would call the green bubble, the lesson remains the same. The real economic value is not tethered to the commodity asset – whether its railway tracks, fiber optic cables, or solar panels. The economic value lies in companies that will take advantage of the falling prices created by the initial overinvestment.

In Britain, there was no big direct winner from the falling transportation costs created by the railways. In America however, the big winner was Standard Oil, which used the railroads to cheaply transport oil to the East coast where it could be shipped to Europe. Most of the large technology companies like Google, Netflix, Amazon, and Facebook would be shadows of their present selves without the initial overinvestment in fiber optic cables. Low-cost bandwidth was a necessary precursor to the success of these companies, yet the companies that created and installed these cables cost their investors a lot of money. At Tacit, we would argue that the same logic applies to the investment into the many new green technologies that we know about today.

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