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Inside: Clearer skies ahead in 2021?

WELCOME

Simon Hillenbrand
Head of UK Retail

For the second successive time I am writing this from a desk at home rather than in the office. It speaks of the considerable change that actions to tackle the coronavirus pandemic have had upon our lives. Once more, our sympathies extend to those who have been affected by COVID-19 at a health, personal and economic level. This has been a stormy journey but there are reasons to believe clearer skies lie ahead.

The stop-start cycle to lockdowns and economic restrictions created volatility within investment markets but the standout story of the second half of 2020, eclipsing even the drama of the US elections, was the news of effective vaccines.

Vaccine boost

The logistics of vaccinating whole populations at speed are challenging, but vaccination programmes offer the prospect of something closer to a more normal way of life by summer. Markets are typically forward-looking and many areas that had been struggling rallied in the final months of 2020. That is not to say everything will revert to how it was before. Mutations of the virus remain a potential threat. Health and safety precautions are likely to be with us in varying degrees beyond the end of 2021, while more broadly, COVID-19 has accelerated changes within the economy.

This issue looks to the year ahead. On pages 4-5, Paul O'Connor notes how economic activity and earnings are set to recover, although it will take time to repair the damage wreaked by COVID-19 and the economic dislocation. On pages 12-13, Hamish Chamberlayne explores the momentum within sustainable development as more countries embrace a low-carbon future, particularly following change at the White House. On pages 14-15, portfolio managers reflect on why UK and European equity markets have lagged and whether change is in store – the agreed trade deal between the UK and the European Union goes some way towards lifting a fog. Meanwhile, on pages 6-7 our Co-Heads of Strategic Fixed Income explain that the experience of bond investors can be very different to equities, underscoring the benefits of diversification.

I hope you find this issue of the magazine interesting. All that remains is for me to thank you for your continued investment with us and to wish you good health and fortune over the coming months..

Simon Hillenbrand
Head of UK Retail
Janus Henderson Investors

Past performance is not a guide to future performance. The value of an investment and the income from it can fall as well as rise and you may not get back the amount originally invested.

CONTENTS

4 **MULTI-ASSET OUTLOOK 2021 – ALL CHANGE**

News of game-changing vaccines have heralded a dramatic change in expectations for markets and the economy. Paul O'Connor, Head of the UK-based Multi-Asset Team, considers the rationale behind this optimism.

6 **CREDIT LIGHT CUTS THROUGH THE INCOME DARKNESS**

Jenna Barnard and John Pattullo explain how credit markets navigated COVID with relative ease and why corporate bonds remain in the sweet spot for 2021.

8 **CAPTURING THE SCENES AROUND EQUITY MARKETS**

Whatever 2021 brings, it is unlikely to beat 2020 for novelty. The pandemic in 2020 triggered deep recessions around the world, yet the vaccine roll out is providing glimmers of hope for an economic recovery. Here, four of our equity fund managers share their views and outlook for the year.

10 **LONG-TERM TECH THEMES SET TO BE POWERFUL DRIVERS IN 2021**

Alison Porter, Graeme Clark and Richard Clode, technology equities portfolio managers, highlight the rapid acceleration of long-term tech themes and explore expectations for 2021.

11 **BUILDING CONFIDENCE**

Portfolio Manager, Ainslie McLennan, outlines the key themes and challenges shaping the UK commercial property market.

12 **SUSTAINABLE EQUITIES: THE FUTURE IS GREEN AND DIGITAL**

Hamish Chamberlayne, Head of Global Sustainable Equities, discusses his expectations for sustainable equities in 2021.

14 **IS THE 'VALUE' RALLY FOR REAL?**

Portfolio Manager, Stephen Payne, considers whether value investing has finally ended its time in the wilderness.

15 **COULD THE SHIFT TO VALUE PROPEL EUROPEAN EQUITIES IN 2021?**

John Bennett, Director of European Equities, shares his view on the outlook for the asset class in 2021.

MULTI-ASSET OUTLOOK 2021 – ALL CHANGE

Paul O'Connor
Head of the UK-based Janus Henderson Multi-Asset Team

News of game-changing vaccines have heralded a dramatic change in expectations for markets and the economy. Paul O'Connor considers the rationale behind this optimism and areas he believes can benefit.

It is hard to avoid the conclusion that COVID-19 will be the dominant driver of financial markets in 2021, as it was in 2020. The coronavirus changed everything, killing over 1.6 million people, wiping $22 trillion[1] off global stock markets in a few weeks, plunging the global economy into the worst recession since WWII and provoking a $21 trillion monetary and fiscal policy response (Bank of America estimate, 22 November 2020). Yet, while 2020 ended with the coronavirus still rampant in Europe and the US, appetite for risk assets shows that financial markets are focusing on better times ahead in 2021.

From the virus to the vaccine

The unusually rapid development and approval of COVID-19 vaccines has been the catalyst for a dramatic reappraisal of when economic life could return to normal. Projections suggest that G7 economies should have enough doses to immunise most vulnerable people and healthcare workers by the spring and get close to herd immunity by the middle of the year. There are risks to these projections, related to vaccine effectiveness, vaccine hesitancy, and production and distribution practicalities. However, there are potential upsides, if other vaccines get approved in 2021.

Although countries and sectors will bear the scars of the COVID-19 shock for years to come, 2021 should see some decisive steps towards recovery (figure 1) as restrictions on economic activity ease from the second quarter onwards. While coronavirus flare-ups are likely in the early months of the year, financial markets may be prepared to look through such setbacks if vaccination programmes remain on track.

[1]Bloomberg, MSCI AC World Index, 12 February to 23 March 2020.

From monetary policy to fiscal policy

With interest rates, bond yields and credit spreads at or near historical lows, central banks are already doing much of what they can to support growth. From here on, fiscal authorities will have to take on more responsibility for managing the economic cycle than they have in recent decades. The big questions for 2021 will be whether fiscal policy (government spending) remains generous enough to support the recovery and policymakers quick enough to respond if more stimulus is needed.

Glass half full

Somewhat remarkably, investors have optimistic expectations for financial markets in 2021. Key indicators show that positioning is fairly elevated for equities and other risk assets. Markets may need good news just to validate consensus optimism. Still, a relatively high chance of market turbulence in early 2021 does not challenge the view of a mid-year upswing in growth and promise of a strong recovery beyond, accompanied by unusually low interest rates.

As things stand, 2021 looks like a year of exceptionally strong earnings growth, with anticipated growth rates of between 40% and 50% in the UK, Europe and Japan. While some of this recovery seems priced in, we note that the last two big rebound years, 2003 and 2010, delivered solid returns for equity investors.

Fiscal policy: a government policy relating to setting tax rates and spending levels. Fiscal austerity refers to raising taxes and/or cutting spending. Fiscal expansion is the opposite.

Monetary policy: the policies of a central bank, aimed at influencing the level of inflation and growth in an economy. It includes controlling interest rates and the supply of money.

Figure 1: consensus forecasts for GDP and earnings growth

	GDP growth forecasts (%)			Earnings growth forecasts (%)		
Region	2020	2021	2022	2020	2021	2022
US	-3.5	3.9	3.1	-11	20	16
Eurozone	-7.4	4.6	3.7	-36	48	19
UK	-11.2	5.4	4.5	-39	42	17
Japan	-5.3	2.8	1.9	-5	38	15
Emerging markets	-0.8	5.0	5.1	-5	34	16

Source: Janus Henderson Investors, Bloomberg, Refinitiv Datastream, as at 16 December 2020.

Notes: GDP = gross domestic product, a measure of the size of the economy. Japan earnings forecast shifted by one year due to different fiscal year end.

Figure 2: falling yields reflect higher prices for bonds

Source: Janus Henderson Investors, Bloomberg, as at 16 December 2020. Notes: Bloomberg Barclays global corporate and high yield indices.

New leadership

If expectations for a recovery are broadly realised in 2021, we see plenty of scope for the late-2020 rotation towards the year's laggards to continue. Regionally, that argues for a tilt away from the US, towards eurozone, Japanese and UK equities. Emerging market stocks may do well in an environment of strong growth and low interest rates, a view complicated by the high weighting of Chinese growth stocks in key indices.

Beyond equities, we see opportunities in some alternative assets, such as infrastructure and renewables, with potentially attractive valuations and access to diversifying non-cyclical[1] earnings streams. For corporate debt, the outlook is less appealing than in some years. The fundamental picture looks solid, and supply should be modest, given the surge of corporate cash-raising in 2020. The problem is simply valuation (Figure 2). While economic and market conditions should be supportive for corporate bonds, it is hard to avoid the conclusion that these assets have already priced in a lot of good news and risk-return prospects look better elsewhere.

The risks to our broadly constructive outlook are skewed to the early months of 2021. We would regard market setbacks associated with near-term flare-ups in COVID-19 as buying opportunities, so long as vaccine programmes remain on track. The emergence of any real doubts about vaccine efficacy or concerns about the longevity of immunity would be more sinister threats to risk appetite. More optimistic scenarios involve brighter developments in the battle against the coronavirus and the scope for these to unlock cash that consumers and corporates have accumulated in 2020, leading to more spending, more inflows into financial markets and more merger and acquisition activity.

[1]Non-cyclical: in this context, referring to businesses less sensitive to fluctuations in the economy, such as utilities or consumer staples.

Jenna Barnard and John Pattullo explain how credit markets navigated COVID with relative ease and why corporate bonds remain in the sweet spot for 2021.

John Pattullo
Co-Head of Strategic Fixed Income

Jenna Barnard
Co-Head of Strategic Fixed Income

CREDIT LIGHT CUTS THROUGH THE INCOME DARKNESS

'Idyllic' is the word we have been using to describe the investment environment for corporate bonds, since March 2020. This is in stark contrast to the news flow surrounding the pandemic (the positive vaccine news only arrived in November) but a confluence of market factors served to make this economic crisis one which has had only minor ripples for credit (corporate bond) markets.

For once, credit was not the villain of the piece

It is worth noting that lenders (banks and credit markets) were not the villains of the piece on this occasion, as they have been in the last two economic downturns in which they either caused or exacerbated economic weakness. Rather, this time around, lenders have stepped up to bridge liquidity shortfalls for companies adversely affected by COVID-19, ensuring that a liquidity crisis has not become a widespread solvency crisis for the large companies that access public capital markets.

Further, the key concern for corporate bond investors – solvency of the borrower or defaults – have been remarkably muted in aggregate and concentrated in obvious problem areas, which have disappointed for years, such as energy fracking companies in the US and traditional retailers in structural decline. Clearly, government and central bank support have played a crucial part in encouraging this generosity and putting a floor under the economy and capital markets. However, it has been a most unusual credit cycle, different to any experienced in living memory.

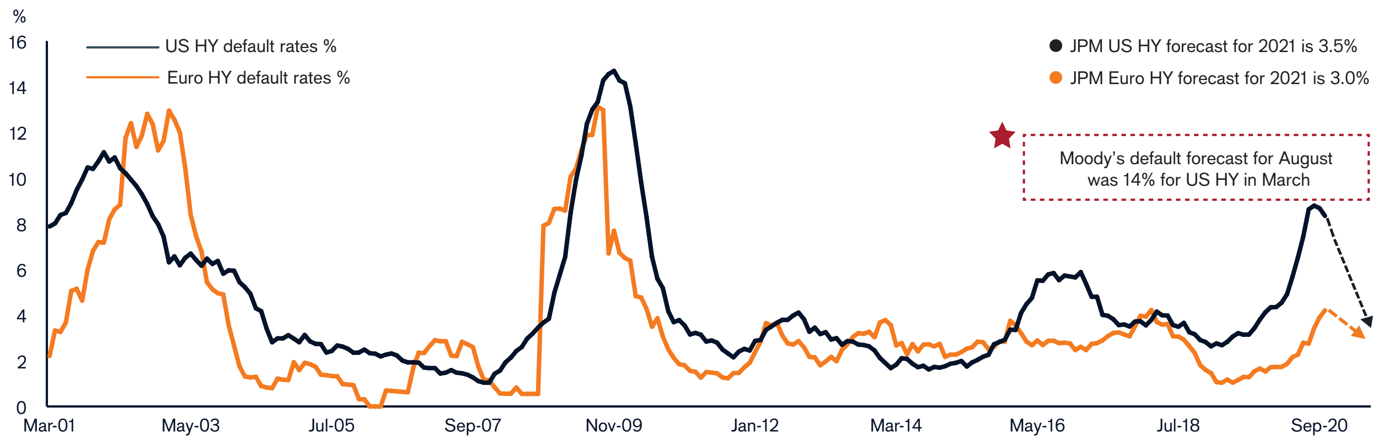
In the first few weeks of the COVID shock, we took the view that this is a liquidity rather than a solvency crisis (which subsequently proved to be correct and gradually became a consensus view after April). Thus, through March and early April, we increased our corporate bond exposure significantly (particularly in high yield) resulting in a substantial increase to income, and continued to do so in the ensuing months as opportunities presented.

The remarkable absence of a default cycle in high yield

Figure 1 shows the actual defaults experienced in the riskiest part of the corporate bond market, ie, high yield, in the US and Europe. At the height of the market crisis in March, the extreme economic downturn led credit rating agency, Moody's, to forecast default rates of around 14% for both the US and Europe.

In contrast to the forecast, Europe has not experienced a major rise in default rates in 2020, by end October it was running at 4.1% defaults and peaking. In the US, although the high yield sector has suffered (again), default rates are remarkably similar to Europe at 2.6%, when excluding energy and retail.

Figure 1: passing the peak in default rates



Source: Moody's, JP Morgan and Janus Henderson Investors, as at 31 October 2020. Note: HY = high yield.

Apart from in the very obvious sectors, there has not really been a default cycle in the high yield market. Its absence is remarkable and is a function of the government response and the willingness of credit (and in some cases equity) investors to provide monies to bridge the challenging months ahead. There have been pockets of defaults and problems of course, but it has not been a generalised cross sector default story. That is a very important point, and one that gets missed amid the doom and gloom.

Credit rating downgrade volumes reinforce the story. The surge in downgrades in the spring was expected but it collapsed very quickly and did not linger as in previous crises. With authorities' support the lights were switched back on in the corporate bond markets, which witnessed a surge in issuance, mainly in investment grade markets, but also in high yield.

More clues in the banking sector

Looking at the other risky part of the credit markets, a similar pattern has emerged in the banking sector. Actual impairments have not been anywhere near as high as expectations, when banks aggressively provisioned for future losses in their second quarter results.

Amazingly, for credit investors, this crisis has been beneficial for their bonds as banks across the UK, Europe and the US built up equity capital levels despite their conservative provisioning. This was due to both strong organic earnings and the intervention of regulators who unilaterally banned ordinary dividends and share buybacks.

Figure 2 shows the total returns of the most subordinated, hybrid contingent convertible or 'Coco' bonds, recovering almost all their losses by the end of October compared to ordinary equity returns. This is an interesting example of the divergence between credit and equity performance in this cycle.

Figure 2: benign cycle for bank credit investors relative to equities

Source: Bloomberg, Janus Henderson Investors, as at 25 November 2020.
Note: ICE BofA indices. Past performance is not a guide to future performance.

The outlook for credit investors remains encouraging

Since the height of the COVID crisis, companies have raised a war chest of cash and engaged in repairing their balance sheets. We believe that we are now past the peak in credit rating downgrades and moving past the peak in default rates.

The outlook for credit investors remains encouraging, albeit tempered by the much lower yields on offer relative to Q2 and early Q3 of 2020. The backdrop, however, remains fundamentally positive, given we are in an early cycle environment in which debt investors continue to be treated preferentially relative to equity investors. This is a sweet spot for credit.

The positive vaccine news cements this outlook and 2021 looks set to be a more interesting year for central banks than credit investors. Should the economic recovery be stronger than their pessimistic forecasts, then the guidance of no rate hikes for the next few years will be tested. As will their willingness and ability to monetise government debt via continued quantitative easing programmes.

Glossary:

Coco bonds: contingent convertible notes, more commonly known as 'cocos', issued to enhance regulatory bank capital. The bonds are loss absorbing and are designed to prevent tax payer bailouts of banks in the future.

Credit: refers to bonds within fixed income markets where the borrower is not a sovereign or government entity. Typically, the borrower will be a company or an individual, and the borrowings will be in the form of bonds, loans or other fixed interest asset classes.

Credit cycle: this reflects the expansion and contraction of access to credit (borrowing) over time. It is related to changes in the economy and the monetary policy pursued by central banks.

Credit market: a marketplace for investment in corporate bonds and associated derivatives.

Default: the failure of a debtor (such as a bond issuer) to pay interest or to return an original amount loaned when due.

Equity capital: equity capital is funds paid into a business by investors in exchange for common or preferred stock. This represents the core funding of a business, to which debt funding may be added.

Fiscal policy: connected with government taxes, debts and spending.

High yield: corporate bonds rated below investment grade (BBB/Baa3) by major credit rating agencies such as Moody's or Standard & Poor's (S&P).

Hybrid bonds: hybrid bonds are subordinated debt instruments issued by non-financial companies or corporates. They are known as 'hybrids' because they combine characteristics of bonds and equities.

Leverage: the use of borrowing to increase exposure to an asset or market.

Liquidity: typically refers to a company's ability to use its current assets to meet its current or short-term liabilities.

Solvency: the ability of a company to meet its long-term debts and financial obligations.

Structural decline: refers to when structural changes in society, including changing demographics, consumer behaviour, low-growth economics and technology-driven disruption, impact a business.

CAPTURING THE SCENES AROUND

Whatever 2021 brings, it is unlikely to beat 2020 for novelty. The pandemic in 2020 triggered deep recessions around the world, yet the vaccine roll out is providing glimmers of hope for an economic recovery. Here, four of our equity fund managers share their views and outlook for the year.

A ROSIER OUTLOOK FOR UK INCOME INVESTORS IN 2021?

Laura Foll, Portfolio Manager, UK Equity Income

2020 was an exceptionally difficult year for UK dividends, with an expected fall of almost 40% versus 2019 levels.[1] Many funds within the IA UK Equity Income peer group have not been insulated from dividend reductions.

Yet, in recent months there have been encouraging signs for dividends, with many companies that had previously suspended their dividends in spring returning to paying. This included companies such as aerospace group BAE Systems, insurer Direct Line and the engineer IMI. Looking into 2021, UK dividends are expected to recover but are unlikely to reach 2019 levels given that some companies have reset dividends lower.

Small and medium-sized companies have tended to have a higher domestic exposure than the more multinational companies in the FTSE All-Share Index and therefore could benefit more from a ‘re-opening’ of the domestic economy, although the reverse is also true if the economic recovery is slower than anticipated. We maintain that UK companies currently trade at too large a valuation discount compared with long-term averages, as well as against international peers. Recent takeover activity in the UK suggests that we are not alone in seeing UK valuation levels as attractive.

[1]Source: UK Quarterly Dividend Monitor Q3 2020. Forecast only.

ARE ASIAN EQUITIES SET FOR CHANGE IN 2021?

Andrew Gillan, Head of Asia ex Japan Equities

As 2020 draws to a close, we are seeing some changing dynamics, will this continue into 2021? The year began with positive expectations for Asian equities, with market leadership from the US. Then COVID hit, driving the continued outperformance of Asian technology and e-commerce stocks (pandemic beneficiaries), while financials underperformed. November was a turning point with markets rising from the US election result and vaccine progress. Within Asia, we witnessed a sharp rotation, with tech and e-commerce stocks underperforming, and inflows returned to Asian equities after significant outflows earlier.

The key for 2021 should be striking the right balance between the structural and the cyclical. Within the structural, ie, the beneficiaries of long-term growth trends such as rising consumption and tech adoption, some stocks appear overvalued but many do offer attractive growth prospects. Economically-sensitive cyclicals, such as financials and real estate, will likely be assisted by stronger economic data in 2021. We remain constructive on China given the wide choice of companies and sheer size of the market, but it would not be a surprise if China lags the rest of Asia in 2021 given the significant recent relative outperformance of its stock market and economic data.

References made to individual securities do not qualify as investment recommendations and are not advice.

EQUITY MARKETS

A FOCUS ON THE MORE PREDICTABLE

Gordon Mackay, Portfolio Manager, Global Equities

2020 was one of the most challenging years in recent memory in many respects. Few could have predicted the upheaval and turmoil that COVID-19 has inflicted on society, nor the wild valuation swings in financial markets that have accompanied it. Yet, despite this, global equity markets have been trading at record levels. So, where do we go from here?

The recent availability of vaccines is promising and may help accelerate economic recovery. Time will tell. That said, many uncertainties remain. How quickly and effectively can vaccines be rolled out, particularly in countries that do not have a well-developed supply chain infrastructure? What impact will the new trading agreement have between the European Union and the UK? To what extent will government stimulus impact future levels of inflation and interest rates? How will the new Biden administration proceed to implement policy in the US? These are all unpredictable variables in our view and we will not be spending time attempting to forecast them. Over the long term, we believe the most important drivers of company performance tend to be related to the unique characteristics of the underlying businesses in question and that is where we will continue to focus our time — focusing on the more predictable.

SELECTIVELY POSITIONED FOR A UK RECOVERY

Neil Hermon, Portfolio Manager
UK Equities and UK Smaller Companies

Following a seminal Conservative Party victory in December 2019 and the formal withdrawal from the European Union in January, investors started to regain confidence in UK equities. But soon COVID-19 hit and led to material outflows from UK equities, with the more economically sensitive small and mid-cap equities suffering the worst. Taking a contrarian view, we are progressively more optimistic on the outlook for small and medium-sized company equities. Governments and central banks have pledged to shore up economies, while unemployment rates have suggested that the economic scarring may not be as deep as feared. Moreover, companies across a range of sectors reported a stronger-than-expected recovery in third quarter economic activity when lockdowns were eased, offering the potential for positive earnings momentum in 2021.

Despite an initial spike in UK equities from encouraging preliminary vaccine results, many company valuations remain attractive and well below historical long-term averages. We believe our approach leaves us well positioned for an economic recovery as the virus effects ebb and the UK forges its way outside of the European Union. However, being selective is key as the recovery will be uneven. The strength of balance sheets, management teams, franchises and market position will determine the winners and losers of the pandemic.

LONG-TERM TECH THEMES SET TO BE POWERFUL DRIVERS IN 2021

Alison Porter, Graeme Clark and Richard Clode, technology equities portfolio managers, highlight the rapid acceleration of long-term tech themes and explore expectations for 2021.

Entering this year, we fully expected that strong secular technology growth themes such as payment digitisation, internet transformation (everything on demand) and next generation infrastructure would continue to gain traction. Before COVID-19 however, we would not have predicted the accelerated pace at which this would occur in 2020.

Strength in long-term growth themes

We see strong evidence that the convergence of long-term growth themes is driving an even broader set of opportunities for investors within technology. As commerce increasingly moves online, social media platforms are establishing their roles as shopping malls – developing social commerce patterns that we have seen emerge in China. This is driving demand for payment digitisation, with the ease of transacting online broadening internet transformation to areas such as education, e-sports, primary healthcare, pharmacy and groceries. As a virus vaccine is rolled out, we believe societies will revert to 'a new normal,' where we will inevitably rely more on technology.

Relative valuation of tech to global stocks

Source: Bernstein, as at 30 November 2020. Note: Forward P/E = price to forward earnings
(Orange line) MSCI ACWI Information Technology Sector, price-to-forward earnings relative to MSCI All Country World Index (ACWI) from November 2000 to November 2018 pre GICS sector changes in MSCI Global indices, then (black line) MSCI ACWI Information Technology + ACWI Communication Services Index relative to MSCI ACWI Index to 30 November 2020 post GICS sector changes in MSCI global indices. Past performance is not a guide to future performance.

But pockets of hype to navigate

Our conviction and enthusiasm for the growth prospects of the tech sector remain high, but we recognise that a combination of low interest rates and pandemic conditions has resulted in a rapid acceleration in valuations in some segments of the sector, like high growth software and certain commerce-related areas.

The chart shows that the valuation – based on the market price of companies compared to their forward (estimated) earnings – of the technology sector as a whole relative to the broader global equity market, currently appears attractive, given the superior growth profile and financial health of many tech companies.

However, the bifurcation in valuations within the sector is extreme by historical standards and reflects in part the increasing diversity within the sector. It also, indicates that there are pockets of hype (some stocks trading on more than 30 times' forecast revenues), which warrant caution and requires experience in stock selection and a disciplined valuation-aware approach.

Tech valuations and earnings power remain attractive

Given the consistent outperformance of the technology sector versus the broader equities market over the past twenty years,[1] the fact that high relative valuations remain within historical ranges (see chart) often comes as a surprise to investors. This sustained outperformance can be attributed to the superior earnings growth that the technology sector has achieved compared to other sectors. Furthermore, earnings for the technology sector have grown this year – one of only three sectors to do so.

While pockets of hype in the sector temper our enthusiasm, overall, we begin 2021 with optimism for a recovering global economy and a political backdrop that should continue to be favourable for technology equities but where valuation discipline will be required.

[1] Refinitiv Datastream. Price returns in US dollars, MSCI ACWI Information Technology Index relative to MSCI AC World Index (broader equities), 20 years to 30 November 2020, Past performance is not a guide to future performance.

Price/earnings (P/E) ratio: a popular ratio used to value a company's shares. It is calculated by dividing the current share price by its earnings per share. In general, a high P/E ratio indicates that investors expect strong earnings growth in the future, although a (temporary) collapse in earnings can also lead to a high P/E ratio.

Forward P/E estimates a company's likely earnings per share for the next twelve months.

BUILDING CONFIDENCE

Ainslie McLennan, Co-Manager of the Janus Henderson UK Property PAIF, outlines the key themes and challenges shaping the UK commercial property market.

Like all asset classes, UK commercial property continues to be impacted by COVID-19 but in different ways to equities and bonds, highlighting its benefit as a source of steady income and a diversifier within a balanced portfolio.

While property did not experience the extreme price movements that many equity investors had to absorb, the lockdowns and their impact on some businesses to pay rent, along with the market uncertainty clauses implemented by property valuers across the commercial market, affected the asset class.

A distribution warehouse in Croydon, South London, owned by the fund and occupied by Amazon.*

Transaction volumes remain considerably lower than in any other recent market cycle and are taking longer than the typical 12-week period. This is more to do with macroeconomic uncertainty than pricing. Unsurprisingly, retail and leisure, impacted the most by the pandemic, are experiencing the least investment activity.

However, optimistic news regarding COVID-19 vaccines should see small steps towards returning to the 'new normal'. This over time should be positive for commercial property, a tangible asset that supports our day-to-day social and working life.

Long-term trends

COVID-19 has accelerated the market shifts that we have been anticipating and for which we had been relatively well placed. The structural transformation within retail to online shopping has been an ongoing theme in the wider market. COVID-19 fast-tracked this with shopping centres, department stores and regional high streets being hardest hit.

Administrations are likely to continue in this challenging economic environment. We have always focussed on the strength and resilience of the underlying tenant base, as well as diversification across sectors. As at 31 December 2020, a value equating to just 0.3% of rents demanded has been written off in the portfolio owing to administrations and tenant defaults, where three of those are COVID-19 related*.

Resilience

Areas within retail that are proving more resilient are supermarkets, London high streets and retail warehouses. This is where the fund's main holdings in the retail sector are focused and is why we believe our portfolio is better positioned to weather the changes. Outside of lockdowns, shoppers often still want the ability to feel, try and touch an item before buying it so it is a case of landlords and occupiers adapting to consumers' needs.

We continue to like the industrial and logistics sectors because they are beneficiaries of the rise in online shopping, which the pandemic continues to encourage. The return of office workers is a stop-start process, but we do not foresee particular issues with the assets owned by the fund, which are all low-rise and located in London and the South East.

Fund focus

The fund retains a broad mix of high-quality assets across sectors and geographies, with a focus on location, depth of occupational demand, strength of tenant, lease length and asset management. The latter includes refurbishments and negotiating existing leases with tenants to deliver longer or more favourable terms. Sustainability has been a significant focus for the fund since 2012, when its first on-site renewable energy system was installed. We have committed the fund to become operationally net zero carbon across its portfolio by 2030.

We expect the UK economy will remain challenged into 2021 due to the pandemic and some Brexit uncertainties. Having resilient tenants occupying well-located assets has served the fund well in 2020 and we expect that will help to continue to positively differentiate the fund during 2021 and beyond.

*Source: Nuveen Real Estate, 31 December 2020.

The Janus Henderson UK Property PAIF invests in assets that may at times be hard to sell. This means that there may be occasions when you experience a delay or receive less than you might otherwise expect when selling your investment. For more information on risks see the prospectus and key investor information document.

SUSTAINABLE EQUITIES:

THE FUTURE IS GREEN AND DIGITAL

Hamish Chamberlayne
Portfolio Manager

Hamish Chamberlayne, Head of Global Sustainable Equities, discusses his expectations for sustainable equities in 2021.

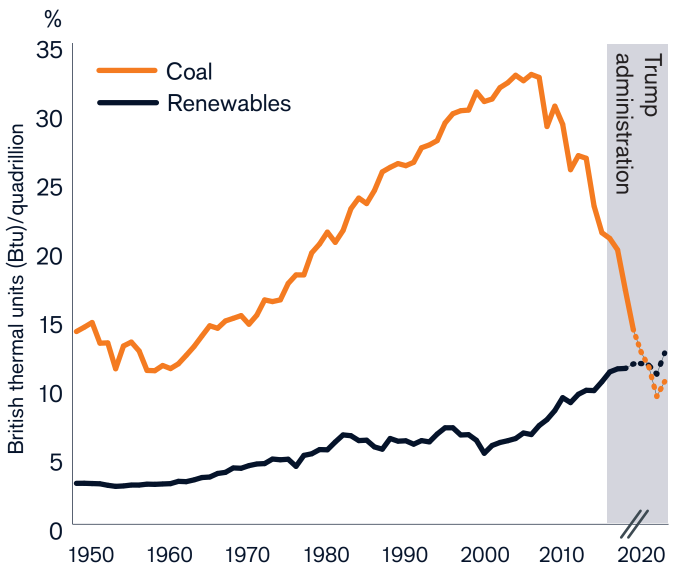
Key takeaways

- The pandemic has accelerated investment into digitalisation, which we consider to be a key enabler of sustainability.
- We expect support for sustainable development to gain momentum as countries embrace the need to be low carbon and as Joe Biden takes his seat in the White House.
- Investment into electric vehicles is expected to surge in 2021 as innovators 'race' to the top.

2020 was a turbulent and unpredictable year and yet we have seen progress made in the name of sustainability. Despite the obvious and devastating consequences of COVID-19, the pandemic accelerated investment into digitalisation and we consider this to be a key enabler of sustainability. By nature, digitalisation results in a lesser physical impact on the planet. Virtualisation of otherwise physical activities or products – such as video calls instead of business travel – is just one example. Digitalisation is also key to advancing social goals around knowledge sharing and economic empowerment and development. Amid the news about potential vaccines and a 'return to normality', it is easy to dismiss the lasting impact that COVID-19 may have on the way we live and work. We do believe there will be a permanent shift, however. From telemedicine to work-from-home setups, digitalisation has provided solutions to several of the problems faced in 2020 and we expect many of these societal changes to endure into 2021 and beyond.

Soon, there will likely be greater support for sustainable development in the US with Joe Biden's election victory. It is expected that the US will rejoin the Paris climate agreement and echo similar commitments outlined in the European Union (EU)'s green deal. Biden has already proposed ambitious plans to make US electricity production carbon-free by 2035 and to reach net zero emissions nationally by 2050. It is important to note however, that even under President Donald Trump the US made huge steps in advancing renewable energy. In March 2020, during his four-year term, US renewable consumption beat coal consumption for the first time in over 130 years[1] – see figure 1. If such progress can be made during an administration that did not appreciate the need for sustainable development, we are excited to see how much progress can be made under a supportive government.

Figure 1: US coal consumption vs renewable consumption



Yearly data from 1950 to 2019 (solid line) and monthly data from January 2020 to May 2020 (dotted line) after axis break symbol.

Source: US Energy Information Administration (EIA), monthly energy review data, as at 24 November 2020. Note: British thermal units (Btu) measure the heat content of energy sources. One Btu is defined as the amount of heat required to raise the temperature of one pound of water by one degree Fahrenheit.

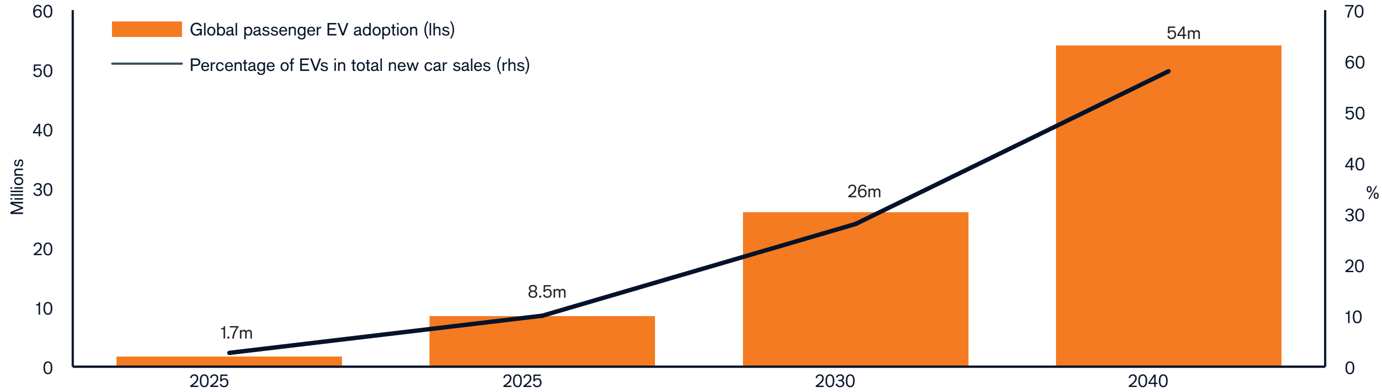
As countries embrace the need to be low carbon, the next decade will be characterised by the mass adoption of electric vehicles (EVs) – see figure 2. In the UK, plans to end the sale of petrol and diesel cars and vans have been brought forward to 2030, a decade earlier than initially anticipated. Elsewhere, Norway, Canada and Germany have targeted 100% passenger EV sales by 2025, 2040 and 2050 respectively.[2] In Europe alone, €60 billion was invested in electric vehicle and battery production in 2019, 19 times more than the year prior.[3] Meanwhile, China has also jumped on board in order to meet its ambitious new low carbon development strategy, targeting 25% EV car sales by 2025.[2]

There is clearly high consumer interest in electric vehicles. In September, an astonishing three million people tuned in to watch Tesla's Battery Day presentation where it unveiled its technology road map and investment plans for the next decade. Tesla has ambitions to increase battery production by a factor of 100 and it has identified innovations to improve both battery longevity and vehicle range. Perhaps most importantly, we expect Tesla's aggressive plans to catalyse a step up in the pace of investment across the entire automotive sector. In fact, some companies have already begun making moves. Volkswagen recently announced a €73 billion investment into electrification, hybrid powertrains and digital technology over the next five years. What is more, nearly half of that investment has been set aside for battery electric vehicles in a "race with Tesla", according to Volkswagen CEO Herbert Diess.

Based on political commitments towards a sustainable economy and the rapid pace of innovation, we see a smart, connected, digital and green future. We see a decade of clean energy and electrification, with breakthroughs in battery technology and widespread adoption of electric vehicles. We see a decade of digitalisation and connectivity, which will enable new ways of organising our economies and promote greater efficiency and circularity across multiple industries.

With interest rates low and the economy weak, we believe it is better to invest in companies with the potential to grow and compound over time and that the most attractive opportunities will be found in companies exposed to the two secular investment trends of green and digitalisation. These two trends cut across our ten sustainable development investment themes – which include Knowledge and Technology, Efficiency and Clean Energy – and help to inform our idea generation. As such, our investment approach in 2021 will not change. By focusing on our sustainable development investment themes, we believe we can find resilient companies exposed to secular growth opportunities.

Figure 2: expected adoption of passenger electric vehicles globally



Source: BloombergNEF, Electric Vehicle Outlook 2020

[1]US Energy Information Administration, 28 May 2020
[2]The International Council on Clean Transportation, Update on the global transition to electric vehicles through 2019, July 2020
[3]Transport and Environment.org press release, 25 May 2020

Portfolio Manager, Stephen Payne, considers whether value investing has finally ended its time in the wilderness.

Stephen Payne
Portfolio Manager

IS THE 'VALUE' RALLY FOR REAL?

> "BULL MARKETS ARE BORN IN PESSIMISM, GROW ON SCEPTICISM, MATURE ON OPTIMISM AND DIE ON EUPHORIA."
>
> John Templeton.

"This time it's different" ... the four most costly words in investing, according to legendary value investor John Templeton. In our view, history does indeed rhyme in markets. There was a sharp rotation away from growth and towards value stocks in November 2020, but sceptics will rightly point out that recent value rallies have been short-lived. However, this time we believe it is different.

The building blocks for an enduring rotation to value are in place, echoing an environment we saw in 1999-2000. The prospects for mean reversion alone suggest that this rally could go a long way. The economic backdrop is supportive in a manner that has been missing until now; the move from an era of austerity to one of fiscal largesse represented a fundamental shift in government policy in 2020. Central bank attitudes have clearly changed towards accommodating a modest rise in inflation – quite a shift from decades of suppressing it.

'Value' is heavily discounted relative to 'growth'

Source: Refinitiv Datastream, 31 December 1998 to 3 December 2020. MSCI UK Value Index divided by MSCI UK Growth Index. Rebased to 100. Past performance is not a guide to future performance.

This value bull market was born in pessimism (as per John Templeton's words); value stocks have been all but written off for a protracted period and growth stocks have been rampant as persistently low interest rates pushed valuations to extreme levels. As a result, the dispersion between value and growth stock valuations has been well beyond anything seen before in the UK (see chart).

From this point forward, the UK equity market seems to have all the ingredients in place for a significant recovery relative to the rest of the world. The end of 2020 represents the end of the Brexit process, helping to dispel some of the uncertainty for overseas investors. A more substantial economic recovery from the pandemic is ahead, with the UK leading the way with vaccinations. Many are now talking about the value opportunity, but portfolios have a long way to go to reflect a tangible style shift, despite the multi-decade levels of valuation dispersion within the UK market. Value has huge scope to recover and could well be back in fashion.

***Bull market:** a financial market in which the prices of securities are rising, especially over a long time. The opposite of a bear market.*

***Mean reversion:** the theory that returns tend to revert to their long-term averages over time; ie, large deviations in any direction tend to reverse over time.*

COULD THE SHIFT TO VALUE PROPEL EUROPEAN EQUITIES IN 2021?

John Bennett, Director of European Equities, shares his view on the outlook for the asset class in 2021.

John Bennett
Director of European Equities

Key takeaways:

- In late 2020, markets shifted from growth to value, thanks in part to the monetary and fiscal response to the coronavirus pandemic.
- A lasting upward change in inflation expectations may be needed to cement a more enduring move into value.
- This could offer a great opportunity for European equities as an asset class, which represents more of a value construct relative to US equities.

I believe the biggest opportunity in 2021 is for European Equities as an asset class. As a European Equities portfolio manager, my job is to operate within Europe and to pick stocks to the best of my ability within the region. However, before we even get to the stock picking stage, it is important to note that there is a great opportunity for the asset class itself in 2021 to outperform.

How might Europe's value stance benefit the asset class in 2021?

Europe represents more of a value construct and it has been growth constructs – particularly the US, such as the Nasdaq, S&P 500 and the Dow Jones – that have performed so strongly over the last decade. However, I believe that the monetary, fiscal and geopolitical response to the coronavirus pandemic will be a gamechanger to this narrative. We have already seen the tides begin to turn in markets as value makes its way back to the fore after almost a decade and I do not see this stopping. In my opinion, the ingredients are lining up for European equities, and maybe also Japanese equities, to outperform. This is potentially a great opportunity for the asset class.

Weak inflation expectations would pose a threat

The biggest risk I see to this thesis is something that could derail any durable recovery of value stocks. The biggest danger, in my view, comes in the shape of a continuing deflationary, disinflationary narrative. For a value rally to prove enduring, we firmly believe that there needs to be an accompanying macroeconomic change: a pickup in inflation expectations. A continued deflationary environment would prove to be a headwind for value stocks and European equities would have less prospect of outperforming the leader for the last decade – US equities. The risk is that this turning point from growth to value fails to persist because inflation expectations do not pick up. However, I do not think this will be the case.

So, I think the single biggest theme for European equities in 2021 will be inflation expectations and, by extension, the bond yield curve. It would not be in the interest of value stocks for German bund yields to sink lower and it is my belief that, given the macroeconomic backdrop, the yield curve may normalise and steepen slightly, albeit not necessarily dramatically.

Evidence of an economic rebound

Coupled with this, I think we are likely to see a vigorous economic rebound after a long period of subdued economic activity caused by the measures put in place to prevent the spread of COVID-19. In fact, the industrial sphere has already shown signs of an economic rebound, and given the increase in consumer savings ratios that is happening just about everywhere, it is only a matter of time before this rebound is reflected in the consumer sphere too. Many people are itching to get out, to travel and to enjoy themselves and once this happens, we are likely to see an economic boom. If this turns out to be an inflationary boom, or even just a minor pickup in inflation expectations, it will be a gamechanger in the type of stocks that investors want to own, and if I am correct in this, they will want to own value.

Glossary

Value stock – a share in a company that trades at a lower price relative to its fundamental metrics and is therefore believed to be undervalued by the market.

German bund yield: a bund is a German government bond. Yield (in simple terms) is the expected return on the bond.

Growth stock – a share in a company that investors anticipate will grow at a rate significantly above the average growth for the market.

Monetary policy – policies made by central banks, to influence the level of inflation and growth in an economy. This includes controlling interest rates and the supply of money.

Fiscal policy – government policy relating to setting tax rates and spending levels.

Deflation/disinflation – deflation is a decrease in the price of goods and services across the economy, usually indicating that the economy is weakening. This is the opposite of inflation. Disinflation is a decrease in inflation rates.

Inflation expectations – expectations of the future path of inflation.

Yield curve – A graph that plots the yields of similar quality bonds against their maturities. In a normal/upward sloping yield curve, longer maturity bond yields are higher than short-term bond yields. A yield curve can signal market expectations about a country's economic direction.

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