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Investing for a  
world of change

# Five reasons natural resources equities could fuel your portfolio

## The fast view

**We see five compelling reasons for investors to revisit natural resources equities.**

### 1 Energy transition

The energy transition is driving structural demand for certain materials and products. At the same time, investment in new supply remains insufficient.

### 2 Inflation

Natural resources equities have historically tended to perform well in times of persistent inflation. We expect the relationship between inflation and natural resources equities to continue.

### 3 Valuations

We believe the structural growth drivers underpinning the next investment cycle are not yet reflected in the valuations of natural resources companies. Also, balance sheets are strong, making companies more resilient than in previous cycles.

### 4 Performance

In our view, the broad and diverse natural resources equity sector is the best way for investors to access commodities, and offers potential for active equity investors to generate alpha from security selection and dynamic sub-sector allocation. Over the past two decades, natural resources equities have outperformed commodities themselves.

### 5 Diversification

Natural resources equities have a low to negative alpha correlation with widely held equity styles such as 'growth' and 'value', as well as other real assets. Despite being a volatile equity sector, natural resources equities may improve the overall diversification of a broad portfolio.

# 1 Energy transition

A new investment cycle in natural resources is underway, fuelled by the transition to a low-carbon economy. For example, electrification within the transport and power-generation sectors is changing demand for mined commodities, both in terms of volumes and the mix of materials required by industry (see Figure 1). Over the last five years, electric vehicle (EV) penetration as a percentage of total car sales in the US has increased from c.2% to c.10%, while in China EV penetration has increased ten-fold to 40% over the same period<sup>1</sup>. Agriculture is exposed to similar structural shifts.

We think there are underappreciated investment opportunities across the natural resources sector in companies that are reducing their carbon footprints and that are providing low-carbon solutions:

## Energy

Select energy companies can be part of a future energy system. Those that transition successfully have the potential to prosper.

## Mining

A scarcity of supply has coincided with greater demand for metals essential for the transition to clean power and the electrification of transport systems (see Figure 1).

## Agriculture

The energy transition is driving structural tailwinds for select producers of fertilisers, forestry products and sustainable protein.

In our view, the most efficient way for investors to gain exposure to these commodities is via the shares of companies that produce them. Natural resources equities provide broader exposure to opportunities in the commodity sector (investors cannot get exposure to some commodities via physical markets) in a liquid and cost-efficient way.

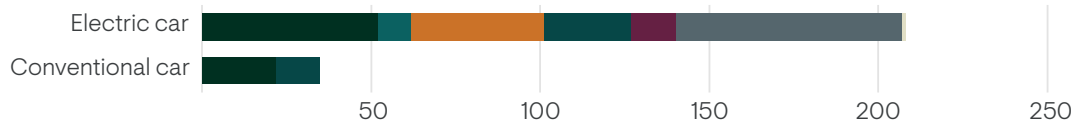
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1. Source: Bernstein passenger EV tracker.

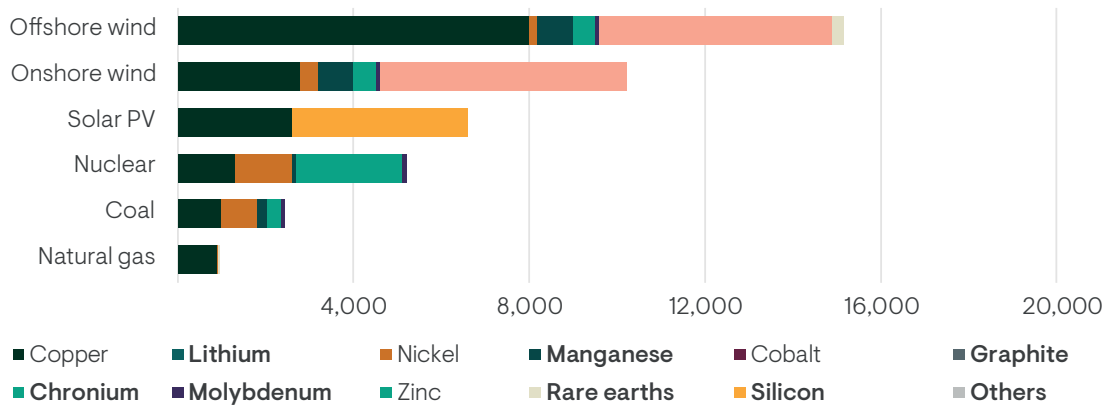
**Figure 1: Minerals used in selected clean-energy technologies**

Commodities shown in **bold** text cannot be accessed directly via futures

Transport (kg/vehicle)



Power generation (kg/MW)



Source: International Energy Agency, May 2021: “The Role of Critical Minerals in Clean Energy Transitions”.

The impacts of this new investment cycle on commodity sectors are only just beginning to be felt. The rally in commodity prices from Q2 2020 to mid-2022 was largely due to idiosyncratic supply/demand shocks: a post-pandemic demand rebound, supply-chain shocks as the world emerged unevenly from lockdowns, and sanctions on Russia following the invasion of Ukraine. The long-term cycle is underpinned not only by the structural changes in demand described above, but by a decade of underinvestment in new supply of many of the metals and minerals essential for the energy transition.

The structural growth opportunity in natural resources comes at a time when many equity investors have abandoned the sector. Arguably, the single most attractive characteristic of natural resources equities right now is what could be termed ‘undiscounted change’ – i.e., investors’ misunderstanding of how the sector is evolving in response to the need to act on climate and other sustainability imperatives. Of course, while our cyclical outlook is positive, differing outcomes for individual natural resources companies are to be expected. But for active investors, stock-specific factors present opportunities.

# 2 Inflation

Natural resources equities have tended to perform well in times of inflation. Will the current inflationary environment persist? While the sharp inflationary spike of the last two years is likely to be somewhat of an outlier, we do expect higher and more ‘sticky’ inflation in the next cycle than the previous one. Decarbonisation and energy supply disruption, together with idiosyncratic supply/demand shocks, are putting upward pressure on commodity prices, which in turn is likely to be an inflationary force more broadly.

### Fossilflation

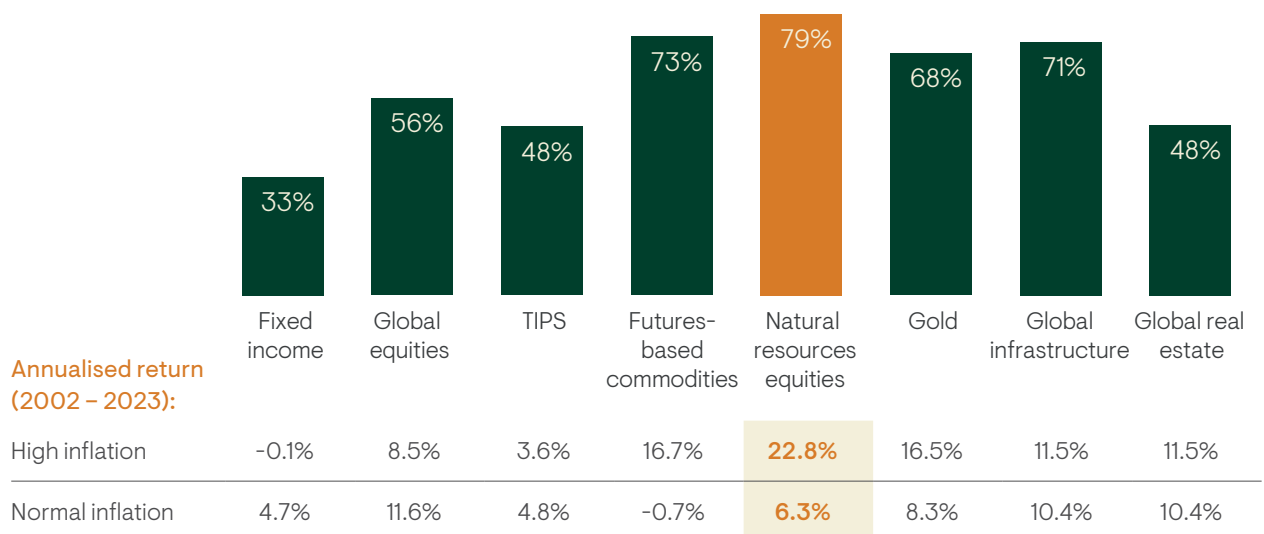
‘Fossilflation’ refers to the inflationary impacts of disruptions to current energy supply; particularly volatile oil and gas prices. With energy demand growing but supply limited, we expect upwards pressure on inflation from energy production.

### Greenflation

‘Greenflation’ refers to the inflationary pressures driven by the transition to low-carbon technologies, production processes and systems. Surging demand for certain commodities and products, combined with supply disruptions, is expected to drive up prices.

When inflation is persistent, the performance of many risk assets has historically been mixed. In contrast, natural resources equities have tended to provide similar inflation mitigation to physical commodities (see Figure 2), but with less downside. We expect this dynamic to persist. In ‘normal’ inflationary periods in the past two decades, natural resources equities have tended to outperform physical commodities.

**Figure 2: Percentage of time asset class generates a positive real return during ‘high inflation’ environments\*:**



Past performance is not indicative or a guarantee of future results.

Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. Source: Ninety One, Bloomberg. High inflation is above 3.3% (the 75% percentile of the data). Normal inflation is below 3.3%. Inflation proxied by CPI US YoY. Data from 31 December 2001 through 31 December 2023. **Fixed income** = Bbg Global Agg UH USD, **Global equities** = MSCI ACWI USD, **TIPS** = Bbg US Treasury Inflation Notes (TIPS), **Futures-based commodities** = BCOM Index (TR), **Natural resources equities** = S&P GNR Index, **Gold** = US\$/oz, **Global infrastructure** = S&P Global Listed Infrastructure Index USD, **Global real estate** = MSCI World/Real Estate Index USD.\*Real return: 12 month rolling net of CPI YoY.

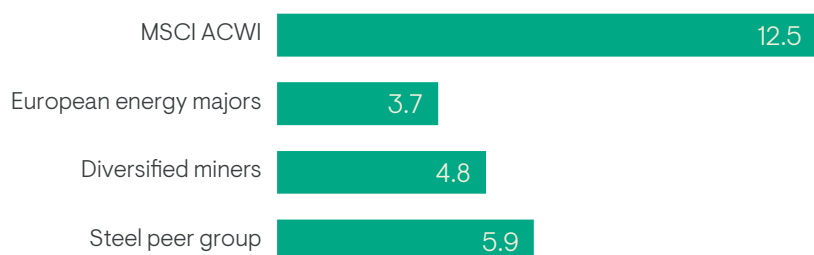
## 3 Valuations

We think the valuations of natural resources equities in aggregate are attractive. Partly, this reflects that areas of the natural resources sector are out of favour with investors. But more importantly in our view, we believe that the market may be misjudging the implications of the powerful structural trends impacting natural resources companies that we described earlier.

Natural resources companies trade at a significant discount to the broad market on the most commonly used valuation metrics. Figure 3 shows enterprise value (EV) relative to earnings before interest taxes, depreciation, and amortisation (EBITDA) of European energy majors, diversified miners and steel companies vs. the MSCI ACWI Index.

**Figure 3: Natural resources equities are trading at a discount to the market**

### EV/EBITDA for select sectors



Source: Ninety One, December 2023 data. Barclays estimates for Energy, Miners and Steels, Bloomberg for MSCI ACWI.

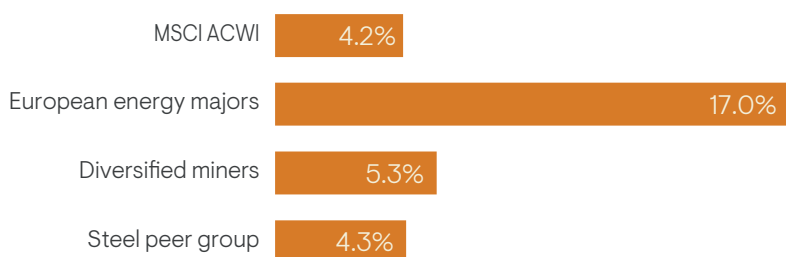
Current natural resources equity valuations not only fail to reflect the significant structural growth opportunity, we believe, but also the fact that the natural resources sector is in much better financial health than in previous cycles. We have seen debt levels fall, and free cashflows rise, leaving these companies better able to withstand challenging times. Share prices are supported further by companies returning cash to shareholders via dividends and buybacks.

## Five reasons natural resources equities could fuel your portfolio

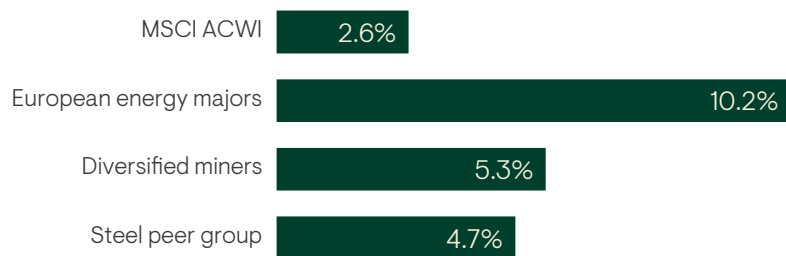
As the cyclical and secular forces we detail above push the market into the start of another commodities bull market, management teams are displaying far greater capital allocation discipline than in the past. There are reasons to believe this will continue given their lower capital expenditure, greater cost discipline and stronger operating performance, underpinned by a focus on value over volume, providing confidence that the attractive supply/demand dynamics we see today (from an investment perspective) will persist.

**Figure 4: The sector is in much better financial health than in previous cycles**

### Free cashflow yields: higher than the broader equity market



### Dividends and buybacks: cash returns to shareholders



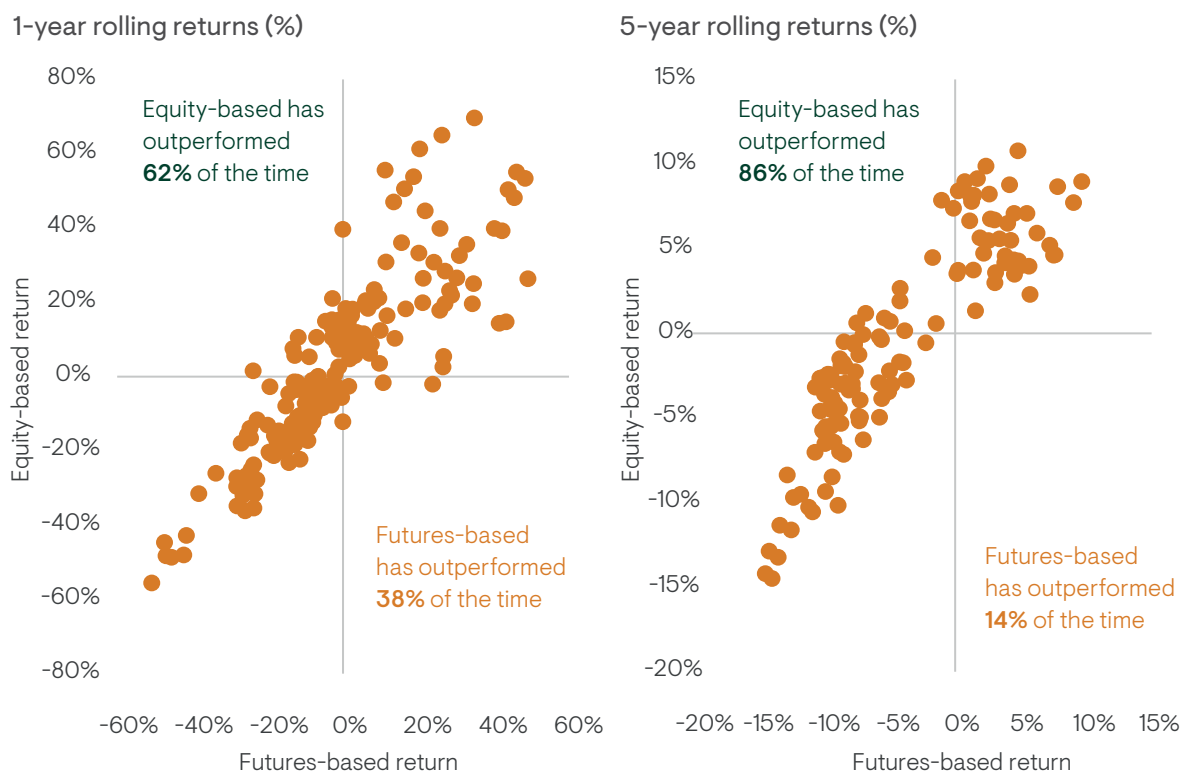
Source: Ninety One, December 2023 data. Barclays estimates for Energy, Miners and Steels, Bloomberg for MSCI ACWI.

# 4 Performance

We believe natural resources equities are the best way to access the natural resources sector. First, as noted above, the opportunity set in natural resources equities is much broader than in physical commodities, with some materials not directly investible via futures. Also, investing in physical commodities can come with hidden costs. For example, commodity roll yield (the positive or negative return that may be generated when short-dated futures contracts are sold and longer-dated ones bought) is impacted by contango-shaped forward curves (futures prices are higher than spot prices). This has resulted in commodity index returns being poor relative to spot price appreciation. By comparison, natural resources equities offer operational leverage, the ability to grow production and reserves, and a positive yield in the form of dividends. Natural resources equities have outperformed physical commodities over the past two decades, on both an absolute and risk-adjusted basis (see Figure 5).

We believe there is significant potential for active equity managers to generate alpha in the natural resources sector through bottom-up security selection and dynamic sector and sub-sector allocations. The investible universe is large – spanning energy, metals and mining, and agriculture – and in our view investors should cast the net wide to capture the full opportunity. Agriculture, for example, is a diverse and differentiated sector, but one that is often overlooked and underappreciated by active natural resources equity funds.

**Figure 5: Physical commodities vs. natural resources equities**



Past performance does not predict future returns; losses may be made.

Source: Ninety One, Bloomberg. Data from 31 January 2008 through to 31 December 2023. Equity-based proxied by MSCI ACWI Natural Resources Select Capped Index; futures-based proxied by Bloomberg Commodity Index.

For further information on indices, please see the Important information section.

# 5 Potential diversification

Finally, natural resources equities have potential to diversify both broad equity allocations and focused real-assets portfolios, given their low to negative alpha correlation vs. growth and value equity styles, as well as to real assets (see Figure 6). Although often a volatile sector, given their diversifying potential, natural resources equities can help to improve the overall performance characteristics of a broad portfolio.

**Figure 6: Alpha correlation of natural resources equities versus:**

**Broad based equity portfolio**

Growth equities	-0.27
Value equities	0.26

**Listed real assets portfolio**

Listed property	-0.14
Listed infrastructure	0.20

Past performance does not predict future returns; losses may be made.

Source: Ninety One, Bloomberg. 30 November 2002 (S&P GNR inception) – December 2023).

Natural resources equities represented by S&P GNR TR Index. Correlation of monthly excess returns vs MSCI ACWI, for MSCI ACWI Value, MSCI ACWI Growth, S&P Global Property and S&P Global Infrastructure, all in USD. Interpretation of correlation: 0.0 to 0.3 (-0.3) = negligible correlation; 0.3 to 0.5 (-0.3 to -0.5) = low positive (negative) correlation; 0.5 to 0.7 (-0.5 to -0.7) = moderate positive (negative) correlation; 0.7 to 0.9 (-0.7 to -0.9) = high positive (negative) correlation; and 0.9 to 1.0 (-0.9 to -1.0) = very high positive (negative) correlation.



## Conclusion

We expect longer-term support for natural resources equities from their potential to perform well in periods of 'sticky' inflation; geopolitical risk and its implications for supply and energy security; and the electrification of transport and industrial processes, which is causing a surge in demand for materials that are already in short supply.

In our view, the opportunities are best captured via an actively managed, diversified, equity-based approach. Through an economic cycle, an actively managed natural resources equity strategy has the potential to provide a differentiated source of returns for investors.

Natural resources equities have delivered strong returns over the last few years. While they may be impacted in the near term should global growth disappoint, we believe downside risk is mitigated by strong fundamentals and relatively low equity valuations. We think investors can further manage near-term risks and capture the upside potential of the asset class via active stock-selection that focuses on quality companies with strong balance sheets and diversified businesses.

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