January 2025

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Investing for a world of change

Five reasons to allocate to natural resources equities (it's not just about inflation!)

The fast view

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

1 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.

2 Electrification

Electrification is increasing the structural demand for mined commodities. At the same time, investment in new supply remains insufficient.

3 Valuation

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

We think 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 sector, natural resources equities may improve the overall diversification of a broad portfolio.

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1 Inflation

Natural resources equities have tended to perform well in times of inflation. Will the current inflationary environment persist? While the post-COVID inflationary spike has eased, we expect higher and 'stickier' inflation in the next cycle than the previous one. Decarbonisation together with idiosyncratic supply/demand shocks, is putting upward pressure on commodity prices, which in turn is likely to be an inflationary force more broadly.

Fossilflation

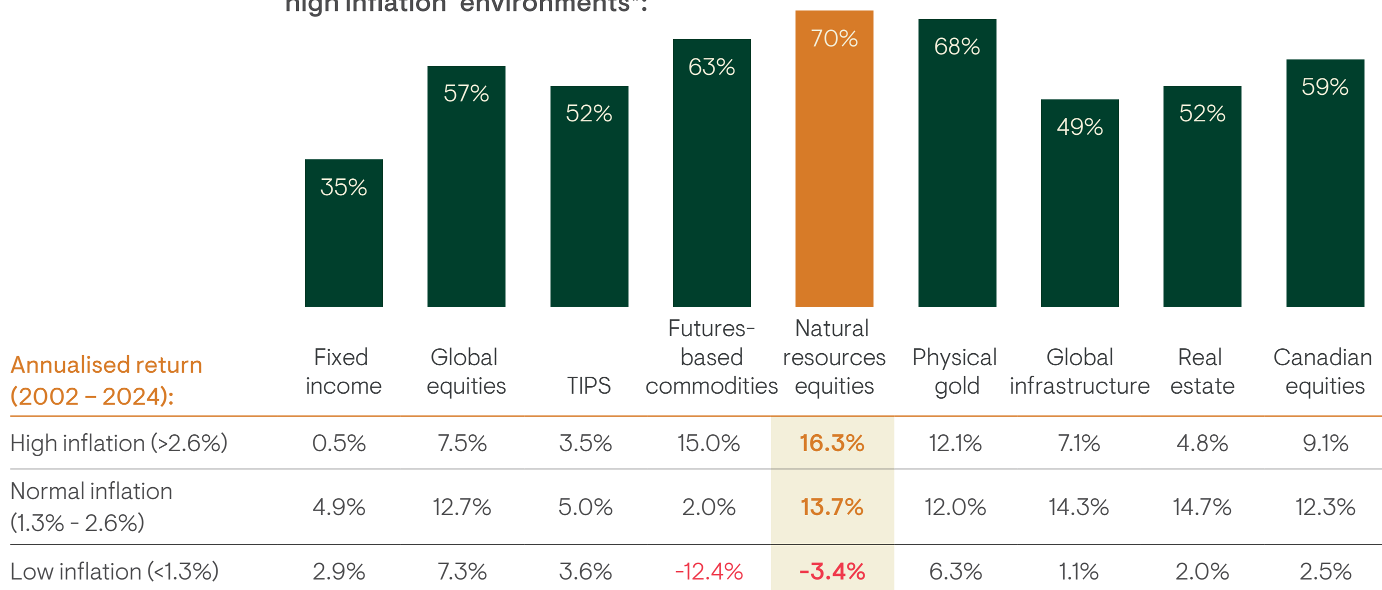
'Fossilflation' refers to the inflationary impacts of disruptions to current energy supply; particularly volatile oil & gas prices. With energy demand growing but supply limited, we expect upwards pressure on inflation from energy production.

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 1), 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 1: Percentage of time asset class generates a positive real return during 'high inflation' environments*:



Annualised return (2002 – 2024):	Fixed income	Global equities	TIPS	Futures-based commodities	Natural resources equities	Physical gold	Global infrastructure	Real estate	Canadian equities
High inflation (>2.6%)	0.5%	7.5%	3.5%	15.0%	**16.3%**	12.1%	7.1%	4.8%	9.1%
Normal inflation (1.3% - 2.6%)	4.9%	12.7%	5.0%	2.0%	**13.7%**	12.0%	14.3%	14.7%	12.3%
Low inflation (<1.3%)	2.9%	7.3%	3.6%	-12.4%	**-3.4%**	6.3%	1.1%	2.0%	2.5%

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 2.5% (the 75% percentile of the data). Low inflation is below 1.3% (the 25th percentile of the data). Normal inflation is between 1.3% and 2.6%. Inflation proxied by CACCPI YoY. Data from 31 December 2001 through December 2024. **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** = US4/oz, **Global infrastructure** = S&P Global Listed Infrastructure Index USD, **Global real estate** = MSCI World/Real Estate Index USD. **Canadian equities** = TSX Composite Index. *real return: 12 month rolling net of CACCPI YoY.

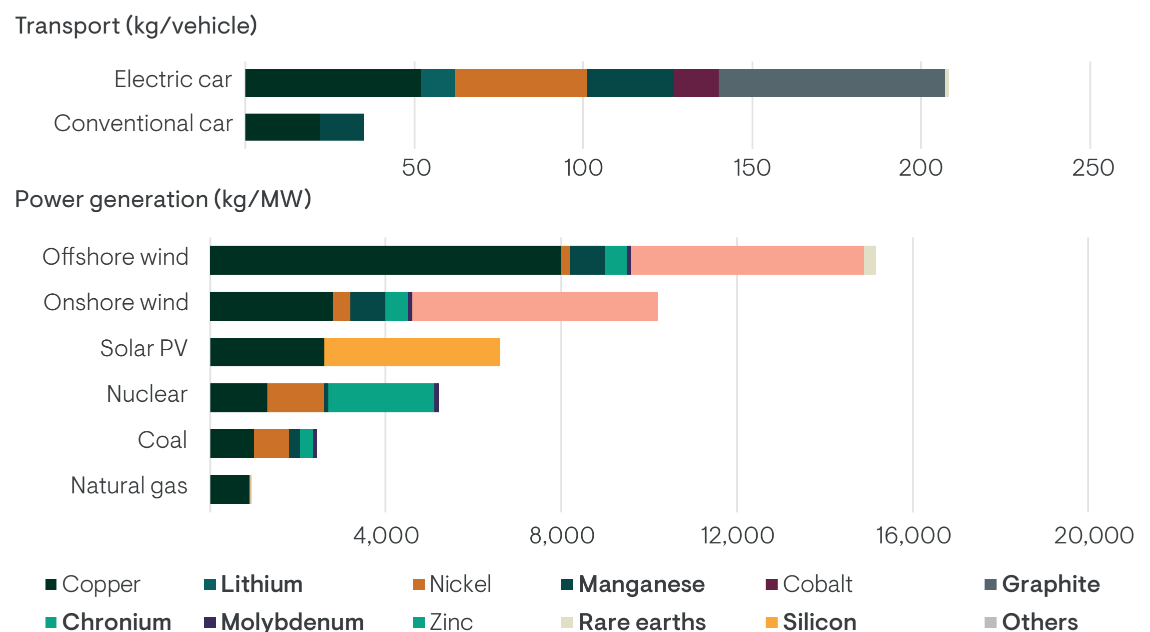
2 Exposure to electrification

A new investment cycle is underway across natural resources, driven partly by electrification within the transport and power generation industries. 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[1]. Electrification is changing demand for mined commodities substantially, both in terms of volumes and the mix of materials required by industry (see Figure 2). Energy and agriculture are exposed to similar structural tailwinds.

We think 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.

Figure 2: Minerals used in selected clean-energy technologies

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



Source: International Energy Agency: "The Role of Critical Minerals in Clean Energy Transitions" (May 2021).

1. Source: Bernstein passenger EV tracker.

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.

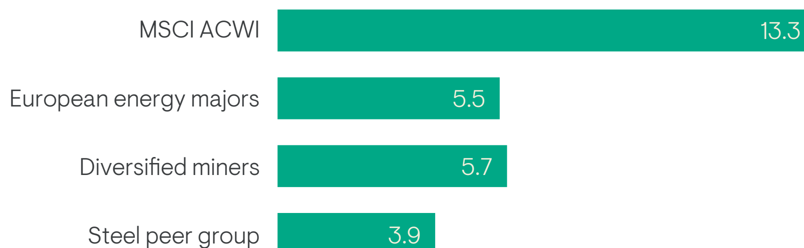
The structural growth opportunity in natural resources comes at a time when many equity investors have abandoned the natural resources sector. Arguably, the single most attractive characteristic of natural resources equities right now is what could be termed 'undiscounted change' – i.e., investors' misunderstanding of the situation. 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.

3 Valuation

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.

Natural resources companies trade at a significant discount to the broad market on all of the most commonly used valuation metrics. Figure 3 shows enterprise value (EV) relative to earnings before interest taxes, depreciation, and amortization (EBITDA) of US refining companies, diversified miners and steel companies vs. the S&P 500 Index overall.

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



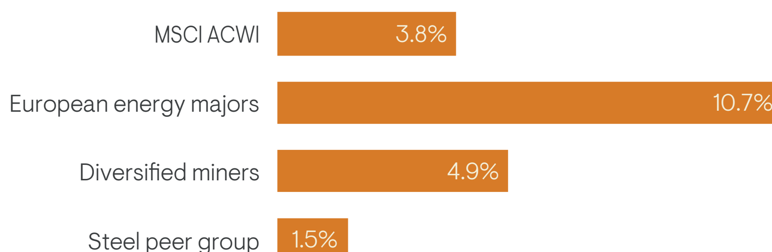
Source: Ninety One, September 2024 data. Barclays estimates for Energy, Miners and Steels, Bloomberg for ACWI.
Figures shown are third party estimates and not representative of related portfolio projections.Actual performance of related portfolio investments and the related portfolio overall may be adversely affected by a variety of factors.
Based on a related portfolio with substantially similar objectives as those of the services being offered.

The valuations not only fail to reflect the significant structural growth opportunity, 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.

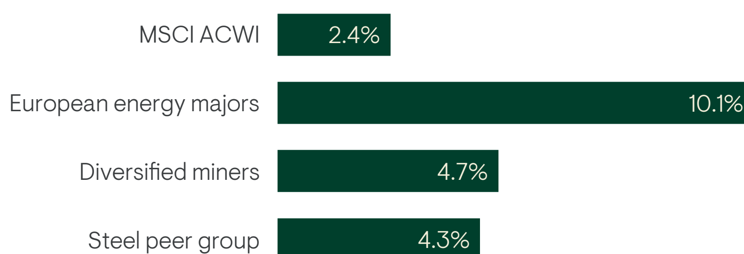
As the cyclical and secular forces we detail above push the market into the start of another commodities bull market, management teams are displaying far greater capital allocation discipline than in the past. In our view, there are reasons to believe this will continue given their lower capital expenditure, 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, September 2024 data. Barclays estimates for Energy, Miners and Steels, Bloomberg for ACWI.
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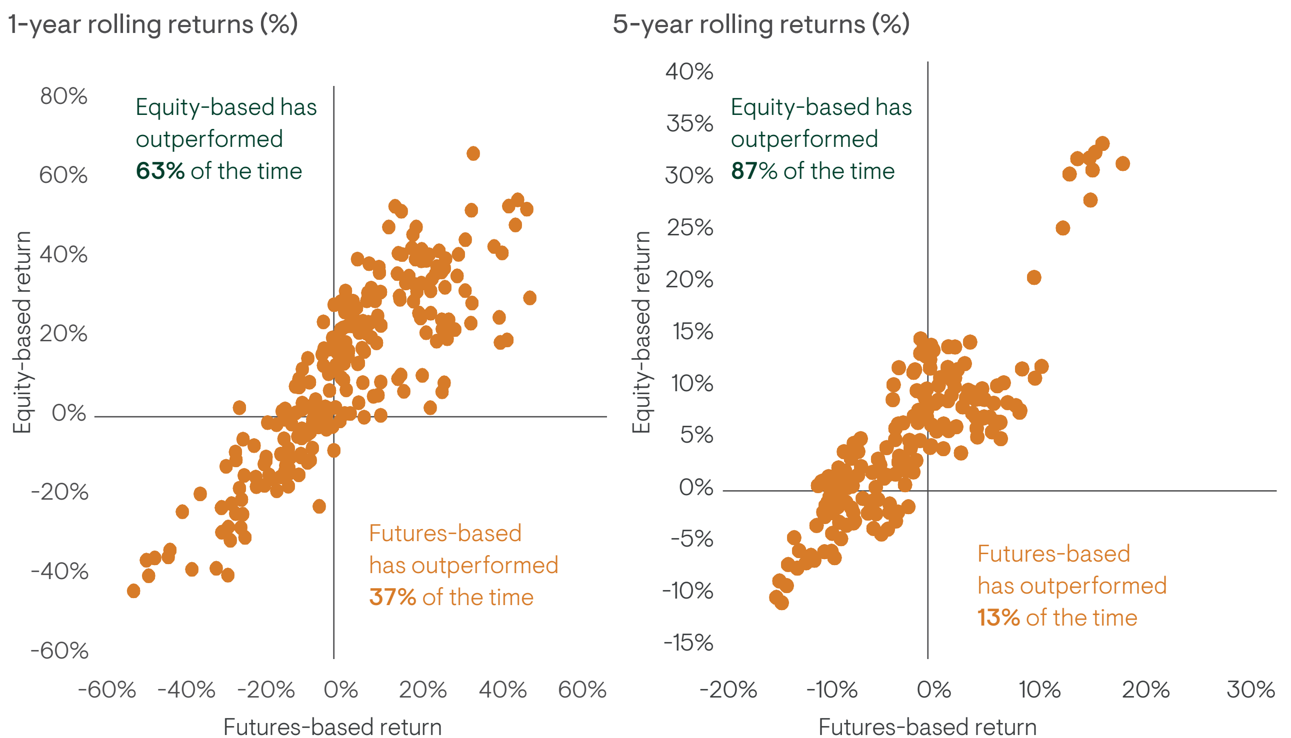
4 Performance

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 & 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 30 September 2024. 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	-0.30
Value equities	0.30
Listed real assets portfolio	
Listed infrastructure	0.19

Past performance does not predict future returns; losses may be made.
Source: Ninety One, Bloomberg 30 September 2024. Correlation of monthly excess returns vs MSCI ACWI Value, MSCI ACWI Growth and S&P Global infrastructure. Ninety One Global Natural Resources shown net of I Acc fees in USD since fund inception in January 2008.

Conclusion

We expect longer-term support for natural resources equities from: its potential to perform well in periods of 'sticky' inflation; ongoing 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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United States
US Toll Free: +1 800 434 5623
usa@ninetyone.com

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