



REPORT PREPARED FOR
Oxfordshire Pension Fund Committee

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Summary

The value of the Fund in the quarter rose to £3.22bn, an increase of £89m compared to the end June value of £3.13bn. The Fund produced a return of 2.8% over the quarter, which was 1.2% ahead of the benchmark. The main positives during the quarter included a continued recovery in property valuations as transactions returned to more normal levels post Covid-19 and in more general terms another positive quarter for equities, although mixed on a region by region, country by country basis. Over a 12-month period the Fund recorded a small negative relative return against the benchmark of -0.3% (18.4% v.18.7%). The Fund has performed ahead of benchmark over the three, five and ten year periods, details of which can be found in Brunel's report.

The high points

1. With the equity mandates it was good to see a healthy outperformance over the quarter of the global sustainable equities over the high alpha equivalent (by 1.9%), although it should be noted that over the one year period the position is reversed (by 0.8%). Sustainable benchmarks have had to face the considerable headwind of the non-renewables energy sector enjoying the massive increases seen in prices over the last year.
2. Realistic property valuations are driven by the evidence provided by transactions and with the return of more normal levels of activity with Covid-19 restrictions easing, the very cautious approach taken by valuers has now relaxed. This, combined with a higher level of rent due being received, has seen a rapid recovery in valuations.
3. One area highlighted by Brunel is the better than expected recovery in the office sector, this had been deemed to have been under threat by a potential move to a much higher level of working from home. In reality offices have been reconfigured to have lower density seating patterns, and there is a shortage of high quality, environmentally friendly office space that is increasingly required. Overseas investors remain as a notable presence in the market.
4. Staying with the theme of environmentally friendly development, or rather redevelopment, there is an encouraging trend towards more refurbishment and/or change of use of older buildings. This isn't new as such (think of barn to "des res" conversions, old office to residential) but changes to planning rules is helping the process.
5. Private Equity in general continues to enjoy a high level of activity, with growing valuations. The high profile taking private of Morrisons supermarkets has highlighted the continued level of interest in this sort of transaction, particularly for businesses that have what are deemed to be undervalued cashflow characteristics.

The lower points

1. Both the Global High Alpha Equity and the Emerging Markets portfolios took a hit in September from increased regulatory actions and concerns about debt levels in China. The latter was fuelled by default warnings regarding Evergrande. That isn't another ship stuck in the Suez Canal, but it is China's second largest property developer.
2. For investors, the Chinese issues should be a real concern. Put simply, the Chinese government isn't concerned about the interests of external investors, but they are concerned about the interests of their law abiding, compliant citizens. Understanding the mindset of the Chinese leadership is a prerequisite for those who wish to invest there.
3. While very desirable from an environment point of view, the renewable energy sector suffered from a major drawback during Q3; lack of wind and a lack of sun. This has highlighted the need for other alternatives to fossil fuels, including greater storage capability which ultimately doesn't need lithium.
4. The valuation of renewable energy infrastructure assets is being chased ever higher. While pension funds acknowledge the long term investment benefits from these assets, the anticipated returns are now becoming questionable.
5. As highlighted in the Outlook section below, some serious economic concerns are starting to cause an intermittent increase in volatility in global equity markets, which may have a particular potential impact on the Global High Alpha portfolios. Those concerns include higher inflation, rising energy prices, supply disruptions and labour shortages.
6. Looking at the hospitality sector in particular, this is an area that has suffered a perfect storm this year. Brexit can be considered to be responsible for some (but not all) labour shortage issues, particularly in the south of England, Covid-19 restrictions reduced capacity and even the capability to open until mid-summer, supply chain issues disrupted food and beverage availability. Labour shortages are part of a wider issue, during lockdown many people moved to other jobs (such as van driving) and didn't wish to return, citing low pay, unsociable and long hours, and the icing on the cake; not having to deal with rude customers.
7. The Brunel International Property portfolio performance seems to be lagging the objective, including over 5 years. What is the agreed timescale for this to be achieved?

Points to consider (perspectives of a new boy)

1. More detailed performance information from Brunel will help with the understanding of the structure of each sub fund, including performance attribution for each manager over different time periods. A multi manager approach may bring diversification of style, but it also comes with the risk of performance reverting to average, at best.

2. Presumably the active equity and bond mandates have performance targets. Brunel should be asked to report against these (and the underlying managers), as well as against their benchmarks. Active management fees are being paid, so that has to be accounted for.
3. Who verifies the performance information provided by Brunel, and for the Fund as a whole?
4. What is the drawdown schedule for the private market investments, given the relatively large sums involved?

Overview and Outlook thoughts

Global overview

The drivers of markets in Q3 included weakening market confidence, due to the Coronavirus Delta variant, supply chain issues, persisting inflation expectations, and the concern that GDP growth rates had peaked. Developed market equity performance was modest, while Emerging Markets performed poorly due primarily to Government actions and high corporate debt in China. Growth orientated stocks modestly outperformed Value stocks (+0.84% against -0.67%). Supply shortages led to sharp price increases across energy commodity markets, whilst metal prices fell. Bond performance was mixed: index-linked gilts performed well on rising inflation expectations, with European and US high yield bonds also positive. Investment grade bonds generally performed weaker, as expectations of rate rises in the US and UK hardened. Credit spreads widened during the first half of the quarter, though much of this was retraced by quarter end.

GDP growth remained positive in Q3 for developed markets; the US posted +0.5% quarterly growth¹, the Eurozone +2.2%, Japan +0.5% and the UK +1.3%. However, growth rates are lower than in Q2 and generally are weaker than forecast. Forecasts suggest that tight labour markets, supply constraints and the withdrawal of Government stimulus will result in more sluggish growth through 2022.

GDP Growth Rate and Monthly CPI

%	GDP		CPI		
	Q3 2021	Q2 2021	Jul	Aug	Sep
UK	1.3	5.5	2.0	3.2	3.1
US	0.5	1.6	5.4	5.3	5.4
Eurozone	2.2	2.2	2.2	3.0	3.4
Japan	0.5	0.5	-0.3	-0.4	0.2

Source: Bloomberg; Trading Economics.

GDP Notes: UK Real GDP (Ticker: UKGRABIQ Index); US Real GDP (Ticker: EHGDUUS Index); Eurozone Real GDP (Ticker: EUGNEMUQ Index); Japan Real GDP (Ticker: EHGDP Index)

Note: US GDP has been de-annualised to be consistent with the other regions.

CPI Notes: UK: UK CPI EU Harmonised YoY NSA (Ticker: UKRPCJYR Index); US: US CPI Urban Consumer YoY NSA (Ticker: CPIYOY Index); Eurozone: Eurostat Eurozone MUCP All Items YoY Flash Estimate (Ticker: ECCPEST Index); Japan: Japan CPI Nationwide YOY (Ticker: JNCPIYOY Index)

¹ Note: US GDP has been de-annualised to be consistent with the other regions.

Outlook thoughts

It is worth highlighting the following themes, potentially impacting investment markets:

Tapering and interest rate increases: The Federal Reserve (“Fed”) has indicated that they will continue asset purchases (QE) at least until until mid-2022, expectations had been that “tapering” would have been complete by then. The most recent Fed guidance is that interest rates may increase to 1.75% by the end of 2024, with the potential for the first rise in 2022. Although there seems to have been some back-peddalling recently, other central banks have been indicating similar shifts in policy: the Bank of England (“BoE”) is expected to end its quantitative easing programme and raise interest rates to 0.75% by end 2022. However, there are some expectations that Chinese monetary and fiscal policy, which has been tightening, could become more supportive of economic growth in Q4, 2021.

Inflation may be looking less transitory: As demand has recovered from mid-pandemic lows, and supply chains remain disrupted, shortages of goods and labour continued into Q3. In particular, energy prices have spiked, and, with climate transition pressures increasing, it is possible that the market remains undersupplied for some time, increasing price volatility. Market implied 20 year inflation has risen by 0.7% YTD, to 3.9%, while the Bank of England is forecasting that CPI will reach over 4% by this year end, before declining to 2-3% in 2022. Investors have become increasingly worried that inflation may last longer than previously thought, and there are some outlier concerns of potential stagflation.

Risk Appetite: While gently rising rates may prove no more than a gentle headwind for risk assets, taking the edge off the forecast economic growth, there is some risk of more rapid rate increases unsettling investors and driving more of a correction. At the same time, rising inflation and negative real rates limit the attraction of bonds, especially Government bonds. In this environment, investors may consider taking some risk off the table, and increasing allocations to more stable, income producing alternative assets (e.g. real estate, private debt, infrastructure).

Value vs Growth: Although the valuation gap between Value style and Growth style narrowed somewhat at the beginning of this year, it is widening again, and remains very high by historical standards. Growth style equities, typically “longer duration” may see their valuations under pressure if interest rates (discount rates) rise, while financial sectors, typically with a more “Value” style signature, usually benefit from steepening yield curves. On the other hand, ongoing disruption of numerous industries, accelerated by the pandemic, is likely to favour new business models, typically found in actively managed “Growth” portfolios. At the same time, the dispersion in valuations between different markets (e.g. US vs UK and Emerging Markets) is also near historic highs. The relative performance of different equity styles and regions looks as if it may be volatile over the next few years, and it would be wise to continue to have an appropriate balance between these styles / geographies.

Equities

Global equities had a mixed Q3, with modest gains across developed markets, excluding the 0.1% fall in Europe, while emerging markets suffered. There were underlying concerns around economic growth peaking, but various news stories in China dominated the headlines. There were successive rounds of regulatory crackdown. First, the Chinese Government moved to turn private tutoring companies into non-profit organisations, and this was followed by regulations limiting children's access to online gaming and tighter regulation around technology. Finally, the potential default on the offshore debt of China's second largest property developer Evergrande contributed to market anxiety at the end of the quarter. The VIX index increased substantially by +46.2% over the quarter, from 15.8 to 23.1. Growth continued to outperform Value (+0.84% against -0.67%).

US equities, measured by the S&P 500, posted modest gains over Q3 (+0.6%). Despite the quarter-on-quarter growth, September (-4.65%, total return) was the worst month for US equities since March 2020 (-12.35%), as the market sold off from its previous highs. Fears around financial instability in China along with the Federal Open Market Committee signalling that they could begin tapering as early as November 2021 dragged on returns.

UK equities performed well over Q3, despite continued supply chain disruption and a more hawkish tone from the BOE, with both the FTSE 100 (+1.9%) and FTSE All-share (+2.2%) indices delivering positive returns. Energy producers (accounting for 10.2% of the FTSE 100) have benefitted from the aforementioned increase in commodity prices, along with supermarkets; takeover bids for Morrisons have seen the stock appreciate over 50% on pre offer prices and lifted the wider sector.

The Euro Stoxx 50 declined by -0.1% over Q3. Energy stocks again performed positively alongside technology stocks, particularly those involved in the semiconductor sector. Conversely consumer discretionary stocks performed negatively. Inflation and supply chain disruption continued to be a headwind to growth.

Japanese equities reversed the Q2 underperformance (-1.2%), now outperforming other developed markets in Q3, returning +2.9%. Bucking the wider trend, September was the strongest month in the quarter, despite the sudden resignation of Yoshihide Suga as prime minister on September 3rd; the news had no noticeable negative effect on markets. Optimism over potential future stimulus and economic reopening drove returns.

Emerging market equities suffered a -8.0% contraction, measured by the MSCI Emerging Markets index. China (accounting for 34.0% of the index) suffered heavily due to its government's regulatory crackdown, fears over Evergrande's default, and electricity shortages, while rising inflation and subsequent rate increases in some countries (notably Brazil) also weighed on returns. Despite the overall EM losses, brighter spots were seen in the major energy exporting nations, such as Russia, while India also performed well due to a strong vaccine led recovery and increased IPO activity lifting sentiment.

Global Equity Markets Performance



Fixed Income

Bonds had a mixed quarter, with government bond yields across the US and Europe initially declining, before ending the quarter flat. Gilts experienced rising yields and so falling prices. Yield increases for Treasuries and Gilts followed a hawkish shift among monetary policymakers later in the quarter as inflationary pressures continued. Corporate investment-grade bonds failed to match last quarter's good performance, whilst corporate high-yield bonds outperformed corporate investment grade bonds in the US and Europe.

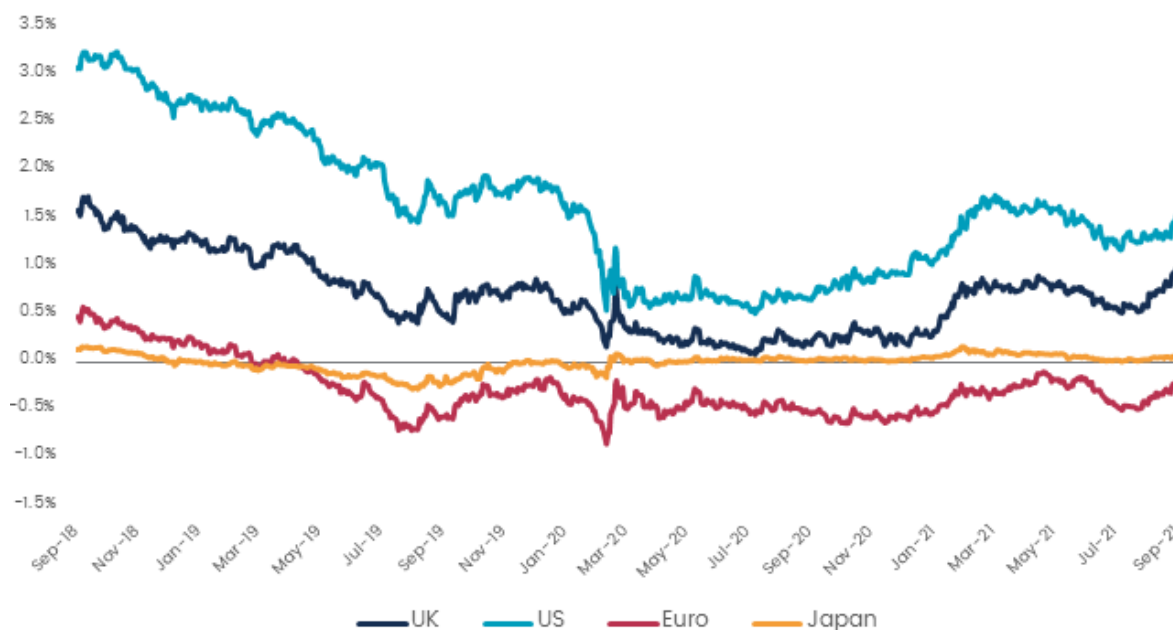
The 10-year US Treasury yield ended the quarter one basis point higher at 1.49%, with Treasuries as a whole providing a total return of +0.1%. Yields initially fell due to concerns over economic recovery due to the Delta variant and inflation concerns, before returning to original levels as the Federal Reserve struck an increasingly hawkish tone. Jerome Powell (chairman of the Fed) suggested that tapering of asset purchases could commence as early as the next meeting in November, although markets were more surprised by the indication that tapering could finish as soon as mid-2022, which would subsequently pave the way for rate hikes earlier than expected. The median rate expectation moved up to three hikes from two for 2023, with three additional hikes expected in 2024. Fed officials were evenly split 9 against 9 on a potential hike in 2022. Additionally, the impending debt-ceiling showdown prompted fears, albeit extremely unlikely, of a default on national debt, with Treasury Secretary Yellen warning that the US will reach its ceiling by the 18th October. A deal between the democrats and republicans since appears to have been agreed, allowing the debt ceiling to be raised until early December.

10-year UK Gilt yields increased from 0.72% to 1.02% over Q3, with Gilts delivering a total return of -1.9%. The yield move occurred towards quarter-end, as the BoE matched the hawkish tone of the Fed. Inflationary pressures once again surpassed expectations, with August CPI reaching 3.2%. This has contributed to growing concerns that rate rises may be

needed before the end of the year, although current BoE guidance suggests no rise until quantitative easing is wound up in early 2022. Index-linked Gilts had another strong quarter following continued inflation, with the over-5 year and over-15-year index-linked bonds both returning +2.3%.

The strong year-to-date performance of high yield bonds persisted in Q3, as European and US high yield bonds returned 0.6% and 0.9% respectively. UK investment-grade bonds returned -1.0% over the quarter, while performance was flat for the equivalents in Europe and the US.

Government Bond Yields



Source Bloomberg. US Generic Govt 10 Year Yield (Ticker: USGG10YR Index); UK Govt Bonds 10 Year Note Generic Bil Yield (Ticker: GUKGI0 Index); Euro Generic Govt Bond 10 Year (Ticker: GECU10YR Index).

Currencies

In the third quarter, Sterling weakened against the Dollar (-2.5%) but held steady against the Euro (-0.1%), as the UK faced ongoing supply-side pressures and a worsening growth outlook. The Dollar had a solid quarter (Dollar Index Spot rose +1.9%), with most of the gains coming in the last few weeks of September following expectations of an earlier rate hike after the FOMC meeting. The Euro weakened notably against the Dollar in Q3 (-2.3%), as the market reacted to the uncertainties caused by the energy crisis. The ECB’s decision to slightly slow quantitative easing was not equivalent to tapering and had limited impact on the Euro.

Commodities

Commodities performed positively in Q3. Energy prices are increasingly becoming a geopolitical touchpoint, as surging natural gas and coal prices have sent consumer and industrial energy costs soaring. This has led to the bankruptcy of multiple UK energy providers who are squeezed by wholesale gas and electricity prices and the consumer price caps. Furthermore, coal shortages in China, which accounts for over half of the world’s coal

consumption, have led to the temporary shutdown of some heavy industry, whilst coal reserves in India were also far lower than normal.

Natural gas prices soared (+60.7%) to \$5.9/MMBTU, a +131% YTD appreciation. A cold start to the year and a hot summer increased demand while supply was constrained by maintenance work that had previously been disrupted by the pandemic and the disruptive winter. This led to reduced summer injection into storage and consequently low inventory. Thematic trends that have seen nations pivot to gas as an alternative to coal for baseload power generation, alongside a faster than expected economic recovery have exacerbated demand side price pressure, particularly from Asia. Furthermore, while no entity is contractually obliged to stabilise European spot prices outside of their contractual supply obligations (which are believed to have been met) the International Energy Agency have highlighted that Gazprom have capacity to increase supply, which would help ease shortages.

Brent crude oil had another strong quarter (+4.5%), the continuing recovery in the global economy and the strong rebound in jet fuel demand helped further lift oil prices.

Copper suffered its first quarterly price decline since Q2 2020 falling by -4.8%, finishing the Q3 at \$4.1/lb.

Gold prices suffered a modest decline during Q3 (-0.9%), with prices falling to \$1,755 per troy ounce.

[Property](#)

Global listed property, whilst positive, underperformed previous quarters: the FTSE Global Nareit index rose 1.0% in Q3. Widespread worries grew regarding the stability of Chinese property developers.

Green Street Advisor's US Commercial Property Price Index rose by +9.5% over the quarter. The index is now +9% above pre-COVID levels. In terms of sub-sectors, only malls, offices, and lodging remain below pre-COVID levels.

The Nationwide UK house price index rose once again across Q3 (+1.7%), though it declined by 0.7% in July. Annual house price growth was +10.0%, down from +13.4% in Q2.

Key Indicators at a Glance

Market Indicators

Index (Local Currency)		Q3 2021	Quarter-on-Quarter	YTD
Equities				
UK Equities	FTSE 100 Index	7,086.4	1.9%	13.0%
UK Equities	FTSE All-Share Index	4,059.0	2.2%	13.3%
US Equities	S&P 500 Index	4,307.5	0.6%	15.9%
European Equities	EURO STOXX 50 Price EUR	4,048.1	-0.1%	16.3%
Japanese Equities	Nikkei 225	29,452.7	2.9%	9.6%
Emerging Markets Equities	MSCI Emerging Markets	1,253.1	-8.0%	-1.2%
Global Equities	MSCI World	3,006.6	0.1%	13.6%
Government Bonds				
UK Govt Bonds	Bloomberg Barclays UK Govt All Bonds TR	400.4	-1.9%	-7.6%
UK Govt Bonds Over 15 Years	FTSE Actuaries Govt Securities UK Gbls TR Over 15 Yr	5,836.2	-2.8%	-12.2%
UK Govt Bonds Over 15 Years	FTSE Actuaries Govt Securities UK Index Linked TR Over 15 Yr	8,095.5	2.3%	-2.1%
UK Index Linked Bonds	FTSE Actuaries Govt Securities UK Index Linked TR over 5 Year	6,327.6	2.3%	-1.1%
Euro Govt Bonds	Bloomberg Barclays EU Govt All Bonds TR	256.7	0.0%	-3.0%
US Govt Bonds	Bloomberg Barclays US Treasury TR Unhedged USD Index	2,495.5	0.1%	-2.5%
Emerging Market Govt Bonds (Soft Currency)	J.P. Morgan Government Bond Index Emerging Markets Core Index	142.3	-3.1%	-6.3%
Emerging Market Govt Bonds (Hard Currency)	J.P. Morgan Emerging Markets Global Diversified Index	981.6	-0.7%	-1.4%
Corporate Bonds				
Pan-European Investment Grade	Bloomberg Barclays Pan-European Aggregate Corporate TR Index Value Unhedged	250.9	-0.1%	-0.2%
Pan-European High Yield	Bloomberg Barclays Pan-European HY TR Index Value Unhedged	437.9	0.6%	4.2%
US Corporate Investment Grade	Bloomberg Barclays US Corporate Investment Grade TR Index Unhedged	217.5	0.0%	-1.3%
US High Yield	Bloomberg Barclays US Corporate High Yield TR Index Value Unhedged	2,444.1	0.9%	4.5%
UK Corporate Investment Grade	S&P UK Investment Grade Corporate Bond Index TR	401.6	-1.0%	-3.5%
Commodities				
Brent Crude Oil	Generic 1st Crude Oil, Brent, bbl	78.5	4.5%	51.6%
Natural Gas	Generic 1st Natural Gas, MMBtu	5.9	60.7%	131.2%
Gold	Generic 1st Gold, 100oz	1,755.3	-0.9%	-7.4%
Copper	Generic 1st Copper, lb	408.9	-4.8%	16.2%
Currencies				
GBP/EUR	GBP/EUR Spot Exchange Rate	1.2	-0.1%	4.2%
GBP/USD	GBP/USD Spot Exchange Rate	1.3	-2.5%	-1.4%
EUR/USD	EUR/USD Spot Exchange Rate	1.2	-2.3%	-5.3%
USD/JPY	U.S. Dollar - Japanese Yen Spot Exchange Rate	111.4	0.3%	7.9%
Dollar Index	Dollar Index Spot	94.2	1.9%	4.8%
AUD/USD	AUD/USD Spot Exchange Rate	0.7	-3.8%	-6.3%
USD/CNY	USD/CNY Spot Exchange Rate	6.4	-0.2%	-1.3%
Alternatives				
Infrastructure	S&P Global Infrastructure Index	2,654.7	1.4%	6.9%
Private Equity	S&P Listed Private Equity Index	214.8	4.2%	31.3%
Hedge Funds	Hedge Fund Research HFRX Fund-Weighted Composite Index	18,189.3	-0.2%	9.9%
Property				
Global Real Estate	FTSE EPRA Nareit Global Index TR GBP	3,838.4	1.0%	14.3%
Volatility				
VIX	Chicago Board Options Exchange S&P Volatility Index	23.1	46.2%	1.7%

* All return figures quoted are total return, calculated with gross dividends reinvested. Calendar YTD.

Source: Bloomberg

COP 26

Much has been written about the outcomes from COP26, with almost every shade of opinion from very positive through to extreme disappointment. Trying to rationalise that leads me to the conclusion that it depends on the perspective of the author in relation to climate change and what their expectations were to start off with.

Rather than add to the volume of words on the subject, I include here some useful thoughts from Pictet Asset Management.

The eagerly anticipated COP26 summit has come to a close. Leading up to the Conference, the world was reminded that human activities have already caused around 1.1°C of warming to date, that impacts are already being felt in every region from more extreme heatwaves and wildfires to floods, and that the planet was still on course for a dangerous 2.7°C of warming according to the United Nations Environment Programme. With such observations providing much impetus to accelerate climate action, we provide some of our thoughts surrounding the event:

1. New Net Zero country commitments signal progress, but needs to continue with a global agreement to revisit 2030 targets next year

This year's COP was seen as particularly important, with countries due to have brought stronger pledges under the 2015 Paris Agreement's "ratchet" mechanism (a structure where countries would submit more ambitious carbon reduction targets every five years to meet the 1.5°C warming goal). Overall, more than 150 countries responded with their updated Nationally Determined Contributions (NDCs). With all the updated national pledges included, this means more than 80% of global GDP is now covered by net zero pledges. Notably at the Conference, we saw more emerging economies (e.g. India, Brazil) and even prior climate laggards (e.g. Australia, Russia) announce long-term net zero targets. To us this signifies that the global direction of travel is set, creating an even stronger supportive backdrop for clean energy and environmental technologies going forward.

*However, even the updated pledges are not enough yet, as experts estimate this puts us on a path to between 1.8°C and 2.4°C of warming. Therefore, the final agreement at Glasgow requests countries **to revisit and strengthen their mid-term (2030) targets to put us on track with the 1.5°C goal by the end of 2022** – something to watch for next year.*

2. First-ever COP decision to explicitly target action against fossil fuels

It is notable that for the first time in COP history, the final agreement mentions an acceleration of efforts towards the "phase-down of unabated coal power and inefficient fossil fuel subsidies". While this has significant political importance, from our perspective the phasing-down of coal and switching to clean sources such as renewables plus storage is already well underway, largely driven by cost considerations.

3. Increased focus on particular green technologies used to achieve decarbonization

In a change from the previous COPs, this year there was a focus on the particular green technologies that can be used to achieve decarbonization goals. In particular, a group of 40 signatories including the US, UK, India, European Union and China (representing more than

70% of the world's economy) launched the Breakthrough Agenda – an agreement to accelerate and stimulate investments through policies into clean technologies to make them the **most affordable and attractive choice for every country by 2030**. The Agenda focuses on five areas, which are all key parts of the Clean Energy or Global Environmental Opportunities investment universes:

- Clean Power (e.g. renewables, energy storage, electric infrastructure)
- Zero Emission Road Transport (e.g. e-mobility and charging infrastructure)
- Low-emission steel (e.g. carbon capture and storage, energy efficiency)
- Low-carbon hydrogen (e.g. green hydrogen)
- Sustainable and Resilient Agriculture (e.g. precision farming, smart irrigation)

4. Final deal made on rules governing an international carbon market

After six long years of negotiations, global governments have finally reached an agreement on the rules governing the international trade of carbon. With agreements in place to eliminate double-counting and standardize carbon accounting, this will provide the tools and framework needed for robust, transparent and accountable carbon trading schemes. In our view this is one of the most concrete outcomes of the conference, as it forms a basis to standardize and expand emissions trading between countries and regions, thus further spurring green investments. Global carbon markets have been on the rise over the past years as the concept of putting a proper price on carbon becomes more important. According to the International Emissions Trading Association, “in the lead-up to COP26, carbon markets surged in many jurisdictions, as businesses contemplated the enhanced ambitions of many countries.

5. More evidence that the private sector is embracing decarbonization

While the COP has historically been considered a political affair, COP26 suggests the private sector's role will grow in reaction to consumer demands and policies to embrace net zero, as well as the need to finance the global transition. Notably, the finance sector had a central role at the COP26, with the reveal of the Glasgow Financial Alliance for Net Zero: a commitment by more than 400 members of the financial industry to accelerate the transition to net zero (including asset owners, managers, banks, insurers, service providers, and consultants), together representing over 130 trillion dollars of assets. Members of the alliance will set science-aligned interim and long-term goals to reach net zero no later than 2050, thus aligning financial flows with the goals of the Paris Climate Agreement. On that note, Pictet Group has also joined the Net Zero Asset Managers initiative (a sub-group of the larger Alliance), and is supporting the Business Ambition for 1.5 degrees from the Science-Based Targets initiative.

So that was all pretty positive, with a lot of useful thoughts that should be helpful in “checking off” how this ultimately relates to investments. Then into the email Inbox came this piece from **LAPFF**, which presents a rather gloomy view on the implications for investment around the failure to establish what many would consider to be a framework for a Just Transition.

COP 26: Just Transition Fail

The Paris Agreement introduced a new concept into the climate lexicon: a just transition. This concept roughly defined is that we need to consider the needs of workers, communities, and consumers – basically, the human element – as we transition to an economy that allows us to limit global warming to the Paris Agreement’s 1.5°C target. A statement at COP 26 was issued in support of a just transition.

The principal reason for promoting a just transition is that many commentators are concerned the climate transition will fail if we do not adequately consider and integrate social factors. This concern presented itself front and centre at the final plenary session of COP 26 when China and India chastised developed countries for pushing to phase out coal without adequately compensating for loss and damage suffered from climate impacts in developing states.

Paragraph 36 of the original Glasgow Climate Pact ‘Calls upon Parties to accelerate the development, deployment and dissemination of technologies, and the adoption of policies, to transition towards low-emission energy systems, including by rapidly scaling up the deployment of clean power generation and energy efficiency measures, including accelerating efforts towards the phase-out of unabated coal power and inefficient fossil fuel subsidies, recognizing the need for support towards a just transition.’ The agreed version of the text referred to phasing down rather than phasing out coal.

Knowing now what we do about the ensuing discussions between developed and less developed states, it is not surprising that the original wording did not pass. There was a fundamental difference of understanding when it came to the allocation of the global ‘carbon budget’. Whilst developed nations pointed to India and China as currently emitting large proportions of the total amount of the world’s carbon, many developing nations pointed to the historic emissions of the developed states over the past centuries that allowed for their economic growth.

Consequently, developed states pushed for phasing out coal without addressing the needs of less developed states to provide jobs, resources, and human rights protections for their populations. Coal is seen as an important source of jobs and economic development in many countries, notwithstanding evidence that renewables are already the cheapest source of new electricity in 90% of the world. Without allowing for provision to compensate countries for potential losses in these areas and for social and environmental loss that has already taken place due to climate change, many developing states were not prepared to make the

sacrifice requested. Not having had their needs met, many less developed states revolted and required a watering down of the language on phasing out coal.

In other words, the crux of the disappointment with the COP 26 outcome was a just transition fail. This outcome further amplifies the need for a just transition.

It is clear from the stance taken by developed states that they have failed to commit to a just transition, either through a failure to understand the concept or a failure of political will. These states had an opportunity to establish funding packages that would compensate the less developed states for loss and damage from climate impacts caused by more developed states but did not do so.

This outcome is a lesson for investors. Focusing solely on technological solutions and negotiated outcomes, especially those set through developed state parameters, will only take us so far; this approach will not allow us to reach the Paris Agreement's, and now the Glasgow Pact's, 1.5°C target. Investors must consider the social impacts of any climate transition and put their money where their mouths are in supporting a just transition. This is particularly the case now because their governments' COP 26 failure to support a just transition makes reaching the Paris 1.5°C target that much more unlikely and makes it much more likely that investor money spent in the interest of climate mitigation and adaptation without a genuine commitment to a just transition will be wasted.

To finish on a positive note, in a discussion with another asset manager they concluded by saying that, "COP26 implementations will create investment opportunities". Our managers need to seize those opportunities.