MARKET SPOTLIGHT - NOVEMBER 2021

New investing considerations in 2022

The investing world is expanding, bringing both new investment trends and new ways to evaluate old asset classes. With ESG considerations now at the forefront, many investors are working to understand these important issues and researching how the investments they hold could be affected. From eroding shorelines that could diminish coastal real estate values to higher operating costs for companies as they work to limit their carbon emissions, almost every industry will feel an impact.

In this edition, we also look at the strange new world of NFTs (non-fungible tokens), with some introductory explanations about this evolving investment phenomenon.

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Climate change presents risks and opportunities

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It's becoming clearer that climate change is imposing significant costs on the global economy. The 26th UN Climate Change Conference of the Parties (COP26) wrapped up in Glasgow in mid-November, marking the latest attempt to galvanize global efforts to address one of the most pressing issues facing humanity. This annual UN meeting is seen as crucial for limiting the effects of global warming. During COP26, most of the world's big banks, major investors, insurers, and financial regulators signed a coordinated pledge to incorporate reducing carbon emissions into their fundamental decisions.

How will your portfolio be affected?

We believe that all investors must consider the increasing reality that climate may have reverberating effects on entire asset classes. This ranges from sovereign bonds, as countries work towards financing their commitments and mitigating infrastructure, to real assets, where extreme weather and mass migrations may impact valuations.

Climate risk is investment risk, and investors must focus on the implications of our changing planet and the inevitable policy response. Global carbon taxes are a logical step to incentivize consumer and corporate behaviour. Investors increasingly will need to consider the carbon intensity and the emissions of their portfolios as a significant risk factor.

Extreme weather and rising sea levels will have significant impacts on hard assets such as real estate and infrastructure. Operating costs and the possibility for catastrophic loss combined with shifting regional migrations will shift supply and demand dynamics. Investors must consider the implications of regional and, in particular, the coastal exposure of their portfolios.

Considering climate change when valuing financial services companies

Banks will play a significant role in financing the energy transition, which may lead to opportunities. Investors must understand the regional exposure of a bank's mortgage portfolio as well as their allocations to industries and sectors that will struggle under stricter climate policies. Insurance companies need to have robust underwriting standards in place to deal with extreme and catastrophic weather events. The last decade has seen a significant increase in insured losses due to natural disaster. Robust climate policies and appropriate risk mitigation will be essential, and investors will need to understand investee companies' portfolio exposure in greater detail.

CryptoCorner: Answering your questions

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What are non-fungible tokens (NFTs)?

In economics, a "fungible" asset is something with units that can be readily interchanged for other units of equal value—such as money. With money, for example, you can exchange a $20 bill for two $10 bills that have the same value.

However, if something is said to be "non-fungible," it can't be interchanged with something else, usually because it has unique properties. A one-of-a-kind NBA trading card, for example, is non-fungible. Other examples include YouTube clips, NBA basketball video footage and digital NHL player portraits, or CryptoPunks (quirky collectable pixel art images of misfits and eccentrics, each with its own unique, randomly generated features).

What do NFT owners actually own?

For such unique digital items, which can be easily and endlessly duplicated, non-fungible tokens (or NFTs) are used to create a digital certificate or "token" of ownership that can be bought and sold. In other words, NFTs can transform digital art, other collectibles and intangible items—including copyrights, patents, royalties and trademarks—into verifiable and tradable digital assets.

NFTs are unique files that have no tangible form of their own but are used to verify ownership of an underlying asset. They are tracked using the Ethereum, which is the same blockchain technology that powers cryptocurrencies. The original content creator can set up a smart contract on the Ethereum blockchain allowing them to collect royalties upon resale. Most NFTs are bought and paid for with digital currency like Bitcoin and Ethereum.

NFTs generally do not give the buyer the actual artwork or its copyright. They are intended to signify original ownership, even if the item has already been copied many times. NFTs encode the provenance and other details about the asset they are certifying. NFT buyers typically get limited rights to display the digital artwork they represent. The content creator often retains copyright and reproduction rights, meaning the item can still be reproduced in the future even once sold as an NFT.

The evolution of NFTs

Since the first NFT was created (or "minted") in 2014, interest in NFTs has steadily risen. Interest spread beyond the crypto community in 2021 as Quantum, an octagon-shaped digital animation created by New York artist Kevin McCoy and the first work ever associated with an NFT-type certificate of ownership, was auctioned by Sotheby's for $1.47 million. Approximately $2.5 billion of NFTs have been sold in 2021 year-to-date[1].

While there is a lot of excitement around using NFTs to sell digital art, the tokens could also become increasingly relevant for illiquid non-digital assets such as real estate, allowing it to be securitized without expensive transaction or management fees.

Cryptocurrency is a digital asset designed to work as a medium of exchange. Individual coin ownership records are stored in a ledger in a form of computerized database using strong cryptography to secure transaction records, control the creation of additional coins, and verify the transfer of coin ownership. It typically does not exist in physical form (like paper money) and is typically not issued by a central authority.[2]

Blockchain is the digital platform behind Bitcoin and other cryptocurrencies. It is intended to create faster, more efficient ways to transmit, receive, and track orders using secure data.[3]

[1] Morgan Stanley (2021), Update: Bitcoin, Crypto & Digital Currencies.
[2] https://en.wikipedia.org/wiki/Cryptocurrency. As at September 2021.
[3] https://www.investopedia.com/blockchain-4689765. As at September 2021.