INVESTMENT WEEK

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Market Analysis: Emerging Market Reforms/Investing in Water

Spike Hughes on Investing in Water

Water-related stories frequently make the headlines, but are usually focused on water's importance in our lives rather than the long-term investment opportunities it provides. The planet has an increasing demand for water, but the earth's supply of this essential resource is finite.

2014 has been supportive for global stock market performance, and another strong year for investing in water stocks. However, there has been a surprising dynamic. Predictably, water sector stocks with higher dividends, margins and earnings have been the winners. But generally these have been stocks that were already more highly valued heading into 2014, and have slower predicted earnings growth. What has worked for most of this year is what we would characterise as defensive stocks. That said, 'defence' is expensive now, with limited upside.

Logically, the other side of the equation is that 'offence' is cheaper and growing faster. Water companies that are more cyclical in nature, supported by positive leading indicators, have become even more attractive. Having lagged most of the year, water infrastructure has recently begun to outperform, as we had expected.

So, as at the end of 2011 and in mid-2012, the sector is now leaning in to the wind and portfolios should be structured to benefit from continued cyclical growth in water infrastructure companies, perhaps paying for any portfolio shifts by a reduction of exposure to US and UK regulated water utilities.

Now is not the time to go 'all in' though. It is key to continue to manage volatility and downside through lower risk stocks, and an appropriately balanced portfolio. Today's best defence ideas are found in companies with unique business models such as EnerCare in the technology sector, which is attractively valued.

Based on current markets, there should be mid-teens earnings growth in 2014 and 2015 combined, with an approximate 2% dividend yield, providing strong total returns for the water stock universe.

Obviously, market multiples and the degree to which company specific investment theses play out will impact the result, and active management and stock selection will be key.

For the rest of 2014 and into 2015, having a wider breadth of exposure than in previous years will ensure multiple ways to generate performance. We are currently focusing a lot on earnings growth and its visibility, and it seems the risk-reward outlook for water infrastructure names is as attractive as it has been for some time.

The water opportunity cannot be captured through broad global, country or regional equity funds. The overlap of stocks between a pure water strategy and the MSCI World index is likely to be under 1%, so to fully benefit from water's growth drivers one must invest in a pure water strategy.

Spike Hughes is CEO of Cohesion Investments, UK distributor for Kleinwort Benson Investors

(IMA) Specialist: over three years

	3yr % change	Rank	Vol (monthly)	Fund size (m) (£)	Morningstar RatingTM
Top 5					
AXA Framlington Biotech	173.04	1	5.59	372.87	★★★
Franklin MENA	86.70	2	3.68	249.02	★★★
AXA Framlington Health	85.26	3	3.23	402.68	★★★
F&C Overseas Equity-Linked UK Inf 3	84.19	4	3.47	240.38	★★★★★
Invesco Global Health Care	83.27	5	3.32	271.54	★★★
Bottom 5					
BlackRock Gold and General	-53.78	158	8.86	1,009.99	★★★★
Thesis Australian Natural Res	-57.25	159	7.69	2.01	★
WAY Charteris Gold& PrecMtls Elite	-67.37	160	11.98	3.84	★
Junior Gold	-77.90	161	11.81	10.21	★
SF t1ps Smaller Companies Gold	-78.57	162	7.39	0.90	★
Sector Average	**13.41**		**4.10**	**390.23**	

Performances calculated bid to bid, net income re-invested, GBP to 10/10/14. © 2014 Morningstar, Inc.

Bull Point

Estimated $22trn spend on water infrastructure up to 2030

Bear Point

Portfolio thesis vulnerable in a material global economic downturn