STRIVE

The Fiduciary Focus

Investment News From a Pro-Shareholder Perspective

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This Week: Strive talks small-caps; Exxon sues climate activists; An Eye on Energy tackles AI.

Straight from Strive

Analysts Are Bullish On Small-Caps In 2024

The giant tech stocks like the Magnificent Seven drove the lion's share of market appreciation in 2023. As inflation cools and interest rates fall, many investors are wondering where to find outperformance in the new year. While going big worked last year, it may be time to go small.

We can first see the appeal in attractive mid-cap valuations. After peaking in 2020, valuations for mid-cap stocks were near a 25-year low as of late 2023. The Bloomberg US 400 Index's price to earnings ratio (PE) was a whopping 29.25 back in 2020, vs. its current PE of 18.28.

But when we look at even smaller companies, the potential looks even better. After prolonged underperformance, small-cap stocks ended 2023 on a high note, and some analysts believe they could continue their run in 2024.

Over the past two years, market conditions such as record-high inflation and interest rates hit small companies the hardest since they rely more on debt than larger companies. Lending rates rose from near 0% to 5.5% within two years, resulting in the cost of capital rising and choking liquidity for small-caps.

Roughly 30% of the debt small companies acquire is in the form of variable-rate loans, compared with only 8% for large companies. These loans have shorter average maturities than fixed-rate debt, and refinancing when rates are rising can stress a small company's balance sheet and weigh on its cash flow, net profit margin, and growth prospects.

But as the economy looks increasingly on track for a soft landing, many investors believe small-cap funds could outperform the market once interest rates decline.

According to Bloomberg Finance, the Bloomberg US 600 Price Return Index has a current PE ratio of 18.12, lower than the S&P 500's 21.90, indicating small-caps are undervalued compared to their mid-cap competitors and the broader market. Industrials, financials, and consumer discretionary sectors drive the index. Whether looking at the price-to-earnings or price-to-value metrics, relative valuations are still roughly 10% lower than before the 2008 banking crisis, suggesting upside for small caps in the coming months.

As participation in the bull market broadens, investors may want to turn their attention to the unloved small-caps last year's rally left behind.

Exxon Sues Climate Shareholder Activists

Last week, Exxon filed a lawsuit against shareholder activists Arjuna Capital and Follow This, the Wall Street Journal reports.

The suit asks the court to block a shareholder proposal that would require Exxon to curb its greenhouse gas emissions to fight climate change. Exxon argues the proposal should be excluded as an attempt to interfere with the company's ordinary business decisions and that a similar proposal was rejected by over 90% of its shareholders last year.

In the first-of-its-kind suit, Exxon further accuses Arjuna and Follow This of abusing the shareholder process by pushing their climate agenda despite "minimal shares and no interest in growing long-term shareholder value." Exxon explains:

> Arjuna's mission is to "shrink" energy companies. . . . [Follow This] states: "We buy shares in order to work on our mission to stop climate change, not to make a financial profit." . . .
>
> Arjuna and Follow This have submitted numerous shareholder proposals to energy companies, including ExxonMobil. Although ExxonMobil's shareholders have consistently rejected Arjuna's and Follow This's proposals, those proposals are expensive and time-consuming to address, and they are rarely designed to promote overall shareholder value.

Semafor writes: "That Exxon—Exxon—feels comfortable throwing its corporate might against a couple of low-budget activists says a lot about how quickly the political weather has changed." That much may be true, but it also says a lot about how far climate activists are willing to go to continue their fight.

Votes for Sale! Startup Urges ESG Activists To Buy Votes

A new startup is letting shareholders sell their proxy votes via an online marketplace, the Wall Street Journal reports.

The California-based startup, the Shareholder Vote Exchange, allows shareholders to sell their votes ahead of annual meetings. Investors, ESG activists, and even companies themselves can then buy those votes to sway the outcome of board elections, mergers, stock splits, shareholder proposals and more.

According to the company, it's a win-win: sellers uninterested in voting can monetize their voting rights, while purchasers can buy elections much more cheaply than having to purchase or borrow entire shares.

As of last week, for example, Walgreens stock was trading at around $22 per share; voting rights were trading at $.01. ESG activists hoping to weigh in on a proposal on cigarette waste could therefore bolster their influence through the exchange. Even better, by buying voting rights alone, activists aren't risking any of the financial fallout from their social activism because they don't hold the actual stock.

While the idea of buying and selling votes may seem odd, corporate vote-selling has long been permitted under Delaware law. But historically, it's been hard to do. HP, for example, was able to push through a controversial merger with Compaq in 2002 by purchasing 17 million votes from Deutsche Bank. But finding a large shareholder willing to sell its votes, coordinating the sale and executing the voting rights is a lot of work. The online marketplace removes these barriers, making it much easier for special interest groups to buy votes on the cheap.

Concerns abound. While many of them center around potential conflicts of interest when a company buys its own votes—perhaps to entrench directors or push through a corporate transaction that shareholders would otherwise reject—there is also the risk that ESG activists will buy up voting rights to push value-destroying social initiatives.

This is not a hypothetical concern. The Shareholder Vote Exchange advertises to just this constituency:

> Another important motivation for investors or stakeholders to acquire shareholder voting rights is the potential to advance environmental, social and governance (ESG) initiates and promote the interests of a broader range of stakeholders. By purchasing shareholder voting rights, interested parties can gain the influence needed to push for ESG initiatives. . . , such as executive compensation packages, environmental sustainability, political lobbying, and employee rights. . . . [A]cquisition of shareholder voting rights [i]s a way to ensure that their values are represented in the company's decision-making process.

Should such tactics catch on, ESG activists will soon be able to sway corporate elections, regardless of whether the company's shareholders are on board.

Starbucks Faces Board Takeover By Union Activists

Starbucks is the target of an "unprecedented attempt by trade union's to bring the fight [for better working conditions] directly to the company's boardroom," the Financial Times reported Wednesday.

The trade unions accuse the company of "severe human capital mismanagement" and seek to install three labor-friendly directors on Starbucks' board, including a former head of the National Labor Relations Board.

According to the Financial Times, the battle is set to be "one of the most closely watched on Wall Street." "I think this is the campaign we have been waiting for and worried above," one advisor to large public companies told the outlet. "Single-issue activists advancing a social agenda."

The boardroom battle is seen as a much bigger threat than related shareholder proposals, as such proposals are nonbinding and so can "easily be shrugged off by company management." But if the unions are able to garner majority support for their directors, those nominees will take the helm whether management likes it or not.

Starbucks is not the first to face a socially-focused takeover—Engine No. 1 mounted a successful takeover at Exxon over climate change and Carl Icahn made a bid to install a new director at McDonald's over pregnant pigs—but companies are concerned that such efforts may be gaining popularity. And Starbucks appears to be the first company targeted by labor unions seeking representation on company boards. Starbucks's annual shareholder meeting may therefore prove to be a bellwether for future social activism.

U.S. Leader in ESG Retreat

ESG funds experienced global net outflows for the first time last year, Morningstar reports, with $2.5 billion in net outflows in the last quarter of 2023 alone.

U.S. skepticism appears to be driving the global losses. "Investors pulled $5 billion from U.S. sustainable funds in the fourth quarter for a total of $13 billion last year," the report states. The second largest ESG outflows came from Japan, which withdrew $1.2 billion.

2023 marks the first calendar year of outflows of U.S. ESG funds since Morningstar began tracking them more than a decade ago. The firm attributed the shift to "lagging performance, continued political scrutiny in the United States, and a bad year for an iShares fund."

The news is unsurprising as more people learn the risks of ESG investing. Although only recently garnering significant attention, research has long shown that despite being marketed as "doing well by doing good," ESG typically does neither.

As one report summed it up: "The potential to make money on ESG for consultants, bankers, and investment managers has made them cheerleaders for the concept, with claims of the payoffs based on research that is ambiguous and inconclusive, if not outright inconsistent with some of the claims."

It seems U.S. investors are finally catching on.

An Eye on Energy

Artificial Intelligence Hungry for Power

On January 24th, the International Energy Agency (IEA) released its Electricity 2024 report, highlighting economic headwinds due to surging electricity consumption.

According to the IEA, electricity demand will grow at a rate of 3.4% through 2026. It believes artificial intelligence (AI), cryptocurrency mining, and data centers are driving this demand. Today, data centers consume 460 terawatt-hours (TWh) of electricity annually; that could reach 1000 TWh in 2026, equivalent to the electricity consumption of Japan.

Over the last year, Generative AI (GenAI)—the use of AI to create content like text, images, music, audio, and videos—has attracted attention because of OpenAI's ChatGPT. GenAI systems are hosted on servers in data centers, which represent a critical part of the digital economy infrastructure. Electricity demand in data centers comes from three main processes, with computing accounting for 40%, cooling requirements accounting for another 40%, and 20% from associated IT equipment.

An analysis in Joule estimated that AI would lead Nvidia to ship as many as 1.5 million A-100 servers per year by 2027. Running those alone would require 85.4-134.0 TWh of electricity annually, consuming electricity equivalent to the amount used by the Netherlands.

But as AI demands more electricity, supply may fall short. Fossil fuels are expected to account for 54% of global electricity generation by 2026, falling below 60% for the first time in five decades. This presents a risk to energy cost and reliability of service, because the processing intensity of GenAI workstreams—as opposed to general purpose cloud computing—is very energy intensive. This strain on the electricity grid requires increased investment in the power distribution and physical infrastructure technology. Most cloud computing and data centers are based in the U.S., and it is reasonable to foresee a future where AI-data will move across the nation efficiently to access server storage space and take advantage of lower energy costs.

Companies like Microsoft are looking to advanced nuclear energy technologies to rethink how to produce and deliver energy to data centers. The U.S. must ensure that it has reliable energy options for data centers, especially with the proliferation of large language models. Businesses will be unhappy if ChatGPT stops working on cloudy days.

The Best of the Rest

Additional stories about ESG investing, company happenings, and more.

- High polluting firms generate higher returns: "[t]he basic intuition is that high-emission firms are more exposed to risks of environmental policy regime change and therefore require higher expected returns as compensation," study shows.
- Texas bars Barclays from bond market over ESG commitments; ban prompted by "Barclays failure to respond to requests for information regarding its net zero carbon emissions policies," the Wall Street Journal reports.
- Nvidia and AMD pull ahead of Intel in AI chips as Intel struggles to manage costs.
- "Index funds have too much voting power," new Manhattan Institute white paper argues and offers suggestions for reforms.
- China is viewed as "risky" for U.S. firms; new survey shows 61% of U.S. executives would choose India over China for manufacturing.
- Ontario Teachers' Pension Fund pushes climate action on company boards.
- The next frontier: should companies use social media to urge retail investors to side with management on contested corporate votes?
- Nevada pension funds face criticism for "leveraging Nevadans' pension funds to push for radical, social justice and political initiatives."
- Elon Musk blasts proxy advisory firms: "There's a lot of activists that basically infiltrate those organizations and have strange ideas about what should be done."
- Church of England going after emitters in new sectors: automakers, steel manufacturers, utilities and banks all targeted.
- Companies should reexamine their insurance coverage in light of new DEI litigation risks and potential claims.
- Asia-Pacific companies jump on ESG-linked executive pay bandwagon; Japanese, Singaporean and Australian companies lead the pack.
- HSBC announces net zero transition plan; plan includes how the bank intends to reduce its financed emissions, as well as its own carbon footprint.
- EU parliament considering two-year delay to new ESG reporting rules.

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Our research team conducts deep analysis of macro economic trends, market developments, and industry- and company-specific metrics to identify potential risks and opportunities for our clients. We then incorporate the results of this research into our engagement and voting strategy, and share it with our clients in the form of white papers and market research reports so they can make the most educated investment decisions possible.

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