

June 2021

Global Value and Income Dispatch

Responsible income: is it time to take your last puff?

Highlights

- Tobacco shares are prominent in income and retirement funds
- There are both moral and financial reasons to consider exiting from tobacco investments
- We provide a tobacco free alternative for retirement and income oriented investors

Despite a broad-based consensus...

Tobacco production has been one of the industries most commonly targeted by advocates of responsible investing. Numerous university endowments, pension plans, insurance companies and sovereign wealth funds have deemed the industry un-investable. The UN Environment Programme Finance Initiative (UNEPFI) has determined that 14 out of 17 UN Sustainable Development Goals (SDG) are hindered by the tobacco industry, while the Tobacco Free Finance Pledge posits that there is “no safe level of use and no opportunity for effective engagement.”

...one last sanctuary exists

One area where **tobacco companies continue to find welcome is in the portfolios of income and retirement funds.** Pension plans and retirement accounts often lean on income funds to support plan participants’ cash flow needs and provide lower volatility return streams. A recent report by the non-profit organization As You Sow estimates that 55% of the 100 most common funds in retirement plans invest in tobacco producers. Many of these funds have income-oriented goals.

Why income?

Tobacco shares and income portfolios have long been thought of as joined at the hip. Tobacco production is a declining industry with strong barriers-to-entry and little need for new investment. As a result these business can throw off very large amounts of free cash flow. This cash flow is generally distributed, which translates into high dividend yields. These yields can be particularly attractive in low interest rate environments (like the present) where yield is more scarce.



Every million USD invested can represent production of over 12,000 packs per year!

- Assumes \$1 million invested in a fund with 5% allocated to tobacco
- Based on Phillip Morris 2020 production of 629 billion cigarettes
- Equates to nearly 5 million sticks per \$1 million of market cap*

*Phillip Morris market capitalization as of December 31, 2020.
Sources Bloomberg, JOHCM, Phillip Morris 2020 annual report.

There are compelling investment reasons why income investors should consider looking outside the ashtray for yield

Tobacco companies, in turn, have sought to promote themselves to income-oriented investors and emphasize the quantum of dividends they pay in their investor materials. The hope is perhaps that income investors will focus less on ESG concerns that plague tobacco companies and can represent more “loyal” shareholders.

Reasons to quit

Beyond powerful moral arguments, there are compelling investment reasons why income investors should consider looking outside the ashtray for yield.

Since joining J O Hambro in 2017, we have explicitly considered ESG-related factors within our “persistence” framework for assessing downside risk. One key aspect of this analysis, is to focus on the risk of business disruption from not being aligned with the values of one’s marketplace. This risk parallels in many ways the risk of disruption from a new technology, in that it can render an existing – even well entrenched product – undesirable or obsolete.

Risk Examples

We have been seeing evidence of this risk play out in recent months, with a number of reports and announcements of policy initiatives:

1. Biden administration announces intent to ban menthol cigarettes;
2. US FDA considers reduction in nicotine content; and
3. New Zealand bans sales of cigarettes to those born after 2004 as part of goal to be smoke free by 2025.

Predictably, tobacco makers responded with delay tactics suggesting, for instance, that benefits from nicotine reduction are “inconclusive.”

Conclusion

We acknowledge that it can be hard to quit tobacco holdings, especially in a low yield environment like today.

At the same time, there are ample opportunities to earn income and align with positive trends in other industries and businesses.

We have invested the time and effort to uncover such opportunities, and **we are pleased to offer a retirement and income-oriented investment strategy that is tobacco-free.**

Sources:

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