

focus



Sleepy Joe causes a **power surge**

The last two months have been a wild ride for the share prices of two New Zealand electricity companies, Meridian Energy and Contact Energy. Over recent weeks the GameStop saga (see [last week's Focus article](#)) captured global headlines of how a band of Redditors took on short seller hedge funds, causing wild swings in some companies' share prices. Closer to home, the case of Meridian and Contact presents another way stock prices can diverge from underlying value.

...President Joe Biden being able to implement his green infrastructure plan compelled some to pile into clean energy investments....



After winning the Presidency and the House of Representatives in November, the Democrats, in the final act of a drawn-out United States election, secured a “Blue Wave” in January with unexpected victories in both Georgia Senate runoffs (Vice-President Kamala Harris represents the deciding vote in the 50-50 split 100 seat house).

The improved prospect of President Joe Biden being able to implement his green infrastructure plan compelled some to pile into clean energy investments. What most probably did not realise was that when purchasing two popular clean energy exchange traded funds (ETFs), around 8% of their money was buying shares in two New Zealand utilities.

What is a passive ETF?

Exchange traded funds (ETFs) allow investors to buy a bundle of securities (such as shares, bonds, or commodities). They trade on an exchange (like shares). An ETF can own hundreds or thousands of securities across different countries and industries, or it can be focused on one specific country or industry.

Passive share ETFs track an underlying index. There are thousands of options. Some of the largest ETFs track country indices such as the United States S&P500 or the New Zealand NZX50. Others are industry-specific, for example, following technology, healthcare, or financials indices.

When an investor purchases a unit in these passive ETFs, the manager then purchases the

underlying shares in the same proportion as they are represented in the index. There are no fund managers or analysts deciding where to invest. As more money flows in, the ETF manager needs to purchase more shares, regardless of the price. These funds are “open-ended” – which means there isn’t really a limit to how large they can grow. In contrast, in actively-managed ETFs (or other active investment funds) portfolio managers decide what the fund buys and sells.

Globally, ETFs and passive investing has become increasingly popular. They offer smaller investors, typically a lower cost way of buying a diversified basket of securities, including across an entire market, or a selection from a specific industry or theme.

Why Joe Biden’s victory fuelled a rally in New Zealand electricity companies

Securing a Blue Wave should better enable President Joe Biden and the Democrats to advance their policy agenda. Many investors concluded Biden’s policy to tackle climate change and create jobs through investment in a “clean energy economy” would benefit clean energy companies. Investment flooded into the sector.

One channel for this investment were two ETFs that track the S&P Global Clean Energy Index. This index contains 30 companies from around the world which are involved in clean energy-related businesses, including New Zealand’s Meridian Energy and Contact Energy. Together,

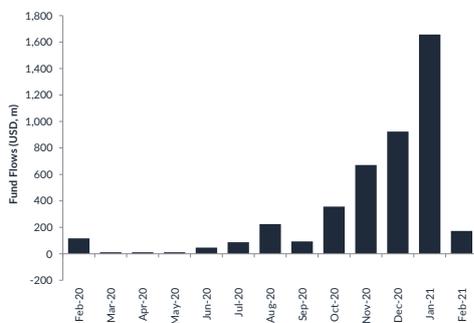


...Meridian and Contact's share prices jumped +27% and +21% in a week...

the two companies comprise around 8% of the index – a large amount for two New Zealand shares in a global ETF.

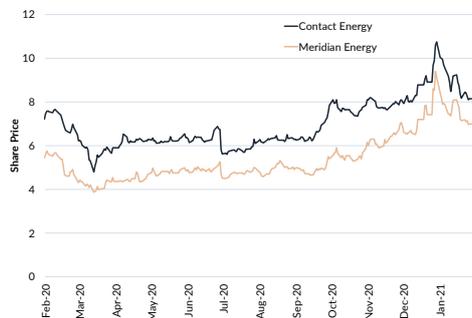
As investment money flowed in, the ETF managers were forced to purchase Meridian and Contact shares in large volumes. Because of Meridian and Contact's relatively small size and particularly their low liquidity (how many shares typically trade on the market), short-term demand substantially exceeded supply. Meridian and Contact's share prices jumped +27% and +21% in a week. Share prices then quickly gave up these gains as ETF demand faded.

SURGE IN DEMAND FOR CLEAN ENERGY INVESTMENTS: FUND FLOWS INTO THE ISHARES GLOBAL CLEAN ENERGY ETF



Source: Thomson Reuters, Forsyth Barr analysis

CONTACT ENERGY AND MERIDIAN ENERGY: SHARE PRICES SURGING AND FALLING WITH ETF FLOWS



Source: Thomson Reuters, Forsyth Barr analysis

Oops! That didn't work so well ... let's try something different

Obviously buying an investment at a high price only to see it fall sharply afterwards is not good for any investor. This is what the surge in ETF buying caused for the share prices of some companies within the S&P Global Clean Energy Index. This led S&P Global, which manages the index, to change how it will be constructed. Last Friday S&P announced: (1) the number of shares in the index would be expanded to a minimum of 35, and (2) the weightings of shares in the index will now consider liquidity (how many of a company's shares typically trade).

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S&P won't announce the exact effects of these changes until 2 April, and they will be implemented on 16 April, but we expect it will mean Meridian and Contact will have a lower weighting in the index going forward. That would mean the clean energy ETFs will have to sell a large number of Meridian and Contact shares (irrespective of price!) to match the new index weightings. This decision has already impacted Meridian and Contact's share prices. As at last Friday's (12 February) close they're down -32% and -38% respectively from their early January peaks. The NZ\$9.2 billion decline in Meridian's market value is more than the entire equity value of some of New Zealand's largest listed companies including Spark, Ryman Healthcare, and A2 Milk. The ETFs, who were forced to buy at high prices, will now be required to sell at much lower prices.

Share prices don't always reflect a company's underlying value

The GameStop saga was one example of how share prices can disconnect from their underlying value. This story of Meridian and Contact is another. There is no doubt New Zealand's electricity companies own high-quality renewable electricity generation assets that are increasingly attractive in a world which is seeking to reduce greenhouse gas emissions. That, however, does not mean they are attractive investments at any price. As legendary investor Howard Marks says, investment success doesn't come from "buying good things", but rather from "buying things well".

Understanding that sudden changes in financial markets can cause concern or indicate opportunity, your Forsyth Barr Investment Adviser is available to provide you with advice and assistance at any time.



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