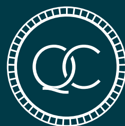


SUSTAINABLE INVESTMENT
INCREASING OPTIMISM AFTER A CHALLENGING PERIOD

There is no escaping the fact that the last two years have proved challenging for sustainable investing, however we remain optimistic that better times lie ahead, encouraged by key positive developments in the space.

Two themes dominated financial markets in 2022 – the Russian invasion of Ukraine and the aggressive interest rate hiking cycles of central banks – and both were not favourable for sustainable strategies.

1. Stock markets posted sizable declines and within that, there was a substantial shift in market sentiment away from "growth" companies as investors marked down the present value of future earnings against a backdrop of higher interest rates. Oil & Gas was the only global sector that performed positively, boosted by supply concerns following Western sanctions on Russian output, and strategies excluding the sector, like the Climate Assets Balanced Fund (CABF) unsurprisingly underperformed. However, looking at the wider peer group the CABF has performance better than many competitors in the downturn, as illustrated in the chart below.

Two-year performance versus the peer group: CABF is below the benchmark whilst outperforming most peers.

2. Another headwind we saw last year was the aggressive interest rate hiking cycles from central banks, impacting economic growth. There was a growing realisation that "real" GDP growth would be negative as economies slowed and inflation ran well above central bank targets. Cyclical companies, such as industrials, were especially sensitive to this development and weighed on sustainable strategies, like the CABF, that typically overweight this sector.

'Magnificent Seven' - a bad movie for sustainable investors

Although interest rates have risen further in 2023, the increases have not outstripped expectations to anywhere near the extent of 2022, leading to financial markets performing better. Taking a high-level approach "growth" has come back in to favour year-to-date, however upon closer inspection it is apparent that this is largely due to a handful of mega cap US tech companies which CABF does not own, due to concerns around ESG performance or a breach of our negative criteria. The sheer size of the so-called "Magnificent Seven" stocks – Alphabet (formerly Google), Amazon, Apple, Meta (formerly Facebook,) Microsoft, Nvidia and Tesla – means their performance can skew widely used benchmarks. These companies have a collective weight of around 28% in US indices and given that global benchmarks contain more than a 60% weighting to US equities, the performance of these stocks can have a major impact.

Clients benchmarked against the MSCI PIMFA Balanced Index will likely have underperformed for this reason. Apple, for example, has an approximately 2% weighting in the benchmark and therefore a gain of c.30% - roughly what occurred during the first three quarters of 2023 - will have a noticeable impact.

Long track record of out performance gives support and comfort

Notably, the CABF has experienced challenging periods before but navigated the economic cycle very well to generate a solid track record of 9 years of outperformance out of the 12 years, since inception.

CLIMATE ASSETS BALANCED FUND - Discrete Annual Performance

Discrete Annual Performance Since Inception	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011
Climate Assets Balanced Fund - C Acc	**-11.1**	**13.5**	**7.9**	**21.6**	**-4.2**	**10.9**	**20.7**	**0.5**	**7.8**	**18.3**	**12.4**	**-7.9**
MSCI PIMFA Balanced	-8.1	12.5	2.0	16.2	-4.8	9.9	17.4	2.0	6.9	14.2	9.6	0.2
IA Mixed Investment 40-85% Shares	-10.0	10.9	5.3	15.8	-6.1	10.0	12.9	2.7	4.9	14.5	10.0	-5.5
Relative performance vs comparator	**-1.1**	**2.6**	**2.6**	**5.8**	**1.9**	**0.9**	**7.8**	**-2.2**	**2.9**	**3.8**	**2.4**	**-2.4**

Outperformance for 9 out of 12 years

** Source: Past performance is not a guarantee of future results. Source: Financial Express.

Positive drivers

Looking forward there are three main reasons to be optimistic that the coming years will be more rewarding for investors - political support, the end of the rate hiking cycle and attractive valuation levels.

1 Political support

There has been an undeniable increase in governmental support for climate solutions and climate technology of late, with the US Inflation Reduction Act (IRA) the most high-profile example. The surge higher in Oil & Gas prices following Russia's invasion of Ukraine drove inflation to its highest level in a generation and, in response, US lawmakers have earmarked US$370bn of future federal spending for the purposes of reducing inflationary pressures. A significant amount of this is aimed at supporting climate-friendly initiatives.

We have already seen companies the CABF is invested in benefit from these funds, and we expect this to provide a tailwind over the next three to five years. The landmark piece of legislation also increases the pressure on other governments to be proactive in this regard and it is increasingly clear that climate change and green technologies are taking a place at the top table of political agendas.

2 End of the rate hiking cycle

Our Renewable Energy Infrastructure exposure in our Alternatives allocation continues to be under pressure due to the higher interest rate environment but we are seeing some light at the end of the tunnel and believe that we are now near, if not already at, a peak in rates for the cycle. After 14 consecutive increases the Bank of England has kept rates unchanged at successive policy meetings and in an environment of stable or falling interest rates we believe renewables become attractive once more.

Over the last year we have reduced our exposure to risk assets, favouring short duration gilts maturing within the next two years. Yield levels in the region of 5% are the best we have seen for 15 years, and we expect them to provide ballast going forward.

3 Attractive entry levels for core sectors

Medical technology was a strong negative contributor in the first half of the year. However, market declines have created some attractive opportunities in life science tools. Whilst R&D spending guidance from pharma and biotech customers in China has been well below analysts' expectations, we believe the worst is behind us and outlook is promising for this sector. We have been taking advantage of market weakness by adding to core ideas in the space that we view as trading on sensible valuations, like **Thermo Fisher**, a well-diversified business with high revenue alignment to SDG 3 – Good Health and Wellbeing.

Green Infrastructure is another area that has become more appealing given a drop in valuations and the sector now trades at a c.15% discount to NAV. Furthermore, the inflation linkage within most trusts held by the CABF means there is a strong element of inflation protection if price pressures remain elevated and we also like the contracted cashflows and solid operational performance. We have been reticent to add to this asset class due to the ongoing increase in interest rates but the increased attractiveness of investing at current levels means we are closely monitoring the situation and ready to act. We continue to like the green infrastructure space in particular the electrification of the car and renewable energy. We continue to hold leading players in this area, like offshore wind energy operator **EDP Renovaveis**.

THERMO FISHER SCIENTIFIC

Investment theme: Health

SDG with largest revenue alignment

Region: North America

Revenue alignment to any SDG: 90%

EDP RENEWABLES

Investment theme: Clean Energy

SDG with largest revenue alignment

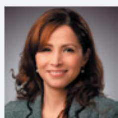
Region: Europe

Revenue alignment to any SDG: 100%

In summary, not investing in Oil & Gas is one of our key exclusions in the Fund but this was also one of the main reasons for the underperformance in 2022 as commodity prices surged due to the Russian invasion of Ukraine. However, whilst the last couple of years have been a challenging time for the Climate Assets Balanced Fund, it has outperformed most peers within the sustainable space.

2023 has been a better year for markets, but a sizable proportion of benchmark's gains are due to just a handful of mega cap US tech stocks, boosted by a rush to invest in Artificial Intelligence. As these stocks don't satisfy our sustainability focus, we have sadly also missed out. We remain committed to our investment philosophy and believe it will deliver solid returns over the long term. Price-to-Earnings ratios for the "Magnificent Seven" are almost double that of the rest of the US benchmark and therefore are potentially vulnerable to a valuation normalisation that would mean the Fund is relatively more resilient.

We believe structural growth themes, like the energy transition and resource efficiency, remain the strongest investment opportunities ahead and will be supported by consumer demand and government policy providing robust spending in decarbonisation and energy connectivity, key areas of focus for our Fund.



Claudia Quiroz
Head of Sustainable Investment
Claudia has over 20 years of experience in Sustainable, Ethical and Responsible Investment and 13 of those are with Quilter Cheviot where she has worked since 2009. She is the Lead Fund Manager of our award-winning sustainable investment strategy, the Climate Assets Fund. She also manages investment portfolios on behalf of private clients, pensions, trusts, offshore bonds and charities with a focus on sustainable investment. Her investment experience and qualifications have led her to be a Chartered member of the Chartered Institute for Securities & Investment.
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Harry joined Quilter Cheviot in 2018 and moved to work with Claudia Quiroz and Caroline Langley later that year. Harry has since been promoted to an Investment Manager and assists with the management of clients' portfolios for private clients, pensions, trusts, charities, and funds, including the Climate Assets Funds. Harry is also co-fund manager of the Quilter Cheviot Libero Balanced Fund. Harry has completed the CFA Certificate in ESG Investing, the CISI Chartered Wealth Management Qualification, and is a Member of the Chartered Institute of Securities and Investments.
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Investors should remember that the value of investments, and the income from them, can go down as well as up and that past performance is no guarantee of future returns. You may not recover what you invest.

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