Thoughts from the sustainable investing team

July 2021

The quarter in review

Markets today are representative of us being in the midst of a global transition out of the pandemic. Some countries are struggling to contain another outbreak and others experiencing days with no deaths at all, with a successful vaccine rollout. Most investors are asking themselves the same questions - what will the long term impact of the last 18 months of disruption to the global economy be, what will it do to labour supply, what will the impact on prices be, and how quickly will we get back to 'normal'?

Over the course of the quarter, the sustainable portfolios generated strong returns: our highest risk portfolio returned over 6%, the lowest risk defensive portfolio with circa 25% in equities returned 3%. All holdings in the sustainable portfolios returned positive performance for the quarter, however this overall positive set of returns, masked what was a fairly volatile period in markets.

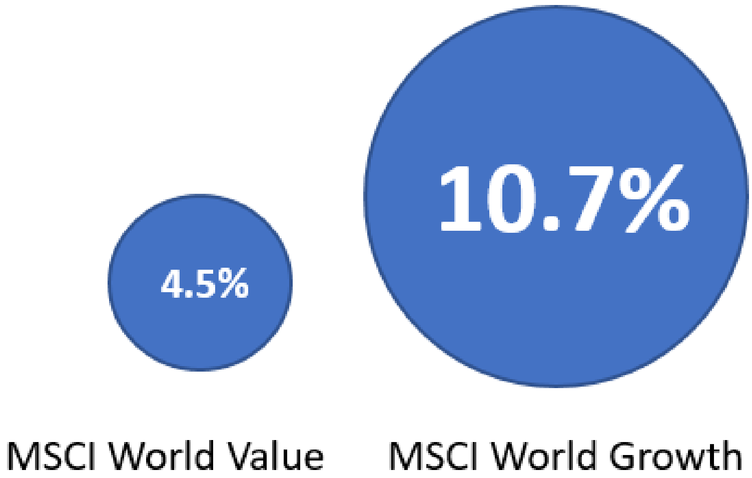
At a glance

- US and green stocks perform strongly over the quarter
- Activism against energy companies gathers pace
- Biodiversity loss becomes more of a corporate mainstream issue

Economic reopening

The twists and turns that we have seen impact markets since the start of the year show no signs of abating. This is characteristic of an economy emerging from recession, as background risk factors, such as rising COVID-19 variants, are played off against positive macroeconomic data releases. We are seeing this reflected in the performance of more cyclically orientated stocks (such as industrial companies and materials sectors aligned to the green transition) and at other times, in the defensive 'stay at home stocks' (such as consumer goods businesses). The value rotation that we saw develop over March reversed at the start of Q2 as growth and tech stocks rallied strongly, which benefited the performance of the sustainable portfolios. During June, growth stocks once again significantly outperformed value sectors, leading to outperformance of MSCI World Growth by over 6% versus MSCI Value over the quarter as a whole.

Q2 2021 style returns

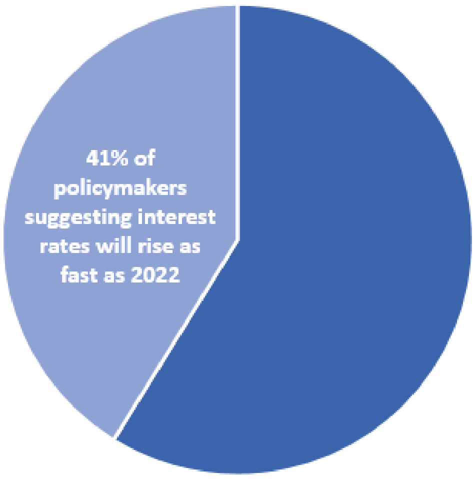


Source: FE Analytics

As a sustainable investment team, we are responsible for implementing sensible asset allocation calls to navigate these changeable markets over the medium term, but more importantly we are focused on the fundamental strength and long term appeal of sustainable themes, which continue to grow in dominance worldwide. Right now is an exciting time for sustainability, but these themes are not just for 'right now' they will continue to touch and impact every sector for the years and decades to come.

Inflation
Over the course of Q2, expected inflation crept up. In the US, price rises were recorded at 5% Year-on-Year in May, driven by energy and used car cost increases. The median Federal Reserve (Fed) forecast now expects two interest rate rises in 2023, however in the previous meeting to June, it hadn't expected any rate hikes in 2023, instead predicting the first increase in interest rates in 2024. Perhaps even more surprisingly, seven out of the 17 policymakers suggested interest rates would rise as soon as 2022. This unexpected hawkish stance from the Fed led to the biggest one day jump in the value of the US dollar since March 2020. Further factors driving inflation are a recovery in the sectors worst hit by COVID-19, which may mean we see price rises for travel and leisure, and disruptions in supply chains which could mean a shift to local suppliers.

Interest rate hikes



Source: the Fed

However, many deflationary pressures remain in place. In Europe and Japan, we have had near-zero interest rates for many years, without seeing any inflation. In the US, pre-pandemic record low unemployment was not inflationary; with many jobs lost permanently. Globalisation has kept costs down and, while there are concerns about supply chains, this will remain a deflationary influence. Automation and artificial intelligence will also reduce the need for expensive labour so, even where production is localised, it may not raise costs. Furthermore, ageing populations will generally be deflationary, although the cost of care in old age may rise.

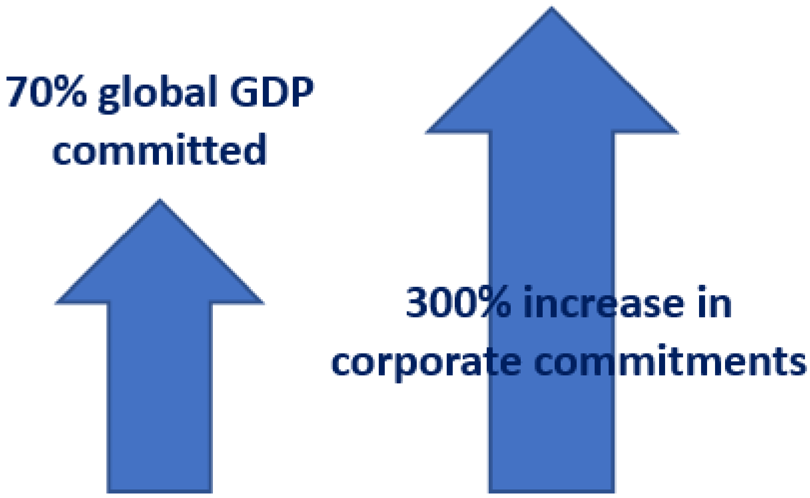
Impact on green metal prices
A strong dollar tends to be negative for commodities priced in dollars, and we saw the impact of this on so-called 'green metals' over the course of the quarter. The prices of commodities such as copper, lithium and aluminium have been increasing since summer of last year due to the surge in expected demand because of the amount of these metals required for the achievement of net zero carbon goals as green metals used in everything from semi-conductors, to electric car batteries. With the recent strengthening of the dollar and a surge in Chinese copper supply, the prices in these metals weakened somewhat towards the end of the quarter, but this is a small dent in what in some cases has been triple digit increases in prices.

Big oil's judgement day

The quarter has been a momentous one for big oil activists. In May we saw a landmark ruling in the Dutch courts that ordered Shell to cut its direct and indirect emissions by at least 45% over the next nine years, relative to 2019. Whilst it is likely to take some years for appeals to be concluded, the reverberations of this result will be felt for even longer. The impact of this legal action is amplified by the successful activism by a small hedge fund against Exxon leading to the oil giant to accept 'climate friendly' directors to their Board. It feels as though fossil fuel industry is undergoing a bit of an identity crisis. Some of the major oil companies are publicly committing to net zero, although the extent and authenticity of these goals in some cases look weak, other oil companies aren't yet making clear how they are planning to adapt to the world of sustainable development. We believe that it is clear that we are at the start of a long term structural shift in how energy is consumed, and where that energy is sourced from.

Now more than 70% of global GDP by country is signed up to net zero, in the first nine months of last year there was a 300% increase in corporate commitment to net zero. This is feeding through to represent trillions of USDs in investment in infrastructure to support this transition, across Europe, UK, the US and many parts of Asia. The pandemic has certainly played a part, providing the opportunity for policymakers to spend and rebuild economies to support the move towards a lower-carbon economic model. The US infrastructure bill is an obvious example of this, as is Europe's allocation of 30% of the EUR750bn recovery package to spending on climate initiatives.

Net-zero commitments



Source: EnviroLab, New Climate Institute

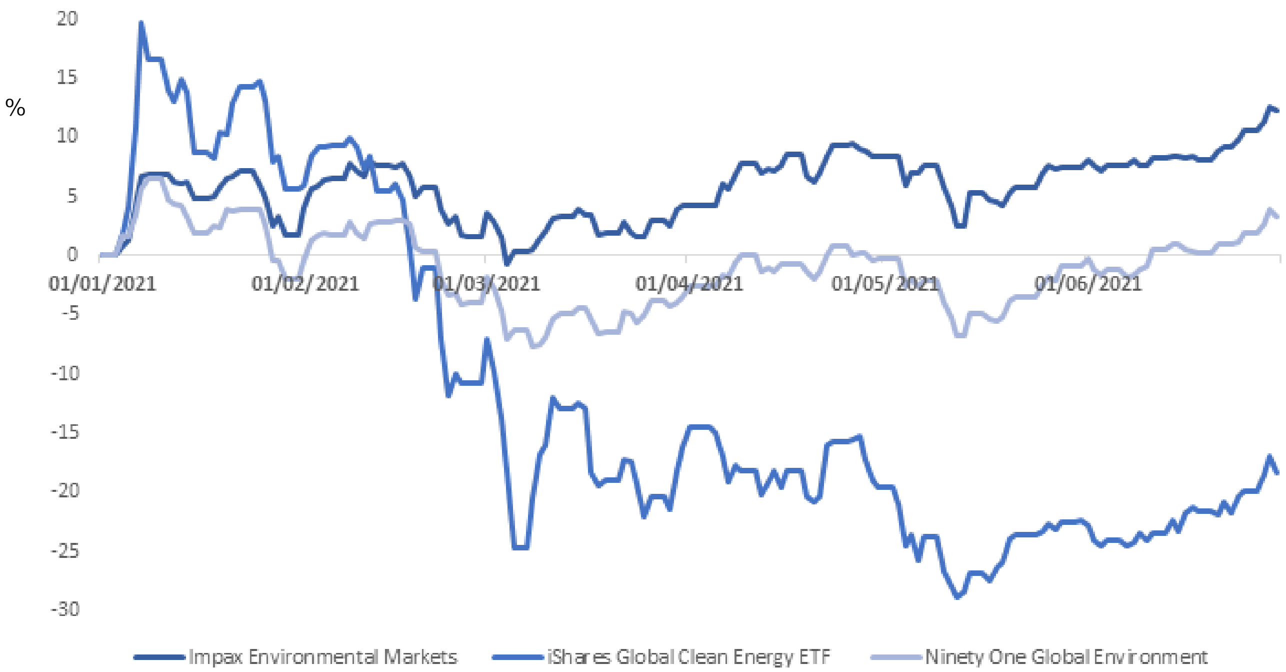
Outside of the energy complex, as is very well documented, supply chains are currently challenged by pandemic (and trade bloc) disruption. However looking further out, supply chains are being redesigned to become increasingly circular, less resource intensive and kinder to the environment. Investors are demanding transparency from businesses on not only their goals around minimising environmental and social impact, but also progress made towards them. These sustainable themes, which have longer-term tailwinds have only been strengthened during the COVID-19 crisis.

Biodiversity
During the quarter, world leaders met to discuss sustainability issues such as net-zero and biodiversity at the G7 summit in Cornwall. Our Chairman signed a letter published by the World Economic Forum's Alliance of CEO Climate Leaders, a global community of CEOs and Chairmen who continue to set the bar higher and catalyse action across all sectors and engage policymakers to help deliver the transition to a net-zero economy.

To coincide with the G7 summit, the new Taskforce on Nature-related Financial Disclosures (TNFD) was also launched. This is a new global market-led initiative for organisations to report and active on evolving nature-related risks (such as biodiversity loss), in a similar way to TCFD (carbon disclosures). We are seeing some significant momentum within the investment industry behind mitigating biodiversity loss, and this framework provides a helpful structure to corporate reporting on this crucial issue.

Valuation discipline
One reason for holding actively managed third-party funds within a sustainable portfolio is the deep and dynamic sustainable analysis undertaken on each and every company, by specialists. Another reason is for the valuation discipline they apply. This means that the managers of the third-party funds don't invest in companies at any price, and instead carefully consider the valuation at which investing in a business makes sense. The benefit to this is clearly demonstrated in one of the largest green energy trackers in the world ($6bn), and the performance of this versus two of the actively managed specialist environmental energy funds in the portfolios. The green energy tracker has attracted a significant amount of investor cash over the past year, and invests in companies delivering on the energy transition. These companies include Plug Power, one of the top holdings of the tracker, which makes hydrogen fuel cells. Blackrock, the fund management company that manages the tracker, is the biggest holder of the company. The company was trading at over 75 times 2021 revenue (Bloomberg data), but since the start of the year the share price has halved. The passive green energy tracker does not take these valuation metrics into consideration, and whilst it held the company as the share price increased this year, it has also held it as it's halved since January.

Returns of active and passive environmental funds, year to date



Source: Morningstar

Important information

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