Sustainable Quarterly review

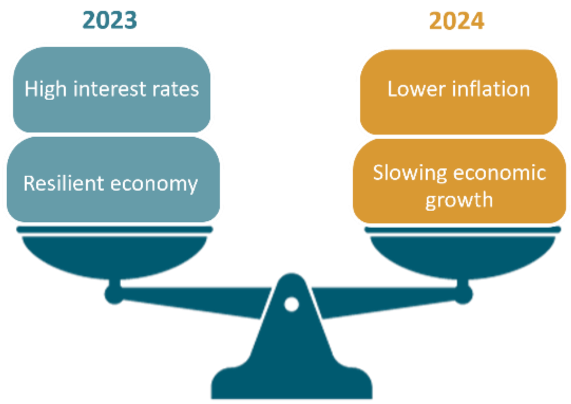
Q4 2023 market review

Overview

- Focus to shift from inflation to growth
- Interest rates to peak and fall
- Geopolitics re-emerging as a primary concern

Growth to overtake inflation as the key market dynamic

High interest rates and a relatively resilient economy characterised 2023. In 2024, the focus is likely to shift from inflation to growth as investors become less obsessed with the outcomes of central bank meetings and the publication of key data points that drive those decisions. For much of 2023, stronger-than-expected economic growth meant that the recession in the US anticipated by many market participants did not materialise. However, as inflation returns to lower levels, markets are likely to start worrying more about slowing economic growth (due to high interest rates, increased energy prices and a slowdown in the world's top economies) rather than high inflation. In a low-growth environment, companies that can continue to grow, and those that show defensive characteristics, are likely to be among the winners.



Equities an area of opportunity despite a challenging growth environment

As equities compete with higher **bond yields**, for a company to be attractive, they will need to demonstrate profit growth in an environment of slowing growth. If growth becomes a "scarcity", investors may possibly be willing to pay more for these companies, positioning them to do well in 2024. We also believe that going into the year ahead, companies that demonstrate characteristics of stability, income generation and low **volatility** will be more attractive when investing in **growth** assets whilst taking a conservative approach.

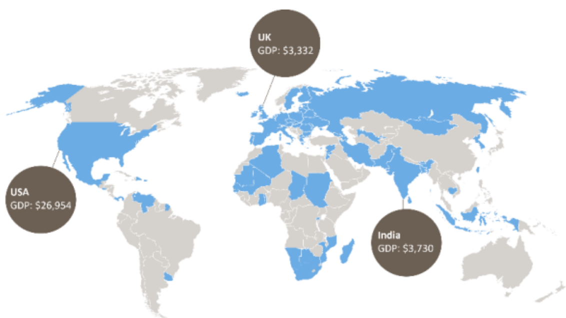
Interest rate peak followed by first rate cuts

2024 should see a shift from risks of interest rate sensitivity to credit risks due to the fear of slowing economic growth. Under normal market conditions, bonds with longer maturities should offer higher yields, as they carry both higher interest rate risks and higher credit risks. However, when the **yield curve is inverted**, as it is now, investors pay a premium for taking on additional risk. This seemingly paradoxical situation only makes sense if we assume that central banks will have to cut interest rates again in the coming years in order to avoid an economic **hard landing**, being a recession. By focusing on bonds with short **maturities** and higher quality bonds, default risks are lower. This is even more important as we expect the economy to continue to slow down next year.

Navigating the dynamics of geopolitics

Geopolitics has re-emerged as a primary concern marked by a distinct sense of volatility. Tensions have exposed the vulnerability of supply chains, pushing resource security up the political agenda, and forcing companies to **re-shore** key elements to bolster stability and reduce dependencies. The events of 2022 with Russia's move into Ukraine shook the world and set a precedent for potential shifts in dynamics. Following closely in 2023, the re-emergence of conflicts in the Middle East further underscored the impact of geopolitics. These incidents not only captured headlines but also refocused the attention of investors, policymakers, and strategists, all of whom must now navigate an increasingly complex maze.

In 2024, countries making up over 50% of global GDP, including three of the top five largest economies, will undergo decisive elections. This will be viewed not only through the prism of their domestic impact but also their potential to recalibrate the global balance. The US, by virtue of its economic might, military strength, and historical role in global affairs, remains a pivotal player. Its actions inevitably have a ripple effect, influencing events and decisions on a global scale.



The next gear change in the energy transition

Written by Ben Palmer, Lead Portfolio Manager

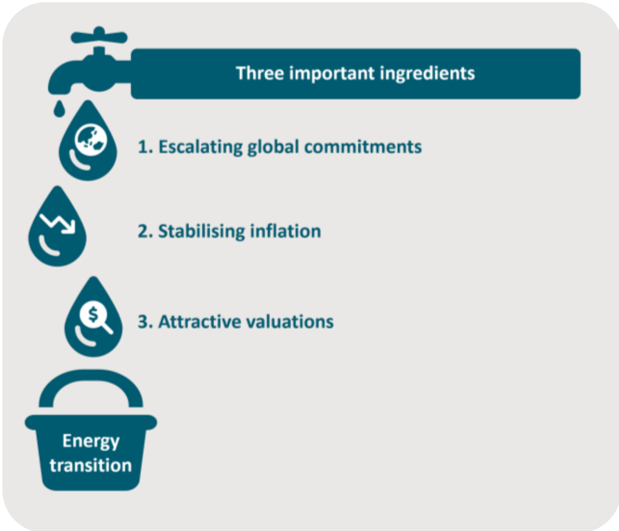
In 2015 at COP21 in Paris, arguably one of the most important global agreements in history was signed by 196 UN parties. Its ambition was grand, yet its focus was simple; limit global temperature rises to well below 2 degrees Celsius above pre-industrial levels (1900) by the end of this century and pursue efforts to limit increases to 1.5 degrees Celsius. The science-based roadmap for getting there, halve global emissions by 2030 and reach net zero emissions by 2050. Whilst global warming and the effects of climate change had been known for several decades, the Paris Agreement really lit the touch paper on the project to decarbonise the global economy. Fundamental to this is evolving our energy system away from reliance on highly polluting fossil fuels to low and zero carbon energy sources such as solar and wind energy.

Following Paris, we saw a surge in supportive policy measures and the falling cost of renewable technologies made them ever more competitive from an economic perspective. Today, onshore wind and solar have become the cheapest forms of new electricity generation globally. The energy transition has created huge opportunities for companies across a broad range of industries that are creating cleaner energy systems and making our use of energy more efficient. This in turn has provided a very fertile investment landscape for investors looking to both contribute to, and benefit from, the energy transition. Whilst there are periods of volatility, many established companies, and emerging challengers have experienced substantial share price increases.

COP28 acknowledges the need to transition away from fossil fuels

This year's COP28 in the United Arab Emirates proved to be contentious however, we think the concluding statement and commitments should be viewed in a broadly positive light. We believe it signals the next gear change in the energy transition, and not just because it was the first explicit acknowledgement of the need to transition away from fossil fuels. More tangible were the two practical targets set, a commitment to treble renewable energy generation, and double energy savings by 2030. Recognising that the statements could have gone further, and this now needs to be translated into policy, the trajectory of travel is clear and high-quality companies helping to deliver on these goals are well positioned. So, whilst risks remain to the outlook, we enter 2024 with three important ingredients that support investments in the energy transition theme: escalating global policy commitments, more stable inflation and interest rate expectations, and attractive valuations.

Supporting investments in the energy transition



The integration of climate risk as a financial metric

Of increasing relevance to the energy transition and climate risk debate is how it relates to an investment manager's fiduciary duty. Or in simpler terms, an investment manager's responsibility to act in the best interests of their clients. As the financial costs associated with climate change become more apparent, and the aforementioned policy landscape tightens, there is an increasing consensus that climate risks are financial risks that are filtering down to corporate performance and should be treated as such. This change in perspective is significant as one of the central arguments against broader adoption of climate analysis in investment decision making was that it would undermine the responsibility of investment managers to focus on financial returns, whereas now it is not just seen as compatible but necessary. Moving forwards we expect to see more investment frameworks integrate climate risks. This has broader implications than focusing in on energy transition enablers as it impacts all areas of the economy. We have been considering climate related risks in our analysis for several years and as we continue to evolve our approach, we believe our ability to effectively value these risks will continue to improve, benefiting our portfolio management and fiduciary responsibility to our clients.

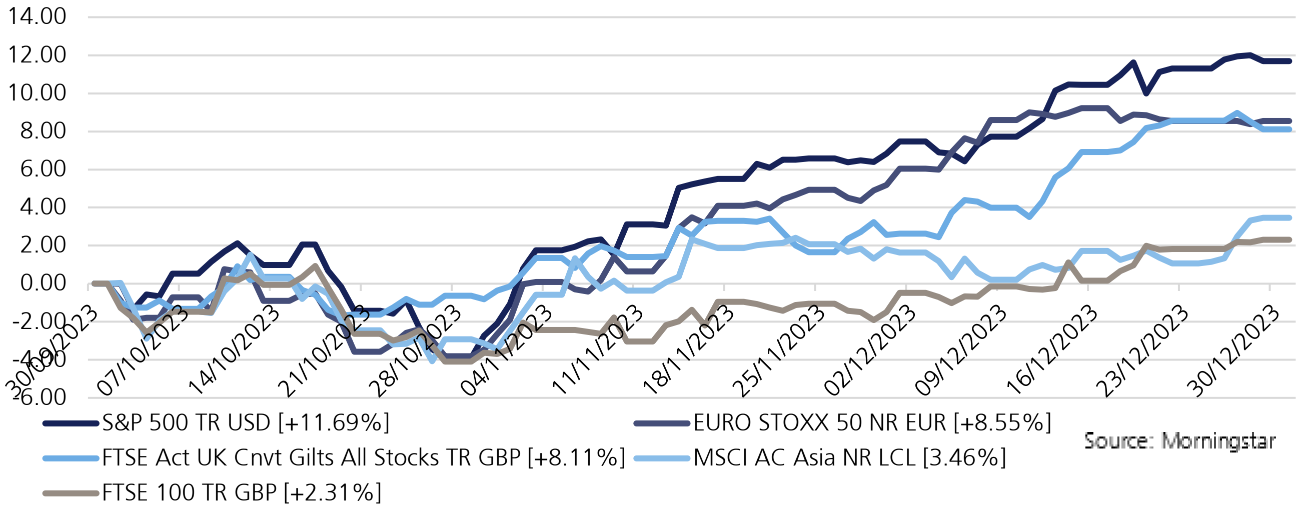
Further reading material

Explore the wider 2024 investment themes with key members from the investment team, including Henry Wilson, Senior Portfolio Manager.

Click here

Scan the QR code or click here to watch Phoebe Stone, Partner and Head of Sustainable Investing discuss the last quarter of 2023 in a five-minute quarterly roundup.

Q4 2023 index performance (%)



Model portfolio performance as at 31 December 2023

Portfolio	3 months	6 months	1 year	3 years
Defensive	5.14	4.71	6.75	-0.67
Cautious	5.44	4.74	7.55	1.37
Balanced	5.73	4.52	8.07	4.10
Growth	6.76	4.38	8.77	4.44
Adventurous	6.94	3.68	8.84	4.39

Source: Morningstar

Performance is gross of 0.30% AMC and net of underlying charges

Past performance is not a reliable indicator of future performance; and the value of investments, as well as the income from them can go down as well as up, and investors may get back less than the original amount invested.

12-month rolling performance

Portfolio	01/01/2019 - 31/12/2019	01/01/2020 - 31/12/2020	01/01/2021 - 31/12/2021	01/01/2022 - 31/12/2022	01/01/2023 - 31/12/2023
Defensive	10.96	6.31	5.25	-11.59	6.75
Cautious	12.88	8.64	8.15	-12.85	7.55
Balanced	15.63	11.84	11.93	-13.94	8.07
Growth	18.75	16.10	14.13	-15.87	8.77
Adventurous	20.88	17.30	15.57	-17.01	8.84

Source: Morningstar

Performance is gross of 0.30% AMC and net of underlying charges

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Performance of LGT WM funds in Q4 2023

Vanguard UK Long Duration Gilt Index
+14.28%

Liontrust Sustainable Future Global Growth
+13.28%

Liontrust Sustainable Future European Growth
+12.27%

Lazard Global Sustainable Equity
+10.62%

Foresight Global Real Infratsructure
+9.44%

Impax Asian Environmental Markets
-0.92%

Source: Morningstar

Q4 proved to be a story of two distinct periods. The first, which encompassed all of October, was very challenging, with markets expecting that rates may well stay 'higher for longer' on the back of more robust US economic data. As we have seen several times over the last two years, when interest rate expectations go up, it results in a selloff in longer duration investments including long dated bonds and more growth focused equities. This impacted the Sustainable MPS portfolios because although we have minimal exposure to longer dated bonds, we do have meaningful exposure to growth focused equities. However, our focus on shorter dated bonds, and our diversifying exposure to more value focused equity holdings held up relatively well in this period, which emphasises the importance of portfolio diversification.

As we moved into November the market dynamics changed considerably. Weaker than expected inflation data was perceived positively by the market on the back of expectations that this would relieve the pressure on central banks, allowing them to consider cutting rates earlier. This instigated a strong rally in the assets which had performed worst in October, and whilst markets were broadly positive, the investments which had provided protection in October, provided more moderated returns. This dynamic prevailed through to the end of the year and given the strength of the "Santa rally", it more than offset the disappointing October, resulting in solid gains for portfolios to finish the year.

The top performing equity funds this quarter were two of the Liontrust Sustainable Future funds, namely the Europe and Global Growth funds, providing returns of 12.3% and 13.3% respectively. Both funds have large exposure in the small and mid-cap growth space which proved to be very favourable this quarter. Within fixed income, Vanguard UK Long Duration Gilt was not only the top performing bond fund, but the top performing fund across all portfolios, returning just over 14%. In contrast, whilst still in positive territory, Schroder Global Sustainable Value ended the quarter at the bottom of the global equity funds, returning 1.8%, alongside Vontobel TwentyFour Sustainable Short-Term Bond which posted 2.9%.

It is interesting to note that if we were considering October in isolation, Schroder and Vontobel would be named as the top performers in the equity and bond space, with Liontrust and Vanguard as detractors. This highlights just how different each half of the quarter was.

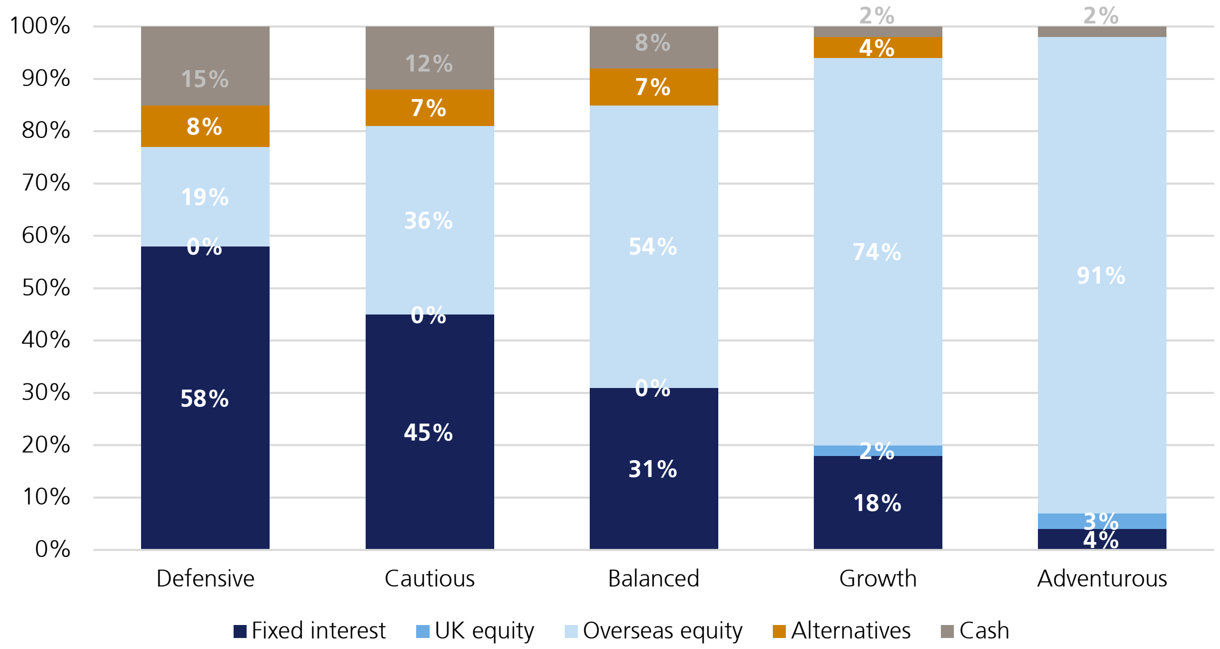
The large swings we have seen in market leadership this quarter show why we have remained focused on balance and diversification in our management of the portfolios. The re-emergence of some of our investments which have weathered a bruising period through the rate rising cycle also evidences the importance of focusing on the longer-term attractiveness of investments, rather than reacting to every news or data release. 2023 was challenging but through this approach we finished the year firmly in positive territory with portfolios returning between 6.8% and 9%, outperforming cash, and in most cases, the 2023 average inflation rate.

Portfolio changes and rationale

Adding to infrastructure

- In November, we introduced a small position of Foresight Global Real Infrastructure into our Balanced portfolio (+1.5%) and increased existing exposure in our Growth and Adventurous portfolios by +1% each.
- Foresight invests exclusively in the publicly traded shares of companies that own or operate real infrastructure or renewable energy assets across the world. It was purchased as a fund with a value bias we would top up on weakness should the fundamentals be supportive.
- Renewables have faced several headwinds this year which has negatively impacted the sector, but we saw a large change in sentiment with several governments announcing significant positive re-adjustment in renewable energy auction prices. Following our view that the interest rate hiking cycle is coming to an end, we are confident in the future valuations of the underlying high-quality assets within the fund.

Portfolio positioning



Glossary of terms

Bonds	Bonds are debt securities issued by governments and corporations to raise money. Similar to an IOU, the investor lends money with the agreement that it will be paid back by a specific date, and they will receive periodic interest payments along the way. Bonds come under the umbrella of 'fixed income' investments.
Growth	Investing in companies that are expected to offer future growth prospects that are above the average in their industry or sector.
Hard landing	When the central bank increases interest rates excessively or rapidly to control escalating inflation, leading to the economy veering towards a recession. It is market by a swift economic decline, elevated unemployment rates, and diminished economic activity.
Inverted yield curve	When the yield curve is inverted, it means that short-term interest rates are higher than long-term rates. In this scenario, investors might have to pay a premium or accept lower returns for investing in longer-term assets compared to shorter-term ones. The reason behind this is that an inverted yield curve is often seen as a signal of economic uncertainty or potential downturn, prompting investors to demand higher compensation for taking on the added risk of committing their funds for a longer duration. This premium is the extra cost investors are willing to bear for the increased risk associated with longer-term investments during an inverted yield curve environment.
Maturities	The agreed-upon date when an investment concludes, usually resulting in the repayment of a loan or bond, distribution of a commodity or cash, or fulfilment of other payment terms.
Re-shoring	To transfer a business operation that was moved overseas back to the country from which it was originally relocated.
Volatility	When a market or asset experiences periods of unpredictable, and sometimes sharp, price movements. Some asset classes are traditionally characterised as being more volatile than others.
Yield	The income you receive on an investment, such as dividends from shares or interest from bonds.

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