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Sustainable Equity strategies

Quarterly overview

30 September 2023

ROYAL LONDON
ASSET MANAGEMENT

Overview

Market overview

Markets made losses over the period under review on fears that interest rates will remain higher for longer than expected, which saw equities drop to their lowest levels since early June. The quarter also saw a market rotation with the best performing sector being the fossil fuel-based energy sector, which had underperformed in prior quarters, and the information technology sector giving back some gains, having been the best performing sector year-to-date. For the third quarter, the MSCI World and MSCI All Countries World Index (ACWI – which also includes 26 emerging markets) produced negative returns for the quarter in US dollar terms. Looking at national MSCI indices, the strongest market was Japan, while the weakest was Eastern Europe. In terms of style, the MSCI World Growth Index produced weaker returns versus the MSCI World Value Index.

The price of Brent crude oil soared by 24.7%, to $92.20 a barrel. Copper futures also declined a further 1.5% in dollar terms on the back of warning signs emerging of a weakening in global demand as China's economic rebound stalls.

The US dollar appreciated by 3.1% against the yen, by 3% against the euro, and by 4% against sterling. On a translational basis, sterling's strength against the dollar impacts sterling investors in overseas assets as it lowers the returns over the quarter. However, the weaker dollar will benefit emerging markets countries and companies that have borrowed in dollars.

The third quarter was characterised by mixed data around the world, with central banks nearing the end of their rate hiking path, but with cuts still seemingly a while away. Economies have been more resilient than was expected at the start of the year, but global growth is spluttering again amid a disappointing bounce in China activity, slow-to-no growth in Europe and against a backdrop of restrictive monetary policy. The US still looks at risk of recession too, even if activity data to date has been fairly robust.

Inflation has fallen significantly and, although higher energy prices threaten a revival in headline inflation, other factors – including a weak economic backdrop – should pull inflation lower still. With taming inflation still the priority for central banks, there is still a possibility of further rate hikes from the Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE), but peak rates look to be near, with real rates now well into positive territory.

Performance and activity

This report covers Royal London's equity-only sustainable funds (Sustainable Leaders and Global Sustainable Equity), plus the two equity-oriented mixed-asset funds (Sustainable World and Sustainable Diversified). Please see our sustainable sterling credit report for commentary on Sustainable Managed Income and Sustainable Managed Growth. As the Global Sustainable Credit Fund is not limited to sterling credit, it has a separate report.

Our sustainable strategies invest in companies that are contributing to a cleaner, healthier, safer and more inclusive society. Areas such as healthcare and technology remain at the core of the equity portfolios, complemented by engineering, utilities, selected financial services, and companies that lead their industries in operational ESG performance. This means that we do not invest in some sectors, such as oil & gas, extractive industries or tobacco. We believe that the exposure to those sectors which offer a net benefit to society is consistent with outperformance over the medium term. While the sustainable funds have different mandates, risk profiles, asset mixes and geographical exposures, equity exposure is driven by the same underlying team, philosophy and process. Many of our key stocks will be held across several portfolios.

For our equity-only funds, net of fees Sustainable Leaders underperformed its wider index-based benchmark (FTSE All-Share) over the third quarter and delivered negative performance. Global Sustainable Equity also underperformed the MSCI All-Countries World Index (ACWI) benchmark.

For Sustainable Leaders, sector performance was the main headwind to performance. Not having exposure to the fossil fuel-based energy sector hurt performance as it was the best performing sector during the period. Higher quality and longer duration assets were also hurt by the rise in government bond yields. On a stock specific basis, Vistry Group contributed to performance – it benefited from its management team announcing a new business plan which was well received by investors. Sage – a leading provider of accounting software for small businesses – also outperformed owing to strong execution from the management team and being viewed as a beneficiary of the advancements in AI. Asian life insurance company Prudential was weak during the period due to ongoing macroeconomic weakness in China, amid the expected recovery from the easing of Covid restrictions not translating into a material rebound. Contract catering outsourcer Compass meanwhile was subject to profit taking after a strong period of outperformance.

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Within Global Sustainable Equity fund and our mixed asset funds' equity exposure, sector performance was also a detractor to performance during the period – the fossil fuel energy sector was the best performing sector while information technology was one of the worst. A key contributor was Standard Chartered which gained from resilient underlying growth of the Asian and emerging markets economies it serves, combined with an attractive valuation versus its peers. Intuit – the small business accounting software and consumer tax company – outperformed owing to strong execution from the management team and also being viewed as a beneficiary of the advancements in AI.

The credit exposure for the mixed asset funds produced a positive absolute return for the quarter, with the impact of rising gilt yields mitigated by a narrowing in credit spreads and the income on the portfolios. On a relative basis, our credit exposure performed broadly in line with the iBoxx Sterling Non-Gilt index. In terms of performance effects, the outperformance of short-dated bonds relative to long-term equivalents was a headwind for performance. However, this was offset by our sector allocation – in particular our overweight in banks and significant underweight in supranationals.

In terms of activity, we started a position in Ashtead group – A large, diversified construction equipment rental company operating within the US and UK under the Sunbelt Rentals brand. Ashtead offers its customers benefits associated with the rental economy which helps to lower embodies carbon from reduced equipment demand. Given its scale as one of the largest buyers of construction equipment is plays a tangible role in encouraging electrification and lower-carbon construction equipment in a hard-to-decarbonise sector.

We also invested in HDFC Bank, feeling that a recent pull-back in the shares presented a compelling opportunity to get exposure to India's leading retail bank and to benefit from the structural growth trends of the Indian economy. Another company we added to was AGCO – A global leader in the design, manufacture and distribution of agriculture equipment. The combination of a growing global population and climate change mean that producing food efficiently and in a more sustainable way is increasingly important. AGCOs machinery and precision ag technology offerings help farmers do this and to save money over the longer term.

Finally we started a position in Linde – The world's leading industrial gas company which provides gasses for a wide range of industries and use cases. Its products range from providing medical oxygen to healthcare providers, to providing hydrogen to high-carbon industries and helping to reduce GHG emissions and increase efficiency.

Outlook

As fund managers, we create our own investment identity which we imprint on markets. This identity can be a function of objective evidence as to what delivers performance in the long run, beliefs such as the importance of sustainability and the strengths and weaknesses of the people who are enacting it. Done thoughtfully and applied consistently, we believe this is the path to long-term investment success. Alongside this we are market observers. Each day there is messaging from within and across asset classes as to what is occurring in the global economy. Sometimes this is right, and sometimes this is wrong, but it is always worth paying attention to. What are the trends in the global economy markets are pointing to today?

The clearest messages we can see are that we are entering into something of a boom time for both the physical and digital worlds. In the last decade, the physical world has been somewhat left behind by the digitisation of large parts of the economy. This has created many of the technology giants we know so well. Investment in physical infrastructure has lagged, but this is changing.

The key trends in physical infrastructure include electrification, a consequence of a desire to decarbonise, and onshoring, which is a consequence of rising geopolitical tensions and a desire to have industrial and manufacturing capacity at home rather than abroad. We have seen this most prominently in the United States, where the Inflation Reduction Act (climate investment essentially) and CHIPS Act (semiconductor manufacturing) have created material incentives to invest in the physical world and those companies which help build it.

The strength in equity markets this year has been a positive surprise and has been a result of the view that we have reached and (potentially) passed peak inflation and interest rates while not seeing a meaningful slowdown in economic growth. In recent weeks however markets have increasingly priced in a higher-for-longer interest rate scenario as a result of more embedded and structural inflation than was previously expected. This has resulted in a weakness in both bond and equity markets while benefitting commodities. We believe the next six months will be crucial in determining the future path of inflation and whether developed economies such as the US and UK are able to avoid a recession.

Overview

Despite more challenging performance in September, we believe that 2023 is on track to be a good year for the Royal London Sustainable funds with our funds ahead of benchmarks and key peers. The macro environment remains complex and confusing, but we continue to have high conviction in the underlying drivers of the companies in which we are invested and in many cases find valuations to be undemanding. We consider our portfolios to be more diversified and lower risk than 18 months ago and would expect them to be relatively more resilient if we do enter a period of slowing economic growth or recession.

There is considerable uncertainty about the economic outlook for the remainder of 2023. In the US, the Federal Reserve has continued to raise interest rates in response to high inflation and many investors fear that this could tip the US into recession, although economic indicators remain broadly positive at this stage. The picture is potentially more problematic in the UK where inflation is higher and growth weaker. Europe is somewhere in the middle of these two outcomes. How inflation progresses from here, and how central banks respond, will be a key determinant of near-term returns.

In the long term, we believe that the trend towards sustainability remains a strong one, with all companies we meet with pointing to an acceleration both in recent years and since the start of the Ukraine war. Whilst this may seem counterintuitive given the strong performance of oil, energy security – as well as increased concerns about climate change – are resulting in an acceleration in the demand for renewable energy. Although innovation may be becoming more incremental in the consumer arena, recent developments in AI are driving significant advances in technology. Within healthcare innovation is accelerating as a greater understanding of the immune system as well as genetics, is resulting in a step change in cancer treatments, amongst other areas. The physical economy is also seeing a renaissance after many years of being overshadowed by the digital world. Electrification is a core part of path to a lower carbon economy and will require a significant investment in infrastructure over many years. These trends make us optimistic about the long-term outlook for sustainable investing.

Further Information

Please click on the links below for further information:

- Stewardship and responsible investment at RLAM
- Responsible investment at RLAM
- Royal London voting and engagement
- TCFD climate report

Find out more

Articles, videos and webinars explaining our investment thinking can be found in the Our Views section of www.rlam.com, including regular updates from our Fixed Income, Global Equity, Sustainable and Multi Asset teams. Notable publications in the third quarter include our annual Climate Report, as well as our annual Assessment of Value reports, available from the home page of www.rlam.com.

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