Sustainable Model Portfolio Service
Quarterly report
Q3 2021

The quarter in review

Building on what has been a strong year so far for sustainable portfolios, in Q3 the strategies continued to outperform traditional indices. Over the quarter, returns of equity funds held in the portfolios were positive, with all of the equity fund holdings in the sustainable portfolios outperforming the wider market over the review period.

There were two major drivers behind this outperformance - firstly, the tailwinds behind sustainable companies as a result of climate change initiatives, along with more focus on the responsible use of resources were a big factor. Secondly, the market began to recognise and consequently reward quality businesses, over those that were more cyclical or financially vulnerable. As a sustainable investment team, we are responsible for implementing asset allocation calls which look to navigate the changeable markets we are seeing play out. We are equally focused on identifying sustainable themes with fundamental strength and long term appeal, and which continue to grow in dominance worldwide. We believe that now is an exciting time for sustainability, and the themes that are incorporated in our portfolios are not just for 'right now' , but will continue to touch and impact markets for years and decades to come.

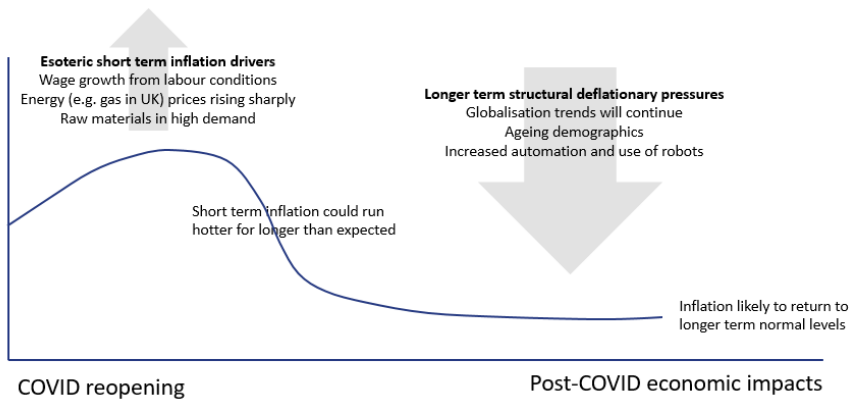
At a glance

- Chinese policy risks come to the fore
- Quality growth businesses outperform
- Global government commitment for sustainable and green policies strengthen

Inflation and the transitory debate

Inflation continues to dominate discussions within financial markets. The recent surge in cases of the Delta variant of coronavirus in developed regions such as the US has put labour markets under pressure, with businesses struggling to find people to fill vacancies. Job quit rates, the level of people quitting jobs voluntarily, currently sit at near all-time highs. This debate has left the market pondering on whether the wage growth spurred on by these labour conditions might become more entrenched and lead to inflation running hotter for longer than expected. We continue to believe that much of the short-term inflation can be attributed to transitory factors, which is in line with the view of the major central banks. Governments around the world have taken on huge levels of debt in order to finance the COVID-19 pandemic and resulting recovery packages, and so are incentivised to keep interest rates low in order to service the cost of this debt. In the run up to Jackson Hole in late August, markets were anticipating announcements from the Federal Reserve around increases in interest rates and tighter monetary policy. However, the prevalence of the Delta variant meant that whilst concerns over inflation remained, any meaningful monetary policy action was pushed back until later in the year.

Inflation expectations

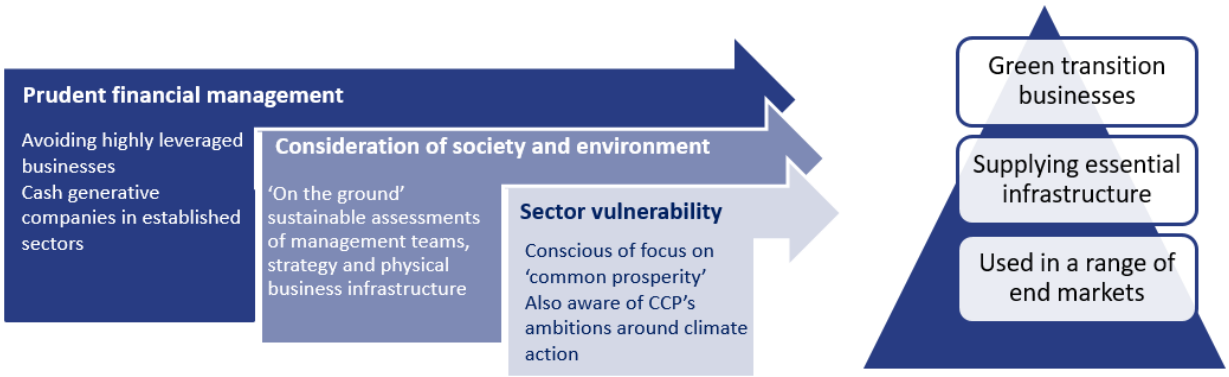


Source: LGT Vestra

Balancing risks and opportunities in China
Whilst the Central Bank rhetoric over the quarter was somewhat muted across the board, a series of risk events in China did add some uncertainty to markets. Through the summer months, the Chinese Communist Party (CCP) staged a number of regulatory crackdowns on various sectors and businesses in support of ensuring common prosperity across China. Most notably on the education sector under the belief that excessive profits should not be attained from schooling. Alongside this, the Party also introduced a number of regulatory barriers for technology companies. These developments have naturally led to increased uncertainty and market risk in China. Although the risks are evident and somewhat unpredictable, we continue to believe there are significant opportunities for growth in the region but we must remain highly selective. In light of these developments, it is positive to see that the Asia Pacific investments in the sustainable portfolios have outperformed the wider market, highlighting the value of selective, active exposure to the region.

There is allocation to Chinese companies in the portfolios, through actively managed Asian and Emerging Market funds. China is the biggest consumer, producer and investor in renewable energy, and at this time, is certainly the global leader in climate technology and innovation. We ensure that both thorough financial and sustainable due diligence is carried out on Chinese companies held, as well as consideration of the sectors the businesses are operating in. Even environmental industries, such as electric vehicles (EVs), have been hit with regulation and recently, Chinese regulators seem increasingly concerned about the amount of data being collected by electric car manufacturers. This being said, the development of EVs is a national priority, making the wider eco-system attractive. Within the portfolios there is exposure not to the Chinese EV manufacturers, but instead to the supporting infrastructure vital to the construction and ongoing maintenance.

Factors to consider when investing in China



Source: LGT Vestra

Fears about China were heightened further through concerns over a potential global contagion triggered by the default of the Chinese property developer Evergrande. Again, the active approach we take within the sustainable portfolios ensured that Evergrande bond assets were not held in any of the sustainable fixed income funds. Unsurprisingly, there is a generally low exposure to emerging market bonds within the sustainable portfolios. There isn't a huge volume of emerging market bond assets that satisfy the necessary sustainable credentials, however, this is slowly changing as more and more emerging economies are issuing sovereign bonds with specific environmental or social targets and projects attached to them. This is extremely important because some of the poorest countries in the world are the ones that most need funding, and the bond market is fast becoming a powerful mechanism to enable the provision of capital to sustainable projects in emerging economies. It is still a small part of the overall market, but we look forward to it growing significantly in the years to come.

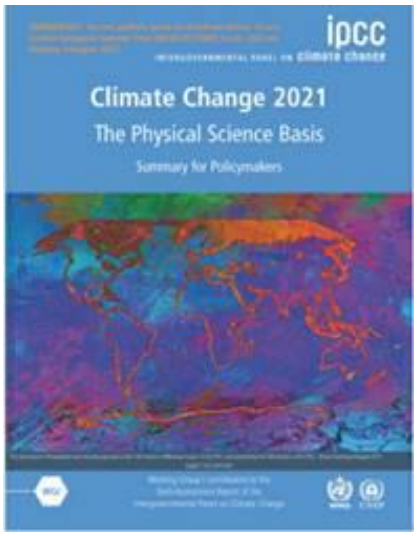
Economic recovery is not a steady ride
As we progressed through the first half of the year, it paid to be a 'value' investor, seeking to buy cheaper companies under the premise that they will revert back to their long term valuation. Growth investing on the other hand looks to identify businesses with significant runways for growth and higher future prospects, albeit you are likely to have to pay more today for tomorrow's growth. We have long had a preference for quality growth businesses with prudent management, forward looking ambitions, and the ability to generate plenty of cash to reinvest and return to shareholders. Q3 2021 saw the quality growth bias we have in sustainable portfolios return to favour as the market rewarded those businesses with better financial strength. The gap between value and growth that had opened up during the start of the year certainly closed over the course of the third quarter. We are not surprised by this, and we have been highlighting the oscillating nature of markets as they reopen. Economic recovery will not happen in a linear fashion, and the gyrations we have seen over the past nine months are a clear demonstration of this.

Value vs growth index performance throughout 2021

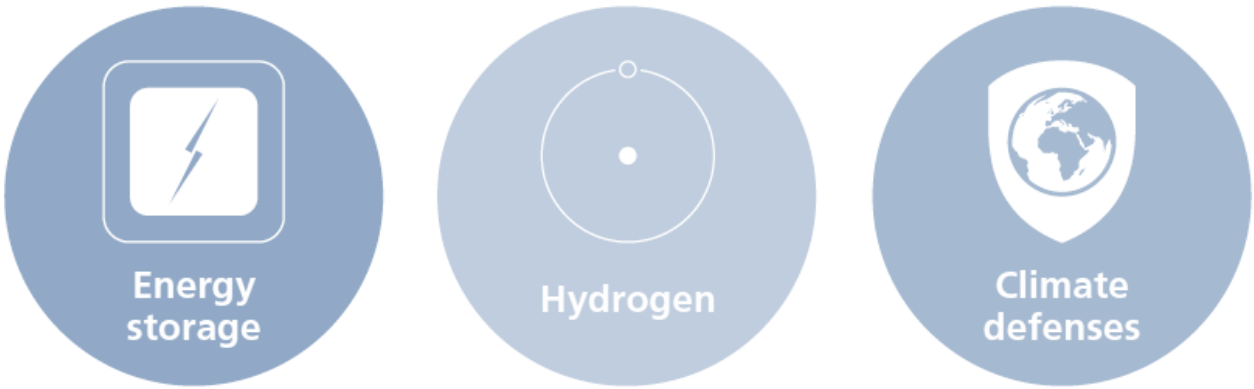
Source: Morningstar

Government commitment and support continues

The Intergovernmental Panel on Climate Change (IPCC), a body of the United Nations, has just released the largest ever report on climate change and highlights the impact of human activities on our planet. The report is the culmination of over eight years of work and 12,000+ scientific papers, concluding that there is a near linear relationship between anthropogenic carbon dioxide emissions and climate change. Although this will come as no surprise to many, developments in scientific analysis and measurement of our climate now make this relationship irrefutable. Although regulation and government support will likely be the largest single catalyst for change, financial market engagement is vital and those companies that sit behind the curve of reaching net-zero and combatting climate change will likely be negatively impacted and those ahead of the curve, positively impacted. From this perspective, it's possible to allocate to companies with lower regulatory risk and falling cost of capital coupled with high growth prospects.



During the quarter, the Democrats in the US further progressed the $3.5trillion social and environmental package. This is separate to the bipartisan $1trillion American Build Back Better Act. Focusing specifically on the climate goals of the $3.5trillion plan, it looks to provide tax credits to areas such as green hydrogen (bringing to almost price-parity per kg with grey hydrogen), management of forest fires and energy storage.



Futureproofing gains momentum

In the sustainable team, we often talk about how positively aligning a portfolio to sustainable development and ensuring the businesses you hold have strong Environmental, Social and Governance (ESG) credentials looks to be value accretive over the long term. Futureproofing is the concept of protecting your portfolio against the risks of tomorrow, often linked to ESG issues, but the financial benefit directly attributable to this is not tangible. However, when we look to the companies held within sustainable portfolios and those that have benefitted from big increases in their share prices, it is positive to see that this is supported by strong improvements to the fundamentals of these businesses, including significant upwards momentum in sales and profitability. Although

it is very difficult to attribute shareholder returns directly to sustainability factors and futureproofing, it is certainly reasonable to suggest that both have played their part in generating strong returns for investors in these businesses and will continue to do so moving forward. The market feels as though it is becoming increasingly momentum driven, and there is undeniably increasing amounts of momentum from consumers, investors and governments about sustainability.

Performance review

Equity markets delivered solid returns on the back of strong earnings, further supported by fiscal and monetary stimulus. Across the quarter, growth businesses have started to recover much of the lost ground to value orientated businesses, that emerged across the first two quarters of 2021. With the performance of growth companies, the MSCI World (developed market index) has reached new all-time highs, with the UK and predominately the US driving investment returns across the sustainable strategies.

Our decision to maintain exposure to quality sustainable growth companies has benefitted performance this quarter. Sector rotations are too quick to time, so instead we stick to the mantra of investing in good quality companies with the goal of generating strong returns over the long term. Across the quarter two funds managed by Stewart Investors, the Asia Pacific Leaders and Worldwide strategies were top performers. Both funds seek to invest well run companies, focusing on quality of management, franchise and financials. Stewardship and sustainability lie at the heart of the investment process: a company needs to meet the needs of the present without compromising future generations.

From a sectoral perspective, the recovery of growth assets has driven the US tech index, the Nasdaq, to new all time highs. Across our sustainable strategies, technology has been the most performance accretive sector held across our portfolios. For sustainable investors there is a huge opportunity to advance sustainable growth and development through the technology industry. This includes areas such as battery technology, the semiconductors that are utilised in everything from photovoltaic solar panels to laser technology, and sensor technology vital to sophisticated recycling systems. Across the strategies, other sectors driving investment returns include healthcare and industrials. COVID-19 has demonstrated the weaknesses in healthcare systems globally. To address these it will be crucial to ensure the reconfiguration of existing healthcare frameworks to increase accessibility and collaboration. The opportunities for investors in healthcare are compelling if care is taken to select well-run companies that are able to manage their risks, and create long-term growth by developing and implementing innovative solutions. Sustainable investment themes contributing to healthcare's performance include diagnostics, genomics and innovative medical technologies focusing on the development of life saving treatments.

Sustainable Model Portfolio performance as at 30 September 2021

Portfolio	3 month	6 month	1 year	Since inception (1/10/18)
Defensive	1.43%	4.49%	5.97%	18.95%
Cautious	1.96%	5.93%	9.92%	26.00%
Balanced	2.38%	7.61%	15.24%	35.12%
Growth	2.81%	8.88%	18.85%	46.07%
Adventurous	2.96%	9.47%	21.26%	51.17%

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

Top contributors over the quarter as at 30 September 2021

	Return	Comment
Alliance Bernstein Sustainable US Equity	4.26%	The US continues to generate strong returns for portfolios with quality growth characteristics again in favour over the quarter. Strong returns have been generated primarily in the industrial and healthcare sectors, both sectors with scope for high impact in regards to improving health and wellbeing and climate and environmental action.
Stewart Investors Worldwide Sustainability	5.69%	As market woes have caused the past quarter to be quite mixed for equities, the high quality companies with robust financials and dependable cash generation have enabled the fund to generate strong returns. The portfolio is well diversified with no single factor delivering the lions share of returns. This fund remains a core holding across our sustainable portfolios due to its defensive characteristics and consistent return profile.
Liontrust Sustainable Future European Growth	4.97%	Much of the European market has traded around its flat line this quarter, however, our dedicated European fund has significantly outperformed the wider market with investments in technology services and financials driving performance during the period. The financials exposure has acted as a good hedge against the looming risks of higher yields.

Source: Morningstar

Changes made in portfolios

Over the course of the quarter, we remained comfortable with the equity holdings in portfolios and remained positive on US and Asian geographies as well as technology and healthcare sectors, and didn't adjust exposure to equities. We conducted work on the bond exposure in portfolios. Given the risk connected to short term inflation and interest rate rises, we decided to reduce the overall sensitivity to interest rates by shifting into low duration bonds (those that will mature in 12 months to 18 months time).

Model Portfolio Service Quarterly Report

Q3 2021

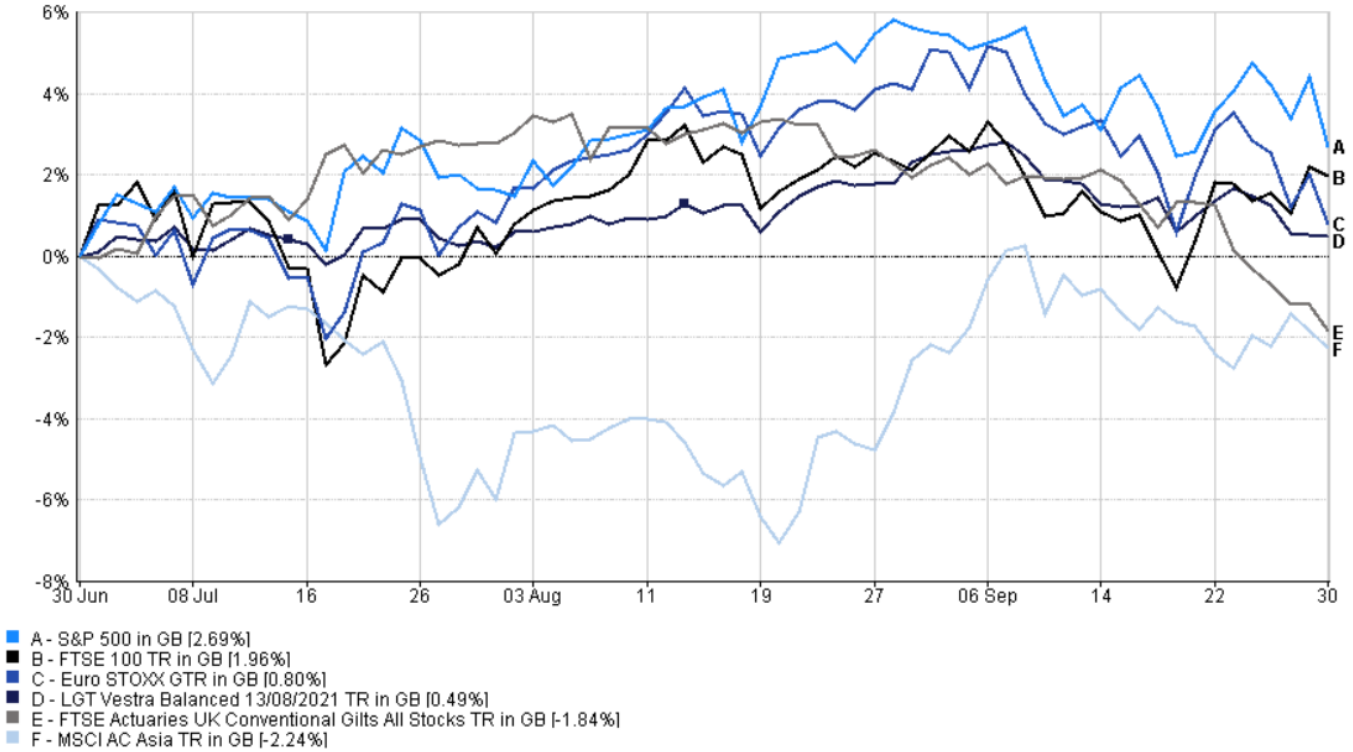
Summary

- Equity markets achieved post pandemic highs at the beginning of the quarter
- Markets pulled back in September due to several market factors
- Asian equities pulled back due to events in China

Q3 market review

The third quarter of 2021 started well, with many equity markets achieving new post-pandemic highs. However, as the quarter progressed, the spread of the Delta variant of COVID-19, supply chain concerns, events in China and the prospect of a withdrawal of pandemic relief measures, weighed on markets. Asian equities ended the quarter lower than where they started, whereas many developed markets ended Q3 little changed. The debate over whether the rise in inflation is temporary, as central bankers suggest, or more permanent, as some investors fear, continued during the quarter. As we enter the final three months of the year, these uncertainties are likely to continue to add volatility to markets. The ongoing debate over the US government budget and the debt ceiling will only add to the uncertainty. Ambiguity tends to discourage investors who are so inclined to sit on the sidelines; as a result, there is still plenty of cash waiting to be deployed into the market when the uncertainties that plague the market at present ease.

Q3 2021 index performance



Source: FE analytics

The pandemic caused large scale damage to the global economy, but massive fiscal and monetary support was forthcoming, and helped to prevent a much greater economic disaster. As the economy returns to work, huge dislocations are becoming apparent. This has driven inflation higher, but many of the drivers of inflation may be seen as temporary, such as the rise in second-hand car prices. In the UK, the return to a normal rate of VAT on hospitality and the rise in fuel costs may mean we do not see the peak in inflation until the end of the year. In the US, however, we may have already seen the peak in inflation.

Central banks have observed inflation surpass their 2% targets. They have repeatedly stressed that they see this as transitory. In any case, the Federal Reserve (Fed) has indicated that it expects to begin tapering its bond purchases this year. However, supply chain issues may constrain economic growth, giving the Fed a reason to delay any action. The debate over the US government debt ceiling, and President Biden's infrastructure spending and tax plans, will continue into the final quarter of the year. Treasury secretary, Janet Yellen, has indicated that the US will run out of money after the 3rd December unless the debt ceiling is raised. Politicians have reached the brink of bankruptcy on many occasions, and we have seen partial shutdowns as a result. However, while the debt ceiling debate adds more uncertainty, it has in the past had little long-term impact on markets and the wider economy.

Communism and billionaires are not natural partners, and the Chinese Communist Party has acted over the last few months to crackdown on large Chinese technology companies and advance its own agenda. During the quarter, they took further action to restrict the activities of Chinese companies selling education outside the state system. Actions to contain the rising property market contributed to the gradual collapse of the Evergrande Real Estate developer. While Evergrande is highly indebted, we do not see it as a systematic risk, like Lehman Brothers was, and the Chinese authorities have acted to contain the damage. The opportunities in China, and Asia more broadly, remain huge. The risk of political interference will be ever-present, but valuations have adjusted to take this into account.

Looking ahead

The world is adapting to new working practices and needs to be weaned-off the enormous fiscal and monetary policy support. Central banks are preparing investors well in advance for this, and will be aiming to do so without damaging markets. The rapid economic gains from a post-pandemic, vaccine-fuelled, recovery may have already been achieved in many countries. As a result, progress from here for markets may be slower and volatility higher. As ever, in the final quarter of the year we will need to look through the short-term noise, and keep an eye on long-term gains.

Model portfolio performance as at 30 September 2021

Portfolio	3 months	6 months	1 year	3 year	5 year
Defensive	0.63%	4.26%	6.16%	13.60%	23.33%
Cautious	1.04%	5.64%	9.09%	17.18%	29.09%
Balanced	0.53%	5.98%	12.44%	22.28%	40.12%
Growth	0.82%	6.52%	14.75%	23.62%	46.82%
Adventurous	0.58%	6.58%	16.18%	27.96%	57.12%
Strategic Income	1.06%	5.21%	13.44%	16.94%	29.93%

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	30/09/2020 – 30/09/2021	30/09/2019 – 30/09/2020	30/09/2018 – 30/09/2019	30/09/2017 – 30/09/2018	30/09/2016 – 30/09/2017
Defensive	6.16%	1.97%	4.99%	3.51%	4.88%
Cautious	9.09%	2.04%	5.31%	4.05%	5.87%
Balanced	12.44%	3.79%	4.80%	5.00%	9.14%
Growth	14.75%	2.03%	5.61%	6.50%	11.52%
Adventurous	16.18%	4.75%	5.14%	8.38%	13.29%
Strategic Income	13.44%	-2.11%	5.46%	2.99%	7.89%

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Performance attribution for the quarter

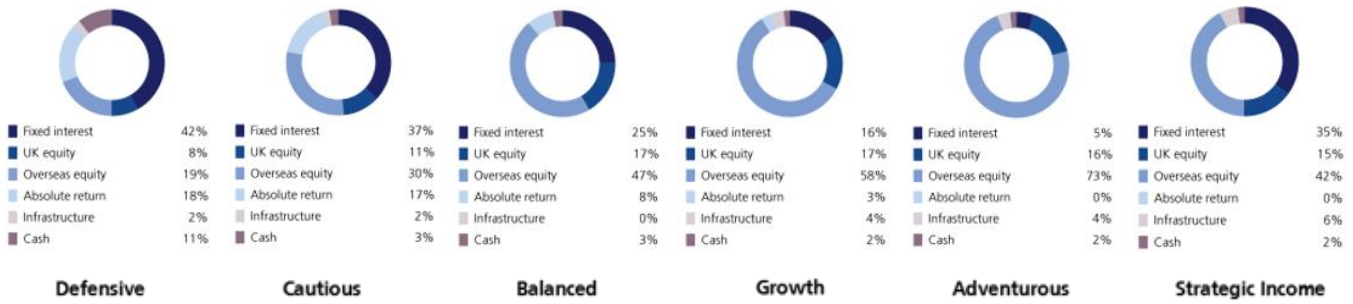
Equity markets reached new all time highs at the beginning of the quarter before selling off during September. Overall, developed markets finished the quarter flat with Asian and Emerging markets underperforming following China specific concerns. The tailwind for growth assets continued in Q3, which aided portfolio performance. Fixed income markets were marginally negative as yields rose but inflation linked bonds contributed positively as inflation expectations rose again.

Top performers

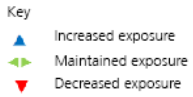
	Performance		Comment
Alliance Bernstein Sustainable US Equity	**Return**	+5.95%	The fund benefitted from growth assets outperforming again in Q3 and having less exposure to businesses more heavily influenced by the prospects of future economic growth. Stock selection was strong with particularly large contributions from the health theme within the portfolio.
	Benchmark *	+2.69%	
	Relative	*+3.26%*	
Stewart Asia Pacific Leaders	**Return**	+5.90%	The funds underweight to Chinese equities and continued focus on high quality, sustainable companies has boosted performance this quarter. The Indian equities in the portfolio performed strongly but the manager continues to see value in the region. Semiconductor exposure was reduced across the quarter due to concerns over valuation and the cyclicality of the industry. A top brand soybean paste company was added to the portfolio as part of the strategy to seek out high quality franchises.
	**Benchmark **	-6.16%	
	Relative	*+12.06 %*	
Liontrust Special Situations	**Return**	+4.82%	Positions in BP and Shell benefitted from spiking oil prices and were among the fund's largest contributors to performance in Q3. Other big contributors were recruiter PageGroup which upgraded second quarter guidance and real estate adviser, Savills which reported record performance during the first half of 2021. The fund made one purchase in Q3, taking part in the IPO of Big Technologies. The company is a provider of integrated hardware/software solutions for the electronic monitoring of criminal offenders which has strong intellectual property and high levels of revenue visibility.
	Benchmark *	+1.96%	
	Relative	*+2.86%*	

* S&P 500 GBP
**MSCI Asia Pacific ex Japan
***FTSE 100

Portfolio positioning



Portfolio positioning rationale by asset class



Fixed interest

We reduced duration within the portfolio this quarter by selling some of the US TIPS that were held via the CG Dollar fund. US 10 year treasury yields moved down from 1.75% in March to less than 1.3% in August, so were offering far less value. With the Fed signalling a more hawkish stance both through earlier rate rises and tapering, we felt the likelihood of increased yields had increased. With negative real rates we also expect to see an increase in the issuance of TIPS, giving us further reason to reduce the position size.

As such, we moved in to the lower duration Vanguard Global Short Term bond index. The fund tracks the Bloomberg Barclays Global Aggregate Ex US MBS 1-5 Year and has an overall duration of 2.8. The Index includes global government, government-related agencies, corporate and securitised bonds.

UK equity

Whilst we appreciate the need for low cost solutions in certain markets and have been happy to maintain this allocation over the last 12 months, we believe that the current investment environment favours stock pickers. It is very important to select the correct active managers that can deliver genuine alpha, and we believe our rigorous investment process enables us to do so.

Active strategies have tended to benefit investors more in uncertain investing climates, whilst passive strategies have tended to do better in rising, low volatility markets. When specific securities within the market are highly correlated or are moving in unison, it is difficult to outperform the index. However, in the current climate, there is a bifurcation of the market; rising dispersions between sectors/companies and stock correlations are at a new low. This has been exacerbated by the pandemic, with lots of winners and some big losers. This could worsen as central banks and governments conclude their stimuli, such as furlough schemes. This opens up opportunities for active investors. As such we've removed our remaining exposure to the FTSE 100 tracker and reallocated in to our existing active UK funds.

This switch will reduce exposure to the large 'old world' style companies that make up a large component of the FTSE 100 and reallocate to businesses that we believe are better suited to tackle the challenges of a post Covid-19 world. These businesses have wide competitive moats, an ability to pass on input costs and face better growth prospects than the broader index.

Overseas equity

No changes this quarter.

Absolute return

We have switched from the Artemis US Absolute Return fund in to the Henderson Absolute Return strategy. Whilst the Artemis fund has been able generate very low levels of correlation to risk assets, performance for the fund has been lacklustre and it has failed to achieve its investment objective of LIBOR + 300bps. Transaction costs have also sharply increased meaning the fund is no longer a viable hold.

We have switched in to the Henderson Absolute Return strategy which has a similar objective, albeit with a more flexible gross / net exposure. The fund is a long / short equity, developed market equity fund with around 60% of the exposure in the UK, net exposure is between -30% and +75%. Around a third of the positions are long term trades, focusing on fundamental stock picking methods, the remaining two thirds is more tactical and aims to capitalise on short term market inefficiencies.

Cash

No changes this quarter.

In conclusion

Spikes in bond yields have caused a short term unsettling of equity markets and added to volatility at the end of the quarter, but we expect this volatility to shortly pass. This is a scenario we saw in Q1 where investors quickly adjusted to the new yield level and markets rallied. Whilst we have been concerned with the continuation of inflation pressures, they still appear to be transitory and focused on a narrow section of the inflation bucket. We believe that these will normalise as supply chain issues are resolved and inflation will fall back closer to central bank targets.

We expect a Fed rate rise is still two years away and that the size of global government debt will force rates to remain low over the long term. Such a scenario will be supportive for the high quality growth businesses held within the portfolios.

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