



The quarter in review

2021 ended with a bang for our business. We [announced](#) a 10-year CO2 removal deal with Climeworks, the organisation behind Microsoft's CO2 removal plan. This is one of the largest-ever direct air capture agreements and truly demonstrates LGT's commitment to the climate. Climeworks' technology is the only solution available today that can reduce CO2 in the atmosphere in a scalable manner and then permanently store it underground.

At a glance

- US equities continued the march higher
- Central banks around the world kicked off interest rate cutting cycle
- COP26 spurs business, government and community climate activity

Inflation and the transitory debate

Inflation continues to dominate discussions within financial markets. The recent surge in cases of the Omicron 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 2021.

Strong quarter for equities

Despite continued fears over inflation and COVID-19, the stock market once again returned stellar performance during 2021. Q4 generated a large proportion of these strong returns as markets batted off concerns over both inflation and the Omicron variant, instead using any sign of market weakness as a buying opportunity. Nowhere was this more clear than in the US, a geography which once again generated the strongest returns both for 2021 as a whole, but also the final quarter of the year, in Sterling terms.

Q4 2021 index returns

Index	Q4 return
S&P 500 (US)	10.8%
Nasdaq 100 (US)	10.4%
FTSE 100 (UK)	4.7%
Shanghai Composite (China)	3.0%
DAX (Germany)	2.5%

Source: FE Analytics, all returns in GBP

One phenomenon that we saw accentuate over the course of the year was the concentration of the US market. According to analysis from Goldman Sachs, just five companies, Microsoft, Apple, Nvidia, Tesla and Alphabet (Google) contributed 51% of S&P500 returns since April, and account for more than a third of the US index's rise since the start of 2021. Given that the US represents circa 50% of the MSCI World, the global index, we will be watching this trend of increasing concentration carefully, and analysing potential implications.

‘Buy-everything’ rally

The rally in US stocks during Q4 was driven in part by what is being referred to as a ‘buy-everything’ rally, in response to the view that Omicron wasn’t a major risk event for markets. The companies that have continued to get stronger during the pandemic were the main beneficiaries of this rally. This also boosted commodities such as carbon, bitcoin and the Nasdaq (technology-dominated) index, none of which are held in the sustainable portfolios. Markets started to become impacted by the increasing focus on the metaverse, a tech sub-theme that is getting some investors excited. During the quarter, Facebook changed its name to Meta (not held in the sustainable portfolios), reflecting the company’s direction towards virtual reality. Other companies, such as Microsoft (a top holding in the sustainable portfolios), are ploughing billions of dollars of investment into the metaverse which looks to offer users the opportunity to exist, via an avatar, in a virtual world. Retail businesses such as H&M (not held in the sustainable portfolios) have already launched virtual stores, enabling shoppers to navigate through a shop, virtually, and purchase items with a digital token. During the course of the quarter, we saw a dedicated Meta ETF launched, providing investors the opportunity to hold 40 companies connected to this sub-theme (not held in sustainable portfolios). We expect more businesses across a range of industries to jump onto the metaverse bandwagon, and we watch with interest in how businesses are able to monetise this hot new trend.

Inflation remains elevated

Across the world, all eyes remained on central bankers as each looked to respond to inflation rates which continue to remain elevated. A number of countries started to increase interest rates during the final quarter of the year, including those in Europe, Eastern Europe and Latin America. A number of countries in Southeast Asia have left interest rates unchanged, and the US Federal Reserve is, for now, in that camp. The US central bank has signalled that it will be likely to raise interest rates three times during 2022. In contrast, the Bank of England was the first major central bank to raise interest rates during December, taking markets by surprise. The final quarter of the year saw the renomination of Powell as Chairman of the Federal Reserve, a move that was welcomed by many investors hoping for consistency in approach.

As the cost of borrowing rises, companies with debt on their balance sheet are more vulnerable. This is a metric we pay close attention to through our investment process. We look to hold investments in companies that have low or no levels of debt, instead funding growth and investment through strong cash flow generation. We monitor this at stock and fund holding level, and believe that investing in companies that are not just tapping into strong environmental or social growth trends but also generating sustainable revenue and maintaining margins is the best way of navigating the current macroeconomic conditions. These businesses are able to increase prices during inflationary periods, enabling them to protect margins. Over shorter periods, data supports the case that global equities protect better against inflation than other major asset classes over shorter periods.

Biden means business

Also providing a boost to US markets over the course of the quarter was the passing of the US Infrastructure Bill, as Biden achieved what Trump was unable to. The bill, which was signed into law in November, represents \$1.2trillion of investment. The scale of the infrastructure package ranges from investment in health and social care to much needed upgrades to water, broadband and an estimated \$15 billion in electric charging for cars and buses across the country. The bill is designed not to tackle a specific crisis but instead, represents a longer-term patient approach to rebuilding soft and hard infrastructure across the US.

We also saw some significant progress on a second US spending bill, the Build Back Better Act as it passed the House in November. This is one of the most important bills in decades in the US, and through spending of £1.7 trillion looks to enable the US to catch up on much overdue investment. The Build Back Better Act looks to prepare the US for the future, including initial steps to deliver on climate ambitions. As this bill passed the House, we saw the prices of major US renewable energy companies soar; Enphase was up 68% and SolarEdge 34% from the start of October to when the bill passed the House, both of which are held in the sustainable portfolios (Source: Bloomberg). As we move into 2022, all eyes will be on Congress to see if the bill can get enough votes to be signed into law.

COP26

Finally one of the major events of the year, COP26, occurred during the final quarter of 2021. We have covered the conference widely through a client webinar, [video](#) and [articles](#) with our take. Regardless of how you view the success or not of COP26, it certainly put climate science well and truly on the map for everyday people. In the lead up to COP26 and during the conference itself, governments from across the world released climate policies in response to growing pressure. It is interesting to consider the state in which the US Infrastructure Bill would have passed, if COP26 hadn’t been held this year.

COP26 was the first at which the presence of business and finance dominated proceedings. The lobbying by the fossil fuel industry drew considerable criticism, but elsewhere there was an important recognition of the bi-lateral coordination between businesses and governments in getting to net-zero. This is seen clearly in the ‘Glasgow Breakthroughs’ that we saw published during the conference, demonstrating a number of clear commitments by governments to progress the use of clean technology across the most polluting sectors. We have been investing in these net-zero ‘enabler’ sectors for some time and believe they continue to be very well-placed given the announcements made at COP26.

Focusing on the future

Climate transition

Despite 2021 being a watershed year of developments around climate change, a great deal needs to be done if we are to even nearly achieve the goals set within the Paris Agreement. In light of this, we believe climate change and the green transition will continue to receive ever-increasing traction and will become further entrenched into corporate and government strategies. As a result, the opportunities to invest in companies that are helping to facilitate a more climate-friendly economy continue to expand and potentially have the capacity to offer interesting returns for investors. We believe the awareness around climate adaption will grow during 2022. It may become increasingly clear that we aren’t able to limit global temperature rises, so for many parts of the world, adaption to the new climate will be necessary. This will create challenges for many, but also we would expect, throw up opportunities.

Volatility to remain

After an extremely strong 2021 for most asset classes, the case for significantly increased volatility is easy to make. Whether this is due to a new COVID-19 variant, central banks' intervention, inflation risks, Russian and Chinese geopolitical instability or the disorderly transition to a cleaner and more sustainable global economy, all of these events are likely to lead to greater market inefficiencies. The 'active' approach we take to portfolio management should enable us to take advantage of these.

Watch out for bond yields

We will continue to monitor central banks' actions, as these have a direct impact on the bond market. Over the past year, with inflation rising across the developed world, the Federal Reserve and the Bank of England have had to pare back their accommodative stance at a faster pace than previously envisaged. Further action cannot be ruled out. This will result in heightened bond volatility, providing us with opportunities through our active approach.

Performance review

Risk assets, namely equities, were the best performers during Q4 despite the ongoing background uncertainties at play. Mirroring the fortunes of the best performing geography, the holdings in US companies were the best performing over the course of the quarter. The quality-growth biased investments also generated strong returns as investors looked to add to holdings in companies that did well during the pandemic during the final quarter of 2021. Exposure to climate themes such as renewable energy, energy storage and energy efficiency generated strong returns following momentum around COP26 and the US Infrastructure Bill. Fixed income assets, aside from US inflation-linked Treasuries, were flat to negative over the quarter. We utilise active, tactical investment grade bond funds to gain exposure to the bond market. Given the expected tightening monetary policy environment we will continue to treat investing in bonds with caution, continuing to take a highly active and selective approach.

Sustainable Model Portfolio performance as at 31st December 2021

Portfolio	3 month	6 month	1 year	Since inception (1/10/18)
Defensive	1.99%	3.45%	5.32%	21.03%
Cautious	2.70%	4.72%	8.22%	29.18%
Balanced	3.69%	6.16%	11.90%	39.92%
Growth	4.13%	7.05%	14.06%	52.01%
Adventurous	4.48%	7.57%	15.58%	57.85%

Source: Morningstar.

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

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 31 December 2021

Fund	Return	Comment
Alliance Bernstein Sustainable US Equity	8.46%	Technology stocks led the strong performance of the fund with semiconductor and electrical hardware being two areas of notable performance. Overall, performance has been broad based across sectors and not isolated to a specific sector. As it is widely acknowledged, many of the technology names held are producing products and services necessary for the green transition and despite short term market rotations, long term prospects for the type of companies we look for remain strong.
Morgan Stanley Global Sustain	8.47%	The fund generated a strong return with US stocks leading the way and UK companies also being a source of good returns over the quarter. Consistent with many of our other funds, technology stocks helped deliver strong returns but more defensive sectors such as fast-moving consumer goods (FMCG) names helped boost returns. The returns generated by the fund highlight the benefit of being diversified across a number of different sectors and sustainable themes.
Janus Henderson Global Sustainable Equity	5.78%	The fund followed suit with tech and the US leading but also strong return generation from financials such as insurer Progressive Corp and Walker & Dunlop. Industrial firms held in the fund also benefitted over the quarter with water technologies and building efficiency two underlying themes supporting performance.

Source: Morningstar

Changes made in portfolios

Q4 2021 saw a number of changes to the sustainable portfolios, both on macroeconomic and sustainability grounds. As we came into the final quarter of 2021, the sustainable portfolios were well positioned in terms of the regional and sustainable theme exposures, however, we did make the decision to further reduce our exposure to the UK market. As we have advocated for some time, we believe that the opportunity within sustainable investing is global and that regions should not be over-represented unless we believe the opportunity to allocate towards sustainable business is disproportionate to their share of the global market. With this reduction, we increased exposure to developed market equities ex-UK, such as Europe and North America.

The second, and more meaningful change to portfolios, was the exit from one of the dedicated US equity funds and the addition of two new global equity funds. The exit from this fund has been a considered discussion and is something we have been monitoring and engaging on through 2021. As part of our ongoing due diligence and holding monitoring, a number of companies were added to the fund which we did not feel were aligned with the fund's philosophy and as such, engaged with the team to discuss the holdings and our concerns. Our decision was ultimately to exit from the fund on sustainability grounds after a number of engagements. This action highlights the importance and value added from our rigorous and in-depth monitoring process we have implemented to ensure that all assets held in the sustainable portfolios are aligned to our philosophy.

The sustainable investing market has expanded significantly since we launched our sustainable proposition and has therefore enabled us to effectively navigate this situation and puts us in a strong position should a similar situation arise in the future. The Sustainable Investment team continuously strive to ensure that sustainable portfolios are true to a philosophy of sustainable investing, and to demonstrate to our clients that we act as effective stewards of wealth.

Companies in focus

MIPS (+41.28% over the quarter) *Held in Lazard Global Sustainable Equity*

- A medical sports technology company
- Produces a low friction layer (0.5-0.7mm thick) that is added into helmets to reduce rotational motion transferred to the brain during impact
- This simple technology has been shown to reduce the risk of concussion by 40% and the layer only costs less than £5
- As people become more environmentally conscious and opt to cycle more, effective safety equipment can significantly reduce negative health impacts

Fortinet (+15.32% over the quarter) *Held in Stewart Worldwide Sustainability*

- Provides cybersecurity solutions to enterprises and governments
- Fortinet's Security Fabric architecture provides security solutions for PCs, cloud and mobile
- The technology systems utilise artificial intelligence (AI) and machine learning to process and analyse more than 100 billion events each day to identify cyber threats

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