Q1 2022 Sustainable Quarterly Review

For Professional Advisers only

The quarter in review

There is an often repeated saying: 'markets do not go up in a straight line'. No time was this truer than the first three months of 2022. Following one of the most positive years for climate action, global collaboration and economic momentum, we have seen one of the most violent and volatile periods in decades.

Putin's invasion of Ukraine has sent shockwaves around the world. Thousands of innocent lives have been lost in the conflict so far and millions more have been displaced as they seek refuge from Russian aggression. The dynamics of the invasion are complex, particularly the multiple catalysts leading to it. The consequences are already being felt across the world: from the millions of Ukrainians forced to leave their homes and homeland, to the rocketing energy, metals and commodities prices, to the impact on investment markets.

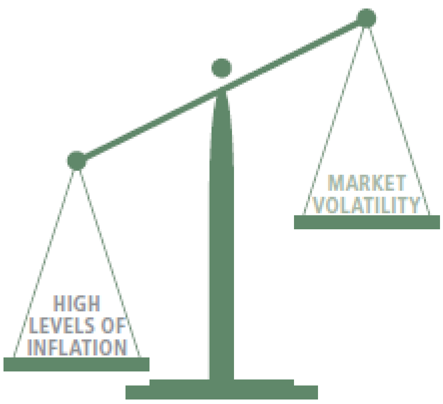
At a glance

- The invasion of Ukraine by Russia impacted bond and equity markets.
- Changing interest rate expectations in response to heightened inflation caused market turbulence.
- Catalysts for investment in sustainable sectors, such as the energy transition, become more urgent.

At a glance

The economic reaction

The immediate response to the invasion by countries, businesses and by Ukraine itself was unprecedented. The introduction of sanctions placed on Russian companies, bank deposits and individuals – designed to tighten the chokehold around Russian economic activity – effectively cut off supply of most Russian exports, including oil, copper, aluminium and iron. This has placed further upward pressure on prices of energy and other commodities such as wheat, uranium and metals. These inflationary impacts have been compounded by China's zero-COVID policy, with continuous lockdowns in the country further disrupting global supply chains.



Before the war in Ukraine started in late February, inflation rates across the world were already stubbornly high. This caused a significant shift in sentiment from central banks looking to keep inflation under control. High inflation and the resulting threat of higher interest rates is deemed negative for more growth oriented, long duration assets. This is because any increase in rates, even small ones, can have a large effect on valuation; these are growing businesses with a large proportion of earnings expected in the medium to long term. Tech and growth stocks, which tend to be highly rated, are therefore disproportionately hurt by higher yields, which have also been ticking up in response to the central banks' more hawkish stance. In effect, these growth-oriented companies (of which a number form part of our sustainable universe), underwent a 'de-rating'. Investors are willing to pay up for tech and high growth companies for the promise of future growth, but when central banks start to tighten policy (raise rates and take away cheap money), those types of stocks look more expensive. The resultant swing from 'growth' investing to 'value' investing happened extremely quickly and was difficult to navigate, as we prefer to allocate client money to quality businesses that are investing in sustainable sectors, which are often growth businesses.

Central banks find themselves in the very difficult position of having to navigate, on one hand, the challenge of tackling currently high levels (and likely higher levels in the future) of inflation and, on the other hand, the highly volatile market conditions.

The dynamics of war

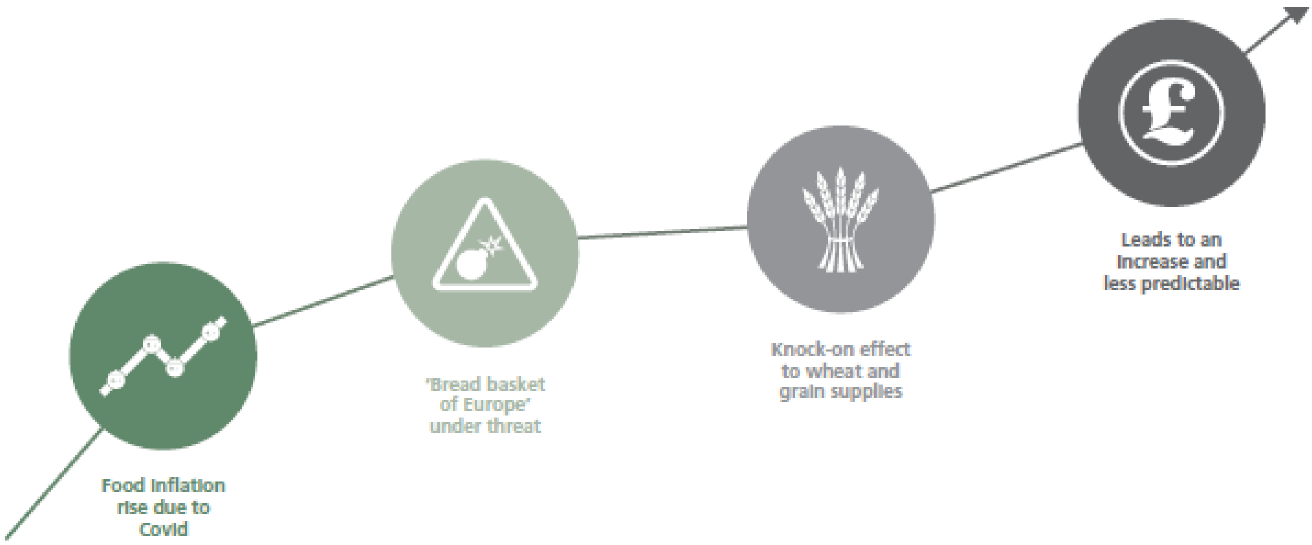
It is interesting to note that the current geopolitical instability is acting as a catalyst for faster and greater investment in renewable energy generation and the energy transition more widely. This is particularly relevant for Europe, for which energy independence is now a short-term priority. There are already reports indicating that Germany is considering halting the planned phase-out of nuclear power, which is a significant change in the direction of domestic politics[1]. This underscores the importance that countries are already placing on energy independence as a result of the current crisis, of which domestically produced renewable energy is a part.

Unsurprisingly, China is ahead of this trend and has been focused on energy independence for some years now, being the highest investors, consumers and producers of renewable energy globally. The US, which is already one of the most energy independent countries, is also involved in this dynamic. We have recently seen Senator Manchin (who to date has been a barrier to passing the ground-breaking Build Back Better Bill through the Senate) change his tune; Manchin is now championing the advance of clean energy through the bill, whilst also pushing for the development of a natural gas pipeline to supply Europe, which he believes can be built in two to six months. Although Manchin's motive is clear, his cooperation would lay the groundwork for the passing of a historical act on clean energy credits and climate spending: the largest clean energy investment in US history.

As a result of this changing dynamic, we have seen the prices of renewable energy stocks rallying strongly since the start of the war, including SolarEdge, NextEra, Vestas, Ørsted and Innergex Renewable Energy. We have explicit exposure to these companies in the sustainable portfolios through funds such as NinetyOne,Impax and AllianceBernstein US Thematic. It is discouraging that it has taken a war to really focus attention on the need for investment in the green transition and that the threat of climate change alone was not enough. This is underpinned by the most recent IPCC report, which demonstrates for the first time that adaptation to climate change is no longer a future problem, but something that many parts of the world are having to battle today[2]

Food security

At the beginning of 2022, food inflation was already on the rise due to COVID-19-related supply chain disruption. Now, with Ukraine's status as the 'breadbasket of Europe' under threat, grain and wheat supplies for the year ahead have become more expensive and less predictable. This further highlights the reliance many countries around the world, including nations like China, have on the grain production of others.



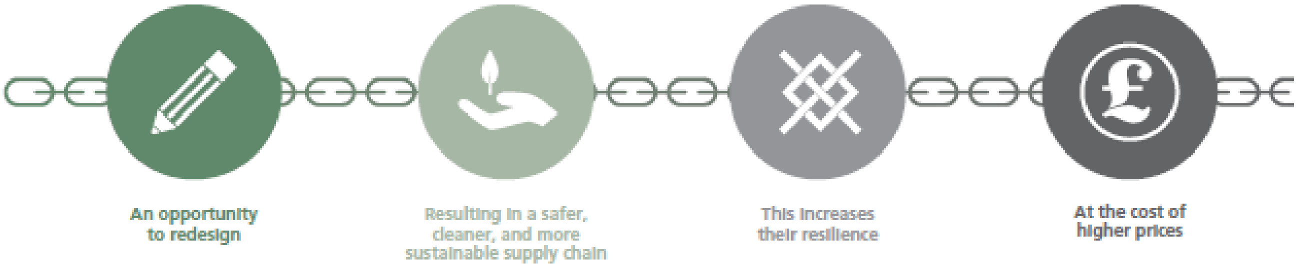
Whilst this is not a dynamic that has a clear transition plan, the concerns over the future of food security demonstrate why a redesign of our agricultural and nutrition systems needs to be seriously considered. According to the United Nations Food and Agriculture Organisation (2013), if food waste was a country it would rank as the world's third largest emitter of carbon dioxide. On the one hand, we have enormous disruption to deal with, and on the other extraordinarily poor management of the food system.

Whilst it is certainly not an overnight fix, investment in vertical farming provides a partial solution to these issues. Here in the UK, sites provide a wide range of vegetables, fruits and herbs to supermarkets grown without pesticides or chemical intervention, in temperature-controlled spaces, powered by renewable energy, in water that is recycled over and over. The food that is grown in this manner is infinitely tastier and has travelled relatively small distances in food miles. Increasingly, supermarkets are securing supply chains through investment in vertical farms and it seems likely that the war in Ukraine will be a further catalyst for this investment.

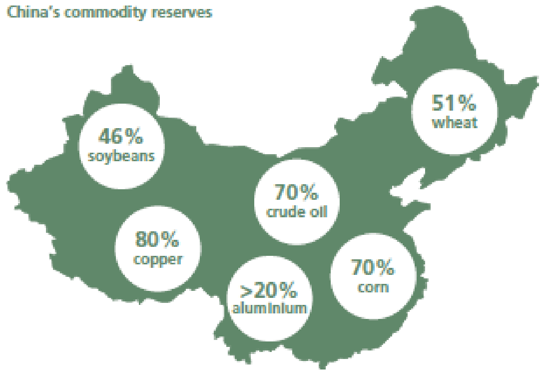
[1] Source: Deutsche Bank
[2] IPCC report: www.ipcc.ch/report/ar6/wg2/

Onshoring production

Shortening supply chains and bringing production closer to home may be seen across more industries than just in food in response to Russia’s attack on Ukraine. Incidentally, this is likely to help tackle climate change as, for the past few decades, countries in the developed world have been outsourcing their carbon emissions to countries such as China. Decoupling from China would force countries to actively tackle carbon emissions if manufacturing is brought back onshore. Shortening supply chains also provides an opportunity to re-design them, so they are safer, cleaner and more sustainable. Shortening supply chains will also increase resilience, but at the potential cost of higher prices. Therefore, onshoring production will, in the short term, potentially act as an inflationary pressure, however in the long term it may reduce the chance of supply chain shocks, which are also inflationary.



While the world is short on commodities, China is not. They have been stockpiling commodities since 2019 and currently hold 80% of global copper inventories, 70% of corn, 51% of wheat, 46% of soybeans, 70% of crude oil, and over 20% of global aluminium inventories[3].

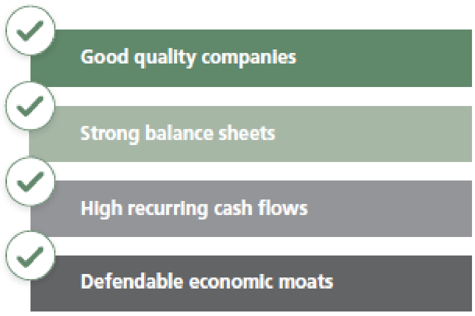


Accountability

Over the past few years, ‘shareholder capitalism’ has been challenged by concepts of ‘stakeholder capitalism’ and even ‘inclusive capitalism’. Businesses now recognise that they have a responsibility to not only their shareholders, but also to other stakeholders – such as people working for or interacting with the business, and the environment.

Widening the scope of a business’ responsibilities has driven higher levels of accountability on both corporate activities and responses to global challenges. We saw this during COVID-19, in how businesses reacted to support consumers, producers and employees, and we are seeing it again in response to the war in Ukraine. Many companies have pulled out of Russia, many more have publicly supported Ukraine and others have donated days of revenue to humanitarian efforts. These actions by companies, once primarily considered engines of economic purpose, are increasingly demonstrating their positions as positive contributors to society and the planet more widely.

A focus on quality



Given the spectrum of risks that exists today, we believe that investing in good quality companies with strong balance sheets, high recurring cashflows and those with defendable economic moats provides us with the best ability to weather the extraordinary market volatility that we continue to witness. The sustainable portfolios we run for clients are naturally overweight of these quality businesses, that are also positioned to tap into end markets with much higher expected growth rates. Due to the re-rating that has occurred since the start of the year, the portfolios and underlying funds are at very attractive valuations, which makes for an interesting entry point for clients with cash to invest. This being said, we continue to carry out extensive work on ways to ensure that the portfolios are able to navigate potential market environments ahead, which involves researching alternative strategies and potential diversifiers. In doing so, it is crucial that we do not dilute the strong sustainable credentials of the portfolios, nor lower the bar to do so.

A catalyst for change

Now more than ever, we believe that an investment process that incorporates analysis of these fast-changing dynamics will better equip a portfolio manager and in turn a portfolio to navigate the shifts we are seeing across the world, as well as the volatility in markets. Following the actions of Putin, we are now in a world that is suddenly laser-focused on energy independence, food security and even the cost dynamic between recycled/bioplastic versus virgin plastic. This further strengthens the case to invest in companies, themes and sustainably run portfolios that are cognisant of these factors and positioned to benefit from an increased focus on them.

[3] Source: JP Morgan

Performance review

During the first three months of 2022, the majority of investment markets experienced drawdowns. This impacted both equity and bond holdings within sustainable portfolios. The dynamics impacting portfolios evolved throughout the quarter as the market moved from pricing in one risk (a sharply rising interest rate environment) to another (the war in Ukraine). Whilst the sell-off over the quarter was broad-based, it impacted sustainable portfolios more than conventional portfolios, due to lack of exposure to the small number of companies and sectors that posted positive returns, including oil and gas companies, tobacco stocks, defence and traditional banking.

The part of the market that was most impacted was the speculative tech space, which is not an area we target investment in. However, some of the tech exposure in the sustainable portfolios, which have demonstrative balance sheet strength (and is far from speculative), were also damaged by this move. During the quarter, the underlying fund managers holding these high-quality technology names have used the weakness in share prices to add to their highest conviction ideas.

In terms of geographies that were most impacted by the equity market sell-off, the UK and Europe were hardest hit. Given the impact of the war in Ukraine on Europe, this is unsurprising. In the case of the UK, we have been warning for some time on our low overall conviction in this geography due to trade-related risks and the waning dominance the UK has in the context of the global economy. Whilst there were pockets of performance strength in the FTSE100 from sectors such as tobacco, oil and gas, defence and traditional banks, given that sustainable portfolios do not invest in those sectors, they were not able to benefit from these moves.

Over the first quarter of the year, due to a significant shift in interest rate expectations, bond markets suffered drawdowns. The vulnerability of bonds in a potential interest rate rising environment is something we have been warning about for a number of months now and, over the course of 2021, we responded by reducing the interest rate sensitivity of portfolios and adding in less interest rate sensitive bond assets. This helped over the course of the quarter as the lower-duration bond holdings were much less impacted by the fixed income sell-off. During periods of market stress, safe-haven assets such as the US dollar (USD) and gold tend to provide positive returns and diversification benefits. As fears started to rise over geopolitical tensions, we saw a corresponding rise in the value of gold, which at its peak during the quarter was up 14%, and a rise in the value of the USD. There is exposure to responsibly mined gold in the multi-asset funds held in sustainable portfolios such as Trojan Ethical. This strategy has been resilient year to date and provided ballast to the wider portfolios.

Given the continued macroeconomic risks present in the short term, such as further escalating geopolitical tensions, central bank policy risk and the risk of bullwhipping as inventories become overstocked, we proceed with caution. As inflation data pushes higher, investors remain concerned over the risks around further supply chain bottlenecks and input cost increases. However, we seek comfort in the continued earnings strength of the underlying stock positions and the ability of these businesses to deliver superior returns over the medium term. Whilst markets are expecting up to eight interest rate rises from the Fed this year, there are also reasons as to why the Fed might underdeliver on these expectations. We continue to watch inflation data, the constituent parts of the inflation figure, and how policymakers look to respond.

Although the energy transition comes with short-term cost implications, it is likely that this will become relatively margin accretive as policymakers tighten regulations around pollution and the use of fossil fuels. This leads to a much bigger cost implication for businesses that are not focused on increasing the sustainable profile of their operations, as they will have to bear the cost of carbon taxes in addition to transitioning their business, just at a later date. The same can be said for other parts of the sustainable arena: there is a new UK plastics tax coming into force in April, for example, with the goal to reduce the use of non-recycled virgin plastic. Imported plastic will also be liable to the tax. For businesses that have not yet begun to think about such changes to their processes, additional costs will be coming down the line soon.

Sustainable Model Portfolio performance as at 31st March 2022

Portfolio	3 months	6 months	1 year	Since inception (1/10/18)
Defensive	-4.80%	-2.91%	1.45%	15.21%
Cautious	-6.17%	-3.63%	2.08%	21.21%
Balanced	-7.59%	-4.19%	3.11%	29.29%
Growth	-8.56%	-4.79%	3.67%	39.00%
Adventurous	-9.67%	-5.63%	3.31%	42.57%

Source: Morningstar.

Performance is gross of 0.25% 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 31st March 2022

Fund	Return	Comment
Trojan Ethical	+0.08%	This fund is held with the intention of providing ballast and diversification to the portfolios. The fund invests across fixed income, equities and some commodities such as ethically mined gold to provide a return profile with a low correlation to equity markets. It is, therefore, unsurprising that it has protected notably on the downside over the quarter where equity markets have been volatile and fixed income markets have also moved lower. We continue to see the Trojan Ethical fund as a core stabilising asset within sustainable portfolios.
Vontobel Sustainable Short Term Bond	-1.61%	This fund has been one of the better performing funds over the quarter, in part due to the weaker equity performance but also due to the style of the fund. This fund targets bonds with a short duration meaning they will mature in the near future. This makes the bonds less volatile to future economic and interest rate expectations, given the greater visibility on returns. As a result, these bonds provide great stability within portfolios and provides ballast and low risk returns during periods of volatility.
L&G Global Inflation Linked Bond Index	-1.86%	Inflation has been the hot topic of the past year or so and indeed the past quarter, and with inflation across the world continuing to push higher, so has the premium investors are willing to pay for inflation linked returns. This premium has led to the fund holding up relatively better than other parts of the portfolio which don't have the same binary inflation link. The inflation picture remains complex however, the fund has provided good stability and diversity within a low risk multi-asset portfolio over the past few years. We will however continue to watch the premium people are willing to pay for these assets as valuations will play an important role in the performance of these assets.

Source: Morningstar

Changes made in portfolios

Heading into the first quarter of the new year, the portfolios were well positioned to continue navigating the macroeconomics risks of 2021. In the first month of 2022, we felt the level of inflation priced into US TIPS (Treasury Inflation Protected Securities), being notably above the Fed's 2% target, provided the potential of more downside risk relative to their conventional equivalents and therefore, made the decision to tilt some of the current government bond exposure towards Treasuries and away from US TIPS. We also trimmed equity allocation in the defensive portfolio as it had benefited from the strong equity rally in 2021, and the weighting towards equity edged higher at portfolio level. We trimmed equity by top-slicing some of the higher weighted equity funds and opportunistically now hold it in cash, whilst we assess new opportunities.

In March we made the second, and more meaningful change to portfolios, a further reduction in equity allocation, as a short-term tactical move. This allocation was predominately taken from our direct UK exposure in the portfolios, as our outlook on sustainable opportunities in the UK continued to fall. We also trimmed funds that were most correlated to inflation and the associated potential slowdown in economic growth. This tactical move removed some equity risk whilst we continued our research on diversifying strategies for the portfolios, which we will look to utilise in portfolios in the coming months.
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 clients that we act as effective stewards of wealth.

Companies in focus

Terna Energy (+25.9% year-to-date)

Held in NinetyOne Global Environment Theme: Climate and environmental action

- Terna is an energy company which generates renewable energy, such as wind and solar power, and also has hydroelectric, biogas and waste management operations.
- Most of the company's installed capacity is in Greece, but they also have operations in North America, Poland and Bulgaria.
- One theme that has been particularly prevalent this year is energy security. Renewable energy is where countries will look to when creating long-term energy independence. Companies like Terna are likely to be long-term beneficiaries of this trend.

Clean Harbours (+12.86% year-to-date)

Held in Stewart Investors Worldwide Sustainability Theme: Climate and environmental action

- Clean Harbours is America's leading provider of environmental and industrial services with end-to-end services covering hazardous waste management, emergency spill response, industrial cleaning and recycling services.
- The safe treatment, recycling and disposal of hazardous materials is extremely important for ensuring biodiversity is not damaged and hazardous materials do not contaminate and impact humans and the environment.
- The company also works to make their operations more sustainable through initiatives such as producing their own power from solar energy.
- Clean Harbours also estimates that the emissions that their products and services help prevent each year is roughly twice as large as their annual environmental footprint, demonstrating their net environmental benefit.

Five-minute quarterly roundup

Scan the QR code to watch a five-minute video from our Head of Sustainable Investing, Phoebe Stone, who provides a concise overview of the first quarter of 2022.