For professional clients only, not suitable for retail clients.

Sustainable Equity strategies

Quarterly Overview

31 December 2023

ROYAL LONDON ASSET MANAGEMENT

Overview

Market overview

Economic attention over the quarter has been on inflation. At the start of the quarter investors focussed on the persistence of large price increases and central bank messaging on rates being held higher for longer. Yet, as headline inflation fell, sentiment swung dramatically towards the end of the quarter, pushing markets to price in interest rate cuts in 2024. The Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE) all left rates unchanged over the quarter, maintaining official rates at multi-year highs. The Fed has now held rates unchanged at its last three meetings. There has however been a significant shift in messaging, with the US central bank now indicating that it expects to cut rates by 0.75% in 2024. The ECB has similarly kept rates steady at its two most recent meetings, but central bankers in the eurozone said that no rate cuts have yet been discussed.

In tune with the other major central banks, and potentially marking the high point in the UK interest rate cycle, the Bank of England left interest rates unchanged over the period. The Monetary Policy Committee continued to be split – at the December meeting three of the nine members were still voting for a rate hike. UK inflation has fallen significantly, with the annual inflation rate falling to 3.9% in November. This is the lowest rate of increase in over two years. However, this remains well above the BoE 2% target, with core and wage inflation significantly higher than the headline rate.

Going into December, equities had sharply rebounded from their October lows as investor sentiment recovered thanks to the goldilocks scenario of falling inflation combined with generally resilient growth, with the fall in inflation and a change in narrative from the US Federal Reserve leading to hopes of rate cuts in 2024.

Global Sustainable Equity

The fund outperformed the MSCI All-Countries World Index (ACWI) benchmark during the fourth quarter. Generally supportive macroeconomic data, and more recently in December, the first signs of a pivot by the US Federal Reserve in terms of the interest rate narrative have meant that the fourth quarter has been one of the strongest for global equity markets for a long time. The best performing sectors in the quarter were information technology, real estate and industrials. The tech sector continues to benefit from the excitement around artificial intelligence (AI) and real estate is a sector that stands to benefit from falling interest rates. Industrials experienced a tailwind from a resilient macro backdrop combined with government stimulus towards infrastructure spending. The only sector that was negative in the quarter was energy, where we have zero exposure given our sustainable approach.

Our top contributor to performance was TopBuild which provides insulation to the US residential housing sector. This company has benefited from strong execution by the management team, accretive acquisitions and from US housing being seen as a key beneficiary of a resilient economic backdrop and falling interest rates in 2024. Dutch distributor of specialty chemicals IMCD had been facing headwinds due to its customers holding excess inventory and we saw evidence in the quarter that those inventory levels were now starting to normalise, benefitting the company's share price.

A key detractor during the quarter was Rentokil, the global leader in pest control and hygiene, where its share price declined after it reported a surprising slowdown in growth in its US business.

There have been several macroeconomic headwinds through 2023 but these have turned out to be better than expected. This has driven a lot of the market performance and the portfolio has been on the right side of that. Furthermore, we've had some strong share price moves that have driven outperformance. Going into 2024, we have a portfolio exposed to some exciting and powerful multi-year structural growth themes – the key ones being the ongoing digitalisation of society through things such as cloud computing and AI, which we think we're incredibly early in. We also have exposure to companies enabling the development of a more sustainable and resilient physical world. These include areas such as HVAC, building electrification and more sustainable transport such as rail. We also continue to be excited by the opportunities in the healthcare sector where we observe advancements in computing are accelerating new drug discovery combined with new large disease categories such as obesity emerging.

Our sustainable strategies are orientated to those companies that have a net benefit to society and create value for investors through their products and services and the way they manage environmental, social and governance (ESG) issues. 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 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 positive contribution 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.

Overview

We exited our position in Agilent, which is a US life science tool provider and started a position in Hologic, a diagnostics company that focuses on Women's Health. Hologic was a big beneficiary of the Covid-19 pandemic as it saw growth accelerate as it placed a greater number of its diagnostics machines and has since seen its core growth accelerate too. We believe its valuation underappreciates higher growth going forwards. We also started a position in Core and Main, a leading distributor of water infrastructure products in the United States.

Combined with ongoing macroeconomic uncertainty one thing likely to continue through 2024 is heightened geopolitical tensions around the world. That said, though, these tensions might be a tailwind to some of our construction and infrastructure related investments, as it will likely serve to only accelerate these trends towards onshoring and near shoring. 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 portfolio to be more diversified and lower risk than 18 months ago and would it to be relatively more resilient if we do enter a period of slowing economic growth or recession.

Sustainable Leaders

Net of fees the fund outperformed its wider index-based benchmark (FTSE All-Share) over the fourth quarter and during 2023, delivering positive performance. Once it became clear that inflation was on a downward path and the Federal Reserve made a pivot about cutting interest rates, this was positive for equity markets. The consequences were also good for several areas that we invest in, so the fourth quarter transformed the narrative for the overall year.

In the fourth quarter the UK equity market was up approximately 3.2% (FTSE All-Share index). The market increase was led by the industrials and financial sectors, with energy and consumer staples lagging. The main reason for the rise was a belief that inflation is now heading towards levels with are consistent with interest rates being reduced. This would be positive for economic growth as well as the value of assets such as equities. Cyclical sectors, such as industrials and financials, are key beneficiaries of better economic growth. The mid-cap index ex-investment trusts outperformed the overall market, up approximately 9.3% reflecting its cyclical nature.

Contributors to performance in the fourth quarter: It was no surprise that the technology sector did well as this tends to be thought of as a long duration equity sector. Sage saw strong results in the quarter and was up 20% in the month of December alone – our biggest overweight position in the fund. Microsoft, which is a smaller holding, was up over 13% in the quarter also after producing good results. Real estate outperformed in the period under review as another beneficiary of lower interest rates. Real estate is an area that uses a lot of debt to finance itself and our two real estate holdings Segro and Unite, gained25% and 18% respectively.

Detractors from performance in the fourth quarter: Financials, which are seen to be a beneficiary of higher interest rates underperformed. Standard Chartered was down 13% in the fourth quarter. This was partly to do with interest rates, but also Standard Chartered is an Asian bank and ongoing concerns about the Chinese economy were also relevant. In the consumer discretionary area, Dr Marten's, which we continue to build a holding in was weak, as trading was weaker than expected.

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We continued to build a holding in Dr Marten's, the well-known shoemaker, which we believe has an interesting sustainability story due to the longevity of their products. As a sustainable fund, we are against fast fashion and for products that last a long time. Dr Marten's boots, looked after well, can last over 10 years. Ashtead is another name that we added to in the fourth quarter. The company is in the construction equipment rental business, so plays well into US infrastructure investment, which is increasing markedly in the coming years.

We exited a position in Intertek which is a consultancy business for supply chains. The company has conducted a number of acquisitions that they have paid a high price for which haven't performed as hoped.

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

Royal London Asset Management's Outlook 2024 document and podcasts are both available on our website. In this year's Outlook document, our fund managers assess the challenges and opportunities in their respective asset classes for 2024. With an environment of falling inflation and modest recession, the benefits or risk for equities or credit is not so clear cut and knowing your companies is key. We analyse the areas of concern and potential growth within this environment.

In our Outlook 2024 podcast, Piers Hillier, CIO, looks ahead to 2024 and discusses the issues he believes will be prominent over the next 12 months, and where the key investment risks and opportunities may lie.

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.

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