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Sustainable Equity strategies

Quarterly Overview

31 March 2024

ROYAL LONDON
ASSET MANAGEMENT

Overview

Market overview

A key theme to emerge during the quarter was indication of a more favourable global macro backdrop. Despite some mixed signals, the US economy remains resilient, while Europe and the UK show signs of gradually exiting their recessions. Activity in China also seems to be stabilising. At the same time, core central banks are still confident that the disinflation trend remains intact, despite some recent setbacks in inflation prints. Policymakers have often highlighted that they are in no rush to cut rates – with markets now generally pricing the start of the easing cycles to begin this summer. The Federal Reserve, European Central Bank and Bank of England all left interest rates unchanged over the quarter.

One major development over the quarter is that markets have recalibrated their pricing for expected central bank cuts over this year. At the end of last year, markets were pricing in an aggressive rate cutting cycle, but then swiftly move to temper those forecasts. This re-pricing contributed to negative returns for global government bond markets over the quarter. Despite the belief of many that it was the anticipation of a 'Fed-pivot' that contributed to the rally in equity markets in late 2023, equity markets proved to be immune to this bond market sell-off as global growth and business confidence showed signs of resilience and investors focused on the potential offered by AI.

Market strength seen in the fourth quarter of 2023 continued though the first three months of 2024 as a result of generally supportive macroeconomic data and indications that the majority of developed market central banks are planning to cut interest rates in 2024. Q4 2023 corporate results were also notably better than Q3 2023 which supported markets. The best performing sectors in the quarter were information technology, communication services and energy while real estate, utilities and materials underperformed.

Some of the same trends that were driving markets during the fourth quarter continued into the first quarter of 2024. The tech sector continues to benefit from the excitement around AI and industrials continued to experience a tailwind from a resilient macro backdrop combined with government stimulus towards infrastructure spending. The energy sector benefitted from higher oil prices though the quarter.

Looking at UK equities, the equity market saw a strong performance, rising 3.6% (FTSE All-Share index). Expectations remain that as inflation continues to moderate, interest rate cuts are around the corner. The corporate reporting season was generally supportive, particularly in the financials sector where banks reported robust results, with industrials also seeing a strong quarter. Investor enthusiasm was further fuelled by several M&A deals being announced.

The price of WTI crude oil gained 17.5% over the quarter to $83.71 a barrel, reversing the losses of the prior quarter amid attacks on Russian refineries and OPEC signalling production cuts. Copper futures meanwhile gained 2.45% in US dollar terms.

The US dollar appreciated by 6.85% against the yen, by 2.23% against the euro, and by almost 1% against sterling.

Performance and activity - Global Sustainable Equity

The fund performed in line with the MSCI All-Countries World Index (ACWI) benchmark during the first quarter.

In particular, companies enabling and exposed to advancements in artificial intelligence (AI) performed well and were amid the top contributors to performance over the quarter. TSMC, which produces the world's most advanced semiconductor chips and has customers like Nvidia and Broadcom, witnessed strong performance over the period. ASML, which produces the world's most advanced semiconductor manufacturing equipment, continued to benefit from structural growth trends. In the US, many companies are benefiting from the huge amount of money being spent on physical infrastructure projects and part of that being a result of geopolitical tensions and deglobalisation, but also parts of it related to multiple decades of underinvestment in US infrastructure. These trends been beneficial to companies like Comfort Systems, a leading building and service provider for mechanical, electrical and plumbing systems. Core & Main was another strong contributor to performance, which is a relatively new holding for us. The company is the leading distributor of water infrastructure products in the US.

A key detractor during the quarter was HDFC Bank, India's leading private sector bank. It was a weak performer as a result of guiding down profitability targets following their merger with HDFC. AIA Group, Asia's leading life insurance company, was also weak, partly as a result of continually disappointing Chinese economic growth. Global leader in offshore wind SSE also detracted after reporting slightly disappointing quarterly results.

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 (heating, ventilation and air conditioning), 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 large disease categories such as obesity emerging.

Overview

During the period, we did not initiate or exit any positions but instead we continued to add exposure to some of our newer holdings, such as Hologic, provider of a Women's Health diagnostics technology and Core & Main, the leading distributor of water infrastructure products in the US. We also added to our position in Latin American e-commerce and payments platform MercadoLibre.

Performance and activity - Sustainable Leaders

It was a positive quarter for the fund, which recorded a strong start to the new year, outperforming benchmark and building on gains made over last year. The same trends that were driving markets during the fourth quarter of 2023 continued into the first quarter of 2024. The technology sector continues to benefit from the excitement around Artificial Intelligence (AI), whilst the industrial sector experienced a tailwind from government stimulus towards infrastructure spending via the Inflation Reduction and CHIPS Acts. This should be a tailwind for some time to come. Another trend driving the portfolio is electrification, which can be seen in the desire to replace carbon-based energy with more renewable sources. There is also huge demand for power due to the explosion of computation, itself driven by artificial intelligence.

Two key beneficiaries of these trends are Schneider Electric and Ferguson. Schneider Electric is a leader in electrification and seeing strong demand as businesses look to improve their own electrification processes. Ferguson gives the fund exposure to enabling the development of a more sustainable and resilient physical world – particularly in waterworks and heating, ventilation, and air conditioning (HVAC) – and is reaping the benefits from the money being spent on physical infrastructure projects in the US. In the digital world, our holding in Sage was a strong contributor in the quarter. The firm helps small businesses with financial software, such as payrolls and accounting, and is seeing a ramp up in demand for its improved AI-related tools.

The key detractors in the period included Rolls Royce and BAE Systems. The two businesses performed well in the first quarter as they got boost from strong end markets due to rising geopolitical tensions. For sustainability reasons we hold no exposure to these firms as we don't invest in defence and armaments. Energy company SSE also detracted following a fall in its share price. The firm noted it expects wind output to be lower than previously expected. Despite this, we still expect solid long-term returns from this investment.

Activity was limited in the quarter. We added to our holdings in Ashtead, a leading provider of rental equipment into the US construction market and beneficiary of US infrastructure spend; and GSK, a world leading pharmaceutical company with an improving pipeline of cancer medicines. We sold our remaining Intertek position, in preference for these ideas.

Outlook

Combined with ongoing macroeconomic uncertainty, one thing we see as 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.

Markets have moved significantly over the last six months, pricing in peak interest rates, yet history has taught us the macroeconomic environment can change quickly. We are not macroeconomic forecasters and refrain from predicting the direction of interest rates or inflation but evidence is accumulating that we might be at peak interest rates. We believe longer-term microeconomic trends are more important drivers of investment returns and should be the focus of investors.

There is a narrative that sustainable investing is becoming less relevant given the economic and political changes we have seen over the last few years, however we believe the drive towards a more sustainable society which we define as cleaner, healthier, safer, and more inclusive continues unabated. When looking at markets we see sustainability becoming more, not less relevant and is illustrated by, but not limited to, trends in digitalisation through artificial intelligence, infrastructure through electrification and healthcare through obesity drugs. These trends make us optimistic about the long-term outlook for sustainable investing.

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.

We will continue to follow our process which has served us well over the years and believe our portfolios focused on high quality sustainable and financial companies that are well positioned to drive long-term performance.

Further Information

Please click on the links below for further information:

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

Find out more

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