

Strategic Ethical Active Profile B: Sustainable Leaders

Quarterly Update, Q4 2023



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The big picture: Macro and Markets

In a nutshell

- **Markets rallied as investors got excited about the prospect of interest rate cuts in 2024**

Both equities and bonds delivered meaningfully positive figures, putting a tough Q3 firmly in the rearview mirror, and perhaps flattering overall returns for the year.

- **Geopolitical unrest and conflict continues**

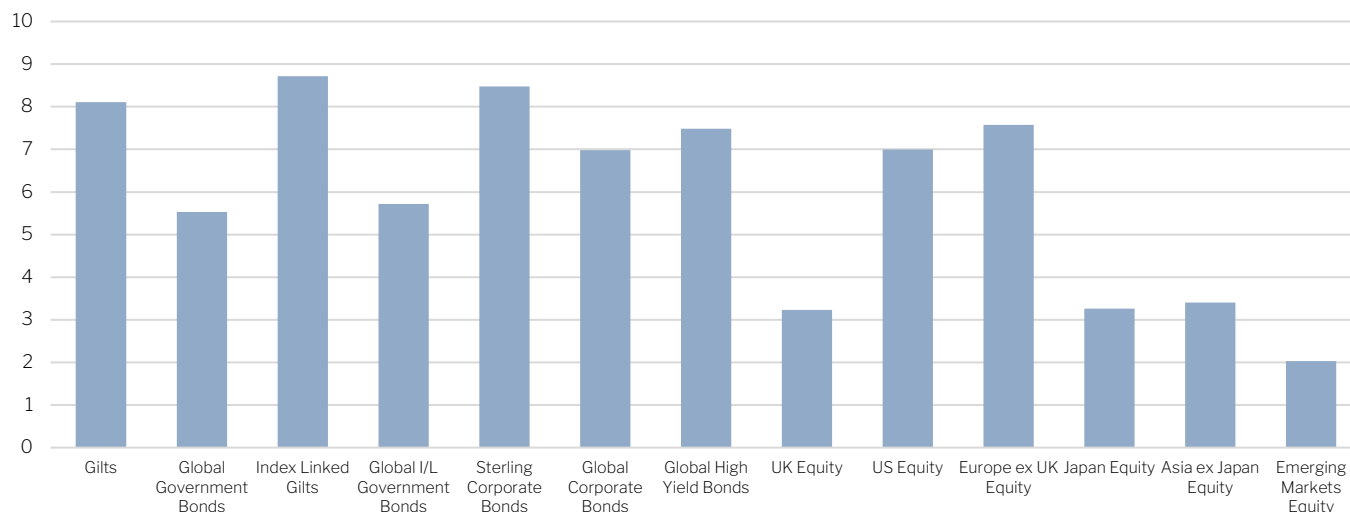
The Ukraine/Russia and Middle East conflicts continued without any signs of a resolution, yet markets remain undeterred.

- **10y government bond yields in the UK fell from 4.5% to 3.5%**

A 1% drop in UK Gilt yields over the 3-month period resulted in meaningful capital appreciation, and when combined with the income generated, a very healthy overall return, particularly for lower risk investors.

What's been happening in Q4?

Asset class returns (Q4 2023)



A strong final quarter of the year gave some more festive cheer to investors. Both equities and bonds delivered meaningfully positive figures, putting a tough Q3 firmly in the rearview mirror, and perhaps flattering overall returns for the year.

Most of 2023 has been characterised by a seemingly uncertain economic backdrop, yet riskier assets (equities) outperformed more defensive areas (bonds and cash). This was reversed somewhat in Q4, with Gilts leading the way (8.11%) – a welcome change for lower risk clients who've had a challenging time lately.

The idea of multiple rate cuts in 2024 really took hold of the market - driven by inflation continuing to fall (often faster than expected) – and in turn this pushed yields down. The 10 Year Gilt yield dropped from around 4.5% to 3.5% over the 3-month period resulting in meaningful capital appreciation, and when combined with the income it generated, a very healthy overall return.

The odds of the Fed manoeuvring a 'soft landing' seem to be increasing - at least in the eyes of the market. Combined with the expectation of rate cuts next year, this is propelling equities upwards. Much has been said about the Magnificent Seven leading the charge, but in the final quarter the rally broadened out, with many smaller companies performing well. This suggests investors are growing more confident in the economy, rather than just backing a handful of global technology leaders.

Negative sentiment around China continued to weigh on Asia Pacific and Emerging Market returns. Anticipation around policy support for the Chinese property sector and broader economy remains, but measures so far haven't given investors enough confidence to move money into the region.

The last quarter of the year reminded us that the attractiveness of cash is always relative. Missing out on the good months in markets can materially impact long term plans, regardless of interest rates on offer.

What does that mean for performance?

Cumulative Performance

	Q4	YTD	1 Year	3 Year	5 Year
Risk Grade 1	3.73	4.52	4.52	-4.50	1.91
IA Standard Money Market	1.38	4.74	4.74	6.03	7.26
Risk Grade 2	5.85	5.66	5.66	-6.09	3.76
Risk Grade 3	6.47	6.34	6.34	-3.87	11.70
Risk Grade 4	6.91	6.95	6.95	-2.14	18.12
IA Mixed Investment 0-35% Shares	5.62	5.97	5.97	-2.86	9.70
Risk Grade 5	6.55	6.46	6.46	-0.65	23.58
Risk Grade 6	6.25	6.21	6.21	0.33	28.92
IA Mixed Investment 20-60% Shares	5.65	6.81	6.81	3.66	20.00
Risk Grade 7	5.95	5.86	5.86	1.34	32.84
Risk Grade 8	5.32	5.36	5.36	2.65	36.67
IA Mixed Investment 40-85% Shares	5.76	8.08	8.08	7.87	31.54
Risk Grade 9	4.69	4.80	4.80	3.57	41.01
Risk Grade 10	4.19	4.50	4.50	5.60	45.64
IA Flexible Investment	5.27	7.08	7.08	8.47	33.86

Discrete Annual Performance


	2023	2022	2021	2020	2019
Risk Grade 1	4.52	-8.41	-0.24	3.14	3.46
IA Standard Money Market	4.74	1.28	-0.05	0.43	0.73
Risk Grade 2	5.66	-13.14	2.32	3.55	6.69
Risk Grade 3	6.34	-13.91	5.00	4.96	10.71
Risk Grade 4	6.95	-14.51	7.04	6.52	13.31
IA Mixed Investment 0-35% Shares	5.97	-10.87	2.84	3.90	8.70
Risk Grade 5	6.46	-14.56	9.22	7.87	15.32
Risk Grade 6	6.21	-14.77	10.83	9.36	17.49
IA Mixed Investment 20-60% Shares	6.81	-9.47	7.20	3.51	11.84
Risk Grade 7	5.86	-14.91	12.50	10.13	19.02
Risk Grade 8	5.36	-14.50	13.95	10.89	20.07
IA Mixed Investment 40-85% Shares	8.08	-10.04	10.94	5.32	15.78
Risk Grade 9	4.80	-14.22	15.21	12.22	21.33
Risk Grade 10	4.50	-13.67	17.06	12.97	22.08
IA Flexible Investment	7.08	-8.98	11.30	6.70	15.66

What worked and what didn't?


It's pleasing to report a very strong quarter, after what has been a tough environment for ethically orientated investors lasting 2 years. The Strategic Ethical Active portfolios finished comfortably ahead of their respective IA sectors over the fourth quarter of 2023.

The strength of the outperformance greatly improves the rolling 1 year picture too. The turnaround in performance is a direct result of inflation cooling more than expected. High levels of inflation have been a major stumbling block for our Ethical Solutions given their inherent growth biases. Regardless of risk level, returns have been strong during the quarter.


Asset classes



Capital markets reacted strongly to inflation rolling over more than expected, as this led to renewed optimism around rate cuts for 2024. In this environment both bonds and equities delivered positive absolute returns over the quarter. Interest rate sensitive areas performed most favourable in the 'everything rally', meaning Gilts with their duration heavily stance bounced circa 8%. Equities delivered strong absolute returns in this environment too, with ethical equities flourishing due to their indirect linkage to the growth style.



Although still delivering well over a short time frame, Emerging Market equities failed to keep up with the wider rally and recorded the weakest rise across all the regions. Valuation levels remain attractive but the structural problems in China, particularly around its property sector continue to weigh on economic activity and dragged down the index level return.



After such positivity and hype around money market funds in 2023, investors were much better placed taking on market risk during the quarter. This illustrates the dangers of market timing. In truth there was little negative to say around the performance of the solution as all asset classes performed well over the period. A welcomed rarity and we expect for correlations to reassert themselves during 2024.

Manager selection

Given the market environment, most funds strongly outperformed their respective benchmarks. Allianz Gilt Yield (Risk Grade 1-9) with its long duration (interest rate sensitive) position outperformed over the quarter as bond yields fell.

Equally, VT Gravis Clean Energy Income (Risk Grade 1-9) also benefited owing to its linkage, through long dated cash payments, to long bond yields.

The UK Equity holdings all performed well, with Janus Henderson UK Responsible Income (Risk Grade 2-10) delivering significant outperformance. The fund's stock selection in financials was an important driver with their holding in Intermediate Capital Group up nearly 25% in the quarter. Liontrust Sustainable Future UK Growth (Risk Grade 2-10) also performed very strongly, as the fund's return was bolstered by its biases to the growth style and down the market cap spectrum.

Janus Henderson Global Sustainable Equity (Risk Grade 2-10) and Stewart Investors Worldwide Sustainability (Risk Grade 2-10) both outperformed handsomely over the quarter. Janus Henderson Global Sustainable Equity was spurred on by its strong growth bias illustrated by its overweight to the technology sector and zero exposure to traditional energy stocks.

Within Sterling Corporate Bonds (Risk Grade 1-9), Rathbone Ethical Bond and EdenTree Responsible & Sustainable Sterling Bond negatively detracted from a relative return sense given their slight underweight duration positions. However, Liontrust Sustainable Future Corporate Bond performed strongly and so the asset class as a whole was broadly in line with the index.

A newly initiated position in UBAM Positive Impact Emerging Equity underperformed through the quarter, as it failed to keep up with the rising equity markets. Impax Asian Environmental Markets also delivered negative returns, mainly due to its China exposure.

Fund changes

Sell

**Aberdeen Standard Liquidity
Federated Hermes Short-Term Sterling Prime**

The funds held in our Managed Liquidity asset class (Risk Grade 1-6) are unscreened, which means they either have no exclusion policies, or they are very light. We have been looking to improve the screened nature of the asset class for our Ethical solutions in favour of a more environmentally aware money market fund. We therefore switched out of the Federated Hermes Short-Term Sterling Prime and Aberdeen Standard Liquidity in all our Ethical solutions, in favour of the BlackRock ICS Sterling Liquid Environmentally Aware fund. The fund has an environmental tilt and strong exclusionary policies. This is therefore a stronger candidate for our Ethical portfolios.

Buy

**BlackRock ICS Sterling Liquid Environmentally
Aware**

Sell

Royal London Ethical Bond

Following a review by our Ethical Oversight Committee, the Royal London Ethical Bond fund was no longer considered appropriate for the Strategic Ethical Active - Profile B solution. This was due to a small holding in airport bonds which are not deemed as sustainable businesses. The exposure was very small and therefore within the mandate's tolerance levels. However, we felt it was not in the spirit of a sustainable portfolio. We had no other issues with the fund or the manager and it remains in some of our other ethical portfolios where there is less focus on sustainable issues and more on other ESG factors. The proceeds were split evenly into the three existing Sterling Corporate Bond funds – Rathbone Ethical Bond, EdenTree Responsible and Sustainable Sterling Bond and the Liontrust Sustainable Future Corporate Bond.

Buy

Consolidate Asset Class

Sell

WHEB Sustainability

The WHEB Sustainability fund had been under review following our last due diligence on the fund. Although the environment for sustainability investing has been difficult over the last couple of years, the fund's performance had disappointed more than we had expected. We also had concerns over the resource at the firm as being insufficient to provide the comprehensive stock coverage we would expect, and this was reflected in the performance of some of the underlying stocks. In its place, we switched into the Impax Global Equity Opportunities fund. While sustainable funds tend to have growth style biases, this fund tries to balance out the style risks where possible as part of its risk controls. This means that it takes a quality growth approach together with quality defensive, to offer potential for more consistent outcomes over the longer term.

Buy

Impax Global Equity Opportunities

Sell

Reduced exposure to current funds in blend

We introduced the UBAM Positive Impact Emerging Equity fund into the Strategic Ethical Active Profile B solution in order to diversify the heavy Asian bias we had in the Ethical Emerging Markets and Asia Pacific ex Japan Equity asset class. Going from two funds to three has also helped reduce fund specific risk in the asset class. Adding the UBAM fund has also helped moderate some of the growth bias we had, although there is a small and mid-cap bias, which we are positive on and is one of the trade-offs when investing in sustainability funds.

Buy

UBAM Positive Impact Emerging Equity

A view on risk

	Volatility			Max Drawdown		
	1 Year	3 Year	5 Year	1 Year	3 Year	5 Year
Risk Grade 1	3.19	3.72	3.19	-0.97	-9.91	-9.91
IA Standard Money Market	0.28	0.64	0.54	0.00	-0.10	-0.10
Risk Grade 2	5.98	6.88	5.96	-3.40	-15.42	-15.42
Risk Grade 3	7.02	8.13	7.36	-4.37	-16.31	-16.31
Risk Grade 4	7.98	9.27	8.68	-5.15	-17.43	-17.43
IA Mixed Investment 0-35% Shares	5.94	6.03	6.48	-3.31	-13.28	-13.28
Risk Grade 5	8.52	9.79	9.58	-6.08	-17.55	-17.55
Risk Grade 6	8.99	10.34	10.55	-6.67	-17.85	-17.85
IA Mixed Investment 20-60% Shares	6.78	6.87	8.45	-3.68	-12.14	-12.89
Risk Grade 7	9.40	10.86	11.26	-7.26	-18.28	-18.28
Risk Grade 8	9.79	11.30	11.90	-7.78	-18.27	-18.27
IA Mixed Investment 40-85% Shares	7.71	8.24	10.29	-4.39	-12.54	-15.41
Risk Grade 9	10.22	11.84	12.68	-8.31	-18.40	-18.40
Risk Grade 10	10.72	12.51	13.42	-8.92	-18.13	-18.13
IA Flexible Investment	7.49	7.91	10.17	-4.31	-11.20	-15.53

What's the outlook?

We think the long-term outlook for Ethical and ESG investing remains positive. Inflationary headwinds are expected to moderate throughout 2024, with central bank and investor focus shifting towards growth and away from inflation.

Variable macroeconomic data will keep central bankers talking tough; however, we believe we've passed the peak in interest rates with cuts expected not only in 2024 but into 2025 as well. Slower economic growth points to weaker earnings growth. This suggests there'll be a greater focus on quality within fixed interest and equities, and a need for duration to hedge against unforeseen risk off events.

Within fixed interest, government bonds (rates) look more appealing than corporate bonds (credit), where spreads have narrowed to below their historical averages. On a risk adjusted returns basis fixed interest is looking relatively more attractive than equities at this stage of the cycle. However, valuation opportunities remain, with mid and small caps looking attractive not only versus core indices but also against their own history.

ESG priorities are coming back to the forefront of investors' minds, as the clock for limiting temperature rises continues to count down. The capital expenditure needed to prevent climate catastrophe and create a better world for future generations is huge. Then there's the increased regulations. Both of these create big risks to those companies and industries not willing to embrace change. But it also creates attractive opportunities for those making positive steps on the path to sustainability. Our Ethical Oversight Committee – a panel of ESG specialists and Parmenion Investment Management - meet each quarter to assess opportunities and threats in the current ESG landscape.

In addition to a performance review, we also aim to share some details around the type of positive work conducted by our underlying fund managers within your ESG portfolios. Over Q3 2023, the managers of Janus Henderson's Global Sustainable Equity Fund (not held in Risk Grade 1) undertook 12 different engagements. Including with North American home-improvement retailer Home Depot. They first engaged with the company in 2022, supporting a successful shareholder proposal calling to eliminate deforestation in their supply chain. A recent follow-up confirmed that Home Depot had completed a deep dive into supplier activity and were finalising a full report, alongside beginning to disclose activity through CDP Forests. However, disclosures so far have been limited and Janus Henderson will speak to management again once full reporting is published later in the year.

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