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FUND MANAGER QUARTERLY REPORT

4th Quarterly Fund Manager Report
Happy New Year
By Wayne Bishop

After the "Annus Horribilis" of 2022.

It was a year that most impact and ESG investors were glad to see the back of as two factors had an especially negative outcome on the sector. The ongoing atrocities of Russia in the Ukraine and the effect it had on already rising inflation, hit both equity and bond markets at the start of the year and reverberated all the way through the year. Much has already been written on these topics (please see our blogs for a more detailed note on ESG and Impact performance and our stance on property), and in the last quarter, as the year finished, we began to see the effects finally wane.

We consider it a fool's errand to attempt to predict the timing or final outcome of the conflict in Ukraine, but as the shock factor fades, without any further escalation, it's impact on market sentiment is declining. Economists estimate that the conflict was responsible for about a third of the increase in inflation seen around the world due to its influence on food and energy prices.

Does this mean better news in 2023?

Three factors will drive the economic background for 2023: inflation; economic growth, and derived from these two, the current and anticipated level of interest rates in the major global economies. The key four factors when focussing on ESG and Impact investments will be: the migration from fossil fuels; the use of certain limited resources; the buildout of social and environmental infrastructure, and increased awareness of biodiversity.

In the case of food prices, the conflict was another problem on top of the weather-related stresses that had already reduced crop harvests in Europe and North America. Furthermore, seasonal factors such as Christmas, were exploited, leading to a spike in food inflation, which we expect to level off.

Energy prices have been in decline since September and there are signs this decline is accelerating as the warmer winter in the Northern Hemisphere reduces gas demand further. Two of the leading drivers of inflation appear in retreat, so it was no surprise that the UK prime Minister picked the first week of 2023 to promise to reduce inflation.

Although it seems like an age ago, it was, in fact, only a year ago that interest rate expectations began to impact the market. The Bank of England (BoE) only began normalising rates from 0.1% to 0.25% in December 2021 before beginning a more aggressive rise in February 2022 to 0.5% and then higher to

the current 3.5%. Likewise, the Federal Reserve (Fed) began raising rates in March 2022 and the European Central Bank (ECB) did not begin until the end of July 2022.

Whilst the impact of rate rises and expectations in bond and equity markets are instantaneous in terms of price action, the impact on the real economy takes up to a year, meaning we are only now beginning to see the full effects of those early rate hikes. The fact that interest rate rises of this speed have not been seen since the late 1970's, coupled with the squeeze suffered by higher energy and food prices, leaves the market in unchartered territory. As a result, we head into the 4th quarter reporting period with expectations low.

This means the goal of a slight economic slowdown and a fall in inflation could well be in sight, with the big question now becoming, did we go too far too fast?

Interest rates are pivotal in both bond and equity market pricing, and whilst the interest rate scenario has cooled and come back to reality, bond markets may still have an eventful year. The volatility experienced in the UK Gilt market in the second half of 2022 reminds us that bond markets should not be considered magic wands. In the Eurozone a different stress, that of the cost of peripheral debt for countries such as Italy (10 year bond rate 4.2% verses Germany 2.2%) reminds us that quality is once again an important issue. With central banks no longer blanket buying bonds, and the ECB now joining the BoE and the Fed in quantitative tightening, fixed income is going to need to find buyers again, at a time when large budget deficits imply there is higher supply than last year.

Fixed income has had a dreadful year, returning a negative 18.77% (sterling corporate bonds) in 2022 and, in doing so, impacting lower risk investors with their larger exposure. Much of this decline reflected the interest rate and supply & demand fears in the market. During the year, and in hindsight a little too soon, we raised fixed income exposure from minimal to what we consider a more neutral level. In the last quarter we saw fixed income recover quite well.

Buyers of fixed income have emerged, as at least fixed income is offering some returns again compared to nothing last year. For example, yields at year end were around: US 3.8%, UK 3.6%, EU 2.2% - 4.7% in the ten-year area. Although these do not currently beat inflation at current levels, this may change. Therefore, we expect short term interest rates to be more stable and any volatility in markets to be focussed more on quality given the likely recession scenario we'll face later in the year.

A more stable interest rate setting will provide a firmer basis for growth focussed equities. Fears of a general slowdown have been growing for some time with the impact being focussed on discretionary spending and consumer sectors, particularly where there is exposure to housing, retail, hospitality and leisure. Recent results have shown some of these fears may have been overdone. However, in our view, the full impact and changes in consumer behaviour are likely to be felt in the coming quarters. Many of these stocks and sectors are not the focus of portfolios.

The energy shock created by the invasion of Ukraine initially led to much higher oil and gas prices, but despite the ongoing war, prices have fallen below pre-war levels. A great deal of money and effort has gone into ensuring gas supplies in Europe, and it's no surprise that interest in alternative and non-geopolitically sensitive energy sources has risen. Whilst the crisis slowed down the clean energy transition at the start, in the longer term it is speeding the process up.

Renewable energy is a core component of the portfolio, from manufacturing and development through to

owning and operating renewable energy generation. The manufacturing and development side suffered in 2021 and 2022 due to issues around input costs and supply chains; in the last quarter we have seen a solid recovery in core names such as Vestas Wind Systems (manufacturer of Wind Turbines) and a positive year on returns. We have seen this with the renewable infrastructure investments as well, which experienced volatility and downward pressure around the turmoil of the Kwarteng mini budget.

Answering renewable energy's key drawback has also moved a step closer as both green hydrogen and battery storage and technology continue to develop.

Worries for 2023?

Mobility is a core area where we see concerns on two fronts. With regards to public transport, there is exposure through bonds and equities. Operators of transport such as buses have suffered due to labour and fuel costs and less predictable demand. We feel this area is in peak pessimism. We also see not only fuel costs falling but also the need for fossil fuels, investments in this area increase their drive to sustainable methods, such as electric buses or hydrogen trains (of which there is exposure within the model portfolios).

Electric cars have had a difficult year. Supply chains and costs remain a difficulty for this sector and although growth is not as fast as expected, we still see the sector growing. Recent statistics have highlighted electric cars are now outselling diesel in the UK, albeit from corporates switching their fleets. We see the sector regaining its poise in the coming years and infrastructure to support this will be vital. Here portfolios have exposure to companies providing charging infrastructure for EVs but also buses and coaches. This includes companies providing solutions for energy management to ensure grids are 'smart' and can cope with the increased demand.

Property has been a difficult sector over the last year. In a note from the autumn, we explained why we favoured REITS (Real Estate Investment Trusts) over open ended funds, despite the fact that can create short term volatility. The sector has remained under pressure and the issues are not limited to just REITS but also to construction where input costs, labour, material shortages and higher interest rates are creating concerns. Demand for social and affordable housing is still very strong and this remains an unresolved economic and social issue. We reduced exposure to construction in the period and expect REITS to recover as per our earlier paper.

Conclusion

The last quarter of 2022 has been a pivotal quarter. The main source of volatility, interest rates concerns, has finally levelled off. The first shock waves from early 2022 in the energy sector have turned from headwinds in favour of fossil fuels to a determination to speed up the transition. Supply chains are being reinvented, meaning areas where we currently still have some turmoil, such as electric vehicles, mobility, infrastructure (IT, physical and mobility) and property are seeing some light at the end of the tunnel and are now presenting more investment opportunities. In these cases, the rethinking favours more ESG and Impact focussed solutions.

Whilst the interest rate turmoil is abating, the impact of higher rates is becoming clearer, and we expect this to make some unsettling headlines once the Holiday period and New Year euphoria abates. Geo-political tensions and uncertainty will remain a significant noise and influence over the year, but it would take a lot to match the shocks we absorbed in 2022.

For the model portfolios, we start the year near the lower end of our equity allocation for each risk profile. This does inevitably mean the next move in equities is higher, although given the alternative that bonds offer, we now have more investment options versus prior years.

In bespoke portfolios, we have been able to de-risk clients by switching from holding a company's equity to buying their bonds, and this thinking will inevitably feed into the investment decisions made for model portfolios.

The appeal of holding infrastructure investments in renewable energy is still intact. These investments have adjusted for a number of reasons such as higher rates, but UK names have also adjusted for "Electricity Generator Levy", which is a temporary 45% charge on wholesale electricity receipts sold at an average price in excess of £75MW. Many companies within this sector are still forecasting earnings growth and continued covered dividends based on long term contracts, the sector is appealing as we head into a period where equity markets are likely to see a year on year earnings decline.

The move higher in our equity allocation is unlikely until we get greater clarity on central bank direction. The pivot point would be beneficial to growth equities, which plays into the favour of many more impact focused equities. So, whilst any moves higher would be incremental, we would likely favour impact funds moving forward.

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