QUILTER CHEVIOT

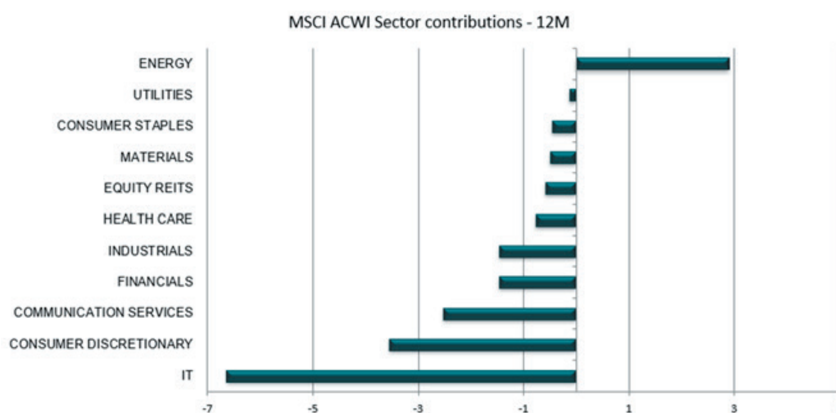
Three reasons to come back to sustainable investment

“We have faced the worst pandemic since the 1920s, the worst conflict in Europe since the 1940s, and the worst energy shock since the 1970s”, said Christine Lagarde, president of the European Central Bank, adding that these disruptions alongside supply chain issues had permanently changed global economic activity. We agree. These are challenging times for active managers. Nevertheless, the tide is turning for sustainable investment.

When writing at around this time last year we were amid interest rate rises with no end in sight. Now, it is almost a year after interest rate rises were put on pause and we are starting to see modest rate cuts as central banks continue to have an eye on services inflation and wage data. It truly feels like a turning point for sustainable investment, a strategy highly sensitive to interest rate rises. This is illustrated by the fact that most sustainable funds are back in positive territory since Russia invaded Ukraine. It is encouraging to realise that what once was a headwind for our Climate Assets strategy, is now set to be a welcome tailwind. Let’s consider three factors that have affected recent performance: Energy, Interest Rates and the Magnificent 7.

1 Energy crisis

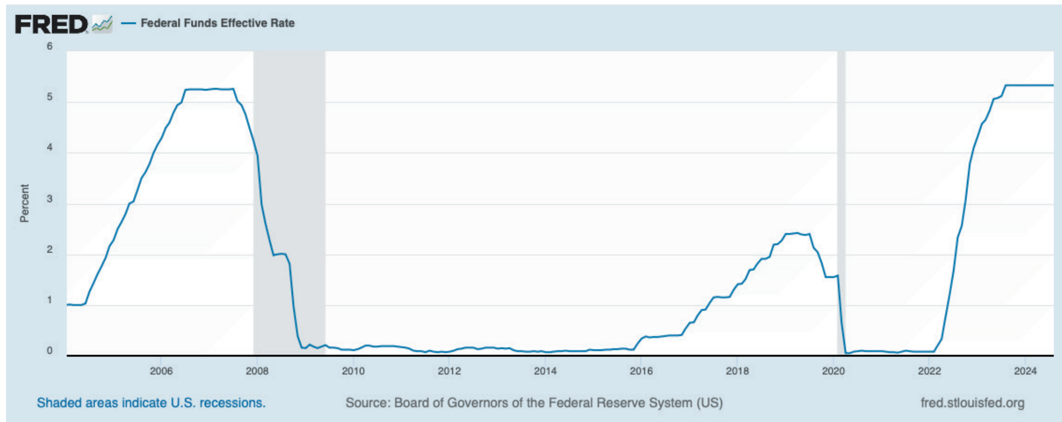
During the energy crisis, back in 2022, energy was the only sector with a positive contribution to global returns. The S&P 500 index was down more than 18% over the year while the FTSE 100 index was up almost 5%. The difference is due to the makeup of the two markets. Our local index is made up of mostly old economy business such as oil & gas, mining (which falls under materials) and financials. Due to the nature of the FTSE 100 index, global sustainable funds are typically underweight the UK and overweight the US. Our sustainable investment strategy is fossil fuel free, therefore it is structurally underweight energy. These two forces acted in tandem against sustainable investment.



Source: Refinitiv DataStream 31 December 2021 – 31 December 2022

2 Interest rate rises

Throughout 2022 and 2023 we saw the fastest increase in interest rates since the late 1970s. In recent history we experienced similar interest rate rises during the Great Financial Crisis (GFC) between 2007 and 2009. At that point it took the US Federal Reserve (the Fed) twenty-seven months to move from a 1.00% to a 5.25% base rate. This time it took the Fed 18 months to move from 0.08% to 5.33%. Interest rate rises have a greater effect on growth companies as their cash flow are realised further into the future. The discounted value of those future cash flows is highly sensitive to the discount rate (interest rates). While the companies we invest in are not blue-sky, they do tend to operate in growing markets. Therefore, they are part of the growth category and are negatively affected by interest rates rises.

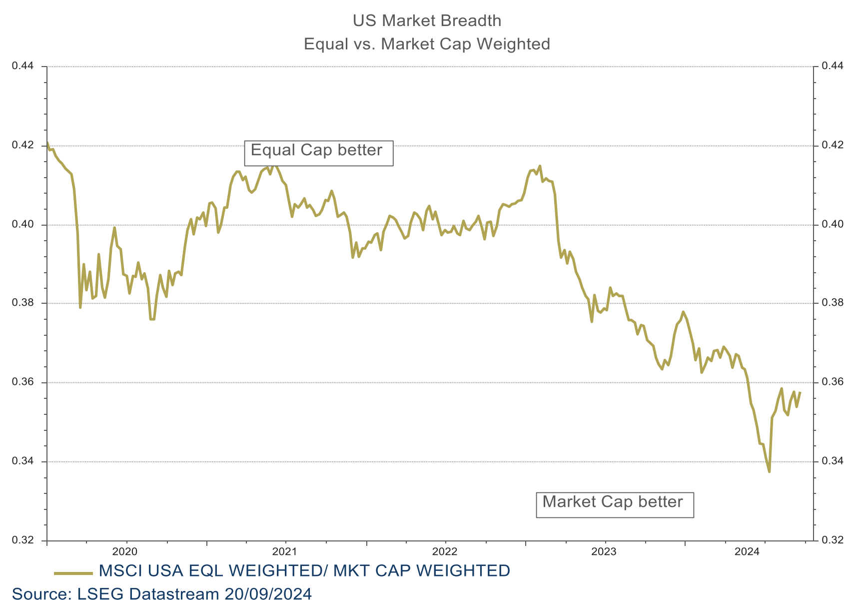


3 Performance of the magnificent 7

Since ChatGPT launched in November 2022, there has been tremendous interest in artificial intelligence (AI). This helped companies like Nvidia become a household name. AI has also been seen as a boon to better known technology companies such as Apple, Alphabet, Amazon, Meta, Microsoft, and Tesla.

The performance of these seven tech companies, known as the Magnificent 7, has been far better than the S&P 500 index. The best performer, Nvidia, has seen its market cap increased by 10 times to almost USD 3 trillion in the last 2 years and now accounts for c.6% of the US index. That rise has turned Nvidia into the driving force behind the S&P 500 index's performance. No other company in history has risen to such a weighting so quickly. Nvidia is held in the Climate Assets Growth Fund, however, due to its high growth profile, it is not held in the Climate Assets Balanced Fund - this has hurt the fund's relative performance over the period.

The chart below plots two different versions of the S&P 500 index: market-cap weighted and equal weighted. The market cap weighted version is commonly used, with companies having a weighting based on their size. The equal weight version gives every company the same weighting in the index, regardless of the company's individual size. Thus, the equal-weight version is more exposed to the smaller end of the index. By dividing the two versions of the same index, one can easily see whether a small group of large companies is driving the market, or the performance is across the market. A concentrated market is not a good backdrop for the sustainable investment sector, as most of the large US companies are likely to fall foul of our ESG integrated analysis or negative criteria. It is worth noting that the last time the market was this concentrated was during the Global Financial Crisis.

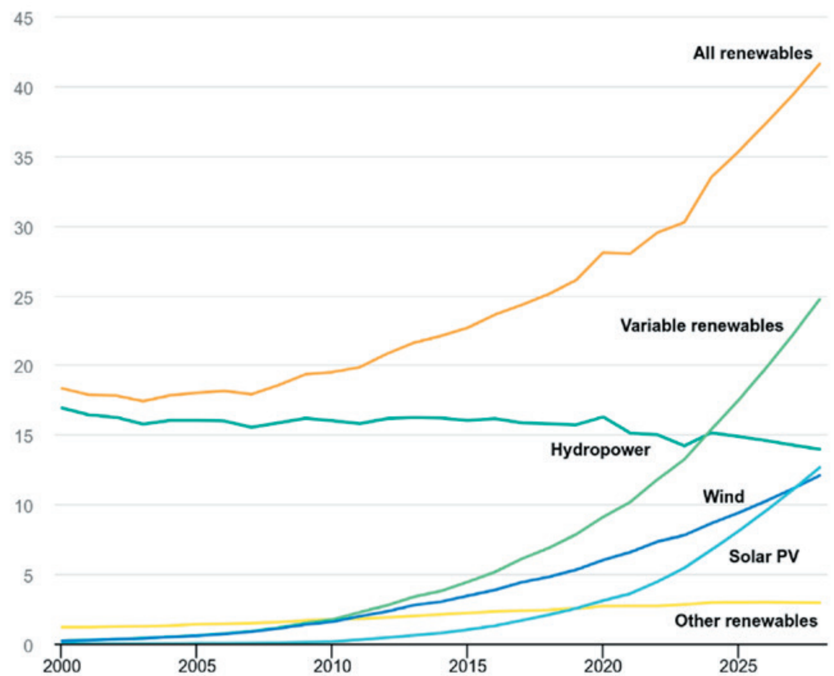


Fast forward two years to today:

Energy

The oil price is down almost 40% from its 2022 peak and remains volatile owing to fears of conflict escalations in the Middle East and recession in the United States. Following Russia's invasion of Ukraine, countries have sought to insulate themselves from further regional conflicts and secure energy supply. Renewables have been a solution with 340 GW of annual capacity additions in 2022. The International Energy Agency expects this to continue and forecasts renewable energy accounting for over 40% of global electricity generation by 2028, from about 30% today. This progress will be supportive of our listed renewable infrastructure holdings as well as EDP Renovaveis, our European renewable pureplay. We continue to see investment in the energy transition by increasing renewables capacity and deploying energy efficient technologies across the economy.

Renewable Power (%) as a contribution to global electricity supply

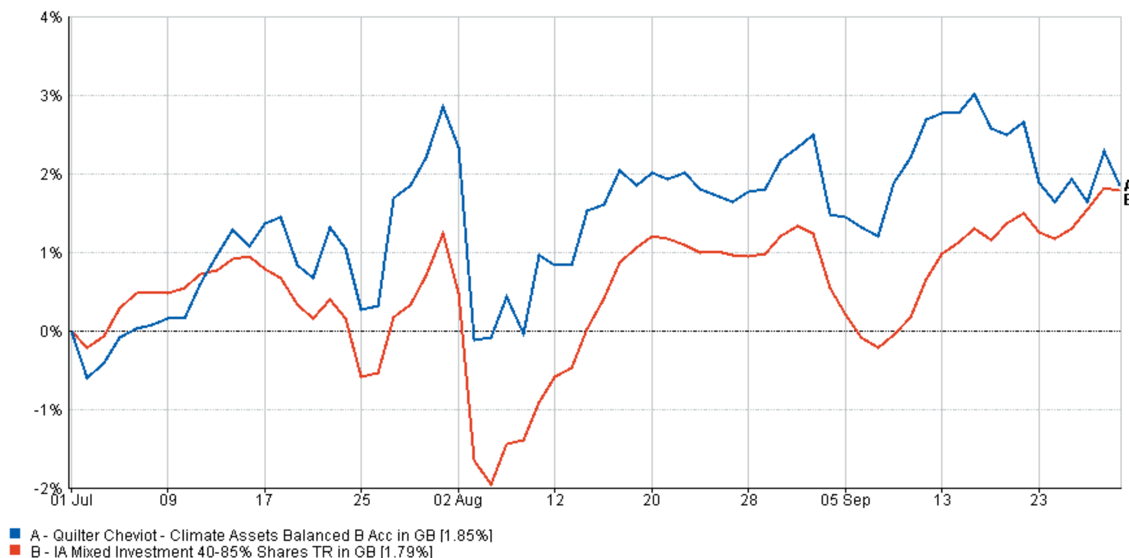


Source: IEA, Renewables 2023 Forecast and Analysis

Interest rates

While interest rate rises hurt the sustainable investment sector, the opposite is true as interest rates come down. The present value of future cash flows of the companies we invest in are valued more highly as interest rates fall. When interest rate rises were put on hold in November last year the market started pricing multiple rate cuts at the start of 2024. This led to one of our best quarters from a performance perspective where our Climate Assets Balanced Fund outperformed the sector by over 3%. Although rate cut expectations where very ahead of themselves, this illustrates the positive correlation with low rates. We have started to see interest rate cuts in Q3 this year which again has been a tailwind to performance.

Climate Assets Balanced Fund Performance 3M to September 2024



Source: Financial Express 30/09/2024

Magnificent 7

Looking at the US Market Breadth chart over a shorter period, one can see that the market has broadened out over Q3. The Magnificent 7's dominance over market performance waned and performance was more spread out over the market. We have seen money leaving the technology names, as investors recycle money out of the technology names that have been a 'safe haven' into the wider market where valuations are looking attractive. This has contributed to better relative performance for the Climate Assets Funds against their benchmarks as well as improved absolute performance.

Remarks

The headwinds seen over the last few years are now reversing and turning into tailwinds. We believe that, barring any unforeseen events, the trends of these three factors should play in our favour and performance should revert to the norm. The sustainability sector still has multiple drivers including the Inflation Reduction Act (IRA) and similar funding schemes in the EU and China as well as the regulation of sustainable funds addressed by the upcoming Sustainability Disclosure Requirements regime.

The IRA is thought by many to be in jeopardy if Trump is elected this year. However, we estimate that c.60% of the jobs it has created and c.80% of the investment has gone to Republican states so far, which should give support even in the event of a Trump administration.

NextEra, the fourth largest energy company in the US, has said that it does not believe a Trump win would lead to a repeal of the tax credits provided to the sector. After 21 years at the helm, the CEO said he has never seen a change or repeal of tax credits. He also pointed out the Republican's failed attempts to remove Obamacare during the Trump administration.

Government initiatives across the world are helping to support growth in renewable energy and energy efficient technologies. The global renewable energy market is forecast to grow at a CAGR of 9.5% from 2024 to 2032, estimated by Straits Research. Rising energy demand, improving power generation mix and favourable government initiatives are the key drivers for the growth of the global energy transition market, which is beneficial to the Climate Assets Funds.

About our offering

Quilter Cheviot's pioneering sustainable offering is two multi-asset funds with one of the longest track records in the sector. Our Sustainable Investment Team has a track record of strong returns over more than a decade. The Climate Assets Funds, Climate Assets Balanced and Climate Assets Growth, focus on investment opportunities that arise from companies providing sustainable solutions, including improving resilience to climate change and healthcare challenges. Often this means helping meet the global and emerging challenge of delivering 'more with less' for a rapidly growing population with a low carbon footprint. There are five positive investment themes at the heart of the stock selection process: Clean Energy, Food, Health, Resource Efficiency and Water. Overlaid with a negative criteria where we use independent research and analysis to ensure our exclusion criteria are applied fairly and consistently. A considered approach is taken for applying each exclusion, incorporating strategic revenue and materiality assessments where appropriate.

Harry Gibbon
Investment Manager

Harry joined Quilter Cheviot in 2018 and moved to work with Claudia Quiroz and Caroline Langley later that year. Harry has since been promoted to an Investment Manager and assists with the management of clients' portfolios for private clients, pensions, trusts, charities, and funds, including the Climate Assets Funds. Harry is also co-fund manager of the Quilter Cheviot Libero Balanced Fund. Harry has completed the CFA Certificate in ESG Investing, the CISI Chartered Wealth Management Qualification, and is a Member of the Chartered Institute of Securities and Investments.

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