Responsible & Sustainable European Equity Fund
Insight

Performance with principles®

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A responsible and sustainable European portfolio that places process over style

Chris Hiorns makes an important distinction between his value-orientated approach when managing the Responsible & Sustainable European Equity Fund and the traditional approach to value investing. It's an approach that has produced impressive long-term results.

In the modern era of fund selection, the question of investment style has developed into a strong differentiator between funds – driven both by the growing valuation and performance gap between 'growth' and 'value' and the popularity of style-based index ETFs offering value and growth based solely on quantitative factors.

When discussing the approach behind the fund, however, we are keen to emphasise that its value-orientated process has greater flexibility and is distinct from stricter notions of a value investment style. This has enabled the fund to avoid many 'value traps' and identify companies which sit in value on a historic basis but are actually on the cusp of returning to growth and higher profitability, driving strong returns.

In practice what this means is that while the fund can have a strong correlation to value over the short term – and should continue to benefit from the tailwind created by the persistence of the current interest rate and economic regime – its long-term performance has been driven by its value-orientated, fundamental stock picking process.

While this process pursues companies on cheap valuations, it has a firm eye to strong market positions and highly capable management teams. Businesses who invest in innovation, as well as their brands. And businesses with solid structural – that is, sustainable – growth potential. In short, we carefully assess the quality and idiosyncratic potential of each holding and the catalyst for its rerating. This is markedly different to a passive value equities approach that largely filters the universe for companies on cheap valuations alone.

Many fund buyers are surprised by the value-orientation of EdenTree's European Equity Fund given its responsible and sustainable – that is, ESG-focused – investment framework. The vast majority of sustainable European equity funds have strong growth bias and this positioning only became more extreme as we moved to the end of the long bull market in 'growth' stocks in 2020-21. The collapse in valuation of growth and especially posterchild growth ESG stocks has since led to material under performance of many peer sustainable European equity funds.

The Edentree Responsible & Sustainable European Equity Fund stands out in stark contrast with these funds due to its disciplined value-orientated approach, performing strongly, even amid a hostile market backdrop for sustainable funds which included a sharp rally in energy, a sector appropriately not held in the portfolio.

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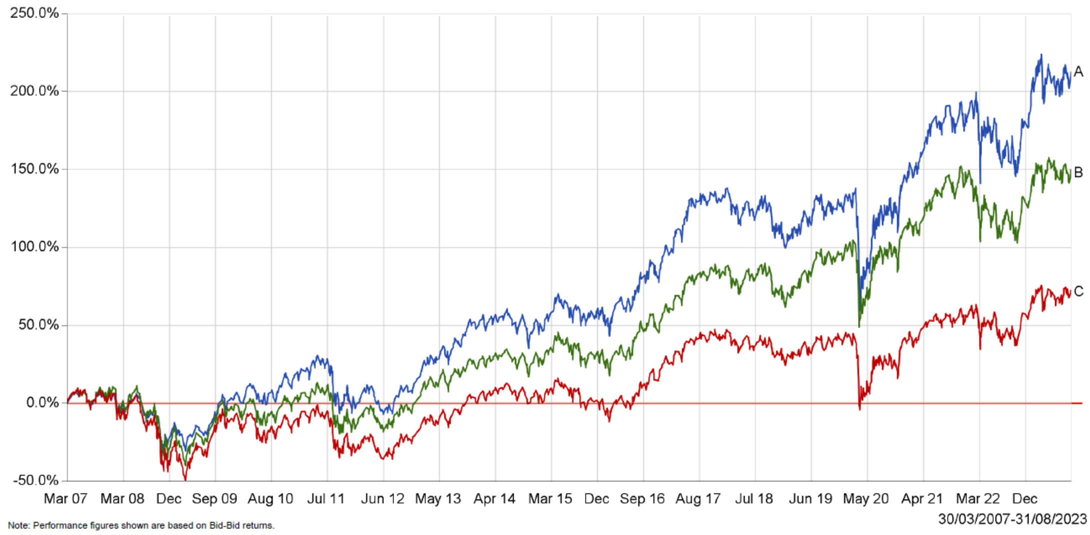
EdenTree R&S European Equity Fund B Class (A) compared to MSCI Europe ex UK (B) and MSCI Europe ex UK Value (C)



Source: FE; net, bid-to-bid returns; performance date range 30.03.07 to 31.08.23

A portfolio built for long-term returns

Most of the companies in which the fund invests fall broadly into three buckets.

- **Income accumulators**: companies with high, sustainable and growing dividends that provide a defensive ballast to the portfolio. Examples of these companies may include pharmaceuticals (Sanofi, Roche), telecommunications (Orange, Telefonica) and insurance companies (Talanx, Mapfre).

- **Contrarian plays:** companies that have fallen out of favour with the wider market (for example due to recent poor operating performance) which we believe are good quality companies with the potential to perform ahead of expectations.

  European banks fall into this category. The fund has generally benefited from overweight positions in the likes of Santander, BBVA and Bank of Ireland, among others – banks which have generally been out of favour since the credit crisis and whose reputations were undeservedly tarnished (fortunately, temporarily) by the recent US regional banking crisis and collapse of Credit Suisse.

  However, being flexible, our contrarian plays can also include out-of-favour cyclical names that might be less common in traditional value-style funds. The fund holds Siltronic, a world-leading German manufacturer of hyper-pure silicon wafers for the semiconductor industry, for example. This stock de-rated amid fears of overcapacity hitting profitability in the semiconductor sector,

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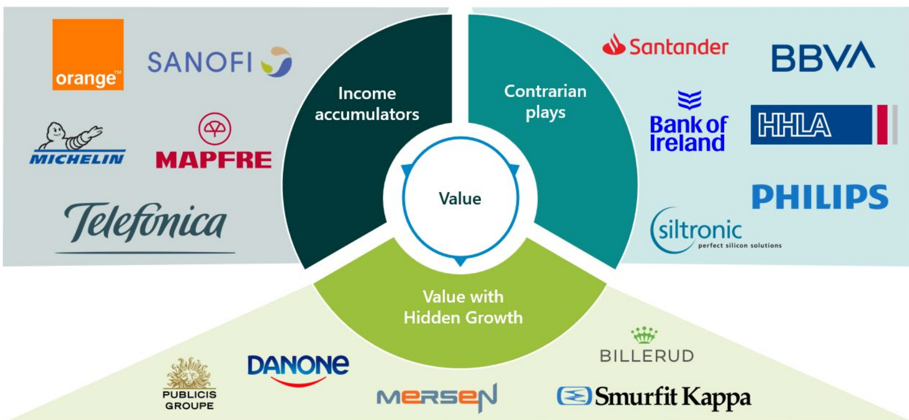
presenting an attractive opportunity to invest in a business we felt would be insulated by persistent demand down the value chain, supported in part by government subsidies in the sector. We have been similarly opportunistic with other cyclical companies where valuations have priced in a far sharper slowdown in the global economy than has played out.

- **Hidden value**: companies which we feel are misunderstood or where the market has not fully recognised opportunities which may exist outside of their normal operational activities. Some of the most exciting of these are seemingly mature companies that prove more agile and innovative than investors expect, with hidden gems that can transform the business into a potential growth proposition for investors. Importantly, we retain the flexibility to hold these sorts of companies through their "growthier" phase as this new potential is realised.

  Electrical components business, Mersen, which is held in the fund, is one such company. With a customer base that has historically been focused on mature heavy and process industries, Mersen has pivoted to supplying fast growing businesses involved in the energy transition with components for wind turbines, solar energy, the green grid and, more recently, electric vehicles. This has not only lifted the sustainability role of the business but has opened a runway for stronger growth which we felt was not recognised in its valuations.

  Other sources of hidden value can be found in the packaging industry. Also seen as a mature industry, innovative businesses from this sector are enhancing growth and margin opportunities through e-commerce and the move towards a more sustainable, circular economy. For example, the paper packing products of Smurfit Kappa and Billerud are replacing disposable plastics, with obvious environmental benefits and improved profitability through the creation of more niche higher margin markets.

Investing for Long-term Returns



While these buckets are useful tools for describing the construction of the portfolio, they are not prescriptive. The allocation to each is driven by the strength of the stock-level opportunities available at a particular point in time. Value factors are a key component of our analysis, but they are part of a wider mosaic of considerations with our focus on fundamental, stock-level prospects allowing us to lean into the prevailing market cycle.

This brings us back to an important point about what we mean by "value orientation". Through our process of fundamental, bottom-up stock selection the fund's value orientation has become tilted towards a deeper value positioning than historically has been the norm. For us, this skew is less a consequence of a "value style" than a result of the huge divergence in valuation that has grown between highly valued growth and quality, on the one hand, and value and high yield, on the other. It's a consequence of the market opportunity. And while the portfolio's value-orientated process does mean it is more correlated to value than to the wider market, this correlation varies over time. So, how does the current tilt position the fund for the current environment? With the relative valuations of value and growth seldom so much weighed in the favour of value, we believe the fund is positioned to potentially benefit from a firm tailwind as the normalisation of interest rate policy continues to play out.

Chris Hiorns, Head of Multi-Asset and European Equities

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