RESPONSIBLE AND SUSTAINABLE GLOBAL EQUITY FUND

COMMENTARY FOR QUARTER TO END JUNE 2022

PERFORMANCE

	3 Months	6 Months	1 Year	3 Years	5 Years	10 Years
Fund Performance (C Class)	-11.14%	-18.76%	-13.86%	12.51%	23.04%	115.95%
FTSE World TR GBP	-9.07%	-10.90%	-2.83%	29.02%	55.80%	223.89%
IA Global	-10.23%	-14.75%	-9.14%	20.10%	41.04%	167.46%
Sector Quartile	3	3	3	4	4	4

Source: Morningstar. Figures compared on a Bid to Bid basis with Net Income Reinvested.

REVIEW

Global equities delivered a total return of -9.1% (in sterling terms) over the second quarter as the plethora of risk factors emerging in the first quarter continued to build. Inflation figures across Europe and the US rose above expectations paving the way for swifter and more significant interest rate rises. In May, the US recorded the highest inflation figure in 40 years of 8.6%, for example, driven by shelter, food and gas. Recession fears also intensified as consumers grappled with higher prices and concerns grew that the interest rate response required to quell supply driven inflation threatens to cool demand into recessionary territory. Growth equities derated heavily to factor in an increased discount rate, while defensive businesses with robust cash flows faired considerably better. This led to a wide performance gap between the MSCI World Value index returning -4.4% and the MSCI World Growth index returning -14.9%.

PERFORMANCE & ACTIVITY

The EdenTree Responsible & Sustainable Global Fund fell 11.1% in sterling terms in the second quarter, underperforming the FTSE World benchmark total return of -9.1%. With the market continuing to favour sectors, such as Energy and Tobacco, outside our sustainability focus, the Fund's relative performance was encouraging and reflects the importance we place on valuation as part of our approach.

From an allocation perspective, the overweight positions in Europe and the UK were positive contributors as the regions fell modestly by 8.4% and 4.1% respectively. The UK market's greater value orientation, coupled with sterling weakness and high overseas earnings representation has resulted in the UK being significantly more resilient in the first half of the year, falling only 2.3%. The US underweight was not a meaningful headwind with US markets falling 9.6%, 0.5% more than the global market. Currency headwinds accounted for a 1.2% headwind to Fund performance, offsetting the positive regional allocation.

In terms of sectors, the Fund's nil allocation to Energy was again a key negative, given the geopolitical backdrop: the sector's 2.3% gain resulted in a 0.5% headwind at portfolio level. Over the first half, the energy sector's 35.4% absolute gain has contributed -1.7% to portfolio performance. Another nil-weighted sector that performed strongly was Consumer Staples (+3.3%), which contains stable businesses such as Tobacco (+8.2%) and Beverages (+4.9%) which typically do not pass our negative screens. Positive contributions were made in defensive sectors such as Utilities, up 0.4%, as well as Insurance. The Fund's 8% underweight to Consumer Discretionary was a strong contributor as the sector fell 16.7% on inflationary, cost-of-living concerns.

Stock selection saw some significant positive developments, principally led by **Biffa**, a top ten holding, which gained 17% during the quarter. In early June, Biffa announced it had received a non-binding takeover approach by Energy Capital Partners, an infrastructure fund focussing on decarbonisation and transitional opportunities. We invested in Biffa due to its strong focus on sustainable opportunities within the waste management industry, particularly its strategic plan to capture value within the circular economy. While we are encouraged that others see value in Biffa's business, we feel the organic investment case offers greater long-term upside than the current tabled offer. This is the second waste management, circular economy takeover the Fund has seen in the last year, with Macquarie successfully bidding for our holding in Bingo Industries in Australia. As ever, we remain convinced that businesses exposed to waste, recycling and the circular economy have attractive long-term opportunities given the scale of the sustainable challenge. Another strong performer during the quarter was **Federal Signal**, a US based leader in environmental cleaning vehicles, which gained 14%. Federal Signal's proactive approach to investing in its workforce has

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resulted in multi-faceted gains through this challenging period for labour availability. In terms of detractors, **Marvell Technology** gave back a fair degree of last quarter's 45% gain on concerns regarding the outlook for semi-conductors. Additionally, the limited exposure we have to smaller-cap growth stocks struggled with holdings in **Exact Sciences, Welbe** and **Cambi** falling over 30%.

In terms of investment activity, we undertook a significant risk assessment of European industrial exposure. An area we've paid particular attention to this quarter is the gas shortage risk in Europe, and the implications for our exposed holdings and sustainable solutions more broadly. This is a significant risk for holdings with notable industrial footprints within Europe, which despite our European equity overweight feel we are relatively defensively positioned. Nevertheless, we have taken steps to reduce near term risk. Early on in the quarter we exited **Mohawk Industries**, a global leader in flooring, due to its ceramic business being highly reliant on gas furnaces to fire tiles, in addition to having some exposure to Russia. The outlook for global repair and maintenance appears to be softening, reflecting higher mortgage borrowing costs, which are approaching 6% in the US. Additionally, relatively early in the quarter, we reviewed and reduced our overall exposure to semi-conductors through the divestment of **NXP Semiconductors**, and a reduction in **Infineon Technologies**. While the long-term sustainable case remains relatively sound, the risk of further inventory build leading to a broad over-supply position at this point in the cycle is concerning. We also took the opportunity to exit **Cerner**, which had been subject to a bid from Oracle. We deployed proceeds from these sales in a new holding in **Veolia**, the French-based waste management leader, which was trading at a c.4.3x 2023 EBITDA and 5.5% yield, which appears deep value, particularly given we lose Biffa to corporate activity. Another new holding in the quarter is **Mapfre**, a Spanish listed responsibly aligned insurer with exposure to growing Latin American markets, and an attractive valuation of c.0.5x P/B 2023 and a 9% yield.

OUTLOOK

With year-to-date drawdowns of 20% across most developed markets, the excessive multiple expansion we have seen over previous years has now reverted closer to the long-term average. With earnings estimates yet to fall materially, how well companies navigate this earnings season will be telling – nominally revenue is likely to be aided by price dynamics, but the extent of cost and margin pressure will as ever depend on the strength of business models and pricing power.

Over the next six to 12 months, the biggest uncertainties for markets will be the level interest rates are expected to peak. Central banks have been late to tighten policy and address the inflationary problem. The urgency to reverse exceptionally easy monetary conditions has led to the Fed raising rates by 75 basis points in a single meeting, with potential further 75 basis point hikes still to come. Its primary aim is to quickly bring demand back in line with supply, yet its dual mandate, which comprises essentially two lagging indicators, unemployment and inflation, has arguably delayed its response. While high inflation in tandem with low levels of unemployment continued to support the case for more hawkish action, the Fed could meaningfully over-tighten based on this data, before having to reverse due to a deteriorating growth outlook. Markets appear to see a "soft landing" scenario – the Fed raising rates enough to tackle inflation but not plunge the economy into recession – as increasingly difficult to achieve. The other side of the price determination equation, supply, has been constrained temporarily, in some cases due to China's zero-Covid policy, while in others there could be more structural forces at play, such as the reverse of globalisation and resource protectionism. The risk from a more structural change is that inflation could be stickier and may require greater demand side tightening, in other words, much higher rates. Naturally, this increases the risk of a more prolonged hit to growth.

In Europe, the growth and inflation outlook will naturally be determined by the geopolitical backdrop. Europe's dependency on Russian gas has proved highly problematic in the wake of the Ukraine war; overall, Russian imports of gas to Europe are down by a third. Within Europe, Germany and Italy are most vulnerable. They import nearly all of their gas needs, with Russian gas accounting for 65% and 40% of supply respectively. Regional supplies could fall further or stop altogether, fears about which have increased with Nord Stream 1 due to shut temporarily in July for scheduled maintenance. Some feared this could be the point where the flow of Russian gas does not return. Germany announced it has moved into phase two of its three stage emergency energy plan, allowing higher prices to be passed onto consumers in the hopes of reduced demand. The next and last phase would require the rationing of gas, with this burden to fall upon industrial activity, while essential services and households are afforded special protections. If Russia does continue to hold Germany to account by withholding gas, we are likely to see the industrial engine of Europe slow quickly. This will create a different challenge for the ECB, who are more versed in fighting the recurring fragmentation risks arising from a weak periphery. All told, we would expect lower growth and lower rates in Europe, even if climbing inflation leads to rate rises in the short term. It is also notable that the ECB will use an anti-fragmentation tool to help stop the divergent borrowing costs across the bloc.

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From a sustainable solutions perspective, while further reductions in Russian gas supplies will put pressure on prices, and will force homes and industries to reduce consumption, it will ultimately increase the uptake of energy efficiency solutions and, over the medium to long term, clean, independent and secure energy. However, in the short term, governments are also responding through distinctly less sustainable solutions, such as the reopening of coal-fired plants. We anticipate that gas supply shortages combined with shorter term thinking behind the government response to be detrimental to longer term climate change targets.

In Asia, China could exhibit similar dynamics to developed markets in 2021 when they eventually emerge from their zero-Covid policy. However, the low percentage of the population that have been effectively vaccinated suggests this may take longer than consensus.

To obtain further information please speak to your normal EdenTree representative, visit **www.edentreeim.com or call** our support team on **0800 011 3821**

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