Liontrust Sustainable Future Managed Funds – 2022 in review

- **The Sustainable Future investment process has served clients well over the last two decades but 2022 was without doubt the most challenging year since its inception.**
- **An abrupt change in the macroeconomic and geopolitical landscape negatively affected almost all asset classes. Notably, bonds failed to provide the diversification of returns seen in many prior years.**
- **Although the five Managed funds invest in different blends of global equities, equity infrastructure, corporate bonds, gilts and cash according to their risk profiles, each suffered similar negative returns.**
- **Following 2022's correction in asset prices, we now view valuations as very attractive in a number of areas.**
- **While financial markets endured a volatile year, the key sustainable investment themes we invest in – supporting a cleaner, healthier and safer future – look stronger than ever. We believe this will support the future performance of our equity investments.**
- **After government bonds suffered their worst returns in 20 years, we took advantage of rebased valuations to increase allocation to the asset class and raise portfolio duration. We think the market is pricing in too many interest rate hikes next year, leaving bond yields looking attractive.**
- **In more muted economic years ahead, we expect the strength of our sustainable themes and the quality of the businesses we invest in will allow for much stronger performance.**

Over the last 22 years, our Sustainable Future investment process has focused on companies enabling and benefiting from the progress towards a *cleaner*, *healthier and safer* world.

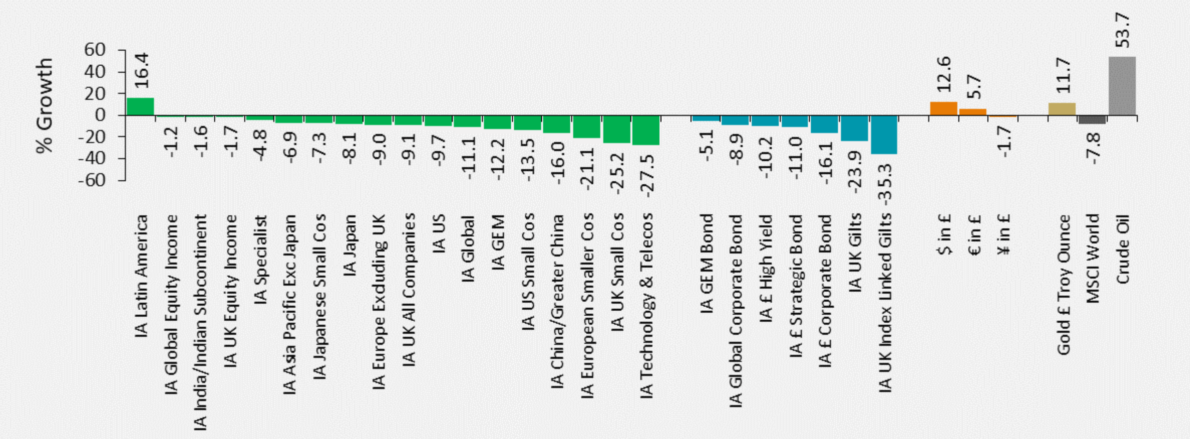
Our process has served our clients well over the last two decades; however, 2022 was without doubt the most challenging year since the inception of the Sustainable Future range of funds in 2001. A sharp market rotation towards 'value' stocks, combined with an exceptionally challenging macroeconomic and geopolitical environment that impacted nearly every asset class, hit our Funds particularly hard.

We began the year with very low central bank rates, stimulative government policies, and bottlenecks in global supply chains causing prices to rise for scarce products and labour. The first two were well-intentioned interventions to prop up economies through the shock of the Covid-19 pandemic, though in hindsight were applied for too long. Inflationary pressures were compounded by the Russian invasion of Ukraine, which exacerbated energy price inflation, and lockdowns in China, which put further strain on global supply chains.

Central banks reacted to worsening inflation by shifting to aggressive tightening of monetary policy. This was an abrupt change in macroeconomic backdrop which sent markets into a tailspin, with almost all asset classes falling in response to a higher cost of capital.

As illustrated by the IA sector returns for the year, very few asset classes were able to deliver positive returns against this backdrop. As interest rate expectations rose, bond yields moved significantly higher while equity markets suffered losses which were worse among long duration areas, such as the growth and quality-style equities the SF funds invest in. Gold, oil and Latin American equities were among the few asset classes to notch a positive return over the year in sterling terms.

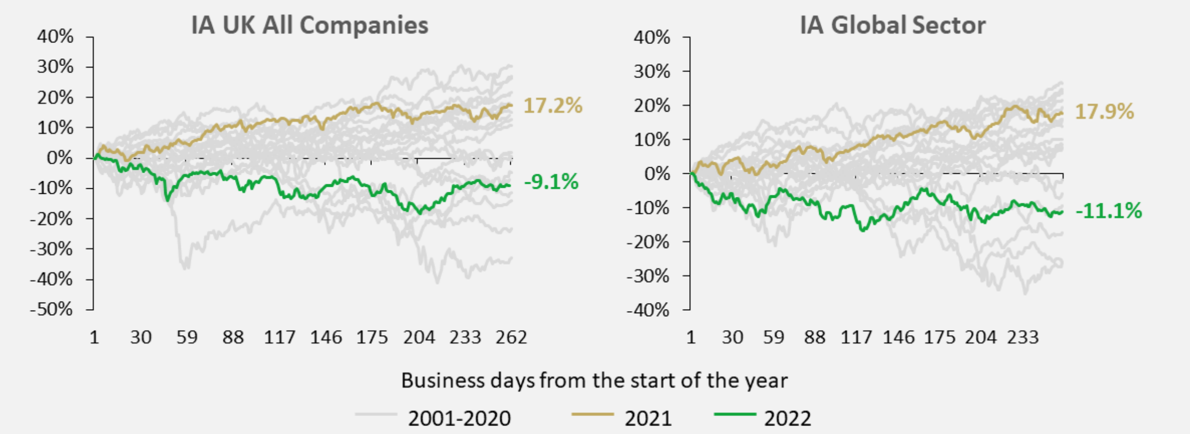
IA sector performance | 2022 performance



Source: Liontrust, FE Analytics, data as at 31.12.22

As a result, 2022 was one of the poorest of the last 20 years for both UK and global equities. However, what is most notable about last year is the lack of diversification provided by fixed income markets. In particular, the 23.9% fall suffered by the IA UK Gilts sector is by far the worst calendar year performance in the past 20 years. This stands in stark contrast to the dependable, steady positive returns in almost all other years over that period.

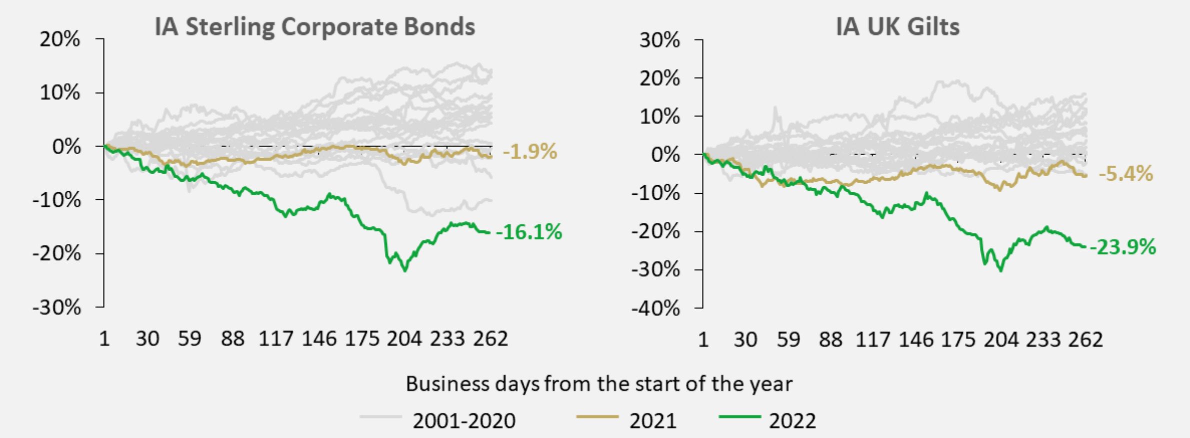
Equities | Calendar years



Source: FE Analytics, as at 31.12.22, total return (net of fees, income/interest reinvested), primary share class, in GBP against comparator benchmarks (IA sectors)

Past performance is not a guide to future performance.

Bonds | Calendar years



Source: FE Analytics, as at 31.12.22, total return (net of fees, income/interest reinvested), primary share class, in GBP against comparator benchmarks (IA sectors)

The impact of this weakness across multiple asset classes is evident through the 2022 performance of the Sustainable Future Managed range. Although the five funds are invested in varying blends of global equities, equity infrastructure, corporate bonds, gilts and cash according to their risk profiles, each suffered similar negative returns.

For example, even though the SF Defensive Managed Fund has under 40% allocation to equities, it delivered a similar return to the 100% equity SF Global Growth Fund.

While 2022 saw a painful correction in asset prices, we now view valuations as very attractive in a number of areas and, importantly, we expect the defensive qualities and portfolio diversification provided by fixed income assets to reassert themselves.

The aim of the SF funds is to deliver strong returns by investing in sustainable companies, something we have delivered longer term but not in 2022. The obvious question to ask now is why are we confident that we will not see a repeat of 2022 and that we can deliver stronger returns in the years to come?

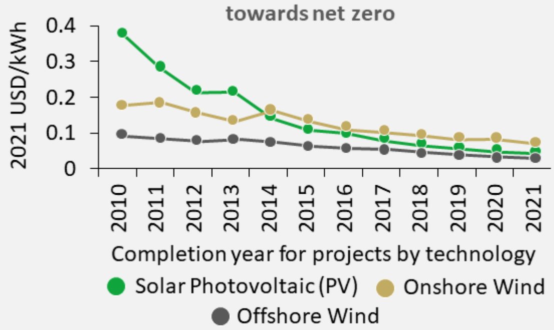
Sustainable investment themes strengthened through 2022

At the heart of our approach is a view that the strongest and most dependable growth trends in the economy are captured by our themes – the move to a *cleaner, healthier and safer* future. It may sound a bold claim but looking at the foundations for our themes, we believe that 2022 was a bumper year, leaving our themes stronger than ever.

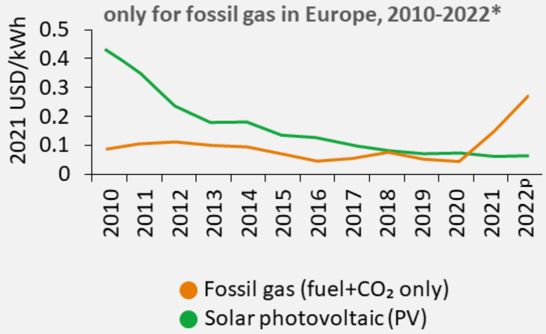
Sustainable investment themes strengthened in 2022

Better resource efficiency

Falling renewable costs mark the next stage in the global energy transition towards net zero



The weighted average LCOE of utility scale solar PV compared to fuel and CO_2 cost only for fossil gas in Europe, 2010-2022*



Source: Liontrust, International Renewable Energy Agency, 2021. *Note: 2022 values are possible outcomes for 2022 and not a forecast

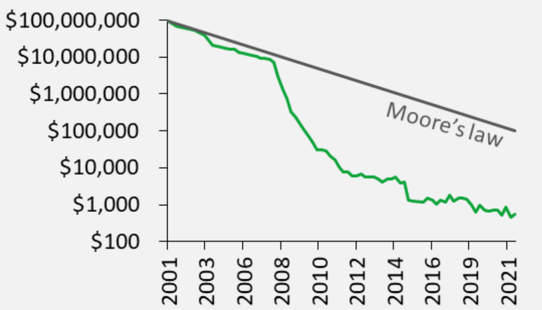
If we look at the picture around renewable energy, for example, which sits within our theme of *Better Resource Efficiency,* the cost of generating electricity from solar and onshore/offshore wind has continued to fall over the past 10 years. In addition, the competitive position of renewables versus fossil fuels has improved dramatically following volatile price spikes in fossil fuels and the very real prospect of not having the fossil fuels required to generate the electricity we need.

When we as societies look to resolve the energy trilemma of being affordable, secure and clean, there is very little that can compete with renewables. We must also not forget government interventions such as the US Inflation Reduction Act (August 2022) which has earmarked $370bn towards reducing emissions, the '*Fit for 55'* EU target of reducing net greenhouse gas emissions by at least 55% by 2030 (which will double the share of renewables), and even China stating its target of being carbon neutral before 2060 and to phase down coal post-2025. These are dramatic changes with exceptional stimulus for this theme and we think the way ahead for energy efficiency and renewables is very strong.

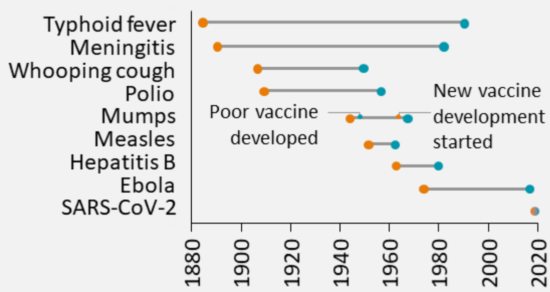
Sustainable investment themes strengthened in 2022

Improved health

Cost per human genome ($ log scale)



Vaccine Innovation



Source: Liontrust, National Human Genome Research Institute, 2021; Our World in Data, Nature analysis 2020

Past performance is not a guide to future performance.

Another one of our important themes focuses on *Improved Health* and moreover, innovation within healthcare. There has been a dramatic change within this theme over the past 20 years, an example being the cost of sequencing a human genome falling from $400 million for the first genome sequenced to around $400 today – an incredible improvement over the last two decades. This is indicative of how much change and advancement there has been in our ability to understand, diagnose and develop treatments for diseases. This has been powerfully demonstrated by the speed at which the Covid-19 vaccine was developed. In comparison, the vaccine for typhoid fever took over 100 years to develop.

We see this innovation driving acceleration in gene therapies and in early diagnosis, leading to entirely new ways to provide early diagnosis and treatment for cancers and hereditary diseases. This is most notably seen in the continuing improvement in cancer survival rates: prostate cancer five-year survival rates have risen from 67% to 97% since the 1970s. Again, this theme of innovation in healthcare has very strong prospects which have been further reinforced through 2022 and we believe our companies exposed to this theme stand to benefit enormously in the long-term.

Sustainable investment themes strengthened in 2022

Greater safety & resilience

Bank	2030 target (£bn)
HSBC	833
Barclays	833
Standard Chartered	300
BNP	565
Société Générale	261
ING	543
Total	**3.3trn**

Source: Liontrust internal research, January 2023

Last among our key themes is *Greater safety and resilience.* If you think that our current energy systems are 80% dependent on fossil fuels, to convert that within the next couple of decades to a clean energy system – one with much lower carbon emission, much greater security and much improved costs – is going to require an enormous amount of capital to be diverted to financing renewable energy. The good news is that through 2022 we have seen extremely strong progress in this regard, with HSBC alone committing $750 billion - $1 trillion towards sustainable financing and investment. This includes helping to finance the early retirement of coal plants in Asia and not financing new oil and gas fields and linked infrastructure.

The total combined amount that six financial institutions in the table above are planning to contribute to financing clean technologies by 2030 is approximately £3 trillion. To put this into perspective, if 1MW of renewables is roughly £1m, then this amount could fund 3000GW, which is equivalent to the entire capacity of US electric generation[1]. This gives an idea of the quantum of capital that is being targeted towards renewables, and the critical importance of banks being prepared to finance these projects.

Put simply, the themes we invest behind have strengthened in 2022 and provide areas of strong dependable growth for our companies.

[1] If we assume a 30% availability factor for renewables.

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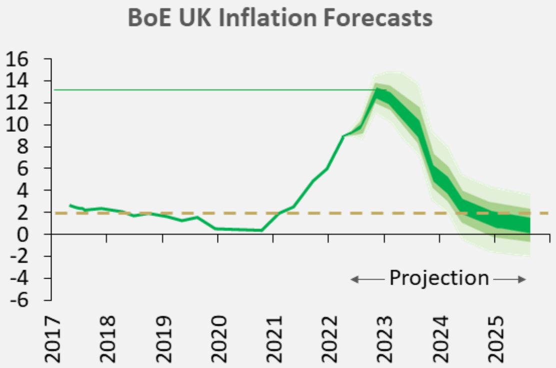
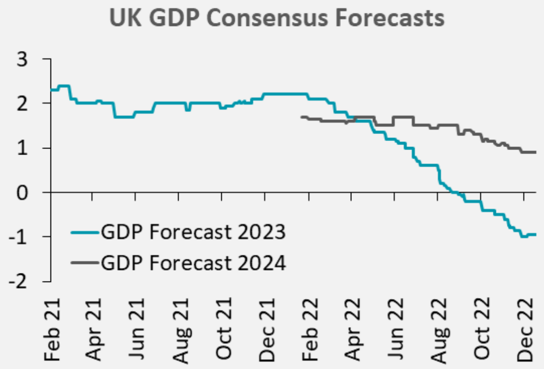
Bond market correction creates opportunity

In 2022, government bonds suffered their worst returns in 20 years (with 2021 ranking second worst), the result of an exceptional set of macroeconomic headwinds which included central banks abandoning their transitory inflation narrative to pursue aggressive policy tightening as inflation soared to 40-year highs.

The market is currently (as of January 2023) pricing in another four 25 basis point interest hikes, which we think is over-aggressive and unlikely. Even looking at the Bank of England's own projections, it is hard to see much need for further tightening. Having peaked at 11.1% last October, inflation is predicted to now fall to 2.5% in 2024, not far off its 2.0% target while the UK economy is now expected to suffer a shallow recession this year.

Rates | Economic outlook





Source: Bank of England as at 01.05.22; Bloomberg as at 31.12.22. CPI – Consumer Price Index

The nature of inflation is important to understand too; we are seeing 'cost-push' inflation which has come from a shock to supply chains, not the more typical 'demand-pull' variety of inflation that you might see in a strongly growing economy. Trying to control inflation by suppressing demand (via rate rises) will therefore have limited results. We would view any further hikes as likely to be economically damaging but have little impact in reining in inflation.

Given we think the market is pricing in too many rate hikes, UK gilt yields of 3.5% look very attractive. While we have no structural duration bias within the funds, we actively manage interest rate exposure and have raised gilt exposure and duration to reflect our constructive outlook.

Turning to corporate bonds, we see significant opportunity here too. On aggregate, corporate fundamentals are strong: leverage is significantly below long-run trends, maturity profiles were termed out when yields were low and interest coverage is high (double the long-term average). While we think the economic environment is challenging, corporate issuers are in good shape to withstand a weakening in fundamentals towards long-run averages.

Considering valuations, investment grade credit spreads look attractive on a number of measures. In the last 25 years they have only really been higher in a handful of exceptional periods: the global financial crisis (GFC), eurozone crisis, Brexit and Covid-19 lockdown. Current spreads are around twice the pre-GFC average and – in the European market – imply a 5-year default probability of 10%, compared to a long-term average of 4% and all-time worst level of 4%.

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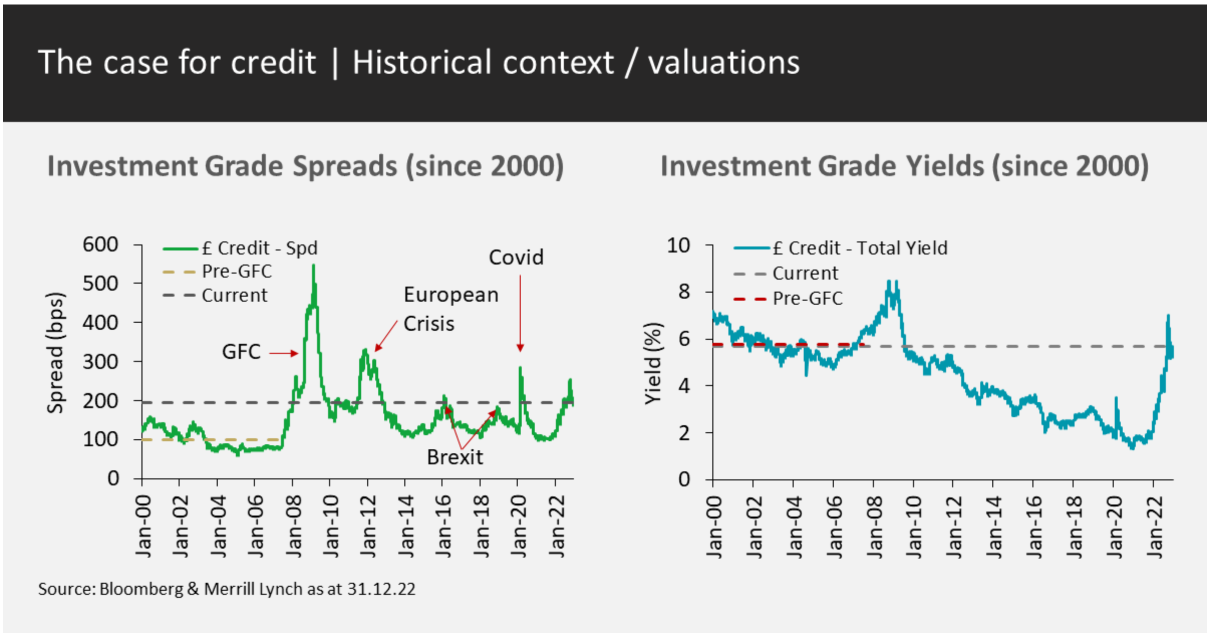

Because corporate credit spreads are high while government bond yields are rising, the 'all-in' yield on investment grade corporate bonds – the sum of these two components – is at a very attractive level of around 6%.

Asset allocation changes

From an asset allocation perspective, the market activity we saw over 2022 has presented an opportunity to rebalance portfolios. The main change we've made is to deploy cash to take advantage of the improved valuation of UK government bonds. Following a decade being maximum underweight to gilts, we have reduced the underweight and increased duration. We have maintained the overweight position in corporate bonds, taking advantage of attractive yields to also increase duration.

Within the UK and global equity allocations, we have maintained neutral positioning, but sought to add to high-quality holdings that have sold off too heavily. The other asset allocation change has been to reduce the overweight infrastructure position, taking some profit from electricity generators after a strong performance.

Conclusion

In summary, 2022 has been an exceptional period with dramatic changes in the value the market ascribes to assets and our strategies have been particularly affected. However, the longer-term track record of the funds remains strong, and we believe the prospects of our equity and corporate bond portfolios are strong.

To reiterate, we do not attempt to forecast or anticipate the moves in macroeconomics that we have experienced in the last 18 months. Our focus is resolutely on our 20 sustainability themes that over the long-term should provide strong and stable growth, relatively independent of economic cycles, and on finding those rare companies that harness this positive growth and which generate persistently high returns on capital. In more muted economic years ahead, we expect the strength of our sustainable themes and the quality of the businesses we invest in will allow for much stronger performance.

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For a comprehensive list of common financial words and terms, see our glossary at:
liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

Key Risks and Disclaimer

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