Schroder Global Sustainable Equity (Wholesale Class)

Fund commentary

Markets continued their upwards momentum in the opening quarter of 2024, building on 2023's strong finish to the year on increasingly bullish sentiment. The outlook for the global economy was bolstered on multiple fronts. Continued US economic strength and resilient wage and employment trends have pushed out expectations for imminent cuts while an improved economic outlook for much of Europe teamed with receding inflationary pressures has increased the possibility of ECB rate cuts this year.

AI bulls remained validated by exceptional earnings results by US tech leader Nvidia, sparking a renewed rally across key industry beneficiaries and helping the Growth index outperform the broader market although on an equal weighted basis, Value outperformed Growth. The broader recovery in Value was particularly within quality value, a space favoured within the QEP process given our targeting of both Value & Quality characteristics.

Amidst this backdrop the strategy finished Q1 ahead of its reference index. The strategy benefitted from broad based performance contributions as market breadth increased and stock selection was positive in a range of areas.

Avoiding low quality spaces, which sold off heavily, was beneficial over the quarter while positioning in cyclicals was a key contributor as our focus on quality was rewarded. Stock selection was particularly strong within financials and industrials as our favoured names in insurers and banks outperformed, as did our holdings in manufacturers and construction related industries. Elsewhere, our diversified positioning across structural growth opportunities in in technology aided. We find compelling opportunities within Taiwanese semiconductors and hardware where valuations remain reasonable, along with select names in Europe and the US which provided support as they moved higher on expected strong revenue growth driven by AI-demand.

A headwind to performance was deeper value exposure to best-in-class European integrated oil & gas majors. A preference for these names over North American peers detracted most significantly as they underperformed.

The portfolio continues to have exposure to a wide range of themes across our pillars of Quality and Value. Our focus in portfolio construction at this juncture is to maintain a balanced exposure to help diversify the strategy and manage for a range of potential market outcomes. With markets rising strongly we remained diligent in profit taking where opportunities arose, rotating into more compelling options particularly within higher quality areas left behind during the market rally.

With strong performance seen across our holdings within the technology sector, this was a key area we took profits over the quarter and have moved to a neutral exposure relative to the index in favour of more compelling opportunities elsewhere. That said, this remains our largest absolute sector weight and we remain focused on stocks demonstrating stronger growth characteristics with still affordable valuations, notably within semis and application software. Elsewhere, an exposure to stable quality areas persist to provide a defensive hedge against potential downside risks. Our preferred holdings within this space are in select consumer staples trading at reasonable valuations as well as global pharmaceutical stocks that are priced cheaply.

Attractive opportunities continue to reside within financials as well as select cyclical areas across both consumer discretionary and industrials. Within financials we maintain our diversified overweight allocation to both payments and banks while we also find attractive opportunities within insurers where we have increased our allocation. Across these areas our focus remains on those companies with higher quality characteristics, and a range of opportunities exist globally to buy such names at attractive valuations. In consumer discretionary, we retain a preference for traditional retailers and hotels & leisure names, partly funded at the expense of online retail where valuations are less appealing and apparel.

At a regional level, we have an index like allocation to the US after taking profits in select names over the quarter. We continue to hold an overweight exposure to the UK and Continental Europe where we find a broader range of opportunities at our preferred intersection of both value & quality. We remain underweight Emerging markets due to their generally lower quality characteristics as well as their greater exposure to sustainability risks versus developed peers.

Market review

Global stock markets continued their march upwards in the first quarter, buoyed by resilient macroeconomic data globally. Whilst the strong gains posted in Q4 were driven in large part by expectations of a dovish US Federal Reserve (Fed) pivot, the continued global rally this year has come on the back of expectations turning hawkish, with stickier inflation and resilient economic activity. Although Growth stocks were again dominant over the quarter on the back of continued AI-related optimism, Value also saw gains with more traditional areas such as financials and energy participating.

US equities continued to lead the advance, helped by healthy corporate earnings with the S&P 500 index enjoying its second consecutive quarter of double digit returns for only the 9th time in the last 80 years. Ten of the eleven GICS sectors finished higher led by communications, energy, technology and financials while real estate was the only sector in the red. Eurozone stocks were also strong with technology again leading while improvements in the economic outlook boosted more economically sensitive stocks. UK equities meanwhile saw more modest gains with the UK economy officially entering a mild recession in the second half of 2023.

The star performers over the quarter were Japanese equities, particularly in local currency terms, with the TOPIX Total Return index reaching an all-time high. This surge was fuelled by foreign investment and optimism about Japan's economic cycle. The Bank of Japan (BOJ) took significant steps to overhaul its monetary policy, including abandoning negative interest rates and yield curve control, although this was widely discounted and led to yen weakness.

Elsewhere, emerging markets also saw gains but underperformed developed market peers as China's struggles dragged on returns and delays in the Fed cutting impacted rate sensitive markets like Brazil. Asian markets generally delivered modest gains over the quarter with India, the Philippines and Taiwan being the bright spots with the latter particularly strong due to its technology heavy index. Central bank policy drove returns in key markets with both Colombia and Peru benefitting from easing monetary policy whilst Turkey also posted strong returns as the central bank continued its orthodox monetary policy approach by increasing interest rates over the quarter. Meanwhile, South Africa was a poor performer against a backdrop of political uncertainty in the run-up to its general election while Egypt generated the worst returns over the quarter on the back of its c. 35% currency devaluation.

Outlook

Equity markets are usually described as climbing a wall of worry during turbulent times but the resilience of stocks this year suggests that investors are firmly focused on the good news rather than the potential for adverse tail events. Admittedly, despite the ongoing conflicts in Ukraine and the Middle East, there has been much to take comfort from. Most importantly, a widely expected global recession appears to have been averted. Some indicators even suggest tentative signs of reacceleration, although it's too early to say whether this will gain traction. Inflation is proving sticky, but the door remains open for rate cuts around the world with the US Fed and ECB still expected to ease in the northern summer. The fact that rate cuts have been delayed (and are likely to be fewer in number than previously discounted) is less of a concern for equity investors as the shift in view is being driven by positive macro momentum. Bond markets are less sanguine but such a divergence of opinion with equities has not been unusual in the recent past.

Our best guess is that the Fed will not want to create unnecessary turbulence in an important election year which should support equities in the absence of a negative shock. Under the surface, it is also encouraging that the narrowness of last year's gains has broadened out beyond the big index stocks. There also appears to be increasing demand for economic sensitivity, which aligns with the re-acceleration argument, but as investors already seem lowly exposed to defensives, this does rather feel like putting all the eggs in one basket. But it may not matter, any rotation in leadership between cyclicals, defensives and structural growth stocks this year will probably be more muted than has historically been the case given that central banks are unlikely to surprise.

It is hard to find historical parallels of other low risk premia periods that rhyme with the current market backdrop, but three possibilities are the mid-1990's, the early stages of the dotcom bubble and the pre-GFC euphoria. Investors currently appear to be discounting the perfectly orchestrated soft-landing of the mid-1990s. AI fuelled sentiment is not yet matching the frenzy which characterised 1999/2000 whilst leverage is clearly not as excessive as it was in 2007/8.

We would not rule out the potential for a bubble developing in big-Tech but a degree of scepticism does seem to be emerging, most evident in their late Q1 consolidation and the performance dispersion between the big-7 index stocks this year. This dispersion is driven by earnings dynamics at the stock level, which is another healthy development but does flag the need for strong earnings momentum to continue. Rather than worrying about the macro or geopolitics, in our minds the key risk to manage today is earnings expectations versus reality at the stock level. As we enter the first quarter earnings season, downgrades have been slightly less than is usually the case which further highlights the risk of disappointment.

With the average pairwise correlation between MSCI ACWI constituents being close to its lowest level in at least two decades, this still feels like a stock pickers market. Our response is to ensure a well-balanced portfolio that is hedged on the market where possible (i.e. a beta close to one) whilst allocating to a broad range of stocks with Value and Quality credentials. This is not requiring us to take significant sector or style tilts as we are not finding it difficult to identify good prospects across the market at present. It also reduces our vulnerability to the macro noise. Given the potential for outsized relative stock gains, it is also important to remain very disciplined regarding profit taking when things have gone well and looking for overreaction where there has been disappointment. In summary, the current market backdrop is offering the opportunity to exploit excess volatility at the stock level without having to make a top-down call, which suits our process well.

Active Ownership

The QEP investment team works in close collaboration with Schroders' Sustainable Investment team to facilitate our engagement activity. Company engagements play an important role in our process, with the information gained key in helping us understand the sustainability issues corporations face and the specific strategies in place to address them. It also allows us to promote change and make clear our transition expectations for the companies in which we invest. The central store of engagement information available to us, covering all Schroders firmwide engagements, also provides useful qualitative information on issues that are otherwise difficult to capture from traditional ESG data sources. Schroders' engagement blueprint includes six priority engagement themes capturing issues relating to environmental (climate change, natural capital & biodiversity), social (human rights, human capital management, diversity & inclusion) and corporate governance.

Several engagements focussed on climate change were initiated in the quarter. Dutch semiconductor equipment company ASML was engaged with to obtain an update on their climate transition objectives. ASML have committed to achieving net zero by 2025, with this ambition covering the company's scope 1 & 2 emissions as well as a proportion of their scope 3 emissions. Their strategy focusses on reducing emissions through energy efficiency while concurrently increasing renewable energies use. The company confirmed energy efficiency has already significantly improved and plans are in place for this to be improved further. Regarding scope 3 emissions specifically, ASML is addressing supply chain emissions via increased supplier commitments to sustainability as well as collaborations with customers, for instance TSMC on renewables adoption. The company's investments to reduce emissions are included within their R&D budget and ESG metrics are now linked to 20% of long-term remuneration for executives. ASML has made considerable progress towards their stated climate ambitions, and we will continue to monitor their progress.

With corporate governance forming an important pillar of the Schroders engagement blueprint, governance engagements were also carried out in the opening quarter of 2024. Remuneration policy was one topic engaged on, and our central Sustainable Investment team contacted Swedish manufacturing firm Assa Abloy. We encouraged them to diversify the metrics used in their remuneration methodology. At present, earnings per share determines all of their long-term incentive programme and almost all of their short-term programme. This is overly simplified and does not capture a broader range of measures that might be useful when assessing the performance of management. As part of this engagement we also requested the company improve the level of their disclosures, particularly around human capital metrics such as fatalities, training hours, turnover and the result of engagement surveys.

Our stewardship process extends to a proactive voting programme, a mechanism we can leverage using the weight of Schroders' asset base and associated voting rights to drive our engagement priorities. We make considered use of our voting rights, acting in line with our fiduciary responsibilities in what we deem to be the best interests of our clients. As a firm, Schroders votes on all resolutions unless we are specifically restricted from doing so with all voting carried out by Schroders' corporate governance specialists. We voted at over 270 meetings on almost 3,000 resolutions for companies held across the QEP desk in the first quarter of the year. Within these votes, around 15% were not with management. Votes against management were focussed on compensation plans, the election of directors or auditor related. We voted against Inpex's director election proposal due to a lack of gender diversity on their board at present and did similarly for D.R. Horton also. We also voted against Applied Materials' executive compensation proposal given certain targets set below median performance and a lack of sufficient disclosure on the broader set of targets used for justifying awards. In addition, there is high-level of remuneration inequity among named executive officers.

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