LOWES
INVESTMENT MANAGEMENT

Ethical RL3

Quarterly Report to 31 December 2023

Objective

To provide capital growth by investing in a diversified portfolio of funds classified as investing with an ethical outlook.

Strategy

The portfolio utilises funds investing both in equities and/or fixed interest assets. The funds used all meet strict ethical and socially responsible criteria and mainly do this by excluding investment in certain sectors and industries. In order to meet the desired Risk Level, the portfolio is constructed to meet the IA's guidelines for a Mixed Investment 40% - 85% Shares fund.

Market Commentary

After a difficult month of October most asset classes ended the quarter in positive territory. Stubborn inflation data, coupled with the potential that interest rates could remain higher for longer, initially caused concern that the global economy could potentially see a harder landing than some commentators were expecting. This had a negative impact on both equity and fixed income markets, with both asset classes remaining positively correlated.

During November, however, we started to see some sign of hope that inflationary pressures maybe starting to ease, particularly in the US, which gave asset markets reason for cheer. This was confirmed somewhat in December, when we saw a change in rhetoric from the US Federal Reserve regarding the outlook for interest rates in 2024. The latest dot plot, which plots the interest rate expectations for policy setting committee members, showed that the median expectation for 2024 was for three interest rate cuts. This caused not only fixed income prices but also equity prices to rally. Whilst the Bank of England and European Central Bank were more stubborn in their policy stance, insisting that they needed further evidence that higher inflation had been beaten, the market gave their view little credence, and priced in rate cuts anyway.

UK fixed income markets therefore posted a strong return for the quarter. Returns were particularly strong within investment grade and UK government bonds (gilts), given their higher interest rate sensitivity. The longer the duration, the stronger the return. Despite their lack of interest rate sensitivity, high yield/non-investment grade bonds also performed positively. Their return is more sensitive to changes in the credit outlook and, for now, this appears to be relatively stable, with little change in current or forecast default expectations.

In local currency terms it was US equities which led the way. The Nasdaq posted a strong return for the quarter, with the 'magnificent 7' companies of Apple, Amazon, Alphabet, NVIDIA, Meta, Microsoft and Tesla, continuing to deliver. Their dominance, however, was not as strong, with smaller companies head of the pack, the Russell 2000 index outperforming the Nasdaq and S&P 500. The latter performed strongly on the back of the interest rate cut expectations, which increased hope that the US economy may be able to avoid a hard landing. It was a similar picture in the UK, where the mid-sized outperformed large sized companies.

There were also positive returns for European and Japanese equities. Woes continued to be seen further east, however, with the Hang Seng posting a negative return. The market failed to be buoyed by the rally seen in western markets. This was despite economic growth for the third quarter being above expectations, and year on year almost in line with the official annual target of 5%, coupled with a benign inflation outlook. Concerns remained that the property sector issues were still to take full effect.

Performance

The portfolio posted a return of 8.84% for the quarter, which compared to the IA Mixed Investment 40-85% Shares sector average return of 5.76%, therefore showing strong outperformance.

All funds allocated to within the portfolio outperformed the sector average with the exception of one. Their were two equity funds which delivered double digit returns, being Aegon Ethical Equity and Liontrust UK Ethical. Both funds benefitted from a meaningful exposure to UK mid-cap companies, which outperformed their large cap counterparts on the back of interest rate cut expectations which were expected to support the economy. There were also high single digit returns for Jupiter Ecology and abrdn Ethical Corporate Bond.

The weakest performance came from Troy Trojan Ethical Income. This fund invests in companies with strong quality characteristics. This includes companies with barriers to entry in their sector/industry, a strong brand/franchise, low levels of debt on balance sheets and high levels of recurring revenue. These types of companies did not participate to the same degree as other stocks in what were strong returning markets. It continues to provide ballast to the equity holdings within the portfolio, however, should we see any sort of economic or earnings downturn. In absolute terms it also achieved an almost 5% return in the quarter.

Portfolio Activity and Positioning

Following changes made in the previous quarter there were none made during this.

We continue to review the underlying funds that are used within this portfolio. Not only must they be suitable in terms of their performance, but also the ethical criteria which they follow, typically achieved through negative screening. We continue to assess these relative to the fairly recent launch of sustainable and impact funds which are now available. These funds tend to have positive screening in the first instance, which can mean that stocks may be invested in which would be considered as failing ethical screening. We therefore look to ensure when reviewing these funds that negative screening is carried out also.

We continue to monitor and evaluate the asset allocation and fund selection within the portfolio, reviewing in context with current and forecast market expectations, along with the economic outlook. Within the fixed income exposure we continue to maintain a blend of funds with shorter and longer duration. Whilst inflation certainly looks like it is headed in the right direction, it could still be too early to call that it has been defeated. This, coupled with the still higher yields available at the shorter end of the yield curve, means that bonds with lesser time to maturity still look more attractive than they have for some time. Markets have already priced in a significant level of interest rate cuts for 2024 and the key question is the market right or has it got ahead of itself.