Sustainable Managed Portfolio Service

Quarterly report – Q3 2024

RBC Brewin Dolphin

Introduction

Welcome to the RBC Brewin Dolphin Sustainable Managed Portfolio Service (SMPS) investment review. In this report, we cover information and events that influenced performance during the third quarter of 2024.

This year was always going to be an important one from a political perspective, as it is estimated half the world's population will have, or have had, the opportunity to vote during 2024. In July, the UK saw a Labour Party landslide win with a majority of 174 seats, their largest in a quarter of a century.

In September, the Federal Reserve and the European Central Bank both cut interest rates, while the Bank of England and the Bank of Japan remained on hold. Neither cut had quite the same market impact as the latest stimulus measures from China.

The People's Bank of China (PBOC) cut its reserve requirement ratio (the percentage of deposits that commercial banks are required to hold in reserve, rather than use to make loans or invest in other assets) by 0.5 percentage points. The governor of the PBOC, Pan Gongsheng, seemed to suggest further cuts are coming.

China's Ministry of Finance is also planning a significant fiscal support package. It's expected that part of this will be used to subsidise upgrades to existing consumer goods (most notably cars), as well as an explicit payment per child for families having more than one child – a significant incentive to have more children at a time when China's demographic woes are coming into sharp focus.

Manufacturing activity slowed towards the end of the third quarter. The U.S. saw a particularly abrupt slowdown, though its services sector remained quite robust. However, growth in the U.S. was a healthy 3%, essentially maintaining the pace of the second quarter. Europe saw some evidence the manufacturing slump was continuing, and the services sector seemed to be losing momentum as well. The case for interest rate cuts in Europe is strong.

Although the U.S. economy is slowing, rather than slumping, policy makers are likely to continue cutting interests rates gradually, with rates ultimately falling to below 3% in the UK and U.S., and potentially as low as 1% in the Eurozone.

The big picture in Q3

- The quarter saw a number of high-profile asset managers withdraw from Climate Action 100+ as the project continued in its second phase. These departures were almost exclusively U.S.-based institutions reacting to political pressure applied by lawmakers ahead of the presidential elections later this year.
- New MSCI research suggests companies that scored the highest on the social pillar in MSCI ESG Ratings outperformed their lowest-scoring peers across North America, Asia Pacific and Europe over the past 11 years. The top performers also scored the highest on three social metrics: human capital, product liability, and stakeholder opposition. ESG (environmental, social and governance) scores are complicated however, and establishing causality is difficult.
- The packaging sector is the largest generator of single-use plastic waste in the world, using nearly 36% of all plastic produced for packaging. Google leads the charge by making the packaging of devices 100% plastic-free, well ahead of its 2025 plastic-free goal. Its Plastic-Free Packaging Design Guide sets a new industry standard for others to follow and encourages other companies to reduce their packaging waste.
- RBC Capital Markets' research points out that the 2024 proxy season was strong for governance proposals, with a higher attention placed on shareholder rights. Artificial intelligence (AI) and biodiversity were new issues on the ballot, highlighting the importance of disclosures on ethical guidelines and boards roles in AI use. The financial sector remained in focus, with proposals requiring the disclosure of clean energy supply financing ratios (ratio of low carbon energy to fossil fuel energy financing). Anti-ESG shareholder proposals received very low support levels.
- The quarter ended with the positive news that the UK's last coal power station at Ratcliffe-on-Soar is ending its operations. This marks a milestone in the UK meeting its decarbonisation targets after a rapid transition away from coal in recent years (in 2012, it still generated 39% of the UK's power). A surge in renewable energy production has helped substitute away. In 2010, renewables generated just 7% of the UK's power. By the first half of 2024, this had grown to more than 50% – a new record.

Market overview Q3 2024

- Q3 2024 saw a positive return across most asset classes. Gold stood out with a strong return of 6.5%, while Absolute Return offered a more modest 1.2%. Global property was the top-performing asset class overall, delivering a 10.6% return.
- Bonds also gave a positive return over the third quarter, and global bonds outperformed their UK counterparts. Global corporate and sovereign bonds rose 4.8% and 4.1% respectively. UK gilts and corporate bonds advanced 2.4% each, while inflation-linked bonds returned 3.2%.
- In the equities space, Developed Asia ex Japan was a notable outperformer, returning 4.4%. The UK equity market also performed reasonably well, with a return of 2.3%. However, Developed Europe ex UK and Emerging markets, together with Japan and North America, saw a broadly flat performance.
- Q3 2024 saw political surprises, with assassination attempts on former U.S. President Donald Trump, and Vice President Kamala Harris replacing President Joe Biden as the Democratic nominee in November's U.S. election. Despite the upheaval, the presidential race continues to be tight. In the near future, the U.S. elections will be a major focus, with complex investment implications based on the outcome and control of Congress.
- Globally, the picture is mixed. Germany may have slipped into a recession, while France's new minority government faces challenges in implementing tough choices. Even though it's slowing down, the U.S. economy is still robust, and interest rates were cut by a significant half percentage point in September. Japan defied the trend by raising interest rates as inflation returned after nearly three decades of deflation.
- The Labour Party's promise of 'hard choices' has already had an impact on consumer and business confidence. However, the economy is still fairly robust and growing at a moderate pace. The Autumn Budget announced on 30 October will be closely watched for any changes to fiscal plans.
- China's recent stimulus package has provided a boost to the stock market, but its impact may be temporary without sustained support.
- The global economy has so far adapted to high interest rates and fluctuations in demand without suffering a significant recession, thanks in part to increasing oil supply and low Chinese demand.

Sustainable MPS performance highlights Q3 2024

Asset allocation

What worked and why?

The quarter saw volatile equity markets, with investors showing some signs of scepticism over the continued outperformance of the U.S. technology sector. However, positive earnings releases helped ease these concerns. This, combined with a softening in the labour market and a taming of inflation, meant that our overweight positions to global property and gold were rewarded.

What didn’t work and why?

Corporate bonds saw positive returns during Q3, which meant that the underweight position was a mild drag. However, this was largely offset by the overweight to sovereign bonds.

Fund selection

What worked and why?

NinetyOne Global Environment was one of the largest contributors to portfolio performance, benefitting from its positioning in Chinese stocks, which rallied on news of fiscal stimulus in China at the end of the quarter. Schroders Global Sustainable Value also contributed well, with its more defensive stocks performing very well.

What didn’t work and why?

It was generally managers holding growth and technology stocks that performed poorly, as there was a pullback in stocks in this area. This particularly affected Brown Advisory US Sustainable Growth, Baillie Gifford Positive Change, and CT Responsible Global Equity.

The value of investments can fall and you may get back less than you invested.

Sustainable MPS portfolio changes Q3 2024

Asset allocation

The Asset Allocation Committee advised for no tactical changes during the third quarter. It was felt that the overweight position in sovereign bonds remained appropriate ahead of the forthcoming interest rate cutting cycle by central banks. The underweight to corporate bonds has been kept, as credit spreads remain at the tighter end of the range. This implies investors are still not being adequately rewarded for the additional risk of these bonds compared to government issued debt. Overall, portfolios remained overweight global equities, with more diversifying exposure to bonds and alternatives in lower risk profiles.

Fund selection

There were no fund changes to fund selection in the portfolios during Q3.

Information is provided only as an example and is not a recommendation to pursue a particular strategy.

SMPS performance

SMPS performance (%)	Q3	2024 YTD	1yr	2yr	2022	2023
Income Portfolio	2.3	4.9	11.2	15.1	-11.7	7.5
Income Higher Equity Portfolio	2.0	5.4	11.9	16.5	-11.7	8.3
Balanced Portfolio	1.7	5.6	12.2	17.0	-11.5	8.5
Growth Portfolio	1.3	6.2	13.1	18.7	-11.6	9.4
Global Equity Portfolio	0.9	7.0	14.2	21.1	-11.7	10.7

All figures shown above are calculated to 30 September 2024. Inception date: 26 April 2021

Performance Calculation: All income is reinvested. Performance is shown inclusive of underlying fund charges but gross of RBC Brewin Dolphin's investment management charge. Deduction of this charge will have the result of reducing the illustrated performance. Neither simulated nor actual past performance are reliable indicators of future performance.

Funds in focus Q3 2024

BNY Mellon Sustainable Global Dynamic Bond

This fund stands out in the alternatives space as it combines a deep and thoughtful level of environmental, social and governance (ESG) integration with a long-standing fixed income investment strategy. In the 18 years since its inception, the core fund, on which this is based, has successfully navigated many different market environments by leveraging the deep pool of fixed income resource at Newton Investment Management.

In a nutshell, the strategy looks to invest in an unconstrained manner across fixed income markets, in order to deliver modest outperformance over cash in a very low-risk manner. This flexibility allows the team to only own assets when they look attractive, and trade out of them when they don't – with the ultimate goal being a positive absolute return in most market environments. In addition to physical bonds, the strategy will also selectively use derivatives and foreign currencies as further tools to manage its risk and generate returns.

From a sustainability perspective, the fund will only invest in the bonds of governments and companies that are positively managing the material impacts of their operations on the environment and society. In doing so, the strategy will naturally favour issuers in sectors such as renewable energy and social housing, while avoiding any exposure to harmful sectors like tobacco and gambling.

A further strength of this process is the team's proactive engagement with bond issuers, which looks to help and encourage companies to address ESG issues. One such example is battery manufacturer Clarios, which the team engaged with on its sustainability blueprint, the setting of environmental goals, and sustainability-linked debt facilities. This particular engagement was deemed a success, after it was referenced publicly by the company as an aid to the formation of its ESG strategy, key performance indicator setting, and frameworks.

Oliver King
Analyst

Funds in focus Q3 2024 continued

Ninety-One Global Environment

The fund seeks to outperform the MSCI ACWI (global equities) over the long-term, with a quantifiable carbon-saving impact. The team invests in a concentrated portfolio of 20 to 40 companies that are deemed solution providers for decarbonisation – meaning companies having products and services that avoid carbon and help address climate change. The team spends a lot of time analysing regulatory changes, technological process, and shift in consumer behaviour – all of which are considered important drivers of the trend towards decarbonisation.

The portfolio managers, Deirdre Cooper and Graeme Baker, are dedicated to the sector, with specialist experience in conventional, new and renewable energy, as well as broader climate solutions. Deirdre has a long-standing experience in the sector, having worked as a vice president at Morgan Stanley, where she founded the firm's European Renewable Energy and Clean Tech Franchise, and subsequently at Ecofin, where she managed a $1bn clean technology sleeve for Norges Bank.

The portfolio is constructed around three main themes which are important drivers of global decarbonisation: resource efficiency, renewable energies, and electrification. While there were some concerns around overcapacity in the solar and electric vehicle sectors in China, the speed of artificial intelligence (AI) development presents a structural growth driver for power demand, thus providing a tailwind for low-cost renewable energy, and for resource efficiency companies essential to the build-out of new data centres.

AI is creating a new long-term structural growth driver which is supported in the medium term by the new falling rate trajectory, lowering capital-intensive businesses' funding costs and supporting their valuations. The portfolio managers believe strongly in the decarbonisation opportunity set and the outlook for the portfolio companies.

Fiammetta Valentini
Analyst

ESG reporting for SMPS Income

(as at 30 September 2024)

Carbon Intensity

Carbon Intensity measures a portfolio's exposure to carbon intensive businesses and is a recommended metric for assessing Carbon Risk by the Task Force on Climate Related Financial Disclosures (TCFD). It is calculated as a weighted average of each portfolio companies total Scope 1(1) and Scope 2(2) Carbon Emissions divided by their annual Sales, with a lower score representing less (better) Carbon Intensity.

Comparisons of Carbon Intensity figures should be made with caution, as generally companies in the sectors with the highest Carbon Emissions (such as Utilities) also have the highest potential for reducing their Carbon Emissions. We believe it is important to encourage these reductions in carbon emissions where they have the potential for highest impact.

References:

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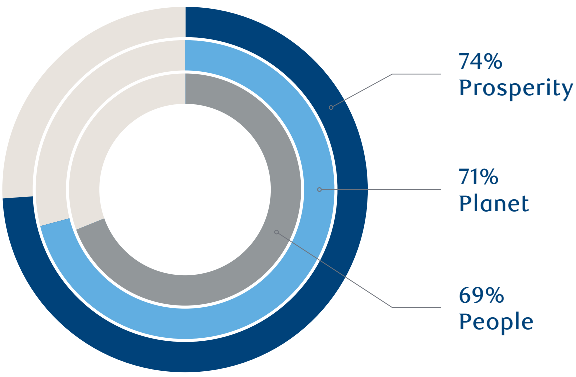
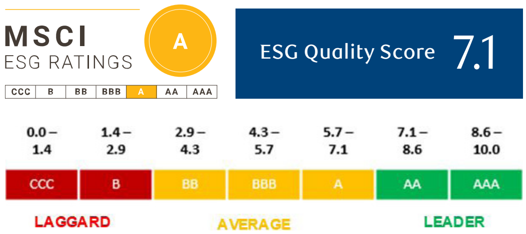
Benchmark for comparison: 45% Global equity, 55% Global aggregate bonds

SDG Alignment



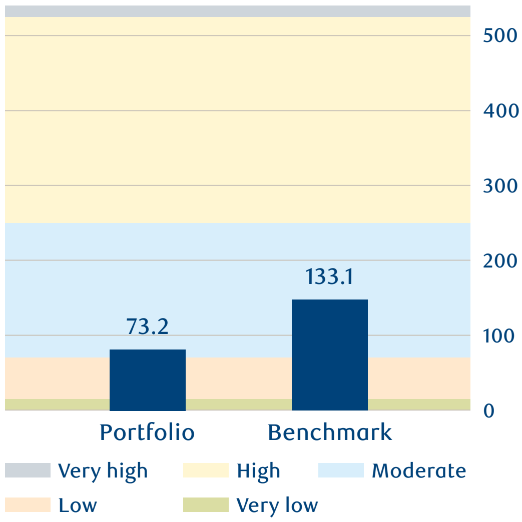
Prosperity Planet People

MSCI ESG Ratings



MSCI's ESG ratings are designed to measure a company's resilience to financially material, environmental, societal and governance risks. They are not meant to serve as a measure of corporate goodness, a barometer on any single issue or a synonym for sustainable investing.

Carbon Intensity vs Benchmark (TCO_2e / \$m sales)



The UN SDG Alignment provides a framework for considering a broad set of seventeen sustainability issues. Although not intended for investment purposes, it provides a useful context for measuring a portfolio's alignment with these goals.

We select 12 of these SDGs and place them into three sustainability themes: People, Planet, and Prosperity, with each sustainability theme consisting of four SDG goals. We use fund alignment data from MSCI to measure the alignment of the portfolio to each of our three sustainability themes. To calculate this, we take a weighted average of each fund's alignment to each of the three sustainability themes.

For instance, if Fund A is a 10% holding in the portfolio, and within the People theme is aligned with both "Zero Hunger" and "Gender Equality" but not the other two SDGs, then the fund will contribute 5% to the overall score of the People theme: 2.5% through Gender Equality and 2.5% through "Zero Hunger".

ESG reporting for SMPS Income Higher Equity

(as at 30 September 2024)

Carbon Intensity

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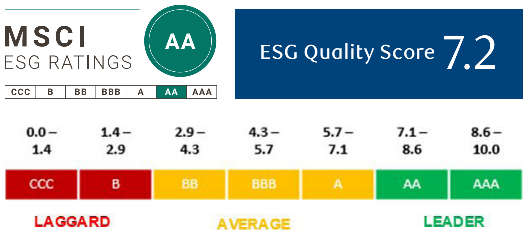
Benchmark for comparison: 55% Global equity, 45% Global aggregate bonds

MSCI ESG Ratings



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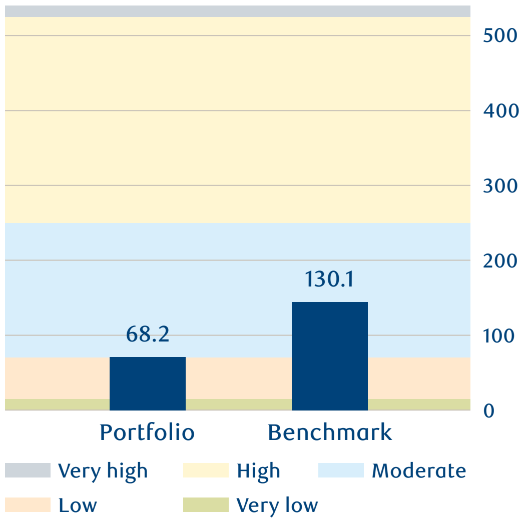
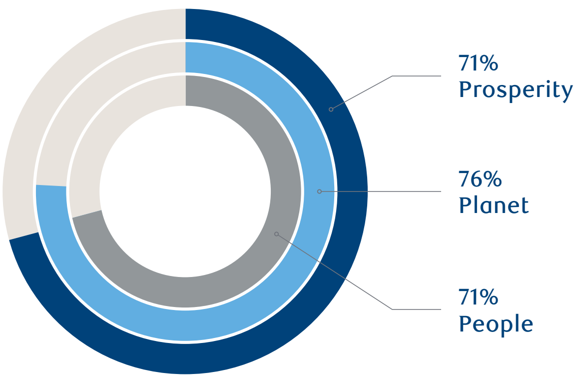
Carbon Intensity vs Benchmark (TCO2e / $m sales)



SDG Alignment



Prosperity

Planet

People

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ESG reporting for SMPS Balanced

(as at 30 September 2024)

Carbon Intensity

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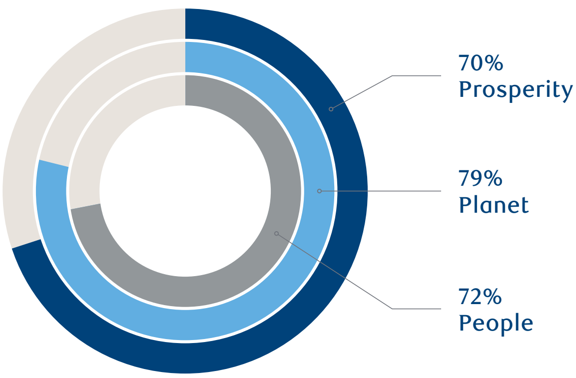
Benchmark for comparison: 70% Global equity, 30% Global aggregate bonds

SDG Alignment

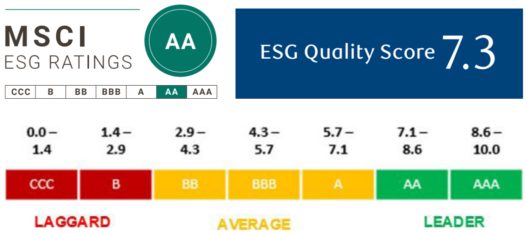


Prosperity

Planet

People

MSCI ESG Ratings



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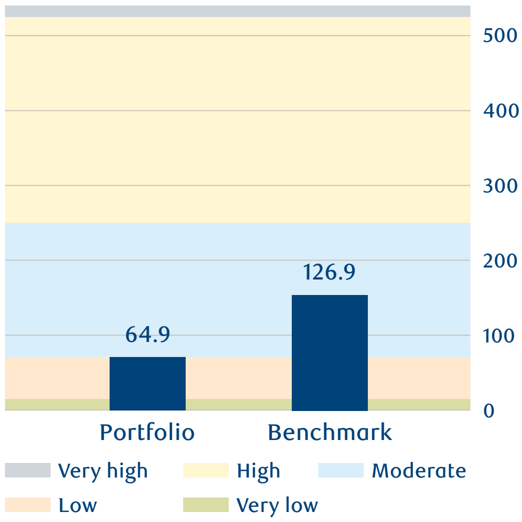
Carbon Intensity vs Benchmark (TCO2e / $m sales)



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ESG reporting for SMPS Growth

(as at 30 September 2024)

Carbon Intensity

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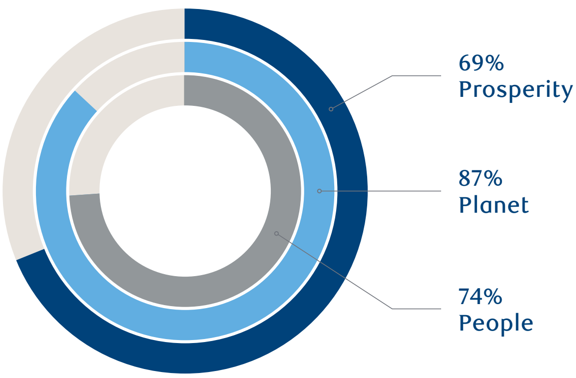
Benchmark for comparison: 85% Global equity. 15% Global aggregate bonds

SDG Alignment

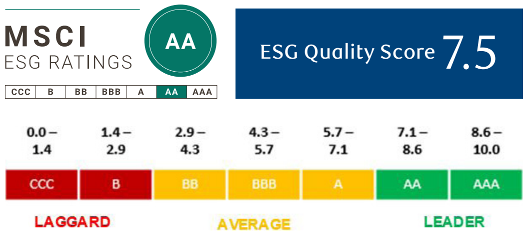


Prosperity

Planet

People

MSCI ESG Ratings



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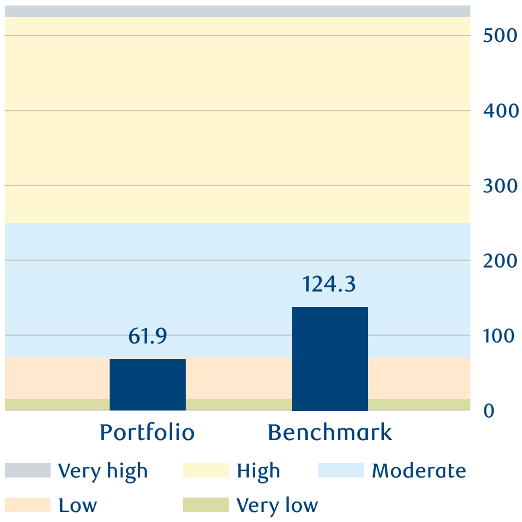
Carbon Intensity vs Benchmark (TCO2e / $m sales)



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ESG reporting for SMPS Global Equity

(as at 30 September 2024)

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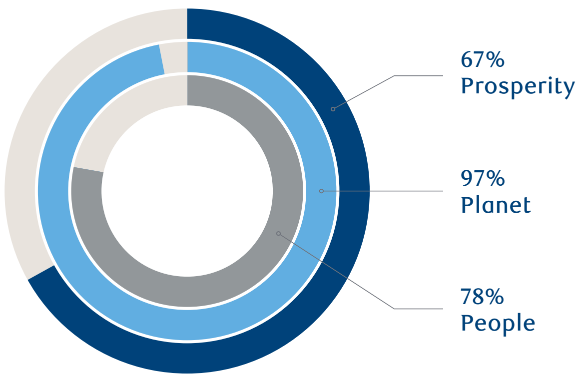
Benchmark for comparison: 100% Global equity

SDG Alignment



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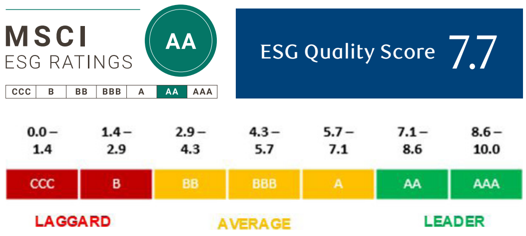
MSCI ESG Ratings



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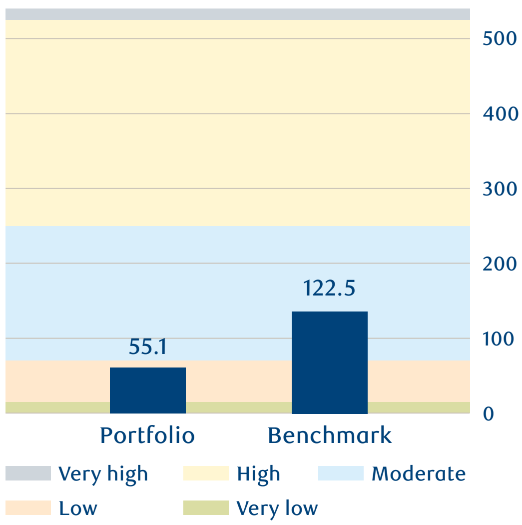
Carbon Intensity vs Benchmark (TCO2e / $m sales)



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Asset Allocation Committee investment outlook

These views are implemented across our portfolios but there may be deviations where asset classes or suitable investments are unavailable or excluded.

Cash

Although cash continues to offer a decent yield, we are underweight. We see continued scope for equity market gains, government bonds to rally modestly as central banks adopt less tight policy stances, and gold to move higher.

Bonds

Traders have priced in significant monetary policy easing in the months ahead. If there is a soft landing, central banks might cut rates by less than what is priced in. In a recession, they would very likely cut by more. A soft landing remains a reasonable base case, although economic growth risks have intensified. Taking a probability-weighted sum of the various possible outcomes, and considering government bond yields move with central bank rate expectations, we remain overweight government bonds. We remain underweight corporate bonds. Credit spreads are not sufficiently large to compensate for global economic growth risks, in our view.

Global Equities

Subsiding inflation and central bank rate cuts should help bring about a soft landing. Meanwhile, there is the potential for artificial intelligence (AI)-related themes to keep pushing the market higher. As such, we retain a modest equity overweight. But the risk/reward backdrop suggests it is probably not a good time to chase this rally further and add to that overweight at the current stage. A U.S. soft landing is completely priced in, U.S. valuations are elevated, and investors and analysts are already bullish. Meanwhile, economic growth risks are higher than in a typical year, it should become harder for the AI names to continue to positively surprise investors by such a large margin, and a Donald Trump win in November would increase trade uncertainty.

Alternatives

Sentiment and positioning toward gold are bullish, which is unsupportive as it points to good news being priced in. The U.S. presidential election could go either way, but a Trump win in November could cause U.S. growth to a weaken and inflation to strengthen – a supportive backdrop for gold. Gold could also benefit from continued inflows from countries not geopolitically aligned with the West. Finally, gold could do well on the back of just a simple moderation in real yields as the economy slows. Turning to property, while fundamentals are challenging in the office space, the market cap weighting of this subsector is small. The backdrop is notably brighter in other REIT subsectors. Nevertheless, safe haven bond yields may not drop that much in the event of a soft landing. Only a small decline in yields might not be enough to drive strong relative performance in this interest-sensitive sector. Against this mixed backdrop, we maintain a neutral position.

UK Equities

UK relative performance should continue to be closely linked to value vs growth-style performance, and there are reasons to believe the outlook for the latter remains brighter. However, some diversification into the value plays that the UK is so heavily weighted in makes sense at this stage, in our view. Although the domestic economic outlook is less important for UK equity relative performance, it still matters. Indeed, there is a reasonably close relationship between the performance of UK vs global gross domestic product and UK vs global equity performance. We suspect the Labour Party will have some success in boosting economic growth with policies that require a limited fiscal outlay. However, the pathway to success is not guaranteed, and implementation will require careful navigation. The UK equity market trades on very undemanding valuation multiples.

US Equities

A key concern with regards to U.S. equity exposure relates to valuation. Both equity valuation multiples and the valuation of the dollar appear stretched. Nevertheless, we are more optimistic on U.S. equities than other regions, for two main reasons. The first is the secular outlook, which appears relatively bright for the tech stocks the U.S. is so heavily weighted in. The main upside risk for the global equity market over the next few years is if an 'AI boom' scenario unfolds. With the Federal Reserve now cutting rates, a weaker version of the second half of the 1990s is a possibility this cycle. Back then, excitement linked to the growth of the internet drove gains. This cycle, AI could be the driver. The second reason for favouring the U.S. relates to the cyclical outlook. Even though the odds of a soft landing have gone up, economic growth risks appear higher than in any given year. The U.S. has a relatively defensive sector composition compared to other regions, which is an attractive characteristic at a time when economic growth risks are elevated.

Europe ex UK Equities

The relative performance of global tech and the direction of continental European foreign exchange (FX) are the key drivers of Europe ex UK equity relative performance. We are optimistic on the secular outlook of global tech, which bodes poorly for Europe ex UK as it has low weightings in this sector. With regards to continental European FX, over the longer term, there appears to be room for appreciation, which would support regional equity relative performance in common currency terms. Importantly, the euro is cheaply valued (based on purchasing power parity conversion rates).

Japan Equities

There is momentum behind shareholder-friendly reform in Japan, which could help drive a further expansion in relatively depressed price-to-book multiples. However, demographics amount to a major structural headwind for Japanese equity relative performance. Meanwhile, with the unemployment rate low and labour force participation high, Japan does not have much scope to put idle economic resources to work to drive cyclical growth. Despite low price-to-book multiples, Japan does not stand out as cheap, in our view. Indeed, it trades at a premium to the world ex US market on 12-month forward price/earnings.

Asia ex Japan Equities

In late September, the Chinese authorities announced a host of policy measures. The coordinated action suggests the authorities are now taking the deflation risk seriously. To successfully boost inflation, the authorities need to boost growth. The combination of higher inflation, stronger growth, and declining real interest rates is a supportive backdrop for equities. The Chinese housing market remains weak, but the authorities are incentivised to drive an improvement as soon as possible. Given that over 90% of Chinese people own their own home, they would be risking a breakdown in social instability (which they are very keen to avoid) if house prices decline much further. China and Hong Kong equities have rallied aggressively in short time, but on a medium-term view, these equity markets still do not look overbought. We acknowledge that the change in tack by the authorities does not alter the fact that the structural headwinds leaning against China have not gone away. But Trump's odds of winning next month have dropped compared to a few months ago. As such, a major geopolitical risk for China (namely, a damaging trade war) has declined. Importantly, there are structural bright spots in the Asia ex Japan equity index, including India and Taiwan.

Emerging Markets ex Asia Equities

Brazil, Saudi Arabia, South Africa, Mexico, and the United Arab Emirates are the countries with the highest market cap weightings in the EM ex Asia equity index, making it very commodity exposed. We do not expect much upside to commodity prices in an environment where global growth is slowing. That said, EM ex Asia remains very cheaply valued.

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