SUSTAINABLE WORLD INVESTORS' REPORT

Spring 2024

Welcome to the Sustainable World Investors' Report. This quarter we highlight sustainability items in the news, a deep dive piece on long duration energy storage, and on this occasion conclude with a fund focus piece on Close Sustainable Select Fixed Income fund.

Q1 has seen a continuation of last year's trend where the more impact focussed funds have been struggling compared to exclusionary type funds. The MSCI ACWI Sustainable Impact Index fell –0.4%, vs an 11% rise for the MSCI World ESG Leaders. The ESG Leaders index tends to follow the MSCI World.

Morningstar fund flow data shows global sustainable funds saw almost $900m of net new money in Q1, more than reversing just less than $100m outflows in Q4 2023. Total assets increased 1.8% to nearly $3tn, but much of this was from market rises.

Within this, European funds had inflows of $11bn– a large increase on Q4, while US funds had a record worst quarter of outflows, losing $8.8bn. This has been driven by several issues, including political uncertainty with the upcoming election.

Growth outperformed value as a factor in the quarter, which should generally help ESG and impact funds. Performance by sector was mixed. Energy outperformed the index, but materials and transport were two of the weakest sectors in the market. Tech and the Magnificent 7 continued to do well.

But a financial background of higher global interest rates and sticky inflation continues to make things difficult for renewable energy in 2024. Danish company Orsted used to be Denmark's state oil company, but is now a global leader in wind energy development. Late last year it pulled out of two large offshore wind developments off the east coast of America. This was after they asked the state of New Jersey to renegotiate pricing, but the state refused, and Orsted walked away from the contract with impairment charges of nearly $4bn.

This has forced them to exit other contracts and sell equity stakes in other projects as they try to repair their finances. They sold equity at a loss on four onshore US wind projects and pulled out of wind markets in Norway, Spain and Portugal.

Middle East geopolitical tensions remain high, the environmental and social impacts have been severe with many countries now demanding ceasefires and de-escalations. The impacts this has on markets is varied. The oil price rose nearly 13% during the quarter, partly on concerns about potential supply disruptions from the war in Palestine.

"2024 may be hotter or it may be cooler. It depends on how our climate variability such as El Niño tracks into the year. What is more certain is that next decade will be hotter than this one."

Dr Jaci Brown, Climate Intelligence Director, January 2024 (Source: https://www.csiro.au/en/news/All/News/2024/January/Expert-commentary-2023-warmest-year-on-record)

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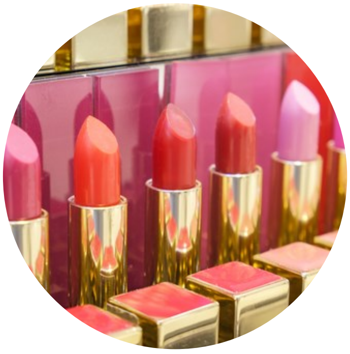
SUSTAINABILITY IN THE NEWS

Here we highlight snippets from sustainability items in the news from the first quarter of 2024.



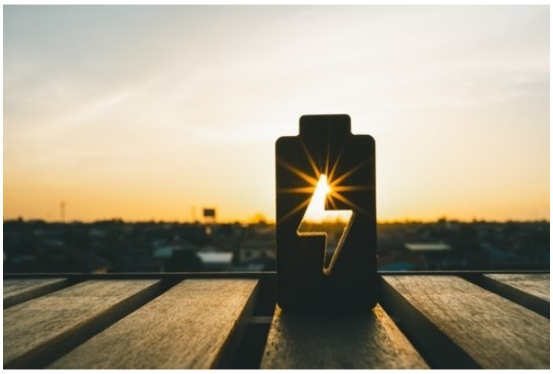
The beauty industry has huge environmental fallout globally, and by 2027 the global cosmetics market is projected to be worth over $460billion. The British Beauty Council highlighted that only 14% of plastic waste is sent to recycling and only 9% get recycled. Many beauty brands and stores have started recycling schemes to help combat these issues. I still remember MAC would give you a free lipstick if you brought back five 'empties' from products of theirs you had used (no idea if that is still in place but a good scheme non the less). Harrods is the latest to add in-store recycling points for cosmetic and personal care packaging and The Perfume Shop is investing in refillable products. Like with any good recycling scheme consumers like to be rewarded. In Harrods for every five pieces of packaging returned, you will receive 500 bonus points (equivalent to £5). The Perfume Shop already has a recycling programme, customers can return empty bottles for a 15% discount for same-day purchases, but this new refillable programme is just being trialled in their Nottingham store and has eight perfume options. (Source: www.edie.net)

The University of Edinburgh's Advanced Computing Facility is the national supercomputer, which is funded by the UK Government's Department of Science, Innovation and Technology. The supercomputer is used for national climate modelling and health data modelling. It currently releases up to 70 GWh of excess heat per year. The next generation of this supercomputer is expected to release 272 GWh of excess heat. There is now a move to reuse this to heat peoples homes in the Scottish capital. "The process of cooling the supercomputers would be augmented to transfer the captured heat into the mine water – up to a maximum temperature of 40°C – which would then be transported by natural ground water flow in the mine workings, and made available to warm people's homes via heat pump technology." The recycled heat could warm at least 5,000 households, and currently there is over 800,000 homes in Scotland in fuel poverty. This project is expected to cost upwards of £2.6million and is headed up by an Edinburgh-based geothermal company TownRock Energy, with various funding sources, including Scottish Enterprise and the USA's Department of Energy. (Source: www.edit.net & www.ed.ac.uk)

Have you ever found common green claims confusing? Well a survey of 1,000 brits feel the same. Although seeing terms like 'sustainable' or sustainability' third quarters of the survey pool could not confidently offer up a definition. There were even lower levels of awareness for terms like 'biodiversity', 'traceability' and 'the circular economy'. The most widely recognised terms were 'recyclable' and 'single-use plastic' and most were able to give a good definition. The terms were also understood across different levels of education and income. Only 11% of the surveyed pool felt confident in the understanding of carbon offsetting, so terms like 'net-zero' and 'net-neutral' are confusing terms for consumers to see. The survey found that if businesses worked on consumer understanding of these various environmental terms then consumers would be most likely to positively engage with those companies. (Source: www.edie.net)

Pandora, the Danish jewellery manufacturer has achieved its goal of sourcing 100% recycled silver and gold for its jewellery. The original goal was for this to be done by 2025 but it actually achieved this in December 2023. All new Pandora products will be made with Responsible Jewellery Council Chain of Custody standard silver and gold, there is still some inventory which has non-recycled metals in which Pandora predict will be sold by the end of 2024. The yearly cost of using recycled gold and silver is about £10million which the company has said it will absorb and it will not pass on to consumers. Pandora have highlighted that by using recycled gold and silver it is avoiding ~58,000 tonnes of CO_2 per year, equivalent to 6,000 cars being on the road. This has meant the company's suppliers putting in new processes and equipment to ensure complete segregation of mined and recycled metals. (Source: www.edit.net & www.pandoragroup.com)

Batteries Not Included...



In March, the Science and Technology Committee published its report into long-duration energy storage.

One of the key challenges with renewable energy is storing it to allow for periods when it is not for example sunny or windy enough generate power, particularly when the weather does not coincide with peaks and troughs in demand.

The UK government has a goal of decarbonising the electricity system by 2035 and is committed to Net Zero.

Net Zero targets will significantly increase the demand for electricity, and the UK is trying to quadruple the amount of electricity it generates by 2050. Increasing electricity demand is also being driven by for example cars, and the growth in datacentres to power fast growing AI applications, which are particularly energy intensive.

Long duration energy storage facilities can take 7-10 years to build, so there is not much time if the target is 2035. They are also capital intensive and developers need visibility on returns in order to invest.

Long duration here means days, weeks, months or years. We already have short term battery storage facilities, measured in minutes and hours, but they are not yet used as widely as they could be. This is because National Grid is having to update its systems to incorporate them properly, and in the meantime are continuing to use fossil fuels to cover periods of excess demand, which has made battery revenues more volatile than expected. The government is consulting at the moment to try to come up with a revenue mechanism that would avoid this.

The key benefit of long duration storage is that it allows larger amounts of cheaper renewable energy on to the grid, because it allows greater security of supply, both due to the weather or events such as the war in Ukraine. This in turn reduces consumer bills.

2023 became the first year where the average global temperature increase exceeded 1.5C. A successful UK domestic energy storage capability would allow exports of technology and capacity, as well as reducing fossil fuel imports from the Middle East, Russia and other geopolitically sensitive regions, and would allow the UK to power its economy with domestically produced low carbon energy.

There are different technologies which could be used for long duration energy storage, but hydrogen seems to be the most likely. There are potential issues with hydrogen though. The amount of energy needed to create hydrogen in the first place is high and also needs a lot of infrastructure itself. This means the overall size of the energy sector would increase, and possibly create inefficiencies, but it is clear that more needs to be done in this area.

Close Sustainable Select Fixed Income

Close Sustainable Select Fixed Income is a UK strategic bond fund which has 50-70 holdings and is £590million in size. It has a yield to maturity of 6.3%, an average credit rating of A+, and duration of 4.9 years, which is slightly shorter than the benchmark. Added together this makes it a relatively conservative bond fund.

It aims to preserve capital and generate a high level of monthly income. The fund invests across the fixed income spectrum, and has a high weighting to government bonds at the moment. It is unconstrained in terms of credit quality, duration and currency. It is actively managed, it can move allocations around depending on the macro environment and bond valuations, and the team focuses on stock selection, where they believe they add value.

The fund excludes companies which have more than 10% of revenue from adult entertainment, gambling, thermal coal, controversial weapons, civilian firearms, tobacco, and severe breaches of the UN Global Compact. It also seeks to have a weighted average carbon intensity below the ICE BofA Global Corporate Index. It is targeting 50% below this by 2030 from the 2019 baseline and net zero emissions by 2050.

The fund managers ran a non-sustainable version of this fund but last year decided to merge the two as the non-sustainable one had become almost identical to this fund. We were supportive of this decision as both had been on our buy-list for a long time. We view this fund as a good holding for all portfolios, not just sustainable ones.

The fund's performance has been consistent and has outperformed its sector (the IA Sterling Strategic Bond) across almost all time horizons. The only time the fund has underperformed was in 2020 which was to do with its allocation to a part of the market (real estate debt) which was hit hard in covid. On a 1, 3, and 5 year time horizon the fund has outperformed its sector by 8.5% vs 5.8%, 3.6% vs -3.0%, and 16.1 vs 8.1% respectively. In February Trustnet named it "the most consistent UK strategic bond fund over the past decade".