Strategy commentary

Ninety One
Global Environment

Quarter ending 30 June 2024

The following commentary gives the views of the investment manager at the time of publication.

Key points

- Global Environment underperformed the MSCI ACWI
- Detractors included some Chinese holdings
- Contributors included Power Grid of India and NextEra Energy
- Tetra Tech was added to the portfolio

Market background

Major global equity indices advanced in Q2, driven by US tech and hopes for a soft landing for the US economy. The positive market sentiment was supported by emerging signs of growth in Europe, China and Japan. In the US, the S&P 500 reached another all-time high, fuelled by the large technology companies and a decline in inflation, which increased optimism of a US Federal Reserve (Fed) interest rate cut later this year. In Europe, while a regional equity benchmark was up over the quarter overall, it dipped into negative territory in June as a snap election in France put European stocks under pressure. Similarly, the FTSE 100 Index performed strongly over the quarter, but lost ground in June partly amid election uncertainty. In Asia, Hong Kong and Chinese mainland stocks were also weaker towards the end of Q2, with markets cautious ahead of a July meeting of China's top leaders. In Japan, the Nikkei was unable to sustain the positive momentum of Q1.

Performance review

The Global Environment Strategy delivered a negative absolute return and underperformed the MSCI AC World Index (in USD, gross and net of fees[1]). The underperformance was largely driven by two themes. The first was geopolitical and investor concern around overcapacity of Chinese electric vehicles (EVs) and solar. Q2 saw a brief rally for our overweight Chinese allocation, but Chinese equities underperformed in May and June, driven by: 1) continued weak domestic investor sentiment, 2) the US and EU proposing tariffs on Chinese goods, and 3) concerns about overcapacity and overinvestment in some of the sectors in our universe in China, namely solar and EVs.

The companies that we own in these sectors (Xinyi Solar, Sungrow, CATL and Wuxi Lead Intelligent Equipment) are in sub-segments of the industry that we think are less exposed to hyper-competition or are delivering differentiated products that will enable them to outcompete without needing to drop prices to loss-making levels. In addition, each has relatively low revenue exposure to the US market, meaning tariffs are largely symbolic rather than materially impacting the fundamentals or growth potential of the companies. However, they have had a negative effect on market sentiment and consequently, asset valuations. It is worth noting that the EU tariffs are location-based, meaning Chinese companies with a footprint in the EU, such as CATL, are likely to be positively rather than negatively affected.

The second theme is the advance of populist policy in the US and Europe, threatening decarbonization ambition and policy support. The increasing likelihood of a Trump presidency and the growth of populism across the EU are causing investors to question the direction of travel for climate policy in more voter conscious areas such as EV adoption and renewable energy development. This has created headwinds for developed market companies involved in the related supply chains, however we view this as a threat to sentiment with more limited risk to overall demand growth. In the US, we think markets are likely overestimating the risk of IRA repeal under a Trump presidency (see our notes from the road: what the US

[1] Where performance is gross of fees, returns will be reduced by management fees and other expenses incurred. Net performance is net of highest institutional segregated portfolio management fee.

Not all securities held have been discussed. For further information on how the overall strategy performed during the period covered, please reference the relative performance noted in the Performance review section.

Past performance is not a reliable indicator of future results, losses may be made.

election means for investors in decarbonisation). In Europe and the UK, the rise of populism hasn't been as extreme as expected with Marine Le Pen underperforming in France and Labour's landslide victory in the UK.

In addition to policy risk across the developed world, persistent inflation and interest rates remaining higher for longer in developed markets has continued to affect the pace of deployment of decarbonisation solutions.

Positively, the speed of artificial-intelligence (AI) development and adoption is generating new structural growth drivers for power demand and a willingness to spend to bring reliable power online quickly. This has resulted in a large tailwind for the utilities we own that are quickly deploying low-cost renewable energy to meet expected demand from the datacentres required for AI. Electrification and resource-efficiency companies essential to the build-out of new, more efficient datacentres have also experienced robust tailwinds. The strong performance of companies in these supply chains has partially offset the underperformance resulting from our lack of exposure to mega-cap tech companies leveraged to AI growth, which we do not own as they are not driven by decarbonization.

At the company level, the main detractors from relative returns included Wuxi Lead Intelligent Equipment, Xinyi Solar and Vestas Wind Systems. Wuxi Lead Intelligent Equipment predominantly designs, manufactures and sells battery production equipment and services to leading EV battery manufacturers. Its performance was negatively impacted by weaker-than-expected results for FY2023 (reported in April 2024), as the company implemented prudent accounting treatment of accounts receivable and inventories, resulting in impairment losses. However, we saw a resumption of good margins in Q1 and remain confident that Wuxi Lead will continue to benefit significantly from growth in the battery sector. Xinyi Solar, the world's largest producer of solar glass, is directly exposed to the solar industry, and therefore well placed to benefit from the move away from fossil fuels to generate electricity towards renewable energy, mainly wind and solar. Xinyi Solar's underperformance was driven by geopolitical concerns, specifically the US government announcing new tariffs, revoking exemptions for modules imported from Southeast Asia. Additionally, some of Xinyi Solar's direct customers reported weak results, leading to concerns about glass prices. We remain highly confident that solar glass is one of the subsegments in the global solar value chain with the most favourable supply-demand balance. Vestas Wind Systems is the world's largest wind-turbine manufacturer and service provider. The company's underperformance was primarily due to the market reaction to its latest results, as the company missed Q1 sales consensus and saw higher operational costs. We do not view weaker Q1 sales as a material issue given this is often the weakest quarter for new orders and followed a record Q4. The other top detractors were zero weights in NVIDIA and Apple, with some of the US 'big tech' stocks continuing to perform strongly.

The top contributors to relative returns included Power Grid of India, NextEra Energy and Voltronic Power Technology. Power Grid is a majority state-owned enterprise primarily engaged in building the power transmission infrastructure in India. It performed well due to continued power demand growth, fuelling earnings growth for the company. NextEra Energy is the world's largest generator of electricity from wind and solar, a market leader in battery storage, and the market leader in North American renewable energy. Its outperformance was driven largely by its latest earnings report. It achieved the second-largest addition to its order backlog ever and forecast growth in renewables to meet the rising demand from AI datacentres. We see this surge in datacentre demand as a new growth opportunity for NextEra. Voltronic Power Technology is a design and manufacturing service (DMS) supplier for uninterruptible power systems (UPS) and photovoltaic (PV) inverters. Voltronic's outperformance was attributable to its recent results, which showed we are closer to the end of the inverter destocking cycle and a return to growth. Other contributors included Schneider Electric, which provides energy-management and industrial-automation solutions; it benefitted from solid datacentre and infrastructure demand linked to AI growth. Finally, market-leading power semiconductor company Infineon Technologies, whose products have wide application across clean-energy technologies, saw its shares gain after it released results, in which it indicated the current cycle had reached its bottom.

Portfolio activity

Significant buys

Tetra Tech provides technical/scientific consulting services to government and private clients focused on decarbonization, climate mitigation, and biodiversity solutions. The stock offers a differentiated asset-light growth and margin profile to the bulk of the portfolio, largely coming from US markets. The company is well positioned to benefit from structurally growing spending by governments and corporates on decarbonization solutions. Tetra Tech's key asset is its people, with strong talent attraction and retention helping it to establish a market-leading track record.

Significant sells

No full sales were implemented over the quarter.

Engagement: Orsted

Orsted is a global leader in developing, constructing, and operating offshore windfarms, with more than three decades of experience in a broad range of green-energy solutions. Radical transformation of our energy systems is a critical step to decarbonising the economy. It requires a range of solutions from solar to onshore and offshore wind, hydrogen and grid-scale batteries. We believe Orsted will play a key role in the decarbonization of the economy and, more specifically, is critical to Europe's transition to a net-zero future.

In Q2 2024, we continued our strategic engagement with Orsted on governance and risk management. The two key areas that Orsted's management need to deliver on this year are:

- The execution of asset sales; recent sector activity gives us confidence this can be achieved (e.g., recent bids by KKR for Encavis, Brookfield for Neoen, and Energy Capital Partners for Atlantica Yield).
- The successful completion of the 7.5GW under construction.

The key purpose of our engagement during Q2 was to go through each of Orsted's projects/assets and gain comfort that there will not be significant obstacles ahead.

We met with the new COO, Patrick Harnett, to conduct a detailed review of operational developments. In the meeting, we discussed his experience and background in delivering significant infrastructure projects, details of current and potential projects across various regions, and received an update on cancellation costs from projects that will no longer go ahead.

The engagement confirmed our confidence that the COO is a high-quality appointment, with a strong background and a proven track record of delivering operational excellence. We learnt that Orsted has moved to a more centralised and focused decision-making model with better accountability, a change we strongly support as it aligns with our proposals from Q4 2023. The company has additionally implemented a smaller global execution leadership team, concentrating on project execution, which is the core engine of the business.

Patrick highlighted that Orsted previously struggled to treat assets as an interlinked portfolio. His focus has been on developing an understanding of how the different regional components are operating, and how they can evaluate and mitigate global risks, which is more effective than a 'single project' perspective. Orsted has also worked diligently with its US partners to enhance the maturity and resilience of its supply chain.

In addition, the COO detailed Orsted's long-term prospects in Asia, which promise higher returns and geographic diversification. Orsted is particularly interested in Asian markets with mature supply chains that can offer shorter lead times for future projects.

Overall, Orsted's view is that risks are weighted towards the US, given the immature supply chain, but it has reinforced and refocused the team and is working hard to increase the resilience of the supply chain. We will continue to monitor the US situation closely, given that supply-chain management needs to evolve to make projects more profitable.

Outlook and strategy

The Fund remains focused on companies that we believe will benefit from the need for decarbonization, via a high-conviction investment approach.

With the US election approaching and uncertainty persisting over China’s macro-outlook, many of our investors have been asking about the prospects for decarbonization in the world’s two largest economies. Unsurprisingly, this has been on our minds too, hence why our research programme has included visits to Washington, DC and multiple Chinese manufacturing hubs in recent months.

First, China. After a poor start to the year, Chinese equities went on to deliver a strong performance between February and May. However, they retracted in June, giving back some of their earlier gains. Even through a period of very negative sentiment towards China, demand for clean technologies grew strongly: in 2023, China recorded 216GW of solar installation, more than double the volume of the next three biggest markets combined. One key reason for this is that Chinese officials continue to regard clean-tech sectors as essential enablers of the economic transition away from reliance on real estate, infrastructure investment, and low-end exports. As such, we expect them to continue to receive policy focus from the government.

For investors, care and selectivity remain crucial, because the current period of hyper-competition still has some way left to run. However, Chinese government-driven supply-side reform within the battery and solar supply chains should encourage healthier market development, which we view as positives for the industry leaders that we own. We think leading companies with strong competitive advantages in the decarbonization sector will emerge stronger from the present difficulties, as weaker players with more generic offerings face a potentially existential struggle.

Meanwhile, the US Presidential election is being contested by candidates with starkly different stances on climate. There are three policy areas that could go in very different directions depending on the election result in November: fiscal, trade and tariffs, and climate. All of them may have consequences for the universe of companies driving the shift towards a lower-carbon global economy. Our trip to Washington highlighted the need to focus on what happens on the ground rather than the noise, and that potential tariffs will be far more consequential to climate investments than an IRA repeal, which we believe is less likely than The Street thinks.

At present, the portfolio is trading on a similar valuation to global equities (MSCI ACWI) on a price-to-earnings basis, which has rarely happened in its history. Meanwhile, the companies in the portfolio are generating attractive revenue growth, and are steadily growing returns on equity due to their competitive advantages and strong margins. Given these fundamentals, we are excited about the prospects for the current portfolio. As always, we will continue to challenge and test our ideas as we execute our highly selective investment approach within the universe of companies that are positively exposed to the shift to a clean-energy world, with a focus on leading businesses across sectors that are making a positive contribution to decarbonization.

Specific risks

Commodity-related investment: Commodity prices can be extremely volatile and losses may be made. Concentrated portfolio: The portfolio invests in a relatively small number of individual holdings. This may mean wider fluctuations in value than more broadly invested portfolios. Currency exchange: Changes in the relative values of different currencies may adversely affect the value of investments and any related income. Derivatives: The use of derivatives is not intended to increase the overall level of risk. However, the use of derivatives may still lead to large changes in value and includes the potential for large financial loss. A counterparty to a derivative transaction may fail to meet its obligations which may also lead to a financial loss. Emerging market (inc. China): These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems. Equity investment: The value of equities (e.g. shares) and equity-related investments may vary according to company profits and future prospects as well as more general market factors. In the event of a company default (e.g. insolvency), the owners of their equity rank last in terms of any financial payment from that company. Geographic / Sector: Investments may be primarily concentrated in specific countries, geographical regions and/or industry sectors. This may mean that the resulting value may decrease whilst portfolios more broadly invested might grow. Sustainable Strategies: Sustainable, impact or other sustainability-focused portfolios consider specific factors related to their strategies in assessing and selecting investments. As a result, they will exclude certain industries and companies that do not meet their criteria. This may result in their portfolios being substantially different from broader benchmarks or investment universes, which could in turn result in relative investment performance deviating significantly from the performance of the broader market. The full list of Fund risks are contained in the appendices of the Ninety One GSF prospectus.

Important information