Biodiversity Strategy

Stricter US regulation on "forever chemicals" should benefit solutions providers for water testing, treatment and disposal technologies

- Global equity markets declined in April due to the prospect of higher for longer interest rates.
- Most companies met or beat Q1 2024 earnings expectations, but provided weaker guidance, in some cases, due to pockets of weakness in end-market demand.
- Following a period of strong relative performance, the biodiversity strategy underperformed in April due to its quality growth bias.

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Global equity markets declined in April in US dollar terms as the prospect of higher interest rates for longer weighed on sentiment for stocks and bonds. Strong US inflation data and a first quarter GDP print that revealed resilient private demand have raised fears that the Federal Reserve may not ease monetary policy as quickly as previously anticipated. The US and Japan fell the most during the month while Chinese equities posted strong returns, supported by an improving economic landscape and undemanding valuations. On a sector basis, information technology, healthcare and consumer discretionary were weakest while utilities and energy performed best. Growth stocks underperformed value during the month but both were negative in absolute terms.

Beyond financial markets, biodiversity and the environment remained in the headlines with the US Environmental Protection Agency (EPA) finalising regulation on water supplies contaminated with "forever chemicals" (collectively termed PFAS). PFAS are useful chemicals, making saucepans non-stick and stopping pizza boxes going soggy, but are hazardous to human health, especially when found in higher concentrations. The EPA concluded that there is no safe level of exposure to forever chemicals without risk of health impacts and thus introduced stringent testing requirements. This will place new demands on water utilities as well as higher demand for testing, treatment and disposal technologies provided by value chain companies. The move to regulate emerging contaminants like PFAS has already triggered a wave of litigation, generally focusing on the original material manufacturers, like 3M and Dupont. In contrast, it appears environmental services companies are well positioned to benefit, albeit over an extended period as the regulation is introduced in a staggered fashion.

Portfolio positioning and performance

The Biodiversity strategy underperformed the wider equity market in April.

Sustainable Food and Agriculture was the strongest contributing sub theme to returns in April. This was led by Deere which continues to navigate a weak large agricultural machinery market. Despite Deere's uncertain near term and cyclical headwinds, investors remain excited about the company's exciting prospects in precision agriculture, which can save farmers money, do good for the environment, and support margins at the group level. On the other hand, German fragrances and

Source: All data sourced from Bloomberg, local currencies, as at 30/04/2024

ingredients company Symrise was weaker. The company reported results that under-delivered relative to peers on volume and pricing, even though they beat consensus expectations. Pricing weakness was led by Aroma and Pet, leading some to question the company's 2024 margin targets. We believe Symrise is still recovering and expect the company to revert to strong levels of historical growth in the coming quarters.

Responsible Production and Consumption returns were led by Keyence. The Japanese technology/automation company was a new position initiated during April. Keyence is a leader in industrial automation and factory efficiency, driving technological progress leading to less material wastage and optimised production footprints. Keyence performed strongly following encouraging FYQ4 earnings, which exceeded expectations. The company is well-positioned to benefit from an expected recovery in its end markets. In contrast, diversified US industrial company Kadant was the biggest detractor to returns in the sub theme. Weakness in two of the company's end markets – paper and packaging and wood processing – weighed on the stock in recent weeks. We expect Kadant to report solid results in early May and hopefully reassure the market of the attractive outlook for the company.

Technology Enablers had a tougher month with software company Autodesk notably weak. Autodesk, a leader in construction and design software, announced at the beginning of the month that its FY2024 10-K (annual report) filing would be delayed, but should be completed within the 15-day extension granted to the company by Nasdaq. The company noted an investigation was being undertaken on non-GAAP operating margin and free cash flow practises. Autodesk has yet to file its updated 10-K. We expect that some of the complexity is driven by evolutions to Autodesk's financial model over time and take comfort from the view that historical financials should not have to be restated. NXP Semiconductors, an enabler of Internet of Things applications, was the strongest contributor to returns as the company reported strong results despite the company's mixed end market outlook.

Dutch environmental consultancy Arcadis led returns in Resilient Infrastructure as the company posted strong Q1 2024 results. Arcadis continues to see strong demand for its services and is executing on its margin expansion opportunity. The stock still trades at a discount relative to US peers, also acting as a tailwind for share price performance. Spirax Sarco was weaker as investors worried about the company's recovery ahead of its AGM trading update on 15th May. The company has guided to an H2-weighted recovery, but to some this reflects management's lack of conviction in improving fundamentals. We take comfort in the still-achievable guidance and believe that the high quality, core steam business will continue to support more cyclically depressed parts of the business, like Watson Marlow.

During April we closed our position in Daiseki, using the proceeds to fund the new position in Keyence. We chose to exit Daiseki given frustratingly weak industrial waste trends. We also had concerns about the company's competitive position and strategy to expand into municipal solid waste.

Outlook

Following recent trades, we think the portfolio is incrementally better positioned to benefit from the structural tailwinds supporting investment in biodiversity. We think agriculture and food, closely followed by water, are the two biggest issues facing the natural world, and we think the fund's holdings in these sectors provide highly valued solutions to these challenges. While good progress has been made in recent years regarding regulation, in particular the Global Biodiversity Framework and the EU Nature Restoration Law, we find the more recent lack of consistency on environmental regulation frustrating (e.g. Scotland's decision to delay its deposit return scheme for recycling). However, we don't think this is stifling innovation or progress in the private sector where companies are making sustainability-oriented investments independent of regulation. In fact, we are encouraged to see technology beginning to disrupt old-fashioned industries, like construction and agriculture, which have some of the largest negative biodiversity footprints.

Our outlook on financial markets remains unchanged. We believe markets are adjusting to a "higher for longer" environment where there will be greater scarcity of finance and growth. This should favour higher quality companies – those with strong cash flow generation and organic growth opportunities – who should be relatively unaffected. We believe the portfolio has good balance and can weather a potentially weaker economy in 2024, feeling the impact of sustained high interest rates, or can outperform a more buoyant market in the event of a "soft landing".

Source: All data sourced from Bloomberg, local currencies, as at 30/04/2024

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Source: All data sourced from Bloomberg, local currencies, as at 30/04/2024

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