

TRANSCRIPT: EPISODE 216

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[INTRODUCTION]

Staci West (SW):

Welcome to the 'Investing on the go' podcast. I'm Staci West, and today I'm joined by Simon Clements co-manager of the Liontrust Sustainable Future Managed fund and the Liontrust Sustainable Future Global Growth fund. Simon, thanks for joining us today.

Simon Clements (SC):

Good morning.

(SW):

So, it's Good Money Week here in the UK. However, 2022 has been far from good for sustainable funds. We have higher inflation and rising interest rates. So, this has meant that companies [that] Sustainable Funds Managed have invested in, have gone out of favour and have seen their share prices fall. Can you just explain briefly to our listeners, what's been going on, and why you remain confident about the long-term returns for these types of companies?

(SC):

Yeah, obviously a really good question. I think we're all aware of the changes that have kind of happened quite rapidly over 2022 in our economy. After a long period - probably more than a decade - of low inflation, very low interest rates, [and] very loose monetary policy, we shifted to inflation being higher than it's been in many a decade and interest rates moving up very, very quickly. So, that's been a bit of a headwind for our style of investing.

The truth is, inflation in itself isn't a headwind really at all, but there's a few other inter-relating factors that really have driven equity markets. And I'll try to explain those.

So, the first is the fact that interest rates being higher, because the type of companies we invest in - growth and quality, that's our kind of style - we tend to invest in high quality companies that

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are also growing. And what that means is that the amount of goods and services that they're selling in the future, is going to be greater than they are today. Okay. And you think about sustainable trends that we invest in. We think that's going to be a bigger part of the economy. And, you know, we obviously invest in companies that display those features.

And the reason that higher interest rates is a headwind for that type of company, is because the way that you value any type of company - the framework for valuation companies - is you take a future value of cash flow streams off a business, and you discount that back at a discount rate. Okay. And the more of the value of the company that's further out in the future, the more sensitive they are to whatever that discount rate is. And the discount rate really works off interest rates and bond yields, both of which have moved up as interest rates have moved up. So, that's been the first headwind.

I mean, the second headwind is, in the very short term in 2022, really the only parts of the equity market that really performed really well, [it] has been a difficult period, have been commodity-related or mostly commodity-related areas to the economy. And that's for obvious reasons. I mean, we've all seen what's happened to the price of oil, the price of gas. And we really don't invest in that part of the economy at all, where we avoid fossil fuels. We're looking for those kind of substitutes as we decarbonise. So, the fact that we are not in those parts and, you know, we've seen the gas price, how much has risen.

So, the types of stocks we've been investing in, have been slightly hurt by this kind of higher discount rate, but also, we are not in areas of the economy that have benefited from these really rapid increases in commodity prices.

And the third reason, is more kind of nuanced in that we're at a bit of a turning point, in that we're moving from this low growth, low inflation type economy into a kind of higher inflation, higher interest rate, whether it's higher growth, it doesn't look like at the moment. But generally, at turning points, what the market does - and this is a feature that we've seen over decades - it tends to rotate out of areas of the market that have done really, really well in the previous phase. And tends to rotate potentially into areas of the market that haven't done so well, because they tend to be a lot cheaper. Okay. So that favours value stocks.

Now, the question we ask ourselves is, are the companies we are investing in going to do any worse in this type of economy as we move forward, than they are in the last? And we don't believe that that's true at all, but in the short term, that's what the market does. It tends to rotate and slightly favour those that are really structurally challenged. And that's been a third factor, and putting all those together, as you know, it's ended up in a very difficult 2022 year to date.

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(SW):

And are you not concerned that the cost-of-living crisis, the war in Ukraine, tensions in China, etc. will stall some of these structural trends that you've mentioned, that you look at in the fund?

(SC):

Yeah. I mean, this is something that we've talked about a lot and when you kind of look at the kind of trends that we invest in, and when we look at the global economy, what we're trying to do is we're trying to invest in a world which is cleaner and more efficient, healthier, and safer. And, when you look at actually what's going to happen, coming out of what's happened with the war in Ukraine and the cost-of-living crisis, we think the sort of things we invest in, are actually really, really well placed. Okay. And let me try and explain that to you.

So, any energy decarbonisation is as important as it is ever, okay. We're still going to need to decarbonise as a global economy. We still need to reduce the amount of carbon that we use to power our economy. On top of that, a lot of the problems that have happened within Russia and Ukraine really is about the way we source our energy and [our] dependence on, particularly on Russian fossil fuels, Russian gas, Russian oil. And I think you'd be fairly confident in saying, in the future, we're going to look to diversify away from that dependence.

Now, the best way to diversify away from fossil fuels - because [the thing with] fossil fuels is that you have them, or you don't - is renewable energy. There are obviously other ways, nuclear energy etc. but really the long-term way to really move yourself away, is to move to renewable energy or increase renewable energy. And when you say cost-of-living crisis, renewable energy is the cheapest form of energy out there at the moment. There's no doubt about it.

So, and again, you don't need to have, it doesn't matter how much resources you have within your physical borders, with renewable energy, the technology's there. So, we think there's going to be more demand for renewable energy, and probably the area that we're most positive and excited about - and it's a big part of our portfolios - is energy efficiency. That's actually the biggest problem at the moment. What we need to do is we need to make our homes, we need to make our businesses more energy efficient, so we need less energy. And I think if we'd done that kind of a decade or two decades ago, we probably wouldn't have all these problems because you know, that gives you the ability to not need as much fossil fuels. You don't need as much oil and gas at all.

And also playing into that is things like the move towards things like electric vehicles, where you're not dependent on oil anymore. You can use all different forms of energy to power your grid. So, again, while the short-term reaction of the market is that commodity prices go up, the kind of second and third round effects, we think, tend to favor that shift away from fossil fuels.

And the truth is, every time we've had an oil crisis, it's led to a structural lower movement in the oil price. It's happened every time. So, you know, there's a reason for that – it's because the oil

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price goes up, it incentivises substitutes, and we invest in those substitutes. And we think that that's going to happen again. And we tend to invest in companies that provide those substitutes.

(SW):

And, you mentioned one of them there, but the Sustainable Future range focuses on three mega trends. You've got cleaner, healthier and safer. So, before we turn to each bucket in turn, maybe just quickly [expand on] why these three areas, what in particular do you and the team like about these three mega trends to kind of make them the focus of this range?

(SC):

Yeah, we've been running our thematic process now for more than two decades. And I think what we've done is, we have 20 different themes and they're categorised into those three buckets and what we think we've found, or what we think we are able to identify trends that are in place - the trends have to be in place. The trends also need to actually make the world more sustainable, and they need to be helping on this trend to a more sustainable world. But also, they need to meet up with investment ideas within the equity markets and corporate bond markets and things like that, where we invest. So, that's really, there are these themes, but they're also themes by which we can invest in, the money that we invest actually makes a difference and helps us on that movement to a more sustainable world.

(SW):

And you mentioned energy efficiency, which I believe falls into that first bucket of cleaner - resource efficiency. Can you tell us a bit more about that bucket, and maybe an example, if you have one?

(SC):

Yeah. I mean, I think the first set of themes, as you say, they're making the world cleaner or more efficient. And really, the thought that the way we think about that, is that again, the global economy aggregate demand tends to grow - pretty much every year it grows - and to power that aggregate demand, we need to lean on a set amount of resources. So, in order to grow with actually less resources or the same or less resources, and increase that output, you need to be more efficient. You need to do more with less. And really, we are looking for technologies and innovations that allow us to do that. And a good example is a company called PTC. And a lot of these innovations kind of play into parts of the economy that whereby the technology is more nascent, it tends not to be adapted to the same degree.

And PTC is a good example, because it really caters for large-scale manufacturing clients. What it is, it's software technology that helps you design, helps you manage your product lifecycle in a way that allows you to reduce the amount of resources that you use. And they also have

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technologies around things like [the] ‘internet of things’, so, that's allowing you to understand how efficient different parts of your factory floor are and trying to work out areas that might need replacing, or areas that may be slowing down your entire process. And that obviously becomes a resource drain across the entire business, where you might need to just put some maintenance on one part of your factory floor. So, PTC is a technology that helps manufacturing and industrial clients really become more efficient, and particularly more energy and resource efficient.

(SW):

Great. And then the next bucket is ‘healthier’. Something that is obviously relevant and probably talked about the most in the last few years, but could you just talk us through this area a bit more; is healthier simply these healthcare pharmaceutical names, or do you have things like, you know, healthier eating and different nuances within this theme?

(SC):

Yeah, so the group of themes that we have within this ‘healthier’ bucket, really the way we think about it, we think that economies need to improve your quality of life. That's why we all participate in the economy, because it makes our life better. And so, healthier means an improvement in the quality of life. And that might mean health in terms of your physical health. We tend to focus on either two areas within healthcare; innovation or accessibility and affordability. So, you know, again, providing innovations that allow us to meet unmet medical needs, or taking what innovations we have and making sure they're available to the widest range of people. But we also have in there, healthy living, we have what's called sustainable leisure, which is about mental health, improving our mental health, which is really, really important, that's our newest theme. The quality of education is another play in there, kind of improving quality of life. Education's really important for that.

So, it's about improving your quality of life and leading a happier, healthier lifestyle, which we think's really important to think about. About [being] more sustainable, the economy, the future...this is what we are trying to invest in; companies that make [up] this economy in the future. And we want it to be, we think it should be, and we think it will be, healthier and[we'll] see an improvement in [the] quality of life.

(SW):

And do you just have an example for us about that kind of ‘quality of life’ aspect within fund?

(SC):

So, this is a reasonably new name company called Masimo. So, Masimo do pulse oximeters. So, pulse oximeters are when you go to hospital, and you have that little thing on your finger and it's

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basically a little infrared light that reads how much oxygen you have in your blood. So, really, really important. It's actually mandated across all intensive care units in the US. They're moving that product across to the general ward. It's really important. It alerts a doctor if your blood oxygen is falling, so helps the doctor there. And it's basically taking that technology - it tends to dominate in that technology - and moving it first of all, into the home.

So, now they have this really interesting, they have developing technologies whereby, instead of when you've had your operation, instead of having to sit around in the hospital for weeks, which everybody hates; the doctors hate it, the hospitals hate it, and the patients hate it most of all, you're always at risk of getting an infection, these nasty infections. So, actually they allow you to go home. And what happens is that the doctor can remotely monitor your blood oxygen, but also other factors. They actually have a set of headphones that are attached to this machine. And, if your blood oxygen drops below a certain level, the doctor can talk straight to you. So, that's the first area of innovation. They're also taking their innovation into wearables. Things... I've got one here... but they're taking their technology, so again, moving into areas like the apple watch, and again, they have the best technology to read things like your blood oxygen. So, a really exciting company, and really we think is improving kind of innovation within the healthcare setting.

(SW):

That's really interesting. So, your final bucket is the greater safety and resilience, so a safer world; what are you looking for in this theme exactly? And again, if there's a company that highlights this bucket for the listeners?

(SC):

Yeah. Again, the third element or group of themes, is what we call 'safer and more resilient'. And again, as it suggests, we're looking for companies that make the economy more resilient, better able to absorb shocks and again, a really important one coming out of, particularly the global financial crisis, but, you know, now as relevant as ever. And really, when we think about safety and resilience, a lot of it will look at things like online security is a big part of what we invest in. So, safety in the digital world. A more secure, safer banking system; things like insurance that's set up to protect people and to provide safety nets into a kind of an increasingly difficult world, particularly related to climate change.

And another one, which I'll give the example, is kind of making sure that supply chains and processes work effectively, and the goods and services that we get in front of us - that we eat, or we drink - don't have nasty contaminants or things that they shouldn't have. And a good example, is another relatively new company. One thing that's good about what's happening in 2022, and it's been a difficult year, is that a lot of the companies we love have taken a pretty sizeable

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valuation downgrade. And that's good for us, particularly when we're looking at new companies. So, one that we've been looking at for a few years, that we were very happy to get invested in, is a company called Agilent Technologies.

They dominate in the area of mass spectrometry and liquid chromatography. And, what that does, really, it's a testing system. So, it really ensures that the air we breathe, so, it tests for air quality, the food we eat, and the water we drink, is safe from contaminants. And they're really the leader in that area, particularly some areas within chromatography, and they actually have, so that's about two thirds of [the] business, and they've got a really exciting business which we love as well, which really fits into partly fits into another theme, around innovation, whereby they're really providing the kits, the picks and shovels if you like, for gene therapy and emerging areas within our medical technology.

So, think about the COVID vaccine which was an mRNA vaccine. That's a kind of new area where they're kind of, you're taking a gene, editing it and you're injecting it back in, or you're injecting the protein to interfere with that. So, they do all the testing, all that kind of new age testing kit. And that's a really exciting area, they're not one of the people developing the vaccines or developing the therapies, but they're the ones providing the kit to allow them to do that, which is a great place to be. Mark Twain said, with the gold rush, 'Don't invest in anybody with the gold, just invest in the people providing the picks and shovels'. And that's the way we like to think about areas like that.

(SW):

You took the words right out of my mouth. And just to wrap up and maybe you've mentioned throughout when we were talking about the three buckets, obviously there's kind of sub-themes. And there's quite a few that fall under these three mega trends, but just to wrap up, is there anything on the horizon, any emerging trends where you think, actually, this could become a fourth mega trend in the future or are you looking at them from a [view that] these are sub-groups within the buckets we already have?

(SC):

Yeah, it's a good question. So, when you really think [about] the themes and the kind of themes, we can think about it as kind of 20 themes and three categories of themes, but you could [also] think about them as categories of themes and the themes of sub themes, and really, they're structural in nature. So, we just don't expect them to change very often.

We're constantly looking at them, we're constantly working on them. The last time we put a theme in was, as I said, the 'encouraging sustainable leisure', which is really about physical wellbeing as an important part of a higher, better quality life. And we wanted to focus a bit more on mental wellbeing, which we think is really important. And we put that in, in 2020, and we

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haven't put another [in since], that's just one theme, it's not a category. So, you know, whilst never say never, you know, we think that within our 20 themes in the three categories, that we're really encapsulating, you know, everything, you know, at the moment that we think [are] structural in terms of those trends within the economy. We definitely would expect to add a theme or what you'd call a sub theme, but I think it was unlikely that we'd add another category, but you never say never.

(SW):

Well, thank you very much for joining us today. That's been very interesting and a very illustrative look at the portfolio through all of the different buckets and what you're looking at. So, thank you very much for taking us through the range and explaining it in a bit more detail and joining us today. Really appreciate it.

(SC):

Pleasure. Thank you very much for asking me on.

(SW):

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