Better World Fund: Investor Note

Impact Team

September 2024

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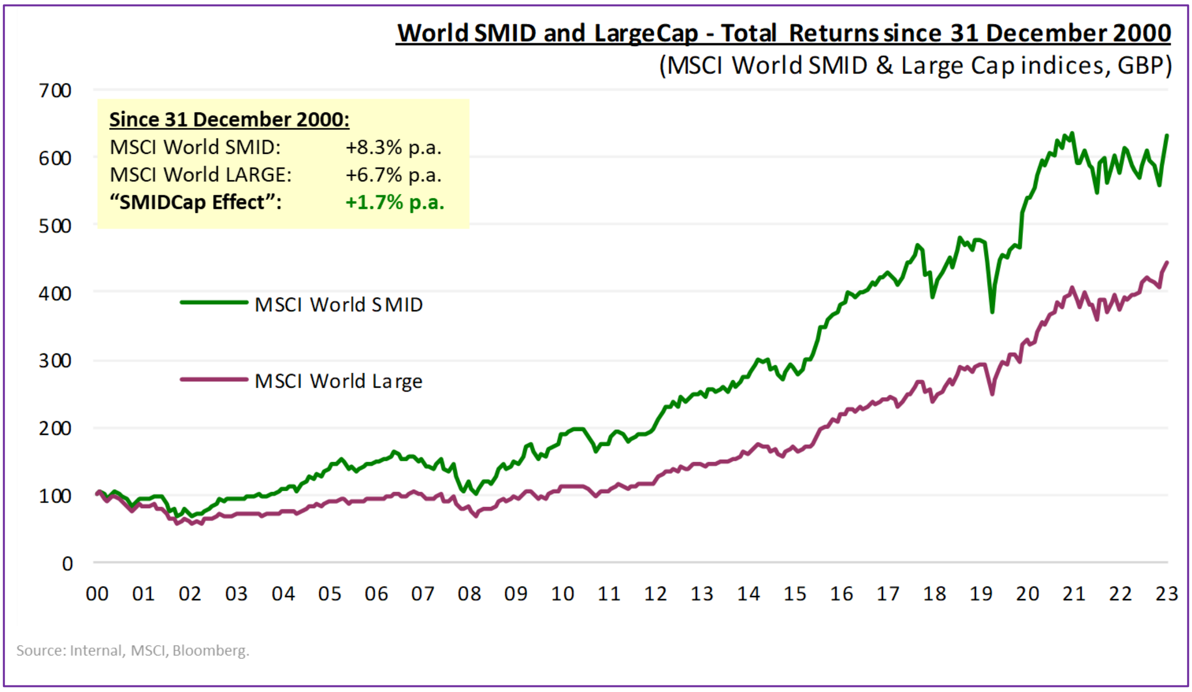
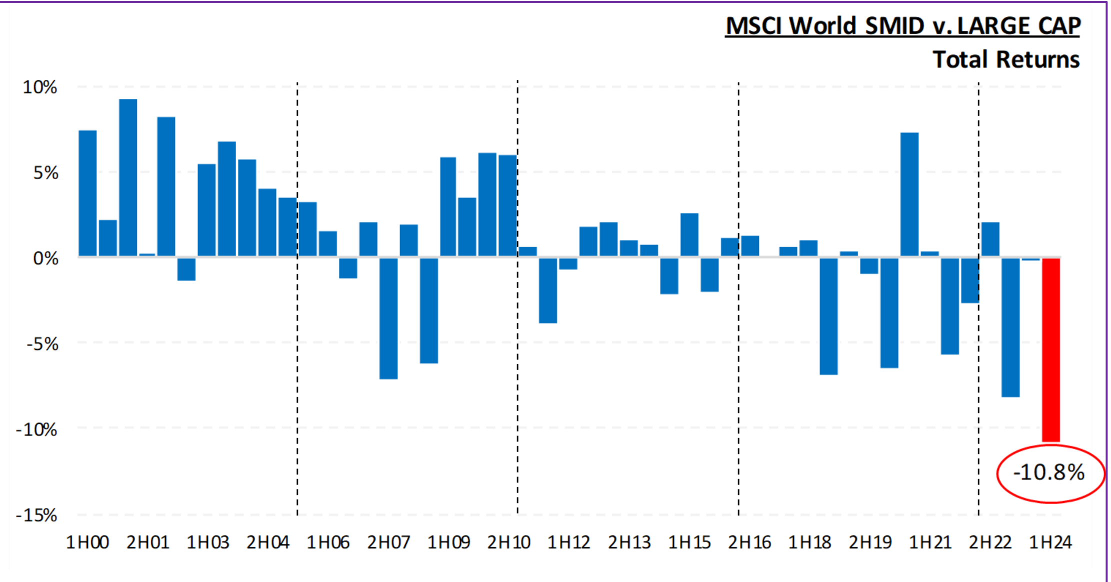
Dear Investors,

It has continued to be a difficult period for investors of certain types: smaller company investors; growth investors; quality investors; and impact investors. The bad news, at least in the short-term, is that our Better World Fund exposes us to all these styles and factors. The good news is that over the long-term, which is our investment time horizon, we believe these styles and factors expose us to some of the most exciting investment opportunities that exist.

Before we delve into how the Fund has performed this year and what we expect the future to hold, allow us to start with some reminders. Why should investors allocate to smaller companies? The answer is simple. This inefficient part of the investment market has offered far better returns than LargeCap over the long-term. Global SMidCap has outperformed LargeCap by 1.7% per annum over the last two decades, until the end of June:



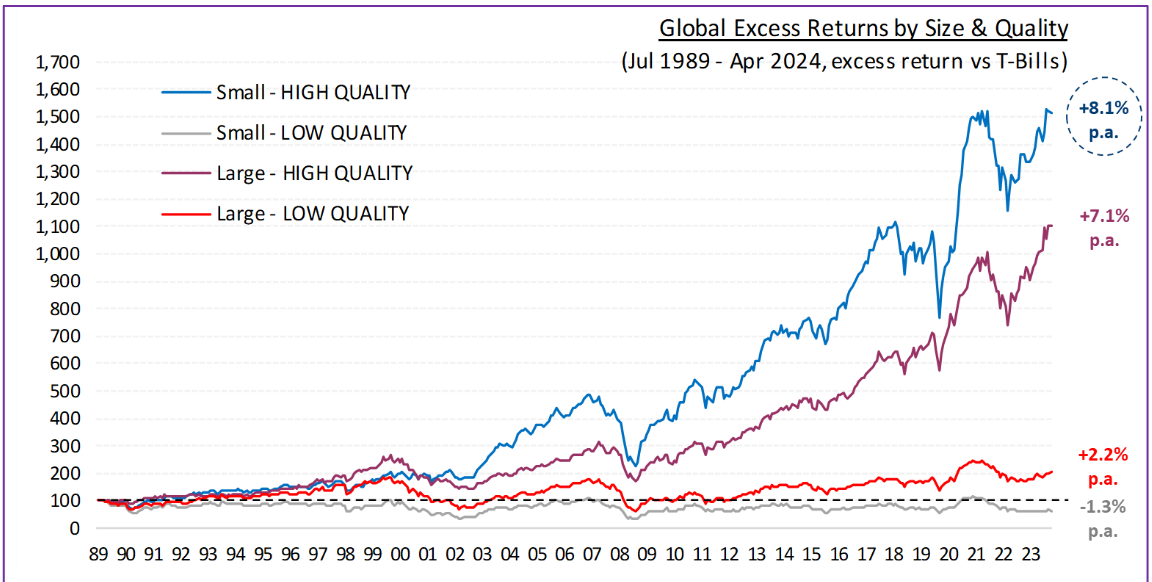
However, this outperformance has not been in evidence in recent years. Indeed, the first six months of 2024 saw by far the worst underperformance of SMidCap versus LargeCap for a quarter of a century:



Source: Internal, MSCI.

The result is that the asset class is heading for a seventh consecutive year of underperformance, a run that is unprecedented this millennium. With the US MegaCaps continuing to soar, this explains why smaller company strategies have underperformed many LargeCap focused funds.

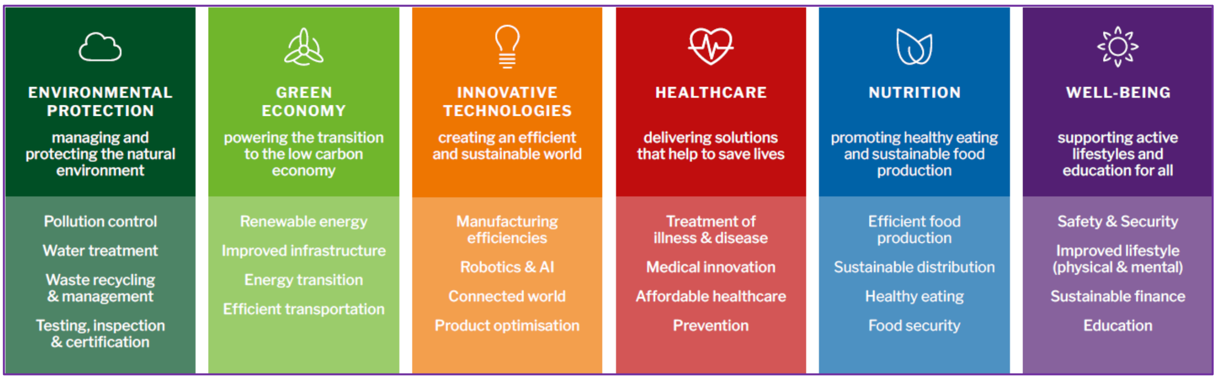
A further reminder involves our Quality Growth approach. Again, the reason for selecting this style over the long-term is because it is where the best returns have been. And not just that – it is the Quality Growth *smaller company* stocks that have offered the very best returns, as this data from AQR demonstrates:



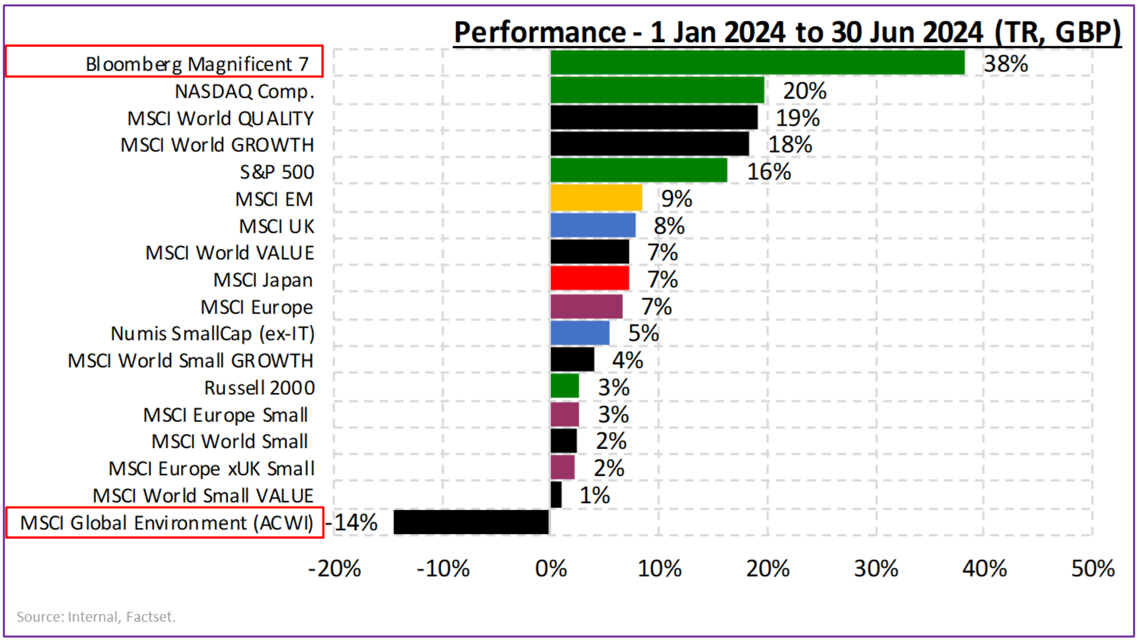
Source: AQR, Internal. "Quality" is defined by AQR based on **Profitabilty**, (RoE, RoA, Gross Margin, CF/Assets, Gross Profit/Assets, % cash earnings), **Growth** (over 5 years), **Safety** (low beta, low leverage, low volatility, low RoE volatility, low bankruptcy risk) and **Payout** (equity & debt issuance, dividend payout).
"Size": the cut-off is defined as the 80th percentile by country.

We will talk more about the impact the inflationary environment has had on the Quality Growth part of the equity market later in this note, but clearly, it has been a difficult recent time for investors who favour this style.

The last style factor to mention is Impact. This is the most challenging to isolate in performance terms – it does not fit neatly into traditional attribution models – so let us start with a final reminder. The themes that we target for investment are long-term and structural. The companies we invest in provide solutions to major world problems. These are enduring global challenges that demand urgent solutions to avoid environmental and social peril: this is the very definition of a structural investment tailwind and we believe that our themes remain just as relevant today as they did when we launched the Fund in 2018:



It has not, however, been an easy period for areas of the economy typically associated with impact investing, such as the Renewables sector:



Source: Internal, Factset.

The stark reality is that it has been the “non-impact” parts of the market that have performed the strongest over the last few years. When we look at the average returns of stocks within our benchmark, for example, traditional Energy stocks (E&P Oil & Gas companies) have delivered a staggering 156% over the last three years to 20 September

2024. These are stocks that we simply cannot invest in, but hurt our performance in relative terms. Similarly, the more important Financials sector is an area not typically associated with Impact and therefore our exposure to it is limited, but it has performed well over this period. This is frustrating, but we have to accept that Impact investing will often lead to short-term *divergences* in performance relative to traditional market indices. During these periods, we remain true to our themes, which act as our guiding light in the storm.

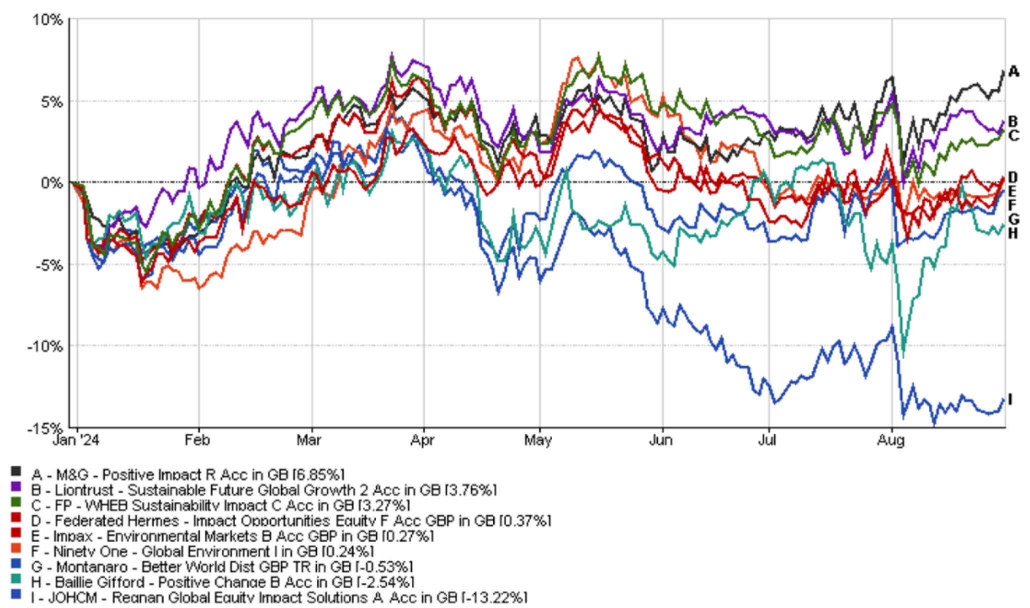
So where does this leave the Fund in 2024? How has it performed and what do we expect the future to hold? These are the questions that we shall turn to next.

Financial performance:

The Fund has broadly moved sideways in 2024 as it has been exposed to soft Healthcare Equipment, weak Renewables and consumer-related cyclical downturns in what are structurally attractive areas. Since the beginning of the year to the end of August 2024, the Fund delivered +2% in Euros and was flat in GBP (in absolute, total return terms). Versus the official benchmark, the MSCI World Smid Cap index, the Fund has underperformed by ~7%, in both currencies.

There were two notable periods in the year when the Fund underperformed. The first was in early Q2, which was driven mainly by weak Healthcare Equipment stocks. The second period was driven by the continuation of weak Healthcare Equipment stocks together with cyclical stocks later in the summer. Across much of the year we also experienced weakness in Renewables. Areas which did well were Water Infrastructure and Semiconductor companies.

Despite the Fund's divergence from its benchmark, it is worth noting that it is holding up respectably versus an Impact peer group. This comprises funds that are more LargeCap in focus – indeed, we believe the Better World Fund to be unique as a Global SMidCap Fund and therefore well positioned to benefit should smaller company performance improve:



Source: Internal, FE Analytics

Note: sterling returns on BWF impact peers (as defined by Montanaro) 1 January 2024 to 31 August 2024. This does not include previously referenced LargeCap Funds which are less relevant for comparison purposes.

Operating performance:

In general, the operating performance of our companies remains good. This can be seen in our internal forecasts: our Analysts are estimating 9-10% expected revenue growth for the Fund in 2024. And it is not just our own assumptions: consensus estimates indicate 2024 EPS growth of 16% for the Fund versus 13% for the benchmark. Margins remain high and balance sheets strong: 50% of companies have net cash.

Below, we look at each area of the Fund that has had a particularly material impact on performance this year:

Healthcare Equipment: we positioned the Fund in 2024 to be overweight Healthcare (25% versus 10% for the benchmark as at the end of June). Most of this exposure is to Healthcare Equipment companies and companies who rely on big pharma R&D investment spending. The last couple of years have presented an exceptionally difficult period for suppliers to pharmaceutical companies. Panic buying during Covid led to an inventory stocking/destocking cycle at an order of magnitude greater than any in living memory.

Following numerous meetings with company management teams and independent experts, we took the view that this downcycle would begin its recovery in 2024, hence our decision to remain overweight. As the year progressed, the recovery was pushed further into 2025 and these stocks disappointed on their revenue and profits.

Outlook: we remain confident that this sector will recover and deliver strong structural growth. We believe biologic drugs remain a good long term growth market to be exposed to in 2025 and beyond. Big pharma is doing well this year and budgets are expected to grow.

Companies: the Healthcare Equipment companies that we own and which have underperformed are Sartorius Stedim, Tecan and Bruker, while certain industrial stocks with significant healthcare equipment divisions include Spirax and Idex.

Renewables and Construction: the macro environment in 2024 has been characterised by prolonged high interest rates and this has had a significant impact on confidence and “animal spirits”. This has influenced demand and investment spending in Renewables, Infrastructure and Residential Construction. This created inventory build-up in some areas and weak demand in subsectors such as EVs, batteries, residential solar and more general DIY. Smaller company stocks are especially sensitive to these capital expenditure cycles and in Q3 several of our cyclical stocks suffered.

Outlook: the long-term outlook for Renewables remains attractive but it is a sector that is very sensitive to the cost of capital as it is linked to infrastructure investment. We believe we are moving towards a more accommodating macro and political environment and expect this sector to be closer to the end of the downturn than the beginning. The investment risk will remain high and we have set our portfolio weightings in this sector accordingly. The Residential Construction cycle also looks to be close to a turn and much of our exposure here has strong medium-term growth potential from new product penetration.

Companies: the companies we own and which have underperformed are: Trex, Alarm.com, Energy Recovery, SolarEdge and Alfen.

Water and Technology: the Fund has benefited in 2024 from two strong demand trends: the investment in Water Infrastructure in the US; and the investment in datacentres and semis. These trends have led to strong outperformance of certain stocks, albeit not enough to offset the weaker areas listed above.

In the US, water scarcity combined with ageing, leaking infrastructure has created a long-term, low-risk investment opportunity, which we have capitalised on by investing in several related stocks. In Technology, our investments have benefited from the growing demand for data usage and the expansion of network infrastructure. Specifically, our holdings play a key role in improving the energy efficiency of data systems, which is crucial as energy demand continues to rise.

Outlook: we believe the Water investment cycle can last for decades, such is the poor quality of infrastructure. As an example, one of our US water utilities is indicating that they have entered a 50 year stretch of high capex. We are also of the view that the growth in data and networks will lead to increased demand for products and services augmenting the energy efficiency of such systems.

Companies: the companies we own and which have outperformed are: Badger Meter, Belimo, Halma and Nova.

What lies ahead?

The macroeconomic conditions for smaller company investing have improved significantly in recent months. While it has taken longer than we had expected to see a turn in "animal spirits", in some part this is due to the macro backdrop, namely inflation and interest rates. The Fed's recent decision to begin cutting interest rates provides an encouraging backdrop for a recovery in the Fund in the coming months. Set against this more supportive environment, the valuation of the Fund relative to the expected growth of our companies looks compelling.

Indeed, the case for smaller companies more broadly is more attractive than it has been for some time. We are seeing more interest from clients in the asset class than at any point in the last three years and are heartened to have seen some positive inflows into the Fund (and indeed across our product range).

We feel confident that the post-Covid pharma headwinds are now mostly behind us and that when things improve the Better World Fund will be well placed to reap the rewards.

We would like to again thank all of you for your support during this challenging period. We are all invested alongside our clients and experience the ups and downs with you. Our focus remains on ensuring that this is a "best-in-class" Impact Fund and we hope to be able to announce some positive news with regards to the SDR Impact Label in the near future.

Montanaro Impact Team – September 2024

2024 Impact Report