Sustainable Investment

Q1 2024 Review

Liontrust GF Sustainable Future US Growth Fund

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The Liontrust GF Sustainable Future US Growth Fund returned 7.7% in US dollar terms in Q1, compared with the 10.0% return from the MSCI USA Index (its comparator benchmark) and the 9.7% return from the IA North America reference sector.

While the Fund lagged both the index and the peer group in the quarter, we have been pleased with the ability of the businesses we invest in to deliver growth and execute, in spite of the slowing global economy. This is testament to the structural nature of the themes we invest in, which we believe have strengthened – digital security, innovation in healthcare and energy efficiency all have a much higher priority than they did even five years ago. We also have great confidence in the quality of the businesses and management teams in the portfolio.

The largest positive contributors to the Fund's Q1 performance were Cadence Design Systems (+14%), Edwards Lifesciences (+25%) and TopBuild (+18%). The biggest detractors American Tower (-8.5%), VeriSign (-8.0%) and Adobe (-15%).

Cadence Design Systems, the provider of electronic design automation (EDA) – the technology that designs and optimises semiconductor chips – continues to perform strongly as the market revalues the intellectual property of this dominant company. Cadence is really a duopoly alongside Synopsis and both are terrific businesses with high barriers to entry and very low customer churn. This, combined with its excellent business fundamentals, has left us reluctant to take profits in our position, leading the position to grow to be one of our largest holdings.

TopBuild was another top performer in during the period, with the shares rising over 60% since the Fund launched in July to the end of the quarter. The company is the largest installer and distributor of insulation products and related building materials in the US and is therefore exposed to our theme of *Improving the efficiency of energy use*. It provides all the products and installation services for single family and multi-homes and also distributes products for other installers of home insulation. TopBuild continues to surprise investors positively with strong earnings reports and guidance. These surprises have resulted in earnings upgrades. Given the strong run in the share price, we recently took some profits in the position.

Edwards LifeSciences, the developer and supplier of patient-focused medical innovations for heart disease and critical care monitoring, reported a 14% increase in fourth quarter sales to $1.53 billion and a 12% increase in full-year sales to $6.0 billion. Held under our *Enabling innovation in healthcare* theme, the majority of the company's revenues comes from their Transcatheter Aortic Valve Replacement. For patients with aortic stenosis, the current standard of care is open heart surgery. Aortic stenosis however is a degenerative disease, which means you are more likely to develop it as you age. Not all patients who need this treatment are fit enough to undergo open heart surgery and this is where Edwards come in. They have developed a method of minimally invasively feeding the replacement valve through the femoral artery, providing high-risk patients with a solution to extend their lives.

Quarterly results also drove shares in Advanced Drainage Systems higher. Having experienced a sales decline in the first half of its current financial year, Q3 results showed a return to growth. Advanced Drainage Systems is focused on developing solutions for water management, while keeping plastic out of landfills due to the high rate of recycled plastic in its product. The company is therefore exposed to the theme of *Delivering a circular materials economy*. Its products keep waterways safe from pollution and prevent excessive stormwater runoff. The company also issued 2024 guidance which was ahead of analyst consensus forecasts and the shares responded positively. Similar to TopBuild, given the strong run in the shares, we recently trimmed our holding.

On the other side of the ledger, shares in software company Adobe fell after announcing weaker-than-expected sales figures for the quarter. The company beat average estimates for its fiscal first quarter, however guidance for the full year fell short of expectations. There is an ongoing debate whether Adobe is a beneficiary or loser from artificial intelligence. Competition in the creative industry is heating up and investors are questioning whether Adobe will be able to match or better the competition, maintaining their dominant position in the creative industry. This is something we are monitoring closely.

In the final quarter of 2023, the market started to believe that inflation was under control and the economy was weakening, as such, multiple rate cuts were being priced into bond markets for 2024, causing long duration assets (assets highly sensitive to moves in interest rates) to perform strongly. During the first quarter, this view changed, causing bond yields to rise markedly. Two of our weaker performers are both highly rate sensitive and so the multiple the market is prepared to pay for them has continued to fall.

The first is American Tower (AMT) which is exposed to our *Connecting people* theme through its network infrastructure. We believe American Tower will benefit from continued growth in communications: 5G, small cells and the internet of things will increase demand for telecoms infrastructure, and network densification is key. AMT's infrastructure assets enable telecom operators to offer telecommunication services, connecting people and facilitating the digital economy. Due to the defensive nature of the business, American Tower is one of the few holdings in the portfolio that has a significant amount of debt. This exacerbates the share price sensitivity to bond yields.

The second is VeriSign (VRSN) that for more than 22 years, has maintained 100% operational accuracy and stability of the .com and .net domain name system infrastructure, helping to keep the world connected online, seamlessly and securely. Held under our *Enhancing digital security* theme, secure, reliable operation of internet infrastructure is the main function of VeriSign, which is critically important in the functioning of our global economy. The company reported Q4 results in February which showed continued weakness from their customers in China, which now represents less than 6% of the business. This, combined with the highly interest rate sensitive nature of the company's valuation, caused the shares to perform weakly during the quarter. We have recently added to our holding.

A retracement in the share price of **Winmark** presented us with an opportunity to re-establish a position in the thrift franchise operator. We had previously exited the Fund's position towards the end of last year after a 30% share price rise in a matter of months left minimal upside in our view. Its shares have since given back much of this ground, leaving their valuation once again compelling. This level of trading – buying a stock one month and repurchasing it the next is highly unusual for us and was solely driven by the unusual share price volatility in the absence of any stock-specific news. We are long term investors, but are prepared to act opportunistically if the market offers such opportunities. In this context, and the fact that Winmark is one of our lesser known holdings, we thought a deeper dive on Winmark may be of interest.

Winmark is a franchise operator that owns several brands that specialise in reselling either clothes, musical instruments, or sporting equipment. In terms of the hierarchy of environmental benefits, significant focus in the sustainability community goes to recycling, but reusing items is considerably better for the environment. Firstly, it takes no energy to reuse an item whereas recycling required fairly complex treatment, which in turn, uses energy. Secondly, for most products, when making a recycled item, there's only so much of the material that can be recycled; there must also be virgin material, in order to produce the quality of finish that consumers expect. In clothing for example, while increasing use of recycled fibres reduce the total carbon footprint by 12%[1], extending an item's life through resale is thought to reduce emissions by 44%[2]. That's why Winmark fits so well into our theme of *Delivering a circular materials economy*. The sustainability credentials are excellent, but let's dig into the business fundamentals in a bit more detail.

Winmark's business model is to provide the brand, training, software and procurement tools to a franchisor in order to help them run and grow their business. In return for this, Winmark charge 4-5% of the franchisor's revenues. This naturally leads Winmark to possess several attractive properties from the perspective of a potential investor. Firstly, it is capital light. The capital investment required to set up and open a new store falls on the entrepreneurial store manager. For Winmark to grow their store count, they do not require capital to do so, this is a nice deal for investors. Also, there is a clear alignment and 'skin in the game' from the entrepreneur who has decided to open a store. They usually take on a loan to do this, so they are highly aligned to make it a success and are unlikely to walk away when times are tough. Winmark's success hinges on its franchises, and clear evidence of this are the 10 year contract renewal rates of 99%.

So how does Winmark grow? There are two options. The first is for the existing stores to grow sales, with highly incentivised store owners, like-for-like revenues tend to be positive over time. Two, Winmark can open more stores. The issue with the latter is finding great store operators to do this. It takes time to find the right people to open up a new store as few have the skills or drive required to borrow a significant of money and essentially start their own business. One of the consequences of Winmark being a franchise operator is that their revenues are somewhat inflation linked. As inflation runs through the economy, this affects, albeit with a delay, the price of second hand items. Winmark's revenues are inflation protected but unlike a typical retailer, their costs are largely fixed and highly scalable – they have just 83 employees. This results in high margins which in turn drives high returns on capital – this has helped Winmark's stock compound at c.19% over the past decade.

[1] WRAP, 2023
[2] Ellen Macarthur Foundation, 2017

Let's end with a discussion on valuation, indeed this was the reason we decided to exit our position in December. Winmark is a relatively unknown company; there are no sell-side analysts covering the company and management rarely participate in investor conferences. As such, there are no estimates, so when talking about a price to earnings multiple we can either use the trailing earnings or our estimate. We believe Winmark should earn c.$12 of earnings next year, which at the $345 share price we re-entered our position, means we paid c.29x earnings. If we invert this multiple, that's a 3.4% earnings yield, which combined with our anticipated earnings growth of 7% per year, should leave us with an annual return meeting our hurdle rate of 10%. This assumes that the current multiple can hold of course. Given the quality of the business fundamentals discussed above and the resilience of second hand retail in a recession, we believe this is a fair multiple and through the cycle Winmark should be able to maintain it. Should the multiple fall significantly, expect the company, who is a fan of opportunistically buying back their own shares, and ourselves, to be interested in acquiring a larger position.

Key Features of the Liontrust GF SF US Growth Fund

INVESTMENT OBJECTIVE & POLICY[1]:	The Fund aims to achieve capital growth over the long term (five years or more) through investment in sustainable securities, predominantly consisting of global equities. Typically at least 90% of the Fund will be invested in the shares of global companies, with up to 10% in bonds and cash. The Fund will only invest in companies that meet defined ethical considerations and will benefit from improvements in environmental standards and a shift towards a more sustainable economic system. While the Fund will invest predominantly in companies from developed markets it may also invest up to 20% in emerging market securities. In normal conditions, the Fund will aim to hold a diversified portfolio, although at times the Investment Adviser may decide to hold a more concentrated portfolio, and it is possible that a substantial portion of the Fund could be invested in cash or cash equivalents. The Fund is not expected to have any exposure to derivatives (contracts whose value is linked to the expected future price movements of an underlying asset) in normal circumstances but may on occasion use them for investment, efficient portfolio management and for hedging purposes including gaining exposure to financial indices.
RECOMMENDED INVESTMENT HORIZON:	5 years or more
SRI[2]:	6
ACTIVE / PASSIVE INVESTMENT STYLE:	Active
BENCHMARK:	The Fund is considered to be actively managed in reference to MSCI USA (the "Benchmark") by virtue of the fact that it uses the Benchmark for performance comparison purposes. Some of the Fund's securities may be components of and may have similar weightings to the Benchmark. However the Benchmark is not used to define the portfolio composition of the Fund or as a performance target and the Fund may be wholly invested in securities which are not constituents of the Benchmark.
SUSTAINABILITY PROFILE	The Fund is a financial product subject to Article 9 of the Sustainable Finance Disclosure Regulation (SFDR).

Notes: [1]As specified in the PRIIP KID of the fund; [2]SRI = Summary Risk Indicator. Please refer to the PRIIP KID for further detail on how this is calculated.

Key Risks

Past performance does not predict future returns. You may get back less than you originally invested. We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments.

All investments will be expected to conform to our social and environmental criteria.

Overseas investments may carry a higher currency risk. They are valued by reference to their local currency which may move up or down when compared to the currency of the Fund.

This Fund may have a concentrated portfolio, i.e. hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the Fund's value than if it held a larger number of investments.

The Fund may encounter liquidity constraints from time to time. The spread between the price you buy and sell shares will reflect the less liquid nature of the underlying holdings.

Outside of normal conditions, the Fund may hold higher levels of cash which may be deposited with several credit counterparties (e.g. international banks). A credit risk arises should one or more of these counterparties be unable to return the deposited cash.

Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

Disclaimer