Sustainable stocks in the spotlight

September 2024

Views from the desk

We support the change to a more sustainable society by investing in companies based on what they do and how they do it. This positive contribution can be through the products and services they provide and operationally through ESG leadership i.e. how a company looks after its operational assets, the environment, its stakeholders and the role it plays within its industry.

We look for well-managed sustainable companies that are leaders in their fields with durable competitive advantages and which we believe can deliver more resilient growth, lower operational volatility, and better bond holder protection as a result of strong management of sustainability risks.

Our sustainable stocks in the spotlight showcases holdings across the Royal London Asset Management Sustainable fund range that we deem to be making a positive contribution towards a cleaner, healthier, safer and more inclusive society. In this latest edition, we look at recent additions to our portfolios – new bond issues from Guinness Trust and Vantage Data Centers UK, as well as the addition of Tesco and GSK to our equity portfolios.

FIXED INCOME

Guinness Trust

Security held	Sterling denominated secured bond
Headquarters	UK
Sector	Social Housing
Portfolios held	RL Sustainable Corporate Bond Trust RL Sustainable Short Duration Corporate Bond Fund RL Sustainable Managed Growth Fund

Summary

- Lack of third-party coverage means own sustainable analysis more important
- Offers strong relative value
- Benefit from both security on underlying properties and strong covenants

Company overview

Guinness owns more than 64,000 homes across England, providing housing for 140,000 people. Around 75% of its revenues is derived from social housing lettings and other social housing-related activities. The remainder is instead generated primarily through open market sales of newly developed homes.

The case for social housing

Guinness is strongly aligned to our approach to sustainability, as it makes a clear positive contribution to society through the provision of homes at social and affordable rents in areas with a strong demand for housing. This is demonstrated by a comparison between the rents charged by Guinness compared to the private sector, with the rent charged by Guinness being only 50% of private sector rent. We also view positively the development activities carried out by Guinness, with a pipeline of homes that includes not only private market sales but also shared ownership and new homes for social/affordable rents.

Investment thesis

Guinness is another example of an issuer in the sterling credit universe that is not covered by third-party data providers. The lack of third-party coverage means that our own sustainable analysis gains even more importance, forming part of our wider credit evaluation and providing valuable insights that feed into our investment decisions.

Like many other in the sectors, Guinness faces challenges from the several competing demands put on housing associations. These include increased expectations for investments in existing stock, continued investments in new developments, and new spending for decarbonisation. On this last area, we identified Guinness as having a relatively high percentage of homes with an EPC rating of C or better – 79% as of 2023. We also welcome the investments being carried out on existing stock to improve energy efficiency, such as work on better insulating homes.

The bonds continued to offer strong relative value, with our position as bondholders benefiting from both security on underlying properties and strong covenants.

Vantage Data Centers UK

Security held	Sterling denominated secured bond
Headquarters	US
Sector	Real Estate
Portfolios held	RL Sustainable Corporate Bond Trust RL Sustainable Short Duration Corporate Bond Fund RL Global Sustainable Credit Fund

Summary

- Strong demand for the assets with very high occupancy
- Strong societal benefits
- Critical part of essential infrastructure that powers digital world

Company overview

Vantage is a privately held company, launched by tech investor Silver Lake in 2010. The current owner is DigitalBridge, an alternative asset manager focused on digital infrastructure investments with $80 billion in assets under management invested across data centres, fibre solutions, macro cell towers, edge infrastructure, and small cell networks.

The case for data centres

Data centres are specialised real estate assets housing IT infrastructure. In today's digital world, data centres represent a critical component of the essential infrastructure that makes modern-day life possible. Every digital service, from music streaming to enterprise cloud computing systems, effectively runs through data centres. Artificial intelligence is arguably the next big driver of data centre demand.

The bonds are based on two assets which represent a specific type of data centres, namely the so-called hyperscale data centres designed to meet the specific needs of "hyperscalers", i.e. the largest cloud providers such as Microsoft and Google. These companies will often lease large sections of data centres or may also occupy an entire building.

Investment thesis

The two data centres, in Wales, come with highly rated tenants who see strong demand for the assets with very high occupancy. We also note that the assets display strong ESG credentials.

Vantage demonstrates a clear commitment towards sustainability through comprehensive disclosure on a range of material matters, including energy usage, water usage, and embodied carbon. Its net zero roadmap is also acceptable when considering the decarbonisation challenges faced by the real estate sector.

While Vantage itself does not operate the IT infrastructure, it nonetheless has a key role to play in enabling the data centres to be run sustainably – namely through its responsibilities for providing power and cooling to tenants.

A key aspect of the long-term leases is the indexation terms, which provide visibility of underlying cashflows. There is also a variety of triggers and reserves in place to protect the senior lending position.

Ultimately, we see these bonds as holding an attractive credit spread on offer given security and rating.

EQUITY

Tesco

Security held	Tesco shares
Headquarters	UK
Sector	Consumer staples
Portfolios held	RL Sustainable Leaders Trust

Summary

- Tesco has been incrementally growing its already leading market share in the last few years
- More than 98% of its total emissions are generated in its supply chain and in customers' homes (scope 3), so Tesco is making the biggest impact by working with suppliers to improve production practices, offering sustainable choices to customers, and working with the wider food industry and governments to change the food system.
- Tesco's packaging strategy is to remove, reduce, reuse and recycle. By 2025, it will have removed plastic from 5 billion products.

Company overview

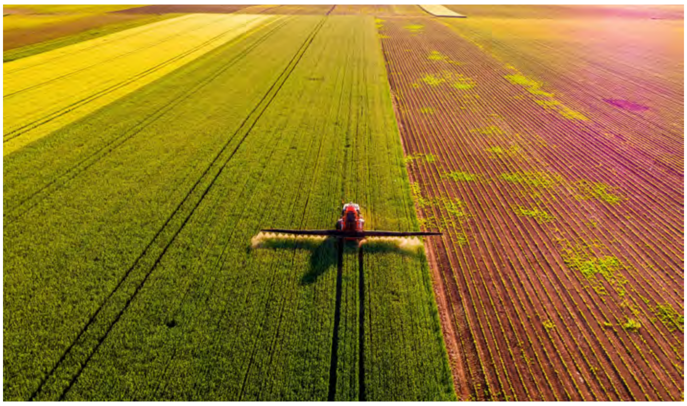
Tesco is the UK's biggest supermarket chain, as well as having a presence in the Czech Republic, Hungary and Slovakia. Within the group, Tesco is a large food distributor and has a data analytics business. It is a large employer with over 330,000 staff and aims to serve customers with affordable, healthy and sustainable food.

The case for sustainable agriculture

Due to Tesco's scale, it is British agriculture's biggest customer. This gives it the unique opportunity to truly make a difference when it comes to production practices; smaller players do not have the same sway. What sustainable agriculture means to Tesco is ensuring everyone has access to a healthy, nutritious diet that is ethically produced, good for the environment and economically viable. Tesco genuinely seems to care about its suppliers (farmers) now which is in contrast to its reputation several years ago. Examples of practices that Tesco is implementing include low carbon fertiliser, which results are showing could cut emissions by up to 50%, with similar efficacy as conventional fertilisers and feed supplements for dairy cows which reduce methane emissions by up to 30%. In paying guaranteed prices and agreeing long term contracts with farmers, Tesco helps to ensure the long-term success of farmers' businesses, at the same time as being able to facilitate the ongoing supply of affordably priced fresh produce to customers. Furthermore, all the work the company is doing on sustainability supports customers' favourable perception of Tesco's brand.

Investment thesis

Tesco's market leadership is underpinned by a number of factors - which we expect it to continue to build on. Given margins are thin in food retail, having scale and a large physical retail footprint are vitally important. Tesco has seen a growth in new shoppers and store visits, as it benefits from problems at Asda, Morrisons and the discounters Aldi and Lidl. Tesco's competitive advantages go beyond scale however and we expect its edge with respect to supplier prices, logistics and marketing continue. Its focus on good retailing is a constant as it continues to invest in low-cost sales strategies to focus fostering loyalty and bringing in more customers.



PHARMACEUTICALS

GSK

Security held	GSK shares
Headquarters	UK
Sector	Pharmaceuticals
Portfolios held	RL Sustainable Global Equity Fund RL Sustainable World Trust RL Sustainable Growth Fund RL Sustainable Diversified Trust RL Sustainable Managed Growth Trust RL Sustainable Leaders Trust

Summary

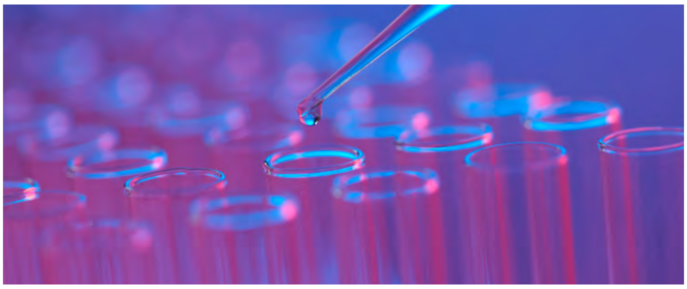
- GSK is aiming to reach more than £38bn in annual sales by 2031 (from £30.3bn in 2023)
- GSK is first in the Access to Medicines Index, for the 8th consecutive year, demonstrating its commitment to making its products affordable and available to more people around the world through responsible pricing, strategic access programmes and partnerships.
- It has 71 assets in its pipeline, many of which have blockbuster potential

Company overview

GSK is global biopharma company which prevents and treats disease with vaccines, speciality and general medicines. It focuses on science of the immune system and advanced technologies, investing in four core therapeutic areas (Infectious Diseases, HIV, Respiratory/Immunology and Oncology) to impact health at scale.

GSK's approach to R&D

R&D is central to GSK's purpose to get ahead of disease. By combining the science of the immune system with leading edge technology, the company discovers and develops new vaccines and medicines that will transform people's lives. In 2023, as proof of this, GSK spent £6.2bn on R&D, an increase of 13% on the previous year. To complement its own pipeline and add to technological capabilities, GSK has also been seeking external opportunities. It is embedding tech to accelerate research to deliver its pipeline better and faster, positioning it to become the industry leader in technology-enabled research. Technology powers its R&D. GSK uses human genetics, functional genomics, along with artificial intelligence and machine learning, to deeply understand the patient, human biology, and disease mechanisms. It can access and analyse huge volumes of data beyond the ability of the human brain, to find connections and predict patterns in disease, and identify novel genetic targets.



Investment thesis

GSK's management has set out stretching yet feasible targets which it has been delivering upon, yet due to decades of underperformance of the stock, the market does not view these targets as credible. Other factors are also weighing on it, such as ongoing litigation relating to a heartburn drug which plaintiffs are claiming has caused cancer and the impending loss of exclusivity of a major HIV drug. However, we think that GSK is a very different business now that it once was and its recent track record demonstrates this. If anything, the 2031 sales target it has set out is conservative given the quality of its pipeline and we believe that rulings will go in GSK's favour given there is no scientific evidence to link Zantac with cancer. Since 2019, there are 16 epidemiological studies looking at human data regarding the use of ranitidine (the generic name of the drug), including outcomes for more than 1 million patients using ranitidine, supporting this consensus.

Investment risks

Concentration risk: The price of Funds that invest in a reduced number of holdings, sectors, or geographical areas may be more heavily affected by events that influence the stockmarket and therefore more volatile.

Exchange rate risk: Changes in currency exchange rates may affect the value of your investment.

Liquidity risk: In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Emerging markets risk: Investing in emerging markets may provide the potential for greater rewards but carries greater risk due to the possibility of high volatility, low liquidity, currency fluctuations, the adverse effect of social, political and economic instability, weak supervisory structures and accounting standards.

Derivative risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both fund losses and gains. The impact to the fund can be greater where they are used in an extensive or complex manner, where the Fund could lose significantly more than the amount invested in derivatives.

Credit risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Interest rate risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Efficient Portfolio Management (EPM) techniques: The fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.

Counterparty risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss. Inflation risk: Where the income yield is lower than the rate of inflation, the real value of your investment will reduce over time.

Investment risk: The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Responsible Investment Style Risk: The Fund can only invest in holdings that demonstrate compliance with certain sustainable indicators or ESG characteristics. This reduces the number securities in which the Fund can invest and there may as a result be occasions where it forgoes more strongly performing investment opportunities, potentially underperforming non-sustainable funds.

Contact us

For more information about our range of products and services, please contact us.

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