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INVESTMENT MANAGERS

# TargetNetZero Equity

# 2022: a real-life stress test for climate strategies

For professional investor use only – Equities

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### Key points

- **2022 was a real-life stress test for climate strategies.** The comeback of the energy sector combined with major sector and style rotation made the market environment challenging.
- **A prudent portfolio construction with tight risk controls proved to be decisive** in 2022 which made our strategy more resilient than our peers and helped us to outperform climate benchmarks.
- **The strategy was therefore quite successful in 2022,** with the energy sector the only significant drag on performance.
- **While the road ahead is uncertain, the path is clear: net zero.** In 2022, the number of companies committed to science-based decarbonisation targets doubled compared to the year before. With the energy crisis we are experiencing, decarbonisation will become even more pressing, not only to reach net zero but also to reduce energy dependence and restore affordability in the longer term.
- **In 2023 we will continue to take risk management seriously,** seeking to allocate most of our tracking error budget to net zero target while avoiding unintended exposures. We believe that our approach will allow our investors to benefit from the climate transition opportunities in a way consistent with a healthy diversification within the equity asset class.

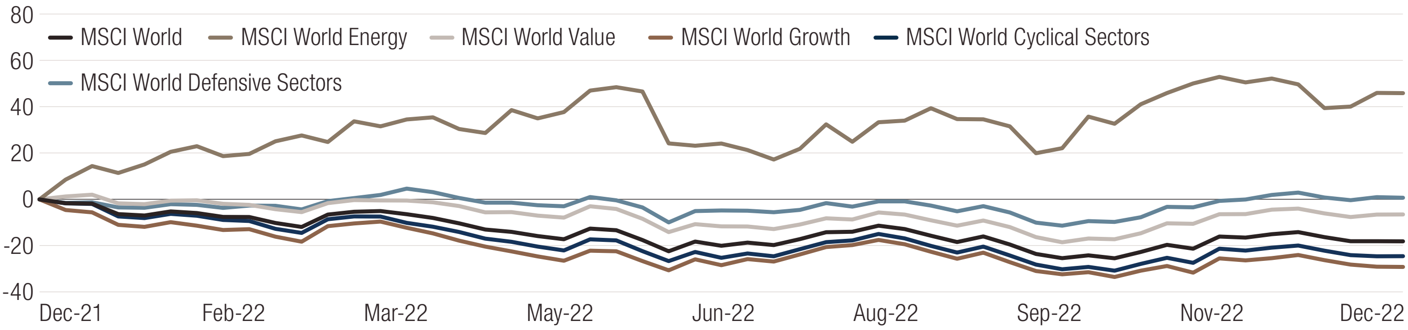
## Comeback of energy

"Permacrisis" was the Collins Dictionary word of the year in 2022 – reflecting an exceptionally difficult 12 months, marked by record inflation, rising interest rates, the cost of living crisis, the Russia-Ukraine war and subsequent energy crisis.

**The invasion of Ukraine** overshadowed the favourable global macroeconomic picture painted after the post-Covid reopening in 2021. Disrupted flows of oil and gas pushed energy prices up eroding household income and squeezing company profits, with the obvious exception of the energy industry. Indeed, at the end of 2022, the energy sector was alone in landing in positive territory with an outstanding performance of +46%. Consequently, allocation to this sector was a decisive and differentiating element of performance and risk among the equity strategies.

**Managing price stability is now the sole obsession of the world's central banks.** Rising inflation rates, on the back of the boom in delayed spending and soaring energy prices, have been a major challenge for central banks around the globe. The intensity of rate hikes to fight inflation has dampened the growth prospects of the global economy, sending equities into bear market territory.

**FIG 1. INVESTMENT STYLE AND SECTOR RETURNS IN 2022**




Source: MSCI. Performance net total return in USD from 30 December 2021 to 30 December 2022. Past performance is not a guarantee of future results.

Cyclical and growth sectors suffered the most in 2022. Information technology was down 31%, consumer discretionary fell by 33%, while communication services lost 37% over the course of the year. Defensive and value sectors fared better, as the utilities sector was down 5%, health care 6%, and consumer staples 10%.

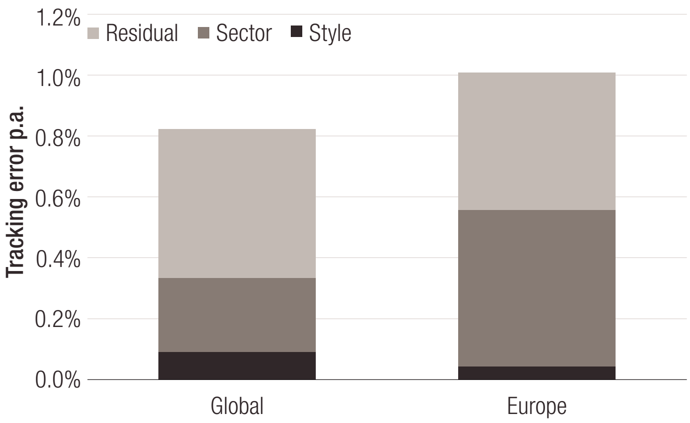
Sector allocation and style positioning were key performance drivers in 2022.

### Risks remained under control

TargetNetZero portfolios are built to have a low tracking error relative to their respective benchmarks, in order to provide investors with core equity exposure. Portfolio construction involves a numerical optimisation procedure that integrates key decarbonisation objectives, while maintaining a low tracking-error.

2022 was marked by increased volatility across different asset classes including equities. In this challenging environment, we managed to control the tracking error of our Europe and Global TargetNetZero portfolios within the limit of 1% on an annualised basis. As shown in figure 2, the Europe portfolio exhibited a higher tracking error than the Global, which can be largely explained by a more significant sector risk impact.

**FIG 2. TRACKING ERROR ATTRIBUTION IN 2022**




Source: LOIM, as at 30 December 2022.

Our portfolios intentionally introduce sector deviations relative to the benchmarks as certain activities like energy from fossil fuels are expected to shrink as the climate transition of the global economy accelerates (more on this in the next section). We are well aware of possible adverse implications of sector biases, which is why we impose ‘hard limits’ in the form of maximum sector deviations. Aside from sector risk, style/factor risks are controlled through tight limits on excess exposures to five factors: value, quality, momentum, beta and size. Thanks to these controls, factors had marginal contributions to the tracking error of our portfolios in 2022.

### Performance comment[1]

All our TNZ Equity Funds had a marginal level of underperformance relative to their market related MSCI benchmarks. As mentioned, this is predominantly down to the lower energy exposure in our strategies.

Relative to other climate related indices, we have observed close to or above a 2% outperformance depending on the market.

**TABLE 1: 2022 PERFORMANCE COMPARISON**

Past performance is not a guarantee of future results.

| Name | Return |
|---|---|
| **LO Funds – TargetNetZero Global Equity IA[1]**<br>*2nd quartile* | **-19.2%** |
| MSCI World Climate Paris Aligned[2] | -21.5% |
| MSCI World Climate Change CTB Select[2] | -22.9% |
| MSCI World (benchmark) | -18.4% |

| Name | Return |
|---|---|
| **LO Funds – TargetNetZero Europe Equity IA[3]**<br>*1st quartile* | **-10.8%** |
| MSCI Europe Climate Paris Aligned[4] | -13.4% |
| MSCI Europe Climate Change CTB Select[4] | -12.7% |
| MSCI Europe (benchmark)[4] | -9.5% |

Source: LOIM. Data as at 30 December 2022. Past performance is not a guarantee of future results.

[1] Dividend accumulated institutional client share class, net performance in USD. [2] Net Total Return USD.
[3] Dividend accumulated institutional client share class, net performance in EUR. [4] Net Total Return EUR.

[1] Past performance is not a guarantee of future results.

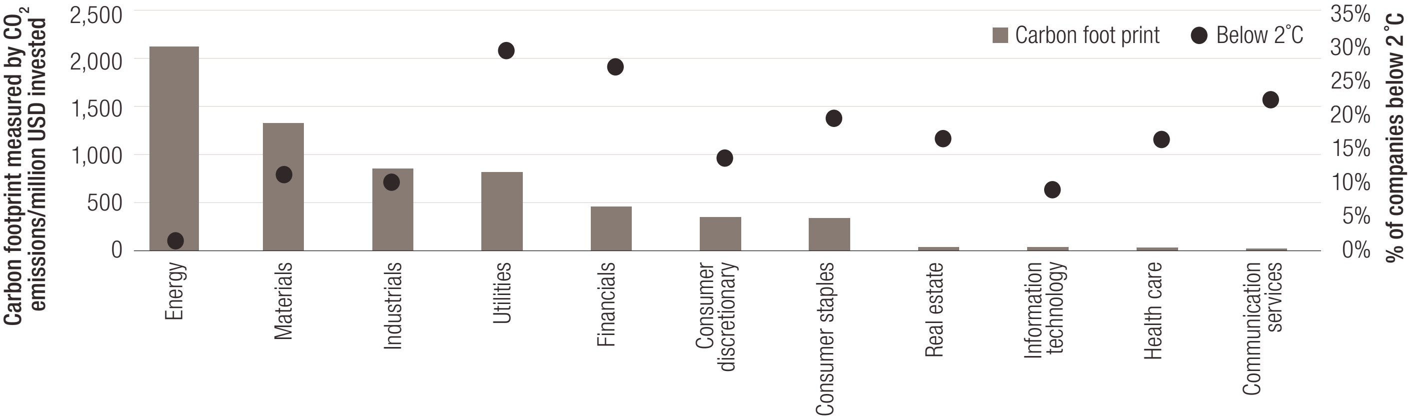
### Encouraging performance ex energy

2022 was not the best for climate strategies. Disproportionate underexposure to energy, overexposure to information technology and bias towards growth stocks made up most of the underperformance of our competitors. A prudent portfolio construction with tight risk controls proved to be decisive in 2022 which made our strategy more resilient than our peers. Importantly, our portfolios outperformed the benchmark on ex-energy basis.

We also tend tend to be underweight on energy stocks, but for different reasons to our competitors. Climate benchmarks cut the exposure to energy to reduce current portfolios emissions. The main objective of TargetNetZero is to promote companies aligned with the climate transition and disinvest from the ones lagging behind. While we tend to find leader and laggard of transitions in all sectors, energy is an exception. Being the highest emitting sector, energy also contains only few companies with the capacity to transition (less than 5%, as shown in figure 3), therefore, we tend to underweight energy stocks in our strategy.

Although our risk controls were tight, the performance of energy stocks was so strong that it had a significant impact on the TargetNetZero portfolios. In fact, our underweight in the energy sector accounted for the entire underperformance of our portfolios in 2022. Excluding energy, the strategy has been quite successful as shown in our performance analysis in figure 4.

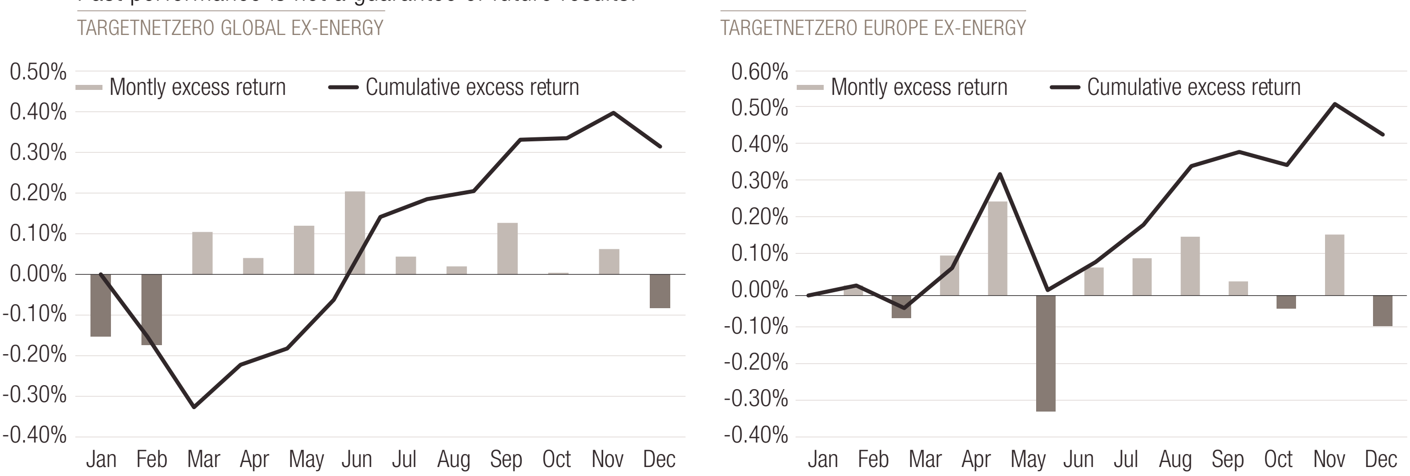
**FIG 3. CARBON EMISSION AND PERCENTAGE OF COMPANIES WITH IMPLIED TEMPERATURE RISE BELOW 2°C BY SECTOR**




Source: LOIM, as at 30 December 2022. For illustrative purpose only.

**FIG 4. EXCESS GROSS RETURN OF THE PORTFOLIO EXCLUDING THE ENERGY SECTOR**

Past performance is not a guarantee of future results.




Source: LOIM. Performance attribution analysis from 30 December 2021 to 30 December 2022, in USD for TargetNetZero Global ex-Energy, in EUR for TargetNetZero Europe ex-Energy. For illustrative purposes only.

**We would like to further emphasise the encouraging result of the ex-energy performance by a deep dive into a number of companies with a high and credible decarbonisation potential that helped shape performance:**

Electricité De France (EDF) helped to generate some outperformance that partly compensated for the negative contribution of materials and energy. Thanks to its low-carbon electricity production, it is one of the best-positioned companies in the utilities sector and has a temperature of 1.4°C, according to our implied temperature rise (ITR) model. The French government's proposal to acquire the remaining 16% of the shares at 45% above market price led to an outstanding performance in July. Signatories of the Paris agreement have come to view electricity generating companies as strategic assets, in terms of meeting both net-zero objectives and domestic energy demand. This would certainly explain the French government's interest in acquiring EDF.

Norsk hydro is a fully integrated aluminum company with strong and credible decarbonisation targets. The company is on a trajectory towards 1.7°C. Producing aluminum is an activity that requires a lot of energy which make it highly sensitive to the climate transition. The company operates more than 20 hydropower facilities throughout Norway, providing clean and renewable energy for their aluminum production. Put differently, Nork hydro have a cost base decoupled from the fossil energy price which has been a considerable strength in the context of the energy crisis we are experiencing.

Cummins is a world leader in powertrains. The company is active in the transition to a lower carbon economy. Over 40 trains were powered by Cummins fuel cell systems in 2022. Cummins is commited to decarbonise its direct emissions – scope 1 and 2 – as well as reducting the lifetime GHG emissions from newly sold products. These targets have been validated by the Science Based Targets initiative. We estimate that Cummins is on a 2°C trajectory, making it one of the best positioned companies in its sector to achieve net-zero. In 2022, Cummins recorded a positive performance of 13% while the industrial sector was down by 13%.

Source: LOIM. Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

### While the road is uncertain, the path is clear: net zero

Global inflation eased in many developed markets towards the end of 2022, although headline levels remain high. The encouraging inflation trends finally allowed central banks to slow the pace of rate hikes. In 2023, central banks are likely to maintain tight monetary conditions and let their balance sheets run off. Inflation should progressively recede, although elevated rates are likely to weigh on aggregate economic demand.

In such an environment, companies could still be exposed to lagging cost inflation but will have a diminishing ability to pass these price increases through to consumers. For companies with material refinancing needs, the higher rates will make new funding very expensive.

In Europe, the successful build-up of gas reserves, combined with warm weather, marginally improves the inflation outlook and continue to give us confidence that shortages can be avoided going forward. We believe that the energy crisis is not yet resolved, but Europe will benefit from the experience of 2022. We expect some degree of normalisation of the energy sector in 2023.

This background, to say the least, further highlights the importance of the energy transition to reduce dependence and restore affordability in the longer term. In addition, there is an increasing pressure on companies to align their business models to net zero. At the end of 2021, more than 2,200[2] companies were committed to science-based decarbonisation targets, which is double the figure for 2020. Regulation, market forces, consumer demand and investor behavior are all pushing in the same direction making net zero momentum inescapable.

### Positioning the portfolio for 2023

The year 2022 has shown the need to carefully manage short-term risks. In 2023 we continue to take risk management seriously seeking to allocate most of our tracking error budget to net zero target avoiding unintended exposures. We believe that our approach will allow our investors to benefit from climate transition opportunities in a smooth way.

[2] SBTi annual progress report, 2021.

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