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Nomura Funds Ireland - Global Sustainable Equity Fund

Sustainable Fund Performance and Style Exposure

Alex Rowe, CFA, Lead Portfolio Manager
Nomura Asset Management U.K. Ltd.
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Part 1: 'Sustainable' does not have to mean Growth

Interest in investing more sustainably rose dramatically through 2019 and 2020. However, investors have found that seeking to pursue a more 'sustainable' fund exposure presents a challenge with regards to the fact that most (but not all) existing sustainable funds are 'Growth' funds. Over the past two years however, as oil has continued to soar, inflation has proved to be far from transitory, and interest rates have risen sharply, the materially overweight 'Growth' sustainable and impact fund sector has come under significant performance pressure and flows into the space have reversed sharply

Taking Morningstar data on Sustainable Finance Disclosure Regulation (SFDR) Article 9 Global Equity strategies as a proxy for the available sustainable strategies, in 2022 sustainable strategies underperformed the MSCI ACWI by an average of 4.7%, with 78% of this peer group underperforming, whilst in 2021 the average underperformance was -4.6% with 71% of strategies underperforming

This is in stark contrast to 2020 in which Article 9 Global Equity strategies outperformed by 7.2%% (8.9% adjusted for Assets under Management) with 70% of strategies outperforming.

	2022	2021	2020
Average Return	-23.01	13.92	23.41
AUM Weight Average	-24.37	13.72	25.18
MSCI ACWI Net TR	-18.36	18.54	16.25
Under/Outperform Average	-4.65	-4.62	7.16
Under/Outperform AUM	-6.01	-4.82	8.93
Proportion Outperform	22%	29%	70%

Source: Nomura Asset Management Research, Morningstar Direct data as of December 2022, Manager Research data as of 31 December 2022.*

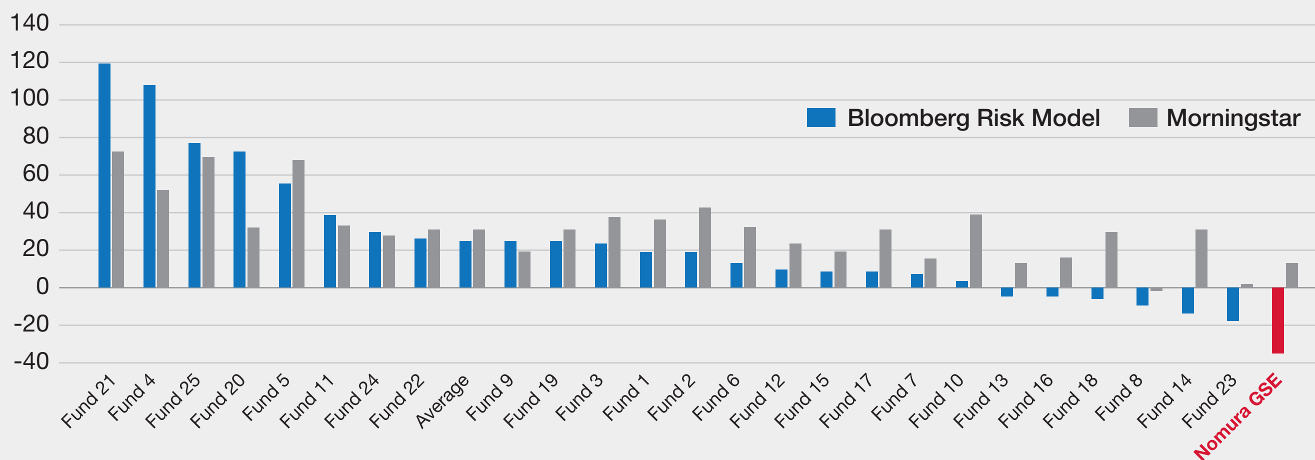
The chart below shows the Growth / Value characteristics of the largest 25 SFDR Article 9 strategies. The degree of Growth exposure is assessed in two ways.

1. Bloomberg 'G-V' is the active 'Growth' exposure (vs. MSCI ACWI) minus the active 'Value' exposure, sourced from Bloomberg.
2. Morningstar 'G-V' is the proportion of holdings characterised by Morningstar as 'Growth' subtracted by the proportion of holdings characterised as 'Value'.

It is clear from this analysis that there is a material bias, in the group, towards 'Growth' with an average 'G-V' of 0.25, with 76% of strategies having Growth bias (i.e. 'G-V' above 0) and 44% having a material Growth bias ('G-V' above 0.2) whilst no sustainable strategies had a material Value bias ('G-V' below -0.2).

In the wider Morningstar analysis, 86% have some degree of Growth bias, whilst only 10% have a Value bias. The average exposure across the peer group is +25%, and 61% of strategies have a material 'Growth' bias, whilst only 3% have material exposure to 'Value'.

Growth – Value Exposure



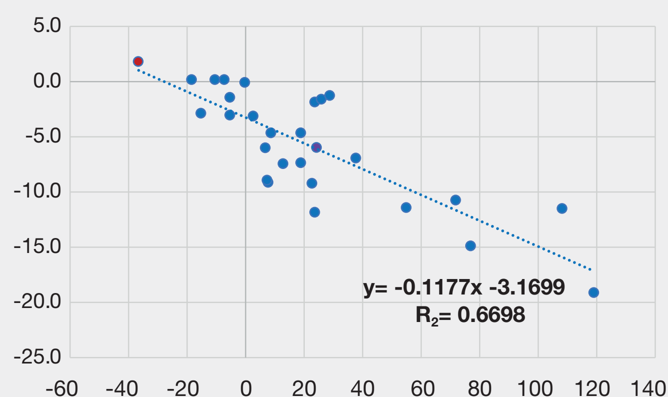
Bloomberg Style Exposure: 25 Funds	
Proportion with G-V >0	76%
Proportion with G-V <0	24%
Proportion with G-V >20%	44%
Proportion with G-V <-20%	0%
Average 'G-V'	**24.84%**

Morningstar Style Exposure: 147 Funds	
G-V >0	86%
G-V >20%	61%
G-V <0	10%
G-V <20%	3%
Average	**25%**
AUM Weight Average	**32%**

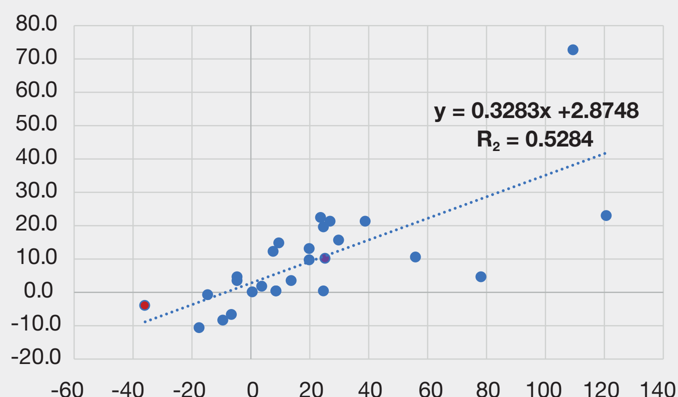
Source: Nomura Asset Management Research, Risk Model, Morningstar Direct as per end of December 2022. Bloomberg as at end of December 2021.*

There is a remarkably strong correlation between Growth exposure and performance. Indeed we would go as far to say that this exposure has been one of the greatest driver of the sustainable fund investor recent experience. Taking the 25 largest active Article 9 strategies over 2022, 78% of the strategies underperformed, as 'Growth' as a factor lagged. The R squared ** over the period further suggests that almost 67% of relative performance can be explained by the 'G-V' exposure. Taking the the 2020 period in which 'Sustainable' strategies experienced especially strong outperformance suggests that 53% of that relative performance can be explained by the 'G-V' exposure.

G-V' vs. Relative Performance 2022



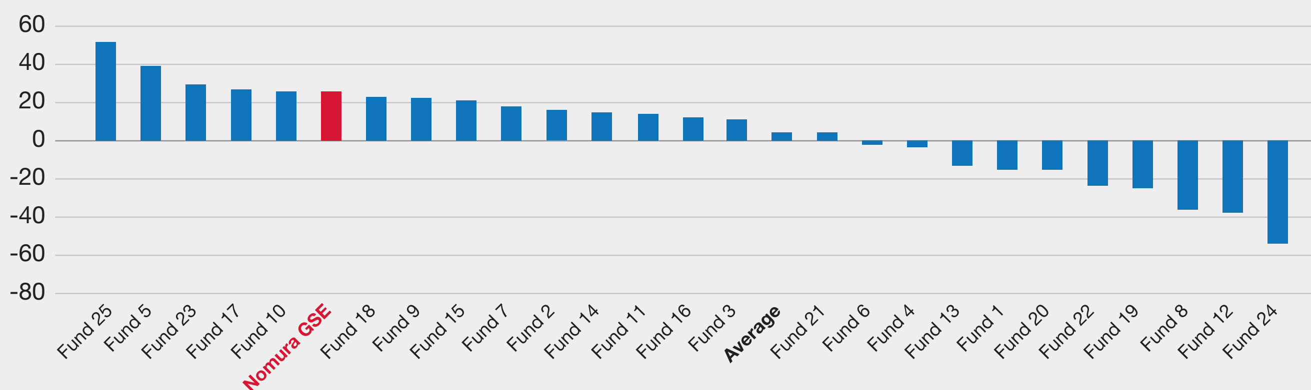
'G-V' vs. Relative Performance 2020



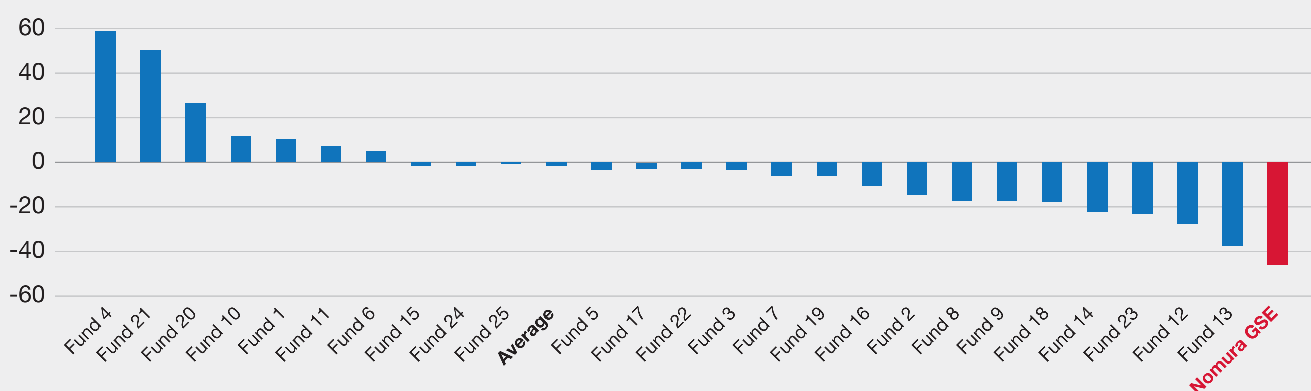
Source: Nomura Asset Management Research, Bloomberg, Risk Model, Morningstar Direct as per end of December 2022.*

Our analysis of these 25 funds further suggests a slight bias towards lower quality and less stable businesses, as evidenced by a modest average negative exposure to 'Profit' (indeed for certain strategies a very significant negative) and neutral exposure to earnings variability.

Bloomberg Profit Factor Exposure



Bloomberg Earnings Variability Factor Exposure



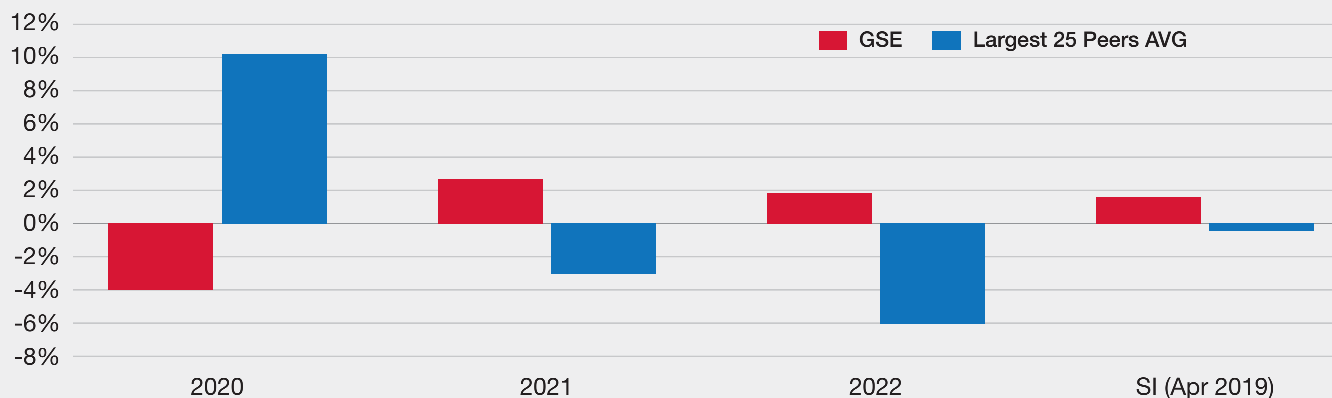
Source: Nomura Asset Management Research, Bloomberg, Risk Model, Morningstar Direct as per end of December 2021.*

Sustainable equity funds do not, however, have to be so overweight growth, valuation agnostic or biased towards lower quality business with higher earnings variability. The Nomura Global Sustainable Equity strategy stands out within these peer groups for its neutral exposure to 'Growth' or 'Value', and overweight to 'Profit' and lower Earnings Variability (we would describe that as overweight "Quality").

Since inception (15 April 2019) the strategy has outperformed MSCI ACWI by 1.53% annualised. This outperformance has been delivered despite not having an overweight to Growth and indeed being underweight growth for periods on valuation grounds – the MSCI ACWI Growth Index has outperformed by 0.55% annualised over this period. This has protected investors during periods in which 'Growth' has underperformed sharply. Indeed over 2022 in which the largest Article 9 Funds underperformed by on average -6.0% the strategy outperformed by +1.9% and in 2021 when the average largest fund underperformed by -3.1% the strategy outperformed by 2.6%.

The Nomura Global Sustainable Equity strategy is a compelling proposition for those investors seeking a more sustainable approach without being forced to take a bet on 'Growth' or compromise on valuation discipline and avoid taking on exposure themselves to sharp reversals in style performance. This highly differentiated exposure has been driven by our rigorous approach to 'Valuation' and 'Quality', and differentiated, impact-aware, approach to defining what makes a 'sustainable' investment. In the second part of this white paper we discuss further, why 'Sustainable' does not have to mean bias to growth or compromising on 'Quality' or 'Valuation'.

Relative Performance of Largest 25 Article 9 Strategies v. Nomura



Source: Nomura Asset Management Research as of end December 2022.

Part 2: Why Sustainable Investing does not actually have to mean Growth

The current offering of 'sustainable' strategies has a very clear bias towards 'Growth', that has been an exceedingly strong driver of the sustainable fund investor experience over the past two years (firstly, particularly strong performance and then noticeably negative performance). We believe this bias is in part driven by the immaturity of the space and the approach to defining 'sustainable' investments.

The earlier origins of 'sustainable' investing placed great emphasis on lower negative (particularly environmental) impact as the primary focus. The industry is now moving more towards a positive impact / role approach in supporting and transitioning towards a more sustainable world, yet many funds have not caught up yet. For example, we would highlight a transition from favouring IT companies, which have naturally lower emissions and environmental impact to a more mature understanding that certain higher emitting companies (operationally) are developing technology, which is crucial to a low carbon economy, and therefore have a more positive impact. The earlier mind-set was certainly better suited to Growth investors, and it is our opinion that, as the sector continues to mature, the range of sustainable strategies will broaden and the current investment biases will decline.

'ESG' or 'Sustainability' is also highly subjective, however it does appear there remains a degree of crowding into certain stocks. Our definition of 'sustainable' is companies that have a high total positive impact, balanced fairly across all stakeholders, and there are certain sectors that we disagree with our peers on. More recently, as 'Impact' strategies have been launched within the public equity space, whilst the focus has shifted more onto positive impact the industry clearly has a bias towards more disruptive technology and solutions (typically smaller, higher growth, lower quality and simpler 'stories') and an under appreciation of the impact of more mature businesses.

For example, within our framework, we have a positive view on a number of sustainably managed pharmaceutical companies that are developing treatments for crippling diseases, approaching 'access' proactively, and responsibly pricing treatments. However, some disagree, focus more on financial risk as a definition of sustainability, and deem the reputational and legal risks that are more pronounced within the pharma space as too high. We also believe that not enough weight is placed on the positive impact of access strategies in reaching lower income patients in emerging economies. Access strategies include for example direct donations of treatments to low income countries and the licensing of patented treatments to generic manufacturers in low-income countries, so that the treatments can be manufactured and sold at a vastly reduced price point.

Among pharmaceutical companies we have identified a number of high quality mature businesses, at attractive valuations (typically this means no excessive growth bias) and that have high total positive impact. This segment is under represented in our view, relative to our assessment of its sustainability. In the absence of more publicly

reported data and a better understanding across the investment management industry with regards to the positive global impact on human life of these businesses, it is likely that the sector will remain under represented relative to more obvious segments such as Clean Tech.

This certainly does not however mean 'impact at any price' and, at this moment, a focus on valuation, in sustainable investing, is perhaps more important than ever, as we have seen bubbles inflate and then burst as different pockets of ESG have garnered attention. Clearly being solely good on ESG does not guarantee strong returns. A company that is positively aligned with climate megatrends and manages the climate impact of its operations diligently will experience greater tailwinds operationally than a company that is less advanced. But that does not necessarily mean that an investment in such a company will generate better returns – it ultimately depends on the price paid. Should 'good ESG' not be appropriately priced in, we would agree that an investment has the potential to outperform. However, should these 'ESG' credentials or opportunities have attracted so much attention, that valuation becomes entirely detached from fundamentals, this would not make for an attractive long-term investment.

Take for example a well-known wind turbine manufacturer that has a long track record of low returns on capital and profitability and management missteps; we have no doubt that the company will experience very strong tailwinds, as particularly offshore wind demand continues to accelerate. However, we do not believe the company can be relied upon to capitalise on the opportunity. Investors who have chased ESG or Impact at any price, with little regard for valuation within sectors such as Clean Energy, have more recently experienced very material headwinds to investment performance, as prices have reverted towards intrinsic value.

S&P Clean Energy ETF vs. S&P 500 Energy

Source: Nomura Asset Management Research, Bloomberg as per end of December 2022.

Certainly, there is a place for higher growth investments – we invest in a number of earlier stage, high growth businesses developing technologies that are enabling financial inclusion. We believe they are acting responsibly and the valuation level is underpinned fundamentally. However, there is also a place for mature companies. Companies such as GlaxoSmithKline that are supporting access to treatment that is saving lives but not necessarily growing very quickly. Indeed these companies will often have a more sophisticated approach to access and ensuring a sustainable approach. Certain companies that have risen in the pandemic through the development of COVID vaccines treatments have for example struggled to balance their responsibilities to support access in lower income economies and have come under scrutiny.

More established and mature businesses that are already having positive impact are furthermore better positioned to report on this. This supports not only our understanding of the company's impact (and assessment with regards to merit in holding it within portfolios) but also the articulation of the impact of the underlying holdings within a portfolio. In contrast, earlier stage, higher growth companies might not even be having any current impact (and more so the prospect of having impact in the future) or the capacity to report on impact.

In summary, we believe that the current bias towards ‘Growth’ is a function of the maturity of the ‘sustainable’ investing space and, as the industry matures towards focussing more on the positive impact of business, we expect these investment biases to decline. There are only 3 out of 133 funds that are Article 9 that do not have a growth bias. The Nomura Global Sustainable Equity strategy is one of those. It offers a highly differentiated approach to sustainable fund investors with regards to both being impact aware and our rigorous approach to ‘Valuation’ and ‘Quality’, which has not left investors exposed to either wild swings in style performance or the bursting of ‘ESG bubbles’.

Maybe it is time for a different way to invest sustainably...

* Morningstar Settings: Global Category = Global Equity Large Cap + Global Equity Mid/Small Cap, Oldest Share Class = Yes, Index Fund = No, EU SFDR Fund type = Article 9, Morningstar Category NOT= EAA Fund sector Equity Ecology, as per end of December 2022. Copyright © 2023 Morningstar. All rights reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied, adapted or distributed; (3) is not warranted to be accurate, complete or timely; and (4) do not constitute advice of any kind, whether investment, tax, legal or otherwise. User is solely responsible for ensuring that it complies with all laws, regulations and restrictions applicable to it. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information, except where such damages or losses cannot be limited or excluded by law in your jurisdiction. Past performance is no guarantee of future results.

** R-squared (R2) is a statistical measure that represents the proportion of the variance for a dependent variable that's explained by an independent variable or variables in a regression model. Whereas correlation explains the strength of the relationship between an independent and dependent variable, R-squared explains to what extent the variance of one variable explains the variance of the second variable. So, if the R2 of a model is 0.50, then approximately half of the observed variation can be explained by the model's inputs. Source: https://www.investopedia.com/terms/r/r-squared.asp.

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