Aegon Ethical Equity Fund: Green shoots ahead

Ethical Investing

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AEGON INSIGHTS

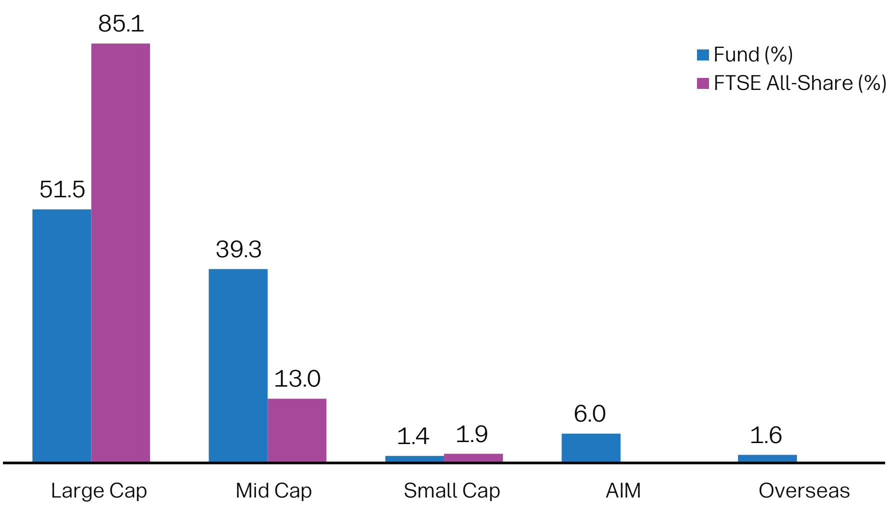
Audrey Ryan and Farrakh Ashraf explain why now could be the right time to consider Ethical Equity.

UK equities have long been attractive on valuation grounds but have lacked compelling catalysts to spark a change in fortunes. That is no longer the case however, as we see several green shoots of recovery ahead.

With inflation lower and close to normal levels, economic data showing signs of improvement and the tailwind of heightened M&A activity, investors are learning to love the UK again. Recent data from Calastone highlighted that UK focused equity funds saw their first positive net retail flows in November 2024 since May 2021! What's more, we think the area that could potentially benefit most from this are UK small and mid-cap stocks, including those with a domestic focus.

The Aegon Ethical Equity Fund has a heavy exposure to these areas of the market relative to the index, primarily driven by our **client-led ethical criteria**. With 35 years of experience navigating market cycles and meeting the needs of clients who wish to align their investments with strong ethical principles, we believe the Fund can be an attractive option for those looking to take advantage of this opportunity.

Market cap split (%)



Source: Factset as of 30 November 2024

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> ***With inflation lower and close to normal levels, economic data showing signs of improvement and the tailwind of heightened M&A activity, investors are learning to love the UK again.***

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Below, we discuss the catalysts underpinning our optimism and some of the ways the Aegon Ethical Equity Fund is positioned to take advantage of these.

Improving macro picture

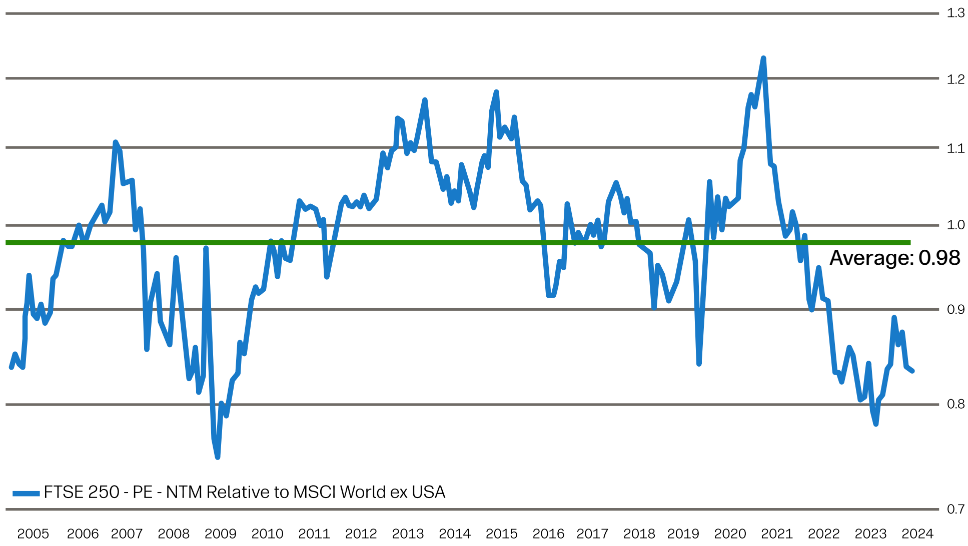
With political clarity in the UK and the Budget now passed, we see scope for improving sentiment in our domestic market. Inflation has been stabilising over recent months resulting in the Bank of England cutting interest rates in August and November. Rates are expected to fall further from here and this should boost domestic consumer sentiment and disposable incomes providing a tailwind to equity market valuations. These factors should disproportionately favour UK small and mid-caps, particularly domestically focused ones.

Furthermore, UK GDP growth has inflected positively this year, which is a marked improvement compared to the second half of 2023 when the economy entered a technical recession. As we look forward, the UK is no longer an outlier with regards GDP growth.

UK equities remain cheap compared to other developed markets and within that, we believe, mid-caps are particularly attractive from a valuation perspective. We expect falling interest rates and accelerating UK GDP growth to drive a reduction in the valuation gap for small and mid-cap stocks.

The valuation gap

FTSE 250: Cheap vs the rest of the world



Source: Factset as of 30 November 2024

Current market dynamics present an attractive entry point for long-term investors.

Heightened M&A activity

The valuation factor has certainly caught the attention of private equity and public listed companies (both domestic and foreign), which are acquiring UK companies at a heightened rate. As at the end of November 2024, inbound M&A to the UK equity market has totaled c. $60bn*. This dynamic has notably boosted the small and mid-cap space, and we expect this to remain a supportive feature going forward.

Fund positioning – Unlocking the opportunity

We are taking advantage of the domestic opportunities on offer in several ways at the stock level. We provide examples of two prominent themes in the portfolio below:

Domestic consumer exposure

UK household savings are currently at unusually high levels and house prices are rising once again. The improving macro picture should also help drive more positive consumer sentiment which will benefit stocks exposed to the domestic consumer. Many of these businesses have been through a tough period but we expect to see numerous areas inflect higher going forwards. In addition to the macro tailwind, we are interested in companies that display additional attractive characteristics, such as gaining market share or benefitting from the planning reforms promised by the Labour government.

Core strengths

- ***Proven ethical investment approach***
- ***35 year track record of successfully navigating markets***
- ***Differentiated market cap exposure***

Key holdings:

Exposure to cyclical recovery names

Within the overall economic cycle, many industries go through their own peaks and troughs at different times and speeds. We have spent time over the past year looking for opportunities where we believe certain end markets are close to or at their trough and have the potential to show meaningful recoveries. We believe there is alpha to be generated from finding attractive companies that are coming to the end of a downgrade cycle and can benefit from the changing environment resulting in earnings forecasts being upgraded. Our focus has been on adding exposure to companies with strong balance sheets and the potential for sector leading cyclical recovery.

Recent additions:

Looking beyond the UK

We have outlined the prospects for domestically focused stocks, but the Fund also offers exposure to compelling international growth themes.

Internationally diverse quality growth

We have long had strong exposure to internationally diverse quality growth companies within the portfolio. These growth businesses have the ability to compound earnings and deliver attractive shareholder returns over time, which makes them important contributors from a portfolio management perspective.

Key holdings:

US exposure

The US continues to lead developed world growth, and its prospects look robust given it has now also entered an interest rate cutting cycle and the incoming Republican administration expects to pursue domestic growth focused policies. Our Fund offers clients the opportunity to leverage the future growth opportunity from across the pond through companies which are geared into the US such as:

Why the Aegon Ethical Equity Fund stands out

- We offer proprietary **client-led ethical exclusions** which are reviewed every two years through a client survey to ensure our criteria remains 'fit for purpose'.
- We leverage the in-house experience and resource of our **Responsible Investment team** to carry out in-depth ESG due diligence, engagement and voting.

Portfolio characteristics

- Our client-led ethical exclusions result in our portfolio having a **bias towards UK small and mid-cap stocks** relative to the index. This makes the Fund look very different to the market and most active UK equity peers.
- The Fund's avoidance of companies that cause significant negative effects on society or the environment results in a **low carbon portfolio**.

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Summary

We believe the present backdrop provides an excellent opportunity to access the long-term opportunities our Fund offers. The catalysts we have outlined should particularly benefit the small and mid-cap space, where our Fund carries a higher exposure than the market and many peers. Notably, our 35-year track record of navigating various market cycles, combined with our distinctive client-led ethical approach, provides a compelling way to capture the UK recovery story while maintaining strong environmental, social and governance ('ESG') characteristics.

Find out more about our ethical equity capabilities **here**.

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*Source: DB Numis

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