Confidence must be earned

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# Amundi US Equity ESG Improvers SMA

Performance Analysis and Market Commentary | September 30, 2022

## Investment Philosophy

We believe companies with a solid fundamental investment case combined with an ESG positive view may be well positioned to drive alpha generation over time.

## Performance Review

| | Year to Date | 3-Month | 1-Year | Since Inception* |
|---|---|---|---|---|
| **Amundi US Equity ESG Improvers SMA (Gross)** | -22.64% | -7.67% | -14.74% | 6.38% |
| **Amundi US Equity ESG Improvers SMA (Net)** | -24.42% | -8.38% | -17.30% | 3.24% |
| **S&P 500 Index (Benchmark)** | -24.14% | -4.88% | -15.86% | 5.45% |

*The performance inception date of the Amundi US Equity ESG Improvers SMA composite is August 1, 2020. Represents partial year performance. Source: Amundi US. Performance shown is based on the US Equity ESG Improvers SMA composite. The percentage of composite assets represented by wrap fee portfolios for the period(s) shown is 0%. Gross of fee returns are presented before management and custodial fees, but after all transaction costs. Net returns are calculated by deducting the highest applicable annual wrap fee (3.00% on all assets) applied on a monthly basis from the gross composite monthly return. Gross and net returns are calculated in the same manner using the Time-Weighted Rate of Return method. The wrap fee includes all charges, transaction costs, portfolio management fees, custody fees, and other administrative fees. Actual fees and account minimums may vary. **Past performance is no guarantee of future results.** Periods less than one year are not annualized.

## Market Review

— US stocks, as measured by the S&P 500® Index (SPX), lost 9.21% in September, which contributed to a decline of 4.88% for the third quarter. This marks the second consecutive quarter that the SPX has ended in bear market territory. Meanwhile, in the third quarter, the Dow Jones Index officially entered its bear market territory for the first time since the onset of the pandemic in early 2020. Typically, the definition of a bear market is a decline of 20% or more. For the year to date ended September 30, 2022, the SPX has returned -23.87%. Should the SPX not post a gain in the final quarter of the calendar year, this would represent the largest loss for the index since the global financial crisis in 2008.

— The third quarter of 2022 also marked the first time since 1976 that both equities and bonds have posted three consecutive quarters of negative returns. Investment-grade bonds, as measured by the Bloomberg US Aggregate Bond Index, declined by 4.75% this quarter and have returned -14.61% for the year to date. This weakness across both equities and bonds through the first nine months of the year has made it more challenging for investors to find a "safe haven."

— The Federal Reserve (Fed) continued to raise the target range of the federal funds rate during the third quarter, including a 0.75% hike in September, as part of its ongoing battle to combat increases in core inflation as well as a firm job market. Despite the risk of recession, expectations are for the Fed to continue tightening monetary policy. This factor has contributed to market volatility reaching its highest level for the first nine months of a year since 2009. In addition to ongoing supply chain headwinds, the Fed's actions have been further slowing the economy. That, in turn, could exacerbate the reduction in corporate earnings estimates for 2022 and 2023.

— From a style perspective, large-cap value stocks—as represented by the Russell 1000® Value Index (RLV)—returned -8.77% in September, en route to a decline of 5.62% for the third quarter. Large-cap value stocks underperformed large-cap growth stocks this quarter, as the Russell 1000® Growth Index (RLG) declined by 9.72% in September, but returned -3.60% for the full third quarter. Year to date, however, large-cap value has outperformed large-cap growth by nearly 13 percentage points, as the RLV has returned -17.75% versus a -30.66% return for the RLG. The rising-rate environment so far this year has eroded the value of the far-off earnings reflected in the share prices of growth stocks.

— Nine of 11 SPX sectors ended the third quarter in negative territory, with consumer discretionary, up by 4.4%, posting the strongest gain, and communication services (-12.7%) declining the most. Year to date, energy is the only SPX sector to show a positive return, gaining 35% as commodity prices have risen significantly, driven by concerns over inadequate oil supplies globally in the wake of Russia's invasion of Ukraine.

| | Third Quarter | Year-to-Date 2022 |
|---|---|---|
| **S&P 500® Index (SPX)** | -4.88% | -23.87% |
| **Russell 1000® Value Index (RLV)** | -5.62% | -17.75% |
| **Russell 1000® Growth Index (RLG)** | -3.60% | -30.66% |

Source: Morningstar. Data as of September 30, 2022. **Data is based on past performance, which is no guarantee of future results**

## Performance Review

— In the third quarter, the Amundi US ESG Improvers SMA (the SMA) underperformed the -4.88% return of the S&P 500 Index (the Index). Year-to-date as of 9/30/22 the SMA's gross returns significantly outperformed the -23.87% return of the Index. Net returns of the SMA underperformed the benchmark.

— Security selection detracted from the SMA's results in the quarter, with selection in information technology, communication services, and energy as the primary headwinds to relative returns.

— One of the largest detractors was the SMA's stock selection in the communication services sector. While the SMA has been significantly underweight the sector for some time, which has contributed to results, we have maintained exposure to what we believe are high quality diversified telecommunications companies that underperformed in the quarter. For example, shares of **AT&T**, a leading multinational telecom company, fell in the quarter after the company reported disappointing results. Despite reporting strong growth in the mobility business and raising their topline guidance, the company's broadband business was unexpectedly weak. We classify AT&T as an ESG leader as we believe they are one of the leaders in the diversified telecom space. We believe AT&T has one of the top climate strategies in the industry, which they first launched in 2018 and includes a commitment to becoming carbon neutral by 2035. In addition, AT&T was a founding member of the Climate Leadership Council, which focuses on market-based solutions to lowering emissions in the US On the social front, AT&T has strong worker unions that have allowed employees to benefit from relatively strong wages and benefits. We maintain our position in the shares as we continue to believe they are attractively valued and have a favorable risk/reward profile.

— Within information technology, similar to communication services, we have maintained a consistent underweight, especially to the mega-cap, "big tech" stocks, as we believe valuations remain relatively high and their ESG profiles are generally not a good fit with the portfolio, in our view. The underweight allocation has been additive to results throughout the year and in the quarter; however, weaker security selection has offset our beneficial asset allocation. For example, our decision to avoid owning **Apple**, given our valuation discipline, was a notable detractor during the period. The installed base of users for Apple products continues to grow and the company has successfully launched new products, such as AirPods and the Apple Watch into that ecosystem. While we are cognizant of the overall attractiveness of the company, we believe that there are stronger investment alternatives based on a combination of more attractive valuation and growth prospects. We also do not find Apple attractive from an ESG perspective. While it does qualify as an ESG Improver, based on our quantitative criteria, our fundamental research has lead us to believe that there are no meaningful catalysts to sustainable ESG momentum.

— Conversely, our underweight position in **Microsoft** was one of the strongest contributors in the quarter. We were underweight the stock primarily due to valuation concerns as technology stocks as a whole, including Microsoft, have been pushed down all year as investors have rotated out of growth stocks and moved into more defensive assets to deal with rising interest rates and to position themselves ahead of a potential recession. We classify Microsoft as an ESG Leader and we believe they do have a strong ESG profile, especially relative to peers, but our concerns with the valuation outweigh the ESG considerations in this case.

— Another area that helped the SMA's results in the quarter and year to date was an underweight position in communication services and its overweight position in health care. The communication services sector has been the worst performing S&P 500 sector year to date. We have long maintained an underweight position to communication services, as we believe there are limited opportunities from an ESG perspective.

— Health care, on the other hand, is a sector that we have favored for some time, especially pharmaceuticals. **Alnylam Pharmaceuticals**, which we classify as a Future ESG Improver, was the largest contributor to results in the quarter. Alnylam reported positive results from the APOLLO-B study of their drug, Onapattro, in cardiomyopathy. We believe the market potential for the drug could be greater than $2 billion. Investors were pleased with the outcome of the study, especially following a competitor study on the same condition that did not produce favorable results. Alnylam is exposed to several ESG risks including product quality and safety, but we believe that as they continue to improve their ESG disclosure and establish measurable ESG performance targets they could see an improvement in their ESG profile.

— Finally, the largest contributor year to date has been the SMA's overweight allocation to the energy sector. Energy remains the top performing S&P 500 sector in 2022, despite a challenging period in July, and has returned more 33% year to date. The sector outperformed broadly during the first 9 months of the year due to elevated energy prices across the globe. Despite recent price decreases, energy prices remain high relative to historical levels. Given its ESG orientation, the SMA is selective in its energy exposure, favoring companies that are responsibly helping to meet short-term and longer team energy demand and showing momentum from an ESG perspective.

## Top Relative Contributors and Detractors

| Contributors | Detractors |
|---|---|
| – Alnylam Pharmaceuticals (ALNY) | – AT&T (T) |
| – Microsoft (MSFT) | – FedEx (FDX) |
| – Danaher Corporation (DHR) | – Church & Dwight (CHD) |
| – Regions Financial (RF) | – Pfizer (PFE) |
| – Starbucks Corporation (SBUX) | – Apple (APPL) |

The portfolio is actively managed and current portfolio information is subject to change. Securities are listed in descending order, from greatest to least, based on contribution to or detraction from the SMA's performance relative to the benchmark as of the most recent quarter end. Note that securities listed may include those *not held* by the portfolio as of the date reported. The securities listed should not be considered recommendations to buy or sell any security. Data is of the representative account in the Amundi US Equity ESG Improvers SMA composite.

## Market Outlook and Positioning

— The economy is slowing quite rapidly and is now affecting job openings in the US. The Federal Reserve hopes that this will continue without significantly raising the unemployment rate. Consumers continue to spend from their savings built up during the pandemic, which is contributing to higher than expected rates of inflation as too much money is chasing too few goods. However, retail inventories are high and supply chains pressure is easing, which, combined with past and expected increases in the Federal Funds Rate, should lead to declines in inflation over the foreseeable future, in our view. Whether these declines are fast enough to prompt the Fed to hold back on too many rate increases remains to be seen. Avoiding a "hard landing" for the economy is going to be difficult, in our view.

— In the second quarter, a number of companies reported margin pressure despite strong revenue growth. This is typical at this stage of an inflationary breakout. Third quarter earnings are about to be reported and we expect to see more companies cite margin pressure and lower or withdraw future earnings guidance.

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- The year-to-date returns for the market have been painful, and it has been entirely due to multiple contractions as interest rates rose. We expect further downgrades to future earnings, and this could lead to further negative volatility for the market until we see signs that the Federal Reserve is about to pause.
- We believe that it is critical to identify sustainable, socially responsible investments by integrating ESG considerations in the fundamental and quantitative analysis of investment opportunities for the Portfolio. Our investment team uses a robust database of research and proprietary ESG ratings on over 17,000 companies compiled by the Amundi ESG Research and Analysis team, which includes over 25 dedicated ESG research analysts (as of September 30, 2022). Our investment team, utilizing these resources, assesses the ESG characteristics of the companies that are under consideration for inclusion in the Portfolio and actively examines the potential for companies to mitigate their ESG risks and improve their ESG profile over time. When appropriate, the team engages with management to improve the company's ESG characteristics.
- We build a concentrated Portfolio by integrating our bottom-up analysis and company engagement with an internally developed dynamic ESG framework that fully leverages Amundi's ESG platform. ESG Improvers and Future ESG Improvers are core to the Portfolio's forward-looking evaluation of a company's ESG metrics. We strive to capture any upward trajectory of the holdings' financially material ESG ratings and subsequent potential improvement in share price performance.
- In addition to incorporating ESG considerations in our fundamental research process, we rely on the combination of our experienced analyst team and a proprietary corporate performance and valuation framework grounded in business-model economics, or economic value added ("EVA"), to navigate macro uncertainties, such as fiscal stimulus, tax policy, interest rates, regulations and the pandemic. We believe that our team and our ESG and valuation framework, along with a meaningful risk overlay, are critical to the success of the Portfolio, particularly in light of the secular and cyclical shifts taking place in nearly every industry.
- From a positioning perspective, the portfolio remains underweight communication services, consumer (discretionary and staples) and information technology. We also reduced our allocation to utilities and industrials and now have underweight positions in those sectors. Conversely, we are overweight materials, pharmaceuticals (though we have reduced our position in the quarter), energy and financials.
- More specifically, within financials we favor banks, as we believe they will continue to demonstrate a durability of returns through this cycle. We have also increased our exposure to capital markets throughout the quarter as valuations have become more attractive. In energy, we own a mix of natural gas exploration & production, equipment & services and US integrated oil & gas companies. In addition to the current supply/demand headwinds, we believe that the sector is on a path forward after companies have changed their manager incentive programs to reflect return on invested capital and are not spending on growth in production after years of underspending on new projects.
- We took advantage of price volatility in health care to trim our life sciences and health care provider weightings. With these reductions, we now have a slight underweight position in health care, although we maintain our overweight position in pharmaceuticals. In addition, we have begun to increase our allocation to the consumer sectors as valuations have become more attractive, in our view, with a preference towards high quality restaurants and retailers. Finally, we decreased our position in utilities, as we have grown more cautious in the space given heightened valuations. We mainly trimmed our position in electrical utilities, which could be subject to enhanced volatility in the coming months.
- Lastly, we continue to favor materials. While materials are cyclical, we do not own any cyclical companies that do not have additional company drivers. We are looking for idiosyncratic themes that will enable a company to be less levered to and do better than the economic cycle. For example, our metals & mining holdings are levered to copper, where the growing demand for electric vehicles is affecting the supply/demand for the metal, and aluminum, which is also in undersupply given the growth in solar and wind energy initiatives. In addition, aluminum from Russia is coming offline, further heightening the supply/demand imbalance.

## Additional Information

Performance Attribution: This performance attribution seeks to identify and quantify the drivers of portfolio performance relative to that of its benchmark. Using FactSet software, we create hypothetical subportfolios by segmenting the portfolio and its benchmark, then measure the value (weight) and returns of those hypothetical subportfolios. This lets us measure the performance impact of a decision to overweight or underweight a portfolio segment. It also lets us measure the performance impact of a specific security selection within each segment.

## Terms and Definitions

**The S&P 500® Index** measures the performance of the broad US stock market. **The Russell 1000® Growth Index** measures the performance of the large-capitalization growth sector of the US equity market. **The Russell 1000® Value Index** measure the performance of the large-capitalization value sectors of the US equity market. Indices are unmanaged and their returns assume reinvestment of dividends and, unlike mutual fund returns, do not reflect any fees or expenses associated with a mutual fund. It is not possible to invest directly in an index.

**Alpha** represents excess return relative to the return of the benchmark. A positive alpha suggests value added by the manager versus the benchmark.

**To qualify as an ESG Leader** the stock must have an ESG rating in the top 1/3 of the investable universe as denoted by Amundi ESG Rating. **ESG Rating scale** is based on a rating scale from A to G (where A is the best). G-rated issuers (worst issuers) are assessed manually and submitted to the ESG rating committee for examination and approval. These issuers are mostly related to Sectorial and Normative exclusions. **ESG Improvers** are companies with solid fundamental investment case and positive ESG trend. **Future ESG Improvers** are companies with a solid fundamental investment case that are expected to deliver improving ESG momentum.

## A Word About Risk

**The market prices of securities may go up or down,** sometimes rapidly or unpredictably, due to general market conditions, such as real or perceived adverse economic, political, or regulatory conditions, recessions, inflation, changes in interest or currency rates, lack of liquidity in the bond markets, the spread of infectious illness or other public health issues or adverse investor sentiment. **The Portfolio generally excludes corporate issuers that do not meet or exceed minimum ESG standards**. Excluding specific issuers limits the universe of investments available to the Portfolio, which may mean forgoing some investment opportunities available to funds without similar ESG standards. **Investing in small- and mid-sized companies** may offer the potential for higher returns, but are also subject to greater short-term price fluctuations than larger, more established companies. **Some securities in which the Portfolio invests may have limited liquidity** and, therefore, may be more difficult to purchase or sell; low trading volume may lead to market fluctuations that may impact the value of those securities. **At times, the Portfolio's investments may represent industries or sectors** that are interrelated or have common risks, making it more susceptible to any economic, political, or other risks affecting those industries and sectors.

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**Performance shown is past performance, which is no guarantee of future results.** Current performance may be lower or higher than the performance data quoted.

There is no guarantee that the portfolio will continue to hold any particular security and securities are held in varying percentages. Holdings are subject to change since the portfolio is actively managed. Holdings are intended to illustrate the composition and characteristics of the SMA for separately managed accounts. Across client portfolios, there may be variations in holdings, characteristics and performance information as dictated by reasons such as diversification needs, specific client guidelines, account size, cash flows, the timing and terms of execution of trades, and differing tax situations.

The Model Portfolio/SMA securities holdings information provided is intended solely for your use in evaluating the Model Portfolio/SMA portfolio(s). Under no circumstances does the information contained within constitute, and should not be construed as, investment advice, forecast of future events, a guarantee of future results, or a recommendation to buy, hold or sell securities.

Separately managed account programs may require a minimum asset level and, depending on specific investment objectives and financial position, may not be appropriate for all investors. Actual fees and account minimums may vary.

**The investment strategies described are those of Amundi US. These materials are being provided for illustrative and informational purposes only. The information contained herein is obtained from multiple sources that are believed to be reliable. However, such information has not been verified, and may be different from the information included in documents and materials created by the sponsor firm in whose investment program a client participates. Some sponsor firms may require that these materials be preceded or accompanied by investment profiles or other documents or materials prepared by such sponsor firms, which will be provided upon request. For additional information, documents and/or materials, please speak to your Financial Professional or contact your sponsor firm.**

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