Ecofin Energy Transition Strategy

Q2 2021 QUARTERLY COMMENTARY

Performance summary

The strategy's long-only gross performance increased by 4.1% in the second quarter, underperforming the MSCI ACWI Index, which returned 7.4%.

As of 30 June 2021

(All total returns in USD)	1 months %	3 months %	1 year	3 years % per annum	5 years % per annum	ITD* % per annum
Strategy composite (net)**	2.9	3.8	64.2	20.5	18.5	15.1
MSCI ACWI Index	1.3	7.4	39.3	14.6	14.6	11.4

*01/01/2013. **Strategy composite information provided in the disclaimer on final page.
Source: Ecofin Advisors Limited.
Past performance is no guarantee of future returns. Returns may increase or decrease due to currency fluctuations.

We were pleased that the strategy continued to deliver positive performance after a challenging Q1 which continued into April and most of May. Performance improved significantly in June with the strategy delivering positive returns and alpha generation. Many of the headwinds to alpha generation which impacted Q1 continued into Q2, particularly the reflation trade, which delivered stark underperformance of structural growth versus value cyclicals, and the continuing underperformance of pure-play renewables stocks, not only due to their bias towards growth but also reflecting the pause in momentum following a very strong end to 2020.

An additional headwind that grew in significance during the second quarter was the continued strength in commodity and freight pricing which threatened to squeeze renewable equipment supplier margins and renewable developer returns for a period of time. Renewables are not particularly pro-cyclical, and as many of the pricing framework agreements for equipment had already been set, as well as some power purchase agreements for renewable developers, the ability to pass through higher raw material costs is likely to be tougher than for a cyclical business that is seeing a concurrent spike in demand as economies re-open. Ongoing strength in polysilicon, steel and copper prices in particular added to the string of uncertainties surrounding the renewable equipment and renewable developers that investors contemplated during the first half of the year. Given the fact that in many regions renewable power purchase agreements are already attractively priced relative to prevailing spot and forward electricity prices, renewable developers should have the ability to demonstrate that they indeed are able to enforce pricing power and the ability to defend new project returns by stabilising and/or increasing power purchase agreement pricing for new renewables projects.

Over the course of the first half of the year, the investment team has increasingly tilted the portfolio to companies that are positively exposed to cyclical reflationary forces as well as long-term structural drivers. We continue to believe that while some inflationary forces are structurally building, most of the cyclical impulse relates to transitory fiscal stimulus and aspects of physical re-opening, although this is by no means assured, particularly in Asia.

From mid-May the intense momentum of the reflation rotation and extreme factor performance biases began to dissipate, resulting in mean reversion across many sectors. The FOMC statement on the 16 June, which signalled a marginally more proactive stance towards controlling an inflation overshoot, further precipitated a decrease in long end rate expectations and, after an initial fractional unwind of the reflation rotation that has dominated YTD, an improved backdrop for structural growth expression in stock selection across a broad range of sectors. As a result the second half of Q2 saw better performance than the first half.

What worked well this quarter

CATL (300750 CH), a Chinese lithium ion battery manufacturer and the largest global electric vehicle battery manufacturer, appreciated significantly in the quarter. The company is establishing an increasingly dominant position in the electric vehicle battery market globally and is continuing to take market share this year. CATL is also establishing itself in the energy storage system (ESS) market. CATL benefits from leadership positions in the two dominant lithium ion chemistries: Nickel Manganese Cobalt (NMC) and Lithium Iron Phosphate (LFP).

China Longyuan (916 HK), a Chinese power generation company with the majority of its generation coming from renewables, was once again the best performer in the quarter. The stock continued its positive momentum when concerns relating to new renewable project auctions and subsidy payments calmed after the Chinese government released a final version of the policy which was more benign to developers than originally feared. Progress towards an A-share listing and assets swaps with its parent appears on track and should prove a further positive catalyst for the stock later this year.

Stem (STEM US), a U.S. battery storage hardware and software system provider, completed its SPAC merger deal (with Star Peak) in late April. The company is a leading player in the U.S. battery storage market which has a very attractive growth trajectory over the next decade and beyond, given battery storage is a key enabler for further renewable energy penetration and grid stability. Participation in the growing end-market and establishing reasonable market share with their Athena software solution will be key drivers of future stock appreciation.

What didn't work well

Orsted (ORSTED DC), a Danish offshore wind farm developer/owner/operator, continued to underperform in Q2. The stock continues to digest the rapid appreciation in its valuation in Q4 2020 and investors are evaluating the company's ability to navigate increased competition from oil majors and higher commodity cost impacts. The capital markets day in early June was reassuring and Orsted also won a large offshore wind farm bid in New Jersey at the very end of the quarter – an event which investors had focused attention on as a signal of Orsted's ability to continue building its pipeline.

Volkswagen (VOW3 GY), a German car manufacturer, underperformed in the second quarter after very strong gains in Q1. Volkswagen is still outperforming its European automotive peer group YTD. Over the medium term, Volkswagen is likely the best positioned traditional mass market vehicle OEM for the electrification of vehicles, and the company has begun an ambitious rollout of new electric vehicle models on dedicated electric vehicle platforms which should enhance both product appeal and margins. In the very short term, while production volumes are being disrupted by semiconductor shortages, the lower volumes are being more than offset by very strong pricing which is likely to be a significant tailwind for margins.

Scatec (SCATC NO), a pure renewables developer and operator in emerging and frontier markets, struggled on the back of the announcement that a Ukrainian electricity offtaker is requiring small amendments to some PPA contracts and delaying payment in the meantime, which is triggering a default on the non-recourse debt. Issues with offtakers in emerging and frontier markets are to be expected over time, however this event in combination with the already poor sentiment in the sector drove the underperformance in the quarter.

Looking ahead

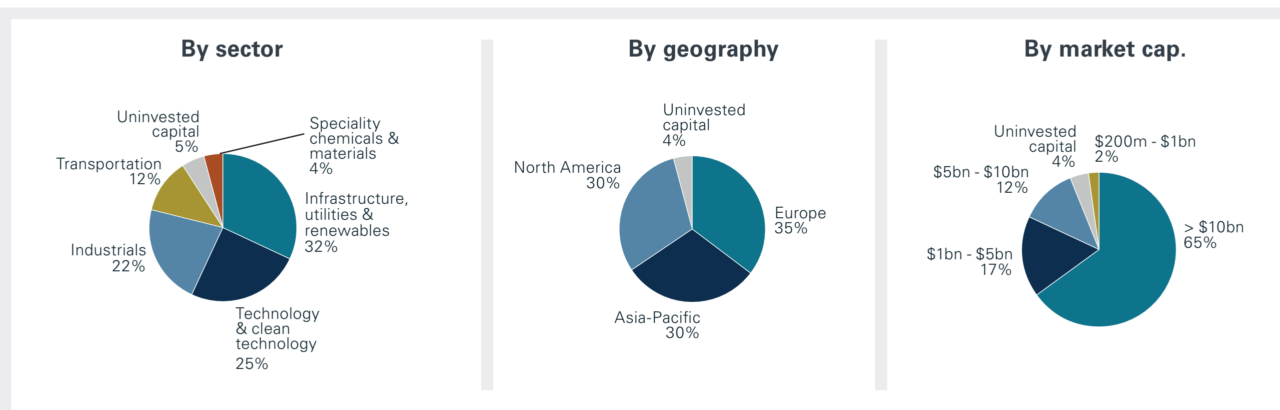
The first half of 2021 was a surprisingly turbulent period for the energy transition strategy from both a macro (reflation rotation) and micro perspective (concerns about inflationary impacts on renewable project returns, more aggressive bidding for renewable project sites by oil and gas companies, give-back of some of the gains in parts of the energy transition universe after very strong performances in Q4 2020). We saw meaningful equity price corrections across many of the 'champions' of the broader space, in large part because the space was taking a breather after a banner 2020. The outlooks for the master themes across which the strategy invests have remained incredibly attractive: Government policy, corporate strategy and consumer preferences are all increasingly oriented towards a decarbonised world which is the cornerstone of the energy transition strategy.

From a macro perspective, inflationary impulses may well peak around the middle of this year and, moving into the second half of 2021 and beyond, a normalisation of inflation should result in less individual factor leadership (such as cyclical and value which dominated the first half) and provide a more benign backdrop for stock picking across a more diverse set of sectors and factors. From a more strategy specific perspective, there are further policy drivers due in the second half of this year which should re-focus attention on the energy transition: the European Commission will release new emissions reduction targets for various industries in July; U.S. infrastructure stimulus is on the agenda for H2 (and should include various tax credits and incentives for renewable technologies such as wind, solar and battery storage and incentives for electric vehicles as well as building efficiency); and the COP26 climate summit in November will encourage more ambitious decarbonisation targets from governments and corporates.

A portion of the portfolio is exposed to renewable developers which, having underperformed YTD, have an opportunity to regain the confidence of investors if they can demonstrate pricing power by increasing the prices of power purchase agreements for new projects in order to pass on the higher commodity costs they face near term. This would demonstrate a discipline in sticking to attractive returns in a market that has good long-term structural growth characteristics.

We have been adding to underperforming stocks in the portfolio which we felt were simply getting more attractively priced, and looking through the portfolio we see a number of large positions with real potential to outperform over the next 6-12 months.

As of 30 June 2021



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All investing involves risk. Principal loss is possible. The risks of investing vary depending on an investor's particular situation.

Past performance is no guarantee of future results. Returns may increase or decrease due to currency fluctuations.

Index Information:

The MSCI ACWI Index captures large and mid cap representation across 23 Developed Markets and 26 Emerging Markets countries. The index covers approximately 85% of the global investable equity opportunity set. The S&P Global Clean Energy Index is designed to measure the performance of companies in global clean energy-related businesses from both developed and emerging markets, with a target constituent count of 100.