October 15, 2021

Dear DWA Environment Strategy Clients and Friends:

Q3 witnessed a notable shift in market sentiment, culminating in a -4.8% September drawdown in the S&P 500 that was the largest since the March 2020 Covid selloff, and prompted questions about potential headwinds ahead.

The cause?

The Delta variant? Evergrande and the Chinese real estate bubble? D.C. brinkmanship? The late quarter dip in consumer confidence? The reduction in GDP forecasts for 2021? Geopolitical tensions? Hurricane Ida and other climatic disruptions? Or, looming over the rest, in headline font size: persistently higher inflation, and attendant risks that it could accelerate the Fed's cadence for withdrawing its unprecedented monetary stimulus, which has been important to the recovery?

As long-term, bottom-up investors, we don't trade or rotate among sectors, styles, market caps or geographies on the basis of news flow or ever-changing macro forecasts. Inflation may prove transitory and benign beyond the next 12 months, as we posit in the Douglass Winthrop flagship letter. But the market-wide preoccupation with inflation afforded us an opportunity to re-test our thesis, conviction level and position size on each company in the Environment Strategy portfolio through a timely macro lens. Is each one resilient to the plausible range of scenarios – not only with respect to inflation and interest rates, but also still-underestimated secular factors like climate change that can, in turn, influence inflation?

In this letter, we spotlight how certain attributes that we select for based on our longstanding analytical framework also position our companies, we believe, to prosper in the face of inflationary pressures. The summary of what follows is this: we like how we're positioned, and why. Although we remain steadfastly long-term in our approach, we are pleased to report that recent performance has held up well: the DWA Environment Composite gained 1.41% net of fees in an eventful third quarter, and is up 16.19% year-to-date -- both higher than the S&P 500 total return for these intervals (see full performance table below).

Attributes That Enhance Resiliency to Inflation

It appears to us that this year's inflation spike has been driven more by "cost-push" factors on the supply side than "demand-pull" factors. While end market demand has significantly recovered from the depths of the pandemic, it is taking longer to re-start and re-synchronize the manufacturing and service capacity needed to supply it. Hence bottlenecked supply chains, clogged ports, labor shortages, and lagged re-investment in everything from semiconductor foundry capacity to container ships to energy commodities such as LNG (the latter contributing to a natural gas squeeze that is spurring power prices in Europe). Even if these inflation drivers do prove transitory rather than structural, uncertainty remains about how long they will take to dissipate.

While Environment Strategy portfolio companies are exposed to economy-wide inflationary pressures, the following is a brief tour of some of the attributes that we believe enhance their comparative resiliency to them, with reference to select holdings in boldface:

- **Market leadership in fast-growing markets:** Typically, the market's reaction to accelerating inflation is rising interest rates, which in turn triggers the sale of growth companies whose relatively long-dated cash flows are worth less as rates rise, all else being equal. One antidote to an inflation-induced rise in interest rates is to invest in companies that hold an advantaged market position in an addressable market growing at above-GDP rates. Even better is when those growth rates are propelled by secular not cyclical tailwinds, such as the growing need to mitigate or adapt to intensifying climate change. In such cases, a company's ability to sustain higher top-line growth can favorably overwhelm the headwind of rate-driven valuation compression. **Generac's** share price initially pulled back in late July after it reported a gross margin decline in the second quarter due to inflationary cost pressures and supply chain constraints. It subsequently recovered as the market re-asserted appreciation for its record top line sales and dominant ~75% market share in home standby generators that help customers adapt to power outages that are growing in frequency and duration

due to climate change. The company has also moved aggressively into attachment of storage, grid services and solar. **SolarEdge** saw steel, aluminum and freight inflation reduce sequential gross margins in the second quarter that were nonetheless higher than the same period last year due in part to its multi-sourcing initiative and operational agility. It has posted surging sales growth for its differentiated optimizer + inverter product that generates higher solar energy system output at less than 10% of the total system cost, offering a compelling return on investment that reduces customer price sensitivity.

- **Essentiality of product/service, combined with inflation-protected business models and captive markets:** Inflation or no, people need waste collection, water, electricity and other essential services – so demand remains relatively stable or inelastic as prices inflate. Our portfolio construction process values the defensive attributes of these businesses. **Waste Management** possesses a dominant network of hard-to-permit landfills and increasingly automated Materials Recovery Facilities that solidify its vertically integrated footprint of collection and disposal routes; also, many of its multi-year contracts generate high-quality, recurring earnings protected by inflation-indexed price escalators. In addition to its high-growth renewable power development business, **NextEra** owns two electric utilities that feature regulated monopoly jurisdictions and an attractive variant of cost-plus pricing that both accounts for inflation in fuel pass-through clauses and generates an allowed rate of return based on its invested capital base.

- **Pricing power through brand strength:** Many consumer brands have been facing intense pressure from rising input prices, and even supply interruptions, as seen in **Nike**'s supply chain woes in Vietnam, which weighed on its stock price this quarter. Companies with strong brands and direct-to-consumer engagement models are best able to pass input price increases along to consumers, thus insulating profit margins. In a multi-sector empirical study of pricing power based on EBIT margin and volatility, survey data and market share back to 2005, UBS cited Nike and Starbucks as being sector leaders.[1] It noted that the Nike brand currently has #1 in mindshare globally and possesses significant headroom to reduce promotional discounting without losing business. The same study found that **Starbucks**' "premium brand image, menu quality, higher-income demographic, and leading customer affinity levels" make it a restaurant sector standout for pricing power.

- **Innovativeness in pursuit of material flexibility (including "dematerialization"):** We believe that industrial companies that invest a higher-than-peer percentage of sales into research & development are more likely to achieve breakthroughs in materials innovation, efficiency and substitution, creating resilience to commodity price inflation. **Aptiv** has been hit by higher prices for semiconductor chips and copper but has been passing much of this burden along to its automaker customers through, for example, copper price escalators. Befitting an innovation-centric company, Aptiv has also invested in engineering redesign to mitigate inflation exposure; for example, it pioneered Selective Metal Coating[2] and a new, more decentralized on-board computing architecture[3] that together enable its automaker customers to replace a portion of high-cost copper content with aluminum. Even though aluminum prices have been rapidly inflating alongside copper this year,[4] substituting it for copper affords automakers a cost advantage as well as weight savings that boost efficiency and enable the systems redundancy that will be required by the Autonomous Vehicles to come. The **New York Times Company** has successfully driven digital subscriptions up much faster than traditional paper-based ones, benefitting from "dematerialization" that insulates its cost structure from the rapid increase in pulp prices and reduction in papermaking mill capacity that have squeezed the global supply of newsprint.[5] This reduction in paper use also saves trees, water,

[1] UBS, US Equity Strategy, Global Research, Pricing power (III): analysts assess relative pricing/cost trends for industries/stocks, September 28, 2021
[2] https://www.emove360.com/selective-metal-coating-the-new-gold-standard-for-automotive-wiring/
[3] https://www.barrons.com/articles/copper-prices-ev-makers-aptiv-51622238496?mod=article_signInButton
[4] https://www.mining.com/copper-price-up-as-inflation-runs-hot/
[5] https://www.printweek.com/news/article/paper-supply-crunch-buyers-urged-to-plan-well-ahead

and energy, while reducing carbon emissions.

- Scale/Cost leadership rooted in logistics excellence: Amazon is making continuing strides in its sustainability journey with expansion of its Climate Pledge Friendly certification guide for browsing customers – now covering 75,000 products based on vetting by 31 third-party certifications.[6] A fundamental key to Amazon's emerging sustainability edge is its ability to reduce in-person customer trips in individual passenger vehicles by substituting fast delivery and end-to-end logistical efficiencies. This in turn depends on its ownership of delivery assets – from its roughly 80 cargo planes to its soon-to-be electrified last-mile delivery vans and electric bikes. This asset base has partly insulated the company from recent jumps in shipping costs, while enabling it to generate additional revenue from the transportation services it sells to third parties in a tight market. Costco, still early in its sustainability journey and a subject of ongoing engagement by the DWA Environment team, has also been making strategic moves -- such as chartering container ships[7] -- to seek to lessen the impact of transportation cost inflation, something its scale, cross-docking infrastructure and concentrated SKU count facilitates.

- Automation and precision to reduce input costs: Schneider Electric, a global leader in advancing the digitalization of industrial automation, enables customers' factories to enhance labor productivity and reduce exposure to labor shortages and wage inflation. Its offering also allows manufacturing operations to respond in real time to changing customer demands and fluctuations in energy and raw material input pricing, dynamically mitigating exposure to commodity price inflation. Trimble's Connected Farm,[8] its precision agriculture suite, harnesses satellite positioning to tighten tractor lines and boost crop yields while reducing use of inputs such as fertilizer, the price of which has recently soared.[9] Higher commodity prices for farm outputs have also enhanced farmer sentiment and net income, which has boosted demand for its machines and software. Trimble is entrenched in essential customer workflows across its served industries, which has given it an ability to reduce price discounting to offset inflationary cost pressures this year.

Climate Change: An Inflation X Factor

Climate change impacts, and transition costs associated with mitigation, are generally adding to inflationary pressures across the world. This includes, for example, a 33% year-over-year increase in the U.N.'s FAO Food Price Index,[10] which has been driven up in part by drought in Brazil. This may matter more to your breakfast than you realize, since Brazil produces the largest share of coffee, orange juice and sugar in the world.[11] As emissions targets tighten, we also expect to see higher prices from greener production processes for glass, steel and other commodities.[12] With time, increasing scale and the sort of corporate innovation we invest in, the premium to make industrial processes cleaner tends to decline toward parity with traditional processes, but we are still early in the transition to net zero.

The energy story is mixed. Solar and wind power are produced at zero marginal cost given that their fuel is free after the system cost is borne upfront. This helpful deflationary effect is being countered by upward pressure on electricity prices due to soaring natural gas prices driven by production cutbacks during the pandemic, pipeline geopolitics, global competition for LNG supplies, and a surge in carbon allowance

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[6] https://www.grocerydive.com/news/amazon-expands-products-sold-under-sustainable-labeling-program/603222/
[7] https://www.forbes.com/sites/sanfordstein/2021/09/24/costco-addresses-supply-chain-pains-by-chartering-their-own-ships/?sh=719f87d76c4f
[8] https://ag.trimble.com/connected-farm
[9] https://www.marketwatch.com/story/fertilizer-prices-soaring-as-natural-gas-rally-adds-to-perfect-storm-11633699973
[10] https://www.fao.org/worldfoodsituation/foodpricesindex/en/ and https://www.wsws.org/en/articles/2021/06/04/food-j04.html
[11] https://www.batimes.com.ar/news/economy/climate-change-in-brazil-fire-frost-drought-upends-global-markets.phtml and https://www.investopedia.com/articles/investing/101615/5-countries-produce-most-sugar.asp and https://www.worldatlas.com/articles/top-orange-producing-countries-in-the-world.html and https://www.visualcapitalist.com/worlds-top-coffee-producing-countries/
[12] https://www.bloomberg.com/news/articles/2021-06-18/the-climate-change-fight-is-adding-to-the-global-inflation-scare

prices in markets such as the EU's Emissions Trading System. We expect energy price volatility to become even more politically contentious in the coming winter, with ramifications we will be monitoring for climate policy and corporate decarbonization, including at the next round of U.N. climate talks beginning in Glasgow in several weeks.

We expect the climate dimension of inflation, and systemic stability more broadly, to grow in significance, and eventually to prompt Fed Chairman Powell to reconsider his recent comment that: "Today, climate change is not something that we directly consider in setting monetary policy."[13] We maintain that the companies we select and own based on our rigorous six-filter criteria are among those best positioned to prosper over the long-term – through a wide range of scenarios for inflation, climate change and other macro risks.

Performance

We encourage you to join us in maintaining a long-term view, but continue to report quarterly performance in these letters, as shown below. Please keep in mind that past performance is no guarantee of future results.

Performance through 09/30/2021	Cumulative Inception to Date	Annualized Inception to Date	3 year Cumulative	3 year Annualized	1 year	Q3 - 2021
DWA Environment Strategy -- Net of Fees	172.00	23.46	91.73	24.23	31.81	1.41
DWA Environment Strategy -- Gross	182.86	24.48	96.50	25.25	32.83	1.62
MSCI World SRI Index	103.31	16.12	54.68	15.65	27.28	0.76
S&P 500 Total Return Index	110.23	16.94	56.07	15.99	30.00	0.58

Note: Inception Date is January 1, 2017.

We appreciate the confidence you place in us to steward your capital. As usual, we welcome any and all referrals you might wish to make to individuals, endowments or other institutions who you think might benefit from an allocation to the DWA Environment Strategy. Please reach out to Mary Kush (mary@douglasswinthrop.com) or Dan Abbasi (dan@douglasswinthrop.com) if you would like to set up a call with the team. Mary leads our institutional engagement and Dan serves on the Environment Strategy Portfolio Management Committee along with Josh Huffard and Bowdy Train.

Best regards,

The Douglass Winthrop Environment Strategy Team

[13] https://www.cnbc.com/2021/06/04/powell-says-climate-change-is-not-a-main-factor-in-the-feds-policy-decisions.html

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The DWA Environment Composite (the “Composite") contains all fee-paying, discretionary accounts that are managed according to the Strategy. DWA also manages accounts outside of the Strategy. A composite of all DWA accounts would have higher or lower performance over different time periods, with increased dispersion among accounts due to meaningful differences in holdings.

Reference Index Disclosure: The Strategy is not managed to a benchmark. The benchmarks most commonly chosen by our clients based on the Strategy are the MSCI World SRI Index and the S&P 500 Total Return Index. The MSCI World SRI Index is a capitalization-weighted index that provides exposure to companies with outstanding Environmental, Social and Governance (ESG) ratings and excludes companies whose products have negative social or environmental impacts. The S&P 500 Total Return Index includes reinvested dividends. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization. Index figures do not reflect the deduction of any fees, expenses, or taxes. Investors cannot invest directly in an index. The indices’ performance results are intended to illustrate the general trend of the equity market for the Strategy’s investable universe and are not intended as a benchmark for the Composite.

Risk Disclosure: Investing involves risk, including the possible loss of principal. There may be market, economic, or other conditions that affect client account performance, or the performance of the referenced market indexes. The Strategy may invest in small-and medium-capitalization companies. Investments in these companies, especially smaller companies, may carry greater risk than is customarily associated with larger companies. A client account invested in the Strategy will hold fewer securities and have less diversification across industries and sectors than a diversified portfolio, such as a portfolio based on an index. Consequently, a client account and/or the composite performance may diverge significantly from the referenced market index, positively or negatively.

Net Performance: Net returns are calculated net of actual management fees incurred and transaction costs. Fees for accounts in a composite may differ at the firm’s sole discretion from the stated fee schedule for new accounts. Performance is calculated on an asset weighted, time weighted return basis. Valuations and performance are reported in U.S. dollars. Returns are not audited.

GIPS Documentation: Douglass Winthrop Advisors claims compliance with the Global Investment Performance Standards (GIPS®). A compliant presentation is available at www.douglasswinthrop.net/gips (password: DWAGIPS2020). A list of the composite descriptions and/or our DWA GIPS Policies and Procedures is available upon contacting our New York office.