WATER

QUARTERLY COMMENTARY

Quarter Ending March 31, 2023

MARKET REVIEW

Equity markets began the year positively, with investor optimism supported by hopes that central banks were near the peak of the rate hike cycle and China's reopening would provide a tailwind to global economic growth. Investor optimism waned in February, as stronger-than-expected economic data stoked concerns that central banks will need to keep rates higher for longer. The Federal Reserve, European Central Bank, and Bank of England all raised rates in the month. Investor sentiment weakened further in March due to high-profile banking failures in the U.S. and Switzerland. As the quarter ended, equity markets rallied on signs of the global banking system stabilizing and revived expectations of a pause in interest rate increases. Global developed markets (as measured by the MSCI AC World Index (net)) rose 7.31% on a total return basis.

Water investments (as measured by the S&P Global Water Index (net)) rose 6.80% in the first quarter. Constructive fundamentals and resilient earnings growth provided tailwinds for the sector. Performance was strong across the value chain, with both water equipment and technology and water infrastructure subsectors gaining ground during the period.

Water equipment and technology performed best in the quarter. Internationally listed companies, particularly in Europe, drove positive returns, as weaker commodity prices reduced the risk of an energy crisis and industrial activity remained relatively resilient. These factors helped the economy avert a predicted downturn. Companies providing water equipment and technology in the municipal and industrial end-markets, notably those involved with the electronics, pharmaceutical, and transportation industries, performed well. On the other side of the spectrum, companies that sell irrigation equipment and technology lagged following strong performance in 2022.

The water infrastructure subsector also contributed positively during the period. European and U.K.-based utilities maintained their positive momentum from the fourth quarter, buoyed by resilient business models and infrastructure improvement initiatives. U.S. utilities experienced a weak start to the year as the market shifted away from defensive stocks and interest rates rose, but they regained their strength in March as investors sought safety on renewed fears of a global economic slowdown.

Despite the volatile economic and market backdrop, we remain confident in the long-term outlook for water companies, as the sector benefits from resilient earnings supported by the critical nature of water for daily life and a functioning economy and the need for investment in solutions that improve water supply, quality, and efficiency across the globe.

PORTFOLIO REVIEW

The Duff & Phelps Global Water composite underperformed the S&P Global Water Index but delivered positive results overall in the first quarter. The portfolio benefited from constructive fundamentals that supported strong earnings and an attractive growth outlook despite macroeconomic volatility. From a sector perspective, the portfolio was driven by positive returns in both the water infrastructure and water equipment and technologies subsectors. Relative underperformance versus the index was driven by overweight positions in the agricultural machinery and life sciences tools and services subsectors, as well as an underweight allocation to European industrials.

At the security level, the largest contributors to relative performance were Veolia Environnement SA and Xylem Inc. Veolia, an overweight position, continued its strong performance during the quarter, benefiting from the rally in European equities and investors taking advantage of its attractive valuation. The company also reported strong earnings results and a favorable outlook during its capital markets day, highlighted by compelling organic growth, a resilient business model, progress on synergy delivery and efficiency gains, and advancement of projects that support decarbonization, water quality, and the circular economy. An underweight position in Xylem also contributed to positive relative performance. Xylem declined on news of the company's all-stock $7.5 billion acquisition of Evoqua Water Technologies, which was announced in late January. Despite the negative near-term reaction to the acquisition, we believe there is strong industrial logic to the deal and expect that its ultimate long-term success will hinge on the realization of revenue synergies over the coming years.

The largest detractors from relative performance were Idex Corp. and United Utilities Group PLC. An overweight position in Idex resulted in negative attribution as the equity trailed the index during the quarter, driven by weaker-than-expected fourth quarter margin performance and cautious comments regarding the company's 2023 outlook. United Utilities, an underweight position, performed well during the period, as U.K. utilities benefited from optimism on increased water infrastructure investment in the upcoming regulatory cycle and investors capitalizing on discounted valuations, despite continued operational challenges and environmental concerns stemming from scrutiny of sewage overflows.

INVESTMENT OUTLOOK

The start of 2023 saw a continuation of challenges in the water sector, including extreme weather events exacerbating water scarcity in certain regions and water quality issues involving emerging contaminants. However, these challenges highlight the need for continued investment in infrastructure, resiliency projects, and technology to create a more sustainable water future. As a result, we see several tailwinds to support investment in the water sector over the coming years, including government infrastructure programs, increasing regulation, and corporate initiatives. These tailwinds are expected to drive significant growth opportunities for companies in the water infrastructure and technology subsectors.

The U.S. is at an inflection point in terms of investment in water infrastructure as funds from the Infrastructure Investment and Jobs Act are beginning to be deployed to support pipeline replacement, water storage, and digital infrastructure spending. Additionally, the re-shoring of supply chains, supported by the CHIPS and Science Act, is driving significant opportunities for water technology companies involved in the electronics, pharmaceutical, and transportation industries. Corporate sustainability initiatives to support efficiency and security of supply are also driving water technology investment.

More stringent regulation of emerging contaminants, specifically PFAS, in the U.S. and Europe is expected to result in significant investment for detection and treatment technologies. The EPA estimates that capital and operating costs for public water systems range from ~$700 million to ~$850 million annually. However, others estimate the costs to be significantly higher. Companies that provide testing/analytical equipment and treatment technologies stand to benefit as municipalities and industrial manufacturers invest to comply with the regulation over the coming years.

The Duff & Phelps Water Strategy continues to be at the forefront of these trends, investing in solutions-oriented companies that improve water supply, quality, and efficiency. We believe that these companies are well positioned for long-term resilient growth as investment rises to create a more sustainable water future. We focus on high-quality, pure-play companies that are poised to benefit from structural support for water solutions.

We continue to have a constructive outlook for the water sector in 2023, as the fundamentals in many end-markets remain strong. We are actively focusing the portfolio on companies with exposure to those healthy end-markets and we favor high-quality operators. We are constructive on water infrastructure companies, as we believe investors will seek earnings stability in a weakening economic environment. Within water equipment and technologies, we favor companies within the municipal end-market due to favorable fundamentals supported by strong project backlogs, resilient repair and replacement activity, and tailwinds from increasing water quality regulations.

With that said, we do acknowledge the headwinds global economies are facing, including persistent inflation, restrictive monetary policies, and banking issues which could pressure risk assets in the near term. However, over the long term, our conviction remains high that the secular tailwinds in the water sector are driving durable, long-term investment cycles that will continue for years despite negative short-term macroeconomic developments.

As always, thank you for your continued support of our team and investment strategy.

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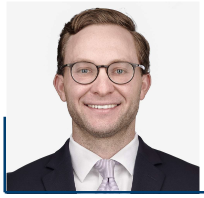

Evan Lang, CFA
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The securities identified were selected from all of the holdings of a representative institutional account for the period based on relative contribution to the account's return versus the Benchmark. An average holding weight was computed based on daily ending market values. The securities identified do not represent all of the securities purchased, sold or recommended for advisory clients and the securities identified may no longer be held in client accounts. The methodology used to calculate the contribution to return or a list showing every holding's contribution to the account's return for the period is available upon request. Results exclude the effect of trading costs, fees and intraday trading prices.

The Benchmark is the S&P Global Water Composite Index (net), a float-adjusted market capitalization index measuring the performance of 50 of the largest companies in water-related businesses throughout the world, including both developed and emerging market countries.

The MSCI AC World Index (net) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of global developed and emerging markets.

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