# MADISON SUSTAINABLE EQUITY FUND

1Q 2023 Investment Strategy Letter

Tickers: MFSYX | MFSIX

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Industry since 1986

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## MARKET ENVIRONMENT AND PERFORMANCE

Equity markets kicked off the year on a strong note with the S&P 500 up 7.5% in the first quarter of 2023. This strong performance occurred despite a mini-financial crisis in March with the failure of Silicon Valley Bank (SVB), the second-largest bank failure in US history. Silicon Valley Bank's failure was triggered by higher interest rates and the mismatch between the bank's assets and liabilities. The issues at SVB reverberated across the financial sector with most banks dropping double digits during the quarter.

The solid performance of the S&P 500 was driven by a narrow field. While there was concern across the Financial sector, the Technology sector rallied sharply with some of the stocks regaining much of their lost ground from 2022. In addition to the Technology sector, Communication Services and Consumer Discretionary also performed quite strongly. These sector performances were driven by a handful of stocks – Apple, Microsoft, Nvidia, Tesla, Meta, Amazon, and Alphabet to name a few. Sustainable Equity performance trailed the S&P 500 during the first quarter as high quality underperformed after solid relative performance in 2022.

The macro-environment has not changed dramatically in the last quarter. Inflation, although trending lower, remains high. Economic growth remains solid but has started to slow with GDP growth in the fourth quarter of 2.6% compared to 3.2% in the third quarter of 2022. Real GDP growth is expected to continue to moderate in 2023 with growth of 1% expected for the full year and 1.6% expected for the first quarter. China has reopened and should boost global growth, but activity has moderated since the initial reopening. Interest rates initially moved higher in the first two months of the quarter due to strong economic activity but moved lower in March as the turmoil with banks will likely lead to tighter financial conditions. The Fed has stated that tighter lending conditions is a substitute for additional rate increases. Core inflation continues to be the Fed's main target for monetary policy as unemployment remains low.

## MORE SPECIFIC PERFORMANCE ATTRIBUTION & ACTIVITY

Sustainable Equity performance lagged the S&P 500 in the first quarter with a very narrow market. Both Sector Allocation and Stock Selection were headwinds to performance. Underweights to Communication Services and Information Technology hurt performance as did overweights to Consumer Staples and Health Care, more defensive sectors. Our underweight to Energy added value as did our underweight to Industrials and Real Estate. Stock selection was positive in Consumer

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Staples, Financials, and Materials while negative in Consumer Discretionary and Information Technology. The largest contributors in the quarter were our digitally-oriented holdings in Technology and Communication Services. Analog Devices, Alphabet, Qualcomm, and TE Connectivity were the top contributors to performance with Target Corp. rounding out the top 5. US Bancorp, Eli Lilly, Danaher, UnitedHealth Group, and Apple were the largest detractors.

**Analog Devices (ADI)** performed well with a strong January quarter result (October fiscal year). ADI's core end markets of auto and industrial (75% of revenues) remain strong, up 30% and 25% year over year, respectively. Communications was also solid, up 18% while consumer was down 6% year over year.

**Alphabet** reported a mixed fourth quarter but messaged a renewed focus on its cost structure. Google has already announced a headcount reduction as well as a reduction to its real estate footprint with additional cost savings benefits to be realized next year. Google also discussed its position on Artificial Intelligence (AI). It has been investing in this area for over six years and uses its AI capabilities across search, YouTube, and its ad quality systems. We remain comfortable with Google's position here.

**Qualcomm** stock was volatile during the quarter but moved higher in March. Qualcomm fundamentals have been hurt over the last several quarters due to excess smartphone inventories. Management messaged in their recent conference call that inventory issues peaked in their first fiscal quarter and should begin to moderate. They are also seeing excess inventory in their IoT (Internet of Things) business, which will take a couple of quarters to work through. By our estimates, Qualcomm fundamentals should trough in the June quarter with a second-half recovery. Qualcomm remains well positioned to diversify away from smartphones with long-term growth in Auto and IoT.

**TE Connectivity** has performed well with continued strength in its Auto business (60% of sales) as content per vehicle continues to grow and drive revenues. TE's Communications segment has experienced softness as well as in some parts of the Industrial segment. Over the long-term, we continue to see growth for application-specific connectors and sensors in transportation as the base of EV's grow, as well as in industrial, medical, energy and communications which leaves TE well positioned.

**Target** reported a solid fourth quarter, exceeding expectations. Same store sales were positive with better-than-expected margins resulting in earnings for the quarter ahead of expectations. At the same time, Target provided guidance for 2023 that was below expectations, which sets them up to meet or exceed expectations after a difficult 2022. Target expects same store sales for 2023 to range from a low single digit decline to a low single digit increase, with operating margins in the 4.5% to 5% range. We continue to view Target as well positioned for long-term growth with its strong owned brand strategy and omnichannel offerings.

**US Bancorp** stock suffered amidst the bank crisis in March. We continue to have a positive view on US Bancorp. First of all, we like the Union Bank acquisition and see strong accretion from this acquisition over the next two years and beyond. More importantly, US Bancorp has an A+ rated balance sheet by Standard & Poor's, very strong liquidity coverage ratio (122%), ample access to additional funding sources and has a culture of conservative lending. We have added to our US Bancorp position.

**Eli Lilly** was down during the first quarter after a strong 2022. Fourth quarter earnings were slightly better than expected but both Trulicity and Mounjaro, key growth drivers, missed expectations. The earnings per share beat was driven by higher gross margins and a lower tax rate. Mounjaro has additional obesity data reading out in mid-2023 along with the expected obesity approval in the second half of the year. Lilly is also working on next generation treatments for diabetes and obesity, with a new GGG and oral GLP-1 in the clinic which will report phase II data in mid-2023. Finally, donanemab for Alzheimer's has an important trial reading out in 2Q 2023 which should be supportive of full FDA approval in early 2024.

**Danaher** has been trading lower since it reported fourth quarter earnings in January. The company lowered Covid-19 related sales for 2023 from $500 million to $150 million as pharmaceutical companies are switching their focus away from pandemic vaccines and therapeutics to the research and development of new drugs. Danaher's pharmaceutical customers will be working through existing inventory before starting to order new products. We remain confident in Danaher's strong competitive position providing innovative products to Life Science companies. Healthcare insurance stocks have been weak due to a ruling by CMS (Center for Medicare & Medicaid Services) in late January where claw back payments totaling $4.7 billion were due from insurers that overcharged Medicare. The claw back payment period goes back to 2011.

We remain confident that **UnitedHealth Group** can deliver long term double digit earning per share growth from its value-based care offerings for both its government and private sector customers.

Our underweight to **Apple** was a headwind to performance during the first quarter. Apple performed well in the first quarter along with the other large cap technology stocks following a weak 2022. Despite recent supply constraints and macro-economic uncertainty, demand for Apple products remains solid. First quarter iPhone sales would have been flat if not for the supply chain issues.

During the quarter, we established a new position in **Oracle** as the company's growth profile has improved from a low single digit revenue growth company to high single digits. The key drivers of improved growth come from the company's Software-as-a-Service applications and the Oracle Cloud Infrastructure (OCI). Oracle's software applications power the Enterprise Resource Planning and Human Capital Management functions of large and small-to-medium sized businesses and are growing in the mid-teens. OCI is a differentiated cloud infrastructure provider that is gaining share due to its strong value proposition in speed, performance, and security. In addition, we believe that the company's operating margins will improve from scale benefits in OCI and cost efficiencies from its recent acquisition of Cerner.

We eliminated Automatic Data Processing from the portfolio due to concerns that the economy is close to a peak job market and interest income on the company's float has also peaked along with interest rates. The company's valuation does not reflect the potential downside in the job market from a weakening economy.

## SUSTAINABLE NOTES

- Nestlé, in conjunction with Cargill, has made one of the largest corporate commitments to regenerative farming in the United States. The two companies will invest $15 million, matched with $15 million in federal funds, to provide grants to improve water management and restore wildlife habitats.
- Nestlé also struck an agreement with Enel North America to invest in a solar-plus-storage facility and will purchase 100% of the renewable energy from the solar plant, estimated to be 333,000 megawatt hours per year for 15 years. The renewable electricity will help reduce carbon emissions in many of the company's U.S. facilities.
- Frito-Lay, the food and snacks division of Pepsi, announced the completion of its facility in Modesto, California, a showcase for sustainable manufacturing, warehousing, and distribution technologies. The project was started in 2019 to demonstrate the sustainability benefits of zero-emission and near zero-emission technologies. This facility is one of the largest in the U.S. with site-wide alternative fuel vehicles, on-site renewable energy generation, energy storage equipment, and electric vehicle charging stations for employees. To date, this facility has already reduced greenhouse gas emissions by 91% from direct fleet operations.
- PepsiCo Beverages North America announced that it will commit $3.3 million in funds toward water replenishment projects across North America. These projects aim to reduce absolute water use and replenish back into the local watershed more than 100% of the water used at company-owned and third-part sites in high water-risk areas.

- Home Depot provided an update on reducing the environmental impact of its stores. Since 2010, the company has reduced U.S. store electricity use by 50% by implementing LED lighting across all of its stores, buying electricity from large-scale commercial solar farms, and installing rooftop solar farms. The company is now applying its experience to other parts of its operations, including reducing electricity use in its supply chain and water use in store irrigation. Home Depot was also recognized by the U.S. Environmental Protection Agency for being one of the nation's largest green power users.

## OUR OUTLOOK AND POSITIONING

At the most recent Federal Open Market Committee meeting, the Federal Reserve raised the Fed Funds rate by one-quarter percent to 5%. The Fed's message was that the economy continues to grow, employment remains solid, and inflation continues to be too high. They also commented that the recent bank crisis will result in tighter credit conditions, which will have an impact on economic activity. It is not clear, however, to what extent this will impact the macro-environment. Bringing inflation under control remains the Fed's key objective. When you look down to the next layer of data, we are seeing growth temper. GDP was revised lower for the fourth quarter of 2022 (+2.6%) and we expect the first quarter of 2023 to show further moderation (1.6%). Inflation has cooled but not as quickly or to the magnitude we would have hoped to have seen by now. Inflation exited the year at 6.5% after peaking in June at 9.1%. Forecasts have the Consumer Price Index (CPI) at 3.3% in the fourth quarter of 2023 but still above the Fed's 2% goal for price stability. With sticky inflation, higher interest rates, a slowing economy, and the ongoing war in Ukraine, we expect markets to remain volatile until we see more improvement in inflation. It is possible that we have seen peak interest rates, but rates will again depend on what happens with inflation.

We continue to look for an impact on earnings from the slowing economy and higher interest rates. Earnings have moderated since the beginning of the year but not as much as anticipated. S&P 500 four-quarter earnings per share forward estimates were for $230 at the start of the year and are now at $221 (3.9%). We could see another 5% decline in earnings to $210. First quarter earnings results will again be an important gauge of where equity markets may be headed. We are cautiously optimistic about the remainder of 2023. With the Fed largely done with interest rate hikes, the companies we own will adjust to the current environment and reset their strategy for long-term growth. We are using this period of volatility to upgrade our portfolio with companies that have become more attractively valued.

*Maya Bittar* *Dave Geisler*

## DISCLOSURES

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The S&P 500® Index is a large-cap market index which measures the performance of a representative sample of 500 leading companies in leading industries in the U.S.

Consumer Price Index (CPI) measures changes in the price level of a weighted average market basket of consumer goods and services purchased by households.

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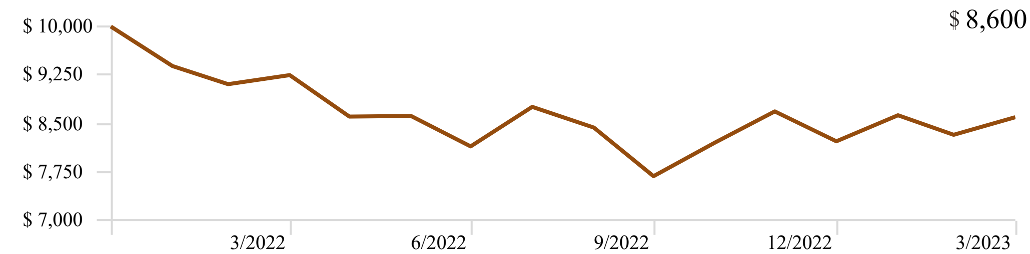
Sustainalytics, a Morningstar Company, is an independent provider of environmental, social, and governance (ESG) research, ratings, and data. Madison utilizes this research as one of the inputs in analyzing sustainability factors of individual companies. MSCI's ESG Rating is designed to measure a company's resilience to long-term, industry material environmental, social and governance (ESG) risks using a rules-based methodology to identify industry leaders and laggards according to their exposure to ESG risks and how well they manage those risks relative to peers. MSCI ESG Ratings range from leader (AAA, AA), average (A, BBB, BB) to laggard (B, CCC).

# MADISON SUSTAINABLE EQUITY FUND

March 31, 2023

## Growth of $10,000 Class Y Shares, Since Inception[1]




## Average Annual Total Returns[2] (%)

| | Three Months | YTD | 1 Yr | 3 Yr | 5 Yr | 10 yr | Since Inception |
|---|---|---|---|---|---|---|---|
| Class I | 4.52 | 4.52 | -6.93 | - | - | - | -11.32 |
| Class Y | 4.52 | 4.52 | -7.03 | - | - | - | -11.39 |
| S&P 500® Index | 7.50 | 7.50 | -7.73 | 18.60 | 11.19 | 12.24 | - |

## Calendar Year Returns[2] (%)

| | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|---|---|---|
| Class I | - | - | - | - | - | - | - | - | - | -17.63 |
| Class Y | - | - | - | - | - | - | - | - | - | -17.72 |
| S&P 500® Index | 16.00 | 32.39 | 13.69 | 1.38 | 11.96 | 21.83 | -4.38 | 31.49 | 18.40 | -18.11 |

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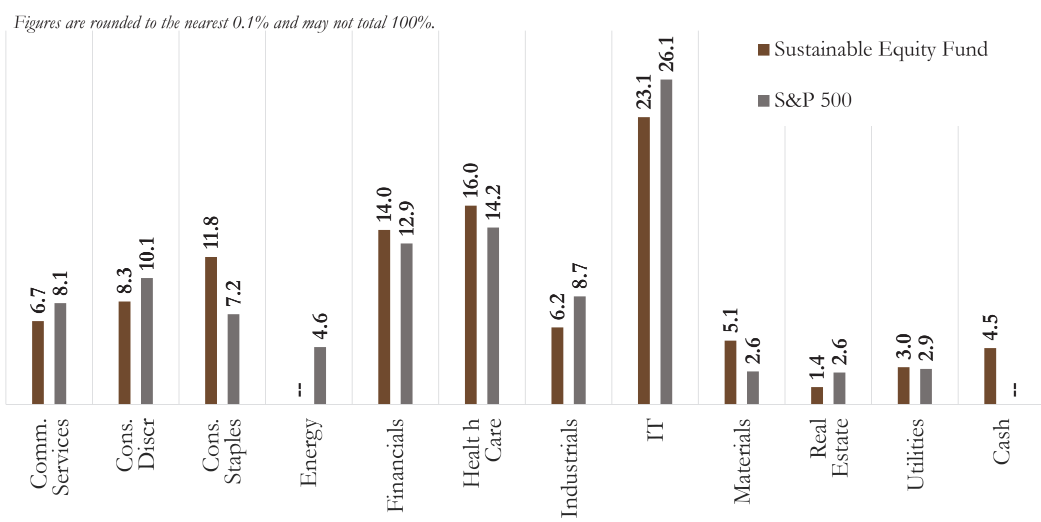
## Sector Allocation (%)




## Experienced Management

Maya Bittar, CFA
Portfolio Manager
Industry since 1986

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Portfolio Manager
Industry since 2004

## Fund Features

- Fund seeks high quality, durable growth companies that incorporate sustainability into their operations and strategy.
- High conviction; 40-70 holdings
- Clear and repeatable investment process

| Class | Ticker | Inception Date | Exp. Ratio |
|---|---|---|---|
| Y | MFSYX | 12/31/2021 | 0.91% |
| I | MFSIX | 12/31/2021 | 0.81% |

*Expense ratios are based on the fund's most recent prospectus.*

## Characteristics

| | |
|---|---|
| Total Number of holdings | 38 |
| Active Share | 71.2% |
| % Assets in Top 10 stocks | 39.8% |
| Wtd. Avg. Market Cap (billions) | $479.1 |
| Total Net Assets (millions) | $8.5 |

Distribution Frequency - Annual

1 Growth of $10,000 is calculated at NAV and assumes all dividends and capital gain distributions were reinvested. It does not take into account sales charges (if applicable) or the effect of taxes.

2 Average annual total returns and calendar year returns assume all distributions are reinvested and reflect applicable fees and expenses. Class Y shares do not impose an up-front sales charge or a CDSC.

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## Complete Stock Holdings (%)

| | | | |
|---|---|---|---|
| MICROSOFT CORP | 6.1 | BECTON DICKINSON AND CO | 2.4 |
| APPLE INC | 4.4 | HOME DEPOT INC | 2.4 |
| ALPHABET INC CL C | 4.4 | TE CONNECTIVITY LTD | 2.4 |
| VISA INC CLASS A SHARES | 4.1 | WALT DISNEY CO/THE | 2.3 |
| COSTCO WHOLESALE CORP | 3.8 | QUALCOMM INC | 2.3 |
| DANAHER CORP | 3.7 | ACCENTURE PLC CL A | 2.1 |
| ELI LILLY + CO | 3.7 | ECOLAB INC | 2.0 |
| TARGET CORP | 3.4 | ORACLE CORP | 2.0 |
| UNITEDHEALTH GROUP INC | 3.1 | UNITED PARCEL SERVICE CL B | 2.0 |
| LINDE PLC | 3.1 | BLACKROCK INC | 1.9 |
| NEXTERA ENERGY INC | 3.0 | NESTLE SA SPONS ADR | 1.6 |
| US BANCORP | 3.0 | AMERICAN TOWER CORP | 1.4 |
| JACOBS SOLUTIONS INC | 2.8 | UNION PACIFIC CORP | 1.4 |
| JPMORGAN CHASE + CO | 2.6 | CISCO SYSTEMS INC | 1.2 |
| NIKE INC CL B | 2.5 | PROCTER + GAMBLE CO | 1.1 |
| ANALOG DEVICES INC | 2.5 | PEPSICO INC | 0.9 |
| PROGRESSIVE CORP | 2.5 | ESTEE LAUDER COMPANIES CL A | 0.9 |
| BRISTOL MYERS SQUIBB CO | 2.5 | MCDONALD S CORP | 0.9 |
| TJX COMPANIES INC | 2.5 | VERTEX PHARMACEUTICALS INC | 0.7 |

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The Fund follows a sustainable investment approach by investing in companies that embed sustainability in their overall strategy and demonstrate adherence to sustainable business practices. In pursuing such a strategy, the Fund may forgo opportunities to gain exposure to certain companies, industries or sectors, and may be overweight or underweight in certain industries or sectors relative to its benchmark index, which may cause the Fund’s performance to be more or less sensitive to developments affecting those sectors. In addition, since sustainable investing takes into consideration factors beyond traditional financial analysis, the investment opportunities for the Fund may be limited at times. Sustainability related information provided by issuers and third parties, upon which the portfolio managers may rely, continues to develop, and may be incomplete, inaccurate, use different methodologies, or be applied differently across companies and industries. Madison’s framework of sustainable investing will vary from other managers. Further, the regulatory landscape for sustainable investing in the United States is still developing and future rules and regulations may require the Fund to modify or alter its investment process. Similarly, government policies incentivizing companies to engage in sustainable practices may fall out of favor, which could potentially limit the Fund’s investment universe. There is also a risk that the companies identified through the investment process may fail to adhere to sustainable business practices, which may result in the Fund selling a security when it might otherwise be disadvantageous to do so.