ROYAL LONDON
ASSET MANAGEMENT

# Royal London European Sustainable Credit Fund

## Quarterly Report 30 June 2022

## Top ten holdings

| | Fund (%) |
|---|---|
| Storebrand Livsforsikring 6.875% 2043 | 1.3 |
| Alpha Trains Finance 2.064% 2030 | 1.2 |
| Gewobag Wohnungsbau 0.125% 2027 | 1.2 |
| Aptiv Plc 1.6% 2028 | 1.1 |
| Hamburger Hochbahn AG 0.125% 2031 | 1.0 |
| Wellcome Trust Ltd The 1.125% 2027 | 1.0 |
| DS Smith Plc 0.875% 2026 | 0.9 |
| Akelius Residential Property Finance 1% 2028 | 0.9 |
| Hemsö Fastighets 1.75% 2029 | 0.9 |
| Statnett 1.25% 2030 | 0.9 |
| **Total** | **10.4** |

*Source: RLAM*

## Fund data

| | Fund |
|---|---|
| No. of holdings | 201 |
| Yield | 2.8% |
| Duration | 4.5 years |
| Fund size | €105.0m |
| Launch date | 29.07.2021 |
| Base currency | EUR |

## Performance

| | Fund (Z Acc GBP hedged) (%) | Fund (Z Acc EUR) (%) | Benchmark[1] (%) | Relative (%) (as compared to Z Acc EUR) |
|---|---|---|---|---|
| **Q2 2022** | **-6.97** | **-7.27** | **-7.15** | **-0.12** |
| Year-to-date | -11.52 | -11.99 | -12.00 | 0.01 |
| Since inception 29.07.2021 | -12.74 | -13.44 | -13.49 | 0.04 |

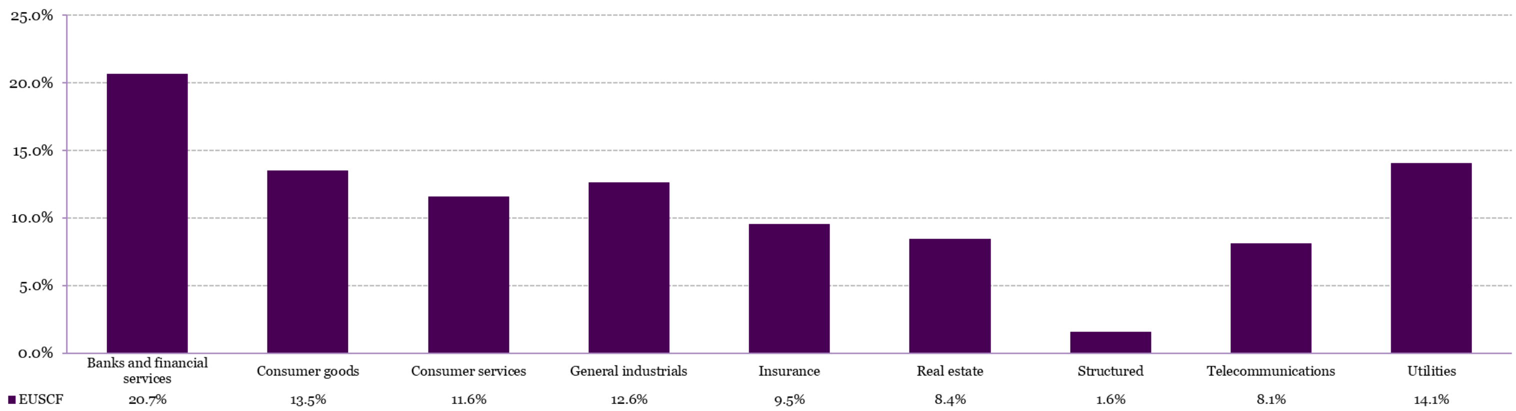
***Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.***

*All performance figures stated gross of fees and tax unless otherwise stated. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment. The impact of fees reduces your return.*

*Source: RLAM, gross of fees.*

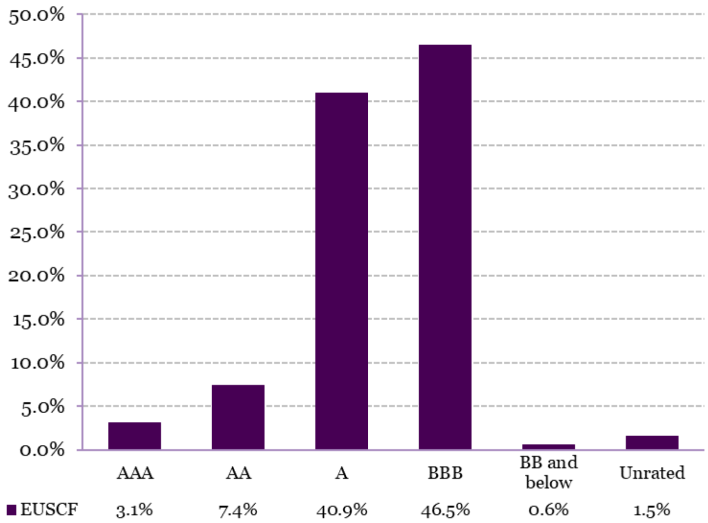
*[1]Benchmark: ICE BofAML Euro Corporate & Pfandbrief Total Return EUR Index.*

## Sector breakdown

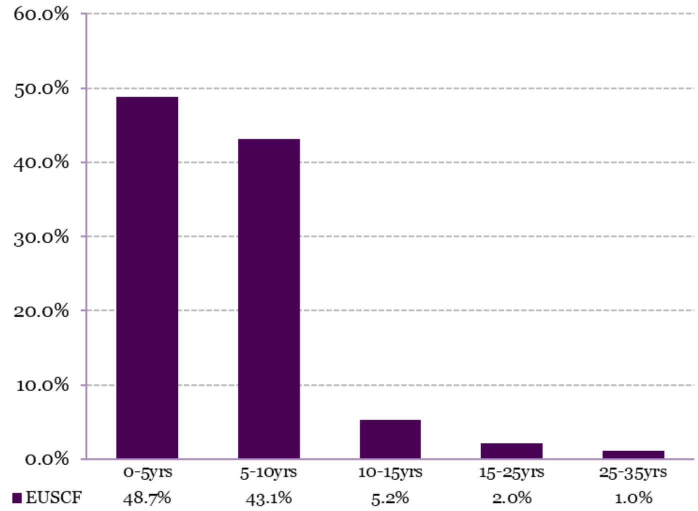



*Source: RLAM as at 30 June 2022*

## Credit ratings




## Maturity breakdown




## Fund performance

- Net of fees, the fund (EUR, Z, Acc) returned -7.34% for the second quarter, modestly underperforming the -7.15% return of its benchmark (ICE BofAML Euro Corporate & Pfandbrief Index (EUR Hedged). For the year to date, the net return for the fund is -12.14%, compared to the -12.00% return for the benchmark.
- For the quarter, continued weakness in government bond markets and a widening in credit spreads as investors started to discount the risk of recession in the US and global economies negatively impacted the absolute returns from the fund. The underperformance against its benchmark was due to the fund's allocation to subordinated debt (both financial and corporate).

## Market background

- Inflation was the headline macroeconomic influence over the quarter, although this crystallised into fears of recession in June. Higher energy and commodity prices added to the supply chain-related increases seen as the global economy emerged from the Covid-induced shutdown of 2020 and 2021.
- Central banks responded to this rising inflation by tightening monetary policy and indicating that there is more to come. The Federal Reserve (Fed) led the way, increasing rates by 1.25% over the quarter – its clear commitment to do more has led markets to price in a further 2% of hikes in 2022. The European Central Bank was less aggressive but confirmed that it will end its bond buying programme in July and signaled that a 25 basis points (bps) hike in July and another 50bps in September are both possible. The Bank of England (BoE) has increased rates at every meeting since December 2021 and this continued through the quarter, with the fifth consecutive increase in June taking the UK base rate to 1.25%.
- Bond markets returns were hit hard in the quarter, as rising interest rates again drove government bond yields higher globally (prices move inversely to yields): the benchmark 10-year US treasury yield rose by 67bps to 3.01%. Longer-dated bonds performed worst in the period due to their greater sensitivity to interest rates (duration risk). Investment grade credit was hit by fears of a sharp slowdown and credit spreads widened sharply – in the euro investment grade credit market, the spread widened by 79bps.
- The price of Brent crude oil rose by another 6.4% to nearly $112 a barrel, but copper futures fell 21.9% on fears of recession and renewed Covid restrictions in China earlier in the quarter.
- Following the volatility of the first quarter, currency moves were again significant in the second quarter. The sharp rise in US interest rate expectations pushed the dollar higher: it was the strongest global currency, appreciating significantly against the euro, yen and sterling. These

movements will impact global trade and overseas earnings over coming months, and dollar strength will also be a risk for any emerging markets countries and companies that have borrowed in dollars.

## Fund characteristics

- The fund only invests in issuers that meet both our financial and sustainable criteria, which include offering a net benefit to society, ESG leadership and observing good governance practices.
- Such issuers are most likely to be found in certain sustainable themes, including energy transition, the decarbonised economy, social and environmental infrastructure, the circular economy and environmental efficiency, social housing, and financial inclusion and resilience (such as insurance products to support individuals through shocks). On sustainability grounds, the fund follows exclusion criteria, which prohibit investment in fossil fuel extraction, mining, tobacco production, nuclear power generation, armaments manufacture, animal and fur products, and pornography.
- Duration is broadly in line with benchmark, sector and security diversifications are features of the portfolio, and there are currently over 200 holdings in the fund. Our philosophy is to seek out opportunities that are under-researched e.g., bonds that do not fall into mainstream indices or benchmarks and/or are unrated by ratings agencies. We believe that sector and security selection will be the main drivers of relative performance over the medium term.

## Fund commentary

- The fund delivered negative absolute returns in the quarter, reflecting the poor performance of government bond markets and wider credit spreads. On a relative basis, its performance was negatively impacted by the allocation to subordinated debt (financial and corporate).
- Due to the adverse market conditions and ongoing volatility, new issuance of euro investment grade credit was weak in the second quarter, compared to the second quarter of 2021 and the first quarter of 2022. We only participated in two new issues, buying euro-denominated seven-year bonds of **Visa**, the global credit and debit cards and electronic fund transfers company: and a new issue from **Rentokil Initial**, the global leader in hygiene and pest control
- While new issuance has been subdued, we are seeing increasing issuance of labelled bonds, such as 'green' and 'sustainable' bonds. While we will consider buying such bonds, they are not a panacea, and we remain cautious about them as they sometimes lack clarity of objective and don't automatically offer value. We will continue to assess each individual credit on its particular merits, remaining focused on adding value in underserved or inefficient areas of the market.
- Secondary market activity mainly focused on maintaining liquidity, as well as managing duration and high yield exposure. Within financials, we added to existing holdings of senior bank debt of **Crédit Mutuel Arkea**, **Deutsche Pfandbriefbank** and **Yorkshire Building Society**; and switched between bonds of **Rabobank**, as well as from **ABN Amro** into **La Banque Postale** and from **SEB** into **RBS** (NatWest Group). We also sold senior preferred bonds of **Investec** to fund the Rentokil Initial new issue and sold subordinated insurance bonds of **Allianz** following the market bounce in late March. Otherwise, we sold covered bonds of **Muenchener Hypothekenbank** and switched between covered bond issues of **Deutsche Pfandbriefbank**. In real estate, we switched between issues of **Heimstaden** on enhanced terms, then sold some bonds later in the quarter to reduce Nordic real estate exposure. We also sold bonds of **Vonovia**. We reduced exposure to telecoms, selling bonds of **Cellnex**, **Orange** and **AT&T**; while in utilities we added to our holding in **Verbund** and sold debt of **Alliander** and **DONG Energy**. We also bought structured bonds of **Thames Water**. Other notable trades included adding to holdings of **Aptiv**, **Medtronic** and the **Visa** new issue; and selling bonds of **Proctor & Gamble**, **Getlink** and **Darling Ingredients**.
- No sales were made as a result of a change in our screening assessments.

## Investment outlook

- There is considerable uncertainty about the outlook for the rest of 2022 and into 2023. With inflation rising at its fastest rate since 1981, the 0.75% increase in mid-June was the largest increase in US interest rates for nearly 30 years. The Fed continues to be hawkish and, with inflation data continuing to surprise on the upside, some economists now expect an additional 1.00% increase at the next FOMC meeting at the end of July. Some investors fear that this could tip the US into a hard-landing recession.
- The picture is only marginally different in the UK: the BoE has said that it will take whatever steps are necessary to bring inflation under control. The strength of the dollar will make this more difficult, however, as dollar-priced imports (such as oil and gas) will become more

expensive. At this point, hard data and forward-looking economic surveys are giving mixed messages about whether inflation will continue to dominate or if higher interest rates will lead to a recession. Meanwhile, with inflation at (slightly) more benign levels, the risks in Europe are centred more on the possibility of further disruption to gas supplies from Russia, particularly in the winter – aside from the human impact, this could be particularly disruptive for industrial production.

- The longer-term risk of recession will be the key driver for credit markets over the rest of 2022. However, the US economy is better insulated from rising commodity prices as it is a net energy exporter. Meanwhile, investment grade credit spreads have widened sharply this year and now offer even better compensation for the risk of default: we expect that credit will outperform government debt over the medium term.
- The fund is constructed to yield more than the benchmark index. We believe that this positioning will be beneficial in the medium term, given the current valuation of credit markets and attractive opportunities we see.

## Find out more

- There are regular updates on our investment thinking in the *Our views* section of www.rlam.com , including a blog each Monday from Head of Fixed Income Jonathan Platt on key issues in fixed income markets. We also deliver regular webinars – please visit the RLAM Digital Insight Hub.

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