Royal London Global Sustainable Credit Fund

Quarterly Report 30 June 2022

ROYAL LONDON
ASSET MANAGEMENT

Top ten holdings

	Fund (%)
Finance for Residential Social Housing 8.369% 2058	1.0
Lloyds Banking Group Plc 4.582% 2025	1.0
XYLEM INC 2031	1.0
Smaakraft As 1.875% 2026	1.0
Avista Corp 4.35% 2048	1.0
Legal And General Group 5.25% 2047	0.9
Clearway Energy Operating Llc 3.75% 2031	0.9
Prudential Plc 6.5% 2048	0.9
Phoenix Group Holdings 5.375% 2027	0.9
GlaxoSmithKline Capital Inc 4.2%2043	0.9
Total	**9.4**

Source: RLAM. [1]Based on Z Acc USD share class

Fund data

	Fund
No. of holdings	230
Distribution Yield	3.13%
Duration	6.8 years
Fund size	$146.0m
Launch date	10.02.2021
Base currency	USD

Performance

	Fund (Z Acc USD) (%)	Fund (Z Acc GBP hedged) (%)	Benchmark[1] (%)	Relative (%) (as compared to Z Acc USD)
Q2 2022	**-7.55**	**-7.64**	**-6.64**	**-0.91**
Year-to-date	-13.73	-13.82	-12.96	-0.77
Rolling 12 months	-13.59	-13.77	-12.88	-0.70
Since inception 10.02.2021	-10.19	-10.35	-9.55	-0.63

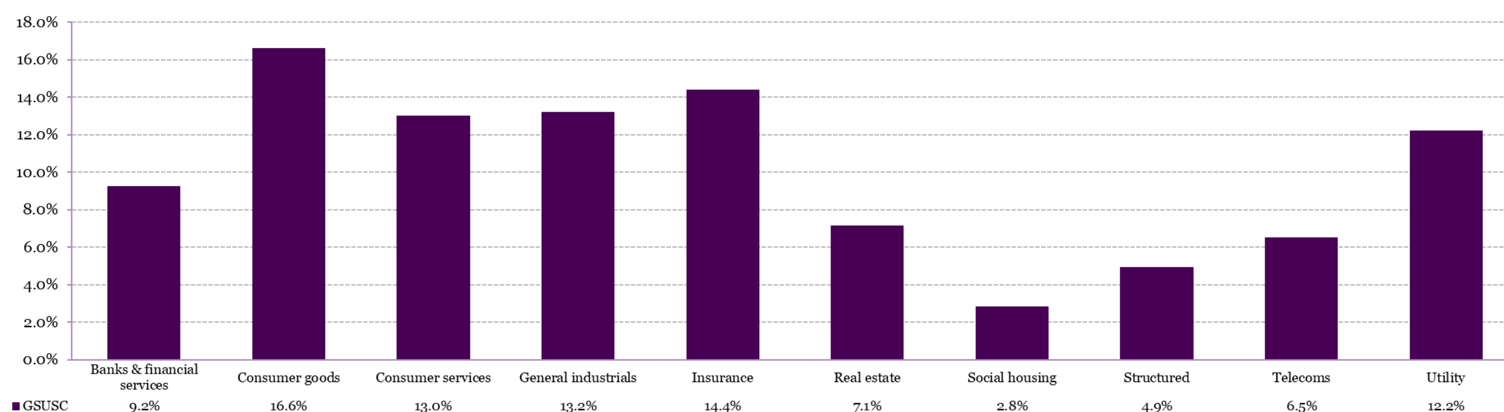
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

All performance figures stated gross of fees and tax unless otherwise stated.

Source: RLAM, gross of fees. 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.

[1]Benchmark: Bloomberg Global Aggregate Corporate Total Return Index Hedged USD.

Sector breakdown



Source: RLAM as at 30 June 2022

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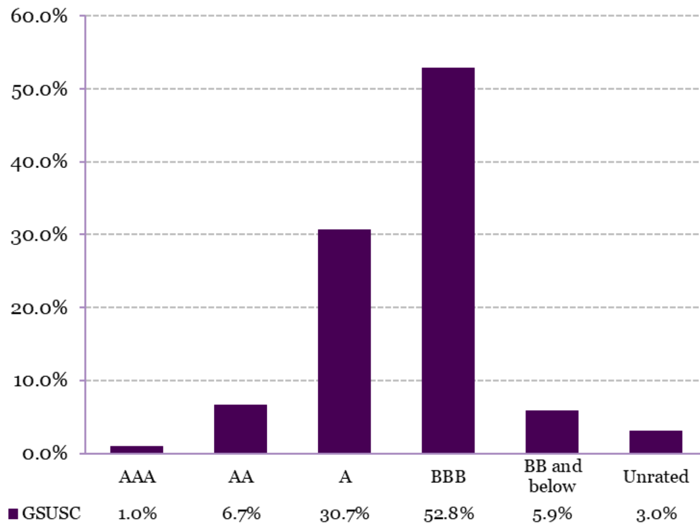
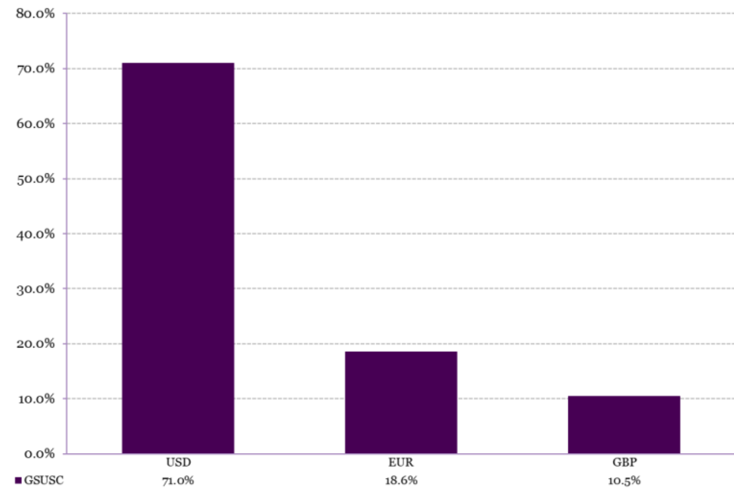
Credit ratings



Currency breakdown



Fund performance

- Net of fees, the fund (USD, Z, Acc) returned -7.65% for the second quarter net of fees, underperforming the -6.64% return of its benchmark (Bloomberg Global Aggregate - Corporate USD Hedged). For the rolling 12-month period, the net return for the fund is -13.94%, compared to the -12.88% 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 high yield bonds as high yield underperformed investment grade credit over the period.

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 signalled 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 – credit spreads widened sharply in the dollar, euro and sterling markets (+42bps, +79bps and +56bps, respectively). Meanwhile, the global high yield spread widened by another 182bps to 614bps, taking the yield on the broad high yield index (including CCC rated bonds) to 8.9%.
- 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.
- The fund remains well diversified with over 200 holdings split around two-thirds in US dollar credit, one quarter in euro credit and the remainder in sterling credit. 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. Duration is broadly in line with benchmark and the fund has an attractive underlying yield that should support income generation.

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 high yield bonds as they underperformed investment grade credit over the period.
- New issuance remained weak in investment grade credit due to the adverse market conditions and ongoing volatility. However, we participated selectively in new issues, buying a 2031 issue from **Telsec** (Telereal), which is secured against telephone exchanges in the UK. We bought a short-dated issue from **John Deere**, the US agricultural and heavy equipment manufacturer, as well as issues from **Rentokil Initial**, the global leader in hygiene and pest control, and Belgian utility **Fluvius**. The UK social housing sector offers an attractive combination of strong ESG credentials, high quality cashflows and security. We bought new issues from **Jigsaw** and **Hexagon** – the latter is a smaller association, but is highly rated and the bonds offered an attractive spread compared to the sector.
- 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, and managing duration and high yield exposure. Within financials, we reduced our overall exposure to the banks sector (e.g. Santander UK), and added to existing positions in **Achmea** and **New York Life** (both insurance). 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 reduced our exposure to utilities, selling bonds of **Enexis**, **SSE** and **ESB Finance**. We also sold some bonds of Danish windfarms operator **Orsted** to reduce our exposure to hybrids (subordinated debt within the capital structure). We were active in the telecoms sector, reducing exposure to short-dated hybrids of **Vodafone** that had outperformed the global IG index on a total returns basis, and selling **Verizon** debt against the new Telsec issue. We also bought bonds of **AT&T** (to cover the partial tender) and **Deutsche Telekom**. We sold bonds of **Peabody**, **Southern Housing Group** and **The Housing Finance Corporation** against the new issues in UK social housing. Other trades included selling longer-dated bonds of **Apple** and **Microsoft** to manage duration, and adding to our existing exposure in **Takeda Pharmaceutical**. Lastly, we switched between different issues of **Ecolab** to enhance terms.
- In corporate actions, there was a partial tender of an **AT&T** bond at an attractive spread level, which we accepted.

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.

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