Royal London Sustainable Equity Strategies

Quarterly Report 30 June 2022

Executive summary

- *This report covers Royal London's equity-only sustainable funds (**Sustainable Leaders** and **Global Sustainable Equity**), plus the two equity-oriented mixed-asset funds (**Sustainable World** and **Sustainable Diversified**). Please see our sustainable sterling credit report for commentary on **Sustainable Managed Income** and **Sustainable Managed Growth**. As the **Global Sustainable Credit Fund** is not limited to sterling credit as with our other sustainable credit portfolios, it has a separate report. Please note: There is no quarterly commentary for **Sustainable Growth** as this fund is still in the initial 12-month period following its launch.*
- So far, 2022 has been a difficult year for sustainable investors. Sustained high inflation, which had built up since the reopening of the global economy following Covid-19 restrictions, put sharp upward pressure on interest rates at the start of the year; and, subsequently, the Russian invasion of Ukraine and retaliatory sanctions pushed up the price of oil and gas and other commodities still further. As a result, central banks have raised interest rates faster than expected, which has led to market conditions that are diametrically opposed to how sustainable funds invest and where we think long-term value will be created. Our sustainable funds embed a long-duration, low-carbon strategy and are not immune to such extreme sectoral performance – they don't invest in the oil & gas and arms manufacturing sectors and have minimal exposure to commodities.
- As a result, our equity-only funds (**Sustainable Leaders** and **Global Sustainable Equity**) underperformed their wider index-based benchmarks in the second quarter. Normally, one would expect equity-market weakness to be mitigated by positive returns from sterling credit, but our mixed-asset funds (**Sustainable World** and **Sustainable Diversified**) also fell as both asset classes were negatively impacted by the unusual combination of macroeconomic and geopolitical factors. However, the credit portfolios performed more-or-less in line with the wider sterling credit market in the quarter and have outperformed the iBoxx Sterling Non-Gilt All Maturities Index in the first six months of 2022 as well as over one, three and five years. *For more details, please see our sustainable credit report.*
- In the equity portfolios, nearly all of our underperformance against the wider market can be attributed to two distinct factors: the majority of it has been due to the derating of longer-duration growth stocks, with the bulk of the remainder from the repricing of commodities and carbon following the invasion of Ukraine. By their nature, sustainable funds tend to have minimal (if any) exposure to oil and gas production and relatively high allocations to long-duration, growth companies – many of which are found in the technology and healthcare sectors and offer longer-term solutions to the sustainability challenges that the world faces.
- Other than the unavoidable impact of equity sector weightings, our sustainable funds performed reasonably well in a particularly difficult environment and outperformed many of their sustainable peers. We have so far seen few problems with the individual companies we own, which are well-established and profitable businesses. Our relative performance has not been because we bought 'bad' companies.
- Despite the challenges posed by higher interest rates and the possibility of a recession, we remain positive on the longer-term prospects for equities and maintain our pro-equity stance in the mixed asset strategies. Over the coming months, we expect market volatility to continue as investors continue to grapple with inflation and interest rate rises as well as the ongoing conflict in Ukraine. We cannot remember a time when there have been so many huge and uncertain forces all impacting the global economy simultaneously.
- We do not invest based on predictions about macroeconomic factors, however: instead, our portfolios are constructed on a bottom-up, company-by-company basis. We have rarely had so much clarity and visibility into the long-term sustainability-aligned drivers of the companies in which we invest. Many of the companies in which we invest have emerged from the pandemic stronger than ever and, despite challenging stock market conditions, reported good results during the second quarter. High sustainability standards, which are embedded in our funds, will continue to be an important differentiator in delivering investment returns with the greater focus on corporate purpose that we believe have arisen from the pandemic and the Russian invasion of Ukraine.

Market overview

- In terms of macroeconomic factors, the second quarter has largely been a continuation of the first quarter – inflation was again the headline influence in the quarter, although this crystallised into fears of recession in June. Higher energy prices added to the supply chain-related increases seen as the global economy emerged from the Covid-induced shutdown of 2020 and 2021. Geopolitics continued to weigh on sentiment, as Ukrainian resistance to the Russian invasion continued. UK economic data generally indicated that growth was slowing, while inflation rose each month – CPI inflation for May hit 9.1% and the Bank of England (BoE) has suggested it could reach 11% by the autumn.
- 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 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%.The European Central Bank was less aggressive – partly due to a more

fragmented backdrop, with the gap between German and 'peripheral' bonds widening in recent months – 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.

- Equities continued to struggle as interest rate expectations rose and investors factored in the possibility of a Fed-induced recession in the next six to 12 months. As a result, the first half of 2022 was the worst start to a year for US equities since 1970. For the second quarter the FTSE-All Share, MSCI World and MSCI All Countries World Index (ACWI – which also includes 26 emerging markets) returned -5.0%, -16.1% and -15.5% to sterling investors, respectively. Regional returns were again widely dispersed. According to MSCI regional data, Asia-Pacific (ex-Japan) was the best-performing region, returning -0.9%. Otherwise, the UK and emerging markets returned -3.0% and -4.4%, respectively, while the returns for Japan, Europe (ex-UK) and the US lagged at -7.7%, -8.1% and -10.2%, respectively.
- Within equity markets, the significant inflation-related rotation out of 'growth' and into 'value' that started in the first quarter continued. The MSCI World Value Index returned -4.4% versus -14.9% for the MSCI World Growth Index, outperformance of 10.5%. Energy again led the MSCI World sector returns (+2.6%), with consumer staples, healthcare and utilities the only other sectors with positive returns (+1.2%, +0.3% and +0.1%, respectively). Consumer discretionary (-17.7%), technology (-15.5%) and materials (-13.25%) were the weakest sectors.
- Bond markets returns were hit hard as rising interest rates drove government bond yields higher globally (prices move inversely to yields). The benchmark 10-year gilt yield rose by 62bps to 2.23%. Longer-dated bonds performed worst in the period due to their greater sensitivity to interest rates (duration risk). In the UK, gilt markets returned -7.42% on an all-maturities basis (FTSE Actuaries), whereas gilts with 5 years or less to maturity provided negative returns of just -0.76%. Total returns for the sterling investment grade credit market of -6.79% were less negative than gilts in the second quarter, but this was still the worst calendar quarter for sterling credit market this century. However, the average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) widened by 45bps to 1.74%. This means that, on average, corporate bonds underperformed gilts of an equal maturity.
- In credit markets, defensive sectors continued to outperform on a relative basis, albeit still providing negative returns – the supranational, covered and asset-backed sectors outperformed, while financials (banks and insurance) lagged, particularly subordinated bonds. Real estate was particularly weak given the significant rise in base rates and future interest rate expectations. Credit quality benefitted relative returns in the period, with bonds in the AAA ratings band outperforming on a relative basis, followed by AA, A and BBB rated bonds – the high yield market underperformed investment grade credit.
- Currency swings were notable in the quarter, following the volatility of the first quarter. The sharp rise in US interest rate expectations meant that the dollar was the strongest global currency: it appreciated significantly against the Swiss franc, euro and sterling, and rose over 11% against the yen. 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. 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 during the quarter.

Performance and activity

- Our sustainable strategies are orientated to those companies that have a net benefit to society and create value for investors through access to long-term growth markets and innovation. Areas such as healthcare and technology remain at the core of the equity portfolios, complemented by engineering, utilities, selected financial services, and companies that lead their industries in environmental, social and governance (ESG) performance. This means that we do not invest in some sectors, such as oil & gas, extractive industries or tobacco. We believe that the exposure to those sectors which offer a net benefit and/or ESG leadership is consistent with outperformance over the medium term. While the sustainable funds have different mandates, risk profiles, asset mixes and geographical exposures, equity exposure is driven by the same underlying team, philosophy and process. Many of our key stocks will be held across several portfolios.
- Our equity-only funds (**Sustainable Leaders** and **Global Sustainable Equity**) underperformed their wider index-based benchmarks in the second quarter. For Sustainable Leaders, the fund's exposure to overseas equities was detrimental, given the relative outperformance of UK equities. Normally, one would expect equity market weakness to be mitigated by positive returns from sterling credit, but our mixed-asset funds (**Sustainable World** and **Sustainable Diversified**) also fell as both asset classes were negatively impacted by the unusual combination of macroeconomic and geopolitical factors. However, the credit portfolios performed more-or-less in line with the wider sterling credit market in the quarter and have outperformed the iBoxx Sterling Non-Gilt All Maturities Index in the first six months of 2022 as well as over one, three and five years.
- In the equity portfolios, nearly all of our underperformance against the wider market can be attributed to two distinct factors: the majority of it has been due to the derating of longer-duration growth stocks, with the bulk of the remainder from the repricing of oil and gas and other commodities following the invasion of Ukraine. By their nature, sustainable funds tend to have minimal (if any) exposure to oil and gas production and relatively high allocations to long-duration, growth companies – many of which are found in the technology and healthcare

sectors and offer longer-term solutions to the sustainability challenges that the world faces. In layman's terms, the companies we buy are expected to deliver growth over a longer timeframe.

- The derating of growth stocks is a relatively straightforward effect – inflation and higher interest rates mean that the stream of future earnings (which represent a greater share of the value of long-term growth companies) have to be discounted at a higher rate. When interest rates are rising, this is a headwind for growth stocks. In addition, we also have a low weighting in financials, particularly banks, as they tend not to score well against our sustainability criteria. The change in outlook for interest rates also cost us as higher interest rates tend to be beneficial for banks – and the more socially-responsible stocks that we favour also performed less strongly than their sector peers. The rise in commodity prices has a relatively high correlation with the share prices and profitability of oil & gas and mining companies. We have seen this before, on the way up and on the way down, particularly in the late 2000s with the China-led commodity boom.
- Other than the unavoidable impact of equity sector weightings, our sustainable funds performed reasonably well in a particularly difficult environment and outperformed many of their sustainable peers. We have so far seen few problems with the individual companies we own, which are well-established and profitable businesses. Our performance has not been because we bought 'bad' companies (see below – 'weaker performers').
- The technology and healthcare sectors contain many innovative companies that are a good fit for our investment framework. We favour more established companies with proven products and significant revenues – we very rarely, if ever, invest more speculatively in IPOs or early-stage tech or biotech companies as the risks are simply too great. We believe that over the medium to long run you can generate attractive above-market returns without taking such risks. Some other investors take a different view – the 'spec tech' rout that started in the fourth quarter of 2021 will have dramatically impacted them in 2022. In contrast, our funds are unlikely to have suffered permanent capital impairment: while more-established tech holdings may have been derated in the interest rate-driven rotation, they continue to be viable revenue- and profit-generating investments. We have not let our investment process drift at the end of the bull market as indicated by our holdings in AstraZeneca and Microsoft *(held in all funds)*, rather than Moderna and Zoom.
- Some other fund managers have made a virtue of running very high cash levels during recent months. This is a more nuanced issue than speculating in earlier-stage companies. With hindsight it could seem wise to stay in cash and not invest in falling markets, but we believe that it is not our role to act as asset allocators. Clients give us their money to invest sustainably, and many studies show that better long-term returns are achieved by being fully invested in the market, rather than trying to beat it through timing. Furthermore, we believe that sitting in cash is poor from a sustainable perspective as it isn't being invested in companies that are offering sustainable solutions to the world's problems.
- The weaker performers in our equity portfolios so far this year include Greggs, Croda International and Ferguson. All three are long-established businesses with healthy earnings. Baker/retailer **Greggs** (*Sustainable Leaders, Diversified and Managed Growth*) and UK specialty chemicals leader **Croda International** (*long-standing core holding in Sustainable Leaders; now held in all funds*) are trading strongly and have reported results at least in line with expectations. We see nothing to concern us in their trading performance or management quality: indeed, they remain high quality businesses that are core holdings in our portfolios. They have simply been derated. The same is largely true of building materials company **Ferguson** (*Sustainable Leaders, Diversified and Managed Growth*), although it is largely exposed to the US housing market: it is understandable that investors who fear a hard landing in the US would be less keen to own these shares, although there is no reason to doubt the quality of the company. To illustrate the capricious nature of current markets, the company recently revised its full-year profit guidance higher by 9% – and the stock fell.
- A more disappointing holding has been **PayPal**, the US online payments specialist (*mixed-asset funds only*). It is by no means a victim of the 'spec tech' rout – the company is well established and generates free cashflow of c. $4bn – but hasn't lived up to our expectations. It has been hit by the success of Apple Pay and the success of 'buy now, pay later' platforms (which some commentators believe will suffer in less benign conditions); with hindsight, given these industry challenges, we feel that the valuation of the stock at our entry point was too high
- For the **Global Sustainable Equity Fund**, performance was similarly affected by sectoral weightings resulting from its sustainable mandate. For its MSCI ACWI benchmark, the energy sector was marginally less positive than for the MSCI World, but it was more impacted by the ongoing derating of technology as around one third of the fund is invested in the sector. Again, there were no stand-out negatives – stocks such as **Adobe**, the US creative software leader, and **Autodesk**, which provides design and product testing software for use in architecture, engineering and manufacturing, were hit by a combination of higher ratings and exiting their exposure to Russia. Although these operations represented just a few per cent of their overall businesses, the effect was still meaningful when combined with a derating. **Mercado Libre**, the South American ecommerce and payments platform was hit by concerns that a recession might affect its growth rate. None of these performance issues concern us unduly: we see no significant impairment on the businesses of these holdings.

- Despite the unfavourable macroeconomic and geopolitical environment, many of the companies that we invest in continue to thrive. **SSE**, the UK's largest renewable energy developer *(held in all funds)*, performed well as the current energy crisis has reminded governments of the need to accelerate the roll-out of more secure and environmentally friendly wind power. **LSEG** *(held in all funds)*, owner of the London Stock Exchange and the data provider Refinitiv, performed well as confidence grew in its data offerings, particularly in the fast-growing area of ESG.
- The falls in equity prices and derating of some of our favoured stocks have provided opportunities to add to our holdings. In the quarter, we added UK utility **SSE** (*held in all funds)*. As well as the pro-renewables Zeitgeist, the invasion of Ukraine has emphasised the need for energy transition with a shift to renewables. We also added to **Spirax-Sarco Engineering** (*Sustainable Leaders and mixed asset funds*), the UK specialist in pumps and steam traps that helps manufacturing companies to capture heat from production processes and thereby reduce their energy consumption. We also added to **AstraZeneca –** the stock has been a core holding in Sustainable Leaders and the mixed-asset funds, but with its pipeline success with cancer drugs it is an attractive addition to the **Global Sustainable Equity Fund**. Other notable trades this quarter included (more details about these trades are included in our monthly reports):

  Sustainable Leaders: added to existing holdings in Prudential, Experian, Unilever and Compass Group.

  Sustainable World: exited Philips and Ansys; added to Intuitive Surgical, Wabtec and Ferguson; and initiated a new position in AIA.

  Sustainable Diversified: reduced Intertek; added to Intuitive Surgical, Wabtec, Sage, Intuit and Experian.

  Global Sustainable Equity: exited Ansys to add to Adobe and Autodesk; reduced Amazon; added to Croda International and Wabtec.

Outlook

- There is considerable uncertainty about the outlook for the rest of 2022 and 2023. The Fed has raised rates again – with inflation rising at its fastest rate since 1981, the 0.75% increase in mid-June was the largest for nearly 30 years. Some investors fear that this could tip the US into a hard-landing recession. The picture is only marginally different in the UK, although the BoE increased rates sooner and seems aware that the UK is more vulnerable to recession. Nonetheless, it raised rates again in June to 1.25%.
- As of mid-June, we are now officially in an equity bear market, which started in November 2021. We believe that we're actually in the middle of a two-legged bear market. The first leg, led by an interest rate-induced derating, is largely over unless inflation genuinely is out of control on a longer-term view. The second leg, led by a recession and earnings downgrades, began in June. It is unusual to get this type of bear market. Usually into a recession, interest rates are falling, so decreasing profit expectations are offset by falling interest rates, which helps the future value of profits via lower discount rates. In effect, one offsets the other. Equally, rising rates are usually at a time of strong economic growth so the negative valuation effect of rising discount rates is offset by rising corporate profits. The removal of this inverse relationship between interest rates and profit cycles is the key reason why equity markets and other classes have been weak; it is hard to make money at a time of rising interest rates and falling profitability.
- How long could this second, earnings-led, bear market last? A golden rule of investing is 'never invest in the present'. Looking beyond the currently discounted 6-12-month time horizon, what will the world look like in the second half of 2023? Will inflation concerns still be prevalent? Will we be in a recession? Will the war in Ukraine have been resolved? There are a wide range of potential outcomes to these questions. We have no privileged insight to the future, but bear markets come and go – this is a feature of investing. Expecting them beforehand helps you to invest in a way that makes them manageable when they come. It also helps with seeing the opportunity within them. Although we can't predict the end of this bear market, we can see the opportunity in it, which for us is to own some great businesses at lower prices than we would have been able to do so otherwise.
- Should higher interest rates tip economies into recession (particularly in the UK and Europe), our equity portfolios should be relatively resilient as we favour high return on equity, unlevered larger-cap companies with good pricing power and strong earnings growth. We tend to eschew (for sustainable and/or financial reasons) stocks with more cyclical exposure to the global economy, such as energy, commodities and non-core cyclical manufacturing.
- In the current environment, it is likely that more companies will miss their earnings targets (or fail to be sufficiently upbeat in their guidance) and face periods in 'investment purgatory' as a result. This will test the resolve of fund managers as you have to decide if the market is overreacting or whether your investment thesis has failed – and the time you have to decide can be very short. In general, we believe that it is better to be considered in such situations. We know the companies that we hold very well and, our investment process has been developed over many years, through different economic and market conditions. We have faith that it will continue to serve our investors well.

Additional information

- There are regular updates on our investment thinking in the *Our views* section of rlam.com, including a regular blog from Head of Sustainable Investments Mike Fox on key issues in equity markets and sustainable investing. We also deliver regular webinars – please visit the RLAM Digital Insight Hub.

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