



Royal London Sustainable Sterling Credit Strategies

Quarterly Report 30 June 2022



Executive summary

- This report covers Royal London's sterling credit-only fund **Sustainable Managed Income** and the credit-oriented mixed-asset fund **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 and is not covered here. For commentary on the equity-only sustainable funds (**Sustainable Leaders** and **Global Sustainable Equity**) and the two equity-oriented mixed-asset funds (**Sustainable World** and **Sustainable Diversified**), please see our sustainable equity 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.
- The second quarter was the weakest quarter for sterling credit markets this century, and although investors might typically expect bond markets to move inversely to equities, both equity and fixed income markets experienced significant losses globally in the period. The combination of rising inflation and falling growth has struck valuations down from the all-time highs, a result of ultra-loose monetary policy not just since the onset of Covid-19, but extending back to the Global Financial Crisis.
- **Sustainable Managed Income** (sterling credit-only) performed broadly in line with the market during the quarter. While the absolute returns have been negative, it has outperformed on a relative basis over the year to date and over the rolling 12 months; the fund has also outperformed over three and five years, delivering top-quartile performance over the latter period.
- The relative performance of the credit portfolio of **Sustainable Managed Growth**, our credit-oriented mixed-asset fund, was also broadly in line with the index over the quarter and these longer periods. However, the fund's overall performance was negatively impacted by the equities portfolio, which underperformed its wider index-based benchmark in the quarter. Nearly all of this underperformance 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. 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.
- Inflation is continuing to rise in the UK, but we believe that inflation will peak in major economies during the second half of 2022. Weaker GDP growth and recession in some areas will impact the corporate sector and we expect to see a move higher in default rates. We will maintain focused on identify companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers, sectors, and other factors.
- Despite the worsening economic outlook, however, we believe that the widening in credit spreads has taken valuations to attractive levels, relative to government bonds. They discount a significant portion of bad news and investors are being paid well to take credit over government bond risk. Although further volatility is likely, our recent preference for short-dated credit bonds is gradually easing as we begin to take on more duration risk – albeit not at the long end of markets where all-in yields still look challenging.

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, 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.
- Bond markets 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 sterling credit, 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.
- 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 MSCI World returned -16.1% to sterling investors. Regional returns were again widely dispersed. According to MSCI, 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.
- 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

- *Please note: As the **Global Sustainable Credit Fund** is not limited to sterling credit as with our other sustainable credit portfolios, it has a separate report and is not covered here.*
- The second quarter was the weakest quarter for sterling credit markets this century, and although investors might typically expect bond markets to move inversely to equities, both equity and fixed income markets experienced significant losses globally in the period. The combination of rising inflation and falling growth has struck valuations down from the all-time highs, a result of ultra-loose monetary policy not just since the onset of Covid-19, but extending back to the Global Financial Crisis.
- **Sustainable Managed Income** (sterling credit-only) performed broadly in line with the market during the quarter. While the absolute returns have been negative, it has outperformed on a relative basis over the year to date and over the rolling 12 months; the fund has also outperformed over three and five years, delivering top-quartile performance over the latter period.
- The relative performance of the credit portfolio of **Sustainable Managed Growth**, our credit-oriented mixed-asset fund, was also reasonable over the quarter and these longer periods. However, the fund’s overall performance was negatively impacted by the equities portfolio, which underperformed its wider index-based benchmark in the quarter. Nearly all of this underperformance 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. *For more details, please see our sustainable equity strategies report.*
- For the sustainable credit portfolios, sector allocation was the most significant performance detractor, specifically our preference for subordinated financials (particularly in insurance), which underperformed the market, and our substantial underweight in supranational bonds, which outperformed. On the other hand, stock selection was positive in the period, particularly in the structured bonds sector, as well as in social housing and real estate. This performance was underpinned by our proven investment philosophy, favouring secured bonds with strong covenants, and focusing on bottom-up research to identify borrowers with resilient cashflows and robust balance sheets.
- Although the underweight in supranationals hurt performance, we are comfortable with our stance given the sector offers a very low yield premium that can be materially improved elsewhere in the market without taking excessive risk. Within subordinated insurance, key detractors



included bonds from the likes of **Aviva** and **M&G** – despite market volatility these are well capitalised entities which we believe will remain resilient in the long term. As a high beta sector (a sector which typically underperforms during a negative market environment but outperforms in a positive environment) we were not surprised or deterred by the impact of our preference to subordinated financials on performance in the short term, and we remain highly confident of the long-term value offered by the bonds held in our funds.

- Stock selection benefitted the funds across sectors. A major contributor to performance was a structured bond issue from **Telereal Securitisation**. Telereal owns key infrastructure assets for the UK, leasing telephone exchanges to BT as part of its fixed line telecommunications network, with bondholders benefiting from security over them. Telereal undertook a liability management exercise in the quarter, which we participated in – the company redeemed two bonds at a significant premium to market pricing. The company then issued two new bonds at attractive spreads, and given the secured nature of the bonds, the key importance of the underlying assets for the UK and their strong credit ratings, we added these to the portfolio.
- Issuance was extremely weak in the second quarter, as rising rates deterred potential borrowers. However, given that first quarter issuance was relatively strong as companies sought to refinance while interest rates remained low, it is little surprise to see a pause at a time when cost of issuance is increasing. While higher yields and spreads damaging absolute returns, market weakness has given us opportunities to add high quality cashflows in sustainable companies at attractive spread levels. The social housing sector remained a key area of interest, with an attractive combination of strong ESG credentials, high quality cashflows and security. During the quarter we bought a new issue from **Blend Funding** – an aggregator which helps smaller housing associations access capital markets. We also added new issues from **Jigsaw** and **Hexagon**, with the latter a smaller association but one that is highly rated and offered an attractive spread compared to the sector.
- Financials, notably banks, remain a material part of the sterling credit market. Financials had lagged in March and April, and new issue pricing was therefore attractive. We added a **Yorkshire Building Society** senior non-preferred new issue at a yield premium of over 200bps. These bonds are senior within the capital structure, but can be ‘bailed in’ in event of bank failure. In effect, they sit between traditional senior and subordinated bonds, and offer an attractive premium to more usual senior bonds. We also bought senior bonds of **OP Corporate Bank** in Finland; as well as deeply subordinated perpetual bonds from **Aviva** (*Managed Income only*) and **Virgin Money**. Otherwise, we bought structured bonds of **AA**. Away from traditional areas of focus, we added a new issue from **Rentokil**. The bonds are BBB rated and came to market at a spread of just over 250bps, providing attractive carry and adding global diversification – while the parent company originated in the UK and is based and listed here, it derives cashflows from its operations all over the world.
- While the quarter saw further issuance of labelled bonds, such as ‘green’ and ‘sustainable’ bonds, some of which we participated in, we remain cautious about labelled bonds, which do not automatically offer value, and sometimes lack clarity of objective. 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.
- Holdings are focused on sectors that benefit from strong covenants (legal restrictions on what an issuer can do) and often offer enhanced security (offering assets as collateral). It is not just at times of economic distress that security is beneficial. When financing costs are low and private equity businesses are awash with cash, we can expect to see balance sheets being utilised to increase leverage. This will eventually lead to higher default risk in those more leveraged business models. Secured bonds also offer potential upside when issuers want to access assets that are encumbered by secured bonds.
- All issuers within our sustainable holdings offer a net benefit to society or show ESG leadership. As well as reducing risk, we 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. Importantly, the sustainable credit proposition provides access to critical sectors that most investors can’t access via equity markets. Key themes in the funds include social housing, social & environmental infrastructure, community funding (regulated banks and building societies focused on SME and retail lending), financial inclusion & resilience (such as insurance products to support individuals through shocks) and the energy transition.
- On sustainability grounds, we have no exposure to bonds of oil & gas companies or extractive industries. We are also underweight in the general industrial and consumer goods sectors, and to a lesser extent in consumer services. The portfolios’ overweight in BBB is targeted to regulated financials, and utility debt, which have exhibited stable cashflows relative to the wider consumer, retail and industrial BBB areas and lower rating transition risk to sub-investment grade, which is a key risk in the current environment.

Outlook

- Inflation is continuing to rise in the UK, reflecting higher raw material costs, energy price increases and tight labour markets. However, central bank interest rate increases are already showing signs of slowing down activity and we believe that inflation will peak in major economies during the second half of 2022. Weaker GDP growth and recession in some areas will impact the corporate sector and we expect to see a move



higher in default rates. We will maintain focused on identify companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers, sectors, and other factors.

- Despite the worsening economic outlook, we believe that the widening in credit spreads has taken valuations to attractive levels, relative to government bonds. Credit spreads discount a significant portion of bad news, and investors are being paid well to take credit over government bond risk. Although some further volatility is likely, our recent preference for short-dated credit bonds is gradually easing as we begin to take on more duration risk – albeit not at the long end of markets where all-in yields still look challenging.
- The BoE announced in May that it will begin the sale of its holdings of corporate bonds from the week commencing 19 September, via a regular multi-stock auction. While its buy programme had a significant (if only temporary) impact on sterling credit markets, we do not expect the same for the sale. Although the holding is material in size, it is not a structurally significant portion of the market, and with the proposed sale's timescale of more than three years, it is unlikely that markets will see enough concentrated activity to generate large swings in pricing.

Additional information

- There are regular updates on our investment thinking in the *Our views* section of [rlam.com](https://www.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 on a range of topics relevant to sustainable investing – please visit the [RLAM Digital Insight Hub](#).



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