Royal London Global Sustainable Equity Fund

Quarterly Report 31 March 2022

Top ten holdings

	Fund (%)
Microsoft	4.9
Taiwan Semiconductor Manufacturing Company	3.6
Thermo Fisher Scientific	3.4
Alphabet	3.3
Amazon	3.3
AstraZeneca	3.2
Texas Instruments Incorporated	3.2
London Stock Exchange Group	3.1
Schneider Electric	3.1
Adobe Incorporated	3.1
Total	**34.3**

Source: RLAM, based on the M Acc share class.

Fund data

	Fund
No. of stocks	42
Fund size	£273.5m
Launch date	25.02.2020

Performance

	Fund (M Acc) (%)	Benchmark[1] (%)	Relative (%)
Q1 2022	**-7.13**	**-2.64**	**-4.48**
Year-to-date	-7.13	-2.64	-4.48
Rolling 12 months	15.83	12.42	3.42
Since inception 25.02.2020	20.19	15.00	5.19

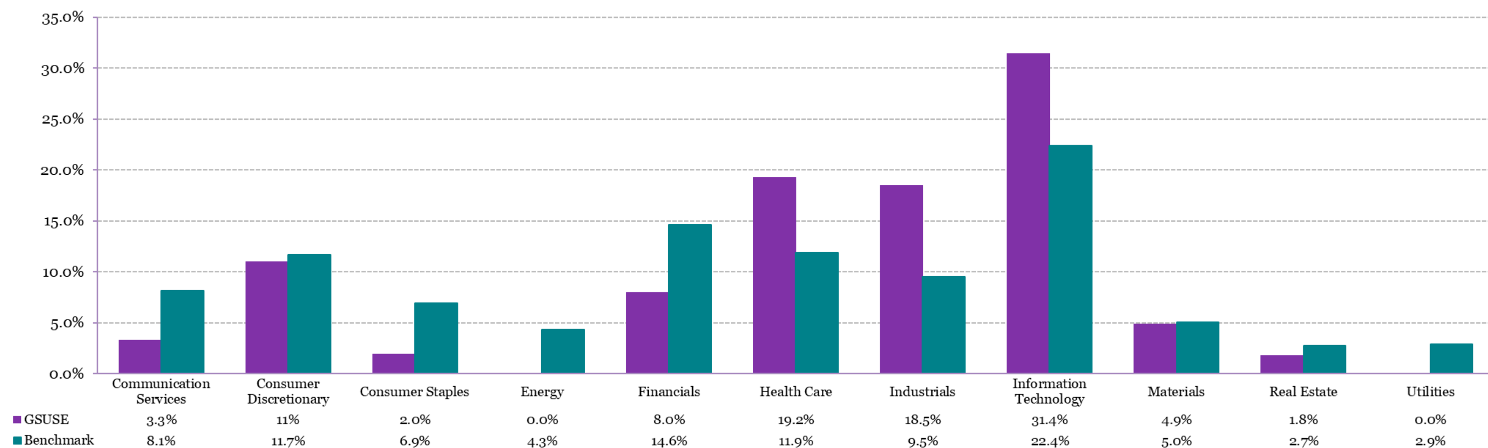
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

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

Source: RLAM, gross of fees.

[1]Benchmark: MSCI All Countries World Net Total Return Index GBP.

Sector breakdown



	Communication Services	Consumer Discretionary	Consumer Staples	Energy	Financials	Health Care	Industrials	Information Technology	Materials	Real Estate	Utilities
GSUSE	3.3%	11%	2.0%	0.0%	8.0%	19.2%	18.5%	31.4%	4.9%	1.8%	0.0%
Benchmark	8.1%	11.7%	6.9%	4.3%	14.6%	11.9%	9.5%	22.4%	5.0%	2.7%	2.9%

Source: RLAM as at 31 March 2022

Executive summary

- Sustainable funds in general had a challenging start to 2022. The Russian invasion of Ukraine in late February rightly shocked the world and attracted huge amounts of media coverage. Yet the double whammy that hit financial markets in the quarter was already underway, with persistently high inflation leading central banks to reassess the timing of interest rate rises and the withdrawal / unwinding of quantitative easing (QE). The publication by the Federal Reserve (Fed) of the minutes of December's FOMC meeting in the first week of the quarter led to a significant inflation-related equity market rotation out of 'growth' and into 'value'. Given longer-duration growth sectors such as technology can fit well with sustainable mandates this meant the quarter was always going to be tough for sustainable investors.
- A significant factor behind the inflationary pressures was the ongoing strength in oil and commodity prices, which were further impacted by the Russian invasion of Ukraine later in February. These two factors caused significant volatility in global financial markets and the effects were felt disproportionately by sustainable funds. Following the invasion, energy prices soared and defence budgets looked inadequate for many NATO countries. Understandably, our Sustainable funds generally don't invest in energy or arms manufacturing and have very limited (if any) exposure to commodities.
- Our Sustainable funds were not immune to such extreme sectoral performance and our equity-only funds (**Sustainable Leaders** and **Global Sustainable Equity**) underperformed their wider index-based benchmarks. Normally, one would expect equity-market weakness to be mitigated by positive returns from sterling credit, but our mixed-asset funds (**Sustainable World**, **Sustainable Diversified** and **Sustainable Managed Growth**) also underperformed as both asset classes were negatively impacted by the unusual combination of macroeconomic and geopolitical factors. Only **Sustainable Managed Income**, our sterling credit-only fund, outperformed its benchmark. However, we encourage clients to consider our sustainable funds' performance over the longer term. Despite the challenges over the first quarter, our funds are all ranked in the top quartile over the 12-month period to 31 March 2022, with the exception of our more credit-oriented funds, **Sustainable Managed Income** and **Sustainable Managed Growth** – which are ranked in the second quartile relative to their IA sector peers.
- Thankfully our approach is not one where we have to make predictions on these macroeconomic factors and 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 quarterly results during the first 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

- Equity markets apparently ended 2021 in rude health with strong corporate earnings, a fast-declining threat from Covid-19 as Omicron proved less deadly than earlier variants and a benign monetary policy environment. However, with the ongoing strength in oil and commodity prices, the inflation that had taken hold in the immediate recovery from the global economic shutdown remained persistent. However, in early January it became clear that the Fed was prepared to increase interest rates significantly faster and higher than expected just a few months before; and the market now expects the Fed Funds Rate to reach 2.5% by year end. Following its first base rate increase in three years in December, the Bank of England also continued to signal that it will tighten monetary policy sharply.
- The subsequent invasion of Ukraine by Russia added to the mix. While depressing risk asset prices, the potential for supply chain disruptions and the downstream impact of sanctions on oil and gas supplies pushed energy prices to new all-time highs, adding to the challenges facing central banks. These two factors caused significant volatility in global financial markets and the effects were felt disproportionately by sustainable funds, which generally don't invest in energy and have very limited (if any) exposure to commodities. Equity markets recovered some of their losses from mid-March as companies continued to deliver strong performances despite the increased uncertainty about the global economy.
- As a result, for the first quarter the FTSE-All Share, MSCI World and MSCI All Countries World Index (ACWI – which also includes 26 emerging markets) returned +0.49%, -2.18% and -2.41% to sterling investors, respectively. Regional returns were widely dispersed. According to MSCI regional data, the UK was the best-performing stockmarket globally, boosted by its notably high exposure to the oil & gas, mining and banks sectors – it returned +4.76% (the only positive regional return on a global basis). Otherwise, the US, emerging markets and Japan returned -2.35%, -4.19% and -4.25%, respectively; while the returns from Asia-Pacific (ex-Japan) and Europe (ex-UK) lagged at -6.30% and -7.56%, respectively.

- The FOMC minutes caused investors to reconsider their expectations of interest rate rises, leading to a significant inflation-related equity market rotation out of 'growth' and into 'value'. The MSCI World Value Index returned +2.53% versus -6.87% for the MSCI World Growth Index, outperformance of 9.41%. Energy led the MSCI World sector returns by far (+34.98%), with materials, utilities and financials the only other sectors with positive returns (+6.05%, +4.56% and +1.56%, respectively). Consumer discretionary (-7.92%), communication services (-7.71%) and technology (-7.40%) were the weakest sectors.
- Over the first quarter, the benchmark 10-year gilt yield rose from 0.97% to 1.61%, leading gilts to return -7.17% on an all-maturities basis (FTSE Actuaries). Yields began moving upwards towards the end of December as the BoE ended its QE programme, increased interest rates and prepared markets for further rises. The invasion of Ukraine drove a significant if temporary dip in yields: 10-year gilt yields reached around 1.55% in February, but fell to around 1.20% following the Russian aggression. The flight to safety was temporary, however, as yields again trended higher in March.
- The first quarter of 2022 was the worst performing quarter for sterling credit markets (-6.2%) since the Global Financial Crisis. Although broad sterling credit indices outperformed government bonds this reflected their lower duration, as investment grade spreads widened by 22bps (iBoxx Sterling Non-Gilt index). Defensive sectors such as supranational, covered and asset backed outperformed, whilst financials (banks and insurance) were laggards, particularly subordinated bonds when looking at excess returns (adjusted for the impact of duration). Some energy bonds were weak despite the rise in oil and gas prices, reflecting exposures to Russia. By credit rating, AAA rated debt outperformed other investment grade ratings bands; BBB rated debt outperformed A rated debt; and sub-investment grade debt outperformed investment grade markets, albeit still delivering negative absolute returns.
- Currencies were volatile in the first quarter impacted by geopolitical tensions, interest rates and the rise in commodity prices. The US dollar played its traditional role as a safe haven, strengthening against other major currencies. Sterling was relatively weak, other than against the yen, which marginally enhanced the returns from global equities to sterling investors. Brent crude oil soared 38.7% to nearly $105 a barrel during the quarter as the invasion of Ukraine raised supply concerns, while spot gold and front-month copper futures gained 6.3% and 6.7%, respectively.

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 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.
- Sustainable funds in general had a challenging start to 2022 with persistent inflation leading to a change in the outlook for monetary policy, and the Russian invasion of Ukraine in late February causing energy and commodity prices to rise further and add to the uncertainty about the outlook for the global economy. Although they recovered some of their losses from mid-March, stockmarkets generally delivered negative returns – other than the UK, which was boosted by its notably high exposure to the oil & gas, mining and banks sectors.
- Headline returns only tell some of the story of the quarter, however: sectors such as energy and materials were boosted by the mix of inflation and geopolitical developments, and the change in the outlook for interest rates led to a significant inflation-related equity market rotation out of 'growth' and into 'value'. Energy dominated the MSCI World sector returns (+34.98%), with materials, utilities and financials the only other sectors with positive returns (+6.05%, +4.56% and +1.56%, respectively). Consumer discretionary (-7.92%), communication services (-7.71%) and technology (-7.40%) were the weakest sectors.
- Our Sustainable funds weren't immune to such extreme sectoral performance and the fund underperformed its benchmark during the quarter. Understandably, we generally don't invest in energy and have very limited (if any) exposure to commodities. In addition, we also have a low weighting in financials, particular 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.
- Within the technology and healthcare sectors, however, 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. This may seem unduly cautious ("What about missing out on the next Google or Amazon?"), but there are so many risks with early-stage companies –

its key product might fail; the company might run out of cash; its product might be a winner, but the company could fail to market or distribute it well; or another company might gain first-mover advantage and secure the market with a similar or even inferior product. The winners are far fewer in number than the many failures and we believe that over the medium to long run you can generate attractive above-market returns without taking such binary risks. Besides, there were plenty of opportunities to buy Google (Alphabet) or Amazon at levels much lower than they are today, but after they were more established and viable (and we did!). Some investors have taken a different view and invested more speculatively in earlier-stage tech and/or biotech companies – they may have done well in the good times (although the risk-adjusted returns wouldn't be so appealing), but the 'spec tech' rout that started in the fourth quarter of 2021 dramatically impacted some of them in the first quarter. In contrast, we believe that our funds are unlikely to have seen any permanent capital impairment: while more-established tech holdings may have been derated in the interest rate-driven rotation, they continue to be strong revenue- and profit-generating investments.

- Conversely, some investors have made a virtue of running very high cash levels during the quarter. This is a more nuanced and philosophical issue than speculating in earlier-stage companies. With hindsight it could seem wise to stay in cash and not invest in falling markets, but it's not our role to act as asset allocators. Clients give us their money to invest sustainably and there are many studies that show that better long-term returns are achieved by being fully invested in the market, rather than trying to beat it through timing. These studies show that investors tend to miss the inflection points, so they are 'out of the market' when the big upward moves occur. 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.
- Looking more closely at the fund, performance was similarly affected by sectoral weightings resulting from its sustainable mandate. For its MSCI ACWI benchmark, energy was less of a stand-out performer than for the MSCI World (+25.13% vs. 34.98%), but it was more impacted by the market rotation and the derating of technology as around one third of the fund is invested in the sector. Key contributors to performance included London Stock Exchange (LSE), Novo Nordisk and Visa. **LSE** performed well after updating the market 15 months into the integration of its acquisition of Refinitiv, the data business of Thomson-Reuters. Having been punished earlier in the process for disclosing that the costs of the integration would exceed LSE's initial forecasts, the company's strategy, financials and communication are now paying off. We feel that the shares still offer significant upside potential. **Novo Nordisk**, the Danish pharmaceutical company with a world-leading diabetes franchise, bounced back as the market positively reassessed the potential for its Wegovy obesity drug following a delay in approval. Global credit card operator **Visa** was boosted by the decreased impact of Covid-19 in many countries and the easing of travel restrictions as cross-border transactions are very profitable. It also benefitted from the resolution of its dispute with Amazon over credit card payment charges. Detractors from performance included **Intuit** as the online tax forms business was hit by the technology sector derating; heating, ventilation and air-conditioning (HVAC) specialist **Trane** was affected by its sensitivity to higher interest rates and the potential slowdown of the new build housing market; and UK credit rating and data specialist **Experian** was similarly hit by the potential impact of higher rates on US mortgage applications. None of these performance issues concern us unduly as they were largely the result of changes in investment sentiment rather than the companies' fundamentals.
- Notable trades this quarter included adding to **Schneider Electric** as the company is a global leader in electrification and factory automation. We also added US contact research outsource leader **IQVIA,** formed by the merger of Quintiles and IMS Health helps pharmaceuticals companies to set up and run clinical trials using its massive patient data sets. We exited our position in Dutch medical technology company **Philips** on the basis it was no longer a preferred idea now that visibility into the investment case had deteriorated following ongoing issues in its Sleep division. We used the proceeds from the sale to initiate a new position in US plumbing and heating product distributor, **Ferguson** where we see an attractive long-term risk/reward

Outlook

- We expect market volatility to continue as investors continue to grapple with the implications of the Covid-19 pandemic (lockdowns, supply chain disruptions, inflation and interest rate rises) as well as the invasion of Ukraine and possibility of further conflict in Eastern Europe. In fact, we cannot remember a time when there have been so many huge and uncertain forces all impacting the global economy simultaneously.
- The deflation of the Chinese property bubble will impact economic growth there. Growth will also be affected by the government's zero-tolerance approach to Covid-19, with cities with millions of inhabitants being locked down fully following a handful of positive cases. This will impact economic growth in China, but also the wider Asia-Pacific region and indeed the world. At the same time, economic sanctions on Russia and higher energy prices will hit growth. We have no direct exposure to Russia or China, and are underweight in the wider Asia-Pacific region because of the emphasis on high standards of corporate governance from our sustainable investment process.
- Thankfully our approach is not one where we have to make predictions on these macroeconomic factors and 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 quarterly results during the first 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.

- While the macro environment is very uncertain, micro factors have never been clearer. This brings us back to sustainable investing and the core of fund management – identifying good companies, valuing them and (to a lesser extent) trying to time our investment to maximise the returns to clients. The pandemic and its aftermath have accelerated the sustainability agenda across governments, businesses and consumers. This is already proving positive for the types of company in which we seek to invest: we saw this in the fourth quarter results season, where many companies that we hold exceeded our expectations. The benefits of sustainability are influencing them in the following ways:

    1. **Cultural** – companies with purpose and strong environmental and social performance are more successful in attracting talent to work for them.
    2. **Operational** – strong environmental and social practices are now seen as making businesses more efficient and effective. Far from being a burden, net zero commitments make businesses more resource-efficient and save money.
    3. **Financial** – sustainability is bringing new business opportunities to many of the companies we invest in, as they themselves help other businesses and consumers to enact their own sustainability goals.

  This combination of hiring the best talent, being operationally efficient and having a greater breadth of opportunity at lower risk is a powerful one. It is also why any periods of underperformance are likely to be temporary. Companies with these characteristics are likely, over time, to be productive investments whatever the overall investment environment, and we own many of them.

- Overall, we remain positive on equities as the global economy continues to recover from the impact of Covid-19 – that, after all, is one reason interest rates are being raised. We therefore maintain our pro-equity stance in the mixed asset strategies. While there may be periods of volatility, uncertainty is the friend, not foe, of investors: long-term returns are improved by buying at times of uncertainty. However, 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. In contrast, as the quarter demonstrated, 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.

- Should the global economy begin to slow, as result of higher interest rates or the war in Ukraine, it is likely that some companies will miss their earnings targets (or fail to be sufficiently upbeat in their guidance) and face periods in 'investment purgatory' as a result. That said, we have developed our sustainable investment process over many years, and it has been effective in various economic and market conditions. While we are always learning and will evolve it where necessary, we have confidence that it will continue to serve our clients well. An example of this process working is our decision to stick with **LSE** when its share price fell because of the market's impatience around its acquisition of Refinitiv – while others sold the shares, we kept faith in the management's strategy and execution, and were rewarded by the stock's strong performance in the first quarter.

- As with equities, there is considerable uncertainty about the year ahead for sterling credit – again centred on inflation and central bank interest rate rises. In the UK, investors are pricing in a move to a 2.5% base rate over 12 months and in the eurozone there has been a significant shift, with tightening now expected in the second half of the year. The US yield curve (between 2- and 10-year maturity bonds) inverted during March, which many view as recession signal. However, we would highlight the uncertainty of any market signals at present, given the unpredictability of war in Ukraine.

- The widening in credit spreads has taken valuations to attractive levels, relative to government bonds. However, if tensions in Ukraine intensify, we would expect further modest widening in investment grade and high yield credit spreads. Nevertheless, at current levels, investment grade spreads overcompensate for default risk, and we expect that credit will outperform government debt over the medium term. Our portfolios have a material exposure to BBB bonds, but we believe that compensation for default risk remains most attractive for the bonds that we hold in this rating band.

- The BoE announced in the first quarter that it will sell its holdings of corporate bonds. 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 sales timescale of more than three years, it is unlikely that markets will see enough concentrated activity to generate large swings in pricing.

Additional information

- RLAM recognises that the Ukraine invasion is a human tragedy, and one that we hope is resolved swiftly. As stewards of our investors' assets, we are monitoring the situation closely, and of course are complying with all restrictions and sanctions issued by relevant authorities. RLAM has no exposure to Russian companies in our active funds. We had limited exposure (less than 0.1% of total assets) in our tilt and Emerging Market Tracker funds at the time of the invasion, but subsequently sold every holding we were permitted to. In our Emerging Market Tracker fund, we removed this in line with the MSCI index changes in early March. Our sustainable funds have no direct investments in Russia, either equity or credit.
- There are regular updates on our investment thinking in the *Our views* section of www.rlam.co.uk, including a regular blog from Head of Sustainable Investments on key issues in equity markets and sustainable investing. We also deliver regular webinars – there have been several sustainable investing-related webinars in late March and early April, and there is a sustainable quarterly update on 26 April 2022 with Sebastien Beguelin (equities) and Matthew Franklin (sterling credit). Please visit the RLAM Digital Insight Hub.

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