



# Royal London Sustainable Managed Income Trust

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Quarterly Report 31 March 2022

## Top ten holdings

	Trust (%)
Scottish Widows Plc 7% 2043	1.4
Aviva 6.875% 2058	1.3
Barclays Bank 5.75% 2026	1.0
HSBC Bank 5.375% 2030	0.9
Quadrant Housing 7.93% 2033	0.8
Sunderland 6.38% 2042	0.8
Leeds Building Society 3.75% 2029	0.8
Penarian Housing Finance Plc 3.212% 2052	0.8
Harbour Funding 5.28% 2044	0.7
Derby Healthcare 5.564% 2041	0.7
<b>Total</b>	<b>9.2</b>

## Trust data

	Trust	Benchmark <sup>1</sup>
No. of stocks	323	1,183
Fund size	£288.5m	-
Duration <sup>2</sup>	7.3 years	7.3 years
Gross redemption yield <sup>3</sup>	3.25%	2.72%
Launch date	07.12.2012	-

Source: RLAM, based on the C Acc share class

<sup>1</sup>Bench mark: iBoxx £ Non-Gilts All Maturities.

<sup>2</sup>Excluding cash

<sup>3</sup>The gross redemption yield is calculated on a weighted average basis.

Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature.

## Performance

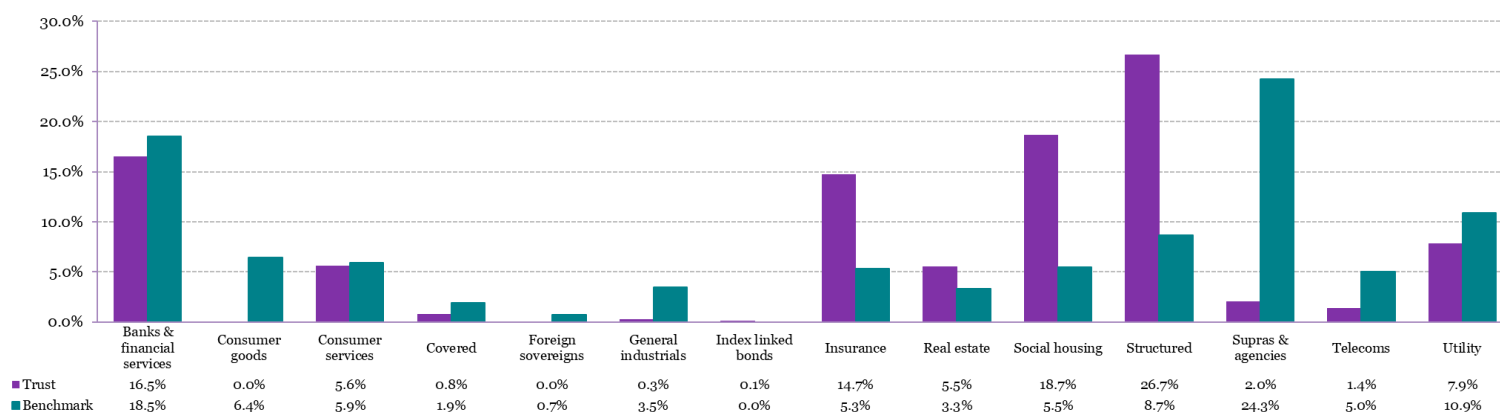
	Trust (C Acc)(%)	Benchmark <sup>1</sup> (%)	Relative (%)
<b>Q1 2022</b>	<b>-5.55</b>	<b>-6.19</b>	<b>0.64</b>
Year-to-date	-5.55	-6.19	0.64
Rolling 12 months	-3.02	-5.20	2.18
3 years p.a.	2.55	0.95	1.59
5 years p.a.	2.91	1.55	1.36
Since inception p.a. 07.12.2012	4.36	3.57	0.79

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, subject to rounding.

Source: RLAM, gross of fees. <sup>1</sup>Benchmark: iBoxx £ Non-Gilts All Maturities.

## Sector breakdown



Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held.



## Executive summary

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- 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

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- 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.
- 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

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- Sterling credit markets provided negative absolute returns in what was the worse quarter since the Global Financial Crisis. Markets were driven by the significant rise in yields of the underlying gilt market, with nominal gilt yields rising by around 60 to 70bps across all maturities in the first quarter. While our sustainable credit portfolios delivered negative returns, they outperformed their respective market benchmark.
- The main contributor to performance was security selection. Specifically, the funds benefitted from having no direct exposure to Russian companies **Gazprom** and **Russian Railways**, which both fell out of the benchmark in the period following the invasion of Ukraine and subsequent Western sanctions – these credits represented a small, yet material portion of the benchmark. Royal London's indirect exposure to Russian companies through sterling credit was also very limited in general, as companies in the highest risk sector, financials, had already curtailed exposure to Russia due to requirements around money laundering. However, specific sustainability and ESG criteria mean that we have even less exposure in our sustainable funds.
- At a sector level, the biggest drag on performance was the large underweight in supranationals, which outperformed the broader market. This strength pushed the performance of the sector above that of the broader market on a rolling 12-month basis, although the sector has underperformed over the medium term to the benefit of our portfolios. Conversely, our allocation to asset-backed securities and secured bonds helped relative performance.
- Security selection was positive, including contributions from 'off benchmark' positions (such as floating rate bonds, sub-investment grade bonds, and unrated bonds). This reinforces our long-standing investment philosophy that good value bonds can be found outside benchmark constituents. Specifically, we saw positive contributions from some legacy subordinated bank debt, which bucked the general financial trend (e.g., **Santander**, **Lloyds Bank**). In the general industrials sector, the biomass and low carbon heat specialist **Aggregated Micropower** had a particularly strong quarter, while real estate company **Eskmuir** was also a notable performer, maintaining its value while the broader real estate sector delivered below market returns. The structured student loans bond **ICSL** was also a standout performer, demonstrating the value of secured lending in uncertain markets.
- In the first two weeks of the quarter sterling credit issuance was extremely strong, helping the market to meet forecast expectations for January even though the latter half of the month proved to be extremely quiet. February was similarly quiet, with the £3.1 billion of issuance in primary sterling markets nearly 50% below estimates. Issuance picked up again in March, as £6.6bn of new debt was brought to market, only a touch below forecasts. Issuance was, however, skewed heavily in favour of financials, particularly non-domestic banks.
- We participated in a number of new issues across sectors in the first quarter of the year. In utilities we bought an issue from **Bazalgette**, a green bond where the proceeds are used to build-out London's 'super sewer', delivering extensive environmental benefits. Also in the utility sector, we bought new issues from **Severn Trent** and **Northern Powergrid**, the latter continuing our preference for regulated electricity providers. In social housing, we bought another 'use-of proceeds' sustainable bond (not to be confused with sustainability-linked bonds) from **Peabody Group**, a housing association based in London – the proceeds will finance the retrofitting of existing homes to improve energy performance certificate (EPC) ratings and energy efficiency, and to boost the number of electric vehicle charging points throughout its developments. We also participated in the issue of a sustainability-linked bond from **L&Q**, as well as taps of existing issues from **Housing & Care 21**, **Flagship Finance** and **Blend Funding**. We also bought a new issue by **Motability**. Otherwise, we participated in a new sterling issue from **Prologis**, the US-based real estate investment trust who acquire, develop and maintain warehouses across the globe, adding diversification through exposure to non-UK revenues. Finally, we were particularly active in the senior banks sector in the quarter, picking up a number of new issues at good value. We added new issues from **Santander**, **Lloyds Bank**, **BNP Paribas**, **BFCM**, **Yorkshire Building Society**, **Toronto Dominion**, and Norwegian bank **DNB**. We also added senior insurance issues from **New York Life** and **MetLife**.



- 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, the decarbonised economy, infrastructure, financial resilience (such as insurance products to support individuals through shocks) and community funding (regulated banks and building societies focused on SME and retail lending).
- 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 community funding, financial resilience, decarbonisation and infrastructure 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

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- 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

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- 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](http://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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