Royal London European Sustainable Credit Fund

Quarterly Report 30 September 2022

Top ten holdings

	Fund (%)
Storebrand Livsforsikring 6.875% 2043	1.4
Alpha Trains Finance 2.064% 2030	1.3
Gewobag Wohnungsbau 0.125% 2027	1.2
Aptiv Plc 1.6% 2028	1.1
Hamburger Hochbahn AG 0.125% 2031	1.0
Wellcome Trust Ltd The 1.125% 2027	1.0
DS Smith Plc 0.875% 2026	0.9
Akelius Residential Property Finance 1% 2028	0.9
Hemsö Fastighets 1.75% 2029	0.9
Statnett 1.25% 2030	0.9
Total	**10.6**

Source: RLAM

Fund data

	Fund
No. of holdings	203
Gross Redemption Yield[1]	3.7%
Duration	4.4 years
Fund size	€100.0m
Launch date	29.07.2021
Base currency	EUR

[1]Gross redemption yield is the rate of discount at which a bond's future obligations of interest and capital payments equates to its current price. The gross redemption yield shown for the fund is the average for its individual holdings, weighted by their current value, net of relevant fund management costs and gross of tax.

Performance

	Fund (Z Acc GBP hedged) (%)	Fund (Z Acc EUR) (%)	Benchmark[1] (%)	Relative (%) (as compared to Z Acc EUR)
Q3 2022	**-3.27**	**-3.63**	**-3.35**	**-0.28**
Year-to-date	-14.41	-15.19	-14.95	-0.24
Rolling 12 months	-14.79	-15.71	-15.52	-0.19
Since inception 29.07.2021	-13.47	-14.34	-14.16	-0.18

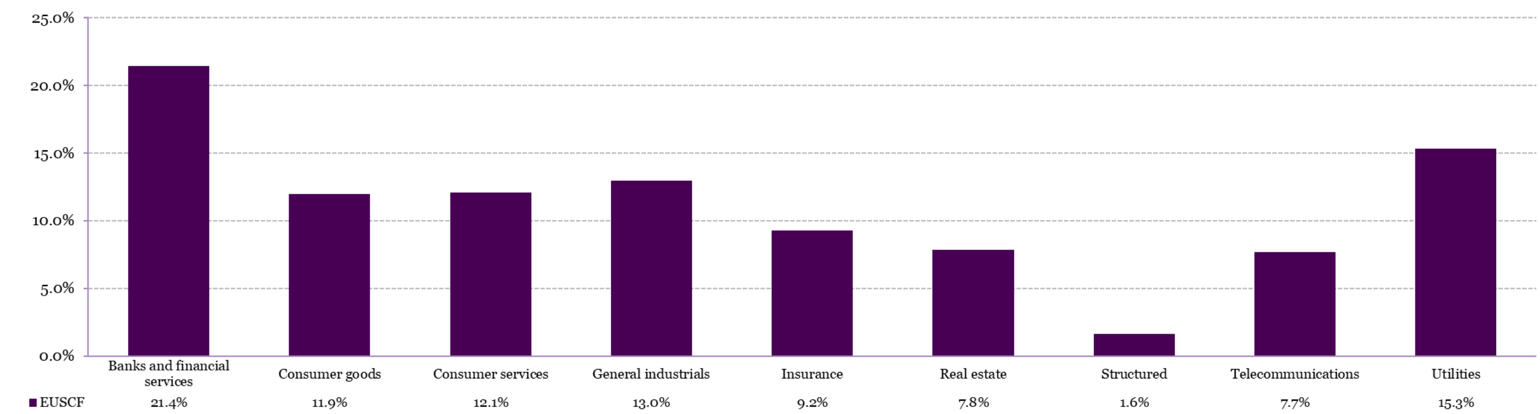
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

All performance figures stated in euro, gross of fees and tax unless otherwise stated. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment. The impact of fees reduces your return.

Source: RLAM, gross of fees.

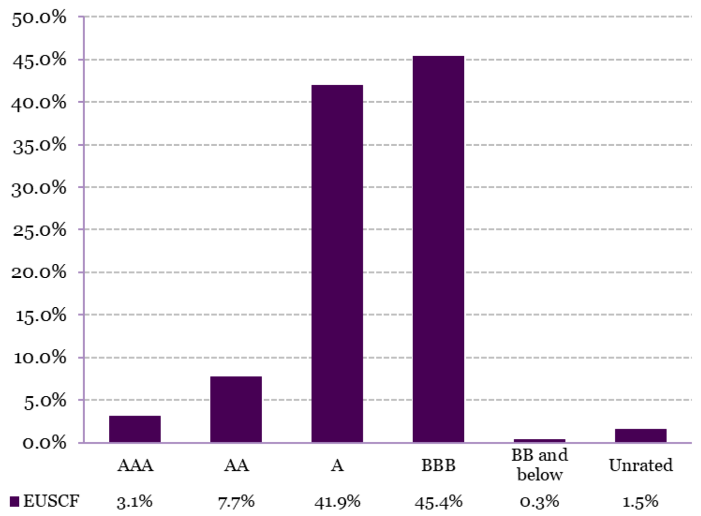
[1]Benchmark: ICE BofAML Euro Corporate & Pfandbrief Total Return EUR Index.

Sector breakdown

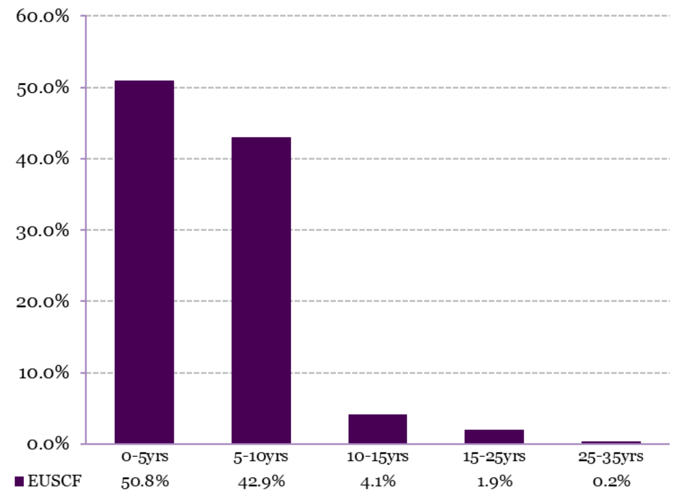


Source: RLAM as at 30 September 2022

Credit ratings



Maturity breakdown



Fund performance

- Gross of fees, the fund (EUR, M, Acc) returned -3.63% (-3.73% net of fees) for the third quarter, underperforming the -3.35% return of its benchmark (ICE BofAML Euro Corporate & Pfandbrief Index (EUR Hedged)). For the rolling 12-month period, the gross return for the fund is -15.71% (-16.06% net), compared to -15.52% for the benchmark.
- For the quarter, continued weakness in government bond markets and the widening of credit spreads negatively impacted the absolute returns from the fund. Duration had no impact on relative performance and credit sector selection was broadly neutral. The moderate relative underperformance of the fund instead mainly resulted from security selection in the real estate and insurance sectors: in both cases, we are strongly overweight and higher beta bonds in these sectors impacted performance during the quarter.

Market background

- The macroeconomic factors that disrupted financial markets in the first half of 2022 continued to dominate in the third quarter – higher-than-expected inflation and interest rate increases were the key macroeconomic influences, along with growing fears of recession in the US, Europe and the UK. Inflation first surfaced in the aftermath of the Covid-19 pandemic, but was exacerbated by the Russian invasion of Ukraine in February and retaliatory sanctions which sharply increased the prices of oil, gas and other commodities. Although they have fallen back slightly, energy prices remain high and geopolitical events continue to affect sentiment as winter approaches. The apparent sabotage of the Nord Stream gas pipelines from Russia to Germany suggests that energy will remain a key pawn in relations between NATO countries and Russia.
- Central banks have responded to the continued strength of inflation by further tightening monetary policy and reiterating that they will do whatever it takes to suppress rising prices. The US Federal Reserve (Fed) led the way, increasing rates by 1.50% over the quarter. Since March, the Fed has raised rates five times by an aggregate of 3% – its 0.75% increases in June, July and September were the biggest increases for nearly 30 years. Its commitment to do more has led markets to price in further hikes this year and in 2023. The European Central Bank (ECB) has so far been slower to react, partly due to a more fragmented backdrop with a gap between Germany and 'peripheral' economies. However, it ended its bond buying programme in July and increased rates by 0.75% (it's first increase in 11 years and a bigger increase than the 0.50% expected by economists).
- All major government bond markets were impacted as the ongoing interest rate rises and hawkish commentary from central banks drove bond yields higher globally (prices move inversely to yields): the 10-year US treasury yield rose by 64bps to 3.83% and the 10-year German bund yield rose by 57bps to 2.11%. Longer-dated bonds performed worst in the period due to their greater sensitivity to interest rates (duration risk). These negative government bond returns took a toll on investment grade credit markets as spreads widened in anticipation of a likely recession.

- The price of Brent crude oil fell by 16.9%, but remains over $90 a barrel, and copper futures fell by another 8.0% in dollar terms on fears of a slowdown in China and global recession. Currency movements had a notable impact in the quarter, following the volatility in the first half of the year. The Fed's more aggressive approach to raising interest rates compared to other central banks has pushed the dollar higher and it was again the strongest major currency in the period.

Fund characteristics

- The fund only invests in issuers that meet both our financial and sustainable criteria, which include offering a net benefit to society, ESG leadership and observing good governance practices.
- While we will consider buying labelled bonds, such as 'green' and 'sustainable' bonds, they are not a panacea, and we remain cautious about them as they sometimes lack clarity of objective and don't automatically offer value. We will continue to assess each individual credit on its particular merits.
- Issuers that meet our sustainability criteria are most likely to be found in our current sustainable themes, including energy transition, social and environmental infrastructure, the circular economy and environmental efficiency, social housing, and financial inclusion and resilience (such as insurance products to support individuals through shocks). On sustainability grounds, the fund follows exclusion criteria, which prohibit investment in fossil fuel extraction, mining, tobacco production, nuclear power generation, armaments manufacture, animal and fur products, and pornography.
- Duration is broadly neutral.
- Sector and security diversification are features of the portfolio, which currently has over 200 holdings. We believe that sector and security selection we be the main drivers of relative performance over the medium term.

Fund commentary

- New issuance remained weak in investment grade credit due to the adverse market conditions and ongoing volatility. However, there were still opportunities and we participated in senior banks issues by **BNP Paribas** and **BFCM**, and a subordinated banks issues from **ING**. Aside from financials, we bought a number of new utilities issues, including **Eurogrid**, **Orsted**, **SSE**, **National Grid** and **Alliander**. Otherwise, we bought bonds of **Air Liquide**, the French industrial gases leader.
- Secondary market activity mainly focused on maintaining liquidity, and managing duration and high yield exposure. We added to existing holdings of utilities **Fluvius** and **Enexis**, to **Swiss Re** in subordinated insurance and **Motability**. We reduced our positions in **Gecina** and **Digital Euro Finance** to manage exposure to the real estate sector, and in **Darling Ingredients** to manage the fund's high yield exposure. Otherwise, we sold bonds of **Xylem** in favour of longer-dated exposure, and **SES Telecoms** on concerns about a rumoured merger with **Intelsat**.

Investment outlook

- We will continue to invest in bonds that meet both our demanding financial and sustainable criteria, and which fit into the sustainable themes that we think will endure and offer long-term solutions to the challenges that the world faces.
- There is considerable uncertainty about the outlook for the rest of 2022 and 2023. The Fed is continuing to raise interest rates and many investors fear that this could tip the US into a hard-landing recession. The picture is only marginally different in Europe, with domestic and commercial energy prices remaining high and geopolitical events continuing to affect sentiment as winter approaches. Meanwhile, China is experiencing a slowdown in growth with particular problems in its over-invested property sector.
- The best way to manage risk at times of rising economic uncertainty and potential recession is to conduct thorough in-house research and identify the full range of risks for specific sectors, and individual issuers and credits; and to construct a portfolio that is diversified across different sectors of the economy and different potential risk events.
- Nonetheless, defaults are very rare in investment-grade credit. Furthermore. we believe that the widening in credit spreads this year has taken valuations to attractive levels, on both a relative basis compared to government bonds and in absolute terms. Credit spreads discount a significant portion of bad news, and investors are being paid well to take credit over government bond risk. At quarter end, the average credit spread for the fund's benchmark index was 206bps, which was 120bps wider than at the start of the year: likewise, it was 256bps for the BBB ratings band (+146bps wider).

Find out more

- Our fund managers and other in-house specialists regularly address the issues that they consider in managing their funds via blogs, articles, webinars, and other media. Please visit the RLAM Digital Insight Hub, or the *Our Views* section of rlam.com, including regular *JP Journal* updates from Head of Fixed Income Jonathan Platt.
- We are experiencing unprecedented challenges in financial markets and the global economy with unsustainable energy prices, inflation at a multi-decade high and rising interest rates. Following the turbulence in fixed income and currency markets in late September, we hosted a webinar for Jonathan and our Head of Rates and Cash Craig Inches to discuss how the current situation and how central banks and policymakers might react. You can listen back to the webinar via the *Our Views* section of rlam.com.

Additional information

- As we highlighted in our Annual Report, RLAM has ambitious targets for the next few years, notably in international growth as well as investment in infrastructure and people. This investment is to make sure that we continue to provide clients with the service they need and positioning us to for future regulation changes and market development.
- As part of that ambition, we are pleased to announce that we are moving to a new investment platform and have selected the industry leading 'Aladdin' platform. This decision has followed months of analysis and pre-implementation planning with the vendor BlackRock. Aladdin will help us improve our service offerings to our clients, as well as delivering operational efficiencies.
- As you would expect, implementation is an extended task, and the project is expected to complete in 2024, but we believe it is important to be transparent about such projects with our clients. Throughout the implementation, the project and management of your client portfolios will be closely monitored by our Board and Risk functions to ensure that this transition is achieved smoothly, and we will keep you updated on our progress. This is an important part of our long-term strategic goal to ensure that we continue to meet your needs today and into the future.

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