Royal London Global Sustainable Equity Fund

Quarterly Report 30 September 2022

Top ten holdings

	Fund (%)
Microsoft	4.8
Thermo Fisher Scientific	3.9
AIA Group	3.6
London Stock Exchange Group	3.6
AstraZeneca	3.5
Texas Instruments	3.4
Taiwan Semiconductor Manufacturing Company	3.2
Visa	3.1
Nordson Corp	2.9
Schneider Electric	2.9
Total	**34.9**

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

Fund data

	Fund
No. of stocks	41
Fund size	£224.7m
Launch date	25.02.2020

Performance

	Fund (M Acc) (%)	Benchmark[1] (%)	Relative (%)
Q3 2022	**1.95**	**1.37**	**0.57**
Year-to-date	-18.25	-9.76	-8.50
Rolling 12 months	-12.92	-4.17	-8.75
Since inception 25.02.2020	10.43	8.71	1.72

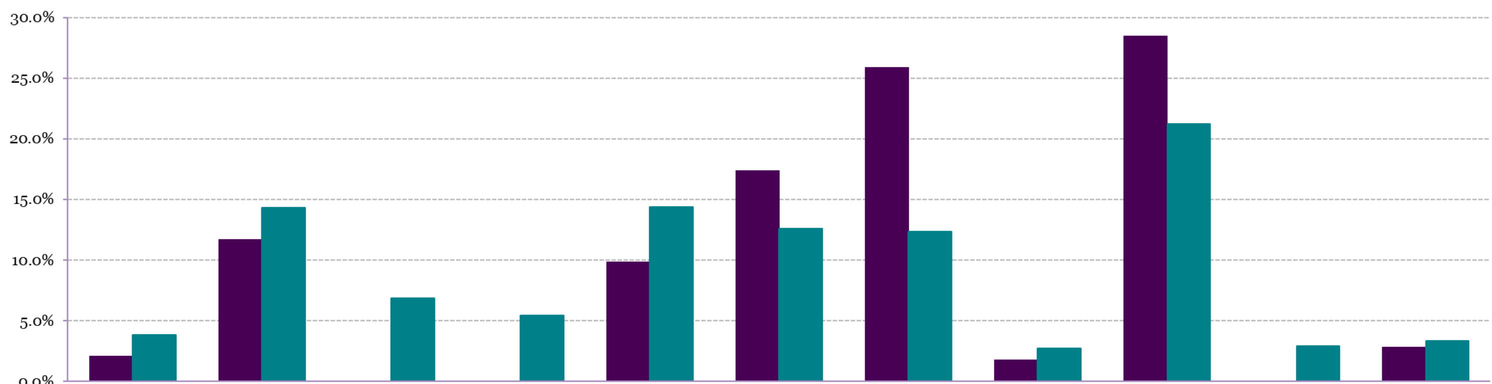
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

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

Source: RLAM, gross of fees. 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.

[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	2.1%	12%	0.0%	0.0%	9.9%	17.4%	25.9%	1.8%	28.5%	0.0%	2.8%
Benchmark	3.8%	14.3%	6.9%	5.5%	14.4%	12.6%	12.4%	2.7%	21.2%	2.9%	3.3%

Source: RLAM as at 30 September 2022

Executive summary

- 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 influences, along with growing fears of recession in the UK, Europe and the US. 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.
- Our equity-only funds (**Sustainable Leaders** and **Global Sustainable Equity**) outperformed their wider index-based benchmarks in the third quarter, with Sustainable Leaders delivering a top-quartile return after a difficult first half of 2022. The global fund delivered positive absolute returns due to currency movements and these also boosted the overseas element of Sustainable Leaders, while both funds benefitted from the energy sector being relatively less strong this quarter.
- There is still considerable uncertainty about the outlook for the rest of 2022 and 2023 and many investors fear that higher interest rates will cause a recession. We believe the current equity bear market will be two-legged: the first leg – the interest rate-induced derating of equities, particularly growth stocks – is probably over unless inflation is genuinely out of control. The second leg is being driven by the increasing likelihood of a recession and earnings downgrades. This could still have some way to go as corporate earnings for 2022 and 2023 still feel overly optimistic. However, it feels like we're nearer to the end of the bear market than the beginning, not least as sentiment is really quite negative. In such an environment, markets can turn quickly. A key factor will be the outlook for inflation: if price rises start to slow and fewer interest rate increases are needed, equities will bounce sharply.

Market overview

- 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 UK, Europe and the US. 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 that 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 Nordstream 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 in 2022. 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, ended its bond buying programme in July and increased rates by 0.75% (its first increase in 11 years and a bigger increase than the 0.50% expected by economists). A further increase of 0.75% followed in September with a clear commitment of further increases to follow. The Bank of England (BoE) increased rates by 1.00% over the quarter to 2.25%, taking its tally to six increases so far in 2022 and seven in this cycle.
- The level of activity in the UK economy is still only slightly above where it was pre-pandemic. The composite PMI business survey indicator of economic activity deteriorated from March and by August signalled only relatively weak rates of activity growth in the economy and, as with the eurozone, it continues to deteriorate as does consumer confidence. UK economic policy is in a state of flux following the new Chancellor's 'mini Budget' in late September. As expected, he outlined details of programmes to limit domestic and corporate energy bills as well as the reversal of his predecessor's increases in corporation tax and National Insurance. However, other measures such as scrapping the top rate of income tax (since abandoned) and the cap on bankers' bonuses came as a surprise, leading to further weakness in gilts and sterling. In the last week of the quarter, after comments to support the currency, the BoE was forced to intervene in the gilt market as problems with levels of collateral in the 'liquidity-driven investing' (LDI) part of the pensions industry pushed down the prices of long-dated gilts.
- The third quarter saw further weakness in equities as interest rates continued to rise and investors increasingly factored in central bank-induced recession in the next six to 12 months. In local currency terms (i.e., without the impact of the strong dollar), nearly all major stock markets fell globally, although currency movements offset this weakness and boosted the sterling returns from overseas equities. For the third quarter the FTSE-All Share, MSCI World and MSCI All Countries World Index (ACWI – which also includes 26 emerging markets) returned -3.4%, +2.2% and +1.5% to sterling investors, respectively. Regional returns were particularly widely dispersed. According to MSCI regional data, the US and Japan delivered the only positive returns (to sterling investors) at +3.7% and +0.6%, respectively. Otherwise, Europe ex-UK returned -2.0%, while the UK and emerging markets returned -2.9% and -3.6%, respectively. The Far East ex-Japan region was a notable outlier, returning -9.8%.

- Within equity markets, the significant inflation-related rotation out of 'growth' and into 'value' that dominated the first half of 2022 switched back, albeit to a limited extent. The MSCI World Growth Index returned +3.4% versus +1.1% for the MSCI World Value Index, outperformance of 2.3%. Unusually, for the MSCI World (in sterling), energy was only the second strongest sector: consumer discretionary returned +9.1%, with energy and industrials returning +7.6% and +2.6%, respectively. The laggards were consumer services, real estate and utilities at -5.3%, -3.7% and +0.3%, respectively.
- The price of Brent crude oil fell by 16.9%, but remains over $90 a barrel, and copper futures fell another 8.0% in dollar terms on fears of a slowdown in China and recession in the US, UK and Europe. 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. It was again the strongest major currency: it appreciated by over 6% against the yen and euro, and over 8% against sterling. On a translational basis, sterling's weakness benefits sterling investors in overseas assets as it boosts the returns over the quarter. However, these movements will impact global trade over coming months, and dollar strength will also be a risk for any emerging markets countries and companies that have borrowed in dollars.

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.
- The fund outperformed its benchmark in the third quarter, delivering positive absolute returns due to currency movements and benefitting from the energy sector being relatively less strong this quarter.
- In 2022, 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 industrial commodities, 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 the third quarter, the derating of growth stocks (which arguably accounted for the first leg of the bear market) seemed to stop – and growth stocks again outperformed their value stock peers. Similarly, the sharp rises in oil and gas prices reversed, albeit they are still at very high levels, and the outperformance of the energy/oil & gas sectors was more muted.
- The fund performed reasonably well in a particularly difficult environment. The technology and healthcare sectors comprise lots of innovative companies that are a good fit for our investment framework. 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. 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 haven't 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 so far seen few problems with the individual companies that we own, which are well-established and profitable businesses. Our performance has not been because we bought 'bad' companies.
- Some other fund managers have made a virtue of running very high cash levels during 2022. 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 it's 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.
- Looking at the third quarter, its notable how few 'winners' there are across the market – particularly outside the oil & gas and commodities sectors in which we do not invest. Despite the challenges, however, some of our holdings performed well in the period. **Texas Instruments** reported better-than-expected results and the share price was boosted by a large buyback; **Mercado Libre**, the South American ecommerce and payments platform, recovered after reporting strong results following a difficult second quarter; and **Trane Technologies** benefitted as

its leadership in heating, ventilation and air-conditioning (HVAC) technology will benefit from companies upgrading their HVAC systems to benefit from energy efficiency.

- The weaker performers were driven by more stock-specific factors. **Adobe**, the US creative software leader, announced the acquisition of Figma, a leading web-first collaborative design platform, for approximately $20bn in cash and stock. Although this may turn out to be a strategic positive in reinforcing Adobe's leadership in creative software (and in keeping Microsoft out of its core market), the acquisition price is high, and the announcement wasn't well received. Otherwise, **Ball Corporation**, the world's leading provider of sustainable aluminium packaging reported a decline in demand for cans, which was a surprise to the market – it may be driven by stock build-up from a slowdown in the US economy, but we will watch carefully over the next quarter or so. Lastly, German sportswear and 'althleisure' specialist **Adidas** was affected by the rise in the cost of living as consumers will have less disposable income. However, the company has been affected by a series of disappointments over the last two to three years and, despite its undoubted quality and sustainable leadership, we must re-examine our investment thesis.
- Otherwise, we remain comfortable with our investment process and most of our holdings – the turnover rates for our sustainable equity portfolios are around 15%, which implies a seven-year average holding period. However, we have taken advantage of market volatility to add to holdings at attractive levels. For instance adding contract caterer **Compass Group** – a long-standing holding in our other Sustainable funds. The company is an ESG leader in its sector and has a very different business model from many of our other holdings. Other notable trades this quarter included adding to **SSE** while we exited **Sysmex**.

Outlook

- 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 the UK and Europe, with 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.
- We remain in an equity bear market, which started in late 2021. We believe it will be two-legged: the first leg – the interest rate-induced derating of equities, particularly growth stocks – is probably over unless inflation genuinely is out of control on a longer-term view. As an example, engineering specialist Spirax-Sarco, which has strong technical leadership in energy reduction for other corporates, has derated from c. 40 times earnings to c. 25 times over the last 12 months or so. The second leg started in June, driven by the increasing likelihood of a recession and earnings downgrades. It is unusual to get this type of bear market – with high inflation and rising interest rates coinciding with an economic slowdown. 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 – one offsets the other. Interest rates usually rise 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? It could still have some way to go as it feels to us like companies and sell-side analysts are still overly optimistic about corporate earnings for 2022 and 2023. While some cyclicals have been hit badly by a generalised double whammy of expected lower demand and higher debt costs (e.g., Segro and Vistry), the market is still wrestling with forecasts. In the last week of the third quarter, two of our Sustainable funds' holdings (specialty chemicals producer Synthomer and retailer Next) reduced their full-year earnings guidance and their share prices were marked down by double the percentage cut. Such periods 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.
- From experience, the impact of earnings downgrades won't be spread evenly across the market: growth stocks such as Spirax-Sarco, AstraZeneca and Rentokil feel relatively stable with more earnings certainty, whereas lower-quality value stocks may have considerable downside. 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. Overall, we believe that there could still be more downside, but it feels like we're nearer to the end of the bear market than the beginning, not least as sentiment is really quite negative. In such environments, markets can turn quickly, which will favour those who are fully invested in high-quality companies. A key factor will be the outlook for inflation: if it feels that price rises are starting to slow and fewer interest rate increases will be needed, equities will bounce sharply.

Find out more

- We are experiencing unprecedented times in markets. Inflation is at multi-decade highs, energy prices are rising and the latest Bank of England announcement created further uncertainty. Following on from the unsettling fixed income and currency markets of late September, RLAM hosted a webinar for RLAM's Head of Fixed Income Jonathan Platt, and Craig Inches, Head of Rates and Cash to discuss the situation and how central banks and policymakers might react. Investors can listen again via *Our Views* section of www.rlam.com, which also contains includes regular updates from Head of Fixed Income Jonathan Platt, Head of equities Peter Rutter, including the regular SustainAbility blog from Head of Sustainable Investments Mike Fox on key issues in equity markets and sustainable investing.

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.

IMPORTANT INFORMATION