Royal London Sustainable Managed Growth Trust

Quarterly Report 30 September 2022

Top ten holdings

	Trust (%)
Aviva 6.875% 2058	1.0
Microsoft Corp	0.9
Thermo Fisher Scientific Inc	0.9
Compass Group	0.8
HSBC Bank 5.375% 2030	0.8
Nordson Corp	0.8
Lloyds Bank Plc 7.625% 2025	0.8
London Stock Exchange	0.8
CSX Corp	0.8
Experian Group Ltd	0.8
Total	**8.4**

Trust data

	Trust
No. of stocks	363
Fund size	£973.1m
Launch date	04.12.2012

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

Performance

	Trust (C Acc (%))	Peer Group[1] (%)	Relative (%)
Q3 2022	**-7.47**	**-3.77**	**-3.70**
Year-to-date	-21.75	-13.45	-8.30
Rolling 12 months	-19.71	-12.88	-6.84
3 years p.a.	-2.51	-2.50	-0.01
5 years p.a.	1.26	-0.23	1.49
Since inception p.a. 04.12.2012	4.48	1.91	2.57

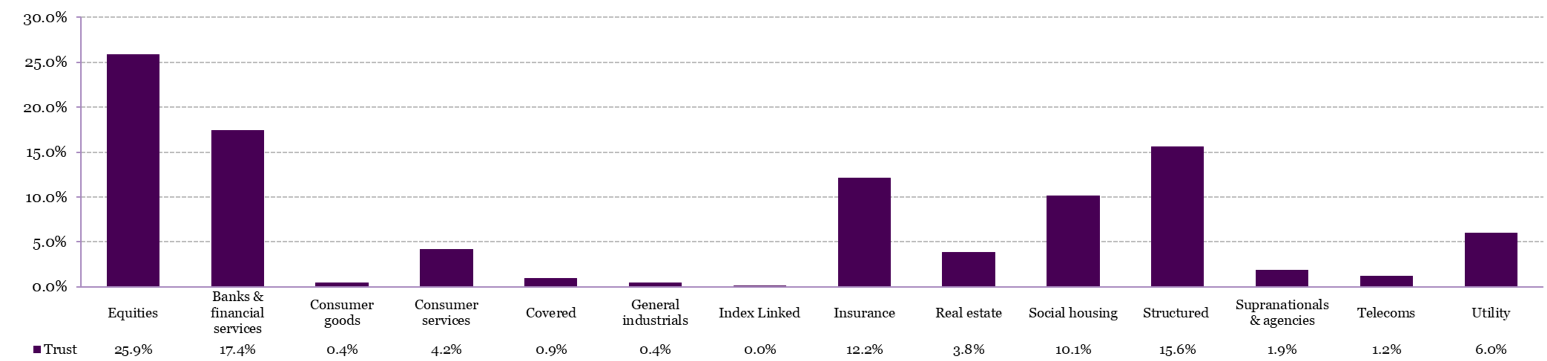
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding.

Source: RLAM, gross of fees. 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]Peer Group: IA Mixed Investment 0-35% Shares sector median.

Sector breakdown



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

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 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.
- **Sustainable Managed Income** (sterling credit-only) outperformed its broad market benchmark (iBoxx Sterling Non-Gilt All Maturities Index) over the quarter, although the absolute returns were again negative. The main driver of the negative returns in sterling credit in 2022 has been the weakness in UK government bonds, with an additional negative impact from widening credit spreads. These factors continued in the third quarter: the UK gilt market was the worst performing major government bond market, returning -12.85% as the 10-year gilt yield rose by 186 basis points (bps) to 4.09%. As a result, the year-to-date return for gilts is -25.1% (FTSE Actuaries UK Conventional Gilts All Stocks Index), while the return for sterling credit is -22.2% (-11.01% for the third quarter). With negative absolute returns, we appreciate that it may be scant consolation to clients that our sustainable credit portfolios outperformed the iBoxx Sterling Non-Gilt All Maturities Index over the quarter, as well as the year to date and one, three and five years. However, relative performance is important and we expect the funds to perform well again in absolute terms once we get back to more normal market conditions.
- Our credit-oriented mixed-asset fund, **Sustainable Managed Growth**, also outperformed its composite benchmark over the quarter. As with our other mixed-asset funds, the sustainable credit portfolio outperformed the broad sterling credit index; the equity portfolio also outperformed due to currency movements and because the energy sector (which it doesn't invest in because of sustainability criteria) was relatively less strong this quarter. Despite this relative outperformance, it ranked poorly (ninth decile) in the Investment Association's Mixed Investments 0-35% Shares category because, unlike other funds in that category, it only invests in sterling credit and equities, rather than other diversifying assets, including cash. This has been a key challenge for our mixed-asset funds throughout 2022: normally, one might expect equity-market weakness to be mitigated by positive returns from sterling credit or vice versa, but in 2022 both asset classes have been hit by the unusual combination of macroeconomic and geopolitical factors.
- 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.
- For sterling credit, the outlook is arguably more positive. 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 significant bad news, and investors are being paid well to take credit over government bond risk. With gilts yielding over 4% and the sterling credit spread at nearly 2%, the 'all-in yield' on sterling investment grade credit is arguably at the most compelling level for nearly 10 years, particularly if inflation starts to fall. Although some further volatility is likely, we are more optimistic about the prospects for the sustainable credit portfolios.

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 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 Fed led the way, increasing rates by 1.50% over the quarter. It has raised rates five times since March by 3% in aggregate – the 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 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% (its first hike for 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 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. Having said the previous week that it would reduce its holdings of gilts and corporate bonds, the BoE announced that it would potentially buy £65bn of long-dated gilts over the following two weeks.
- The UK gilt market was the worst performing major government bond market over the quarter, delivering a return of -12.85% as the benchmark 10-year gilt yield rose by 186bps from 2.23% to 4.09%. However, 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 82bps to 3.83%; and the 10-year German bund yield rose by 77bps to 2.11%. Longer-dated bonds performed worst in the period due to their greater sensitivity to interest rates (duration risk). In the UK, for example, gilts with five years to maturity or less provided returns of -4.93%, whereas the 15 years or more to maturity segment returned -18.77%.
- These gilt market returns took a heavy toll on the sterling investment grade credit market, which returned -11.01%. Although it appeared to outperform the gilts market, at around seven years the duration of the sterling credit is lower than for the gilt market: corporate bonds underperformed gilts of an equal maturity as 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 25bps to 1.99% (iBoxx).
- In credit markets, defensive sectors continued to outperform on a relative basis, albeit still providing negative returns – supranational, covered and senior banks bonds outperformed, while the real estate, utilities and asset-backed securities sectors underperformed the wider market. Credit quality had a mixed impact on relative returns in the period – although bonds in the AAA ratings band outperformed their investment grade peers, the high yield market outperformed investment grade credit and BBB rated bonds outperformed AA and A rated bands.
- 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 MSCI World returned +2.2% to sterling investors. Regional returns were 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

- After a difficult first half of 2022, the third quarter was again extraordinarily volatile and delivered the worst absolute returns for sterling credit in living memory. The main driver of returns was further weakness in government bond markets, particularly the UK gilt market. ‘Unprecedented’ has become a cliché in describing the challenging conditions in financial markets, yet it is the only way to describe the events of the quarter as inflation continued to rise, and central banks raised interest rates and reiterated their hawkish messages to take whatever action is needed to quell rising prices.
- Despite being negatively impacted by the significant underweight to supranational bonds (the sector offers a very low yield premium that we believe can be materially improved elsewhere in the market without taking excessive risk), our credit portfolio slightly outperformed the broader market over the quarter. Despite the negative absolute returns, our emphasis on sector and issuer diversification and the bias towards secured debt generally counteracted the low exposure to supranational bonds.
- Credit sector allocation was the most significant performance detractor, reflecting the underweight allocation to supranational bonds, while our main overweights, such insurance, social housing and real estate sectors also impacted returns. Conversely, duration contributed positively to performance as the average duration of our strategies was slightly shorter than the market over the quarter. Security selection was a small positive, with contributions, in particular, from the structured, banks, insurance and real estate sectors.
- Stock selection in the structured sector was positive with notable contributions to performance from **Income Contingent Student Loans** (ICSL) and **Center Parcs**. As well as the benefit of security, this sector offers well-diversified bonds that are exposed to different areas of the economy. Despite market volatility, the perpetual bonds of **Santander** and **Lloyds Banking Group** performed relatively well.
- While new issuance remained subdued for periods in the quarter, there were still opportunities to participate. Overall, financial bond issuance continued to be the dominant theme in sterling credit markets. New issue credit spread premiums tended to be relatively large and we participated in a range of new financial issues, including senior insurance bonds of **MetLife** and **New York Life**. We also bought subordinated banks bonds of **Lloyds Banking Group** and **Svenska Handelsbanken**, and a subordinated insurance issue from **Zurich Finance**. Away from the financial sectors, we bought a new issue from **Orsted**, the Danish leader in offshore wind generation, and increased exposure to **Sanctuary Housing** in a tap of a 2050 social housing issue – this issuer offers robust cash flows and strong net benefit through the provision of affordable housing. Otherwise, we participated in a new long-dated issue in the supranationals and agencies sector, **Saltaire Finance**, which is backed by affordable housing and benefits from a guarantee by the Secretary of State for Communities and Local Government. We also bought a 2025 supranational bond issue from **The International Finance Facility for Immunisation Company** (IFFIm), which will finance Gavi vaccination programmes, with bonds backed by aid pledges from countries such as the UK.
- 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.
- Secondary market activity was relatively subdued in the quarter, reflecting lower market liquidity and the higher transaction costs associated with wider bid-offer spreads. There were no defaults in our funds in the quarter and we remain happy with the shape of our sustainable credit portfolios. While deteriorating economic and market conditions demand extra vigilance, we are comfortable that our proven investment philosophy and process will help us to navigate the challenging environment by favouring secured bonds with strong covenants and focusing on bottom-up research to identify borrowers with attractive risk and return characteristics.
- Our portfolios are widely diversified across sectors, individual issuers and economic exposures. We believe that the lower credit rated segments of our portfolios have yields that more than compensate us for the increased risks. We continue to run overweight positions in subordinated financial debt despite the worsening economic outlook. This reflects our view that capital ratios are robust, while yields are at multi-year highs. Where we have exposure to sub-investment grade bonds and unrated debt, we consider that the diversification and yield benefits are appropriate.
- 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 overweight position 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.

- In our equity exposure, nearly all of our underperformance against the wider market in 2022 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.

- During the quarter, our equity exposure outperformed its benchmark on a relative basis, delivering a positive absolute return because of currency effects. However, it is notable how few 'winners' there are across the market – particularly outside the oil & gas, commodities and tobacco sectors in which our sustainable funds don't invest. Despite the challenges, however, some of our holdings performed well in the period. Enterprise software specialist **Sage Group** reported good results and ongoing operational progress in turning around its business. Likewise, **London Stock Exchange Group** had good results and continued to make progress with the integration of its Refinitiv acquisition.

Outlook

- Inflation is continuing to rise in the UK, reflecting higher raw material costs, energy price increases and tight labour markets. However, interest rate increases are already showing signs of slowing down activity and, despite more aggressive market expectations, 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 some increase in default rates. We will maintain focus on identifying companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers and sectors.

- Despite this outlook, 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. With gilts yielding over 4% and the credit spread at nearly 2%, the 'all-in yield' on sterling investment grade credit is arguably at the most compelling level for nearly 10 years, particularly if inflation starts to fall: furthermore, many of our investment grade strategies deliver a yield premium to the market. 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. Most strategies have a material exposure to BBB bonds, but we believe that compensation for default risk remains most attractive in this rating band.

- It is too early to say whether the UK government will be forced into further U-turns in economic policy, either by its backbenchers or financial markets, but its reputation has undoubtedly been affected by recent events. The goal of boosting UK economic growth is laudable, but would require a wider programme of measures over a sustained period of five to 10 years. Also, despite the ambitious scope of the mini-Budget, it would have been more effective had the Chancellor also detailed a fiscal framework and package of supply-side reforms. Furthermore, having sacked key advisers on assuming office, the new Prime Minister and Chancellor didn't communicate their plans well: even if events subsequently play out in their favour, they cannot afford to take the gilt market for granted at a time of such economic strain.

- The BoE announced in May that it would begin the sale of its holdings of corporate bonds in mid-September, via a regular multi-stock auction. However, the sale was delayed by the adverse market conditions in the gilts market and it isn't yet clear if and when the sale will start. However, although 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 previously 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.

- For our equity exposure**,** we remain in an equity bear market. 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. The second leg started in the summer, 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.

- This second, earnings-led bear market could still have some way to go as 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, the market is still wrestling with forecasts. From experience, the impact of earnings downgrades won't be spread evenly across the market: growth stocks 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, there could still be more downside. 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 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