ROYAL LONDON SUSTAINABLE LEADERS TRUST

Quarterly Report 31 December 2020

For professional clients only, not suitable for retail investors

CONTENTS

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Top ten holdings

	Fund (%)
SSE	4.8
Prudential	4.8
AstraZeneca	4.6
London Stock Exchange	4.6
Experian Group	4.3
Rentokil Initial	4.1
Unilever	4.0
Croda International	4.0
Segro	3.5
Ferguson	3.4
Total	**42.0**

Source: RLAM, based on the A Inc share class.

Fund data

	Fund
No. of stocks	40
Fund size	£2,358.5m
Launch date	25.05.1990

Performance

	Fund (C Acc) (%)	Benchmark[1] (%)	Relative (%)
Q4 2020	**5.38**	**12.62**	**-7.24**
Year-to-date	4.04	-9.82	13.86
Rolling 12 months	4.04	-9.82	13.86
3 years p.a.	10.25	-0.91	11.16
5 years p.a.	11.37	5.13	6.24
10 years p.a	11.78	5.56	6.22
Since inception p.a. 25.05.1990	9.15	7.69	1.45

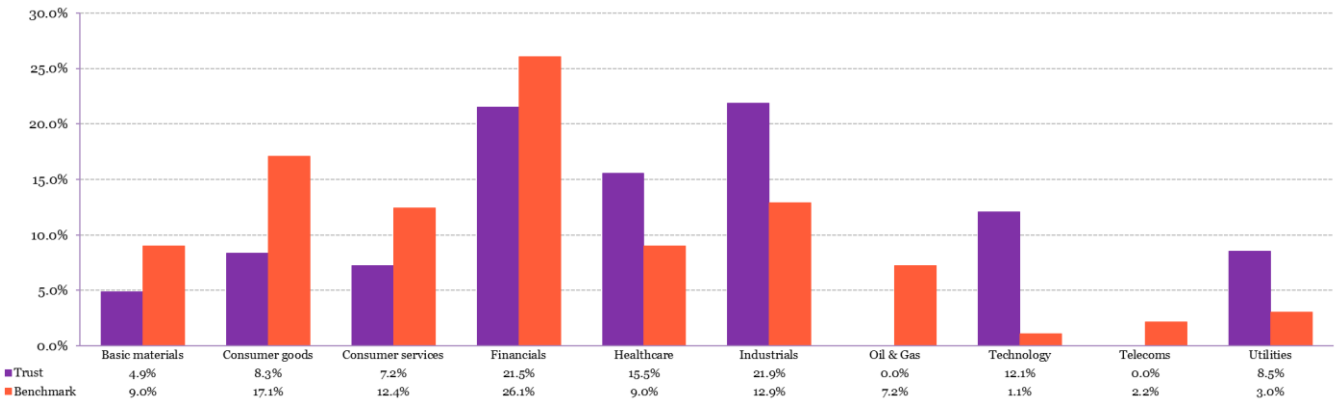
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

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

Source: RLAM, gross of standard management fees.

[1]Benchmark: FTSE All Share Index.

Sector breakdown



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

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Executive summary

- Covid-19 cases generally increased over the quarter with a more transmissible variant spreading quickly in parts of the UK, leading to tighter restrictions. However, strong efficacy data in early November and subsequent regulatory approval allowed vaccination programmes to start. As a result, investors looked through the short-term challenges to the possibility of a strong recovery in the second half of 2021, helped by ongoing government and central bank support. Political issues were also prominent. Financial markets responded positively to the expected combination of a Biden presidency with a Republican Senate, even though two seats in Georgia required a runoff in early January. Congress finally agreed a $900bn (4% GDP) fiscal deal. The UK also agreed a trade deal with the European Union.
- For the quarter, the funds delivered net returns as follows:
  - **RL Sustainable Leaders** (equity-only): +5.18%, underperforming the FTSE All Share Index (+12.62%).
  - The three mixed-asset funds underperformed their respective composite benchmarks and IA sectors:

    RL Sustainable World +3.11% (IA sector average: +7.99%);
    RL Sustainable Diversified +4.27% (IA sector average: +6.71%);
    RL Sustainable Managed Growth +4.06% (IA sector average: +4.21%).
  - **RL Sustainable Managed Income** (credit-only): 3.34%, outperforming the Markit iBoxx Sterling Non-Gilt All Maturities Index (3.12%).
  - *Please note: Fund performance shown is based on the C Acc share class, which is the clean share launched post-RDR (except for the Sustainable Diversified Trust, which is based on the C Inc share class).*
- The fund delivered positive returns over the quarter, although relatively underperformed as described above. Despite this, the fund delivered top-quartile performance for the 12-month period (+3.27%), outperforming the FTSE All Share Index (-9.82%) by 13.08%. Over the quarter, the fund's c. 18% allocation to overseas equities detracted from relative performance as global equities underperformed UK equities. In addition, it was impacted by its zero exposure to the oil & gas sector, which bounced back sharply as oil prices rose over 25%, and basic materials, which recovered further as industrial production grew strongly in China.
- Our sustainable strategies invest in companies demonstrating a net benefit to society, either through the products and services they offer, or leadership in environmental, social and governance (ESG) factors. This is how we define sustainability. As a result, we invest in a range of innovative, responsible, well-managed companies with strong long-term growth potential. We believe the funds to be well positioned to benefit from powerful trends in healthcare, technology, infrastructure and corporate governance, as well as the correlation between investing sustainably and investment returns.
- We believe that sustainable strategies will be a net beneficiary from the changes that could come from the pandemic and our funds are well positioned to benefit from this. We feel that the responses of governments, companies and individuals to the pandemic could lead to a step change in real-world sustainability and in the trend to sustainable investing.

Market overview

- Major global stock markets delivered a strong fourth quarter. The MSCI All Countries World Index (ACWI), which covers leading developed and developing markets, rose +8.6% in sterling terms. This helped 2020 as a whole to post positive returns (ACWI +13.5%), despite the pandemic. All major markets rose during the quarter with the dispersion in returns resulting mostly from sector rotation. Among the major regions, emerging markets, Asia Pacific excluding Japan and the UK were the strongest markets, whereas Japan, Europe excluding the UK and the US were slightly more pedestrian.
- Companies that had been struggling because of Covid-19 tended to perform well on the Pfizer vaccine news, while several sectors rose on the prospect of a more traditional US president and gridlock in the legislative bodies preventing extreme policy decisions. Unlike prior quarters, it was not technology that led sectors (+6.8% in sterling terms during quarter), but a strong recovery in energy (+20.3%) and financials (+17.4%), which had previously underperformed. For the full year, however, energy was still down -32.8%.
- The Bank of England (BoE) has continued to neutralise the impact of government bond issuance through asset purchases, which were extended in the quarter. The Federal Reserve (Fed) and European Central Bank (ECB) are operating similar quantitative easing (QE) programmes. In addition, the removal of roadblocks to the dispersal of the €750bn EU Recovery Fund was a significant positive for European economies.
- With renewed lockdowns in many countries and activity remaining below normal levels, yields on benchmark 10-year government bonds fell over the quarter in most major developed markets, apart from the US, Canada, Sweden and Japan. The yield on 10-year gilts decreased 3 basis points (bps) to 0.20% and shorter-dated government bond yields remained negative, although the BoE continued to eschew the policy option of negative base rates.

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- Credit spreads tightened further reflecting positive developments on vaccines and central bank support for struggling companies. The average sterling investment grade spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) ended the quarter a further 30bps tighter at 0.99%, which compares with an average spread of 1.14% at the end of 2019. This is a remarkable turnaround considering that the average spread was as wide as 2.25% at the peak of the market sell-off in March. The Markit iBoxx Sterling Non-Gilt All Maturities Index delivered total returns of +3.12% for the quarter.
- Sterling was among the stronger major currencies over the quarter, strengthening another 5.4% against the US dollar following the recent decision by the Fed to alter its inflation targeting methodology. It also strengthened marginally against the euro and against the yen. This strength tempered the returns for sterling investors in global equities.
- Oil prices recovered strongly in the quarter as global economy continued to grow and Saudi Arabia announced production cuts. The price of Brent crude oil rose by +26.5% to over $52 a barrel. Copper continued to strengthen as economic activity strengthened in China, rising +15.8% over the quarter. The strategies have no exposure to oil & gas and basic materials.

Performance and activity

- The sustainable strategies are orientated to those companies that have a positive impact on 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.
- The fund underperformed this quarter. This underperformance largely reflected three weeks in November with the significant sector rotation that followed the release of positive vaccines trials data and approval of the Pfizer/BioNTech vaccine in the UK. Performance then stabilised in December. While surprised by the scale and speed of this, we knew that there would be a point in the cycle when the market switched away from the higher quality, growth companies that we prefer in favour of more cyclical 'Covid recovery' stocks. Indeed, we had increased our exposure to such stocks in the market turmoil in March and April, buying some good companies at very low prices – these investments paid off handsomely over the subsequent three quarters.
- In addition, performance was impacted by the fund having zero exposure to the oil & gas sector, which bounced back sharply as oil prices rose over 25%, and basic materials, which recovered further as industrial production grew strongly in China. We believe these sectors have a poor track record of creating value for shareholders and will be long-term losers from the trend towards a lower-carbon, environmentally-aware society.
- The fund delivered positive returns over the quarter, although relatively underperformed. It was affected by the vaccine-driven relief rally and sector rotation; its zero exposure to the oil & gas and basic materials sectors; and its allocation (c. 18%) to overseas equities. Significant stock-specific underperformance was limited to Sage Group as the UK software company issued a trading update in November that was not received well by investors (see below). Despite this weak quarter, the fund delivered top-quartile performance for the 12-month period (+3.27%), outperforming the FTSE All Share Index by 13.08%.
- Within the fund, stocks that are economically sensitive benefitted from the optimism unleashed by vaccines news of a return to more normal social and economic activity in the second half of 2021. In the UK, contributors to performance included housebuilder **Vistry**, baker **Greggs**, utility **SSE** and financials companies, including insurers **Legal & General** and **Prudential**, and **Unite**, the student accommodation provider. Other than SSE, these are all more cyclical, market recovery stocks.
- Detractors from performance included **Rentokil Initial** (hygiene services and pest control), **Intertek** (product testing, inspection and certification) and credit data specialists **Experian**. All three companies are highly-rated growth companies that had performed particularly strongly in the recovery. In addition, software company **Sage Group** issued a trading update in November that was not received well by investors. As the company moves from being licence subscription-based to SaaS-based (software as a service), it will have to invest more in R&D to deliver regular customer upgrades. This will impact margins in 2021. While the share price impact isn't helpful, we believe management is taking the right approach and we are supportive. The company is at a significant discount to comparable peers and we believe this additional investment will pay off over time.
- Despite the sector rotation, we did not materially change our holdings, feeling that it was not the time to reshape portfolios. We had, after all, increased our 'Covid recovery' exposure at the lows in March and April. Notable trades this quarter included adding to the fund's holdings in insurer **Prudential** and **London Stock Exchange** on weakness. During the volatility in November, we added to positions in **Compass**, the UK multinational food services operator, and insurer **Legal & General**. We reduced the position in **Alphabet**, following strong results.

ROYAL LONDON SUSTAINABLE LEADERS TRUST

Outlook

- While new, more transmittable strains of Covid-19 represents a near-term challenge with the need for tighter lockdowns, a number of other risks have lifted, including whether vaccines could be developed, US political risks and the UK-EU trade talks. While, the first half of the year particularly volatile, the government and BoE remain committed to supportive monetary and fiscal policies, and we believe that equities will outperform bonds over the year with a strong economic recovery in the second half. We have therefore maintained our pro equity stance in the mixed asset strategies as we remain positive on the medium- to long-term outlook.
- The portfolio is invested in a range of innovative, well-managed businesses with durable competitive advantages and which are supporting the transition to a more sustainable world. We believe that many of the companies we are invested in will come out of this crisis even stronger than they went in. While we remain focused on managing balanced portfolios that will provide resilience during periods of volatility, a greater degree of cyclicality may be beneficial as economies recover. While we are not looking to radically rebalance the funds, we will seek to broaden out our holdings. In particular, while we remain committed to long-term trends that will be facilitated by technology, including digitisation and in healthcare, we are wary of unproven nascent business models and companies that may have brought forward sales through the pandemic, rather than benefitting from accelerated societal shifts.
- Longer term, the strategies are invested number of the key social and environmental trends we see as being key investment areas for the foreseeable future, such as decarbonisation, digitisation and healthcare.

A long history of sustainable investing

- Our flagship **RL Sustainable Leaders Trust** celebrated its 30th anniversary last year. You can find out more about our full range of sustainable funds, including the more recently-launched **RL Global Sustainable Equity Fund**, at rlam.co.uk.
- Talks from the online *RLAM Investment Series* that was held in September/October 2020 can be viewed on BrightTALK.com; including *30 years and counting* by Mike Fox; *Who was responsible?* by Ashley Hamilton Claxton; *Climate change and disclosure requirements for asset owners* by Carlota Garcia-Manas; and *Responsible global equities* by James Clarke and Carlota Garcia-Manas. Each presentation lasts for 30 minutes, including Q&A.
- You can find more of our thoughts on the opportunities and risks in the year ahead in our RLAM Outlook 2021 document.

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