# ROYAL LONDON SUSTAINABLE MANAGED GROWTH TRUST

## Quarterly Report 31 December 2020

For professional clients only, not suitable for retail investors

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# ROYAL LONDON SUSTAINABLE MANAGED GROWTH TRUST

## Top ten holdings

| | Fund (%) |
|---|---|
| Aviva 6.875% 2058 | 1.5 |
| Prudential | 0.7 |
| Reassure Group Plc 5.867% 2029 | 0.7 |
| London Stock Exchange | 0.7 |
| HSBC Bank 6.25% 2041 | 0.7 |
| Co-operative Bank 4.75% 2021 | 0.7 |
| SSE | 0.7 |
| ASML | 0.7 |
| AstraZeneca | 0.7 |
| Adidas | 0.7 |
| **Total** | **7.7** |

## Trust data

| | Fund |
|---|---|
| No. of stocks | 399 |
| Fund size | £932.5m |
| Launch date | 04.12.2012 |

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

## Performance

| | Trust (C Acc (%)) | Peer Group[1] (%) | Relative (%) |
|---|---|---|---|
| **Q4 2020** | **4.23** | **4.20** | **0.02** |
| Year-to-date | 11.27 | 4.40 | 6.87 |
| Rolling 12 months | 11.27 | 4.40 | 6.87 |
| 3 years p.a. | 8.01 | 2.90 | 5.11 |
| 5 years p.a. | 8.69 | 4.11 | 4.58 |
| Since inception p.a. 04.12.2012 | 8.02 | 3.82 | 4.20 |

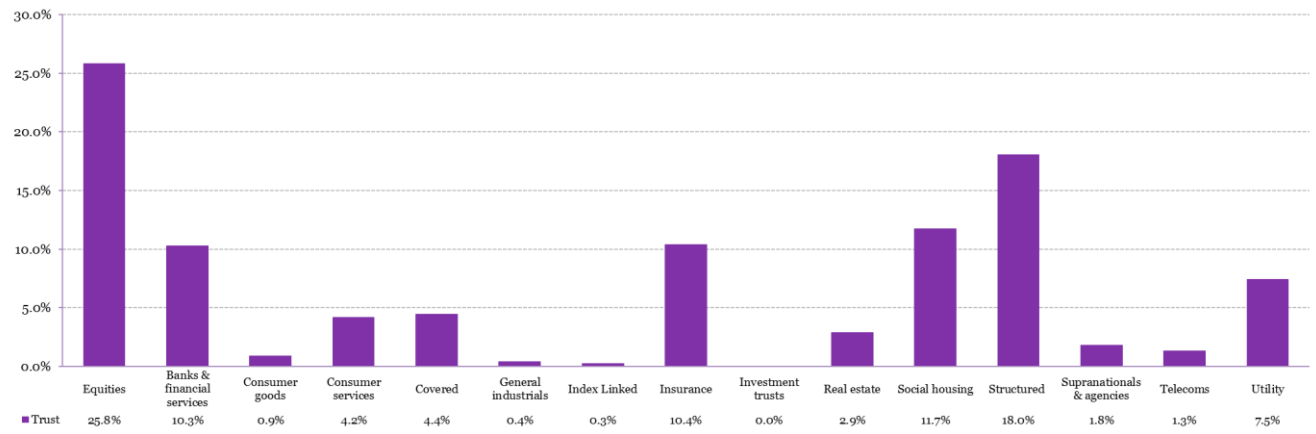
***Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.***

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

*Source: RLAM, gross of standard management fees.*

*[1]Peer Group: IA Mixed Investment 0-35% Shares sector.*

## 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 underperformed this quarter. This 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. While acutely aware that underperformance is disappointing, we hope investors will see it in the context of the strong performance of the funds over the year and longer time periods. Perhaps surprisingly given the weak relative performance, there were very few stock-specific negatives.
- While the fund is overweight in equities relative to its peer groups, relative performance was affected by the sector rotation described above and by the zero weighting to oil & gas and basic materials. However, the credit allocation outperformed, primarily driven by positive asset allocation (strongly overweight in insurance and lower-rated credit, and underweight in supranational bonds).
- 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.
- 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 selloff 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 – sustainable equity exposure

- 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 equity exposure 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 funds 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.
- Global equity exposure has been beneficial for UK-based investors over recent years. This remained the case for 2020 as a whole as the FTSE UK All-Share Index returned -9.8% to sterling investors, compared to +13.5% for the MSCI ACWI. The UK market suffered its worst year since the height of the financial crisis in 2008. However, this trend reversed in the fourth quarter as the FTSE All-Share Index returned +12.6% to sterling investors, compared to +8.6% for the MSCI ACWI. This outperformance was driven to an extent by the UK-EU trade deal that was struck on Christmas Eve, exacerbated by notable US dollar weakness.
- **Sustainable Leaders** 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%.
- While our mixed-asset sustainable funds – **Sustainable Diversified**, **World** and **Managed Growth** – are overweight in equities relative to their peer groups, their relative performance was affected by the vaccine-driven relief rally and sector rotation described above, and by the zero weighting in oil & gas and basic materials. Significant stock-specific underperformance was limited to UK healthcare company AstraZeneca and Salesforce, the US cloud-based CRM software leader. In both cases, investors reacted negatively to large acquisitions, rather than operational factors (see below). Despite this poor quarter, the funds all delivered top-decile performance for the 12-month period, significantly outperforming their benchmarks and IA sector averages.

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- Within the strategies, 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. Globally, similar factors typically drove the strongest contributors, which included **Aptiv**, which supplies auto components, particularly for electric vehicles; and **ASML**, the Dutch semiconductor equipment manufacturer. The exception was **Orsted**. The Danish leader in the construction and operation of offshore windfarms benefitted from the emphasis of fiscal spending packages on 'green recovery' projects.
- Detractors from performance in **Sustainable Leaders** 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.
- In the mixed-asset sustainable funds, **AstraZeneca** and **Salesforce** detracted from performance. Both companies made apparently expensive acquisitions that were not well received by the market as they will take years for the benefits to become clear. AstraZeneca paid $39bn for Alexion, a US biotech company specialising in immunology. It was also penalised by the market for its vaccine developed in partnership with researchers at Oxford University apparently having lower efficacy than the Pfizer/BioNTech and Moderna vaccines, even though its vaccine is more easily distributed and will be sold at cost, so it has no profit impact. Salesforce acquired Slack, the US business communication platform, for $27.7bn. While expensive (Slack's revenue forecast for 2020 is only c. $600m) and with management previously having ruled out a large deal, it is a strategic opportunity for Salesforce and such transformative deals tend to be expensive in the technology sector. In both cases, we believe the deals will pay off in time and remain committed to the holdings. For index reasons, AstraZeneca had a more negative impact in the global funds than in Sustainable Leaders.
- 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 holding in **Nordson,** a US company that makes precision parts for industrial applications. Its products facilitate meaningful energy and materials savings for customers, making it a good fit from a sustainability perspective. We also added to the fund's holdings in insurer **Prudential** and **London Stock Exchange** on weakness.

## Performance and activity – credit exposure

- All sterling credit sectors outperformed gilts and delivered positive absolute returns during the quarter. The subordinated financial sectors (banks and insurance) were among the best performing sectors in the market, with spreads contracting significantly as investors searched for higher yields. At the other end of the spectrum, the weakest returns came from supranational and covered bonds, which are considered less risky and so feature lower yields. Reflecting all of these dynamics more broadly, lower-rated and longer-dated debt outperformed.
- The credit allocation performed very strongly in the fourth quarter, significantly outperforming the benchmark. This primarily reflected the substantial underweight exposure to low-yielding supranationals, the overweight allocations to bonds in the insurance and structured sectors, and security selection within the banking & financial services sector. The outperformance of lower-rated bonds (BBB and below) was particularly positive for performance given the targeted overweight position in BBB rated, sub-investment grade and unrated bonds. The partial unwinding of the market distortions caused by the BoE's Corporate Bond Purchase Scheme also helped as this had negatively impacted performance in the previous two quarters.
- 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). 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 trust's targeting in BBB is weighted to community funding (regulated banks and building societies), financial resilience (regulated insurance debt), 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.
- Throughout the past year we have been meeting issuers as we sought to protect our clients' interests, while appreciating the need to be responsible lenders at a time of unprecedented economic and social disruption. Such meetings allow us to express our concerns on traditional financial factors as well as ESG issues, and we typically find that issuers welcome this

feedback. Ultimately, we want issuers to deliver sustainable cashflows and we most effectively influence this by acting as a long-term, responsible investor. We have our greatest voice when lending on a secured and covenanted basis, which helps to redress the subordinated control position of unsecured lending.

- Sterling investment grade credit issuance had been very high in the first half of the year, as companies sought to raise liquidity to protect themselves from a potentially protracted period with severely reduced revenues. Issuance dropped markedly in the second half of the year. While issuance was still relatively high for the year overall (the third highest year in the past decade), there was no end-of-year surge, which used to be a feature of the market. Nonetheless, we participated in a number of new issues, including subordinated insurance issues from **Just Group** and **Pension Insurance Corporation**, a senior banks green bond from **Barclays** and a senior opco bond from **Close Brothers**, the UK merchant bank. We also bought a new issue from the social housing aggregator **Blend Funding** and two longer-dated issues from housing associations **Orbit Capital** and **Clarion Group**. We participated in the issue of AAA rated structured bonds by Sage Funding**,** secured on social housing with a low loan-to-value ratio, and a holdco bond issued by **Thames Water**. We also participated in a green bond issue from **Tritax Big Box**, the logistics and distribution real estate trust. Otherwise, we bought a new issue from packaging and PPE supplier **Bunzl**; a hybrid new issue from **National Express**, the transport operator, and a new issue from builders' merchant **Travis Perkins**.
- 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, vital infrastructure, financial resilience (such as insurance products to support individuals through shocks) and community funding (banks focused on SME and retail lending). The remainder meet one of the overarching criteria.
- The sterling credit portfolios are highly diversified in order to improve overall portfolio liquidity and reduce the effect on overall performance of any deterioration in the creditworthiness of an individual holding or sector. The value of diversification in spreading risks is likely to become increasingly clear over the next few months. Our bias towards secured and covenanted debt should provide some mitigation and allow us to better protect our clients' interests.

## 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 equity allocation 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.
- In credit markets, we expect a further extension of QE in 2021 because the government and BoE will wish to avoid the increase in bond yields that would result from a substantial increase in net supply. Nevertheless, the level of QE is likely to be reduced over time and that diminished support for the market is likely to result in higher long-term yields. Given that the upside in fixed income is capped, we place a heavy emphasis upon protection for our clients. We focus on whether issuers will survive through to the period in which societies have been widely vaccinated against Covid-19 and can return to normality, and so far this has been very encouraging. While corporate bond yields are low in absolute terms, the yields on UK government bonds with maturities of less than seven years are currently in negative territory. As such, we think that credit spreads are attractive and the outlook for sustainable credit remains encouraging.
- 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.

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## 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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