ROYAL LONDON SUSTAINABLE MANAGED INCOME TRUST

Quarterly Report 30 September 2020

For professional clients only, not suitable for retail investors

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Top ten holdings

	Trust (%)
Quadrant Housing 7.93% 2033	1.4
Co-operative Bank 4.75% 2021	1.3
Finance for Residential Social Housing 8.368% 2058	1.1
Penarian Housing Finance Plc 3.212% 2052	1.1
PRS Finance Plc 1.5% 2034	1.0
Derby Healthcare 5.564% 2041	1.10
Genesis Finance 6.064% 2039	0.8
Myriad Capital Plc 4.75% 2043	0.8
The Housing Finance Corporation Funding 6.35% 2041	0.8
Thames Water Utilities Finance 7.738% 2058	0.8
Total	**10.0**

Trust data

	Trust	Benchmark[1]
No. of stocks	324	1,163
Fund size	£180.7m	-
Duration[2]	8.2 years	7.9 years
Gross redemption yield[3]	2.09%	1.43%
Launch date	07.12.2012	-

Source: RLAM, based on the C Acc share class

[1]Bench mark: iBoxx £ Non-Gilts All Maturities.

[2]Excluding cash

[3]The gross redemption yield is calculated on a weighted average basis. Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature.

Performance

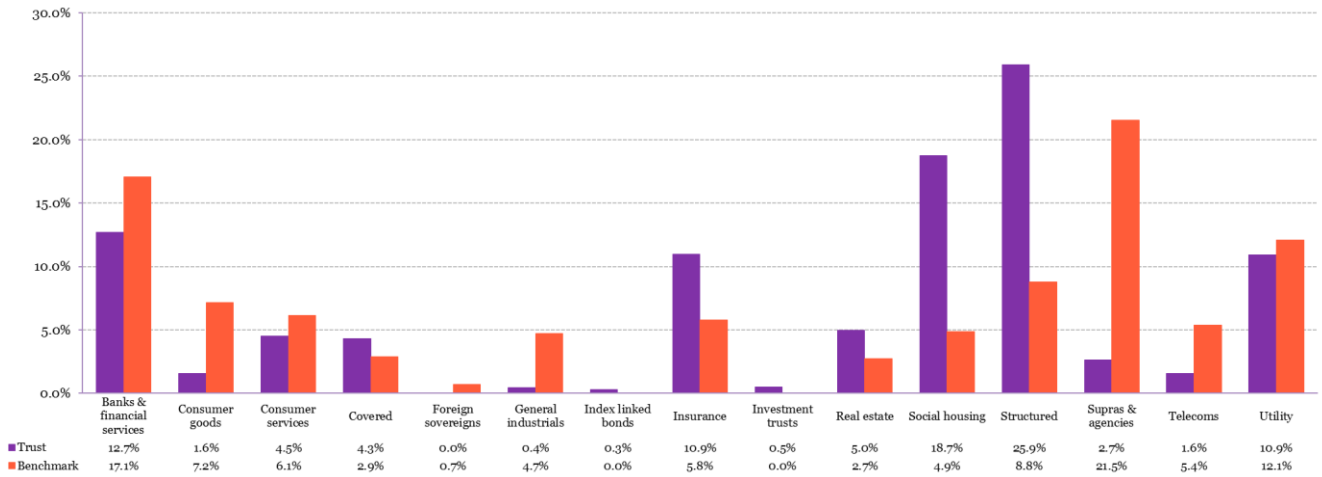
	Trust (C Acc)(%)	Benchmark[1] (%)	Relative (%)
Q3 2020	**1.73**	**1.16**	**0.57**
Year-to-date	5.07	4.54	0.53
Rolling 12 months	4.84	3.82	1.02
3 years p.a.	5.45	4.63	0.82
5 years p.a.	6.05	5.44	0.61
Since inception p.a. 07.12.2012	5.61	5.13	0.48

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]Benchmark: iBoxx £ Non-Gilts All Maturities.

Sector breakdown



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

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Market overview

- The scale of the impact of the pandemic on government finances became clearer. UK government borrowing in the current year is now estimated to be £470bn (c. 23% of GDP). The Bank of England (BoE) has continued to neutralise the impact of government bond issuance through asset purchases; this is due to be complete in November, although a further extension of quantitative easing is expected. With the economic recovery slowing and activity remaining below normal levels, and with so much monetary stimulus and government bond issuance, yields on benchmark 10-year government bonds fell over the quarter in nearly all major developed markets, apart from the UK, US and Canada. The yield on 10-year gilts increased 6 basis points (bps) to 0.23% and short-dated government bond yields remained negative at maturities of less than seven years, although the BoE played down the imminent likelihood of negative base rates.
- In corporate bond markets, credit spreads tightened further reflecting increased economic activity and the support of central banks 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 18bps tighter at 1.29% – it was well over 2.0% in March. The tightening of credit spreads boosted the performance of sterling credit with the Markit iBoxx Sterling Non-Gilt All Maturities Index delivering total returns of 1.16% for the quarter.
- Sterling was among the strongest major currencies over the quarter, strengthening over 4% against the US dollar as the Federal Reserve altered its inflation targeting methodology. It strengthened only marginally against the euro. Nonetheless, sterling strength tempered the returns for sterling investors in global equities.
- Oil prices were far more stable in the third quarter. The price of Brent crude oil fell by -0.5%, although it was notably weaker in September, falling by -9.6% to under $42 a barrel. Despite this stability, however, energy stocks were notably weak over the quarter as investors increasingly considered the risk of stranded assets in a carbon-neutral economy. Copper continued to strengthen as economic activity picked up in China, rising +10.6% over the quarter. The strategies have no exposure to the commodity sectors, i.e. oil & gas and mining. These have a poor track record of creating value for shareholders and are long-term losers from the trend towards a lower-carbon, environmentally-aware society.

Performance and activity

- The fund outperformed its benchmark over the quarter, primarily driven by positive stock selection and asset allocation – notably an overweight in financials, especially insurance, lower-rated credit, and an underweight in supranational bonds. This was despite the ongoing market distortions caused by the BoE's Corporate Bond Purchase Scheme.
- At a sector level, financials gave higher excess returns than non-financial bonds, while supranational bonds generally lagged the wider credit market. Insurance performed strongly as the sector continued to recover from the weakness seen in March and April. Similarly, bank debt outperformed significantly, particularly subordinated bonds (i.e. those lower in the capital structure and therefore deemed to be more risky) as investors sought the higher yields available. All these factors supported performance as we are overweight in insurance and subordinated banks, and underweight in supranational bonds.
- Sterling credit valuations have lagged those in the euro and US dollar markets with generally wider spreads; this is most marked in financials, despite the relative outperformance seen in the quarter. It is likely that the 'Brexit' credit spread premium, which has been a feature of sterling assets since 2016, will continue until there is greater clarity on the eventual trading arrangements with the EU. The relatively wide credit spreads in sterling markets meant that issuance lagged behind expectations in the latter part of the quarter as companies sought cheaper debt funding in other markets. While most of the £7.8bn of issuance was concentrated in September, the month's issuance was only half that seen in September 2019.
- In new issues, social housing was an area where we saw renewed activity, after several relatively quiet quarters. We have a structural bias towards this sector. Underlying cashflows are stable and most of the bonds issued are secured, while the sector is also delivering a wider social benefit. Examples during the quarter included longer-dated issues by: **Platform Housing Group**, one of the largest housing associations in the Midlands; **Hyde Group**, a not-for-profit housing association in the south-east of England, with more than 49,000 homes for over 100,000 people; **Housing & Care 21**, which provides retirement homes and care; and the social housing aggregator **Blend Funding**. We also participated in two new issues by **PRS Finance**, which is part of the UK government-backed Private Rented Sector Housing Guarantee Scheme that makes loans secured against new institutional private rented sector housing. Other notable new issues included a senior green bond from **LBBW,** the German state-backed lender, and a senior non-preferred bond from **Skipton Building Society**, and subordinated bonds of **Virgin Money**; bonds of electricity distribution network operators **Electricity North West** and **Western Power Distribution South Wales**; bonds of **Assura**, a healthcare-focused REIT; and two residential mortgage-backed securitisations (**EMI 2020** and **CASTE 2020-1**).
- Rating agency action was less pronounced in the third quarter than might have been expected given the scale of the economic impact arising from Covid-19. Nevertheless, nearly 20% of investment grade bonds have seen some credit rating downgrade in 2020. This was most evident in the second quarter with the rate materially lower this quarter. We expect that

the rate of downgrades will pick up again as the economic impact on the corporate sector becomes clearer. Given the high weighting of BBB in credit market indices, it is likely that there will be further downgrades to sub-investment grade; at the present time, only 1% of bonds have transitioned from investment grade to sub-investment grade in 2020. Overall, downgrades in the portfolio remain significantly lower than the market average. We would expect this due to the nature of the strategies relative to the broad market; however it was pleasing to see that our focus on the integrity of the initial lending position has been paying off.

- Our sterling credit approach emphasises the attractions of strong covenants and the importance of security. One consequence of the strong creditor position that secured lending provides is the existence of restrictive operational and financial covenants to which issuers need to remain compliant. This is distinct from the vast majority of unsecured corporate bonds. While these credit enhancements are a key protection, they do mean that we continued to engage in a number of discussions over the quarter with the most immediately impacted issuers (largely encapsulating the airport, retail property and leisure sectors) regarding temporary waivers and amendments to bond terms in order to accommodate the specific impacts of the Covid-19 pandemic. As mentioned in our Q2 report, intu Properties entered administration and in September, one of its subsidiary secured bond issuers, intu debenture, announced that it had failed to make a scheduled interest payment on its 5.562% 2027 debt. This followed an active decision by bondholders to preserve cash in the issuer and ensure the underlying shopping centre assets would continue to trade despite the significant short-term disruption to rental income from Covid-19 (including government allowance for tenants to remain in situ even if they are unable to pay rents), as well as an increase in temporary costs following the parent company entering administration. While disappointing, the relatively small impact on the portfolios emphasises the value of a diversified portfolio with a bias to bonds offering security and covenants. We continue to be involved in restructuring discussions as part of a unified bondholder group of institutional investors with a clear focus on maximising realisations. This applies also to other challenged intu-related secured bonds (SGS and Metrocentre, which were not in default in Q3), but where there are ongoing bondholder discussions that are focused on maintaining the shopping centres open and allowing for maximising potential recoveries should the situation deteriorate further. We will continue to monitor this situation closely and engage with stakeholders in order to maximise recovery, and believe that market pricing is appropriate given the range of outcomes but reflecting our senior claim on the underlying assets.
- We approached all of these discussions with a common philosophy of balancing the need to be responsible lenders at a time of unprecedented social and economic disruption, while ensuring that we preserve our clients' economic interests. We have typically assented to the changes required, but in a number of cases we sought appropriate enhancements to maintain the correct balance between different stakeholders. While we expect these interactions to continue through the remainder of the year, this extraordinary event has underpinned our strong belief that security and effective covenants remain both undervalued by the market and underappreciated in terms of the tangible creditor control and protection they provide.
- Our sustainable credit portfolios are also 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 year or so. The widespread theme that we have seen in markets over the past few years of 'chasing the yield' has led to tremendous sector concentration, and it is now difficult for fund managers to reposition themselves due to the high transaction costs in the secondary market.
- The BoE's Corporate Bond Purchase Scheme reached its £20bn target for purchasing investment grade corporate bonds (i.e. an additional £10bn) on 1 October. This has distorted market valuations with many asset-backed securities and all financial bonds being excluded. This continued during the quarter, but its impact started to reduce as the programme wound down compared to earlier in the summer. As the scheme ends, we believe this will lead to an unwinding of the distorted market valuations of eligible corporate bonds, as occurred in 2016 and 2017 when the BoE previously bought corporate bonds as part of its asset purchase programme. It is difficult to predict a timeframe for this. The 2016 effect took several quarters to unwind and, while it may be reasonable to suggest a similar timeframe today, the crisis is still not over and so an extension of the scheme cannot be ruled out.
- 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.

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Outlook

- Looking at our credit portfolio strategy, while we have seen a recovery in risk markets including sterling investment grade, there is no real change to our outlook since April – namely that the short-term outlook is highly uncertain. It is consequently essential that our portfolios are maintained in such a way that they will be resilient across a variety of market scenarios. Specific targeting within the BBB area, which is more prone to heavier price falls on downgrades to sub-investment grade, remains key in an environment of increasing ratings transition risk. Our emphasis on seniority within capital structures, proximity to the underlying assets and diversification across sectors and issuers remains necessary for controlling the risks that we may face.
- Longer term, we believe sustainable strategies will be a net beneficiary from the changes that could come from this crisis and our funds are well positioned to benefit from this. While it is too early to draw grand conclusions about structural and societal shifts, we feel that this pandemic and the responses of governments, companies and individuals could lead to a step change in real-world sustainability and in the trend to sustainable investing. 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

- The **RL Sustainable Diversified Trust** and **RL Sustainable World Trust** celebrated their 10th anniversaries last year. Similarly, 2020 marks the 30th anniversary of our flagship **RL Sustainable Leaders Trust**. You can find out more about our full range of sustainable funds, including the recently-launched **RL Global Sustainable Equity Fund**, on our website (rlam.co.uk/sustainable), which also has a range of articles and other information about sustainable investing.
- Talks from the online *RLAM Investment Series* that was held in the week of 28 September 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.

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